NOTES ON BANK FEES ON SMALL BUSINESSES[1]

At the previous meeting of this Committee, the Bank presented a preliminary analysis it had conducted into bank fees in Australia.[2] That analysis provided an overall perspective on banks' non-interest income and concluded that:

- over the past decade, banks have earned a rising proportion of their total income from non-interest sources;

- the major reason for this was the slower growth in interest income due to declining margins. Growth in fee income has been no faster than growth in bank assets over the past decade; and

- the increases in non-interest income have not been sufficient in the case of the household sector to offset the decline in interest margins. Thus, on balance, customers are better off, although those with small balances and a lot of transactions could be worse off.

The Committee subsequently asked if the Bank could provide more detail about how small businesses have been affected by changes in bank fees and charges. This note looks at this issue, although the qualifications applying to the previous study, because of a lack of comprehensive data, apply at least as strongly to this analysis.

There are two main sources of data on bank fees. The first relates to the fees on individual products. This information is often publicly available and the Bank has been collecting it for some years. It is, however, very detailed, is affected by changes over time in the range of products that banks offer, and does not capture the fact that, particularly for business customers, fees can be negotiable. Drawing conclusions about trends in fees is only possible by standardising the information using assumptions about the size and term of loans. Our analysis of changes in the pricing of individual bank products over the past five years, using this approach, is given in the first half of this note.

The second source of data relates to the total amount of fee income earned by banks. Banks have always included very aggregated data on this in their annual reports. But they do not show enough detail to allow much analysis of how different types of non-interest income have moved, or how different types of customers have been affected. Consequently, the Bank has begun a new data collection which gives more detail on bank non-interest income. These figures, however, are only available from 1997. This limits the extent to which we can draw conclusions at this stage, but some preliminary assessments – as they relate to small businesses – are given in the second half of this note.

1. Bank Fees from Small Business

Banks charge small businesses fees on loans and bill lines, on transactions they undertake, as well as for access to the payments system, mainly in the form of merchant service fees.

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[1] These notes are prepared for the information of members of the House of Representatives Standing Committee on Economics, Finance and Public Administration.

[2] See *Bank Fees in Australia,* Reserve Bank *Bulletin,* June 1999.

Loan and bill fees

There are two main types of fees payable on loans: an establishment fee, usually charged up front as a dollar amount, plus an on-going line or service fee (usually a percentage amount). Estimates of average loan fees faced by small business for different types and sizes of loans are summarised in Table 1.

Table 1: Small Business' Loan Fees
(Average of Major Banks)

	1994	**1997**	**1998**	**1999**
Loan establishment fee ($)				
$50,000 loan	590	625	630	615
$100,000 loan	965	925	890	740
$250,000 loan	2170	2080	1930	1480
Overdraft fee (% p.a.)				
$50,000 loan	1.20	1.20	1.20	1.20
$100,000 loan	1.10	1.10	1.05	0.95
$250,000 loan	1.00	1.00	0.90	0.65
Term loan fee (% p.a.)				
$50,000 loan	0.60	0.60	0.65	0.75
$100,000 loan	0.35	0.35	0.40	0.45
$250,000 loan	0.20	0.20	0.25	0.25

Source: Reserve Bank estimates based on information provided by banks.

Loan establishment fees apply to both overdrafts and term loans. They are a once-off payment made at the time a loan facility is approved. The establishment fee paid depends on the value of the loan, although banks' pricing structures usually mean that this fee increases less than proportionally with the value of the loan. Loan establishment fees have tended to fall in recent years, especially on medium to larger loans. For example, the average establishment fee of $740 on a loan of $100,000 is about 75 per cent of its level, in nominal terms, five years ago.

Line fees on overdrafts or service fees on term loans, which are additional to loan establishment fees, are charged as a margin to the approved limit of the relevant facility. Fees on overdrafts are higher than those on term loans, although the former have recently tended to fall, whereas the latter have increased slightly.

It is possible to estimate the overall impact of these fees by expressing the sum of loan establishment fees and line/service fees as an interest-rate equivalent using assumptions about the term and size of the loan concerned. The figures in Table 2 illustrate the impact of these fees on the cost of loans to small businesses.

Table 2: Effective Interest Cost of Small Business Loan Fees*
(Per Cent Per Annum – 1999)

	Three-Year Term	Five-Year Term
Overdraft		
$50,000 loan	1.60	1.45
$100,000 loan	1.20	1.10
$250,000 loan	0.85	0.85
Term loan		
$50,000 loan	1.20	1.00
$100,000 loan	0.70	0.60
$250,000 loan	0.45	0.40

* Estimated effective cost due to establishment and line/service fees of a fully-drawn facility.

