

## **PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES INQUIRY INTO ACCESS FOR SMALL AND MEDIUM BUSINESS TO FINANCE**

This submission is in two sections, reflecting the Inquiry's terms of reference. The first section summarises recent developments in small business finance. The second discusses the state of competition in lending to small businesses. This submission updates the Reserve Bank's submission to the Senate Inquiry into the Access of Small Business to Finance in March 2010.<sup>1</sup> The main conclusions are:

- Lending to small businesses has increased slightly over 2009 and 2010, after growing steadily over the decade prior. The slowdown reflects both reduced demand from businesses and a general tightening in banks' lending standards. Small businesses in most industries have been able to access funding throughout the financial crisis, albeit on less favourable terms than previously.
- Higher funding costs and a reassessment of risk have resulted in an increase in the spread between the rates that lenders charge on business loans and the cash rate. The Reserve Bank Board has taken this into account in its monetary policy decisions, and the cash rate remains below its average since the end of 1996. Lending fees have risen, though for most businesses, these represent a small part of the overall cost of a loan. Fees charged on deposit accounts have fallen as banks compete more aggressively for this source of funding.
- 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. This should continue as the economy continues to strengthen.

### **Trends in Intermediated Small Business Finance**

Businesses use a combination of debt and equity to fund their operations. Compared with large companies, smaller businesses tend to make greater use of debt funding and less use of equity funding; the latter is generally limited to the personal capital of the owners. Small businesses rely mainly on loans from banks and other financial institutions for their debt funding, as it is difficult and costly for them to raise funds directly from debt capital markets. Most lending to small businesses is secured against residential property.

There is no single measure of what constitutes a small business, and so the Reserve Bank uses several measures to delineate small and large businesses and the finance flowing to these sectors. One measure of finance provided to small business is lending to unincorporated enterprises. Another is based on the size of loans, where it is assumed that loans of less than \$2 million are generally provided to small businesses, while loans larger than \$2 million are assumed to finance larger businesses. No further

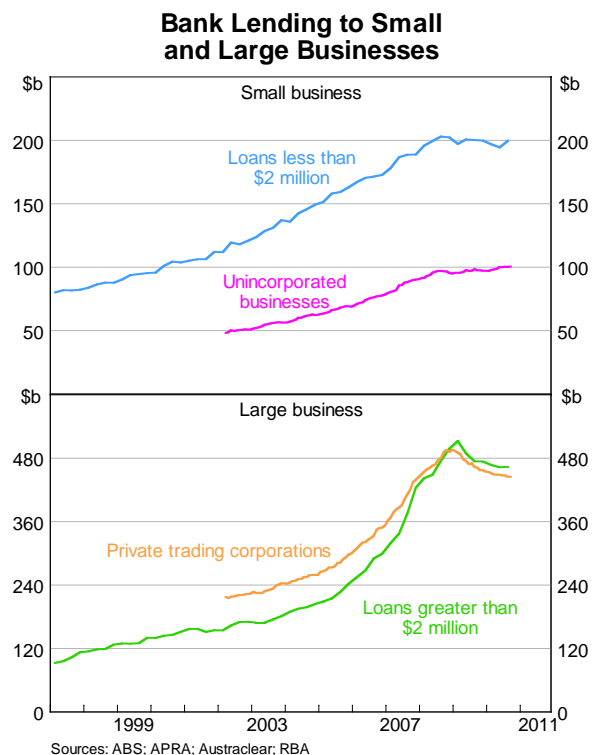
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<sup>1</sup> Reserve Bank of Australia, (2010), '[Inquiry into Access of Small Business to Finance](#)', Submission, March.

breakdown of loans above \$2million is available, and hence, it is not possible to provide any further information on financing to medium-sized businesses.

