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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: Access for small and medium business to finance

FRIDAY, 11 MARCH 2011

SYDNEY

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JOINT STATUTORY COMMITTEE

ON CORPORATIONS AND FINANCIAL SERVICES

Friday, 11 March 2011

Members: Mr Ripoll (Chair), Senator Boyce (Deputy Chair), Senators Cormann, Hurley and Stephens and Mr Fletcher, Mr Griffin, Mr Anthony Smith and Ms Smyth

Members in attendance: Senators Cormann and Stephens and Mr Griffin and Mr Ripoll

Terms of reference for the inquiry:

To inquire into and report on:

(1) the types of finance and credit options available to small and medium business (SMEs) in Australia;

(2) the current levels of choice and competition between lending institutions, but not limited to, credit availability, fees, charges, comparative interest rates and conditions for business finance;

(3) credit options available from banks, non-bank lenders and second tier lenders;

(4) the impact of financial institution prudential requirements and banking guarantees on lending costs and practices;

(5) comparison between the credit options available to SMEs located in regional Australia and metropolitan areas;

(6) the impact of lenders' equity and security requirements on the amount of finance available to SMEs;

(7) policies, practices and strategies that may restrict access to SME finance, and the possible effects this may have on innovation, productivity, growth and job creation;

(8) the need for any legislative or regulatory change to assist access by SME to finance; and

(9) any other related matters.

WITNESSES

BROADBENT, Mr John Stanley, Head of Domestic Markets Department, Reserve Bank of Australia **2**

BYRES, Mr Wayne, Executive General Manager, Diversified Institutions Division, Australian Prudential Regulation Authority **41**

DEBELLE, Dr Guy Lawrence Geoffrey, Assistant Governor, Financial Markets, Reserve Bank of Australia **2**

GADIEL, Mr Aaron, Chief Executive Officer, Urban Taskforce Australia **10**

JOHNSON, Mr Graham, General Manager, Industry Technical Services, Australian Prudential Regulation Authority **41**

JOHNSTON, Mr Michael, Head of Government and Regulatory Affairs, ANZ **30**

MOORE, Mr Andrew Geoffrey, Chief Operating Officer, St George Bank **22**

MOTTON, Ms Tania, General Manager, Regional Commercial Banking, ANZ **30**

READE, Mr Nick, General Manager, Small Business Banking, ANZ **30**

TATE, Mr James Joseph, Chief Product Officer, Westpac Banking Corporation **22**

Committee met at 1.47 pm

CHAIRMAN (Mr Ripoll)—I declare open this public hearing of the Parliamentary Joint Committee on Corporations and Financial Services, the third in a series of public hearings the committee is holding to inform its inquiry into access for small and medium business to finance. The committee is to report by 30 April 2011. I remind everyone here today that witnesses giving evidence to the committee are protected by parliamentary privilege and that any act which may disadvantage witness on account of their evidence is a breach of privilege and may be treated by the parliament as a contempt. It is also a contempt to give false and misleading evidence to a committee. Witnesses should be aware that if, in the giving of their evidence, they make adverse comment about another individual or organisation, that individual or organisation will be made aware of the comment and given a reasonable opportunity to respond to the committee. The committee prefers to hear evidence in public, but we may agree to take evidence confidentially. The committee may still publish confidential evidence at a later date, but we would consult the witnesses concerned before doing this.

[1.48 pm]

BROADBENT, Mr John Stanley, Head of Domestic Markets Department, Reserve Bank of Australia

DEBELLE, Dr Guy Lawrence Geoffrey, Assistant Governor, Financial Markets, Reserve Bank of Australia

CHAIRMAN—Welcome. I invite either or both of you to make some opening remarks.

Dr Debelle—Just by way of introduction I will repeat the main conclusions from the front page of our submission. We make four main points. Firstly, lending to small business increased slightly over 2009 and 2010, after growing steadily over the decade prior to that. The slowdown in growth in the most recent years reflects both reduced demand from businesses and a general tightening in banks' lending standards.

The second point we make in our submission is that higher funding costs and a reassessment of risk have resulted in an increase in the spread between the rates that lenders charge on loans and the cash rate. The Reserve Bank Board, as it has said on a number of occasions, has taken this into account in its monetary policy decisions.

Thirdly, lending fees have risen, though for most businesses these represent only a small part of the overall cost of a loan. But fees charged on deposit accounts businesses have actually fallen as banks have competed aggressively for that sort of product.

Finally, competition in the small business lending market eased following the onset of the financial crisis, but there are some early signs that competitive pressures are again beginning to intensify in some segments of the business lending market.

We go into those points in more detail in the submission.

CHAIRMAN—Thank you. In your submission you talk about a whole range of issues, mostly about market forces around what has taken place. Is there a good measure of determining, or a way of determining, whether it is more difficult today for small and medium enterprises to access finance in particular areas? Are particular things happening in the market today which perhaps should have ameliorated by now, coming out of the GFC?

Dr Debelle—As I just said, we are seeing some signs that banks are looking to compete more aggressively for small business and I think, if anything, over the last week or two—at least on the rhetoric side—that has probably ramped up, with banks looking to lend more. If you think about where things were in 2007, the standards were reasonably easy. Obviously they tightened up a lot over the subsequent couple of years, but now there does seem to be some sign that banks are willing to lend a bit more. That does not mean we are back to where we were in 2007, but it would seem to have passed the peak.

CHAIRMAN—A number of submitters have put to us that finance was just too easy to get pre the GFC. Could you give us some more insight into whether the RBA has a similar view and why that might have been the case?

Dr Debelle—I would not put it quite that way, but risk margins were low by 2007 across a whole range of products including business 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. Obviously credit was pretty easy in the period before the financial crisis and, as I said, it was mostly reflected in a compression in pricing of risk across a vast range of products, including small business.

CHAIRMAN—It certainly makes sense and there seems to be some evidence in individual lender policies that it allowed there to be a greater level of risk taken. We have also seen in graphs that in fact it has not really changed, that the amount of money being lent is pretty much the same. There certainly was a period through the GFC where that slowed, but we are back at the same levels of lending. There seems to be a misfit somewhere in terms of the pre-GFC environment and now. If policies have changed, if the risk levels have changed, and the amount of finance that is available, is it because it is right across the board or is it in particular sectors of SMEs?

Dr Debelle—The nominal economy has grown in the last couple of years. In other circumstances you would have expected credit to have risen, and basically it has gone sideways to slightly up. There is less credit out there, at least on this business side, as a share of the economy than there was three years ago. There are some sectors which are seeing more restraint in terms of lenders' willingness to lend to them, which we have remarked on a few times, including related to commercial property—which, depending on how you want to look at it, is not necessarily a small-business issue.

CHAIRMAN—There are distinctly different markets that have found it more difficult coming out of the GFC. Is that for a number of reasons? Is there less competition? Are fewer people prepared to lend? Is it now an appropriate setting in terms of who should have access to funds and who perhaps should not have as much access?

Dr Debelle—There are some people who are not around now who were around a few years ago. That is at the margin, not in the main; obviously the main providers of credit are still out there. It is difficult to say there is a 'right' level of credit provision out there that you can work out. It is not just the quantity which has changed; it is the price which has changed too. So when people talk about credit being tight, sometimes they are talking about the price and sometimes they are talking about how easy it is to actually borrow.

CHAIRMAN—Has there been much restructuring of finance so that people who are currently in a position with a bank or lender are having their conditions changed on existing loans? Do you have much evidence of that type of restructuring where existing loans were changed to reflect—

Dr Debelle—Interest rates have changed, which happens regularly.

CHAIRMAN—I meant more terms and conditions, revaluations of assets—a material change in the terms and conditions around current loans.

Mr Broadbent—We have really only had anecdotes. There has not been data available that would allow us to easily see one change from the other. A lot of it just comes from the view that banks tend to behave quite cyclically and so 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.

Dr Debelle—We have a regular meeting with small businesses at which we ask these questions. Over the last couple of years they have talked about tightening of standards and having to produce more documentation—more cash-flow projections, more profit and loss projections et cetera—than they had to previously.

CHAIRMAN—So you are saying that there is no data on whether there is any material change in the conditions for people who are already in the market?

Mr Broadbent—I think the material change for them is that banks typically have not looked to reduce their outstandings. What they may have done for some businesses is reassess the size of their facility—so the facility would be able to be borrowed against but the business keeps that as an uncommitted facility. They may have repriced that or they may have actually looked for additional documentation to ensure that the banks are content to hold that size of facility out there. Again, these are anecdotes that you hear, and we have heard them both from bankers and from small business people as well.

Dr Debelle—What you are talking about is inherently unmeasurable. You can go on asking people, but it is not something that you can really get a firm handle on. One thing we are able to get a firm handle on is how much lending actually is taking place and also at what price that lending takes place.

CHAIRMAN—So, in an overall picture, you know how much is out there and how much has been—the big numbers. But, in slicing that down to give us some quality information, that is not available, particularly in terms of financing or lending arrangements.

Dr Debelle—No, not that we are aware of.

Senator CORMANN—May I ask a quick question in relation to your picture of the rates and the prices being charged out there. Have you got a view as to whether the current rates available for small and medium-sized enterprise directed loans are appropriate?

Dr Debelle—I do not think we could comment on whether they are appropriate. Obviously, the board takes them into account in its setting of monetary policy.

Senator CORMANN—You do not have a view, given everything you know about the market, about whether they are pitched at the right level?

Dr Debelle—No. I do not think that is something we would have a particularly strong view on.

CHAIRMAN—What we have been hearing anecdotally, and I suppose the RBA has been hearing similar things, is that some people's finances have been rearranged by banks and, through that rearrangement, they have been compelled to reorder or rewrite loans and therefore incur new fees—perhaps mortgage insurance; depending on what type of loan it was, for a small enterprise it may actually be through some sort of a mortgage or a second mortgage—and that through this process there is actually significant cost to a borrower. Have you been hearing similar stories?

Dr Debelle—Have we heard those stories? Yes, we have. How widespread it is is difficult to say. You will either have to ask a lot of small businesses or ask the banks, really.

CHAIRMAN—And we will, of course.

Dr Debelle—That is right. They can probably answer that better than we can.

CHAIRMAN—In terms of banking policy, again from the perspective of the Reserve Bank, there is nothing preventing banks on the basis of any condition just changing a particular finance arrangement because of change in market conditions?

Dr Debelle—That is not something which is at all in our jurisdiction, really. Obviously we monitor what the lending rates are and how restrictive conditions are in our assessment of what is going on in the economy, but it is not something we have any control over.

CHAIRMAN—Does the Reserve Bank monitor particular types of lending such as credit card lending or what is defined roughly as 'small business lending'—each segment?

Dr Debelle—Yes. We do the best we can with what is available. As we said in our submission, it is partly because it is sometimes difficult to define what a small business actually is. We have a few different ways of looking at small business lending—one is by the size of the loan and another is by whether it is an incorporated or unincorporated enterprise—and you get roughly the same picture on either. That is on the quantity side. On the price side, we have a pretty good handle on what the rates are on the different sorts of products that are offered—whether it is a residentially secured facility, a line of credit or whatever.

CHAIRMAN—Has there been any material change in that or does it seem to be pretty consistent?

Dr Debelle—As we say in our submission, there has been a repricing of those loans upwards over the last three or four years, about half of which reflected a rise in funding costs and about half of which reflected a repricing of risk.

CHAIRMAN—Where I am leading with this question is whether there has been a shift in credit from a particular type of credit to another type of credit and whether there is any sort of discernible difference. So there is more a change in the type of financing that is available—for example, from a particular type of loan: overdrafts to credit cards or things like that.

Dr Debelle—I do not think we can disaggregate credit card data as to whether it is a small business or a regular person, but the credit card data has actually been going backwards more

than anything. The only thing you can tell when you break up the data is that lending to large businesses has come down and lending to small businesses, as I said earlier, has been sideways to up. Within the different facilities I do not think we have anything about whether there has been much of a compositional shift in the exact nature of the loan.

CHAIRMAN—Regarding your expectations of requirements under the new Basel III, do you see that having any significant impact on top of where we are already in terms of Basel II?

Dr Debelle—You can probably ask Wayne and Graham from APRA, who are sitting behind us, that question shortly. They are best able to answer that. From 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.

CHAIRMAN—There is a view that the Australian Chamber of Commerce and Industry and the NSW Business Chamber have—and a number of people have recommended this—which is that the government look at guaranteeing small business loans in some form. Does the RBA have any particular view on that?

Dr Debelle—That has been tried in a number of other countries—the UK, the US, Canada. We have had a look at how those schemes have worked, and they have had mixed success. In particular, the UK one, which was put in two or three years ago, has not done all that much in the end. We have had a bit of a look at them, but by and large it seems that the risk protection that the government ultimately wants means that the loan does not really end up being any cheaper for the borrower than if they had just borrowed from the bank in the first place. The evidence that we have, just looking at what happened in those other jurisdictions, is that it was not particularly helpful.

Mr Broadbent—The other issue, which was not mentioned in the other submissions, is the actual pricing, the premium charged on the guaranteed loans. They are quite expensive. Typically the borrowers are charged around two per cent to three per cent of the outstanding. When you compare that with the actual small business rate here, it would be a very large slice of what small business rates otherwise are. Our view is that there is a true moral hazard in guaranteeing to any sector, in fact—not just small business.

CHAIRMAN—Do you believe there is a distortion in the market, given that there is a fair price differential between a mortgage type loan and a small business loan? Do you think that differential is about right?

