Chapter 3

Regulatory frameworks

Prudential requirements

3.1 The Global Financial Crisis (GFC) demonstrated that a stable, prudent banking sector is an essential part of a stable, productive economy. Lenders, or 'authorised deposit-taking institutions (ADIs)', do not have absolute discretion in setting their lending policies but must comply with the prudential regulatory framework overseen by the Australian Prudential Regulation Authority (APRA). The framework applies to all ADIs, including banks, building societies and credit unions, which cannot provide banking services in Australia without APRA's authorisation.[1] Making a sporting analogy, APRA's Chairman has explained the application of the prudential framework to ADIs as follows:

> We licence financial sector participants — we decide whether each team has the fitness, skills and experience to compete — and then we monitor teams continuously to ensure they are meeting prudential requirements and managing their affairs with appropriate prudence. In other words, we ensure that regulated institutions play within the letter and spirit of the rules and remain match fit.[2]

3.2 Abacus – Australian Mutuals (Abacus) advised that the application of one framework to all ADIs is a feature unique to the Australian prudential system:

> What is unusual about the Australian banking regulatory system is that mutuals, credit unions and building societies are entirely integrated into the same regulatory system. You will find in other markets that mutuals, credit unions, will have their own regulatory system. The banks will be off separately. Our members meet all the requirements that banks meet. We are, I think, the only credit union system anywhere in the world which is fully compliant with the Basel international banking regulatory frameworks.[3]

3.3 The prudential framework promotes financial stability through directing ADIs to appropriately engage with risk. As APRA has previously stated, the framework, which is comprised of legislative requirements, prudential standards and prudential guidance, 'aims to ensure that risk-taking is conducted within reasonable bounds and

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1 *Banking Act 1959*, s. 9; Australian Prudential Regulation Authority, 'Authorised Deposit-taking Institutions Home', http://www.apra.gov.au/adi/ (accessed 1 April 2011).

2 Mr John F. Laker, Chairman, APRA, American Chamber of Commerce Business Briefing, 25 August 2010, p. http://www.apra.gov.au/Speeches/upload/05-AmCham-speech-25-Aug.pdf (accessed 1 April 2011).

3 Mr Luke Lawler, Senior Adviser, Policy and Public Affairs, Abacus, *Proof Committee Hansard*, 4 March 2011, p. 7.

that risks are clearly identified and well managed.'[4] Treasury supported this view, advising that '[t]he purpose of prudential regulation is to protect bank depositors and maintain financial stability.'[5] Westpac Group submitted that the prudential framework promoted financial stability in Australia throughout the GFC:

> We would just like to reinforce that we think the prudential regulation that existed through the crisis stood up well in the great scheme of things, and we are quite supportive of it.[6]

3.4 The regulatory framework adheres to the global capital adequacy regime endorsed by the Basel Committee on Banking Supervision (the Basel II framework), which Australia adopted in 2008.[7] Treasury stated that the Basel II framework 'is based on risk-weighted capital requirements', and further noted that:

> Minimum capital requirements are a core component of prudential regulation [....] The amount of capital required for different types of loans varies in line with differences in the amount of risk they involve. The amount of risk involved in a loan is a function of the probability of default by the borrower and the expected recovery value of any collateral provided to the lender.[8]

3.5 The prudential framework influences conditions attached to the provision of finance, including business lending. Treasury advised that the Basel II framework directs ADIs to 'hold capital requirements proportionate to a loan's riskiness'.[9] APRA advised that the prudential regulations also require the interest rates to reflect the risk-weight, with higher risk-weights attracting higher interest rates:

> APRA [...] expects ADIs to reflect the credit risks to which they are exposed in setting their lending rates, with a higher risk margin on higher risk loans to reflect the greater probability of default and/or the potential for loss if the loans were to default.[10]

3.6 APRA and Treasury stated that the Basel II framework provides two methods for calculating the risk-weight; the standardised approach and the advanced approach.[11] APRA stated that the standardised approach 'is more about [ADIs] putting

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4 APRA, Letter of 18 May 2007 to the Hon Peter Costello MP from Mr John F. Laker AO, Chairman APRA, http://www.apra.gov.au/AboutAPRA/upload/Ltr-to-Treasurer-Statement-of-Intent.pdf (accessed 1 April 2011).

5 Treasury, *Submission 16*, p. 10.

6 Mr James Tate, Chief Product Officer, Westpac, *Proof Committee Hansard*, 11 March 2011, p. 22.

7 APRA, *Submission 12*, p. 1.

8 Treasury, *Submission 16*, p. 10.

9 Treasury, *Submission 16*, p. 11.

10 APRA, *Submission 12*, p. 1.

11 APRA, *Submission 12*, p. 1; Treasury, *Submission* 16, p. 10.

things into buckets that we have decided.'[12] In contrast, APRA advised that the advanced approach allows the ADI to 'use its own internal modelling, drawing on its actual historical loss experience in the various lending categories, to assist in quantifying, aggregating and managing its credit risks.'[13] At present, the major banks and Macquarie Bank are authorised to use the advanced approach.[14]

3.7 APRA further advised that for SME loans secured by residential property, 'the credit risk-weight under the standardised approach is the same as that applying to an owner-occupied mortgage'. Using the advanced approach the risk-weight is generally higher than the risk-weight for an owner-occupied mortgage. This reflects historical experience that the probability of default for small business loans is higher than the probability of default for residential loans.[15]

3.8 APRA stated that while the prudential regulations distinguish between broad categories of credit, for example personal, residential mortgage and business, the framework 'does not generally distinguish by size of business borrower.'[16] Mr Wayne Byres, Executive General Manager, Diversified Institutions Divisions, APRA, further advised that '[t]he regulatory system is really designed, to the extent possible, to reflect differences in risk rather than differences in type of borrower or the purpose of borrowing.'[17]

