Chapter 5

Competition in the market for small business finance

Introduction

5.1 The increase in margins on small business lending, and some complaints about lack of finance, suggest that competition may not be as intense as it should be in the market for lending to small businesses.

Views about current extent of competition

5.2 A strong consensus emerged from small businesses across industries that competition had declined and was now inadequate among lenders:

> …number one on our wish list would be an increase in competition because we have seen concentration within the marketplace in recent times.[1]

> …52 per cent of respondents were of the view that there has been a reduction in competition in the small business lending market over the last 12 months to two years.[2]

> There also appears to be relatively little price competition across the major lenders.[3]

> We see a return to competition in the market as being absolutely essential. We would also be concerned if there were any further diminution of competition in the market through acquisitions or mergers, be they between banks or other large financial service organisations.[4]

> ,,,as far as automotive finance goes there are really only two players in the market at this stage and certainly all the major businesses typically have a relationship with those financiers.[5]

5.3 The Reserve Bank acknowledge that competition for small business lending has been lacking, at least temporarily:

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1 Mr Jock Kreitals, Manager, Policy, Real Estate Institute of Australia, *Proof Committee Hansard*, 10 May 2010, p. 55.

2 Housing Industry Association, *Submission 7*, p. 10.

3 WA Small Enterprise Network, *Submission 18*, p. 4.

4 Mr Greg Evans, Director of Economics and Industry Policy, Australian Chamber of Commerce and Industry, *Proof Committee Hansard*, 10 May 2010, p. 10.

5 Mr Richard Payne, Principal Policy Director, Queensland Motor Trades Association, *Proof Committee Hansard*, 10 May 2010, p. 46.

> Since the onset of the crisis, competition in lending has decreased. The easing in competition is to some extent cyclical. During periods of strong economic growth, banks tend to compete aggressively for business lending by cutting their margins and relaxing their lending standards. However, when the economic and business outlook is uncertain and loan losses are rising, as has been the case over the past couple of years, banks see the loans as being more risky and pull back a little.…as the Australian economy strengthens, there may be some incentive for new or existing lenders to expand their lending in this sector and compete away some of this spread.[6]

5.4 The bankers themselves concede that the global financial crisis reduced competition:

> Immediately prior to the global financial crisis when credit was very cheap, very cheap credit meant that there was fierce competition amongst a whole range of lenders to provide businesses with loans. That choice, that competition, has undoubtedly diminished as a number of those players have been forced out of the market, but we are seeing signs of those players returning.[7]

5.5 The Australia Institute's David Richardson views the manner in which banks change their interest rates synchronously as indicative of a lack of competition:

> A good example of the exploitation of market power on the part of the banks follows the increases in official interest rates by the Reserve Bank of Australia. Objectively bank costs have not changed from one day to the next but the banks use the official interest rate decisions as cover to increase their interest charges…The clear impression from watching bank interest rate changes is that official interest rate changes are taken as the signal to change bank lending rates whether bank costs justify an increase or not. It looks like a textbook example of oligopolistic pricing in which the main players set a common price to maximise their collective earnings. Usually explicit collusion to set prices is illegal but there is implicit collusion that may take other forms. For example, one firm may emerge as the price leader occasionally announcing changes in prices that are copied by other participants in the market…In the case of banking, it is actually the RBA that acts as an unofficial price leader. The RBA announces interest rate changes which are followed by the banks, at least on their lending side. Hence the RBA acts as the price leader and the banks follow the leader irrespective of their costs.[8]

5.6 There are hopes of improvement in competition:

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6 Reserve Bank of Australia, *Submission 2*, pp 4, 6.

7 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 12 April 2010, p. 5.

8 David Richardson, Senior Research Fellow, Australia Institute, *Submission 47*, p. 2.

> Competition in the small business lending market has eased from the strong levels just prior to the onset of the financial crisis, but we think it should recover as the economy continues to strengthen.[9]

5.7 Business, however, is yet to observe this:

> We have not seen a significant increase in competition, no.[10]

The role of non-ADI lenders

5.8 The global financial crisis has reduced the role of lenders who are not authorised deposit-taking intermediaries (banks, building societies and credit unions).

5.9 The Reserve Bank estimates that:

> The non-ADI lenders were about 10 per cent of the market in 2007…they are probably about five per cent of the market now…[11]

5.10 In some cases the tougher global financial conditions may have hastened but not caused the demise of non-ADI lenders:

> …certainly with some of them—their business models were not sustainable in a medium-term sense. They were sustainable in 2007, but they were obviously not sustainable in the height of the crisis and they probably would not have been sustainable going forward.[12]

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9 Dr Guy Debelle, Assistant Governor (Financial Markets), Reserve Bank of Australia, *Committee Hansard*, 12 April 2010, p. 18.