Dr Debelle—We went into that in a little bit of detail in our submission. Without saying whether that is exactly right, the consideration you have to take into account is that small business loans are more risky. The bank has the same protection behind it, which is the house or property, but a small business loan is more risky, and recovery rates, historically, on small business loans are less than they are on regular housing loans. That difference between the risk and the loss, given default, is reflected in the price. Whether it is exactly right is hard to tell, but that explains why there is a difference.

CHAIRMAN—Does that create a distortion, though? We have heard, again anecdotally, and I think we would all agree it would be the case in some circumstances that, rather than seeking a small business loan of some description, people would go for some other product that is cheaper.

Dr Debelle—If you are looking to take out a small business loan, a residentially secured loan is generally the cheapest way to do it.

CHAIRMAN—So there is no distortion in the market because conditions might be different between one loan and another? Is there the need for a closer look at the particular part of the market where there might need to be some reform or a need to make clearer what the loan is actually for?

Dr Debelle—That would not be the sense I would get, no. The different products available for small business are reasonably clear. The banks are reasonably aware of the purpose for which they are lending the money. That is not the sense I would have.

CHAIRMAN—I was thinking more in terms of whether people have overdrafts or whether they use a credit card facility or whether—

Dr Debelle—A credit card facility is not going to get you too far in running a small business, I would have thought. You need a little more credit available than what you can run up on your credit card. Relative to what you can get with a residentially secured loan, that is obviously considerably less.

CHAIRMAN—It is not your view that that is significant in any way—that it either distorts the market or limits access to funds?

Dr Debelle—Not that we are aware of.

CHAIRMAN—Westpac and the NSW Business Chamber have recommended that the government continue its investment in residential mortgage backed securities. Do you have a view on that in terms of access to funds and liquidity in the market?

Dr Debelle—When Glenn and I appeared before some of your colleagues on banking competition just before Christmas there were a lot of questions on that. What we said at the time—and it was only three months ago, so we have not changed our minds on that yet—is that, yes, we thought that was a reasonable proposition to support the mortgage backed security market.

CHAIRMAN—Going back to one of the earlier questions around particular segments of the market, property and property developers et cetera, there seem to be very different conditions around lending for property. Is it simply that it is riskier market for lenders to be in and they are not prepared to be in that market at all or is it the case that it is too expensive in terms of borrowing—

Dr Debelle—I think the banks made an assessment, going back a couple of years, that they had too large a share of property related loans in their portfolios, and that segment of the market has certainly seen the tightest conditions. We have heard that repeatedly and still hear it. I am not

sure whether we are there yet—you would be better to ask the banks this than us—but, when the banks are comfortable with commercial property again, one would assume those lending standards would ease. There was a general assessment by basically every bank that they had too much exposure to property related lending—hence the tightness in lending conditions there.

CHAIRMAN—It seems almost counterintuitive. We are continually given data and figures that show there is a shortfall of up to 180,000 homes and a shortfall every year of new construction of 50,000, 60,000 or even 80,000. It seems counterintuitive that at one end of the market there would be strong need, and a strong demand coming out of that need, and that at the other end of the market those who provide funding would be reluctant to provide it.

Dr Debelle—I think it reflects the exposure that the banks have, including to the loans they have on their books where the property is not where the demand necessarily is. While they have got that exposure—I do not disagree with everything else you have said—that is contributing to their reluctance to lend.

CHAIRMAN—Has that created an opportunity somewhere for other lenders?

Dr Debelle—We are seeing more equity-like funding for commercial properties. I would not say it is big yet, but you are seeing it for exactly the reasons you just said. Because people can see there are some decent returns to be had there, you are seeing finance provided which has much more of an equity feel to it than a credit feel.

Mr Broadbent—I think that the general message that we take out of it is simply that when the property market started to turn down it was too leveraged. Therefore, you just need time to get it back to a more balanced equity financing to debt financing than you would otherwise have. The fact that it is not there yet simply means that, as Guy said, the lending standards and the like continue to act as a brake on lending until there is enough equity that will satisfy a bank to lend out to that entity.

CHAIRMAN—Is the limit on smaller enterprises and the types of finance they can get compared to a larger organisation a problem in itself?

Dr Debelle—I am not quite sure exactly what you are getting at with that question.

CHAIRMAN—Small business is very limited compared to large organisations in the methods by which it can fund its enterprise to either grow, fund expansion or whatever it might be.

Dr Debelle—Small businesses, obviously, cannot raise equity like a large corporate can—not like a BHP, where you can raise money in your own name. So, no. Do they have fewer avenues available for financing? Yes, they do, and it has ever been thus. It reflects the nature of the beast, really. They cannot raise equity, given they are small, so that does make them much more bank reliant.

CHAIRMAN—So there is limited capacity for any particular change in that area?

Dr Debelle—Yes. I think it just reflects the underlying reality.

CHAIRMAN—As there are no further questions from my colleagues, thank you very much for your submission and for your time.

[2.16 pm]

GADIEL, Mr Aaron, Chief Executive Officer, Urban Taskforce Australia

CHAIRMAN—Welcome. Would you like to make some opening remarks?

Mr Gadiel—Yes, thank you. The Urban Taskforce Australia is a non-profit organisation representing Australia's property developers and equity financiers. We provide a forum for people involved in the development and planning of the urban environment to engage in constructive dialogue with both the government and the community. We are here today because there is a serious issue with the financing of urban development activity. It has been identified in numerous independent and government-sponsored reports, and is restricting the ability of our community to get the housing it needs and also restricting investment in new business premises and workplaces. Despite the popular imagery, most property developers are firms with fewer than 20 employees. Most property development is carried out by small businesses, and they are the lifeblood of the urban development industry. Of course, their activity hooks through to so many other small businesses, including builders, architects, town planners, building suppliers and tradespeople.

In the three years from June 2007 the real inflation-adjusted, per capita annual spend on new private housing declined by 6.2 per cent. If you break up those figures between detached housing and higher density residential development, you can see that the detached housing numbers have fallen in real terms by 3.9 per cent, while spending on apartments and town houses has declined by 11.3 per cent. The difference is important. The Australian Bureau of Statistics detached housing numbers include knockdown-rebuilds by mum and dad homeowners, who are not impacted by problems that small businesses face in accessing bank finance. However, almost without exception, higher density urban development, whether it be terraces, town houses or apartments, is carried out by businesses seeking to borrow from banks and develop. I would suggest to the committee that the 11 per cent figure—the 11 per cent decline in the real inflation adjusted, per capita annual spend on new private housing—is typical of the true state of the commercial side of new residential development supply. These figures are also matched in the field of non-residential construction. Like higher density residential development, the development of new business premises is dependent on commercial mortgages or finance. The real per capita of the value of private sector non-residential building work has plummeted by 13.6 per cent in the three years to June 2010.

The consequences of this lack of urban development are significant. I appreciate the committee may not necessarily be concerned whether one particular group of businesses does better than another group of businesses, and I will not argue it in those terms. My concern is what is happening to the broader community and the broader economy. The federal government's Housing Supply Council said that at June 2009 we had a cumulative shortfall in housing of 178,000 dwellings. Based on their figures it would presently be in the order of 200,000 dwellings, to reach a shortfall of 308,000 by 2014.

The National Housing Supply Council, a government body, has said this is, in part, a consequence of a tightening of finance to developers that has occurred since the global financial

crisis began in the second half of 2007. In our view, there is not a sufficiently deep or competitive market for commercial mortgages to property developers. The number of lending institutions competing for the business of property developers has shrunk quite considerably and that is, in part, as a result of the ACCC's decisions to approve a take-over of Bankwest and St George. The remaining lenders have nearly tripled their interest-rate margin. It used to be around one per cent; it is now 2.5 to three per cent. Loan-to-value ratios are much higher than they used to be—and that is only half the story. Looking at loan devaluations, they used to be lending up to 70 per cent of a property's value; now it is 55 per cent of a property's value. We have seen a significant lack of competition between lenders on the terms and nature of their agreement. Obviously, this is of concern to developers but it should be of concern to the broader community.

The COAG Reform Council in its report on affordable housing indicates there is strong evidence that the disconnect between supply and demand in the housing market is resulting in a shortage of supply and that has led to increased housing costs. It quotes a series of statistics which show the social impacts of that, including a figure that just 28 per cent of homes sold, Australia-wide, are available to moderate-income households. The OECD has published a report, specifically on Australia, observing that a rising share of the population is being priced out of the housing market. It nominated strong housing markets as one of the main medium-term risks to the economy, and the OECD said that the government should be taking measures to stimulate supply.

We would urge the federal government, in the context of the finance constraints that we are observing, to consider measures such as a mandate for superannuation funds to expand the range of institutions and the pool of funds available to extend commercial mortgages to the property development sector. I am happy to take any questions.

CHAIRMAN—Thank you very much and thank you for the detailed submission and your introductory remarks. I asked the Reserve Bank of Australia this question and I am interested in your view: how do you reconcile this sort of conundrum, this huge shortfall of housing, that we all agree exists? You said, 178,000—today's numbers are probably substantially higher. How do you reconcile that and the fact that there are fewer funds available and less interest from lenders to get into a market where there is such huge demand? How does that play out?

Mr Gadiel—There are two intervening factors that stop our housing market operating efficiently: government infrastructure investment and town planning controls. Those two interventions make the process of developing new housing riskier than it otherwise would have been. Looking at greenfield housing development, if the success of your project, which might have a five-, 10- or 15-year time frame, is dependent on government making infrastructure investments in accordance with its press releases—no disrespect to any particular government—there is a huge risk that those press releases will never materialise, or what is promised will never materialise. In an in-fill environment you might have land that is zoned for apartment development, high density development, but nonetheless be unable to secure approvals in a timely way. The costs that are there and the regulatory costs of doing even the routine business of development are very significant and there can be a disconnect. People might need the housing. The underlying demand might be very strong if the community is to maintain its access to housing but, in reality, the community might not be able to afford housing in some instances, in some areas, because the planning system effectively puts a floor price on local housing supply. Even though the underlying demand is very strong, nonetheless the risk is: will households be

able to afford the full cost of housing? That can be the difficulty for developers and it can be the difficulty for the financiers.

It is very important to understand that we are in a tight credit rationed environment for property development, so what we are seeing is only the lowest risk developments securing bank finance. The Reserve Bank will say, ‘This is a good thing. We are getting our banking sector to focus on reducing its risk profile.’ The Australian banking sector has not copped the sorts of losses on property development that we see in other countries, because the Australian banking sector always took a reasonably conservative approach in these areas. The reason it is so tight now is not that there was a fundamental problem with what was going on before in Australia but simply that there is far less money available, and when there is far less money available, clearly, you allocate the money to the lowest risk propositions first.

CHAIRMAN—There still seem to be some missing parts. That explains, perhaps, to some extent why that might be the case and why financing is so difficult for property development. But even if it is the case that it is an affordability issue, and other issues, it probably only explains it in terms of owner-occupiers, perhaps. For example, the rental market can be and is subsidised through rental assistance, so the government does assist in those areas. If the underlying demand is there and the providers’ supplies are there, surely there would be finance available—unless they are really risky; unless there are other mitigating circumstances which mean that that particular segment of the market is treated ‘appropriately’, let us say, in terms of what it does. Is that maybe closer to some of the underlying issues rather than just saying things in media releases about infrastructure? It is always going to be an issue; there are always infrastructure issues. It cannot just be that. It cannot just be that banks will not lend to a proper developer because they are not certain about what community infrastructure there will be.

Mr Gadiel—You are right. It cannot just be that, and I will expand a little bit further. Firstly, I would say that the fact that the Commonwealth pays rent subsidies is largely not relevant. Commonwealth rent assistance is in the main extremely tightly targeted, unlike in some other countries. Commonwealth rent assistance is targeted at the very poorest people in our communities and, as a result, generally those people live in quite old housing stock; very rarely will they live in new housing stock. The only exception is under the federal government’s National Rental Affordability Scheme, but that is a very modest scheme and, whilst it is not as tightly targeted in terms of income—in fact it supports new housing construction—in the scheme of things it is a drop in the ocean.

But you raise a really good point. If I take where we are at the moment, Sydney, I have recently been speaking to a property developer who has secured the ability to acquire a site in inner suburban Sydney within five kilometres of the CBD. It is an excellent site. In reality he will have no difficulty selling the apartments. There is a very significant shortfall in dwellings in the price range he will be looking to sell in, which is in the $600,000 range. Probably the biggest risks he will have will be the approvals process and the amount of time he will be in it. Bear in mind, if he can get an approval within six months the project should be quite profitable; but he could get an approval in three years, in which case he will be making a loss. So there is a risk for him there. That is probably the riskiest part. Controlling the construction costs and selling are probably not a problem.

However, the bank nonetheless will say to him, 'You're not a name brand property developer. You're not a listed company. You're not on the BRW rich list. You're not known to us. So we are not going to extend to you, in a credit-rationing environment, the most favourable terms.' The most favourable terms would include, for instance, a requirement that he do presales of, say, 70 per cent. They might say, 'Because you're not known to us, we will require you to have 100 per cent presales before we will approve the go-ahead on the construction facility for your apartments.' That does not mean 100 per cent of the dwellings; it means he must have gross sales that are equivalent to 100 per cent of the development costs of his unit, which might equate to a majority of the units being sold.

