COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Access of small business to finance

MONDAY, 12 APRIL 2010

SYDNEY

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SENATE ECONOMICS

REFERENCES COMMITTEE

Monday, 12 April 2010

Members: Senator Eggleston *(Chair)*, Senator Hurley *(Deputy Chair)*, Senators Bushby, McGauran, Pratt and Xenophon

Participating members: Senators Abetz, Adams, Back, Barnett, Bernardi, Bilyk, Birmingham, Mark Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Cameron, Cash, Colbeck, Jacinta Collins, Coonan, Cormann, Crossin, Farrell, Feeney, Ferguson, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Furner, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Joyce, Kroger, Ludlam, Lundy, Ian Macdonald, McEwen, McLucas, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Sterle, Troeth, Trood, Williams and Wortley

Senators in attendance: Senators Bushby, Eggleston, Hurley, McGauran, Pratt, Williams and Xenophon

Terms of reference for the inquiry:

To inquire into and report on:

The current circumstances of issues surrounding access of small businesses to finance, including:

(a) the costs, terms and conditions of finance and changes to lending policies and practices affecting small businesses;

(b) the importance of reasonable access to funding to support small business expansion and the sector's contribution to employment growth and economic recovery;

(c) the state of competition in small business lending and the impact of the Government's banking guarantees;

(d) opportunities and obstacles to other forms of financing, for example, equity to support small business 'start ups', liquidity, growth and expansion;

(e) policies, practices and strategies to enhance access to small business finance that exist in other countries; and

(f) any other related matters.

WITNESSES

Committee met at 9.30 am

BURKE, Mr Tony, Director, Taxation and Security Issues, Australian Bankers Association

MUNCHENBERG, Mr Steven, Chief Executive Officer, Australian Bankers Association

CHAIR (Senator Eggleston)—Welcome. I declare open this first hearing of the Senate Economics References Committee into the access of small business to finance. These are public proceedings, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera.

I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee. If a witness objects to answering a question the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer a witness may request that the answer be given in camera. Such a request may, of course, be made at any other time. A witness called to answer a question for the first time should state their full name and the capacity in which they appear, and witnesses should speak clearly and into the microphones to assist Hansard to record the proceedings.

The largest source of external finance for small business is the banking system and I welcome Mr Steven Munchenberg and Mr Tony Burke from the Australian Bankers’ Association. Would you care to make an opening statement?

Mr Munchenberg—Thank you. I will just make a short statement and then we will be happy to take questions. I thank you for the opportunity of appearing before the committee. I suppose it underlines the importance of the issue and we are flattered that there is such a strong turnout first thing on a Monday morning in Sydney.

As we stated in the opening of our submission, the small business sector is critical to the Australian economy, accounting for nearly 50 per cent of GDP. Small businesses are, therefore, critical customers to Australian banks as well. I make that point because the essence of our submission is the argument that, ultimately, banks need small business to be doing well for banks themselves to be doing well. However, we are aware that there has been a number of concerns expressed for some time now about both access to finance from the banks but also the price that small businesses are paying for that finance. In the large part we think these concerns are based in changes that banks have reasonably and prudently made in their approach to lending through the course of the global financial crisis, and I am happy to explain that in more detail should senators wish. Nonetheless, the banks have stood by their small business customers and, indeed, have picked up a lot of customers from lenders who are no longer operating because of changes in credit markets.

We have also been participating with the government, through various roundtables and other processes, to try to throw some light on what is happening in small business lending and we welcome this inquiry as another opportunity to do that.

While there have undoubtedly been some concerns and some issues in small business lending, I suppose my final note is that as both we and other independent commentators have argued the credit situation in Australia is slowly but surely improving and we are seeing increasing activity from a wider range of lenders, so to the extent to which there have been some problems, we see these as already improving. With that short introduction I am happy to take questions.

CHAIR—Thank you. Lending to business by banks has contracted recently; everybody seems to agree on that. What would you say are the underlying causes for this? Does it reflect less demand for finance, fewer loan applications meeting established lending criteria, or the banks tightening their criteria, post the global financial crisis?

Mr Munchenberg—I am not quite sure where the figures are saying that lending to banks has decreased because the total lending to business, the total stock of money outstanding—

CHAIR—I am sorry, I missed the first part of your answer.

Mr Munchenberg—I am just not sure where the figure that shows that total lending to business has decreased has come from, because our own figures show that it has actually increased to all business.

CHAIR—I said that people seem to agree, so you are welcome to dispute that.

Mr Munchenberg—We would dispute that. In fact, business lending in total has actually increased over the course of the global financial crisis. That is lending to all businesses. We measure lending to small businesses by loans of less than $2 million. We assume that to be largely for small business. That has undoubtedly been flat, but that is what you would expect through one of the closest shaves Australia has had, in economic terms, for two decades. We saw last year the slowest economic growth for nearly two decades. Demand has undoubtedly fallen significantly and we think that is the major driver of any flattening out of business lending.

CHAIR—You see that the lessening of demand has been the key factor.

Mr Munchenberg—Yes. I should say that banks have taken a more stringent approach to lending. There is no doubt about that.

CHAIR—Yes.

Mr Munchenberg—They need to do that. That is part of both their regulatory prudential obligations and their broader prudential obligations to make sure that they lend responsibly and that they are lending in a way that they are confident that the money is going to be repaid. We must remember that even this time last year the outlook for the Australian economy and the global economy was extremely bleak. Fortunately Australia has largely avoided a lot of the problems; other countries have been a lot less fortunate in that regard. Banks were right to look at business, in particular small business which is inherently more risky, as a source of potential increases in bad debts. The number of business loans that are 90-days plus in arrears or over three months outstanding has increased significantly over that time, which underlines the fact that the banks were right to see this as being a riskier area of lending.

Mr Tony Burke—There is one other factor to mention in relation to your original question. We do think that there are demand factors, but there is also a supply factor. Over the period of the GFC it is the case, which the Reserve Bank commented on in its recent bulletin, that certain lenders withdrew from the market.

CHAIR—Yes.

Mr Tony Burke—So there is a supply issue.

CHAIR—That is very true. There were bank mergers, and other people dropped out. The ACCI claim, in their submission to us, is that it is a fact that major banks have tried to ensure their profitability and minimise asset risk by tightening their lending criteria. Would you like to make a comment on that claim made by the ACCI?

Mr Munchenberg—I do not know that the motive described is correct. A lot of the commentary about what the banks are doing seems to lose sight of the fact that at the end of the day banks actually make money by lending. If they are not lending then they are not making money and they are not making profits.

As I said in my opening statement, if nearly half of the economy is small business, then if you are not lending to small business then you are seen to be greatly reducing your ability to make profits. Having said that, as I said earlier the banks have been very wary, particularly over 2009 and the end of 2008, about the increased risk associated with business lending. The fact that those arrears rates, those loans that are potentially in trouble, have increased by nearly five per cent over that time is an indication that is the case. That figure is seven times higher than what home lending is, so to compare it with home lending, which is a relatively safe and secure form of lending, business lending is less safe and banks have been right during the economic times to make sure that they are lending appropriately. At the end of the day, when talking to the banks, I am not aware of any reason why banks would not lend to viable businesses.

CHAIR—You mentioned profitability and importance of small business in bank profitability. Can you give us any indication or breakdown of the profitability percentages in terms of small business versus bigger business, which you have defined as businesses turning over more than $2 million a year?

Mr Munchenberg—I may need to take that on notice. Because of the different ranges of lending it is hard to identify precisely. My colleague may have the figure off the top of his head, but it is hard to identify precisely what profit is coming from different parts of businesses. The point remains that small business is an important constituent, but if we can produce that figure we will provide it to the committee.

CHAIR—If you could, that would be very useful. I have one last question. Can you tell me why you think credit provided to the rural sector has declined over recent years, even before the global financial crisis? In Western Australia, in particular, as I have been going around the state in the last month or so I have been told that there is a serious decline in the availability of credit to farmers, particularly in the wheat belt.

Mr Munchenberg—I am not sure that that is the case. There may be isolated areas where that is the case, so I am not disputing what you are saying.

Mr Tony Burke—I could not comment on particular cases or even a group of cases, but just looking at some data from the Reserve Bank for the year ending December 2009, in fact the total loans outstanding for agriculture and fishing increased, only by a small proportion, but at the height of the GFC.

Mr Munchenberg—There may be regional variations and that can sometimes be attributed to long-term drought in some areas. It is difficult to get credit and access if farming businesses have been in financial difficulty for some time. The information that my colleague has quoted is in our submission.

CHAIR—There is also an issue about the prospect for the price of wheat. Farmers in Western Australia are finding it difficult to borrow money to put in their wheat crops, but in fact I think there is an issue that the price of wheat has dropped considerably. Thank you very much for that answer. Senator Hurley.

Senator HURLEY—You are saying that demand for small business loans has dropped and I am sure that is the case, but the anecdotal evidence, and one of the reasons why we are here, is that small businesses are finding it very difficult to access loans, even businesses that are quite viable, and there have been some examples in other submissions. Businesses that have been going steadily for many decades are suddenly finding that they cannot access loans or that the flexibility of conditions for those loans has considerably tightened up. I think that it is easing up, but it is still there. It is still a very difficult component. I think small business, especially the ones that have been consistently viable, feel that they are suffering from the effects of other more risky businesses going under or perhaps going under. Can you comment on that?

Mr Munchenberg—There are two points. One is that having read through a lot of the submissions and also having looked at a lot of the media commentary on this issue for some time now, we need to be a little wary of extrapolating from what ultimately is a handful of examples that are put forward to suggest that there is some systemic problem. There will always be businesses, for some reason or another, that are finding it difficult to get credit, or to get credit on the terms that they previously had or the terms that they want. Where opportunities are provided for small business to come forward with specific examples these examples exist, but they tend to be a small number. The government’s own clearing house, Hotline for Small Business, has attracted less than 100 calls in the time that it has been set up since March last year, just over 12 months.

I think we need to be wary. One of the points that I have seen in a lot of the small business submissions is fairly consistent, which is that only a small number of specific examples are put forward. They may well be legitimate examples. Having worked for one of the major banks I know that there are always issues between a handful of small businesses and their bank at any particular point in time. I am not calling into question the integrity of those examples, I am just saying that we need to be careful to extrapolate that to suggest that there are some system-wide issues.

Even the surveys, which are more widely cast, provide a range of results. A number of the surveys are showing that some 10 per cent of small businesses have some concern about credit availability and other surveys are showing much higher ones. That is my first point.

Senator HURLEY—I think this is a bit of a diversion, in some senses, to talk about credit availability. I am hearing those issues about flexibility, but I am also hearing issues about fees and penalties being applied more stringently. I think it was the Reserve Bank that referred in their submission to that. Yes, people can get loans at whatever interest rate is going, but it is also under quite stringent conditions. It is a bit of a red herring to talk just about availability.

Mr Munchenberg—I am only responding to the assertions that have been made to us that I am having to deal with in my role all the time. One of the assertions is that you cannot get finance and the other assertion is that when you can it is at unacceptable terms or unacceptable conditions. On that, undoubtedly banks have tightened their approach to lending, not just to small business, of course, but to all businesses. Even large businesses carry their risk as well and that risk is increased during the economically difficult times. There will be people out there who found that credit was relatively reasonably available through several decades of continuous growth that Australia experienced. Immediately prior to the global financial crisis when credit was very cheap, very cheap credit meant that there was fierce competition amongst a whole range of lenders to provide businesses with loans. That choice, that competition, has undoubtedly diminished as a number of those players have been forced out of the market, but we are seeing signs of those players returning.

The other point to make is that I think it is important, to the extent that we can, to categorise small business between those who may previously have not had a relationship with a bank, but sourced their lending from some other source which is now no longer available and therefore have needed to move to the major banks to get finance, and those customers that have been with major banks for some time, some of whom are finding different circumstances, finding that the banks want more information, more substantiation of their forward cash flow projections and so on, but that is just part of the banks making sure that they are acting responsibly and prudently in their lending.

Senator HURLEY—It is also in the tightening up of fees and fee conditions in slapping on fees and penalties more quickly.

Mr Munchenberg—You will need to address that to the individual banks. I am not aware of that as a generic issue.

Senator HURLEY—Just to go to another topic, the question of interest rates, the Reserve Bank has been steadily raising the interest rates. I was wondering what your view was of that impact on small business? Clearly, banks are going to have to raise their rates in line with that to small business. Are you seeing small businesses starting to struggle a little with that or being concerned about that?

Mr Munchenberg—Those 90-day plus arrear figures have grown; there is no doubt about that. I would not like to suggest any causation between the interest rate rises. I am not aware of anyone who, in paying higher interest rates, is happy about that. Depositors at the moment are happy, although even some of those are grumbling, despite the intense competition for deposits.

Undoubtedly, a rising interest rate environment is going to make it more difficult for some businesses, simply because it is going to increase their costs. I should let the Reserve Bank speak for themselves as to why they are doing that and I am aware that they are appearing before you later this morning.

Senator HURLEY—Are you seeing some signs of small business or any business struggling a little with that?

Mr Munchenberg—Undoubtedly, the loans are in distress. The loans that are 90-days plus in arrears are continuing to increase. Part of the reason for that may well be that businesses have held on this long through the global financial crisis. Some of them have been able to access additional funds from their bankers and some would be relying on their own funds to keep going. I think there would be a range of reasons for that and we would expect to see that lag as well between where the economy is and where businesses are in terms of their difficulties.

I have one final point and I know I sound like a cracked record on this, but while the banks will undoubtedly be increasing their lending rates to business as the RBA moves the cash rate up, of course the cash rate from the RBA is not the sole determinant on those pricing decisions.

Mr Tony Burke—We could not, of course, predict outcomes, but perhaps point to surveys such as the NAB survey of business conditions and business confidence. The confidence reported is still very high and business conditions which actually look out until a year forward are looking pretty strong. Yes, rising interest rates will have an impact, but as to what impact they will have in terms of outcomes for individual small businesses, we could not predict that.

Senator HURLEY—I have one last question about switching banks. You mentioned that other lenders are starting to come back into the market. Can you comment on the ease of any businesses being able to take advantage of that and whether you see that has eased or become more difficult?

Mr Munchenberg—I do not know of any reason why it would have become more difficult. I would have thought that it is reasonably straightforward for business customers, subject to whatever arrangements they have in place. I cannot give a general answer because it will depend on what arrangements particular businesses have, whether they have fixed loans with banks which are obviously more costly to break or whether they have variable loans or loans that are backed by mortgages on their own properties.

Senator HURLEY—Some submissions have called for more ease of switching between banks to assist competition.

Mr Munchenberg—We are very happy to consider proposals to make switching easier for both business and retail customers, provided it does not require a major investment from the banks, which defeats the purpose if it adds to banks’ costs.

Senator HURLEY—Where would you see that easing of switching coming from? How would you see it operating?

Mr Munchenberg—We do not have any particular proposals to bring to the table at the moment. We have worked with the government to make it easier for retail or individual customers to switch banks by making it easier for them to access the direct debits and credits arrangements, which are often one of the major complications, if you like, in changing their banking from one bank to another.

Senator WILLIAMS—Can I ask a question on that?

CHAIR—Yes, of course.

Senator WILLIAMS—In relation to the competition of banks that Senator Hurley pointed to, surely if you have a situation where you have exit fees and establishment fees, that makes it difficult for people to change banks. I can understand exit fees on a fixed term loan, but not on a variable loan. It is just like if you wished to change to a mechanic down the road if you did not like the way your car was being serviced, then you can just go and change. If you have got to pay an exit fee to get out of the loan, especially a variable loan, and then you have got to pay an establishment fee down the road with the next financial institution, that in itself would curb competition.

Mr Munchenberg—In Australia we are fortunate that establishment fees, by international standards, are much lower.

Senator WILLIAMS—That is not the point I am making. When I left my credit union, for example, six months ago to go to a bank I did not have any exit fee. When I went to the bank I was lucky enough to get a loan with no establishment fees. The only thing that I had to pay was the stamp duty on the mortgage. Now while you have exit fees and establishment fees you could see a cheaper interest rate down the road with a different institution, but by the time you pay that exit fee and establishment fee, it does not pay you to change. Surely they are hindering competition.

Mr Munchenberg—No, they are just cost recovery. The only time you are paying those is if you are leaving a mortgage within three to four years. The vast majority of mortgages are longer than that and those people do not pay exit fees. They are, in many ways, just part of a deferred establishment fee, deferring the costs of the bank establishing those mortgages. To be quite frank, if people were constantly churning their mortgages then the banks would not be making a profit out of those churned mortgages.

Senator WILLIAMS—The point I make is this. If I leave my loan now with St George I will pay $1,000 exit fee within three years. That is a hindrance for me to go down the road if I can see a better deal at say NAB, ANZ or some other institution. While I have got to pay an exit fee I have got to factor that into the cost of my new loan if I am going to change institutions. If I have an establishment fee at the next institution, there is another cost.

What I am saying is that this is a hamstring which is curbing competition because it costs people, whether in business or for home loans, to pay out an exit fee to get out of an institution and then to pay an establishment fee with the next one. It might be cost recovery, but it simply hinders competition. It is not free competition because of those fees. What is your comment on that?

Mr Munchenberg—I am trying to explain that they are legitimate costs to the bank. That is just banks meeting their legitimate costs.

CHAIR—We will go to Senator Bushby and then Senator Pratt.

Senator BUSHBY—Senator Hurley asked about the RBA comments and I noticed that when the RBA said that small businesses in most industries have been able to access funding throughout the financial crisis on less favourable terms than previously, you acknowledge that as being the case.

Mr Munchenberg—There has been some tightening, as you would expect.

Senator BUSHBY—Exactly. ACCI have had some interesting comments to make about small business finance in recent times. Mr Greg Evans, Director of Economics for ACCI pointed out:

… access to finance for SMEs remains very difficult with the imposition of much stricter credit criteria applying throughout the banking sector. Our analysis suggests even sound credit proposals with appropriate security arrangements are often declined as they fall outside arbitrary credit controls.

I noted, in replying to Senator Hurley's question, that you provided an answer that to some extent addressed that, but they have also gone on to say, and this is reported in the *Australian Financial Review* on March 27-28:

… access to and renegotiation of affordable finance has now become the most substantial issue facing the day-to-day wellbeing of Australia's small and medium business sectors.

At least from ACCI's perspective, this is an issue. ACCI is obviously the major business representative organisation in Australia representing more firms than anybody else and they see that this is a real issue. To some extent what you said today suggests that you and your members do not think that it is. How do you reconcile the view that ACCI has with what you have been saying today?

Mr Munchenberg—I am a little perplexed by those media statements coming from ACCI, many of them in the lead-up to this inquiry. The Westpac ACCI survey itself actually shows that access to credit is not one of the major concerns of business. They identify a number of other concerns to business such as tax reform, the emissions trading scheme and skill shortage, which from memory businesses are saying are of more concern to them than access to finance. I am not sure of the basis of ACCI's assertions there when their own surveys indicate otherwise.

Senator BUSHBY—The statement about it being the most substantial issue came from a general council meeting of the chamber's 35 member organisations which was held in Melbourne a couple of weeks ago.

Mr Munchenberg—That is an opinion that they are expressing in the lead-up to this inquiry. As I said, their own data published jointly through the surveys—and they do a very credible survey—suggests that it is much less than that. Again, I am relying on memory here because I do not have the submission in front of me, but I think that identifies only some 10 or 11 per cent of businesses that actually expressed major concerns about access to finance.

Senator BUSHBY—Ten to 11 per cent is still a substantial proportion of businesses.

Mr Munchenberg—It is actually around the long-term average.

Senator BUSHBY—You are saying that the evidence suggests that the conclusion of the general council meeting is not substantiated.

Mr Munchenberg—What we are ultimately saying is that we do believe that businesses have seen changes in their relationships with banks over the course of the last two years. That does not necessarily mean that they are not getting credit, but it does mean that they are sometimes getting credit on different terms and conditions or at different prices than they were back before the global financial crisis when credit was dirt cheap and when there were a whole plethora of providers out there competing fiercely for small business loans who are no longer present. We acknowledge that there has been a small decrease in competition, but we also argue that there is adequate and quite substantial competition between those players that are left.

Senator BUSHBY—You have already talked about competition to some extent. You mentioned that part of the reason for the flattening off of percentages is the fall in demand.

Mr Munchenberg—The major part would be a fall in demand.

Senator BUSHBY—I acknowledge that a fall in demand would, to some extent, be caused by the recent downturn in economic conditions, but to what extent do you think that it is also caused by the fact that the product is more expensive and harder to obtain with its impact on demand in that case? I note that you have addressed some of the anecdotal evidence to some extent, but the anecdotal evidence is that small businesses are screaming for more funding, but it has got to be appropriate and affordable. Given the tightening of terms and the change of conditions that you have already mentioned, do you think that there are, to some extent, small businesses that would like to go out and get some more money to expand or continue their operation but do not even bother making the application? As you have also acknowledged, some of the non-bank opportunities no longer exist and, with the greater hurdles that they have to overcome to get funding through banks, they just do not bother going there because they know they are not going to get it.

Mr Munchenberg—I cannot speculate on the individual motives of individual organisations, but in terms of the decline in demand, we must not lose sight of the fact that Australia, whilst being fortunate enough to technically avoid a recession, has gone through the biggest slowdown in the economy in nearly two decades. Logic would suggest that the greatest driver of the decrease in demand is that businesses are unlikely to be wanting to radically expand or recapitalise their businesses when the economy was so uncertain and they were so uncertain about their own prospects.

Senator BUSHBY—I acknowledge that is quite clearly going to be a major factor in effecting demand, but do you think that also effecting demand is the fact that there are higher criteria and fewer options and therefore some businesses just do not bother applying?

Mr Munchenberg—They may not. There are 26 providers of residential backed business loans out there, so there is plenty of choice and opportunity for small businesses.

Senator BUSHBY—What proportion of those are ADIs?

Mr Munchenberg—I would guess the majority of them, but I would need to check that.

Senator BUSHBY—And prior to the GFC there were a lot more ADIs?

Mr Munchenberg—Prior to the GFC there were a lot more sources. Let us not forget that prior to the GFC we were dealing with a circumstance where globally credit was at unusually and as it turned out unsustainably low levels. That allowed a number of businesses to operate in a certain way which became no longer tenable once the global financial crisis—

Senator BUSHBY—Not so much in Australia.

Mr Munchenberg—In Australia, because securitisation markets and other markets where these businesses were getting their funding from stopped operating.

Senator BUSHBY—That was not because of events that occurred in Australia.

Mr Munchenberg—No, it was because of events that occurred offshore.

Senator BUSHBY—Exactly.

Mr Munchenberg—The effects were very real in Australia.

Senator BUSHBY—Absolutely. That has had an impact, though.

