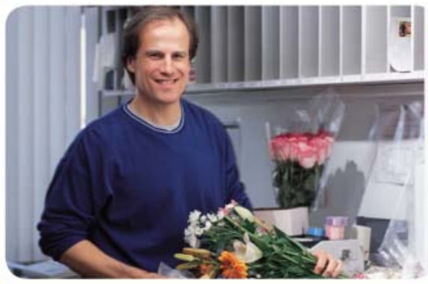
WA Small Enterprise Network

Submission to the Senate Economics Committee

Inquiry into Competition within the Australian Banking Sector

30 November 2010



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About WA Small Enterprise Network

The WA Small Enterprise Network (SEN) exists to represent the interests of small businesses in Western Australia. SEN represents over 3,000 companies, across all industry sectors, with each member employing between zero and thirty staff.

SEN is supported by the Chamber of Commerce and Industry of Western Australia (CCI), which is the State's leading business association, representing over 5,600 businesses across all business sectors.

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"WA Small Enterprise Network" is an initiative of the Chamber of Commerce and Industry of Western Australia

Summary of recommendations

The WA Small Enterprise Network (SEN) recognises the importance of the banking sector within the Australian economy. Banks support the ability for other sectors of the economy to function effectively, particularly small business.

The small business sector values the contribution that banks play, but also desire continued improvements in the products and services they offer. SEN considers that improvements to the overall level of bank competition in the market will help deliver these outcomes at a lower cost to customers.

Within SEN's submission, there are a number of key recommendations that can be drawn with regard to improving competition within the Australian banking sector.

These include:

- Standardise banking product terminology to enable easier product comparisons to be made.
- Require the publication of comparison rates for business lending products, to enable cost comparisons to be made of different banking products.
- Ensure that open data standards and reasonable access to data can be delivered to customers to support future innovation in the banking and non-banking sectors.
- Any changes proposed to the regulation governing the Australian banking sector should ensure that competition and innovation from international banks is encouraged.
- Bank account number portability may have limited benefits for small business lending, and may impose significant costs upon the banking sector.
- Regulation should promote competition and incentivise new market entrants, as opposed to raising the barrier to entry.
- A complete and independent review of the Australian banking sector by the Productivity Commission is recommended.
- Bank fees should be cost-reflective and the principle of user-pays should be maintained in the application of these fees.

Introduction

An efficient and competitive banking sector is vital to the long-term health and well-being of the Australian small business sector. Small businesses generally do not have large amounts of capital with which to underwrite their operations. Consequently, they are often heavily reliant on the banking sector to provide the debt funding necessary to support their business activities.

SEN considers that one of the best ways of achieving sufficient access to finance for small businesses is to ensure that Australia offers a thriving and competitive banking sector. This should be achieved through appropriate regulation that balances the importance of delivering a stable banking sector, with the need for businesses and individuals to be able to access sufficient and reasonably priced debt.

SEN understands that banks play a key role in the market and are fundamental in supporting a well-functioning economy. It is important that banks are able to operate profitably to deliver a return to their shareholders, many of whom are in fact small business owners (held either directly or indirectly through investments, self-funded superannuation funds, etc).

However, given their importance to the overall economy, banks have a duty to ensure their profitability is balanced against the need to support the banking system generally, and ensure that customers and the public are provided with a banking system that delivers on the needs of the Australian business community and society more generally.

SEN encourages the Committee to closely examine the Australian banking sector. Any improvements that can be delivered that will allow for a more competitive market will help to apply downward pressure on prices, and encourage banks to be more innovative in their lending practices and provide better product options for their customers.

Small business can suffer dramatically when the Reserve Bank is required to utilise monetary policy levers, particularly when interest rates are increased, as has been the common experience more recently. SEN considers that the government has a responsibility to develop sound policy that will deliver a stable economic environment, thereby mitigating the need for the Reserve Bank to independently undertake monetary policy adjustments.

SEN considers there may be value in a further and more detailed examination of the banking sector by a fully resourced agency. SEN recommends that the Productivity Commission be charged with a project to undertake a complete assessment of the competitive structure of the Australian banking sector.

Context of this submission

SEN's submission is written from a perspective of considering and recommending changes and improvements to the banking sector that will better support small business.

Approximately 80 per cent of businesses in Western Australia are small businesses. It is estimated that the small business sector in Western Australia accounts for over half of all private sector, non-agricultural employment. Other estimates also show that small businesses employ around a third of the State's labour force.

Small business is critical in ensuring that both the broader business sector and local communities are able to access a wide range of goods and services on a daily basis. Small businesses can reasonably be considered the building blocks of the Western Australian economy.