Lending to unincorporated businesses by banks has continued to grow over 2009 and 2010, albeit at a much slower rate than in the prior few years (Graph 1). The other measure – loans of less than \$2 million – shows a similar pattern. The value of these loans outstanding was little changed since the beginning of 2008 after growing steadily over the previous decade. In September 2010, the total value of all loans smaller than \$2 million was around \$200 billion and accounted for about 30 per cent of total business lending by banks.

**Graph 1**



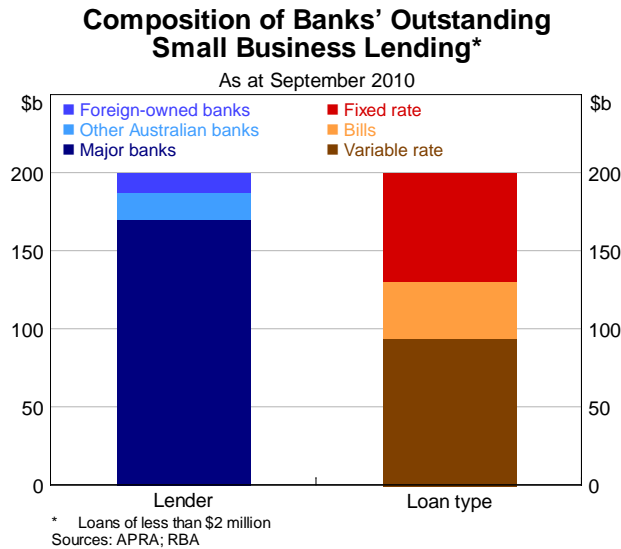
In contrast, borrowing by large business has fallen as these businesses have raised new equity capital to repay debt and have scaled back their debt-funded acquisitions.<sup>2</sup> Banks have also tightened their lending standards for large businesses (as they have for smaller businesses – see below).

In September 2010, the majors accounted for about 86 per cent of the total value of business loans smaller than \$2 million, compared with 74 per cent of larger loans (Graph 2). The smaller Australian banks account for most of the remaining lending to small businesses. Foreign-owned banks provide only a small share, in part because they do not have a substantial branch network.

<sup>2</sup> See Black, S, J Kirkwood and S Shah Idil, (2009), '[Australian Corporates' Sources and Uses of Funds](#)', RBA *Bulletin*, October.

About two-thirds of lending to small businesses is through commercial bills and other loans with variable interest rates. The remaining third of lending is at rates that are generally fixed for between one and five years.

**Graph 2**



The slowdown in small business credit growth over the past couple of years reflects both demand and supply factors. Small businesses' demand for debt funding fell as the increased uncertainty about the economic outlook led them to scale back their capital expenditure plans and focus on reducing their existing debt. On the supply side, financial intermediaries tightened their lending standards during the recent economic slowdown as their non-performing assets rose. Small business borrowers have faced lower loan-to-valuation ratios, stricter collateral requirements and higher interest coverage ratios.

Business surveys suggest that the availability of finance is not the most significant factor concerning small businesses at present.<sup>3</sup> According to the PwC/East & Partners Business Barometer, the availability of credit appears to have been less of a constraint than it was a year ago. In September 2010, 37 per cent of businesses expected the availability of credit to be a constraint in the year ahead, compared with 82 per cent of businesses surveyed in late 2009. By comparison, in September 2010, around 60 per cent of businesses cited global economic conditions and a general deterioration in confidence as an impediment on business activity. Likewise, the Sensis Business Index and ACCI Small Business Survey suggest that issues such as lack of sales, economic climate and future cash flows are more of a concern for small businesses than the cost and availability of debt financing. NAB's Quarterly SME Business

<sup>3</sup> The PwC/East & Partners Private Business Barometer surveys around 1 100 private businesses with annual turnover between \$10 million and \$100 million; around 90 per cent of companies have fewer than 100 employees. The Sensis Business Index covers approximately 1 400 small businesses and 400 medium businesses (20 to 199 employees). The NAB SME survey includes about 700 firms with annual turnover between \$2 million and \$10 million. The ACCI Small Business Survey covers small (fewer than 20 employees), medium (20 to 99 employees) and large business (100 or more employees). The survey generally includes 1 000 to 2 000 firms.