3.9 While the prudential framework is intended to apply equally to all categories of lending, it was evident that the prudential requirements have particular consequences for SME finance. It was apparent that the prudential requirements influence the range of ADIs that provide finance to small businesses. Abacus explained that ADIs are required to meet certain standards before entering the SME finance market:

> APRA strongly advises mutual ADI boards not to allow their institution to move into commercial lending without ensuring they have the personnel, expertise and systems to do so prudently. APRA's position is that assessing, pricing and securing commercial exposures requires a set of skills distinct from those required for assessing standard mortgages and personal lending. APRA requires ADIs to have robust product development processes to analyse new lines of business before products are formally endorsed and launched.[18]

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12 Mr Graham Johnson, General Manager, Industry Technical Services, APRA, *Proof Committee Hansard*, 11 March 2011, p. 48.

13 APRA, *Submission 12*, p. 2.

14 APRA, *Submission 12*, p. 2.

15 APRA, *Submission 12*, p. 2.

16 APRA, *Submission 12*, p. 1; Mr Wayne Byres, Executive General Manager, Diversified Institutions Divisions, APRA, *Proof Committee Hansard*, 11 March 2011, p. 41.

17 Mr Byres, APRA, *Proof Committee Hansard*, 11 March 2011, p. 42.

18 Abacus, *Submission 18*, p. 3.

3.10 Abacus advised that the prudential framework can constrain second-tier lenders from providing finance to SMEs. Mr Lawler stated that '[i]f our members want to enter into new forms of businesses, they can. They just have to make sure that they have the right level of expertise and capacity and risk management systems to do it.'[19] However, Mr Lawler further stated that these requirements can deter smaller ADIs:

> [I]t is challenging to meet all the prudential regulatory requirements and to meet all the other regulatory compliance issues. We see ongoing consolidation in our sector. The sector itself continues to grow, and our assets are growing, but the number of participants is shrinking because the smaller mutuals either find the regulatory compliance burden too heavy or they see, for good strategic reasons, a case to merge with another institution to become larger and get access to economies of scale. Economies of scale help in the context of entering new lines of business, such as business lending.[20]

3.11 Additionally, Treasury advised that ADIs 'are likely to need to hold more capital against SME loans, relative to residential mortgages.'[21] Similarly, ANZ reported that:

> [t]he 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.[22]

3.12 NAB also reported greater capital requirements for SME loans, stating that 'the amount of capital required to be held by banks is generally three times higher than for residential loans, and in some instances can be up to seven times higher for certain products.'[23]

Codes of conduct and additional legislative requirements

3.13 In addition to complying with APRA requirements, ADIs may choose to adhere to voluntary, industry-based policies and guidelines. The two key industry codes are the Code of Banking Practice and the Mutual Banking Code of Practice.

3.14 The Code of Banking Practice, developed by the Australian Bankers Association (ABA), directs the banks' interactions with customers.[24] Matters that the

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19 Mr Lawler, Abacus, *Proof Committee Hansard*, 4 March 2011, p. 7.

20 Mr Lawler, Abacus, *Proof Committee Hansard*, 4 March 2011, p. 8.

21 Treasury, *Submission 16*, p. 11.

22 ANZ, *Submission 14*, p. 13; NAB, *Submission 19*, p. 8.

23 NAB, *Submission 19*, p. 8.

24 Mr Steven Münchenberg, Chief Executive Officer, ABA, *Proof Committee Hansard*, 4 March 2011, p. 49.

code covers include disclosure of application fees and notification of changes to terms and conditions such as fees, charges and interest rates.[25]

3.15 The ABA advised that the code applies to small business finance.[26] However, the code is voluntary and therefore may not apply to all bank lenders.[27] A list of banks that have adopted the code is at Appendix 3. For banks that have adopted the code, compliance with the code is monitored by the Code Compliance Monitoring Committee.[28]

3.16 The Mutual Banking Code of Practice (MBCOP) outlines requirements regarding the provision of finance from a second-tier lender. Matters that the MBCOP covers include notification requirements for setting terms and conditions for products and facilities, reviewing fees and charges, and providing notification of increased interest rates.[29] Abacus stated that the MBCOP is designed to build on the prudential framework:

> The MBCOP sets high standards in a range of areas beyond those required by law, as an expression of the value mutual ADIs place on improving the financial wellbeing of their members and communities. The number one promise in the MBCOP is: "We will always act honestly and with integrity, and will treat you fairly and reasonably in all our dealings with you.[30]

3.17 In addition to regulating the provision of finance to individuals for non-commercial purposes, the MBCOP applies to small business members or customers and covers the provision of small business loans and other financial products.[31] However, the MBCOP does not cover the field for mutual lending. Similar to the Code of Banking Practice, the MBCOP only applies to the credit unions or mutual building societies that choose to subscribe.[32] A list of ADIs that have subscribed to the MBCOP is at Appendix 4.

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25 ABA, *Code of Banking Practice*, May 2004, items 15, 18, p. 10.

26 Mr Münchenberg, ABA, *Proof Committee Hansard*, 4 March 2011, p. 49.

27 ABA, *Banking Code of Practice*, May 2004, p. 2.

28 ABA, 'The main feature of the revised code', http://www.bankers.asn.au/Default.aspx?ArticleID=450 (accessed 5 April 2011).