In many instances that can be very difficult to achieve, to sell off the plan the majority of the dwellings in a relatively short time frame, because people only buy dwellings off the plan for a period. If you have been trying to sell dwellings off the plan for a year people might get the sense that this project will never happen. To try and sell that many units off the plan, even in a strong market, can be difficult. As it turns out, in Sydney we have had some assistance in the last seven or eight months because the state government has put in place a temporary stamp duty concession for sales off the plan. Victoria has a permanent stamp duty concession for sales off the plan, which is one of the reasons that the Victorian apartment market barely took a dip during the whole global financial crisis. Nonetheless, it is a tall order to meet. This sort of transactional issue creates an ongoing finance problem for developers. Bear in mind, the idea that you would have to do 100 per cent presales to secure finance, when you do not, yourself, have a bad credit history, was almost unheard of prior to 2007.

CHAIRMAN—Do you think that is an appropriate setting for lenders? Has the pendulum swung too far against property developers?

Mr Gadiel—The lenders are just rationing the credit available to them. At a global level, within each of the incumbent financial institutions, they have only allocated X amount of their capital to property development. They are making commercial decisions based on where they can get the best return and what a good mix is for them. The only problem is that there is a limited number of institutions, so effectively the pool of money available for this area of business activity is constrained, and then they are rationing it. The reality is, yes, it is a slightly higher risk to go to this person who is not on the *BRW* rich list; but, nonetheless, the fundamentals of their project are extremely strong. While there is an appreciable risk, it should not be a risk that is so high that it should disqualify them from getting funding on commercial terms. But the reality is that it is at the moment, merely because there are not enough lenders competing in the market. What has happened is that because of the ripple effect of the global financial crisis there have been fundamental changes in the way financial services are provided and it does not seem to be solving itself. In fact, we cannot foresee it solving itself. It is going to require proactive public policy action, and the longer this policy action is delayed, the longer this problem will deteriorate.

CHAIRMAN—I understand what you are saying, that perhaps one of the biggest problems is a lack of funds—the pie is not big enough. Would it not be a matter—if it is, like you say, a completely viable, sound, properly risk-weighted project—that a funder comes in from somewhere? Isn't there an opening in the market for somebody to come in and provide the funding, or is that just not realistic in today's market?

Mr Gadiel—There is an opening. There are plenty of people who have money and who could provide it. For instance, take the superannuation funds: at the moment, they have exposure to the risks of property development because they hold shares in listed property development entities. That is exposure on equity property development. It is a higher risk exposure than exposure on senior debt, effectively a first mortgage, which is what normal property development lending is. So a superannuation fund will take an equity risk on property development but at the moment does not get involved in being a senior debt funder of property development, even though that represents a low-risk proposition. When I talk to people on the finance side and ask, 'Why is this so?', in the end it seems to come down to 'that is just the habit of the funds'. They have not been used to doing that, they have not been thinking about it and it is not an area of business that they know about. Will they wake up to themselves one day and say: 'Hey, hold on, we're taking equity risk on property development. Why don't we make more money, take a lower risk proposition and get in the senior debt funding thing where we've got full interest cover, we're fully secured against land—which is very conservatively valued these days—and enjoy some of that return for our members?' At this stage there is no sign of the super funds doing it themselves. For us it seems there needs to be some public policy incentives or signals to encourage them to look at that area.

CHAIRMAN—Your organisation has been doing work in that area—talking to funds?

Mr Gadiel—Absolutely. We are always doing that.

CHAIRMAN—What sort of response do you get? What is their explanation as to why they are not interested in that particular area?

Mr Gadiel—They do not particularly understand it. The people who are managing the funds do not have any expertise in that area—it is something they view as going to the banks. They do sometimes say they are interested in getting into property, but what they mean is that they are looking for a single, very large transaction—where somebody might go and buy an iconic office tower somewhere and they will stand behind the transaction. That is not really the same thing. In fact, often that transaction would not be important in getting the tower built, it would just help somebody take ownership of it. At the moment, that money is largely not being motivated to produce and add to the productive needs of our economy through improving the value of land property assets.

CHAIRMAN—We heard from the Reserve Bank earlier, and I am not sure if you were present when they were here. Their view was that, on paper, at least in terms of total borrowings and money available, there is no real distinctive difference over a period of time. Certainly there was less competition and less funds available for a period but that has pretty well been restored so that the post GFC environment has quickly restored itself in terms of funds that are available and lending, certainly in terms of data that is available to us. There has been more of a drop in large organisations—large enterprise having access to funds rather than small to medium. Certainly you are saying that that is not some you are seeing reflected in your part of the world.

Mr Gadiel—No, not in our industry. That is definitely not the case. I can swear on a stack of bibles that that is not the case. In our industry what we observe is that there is credit rationing going on. So the businesses that have got a personal and deep relationships with their banks, the businesses whose business model the banks can trust completely—and, not surprisingly, the

banks view those people as lower risk—will be able to get access to finance. But a small business person who, for instance, wants to secure a nonrecourse loan—a loan that stands on its own merits based on the land it is secured against—would have Buckley's. It used to be that every loan was nonrecourse; these days they are all recourse. Even then, the small businesses in our sector are having a very difficult time because they do not have those long-lasting and deep relationships with the banks that the larger businesses in our sector do. Do not get me wrong, the larger businesses in our sector do not have it easy either; but they are able to get finance and some things are happening. For the small businesses, it is just very difficult.

CHAIRMAN—What do you see as the core work that needs to be done in your particular sector to start to shift that reluctance of lenders?

Mr Gadiel—The outcome that we need really is for there to be more competition. We miss having Bankwest, St George, Suncorp and more commercial mortgage funds out there competing with the majors. That is absent. We miss it. It is not there anymore. That is the outcome we need to have: more competition.

CHAIRMAN—I accept that—more competition is always going to be a better thing. But does that at the same time mean that Suncorp, Bankwest and the others that you mentioned would be prepared to take on more risk? Is it really a case of just more players or are they all playing by the same rules, which is that they have re-evaluated risk and are dealing with risk appropriately given the current market? So is it just a case of whether you have got 20 banks or lenders or second-tier lenders or 40? What difference does it make if they are all playing by the same rules?

Mr Gadiel—When I talk off the record to the bankers who are in the property lending part of the banks, they tell me that there is a lot more lending that they think should be done and can be done—that, whilst it is a gradient slightly higher in risk in the scheme of things, it is a no-brainer. But when they put those forward, essentially the capital rationing committees within the banks just say: 'Look, this is the allocation of capital that your division is getting. It is not about the fact that you are presenting higher risk propositions to us; we simply are not prepared to allocate anymore of the bank's capital to that component of the business.'

Those decisions have been made for the interests of the whole bank and the mix they want to have. It is not about saying, 'You're bringing to us loans that are too risky.' This is before that even happens. The constant feedback that we get from the bankers—off the record, because they are not able to speak about this on the record; they are not authorised to—is that more global decisions are made within banks about the amount of money they are going to extend. It is reasonable, by the way, that individual financial institutions make decisions that quarantine their exposure to different segments. The difficulty we have is that there are not enough financial institutions. Those banks can know that they are able to quarantine it can still be assured of getting the cream, as they are, of the senior debt funding for property development, because there is no-one else in the marketplace.

By the way, you might say, 'Well, look, what you are arguing for, Mr Gadiel, is that our financial sector be exposed to even greater risk, and may we go the way of Ireland.' But, look, you can always tighten up standards. You could halve the credit rationing pool and you could mandate the interest cover that senior debt will require for commercial development. Before 2007, if you were developing commercial premises, you would have to show interest cover of

100 per cent. That is, you have to show that the revenue coming in would meet 100 per cent of the interest costs. These days it can range between 130 per cent and 170 per cent. That is to protect against the revenue suddenly halving or not being able to get tenants. But you could make that 500 per cent.

CHAIRMAN—But is this something that government should interfere with or something that should properly be left to the market?

Mr Gadiel—Government certainly should not come in and dictate the lending standards. That has got to be left to the market, absolutely. What government should be trying to do is create an environment where there are competitors. They are doing this, I note, for residential home lending. Government is intervening, deliberately, to sell securities for the purposes of ensuring that there are non-bank competitors lined up against the major banks. That is an appropriate public policy response to try to ensure competition. But we also need to ensure competition on the other side of that, which is the supply of new homes.

The OECD looking at Australia’s housing supply says that our housing supply is not responsive enough to price signals. Our prices are rising more rapidly than in many other countries for home prices because our housing supply is not responsive. They are saying that that is creating a macroeconomic risk for the Australian economy. The Reserve Bank itself has said that it is adjusting interest rates up to dampen home prices, so we are having higher interest rates than we otherwise would be because of home price inflation, or the risk of it. So there are powerful reasons that have got nothing to do with helping property developers, because I appreciate that is not politically popular, why it is in the government’s interests to support and facilitate competition in the provision of commercial mortgages to the property development sector.

Senator STEPHENS—Can I go back to your earlier evidence. You said that the government in New South Wales had taken some action and also in Victoria. What is happening in other states and to what extent are your members concerned about what is happening in other states?

Mr Gadiel—We were very concerned. Queensland is obviously difficulties now because of floods, but even before that Queensland has been having a horrific time with construction starts, particularly for medium- and high-density dwellings. In part that is because of an overbuild in the Gold Coast. Nonetheless, generally across Queensland, even if you isolate the Gold Coast, there has been a fundamental problem and it has been very difficult for developers to get finance there.

The situation is not as strong as we would like or should be the case in Western Australia, which is another important growth market. If you think about Australia’s big areas of growth—economic growth and population growth—we are talking about Victoria, in particular Melbourne; South-East Queensland; Sydney; and Perth. In Sydney we have got a bit of a surge on at the moment—we will see how long that lasts—because of the state government’s measures their. Victoria has done well consistently, because they have permanent arrangements there. In Western Australia it is not strong enough by any means compared to the underlying demand and economic needs. Queensland has been very difficult—prior to the floods in the last six months. I suppose the silver lining of the floods is the construction workforce in Queensland will have a lot of work ahead of them, but that is building replacement stock, not new stock. There is going

to be a fundamental problem in Queensland for some time to come because the lack of new stock is going to hinder their population growth, and that is going to hinder their broader economic activity.

CHAIRMAN—How much impact has the re-evaluation or reassessment of assets, coming out of the GFC, had on the property sector?

Mr Gadiel—I am glad you raised that, because that is a significant issue. It is worth noting one of the other symbols of the lack of competition we have in the banking system is how land valuations are done. Before, we had very many financial institutions, who are effectively the paymasters or the employers of land valuers because when loans are taken out they require valuations to be done. Certainly the punter or the borrower pays for it, but they end up using a valuer on the bank's panel. So if the bank were to remove—

CHAIRMAN—It would make sense, though, wouldn't it? You would be using your own valuer and not somebody else's.

Mr Gadiel—That is right. There used to be a lot more flexibility about this. What we have found is that banks in the last few years have been using their increased market power to effectively require you to use a small range of national valuers. So they are killing off the small side of the valuation industry—the small businesses and the medium-sized businesses. That gives the banks a greater ability to influence the way the valuers carry out their business. For instance, I had a developer tell me that the difference between the valuation given by a national bank accredited valuer and that of another very respected valuer with 30 years experience in the industry, only 18 months beforehand, was a 60 per cent difference. That is, the bank's valuer ascribed the value of the land as 60 per cent less. We find extreme conservatism in land valuations now from the bank's preferred valuers, and a lot of that conservatism is not justified by reference to what goes on in the property market.

CHAIRMAN—Is this a new phenomenon?

Mr Gadiel—Yes, this is since 2007 and particularly in the last two years—absolutely.

CHAIRMAN—What purpose does it serve for the bank? Can you describe that to us?

Mr Gadiel—Among other things, it hides the impact of the adjustment of loan to value ratios. The bank obviously has a loan to value ratio. It only lends so much against the security that is offered. Loan to value ratios used to be around 70 per cent of the property value for a commercial mortgage; these days it is 50 to 60 per cent. That is a big adjustment, but it does not sound like a big adjustment—70 down to 50 or 60. But in fact the adjustment is much, much bigger—

CHAIRMAN—Because of the valuations.

Mr Gadiel—because the valuations are massively down on where they were. Yes, some land value has come down in some areas—

CHAIRMAN—Isn't it just reflective of the market, though, in particular markets? There are some big shifts, especially in some overheated markets.

Mr Gadiel—We have not seen the sale of the final end property that we are developing shift like that. We are talking about development sites that are suitable for building low-density housing, potentially some higher density housing, retirement villages. The end property value is more or less in the same ballpark as where it was three years ago, and in some instances it is higher. Yet the banks are now rating the raw development site far, far lower than they were before. There was some overvaluation of some land types in some areas. A proper valuation can distinguish between those areas where there was overvaluation and where there was not. What we are seeing is across-the-board bank sponsored devaluations that are not reflective of the market reality. It is really just a way of covering up the fact that, effectively, loan to value ratios have dropped much lower. So when the Reserve Bank come in they say, 'Well, it's not that different,' because they are just looking at those controls. They are not looking at what has happened with the much more conservative approach that has been taken on land valuation.

Senator CORMANN—In relation to this, isn't it that the risk profile of property investment has increased compared with where it was, and isn't that why access to finance is fundamentally more difficult for your sector?