10 Mr Philip Chidamo, Chief Economist, Australian Industry Group, *Committee Hansard*, 12 April 2010, p. 46.

11 Dr Debelle, Reserve Bank of Australia, *Committee Hansard*, 12 April 2010, p. 24.

12 Dr Debelle, Reserve Bank of Australia, *Committee Hansard*, 12 April 2010, p. 25.

Bank switching costs

5.11 The Council of Small Business of Australia's submission focuses on reducing switching costs between banks as a way of improving competition. They advocate the Government:

> …regulate with respect to some of the high costs of switching banks that currently exist. For example, bank account number portability, like mobile phone number portability, has the capacity to promote choice, reduce costs and increase productivity.
>
> …work with State and Territory governments to overcome other barriers to switching banks that are attendant on business loans for mortgage-secured businesses, such as stamp duty costs.[13]

5.12 Questioned at the hearing, other business representatives also indicated this is an issue:

> We certainly have some anecdotal evidence of transaction costs associated with switching banks or financial institutions…some [businesses] have indicated that they find it difficult to switch banks or it is just too costly for them to switch banks, so therefore it is a hindrance…[14]
>
> …the government must act as it did in the household mortgage sector to reduce the barriers to switching providers. We believe the Productivity Commission should do a full review of the costs and constraints faced by small business when they engage with banks to secure finance.[15]
>
> If exit fees act in an almost prohibitive way for the transfer of funds from one institution to another, they effectively act in an anticompetitive manner in the market.[16]
>
> I, for one, changed our financial institution about 15 years ago after our family had been with them for a hundred years, and it was not an insignificant cost to us with all the extra things such as stamp duty and all that sort of activity which made what seemed a simple business decision at the time start to look like maybe we should not be doing it because there was going to be a direct out-of pocket cost.[17]

5.13 Treasury also highlighted the importance of switching:

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13 Council of Small Business of Australia, *Submission 27*, p. 3. See also the comments by their chief executive officer, *Proof Committee Hansard*, 10 May 2010, p. 78.

14 Mr Chindamo, Australian Industry Group, *Committee Hansard*, 12 April 2010, p. 51.

15 Mr Stephen Cartwright, Chief Executive Officer, New South Wales Business Chamber, *Committee Hansard*, 12 April 2010, p. 88.

16 Mr Peter Anderson, Australian Chamber of Commerce and Industry, *Proof Committee Hansard*, 10 May 2010, p. 14.

17 Mr Charles Burke, Vice-President, National Farmers Federation, *Proof Committee Hansard*, 10 May 2010, p. 66.

…switching is probably one of the best things you can do in terms of stimulating competition…[18]

5.14 They were, however, less critical of the current amount of switching:

…Australia's switching rates are actually no lower—and probably higher—than other major countries.[19]

5.15 Rival lenders are also opposed to banks' high exit fees:

…they are in our view operating as a definite brake on the ability of consumers to leave…[20]

5.16 A report by the House Economics Committee recommended that:

…as part of the adoption of responsibility for the regulation of credit…the government consider mechanisms…for addressing unfair entry and exit fees.[21]

5.17 In particular, exit fees (or 'early termination fees') on variable interest rate loans and establishment fees for new loans act as a disincentive to change banks. This was put to the banks:

Senator HURLEY—… Can you comment on the ease of any businesses being able to take advantage of that and whether you see that has eased or become more difficult?

Mr Münchenberg—I do not know of any reason why it would have become more difficult. I would have thought that it is reasonably straightforward for business customers, subject to whatever arrangements they have in place.[22]

5.18 The Committee is not aware of any study of the size of exit fees on loans to small business but an indication may be gleaned from a study by ASIC in 2008 on exit fees on home mortgage loans. This found that exit fees have been increasing, both absolutely and as a proportion of total bank fees.[23] A typical exit fee charged by a major bank for a repayment of a $250,000 variable interest rate loan after three years

18 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Proof Committee Hansard*, 10 May 2010, p. 4.

19 Mr Murphy, Treasury, *Proof Committee Hansard*, 10 May 2010, p. 4.

20 Mr Mark Degotardi, Abacus, cited in House of Representatives Standing Committee on Economics, *Competition in the Banking and Non-Banking Sectors*, November 2008, p. 84.

21 House of Representatives Standing Committee on Economics, *Competition in the Banking and Non-Banking Sectors*, November 2008, p. 86.

22 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 12 April 2010, p. 6.