29 Abacus, *Mutual Banking Code of Practice*, January 2010, items 4, 6, 17, pp 11, 17.

30 Abacus, *Submission 18*, p. 2.

31 Abacus, *Mutual Banking Code of Practice*, p. 6.

32 Abacus, *Mutual Banking Code of Practice*, p. 5.

3.18 As noted in the MBCOP, regulatory requirements that can impact SME finance are also contained in:

- the *Corporations Act* 2001 and requirements set by the Australian Securities and Investment Commission;
- Commonwealth, State and Territory privacy legislation; and
- fair trading laws.[33]

3.19 At present, the National Consumer Credit Code does not regulate the provision of finance to SMEs. However, the ABA advised that while not officially applying to SME loans, banks may be choosing to apply the Code to SME customers:

> While they apply to individual customers, for a small business, whether it is doing individual banking or small business banking is quite blurred. We will find that certainly for small operations the banks will err on the side of caution and treat them as small customers.[34]

3.20 In July 2010, Treasury sought public feedback on a proposal to extend the consumer credit code to apply to small business finance.[35] Three options were outlined. Option one proposes limited application of the consumer credit regulations, under which '[m]inimum standards of conduct and competencies could also be developed for small business lending'. Option two proposes full application of the National Consumer Credit Code to small business lending. Option three proposes the development of industry standards, which could be enacted in legislation, to address current regulatory gaps.[36] The committee understands that if the proposal is endorsed, it is intended that legislative measures be in place by mid 2012.[37] Treasury advised that 'there has not yet been any decision or outcome arising from the consultations following the release of the Green Paper.'[38]

SME concerns with the regulatory framework

3.21 APRA stated that SMEs have benefitted from the Basel II framework:

> The second point I want to make is that, although the capital adequacy requirements for banks, building societies and credit unions were changed in 2008 with the introduction of the Basel II framework into Australia, we

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33 Abacus, *Mutual Banking Code of Practice*, p. 5.

34 Mr Münchenberg, ABA, *Proof Committee Hansard*, 4 March 2011, p. 55.

35 Treasury, *National credit reform, enhancing confidence and fairness in Australia's credit laws: Green Paper*, July 2010, p. 1.

36 Treasury, *National credit reform, enhancing confidence and fairness in Australia's credit laws: Green Paper*, July 2010, pp 12–14.

37 The Hon Chris Bowen, Minister for Financial Services, Superannuation and Corporate Law, 'Release of green paper on phase two of the COAG national credit reforms', media release no. 085, 7/7/10.

38 Treasury, answers to question on notice, 25 March 2011 (received 8 March 2011).

> would say those changes were, if anything, marginally favourable towards SME lending and certainly we do not see anything in those which would materially disadvantage SME lending relative to other sorts of lending that a bank might choose to do.[39]

3.22 In contrast, evidence presented to the committee highlighted three main concerns with the regulatory framework's impact on SME access to finance, namely,

- Increased lending costs;
- The introduction of Basel III requirements;
- Changes to the conditions of existing loans following the GFC.

Increased lending costs

3.23 The RBA informed the committee that interest rates are determined taking into account the cost of obtaining funds to lend and the 'perceived riskiness of the borrower.'[40] As the RBA explained, and as explored elsewhere in this report, the GFC prompted ADIs to re-evaluate the risk of lending:

> One of the things you have seen as to why interest rates have gone up over the subsequent few years was that the banks repriced that risk, which saw lending rates rise.[41]

3.24 Similarly, Treasury advised:

> Lenders' perception of the risk associated with a loan are also significant drivers. Just as the risk appetites of the banks' wholesale funders have decreased since the financial crisis, so too have the risk appetites of lenders themselves.[42]

3.25 The RBA reported that the variable interest rate for residentially secured loans increased 220 basis points relative to the cash rate from mid 2007, and further advised that '[o]ver the same period, the spread between the actual variable rate paid by small businesses and the cash rate also rose by about 175 basis points.'[43]

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39 Mr Byres, APRA, *Proof Committee Hansard*, 11 March 2011, p. 41.

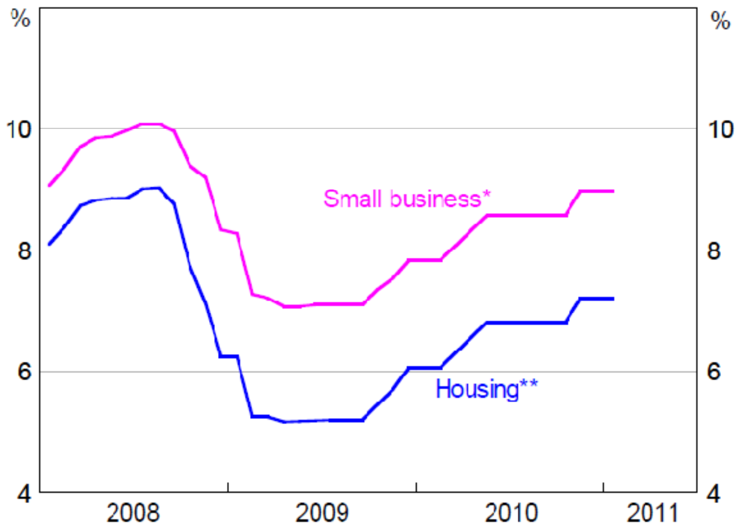
40 RBA, *Submission* 3, p. 4.