Structure of this submission

This submission has been structured in line with the terms of reference of the inquiry, to assist the Committee in considering the viewpoints and recommendations of SEN.

The current level of competition between bank and non-bank providers

Free enterprise supports the theory that competition represents the best method for applying downward pressure on prices, stimulating innovation and encouraging product development. The banking sector can also benefit from these principles of free enterprise.

The Australian banking sector is heavily dominated by the four major banks; they being ANZ, Commonwealth Bank, NAB and Westpac. Since the beginning of the global financial crisis, the four banks have seen their market share climb higher, through the acquisition of second-tier banks (for example, St George Bank acquired by Westpac and BankWest acquired by Commonwealth Bank) and also through the exit from the market of international banks and non-bank loan originators. The major banks now account for around 75 per cent of lending to unincorporated businesses and around two-thirds of total business credit.[1]

A survey of business finance, jointly conducted by SEN and Victoria University, is currently underway. While final outcomes of this survey are still pending, preliminary results show that in Western Australia, around 90 per cent of respondents have sought finance from one of the big four banks.

It is important that as the Australian economy recovers from the effects of the recent financial crisis, that policies are introduced that will support market based outcomes for delivering enhanced levels of competition, both amongst the existing industry participants, and also by attracting new businesses to the Australian market.

SEN is concerned that the current dominance of the banking sector by just four banks has the potential to lead to unintended oligopolistic behaviour. With just three other major competitors to consider, the incentive for any one of the four major banks to differentiate itself from the others is relatively small.

Government should seek to develop policies that encourage competition in the sector.

[1] RBA 2010, Submission to the Inquiry into Access of Small Business to Finance, March 2010, p5.

The products available and fees and charges payable on those products

With regard to financial products and borrowing options offered by lending organisations, small businesses are generally limited to the role of price taker. Small businesses acting alone do not have the capacity to negotiate terms or vary the cost structures associated with debt finance. This has resulted in a situation where there is minimal price competition in the small business lending market.

A lack of competitive tension in the market leads to there being little variability for loan products marketed towards small business. Put simply, it is difficult for small businesses to 'find a good deal' through lender-based competition. This means that it is small businesses, who generally have a limited cash flow, that are required to pay the highest costs for debt.

SEN is concerned that small businesses are often forced to accept higher rates of interest on loans, lines of credit and short-term credit. Small business advises that it can be difficult to obtain timely funding. This has a tendency to push small business borrowers towards less appropriate, higher cost options such as credit cards and short-term lines of credit backed by non-business equity, such as personal mortgages.

SEN understands that banks are now scrutinising applications for finance more thoroughly than has been the case in previous years. Underpinning these requirements is a strong view on the part of the banks that risk has been underpriced in the past.

The question is whether market or company risk is now 'overpriced', particularly in the small business sector. Many small and medium enterprises are now finding it difficult to access finance, while those who can are confronted with relatively high costs associated with that debt.

SEN is concerned that high borrowing costs, combined with general difficulties in obtaining finance, remain a constraint on business, many of which have to manage through generally weaker economic conditions than have been experienced in WA for many years.

Product complexity

For small businesses, the ability to reasonably compare a range of product options from a series of potential lenders has become extremely difficult. Banks are motivated to maintain customers through the development and sale of complex products that will help them to maintain a customer, due to the difficulty of assessing and comparing alternative product offerings.

This can lead to very high switching costs for the customer, not only in terms of fees and charges payable as a result of changing their banking provider, but also indirect costs, such as the time spent comparing options and then actioning any changes, notifying suppliers and customers of new bank arrangements, and so on. These 'below the line' costs can be significant and for a small business customer can act as a strong deterrent against switching to an alternative bank.

Small business would benefit from the standardisation of product terminology and the requirement for banks to publish comparison data for all their products, to assist financial decision making. In the residential mortgage sector, this has been successfully applied through the publication of comparison rates for mortgage products. The introduction of a similar concept for all business banking products would help reduce the level of product complexity and increase the transparency of each bank's competitive position.

How competition impacts on unfair terms that may be included in contracts

Lack of competition limits the ability of the consumer to shop around and leverage the possibility of buying a competitor’s product as a driver to gain a better deal from a finance provider. With the market currently concentrated around a small number of lenders, it is unlikely that a major bank will be greatly concerned about losing overall customer volume.

As it stands, small business customers are confronted with an asymmetric power arrangement between themselves and banks. The customer has very little leverage to force any changes to contract terms or conditions. Being in the dominant position, banks can adopt a ‘take it or leave it’ approach to contract negotiations, with the customer being relatively powerless. If each bank adopts the same approach, then the customer has very little opportunity to improve the conditions associated with their banking contracts.