Survey indicates that cash flows, global economic uncertainty and a lack of demand are significant issues facing around 30 per cent of small and medium businesses, while credit conditions remain a concern for around 15 per cent of businesses.

In aggregate, the available data and liaison by the Reserve Bank, including through its Small Business Finance Panel,<sup>4</sup> suggest that small businesses in most industries have had tighter but still reasonable access to funds throughout the financial crisis. Property companies are a notable exception. Smaller developers may have also faced financing constraints as a result of the contraction in mortgage trusts. Liaison suggests that recent concerns for the retail and agriculture sectors have also resulted in some banks monitoring these sectors more closely.

### *Interest rates*

In setting their interest rates on small business loans (as well as on loans to large businesses and households), lenders take into account their funding costs and the perceived riskiness of the borrower.

In the decade prior to the financial crisis, small business indicator rates generally moved in response to changes in the cash rate, which were the predominant driver of changes in funding costs. The average outstanding rate on small business loans declined, however, as there was a gradual fall in the perceived, and realised, riskiness of small business borrowers during this period (partly due to the increased use of residential property as security).

One common concern of small businesses is that interest rates on residentially secured small business loans are priced at a premium to residentially secured housing rates. However, this pricing results from the higher expected losses on small business loans as well as the larger amount of capital that banks hold as a buffer against unexpected losses. In the first case, estimates based on past experience suggest that small business borrowers are more than twice as likely as standard mortgage customers to default and, in the event of default, a lender is likely to lose close to 30 per cent of the small business loan's value, compared to 20 per cent for housing loans. In the second case, commercial bank estimates suggest that they hold about three times as much capital against small business loans as residential mortgages.

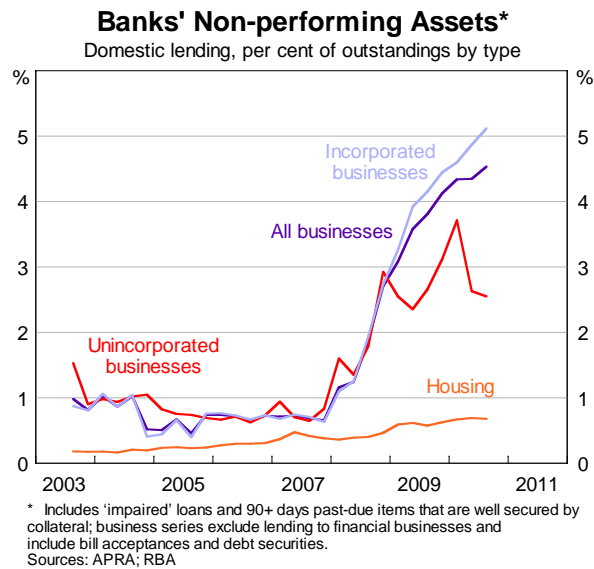
As the financial crisis unfolded, the higher cost of deposits and long-term wholesale funding has seen banks' funding costs increase by more than the cash rate.<sup>5</sup> There has also been an increase in the assessed riskiness of small business loans. This is consistent with the increase in non-performing small business loans, which have risen to be around 2½ per cent of banks' total small business loan portfolios as of September 2010 (Graph 3). This is up from a little under 1 per cent during 2005–2007.

<sup>4</sup> The Small Business Finance Panel is a group of small business operators from around Australia that the Reserve Bank convenes to discuss finance conditions in the small business sector.