41 Mr Guy Debelle, Assistant Governor, Financial Markets, RBA, *Proof Committee Hansard*, 11 March 2011, p. 3.

42 Treasury, *Submission 16*, p. 7.

43 RBA, *Submission 3*, p. 5.

Figure 3.1 Variable lending rates, residentially-secured term loans[44]



* Indicator rate
** Full-doc indicator rate less discounts
Sources: ABS; APRA; Perpetual; RBA

3.26 Submissions from SME representatives recognised that lenders must assess the level of risk and offer credit accordingly. However, it was disputed whether the interest rates accurately reflect the cost of, and the risks associated with, providing SME loans. For example, the NSW Business Chamber argued that:

> [W]ith the worst of the crisis now behind us, lending conditions should have improved, and small businesses should now be able to access the funding they need to expand and support the economic recovery. Unfortunately, it appears that banks are reluctant to move away from the high levels of risk aversion adopted during the height of the crisis.[45]

3.27 The Council of Small Business Organizations Australia (COSBOA) questioned the disparity between the interest rates for SME loans and residential mortgages, particularly for business loans secured by residential property: '[i]t still seems wrong. It is the same house, the same person and the same business earning them money.'[46] ACCI stated:

> Data from the Reserve Bank indicates that small businesses were paying a margin of 4.17 percentage points above the cash rate on average for bank finance, compared to a margin of 2.23 percentage points for large businesses and 2.47 percentage points for mortgage customers as of 2 February 2011, despite most of these small business loans being residentially secured.[47]

44 RBA, *Submission 3*, p. 5.

45 NSW Business Chamber, *Submission 8*, p. 10.

46 Mr Peter Strong, COSBOA, *Proof Committee Hansard*, 4 March 2011, p. 66.

47 ACCI, *Submission 6*, p. 1.

3.28 It appeared there were three causes for the higher interest rates for SME loans. First, it was submitted that the higher interest rates resulted from the increased cost to ADIs in obtaining funds to lend. The ABA explained:

> [The GFC] had two major impacts on lending to small business. The first was that the cost of funds to lender increased dramatically. For many lenders, particularly smaller lenders, even access to funds became a real issue. In other words, money became less available and much more expensive. This inevitably affected bank lending.[48]

3.29 The ANZ also noted the impact of rising costs on interest rates, stating:

> 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.[49]

3.30 Second, it was argued that the higher costs are an appropriate response to the higher default rates, and therefore the higher risk, of SME loans. The RBA submitted:

> One common concern of small businesses is that interest rates on residentially secured small business loans are priced at a premium to residentially secured housing rates. However this pricing results from higher expected losses on small business loans...[50]

3.31 The RBA advised that non-performing small business loans have increased from approximately 1 per cent during 2005-07 to approximately 2.5 per cent of banks' total small business loan portfolios as of September 2010. Figure 3.2 shows that the growth in the number of non-performing assets on the banks' books in the business sector now far exceeds those in the housing sector.

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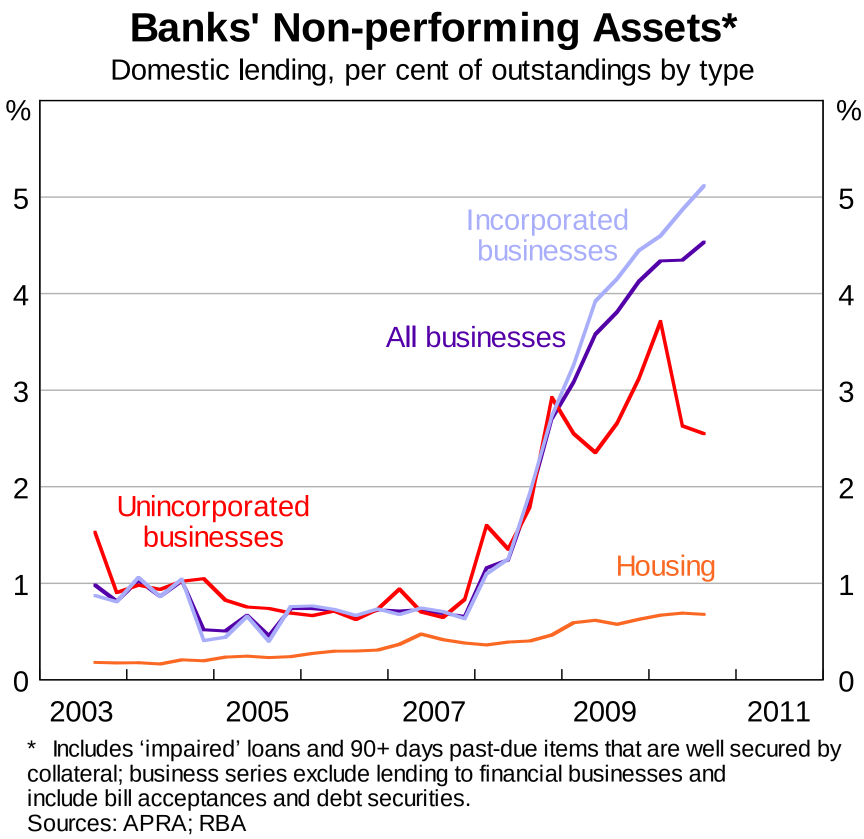
48 Mr Münchenberg, *Proof Committee Hansard*, 4 March 2011, p. 48.

