Inquiry into Access for Small and Medium Business to Finance

February 2011

ANZ Submission to the Joint Parliamentary Committee on Corporations and Financial Services

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In March 2010, ANZ provided a submission to the Senate Economics Committee's Inquiry into Access of Small Business to Finance. In that submission we reported that, since the beginning of the global economic crisis, overall lending to business had been subdued both at ANZ and other lenders. This primarily reflected a fall in loan applications due to reduced demand for credit in uncertain times and to a lesser extent a tightening in credit criteria. Approval rates initially fell but then stabilised at around 80% through 2009.

The overall picture masked good growth in lending at the smaller end of the market. ANZ regards businesses with total lending of less than $500,000 as small business. Lending to this segment grew in excess of 10% in the 2009 financial year despite a difficult economic environment.

Since that submission, we have continued to support small business in Australia. In the small business segment (ie <$500k total lending), lending increased by 10% in the 2010 financial year and lending to larger business also started to increase from March 2010 after a period of decline. Approvals are now almost back to pre-GFC levels, although demand has not fully returned with the average size of new loans slightly lower than before the GFC. Looking ahead we expect overall business lending to increase slightly in line with a strengthening Australian economy with demand potentially offset by an increase in the RBA cash rate over the coming 12 months.

The last two years have been difficult for most businesses, not least small business. ANZ recognises this and the important contribution small business makes to the economy, including as a major employer. We are committed to supporting customers who are running viable small businesses and offer both traditional banking products for small businesses along with value adding services aimed at assisting owners to grow their businesses. To assist our small business customers and indicate our continued support for this sector, we:

- employed 130 additional small business specialists in branches and business centres across Australia
- extended support to small business in difficulty by providing easy access to our dedicated specialists, who are trained to help small business customers experiencing financial difficultly, through our toll free hotline and repayment deferrals and fee waivers
- provided temporary overdraft facilities and repayment holidays to businesses affected by the recent natural disasters across Australia
- continue to provide support, education and training to small business customers through our online small business hub (www.sbhub.com.au)

ANZ regularly reviews its lending criteria in response to shifts in the broader economic environment. In response to the global financial crisis and uncertain economic outlook, we moderately tightened lending criteria for higher risk segments that showed signs of deterioration

EXECUTIVE SUMMARY

with higher then expected credit losses, and we continued to price for the risk associated with lending to small business and increased cost of funds. We believe this was a prudent move to protect our customers who may find themselves in trouble during difficult economic times. However, in the last 12 months we have adjusted our lending criteria in response to the improving economic environment where it was prudent to do so.

We believe that, despite the retreat of some finance providers during the GFC, the market for small business banking remains competitive with a range of lending and deposit products targeting this segment across both metropolitan and regional geographies.

ANZ'S COMMERCIAL BANKING BUSINESS

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ANZ provides products and services to small businesses through its Commercial Banking Division. Commercial Banking delivers products and services to small and medium-sized enterprises through dedicated managers focussing on Business Banking, Small Business and Regional Commercial and Agribusiness segments. ANZ provides a range of credit products to business customers including overdrafts, lines of credit and credit cards. Through our Esanda division we offer asset finance including equipment and car financing. ANZ also offers small business customers a range of other banking products including transaction accounts and merchant services (i.e. EFTPOS terminals).

Small Business Banking serves customers with lending of up to $500,000. ANZ considers these businesses to be ‘small business’ and they typically have 20 or fewer employees. We recognise that small business customers have a significant deposit and lending requirement. These customers have access to small business specialists through our extensive branch network, business centres, via our Small Business Call Centre and over the internet.

Larger businesses are managed through Business Banking. These businesses have lending of more than $500,000 and up to $10 million. These customers typically have a dedicated relationship manager who is responsible for tailoring their banking arrangements to their needs and managing those arrangements as needed.

Regional Commercial Banking is dedicated to supporting small and medium-sized commercial and agricultural businesses across regional and rural Australia. This segment offers many of the same products as the above segments, but also offers specific products for farming business, such as revolving lines of credit which are specifically structured to account for typical (i.e. infrequent) agribusiness cash flows as interest can be charged in accordance with the customer's income (i.e. monthly, quarterly, half yearly or yearly). In the last 2 years we have added 65 small business specialists to our Regional business.