Mr Munchenberg—Yes. There is less choice now than there was back then.

Senator BUSHBY—There is less choice and fewer options, particularly for those small businesses that may otherwise be quite viable but cannot meet what may be seen from their perspective as arbitrary criteria for lending.

Mr Munchenberg—I do not know why any lender would put arbitrary criteria in as a disincentive to lend to people. It gets back to the fundamental point that at the end of the day banks and other lenders make money from lending money. I do not understand why there is this assumption that somehow banks are benefiting from not lending.

Senator BUSHBY—If you have a shift or a contraction in options available to small businesses looking for finance—

Mr Munchenberg—We have 26 providers.

Senator BUSHBY—a contraction, particularly away from the non-ADI options, which may have come at higher interest rates—there may have been other negative aspects to it, but probably more able for businesses to actually access that finance, with lower lending criteria than what ADIs generally have—if we had most of those options removed then—

Mr Munchenberg—The situation then arises where there were businesses prior to the financial crisis that were only able to raise money because money was dirt cheap and because there were a lot of people out there who were providing money on very limited risk analysis. When those elements have been removed then obviously there is going to be a tightening.

Senator BUSHBY—What I am saying is that the banks now, with those options removed, have the ability to pick and choose the best of the opportunities in terms of small businesses coming to them and to fund them.

Mr Munchenberg—They are clearly not doing that because we are being criticised for expanding our market share in small business.

Senator BUSHBY—Of course you are going to expand your market share if there are fewer options. I do not have the market share in front of me of what it was before, but the share of lending that was occurring through non-ADIs prior to the global financial crisis has basically disappeared, and to some extent the better options there would have been absorbed by the banks, which would have offset some of the contraction they might otherwise have seen through the downturn in the economy and also as a result of the higher lending criteria that banks are applying because some of that would have shifted across from the non-ADIs into the ADIs.

Mr Munchenberg—Yes.

Senator BUSHBY—That would have helped prop up the share that you have seen.

Mr Munchenberg—Correct.

Senator BUSHBY—But it was at the expense of a lot of other small businesses that were operating quite profitably and were meeting their loan repayments, but do not quite meet that cut-off.

Mr Munchenberg—But they were meeting their loan repayments at a time when credit costs were very low and because of the higher level of competition. We accept that there has been a reduction in competition. Our argument would be that the competition that is there is still adequate—and I can discuss that further if the committee is interested—but there will be businesses that prior to the global financial crisis were able to get credit that were not able to get credit during the financial crisis. I can see that is an issue for the businesses, but I do not see that is an issue—

Senator BUSHBY—It is also an issue for the general economy as well. Given the percentage of the economy that is driven by small business, which you mentioned in your opening statement, we need to be able to make sure that small businesses can actually recover and grow as an important factor—

Mr Munchenberg—Equally, one of the reasons why the Australian economy has weathered the global financial crisis as well as it has is that the banks have lent prudently under the supervision of the RBA and APRA, but through their own prudent management as well.

Senator BUSHBY—We were very well regulated coming into this.

Mr Munchenberg—We are very well regulated and very well managed.

Senator BUSHBY—I have one final question. You mentioned in your submission that your stock of lending has increased by $30 billion since the beginning of the GFC. The RBA points out that in respect of loans of less than $2 million, and I quote:

Loans smaller than $2 million amounted to around $200 billion, about 30 per cent of the total business lending by banks, which suggests that lending to small business by banks was changed little during 2009.

Mr Munchenberg—Our own submission says that. The $30 billion is all business lending, so the amount of lending that banks are doing to all businesses has increased.

Senator BUSHBY—It has gone up.

Mr Munchenberg—The amount of lending under $2 million is flat; it has decreased by about 1.3 per cent.

Senator BUSHBY—Most of your increase in business lending is at the top end.

Mr Munchenberg—Yes.

Senator BUSHBY—Thank you.

CHAIR—Senator Pratt.

Senator PRATT—We have had some discussion this morning about tighter lending conditions. I would like to ask you what kind of characteristics might a small business have that see it being at risk of being refused finance? How would you characterise that tightening?

Mr Munchenberg—Banks go through very thorough risk assessment analyses of businesses. One of the big determinants will be the sector that the business is operating in and the risks in that area. We know through an economic downturn that people's spending patterns change, for example, so some retailers may be at more risk than others. We have seen retail figures looking very shaky at various times. There are other sectors such as construction, for example—commercial property is the well-known one—banks are very wary of lending to commercial property because commercial property prices have fallen, as they always do during an economic downturn. I think the banks are also remembering the early 90s when they got into quite a bit of trouble with being over exposed to commercial property during the recession then.

It is going to vary by sector and it is going to vary by business. Ultimately, the businesses need to make the case to the bank that they are able to meet their repayments.

Senator PRATT—If there are businesses out there who argue that their fundamentals have not changed and yet they cannot get finance, would you refute that that should be the case?

Mr Munchenberg—Again, we would be surprised, because why would you not lend to viable businesses? Sometimes there is a tendency for businesses, particularly last year when things were uncertain, where they may have had a more rosy expectation to their outlook than the banks might have had who were being more conscious of what was happening in the broader economy.

Senator PRATT—In terms of banks still lending to viable businesses there is that $30 billion increase.

Mr Munchenberg—In total business lending.

Senator PRATT—Are you able to tell us what proportion of that would have come from an increased market share from banks, as opposed to an increase in lending?

Mr Munchenberg—No. We will take that on notice, if we may.

Senator PRATT—Thank you.

Senator XENOPHON—I will put a number of questions on notice because we are running out of time. In today's *Financial Review* it is reported that the Commonwealth Bank tipped 79 small businesses into administration, up 13 per cent from 2008, but the ANZ and NAB would not say how many they tipped into administration. Are those figures made publicly available in terms of the number of businesses that are either tipped into administration or individuals pushed into bankruptcy for failing to comply with their loan conditions?

Mr Munchenberg—I do not know whether those numbers are publicly available or not. We can take that one on notice.

Senator XENOPHON—Given the regulatory framework of banks, given the bank guarantee that was enforced previously, the roll of taxpayers in a sense in assisting the banks, do you think it is reasonable that the number of companies forced into administration or people forced into bankruptcy for not being able to comply with loans ought to be made publicly available so that can assist us in terms of any policy settings?

Mr Tony Burke—I believe that ITSA publishes a range of information about companies entering insolvency, including the creditor.

Senator XENOPHON—The information may be public.

Mr Munchenberg—I saw that article this morning where the CBA suggested that they put 79 businesses into administration. The CBA have 700,000 business customers so we need to keep these things in perspective.

Senator XENOPHON—Sure. I would like to move on, given the time constraints. In the same article, the RSM Bird Cameron Partner Peter Marsden said small business insolvencies were skyrocketing at the moment as bank finance dried up. He said that many firms had depleted their working capital in the downturn, but were now unable to access finance because banks have tightened their credit policies and that small firms could not go to the market to raise capital. He said that it is only starting to become apparent and that we will probably see growth for the rest of this year and probably into next year as well. There is an opinion that it is now easier for banks to find buyers for distressed assets because the economic recovery has brought more liquidity and buyers into the market and banks are likely to get a better price for distressed assets. Does that mean that banks are going to move in for the kill in the sense that you are now in a better position to call in the loans?

Mr Munchenberg—I am aware that it is a strongly held view in the community that banks enjoy foreclosing on people.

Senator XENOPHON—I did not say that.

Mr Munchenberg—I know you did not say that. I am just saying that I am aware that there is that assumption often in the community. Banks actually go to great lengths to avoid having to shut down businesses and to avoid having to foreclose.

Senator XENOPHON—Now that asset prices are improving it makes more sense from a prudential point of view and from the banks' point of view to say that we are now in a better position to realise assets.

Mr Munchenberg—Equally, we have a large and growing number of small businesses that the banks have been working with, who have been in distress for some time. I think it was even mentioned in that article this morning that banks have been working consistently through the whole financial crisis to try to keep businesses operational. After nearly two years of difficulty there will be increasing numbers of circumstances where the banks are saying, 'We're no longer able to continue to support this business. It's been unable to sell assets to help de-debt. It's been unable to increase its income to help meet those.' It is unfortunate, but at the end of the day businesses and banks get to situations where the bank makes the judgement that the business is not going to return to a viable situation.

Senator XENOPHON—What you are saying is that, notwithstanding that we have dodged a bullet with the GFC, because of the difficulties that you refer to we can expect things to get worse in terms of the number of businesses being wound up before they get better; in other words, we expect to see more companies wound up and more people going into bankruptcy because they cannot meet their commitments?

Mr Tony Burke—We cannot predict that sort of outcome.

Senator XENOPHON—Is that essentially what Mr Munchenberg has just said?

Mr Munchenberg—No. What I am saying is that we know that there are more and more businesses getting behind with their repayments.

Senator XENOPHON—That means that will happen.

Mr Munchenberg—We also know that there are many businesses that are being nursed, if you like, through the crisis, but as time progresses those businesses are unable to recover. Will there be increasing numbers of businesses falling over? It is very possible. That is what you would normally expect coming out of an economic downturn.

Senator XENOPHON—So things will get worse before they get better?

Mr Munchenberg—For some businesses; for many businesses. Do not forget that it is only a small minority of businesses that are in trouble, despite the figures; we are looking at four per cent.

Senator XENOPHON—We will see more people falling over in the next few months.

Mr Munchenberg—It will be a tough time for some businesses, but for many businesses circumstances are improving as the economy recovers. The majority of businesses will be better off.

Mr Tony Burke—We note from the ITSA data that this is only until December 2009. Business insolvencies for the year ending December 2009 were actually down that year.

Senator McGAURAN—As you know, this inquiry's base reference is the access, availability and ability of small business to access credit. In your opening statement you said that conditions were improving; business, credit, lending were improving. You then changed it to it is flatlining.

Mr Munchenberg—I was referring to flatlining as a reference to historical data, probably up until the end of last year I would imagine, but I can check that.

Senator McGAURAN—You then changed it to flatlining. We now have a Reserve Bank governor who says that it is in decline, be it the pace of decline is less in the quarter or month before, but it is in decline. I then look at your own submission, graph 11, and it is in decline. What is it? We would like to get that at the start, because every question we ask flows from that. Do you have the March quarter figures, not just the December 2009?

Mr Munchenberg—Unless they have come out in the last week, no we will not have that. I think that is the essence of—

Senator McGAURAN—Let me get this in for the sake of *Hansard* if nothing else. Our access to small business, which is significant for all of us around here, is that it is not improving. It is getting harder. Bankruptcies are increasing. Banks are squeezing them and, frankly, banks are not all that interested in small business, be it they will take the rolled gold. The GFC has psychologically damaged the banks, if you like, in regard to risk with small business. That is the on-the-street evidence that we are getting. You have given us two different answers in one submission and the Reserve Bank governor has given us another one. Which is it?

Mr Munchenberg—Let me address your point. The issue here is the difference between historical data, which obviously lags, and what is being seen at the moment. From my recollection of the Reserve Bank's own submission—and they are appearing later so they can tell you whether I am right or wrong—they, themselves, have indicated that they can see improvements occurring in lending.

Senator McGAURAN—Do not try to snow us. Their improvement is that it is declining at a lesser rate. There is a difference between declining and increasing.

Mr Munchenberg—I think their submission to this inquiry says that lending circumstances are improving. You can test that with them; I am relying on my reading of their submission. I would go back to the point that I think a lot of small businesses believe that they are being targeted because what they are seeing is changes in the approach of their banker to their businesses. What we are seeing and what we are arguing is that is just a series of changes that occurred during the economic downturn, which remain in place. I should say that, while the Australian economy is continuing to look more and more promising, there are still people who are concerned about the state of the global economy, so those risk settings remain appropriate. But there is no reason why banks would not lend to viable businesses.

Senator McGAURAN—Is it improving, flatlining or declining at a lesser rate?

Mr Munchenberg—Last year the amount of loans to small business was flat. What we are saying is that this year, and we are already a third of the way into the year, our understanding is that the circumstances are improving.

Senator McGAURAN—Can you give us figures and statistics to that assertion?

Mr Munchenberg—We can only base that upon the experience of our members in terms of their approach to business. I am not aware that we have any particular figures.

Senator McGAURAN—You have access to the banks. Ask them to supply something to this committee. It is a critical question.

Mr Munchenberg—You have two of the banks appearing before you this afternoon, so I am sure that they will be able to address that.

Senator McGAURAN—You will not do that?

Mr Munchenberg—No, I am happy to take that on notice.

Senator McGAURAN—Thank you.

Senator WILLIAMS—On 3 September 2008 we saw the start of the reduction in interest rates. It went down four per cent. Most of those reductions over that time were passed on to home loan borrowers, but many of the small businesses and farmers that I have spoken to about that four per cent, received two per cent or less reduction in their loans. Your predecessor told me that it was because of the political side of it, there are a lot more voters that have home loans. Those interest rate reductions were not passed on fully to small businesses and farmers. Can you tell me why not?

Mr Munchenberg—I cannot speak for my predecessor, but the RBA cut interest rates by 4.25 per cent, of which about 3.8 per cent was passed on on home loans and about three per cent was passed on to business loans backed by mortgages. They are obviously a more secure form of lending. What businesses were seeing was the effect of the repricing for risk, so particularly there was less pass-on of those interest rate cuts to riskier lending.

Senator WILLIAMS—I knew that would be the point. With the risk I see farmers that have had less than two per cent reduction that have real assets and a lot of equity in their land and they still did not get it. They were as safe as they could be as far as lending goes and those interest rates were not passed on. Likewise, many small businesses were backed up by real security such as houses and land and they did not get the same. I think that whole reduction period was very unfair to farmers and small business.

Mr Munchenberg—I will have to accept your view on that one. I put forward the reasons for why the banks did not pass those on.

CHAIR—We thank the Australian Bankers' Association for appearing. We will put some questions on notice for you and would appreciate it if you could answer those as quickly as possible.

[10.21 am]

BURKE, Mr John, Head, Domestic Markets Department, Reserve Bank of Australia

DEBELLE, Dr Guy Lawrence Geoffrey, Assistant Governor Financial Markets, Reserve Bank of Australia

CHAIR—Welcome. Would you like to make a short opening statement?

Dr Debelle—Yes. My statement will be appropriately brief. I appreciate the opportunity for us to speak to our submission to the inquiry. Let me quickly summarise the main points we make in the submission. The main points that we make are that lending to small business was little changed over 2009, after growing steadily over the previous years. We think the slowdown in lending reflected both supply and demand factors. On the demand side, as Mr Munchenberg said, there was reduced demand reflecting the state of the economic cycle. On the supply side there was a general tightening in banks' lending standards. Nevertheless, as we have said in our submission, our assessment is that small businesses in most industries have been able to access funding through the financial crisis, albeit on less favourable terms than they were previously.

In terms of interest rates, the interest rates on small business lending in 2009 were below their averages over the past decade as a large net reduction in the cash rate we put through has more than offset the increases in banks' lending spreads. Currently our assessment is that rates are around about their average levels over the past decade or so.

Competition in the small business lending market has eased from the strong levels just prior to the onset of the financial crisis, but we think it should recover as the economy continues to strengthen.

Finally, in terms of where we source our information on small business finance, for the past 17 years we have run a liaison program with small business, specifically about their financing access, through a small business panel which is a group of businesspeople that we find throughout the country in a wide range of small business activities. That small business finance panel is in addition to our regular and extensive liaison program with medium and larger businesses. Mr Broadbent and I will be happy to respond to any questions that you might have.

CHAIR—I will just ask the first question. You presented a chart in a recent talk which showed that since June 2007 business loan interest rates have increased relative to banks' funding costs. A chart in your March 2010 RBA bulletin showed that interest rates for small business had risen more than for large businesses. Does this suggest that banks are less keen on making small business loans and is there any evidence that there has been a greater increase to risk for small business loans than for big business over the same period, or can this be taken as a sign that competition has reduced in the small business lending market?

Dr Debelle—The main reason for those interest rate increases, as the previous speaker said, was that it was an assessment of risk by the banks; that was their justification for increasing those spreads on those loans. I think it also varies somewhat sector by sector. I would think that you would find interest rates for, say, anyone associated with commercial property are probably relatively more than for other sectors of the economy.

Our general assessment is that it was the differentiation in the riskiness of lending across both large and small businesses and probably more so across what sectors of the economy that they happen to operate in. In terms of the competition, there has probably been a greater reduction in the number of banks lending to large businesses than there has been in lending to smaller businesses.

CHAIR—In effect, you are saying that there is a reduction in the degree or the number of loans to big business rather than to small business.

Dr Debelle—The number of banks which lend to large businesses has probably dropped off a bit more than there has been for small businesses.

CHAIR—That is an interesting point.

Dr Debelle—The number of competitors, at least.

CHAIR—Can you produce some documentation for us?

Dr Debelle—Yes, I can provide that.

CHAIR—Can we have that on notice?

Senator McGAURAN—Is that a percentage or a dollar figure?

Dr Debelle—That is the actual number of institutions. The numbers that we provided address the question that you were asking the previous speaker, Senator McGauran, that is that the numbers we have on small business credit are up until the end of last year, which showed that the small business credit had basically been flat over the year. Over that period there had actually been a decline in lending to large businesses, which means if you look at lending to businesses in total, which is the comment that you were referring to made by the governor, what he was referring to is that it is declining at a decreasing rate.

CHAIR—I have another question. Why do you think that credit provided to the rural sector has declined over recent years, even before the global financial crisis? Does the Reserve Bank have a view on that?

Dr Debelle—I suppose I do not have a view because I am not a commercial banker.

CHAIR—No, but you are the overall supervisor.

Dr Debelle—That is right. In terms of the last year or two, from what we can see from the lending to the rural sector, it has performed about the same as lending to the small business sector in general, so it is about flat. There does not seem to have been any particular differentiation over the last year or 18 months between the small business sector and the rural sector more generally.

CHAIR—Anecdotally people in regional Australia could disagree with that. There is a strong perception out there that bank lending to the rural sector borrowers has declined quite significantly. That is certainly a view in regional Western Australia.

Dr Debelle—That may well be true in particular parts of the country. All I am saying is that the numbers that we have for lending to the rural sector across the whole country looks about the same as it does for the small business sector.

CHAIR—Thank you. Senator Hurley.

Senator HURLEY—In your submission it is summarised that competition in the small business lending market has eased from the strong level just prior to the onset of the financial crisis but should recover as the economy continues to strengthen. This is purely anecdotal, but in talking to a lot of small businesses, yes, the economy is recovering to some extent and they would like to take advantage of that, but now they are worried about increasing interest rates, as well as the fact that that finance carries with it interest rates significantly higher than the RBA cash rates and there are significant other fees and penalties for any sort of overdraft, overruns and so on. In terms of the RBA, you said that you have those liaisons with small business, but the interest rate is a significant problem for small business, not only in terms of paying their own interest but in terms of deterring their customers from spending. Can you elaborate a bit more on how you take that into account in determining interest rates?

Dr Debelle—All of those channels are something we take into account in setting the interest rates that we set for the economy as a whole. In terms of the rates that small businesses are paying, as I said in my opening remarks and also in our statement, rates have risen. That is right. Our assessment is that they are about the average of where they have been since 1997. They are obviously coming off very low levels, as low as they have basically been in the past 30 or 40 years, and they have risen back to about where they have been for the last 10 or 15 years.

We take into account both the rate we set, which is the cash rate, and also the rate that businesses actually pay. We are taking that into account as best we can. We also try to take into account as best we can the tightening in lending conditions that you have referred to. We try to make an assessment of that. In terms of the demand for their business, that is something that we are trying to manage, to some extent, as part of the demand in the economy as a whole.

Senator HURLEY—Yes, but you are trying to depress demand, aren’t you?

Dr Debelle—No, we are not trying to depress demand, we are trying to make it grow at a sustainable pace. It is still growing. We are trying to ensure that it grows at a sustainable pace, which over the past has proven to be the best for the economy as a whole.

Senator HURLEY—I presume you also take into account the kind of unique circumstances where Australia is in a relatively benign position compared to a lot of other countries around the world. That means that a lot of Australian exporters are in a position to move into markets, but if they are constrained by finance and interest rates then that makes it more difficult for them.

Dr Debelle—Obviously EFIC exists to provide finance to the export sector. Again, if it is a viable proposition, one would assume that a bank would be willing to lend to it. They get assistance from EFIC.

Senator HURLEY—It might be more risky than usual. If you are moving into a new market then of course it is more risky. This is where some businesses might find that banks—

Dr Debelle—Sure, but as I said EFIC exists specifically for that purpose, as well as non-finance assistance which you can obviously get through Austrade.

Senator HURLEY—We have venture capital markets, too. Do you think that there is sufficient capital in there for that kind of expansion? There has been some suggestion of a development bank. Do you think that the current channels are good enough for us, or is there a need for something else?

Dr Debelle—Over the past 10 or 15 years there has been clearly inadequate supply of funding. As I said, the reduction that we have seen over the past 18 months or two years has, in a large part, reflected the economic cycle. I would expect that to pick up as the economic cycle continues to strengthen. Going back a couple of years you would be hard pressed to say that there was an inadequate supply of funding. Things have certainly got tighter since then. I would expect that to improve as the cycle improves again.

Senator HURLEY—There is often criticism in Australia of small to medium enterprises not being able to take the next step or not making the time. There are a lot of pressures on businesses into moving ahead and when you get requests by finance institutions to have guarantee against personal assets or other assets of the business, it is difficult. Is there scope for the government to try to encourage other means of finance apart from the banking institutions that exist?

Dr Debelle—As I said, by and large the supply of credit has been about adequate.

Senator HURLEY—In that more risky area?

Dr Debelle—As you said, there is a venture capital market. It is not as large here as it is in other countries. I do not know enough about that part of the finance sector to really answer that question appropriately. As I said, certainly going back a couple of years, those opportunities were certainly lent into. I would expect, as conditions continue to improve, that there will be more people willing to provide the finance for those sorts of projects going forward.

Senator HURLEY—Thank you.

Senator WILLIAMS—With competition in the banking industry now we have seen the government with the global financial crisis underwrite the investments in those ADIs, but those companies who were not registered ADIs, debenture issuing companies and so on, many of those had their funds withdrawn and put into what would be perceived as a safer investment underwritten by the government into those banks, and then we had a situation where the smaller ADIs had to pay a higher premium for that guarantee than the bigger banks. Does it concern you about competition now that we have lost many of those smaller companies? We have had the credit unions that have had to pay a higher premium for that bank guarantee and it seems as though everything was stacked in favour of the big banks. What I am saying is that I think that we have had very unfair competition over the last 18 months or so in the finance industry. Does that concern you?

