APRA – Question on Notice – small business inquiry
Why do you think credit provided to the rural sector has declined over recent years, even before the global financial crisis? *This is a question for the Reserve Bank of Australia which collects data on rural lending (Table D9). These data indicate that credit to the rural sector grew by 10 per cent in 2007 and 13.5 per cent in 2008 before falling back to 3 per cent in 2009.*
Some submitters claim the banks have 'over-reacted' to their previous lax lending and cut back small business financing excessively. How would you measure if there had been such an over-reaction? *There is no simple measure to test such a claim. During the global financial crisis, authorised deposit-taking institutions (ADIs) tightened their lending requirements and increased the risk margin on loans in response to the increased uncertainty about the economic outlook, increased levels of impaired assets and higher arrears rates. This was a prudent response in face of the considerable uncertainty at the time. It is expected that lending requirements and risk margins will be eased as the economy recovers.*
Some overseas studies suggest that small banks are more likely to lend to small business while larger banks concentrate more on lending to large companies. Do you think this is also the case in Australia? If so, does this imply that increasing concentration in the banking market will be making it harder for small business to attract funding? *Some historical context may be of use here. In some countries such as the United States and Japan, the current larger banks originated as 'city' banks with a focus on large business lending, while smaller banks started in regional centres and naturally had more focus upon personal and smaller business lending. This is not the historical pattern in Australia. In Australia, the current smaller banks and other ADIs typically originated as home lenders and personal lenders, and the larger commercial banks dominated not only large corporate loans, but small and medium enterprise loans. Based on statistics available to APRA as at end-December 2009, there is no clear pattern that supports the view that large banks concentrate on lending to large business while smaller banks focus on small business. There is considerable variation from bank to bank depending on their business strategy, with some larger banks having a relatively higher share of lending to small business. Regional banks as a group tend to have a relatively high share of small business loans to total loans.*
An individual loan to a small business may be more likely to fail than one to a large business. But would you regard 100 loans of $1 million each to typical small businesses as more risky or less risky than one loan of $100 million to a typical large business? Would it make a difference to the amount of capital you would require a lender to hold against such loans? *The level of capital that needs to be held for business loans depends on a range of factors, including the rating of the counterparty and any security provided. It is not possible to compare loans on the basis outlined in the question due to the unique risk profiles and different ratings and/or collateral provided. APRA's capital requirements are structured so as to generate a higher capital outcome for the higher risk loans. It is worth noting that APRA's standardised method for calculating the level of capital requires the same risk weight to be applied to an unsecured small business loan as to an unsecured loan to a large corporate with a similar (or no) credit rating.*

Do you have 'large exposure' limits or concentration limits that have the effect of encouraging banks to lend to small business?

APRA has large exposures limits for different classes of counterparty as a percentage of the ADI's capital base. The maximum for non-Government non-ADI counterparties is 25 per cent of capital; typically, there are limited exposures beyond 10 per cent of capital to this category of borrower. It is unlikely that APRA's requirements would limit the ability of ADIs to lend to large businesses and thus have the suggested impact on lending to small business. ADIs also have their own limits on exposures to individual borrowers and sectors as part of their internal risk management and these limits are aimed at avoiding a concentration of exposures to individual counterparties, groups, sectors or geographical regions.

Do you think small business lending suffers when banks close branches in small towns? How important do you think the 'local knowledge' of a bank branch manager is in making a good loan decision for a small business?

APRA does not have sufficient information to answer the first question. As to the second question, while there may be some advantage in having specific 'local knowledge' when making a loan, most ADIs have centralised credit approval processes in order to better manage risk and ensure consistent outcomes across their loan portfolios.

We note that banks have recently begun increasing their branch networks, as reported in APRA's 'Points of Presence' annual publication.

Banks have recently increased fees on overdraft facilities and attributed them to being required to put aside capital for unused lines of credit. Can you explain the calculation of how much these new capital requirements add to the cost of a $100,000 overdraft?

APRA's prudential standards (refer APS 112 Capital Adequacy: Standardised Approach to Credit Risk) specify that commitments that can be unconditionally cancelled at any time without notice (e.g. undrawn overdraft facilities providing that any outstanding unused balance is subject to review at least annually) or which effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness receive a 0 per cent risk weight. Only commitments with certain drawdown require a 100 per cent risk weight for capital purposes.

How easy is it for small businesses to switch banks? What are the main impediments? Would bank account number portability help? Are stamp duties a major impediment? Are establishment and exit fees for variable rate loans (that do more than just cover banks' paperwork costs) an impediment to competition?

APRA is not in a position to answer this question.

What role do you see banks playing as financial advisors to small business?

This is not a question for APRA.

Do banks have an obligation (legal, prudential or moral) to ensure that a small business will benefit from a loan and can afford to repay it from future cashflows? Or is it enough to ensure the loan is adequately secured against the assets of a small business owner, such that the lender will get their money back even if the business fails?

From a prudential perspective, while security is an important aspect of risk management when making a loan, APRA expects ADIs to adequately assess the ability of the borrower, whether small business or otherwise, to service the loan, as well as consider all other risks associated with the loan.

What is your view of the NSW Business Chamber's suggestion of a temporary, appropriately priced, guarantee of 80 per cent of the value of business loans below a certain size? *This is a competition matter which falls outside APRA's legislative remit.*
What is your attitude towards superannuation funds investing in venture capital? *APRA recognises that investment in venture capital can form a legitimate part of a diversified portfolio. As with all investments, any venture capital investment has to be consistent with the investment objectives and strategy of the fund.* *The trustee needs to, inter alia:* • *make an appropriate assessment of the expected risk and returns of venture capital investment, with specific regard to the risk profile of such investments;* • *undertake due diligence and ongoing monitoring of venture capital investments;* • *consider the liquidity profile of venture capital investments, especially due to the requirement to meet future commitments; and* • *understand there is greater dispersion of returns from venture capital funds; as such, the trustee needs to make a stronger assessment of manager skills.*