49 ANZ, *Submission 14*, p. 10.

50 RBA, *Submission 3*, p. 4.

Figure 3.2 Bank's Non-performing assets[51]



3.32 Westpac Group also submitted that the higher interest rates were an appropriate response to the default rate of SME loans:

> [S]lightly higher interest rates for SME lending when compared to residential mortgage lending is consistent with the performance of SME loans across Westpac Group portfolios. Currently, small business '90 days+' delinquency rates are approximately two-and-a-half to three times greater than that of residential mortgages. Further, SME borrowers have a significantly higher net bad debt rate when compared to the consumer mortgage portfolio.[52]

3.33 Treasury also argued that the higher costs were a proportionate response to the probability of SME loans defaulting, stating that:

> While the Australian economy performed well during the financial crisis, it is likely that loans were re-priced by lenders to reflect the higher probability of default on SME loans.
>
> While many loans to SMEs are secured by residential property, banks take into account several factors, in addition to the type of collateral used, when pricing a loan. The average probability of default on small business loans is

51 RBA, *Submission 3*, p. 5.

52 Westpac Group, *Submission 9*, p. 4.

> around 2.4 per cent. This compares to residential mortgages, whose probability of default is less than half that, at around 1.1 per cent. Further, once a borrower has defaulted, banks stand to lose different amounts on different loans. The loss given default on loans to small business is approximately 30 per cent of the loan's value. This figure is around 20 per cent for housing loans.[53]

3.34 Third, the ANZ submitted that the higher capital requirements for SME loans increased the cost of providing SME loans relative to residential mortgages.[54] This was confirmed by the RBA, which also stated that the higher interest rates result from 'the larger amount of capital that banks hold as a buffer against unexpected losses.'[55] The CBA supported the additional capital requirements, stating that 'there are legitimate reasons why APRA requires additional capital be held for small and medium business lending, which carries a higher risk than mortgage lending.'[56]

3.35 NAB argued that the prudential framework contains 'an inherent bias in favour of residential mortgage lending', and further stated:

> The operational impact of such prudential settings is that Australia's commercial banks can do significantly more residential mortgage lending relative to business lending in terms of capital management.[57]

3.36 However, this did not appear to be a view widely shared by other lenders or oversight bodies. As previously explored in this report, it appears that risk was less rigorously priced prior to the GFC. On this point, Treasury stated:

> We think that the banks themselves or the lenders have become—maybe you could call them—risk adverse, but at the same time it is more likely than not that they are pricing in risk much better post-GFC than they probably were beforehand.[58]

3.37 The CBA argued that 'the GFC is the most recent reminder of why higher risk lending must be priced accordingly.'[59] Australia's response to the GFC, including the actions of ADIs, has received international approval. For example, the Organisation for Economic Cooperation and Development (OECD) has concluded:

> Australia’s financial system has proved very resilient during the global crisis. This is partly due to solid domestic banking supervision, which was substantially reinforced after sizeable banking sector losses in the early

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53 Treasury, *Submission 16*, p. 7.

54 ANZ, *Submission 14*, p. 13.

55 RBA, *Submission 3*, p. 4.

56 CBA Australia, *Submission 17*, p. 9.

57 NAB, *Submission 19*, p. 8.

58 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Proof Committee Hansard*, 4 March 2011, p. 35.

59 CBA, *Submission 17*, p. 9.

> 1990s, and low exposure to toxic assets...Banks have remained profitable with stable capital ratios, and the largest Australian banks are now among the soundest in the world.[60]

3.38 The OECD has further stated:

> The good performance of the financial sector has improved the ranking of Australian institutions by international standards. Reviews of Basel II implementation and stress tests give good marks to the solidity of the system.[61]

Committee view

3.39 On the basis of the evidence submitted to the committee, it appears there are sound reasons for the higher interest rates for SME loans compared to residential loans, and the increased cost of SME lending that resulted from the GFC. It would be of significant concern were the prudential framework misapplied to attempt to justify inappropriately high interest rates or other charges. However, the committee has not received evidence of inappropriate application of the prudential framework. On the contrary it appears that the prudential framework has served Australia well throughout the GFC.

Basel III requirements

3.40 In its report to the G20[62] in October 2010, the Basel Committee on Banking Supervision announced the introduction of the Basel III regulatory framework.[63] The new regulatory framework was developed in response to the GFC, and is intended to 'strengthen the regulation, supervision and risk management of the banking sector.'[64] APRA stated that 'Basel III remedies a number of weaknesses which were highlighted in previous global capital standards, highlighted by the GFC.'[65] As the RBA noted during an address at the Basel III Conference 2011, the new requirements are 'about applying the lessons learned from the crisis to the way we regulate banks.'[66]

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60 OECD, *OECD Economic Surveys, Australia: Volume 2010/21, Supplement 3*, p. 12.

61 OECD, *OECD Economic Surveys, Australia: Volume 2010/21, Supplement 3*, p. 27.

62 The Group of Twenty Finance Ministers and Central Bank Ministers. It was established in 1999 to promote international dialogue among key emerging market countries.

63 Bank for International Settlements, 'The Basel Committee's response to the financial crisis: report to the G20, http://www.bis.org/publ/bcbs179.htm (accessed 5 April 2011).

64 Bank for International Settlements, 'International regulatory framework for banks (Basel III), http://www.bis.org/bcbs/basel3.htm (accessed 5 April 2011).

65 Mr Byres, APRA, *Proof Committee Hansard*, 11 March 2011, pp 42–43.

66 Dr Malcolm Edey, Assistant Governor (Financial Systems), RBA, 'Basel III and Beyond', Basel III Conference 2001, 24 March 2001, http://www.rba.gov.au/speeches/2011/sp-ag-240311.html (accessed 5 April 2011).