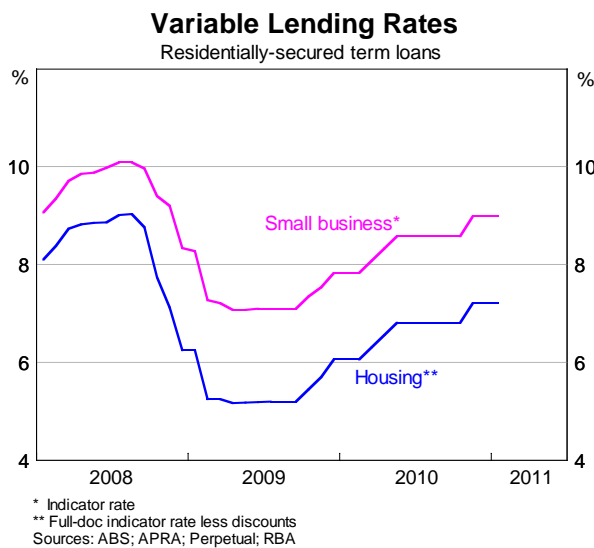
<sup>5</sup> See Brown, Davies, Fabbro and Hanrick (2010), '[Recent Developments in Banks' Funding Costs and Lending Rates](#)', *RBA Bulletin*, March, Reserve Bank of Australia, (2010), '[Developments in Bank Funding Costs](#)', *Statement of Monetary Policy*, August, and Reserve Bank of Australia, (2010), '[Inquiry into Competition within the Australian Banking Sector](#)', Submission, November.

As a result of the above factors, the average residentially secured small business rate is estimated to be currently about 180 basis points above the residentially secured housing loan indicator rate (Graph 4), compared with a differential of about 95 basis points at the beginning of 2008.