In mid-2010, to further expand our business in the rural and regional market, ANZ acquired Landmark's financial services business. Through the acquisition, Landmark's 10,000 customers gained access to ANZ's Commercial Banking products that were previously unavailable to them through Landmark. While ANZ offers specialist agribusiness products, we also offer a similar range of products and services to both rural and metropolitan customers.

Esanda is a division of ANZ which supports the Asset Finance requirements of Small Business customers. As a result of the global financial crisis, several asset finance businesses ceased trading and withdrew from the Australian market (eg GMAC). During this time Esanda stepped in to fill the gap and continued to finance motor vehicle, truck and other business equipment and has continued to support viable small business customers with asset finance needs.

ANZ SUPPORT FOR SMALL BUSINESS

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ANZ is committed to supporting viable small business customers. ANZ has demonstrated its commitment by:

- Maintaining our approval rates for Small Business lending (over 80% to year end September 2010)
- Providing easy access to our dedicated specialists, who are trained to help small business customers experiencing financial difficulty, through our toll free hotline (1800 252 845); and
- considering tailored solutions on a case-by-case basis including: deferred or reduced repayments for periods of up to 12 months (with interest capitalised into the loan), fee waivers and repayment extension periods - temporary adjustments to customer lending limits including business credit cards and overdrafts.

In the last two years, ANZ has employed additional small business specialists who are located in branches and business centres across Australia. The investment in 130 additional specialists will boost frontline staff, with about 85% of the new small business specialists located in our 820-strong branch and business centre network, including in rural and regional areas. We appreciate that small business owners want to deal with people who understand the pressures and needs of running a business, so we look to hire staff with experience in family-run businesses. We also provide a variety of ways to interact with our frontline specialists including our business centres and branches or over the phone and internet.

ANZ's acquisition of the financial services customers of Landmark in 2010 allowed us to introduce a lending facility targeted at seasonal finance that enabled small to medium sized farms to purchase seasonal inputs such as stocks and crops. Further, as a result of the acquisition, small to medium sized farms have access to ANZ finance through Landmark Rural Services in 153 rural townships. ANZ recognises that agribusiness is a seasonal business and income can vary significantly year to year. ANZ is committed to helping our agribusiness customers running viable businesses to manage their finances through their business cycle and support them during periods of lower income.

In addition to traditional banking products, ANZ supports Small Business owners with additional services that provide them with improved knowledge and confidence to operate their businesses. ANZ provides our small business customers with an online small business hub (www.sbhub.com.au) which allows customers access to business tools and data about their industry and other market trends. We have also recently launched Business Insights, a business intelligence tool to assist small business customers better understand their business and their customers. Business Insights can be used to improve the efficiency of marketing spend and customer service. ANZ has also signed a marketing alliance with online accounting software provider, Xero which entitles ANZ customers to additional fee free periods and enables our customers to link their accounts via their Internet Banking and therefore eliminate unnecessary manual, paper based processing.

anz SUPPORT FOR SMALL BUSINESS

In addition to the standard solutions for customers experiencing financial difficulty, ANZ also provided a package of measures for business customers affected by recent natural disasters across Australia, including droughts, floods, cyclones and bushfires. This included:

- Contacting business customers to understand the impact of the disasters and offer immediate and ongoing assistance;
- Where necessary provided 3-month loan deferrals without the need for formal documentation and credit processes to reduce repayments;
- Provided temporary overdraft facilities of up to $20,000 for 6 months to support working capital requirements;
- Waived break costs for Term Deposits to provide immediate access to funds; and
- Suspended repayment follow up calls to customers in impacted areas.

SMALL BUSINESS LENDING STATISTICS

SMALL BUSINESS LENDING STATISTICS

In the uncertain economic conditions which have existed since late 2008, ANZ continued to lend to viable small businesses. During this time, ANZ observed that:

- finance application numbers fell in small business mainly due to the withdrawal of our 'low doc' product and are yet to fully recover to pre-GFC levels;
- following the withdrawal of our higher risk "low doc" product in late 2008, approval rates reduced marginally but remained solid at over 80% on average in 2009 and have increased to 83% in 2010; and
- total lending in ANZ Commercial Banking division declined during 2009 but returned to growth in 2010. Total lending grew in excess of 10% in Small Business Banking in 2009 and 2010 and, in March 2010, lending in Business Banking returned to growth. In Regional Commercial Banking, lending has grown year on year in both 2009 and 2010 after a small decline in late 2008.