3.41 The Basel Committee has advised that Basel III aims to 'improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, improve risk management and governance and strengthen banks' transparency and disclosures.'[67] The new requirement include the Liquidity Coverage Ratio, which will require ADIs to 'have sufficient high-quality liquid assets to survive an acute stress scenario lasting one month', and the Net Stable Funding Ratio, which will encourage ADIs to access 'more stable sources of funding (e.g. deposits or long-term debt).'[68]

3.42 On 17 December 2010, it was announced that Australia will comply with the new Basel III framework.[69] APRA stated that staggered phase-in arrangements will apply in Australia, advising that 'for the purpose of this discussion we can say it is coming in a couple of years' time.'[70]

3.43 The *Australian Financial Review* has reported that banks are concerned that the new requirements will lead ADIs to raise mortgage rates faster than changes to the official cash rate.[71] However, these concerns were not raised in the evidence banks provided this inquiry. Referring to Basel III, CBA Australia noted the bank 'accepts the scope to further improve the framework and the global agreements to do so (such as the implementation of Basel III).'[72]

3.44 In contrast, ACCI submitted that the new requirements may increase the cost of SME finance:

> ...ACCI is concerned that the Basel III requirements will put small business borrowers at a substantial disadvantage compared to mortgage borrowers and larger corporates, with the flow on impact of higher funding costs and bank charges as well as further tightening in non-price lending requirements imposed on the small business sector.[73]

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67 Bank for International Settlements, 'International regulatory framework for banks (Basel III), http://www.bis.org/bcbs/basel3.htm (accessed 5 April 2011).

68 APRA, 'Letter to All Authorised Deposit-taking Institutions (ADIs), Basel III Reform Package', 17 December 2010, http://www.apra.gov.au/ADI/upload/20101217-Ltr-to-all-ADIs-re-Basel-III-package.pdf (accessed 5 April 2011).

69 The Hon Wayne Swan MP, Treasurer, 'Release of Basel III Global Banking Standards', Press release, 17 December 2010.

70 Mr Byres, APRA, *Proof Committee Hansard*, 11 March 2011, p. 42.

71 Geoff Winestock, 'No escape from new bank rules', *Australian Financial Review*, 6 January 2011, p. 1.

72 CBA, *Submission 17*, p. 7.

73 ACCI, *Submission 6*, p. 22.

3.45 This view was not shared by the RBA and APRA, both members of the Basel Committee.[74] APRA has advised ADIs that '[a]s a member of the Basel Committee, APRA has been actively involved in developing these global reforms and it fully supports the package.'[75] In evidence to the committee, APRA stated that transitioning to the Basel III framework was 'quite manageable without particular disruption', and further advised that 'most of our banks have been quite happy to say quite publicly that they are quite well placed and already very close to compliance with the new requirements.' [76] APRA further stated that the regulator does not consider that Basel III will trigger significant changes in lending conditions:

> The impact of Basel III on our ADI sector will be far less than on many other similar sectors around the world, in other jurisdictions. We see the Australian ADI sector as quite well placed to be able to meet these new requirements without the need for large-scale capital raisings or substantial changes to balance sheet structures. The point being made is simply to say that we do not see it as being particularly disruptive or costly from the position the banks are in today.[77]

3.46 Mr Guy Debelle, Assistant Governor, Financial Markets, RBA, stated that '[f]rom my point of view, no, I do not think that should have any particular impact. Certainly I do not see it having a disproportionate impact on small business lending.'[78] Similarly, in announcing Australia's commitment to Basel III, the Treasurer stated that 'no Australian bank will be able to cite them [the Basel III requirements] as justification for stinging customers with any additional costs.'[79]

Committee view

3.47 It appears from the evidence provided to the inquiry that there is overall support for the introduction of Basel III. Even where concerns were raised no evidence was provided, nor were there any suggestions that Australia should not be part of Basel III. However, it would be a significant concern were the new requirements to result in imposing further barriers to finance for SMEs. The committee is of the view that it would be improper for ADIs to use the introduction of Basel III as an opportunity for 'price-gouging'. Given the serious negative impact that

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74 Dr Malcolm Edey, Assistant Governor (Financial Systems), RBA, 'Basel III and Beyond', Basel III Conference 2001, 24 March 2001, http://www.rba.gov.au/speeches/2011/sp-ag-240311.html (accessed 5 April 2011).

75 APRA, 'Letter to All Authorised Deposit-taking Institutions (ADIs), Basel III Reform Package', 17 December 2010, http://www.apra.gov.au/ADI/upload/20101217-Ltr-to-all-ADIs-re-Basel-III-package.pdf (accessed 5 April 2011).

76 Mr Byres, APRA, *Proof Committee Hansard*, 11 March 2011, p.43.

77 Mr Byres, APRA, *Proof Committee Hansard*, 11 March 2011, p.43.

78 Mr Debelle, RBA, *Proof Committee Hansard*, 11 March 2011, p. 6.

79 The Hon Wayne Swan MP, Treasurer, 'Release of Basel III Global Banking Standards', Press release, 17 December 2010.

this could have for the SME financial market, the committee recommends that the impact of Basel III in Australia be closely monitored. While not provided to the committee, it is noted that similar concerns could be raised regarding the cost of residential mortgages. The committee sees merit in also monitoring the impact of Basel III on Australian residential mortgages.

Recommendation 2

3.48 The committee recommends that the Reserve Bank of Australia specifically track the impact of the introduction of Basel III on the cost of small and medium business finance and residential mortgages.

Changes to the conditions of existing loans following the GFC

3.49 Business representatives reported that the GFC prompted significant changes to lending conditions not only for new but also for existing SME loans. For example, CPA Australia stated:

> From the beginning of the GFC, the banks were acutely aware that the fallout from this crisis would change the risk profile of most businesses. One step they undertook to mitigate their risks was to review their loan portfolios with additional rigour. The result was that many businesses were required to agree to changed loan conditions.[80]

3.50 Similarly, the NSW Business Chamber reported that '[r]isk aversion during the GFC saw small business lending conditions tighten significantly, both in terms of tightening lending criteria and relative costs of funds.'[81] The reported changes to lending conditions included increased security requirements, a reduction in the kinds of security accepted, a decrease in the loan-to-valuation ratio and increased reporting requirements that included requirements outside the scope of the original loan agreement.[82] CPA Australia also reported member feedback that ADIs are requesting personal and directors' guarantees, and key man insurance.[83]

3.51 It appeared that the changes were prompted by prudential considerations. Commenting on the impact of the GFC on the lending market, the ABA reported that 'the banks and non-bank lenders took steps to re-evaluate risks associated with business lending.'[84] The ANZ stated that:

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80 CPA Australia, *Submission 10*, p. 8.