Dr Debelle—You could have an inquiry about the guarantee. You have been talking about risk with the previous speaker. The guarantee fee structure was put in place to reflect the different risk characteristics of those different institutions. The guarantee has obviously finished, so that is no longer in force.

My general assessment is that the credit unions of the world have had about as ready access to funds because they virtually source their funds from deposits, and the larger banks were paying a lot more for their market and the money that they raise on the wholesale markets. I think there have been offsetting factors which have affected both of those sides of things.

In terms of the non-banking sector, there is less activity there than there was a few years ago. As Mr Munchenberg said, some of that activity a few years ago was probably unsustainable in the medium term. As I said in reply to Senator Hurley's question, I think that you will find activity in that sector starting to pick up as the economy has improved and as people's worst fears are proven not to be realised. I think you will see increased competition in large part because you are looking at an economy which is growing pretty well with some pretty good opportunities in front of it, particularly relative to elsewhere in the world. I would expect to see people wanting to come in, take advantage of that and to provide the finance for that going forward.

Senator WILLIAMS—Just taking you to the increase in the Reserve Bank cash rates over the last few months, I think we have had four now of one-quarter per cent. Is that correct?

Dr Debelle—Five.

Senator WILLIAMS—The Reserve Bank is saying, 'The economy is starting to scoot along pretty well. We're just pulling the brakes on a bit. We don't want it to overheat.' With the stimulus package and the government spending pouring money into the economy, whether it will be Building the Education Revolution or whatever, then surely that is assisting in you having to pull that brake on interest rates.

Dr Debelle—The governor has talked about this question at length. I am not sure if this is the right forum to be commenting on this, but the government stimulus has passed its point of maximum impact on the economy. It provided a boost to growth, but it is now providing less of a boost to growth than it was in the past. We are deciding that the situation where we needed historically low interest rates is no longer necessary, so we are moving back to something around about average levels, which is not far away from where we are at the moment, given that there are expectations for where the economy is going forward.

Senator WILLIAMS—My final question is in relation to interest rates prior to when you commenced raising interest rates. I have spoken to many people in small business and farmers that have been through drought since early 2002. We saw the four per cent reduction of interest rates since commencing on 3 September 2008, yet many of those farmers did not get a reduction of anywhere near four per cent. Some did not even get two per cent and yet we hear that it is because of the high risk. They have real security, not paper security. What I am saying is that they are a vital part of our economy; they did not get the interest rate reductions. Where is the fairness when small business and farmers do not get those interest rate reductions when home loan borrowers do, and yet they are the people that produce 50 per cent of the nation’s GDP? What can be done next time this comes along to see that they actually get a proper reduction in interest rates?

Dr Debelle—We would agree with you, in terms of the numbers that you were talking about.

Senator WILLIAMS—It is terrible.

Dr Debelle—Rates for small business, in general, fell less than the amount that you were just talking about. I do not make the lending decisions on what the banks set as their interest rates. We set one interest rate for the economy as a whole, not the interest rates on lending to particular sectors of the economy. If you go back a year or so, you might remember that optimism was not all that high. Everyone, including ourselves, was reasonably concerned about where things were going. I think the banks decided to set risk margins based on an assessment of probably a weaker economy than what has subsequently turned out to be the case.

As Mr Munchenberg said, risk premiums in 2007 were very low. There probably needed to be some repricing of that, but then early last year people’s assessment about where the economy was going, and therefore the riskiness of their lending, was probably extremely conservative, hence the outcomes that you were talking about occurred. That is one of the reasons why we think, given things have turned out to be better than most people, including ourselves, expected, we expect things to continue to improve going forward, so you would expect to see some reassessment in the other direction of those risk premiums that banks have set on their lending.

Senator WILLIAMS—Thank you.

Senator BUSHBY—Thank you for coming along and helping us. We heard from the previous witness, and I think you have probably touched upon it in your submission, about the falling demand for finance for small business. You acknowledge that there is a range of factors that have led to that fall in demand. Do you acknowledge that may be due in part to small businesses withdrawing from the loan market due to the difficulty or perceived difficulty of access to funds and also the conditions and the cost of doing so?

Dr Debelle—Yes. Distinguishing between demand and supply partly depends on which side of the fence you are sitting on. When we are talking about supply factors, then it is actually tighter lending conditions. Banks setting a higher interest is the supply side, but then on the demand side, obviously if you are facing that higher interest rate, you are less willing to borrow, which makes it difficult to determine how much is one and how much is the other. As we said in our submission, conditions were tightened. The premiums were increased. Did that have an effect on financing? Yes, it did.

Senator BUSHBY—You have already discussed the fact that with the onset of the global financial crisis most of the non-ADI lenders disappeared from the market and, as to the effect that has had on competition in terms of the dollar value of the amount of the loans that have been written for small business, you note that in 2009 that was fairly steady for loans under $2 million. Do you think that part of the reason why it actually held up was because there was a shift of share from non-ADIs to the ADIs?

Dr Debelle—Yes. I can put some perspective on this. The non-ADI lenders were about 10 per cent of the market in 2007.

Senator BUSHBY—In terms of dollars?

Dr Debelle—Yes. They are probably about five per cent of the market now.

Senator BUSHBY—Of what market?

Dr Debelle—The small business market.

Senator BUSHBY—So that would be under $2 million?

Dr Debelle—Yes. Finding out what a small business is financially is more difficult than you might imagine, but on our criteria it is from 10 to about five. Even before the financial crisis they were not a large share of the market and they are obviously a smaller one now. Did people who were previously customers of those non-ADIs then get funding from the banks when they pulled back? Yes, they did. Some of it was probably a shift in market share.

Senator BUSHBY—Not everybody who was being funded by non-ADIs would have achieved funding with ADIs.

Dr Debelle—I cannot tell you loan by loan.

Senator BUSHBY—With the impact of the bank guarantee on the reduction in competition, this committee held an inquiry and looked into that issue. I do not think either of you were there.

Dr Debelle—Mr Broadbent was not, and I think the deputy governor represented the bank.

Mr Broadbent—No, not at that particular thing.

Senator BUSHBY—One of the statements that was made at the time—and forgive me if I do not quote this correctly because I did not look it up—was essentially that in difficult times like those being faced when the decisions were being made about the bank guarantees, stability and solvency were more important than competition. To some extent competition, or the promotion of competition, was sacrificed in order to—I think from the Reserve Bank’s perspective—maintain stability. Do you agree that is the case, that when the decisions were made there was some not necessarily overt intention to reduce competition, but that reduction of competition from taking actions at the time was an acceptable consequence in order to retain stability and solvency?

Dr Debelle—The primary goal was to ensure the stability of the financial system. That was definitely the primary reason for that decision.

Senator BUSHBY—Clearly it worked and we do not want to go over that in great detail because we have already done that, but there are issues in terms of timing and how that bank guarantee was applied. Everybody agrees that it was a necessary thing, but in doing so it did have some impact on the ability of non-ADIs to fund loans.

Dr Debelle—Yes. You also need to be careful because the other thing which was having an impact on non-ADIs—and I am not saying this is true of all of them, but certainly with some of them—their business models were not sustainable in a medium-term sense. They were sustainable in 2007, but they were obviously not sustainable in the height of the crisis and they probably would not have been sustainable going forward.

Senator BUSHBY—I acknowledge that there are other factors at play, but by introducing a guarantee for ADIs that did not apply to non-ADIs, that also had an impact on their ability to attract funds.

Dr Debelle—Yes. It had an impact on their ability to attract funds. That is true. As you said, the crisis as a whole was having a material impact on their ability to attract funds.

Senator BUSHBY—At the time when the anecdotal evidence was arising a lot of small businesses—as you say it is only 10 per cent—were being funded through non-ADIs and suffered disproportionately as a consequence of the non-ADIs' withdrawal from the market compared to those that were funded by ADIs. That means it has relevance.

Dr Debelle—Some of those non-ADIs are also the finance companies of the world which have some sort of ADI backing behind them. Again, I think we are ending up talking about an absolutely small share of the market. As I said, it is hard to distinguish between the circumstances going on at the time economically and financially and the impact which the guarantee was brought in to address. To say the guarantee caused this separate from the other factors—

Senator BUSHBY—No, I am not saying that. It contributed to it.

Dr Debelle—Yes. There was a lot of stuff going down at that time.

Senator BUSHBY—There certainly was. I have one final question. Looking forward, in the submissions that we have received we have had information about other jurisdictions and what they do. For example, in the United States there is a small business administration which administers a program to help small businesses apply for loans up to $5 million. Canada has a small business financing program under which the government guarantees 85 per cent of loans up to Can$500,000. There are a number of other jurisdictions that do similar sorts of things. What would the RBA's view be, without looking at specifics, of a similar program that is designed to assist small business finance and facilitate loans to actually help increase economic activity in that area?

Dr Debelle—We have looked at some of those schemes in other countries. Small businesses have not particularly liked the UK one.

Senator BUSHBY—The United States one has been going since 1953.

Dr Debelle—That is right. I think that accounts for about 10 per cent of small business finance in the US. The question you have to ask is: what is the reason that a financial institution is not willing to lend to this small business off its own bat? Are you going to be able to find small businesses that have viable propositions which a regular financial institution is not going to be willing to lend to? I am not saying that because surely you probably can. That is the question that you have got to ask; it is coming up with a scheme that is going to provide enough protection with whatever form of government backing that you are providing to it, while being on terms which are attractive enough to the business to actually want to access it. I think that is the problem that they have come up with in other jurisdictions.

Senator BUSHBY—Conceivably there is a role for such government intervention if it can actually answer those questions.

Dr Debelle—The question is: can you actually answer those questions?

Senator BUSHBY—You can use the UK, for example, where it does not work, but there are other places where it does.

CHAIR—It would be interesting to know what the criteria are in other countries.

Dr Debelle—I believe you have information on that in other submissions, but we can also provide you with some information on that.

CHAIR—Senator Xenophon has a question.

Senator XENOPHON—I would like to follow on from Senator Bushby’s line of questioning. With the Canadian scheme has the Reserve Bank looked at small business financing schemes in other countries and assessed them on the impact that they have in terms of the availability of small business finance?

Dr Debelle—Yes, we have had a look at them. Do we know the high level details of them? Yes, but we have not done much more work on that.

Senator BUSHBY—Has there been an assessment on what the effects of a similar scheme to the Canadian scheme would have on the availability of small business financing?

Dr Debelle—No, we have not done that.

Senator XENOPHON—That is something that is within the purview and the ability of the Reserve Bank to look at, isn’t it?

Dr Debelle—It would generally be more in the purview of whatever agency is responsible for setting it up rather than ourselves necessarily. If it were proposed we would look at it.

Senator XENOPHON—Following on from that, in Australia we have the Commonwealth Development Bank, which was established in 1960 as part of the Commonwealth Bank Group and then it was wound down from 1996. Do we know what effect the Commonwealth Development Bank had in that period in terms of the availability of finance, particularly for small business? In other words, did that have a positive role in terms of competition and the access to finance for small businesses?

Dr Debelle—One major point is that the financial system today looks a lot different than it did in 1960.

Senator XENOPHON—But not so different as 1996.

Dr Debelle—No. In terms of the size of the Commonwealth Development Bank by 1996 relative to the size of the finance sector as a whole, at that stage it was not particularly—

Senator XENOPHON—I understand that, but have any studies been done to indicate if the mere presence of the Commonwealth Development Bank, even if it was not a big player, did act to give a degree of competitive pressure on the other main players.

Dr Debelle—I am not aware of any.

Senator XENOPHON—You are not aware of any, but is that something that other agencies may be able to assist us with? Would there be information about the impact of the Commonwealth Development Bank, in terms of keeping competitive pressures in the marketplace?

Dr Debelle—You are going back in history a little way now, so I am not sure.

Senator XENOPHON—Finally, the Australian Bankers' Association, in its submission, said that capital required by APRA to be held by banks for small business loans is generally three times higher than for home loans and can be seven times higher for some products. Are you able to comment on that?

Dr Debelle—APRA has risk weighted capital standards, so it is an assessment of the riskiness of different forms of lending. As Mr Munchenberg told you previously, the arrears rate on small business lending tends to be higher or has historically been higher and is currently quite a lot higher than it is on housing. In part, that reflects the characteristics of the lending, but in terms of how that translates into the numbers that you just mentioned, that is a question probably better put to APRA than to ourselves.

Mr Broadbent—I can add to that. One of the issues for the way those weights come out bears largely on the basis of the banks' internal funding process. They look back at their historical data and they work out just where their relative risks lie. That is why the APRA came out with a variation across the weights because for some banks, depending on where their loan composition is, if they are using these internally generated risk weights it will determine in relative terms where each of the risk rates would be for housing, for small business, size of the loan and the like. Each of those things are determined within the individual bank, but obviously ticked off with the overall model being approved by APRA.

Senator XENOPHON—Given what you have just said, is the question of the weighting given, with the amount of assets required to back those loans, commensurate or proportionate to the level of weights given, and who independently assesses that?

Mr Broadbent—What I said is that the individual banks in looking at their loan history back cast and go back through that data to generate the various loan relative riskiness of the loans.

Senator XENOPHON—Who determines whether that is reasonable or not?

Mr Broadbent—That is APRA. They take their model to APRA and APRA looks through that.

Senator XENOPHON—APRA relies on the bank's information?

Mr Broadbent—Yes.

Senator XENOPHON—Thank you.

Senator PRATT—Your submission outlines a link between competition in small business lending and lending standards, but I would like to unpack that statement with you a little bit. On one hand you seem to be arguing that lending conditions are relaxed in order for banks to better compete with each other for their market share, versus being relaxed or tightening because there is less risk in the market. What I want to know is what is your assessment in terms of that link where banks are in a position to tighten their lending standards as they do not need to compete as much because they have a greater market share at the moment.

Dr Debelle—The banks still compete in lending against each other. The sense that we are getting is that the standards were tightened over the past couple of years, as I said earlier, based on an assessment for the economy which proved to be more pessimistic than what it has subsequently turned out to be the case.

As Mr Munchenberg said earlier, in the end the banks are in the business of trying to make profit, so if they can see profitable opportunities out there then they will probably try to go for that. Given that the economy is now looking better—and this is our assessment which is reflected in our statement—there are more profitable opportunities out there than you would have expected even a year ago. I think you will see the banks starting to compete more aggressively for those opportunities and potentially pull back on some of their tightening in lending standards that has clearly happened over the last couple of years.

Senator PRATT—During periods of strong economic growth banks tend to compete more aggressively for business lending by cutting their margins and relaxing their vending standards. Are we going to see lending standards relax again as business conditions improve and there is more competition for that lending?

Dr Debelle—I would say that there is a reasonable chance of that going forward if the economic outlook continues to improve along the way that we expect it to do so.

Senator PRATT—Thank you.

Senator McGAURAN—Senator Hurley touched on the question of the interest rate rises and, of course, they are a major part of the determinant of the price of credit. The backdrop to my question is: the Reserve Bank board in its interest rate deliberations back in 2007 increased the interest rates in an election period. They continued to increase those interest rates through the early part of 2008 on the basis that they judged inflation was taking off. It turned out to be a very, very bad judgement, but we would hope that you would learn from that.

Dr Debelle—Let me just say that inflation—

Senator McGAURAN—I have a question in all of this.

Dr Debelle—I am sorry, I thought you had finished.

Senator McGAURAN—No, that is the backdrop.

Dr Debelle—You said 'we would hope that you would learn from that,' so I was going to respond to that remark.

Senator McGAURAN—I would assume that you would learn from that. But have you? Here you go again. What is the rush? Five interest rate rises over the last seven months on the grounds you think inflation again needs to be stifled. I say that with these facts behind me. The Australian dollar is choking our rural manufacturing exports, small to medium businesses. Long-term investment is flat. Consumer expenditure is sluggish. Our interest rates are way higher than our trading partners, but moreover your own inflation forecasts have the headline rate within your band and the underlying rate, which we assume is what you take your judgements on, is at 3.4 and declining, yet you have jumped the gun again last month on the grounds of some yet unsigned contract of iron ore and coal prices and an economy being stimulated by the government's stimulus package. We have been told by Treasury that out of the 2.7 per cent growth recorded over the last 12 months to December 2009, 2.1 per cent was from the government's fiscal stimulus. Are you looking at the real economy? Have you learnt your lessons?

Dr Debelle—I believe the house has an inquiry every six months where it asks the governor these questions and where we respond directly to that. I thought we were mostly here to talk about small business and not about our interest rate decisions. There is another part of the parliamentary process which holds us accountable to that every six months.

Senator McGAURAN—Don't interest rates determine the price of and access to credit?

Dr Debelle—Yes.

Senator McGAURAN—Are you talking into account the real economy for retail, rural, manufacturing and tourism?

Dr Debelle—May I just respond to your question, please? We are looking at an economy at the moment which is growing at about trend rate. We are looking at interest rates which are probably a little bit below average for an economy growing at the trend rate. We are certainly taking into account the level of the currency in our deliberations. In 2007 and 2008 that rise in inflation actually eventuated. Inflation peaked at about five per cent, so that forecast rise in inflation did actually materialise. In terms of our forecast we embody a rise in interest rates within our forecast beyond what has actually occurred, as the governor explained at his last parliamentary testimony. We are looking at the conditions in the economy in coming to that determination.

Senator McGAURAN—What is the rush? Why five in seven?

Dr Debelle—I think that question is probably better placed to the governor. I am not on the Reserve Bank board.

CHAIR—Senator, later in the year you can certainly put a question to him.

Senator McGAURAN—I might get the opportunity and I certainly look forward to it.

CHAIR—We thank the Reserve Bank for appearing this morning.

[11.03 am]

CUMMINGS, Mr John Watson, Chairman, National Association of Retail Grocers of Australia

HENRICK, Mr Kenneth Michael, Chief Executive Officer, National Association of Retail Grocers of Australia

VAN RIJSWIJK, Mr Gerard, Senior Policy Advisor, National Association of Retail Grocers of Australia

CHAIR—Welcome. Would you like to make an opening statement?

Mr Cummings—Thank you for the opportunity to state a case on the access of finance to small business. Speaking from experience, being a retailer myself and as one who deals with my bank on an irregular basis, we are actually going through some dramas with them right now.

We are a small to medium sized enterprise and in regard to the current economic position definitely in Western Australia, and nationally, we have survived the financial crisis quite well. There has been no downturn in employment. We are now seeing a downturn in economic activity and we are definitely seeing banks tightening the screws again. This is a cycle that we seem to go through every 10 years or so. They simply change the rules on you as you are going forward.

One of the major concerns that we have in our sector, which is the grocery sector, is that you are looking at businesses that cost between $1 million to $5 million. For somebody to get into one of these businesses the average loan would be $1.5 million to $2 million. Unless you have property worth the value of what you are borrowing it is a case of: do not even talk to us.

There is a huge amount of ongoing problems in the small business sector in this country. What about a succession plan? Who do I sell my business to? What 25-year-old has the incentive to go out and borrow some money to buy a mixed business to trade up to be in the same position as perhaps I am at the age of 58? How do we go through that? We are dealing with fewer people.

Interestingly, when we started out 20 years ago we had to go to the Bank of South Australia, Beneficial Finance, to get our money in Western Australia. It is an institution that is no longer around. We paid 23 per cent interest at the time.

Senator WILLIAMS—Mine was 25.25 per cent.

Mr Cummings—We got off cheaply, yes. There were plenty of sleepless nights. That is the reality of what is there. As I said, there is no incentive today for people to look at small business as a way forward. The succession plan I think is something we have to consider. If you look at our sector we are nearly in a situation now where, unless somebody has got a $5 million to $10 million house, they cannot get into our business. That means if you want to sell your business when you are 65 or 70 and you want to retire it is probably going to be one of the chains that are going to buy it off you, so you get further market concentration in an area brought about because finance is not available to you. It is a real issue that I think we need to address.

We do note that in some other jurisdictions there are different rules in place. I note that the committee has touched on some of those earlier on. I am aware of some South East Asian countries—I think the Philippines—where banks have to put 25 per cent of their loan book into small business.

I also note that when I was a young boy growing up each state had a rural bank. I guess the reason was because big banks were not lending to farmers and farmers needed the money. Maybe we are in the same position today and it might be something we need to look at.

CHAIR—Our first witnesses were the Australian Bankers' Association and they classified small business as anything under a $2 million turnover. You are talking about figures larger than that in terms of the requirement to buy into your business. Realistically, what should the classification of a small business be in this day and age?

Mr Cummings—Nearly every business that is not a public company is treated like a small business in the banking sector. I think you have to look at different sectors for different ways to get there. We are definitely treated in a different way. I also heard somebody say that there is competition in the banking sector. Let me assure you, in 20 years a bank has never come to me and offered me a product called finance.

You go along there, cap in hand with your heart in your mouth hoping like hell somebody will talk to you and hoping like hell you will get a good result. If that is competition, it is a funny form of competition.

CHAIR—Given that you are a very experienced businessman, do you feel that there really is a crisis in financing for small business at the current time?

Mr Cummings—Without a doubt. As I said, there is no incentive for young people. If you take our sector, I am pretty typical of a West Australian independent grocer. I am 58 years of age and there is no 25-year-old champing at the bit to get in there. If I were to sell my business tomorrow the reality is that I would have to go internally to another 58 to 65-year-old bloke who owned a few businesses and who would perhaps have the wherewithal to raise the finance to buy the business. The incentive is going out for small business people to even start.

CHAIR—Both the Reserve Bank and the Australian Bankers' Association have told us that the demand for credit by a small business, as they define it, which is a loan up to $2 million is flat; it has not changed. Would you disagree with their assessment?

Mr Cummings—It is flat because everybody hates getting knocked back.

CHAIR—Yes, but in effect they are denying there is any problem, any crisis, any issue, about finance for small business.

Mr Cummings—I would put it more simply. If people need to borrow money today for a refit of their shop, or for whatever purpose, if they are a small to medium sized enterprise and their first port of call was a broker—which nine times out of 10 it may be because if you go to a bank they do not have the in-house expertise to handle loans nowadays; it is normally outsourced to somebody else—that person would probably tell you that you probably have a snowflake's chance in hell of getting this through, so why bother, and that may be one of the reasons why it is not there. There is very little or no incentive to go along there.

An example: if you were going to open a coffee shop tomorrow, wherever the shopping centre was if you said, 'I am going to open a Gloria Jean's', or a franchise coffee shop, there is a chance a bank will talk to you. If you went along to a bank and said, 'Hi, I am going to open John's coffee shop tomorrow.' They would say, 'Bye.' That would be their answer.

CHAIR—That is very interesting evidence. Senator Williams.