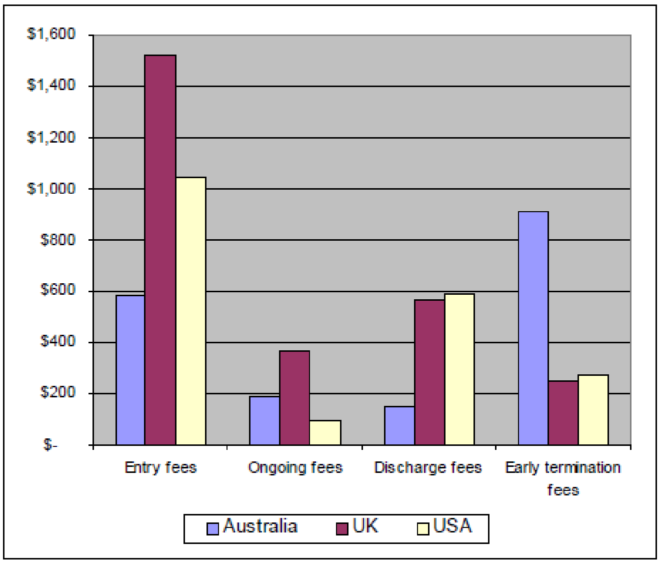
23 ASIC, 'Review of mortgage entry and exit fees', Report no. 125, April 2008, p. 7.

was around $1,000 and over 90 per cent of mortgage products from major banks had exit fees.[24]

5.19 The study also shows that exit fees charged in Australia are much higher than those charged by banks in the UK and US (Chart 5.1). A similar conclusion was reached by the Reserve Bank:

> …by international standards we have relatively high exit fees on mortgages…[25]

Chart 5.1: Comparison of selected bank fees



Source: ASIC, 'Review of mortgage entry and exit fees', Report no. 125, April 2008, p. 11.

5.20 Treasury suggested exit fees could be challenged:

> With exit fees it is questionable and some people say that they could be challenged as a term of an unfair contract. So the government has introduced—under the new credit legislation—capacity for individuals to challenge unfair conditions in terms of contracts…Treasury questions exit fees...[26]

5.21 Section 72(4) of the Uniform Consumer Credit Code states:

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24 ASIC, 'Review of mortgage entry and exit fees', Report no. 125, April 2008, p. 8. Smaller banks charged an average of $700 and building societies and credit unions an average of $400. The majority of building society and credit union mortgage products did not have exit fees.

25 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, quoted in House of Representatives Standing Committee on Economics, *Competition in the Banking and Non-Banking Sectors*, November 2008, p. 78.

26 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Proof Committee Hansard*, 10 May 2010, p. 5.

> A fee or charge payable on early termination of the contract or a prepayment of an amount under the credit contract is unconscionable if and only if it appears to the Court that it exceeds a reasonable estimate of the credit provider's loss arising from the early termination or prepayment, including the credit provider's average reasonable administrative costs in respect of such a termination or prepayment.[27]

5.22 As far as ASIC was aware, however, no cases had proceeded under this section.[28] A likely reason is the legal costs for an individual borrower are dauntingly large when there is no guarantee of a case being successful. Justice Morris may not have helped when in a related case he ruled that:

> …there is no implied obligation to refrain from charging an unconscionable establishment fee, rather, that a lender is at risk if it charges an unconscionable establishment fee.[29]

5.23 Small businesses do not have access to this consumer protection so are even less able to challenge exit fees.

5.24 Some business organisations are reluctant to embrace a ban on exit fees:

> I am hesitant to bandy around the word ‘ban’. Given that my members are essentially participants in the free market capital economy that we have, they would want the right at all times to charge whatever fees they want in their own businesses. So I think it would be fair to say that, rather than dictating what fees and charges an institution could or could not charge, the key is transparency.[30]

5.25 Bank exit fees are not the only impediment to switching banks:

> It could be relationship factors. They are used to dealing with one bank, one branch and so forth and so on.[31]
>
> There is also a perception amongst small businesses that there is not much benefit from trying to shop around, as the banks all have similar application and assessment processes.[32]
>
> During the crisis people who had solid banking relationships have tended to say, ‘Look, I’m going to really value this.’[33]

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27 ASIC, 'Review of mortgage entry and exit fees', Report no. 125, April 2008, p. 22.

28 ASIC, 'Review of mortgage entry and exit fees', Report no. 125, April 2008, p. 23.

29 Justice Morris in *Director of Consumer Affairs Victoria v City Finance Loans and cash Solutions 2008*, cited in ASIC, 'Review of mortgage entry and exit fees', Report no. 125, April 2008, p. 23.

30 Ms Jaye Radisich, Chief Executive Officer, Council of Small Business of Australia, *Proof Committee Hansard*, 10 May 2010, p. 77.

