Box E: Aspects of Small Business Finance

The tentative signs of increased competition in small business finance that were evident six months ago have become clearer in the period since. In particular, banks have started cutting interest rates on mainstream lending products, such as overdraft facilities, and the average all-up interest rate paid by small businesses (including customer risk margins) has fallen significantly even though monetary policy has not been changed.

As noted in the material provided in the lead-up to the Bank's previous appearance before the Committee, signs of increased competition in the small business loan market began to emerge following the reduction in banks' housing loan margins in 1996 and early 1997. Initially, competition for small business loans took the form of products at discounted interest rates aimed at new customers. These developments had some parallels to the way competition in the housing loan market first appeared. But, as was the case for housing loans, competition eventually spread to mainstream small business products. In early 1997, major banks announced new residential-secured products, either as overdraft or term loans, at interest rates of $1\frac{1}{2}$–2 percentage points below the standard overdraft indicator rate, and without a customer risk margin.

In recent months most of the major banks have announced reductions in overdraft indicator interest rates of between 1 and 1.8 percentage points. In some cases, a fixed margin applies above these indicator rates according to collateral and whether the facility is a term loan or overdraft. While there is no single predominant rate, indicator rates on small business variable-rate loans from major banks are now concentrated around 7 per cent, the lowest indicator rate offered on a 'widely available' product by a major bank since the early 1960s. Previously, all the major banks had been advertising indicator rates of 8.75 per cent or a little more for all but residentially secured lending (Table E1). Before the easings of monetary

Table E1: Small Business Indicator Rates[a]
Per cent

		May 1998	December 1997	June 1996
Overdraft:				
Secured by residential property[b]	range	6.95 – 7.20	6.80 – 7.70	n.a.
	average	7.1	7.2	n.a.
Other[c]	range	6.95 – 8.75	8.75 – 8.95	11.25
	average	7.7	8.8	11.25
Term:				
Secured by residential property[d]	range	6.80 – 6.99	6.80 – 7.15	n.a.
	average	6.9	7.0	n.a.
Other[c]	range	6.95 – 8.75	6.99 – 8.95	9.45 – 11.25
	average	7.7	8.8	11.0

(a) Major banks.
(b) Most banks do not apply a margin to overdrafts secured by residential property, although one does.
(c) Customer risk margins apply to these products.
(d) Since March 1997, banks have not applied a customer risk margin to term loans secured by residential property.

policy in mid 1996, the major banks' overdraft products were based uniformly on an indicator rate of 11.25 per cent.

The recent announcements by banks have reinforced a trend towards giving greater recognition to the type of security offered for loans. This tiering of interest rates according to security offered reflects the spectrum of risk in business lending if the need arises to liquidate collateral in the event of business default.

The effects of growing competitive pressure will show up over time in further falls in the average interest rate paid by small businesses. These data, which cover the all-up interest rate paid by small business – i.e. indicator rates plus customer risk margins – are collected by the Bank on a quarterly basis. The latest figures available are for the December quarter. Whereas in the couple of years to mid 1997 there had been little change in this rate apart from that due to changes in monetary policy, in the period since then it has fallen significantly. The average overall interest rate paid by small businesses on variable rate loans was 9.4 per cent in the December quarter, down from 10.6 per cent six months earlier. This reduction reflected, to an important extent, the new lower-priced products introduced in 1997. Obviously, the more recently announced reductions in overdraft rates referred to above have not yet been reflected in these figures.

These reductions have meant that the margin between the rate banks charge customers and their funding costs has narrowed (Table E2). In the case of variable-rate loans, banks' funding costs can be approximated by the cash rate. The margin between the indicator rate on a standard overdraft and the cash rate had been mostly around 3.75 percentage points over 1996 and 1997; the average margin for major banks is now 2.7 per cent. The margins for residential-secured *overdrafts* and *term* loans are now 2.1 per cent and 1.9 per cent, respectively.