**Graph 3**



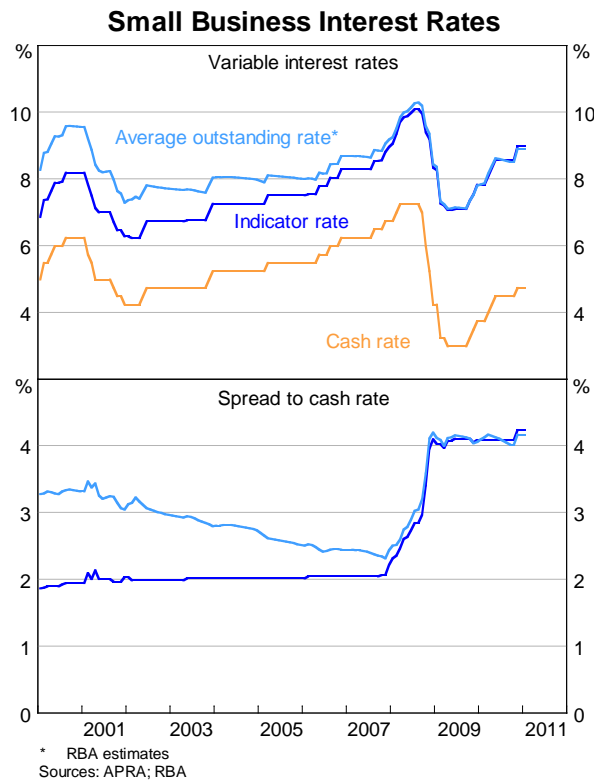
**Graph 4**



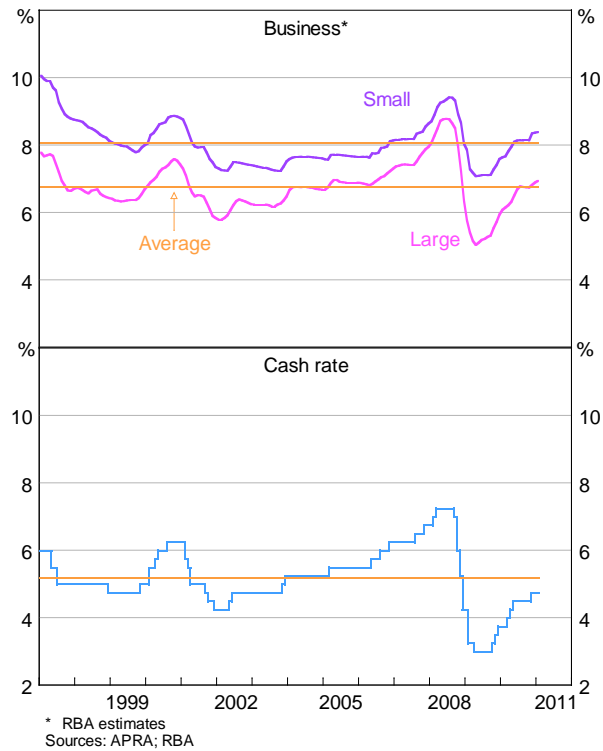
Reflecting higher funding costs and a reassessment of risk margins on business loans, the major banks' variable indicator rate for residentially secured loans has risen by about 220 basis points relative to the cash rate since mid 2007 (Graph 5). Over the same period, the spread between the actual variable rate paid by small businesses and the cash rate also rose by about 175 basis points. Over the decade prior to the onset of the financial crisis the actual variable rate paid by small business moved much closer to the small business variable indicator rate, reflecting the strong competition between lenders and an increase in the use of residential property as collateral.

Indicator rates on new 3-year fixed rate small business loans have risen by about 150 basis points relative to the corresponding 3-year swap rate, a common pricing benchmark. This reflects both an increase in risk margins of business loans and an increase in the funding costs for fixed rate loans.

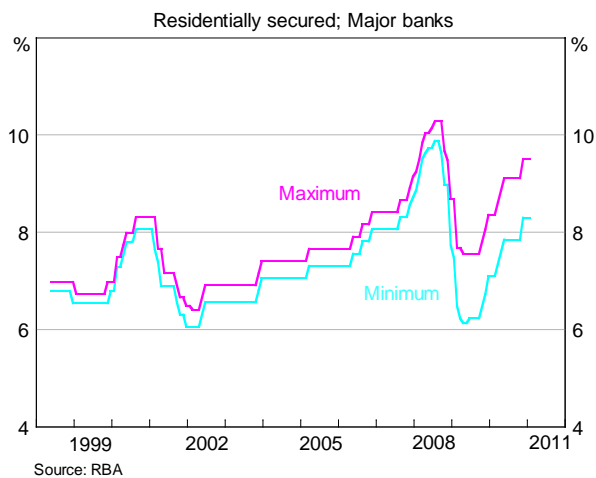
**Graph 5**



Notwithstanding the increase in spreads as a consequence of higher funding costs and greater risk, the average rate on outstanding small business loans (including variable-rate and fixed-rate) has fallen by about 110 basis points from its peak in mid 2008, reflecting the large net reduction in the cash rate since then (Graph 6). At the end of January 2011, the average rate on outstanding small business lending is estimated to have been about 30 basis points above its post 1996 average. This is similar to the relativity between the current level of the standard variable housing loan rate and its long-term average.

**Graph 6****Average Interest Rates on Outstanding Lending**

Over recent years there has also been a marked increase in the range of interest rates offered for similar products, possibly reflecting banks competing on non-price criteria. For example, in January 2011, the range between the highest and lowest rate offered by the major banks on a residentially secured small business loan was around 120 basis points, compared with 35 basis points in June 2007 (Graph 7).

**Graph 7****Indicator Rates on Small Business Variable-rate Loans**

## *Fees*

The RBA Bank Fees Survey shows that in the 2009 financial year, banks' fee income from businesses (both small and large) amounted to \$7.6 billion, a rise of 13 per cent over the previous year.<sup>6</sup> Lending fees – those on loans and bank bill facilities – accounted for just over half of total fees on businesses, while merchant service fees and fees on deposit accounts accounted for most of the remainder.