APPLICATIONS AND APPROVALS

A moderate tightening to our lending policies during the GFC (as was considered prudent at the time) led to a slight decline in approval rates. However, approvals have almost returned to pre-GFC levels. In fact, the approval rate for Small Business lending (83%) is marginally higher than approvals for residential lending.

Esanda's asset finance business has seen a similar increase in approval rates increasing from 71% in 2009 to 74% for year ending September 2010. The increase is in line with a strengthening of the broader economy.

LENDING VOLUMES

Total lending in ANZ Commercial Banking has been subdued since the beginning of the GFC. In 2010, it increased slightly in line with strengthening business conditions. Subdued growth has been caused by lower demand for credit and slightly lower average loan size. This overall figure disguises the fact that ANZ has continued to provide new lending to businesses of all sizes and in some segments we have had solid growth.

Total lending in Small Business Banking has grown strongly since the GFC and in Regional Commercial Banking, which includes rural and regional small businesses experienced a small decline in late 2008 but has since returned to growth. In particular, growth in Small Business Banking was in excess of 10% which was significant given the difficult economic environment.

SMALL BUSINESS LENDING STATISTICS

This growth reflects strong demand for credit in these markets and ANZ’s ongoing willingness to lend to viable small businesses.

The Business Banking portfolio declined in net terms over the 2009 financial year mainly due to customers deleveraging as a rational response to GFC pressures and because of their reduced demand for new lending as projects and acquisitions were deferred. Despite this our 'doors remained open' and a reduced but still solid volume of new advances were made. These advances ramped up over late 2009 and continued to strengthen over 2010.

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SMALL BUSINESS LENDING POLICIES

SMALL BUSINESS LENDING POLICIES

To protect the interests of both the bank and borrowers who could find themselves in difficulty in a changing economic environment, we believe it is prudent to ensure our interest rate settings and lending policies accurately reflect the level of risk associated with different forms of lending. For example, the very uncertain economic outlook which existed for much of 2009 warranted a more conservative approach by banks. ANZ considers a number of elements when determining its credit policy and to ensure we remain a responsible lender, we will consider regional issues as and when required. However, these issues can impact both regional and metropolitan customers alike and ANZ does not differentiate its lending policies between regional and metropolitan customers.

SMALL BUSINESS LENDING CRITERIA

It is prudent for all banks to review their lending criteria on a regular basis in response to the broader economic climate. In early 2009, ANZ implemented moderately tighter business lending standards in response to adverse economic conditions impacting certain segments of the portfolio. In particular, we withdrew our “low doc” product for small business.

We are continually reviewing our lending criteria in light of the economic conditions and the quality of our lending portfolio. As the economy has recovered, we have relaxed lending criteria in some areas. For example, in March 2010, ANZ streamlined the loan application process and implemented a process of self-certification whereby we rely on the Business Activity Statement and GST payments when assessing the secured loan applications for some small business lending customers with a proven trading history of at least one financial year.

SMALL BUSINESS INTEREST RATES

In setting interest rates, ANZ considers our funding costs and the inherent risk profile of the lending portfolio. The GFC impacted on both these fronts and required us to consider all interest rates, including those to small businesses, to ensure they adequately reflected the cost and risk of lending. When looking at a specific lending decision we also consider the individual risk of the transaction and/or the customer. As a result, businesses with different risk profiles may receive different interest rates for similar lending.

ANZ lends to start-up small businesses and offers a range of unsecured small business lending products. In some cases, this involves lending to small businesses with limited history of financial success. Notwithstanding our assessment of business plans as part of the lending decision, a proportion of small businesses will fail. As such, lending to small businesses carries a greater risk than some other forms of lending (e.g. residential mortgages) and this will affect the interest rate charged to some small business borrowers. In comparison, residential mortgages are considered less risky as we are lending to customers who are in employment, have a record of income and the loan is secured against the value of the home. This makes the loan much more secure.

Cost of funds

Banks obtain funding to lend to customers from customer deposits and wholesale funding markets.

The market for deposits has been highly competitive over the last 18 months as banks rely more on this as a relatively stable source of funding rather than more volatile wholesale funding (in particular short-term funding). This competition has put upward pressure on the rate banks and other deposit-taking institutions must pay customers for their deposits. Research published in the March 2010 RBA Bulletin found that ‘the average cost of the major banks’ new deposits is currently slightly higher than the cash rate, compared with about 150 basis points below the cash rate prior to the onset of the financial crisis.’[1] Small business customers have benefited from these higher deposit rates.