Mr Gadiel—I do not know that the risk profile for property development in key markets in Australia has increased any more than it ever was. Certainly if you are developing for Perth, if you are developing for Melbourne, if you are developing for Sydney, these are very robust markets. I think there is some confusion in the more ill-informed people internationally who might not be familiar with it. They have trouble distinguishing between Buffalo and Melbourne or Toledo and Sydney. Australia's growth areas are big cities. They are big cities by Australian standards but they are also big cities by American standards. The American subprime crisis and the Irish property crisis are in more peripheral urban centres than the centres where property development takes place in Australia. There are some exceptions. The Gold Coast has clearly got some particular challenges, but generally Australia is not the Gold Coast.

Senator CORMANN—There is at least a lot of debate as to whether property values are going to be stable at current levels moving forward—even now, when we are past the global economic downturn period. There does not seem to be a high level of confidence that property values are at the right level. Isn't that part of the reason why anybody considering providing finance will take a more cautious approach to investment in that sector?

Mr Gadiel—The more that people know about it the less they have that concern. I note the Governor of the Reserve Bank this week explained that he had absolutely no concerns. I think he was saying there were 100 other things he would be losing sleep before he would be losing sleep over this issue. In the last week we have seen people like those from the *Economist* magazine make statements about property valuation and its relationship to incomes in Australia. But I have to say these are very broadbrush statements. They are not a sustained analysis of what is actually going on in Australia.

Senator CORMANN—Being simplistic, if I were a lender and there was a dollar to be made by lending to the property development market, surely I would assess the level of risk and if there was a dollar to be made reasonably safely I would go that way. If I thought there were

more attractive propositions in other parts of the market I would go that way. In the context of the whole economy, hasn't your risk profile increased more than other sections of business?

Mr Gadiel—I am not sure that is the case. If you talk to the banks they will tell you that the suggestion that property is overvalued is an exaggeration and that it is not supported by the evidence. Many of them, like the Commonwealth Bank, have detailed roadshows internationally to try and demonstrate that to be the case. Banks are certainly saying there is a buck to be made in property development and they are lending for it. But they are also saying that there are bucks to be made in other sectors of the economy, too, and they want to lend for that. But they have got constraints on their capital, as any institution does. So the issue for us is that there are institutions who have capital and who at the moment because of tradition and custom and practice have made the decision to put their capital into passive property whenever they do property rather than develop and contribute to new productive property for the economy. I think there is a role for government in not dictating lending standards, not trying to force people to invest in things they do not want to invest in but in perhaps adjusting some policy settings so that it is a little bit more obvious to people like superannuation funds that there is an option for them. Bear in mind, super funds are exposed to greater risks when they buy into the units of a listed property trust, yet they are not willing to participate as a senior debt funder in significant scale to the same sector.

Senator CORMANN—In that context, you mentioned earlier that there are a smaller number of lenders who are able to provide the finance and they are rationing it. How do you think that should be opened up? Do you accept that there are going to be some limits on the amount of finance that will be available through the lending market?

Mr Gadiel—Oh yes, and there has always been limits and capital is always rationed. That is the business of economics: to work out how to ration our scarce resources among our various priorities.

Senator CORMANN—And you are competing for it.

Mr Gadiel—We are competing for it, absolutely. It seems to us that the problem can be, as the market does not always work efficiently, that there is a little bit of market failure going on here because government has allowed a number of lenders to be taken over by other lenders and that has created an uncompetitive market. So banks are able to ration and ration very tightly without any penalty because they are still guaranteed the cream of the industry because they are not facing competitors. Now government brought about this situation where it is a less competitive market by approving amalgamations, so we are looking to government to take some steps to try to recreate the competitive tension that used to be there.

Senator CORMANN—What options do your members have beyond the banks in accessing finance?

Mr Gadiel—These days there are a couple of other options, but it is not what it used to be. There are non-bank lenders like building societies, organisations like ING or AMP. There are mortgage trusts like the Challenger Howard mortgage trust. But it is not in any way the volume it was. By and large people find themselves largely limited to the majors, perhaps with some peripheral lending outside of that.

CHAIRMAN—Could it be the case that the markets made a determination about this particular sector? That they said, aside from just the limitation on funds that are available, there might also be a skills deficit, there might also be a capacity deficit or an experience deficit of individual players within that market being able to do what they do. That there is an assessment made by banks, by the market, by others that the skill levels, the experience levels and capacity levels are not as high as perhaps in other sectors?

Mr Gadiel—If there was a competitive market and the lending still was not happening, then I would agree with you that that would be the natural market process. And then I would be saying we need to find a way to tackle those issues because it is the public interest that we have a strong housing supply.

CHAIRMAN—But isn't there a perception issue as well that in the property sector there is just more risk?

Mr Gadiel—It cannot be any riskier than buying units in a listed property trust. Bear in mind we are talking about senior debt funding which is secured with more than 100 per cent interest cover if we are talking about commercial industrial development, or if it is residential development then with 70 per cent presales.

CHAIRMAN—But you are only looking at one particular segment when you talk about that, is it riskier than your trusts. Are you talking about superannuation funds? Is it too specific in just looking at that particular sector?

Mr Gadiel—Look at it like this. We have not seen any evidence that the projects that are missing out are that much riskier than the projects that are getting in. I again use my example of Sydney. If you have a site and you are able to go ahead with apartment development in Sydney, that is very low risk. There is a huge undersupply of apartments. You are going to achieve your sales. We have had feedback from people where half their development sold within a couple of months of marketing. So the idea that the banks then are excluding or slowing down some of that—it does not stand up to robust scrutiny, other than they are capital constrained. And, look, they can make so much money in property bond that they might be able to make more money lending to someone who wants to just own an existing office tower. The issue for government is that the changing of ownership of an existing office tower does not create that much for the economy, while the construction of new homes to meet underlying demand is good for the economy and is also good for social issues, it is good for solving our traffic congestion and good for providing affordable housing.

CHAIRMAN—What you describe in the example you used sounds like a very attractive investment. I am surprised people are not beating your door down to pour money in. It almost would sound like that, I am just wondering why there is not a rush on—people want to make money is a baseline for investing—if it is so attractive unless—

Mr Gadiel—When you say 'investing', it makes it sound like people doing equity investment. We do not have any trouble selling to investors, selling apartments in Sydney, for example, to investors at the end. In this case we have some equity lined up, someone who is willing to lose their house and their shorts. The bit in the middle is the senior debt funding, someone to come in and provide the loan for the construction facility. The difficulty is—yes it is a good proposition,

but there are pretty much four majors and a smattering of others in this marketplace and there is only so much they are able to do. So we need more people in the marketplace so that that gap can be filled. The reality is that, if you, Senator Ripoll—

Senator CORMANN—You have been promoted, Mr Chairman.

Mr Gadiel—Mr Ripoll might take the view that you like the sound of what I am saying and you want to go out and make an investment. What is the mechanism for you to get exposure to that senior debt funding? At the moment there is no mechanism. You cannot do the lending yourself. The only way you can get exposure to that is to buy shares in the bank. That is it. There is no mechanism. Your super fund is not taking any significant exposure there. You personally cannot do it. You can buy a developed unit once it is built, but there is not where the issue is. We do not have a lack of demand problem. We are not asking the government to go and create demand for the end product; we are confident the demand is there and is unmet. The problem is this transactional issue. And we are not asking for government for equity; we can cover the equity issue. The issue is the senior debt funding.

CHAIRMAN—Thanks. As I said, there are not enough lawyers and not enough banks. Thank you for your submission and your time.

Mr Gadiel—Thank you very much. I appreciate the opportunity.

[3.02 pm]

MOORE, Mr Andrew Geoffrey, Chief Operating Officer, St George Bank

TATE, Mr James Joseph, Chief Product Officer, Westpac Banking Corporation

CHAIRMAN—I welcome witnesses from Westpac. Thank you for coming and thank you for your submission. Do you have any opening remarks?

Mr Tate—I think most of what we want to say is covered fairly comprehensively in the submission. In relation to small business generally, it is a priority segment not only for Westpac but for all the major banks as well, I would suggest. Generally speaking, the exposure or the like we have taken in the past couple of years is to remain open and out there. There have been some structural issues in the market, which you have no doubt heard about—particularly for non-bank lenders taking out. We have been there throughout that period and we have definitely seen some improvement in the credit outlook in small business in the past year or so. It remains, we think, quite competitive, certainly among the four major banks. 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.

Mr Moore—Firstly I would like to say thanks to the committee for the invitation to appear here on behalf of St George, BankSA and the very soon to be Bank of Melbourne brand, within the stable of brands in the Westpac group.

CHAIRMAN—I read that this morning.

Mr Moore—In addition to Jim's comments, I want to say that certainly St George and BankSA have always valued our relationship with the small business sector. It is strategically very important to us. In recent times we have made a commitment to invest even more in it, through increasing our number of dedicated relationship managers in the sector, and making a real effort to get those relationship managers close to the customers, which is what our research tells us is critically important. We have a dedicated telephone support centre within St George, Business Direct, which is a sales and service channel open 24/7. Recently we also had a business mentor program which makes free business coaching available to small businesses and we have had some excellent subscription to that service. We see ourselves wanting to continue to support this sector. It is critical to St George and the other brands. We are looking forward to answering some of your questions today.

CHAIRMAN—For ease in terms of asking questions I might treat St George and Westpac as two entities, but if you have the same view, for whatever reason, I am certainly happy to take that as well. Going right back to the beginning, there is a general view, and I think it is an accepted view and has been part of quite a few submissions, that pre-GFC finance for small to medium businesses was just too easy to get and that things have changed. Is that your view? Is that how you would see this concept—that it was just too easy to get?

Mr Tate—At the end of any bull market, and we could go back to the 1980s and to the 1970s, you will see that when it gets very competitive for bank assets then there is going to be changes to underwriting standards or the interpretation of that and there is going to be people going for market share and the like. The obvious way to do that is to either amend the risk that you are prepared to take or to change the price at which you are prepared to take it. There is no question that in the 2006-08 period that was extremely evident. I think in terms of coming through the far side of that there are a couple of structural issues, but we can cover that later. If you had to nominate a period where credit was easier to get, relatively speaking, compared to the previous 10 years then 2006-08 would definitely be high on your list.

CHAIRMAN—Mr Moore, would you have the same view?

Mr Moore—Yes, absolutely the same view.

CHAIRMAN—For the record and from the perspective of both your organisations, what has changed? Is it harder today to get?

Mr Tate—Yes, it is harder to get today; and there are two reasons for that. First of all, let us look at the normal business cycle. There is always going to be a retracement of the business cycle and that is going to reflect itself in the price of credit, particularly where there is property valuations moving—which are, by far and away, the largest single exposure that any of the major banks have to the business market. So there is going to be a cyclical adjustment there where the risk of that asset class moves and you have to re-price that risk.

The second element, but in my view a primary consideration, is the structure of funding in the system. So up until 2008 you could, as a reasonably large company or even a large property developer or the like, go to a number of other sources of funds—you could have gone to one of the offshore banks, a Bank of Scotland, a Citibank or someone like that. You could have gone to a good-sized finance company. You could have gone a number of different ways to get hold of that money. You could have securitised. You could have sold bonds on to the market. In 2008 that simply stopped, and the pool of liquidity that was associated with that disappeared. The absence of alternative sources of funding in that regard is still an issue that remains into this period now. You have a double bunger as it were—you have a funding outcome and you have a risk outcome based on a cyclical move. We are coming out of the credit part of that, out of the cyclical aspect of it, and we are still coping with the funding part of it.

Mr Moore—The only thing I would add to that is that both of those things are perhaps supply side aspects of the equation. I think there has also been, post-GFC, a fundamental change on the demand side too in terms of appetite for—

CHAIRMAN—so there is less demand—there is less people seeking finance?

Mr Moore—Well, no. There is an appetite for a certain level of leverage. So whilst there may have been some change, as Jim was describing, on the supply side from banks, whether that is in appetite or just number of alternatives, I think on the demand side too we have seen a change in the level of appetite for gearing at the levels that we saw pre-GFC.

CHAIRMAN—So the big change really is in a couple of significant things. One is a restructuring, if you like, of finance that is available, funds available, but also a rejigging of bank policy, risk appetite of—

Mr Tate—No, I think that is was where the demand issue comes in. I think where the risk appetite comes through—is those people who would have accessed, say, finance company or other debt, and that disappeared, they were never customers of the big four banks, generally speaking. So they tended to run riskier arrangements, much more property development in that part of the argument. The banks, as your previous witness indicated, have balances on development being property investment that they pursue. So the traditional sources of funds for a lot of those people just moved. So it is not so much a question of the banks changing the policy; they were never traditional customers of the bank anyway. Certainly, the bank got a lot tighter about any exceptions that it might give to its policy, and I go back to what I said in the 2006-08 period: the policy is always there; it is a question of how often you give an exception to it, and there is definitely a tightening of that, no question.

CHAIRMAN—I might ask you the same year bit in the two. Let’s just say if me broke up the SME into two parts—one being, say, the property sector of SME, broadly speaking, and the other being everyone else—would you say there is a key difference in terms of how they are treated because of the risk appetite of banks or because a particular segment of the lending market has shifted or gone?

Mr Tate—There is no question that commercial property is traditionally where you will lose most of your money. Within commercial property, the development finance is the riskiest part of that exposure.

CHAIRMAN—So you have a very different view or you are telling us a very different story in terms of competition, that it is not about more banks, for example, at a crude level; it is really about who was providing what to whom in those particular segments of the market. You are saying you weren’t doing that anyway to any great level. Can you categorically say to us that there is no significant change in the business model that you are applying; perhaps there are less funds—

Mr Tate—I would certainly say there is no change in the business model. I would say that the level of exposure we have to property is lower than what it would have been back in 2006-07.