81 NSW Business Chamber, *Submission 8*, p. 10.

82 CPA Australia, *Submission 10*, pp 8 – 9, Appendix A, p. 16; NSW Business Chamber, *Submission 8*, pp 11–12.

83 CPA Australia, *Submission 10*, Appendix A, p. 15. 'Key man insurance' is defined as 'insurance that covers the key personnel in the business and provides the banks with some certainty that the business will continue to operate under the current management.'

84 ABA, *Submission 13*, p. 2.

> 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.[85]

3.52 CPA Australia noted member feedback that the increased reporting requirements may be appropriate as 'the banks are now doing what perhaps they should have always been doing.'[86] It was also noted that tighter lending conditions may ease as the economy improves. For example, the RBA stated that 'you do get this tightening across a range of standards and then, as the economy comes back into recovery, general easing in the conditions as well.'[87]

3.53 However, evidence presented to the committee indicates three main concerns with the changed lending conditions. First, it was put to the committee that the new conditions may restrict SME's access to finance. NSW Business Chamber stated that 'generally speaking the banks appear to be unwilling to lend without very high levels of cash flow and security.'[88] Participants in Victoria University's small business survey argued: '[T]he Banks are not interested in you if you have no security' and '[i]f you have equity in your house you can get finance – if not good luck.'[89] APESMA Connect stated that there is an 'unwillingness of banks to lend where there is limited non-personal collateral.'[90] CPA Australia argued that the new requirements could impact business growth, noting that 'the security required for such [additional] lending may not be available as it is already pledged as security.'[91]

3.54 Second, CPA Australia raised concerns with the manner in which the conditions were altered. The organisation reported:

> Changed lending conditions (including implementing additional reporting requirements) were, at times, imposed with great speed and (often) lack of warning. In our view, the inadequate time many businesses had to adjust their systems to meet the new conditions added to the pressure many businesses felt during the GFC; the banks could have handled this better.[92]

3.55 Under the MBCOP, mutual ADIs undertake to provide 'clear and effective communication' with customers.[93] The Banking Code of Practice directs banks to

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85 ANZ, *Submission 14*, p. 10.

86 CPA Australia, *Submission 10*, Appendix A, p. 17.

87 Mr John Broadbent, Head of Domestic Markets Department, RBA, *Proof Committee Hansard*, 11 March 2011, p. 4.

88 NSW Business Chamber, *Submission 8*, p. 11.

89 NSW Business Chamber, *Submission 8*, pp 11–12.

90 APESMA Connect, *Submission 4*, p. 3.

91 CPA Australia, *Submission 8*, p. 8, Appendix A, p. 15.

92 CPA Australia, *Submission 8*, p. 7.

93 Abacus, Mutual Banking Code of Practice, p. 16.

notify customers of changes to terms and conditions, including standard fees and charges, no later than the day on which the changed conditions take effect. Notification may occur either in writing or through advertising in the media.[94] However, it is unclear whether changed lending conditions such as increased security and reporting requirements are covered by the Code of Banking Practice or the MBCOP. In response to the concerns, the ABA advised '[w]ithout having heard the precise circumstances, I am not sure. I cannot tell you precisely whether the code or the legislation would cover that sort of behaviour.'[95]

3.56 Third, submissions also questioned whether the changed lending conditions, particularly the reporting requirements, were appropriate. CPA Australia reported members' concerns that the reporting requirements are unnecessary, arguing that 'the lack of experience and skills of many business bankers is in fact counterproductive to accessing finance and is leading to unnecessary information requirements.'[96] The organisation further stated that members believe ADI staff request unnecessary information 'as they do not have the skills to make a professional judgement on what is necessary and not necessary to make an informed decision.'[97]

3.57 It seemed that underlying this is a concern about the quality of service ADIs provide. A participant at CPA Australia's small business roundtable questioned whether ADI staff have the technical expertise to understand the information requested:

> They don't seem to understand what is in the forecast, because they keep asking questions – they just don't seem to get it. I don't think they know what they are looking at, especially for a mining company, unless they have a background in mining.[98]

3.58 Similar concerns were noted in the Victoria University small business survey.[99] ACCI reported that its March 2010 survey found that 34 per cent of the 215 respondents considered that business bankers 'do not have adequate understanding of their business' cash flows and its ability to service any current or prospective loan obligations.'[100] The Real Estate Institute of Australia (REIA) stated:

> Many respondents to the March 2010 REIA survey in their comments felt that the financial sector did not understand the small business sector and furthermore tended to group all small businesses in the one basket without

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94 ABA, Banking Code of Practice, p. 10.