As a result of the GFC, the cost of wholesale funding increased dramatically. Following the collapse of Lehman Brothers, wholesale funding markets closed for around six weeks and the cost of wholesale funding increased dramatically. The marginal cost of term wholesale debt reached a peak in March 2009 at levels which, if maintained, would have greatly increased borrowing costs to consumers. Fortunately, the cost has declined significantly since then but it remains elevated and volatile in comparison to pre-GFC costs.

Before the GFC, the average cost of five-year term funding was 16 basis points (bps) above the Bank Bill Swap Rate (BBSW). Today, the cost of five-year term funding is between 120 and 150 bps above BBSW. BBSW is the swap rate (usually the 90 day rate for bank funding instruments) and moves in a reasonably limited band around the RBA cash rate. This has contributed to an absolute increase in ANZ’s funding costs since 2007 relative to the RBA cash rate. The offshore component of our wholesale funding is of course, not related to the rate set by the RBA.

ANZ has also sought to increase the proportion of funding sourced from longer-term debt. This gives more certainty over funding as it is locked in for a longer period and not subject to short term volatility in the markets. To continue to provide a premium rating, ratings agencies are demanding a greater proportion of longer term funding to insulate banks from short-term shocks. ANZ has adjusted its term debt portfolio from terms mostly of 1, 3 and 5-year debt to 3, 5 and 7-year debt. Longer-term debt is more expensive than shorter-term debt and the increase in this form of funding is contributing to an increase in overall funding costs. This is part of ANZ’s strategy of helping maintain its AA rating. APRA has also been encouraging banks to increase term funding and reduce reliance on cheaper short-term wholesale funding.

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[1] Brown A, Davies M, Fabbro D & Hanrick T (2010) ‘Recent developments in Bank Funding Costs and Lending Rates’, *RBA Bulletin*, March Quarter 2010, p 35.

SMALL BUSINESS LENDING POLICIES

While for around a decade banks' funding costs moved in line with RBA official rate movements, this nexus has been broken. Research published in the March 2010 RBA Bulletin found that 'banks' overall funding costs remain significantly higher relative to the cash rate than they were in mid 2007, mainly due to the large increases in the cost of deposits and long-term wholesale debt'[2].

Role of the Government guarantee

Actions taken by governments around the world in response to the severe disruption in global financial markets included instituting guarantees on deposits in order to shore up depositor confidence. For example, European Governments, including Ireland, Germany, Denmark and Iceland, moved to insure 100 per cent of eligible deposits. Other governments, including the US and the UK, increased their deposit insurance caps. Governments also provided support for financial institutions to gain access to wholesale borrowing, including guarantees on debt issuance in order that they could continue to lend to their customers.

On 12 October 2008, the Australian Government announced that it would provide similar guarantees. The Prime Minister's announcement acknowledged that the Australian banking system is affected by global events and, if the Australian Government did not follow international developments, Australian financial institutions could find it more difficult and more expensive, to borrow in international financial markets. The Australian Government's decision to put in place wholesale funding and deposit guarantees was a rational response to the environment and dealt effectively with the systemic risks presented by disruption to global markets. ANZ supported the Government's provision of the schemes.

The wholesale funding guarantee facilitated access to global funding markets for Australian banks. It is important to note that banks in Australia would have survived without the scheme. However, they would have found it difficult to maintain an adequate supply of affordable credit in the economy. This could have had significant ramifications for the Australian economy and may have delayed the economic recovery. As a result it was necessary at the time for the Government to put the scheme in place urgently. However, when the emergency situation passed, the Government withdrew the scheme in an orderly fashion. This was the most effective course of action to support the economy while minimising any distortion to the market.

Pricing for risk

Concern has been expressed about the difference in interest rates for lending to residential mortgage customers compared with small business lending, including where that lending is secured by a residential property. Interest rates set by the banks must take account of the risk of lending money. In accordance with APRA's prudential standards, that risk is determined primarily by two factors:

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[2] Brown et al, p 35.