CHAIRMAN—Significantly lower or are we talking just at the margins?

Mr Tate—No, in 2006 we probably had about 35 per cent of our book in property; now it is down around 29 per cent. So it is about six per cent lower over those four years. But, in terms of the mix development versus investment and regional mixes, they are all very much the same.

CHAIRMAN—It is pretty significant, though, because it is not really six per cent—six percentage points, if you like; it is a bigger proportion of a six, not just 35.

Mr Tate—Well, in fact, the amount we have on our balance sheet for business lending is now lower than it has been. When the merger of St George and Westpac took place, the combined business banking exposure was about a $100 billion. Now it is about $85 billion, $86 billion; it

is about $15 billion lower. So it goes to what Andrew was saying about demand for credit during this period. If you look back through the—

CHAIRMAN—Are you saying though that is a demand result rather than a change of conditions from the bank?

Mr Tate—Absolutely. That is absolutely a demand situation. I can show you a graph of the September 08 quarter where business lending hit a full stop. That was the Lehman's thing was on 12 October, even before that.

CHAIRMAN—So we were talking applications; people are not coming in?

Mr Tate—We saw it not only in business but in consumer as well. We have seen this over a couple of cycles now. Once that household leverage ratio gets to about 160 per cent, something goes off in people's minds that says, 'Look, I'm just too heavily exposed here; I've got to take—'

CHAIRMAN—Only at 160 per cent?

Mr Tate—It is amazing. But, see, credit card balances have not moved for three years either. The biggest growth in actual transaction activity in the past three years has been in debit cards.

CHAIRMAN—But for the credit cards, if it has not moved in three years then it is effectively a decrease.

Mr Tate—Yes, in real terms.

CHAIRMAN—I am assuming that there would have been an annual growth increase. So there has not been that in the last three years?

Mr Tate—Not much.

Mr Moore—Sometimes you need to separate a decrease in the number of people we are dealing with versus balances. Interestingly, if I look at this financial year for St George, we have increased the number of our small business customers that we have by around about 800. But the balances have not moved, which was the point that Jim was making before. There are more businesses that we are prepared to deal with but the extent to which they are seeking financing is less, on average, than what we have seen historically.

CHAIRMAN—Let me tell you some of the criticisms that we receive, and you probably read about them in the newspapers as well. There has been a restructuring of finance where existing customers of banks generally have either their mortgages or their lend restructured because of re-evaluation assessments of property or of assets and then they are compelled to rewrite a loan, an existing loan into a new loan, attracting more fees or perhaps mortgage insurances or other insurance to insure the risk. Has that been a feature? Does that happen?

Mr Tate—It gets a lot of publicity. It does not actually happen as much as you would think. Let us look at a classic development situation. The maximum we would lend to a developer to

build something would probably be in the order of 70 to 75 per cent of the cost of that development. So if someone is going to build a new block of units for $100, then we would lend them $70. If the value of the land and the buildings associated with that falls to $80 and we are still owed $70 or $75 then we have got an issue.

CHAIRMAN—Is that backed up by real-world data in terms of reduction in land values? For example, as you heard from our previous witness there are some pretty solid numbers on land values. Do you have different data?

Mr Tate—I did hear your previous witness, Mr Ripoll, and I am trying to figure out where I agreed with him, which is pretty limited. In terms of some regional exposure, we have seen valuation decreases in the order of 20 per cent. I think if you read the *Australian Financial Review* this morning then you will see that it makes very specific mention of Noosa and other places like that.

CHAIRMAN—There would obviously be specific markets, but I think the point of the previous witness was about the larger cities and those robust markets. Is it just about the valuation or is it the actual sell price?

Mr Tate—Both. You have got both. Prices in Sydney have not moved that much for well over 18 months. When I say 'moved' I mean 10, 15 or 20 per cent increases. It would be, in real terms, flat.

CHAIRMAN—Isn't that counter to what you were just saying? If it is steady and flat, isn't that a great thing? There is not much risk in stead and flat.

Mr Tate—There is the first thing on the value of the land. Then there is the value of the apartments that one would build there, and they have been very volatile. Most of those appeal to investors rather than first home owners and investors have abdicated the market, particularly in the past six months. So we have valuations of those individual units fall quite markedly, depending on where you are, of course. I can give you heaps of examples of where they have moved 20 per cent and I can say where things have been quite flat or even in some suburbs, close to transport hubs, probably up slightly.

The thing that has also come into play is that people are walking away from their pre sales. So previously, as your previous witness indicated, some things that were presold to say 50 per cent or 75 per cent we would have regarded as a pretty easy risk to cope with. But in the past two years, as people have become nervous, and they put $5,000 or $10,000 down as an option on an off-the-plan unit, they have simply walked away from it. So we cannot rely on pre-sales as heavily as we did previously. In major developments there is both the land value, there is the value of the individual units involved and there is the certainty of the cash flow to service that.

CHAIRMAN—One issue that is consistently raised is the capacity of the banking sector to properly understand those markets, whereas the people who are dealing in those markets are experts. Would you say that there is a skill issue, an experience issue, an understanding issue or a knowledge based issue—

Mr Tate—Within the banks?

CHAIRMAN—Within the banks themselves to properly assess and make sound decisions in terms of risk in markets that they are perhaps not experienced in? They may be experienced in banking and finance but not in property development.

Mr Tate—I would say that Westpac has been involved in property finance since 1817. I think you could put it in those terms. As I indicated—

CHAIRMAN—Westpac has done well out of it since 1817.

Mr Tate—It has probably. As I said, about 30 per cent of that part of our balance sheet is associated with property. We have property specialists in terms of people who liaise with developers, who assess the risk in respect to it. It is such a significant part of our activity that for us not to have specialists involved in it would be very counterproductive.

Mr Moore—I would strongly support Jim's comments on that. As St George grew into this sector, a lot of that growth was actually in the property finance arena. I think the nature of the finance specialists who are working there is that that is very much what they are specialists in. So they may not be specialists in the development itself but they certainly are in the financing of it. These people have often spent their entire careers involved in that sector. So I do not think there is a skill issue in that.

CHAIRMAN—How does your own data bear out against the criticisms that you are just not lending to that sector or to any other small businesses? How does that balance out with your data? Are you still lending at the same types of rates?

Mr Tate—The approval rates are as high as they have ever been. Eighty-five per cent of anything that comes across our desk on a small business basis gets approved. That ratio has not changed. The bad debt or delinquency situation in small business is now better than it was in the middle of last year. In fact, it is down a couple of points. That is why we say things are improving. In terms of property specifically, investment property or people looking at major A-grade office blocks and the like, there is quite large activity in that going on. On the developer side, if you have had a long and vibrant relationship with an individual institution, you will get your money. If you have had a very mercurial relationship with the industry, you are going to find it tough. In other words, those who have invested in long-term relationships with a bank or a suite of banks and where they and the bank have essentially had a mutual interest with one another over a longish period of time, I do not see any diminution in their activity. For those who have been quite mercurial in moving from bank to bank and seeking cheaper funding, there just is not the relationship structure there for banks and they are naturally going to be harder on it because there is not the track record.

Mr Moore—The only other thing I would say from a similar sort of experience is that we are certainly not bumping up against a capacity constraint in terms of our preparedness to lend to small business; it is quite the opposite. We actually have a very strong appetite to lend to the sector and would like to be able to see more business clearly of a type which is consistent with the lending criteria that we have, which—as Jim was saying, and I would support that thought too—has not fundamentally changed as we have travelled through this period.

CHAIRMAN—There is obviously a cost price differential between the larger block of lending in mortgages and traditional financing and the small business financing. There is a higher cost which would, I assume, be reflective of higher risk.

Mr Tate—Yes.

CHAIRMAN—Has that materially changed from the pre GFC environment to the post GFC environment?

Mr Tate—Very much on a sector basis. So let us say, as a spread to the bill rate, which is the way we would look at credit generally speaking, property pre the GFC would have been up around the one per cent to 1¼ per cent over the bill rate. Now it would be two to 2½ per cent over the bill rate. For cash rich sectors, those that have big flows—things like pharmacies or professional services or accountants; those where essentially the demands for credit are not enormous—their credit arrangements are very comparable to what would have existed a short while back. Mining industry or mining support services, for instance, would be getting their money quite cheaply. It is simply a demand issue. For a period of time anything to do with autos found it hard going until some of the tax advantages were brought in during the first package; they have had a booming couple of years on the auto side, so it has been quite mixed. I suppose if you had to characterise the three industries which have found it toughest, they would be property, retail, and pubs and clubs. They would be the three sectors that have found the increase in credit risk to be the most profound.

CHAIRMAN—And how would you generally respond to criticisms that banks are making greater margins, that the spread is greater certainly than pre the GFC? You are taking less risk but making more profits. Banks are very profitable. In fact, they have been making record profits. But at the same time it is really at a cost of economic activity. Banks are hedging themselves, still making the high profits and bigger margins. How would you respond to that?

Mr Tate—I would respond that I would question whether we were taking less risk. The whole economic outlook is a more risky environment than what we had previously encountered. On this issue of the margin between the two, the net interest margin between what we would earn on assets and pay on liabilities is about two per cent. It goes up and down around that, but to maintain a AA rating in the market, to maintain our access to funding more generally, something in the order of around that two per cent mark would be what you have to throw off in proving to the market your ability to create capital. Remember that two per cent is capital that goes into you retained earnings and are used to build the bank. Obviously if that aspect around two percent has not moved that much then we are essentially running on the spot in terms of the relative risk. As the balance sheets get bigger, that two per cent of a big number gets bigger and bigger, which is obvious.

The banks have to throw off enough capital to maintain access to funding markets at a reasonable price. We could easily say, 'Let's take a lower margin, let's put that down to one per cent,' but a bondholder or someone funding us on the other side is going to say, 'You're now a riskier proposition because you're not throwing us as much off the assets that you have; I'm going to charge you more for the funding that I give you.' To some extent it is a circular argument. You cannot divorce the profit and the funding argument, and that is really at the nub of where this whole GFC debate starts and finishes: how does the system fund itself in the

cheapest and most efficient way? At the moment it is a much riskier proposition to borrow and raise money than it would have been four or five years ago. So to the premise that the banks are taking less risk, I put the case that says in fact, based on where the bank has to go to get its money, the risks have never been higher. Now who pays for that risk can only really be the asset side of the balance sheet, and so it looks to some extent, therefore, if you pick winners and losers on that side of the balance sheet, in other words if you say, 'I'm not going to lend to specific sectors', it looks like the bank is protecting its risk.

I am saying, systemically, the risk in the system has never been higher. In fact we are only just really coming into in Australia the real ramifications of that. We are only seeing the deleveraging of businesses and consumers happening here which was really going on in North America and European markets 18 months ago. So it is going to be a long, slow process in my view for the funding side of balance sheets to have the risk taken out of them. To the premise that there is less risk, I am 180 degrees opposed to that view.

CHAIRMAN—I thank both Westpac and St George for coming. I thank you for your submission and the time you have taken today. Thank you for your evidence.

Proceedings suspended from 3.31 pm to 3.42 pm

JOHNSTON, Mr Michael, Head of Government and Regulatory Affairs, ANZ

MOTTON, Ms Tania, General Manager, Regional Commercial Banking, ANZ

READE, Mr Nick, General Manager, Small Business Banking, ANZ

CHAIRMAN—The committee welcomes representatives from ANZ. We invite you to make an opening statement, which will be followed by questions.

Mr Reade—Tanya is the General Manager Regional Commercial Banking at ANZ. That is a commercial banking focus in the bush—in rural and regional Australia—and also a dedicated agribusiness focus.

Given the short time today, I will keep my opening remarks brief. Firstly, over the last two years in what has been a pretty difficult environment ANZ far from turning off the taps, so to speak, has been very committed to supporting the small business sector. The commitment is apparent in our approval rates for lending, which remain well above 80 per cent throughout 2009 and 2010 and today is around the pre-GFC's level of 83 per cent. While demand was down overall in the business market, we have solid growth in lending to small businesses. At ANZ we actually classified small business banking probably a little smaller than some of the other banks. For us it is total business lending under $500,000. In this segment of our business we had lending growth of around 10 per cent for both 2009 and 2010, so our book grew 10 per cent through that period in both years. In addition, we continue to lend to businesses looking to start up. We approved seven out of 10 lending applications to start-ups through that period and still today. On a non-secured basis we approve eight out of 10 applications. Secured lending, though, still makes up the majority of our lending. Currently nine out of 10 applications are approved for secured lending deals.

Secondly, we are committed to supporting our customers in other ways, with options such as extended repayments, deferred repayments, interest waivers, fee waivers et cetera, to support them when they are facing difficulty. Right now, for example, it would be the floods in Queensland and other natural disasters around the country. We have also added staff. There are around 130 new front-line staff in the small-business team across both metro and regional Australia. These are mainly in the branches but also some of our other channels, like the call centre. In addition, ANZ provides small-business customers with an online small-business website which gives them access to great business tools, data and information and even online courses. The education material is for people like start-ups or any up-and-running business to help them understand topics such as marketing, cashflow planning et cetera. Last year we launched a great new tool called ANZ Business Insights. It is free of charge and it is based on all the merchant, credit card and debit card data that the bank has access to. We packaged that together in an aggregated form and provide that to customers to look at the trends of their business relative to competitors in their local market but at an aggregated level. This is invaluable information, particularly for a business to see how they are going in terms of market share or sales trends, particularly for a start-up who is looking to open a business in a particular market. They can see some great information from that.

