The Real Estate Institute of Australia

Submission to the Senate Economics Committee: **Competition within the Australian banking sector**

Prepared by the Real Estate Institute of Australia

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REAL ESTATE INSTITUTE OF AUSTRALIA COMPETITION WITHIN THE AUSTRALIAN BANKING SECTOR

Background

The Senate Economics Committee is seeking submissions in competition within the banking sector.

REIA represents around 80% of real estate agencies and is an important element of the broader property and construction sector, which makes a significant contribution to Australia's social climate and economic development. The real estate profession employs approximately 77,000 persons with most agencies having less than 10 employees and contributes $300 billion annually in economic activity.

REIA has the commitment of providing and assisting research and well-informed advice to the Federal Government, Opposition, professional members of the real estate sector, media and the public on a range of issues affecting the property market.

The REIA is concerned about access to and the costs of finance to both home buyers and to real estate agencies as small businesses - small businesses play an important part in the economic activity creating jobs and driving economic recovery; accessing affordable financing on reasonable terms has become more difficult and financial services more expensive since the GFC.

The REIA made a submission to the Senate Economics Committee Inquiry into Access of Small Business to Finance in April 2010. For that inquiry the REIA conducted a survey of real estate agents across Australia – capital cities, major non-metropolitan centres and smaller towns – to provide "real evidence" of the impact that a lessening in competition in the financial services sector has had since the GFC. The findings of this survey are included in this submission as they are also relevant to this inquiry.

Issues

In responding to the Senate Economics Committee Inquiry the REIA welcomes the opportunity to be part of the process and address the following issues:

- The impact on housing affordability of interest rate increases

- The level of competition in the financial services sector, including its impact on small business lending

- Importance of reasonable access to funding to support small business operation and expansion and the sector's contribution to employment growth and economic recovery

- The costs, terms and conditions of finance and changes to lending policies and practices affecting small businesses.

Impact on home affordability of interest rate increases

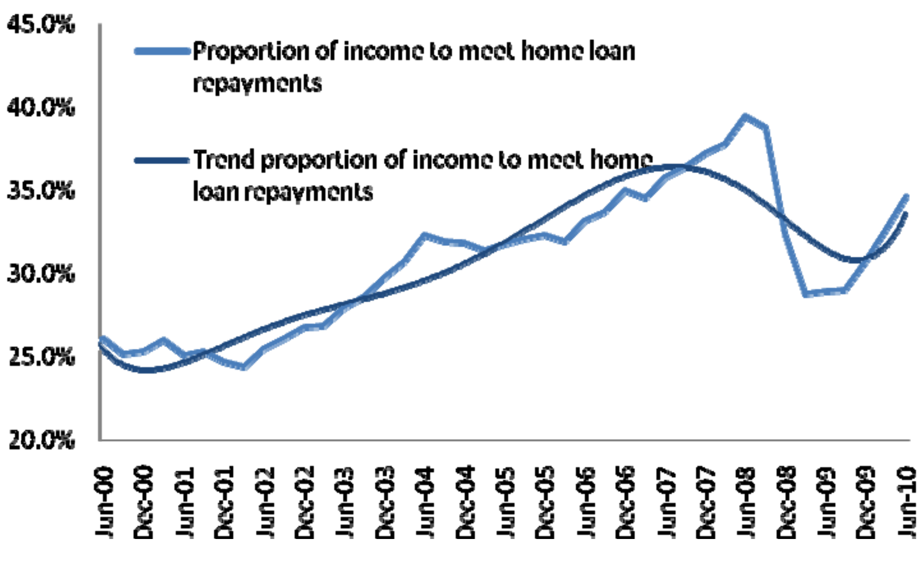
Since the REIA introduced a measure of housing affordability in March 2000 the trend has been of dramatically declining affordability. Chart 1 shows the proportion of median family income required to meet home loan repayments over the period March 2000-Jun2010.

During the decade, the proportion of family income to meet home loan repayments increased dramatically from 25.5 per cent in March 2000 to 39.5 per cent in June 2008. The easing of monetary policy in response to the Global Financial Crisis (GFC) resulted in the proportion of income to meet home loan repayments decreasing to 28.8 per cent in March 2009.