SMALL BUSINESS LENDING POLICIES

- **Probability of default** – How likely a customer is to be unable to repay their loan. Small business customers have a higher probability of defaulting than Mortgage/Retail customers; and
- **Loss given default** – The amount the bank can recover if a customer defaults on a loan. A significant proportion of small business loans are unsecured, therefore the bank generally will be able to recover less than other forms of lending with higher security (e.g. mortgages).

The higher probability of default and loss given default for small business customers when compared to mortgage customers requires banks to hold a higher level of capital and reserve more for bad debt expenses for small business lending. A requirement to hold three times as much capital for small business customers than residential mortgage customers is typical and is required by APRA. This increases the cost of providing small business loans relative to retail lending generally.

The number of small business customers who are 90 or more days past due on their credit facility increased as a result of the financial crisis. An increase in delinquencies increases the probability of default and the capital we must hold and therefore the cost of lending to small business.

DELINQUENCIES

Despite a general strengthening in the economy, arrears for small business have continued to increase. The number of delinquent customers began increasing noticeably around February 2008 across all business segments. This was before the onset of the financial crisis but reflects a higher interest rate environment at the time, with the RBA’s cash rate peaking in March 2008. Since then, interest rates have decreased but the financial crisis significantly affected some small business’ cashflows, with these issues persisting. The proportion of customers who are 90 days or more overdue with the repayments has doubled since 2007. While growth in arrears is slow, we have not yet seen the trend abate.

We continue to monitor our arrears closely and we have put in place arrangements to assist customers who are in financial difficulty. These include providing access to dedicated specialists, trained to help small business experiencing difficulty and considering tailored solutions on a case-by-case basis to enable these customers, where possible, to manage through temporary difficulties.

COMPETITION IN BANKING FOR SMALL AND MEDIUM ENTERPRISES

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Concern has been expressed about the level of competition in banking.

Since the global financial crisis, there has been some consolidation in the Australian banking sector. The market shares of the major banks have increased whilst those of non-major banks and non-banks (including finance companies, credit unions, building societies and other non-bank lenders) have decreased. This has coincided with significant investment by major banks in services to small and medium enterprises adding over 500 additional staff in banking services to this segment. Major banks have stepped in when other lenders were exiting the market or scaling down their lending.

Since 2007, major Australian banks have acquired other lenders in the market, in particular Bankwest and St George. Securitisation as a method of funding failed as a direct result of the GFC, leading to the acquisition by banks of some non-bank lenders such as RAMs and Wizard. Some non-bank home loan lenders have exited the market completely or are not writing new loans, including finance companies GMAC and Bluestone.

Some of this competition was from players whose business models were not sustainable and did not reflect the full cost of providing financial services throughout the economic cycle. Furthermore, although the number of small business credit providers expanded in the period leading up to the global financial crisis, many of these were niche players and not ‘full service’ providers. For example, Bankwest’s main focus was in larger property lending.

Banking competition in Australia is often compared to countries whose financial models were also proven to be unsustainable. Liquidity and credit risks were not being properly recognised and built into prices which ultimately resulted in the failure of those businesses.

Notwithstanding this consolidation there are still a reasonable number of players in the business banking market. For example, according to CANNEX, there are over 20 providers of business term loans and overdraft facilities.[3] This is a greater number of providers than in many other industries.

The four major banks hold 14-18 per cent market share with the balance serviced by regional banks such as Suncorp, Bank of Queensland and Bank of Adelaide, foreign banks and some credit unions. In addition to the number of finance providers in the SME market, a number of small business customers access finance, and therefore an additional source of advice, via the broker market. Brokers are estimated to secure between 30 and 40 per cent of SME finance requirements.

3 Data sourced from canstar.com.au on 10 February 2011

COMPETITION IN BANKING FOR SMALL AND MEDIUM ENTERPRISES

THE FEDERAL GOVERNMENT'S COMPETITIVE AND SUSTAINABLE BANKING SYSTEM PACKAGE

In December 2010, the Government announced a major package designed to increase competition in the Australian banking sector.

ANZ supports practical measures which will increase choice and competition without imposing unnecessary costs on banks and their customers or distorting the market.

ANZ is therefore supportive of a number of measures announced in the package which we believe fit this description including:

- Further support for the securitisation market;
- Support for diversification of bank funding sources, such as the introduction of covered bonds; and
- Support for the development of a substantive corporate bond market in Australia.

Over time these measures will benefit all bank customers, including small business customers.