Thirdly, in light of improved economic conditions, we are reviewing our lending criteria. Last year we moved to reintroduce a self-certification process, or a more streamlined lending process, for secured lending to small-business customers. ANZ remains strongly committed to this segment.

We thank you for the opportunity to appear and we are happy to answer any questions.

CHAIRMAN—Thank you very much. We will give you the same opportunity as the others to give us some idea of your view about whether credit was too easy pre the GFC. Things have rebalanced and are perhaps more appropriately balanced now—perhaps not; I am not sure. Is it your view that lending conditions were just too easy and that there was plenty of funding around?

Mr Reade—Yes. There is some evidence that one small segment of the market has pretty well disappeared, and that is the low-doc space. Other than that, I do not think there has been any change. Our approval rates, as I just mentioned, are between seven out of 10 for start-ups through to nine out of 10 for secured lending, and that is pretty good. I would say it is very good. The only ones not getting through are probably not viable, in the sense of being able to support the loan. The low-doc segment that was evident across multiple banks in the pre-GFC time frame is probably the only key segment that I could say has disappeared. It disappeared largely because the loss rates were unsustainable.

CHAIRMAN—Is that a different outcome than for other banks? Have you made any comparison as to how you sit within the environment—the competition, as it were, for small and medium enterprises?

Mr Reade—We have probably been at the small-business game for a little bit longer than other banks, in the sense of the dedicated investment. Most banks probably through the eighties and nineties did not have a huge focus on the small-business space. Early in 2000 we decided to reinvest significantly in this segment and we have going at it in a full-on way for six or seven years. The other banks have more recently increased their investment. All banks are very heavily investing in this space right now. You only need to look at the television to see multiple ads for multiple small-business propositions across different banks. We have just been at it for a little bit longer. Our dedicated focus on having our people in both metro and regional Australia, which Tania represents, is probably a little bit ahead. The others are all catching. They have all added staff. Every bank has added a lot of staff to this segment over the last few years, but we are probably just a little bit ahead. Not all banks would take the view of wanting to back a start-up, and we do. Not all banks will lend on an unsecured basis, and we do. So I think we are a little different in that respect.

CHAIRMAN—How does that balance out? The evidence we are getting in submissions and through witnesses is that other banks are properly weighing the risks and have not significantly changed any of their policies. It is just a case of the balance between available funds and appropriate risk. But you are telling me a different story.

Mr Reade—We represent the true small business, if you like. The previous discussion was about the bigger end of the SME market. We have 300,000-odd small business customers—butchers, bakers, hairdressers and those types of customers—and not all of them want to put up

their house as security for a loan. They might be talking about a $20,000 overdraft but not want to have their residential home as security for that. So we have a really close understanding of the needs of small customers and the fact that not all of them want to put up their home as security.

CHAIRMAN—What do you take as security? Perhaps you could give an example.

Mr Reade—We do take residential homes as security, but unsecured is unsecured. We do not take any insecurity. It is almost like a personal loan, for example.

CHAIRMAN—What defines the difference between what the ANZ does and what others do in that sense? I am assuming you do not take any more risks than anyone else.

Mr Reade—I do not know. I cannot speak for the others.

CHAIRMAN—But you would not assert that you are playing a riskier game? I am assuming you have pretty strict rules.

Mr Reade—We have guidelines around the amount of unsecured lending. My point is that there is a portion of the market that does not want to put up their home. Typically they are the small customers—the microbusinesses, you could call them. They might want $20,000, $15,000, or sometimes just $10,000, just to get some working capital going. You have to remember that most small business customers do not borrow. Two-thirds of our customers do not borrow at all; they fund their business out of their own cash flows. We recognise that there are quite different segments of customers out there, and we have a proposition for each and every one of them.

CHAIRMAN—The impression I get from a number of banks and from the banking sector—the Bankers Association and others—is that there are fewer funds available but lenders are less prepared to take risks, so they have re-evaluated risk and revalued assets. There is less available on those terms. Certainly there is some pick-up. We all understand that the market is coming back and that there is a shift. If I understand what you are saying to me, ANZ has taken a different approach. It has been consistent from a pre-GFC environment to a post-GFC environment and continues to grow in that sector of lending to small business. Is that right? Can you just explore that a little bit further?

Mr Reade—Our commitment has never been stronger. The only way ANZ can grow in its small business base is to support start-ups. The only two ways to grow a business are through start-ups and through customers switching from other banks. We believe we need to play in that start-up space. The loyalty you engender from a customer when you bank their idea—they have woken up in the morning with an idea for a new business, they come in and talk to one of our people, we work through the business plans and the cash flow forecasts and we decide we will support that—is amazing. It gives our staff an absolute thrill.

CHAIRMAN—How have you managed to do that differently to the others? Do you have access to more funds internally in that particular segment, as a percentage?

Mr Reade—All I can talk about is ANZ. As I said, we know we have to play in that space. We do constantly understand our portfolio mix of secured versus unsecured and also start-up versus existing and various things like that. We monitor it regularly. Every month we look at detailed

reporting on how we are tracking. It is a stated goal of ANZ to support this segment. We believe it is important and one way we can grow and support the entire system.

CHAIRMAN—You do not see it as any riskier? Obviously you are competing in that market. I am assuming you have competitive rates and you are competing with other banks to either retain customers or gain new customers?

Mr Reade—Exactly. A start-up business could be a true start-up, in the sense of being an idea that someone wants to foster and develop, or an existing business that a new customer comes in and wants to buy. That also could be considered in the sense that the person has never run a business before but the business is existing. We consider a broad range of those start-up categories and try to bank people who have that broad range of ideas. So, no, I do not believe we are taking extra risk. It is simply a part of the market that we need to plan, and we price it accordingly.

Senator STEPHENS—There is a very positive message coming through here. I am interested in the extent to which you have managed to encourage small businesses to shift to your products because they were not getting support or there was a perceived risk and yet you were able to accommodate their financial needs. Have you got some data on that?

Mr Reade—I have been running the small business team for four years so I have a reasonable amount of experience and, over that time, have really understood the subsegments or the opportunities within that. Probably a couple of years ago some deep analysis of the market saw this opportunity to do more in the start-up space. So we have created offerings and propositions, and started marketing ourselves as the bank to really support start-ups—that has been on everything from radio and television down to internet and things like that. We have been successful at it. We have grown market share strongly. Last year, for example, we grew two per cent. We think one of the reasons is our focus on that segment. It is not the only reason, but it is one of them. As I said, it is hard to get customers to switch, but we are there and want to focus on start-ups and that is part of it.

CHAIRMAN—Firstly, is ANZ having any more difficulty than anyone else in the market in accessing funds, from whatever sources, or are you finding that access to funds is an issue in terms of how much you are dealing with small business?

Mr Reade—I would have to say that it is the opposite. As I said earlier, the small-business segment is a deposit-rich segment. There are more deposits in the small business market than there are loans. If you look at the growth rates—and let us say that they are even the same; 10 per cent, for example—10 per cent of a bigger number gives you more funds. So we are self-funding our lending at a rate of 3½ times. It is a good model from that perspective. We do not have any constraints when it comes to small business lending because our customers almost help us to self-fund the lending. So we have no constraints on lending.

Senator STEPHENS—We had some evidence in Canberra last week about the value of intangible assets such as goodwill, cash flow and, in the sense of the real estate market, rent rolls. We did hear some evidence that, particularly for some regional customers, this is becoming a big issue—that those intangible assets were now no longer valued or were no longer being assessed as part of the business profile. Is that occurring in your bank?

Ms Motton—In terms of our products and the way in which we service our customers, we actually do not differentiate between metro and regional in terms of what we can provide. Probably the only additional thing that we would provide to our agribusiness customers would be revolving agri-lines that would match more the seasonal cash flow of their businesses. Obviously, in terms of how we set our policies versus the application on a case-by-case basis, we always take individual circumstances into account. But I would be confident in saying that the way in which we would treat a regional customer is not different from the way in which we would treat a metro customer.

CHAIRMAN—Including where you process the applications? Are they processed locally—like, in a country town—or are they processed centrally, at the Sydney office, for example?

Ms Motton—For our small-business segment, it is a bureau service in terms of how assessment works, and that is done all in the same place, in Melbourne. But the actual people on the ground, the small business specialists, are regionally located. So, as Nick has mentioned, we have added 130 specialists in the last two years; half of those have been in regional Australia.

CHAIRMAN—And how much influence do they have in terms of the processing of an application?

Ms Motton—They are actually putting the transaction together. So in terms of the guidelines that we operate under from a lending principles perspective, they are putting together each transaction.

Mr Reade—There is no credit authority in the front line of our team. They do not make the decision. They work with the customer to structure the best possible application, then it is submitted—it is a scorecard approach, like a retail credit environment—and that would be approved, declined or referred out to an assessor for a closer look. That is the model.

CHAIRMAN—So almost like a broker arrangement where you have your own embedded people, but who are out in the field?

Ms Motton—Not really.

Mr Reade—No.

CHAIRMAN—You do not like the word 'broker'?

Mr Reade—No, it is very different to that.

CHAIRMAN—It sounds very similar to me.

Mr Reade—It is simply an efficient model, and with many years of experience we can build scorecards and the bars or rules allow us to automate the credit. The customer and the front-line person would do everything other than our person making the final decision. They just input it and out comes an answer. It works that way. We are very active with the customer: hours of discussions and working through all of the numbers.

Ms Motton—Understanding their business.

CHAIRMAN—So these are people particularly skilled in either that region or that locality? So if it is agribusiness, for example, or something like that—

Mr Reade—Tania can talk about the regional, which is a really good example.

Ms Motton—From a specialisation perspective, especially on the agri side, we work very proactively trying to identify individuals who have not only agri skills and knowledge and background but also, as much as possible, banking skills or, if not, to couple them with those banking skills. Obviously that varies from region to region. Someone in central Queensland is more likely to have beef or cropping experience versus someone in Gippsland who may have dairy experience.

CHAIRMAN—Thanks. Since the global financial crisis, has the ANZ gone through a process of re-evaluating its balance sheet and looking at risks and liabilities and customers and looking at where points of risk might exist—something like that? I am assuming you would, I am really just asking you to tell me how you have done it rather than if.

Mr Reade—I know we have. I am not privy to all of the details of the whole bank; I see my part of the bank. Certainly we constantly look at our portfolios. We have business writing strategies that we present to the chief risk officer.

CHAIRMAN—The point of it being that in the small business lending section, you look at this regularly—particularly through the GFC, like everybody else—and you look at where are your risks. What did you do with that information? Did you identify some more risky sectors, clients or business?

Mr Reade—No, not really. Again, when you look at the small business banking market and our business, it is very heavily weighted to deposits. The lending obviously gets more profile, but the deposits, when you look at the entirety of the business and we look at the risk that we are taking in the small business space, it certainly puts it into a different perspective because of all of the large deposit holdings that we have.

CHAIRMAN—No revaluation of assets for secured—

Mr Reade—The only one we have talked about in our submission is the ‘low doc’ product. That was the one we pulled back from.

CHAIRMAN—So you just do not do it any more at all?

Mr Reade—No. We had a low streamlined process, which we also refer to, but it is for secured lending.

CHAIRMAN—So the picture you are painting for me is that pre change in the global environment, during and post, there was really no shift in your risk or the profile or how you do business in that particular sector? You are still lending. There is growth.

Mr Reade—Yes.

Ms Motton—To add to that, the appetite for growing our small business, both metro and regional, continues. We absolutely have appetite to continue to grow. Probably the delineation between us and some of our competitors that have presented already is that we are talking about our true small business market, which is where lending is below $½ million, whereas the market that they are talking about could be up to businesses that have turnover of $50 million. So the point I think you were inferring was around the question of are there particular industries or riskier parts of the balance sheet that they had considered. We are not comparing apples with apples. We are talking about that true small business segment.

CHAIRMAN—One of the issues that has been raised across a number of submissions is skills. You have already talked about it, but I just want to get a fuller response, I suppose, on investment in skills of your own people, specifically to deal with small-business lending and their capacity to make assessments—across the whole bank, not just in agribusiness or anything else?

Mr Reade—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.

CHAIRMAN—Do they put everything through?

Mr Reade—Yes. One of real successes is that 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. That is one of our great initiatives. Straightaway they connect because they can tell you a story, such as, 'My father had a bakery,' or, 'I worked in one.' Sixty or 70 per cent of our recruitment comes from that space. That is a really good thing. Our staff would handle the entire breadth of need. They would have what we call an A to Z review at ANZ. That is something we are promoting at the moment on television. That is a full review of the needs—everything from consumer through to business. Obviously business is the priority, but we will also look at consumer needs, in the sense of making sure we have understood the entire gamut of what their needs are at the time.

We are talking about loans today, but we could easily be talking about savings accounts, transaction accounts, merchant facilities, credit cards, mortgages, financial planning, insurance, FX et cetera. They are relatively junior in the overall scheme of things, but they are trained well. They go through significant induction training and significant credit training. Even though they are not making the decision, they need to understand the credit side of it so that they can help a customer put through the best submission. I am pretty confident that we have a good model when it comes to that.

CHAIRMAN—We have heard from others that, generally, demand has been lower than the past couple of years. Have you had the same experience? We have touched on it already.