Senator WILLIAMS—What you just said then about your industry is also the same in farming. I think the average age of a farmer is about 58 years. Throughout my life as I grew up in South Australia I have seen that you could make a living with 500 acres. All of a sudden you needed 800 acres. Then you needed 1,200 acres. You needed more acreage. And finance is a problem. I just think it is so wrong that when we have had these interest rate reductions from 3 September 2008 little was passed onto small business and farmers, yet nearly all was passed onto home loan borrowers. It seems as though the small business sector has had to cop the brunt of maintaining the profits into the banks during these times. I think it is because when it comes to home loans there are probably a lot more voters, so there is a lot more political pressure put onto banks.

But I want to take up this point of when it comes to someone buying your business is it time now that we need another Commonwealth Development Bank or some industry to get people not only back into your industry where you are going to be gobbled up by the big two but also getting people back onto the land to actually feed us. Unless you have got a bucket load of real security—land, bricks and mortar, or something—the banks do not want to know you. When it comes to small business the banks want security; they seem to be very strict on it. Is it time now that we once again had a development bank in Australia?

Mr Cummings—To answer that question let me start off by making a statement. In food production, especially in Australia, it is all down to small to medium sized enterprises. That is to produce it. Without small to medium sized enterprises which are producing the ingredients for large companies to put the package together to end up on grocery shelf, it just does not work.

In my experience in Western Australia I have some 120 suppliers supplying food to my business. That is from farmers, through small bakeries, through specialty tea manufacturers, et cetera. It is all small to medium sized enterprise.

In regard to the way that we are treated as a sector by the banking industry, I think that one of the reasons that the small business sector is not overly vocal about it is, quite frankly, we are all pretty grateful that somebody bothered to give us some money. We do not argue about the interest rate. It is a matter of being thankful. I have had my heart—

Senator WILLIAMS—You are lucky to get it?

Mr Cummings—I have actually worked my whole life and have had my heart absolutely sold on doing this and then somebody has given me the money to do it. In regard to do we pay competitive rates, again from my own experience and going back to Beneficial Finance, when we took out that first loan at 23 per cent when interest rates came down I personally had to ring Beneficial Finance every month and say, ‘Excuse me, would you mind reducing the interest on this loan?’ That was every month. If I had not rung them every month they would have continued to charge the 23 per cent. It is absolutely just a one-way street. It ain’t competition as I know it.

Senator WILLIAMS—Hence I think the forecast profit for this financial year for the four big banks is $21 billion, yet we are just coming out of a global financial crisis. It appears to me that they have come out of it very well. Obviously a lot of that profit they are returning is not only on fees but the interest rate margins they have maintained on small and medium businesses and farmers.

Mr Cummings—Absolutely. It is not only interest rates, it is also what we are charged for EFTPOS transactions; it is what we are charged for bank charges. One of the problems for us to take out a loan the bank would say—and I can understand this—is that under previous regulations that were put in place there needs to be all these privacy documents. So when we take out a loan we get a pile of documents about that high to be signed just on privacy records. They say there is a cost to business in doing that so they charge us $1,000 every time they do one of those.

That is not just in creating a new loan. That is if they change your overdraft; if they change a facility, or those sorts of things. It is $1,000 each time for that. You then get an $850 or $2,000 line of credit fee that is put on top of it. Then you get the pleasure of paying the interest on top of that. It is no doubt a very profitable business for the bank.

Senator WILLIAMS—I will close by saying I had one farmer who had to change the names because he got divorced. There was a fixed interest rate. Nothing was changed except to take his ex-wife and his son off the loan and he was quoted $46,000 to change those loan documents. Luckily we got it back to about $500. But if we had not gone in to bat for him he would have paid $46,000. Would they do this to a big business? Would they do it to a home loan borrower? But it seems that when it comes to small business it costs $46,000 to remove two names from the loan document.

One of the big concerns I have is when you see small business or farmers get into financial trouble, what do they do? They raise the interest rate by two per cent and say you are getting into an area of higher risk. But when they raise the interest rate more does that just not add more pressure on that enterprise so that they do go broke?

Mr Cummings—Without a doubt. I think getting back to your comment about should there be another Commonwealth Development Bank or something like that, I think one of the other problems that we have in our sector is that even banks that have big loan books to small business in our sector do not know how to actually value that business. They have lost the ability to value business to those areas, so how do they put a value on it? How do you put a value on a small business that is only a leasehold operation with five years on the lease? They find it basically impossible to do.

We are trying to work with them so that we can get those sorts of figures. But what we are finding is that, whereas two or three years ago they might have loaned 85 per cent of the value of the business, today it will be about 35 per cent of the value of the business with the rest made up by your home and a mortgage on your home; and your dog has to sign it and everything else so that everything that you own is at risk on a daily basis.

Senator BUSHBY—Thank you to the representatives from NARGA for coming along today to assist us with this. It is actually good to hear the reality of actual challenges faced by small businesses as opposed to the theoretical approach that we have heard from the previous two witnesses from high above.

I think you mentioned some of the Asian countries and used the Philippines as an example. I am not sure about the Philippines but you may be interested to know that the Industrial Bank of Korea is required to make at least 70 per cent of its loans to small business. So there are examples in other countries of government intervention to help facilitate the small business sector and its growth. That is something I was interested in asking the RBA about earlier.

I asked the ABA about some comments that were made by the Australian Chamber of Commerce and Industry. At their recent council meeting they concluded that:

> … access to and renegotiation of affordable finance has now become the most substantial issue facing the day-to-day wellbeing of Australia's small and medium business sectors.

Is that something that you would agree with?

Mr Cummings—Without a doubt; it is the most vital thing. The reason most small businesses of any description fail is a lack of cash flow, a lack of finance. From my experience in dealing with the banks is that they seem to have statistics that say that if you get through the first two years there is a chance you will make it forever. But your situation changes along the way. Therefore you have this constant battle going on with it.

I am very fortunate that we have been in a stable business for 18 years. We have paid back a fortune to banks over those 18 years. In terms of what our business is worth we have a modest loan as we bought a new business some four years ago. But again that has not stopped them reviewing our total loan book again.

Whereas they might have been happy for us not to have our houses up as security three years ago, it is not beyond all realms of possibility that they will not require us to do that within the next 12 months when they do these current reviews. We have banked with Bankwest in Western Australia, which of course is now taken over by the Commonwealth Bank. When it was the R and I bank it was a totally different bank in its outlook; that is where we got our original finance from. It will be interesting to see where that ends up. If it ends up just as another branch of the CBA I guess we will have to live under the CBA's rules. They are the unknowns, that we do not know what we are dealing with.

All I can say is that in 18 years the fundamentals of my business have not changed. The fundamentals and the rules by which I obtain finance is an ever-moving feast—

Senator BUSHBY—In a sense what you are looking for is stability or consistency in terms of being able to enter an agreement with a bank, obtain the finance and know what you are going to be facing and the challenges that will be placed in front of you so that you can actually plan ahead and meet those challenges and requirements and so forth?

Mr Cummings—Absolutely. I think we also have to realise that in 18 years or 20 years, or however long you are going to be in business for, every year will not be a diamond year. If the banking sector applied the same rules that they apply to small business, which is you are going through a bad year therefore we are going to renegotiate your loans or we are going to pull it, there would not be one public company left in the world that was financed.

Senator BUSHBY—On that, the ABA and some of the submissions from the banks that we have received say that particularly during the global financial crisis they have instituted all sorts of measures, and some examples have been provided as to how they sit down with their small business borrowers and they go through the issues they are facing to try to help them through that. Is that something that is a reality? Are they doing that?

Mr Cummings—Yes, without a doubt. There are some exceptionally good, well-meaning people working in banks. Again, they just work by the rules. I will give an example. Years ago we banked with the CBA. We had a terrific relationship with the regional manager and another bloke there. We were looking at buying another business. I went to the bank at the time. I said, ‘Look fellas, here are the numbers, the fundamentals, on this. Please tell me if it stacks up because I do not want to waste the time of the guy we are going to buy it from.’ They looked at it and said, ‘Yeah, that should be fine.’ So we went ahead and did the contract. They came back three months later and said, ‘No, we are not interested. We cannot help you.’ We went somewhere else and got money. I saw those guys three months later and they said, ‘You would not believe this, but the rules have changed again and we would do that tomorrow.’ And that is in six months.

Senator WILLIAMS—Is that in recent times?

Mr Cummings—Ten years ago.

Senator BUSHBY—You mentioned that you have been in the industry for 20-odd years?

Mr Cummings—Yes.

Senator BUSHBY—Are you saying that there are challenges for people who want to buy into an independent supermarket these days in terms of getting the finance? What impact does it have on your industry if people who want to get into a small business and think that running a supermarket is what they want to do cannot get the finance? If a 28-year-old, as you mentioned earlier, decided that is what they wanted to do, what criteria would they have to meet to be able to buy into a supermarket business?

Mr Cummings—They would need to steal their parents’ home, number one, to act as collateral. Realistically, I think that the only way if I were to sell our business to somebody of that ilk we would have to leave some finance in there. I think that is the only way.

Senator BUSHBY—Vendor finance?

Mr Cummings—I think that is the only realistic way to push forward. As I said what you have got is not just in our sector. Look around at all the small business people, whether they are running panel beating shops, farmers, whoever you want, they are all grey-haired and my age. Where are all the young ones coming through? Where is the next wave of enterprise going to come through? Where is the small to medium sized enterprise that is going to feed the 35 million people who will be sitting here in the year 2050?

Senator BUSHBY—That is the situation we currently face. How is that different from when you got into the industry? Is it different?

Mr Cummings—I think that part of the reason that we have had concentration in these areas is that finance is one of the sweeter things that causes market domination and concentration of a market. It does not allow people to go somewhere else. If you have a favoured set of people who are getting a favoured set of rules by either getting finance at a cheaper price, or access to leasing, or whatever you want it to be, they are actually going to grow and ultimately—

Senator BUSHBY—You are saying that it also feeds into the competition within so that the market that you are in, grocery retail, and that may well have a deleterious effect on consumers in terms of the supermarket industry itself?

Mr Cummings—Yes, absolutely. At the end of the day it must lead to further concentration.

Senator HURLEY—Perhaps I will play devil’s advocate for a little while. The ABA has certainly talked about small businesses being high risk. I do not think you can really dispute that. People do go in as you have described wanting to be in some business and having a dream to do it. They do accept finance that is at a very high rate. They just go in and probably for various reasons, including perhaps not having the requisite business skills, they do fail. Probably your area, the grocery area and the suppliers you talk about, is one of the areas that are most at risk.

You detail in your submission a number of other risks. You talk about state government taxes and charges, the issues of competition and so on. You do have to accept, do you not, that there are high risks in financing this area?

Mr Cummings—The premium that is built in to charge small business a higher interest rate is there. I do not think we are disputing that. We have made no comment as to whether we think it is too high, too little, too few, or too whatever. Providing it is justifiable I think that is fine. There has to be margin for risk. We accept that concept.

The other side of it that we are talking about is that the risk has already been there; you are changing the rules along the way to recalculate the risk. In a lot of cases we were talking about situations where financiers have come back to a business and said, ‘Look, we might have done this six months ago but we have rethought it and we are not going to do that this six months. We are going to change it and, sure, you will still pay a premium but we are not going to go forward with that particular thing.’ That can stymie you in expanding your business, in putting in new plant and equipment. Even though there is a risk there we have to consider what the incentive is for a bloke to go out and actually borrow the money to buy a semitrailer to start to lug stuff around.

Senator HURLEY—I suppose that is my point. The banks are not really responsible for providing incentives for business to go and do things, are they?

Mr Cummings—No. They are businesses who should just be allowed to do whatever they wish to do, I guess. But we are talking about a competitive environment from a legislative point of view; is there something that we need to do to make finance more available to small to medium sized enterprise.

Senator HURLEY—Now we are getting to the flipside. What are your suggestions?

Mr Cummings—We have had a bit of a chat amongst ourselves in regard to this. I think that one thing you could look at would perhaps be something along the lines of unconscionable conduct regulations in the banking sector. I think all that unconscionable conduct does is make a big business think twice about what they are doing, as to whether it is the right thing or the wrong thing. It might bring down that risk margin to a manageable level in some areas. It might see longer terms, shorter terms. It could do a whole pile of different things.

I make the comment that I made before, when I was a kid every state had a rural bank because farmers could not get finance from anywhere else—

Senator HURLEY—That is precisely the difficulty in government legislation, is it not? Some banks may choose to concentrate on small business and so they may choose to take out a lesser risk margin. If you are dealing with regulation of that kind of thing you run into all kinds of problems, don't you?

Mr Cummings—We come across it all the time. I can remember just a simple little thing like going to buy a car. You would think that the best deal you would get would be with the bank that you had a loan for $1 million with. Quite often you will find the bank down the road will give you a far better deal than your own bank. The reason when you get down to it and you ask the questions is that this bank thinks they have got too much of their loan book tied up in equipment at the moment whereas the bank down the road is looking for equipment finance, so they will actually offer the cheaper price.

Senator XENOPHON—Thank you for your submission. I think your point was quite telling, that you do not get too many banks knocking on your door despite this so-called competitive marketplace. Back from 1960 to 1996 the Commonwealth Development Bank was in place. Also I think the New South Wales Business Chamber has suggested a temporary and appropriately priced guarantee of 80 per cent of the value of business loans below a certain size. In relation to that we have a small business loan guarantee that has been in place in other places, such as the United States, Canada, Japan, Korea and Singapore. Under the Canadian small business financing program the government guarantees 85 per cent of loans up to $500,000. You have told us about the problems. What do you see as the solutions to try to give small business a fighting chance in this marketplace?

Mr Cummings—It is interesting you mentioned the Commonwealth Development Bank. My recollection of the time then was that whereas a lot of small businesses might not have ended up getting their finance from there, it actually focused the other banks on looking at that market. They seemed to free-up funds into that market. If you can provide certainty to the lender about the value of the business in some way—and I do not think that can be overly difficult to achieve—if you can give a guarantee to the repayment of some of the loan, you must ultimately free up the availability of finance to small business. I do not think it is out of the question that something like the Commonwealth Development Corporation should not be put back on the books.

Senator XENOPHON—It is certainly not government policy but what about the speculation that Australia Post be turned into a bank? I know that Mr Fahour, who has a very good reputation, has got banking experience and is now the CEO of Australia Post. Would another entrant into the marketplace make a difference from your point of view in terms of making it easier for small businesses?

Mr Cummings—Without a doubt. If you get down to the micro small businesses such as painters—local tradesmen—they tend to do all their financing through a credit card because it is easy to do. They only have to go to a bank and fill out one form. They pay very high interest rates but it is an easy operation for them to do. If there are more people available it must make it easier for people to get money.

Senator XENOPHON—In the ABA's submission they stated that the capital required by APRA to be held by banks for small business loans is generally three times higher than for home loans and can be seven times higher for some products. You may have heard me put a question to the Reserve Bank's Dr Debelle along those lines. Do you have a view on that? Do you think that the lending criteria for a small business loan are unnecessarily tough because, as I understand it, they generally use real estate as security for the loan anyway?

Mr Cummings—Yes, I do. I think they are extremely high hurdles. I have made the point that I think the hurdles are so high now that if a young 25-year-old woman or a bloke came to me and said, 'Do you think I should get into this? How do I go about it?' I would suggest that they really think twice about this because it is a very difficult process today.

Senator XENOPHON—You may wish to take this on notice, insofar as you may liaise or have communications with other small business groups overseas, what can you tell us about say in Canada or the US, Europe or UK about the lending criteria there particularly in terms of the APRA requirements that I just referred to? What can you tell us about how tough it is for them? Also in Canada, given that they have got that small business loan scheme, if you are able to get back to the committee on that I would find that very useful.

Mr Cummings—We will take that on notice. We will do some research and get back to you as soon as we can.

CHAIR—In your submission Mr Henrick refers to the differences between Australia and other countries in terms of there not being a prohibition in our Trade Practices Act on price discrimination. Would that be something which you would like to expand on for the purposes of the committee in terms of Senator Xenophon's last question?

Mr Henrick—We put that into the submission in the context of the big picture of burdens that small businesses have to bear. This is particularly relevant to our sector because, on the recommendation of the Hilmer committee in 1993, the then prohibition on anticompetitive price discrimination was repealed. We are the only developed western economy that has no such prohibition now. In practice that means that right at the beginning of the supply chain big business gets a free kick and a very substantial advantage in terms of trade. If that prohibition were to be reintroduced that would not be allowed to continue. In practice that means that economies of scale are not eliminated at all but they have to be justified. It means that a supplier supplying products to one customer at one price has to give all other customers the same quantities at the same price. Since in most cases in our industry the orders are pretty similar, the big advantages that the chains have at the moment would not apply.

CHAIR—Could you provide some additional information about that to the secretariat?

Mr Henrick—Yes, certainly.

Mr Van Rijswijk—I think it goes to the core of the problem that small business has. As we have tried to say in our submission where we tried to paint a bigger picture, I know this inquiry is looking particularly at the disadvantage small business has in relation to access to finance, but there are disadvantages right across the board. It is the cost of product. Going back to Senator Hurley's questions about the failure rate of small business, part of the problem with the failure rate of small business is that in a total sense we do not have a competitive environment. We have small business being subject to disadvantage right across the board in its dealings with banks, its dealings with suppliers and its dealings with government, et cetera. One of the core reasons of that disadvantage is the absence of price discrimination legislation.

We see it in retail leasing. If a major store can get premises of $200 a square metre and a small store has to pay $6,000 a square metre, that is a major disadvantage. The business goes broke. I am not surprised the business goes broke. It has that major disadvantage to contend with. That then feeds back into the lending criteria for all small business. Small businesses are going broke. The playing field is not level. That is why small businesses go broke.

Mr Henrick—Whenever there is an impost on small business, because small business has fewer resources both in terms of bodies and money the impact of that impost is disproportionate.

Senator WILLIAMS—This is a regulatory impost?

Mr Henrick—Yes.

CHAIR—Thank you for that. We look forward to some further material on that.

Mr Henrick—Sure.

Senator WILLIAMS—The cost of small business, whether it be buying your stock or buying your money, or whatever, the small service station cannot get the fuel at a price that their competitors are selling it for. They are paying more to buy it than the gate price on it. How can small business survive? Small business is 50 per cent of GDP in Australia yet they seem to be getting hamstrung at every corner.

Mr Van Rijswijk—The price discrimination section of the act is core to that. If you had price discrimination as part of the Trade Practices Act, those differentials would narrow quite considerably and small business would have a fair go.

Senator PRATT—Clearly there is a growing accountability on banks not to lend irresponsibly and there has been a growing awareness of that. What significance do you place on this risk assessment because clearly one of the things that has been debated, as you would have seen from the previous evidence, is that risk assessments might be looser when there is more competition in the market and tighter when there is not. Some of that relates to a risk assessment around confidence in the market in a general sense and therefore availability but some of that relates to risk assessment around the actual business. Where do you see that balance naturally sitting?

Mr Cummings—That is a good question. Let me answer it this way, with our own experience. There are currently some 375 stores that call themselves independent grocers in Western Australia. It was interesting; I asked a company, Peters and Brownes, who have been a big supplier to the independents direct for the 20 years that I have been in there, and in that period of time, in 20 years, they have had one bad debt. None of those businesses have actually gone broke in that 20 years. They have been taken over by Coles and Woolworths which have bought out a few, but no businesses have actually gone broke. There has not been a bank that has actually lost a dollar in lending money to our sector, but they changed the rules. The risk is reassessed. Is there a need for that risk to have been reassessed in our sector?

Senator PRATT—You would argue no?

Mr Cummings—It would seem apparent that there is no need to be. I think the lender needs a bit more of a proactive attitude as well. Going back to the incentive of trying to get people to go into small business, if a guy was going to sell a business—say if I was going to sell my business—could I ever do a set of books, talk to a couple of financiers and say, 'Look, I am going to sell my business. Give me what you need as a preapproval for people to actually buy it.' Just as you can get preapproval to buy a house in today's market, can they do preapprovals for small business?

Senator PRATT—Banks argue that they are there to lend money to viable businesses because that is what they make a profit from. Would you argue that they are not really interested in doing that when they do not have to compete?

Mr Cummings—I do not think I am qualified to say that. I would just say that the rules have changed. In my experience the rules have changed. They have changed their criteria. I think today our experience as a sector is that banks are having difficulty in getting to understand how they should assess an individual business in our sector.

Senator PRATT—In your view why do the banks change their rules?

Mr Cummings—I have no idea.

Senator PRATT—Is it just about setting new criteria so that they can reframe their profits for the period ahead?

Mr Van Rijswijk—The question may be: do individual banks have the skills-set to actually assess the viability of a business. When a bank has a bad experience with small business do they simply apply a blanket rule right across the whole sector and apply that rule across the sector whether or not individual businesses are more viable than what their rule would suggest.

Senator PRATT—In a time when there is less competition in the marketplace are they likely to be more active in setting those rules?

Mr Van Rijswijk—Yes.

Senator PRATT—In a time when they are competing with other financial institutions then they are going to be more lax in the way they put those forward.

Mr Cummings—I think it is also probably just human nature, you get the flavour of the month syndrome as well. In our sector it was very easy to get finance a few years ago. It has tightened up. Nursing homes and aged care places found it extremely easy to get finance a few years ago. I do not know where they sit now.

Senator PRATT—No, they cannot get finance.

Mr Cummings—A few years ago you would just walk in there and say, ‘I am thinking of opening up an old people’s home’, and they would give you the money before you walked out the door.

CHAIR—Not today, by any means. Thank you very much for appearing.

Proceedings suspended from 11.43 am to 11.54 am

BURN, Dr Peter, Director Public Policy. Australian Industry Group

CHINDAMO, Mr Philip, Chief Economist, Australian Industry Group

CHAIR—Welcome. I invite you to make an opening statement.

Dr Burn—The AI Group appreciates the opportunity to appear before the inquiry into small business finance. AI Group's membership covers businesses in a broad range of sectors across the economy, including in the manufacturing, construction, logistics, defence, ICT, food and services sectors. Small businesses play a vital role in the general economy and in line with the broader structure of the business community the majority of AI Group's membership is made up of small businesses.

Our close monitoring of business conditions and ongoing liaison with our members suggests that credit availability remains an important constraint on small businesses. While the availability of creditors improved markedly over the past year, it remains an issue of concern for many businesses.

We have some material we would like to add to the points we presented in our submission. These relate to a survey of our members and an international monetary fund working paper on credit availability in the context of recoveries from financial crises.

We recently surveyed our members asking them about the likely positive and negative influences on the business outlook over the next 12 months. Although we are still finalising the results we can provide the committee with the results of a question relating to credit availability. A total of 25.8 per cent of respondents identified the availability of credit as a negative influence. While this did not vary much by company size, some 27.3 per cent of businesses with fewer than 10 employees identified the availability of credit as a negative influence.