Since then, however, the proportion of income increased 5.8 percentage points to 34.6 per cent in June 2010 due to successive increases in the official cash rate and to some extent to an increasing spread between cash rates and mortgage rates. The June quarter of 2010 recorded the sixth consecutive decline in housing affordability.

At current levels of median house prices, a 0.1 per cent increase in interest rates means a decline in housing affordability of 0.3 per cent. With a direct link between interest rates and home affordability it is important that any changes in retail interest rates are justifiable and are kept to a level that can be accounted for by changes in the banks' borrowing costs.

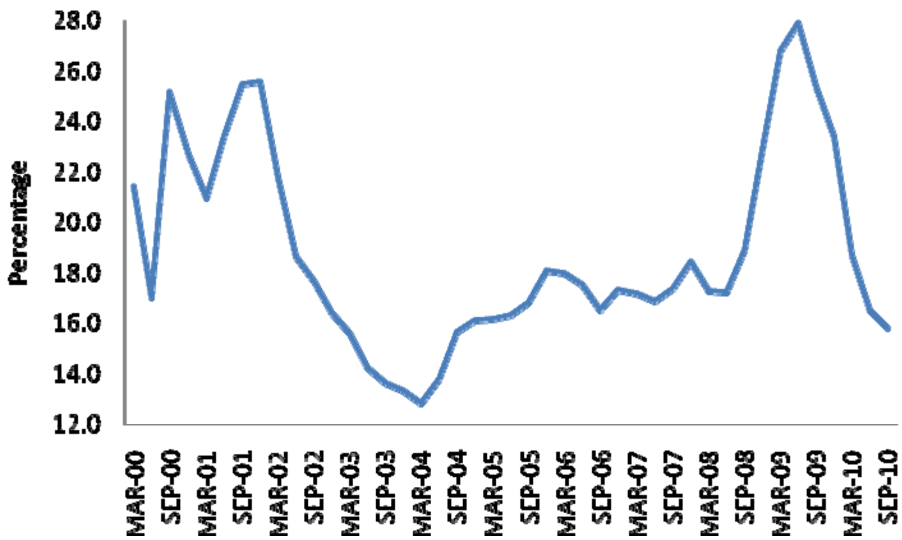
Chart 1: Proportion of median weekly family income to meet home loan repayments



Source: REIA

The decline in affordability can be attributed to the current low number of first home buyers. As seen in Chart 2, during the last decade, the proportion of all finance approvals to first home buyer has been extremely variable but declining. The downward trend was arrested by the introduction of the first home owners grant boost in October 2008. In June 2008, 17.2 percent all finance approvals were to first home buyers. In June 2009 this was up to 27.9 percent. However, the phase down of the boost during 2009 and its cessation in December 2009, along with a tighter monetary policy, caused a dramatic decrease in the participation of first home buyers to 15.8 per cent in September 2010. This is well down on the average since July 1991 of 21.3 per cent.

Chart 2: Proportion of total finance approvals to first home buyers



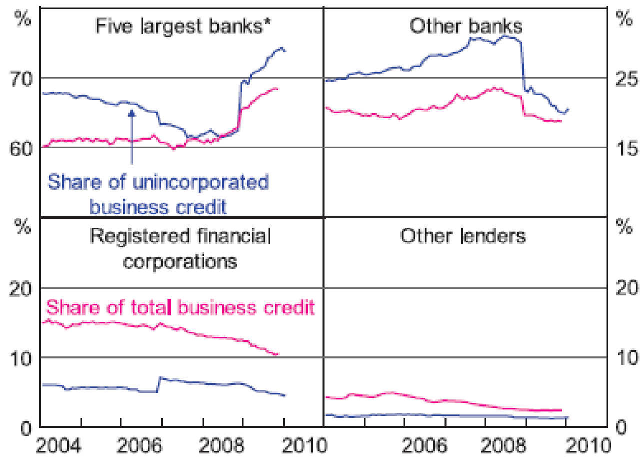
Source: ABS

<u>The level of competition in the financial services sector, including its impact on small business lending</u>

That competition in the banking sector has declined following the GFC can be seen by the increase in concentration of credit in a few financial institutions and by the increase in lending margins by the major banks relative to the small ones. The changes in the concentration of business lending and net interest rate margins (NIM) by the major banks indicate that small lenders are being pushed out of the market and the big four banks are consolidating their market power.