Mr Reade—Yes, it was. Through the GFC, demand for lending came off. There is some good evidence out there from independent marketing researchers. Ross Cameron is a very experienced small-business researcher who has 15 years of experience in researching small business. He says

that certainly customers went through a stage of really tightening their belts and not wanting to put themselves through extra pressure at that time. It is interesting that they have come through that. They are really focused on cost. They went away from growth. Small businesses are very optimistic. They are always thinking about bigger and better and growth. Even the ones that are not necessarily seeking growth—that is, a lifestyle seeker customer—but they are always looking for opportunities for their business. Through that period, they certainly did not do as much of that and really focused on the cost side, which is not normal for them. Interestingly, now they are coming back to revenue and growth. Westpac were talking about it and we could say the same thing—there, some positive signs around demand and willingness to re-enter discussions with the bank about growing their business again.

CHAIRMAN—You would have heard earlier that there might be two distinctive parts when it comes to small business—the property development, commercial property, sector and then there is everybody else. What has been your experience in the ANZ regarding commercial property financing and development?

Mr Reade—That is not really my thing, to be honest. We do not do it in the small-business space at all.

CHAIRMAN—Not at all?

Mr Reade—It is really not a focus.

CHAIRMAN—Is that a definitional issue within the bank or is it a particular policy?

Mr Reade—No. We represent the true heartland of small business, if you like. If you go higher—

CHAIRMAN—I am sure some property developers would like to think they are the—

Mr Reade—But property developers would be typically borrowing more than half a million dollars.

CHAIRMAN—Is that the limit? You mentioned $500,000 before. Is that the upper limit of what you term as a small-business loan?

Mr Reade—That is right.

CHAIRMAN—That is significantly lower than pretty much everybody else, including what the RBA defines as a small business.

Mr Reade—Yes, it is. We like that because it gives us a focus on where the vast majority of customers are. We do not forget about them, because there are other parts of the bank that worry about that.

Ms Motton—Would you like me to perhaps touch on that?

CHAIRMAN—Just briefly.

Ms Motton—In terms of the segmentation piece within the ANZ—the market that is perhaps comparable to what Westpac were talking about before and even to what the NAB talked about in their submission; I have not heard them speak—the business banking is probably a better comparison. From what I can tell, they have included both their business banking and the small-business part of their book together. Business banking for us is metro and, as part of my business, commercial. The commercial part of the regional offering would be more that equivalent. You have got to understand—although it is probably not so helpful for the committee—that each of the banks do not specifically have exactly the same segmentation rules, which does not help.

CHAIRMAN—I understand that, but the ANZ obviously does lend to property developers.

Ms Motton—We do.

CHAIRMAN—It is just done in a different section or a different part of the bank—is that what you are saying?

Ms Motton—That is correct. Both development and investment are absolutely markets that we are involved in at ANZ. If I am honest, I do not know if you will get the best representation of information out of Nick or me today on that.

CHAIRMAN—In that detail. If you do no know, that is fine, but I will just ask broadly: has there been any reporting within the ANZ of any downturn, changes, or differences in that particular segment of the bank business? There is a lot of criticism, as you would be aware, from the property sector that they cannot access finance.

Ms Motton—I can take that at a holistic level. For one of our peers within the business bank book, it is something that we have grown since the GFC. So there is absolutely appetite in the market for both.

CHAIRMAN—So you have grown the property division?

Ms Motton—Yes, from an ANZ perspective within business banking. Obviously there are quite clear guidelines around how we would approach that market. I cannot give you specific stats on what percentage that increase is but we would be more than happy, if you want some more information, to provide that.

CHAIRMAN—We would certainly be interested. For us, as a committee trying to make some determination about how the ANZ, as one player in the market, makes a risk assessment of different sectors, what its response to that risk assessment is—whether your bank, other banks and other lenders see it as risky or just normal as part of all lending across the whole bank. We would be very interested.

Mr Johnston—We are happy to take that one on notice.

CHAIRMAN—That would be great; thanks. I have an overall question about risk. Obviously every lender would have made an assessment about risk when the GFC was taking place, reassessed its own book and looked at all of that. Can you give me some idea about, in your area

of expertise, small business, that level of risk, where it was during the GFC and where it is now? How confident is your bank about taking risk and lending?

Mr Reade—I was there so I can comment. At the time, the only concern we had was that low doc space. The rest of the portfolio, the rest of the customers, were performing well. There was clearly, in general terms, some stress. We supported customers with a whole range of initiatives, but it was quite small. The overall portfolio metrics were good. We only really made one decision, which was to stop the low doc lending. Other than that, we continued because the fundamentals were strong, and, if anything, I had senior people saying, 'Do more of it because we want to be in the small-business space.'

Ms Motton—Probably on the regional side, the GFC had a factor across all of Australia but for us it was more about understanding our industries, especially if we talk agriculture. We have to bank, in our minds, through the cycle. Understanding the geographic impacts of weather and conditions, we have to continue to understand and work with our customers about how we can support them if there is drought, flood et cetera. The GFC aside, that risk assessment and being clear in our own minds between business appetite and credit appetite is really something that we continue to deal with, assess and become clear on very much on a daily, weekly and monthly basis. That risk piece is very much at the forefront of our minds. But, obviously, there are customers on the end of every decision we make so we do not make them lightly.

Senator STEPHENS—On the issue of regional lending, your submission says that you have taken over Landmark.

Ms Motton—Yes.

Senator STEPHENS—That financial services business would have had existing loans and conditions; were they revisited as part of the takeover, and were the terms and conditions of those loans changed?

Ms Motton—That is actually a very timely question. As part of the integration of Landmark into ANZ we have been working through the transfer of the 11,000 accounts. We actually finished it this week, in terms of the timing of the agreement. But we are working through the redocumentation of those loans at the moment. We have worked through approximately 25 per cent of them.

Are all of their terms and conditions going to change? The answer is 'yes', because they were on Landmark terms and conditions and now they will be on ANZ terms and conditions. Would the circumstances of the way in which they have been assessed and their rates et cetera change? Not necessarily, but legally we do need to bring them over to be on our own terms and conditions over time.

Mr GRIFFIN—It is an interesting point, because some of the evidence we have taken is that different people in the sector have their loans reassessed at particular points and, depending on the value of their asset or whatever it may by, either incur more fees or extra fees through this re-evaulation, or perhaps the rewriting of a particular loan or some sort of insurance cover for the loan. Is that something that could potentially happen with regard to changing the terms and conditions?

Ms Motton—The honest answer is 'yes', because when we assess individual customers—and we are at that level—everybody's circumstances are different and the timing in which they become a customer. Their circumstances with their business change over time in a positive way and sometimes not as favourably as the conditions in which they had originally come on. What we are now very much trying to work through is that we have a significant number of customers and the opportunity to provide them with a full banking service, which they could not actually receive with Landmark. This is something that we are very positive about, so we are having that conversation to understand what business needs they have and how we can best structure their facilities. Obviously, we have more facilities to offer than perhaps what they could have had before.

Mr GRIFFIN—You are doing that process—and you said you have done about 25 per cent—in the same manner that you would for a new applicant? Like a face-to-face for somebody or a—

Ms Motton—Yes.

CHAIRMAN—Thank you very much. We appreciate your submission and your time to appear as witnesses.

[4.19 pm]

BYRES, Mr Wayne, Executive General Manager, Diversified Institutions Division, Australian Prudential Regulation Authority

JOHNSON, Mr Graham, General Manager, Industry Technical Services, Australian Prudential Regulation Authority

CHAIRMAN—I welcome witnesses from APRA. Do you wish to make an opening statement?

Mr Byres—We have made a short submission which focuses on the prudential framework that we apply to authorised deposit-taking institutions, ADIs,—that is banks, building societies and credit unions in this country. It relates to item 4 of your terms of reference on the impact of the prudential framework. I just want to draw out three points that we made in our submission. First of all, by and large, we have very little in the way of rules or requirements that relate specifically to SME lending. If you trawl through our website and look at all of our various standards and guides et cetera, you will have to work very hard to find any particular reference to specific SME requirements.

CHAIRMAN—And that is because it applies consistently across—

Mr Byres—We generally do not distinguish between types of business borrowers. 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 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.

Thirdly, to the extent that there have been changes to lending standards and pricing arrangements in the last few years, that has primarily affected the state of global financial markets and the flow-on from financial market conditions more generally rather than any specific regulatory changes. So, with those opening remarks, Graham and I will be happy to answer any questions you have.

CHAIRMAN—Your first point—that you do not distinguish between borrowers—would appear to me to be a normal approach, given that you have a set of rules, regulations and policies around consistency across markets and lending and so forth. Is there the potential though to look at specific rules? Is there a difference in the market, something which does differentiate the way people can borrow? Large enterprises—for example, equity financing—they have more options available to them, whereas small business really are very limited in terms of how they can access funds. Is there any potential or do you have a view in terms of what could affect different rules?

Mr Byres—I think the way many of our rules are expressed is that we would certainly be expecting the ADIs to take all of those factors into account in deciding whether a borrower is credit worthy and has an appropriate risk profile that the bank is happy to deal with. So, clearly,

we would be expecting a bank that was dealing with a very large corporate customer—the BHPs of the world—to assess the credit very differently to how they might look at the owner of a corner store or a shop in a regional town. So we would expect that difference; we would not expect a template approach that applied from top to bottom. The regulatory system is really designed, to the extent possible, to reflect differences in risk rather than differences in type of borrower or purpose of borrowing.

CHAIRMAN—Given that it reflects risk more than type of borrowing, it is an interesting point, because across the sector it is pretty much accepted that there is more risk, or more weighted risk, towards small business borrowing rather than a mortgage. Do you have any view on that—because there is a difference, there is a cost price difference between what is available in terms of a mortgage and what is available in terms of a small business? So there is a risk difference? There is a marked risk difference?

Mr Byres—Yes, I think there is a genuine consensus that that risk exists. I was looking earlier at the Reserve Bank submission, and there is a chart in their submission which looks at the spike in non-performing loans over the last few years within the banking system as a result of the more difficult economic conditions, and it is quite clear that, with the problems the banking system has had, there has been a stark distinction between the business experience and the residential mortgage experience, for example. That is where you are seeing the risk profile come out. One is many magnitudes of the other. It is natural for banks to seek to price to cover that risk.

CHAIRMAN—On the basis of that, there is a distinguishable risk difference. Does that have the potential to require further investigation in terms of regulation or activity in that area or is it really just a matter for the market to price that risk differently rather than there being different rules around it?

Mr Byres—Our objective would be to say that we do not want to be steering credit one way or another by way of our framework. That is not our job. Our job is simply to make sure that the risk that is taken on is appropriately managed and that there is a reasonable reward commensurate with that risk taken by the bank so that the depositors on the other side of the balance sheet are not unduly put at risk.

Mr Johnson—I think our letter makes clear, for example, on the SME side that an unsecured loan would have 100 per cent risk weight to a small business, whereas, if it were secured against residential mortgages, depending on the loan devaluation ratio, it would be substantially lower—perhaps down as low as 35 per cent. That is the risk base. If you have security, you get a lower capital requirement, which translates into a lower interest rate differential.

CHAIRMAN—You talked about Basel II, and Basel III is expected soon. Perhaps you could give us a view, from a regulatory perspective, of the impact of moving to a Basel III framework.

Mr Byres—The Basel Committee on Banking Supervision, which is the global standard-setting body, announced agreement on what is termed Basel III in late 2010. That has a start date of January 2013. There are phase-in arrangements that exist beyond that date, but for the purpose of this discussion we can say it is coming in in a couple of years time. Between now and then, we will be working on translating that international agreement into Australian standards. Over the coming months, and certainly for the rest of this year and early next year, we will be drafting

new standards for Australian ADIs, consulting with the industry and other interested parties about the shape of those, with a view to having them in place around the middle of next year with, as I said, a kick-off date of 2013.

What does that mean? Basel III remedies a number of weaknesses which were highlighted in previous global capital standards, highlighted by the GFC. Our view would be—and we have said is quite often—that the Australian prudential standards were some way above the global minimum requirements before. In many cases, this is the rest of the world moving up, and perhaps slightly beyond in some cases, from where we currently sit. 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.

CHAIRMAN—There is a concern that exists that any change involves some cost and that, in already difficult markets, the extra cost can be quite significant. But your view is that here in Australia we are already well placed with our regulatory frameworks and that, moving through Basel III—

Mr Byres—Given the fairly lengthy time horizon for full implementation, which extends for some years beyond 2013, plus the fact 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, we actually see that move to Basel III as being quite manageable without particular disruption.

CHAIRMAN—When you say ‘the banks’, are you referring to all deposit-taking institutions and all approved—?

Mr Byres—Yes. All ADIs.

CHAIRMAN—It has been raised with us on a number of occasions and in submissions that, if only there were more—broadly speaking, more banks, lenders, whatever it might be—then there would technically be more competition. I was wondering if you have the same view. Do you think ‘more’ is ‘more competition’ in the banking sector, or whether it is, as others have stated, just more funding that is required, more access to funds or whatever it might be, or other conditions.

Mr Byres—I think access to funds is the key. Clearly there has been some merger and acquisition activity, and some players have left the market as a result of that or been consolidated. But, many unregulated providers of finance have left the market simply because their access to funding has disappeared or is no longer cost-effective, so the new world is such that they can no longer provide finance in a cost-effective way.