Lending fees increased by about 24 per cent during the 2009 financial year, somewhat faster than in previous years. The increase in fees on these facilities largely reflects the repricing of credit and liquidity risks; in particular, fees on undrawn facilities appear to have risen significantly. However, fees are only a small part of the overall cost of a loan for most businesses. In 2009, lending fees were equivalent to about 60 basis points on the stock of banks' outstanding business lending, around one-tenth of the average interest rate paid on outstanding business loans.

Based on information released in banks' annual reports, it is likely that the major banks' banking fee income, derived from both households and businesses, will decline a little in the 2010 financial year. Details of changes in banks' fee income from businesses will be available from the RBA's next survey of bank fees to be published in mid 2011.

### **Competition in Small Business Lending**

Competition in lending is cyclical. During periods of strong economic growth, banks tend to compete aggressively for business lending by cutting their margins and relaxing their lending standards. However, when the economic and business outlook is uncertain and loan losses are rising, as has been the case over the past couple of years, banks take a more conservative approach.

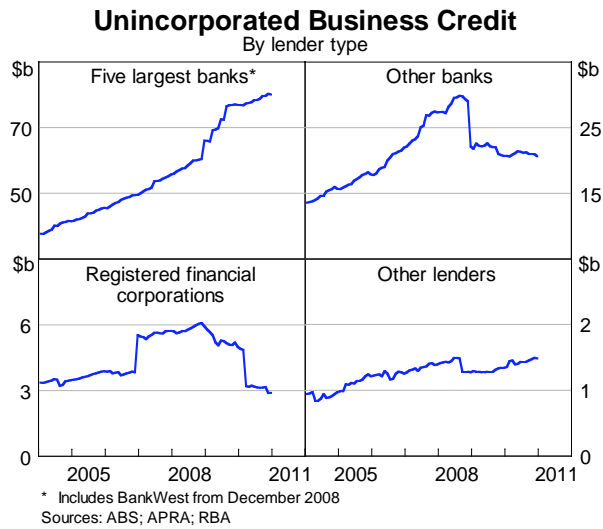
Reduced lending by the smaller banks and the non-bank financial institutions appears to have been the main factor in the easing in competition for small business loans in the recent cycle (Graph 8). Lending by non-bank firms has fallen by almost a half since the onset of the financial crisis, while lending by smaller banks remains well below its peak in 2008. In contrast, the major banks have continued to increase their lending over the past few years. This has resulted in a significant jump in their market share, accounting for about three-quarters of lending to unincorporated businesses, and about 70 per cent of total business credit (Graph 9).

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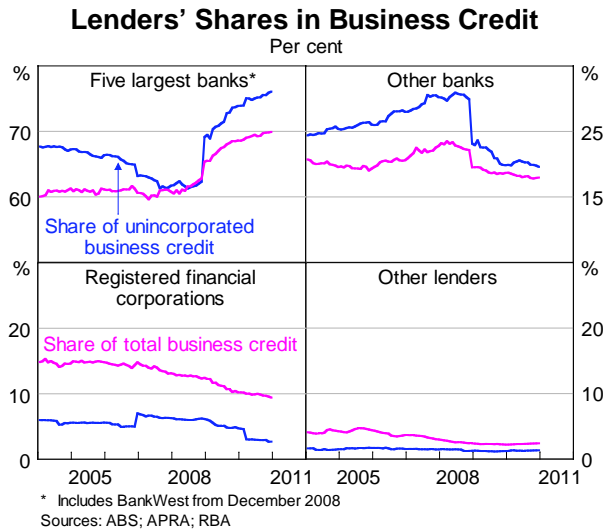
<sup>6</sup> See Reserve Bank of Australia, (2010), '[Banking Fees in Australia](#)', *RBA Bulletin*, June.



Graph 8



Graph 9



Past cyclical patterns suggest that competition for business lending is likely to pick up over time and there are some early signs of this in the Reserve Bank's liaison with medium and large businesses. Foreign-owned banks are also likely to look to expand their presence in the market as global conditions continue to improve.

Reserve Bank of Australia  
SYDNEY

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