Summary and Recommendations

Small business is a vital element of the Australian economy, employing half the workforce. Lending to small business has slowed since the global financial crisis, and interest margins have widened. The outstanding value of smaller loans (under $500,000) has fallen in the agricultural, manufacturing and financial sectors. Surveys of small businesses show that the availability and cost of finance remains a major concern.

The slowdown in lending to small business appears to reflect a combination of demand factors such as;

- less demand for finance by small business in the wake of the global recession, as weaker sales mean that existing capacity is adequate and there is not the need to borrow for investment;
- less demand for finance by small business as reduced confidence leads to a more conservative attitude towards debt;

and supply factors such as;

- fewer small businesses being able to meet existing lending standards in the wake of the global recession;
- some tightening of lending standards by financial intermediaries. It is arguable that banks were tending towards recklessness in the preceding boom, and that some tightening of credit standards represents a prudent return to 'normal' practice, but there may also be cases where banks are over-reacting; and
- non-bank lenders having fewer funds available as securitisation and interbank lending markets dried up and/or interest rates in them became prohibitive.

Witnesses were reluctant to apportion the roles played by these various factors.

Most small businesses borrow at variable interest rates. Banks did not fully pass on the reductions in the Reserve Bank's policy rate between August 2008 and September 2009 to small business borrowers but fully passed on the subsequent increases. Over this period, banks have widened the margin between the cost of their funds and the rate they charge small businesses on loans. Some view the near-simultaneous increases in interest rates as a form of price leadership. Banks have also increased the fees they charge small business and required greater security for their loans.

These developments are reflections of competition for lending to small business having diminished. Important drivers of this include bank mergers and the difficulties faced by non-bank competitors. While some of this diminution in competition is related to the global financial crisis, and so should be temporary, the impact of structural changes such as mergers will be long-lasting.

The Committee is concerned that bank exit fees on variable-rate loans are an impediment to competition in that market.

Recommendation 1

5.29 The Committee recommends that banks abolish exit fees on variable-rate loans. If banks do not do so by the end of 2010, then guidelines or regulations, or if necessary new legislation, should be used to compel them to do so.

The Committee notes evidence suggesting that larger banks may be less interested in lending to small business than are smaller banks, which prompts further concerns about the big four banks taking over smaller rivals. The Committee is concerned that the existing provisions of the *Trade Practices Act 1974* may be insufficient to prevent further undesirable takeovers in the banking industry.

Recommendation 2

6.28 The Committee reiterates its recommendation that the Government retain the 'four pillars' policy of not allowing a merger between any of the four major banks.

Recommendation 3

6.29 The Committee recommends that a moratorium be placed on approval of any further takeovers in the banking industry for one year, unless the bank being taken over is at imminent risk of failure.

Recommendation 4

6.30 The Committee reiterates its recommendation that the *Trade Practices Act* be amended to inhibit firms achieving market power through takeovers or abusing market power and that 'market power' be expressly defined so that it is less than market dominance and does not require a firm to have unfettered power to set prices. A specific market share, such as, for example, one third (set based on international practice), could be presumed to confer market power unless there is strong evidence to the contrary.

Recommendation 5

6.31 The Committee recommends that the Government request the ACCC, APRA and the Reserve Bank to provide a joint annual report to parliament on competition in the retail banking market in Australia, and the provision of finance to small business, but taking care not to increase unduly the reporting burden on financial institutions.

Some submissions called for some form of 'development bank' or 'rural bank' to be established, or Australia Post to be offered a banking licence, to fill perceived gaps in lending by the private banks, or for a body to be established to guarantee small business loans (as exists in some other countries). The Committee prefers to increase competition within the existing commercial banks.

The Committee believes that small business will be better placed to benefit from a competitive market, and place pressure on banks to make the market more competitive, if they have a stronger understanding of financial markets. It commends the Australian Securities and Investments Commission for developing a small business portal to explain concepts relating to small business credit and those banks which have also developed online tools for small businesses.

The Committee notes that some other countries have a specific code of conduct governing banks' lending to small business.

Recommendation 6

7.14 The Committee recommends that the Australian Bankers' Association meet with small business representatives to develop a code of practice for lending to small business.

The Committee notes that farmers comprise an important class of small business and have had difficulty attracting credit to tide themselves through droughts or periods of low prices.

As there is inherently more risk in subscribing venture capital than in making a secured loan, the increase in risk and risk aversion that occurs in recessions tends to lead to larger reductions in the provision of capital than in loans. The Committee, however, received far more submissions about lending to small business than about the provision of venture capital, so while it offers some comments in this area is not in a position to make recommendations.