CHAIRMAN—Is there anything from a regulatory perspective or a government policy perspective to turn that around? Does APRA have a view about whether it is simply a case of reality—that is, less funds available and therefore less competition in that sense? Or is there a particular policy lever that could be looked at by this committee?

Mr Byres—From an APRA perspective I am not sure that we could offer you much that was within our mandate. I do think there needs to be a recognition that, if people see the world in early 2007 as 'normal' and are waiting for a return to 'normal', they might be waiting a long time.

CHAIRMAN—Mr Johnson, do you have a view in this area?

Mr Johnson—I suppose it is worth saying that when there was non-bank competition, up to the latter part of 2007, that is when we saw a lot of the driving down of the risk margins and in many ways the mispricing that I think everyone acknowledges was around then and explains what subsequently happened. Competition can have two sides to it. One is that it drives down the risk margins to the extent that we saw and then we had certain consequences; none of those lenders are now in existence. I think that is just something worth keeping in mind.

CHAIRMAN—Moving to a more complex matter, within banking policy within individual banks and their own internal mechanisms and policies—those which are compliant with all of their responsibilities—but there is a great deal of scope for them to lend on a whole range of criteria which are really very much internal policy, like reassessments of liabilities, revaluation of assets, levels of risk they are prepared to take. Are there any mechanisms to ensure that there is fair treatment or consistency across the treatment of people who have, for example, existing finance arrangements with a bank and who are not unfairly treated in the way that their existing financial arrangements are reassessed?

Mr Byres—Well—

CHAIRMAN—I started with the hard one.

Mr Byres—The difficulty is that sometimes unfairness can be in the eye of the beholder.

CHAIRMAN—Consistency as well.

Mr Byres—The reason that banks and their customers enter into facilities that have maturity dates is so that there is an opportunity for both sides to renegotiate the terms and conditions. Some customers will choose longer-term facilities because they provide certainty. It is a bit like the decision that customers make between whether they take a floating rate facility or a fixed rate facility. Some people will want certainty and they will take a fixed rate and miss out potentially—

CHAIRMAN—The point I am driving at, and it is a difficult one, is the consistency across the bank itself or between the banks and lenders and how they treat those. If it is in the middle of a financial arrangement, and as we know there have been reassessments of the valuation of assets and the riskiness of a particular arrangement, it gives the lender a great deal of scope for completely restructuring a particular finance arrangement to the point where that restructure could mean extra fees, rewriting of the loan or perhaps extra insurance cover which in itself can mean a huge financial blow to that small business. It seems to me that there is a hole in that area. It is complex in terms of how you would deal with those particular issues, but it seems there may not be an existing mechanism to provide consistency across the banking sector on how that is treated.

Mr Byres—Yes, and I would have to say that I am not the experts in terms of the arrangements that exist, for example for the financial ombudsman scheme et cetera and the extent to which those sorts of arrangements could be utilised in the sorts of circumstances you are alluding to.

CHAIRMAN—It has been brought to our attention—and I dare say there is a fair bit of anecdotal evidence of this—that small business will describe situations where business, for argument's sake, was doing okay and the current arrangements were working, but the business was compelled to come in for a reassessment. A new risk profile was attached and a re-evaluation of assets which meant a rewriting of a particular financial arrangement which led to a new set of fees and charges which in turn meant that the LDRs changed and therefore insurance had to be paid for. This potentially meant that the business was now no longer financially viable because of that. It is almost like a self-fulfilling problem within the reassessment process. To me there seems to be a bit of a regulatory gap or some sort of greyness in that area about how the process around that is done. For a new application you would treat it at particular point in time on the information that you have at that point in time, but a reassessment leading to possibly a complete change in the viability of the business would be a hazardous circumstance.

Mr Byres—I understand the problem you are alluding to, but I am not sure I can offer you anything by way of solution on that one.

CHAIRMAN—It is a complex area, but I ask APRA, as the regulator, perhaps to consider that and write to the committee with some thoughts—if this is just not possible, fair enough—on whether there is some consideration of how regulation works on the treatment of specific financial arrangements.

Mr Johnson—You are looking at something similar to the hardship loan arrangements that the ABA has put in place?

CHAIRMAN—Yes, that is one example. I have heard of several, but a hardship provision might be that the bank, in appearing to be doing a good thing, says to someone they will be given a three- or six-month interest-free period or moratorium when in effect the bank is rewriting the loan and tacking the time period on at the end of the loan under the new loan conditions. So the customer is actually much worse off financially than they would have been if they had just maintained the position they were in even if it was difficult. I think there are some real moral hazard issues in that area and some real potential problems. It is an issue of scope and non-consistency. It would literally be up to an officer of the institution to make the decision on how to do that and whether it did it or not.

I have heard of—and as I said this is anecdotal, but I know there are such cases—of a business which was operating well, was viable and managing itself although things might have been tight, for which their bank, having reassessed a number of things and suggested a number of courses of action, actually created a problem resulting in the business failing because the new terms and conditions just were not possible to meet.

Mr Byres—I think we certainly understand the issue. The challenge is what to do about it because, as I said, what is someone's reasonable risk based pricing is someone else's

unreasonable request and excessive margin. They are often in the eye of the beholder, but I understand the issue and we will have a think about it.

CHAIRMAN—Can you take it on board?

Mr Byres—Yes.

CHAIRMAN—We would appreciate that. Thank you. I turn to the issue of capital requirements. ANZ reported that APRA has encouraged banks to increase term funding and reduce reliance on cheaper short-term wholesale funding. In fact, we have just heard from ANZ and they tell a story of things being quite rosy and positive, certainly for them, for small business lending and financing. Has there been any real impact that APRA can measure or tell us about in terms of this increased term funding and reducing reliance on cheaper short-term wholesale funding?

Mr Byres—Certainly we have been encouraging banks to heed the lessons of the GFC. One of the big lessons for the Australian banking system was that during the GFC those short-term wholesale markets, particularly the offshore markets, closed or became much more difficult for our banks to access even though, to all intents and purposes, they were very healthy banks. We have said to the banks that it is important they are not overly reliant on short-term offshore funding and encouraged them to seek either more deposit funding or more stable longer-term funding. That is part of the global Basel III regime as well, not just an Australian edict. It is part of the global thrust.

CHAIRMAN—When you say you have encouraged them, how have you encouraged them?

Mr Byres—We have spoken to them.

CHAIRMAN—You have spoken to them? That is fine.

Mr Byres—It is not as though there is a hard and fast rule. We have been talking to them. They were all well aware of the difficult experiences they had through the GFC, so it is a lesson and we have not had to earbash them very much for them to understand this lesson.

CHAIRMAN—How have they responded to your encouragement?

Mr Byres—Most of them have been saying, ‘Yes, that is what we are doing.’

CHAIRMAN—That is encouraging.

Mr Byres—One could say we are pushing on an open door there. We have been doing that and the banks have all made it clear that that is what they are doing. The point I would make though is that I do not actually see that has in any way restricted access or having any cause to restrict access to financing. Indeed, having spoken to a number of the larger banks recently, I would say they had all budgeted for more lending than they are currently doing.

CHAIRMAN—Is your assessment that demand has fallen off and there has been a natural falling away of growth in demand?

Mr Byres—These things are very hard to tell, but my observation from looking at banks' business plans and funding plans is that most banks had positioned themselves to be growing faster than they currently are. They had set themselves up to lend more than they are currently lending.

CHAIRMAN—If that is the case and that is correct then you would have to assume that they have spare capacity. The natural assumption would be spare capacity.

Mr Byres—Certainly if you look at their financial position at present, they have got good liquidity and they have got good capital.

CHAIRMAN—There are a number of contradictions in this whole debate. I suppose it is for us to sort.

Mr Byres—I can only say what we observe.

CHAIRMAN—Yes, that is all I am asking. But there does appear to be contradictions in terms of different organisations views as to what is happening in the market at present. I think there is a general agreement or view that demand has fallen off, although some are saying that demand is better than it has ever been. Others are saying, 'Look, there's just not enough competition and it is really about access to funds. There's just not enough.'

Mr Byres—Demand and supply are obviously interrelated. The supply might be there but not at a price that most people are happy to take the funds at.

Mr Johnston—It is definitely not there on the pre-2007 basis, which is what I think a lot of people are wanting.

CHAIRMAN—Please tell me if I have already asked this, because I have asked this question so many times, I almost forget: would you share the view of many others that, pre-GFC, finance was just too easy to get?

Mr Byres—I think was certainly too cheap. As a number of people have already said, risk premiums were very low, and that probably meant that people were able to show that they could afford funding which, in a tighter environment where risk premiums were higher, like now, is much more difficult to demonstrate. There is no doubt low risk premiums did allow people to access credit who perhaps now would find it difficult.

CHAIRMAN—Has the pendulum has now swung too far the other way? Is the risk assessment perhaps too difficult now? Is the balance not quite right?

Mr Byres—I would agree with the comments the RBA made earlier on: we would expect, as economic conditions improve, as the crisis drifts further behind us, to see more competition emerging and easier access to funds. I am not sure what the answer is—whether that is right or wrong.

CHAIRMAN—It just appears to me that there is an issue. Everyone accepts that in general terms finance was too easy pre-GFC and there was a runaway in the market. Most people said it

was bull market type conditions and so forth, with more and more risk being rated down and not being a concern. Is that a regulatory problem? Is that an issue in terms of how much scope you allow the market? Do you allow market participants to determine themselves the full risk to the point of disruptive behaviour or destruction of small businessmen? It just appears that we all agree that there was too much. Maybe now it is a little bit too tight and as the market improves that will lessen. Is there a regulatory issue in allowing players in the market to determine themselves what levels of risk they will assume—at that destructive level pre-GFC, I mean?

Mr Byres—We would hope that there is a role for the regulator there when things are getting to destructive levels. Having said that, though, we do not pretend we somehow know more than anyone else. In Australia we would argue we certainly saw some concerns building through the past decade. That is one of the reasons why we had tightened up our capital standards ahead of the rest of the world. We are not going to start telling banks how much they can lend or who they can lend it to, but if the environment is a more heady one, we should make sure there is sufficient buffer there such that when things inevitably turn around people can deal with it. That is typically how we would respond in a regulatory way to that sort of thing.

Senator STEPHENS—I will ask a very basic question. It might seem to be the wrong end of the day to be asking this question, but having you before us is helpful. The banks apply to APRA to be able to use the advanced risk weighting model. Could you tell us about the features of that advanced risk weighting model and what are the benefits to the banks being able to do it?

Mr Johnson—Essentially, they are models based on past experience. They also look at, over the cycle, the potential losses and look very much at the various segments of business. They look at—as some of the bankers have mentioned—the probability of default in those loan categories over the cycle and the loss given default, and they generate capital outcomes. Five banks are now advanced model users. We took 2½ to three years to approve those models. We benchmarked them to ensure the robustness of the process. After going through a trial, a parallel period of comparing how those models worked, we allowed them to determine their capital on that basis. We review that on a regular basis. Every year we have quite detailed on-site visits to look at the actual performance in those categories of lending and what the models would have predicted. All the other banks that do not meet those models are on a standardised approach.

Senator STEPHENS—The incentive is there for the big banks to move that way. Are there incentives for the smaller banks to adopt that model?

Mr Johnson—Anyone who is sophisticated enough can use a model but, to date, we only really have a small number that have either applied or got through the process.

Mr Byres—If you looked through all our standards, there is nothing that precludes any sort of institution from applying. It is all about: do you have the capability; do you have the robustness in your modelling approaches? What we are really saying in these advanced approaches is, instead of the regulator determining how much capital you have, we will give you much more input into that process. You will have a fair say in determining how much capital you need to hold. For us it is a big deal to allow banks to do that. The test is not about size; it is about capability and, as Graham said, the robustness and the reliability of the output of these models.

CHAIRMAN—Do you encourage the sector to do this? Is there an advantage in doing this to get the right settings or capital requirements?

Mr Byres—On the whole, the incentive for the models based approach is that we generally have lower capital outcomes overall than the standardised approach. For example, I mentioned earlier the 100 per cent risk weight for unsecured lending. That is a blanket weight; it could apply to a doctor or somebody with a cashflow with no uncertainty of earnings through to someone just starting up a business with a potential of volatility of cashflow. The advanced models allow a far more granular way of structuring capital requirements and pricing according to the particular segment you are dealing with.

Mr GRIFFIN—Can you tell us the five banks that use the advanced model?

Mr Byres—The four major banks and Macquarie Bank.

CHAIRMAN—I will finish on the issue of a code of practice for lending to small business. I want your view, from a regulatory perspective. The Australian Bankers Association have put forward a view that they have developed a code of practice and so has CPA Australia. I would be very interested in APRA's view as to the potential advantages and how it might work. Is this something that deserves further attention?

Mr Byres—I am not sure it is something that APRA would seek to promote, but it is certainly something that we would have no objection to. Many codes of practice exist around the world. They obviously need to reflect the legal environment in which they operate. Provided they did not do anything that would explicitly conflict with one of APRA's prudential requirements, there is no reason for us to be concerned about developing that sort of code.

CHAIRMAN—You would not see it as a negative, though?

Mr Byres—No.

CHAIRMAN—There is no down side to a code of practice?

Mr Byres—Not that I can think of.

CHAIRMAN—We can clear that one off the table. There is no negative. Would you like to add anything else, following on from what we have just discussed, that you think might be of importance?

Mr Byres—No.

CHAIRMAN—In that case, I thank both of you for appearing. We appreciate your submission and your time.

Committee adjourned at 4.55 pm