31 Mr Chindamo, Australian Industry Group, *Committee Hansard*, 12 April 2010, p. 52.

32 NSW Business Chamber, response to questions on notice.

33 Mr James Tate, Chief Product Officer, Westpac, *Committee Hansard*, 12 April 2010, p. 76.

> Anecdotal evidence from our members suggests that banks are currently less interested in winning additional business from small business customers. Some members have stated that banks are worried that businesses trying to leave their current provider must be doing so because they represent a bad risk.[34]

5.26 Another barrier to switching between banks is stamp duties. Under the *Intergovernment Agreement on Federal Financial Relations*, stamp duties on mortgages are scheduled to be abolished before 1 July 2013.[35]

5.27 Bank account portability has been suggested as another means of facilitating switching. Asked about this, the Australian Bankers' Association responded:

> Whilst we can appreciate the appeal of such a concept, this will not be pursued by the wider industry at this stage given the very high cost, complexity and disruption involved in the potential implementation of such a facility. By way of background, the account number (including the BSB component) is a unique (to each bank) identifier which permits all the bank's systems and customers' systems (e.g. payroll, accounting packages etc) to 'know' where to send funds. Financial institutions maintain separate IT systems for the different payment clearing systems and each IT system is integrated into many other product and accounting systems. Account portability would mean a fundamental change to each of the IT systems used to exchange payments and substantial rebuilding of other systems. Moreover, many businesses and service providers, including government departments (such as ATO and Centrelink) have IT systems which store BSB and account number information for their staff (for payroll purposes) and customers. It would require them to also update their IT systems and payment records at considerable expense.[36]

Committee view

5.28 Exit fees are not the only factor reducing switching between banks, but this is no justification for maintaining this impediment to competition. While there are valid arguments for some exit fees on fixed-rate loans, no convincing justification has been put forward for exit fees on variable-rate loans. It is not a sufficient response to say that excessive exit fees may be challenged in the courts. This is too expensive and risky an option for a small business.

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.

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34 NSW Business Chamber, response to questions on notice.

35 *Report on Australia's Future Tax System*, December 2009, p. 479.

36 Australian Bankers' Association, response to questions on notice.

5.30 The Committee supports the abolition of stamp duties on mortgages.

The Government's bank funding guarantees

5.31 The bank funding guarantees were the subject of a report by the Committee in 2009. The Committee did not call for a repeal of the guarantees but called for a review of the premia charged for the wholesale funding guarantee.[37]

5.32 The Committee also expressed concern that:

> The introduction and implementation of the guarantees served to greatly increase the lack of confidence in those institutions not the beneficiaries of guarantees, with the consequence that most experienced unsustainable requests for redemptions within a very short period.[38]

5.33 Treasury regards the schemes as positive for small business:

> Without the Guarantee Scheme, banks (including both majors and non-majors) would have had no choice but to ration credit to businesses and consumers, and charge higher interest rates.[39]

5.34 The guarantees have probably benefited smaller domestic banks, but at the expense of the larger domestic banks, foreign banks operating as branches and unregulated entities such as mortgage trusts. Given the arguments (developed further in the following chapter) about smaller banks lending more to small business, the guarantees have therefore probably had a supportive role for small business lending. It could have been even more supportive if the smaller, lower-rated, banks were not charged a higher premium for the wholesale funding guarantee than are the large banks.

5.35 The Australian Bankers' Association opined that:

> The guarantees, for which the banks paid more than a billion dollars in fees, supported market confidence and stability during a period of great uncertainty internationally, and facilitated the continuing provision of affordable credit by banks to their small business customers.[40]

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37 *Government measures to address confidence concerns in the financial sector – The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding,* September 2009, p. 19.

38 *Government measures to address confidence concerns in the financial sector,* p. 31.

39 Treasury, *Submission 50*, p. 14.

40 Australian Bankers' Association, response to question on notice.

The Government's support for mortgage-backed securities

5.36 Initially, the programme of support for residential mortgage securitisation could have been attracting some lending to home lending at the expense of small business loans.

5.37 With the second tranche of the programme, Treasury regarded the scheme as supportive for small business:

> …the Government's direct investment of up to $16 billion in the residential mortgage-backed securities…market has enabled smaller lenders to lend at competitive interest rates and maintain a higher level of lending and market share than would otherwise have been possible. Applicants' small business lending commitments are taken into account under the second tranche of this initiative…. The extension to the RMBS program includes an additional objective of supporting lending to small businesses. Consequently, lenders who seek support under the RMBS program are encouraged to outline how active they are in lending to small business and to allocate part of the proceeds raised under the program to lending to small business. This is one of the factors that the AOFM assesses when deciding whether to support an RMBS deal.[41]

41 Treasury, *Submission 50*, pp 14-15.