This figuring shows that, as would be expected, fees add less to term loans than overdrafts, and effective costs decline both with the term of a loan and its size. Fees are estimated to add about 1.6 percentage points a year, over three years, to a fully-drawn overdraft of $50,000, whereas they might add 0.4 of a percentage point to a term loan of $250,000 for five years.

Transaction fees

In the case of transaction accounts (mainly deposits) banks charge two main types of fees: account-servicing fees and fees per transaction. These fees, as they apply to small businesses, are summarised in Table 3. As in Table 1, these fees represent the average of the four major banks and there can be significant variation among the banks.

Table 3: Small Business Transaction Fees
(Average of Major Banks – 1999)

	Small Business				Memo item: Household fees
	1994	**1997**	**1998**	**1999**	**1999**
Account-servicing ($/month)	11	10	10	10	5[(a)]
Number of free transactions (monthly)	30	40	37	35	8[(a)]
Transaction fees ($ per transaction)					
ATM (own bank)	0.25	0.30	0.30	0.25	0.60
ATM (other bank)	0.25	0.95	1.15	1.30	1.40
EFTPOS	-	0.30	0.30	0.25	0.50
PC-linked	0.30	0.10	0.15	0.25	0.10
Cheque	0.30	0.30	0.40	0.40	0.75
Counter withdrawal	0.25	0.40	0.55	0.65	2.15
Bill payment	-	0.30	0.30	0.25	0.45

(a) For major banks which have this structure of fees on their main retail transaction accounts. For one major bank, the most popular option of its main retail account has no free transactions and no account-servicing fee. Transaction fees can be waived under certain conditions. The averages are rounded to the nearest 5 cents.

Source: Banks' brochures.

Account-servicing fees are usually charged on a flat rate per month, and provide for a number of free transactions before business customers pay fees on the transactions they make. Over the past five years, the average account-servicing fee has fallen slightly while the number of fee-free transactions has increased. Both changes would have reduced costs of small businesses.

In the case of transaction fees that apply once the fee-free threshold has been reached, the following conclusions can be drawn about movements over the past five years:

- the average fee on transactions in which the ATM of a business' own bank is used has remained unchanged;
- fees on use of other bank's ATMs, cheques and counter withdrawals have increased;
- fees on PC-linked transactions initially fell, but more recently have risen to a level similar to those for other electronic transactions; and
- in the past couple of years, fees on some new services, such as EFTPOS and bill payments, have fallen.

In comparing the transactions fees paid by small businesses to those paid by households, the following appears to be the case:

- transaction fees on small businesses are lower than the corresponding fees for households;
- the average account-servicing fee for small business borrowers is higher than for households; and
- the number of fee-free transactions is substantially larger (35 per month compared with 8 per month).

2. Total Fees

As noted, earlier this year the Bank began collecting from banks comprehensive data on their total fee income. At this stage, data are available only for 1997 and 1998, though figures for 1999 should be available within the next couple of months.

These data show that, in 1998, the six largest banks in Australia collected about $1.6 billion in fee revenue from small business, representing about 35 per cent of these banks' fee income (Table 4). Growth in this fee income in 1998 was 15 per cent, which was less than the rise in fee income from households but more than that from large business.

Table 4: Banks' Fee Income in Australia

	1997 ($m)	1998 ($m)	Per Cent Change
Households	1095	1410	29
Small business	1395	1610	15
Large business	1400	1490	6
Total	3890	4510	16

Source: Reserve Bank of Australia.

The sources of banks' fee income from small business are summarised in Table 5. It should be noted that, in discussing the composition of banks' fee revenue from small businesses, we have greater confidence in the aggregate statistics than in the components because we are relying on data from banks' internal management systems in which definitions may vary from bank to bank.

Table 5: Sources of Fee Income from Small Businesses

	1997 ($m)	**1998 ($m)**	**Per Cent Change**
Loans	475	585	23
Bank bills	285	265	-7
Deposit accounts	150	165	10
Merchant service and other fees	485	595	23
Total	1395	1610	15

Source: Reserve Bank of Australia.

Fee income from small business loans amounted to $585 million in 1998, about 35 per cent of fees collected from small business. This category of fees rose by 23 per cent in the year, compared with a rise in lending to small business (excluding bills) of 13 per cent, suggesting that the rate at which loan fees have been levied might have increased. With one exception, this pattern is difficult to see in the relevant fees which banks advertise. It is possible that some revenue from transactions is being captured in loan fees. Data for 1999, when they become available, may help to resolve this apparent inconsistency.

Aggregate fee income from bill lines was $265 million in 1998, a fall on the previous year, which was in line with the trend in bill financing.