Table E2: Interest Rate Margins [(a)]
Percentage points

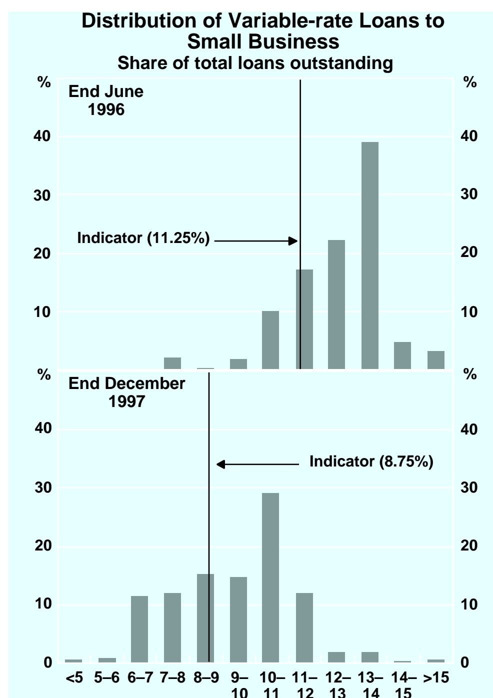
	Over cash rate				Over swap rate
	Small business indicator rates:			Average rate	
	Residential-secured		Other overdraft	Paid by small business on variable-rate loans	Fixed-rate indicator
	Term loans	Overdraft			
Mar 95			3.60	5.1	1.6
June 95			3.60	5.0	1.2
Sep 95			3.60	5.0	1.6
Dec 95			3.65	5.0	1.8
Mar 96			3.75	5.1	1.4
June 96			3.75	5.1	1.6
Sep 96			3.75	5.0	1.8
Dec 96			4.25	5.4	1.9
Mar 97	1.9	2.5	3.75	4.9	1.5
June 97	2.0	2.3	4.00	5.1	1.6
Sep 97	2.0	2.2	3.80	4.6	1.5
Dec 97	2.0	2.2	3.80	4.4	1.6
Mar 98	2.0	2.2	3.80	n.a.	1.5
May 98	1.9	2.1	2.70	n.a.	1.4

(a) Margins are based on average indicator rates charged by major banks.

Measured across all variable-rate products, and after taking into account customer risk margins, the total interest rate paid by small business fell to 4.4 percentage points above cash in the December quarter 1997, after having been fairly steady at around 5 per cent over the period to mid 1997.

As the recently announced reductions in interest rates come into the figures, it might be expected that this margin will narrow further. It seems unlikely, however, that small business margins overall will fall to the same extent as those on owner-occupied housing because small business lending is, on the whole, more risky than lending for housing. While, as noted in the past, competition of mortgage managers in the housing market was a spur for banks to compete more actively in the market for small business loans, *direct* competition from mortgage managers in the small business market is likely to be less intense. Some mortgage managers have entered the small business market on a limited scale and with mixed results.

Graph E1



The distribution of interest rates paid by small businesses on variable-rate loans is shown in Graph E1, both for the period before the monetary policy easings which began in mid 1996, and for the latest period. Most of the shift to the left (i.e. downward move) of this distribution is due to the easings, as reflected in the fall in the standard overdraft indicator rate from 11.25 per cent in June 1996 to 8.75 per cent in December 1997. In addition, however, the proportion of loans at rates below these indicator rates has increased, due to the availability of new lower-priced products, including residential-secured products.

The recent increase in competitive activity has been concentrated in variable-rate loans. The fall in interest rates on fixed-rate loans has been smaller than that for variable-rate loans, in part because banks' margins on fixed-rate loans were always smaller than those on variable-rate loans (as shown in Table E2). In recent months, indicator rates on small business fixed-rate loans have fallen slightly. Those on three-year fixed-rate loans are currently around 7 per cent, 2.9 per cent lower than in mid 1996. This fall is a little more than the fall in the cash rate but roughly in line with the fall in relevant funding rates, which can be approximated by rates in swap markets.

The average interest rate measured across all existing fixed-rate loans to small businesses has fallen by 1.5 percentage points (to 9.1 per cent) since mid 1996. The smaller fall in this rate than in the indicator rate is because the lower indicator rate has not yet worked through the stock of existing loans. As noted in the previous *Semi-Annual Statement on Monetary Policy*, during periods of falling interest rates, these adjustment lags work to hold up the average interest rate on fixed-rate loans, while they operate in the opposite direction during periods of rising interest rates. ✣