This was the second year we asked our members this question. In 2009 the proportion of businesses identifying the availability of credit as a negative influence on their outlook was 39.6 per cent. For businesses with less than 10 employees the figure was 29.5 per cent. This was well below the average for all businesses in 2009, possibly reflecting the perception on the part of many in this small business group that they would have little demand for credit over 2009. A point of interest in these numbers is that whereas there was a distinct decline between 2009 and 2010 in the proportion of all businesses reporting that the availability of credit was a negative influence, the same cannot be said for businesses with fewer employees where the decline was not all that noticeable.

My colleague will make some comments about the IMF working paper that was released subsequent to our submission.

Mr Chindamo—I would like to bring to the attention of the committee the IMF working paper released on 1 March entitled *Credit Conditions and Recoveries from Recessions Associated with Financial Crises*. The objective of the IMF study was to assess whether stressed credit conditions affect the pace of recoveries from recessions associated with financial crises.

That is, the IMF examined to what extent stressed credit conditions, that is, situations where the cost of credit is unusually high or the availability is unusually restricted, whether they dampen recovery in the aftermath of a financial crisis. According to the IMF, recoveries associated with the financial crisis tend to be more sluggish. That is, output returns to peak five and a half quarters after the recession associated with the financial crisis versus three-quarters for all recessions.

The scope of the study was to use panel data and regression analysis covering 21 industrialised economies, including Australia, spanning the period 1970 to 2004. The key findings of the paper suggest that credit conditions continue to play an important role in constraining recovery from recessions associated with financial crises. In particular, industries that rely on external finance or have fewer assets eligible as loan collateral or that are populated by smaller firms grow relatively slowly during recoveries from these episodes. The paper infers that credit conditions remain stressed well after the trough of the recession. The negative effects are strongest during the first year of the recovery and become insignificant after only three years.

Dr Burn—I would like to reinforce a couple of points in regard to policy making that we make in our submission. We think that there is an important role for governments to play in improving the financial training of owner/managers of smaller businesses and in providing better information regarding finance options, preferably through trusted intermediary organisations. Thank you.

CHAIR—Is it possible for you to provide the secretariat with a copy of the IMF paper, please?

Mr Chindamo—I have a hard copy but I can certainly email a copy as well.

CHAIR—Could you do that, as it is something we might refer to in our report? We have had a little bit of a difference of opinion this morning about whether or not there is a problem in obtaining credit for small business. The Reserve Bank and the Australian Bankers' Association, defining small businesses as loans under $2 million, thought that there was no change in the rate of providing such loans but other people disagree with that point of view and do feel that there is an issue about credit for small business. I gather that you would agree with the latter viewpoint, that there is a problem there; would you?

Dr Burn—Businesses identify credit availability as an issue of concern to them. Unfortunately we do not have good time series data to be able to compare pre-crisis and now. Had we known we were going to be in a financial crisis we would have been asking this question for several years beforehand. It is certainly an issue for small businesses and it is identified by them as a constraint.

CHAIR—One of the comments which you have just made is the need for more training for people in small business to better educate them in terms of running a business, handling capital management and so on. Many other people have made the same point. I suppose that one could argue that perhaps the banks', if you like, diffidence about lending to small business in a time of financial crisis may relate to their view of the reliability of the management skills of small business. Would you agree with that?

Dr Burn—I do not know what the views of the banks are about the management skills of small business.

CHAIR—I was just speculating in terms of your comments.

Dr Burn—But we think that there is certainly value in providing that training to small businesses so in that sense we think that the skills could be improved. So that may be an indirect answer to your question.

CHAIR—There is a very high incidence of failure of small business over a five-year period though; isn't there? That is generally thought to be due to the fact that many people who go into small business are inadequately prepared in terms of managing finance and managing business, which I presume really is the point you are making.

Dr Burn—I think that is correct, yes.

Senator HURLEY—I was particularly interested in point four of your submission, a choice of finance options, and you talked about overdraft facilities. Small businesses often do use the overdraft facilities quite extensively to manage their cash flow, particularly micro businesses. You make the good point that stable relationships are highly valued with banking staff, so I think sometimes people persist with the same bank even though the actual conditions might not be quite right. You make the point that that is not the only method of finance, people might use leasing or hire purchasing options. But in relation to the overdraft, are you getting any feedback about any penalties that might be incurred and whether banks that are quicker to impose penalties are more stringent in the application of fees and penalties for these kinds of accounts?

Dr Burn—We certainly were getting that feedback during the past year but we have not had that sort of feedback over, say, the last six months. But that was certainly a keen topic of conversation among our members in the early part of the last year.

Senator HURLEY—Do you attribute that to the banks being less stringent or to an increase in competition in the lending sector?

Dr Burn—A decrease, sorry?

Senator HURLEY—An increase in competition or a decrease in the willingness of banks to charge fees and penalties.

Dr Burn—I think some would attribute it to a change in behaviour on the part of the banks in that period following the Lehman Brothers collapse.

Senator HURLEY—There was an issue with fees and penalties on overdrafts but that is decreasing as an issue?

Dr Burn—It is certainly decreasing as an issue that is raised by our members with us.

Senator HURLEY—And you feel because the banks are not being quite as difficult about those areas?

Dr Burn—We would draw that conclusion, yes.

Senator HURLEY—In terms of that increasing competition, do you see more lenders coming into the market at the moment or is that still fairly stable?

Mr Chindamo—From what we have seen it is still fairly stable. We have not seen a significant increase in competition, no.

Senator HURLEY—One of the themes of this inquiry has been that issue, and Senator Eggleston did allude to the issue as well of whether there is enough finance around or enough competition for small business, not only in the commercial sector but whether there is enough venture capital, enough capital to support start-ups and that kind of thing. Do you have a view on that?

Dr Burn—Our feeling is that that area of the market is not as liquid as it might be and that, particularly for smaller businesses, a barrier for the new business starting up with an experimental idea is a financing problem because it is like the chicken and the egg, you have to prove yourself before you can attract finance and you have to have the finance to prove yourself. That is an area where we think ideally the market would provide more funds. Mind you, it is a high-risk area.

Senator HURLEY—Do you think that there is any reason for the government to get more involved in that particular area of venture capital start-up finance or do you think that the avenues exist as the economy grows for that to increase naturally?

Dr Burn—We think that there is a case for government involvement in those areas where information failures occur, if you like, so that the market is not working as efficiently as it might. The feedback we received at the time the commercial ready program was axed was that this was having an influence on the interests of venture capitalists in providing funds to emerging businesses, that that source of liquidity into that area of the market was withdrawn and that the flow-on of that was less venture capital was available to small businesses. That was an area where government intervention was facilitating lending in that area, but that was withdrawn a couple of budgets ago.

Senator HURLEY—But you do emphasise the importance of training and education for small business? I raised this issue previously with the National Association of Retail Grocers of Australia that small businesses are high risk in the scheme of things. It is interesting that you see that education is the way to mitigate some of that.

Dr Burn—I think that is a good conclusion to draw from what we say. There is a lot of scope. We have got quite a bit of experience in the current Enterprise Connect program. We are a host organisation in that program. The feedback that we get is that there is a lot of scope for improving small business management of their financial affairs and awareness of their financials. We think that would only help the success rate of those businesses.

Senator HURLEY—I know the Enterprise Connect program in the northern suburbs of Adelaide is very well regarded and, as I understand it, very useful. Do you think that that might be a priority for government in assisting start-up businesses and businesses looking at expansion, that the education area might in fact be the priority?

Dr Burn—It is certainly a priority for businesses. There are so many other areas in this skills space for businesses. I think there is probably a lot of scope for businesses to learn better how to hedge against the exchange rate and what options are available for them. There is a lot of scope for businesses to make inroads into better staff management. We think there is a lot of scope for businesses to improve the way they manage their financials. To rank those sorts of things is very difficult, because there is so much variety across the small business sector about what needs are the highest priority for the different businesses.

Senator HURLEY—Is it your experience that banks perhaps point small business lenders in the direction of that further education or do they provide any education themselves?

Mr Chindamo—Essentially what we have seen is that they provide some limited education but not necessarily a comprehensive program, if you like, of education, so there are gaps that exist there.

Senator HURLEY—You would think it would be a good area to start, would it not, because that is where businesses tend to go first, to see if the finance is available. So it would be a good place to start to give them information about where to seek further assistance.

Mr Chindamo—Potentially, yes.

Dr Burn—There is another point there. There are some inhibitions on organisations being seen to provide financial advice to businesses, or to individuals for that matter, and it may well be that there is a risk of stepping into an area where they are not meant to be operating legally.

Senator HURLEY—This committee has indeed had a look at some of those restrictions. I take that point. But I was thinking more in terms of just pointing people to where they might get that advice rather than providing it as such.

Senator XENOPHON—You referred earlier I think to a lack of information in terms of access to finance for small business. You then said there was information failure—you did not say market failure—but would you agree that the markets have been distorted by virtue of some policies that have been in place in the sense that small businesses are at a relative disadvantage compared to larger businesses?

Dr Burn—I think that the information problems are more significant for smaller businesses because essentially the fixed cost barrier to overcoming those information hurdles impacts more on small businesses than the large businesses, so in that sense there is a market failure that is biased against smaller businesses in that area.

Senator XENOPHON—We have heard evidence today about the extent of the problem from the National Association of Retail Grocers before you. What are the solutions? Do we need to look at the approach in other places such as Canada where they actually guarantee up to around 80 per cent or 85 per cent of small business loans? Do you look at the issue of, for instance, the requirements? The Bankers' Association said that the APRA requirements for security seem to be much, much higher for small business loans compared to other loans. What are the solutions so that we can deal with this problem?

Dr Burn—The solutions that we put forward are for greater information to businesses. That might be making information about financial options available and in plain language. There is probably a lot of scope for improvement across the board in that regard. For instance, a sign saying, ‘Please turn off your mobile.’

Senator XENOPHON—I do not think that will improve the access to finance for small businesses.

Dr Burn—The other thing that we think would be very useful is the sort of Enterprise Connect program or a similar type of program, active programs that are often delivered by a trusted intermediary that is not necessarily held up in the department of industry.

Senator XENOPHON—Don’t we need to go a bit further than that? I think there was some reference made to commercial ready. We had a Commonwealth Development Bank until 1996. Do you actually need some greater competition injected in the marketplace or some mechanism guaranteeing small business loans so that market asymmetry or that market failure can be redressed?

Dr Burn—My instincts in that area are that there is a warning bell that rings government failure when we talk about governments guaranteeing loans.

Senator XENOPHON—Do you know how it has worked in Canada for instance?

Dr Burn—No, I do not, but I would be very interested to pursue that.

Senator XENOPHON—Perhaps through your related associations or colleagues overseas you could take that on notice as to what their experience has been.

Dr Burn—We will certainly see what we can dig up and provide the committee with that.

Mr Chindamo—We are saying that by providing financial training to firms it will allow smaller businesses to actually be in a better place to make a business case, if you like, to banks so that they can actually tap into the credit markets a lot easier, and external finance a lot easier, irrespective of where we are in the economic cycle. Often smaller firms have not necessarily done all the homework required, have not necessarily put together a business case and banks seem to be more reluctant to therefore lend.

Senator XENOPHON—I agree with you that that is a good thing, but even if you have a well-informed small business that ticks all the boxes and that provides all the information, when you have got things such as the ABA who said in their submission, ‘Capital required by APRA to be held by banks for small business loans is generally three times higher than for home loans and can be seven times higher for some products.’ Isn’t that a problem? Are there some deeper problems both in terms of competition and in terms of the way that the system of loans for small businesses is structured such that they are at a natural disadvantage?

Mr Chindamo—Those prudential requirements are presumably set in a way that obviously reflect the risks associated with lending to smaller versus larger firms, so obviously you would have to look at whether they are set in an optimal way. We do not have any evidence to say that they should necessarily be changed.

Senator XENOPHON—Again, if you would take this on notice, is it possible to look at whether those lending requirements are comparable in other jurisdictions in other places? I am not saying we should go to the US as a benchmark, given their problems.

Dr Burn—We will certainly look at that.

Senator McGAURAN—As you know, every interest rate rise goes to the heart of the ability of small and medium businesses to access funds, which affects their viability. In the last seven months we have had five interest rate rises. We were talking about this with the Reserve Bank earlier this morning. My question would be: in those five interest rate rises have you seen the direct effects that go to the heart of the viability of your membership? What is your view in relation to the haste to ratchet up the interest rates? Should the Reserve Bank stop and wait and see? Are they raising them too quickly?

Dr Burn—We are very cautious about the speed at which the bank is returning the official rates to a neutral level. As far as we have seen with our surveys and the talk within our membership, we are still in recovery mode. We are not recovered. Recovery is quite patchy. Our performance of manufacturing index, our performance of services index, our performance of construction index are not showing that we are in strong rebound territory but we are gradually building up to a respectable level of growth. We keep an eye on those Reserve Bank movements—which we understand in the bigger picture—and we are eyeing the pace of that return to neutral rate as something to keep an eye on and to be concerned about. Certainly in our liaison with members the prospect of further rate rises over this year has emerged as an issue of some concern to them and is anticipated as a significant constraint on business.

Senator McGAURAN—Treasury claim to December 2009 the growth rate was 2.7 per cent and, of that, 2.1 per cent can be attributed to the government’s stimulus package. As I take it, many in your membership, for want of a better word, benefited from the stimulus package. Now we see all the rip-offs and the rorts and that it was absolutely riddled with overpayments and rip-offs. If it were not so serious it would be funny. But we have a finance minister who says that we had to rush it out. Forget about dotting the i’s and crossing the t’s; we just had to get it out there. For example, the Building the Education Revolution and the pink batt schemes would both affect your membership, I am sure. Would you like to make a comment as to what extent it did benefit and what are your membership’s and your industry’s view of the rip-offs, rorts and outright corruption?

Dr Burn—Perhaps I could make some comments at two levels. I will leave the second one to the end, but just in relation to the stimulus generally, we think that the stimulus has been and indeed will continue to be a major factor in the total growth of the economy certainly over the last six months and we think into the rest of this year as well. The withdrawal of the stimulus from the end of the December quarter we think is a factor in the patchy recovery, so that the fact that the stimulus is being wound back is not being compensated for by private sector growth yet, certainly not fully, so that we saw from the end of last year a fading in the demand and in the activity in consumer-related sectors that we surveyed. We think that was pretty closely related to the phase-down of the cash stimulus that went to households, the payments that went in December and the first part of last year. We think that they are no longer having a real effect in the economy.

Many of our construction members say to us that we would not have survived had it not been for the infrastructure elements of the stimulus package. The schools building fund was seen as a saviour by some of the smaller construction companies—

Senator McGAURAN—Have you done an audit of your own membership in regard to that stimulus package rip-off effect? Were you ever aware of what was going on there?

Senator HURLEY—I do not think they would be doing the rip-off then? I do not think they would really be jumping into—

Senator McGAURAN—Is Mr Burn saying he did not know anything that was going on? Is that what you are saying? You may well laugh, but it was happening under your nose if you did not know.

Dr Burn—It was not me who was laughing, but I would strongly object to the fact that it would be our members that were ripping anyone off.

Senator McGAURAN—When you know that?

Senator HURLEY—Where is it then? If you acknowledge that there is a rip-off, as Senator McGauran said or even indeed outright corruption as he said, where is it coming from if it is not people getting the money?

CHAIR—Let us get back to the issues of this inquiry.

Senator McGAURAN—If the stimulus package was to benefit the economy my point is that if some $6 billion to $7 billion has been wasted, has it just benefited your membership and no-one else?

CHAIR—This is access to smart finance for small business.

Dr Burn—As a general point, we detest all forms of waste of government expenditure, wherever they be. We would not confine ourselves to concern around the stimulus payments on that score. We certainly would not condone any inappropriate business behaviour in relation to them or indeed any other government program.

Senator McGAURAN—I am sure you would not condone it, but did you know it was going on? Did you have any idea? There is a lot of chatter going on amongst the builders and you say that builders told you that this saved the day for them, so I think you had your ear to the ground more than you are letting on. Certainly Heather Ridout would have.

Dr Burn—We have not had any information about rip-offs from any of our members.

Senator McGAURAN—It is a pretty wasted stimulus package if some $6 billion of it has basically been part of a rip-off. We are told that the effect at this stage is that some $10 billion of the $16 billion—the rest—

Senator HURLEY—Who told you that? You are stating these things as fact.

Senator McGAURAN—I am asking the questions here. You do not have to ask me the questions.

Senator HURLEY—You are making allegations that I think cannot go unanswered.

Senator McGAURAN—I am just surprised that the industry group knows so little. Let us not kid ourselves.

Senator HURLEY—Maybe you are wrong.

Senator McGAURAN—No, I am right; I am sure of it. I am sure Heather Ridout and her industry group knew more than meets the eye in regard to the rip-offs of the Building the Education Revolution because I can tell you it was very much the talk of the town amongst the builders and the construction workers. It has been going on for a long time.

Dr Burn—As I said before, we did not have any information—we do not have any information about any rip-offs.

Senator WILLIAMS—In relation to competition in banking and finance for small business et cetera, when you see small business paying a rate at one institution and they see a better rate down the road, do you see it as a hindrance to competition if they have to pay an exit fee on a variable loan and an establishment fee down the road? I just think that is a situation where people are not free to walk from one institution to another. I will give you an example. Let us say someone has $1 million worth of real assets, real security in land or bricks and mortar or whatever, and they might owe $200,000 so they have 80 per cent equity. They might be being charged 9½ per cent at one institution. They can see the money down the road for small business is 8½ per cent at another institution. But to get out of that 9½ per cent institution they might have to pay $3,000 exit fee and might have to pay a $2,000 establishment fee down the road. Aren’t those exit and establishment fees surely a hindrance to free competition in the finance market?

Mr Chindamo—We certainly have some anecdotal evidence of transaction costs associated with switching banks or financial institutions and that obviously can make it difficult for some businesses to—

Senator WILLIAMS—Can you expand on that evidence?

Mr Chindamo—Essentially talking to a few members in terms of getting some qualitative information about their experiences in the last six or so months in dealing with banks and so forth, some have indicated that they find it difficult to switch banks or it is just too costly for them to switch banks, so therefore it is a hindrance—

Senator WILLIAMS—Because of those costs?

Mr Chindamo—Costs. It could be relationship factors. They are used to dealing with one bank, one branch and so forth and so on.

Senator WILLIAMS—In my opinion I think exit fees and establishment fees should be banned through legislation so that we can actually bring in proper competition where you can walk out of one institution and walk in next door, like you can with your mechanic who services your car. If you think you are being ripped off you can go to a different mechanic next time. But in finance in many cases you have to pay an exit fee to get out of that mechanic's shop and then pay an establishment fee to get into the next mechanic's shop, if I can use that as an analogy. I think that is very wrong when it comes to free enterprise and competition. Would you like to add to that?

Mr Chindamo—The lower the transaction costs in moving between financial institutions the easier it is to shop around.

Senator WILLIAMS—Yes, that is what competition is about. That is what the nation runs on—free enterprise—but not in some sectors of finance, obviously.

Senator BUSHBY—You mentioned in your opening statement that credit availability remains a constraint on the activities of your members. What activity are you seeing being constrained? What are we essentially missing out on through the constraint that is being applied?

Dr Burn—We do not have any information that drills down into that response.

Senator BUSHBY—Presumably some of your members would be looking to expand or to undertake activities that they currently are not able to; is that correct?

Dr Burn—We assumed that they would be across their finance the things that they use money for. Whether that is just the working capital for their existing operations or expansions, we would think that that would apply, the barrier would be evident in both cases.

Senator BUSHBY—You mentioned working capital for existing operations. Are you aware of any members who are having difficulty refinancing or continuing their existing operations because of either lack of availability of finance or finance on reasonable terms?

Mr Chindamo—We have provided in our submission a couple of case studies where we touch upon two examples of how the tight credit conditions have affected a couple of our member firms. The first one relates to a builder firm in the transport industry. Essentially it is affecting their cash flow as well as potentially some of their investment opportunities. The second one relates to manufacturing of stainless steel wine storage tanks, and again there it relates to new purchase orders and investment in capital and equipment.

Senator BUSHBY—Are those two examples that you have included in your submission something that would be extraordinary examples or would they be typical of common challenges faced by your members?

Mr Chindamo—They are representative of the type of activity.

Senator BUSHBY—They are not specific, extraordinary examples that would represent only a very small percentage of the types of challenges that your members would face in trying to operate on a day-to-day basis?

Mr Chindamo—From the feedback we have been getting through our business liaison programs.

Senator BUSHBY—You also mentioned the survey that you have undertaken. You gave us some advanced results of both. We appreciate that. Thank you for that. Obviously the percentage of members that are concerned about that has fallen since last year. That is probably understandable given that things have moved on a little bit in terms of the downturn, but it still at 25.8 per cent is a relatively high proportion of your members that are concerned about finance as a major issue.

Dr Burn—It appears so to us as well, although as I said also we do not really have the time series data that allows us to compare with previous periods, so we cannot really say—

Senator BUSHBY—It would have been very nice to be able to see what they thought in 2007.

Dr Burn—Yes, exactly.

Senator BUSHBY—But the interesting factor as you noted is that the fall for small businesses has been negligible in terms of statistic variance; it is a couple of per cent.

Dr Burn—That is right. It is certainly nowhere as decisive as the general fall.

Senator BUSHBY—The larger end of your membership's concerns are being satiated to a greater extent than small business?

Dr Burn—The interesting thing about that survey is that we are asking them in both cases about their expectations over the coming 12 months. This time last year, or March when we did the survey, people were probably very gloomy about the outlook.

Senator BUSHBY—On balance over a quarter of your membership as a whole and a slightly higher percentage of small business are concerned about their access to finance. We have had evidence today from the ABA and also the Reserve Bank to some extent which indicates that on the evidence available to them access to finance is not an issue, so it is interesting that your member survey results return something which shows that a significant proportion of your membership considers that it is. What do you think the factors are that have led to finance being an issue with small business. What are the problems? Is it decisions made by government; decisions made by banks or is it the general economic climate? What is actually causing the problems for your membership?

Dr Burn—The evidence that we have is that probably for small businesses a return to the borrowing market is a factor in the slightly higher number for small businesses reporting a concern. We think that this time last year small businesses were probably saying, 'We do not want any money; we are not confident enough to go and borrow anyway.' But now they are more likely to be in the market so that they are more likely to be rejected, if you like, because they are going along to the bank. But we also think that the banks have tightened up their lending criteria and so we think that is having an impact as well.

Senator BUSHBY—So far as you are aware is that having an impact on any of your members that have viable businesses but who fear that they may not be able to meet the lending criteria regardless?

Dr Burn—That is the feeling we are getting, that they are more likely to come up against those lending criteria than they were in the past.

Senator BUSHBY—Despite the fact that their businesses are running soundly and they are quite solvent and anticipate being able to meet any loan repayments that they might get into?