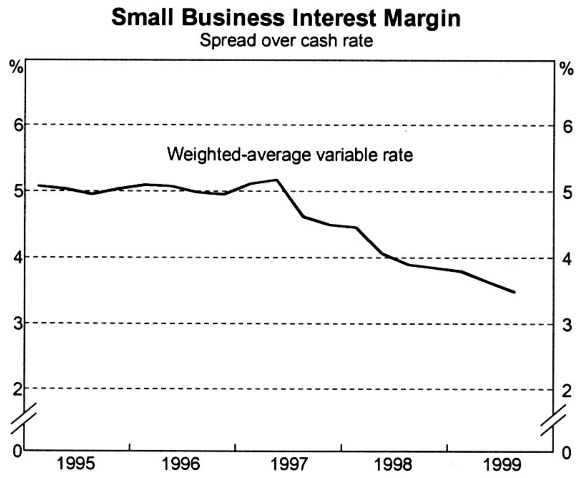
Fees from deposit accounts – mainly from transactions and account-servicing – grew by about 10 per cent in 1998 to $165 million. This was broadly in line with overall deposit growth.

Other fees, which mainly comprise merchant service fees paid by business on card transactions, were $595 million in 1998, a rise of 23 per cent on the previous year. This was in keeping with growth in turnover in credit cards. Accordingly, it is likely that the rise in fee income from this source did not reflect higher charges *per se*.

Have higher bank fees offset the fall in interest margins?

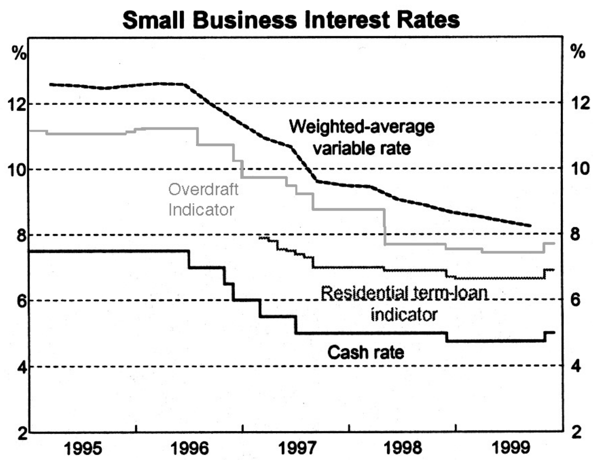
As with banks' interest margins generally, interest margins on small business loans have narrowed in recent years. The margin between the average interest rate small businesses pay on variable-rate loans and the cash (policy) rate (which is a proxy for the cost of funding such loans) has narrowed by about $1^1/_2$ percentage points – from a little above 5 percentage points in mid 1997 to about $3^1/_2$ percentage points at present (Graph 1).

Graph 1



This narrowing in margins reflects a combination of factors: reductions in 1998 in the small business indicator rates, independent of any move in monetary policy; the introduction of new, lower-cost products by banks; and reductions in risk margins, partly reflecting the more explicit recognition of the quality of assets offered as collateral. Small business loans secured by residential property, for example, in most cases no longer attract a risk margin and are available at an 'all-up' cost close to the standard mortgage rate available to households.[3] Interest rates on various types of loans to small business are shown in Graph 2.

Graph 2



We do not have data to draw firm conclusions about whether, over a long run of years, fees have increased by more or less than the fall in interest margins. But, the various pieces of evidence suggest that fees on small businesses have increased by much less than the fall in interest margins. Between the two years for which data are available (1997 and 1998), total fees collected from small businesses on loans rose from the equivalent of 1.3 per cent of loans to 1.4 per cent of loans. This increase was much less than the fall in interest margins on small business loans that took place at that time, so there does not seem to have been any simultaneous switching by banks from interest to non-interest income.

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[3] See *Recent Developments in Bank Interest Rates,* Reserve Bank *Bulletin,* April 1999.

3. Conclusions

From the above, we draw three conclusions:

a) Looking at the fees charged on individual products:

- there does not seem to be any systematic increase in fees charged and in some cases, particularly for larger small business loans, fees seem to have fallen;
- account servicing fees have, if anything, fallen a little over the past five years, and the typical number of fee-free transactions has been increased;
- fees for transactions have increased for those types of transactions involving old technology and higher costs (eg cheques and counter withdrawals) and for use of other banks' ATMs. But fees on use of own-bank ATMs have been steady and, over the past five years, there has been some net reduction in fees for newer services such as PC-linked transactions and bill payments.

b) At the aggregate level, total fees earned from small businesses increased by 15 per cent in 1998, the only year for which data are available. While this is a fast growth rate, it is broadly in keeping with the growth of small business financial transactions so that, on a "per unit" basis, there does not seem to have been an increase in fees.

c) It is unlikely that the increase in fee income for small business has offset the benefit these businesses received from falling interest margins. This conclusion is necessarily tentative because of the short run of data. As noted, estimates for 1999 should be available in a couple of months.

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