Chart 3: Lenders' share in business credit

Per cent

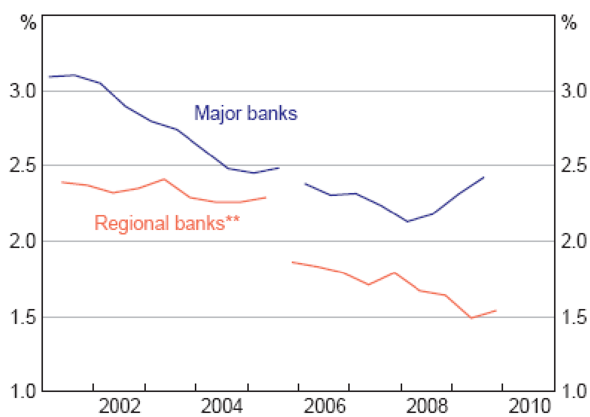


Source: RBA-Submission to the Inquiry into Access of Small Business to Finance, March 2010

Chart 3 above shows the changes in the lenders' share of business credit over the period 2004-2009. The big five banks – including Bank West from Dec08 – significantly increased their share from around 60 per cent in 2004 to around 75 per cent in 2009, while other lending institutions (other banks, registered financial corporations and other lenders) lost market share during the same period.

There has also been a widening in the lending margins by the major banks. Chart 4 below shows that major banks' NIM started to increase from 2008 while that of regional banks decreased relatively to major banks. The NIM for the major banks was around 20-25 basis points above pre-GFC levels whilst regional banks' NIM was around 20 basis points lower than in mid 2007[1].

Chart 4: Banks' Australian Net Interest Margin



Source: Recent Developments in Banks' Funding Costs and Lending Rates, RBA March Quarter Bulletin, 2010

[1] Brown A, Davies M, Fabbro D and T Hanrick. Recent Developments in Banks' funding costs and lending rates, RBA Bulletin, March 2010.

In relation to profits, according to Dr. Ken Henry - Secretary to the Treasury – "all Australian financial institutions have experienced a drop in profits as a result of the crisis, but the fall has been more pronounced for smaller institutions"[2].

The recent increase in market concentration by the major banks can be explained by several factors such as:

- Mergers and acquisitions in the banking sector
- Higher bank's funding costs
- Closure of securitisation markets and constraints in other funding markets.

Lack of competition in the banking industry brings about credit restrictions and higher funding costs. There is evidence that bank concentration increases financing obstacles and decreases the likelihood of receiving bank finance. In business, this results in small businesses being more affected compared to large firms[3]. This is in part because large firms are more likely to be dominant in their markets and are more likely to pass on higher funding costs and partly because they have access to capital markets.

REIA is concerned about the current market concentration trend in the banking industry and the impact this has on access to finance by both home buyers and of small business. Responses to the March 2010 REIA survey indicated that the decrease in competition in the finance market is having a debilitating affect on many real estate agencies.

REIA believes that ways of improving competition in the financial sector need to be vigorously assessed including the possibility of a new pillar in the banking system based on the mutual sector - credit unions and building societies.

<u>Importance of reasonable access to funding to support small business expansion and the sector's contribution to employment growth and economic recovery</u>

Small businesses play a vital role in the economic prosperity and development of Australia yet little is appreciated about the importance of access to funding and their contribution to the economy and on how tighter lending criteria and higher costs of finance affect their operational activities relative to larger firms.

Many analysts have failed to differentiate the impact tighter credit conditions have on small and large firms. Instead there is a perception that access to funding has deteriorated uniformly for all businesses. They claim, for example, that relative to the cash rate, bank's average variable indicator rate for residentially- secured term loans has risen by the same magnitude as the average large business borrowing rate, and that banks' lending standards have been tightened for both large and small firms[4], minimizing the impact higher finance costs and tighter lending rules have on small business profitability.