Dr Burn—We would like to think that all our members were in that situation but we cannot vouch for that.

Senator BUSHBY—That is right. But the question I guess is are there small businesses out there that are quite capable of meeting loan repayments and who maybe even have a demonstrated history of being able to meet loan repayments but who are now finding themselves unable to secure finance either to continue or to expand on the basis of decisions that banks have made to raise the bar in terms of lending criteria?

Dr Burn—We fear that that is the case. We do not have any direct evidence about that.

Senator BUSHBY—What impact would that have if it is the case on the general economic activities of your members?

Dr Burn—The evidence we have about the activity of our members is that the recovery is quite patchy. Whether that is due to finance or to the pace at which confidence is being restored to the economy we are not yet able to discern.

Senator BUSHBY—The IMF information that Mr Chindamo outlined indicates that financial credit means that it is probably a slower recovery for a lot of small business that are affected by that, so that was very interesting. In terms of the competition, in the course of the economic downturn we saw almost all lending from non-ADIs cease and basically consolidation of lending activities to small business through the ADIs. Has that had an impact on your members?

Mr Chindamo—We do not have hard evidence on that.

Senator BUSHBY—You have not in your surveys asked questions about the source of funding that they seek?

Mr Chindamo—No, we have not.

Senator BUSHBY—You mentioned that there is an important role to play for financial training and better information. Is that a role that an organisation like yourself could deliver to your members at least?

Dr Burn—We have a role for example in the Enterprise Connect program where we sort of intermediate between the government who provides the program and our members. The advantage that we have in that is that businesses are likely to trust us more than they would trust, say, the department of industry, God bless its soul. In that context we think that organisations like ours have an advantage in the provision of that sort of training.

Senator BUSHBY—Presumably you do not have the resources to supply that kind of information without some form of financial input by government or otherwise?

Dr Burn—We do provide some information but—

Senator BUSHBY—But to the level that you think these require?

Dr Burn—That is right.

Senator PRATT—You have argued that banks have tightened lending criteria and that they are more likely to come up against lending criteria even though they are viable businesses. You have said you have not got any hard evidence to that effect but you think that that is the case. How would we go about substantiating that argument?

Dr Burn—Testing the hypothesis I think would involve focus group encounters with small businesses. That might be one methodology. Surveys of the kind that we conduct are not really great instruments for digging down deeper below the surface of things.

Senator PRATT—On the question of competition you have talked about the need for greater competition and that basically one of the things that is coming out with this inquiry is the clear link between greater levels of competition and more generous, or more lax, lending criteria. That is a clear argument that has been put forward. Do you therefore expect to have to wait for economic conditions to improve before there is an increase in competition and therefore in turn before the finance situation improves?

Mr Chindamo—Possibly so, in the sense that potentially lenders are still waiting to see how economic conditions improve before offering different and additional products. There is potentially some of that.

Senator PRATT—How would you perceive lending criteria being related to actual risk as opposed to lending criteria becoming more generous in response to, I suppose, the players that are trying to gobble up market share and the different ways in which those two things affect the ability of business to access finance?

Mr Chindamo—I suppose I mean lending institutions will make those decisions based on all of those factors in the sense of what the actual viable business proposition is as well as the state of the economy at the time and obviously any prudential requirements as well. What we have seen is a kind of rational decision to tighten lending conditions as a response to the GFC. Whether that then becomes the norm remains to be seen in terms of lending practices.

Senator McGAURAN—In order to follow up on what we were talking about before and maybe to pull it together, Senator Hurley, to make it more relevant because it is relevant. It is all about interest rates and the cost on small business. You agreed that you are concerned about the latest ratchetting up of interest rates and for the best advantage of your members you wish that the Reserve Bank would take a wait-and-see attitude. So do I. You also then, on the other hand—wanting it both ways, I might add—wanted the stimulus to save your membership. Putting all the rorts aside, that you did not know anything about and to date you say that it has really helped your members, as from today—you cannot have it both ways—if the government continue to spend at the rate they are they are going to affect interest rates. Which one do you want? Do you want the government to pull back on stimulus spending? If so, interest rates will come down—or there will be a downward pressure. What do you want?

Dr Burn—We support the current program of the withdrawal of stimulus because we very much hope that the private sector will emerge to fill that void that emerged with the global financial crisis and that as this year unfolds private sector activity will increasingly take the place of that government spending as it is withdrawn according to the current timetable of its withdrawal.

CHAIR—I thank the Australian Industry Group for appearing.

Proceedings suspended from 12.44 pm to 1.34 pm

CHAPMAN, Mr Keith, Executive General Manager, Supervisory Support Division, Australian Prudential Regulation Authority

JOHNSON, Mr Graham, General Manager Industry Technical Services, Supervisory Support Division, Australian Prudential Regulation Authority

CHAIR—Welcome. Would you like to make an opening statement? I note that you do not have a submission, but would you like to make some general comments about the issue of finance to small business to set the scene from your point of view.

Mr Chapman—Thank you for the opportunity. I am not sure that we really do want to make an opening submission. From our perspective, we do not see that the banks are treating small business differently from how they are treating other clients.

CHAIR—You do or do not?

Mr Chapman—We do not. We are happy to answer questions.

CHAIR—There has been a bit of discussion about whether or not small business is being treated differently. We were told by the Australian Bankers' Association that they regard loans of under $2 million as being for small business, but obviously normal banking assessments apply to loans to small business. But there is a perception in the community that in fact small business is finding it difficult to raise money. Would you like to comment on why that perception might exist?

Mr Johnson—I think there are two dimensions to that. One is the demand for credit, particularly after the GFC. Having gone through a period of economic stress like we had, from the evidence available to us, businesses as a whole had less demand for credit. The large end of town, for example, was raising equity and deleveraging, and the smaller end had a fall-off in their approaches to the banks and other lenders for loans.

On the supply side, after something like the global financial crisis, the increase in arrears rates and non-performing loans, the authorised deposit-taking institutions and other lenders actually tightened up their lending terms, as would be expected after something like the global financial crisis. The ADIs did things like reducing the maximum loan they would give to particular classes of borrower, they lowered maximum loan to valuation ratios, had higher interest coverage ratios—those sorts of things—to tighten up their terms, with more stringent covenants, and hence there was a drop-off in the available supply. From that point of view, there were two elements—a demand impact and a supply impact. I do not really know which one dominated.

CHAIR—The background to that is that it was perhaps too easy to get credit prior to the GFC. That seems to be a view that people accept, that the provision of credit was easy and lax. What we are seeing is what might be expected to be a predictable reaction, with banks being more careful about their assessment of loans.

Mr Johnson—I think that is a fair characterisation. Prior to the GFC the spreads on lending were probably the lowest they had been for the statistics that had been collected. There had been 15 years of economic good times, and non-performing loans were at historical lows. I think there was a movement towards lending perhaps without the risk based pricing that should have really been there just prior to the GFC hitting, and then there was the correction after that. Our view is that probably we will not go back to the low spreads that we saw just prior to the global financial crisis.

CHAIR—Is that of concern to you as a regulator? Is there some role that perhaps your organisation might have played in tightening up that fairly lax approach to the provision of credit?

Mr Johnson—If you look back on some of our chairman's speeches, he was making comments about the pricing of loans. At that stage we were also bringing in Basel II and we were tightening up capital requirements on particular classes of borrowing to try to ensure that the capital was sufficient for them. We were also undertaking more on-site visits to look at the pricing of loans. I think it was an area that we were looking at. I am not just talking about the regulated entities, I am talking about the whole system.

Mr Chapman—Perhaps our more obvious area of concern in this regard about the underpricing was in the mortgage market. If you go back, you will see a lot of history of Dr Laker making public announcements about that as well as the on-site work that Mr Johnson is talking about. It was not a small business-only issue; it was across-the-board.

One of the things that has always struck me about all the industries we regulate is that you do get cycles. I know there were a number of people in the banking industry who were concerned about the fact that their credit assessment officers had only seen the last 10 years and were not familiar with what could go wrong. A continual part of our regulatory approach is to make sure that in some ways we act as a long-term consciousness—if you would like to put it that way—a long-term repository of knowledge about the cycles in the system, and that applies in all the industries we have.

CHAIR—Since you raised Basel II, NARGA's submission expresses concern about Basel II regulatory capital requirements as a factor leading to higher costs for small business and causing a skewing away from business lending, as under Basel II banks have to provide a higher level of capital reserves for business loans. Some submissions have claimed that banks are or will be required to hold up to seven times the amount of capital for a small business loan than would have been required for a home loan of the same size. Is that right, and what impact is Basel II having on the availability of finance for small business?

Mr Johnson—It is feasible in certain circumstances that some loans could have quite significantly higher capital requirements and it would look, to somebody looking at the underlying security of that loan, as if they were the same. I will take a small business loan as an example—one that is secured against a residential mortgage as opposed to an owner occupier buying their house. The risk profile is quite different, as I am sure some of the submissions have indicated. The underlying default rates and arrears rates on owner occupied homes and investor lending is a lot lower than it is for small and medium sized enterprise loans that are secured against a residential mortgage. They have a far higher likelihood of what they call 'probability of default rates' and 'loss given default' than do the normal residential mortgages.

Basel II, as a whole, is intended to be risk based, so it actually ensures that the capital that is being held is commensurate with the risk of the loan, and that is whether it is a low-doc mortgage loan, an owner-occupied through to a large corporate loan that is unsecured; it differentiates the security and basically requires capital according to the underlying risk profile. By itself it is attempting to be a better way of ensuring proper capital is held for the risk faced. That may mean that you do have differences according to the sector because of the nature of the business, the risks in the business, the nature of the security and that sort of thing.

CHAIR—So you are writing in the risk factor or including the risk factor?

Mr Johnson—Yes.

CHAIR—Senator Xenophon has a supplementary question.

Senator XENOPHON—In terms of the weight of the assets that are required for a loan, do you determine that on the basis of information given to you by banks or how do you get to that particular weighting?

Mr Johnson—There are two forms of the capital regime. One is what we call standardised, which is basically for the non-model users, the smaller authorised deposit-taking institutions and banks that have not got approval to use an APRA model. We basically specify what risk weights you use. For example, if you have an SME or a corporate loan that is unsecured it would be 100 per cent risk weighted—$8 capital per $100 of loan. The larger banks have their own models, which we have accredited over a lengthy process for them to get their Basel II accreditation. Those models use historical data to determine the probability of default and loss given default, on all the various portfolios and generates a capital outcome commensurate with the risk. We have to approve that. We monitor it closely. We compare those banks with their peers. Yes, it will give potentially differential rates for the model users as opposed to the standardised users, but that reflects the fact that the more complicated models are supposed to be better at predicting the underlying risk.

Senator XENOPHON—You can understand that some small business groups say that you need a lot more equity for a loan for a small business than for a residential loan. I am not saying that you should not have more, but there is an argument that the weight given is unreasonable. Can you understand where some small business groups are coming from on that?

Mr Johnson—Yes, but you have to look at the underlying performance of those loans versus the others. Our approach, in terms of the standardised method, is meant to be conservative, because where there is not a sophisticated model with a lot of data that you can look at to track the performance you would err on the side of conservatism. But for the others it is a—

Senator XENOPHON—Sorry to interrupt, but does that mean that if we had some better information you would not need to err so much? I am not saying you are erring, but I am saying that you would have a different approach in the sense that if you had more information it may be a more nuanced approach and therefore you would not require as much equity for a small business loan, if you had that information available to you?

Mr Johnson—Any authorised deposit-taking institution that can make a sophisticated model that can pass our requirements to model the capital required for those risks would be allowed to do so.

Senator XENOPHON—But they have not to date, have they?

Mr Johnson—No.

Mr Chapman—The answer to your question is clearly, yes, we can understand small business making the case. Where we are sitting and the way that the regime works there should be higher capital required for those that are greater risk of default or, as Mr Johnson said, where there is a greater loss if there is a default. If the information we were obtaining from the advanced banks who do internal models indicated that the standardised approach is well out of the water—for example, if the model said it should be 10 per cent and the standardised approach is 20 per cent—clearly we would have to think about whether the model is right. We are not seeing that sort of disconnect in the process.

I am not sure whether you were heading down this track as well. The other element is that the models are different for each bank—for each of the model banks—because they use their own experience to produce those models; it is their own data. Westpac will use their data and NAB will use theirs. Again, one of the things we look at is the comparability across those banks. If there is a big difference—and, again, I think there are probably a couple of areas where there has been a decent amount of difference—we look at whether their underlying portfolios are actually that different. So far what we see is that they are reflecting the specific risk of their portfolios. We can argue about whether Mr Smith with his sandwich shop is in the right bucket in an individual case, but in the listed case there is nothing that shows us, at this stage, that those buckets and those requirements are well and truly out of kilter. I think that is the balancing factor that comes from having the regulatory overview of the entire sector. We do a lot of data mining through this area and we can start to see where something is well and truly out of sync with the rest.

Mr Johnson—I would like to add something with respect to those comments. One example of how we have changed things is with residential mortgage lending and the standardised versus the non-standardised loans. One is like a low-doc versus a prime loan, where the lender does all of the due diligence and valuations. We looked at the different loss rates that were coming out of the material that we got from the banks and then changed our rules to actually lower the amount of capital for the higher quality loans where they did do all the due diligence, what we call the standard versus the non-standard, and required higher capital. Where we have enough information we try to adjust our rules to differentiate for the risk.

Senator XENOPHON—Is that a model for small business perhaps?

Mr Johnson—It could be.

Senator XENOPHON—Thank you.

CHAIR—Senator Pratt.

Senator PRATT—Did you clearly say that you see this as a permanent tightening of lending based on authentic risk assessment?

Mr Johnson—When I was making the comments before it was more on the spreads not going back to where they were just prior to the crisis. The lending conditions tightened during the crisis, and there are very strong reasons for doing so. As I said, the impaired assets and arrears rates were rising. The outlook for the economy looked a lot worse, so therefore there was more likelihood that a large number of borrowers were going to experience more stressful times than they had before. From that point of view, I think the spreads will not go back to where they were. But lending conditions go through a cycle. They tighten when things get like they have been. As things improve and the outlook gets better, the loan to valuation ratios, maximum loan terms and those sorts of things will probably move back to closer to what they were.

Senator PRATT—Do you expect them to continue to loosen? That might not be the right word.

Mr Johnson—As there is more sign of the problems diminishing I think there will be a return to more normal conditions and lending terms.

Senator PRATT—Can you explain to us the link between the return to normal lending conditions based on risk and how that risk relates to the level of competition for the customer? How would you characterise that dynamic?

Mr Johnson—There are two quite separate elements there. We will see a return to more normal lending conditions. On the competition side, that really depends, I suppose, on the non-bank sectors being able to raise funds and come back into the market. But from the banking side what we have seen is that the large banks have moved in and there has been an increase in their lending as a share of small business.

Senator PRATT—Do you think there is a lack of competition or that greater competition in the sector will see lending practices change?

Mr Chapman—The issue of whether there is enough competition is not really one for APRA. In any market the more competition there is, the greater the divergence of practice. That might be the best way I could put it.

Senator PRATT—So, it is a question for you in the sense that if there is more competition and therefore people change their lending practices in order to get a slice of the market, that is clearly something you need to monitor.

Mr Chapman—Yes. That comes back to the point that I was making before about the cycles that we go through. We do not ever want to get into a situation where the banks feel that to compete with some new mega lender, whether it be a small market or whether it be Aussie Home Loans or whatever, they reduce their lending standards to a stage that actually puts the security of deposits at risk. We have not seen that happen. We have seen a lot of changes in the banking industry. But while we have been concerned with some areas, particularly with housing lending, as I said before, over a number of years; we have not seen weaknesses at a stage that fundamentally threaten the security of individual institutions. At the smaller end it is a bit more of a challenge. If you are a smaller institution a big loan can actually be something that is a real concern for us in that perspective. But they have to be right at the very small end of the spectrum.

That is just part of our ongoing work of, 'What are your standards?' One of the things we often do is try to get an enunciated appetite for risk from the board—loosely described as kicking the tyres by looking at credit files. A board might say, 'We want nothing to do with rural lending', and there is a portfolio of rural loans down the bottom. We do try to get that alignment across the institution, from the board risk appetite down to what happens.

The other one we use a lot is peer group comparisons internally, both in terms of the hard numbers and also in terms of the supervisors of different institutions talking to each other regularly and having that challenge about why you thought this about X bank, and Y bank looks similar but is being treated differently and has a different type of risk profile.

Senator PRATT—This morning we heard of anecdotal evidence that businesses who should be getting access to finance no longer can. Would you contend that that is not accurate and that, in a general sense, that would all be based against a legitimate risk assessment?

Mr Chapman—In a general sense we would contend that that is not accurate. In an individual sense we can completely understand the fact that a business owner has a different view about their business. Sometimes there will be a legitimate view that has not been recognised in bank lending criteria or lenders' criteria. But we would contend that we do not see, from what we look at with the banks, that they have fundamentally different criteria and risk assessment processes, or that they are deliberately saying, 'You can only go and lend $100 to any small business, so pick the Rolls Royce as opposed to the Holdens.'

Senator PRATT—If there are more small businesses complaining about lack of access to finance post global financial crisis you would argue that that is based on the fact that their business prospects post global financial crisis have not yet recovered adequately to put them in a viable situation?

Mr Chapman—No, I think that is a little bit too far. We would argue that we are comfortable that the banks have put a robust risk based system in place where they are making that assessment. If you understand the point?

Senator PRATT—Yes.

Mr Chapman—I am trying to draw a distinction specifically on the question for the *Hansard* record. We think the banks have taken a responsible approach to tighten their criteria based on what they have, and they are making a risk based decision. As Mr Johnson said, you can argue about whether that is too tight in an economic sense, but in terms of a risk based sense we can see an alignment there with their experience.

Senator PRATT—Once there are more players offering credit and finance, do you expect the banks will continue to make decisions on the same basis or that the criteria will loosen?

Mr Chapman—I think that is another one of the cycle and competition questions. As I said, the chances are that their risk averseness will be reduced in an environment where there is greater competition than there is at the moment. Having said that, I would also like to clarify that situation. We are not arguing there is no competition in the banking sector. It is purely that obviously if you have another outside player then the competition is increased.

Senator PRATT—Thank you.

CHAIR—Senator Bushby.

Senator BUSHBY—Thank you for coming along to assist us today. APRA's main remit is the solvency of the ADIs, is it not?

Mr Chapman—The protection of depositors, which goes with solvency.

Senator BUSHBY—That is right; ensuring their solvency to protect depositors. We had the RBA before us this morning and they indicated that their main focus, when it comes to the financial sector, is the stability of the sector, and yours is essentially the solvency. You have said yourself that competition is not what you look at. If anybody, I presume it is the ACCC's responsibility to ensure there is competition within the banking sector. So, competition is not really where you are coming from when you are looking at the standards that need to apply with ADIs?

Mr Chapman—Yes.

Senator BUSHBY—If there are decisions to be made that may promote solvency at the expense of competition then your preference would be for solvency rather than competition?

Mr Chapman—To those black and white questions, yes.

Senator BUSHBY—That is right. You may well have been before us when we held the inquiry into the bank guarantee.

Mr Chapman—Yes.

Senator BUSHBY—I think at that stage you indicated that, regardless of the fact that there may have been some competition collateral damage from the bank guarantees, you think that was justified because of the benefits of the bank guarantees.

Mr Chapman—Also, with that particular case, we now have financial stability as an objective of APRA as well in the legislation. But, yes, it was not the competition issue.

Senator BUSHBY—That is right. I think, to some extent, there is probably bipartisan agreement that some competition needed to be sacrificed in order to ensure that the financial sector, particularly the banking sector in Australia, continued to be both solvent and stable. Today is not the day to go into that, but there were issues about the application, how the bank guarantee was approached and some of the consequences. One of the consequences was that the bank guarantee contributed to—I am not saying it is the only reason, and I do not want to go through the details, because we have already done that—the demise of the non-ADI lending sector, which certainly had the impact of reducing competition in the lending market. Would you agree that that is the case?

Mr Chapman—Yes. There appears to now be less competition to the banks in the lending market than there otherwise was.

Senator BUSHBY—Yes. Although competition is not your area, that may well have some impact on the degree to which decisions are made by lenders to compete for business.

Mr Chapman—I think that is definitely the case. Equally I do not think that by any stretch of the imagination you could claim that the major banks act as an oligopoly at the moment. They are very fierce competitors with each other.

Senator BUSHBY—They are, but they are all competing for a certain section of the market.

Mr Chapman—The same sort of pot; that is right. The other point to recognise about this, too, is that despite the comments I was making to Senator Xenophon before about the way the models work, they are all competing on a level playing field in terms of the regulatory rules that apply to them. That is always a different issue. We can go back to Aussie Home Loans. They really shook the mortgage market up when John Symonds came in with that franchise. But they were operating under a somewhat different set of rules from the CBA, NAB, ANZ, Westpac and so on. That is one of the other things to recognise here. While there is a potentially smaller pool of providers, they are now operating all under the same discipline than might have been the case previously.

Senator BUSHBY—I understand that, but where I am trying to come through this committee is ensuring that small businesses have access to the greatest range of options to be able to finance their activities, because I think that if small businesses can get money, have a good idea and make something of it, that is a good thing for the overall economy and good for Australia. I do not argue with anything you have just said, but the fact is that in the past 18 months to two years options for small businesses, in terms of some avenues of finance, have vanished and no longer exist. There is no shortage of small businesses out there that, prior to the end of 2007, may well have gone out to a bank and said, ‘This is what I want to do. Can I have some money?’ and the bank has said, ‘You don’t meet our criteria.’ They have gone to a non-ADI, managed to get the money and then made a real go of their business. That option, to a large extent, no longer exists. I will just change tack slightly. You talked about demand and supply and you noted that the demand for credit has fallen during the crisis. You mentioned that the crisis, itself, would have had direct impacts on the decisions by small businesses as to whether to go out and seek money. Do you think that the higher criteria that have been applied by banks since then, in terms of some of their lending criteria, would have also put off some applicants for finance that might otherwise have applied, and that may have flown through into the level of demand?

Mr Johnson—Yes. The tighter criteria would have definitely removed some that may have got loans prior to the crisis, and that just reflects, as I said, the banks’ experience with their arrears rates, non-performing loans for those sorts of classes of business.

Senator BUSHBY—Does it reflect an ability of the banks post the economic downturn or even during it to pick and choose a little bit more as to what they might accept as opposed to an absolute criteria that reflects what might otherwise be a sound application?

Mr Johnson—I am not really sure I could answer that. They have their criteria and they do allow exceptions around them if there are other things that are not taken directly into account in their policy. They do have certain cut-off points for things, but they can go through that if there is another issue that they think can cover for that risk. But I do not think I can really answer specifically.