95 Mr Münchenberg, ABA, *Proof Committee Hansard*, 4 March 2011, p. 55.

96 CPA Australia, *Submission 8*, p. 8.

97 CPA Australia, *Submission 8*, p. 9.

98 CPA Australia, *Submission 8*, Appendix A, p. 16.

99 NSW Business Chamber, *Submission 8*, p. 13.

100 ACCI, *Submission 6*, p. 13.

> any differentiation, neither of the factors affecting a particular segment nor of the outlook for that segment.[101]

3.59 It appeared that there was a disconnect between the views of some SMEs and the evidence submitted by ADIs. For example, ANZ stated that it provides SMEs with 'dedicated specialists, who are trained to help small business customers experiencing financial difficulty.'[102] ANZ further advised:

> In the small-business space, our team does not make assessments, in the sense of the actual credit decision. They certainly work with customers to put together the best possible submission for a loan...We hire a lot of people from small business or who have had family working in small business, so they really understand and have empathy with small business. They go through significant induction training and significant credit training.[103]

3.60 Westpac Group reported that Westpac Business Assist 'provides personalised support to SME customers.'[104] The CBA stated that '[s]ince 2006, CBA has achieved a fast growth rate in business customer satisfaction.'[105] The Code of Banking Practice also directs bank ADIs to ensure staff are 'trained so that they can competently and efficiently discharge their functions and provide the banking services they are authorised to provide.'[106]

3.61 To address these concerns, CPA Australia advocated for the introduction of a dedicated code of conduct for SME lending.[107] The ABA advised, and the Code of Banking Practice states, that that Code applies to small business lending.[108] However, CPA Australia argued:

> There are significant gaps that could be corrected in an expansion of the ABA Code of Banking Practice or in a separate code of practice. Such a specific Code would provide the framework for banks to improve their relationship with small business and more clearly set out the rights and responsibilities of banks and borrowers and enable banks "*to get closer than ever to business*". This would no doubt lead to improved outcomes in small business lending.[109]

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101 REIA, *Submission 7*, p. 5.

102 ANZ, *Submission 14*, p. 6.

103 Mr Nick Reade, General Manager, Small Business Banking, ANZ, *Proof Committee Hansard*, 11 March 2011, p. 36.

104 Westpac Group, *Submission 9*, p. 4.

105 CBA, *Submission 17*, p. 2.

106 ABA, Code of Banking Practice, p. 5.

107 CPA Australia, *Submission 10*, p. 9.

108 Mr Münchenberg, ABA, *Proof Committee Hansard*, 4 March 2011, p. 49; ABA, Code of Banking Practice, p. 2.

109 CPA Australia, *Submission 10*, pp 9–10.

3.62 The organisation stated that gaps exist in the areas of explaining the requirements needed to obtain bank credit, estimating the time to process credit applications, informing the SME that further information is needed to process the loan, and informing the SME about the reasons for declining an application.[110] On the basis of requirements of banking codes in the United Kingdom and Canada, CPA Australia recommended that a minimum of 15 days notice should be provided of changes to lending terms and conditions, such as reporting requirements.[111] The ABA informed the committee that the ABA and CPA Australia are discussing 'getting together to talk about a lot of these small business issues.'[112]

3.63 CPA Australia also recommended additional technical training for business banking staff 'so that such staff have a reasonable understanding of financial matters and the industries in which their clients work.'[113] The NSW Business Chamber stated 'we think there is room for improvement on the part of credit providers; they could do more to evaluate individual loan applications than simply applying a sectoral or regional template that they have developed as part of their credit systems.'[114]

3.64 SME representatives also stated that there is scope for additional training for SMEs. CPA Australia acknowledged that 'some businesses are finding it difficult to meet the information requirements imposed by lenders for new loans partly because of poor record keeping.'[115] The NSW Business Chamber noted:

> We find information deficiencies and differing rates of capability are issues on both sides of lending transactions. There is always more that can be done to improve the ability of small business to get across their business opportunity and prospects to a prospective credit provider. There is always room for that.[116]

Committee view

3.65 The committee notes the concern expressed by some stakeholders that ADIs, and in particular banking staff, do not fully appreciate the conditions peculiar to the SME sector and the nuances of SME finance. The committee considers that a uniform definition of micro, small and medium business can facilitate better policy analysis and development. Timely dissemination to financial sector participants and business organisation of data about the SME sector could assist lenders to more fully

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110 CPA Australia, *Submission 10*, Appendix B, pp 23–38.

111 CPA Australia, *Submission 10*, Appendix B, p. 31.

112 Mr Münchenberg, ABA, *Proof Committee Hansard*, 4 March 2011, p. 51.

113 CPA Australia, *Submission 10*, p. 9.

114 Mr Paul Orton, Director, Policy and Advocacy, NSW Business Chamber, *Proof Committee Hansard*, 4 March 2011, pp 28–29.

115 CPA Australia, *Submission 10*, p. 8.

116 Mr Orton, NSW Business Chamber, *Proof Committee Hansard*, 4 March 2011, pp 28–29.

understand their clients' circumstances and to develop lending practices that are tailored to each client's needs.

3.66 It would be of concern were significant changes to lending conditions introduced without providing SMEs sufficient opportunity to adjust to the new requirements. The committee accepts advice from Abacus and the ABA that the MBCOP and the Code of Banking Practice apply to SME products. However, the codes should be amended to make clear the service standards required for ADIs when altering lending conditions. In this regard, the committee notes CPA Australia's advice that 15 days is the minimum lead time required under banking codes in the United Kingdom and Canada.

3.67 The committee approves the measures many ADIs have taken to improve services to SMEs. While evidence is inconclusive, the committee notes the substantial anecdotal evidence of SMEs concerns with the skills and training of business bankers. The committee encourages the ADI sector to take on board these concerns, and to prioritise staff training in this area.

Recommendation 3

3.68 The committee recommends that the Code of Banking Practice and the Mutual Banking Code of Practice be amended to include a standardised notice period for notifying business borrowers of changes to loan terms and conditions that may be materially adverse for them.