According to ABS figures, there are approximately 1.93 million active small businesses, which represents 96% of all businesses in Australia; they contribute around 39% of private industry value added and around the same proportion of all goods exported; it also

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[2] The Australian Financial System – Emerging from the Global Financial Crisis, Address to the Count Financial Canberra Conference, March 2010.
[3] Bank Competition, Financing Obstacles and Access to Credit. The World Bank, Development Research Group, March 2003.
[4] RBA submission on access of small business to finance.

contributes around a half of private sector employment. The real estate profession employs around 77,000 persons and property contributes $300 billion annually in the economy. Despite this many respondents to the March 2010 REIA survey in their comments felt that the financial sector did not understand the small business sector and furthermore tended to group all small businesses in the one basket without any differentiation, neither of the factors affecting a particular segment nor of the outlook for that segment.

An example of this is the treatment of rent rolls as security against borrowings. A number of respondents indicated that financial institutions did not recognise rent rolls as an asset despite low vacancy ratios in the rental market and the cash flow stability offered by the rent rolls. When rent rolls are considered as an asset the LVR had changed markedly since the GFC despite the risk associated with the rent roll remaining unchanged – from 90% down to 65% of the value.

The impact of higher credit restrictions on large and small firms depends on firms' capital structure and the accessibility to capital markets. Currently, there is no public data available on small firms' capital structure. However, a survey conducted by the CPA in 2008 shows us how they finance their economic activities. Among those businesses requiring additional funds, 68% were financed by banks and 31% used internal funds[5]. According to this survey, the additional financial resources were for funding business growth (49%) and business survival (36%). These findings are consistent with the responses to the March 2010 REIA survey with 39% of respondents seeking funds for ongoing/operational purposes and 50% for expansion (including purchase of additional/new offices, purchase of rent rolls and purchase additional business).

In terms of access to capital markets, it is very difficult for small businesses to raise funds issuing debt or equity due to their business structure. This means that internal funds and lending from financial institutions are the principal sources of funds[6].Unlike small firms that rely more on bank loans, large firms can substitute bank loans for corporate debt and equity going to the capital markets[7]. Some studies have identified this showing that small firms use more debt than large firms when they face insufficient internal funds[8]. According to the Australian Securities Exchange (ASX) and the RBA, companies with access to capital markets were able to raise equity capital in the absence of debt issuance or bank funding during the recent global economic crisis[9].

When small businesses face external funding restrictions, they have to rely on internal funds that sometimes are not adequate to fund the investments required and working capital needs. This is an important aspect that must be stressed, as rationing of small business credit can severely affect not only investments but also employment. According to a survey conducted by the Economist Intelligence Unit (EIU), small business employment is extremely sensitive to the supply of finance, and those facing tough credit conditions are almost three

[5] CPA Australia Small Business Survey 2008. Financial Management of Small Business, August 2008

[6] 60% of small business operators operated unincorporated enterprises while 40% operated incorporated enterprises. ABS Australian Small Business Operators – Findings From the 2005 and 2006 Characteristics of Small Business Surveys; 2005–06, released 6 August 2008, 8127.0

[7] http://sbaer.uca.edu/research/icsb/1998/44.pdf

[8] Graham, J and Campbell, H. (1999). *The theory and Practice of Corporate finance: Evidence from the field.*

[9] Black S., Kirkwood J and Sha Sha Idil (2009). Australian Corporates' Sources and Uses of Funds, RBA Bulletin, October.

times as likely to lay off staff as those not so affected[10]. Similarly, the ACCI have affirmed that "investment by small businesses continued to be subdued with the sector reporting insufficient retained earnings have constrained their ability to invest which has been exacerbated by difficulties in obtaining external funding"[11].

The March 2010 REIA survey indicated that three-quarters of respondents felt that access to finance was more difficult than before the GFC. This was despite the fact that two-thirds of respondents felt that their financial position was either the same or better than 12 months earlier.

Given the strong prospects of the Australian economy and the reliance of small businesses on lending, it is important to ensure competition in the finance sector and thus an adequate flow of funds to small businesses.

Costs, terms and conditions of finance and changes to lending policies and practices affecting small business

According to COSBOA, of which REIA is a member, over the last two years banks have changed lending practices towards small businesses. Some of these are:

- The withdrawal of pre-approved loans, lines of credit, overdrafts, etc
- Higher credit assessment hurdles
- In circumstances where credit has previously been available, there has been outright denial of access to credit
- Re-assessment of already agreed loans and terms
- The application of risks assessments of small businesses by type of enterprise ignoring the individual circumstances of particular enterprises. This is that access to credit is not being assessed on the basis of the ability of that particular business to pay the loan, but on the basis of a generalised assumption about small business' ability to repay debt in the current economic climate
- High costs of interest on credit cards which many small businesses rely on to meet expenses.