Without adequate competition in the market, small businesses will continue to suffer from this power imbalance. This will result in the continuation of lending arrangements that predominantly favour the lender and impose higher costs on the small business borrower.

For small business, this will either require them to pass on these costs to customers, attempt to absorb the costs at their own expense, or elect not to borrow. Each of these alternatives represents a net loss for the economy, be it through the addition of inflationary costs, a reduction in the profitability of the small business and thus a reduced incentive to continue to operate, or reduced overall growth and the loss of productive capacity and employment potential. Competition will improve the chances that these negative ramifications can be avoided.

The likely drivers of future change and innovation in the banking and non-banking sectors

There is no doubt that change and innovation will continue to occur within the banking and non-banking sectors. This will also impact upon how lending organisations are able to support their customer base, and in fact, it will likely change what a customer expects from a banking institution.

SEN has identified some key aspects of future change that might impact the sector, and that should be considered as part of this review to improve competition in the banking sector.

Technological change

Technological improvements have delivered incredible amounts of change in the banking sector over the past two decades. Banks are now able to offer an integrated suite of products designed to support customer needs. This innovation has delivered many benefits to customers and created opportunities for accelerated economic growth.

However, this change has also made it increasingly difficult for customers to understand, compare, and change their banking products.

SEN believes that the next step in this technological development should be to seek methods to empower the customer by providing them with better information and a more holistic view of their financial position. Technology should be leveraged to support customer decision making and increase the transparency of their banking arrangements. Whereas the traditional view has been that the provision of information was sufficient, the next technological frontier may entail the interpretation and analysis of this information, to assist the customer to better understand and interpret their overall financial position.

Open data standards and cross-platform access to banking data would support competition in the finance sector. Customers would benefit from being able to utilise more than one provider for their banking and financial services, while being able to gain access to all this information from a single access point.

International competition

The continued globalisation of the economy will likely lead to further structural change occurring in the banking and non-banking sectors. It is important that the policy framework governing these sectors in Australia is flexible enough to ensure that innovative developments in other world markets are able to be introduced here as well, whether by international businesses, or by local businesses adopting and customising those innovations for an Australian market.

After the global financial crisis, and with a number of international businesses exiting the Australian market as a result, there were calls to re-regulate and impose greater controls on the finance sector. While appropriate regulation is vital, it is imperative that not so much regulation is imposed so as to limit the ability for the sector to gain from useful and beneficial innovation. The inclusion of international businesses within the Australian market, and the supporting capital that can help build productive capacity in the local market, should be supported.

Any changes proposed to the Australian market should ensure that international competition and innovation is encouraged.

Reductions in available equity

Traditionally, small business owners have often used the equity they have built up in their own home as a starting point for a business loan. Banks are more comfortable lending money against an asset backed proposal and using home equity makes it easier for an entrepreneur to commence business.

The preliminary results of the SEN/Victoria University survey, show that in Western Australia, around 68 per cent of business owners have used personal assets such as the family home as collateral against a business loan.

In the shorter term, this model of lending may be as viable as it has been in the past. The median house price in Australia is continuing to grow, and the relative cost of a house measured against average weekly earnings is significantly greater than it has been in the past. As such, it is becoming more difficult and costly for the younger generation of Australians to enter into home ownership. As a result, it is possible that by the time future entrepreneurs have purchased a home and built up sufficient equity to act as collateral against a business loan, they will be on average older than is the case now. They may be past the current average age where people currently seek out finance to start their own businesses.

This may require new and innovative thinking from the banking sector. Relying on the security of household equity for business lending may not be such a reliable option in the future. SEN considers that this may present a real challenge to the lending sector. The concern is that the net cost of finance may increase significantly for young people seeking to start a business who have not had the capacity to build prior equity in a home. If this reduces the overall number of business start-ups, then there could be a commensurate negative impact on the productive and employment capacity of the overall economy.

Over time, it may be necessary for banks to reconsider the use of home equity as a key element of collateral supporting small business lending. Therefore, it will be important that any changes to the regulation associated with banking is cognisant of this fact, and supports actions that banks may adopt in finding new ways of underwriting loans.

The ease of moving between providers of banking services

Creating an environment that supports a customer's ability to respond to product changes and price signals by transferring their business between providers is important. The ease of achieving this, however, will vary depending on the products in question.

Bank account number portability

Bank account number portability would improve the ability for customers to change their transaction based banking, and reduce the cost overheads that are currently associated with switching. Some of these costs include updating accounting software, notifying customers, printing new stationery, etc.

However, bank number portability would be less beneficial in the area of business loans. In these instances, the carriage of the debt itself is required to be transferred and it is this aspect which has the potential to be costly and difficult, rather than the account number associated with the debt.