Senator BUSHBY—Once again, my concern is that there are businesses out there who in other times may well have been able to obtain finance for a business venture or to expand a business venture that would normally present as a good option, and probably would make a good go of it, but who might not be able to get the money, whereas two or three years ago they may well have been able to and actually may have been able to make a good go of it.

Mr Chapman—I know I have said the ‘cycle’ word a few times today, but we have to be a bit careful about assuming that the normal times were the times three years ago. There might well be businesses now that are getting funded that would not have been funded 10 years ago; 10 years ago the criteria might have been quite different. I am just making the point that I think the answer clearly is, yes. Business that might have got funding for whatever their new venture was—

Senator BUSHBY—I am not just talking about an absolute, business that might have got funding. I am talking about business that might have got funding that could demonstrate, to a reasonable degree, that they could make a real go of what they wanted the funding for. I have no doubt that three years ago there were businesses getting funding for ventures that were fairly risky and maybe even through the banks but more so through the non-ADIs, and who arguably possibly should not have received that funding. I also think there were probably businesses three years ago that were getting funding for what were good projects that might not now, despite the fact that they are—

Mr Chapman—I am not disputing that at all. I am saying that if you go back to a different environment 10 years or so ago even the people who had business plans that we now think might be viable might not have been getting funded anyway. If you take the three-year spectrum, the answer to your question is clearly, yes.

Senator BUSHBY—I can remember that in the early eighties it was very difficult for business to get funding on all sorts of terms. We have certainly matured a long way. We have a system that has worked very well and taken us well through the global financial problems. Once again, I come back to the point that I want to see small businesses that have good ideas, with a good business case to go off and make a dollar, employ people and help the economy go around, actually get their funding. Do you see there is any role for APRA in the regulation of non-ADIs in terms of how they approach funding?

Mr Chapman—The short answer is no. The longer answer is that one of the real challenges is what we would then be regulating. In the ADI world we have a settled regime. The standards of the ADIs have been accepted worldwide and so on. What would we be doing if we were regulating a non-ADI? What is the promise that we are protecting? What is the solvency test? How is it done? There are a lot of difficulties with the whole process.

Senator BUSHBY—There are a lot of questions there, but most of those could be answered by sitting down and working through it. There could be a role for some sort of prudential regulation of non-ADIs, if they get into the lending market. It is a matter where government can sit down and decide it can regulate if it is actually going to provide an advantage, which may well be greater competition.

Mr Chapman—If the parliament changes the remit of APRA, we would need to look at what skills we would need to do other things. Do we think our current regime could be extended to a non-ADI? No. APRA was formed from a combination of agencies and we changed the way we did things internally to make sure we could regulate all the industries we now have. If the government made a decision to change our remit, we would have to look at what we needed to do to fit that in.

Senator XENOPHON—I have one supplementary question.

CHAIR—Senator Xenophon.

Senator XENOPHON—In other jurisdictions, in terms of similar organisations to APRA, do they have a broader remit in terms of looking at the non-ADI-type institutions? You may wish to take that on notice.

Mr Johnson—With most regulators like APRA in other countries it is really the deposit-takers. As Mr Chapman said, the focus is on protecting the depositors.

Senator BUSHBY—Other countries actually do not have a separate prudential regulation authority either, do they?

Mr Johnson—A lot do.

Senator BUSHBY—The US does not.

Mr Johnson—The US does not, but a lot of the others do.

Senator BUSHBY—We mentioned Basel II. Are any of the outcomes of Basel II likely to impose regulation that will actually limit or potentially limit availability of finance, or raise the cost of finance to small business?

Mr Johnson—When you say Basel II, do you mean the existing one or some of the changes being proposed?

Senator BUSHBY—I was going to say ‘existing’. I will go to some of the international negotiations with my next question.

Mr Johnson—No, the only thing with the existing approach is, as I said before, that we are constantly looking at the results of the models and the like for the model user banks. We have debates with them as to the capital charges that should be associated with particular types of lending and whether it is appropriate. But I do not think that would have a material impact.

Senator BUSHBY—What about the discussions that are currently occurring with respect to future changes, which are coming out of the consequences of the global financial crisis, and looking to put in place regulation to prevent similar outcomes in future. We have had discussions on this in Senate estimates before, that is, that some things may not be as relevant in Australia, because we already had a well regulated system and did not suffer the same consequences. Are there issues that are being discussed that may well play out in Australia and which could actually impact on the cost of finance, particularly for small businesses and the availability?

Mr Johnson—The chairman and Wayne Byres spoke last week at a conference and basically said that the expectation is there will be higher capital charges and higher costs coming from the changes proposed. Changes to liquidity arrangements will increase the cost of funds, and it would be expected that they would be passed on. Globally it has been decided to put higher capital requirements on a range of activities. Higher capital normally feeds through into a higher cost and, hence, higher rates. I suspect there will be.

Senator BUSHBY—From APRA's perspective, given what we discussed initially as your remit, namely, the protection of depositors' funds, this is all a good thing because it just creates a greater degree of protection for the depositors' funds.

Mr Chapman—I accept that point. As I said before, while that is our primary focus; we try not to do so in a vacuum. The other point about the current round of Basel II changes proposed is, as our chairman has said previously; the real issue comes down to what the outcomes of the quantitative impact study are. We are currently going through the process of that at the moment to see what impact those proposed changes are going to have. Until we see the outcomes of that both in Australia and internationally, it is really hard to specifically answer your question. It is hard to argue that any increase in regulation does not result in increased costs to the regulated institutions. That is not always the case, because it depends on exactly what the increase is, but we are very conscious of this issue. We are also very conscious of the issue that the banks keep reminding us, that Australia did not suffer lots of the things that happened elsewhere in the world; but our banks do compete on the international market, and in some cases whether it is an APRA-imposed regulatory change or something the banks just have to do to continue to be able to compete internationally, the outcome is going to be the same. It is a question of trying to get that balance right. The specific answer I would have to go back to is the QIS and what comes out of that process.

Senator BUSHBY—My major concern on that point is, of course, that small businesses, in the context of this inquiry, will end up paying the cost of solutions to problems that Australia never had. I understand that you are trying to get that balance.

CHAIR—We will go to Senator Williams.

Senator WILLIAMS—When it came to the government guarantee for deposits for the registered ADIs did APRA request that guarantee from the government?

Mr Chapman—I think our chairman has answered that question a number of times before. To my knowledge, the answer is no, we did not request that, but I think Dr Laker has previously been recorded in a couple of the *Hansard*s with a more fulsome description. Neither myself nor Mr Johnson was directly involved in the discussions, whereas the chairman was.

Senator WILLIAMS—Finally, I want to take you to registered ADIs. During this period when there was talk in the Senate about the underwriting of those deposits with the banks and so on, I raised the issue with Senator Conroy and Senator Sherry that in respect of those companies that were not registered ADIs, and that came under ASIC instead of the ones under APRA, no doubt this would force a withdrawal of investments in those companies and into registered ADIs. That is exactly what happened. Probitas Group in Victoria had a lot of funds reduced, and some of those companies fell over. I think the answer by the Treasurer in those days was that these companies should become registered ADIs. Taking you to that point of registered ADIs, how difficult is it for someone, say a debenture issuing company, probably based in rural or regional areas, to become a registered ADI?

Mr Chapman—When the guarantee was put in place we did dedicate another one of my general managers, like Mr Johnson, to answering those questions. We had a lot of the finance companies and a number of other players come to us to talk about that issue.

Senator WILLIAMS—Could it take up to 18 months to actually become registered ADIs?

Mr Chapman—I am not trying to avoid the question. I am just trying to answer it by explaining the sequence. They all came and talked to us. In only a very few cases did they, in our view, make a serious effort to think about the issues. I think there was an expectation they could all take their business model as they then ran and just get an ADI licence and be subject to the guarantee. Of course, it is actually a fundamentally different business model. A debenture issuer is not a deposit-taker and a debenture is not a deposit. One of the biggest challenges that a lot of those finance companies had was how they would actually restructure in order to become a deposit-taker as opposed to a debenture issuer. That restructure could take a considerable time, which is why I am trying to answer by describing the sequence.

A couple of them came back a few times to talk to us, but none of those companies, once they understood what an ADI was and its structure, really wanted to pursue the issue. This is not APRA driven thing, telling them they cannot get in. I suspect that when they thought about it and looked at what they were they decided the business model just was not capable of being changed to the extent it would need to be to be an ADI.

Senator WILLIAMS—Thank you.

CHAIR—Thank you for appearing.

[2.15 pm]

LEWIS, Ms Sian, General Manager Retail Business Banking, Westpac Banking Corporation

POINER, Dr Anthony, General Manager National Segments and Operations, St George Bank

TATE, Mr James, Chief Product Officer, Westpac Banking Corporation

CHAIR—Welcome to the hearing.

Mr Tate—Thank you for the invitation and the opportunity. My role is as Chief Product Officer of Westpac, which is essentially responsible for all retail products on both sides of the balance sheet, that is, lending and deposits. With me is Ms Lewis, who is the General Manager of Business Banking. She has direct responsibility for the relationship management of SMEs as a specific customer set. Also, Mr Poiner, who is the General Manager of National Segments and Operations for St George Bank. He has responsibility for all segments of our customer base in the St George brand, of which obviously SMEs would be a prominent part. So, that is who we are.

Firstly, the essence of our position is covered in the submission, but I will go over a couple of critical points. Obviously, SMEs are a massively important segment not only for us but for all banks. But there is no question that the numbers do tell the story, and that is that flows of credit to business and SMEs have contracted over the past 18 months to two years. As a result of that we have greatly expanded the amount of direct relationship management we have towards small and medium enterprises as opposed to using other channels, such as branches and the like, so there has been a lot more face-to-face contact over the past 18 months.

However, one of the important things to note is that the market is a great anticipator of things moving and, in fact, when we look back the business segment did start to tighten its demand for credit quite aggressively in the September quarter of 2008—some of the early warning signs. There is no question that they saw things starting to tighten and get bleaker, and so we saw demand, particularly in the September quarter of 2008, start to contract quite markedly. It is pretty fair to say that since that time credit demand in this area has been flat and, in fact, the system at the moment is down slightly.

So, there has been quite an aggressive and open move by individual corporations and companies within that area to position themselves for what they saw as quite an important tightening of arrangements in the macro economy. There is no question that within SMEs there are some businesses that are struggling. You can look at specific industry groups. You can look at particular areas. There is no question that it is not an even arrangement. There are some SMEs that are thriving and doing really well, but there are others that are struggling and have been struggling for some time. We acknowledge that quite openly. There is no question. That has always been part of the cycle, but it has probably been a more important part of this cycle than previously.

As a result, there has been a need for us to institute some assistance programs for SMEs. There is a unit that we have called Westpac Assist. We also have St George Assist, which is a specific unit within the bank whose role it is to deal with and work with individual SMEs who are struggling and to try to navigate a way through. They are the main features of our submission that I want to highlight. I might offer Ms Lewis and Dr Poiner a quick opportunity to summarise their position on how they see things at this point.

Ms Lewis—I would reiterate Mr Tate's point about us being open for business during this difficult period. In fact, we have heavily invested in Westpac in this specific segment of businesses with turnovers of below $5 million. In the last 18 months we have recruited 380 local business bankers. They are based in our branches and are able to give specialist advice and support to our business customers. We have also recruited nearly 600 bank managers, and given them increasing local autonomy to make local decisions for local businesses in their area. Mr Tate has already mentioned Westpac Assist, which we extended from our consumer segment to small businesses in April 2009. It has been positioned very firmly to support those who are experiencing distress through this period of uncertainly. We have also increased the volume of financial education that we deliver to this segment specifically via Westpac Financial Education, particularly focusing on small businesses managing their cash flow in this climate of uncertainty and increasing costs.

CHAIR—Thank you.

Dr Poiner—St George has long valued the relationships we have with our small business customers, and that has not changed. In fact, we have been looking to invest more into this space, and in particular into relationship management with dedicated relationship managers for small businesses. We now have 90 dedicated small business relationship managers across the country. We have also recently injected some small business experts within each of our branches, so we have some 30 of those around the country, to identify small businesses as they show an interest when they approach our branches and to refer them on.

We have also been investing into a mentoring program that we launched this year, which has received some really positive responses from about 2,000 existing and future potential customers for St George. We have an ongoing interest in this market and it is our intention to continue to invest in this space.

CHAIR—I would like to ask you a question about your mentoring program. One of the issues which has cropped up several times today has been the level of financial expertise and knowledge of small business. Could you tell us a little about your mentoring program and whether it is just confined to St George?

Dr Poiner—It is open to existing and referred customers. Customers of ours may refer members of their value chain and colleagues. It is a day-long program where we have experts who come in and provide some speeches. They also have workshop-type setups where they go through some really structured approaches to business planning, looking at financial capacity, options to grow and how to manage risk.

CHAIR—Do you agree with the impression that this inquiry is based on, and that is that finance has been more difficult to obtain for small business since the global financial crisis?

Mr Tate—There are three important elements to look at when lending to someone. They are the cost of funds, the credit risk involved and the liquidity of the amount being sought. Obviously, at the corporate end of activity, the big end of town, the amounts are very large, so liquidity is a massively important issue there. At the small end of the game, it tends to be built around cost of funds and credit risk. The cost of funds issue has been well spoken about in a whole range of forums, and there is no question that the cost of funds has been a driver of the price of credit. On top of that there has been that period particularly from October 2008 through to October 2009; there is no question that credit risk during that period became a much dicier proposition. There is no question during that period that the price for credit, quite apart from the cost of funds element demanded by banks, increased.

Since October of last year we would say that the cost of credit risk on top has tended to stabilise. The cost of funds continues to increase. The actual credit risk situation has stabilised. It has not markedly moved south. There are certain segments and the like where it has moved slightly. There is nothing we can see in terms of the criteria we established for lending to SMEs which has changed markedly. There is no question that we would be more circumspect about things like cash flow forecasts and making sure that the viability of businesses is there, but in terms of actual credit criteria, those have not moved. What has moved is the price. The price has moved on two levels—a cost of funds level and the credit risk element. If that manifests itself, like any arrangement, if the price of something increases, demand moves. There is no question that demand for credit, as I indicated in the opening statement, really from about the September quarter of 2008 onwards has been quite restrained.

CHAIR—We have heard that Westpac is putting back local managers, which presumably is to improve the relationship with local business.

Mr Tate—Yes.

CHAIR—We have heard that you have a day sort of tuition/mentoring program. But the Australian Industry Group expressed the view that there has been little incentive for businesses to improve their risk profile via better management, with the view that banks only look at asset backing to determine the interest rate. Do you think there is a case for your local managers—and it is commendable that you are reinstituting that arrangement—perhaps spending more time than one-day sessions improving the financial expertise of local businesses? Would that be something that would improve their likelihood of being seen as good risks for loans? Have you considered a broader education program than the one-day program that we heard about earlier?

Mr Tate—I will ask Ms Lewis to speak specifically about this, but let me just comment briefly on the Australian Industry Group's proposition. There are a couple of important factors to understand in the lending of money. There is the asset element or the security element, which for banks is the second way out. The first way out always is the cash flow of the underlying business. The proposition that a bank or indeed any lender would just ignore or even depreciate the underlying cash quality of a business with a view to saying, 'Well, look, it doesn't really matter because at the end of the day I'll get hold of the security', has never been a basis to good credit management. You always have to look at whether there is a viable business first and then the security provides you with the backstop should those forecasts and the like change appreciably, and of course that is why security ranges, depending on size, type and other aspects of a corporation.

I would really want to take on that point that there has been any change in that credit approach. Viability first and security second is always a basic credit principle. I will ask Ms Lewis to speak about the local model.

Ms Lewis—Both local business bankers and our local bank managers are absolutely positioned to be able to help the financial literacy of our SME customers. In addition to some of our more formal cash flow courses that we run via Westpac Financial Education we run regular sessions in branches either in the morning or in the evening where we talk about cash flow, preparing your business plan to be bank ready, understanding exactly what we are looking for in terms of transparency, and enabling our customers to present to us the best case they can and that is happening on a regular basis in both regional and metro Australia.

CHAIR—Thank you. Senator Williams.

Senator WILLIAMS—When we had a quarter per cent increase in interest rates by the Reserve Bank last December you raised your home loan interest rates by 0.44 per cent. Did you do the same with your business loans and small business loans in December as well? Did you raise their rates more than what the Reserve Bank had done?

Dr Poiner—In fact, we raised our rates in December for home loans by 0.39 per cent. We actually priced differently from the Westpac Group, so there is a little bit of a difference.

Senator WILLIAMS—I am with St George and mine went up 0.44 per cent.

Senator PRATT—You must be a bad risk.

Dr Poiner—I should clarify that point. There is one group of home loans—

Senator WILLIAMS—The bad risk ones!

Dr Poiner—we call the basic product, which did go up by 0.44 per cent. So, you are quite right there.

Senator WILLIAMS—Thank you for that. I had been with you for four weeks when I changed to you; that was good. That was a nice surprise. Hopefully it will not happen again. Seriously, with respect to small business loans, how much did you raise those rates in December?

Dr Poiner—I cannot recall the exact number, because there are many different types of loans, but we did raise in excess of the 0.25 basis points. I would have to get back to you with the ratio.

Senator WILLIAMS—Was that because of the cost of funds or what was the reason?

Dr Poiner—Yes, it is because of the cost of funds.

Senator WILLIAMS—Not in search of more profits, of course. Let us go to that very point about the cost of funds for small business now. Let us say in the immediate future, in the next 12 months, when the Reserve Bank raises cash rates again, do you see that you have to go higher than those official Reserve Bank rates in the future, or how do you see the cost of funds panning out for the cost of money for small businesses?

Dr Poiner—For small business we are reasonably in the right place, in terms of the charging for liquidity or the availability of the funds themselves. Each week we look at this proposition. We do not try to guess what is going to happen in 12 months time. We do not have a specific set of plans to raise rates above and beyond what the Reserve Bank does, and we do not see those rates getting up to, for example, the rates that they were, say, two years ago before we saw the reduction in rates. We do not see them getting to that point.

Senator WILLIAMS—My final question in relation to the cost of interest rates for business/SMEs: imagine I owned my house, valued at $400,000, and I wanted to borrow $200,000 to go into small business. My home loan rate might be 6.5 per cent, but if I were to borrow that money for a business loan it would be substantially higher than 6.5 per cent.

Dr Poiner—It can be, yes.

Senator WILLIAMS—Why is that? Even if I gave up the land and the house as total real security, why is it so much more expensive for a small business to borrow money, even with the security there safe and sound, than for a home loan?

Dr Poiner—It goes to a point that Mr Tate raised earlier on. The first and primary criteria that we apply is the ability of the business to be able to service the loan, to be able to pay for the loan, and to be able to operate within the environment of their business plan. The volatility of potential earnings for a small business tends to be on average higher, because there is less security about where income comes versus, say, a wage earner.

Senator WILLIAMS—Yes, there is less security, if you put it over your whole portfolio. In my example of a 50 per cent loan on the value of my asset, which would be unencumbered, you have total security. We see a situation where a small business that offers good, real security is obviously subsidising small business finance where the security is not so good; and this relates to the balancing of your portfolio? Is that correct?

Dr Poiner—That goes to the second way out, and that, for us, is a very much not preferred outcome. We do not want to go and seek access to the asset that secures that particular loan. We look to the ability of the business to service the loan, and for a small business we see in the evidence over the years that there is greater risk associated with a small business supporting a loan than there is with, say, a salary earner.

Senator WILLIAMS—Lastly, I personally believe that exit fees and establishment fees are wrong. I think they reduce competition. As I said, I have seen situations where someone has a loan with a bank and they have a monthly account keeping fee that might be $12, which all of a sudden is raised to $15 and sometimes to $18 over time. If they wish to get out of their variable loan—I understand fixed loans are different—then they may have to pay a $2,000 or $3,000 exit fee, and if they go off to another organisation they may have to pay an establishment fee. How would you feel if it were legislated to ban exit fees and establishment fees and you have to factor those costs into your margins? How would your organisation feel about that?

Mr Tate—There are a couple of points there, quite apart from the level of exit fees, entrance fees and the like. We can have a whole debate about what they should and should not be, which is fair enough.

In terms of what an exit fee is meant to do primarily, if a borrower makes a contract with the bank for a specific period of time, less us say for argument's sake they buy a ute on a four-year equipment lease or whatever, then the bank, when it looks at that entire portfolio, makes a funding decision against that portfolio. It says, 'I have got a portfolio of cars with an average life of, say, three to four years. I go out and I borrow or I raise funds in about that sort of maturity.' In other words, I reduce the interest rate risk I have got on both sides of the balance sheet. If people can come and go in and out of that contract on the asset side without penalty, then you could end up in a situation, from an interest rate risk perspective, where the asset has disappeared and you still have three-year money on the liability side. It is highly unlikely; nonetheless, that situation could exist.

The reason exit and termination fees are there is to say, 'You made a contract for four years. If you want to get out in less than four years there's going to be a cost to the bank, because the bank has made some assessment on the liability side.' We look at these, as you said, in portfolio terms. The basis of that cost, how it is calculated and all of those sorts of things have changed with competition and the like over time. I am very open and would be very happy to go through the bases of calculation on a lot of things. Similarly, on the entrance fee, where a customer who goes to another bank, say, leaves Westpac and goes to the Commonwealth Bank, the Commonwealth Bank or any other bank who is receiving would say, 'If we're going to establish a four-year lease over a motor car there's work to be done. We've got to get your stuff in order. We've got to make a credit risk assessment on you. We're expending some money in doing that and we want to keep you for four years', so there is going to be some cost associated with establishing any customer with a credit limit.

Senator WILLIAMS—If you put them into the margins instead of upfront costs, then surely that would free up competition. I did not have to pay an exit fee when I left the credit union to go to St George.

Mr Tate—But was your margin higher?

Senator WILLIAMS—A whisker higher.

Mr Tate—But you are still paying, whether we put it to the margin or put it in a fee.

Senator WILLIAMS—In general, you are saying that if it were legislated that exit fees and establishment fees were to be banned you would not be happy with that?

Mr Tate—No, I am not saying that at all.

Senator WILLIAMS—That is the question I put to you. How would you feel about it if that were the situation?

Mr Tate—The proposition you put was having that form part of the interest margin that someone was charged. I am saying, what is the difference between a specific fee being charged and then taking the cash that would have been received via that fee and incorporating it over time in an interest margin? You are still in the same position, are you not?