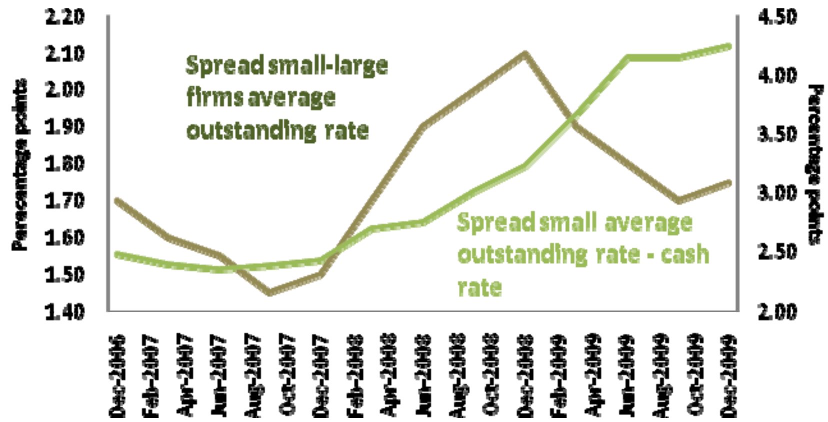
Similarly, ACCI's Small Business Survey has also identified changes in finance conditions for small businesses:

- Charges by lending institutions has risen from the eighth to the second largest constraint on small business investment
- Tightening in bank lending criteria and difficulties in accessing credit has caused insufficient retained earnings to become the fourth largest impediment to small business investment.

The March 2010 REIA survey reaffirms these findings. Four-fifths of respondents believed the requirements by financial institutions such as LVRs, asset backing mortgage over personal assets, etc. is more stringent compared to the period before October 2008. Two-thirds of respondents also felt that the cost of finance for small businesses relative to official interest rates is more expensive than before October 2008. Indeed, as shown in the graph below the cost of finance for small firms has increased significantly. At the same time the amount of credit has declined.

[10] Access to Finance for the Small and Medium Sized Enterprise sector. Evidence and Conclusions. October 2009.
[11] ACCI Media Release, Tuesday 16 February 2010.

The spread between small and large firms (brown line) average rate increased by 40 per cent from 1.5 percentage points in Dec-07 to 2.1 percentage points in Dec-08. This indicates that the relative rate for small business increased much more than that for large firms' business during that period. From Dec-08 the spread began to decline and at the end of 2009 reached the levels observed in the first quarter of 2008. However, since the GFC, the small business average rate increased relative to the cash rate (green line) by 31.4 per cent over the period Dec08-Dec09.



Sources: RBA, REIA calculations

Over the period Dec08-Dec09 new credit approvals between $100,000 and less than $2 million, which are generally provided to small businesses, declined by 26.3 per cent, while new approvals over $2 million decreased by 15.3 per cent.[12] During this period, banks' fees increased by 8 per cent to $6.7 billion, faster than the annual average growth rate of 4 per cent over the preceding five years[13]. Small businesses which rely on credit cards for meeting expenses have also been affected by an increase in credit card fees. Credit card fees increased from $1,119 million in 2007 by 11 per cent to $1,332 million in 2008.

REIA believes that measures that stop the penalising of small business finance costs need to be put in place.

REIA Recommendations

The REIA recommends that the Senate Economics Committee:

1. ***Explores a mechanism that is comprehensive and transparent and ensures that any changes in retail interest rates are justifiable and are kept to a level that can be accounted for by changes in the banks' borrowing costs.***

[12] RBA, Bank lending to business F7.
[13] McLachlan R and M Wright (2009). Banking Fees in Australia, RBA Bulletin, May.

2. ***Vigorously assess ways of improving competition in the financial sector including the possibility of a new pillar in the banking system based on the mutual sector - credit unions and building societies.***

3. ***Propose measures that stop the penalising of small business finance costs.***

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