Any implementation of bank account number portability may also impose significant costs on the industry, in terms of system development and rollout. SEN would be concerned that this cost would ultimately be borne by all consumers. It is important to carefully consider the full costs and benefits of a bank account number portability scheme before recommending its introduction.

Regulation that has the impact of restricting or hindering competition within the banking sector, particularly regulation imposed during the global financial crisis

SEN considers that the best outcomes in terms of small business lending can be achieved where there is a market that promotes competition and provides opportunities for product innovation.

Currently, there appears to be relatively little differentiation in the products offered to small business across the banking and lending sector. There also appears to be relatively little price competition across the major lenders.

The role of government should be to establish a regulatory framework that encourages competition. This can come from existing participants, while also not restricting new market entrants who may be able to offer new and innovative product offerings.

Regulation must protect the banking system and the consumers and investors who participate in it, while not limiting the ability for new market entrants to participate. It should not raise the barrier of entry for new banks and lending providers to a point whereby the return on investment does not warrant involvement in the market.

It is necessary to have strong prudential requirements that deliver certainty and stability to the banking sector. However, this governance should act to provide certainty to customers, not deliver a further competitive advantage to existing banks.

SEN encourages government to ensure that the regulatory framework for banking and lending products is not limiting competition in the market, and thus limiting the number of loan providers and product choices available to small business borrowers.

Opportunities for, and obstacles to, the creation of new banking services and the entry of new banking service providers

SEN considers that government should establish policies that encourage greater use of alternative funding sources beyond traditional bank lending. For instance, policies that encourage venture capitalism, angel funding, and philanthropy should be considered, where appropriate.

Stimulating investment from alternative sources should establish greater competitive tension for funding in the market, build new investment and income streams for potential investors, and provide new avenues for small businesses to pursue in terms of gaining access to capital, both for long-term and short-term purposes.

Assessment of claims by banks of cost of capital

Banks have justified increasing their interest rates, even above the official Reserve Bank imposed increases, on the basis that their own cost of capital has increased.

SEN is concerned, however, that the growth in rates charged to businesses has outpaced both the increase in official rates and the rate increases passed on to individuals or mortgage holders. It would appear that small business is bearing a larger proportion of the impact of any cost of capital increases faced by the banks.

In effect, small businesses have been confronted with a ‘double whammy’ encompassing greater restrictions on lending from the banks, and a higher price of any debt should it be obtained.

SEN recommends that an investigation be undertaken into the claims regarding the cost of capital made by banks. This review may best be conducted by the Productivity Commission, given it is an independent body with the capacity to undertake comprehensive research and investigation.

Any other policies, practices and strategies that may enhance competition in banking, including legislative change

Bank fees

Bank fees, particularly entry and exit fees, can act as a disincentive for business customers to switch credit providers.

The risk associated with legislating around these fees is that trade-offs between the various fees may occur, which will simply create cross-subsidies and reduce the level of transparency in the market. If banks seek to recover the income that was generated by these fees through other mechanisms, then it will create a shift away from user-pays principles, to one that potentially involves all customers subsidising the costs associated with those customers who do elect to switch. Clearly, this is an inequitable outcome, and is why maintaining the user-pays principle is critical.

SEN recommends that bank fees should be cost-reflective and should not represent a method by which banks can enhance their profitability.

Information provision

As stated earlier in this submission, product complexity is a key challenge for small businesses. Understanding and comparing banking products across providers is a difficult challenge.

To simplify the process for customers, and increase the level of transparency, SEN recommends that standardised terminology be adopted for banking and loan products and that the real cost of loan products be disclosed in a way that allows for fair and accurate comparisons to be made by consumers.

Conclusion

SEN appreciates the complexity associated with the Australian banking sector, and the limitations that government regulation has in addressing and improving competition within the sector.

The fact that Australia escaped the worst of the global financial crisis, with a banking system that is still largely intact, is a credit to the current market structure. Of course, that is not to say the current structure is flawless, or that it cannot be improved. It can, and SEN encourages the Government to take steps to do just that.

SEN accepts that there is no single ‘silver bullet’ to the problems that are faced with respect to banking competition. However, the problems are real, and small businesses are feeling the impacts associated with struggling to obtain bank finance, and then if they do overcome the hurdles of getting a loan, they face high and increasing costs associated with servicing that debt.

SEN considers that it is important that government focuses on its duty to provide a stable and effective banking sector that will deliver reasonable financial returns to those banks that elect to participate in the market.

Government should focus on creating an effective market with appropriate and reasonable levels of regulation. The objective should be to create a market that of itself will deliver improved competition, rather than attempting to regulate and apply restrictive controls upon current and future market participants.