Senator WILLIAMS—No. If you have the fees you can walk out of one and go into the next institution. You do not have to pay to get out of the loan, if you had it built into your interest rate margin. Therefore, it would be free. You could walk in where you life. Treasurer Swan has said, when you were gouging extra interest rates, ‘Go to another institution.’ It is hard to go to another institution when you might save a little bit on the interest rate. You might save $10 a month, but it costs you $3,000 to exit your loan. It is not worth going down to the other institution. Because of exit fees and establishment fees you are, in effect, doing away with competition in the finance industry. That is the point I make.

Mr Tate—That is your position. I do not think that is the case. The question is: what other aspects than price are you incorporating in that argument?

Senator WILLIAMS—When it is the same product price means a lot.

Mr Tate—It does. If it were a totally commoditised market, that would be the case. There would be plenty of people who have been Westpac, Commonwealth Bank or St George customers for 40 years. They might have a different view as to whether they were as keen to move from one to another.

Senator WILLIAMS—Thank you.

CHAIR—Senator Hurley.

Senator HURLEY—In your submission you talk about lending through the crisis and state that, importantly, Westpac’s rate of overriding adverse credit bureau decisions has remained steady in order to support more SME borrowers and overall approval rates have remained high at above 85 per cent.

Mr Tate—Yes.

Senator HURLEY—Can you tell me what that rate of overriding adverse credit bureau decisions is?

Mr Tate—No, I cannot, because it varies. When someone applies for a loan, there will be a whole range of information a credit officer looks at. Obviously the history with the bank and the nature of the underlying business. Part of that will be to look at credit bureau data in respect of that borrower. We have negative credit bureau reporting in Australia which says, ‘Has this person missed a payment on something or other?’ That information will come in. There is no blanket response on behalf of the bank that says, ‘If the person has missed one payment on a credit card, they will not be eligible for a loan.’ The credit officer has the ability to say, ‘These negative arrangements are completely explicable in terms of the overall business. They’re not material within what we are looking at. We’re going to override it and we’ll go ahead with the lending anyway.’ That is a flexibility given to Ms Lewis and Mr Poiner’s people to make that decision, based on what they know of the customer and the like. There is no net rate, because we do not keep records specifically as to what percentage of times that happens and the like. It will reflect itself more through the approval rate. If the approval rate really started to decline, then you would say, 'What's driving that decline in the approval rate? Is it negative credit bureau information or not?' You tend to look at it if that 85 per cent number really started to move. That is the primary number we look at. Is that a fair enough assessment?

Ms Lewis—Yes.

Senator HURLEY—I take it that approval rate is on formal approval, and not just the informal approach?

Mr Tate—That is formal approval, yes.

Senator HURLEY—You say, 'Approval rates have remained high at above 85 per cent.'

Mr Tate—Yes.

Senator HURLEY—Has that been a steady figure over the last, say, five years?

Mr Tate—Yes, remarkably steady. During the crisis people who had solid banking relationships have tended to say, 'Look, I'm going to really value this.' There is no question that each of the banks would find that they have customers who say, 'I've got good arrangements with the bank. I'm going to hold on to them.' Similarly, the bank is keen to hold on to their good customers under those circumstances. There tends to be more of a situation where it is a mutual arrangement where we need to look after the situation. When you add more relationship managers to it, as Ms Lewis would—that is people who deal directly—they get a much stronger and deeper feel of the individual business at hand, and of course that ameliorates the credit decision as well.

Senator HURLEY—You also say that you have made no major changes to key SME credit policies relating to debt service cover, entrance cover, loan to value ratios.

Mr Tate—Yes.

Senator HURLEY—Have there been any changes to fees and penalties?

Mr Tate—As to the types of fees being charged, no. As to the level of fees being charged, yes. They have been both up and down. In fact, exception fees, for instance, fees associated with cheque dishonours or overlimit usage of cards and the like, have actually come down appreciably. We charge a flat $9 across all those fees, whereas two years ago we would have charged between $35 and $40 for each instance of those.

In terms of the types of fees that Senator Williams was talking about, exit and entry fees and the like, they are used pretty much the way they have always been used. The method by which exit fees are calculated and so on varies from bank to bank. We have not changed our method and I would be surprised if other people have.

Senator HURLEY—Specifically, have overdraft fees and charges changed at all?

Mr Tate—No. In fact, overdrafts are one of the areas where exception fees—people drawing down a cheque beyond their limit and the like—are the most assiduous. In fact, fee revenues, certainly for Westpac, would have come down in that area. There is no question that that is unsecured credit. An overdraft is unsecured credit, or come and go credit, at call, and so it always attracts a reasonably high interest rate across all banks.

Senator HURLEY—That is all from me.

CHAIR—Senator Xenophon.

Senator XENOPHON—I love Westpac's ads for the local bank managers and bringing them back. Can you tell us why you removed them in the first place?

Mr Tate—Through the mists of time—I was in the bank at that stage, but not party to the decision. I think one of the big things is that the branch, as a channel, has changed markedly. People often ask that question, but when we think of what the nature of branch banking was even 15 years ago, the two big channels that have been added to that since that time are clearly the internet and, of course, the extent to which debit and credit cards have boomed as a transactional mechanism, when you compare it with what it was like in a branch previous to that. I do not want to get into a debate about whether it was a good decision.

Senator XENOPHON—I do not want to get into a debate and I am constrained by time. I just wanted to follow on from that. How important do you think the local knowledge of a bank manager is in terms of the quality of decisions made? If you think it is important, does that mean that small businesses are likely to get a better deal through your bank rather than other banks that do not have local managers in place?

Mr Tate—I will let Ms Lewis answer that. She runs all of them.

Ms Lewis—I always hope it will give us a competitive advantage, yes, and it will help with I think overriding some of the credit bureau decisions. I think it was our ability to understand what led to any default that led to an adverse credit bureau rating. The closer we get to customers and the more we are able to understand the underlying causes of any of those issues the better able we are to make a judgment about their ongoing viability and therefore our ability to support them.

Senator XENOPHON—I do not know if you were here when APRA gave their evidence or you may have been in part.

Ms Lewis—In part.

Senator XENOPHON—Reference was made to the difference between low-doc loans and—what would you call them?—high-doc loans?

Mr Tate—Full doc loans.

Senator XENOPHON—That different decisions are made and you could charge both in terms of the quality of the decision and interest rates charged. Do you have a similar approach in terms of small business lending? If you are more rigorous in terms of the questions that you ask and more information is provided by small businesses, would that not be more likely to get a better outcome for both the small business and in terms of the interest rates charged?

Dr Poiner—We have long supported our direct relationship managed customers very strongly. One reason for that is that one of the greatest predictors of future success of a small business, we find, is the quality of the management decisions that are made. Our ability to develop a strong relationship and to be a party to that, we find, is a significant difference not only in terms of how we grow with that customer, but also how that customer grows.

Senator XENOPHON—Is there a differential at the moment in terms of higher doc loans or your requiring more information? Do you have that formalised?

Ms Lewis—The customer will be allocated a risk rate on which a pricing decision is made; the more viable and less risky you are the cheaper it is.

Senator XENOPHON—So that is in place. An article in today's *Financial Review* by Sam McKeith refers to Grant Thornton partner Syed Jehani, who said that many banks were calling in loans after supporting firms through the downturn; the client who has been given multiple opportunities, but has not been able to deliver, is now under more pressure; that the banks are saying, 'We're going to have to take action and take the reins ourselves', and making the point that with asset values increasing it is an appropriate time for banks to move in. I am not sure whether you are aware of the ABA's evidence this morning. Would you agree that the banks, generally, will be moving in more on small businesses, given that the worst is not over, in the sense that there will be more foreclosures and more loans being called in because asset values are increasing so it is an appropriate time to—

Mr Tate—To dump the stock on the market?

Senator XENOPHON—No, I am not saying that, not to dump the stock on the market. I think the rationale is that you can only carry people so far. Is it the case that things will get worse before they get better in terms of small businesses having their loans called in and administrators being called in?

Mr Tate—The demand for credit has been flat for 18 months. There is no question that there are certain industry segments that are under more pressure than others. I go back to the argument I made about the second way out; the bank does not want to get into a position where it goes to someone who, for example, has set up a milk bar as a small business using their house as collateral and sells the house from underneath them. The bank is certainly not sitting there saying, 'The house is now worth more. Let's really get fierce with the milk bar owner.'

Senator XENOPHON—I am not suggesting that. Again, I am constrained with time. You have a partner from Grant Thornton saying this. RSM Bird Cameron partner Peter Marsden has said that it is getting to crunch time; that we are getting to the tipping point in a sense. I do not think it is a tipping point. There is a suggestion that we might be getting to a tipping point where you have carried these customers for so long, things are not improving, asset values are increasing and you have an obligation to your shareholders, so is it going to be crunch time for more and more people in the coming months?

Mr Tate—There is stress in certain parts of the portfolio which has not moved.

Senator XENOPHON—If stress has not moved, then the bank has to eventually?

Mr Tate—Yes.

Senator XENOPHON—Finally—and this is a bit out of left field—I turn to media reports in January this year, including from the *Daily Telegraph*, about Westpac blocking 10,000 skimmed cards in New South Wales. You had the New South Wales Fraud Squad's Detective Superintendent Colin Dyson stating that the skimming was the worst he had ever seen, I think from some overseas gangs, and obviously Westpac acted prudently to deal with that. My concern is: what impact does that sort of criminal activity have in terms of the impacts on small businesses, the cost of finance and so on?

Mr Tate—Cost.

Senator XENOPHON—What more can be done? Does it require legislative reform? Does it require increased penalties? Do it require the Federal Police having the resources to tackle this? When you have the head of the New South Wales Fraud Squad saying that it is the worst he has ever seen in his career, what does that mean for small businesses?

Mr Tate—It just means that you have to really understand the types of people using that small business. We can take that example through a big fast food outlet, where there is going to be a heap of transactions flooding through. You have to pick who you give the terminal to, because the terminal is the thing through which the skimming occurs. You have to know intimately the type of people who are going to come through that, which is what the fraudsters know better than anyone else.

There are two levels. Firstly, you have to speak with the particular fast food outlet and make sure that the kids working there understand that if someone comes in and says, 'Can I take that terminal and replace it with this one?', that that should send off an alarm bell.

Senator XENOPHON—Does the bank have a responsibility?

Mr Tate—We do. We do pursue that. The second element is to make sure that the data feed from each terminal is quick and gets up through our fraud processes quickly. Some of the technological advances made in respect of the newer terminals are of a much higher quality than what we have traditionally seen. It is more a process around fraud monitoring than saying, 'This is going to cost us an extra $10 a terminal.'

Senator XENOPHON—Do you think more can be done both by the banks and also from a regulatory or criminal enforcement point of view to prevent or mitigate against this risk?

Mr Tate—I think the links with the criminal enforcement and the banks are pretty good now. Most of the guys working in our fraud area are former coppers, anyway. I think the issue is how quickly we sniff out if something is going on and then bring the whole process into play. The technology is definitely improving in that regard, but the level of fraud is also improving, so we are kind of chasing one another at the moment.

Senator XENOPHON—It could get worse before it gets better in this respect?

Mr Tate—It could do, yes. There is no question about that.

Dr Poiner—These are international rackets so it is quite difficult to have a one-nation solution within Australia.

Senator XENOPHON—I noticed you said a one-nation solution.

Dr Poiner—We will avoid that. It is difficult to have a solution with just an Australian perspective. We are getting skimmed from Canada.

Senator XENOPHON—Thank you.

CHAIR—Senator Pratt.

Senator PRATT—You touched on the fact that you have seen small to medium enterprises suffer some distress and financial difficulty as a result of the global financial crisis. Can you tell us how that has informed your process of risk assessment?

Mr Tate—Like I said right up front, it reflects itself in the relative credit risk area. Anything to do with property, particularly commercial property, is inherently more risky. The credit risk spreads associated with anything to do with commercial property have increased. So, too, has been the extent of analysis that one would do on any commercial property transaction that comes up. There are certain segments of the market that have found life very tough and in their forward cash flow assessments and the like they cannot show the evidence that they are going to be as viable. That goes to what Senator Xenophon has heard, and what Bird Cameron, PKF and others have said through the market; there is going to be increased credit risk associated with them as well. It is more segmented, though. It is not a generic SME argument.

Senator PRATT—Lastly, as to the frontline services for small businesses that you are providing, clearly that will be of assistance to them, but you have also touched on the fact that you think it will better enable you to assess the risk that they might present to the bank.

Mr Tate—Yes, I think so. Knowledge is everything in that regard. The more bespoke you can make the process, the more intelligent and informed decisions you are going to make about individual borrowers.

Senator PRATT—And to work with those borrowers to mitigate their own risks.

Mr Tate—That is exactly right.

CHAIR—Senator Bushby.

Senator BUSHBY—Thank you for assisting us today. I would like to come back to the discussion about the premium charged to business clients as opposed to residential clients. Mr Poiner stated that you ‘don’t want to realise assets’; that that is not something you want to do, and that is part of the reason they have higher rates. He also stated that there is a greater risk for business compared with residential. I acknowledge that there is a greater risk that repayments might not be met, which is what you are talking about, but how does that actually play out in terms of financial costs to you, given the differential in the risk to the bottom line, given the ultimate security, would be nil? I can see the difference in the risk, but why does that justify a higher interest rate?

Mr Tate—We can go back to the first way out. I lend the milk bar $100. I go out and raise money in deposits against that. The fact that I have a $200,000 unit or condo against that risk is my second way out. The thing is that I have to produce cash earnings on the $100 I lend out and the $100 I borrow, so I make a margin between the two. If the revenue side of that evaporates, just disappears, then I have to repay the borrowing I have raised to lend that person the money. I may have raised that at a level with two or three years difference, so I have a cost that I may have to absorb in terms of clearing that borrowing that I have made from the wholesale international markets or depositors. I have that situation. I have to go out and replace that asset with another asset, if I cannot move the borrowing that I have made, and I also have to then get the house and assess whether it is still worth the $200,000, go through a process to sell it, and then make an assessment as to whether I take a loss on it or not.

Senator BUSHBY—The last part of that would be covered by the contract and any costs involved in realising the asset you could actually deduct from the asset—proceeds of sale.

Mr Tate—That is right.

Senator BUSHBY—The first bit is an overly simplistic representation of it. You borrow big chunks of money.

Mr Tate—That is correct.

Senator BUSHBY—And then you loan it out in lots of little parcels. There would be a natural progression of turnover in that, anyway, where you are actually refinancing parts of it constantly as loans mature during the normal course of events, anyway.

Mr Tate—Yes.

Senator BUSHBY—You would not be borrowing $100 to finance $100. You would be borrowing $100 billion, or probably not that much, but $10 billion to finance lots of smaller loans.

Mr Tate—Not far off.

Senator BUSHBY—The cost there would probably be fairly marginal.

Mr Tate—Yes, but there are a couple of other things. There is a timing difference, from the time I make that first loan through to the point I realise the asset, and I am not going to do that in a rush. The second thing is the valuation of the security itself; if there is a situation where markets are falling away from you, let us say residential real estate, which tends to be—

Senator BUSHBY—The same risk applies in residential as it does to business.

Mr Tate—Sure.

Senator BUSHBY—In terms of relativities, that exists in both of them.

Mr Tate—Yes.

Senator BUSHBY—Usually with business lending the banks do not tend to lend to the same percentage as they do in residential anyway, so you have probably got more fat in terms of the security than you would in a normal residential.

Mr Tate—Yes, because the risk is higher.

Senator BUSHBY—The risk is higher so you have greater fat in the security, but also a greater interest rate, do you not?

Mr Tate—Yes.

Senator BUSHBY—I just wanted to explore that a little bit further. I understand what your argument is. I do not necessarily think that it justifies the full spread difference, but we will work through that as part of the committee. ACCI has made a number of statements in recent times, backed up by comments and evidence that we have received today and in submissions by the Australian Industry Group, COSBOA, NARGA and other groups, that there is a shortage of reasonably priced finance for small business. I can give a couple of quotes from ACCI reported in the *Financial Review* on 27 and 28 March. ACCI stated that access to and renegotiation of affordable finance has now become the most substantial issue facing the day-to-day wellbeing of Australia's small and medium business sectors. Further, they stated that small businesses were heavily reliant on banks and other lenders for finance because they could not raise money in the market like large firms. They then go on to state there will be no private sector led recovery amongst small and medium enterprises unless lines of credit are eased and retail banks demonstrate a greater sensitivity to their SME customers. Those statements, as I said, were backed up by other industry groups. Do you take any issue with that or do you think that the comments they are making are true? Is there a shortage of reasonably priced finance available to small businesses that are able to demonstrate a reasonable case for funding?

Mr Tate—I heard some of your questions of APRA previously. I think there are two elements. There are market structural elements that we really need to think about. Let us leave the bank to one side in the first instance. There is access to equity. So for a small business starting up, how much equity has it got, where does it get it, venture capital and so on. They are always tight. They always have been tight and always will be tight. Then there is the access to credit of people who would not meet the major bank criteria. We could say these were corporations or entities previously funded by finance companies or non-ADIs, as you put it earlier. There is no question that that segment of the market has been the most substantially affected by the global financial crisis, because it just simply has not been able to raise the money to lend at a cost that makes it competitive to the other side. That has been the case in the mortgage market, with non-bank mortgage players, just as it has been the case in the business market. Say a small enterprise that previously would have got its money through a finance company comes along to a bank and then says, 'Look, I can no longer get it from XYZ finance company. I want to get it from you.' The bank's lending criteria have not changed. They were people that never would have come to the bank in the first instance. I know this is a generalisation because there would be a heap of exceptions to this, but I am just saying that in terms of the difference in the market structure we have now as a result of the crisis, that portion of the debt providing mechanism has really contracted.

Senator BUSHBY—That example you just used is exactly the type of example that I think is a real problem. Despite the fact that for whatever reason they may not meet banks' lending criteria, they can probably demonstrate that they have been in business for the last five years, with finance from non-bank sources, and have managed to operate, make a profit, run, employ people and do whatever they are doing, but they need to refinance now and they turn up to the bank and for whatever reason, whether it is security or otherwise, they do not meet your criteria. What do they do and where do they go? It is a sound business that is operating and paying its bills.

Mr Tate—The motor industry, for instance, traditionally always operated through finance companies. There is no question that the government attempted to provide some mechanism to release that valve, that pressure that was building there. GE left the market. There was a range of government initiatives around tax deductibility and the like.

Senator BUSHBY—Some of which ended up more controversial than others.

Mr Tate—Yes. St George, for instance, has always been a major lender to that segment. The bank has two choices. It can either say, 'Look, here's an opportunity. I can start a'—for want of a better term—'a higher risk lending aspect', in which case it has to assess what the market would make of that. Secondly, how does it insulate that part of its book from the more traditional part, so that an investor can make a genuine decision between what the risky part of its business is and the less risky part is. That is why banks have always tended to operate through separate corporate entities in that regard, because it made it much easier for investors to make a differentiation in the risk assessment. There is a massive issue as to where that segment of the market, which traditionally did not go through ADIs, will go ultimately to get its money.

Senator BUSHBY—Senator Williams actually moved the terms of reference for this inquiry, but without wanting to usurp your thoughts, I think that, to a significant extent, is one of the reasons we are sitting here today, because there are segments of the small business market that are finding it challenging to get finance now that probably should have it, but banks may not be the answer. This may be a question for Ms Lewis. Do you actually see applications from small businesses that represent great ideas and projects, but which do not meet some of the criteria?

Ms Lewis—Yes. The issue with statements like that are definitions around 'great' and, therefore, understanding how that looks in terms of viability and the ability of the business to service.

Senator BUSHBY—Ones that actually look like they would be, such as business projects or expansion projects for existing businesses that are very sound on the business case and most criteria, but for some reason they get knocked out by one criterion. I presume you would see that sort of thing quite regularly?

Ms Lewis—Our approval rates have stayed reasonably steady. Obviously that tells a story about a fairly consistent 15 per cent of businesses, all of whom have great faith in their idea, who we have agreed to differ with in terms of our ability to lend them money.

Senator BUSHBY—Do your banking managers have a degree of discretion with respect to some of the criteria, where some of them do look good, but they might not tick the right box?

Ms Lewis—We do, absolutely. We have already talked about overriding adverse credit bureau checks. We also look at the actual viable position of the books. We do look at both cash flow projections as well as business plans. It is part of the job of the local business banker and the bank manager to present the case possible and support the case for businesses having access to funds.

Senator BUSHBY—So, they do not have ultimate discretion in those things? Do they still need to go to higher levels?

Ms Lewis—They have some discretion. We work in partnership with credit in the same way as we work with businesses in order to make the right decisions.

Senator BUSHBY—Finally, what regulatory constraints currently exist from Westpac's perspective that might limit the access to or increase the cost of finance to small business? What changes could be made, regulatory wise, which would improve access to finance for small business?

Mr Tate—Let us separate here the cyclical aspects of the economic cycle. There is no getting around it, we are in the midst of a cycle. Whether there is a regulatory response to either smooth that, provide some air cover for it and the like, is a different matter. I would certainly take this on notice and we would think about it, but off the top of my head there is no obvious regulatory gap separate from the cyclical aspects.

Senator BUSHBY—Not so much a gap, but are there any constraints placed in your way to doing things that you would like to do that you cannot, because of the way that the regulations work. Or using your experience in the finance and banking sector, ways that we might facilitate funding for those small businesses that we were just talking about that might not meet banking criteria? How would you actually foster that sector of the market?

Mr Tate—There is nothing within the bank sector that I could say. Certainly going back to that market structure issue, in terms of what the nation would want from an equity perspective, venture capital, and what it would like in terms of higher risk lending criteria or entities that were engaged in that part of the market, there are certainly some question the committee could ask itself as to how to ameliorate that. To go to Ms Lewis's point, generically the biggest issue for any small business is optimism about cash flow. The great idea—people believe in it passionately. That is one of the attractive aspects about entrepreneurialism in that regard. The thing is, as a generic statement or as a vastly generalised statement, they tend to be vastly undercapitalised for what is required, and as a result they end up with much more debt than they can carry.

The issue is really about how does one get them into a capital position before they even ask for the debt that makes it a much more viable argument, and entrepreneurs tend to operate on extremely thin ideas of what constitutes equity. I think that is one of the issues that we definitely have to think about, but it is more market structural. You cannot necessarily regulate your way through that. There might be other incentives and structural issues that you put in play to assist that. But there is nothing within the APRA regulation or the way we have to operate within APRA regulation that says, ‘Look, if we just had a nuance change here or a nuance change there, that would open up a part of the market that didn’t otherwise exist.’

Senator BUSHBY—If you do think of anything I would appreciate it if you could provide us with that information.

CHAIR—We will put questions on notice for you. Thank you very much for appearing.

[3.28 pm]

CARTWRIGHT, Mr Stephen, Chief Executive Officer, New South Wales Business Chamber

GREEN, Mr Micah, Policy Adviser Tax and Competitiveness, New South Wales Business Chamber

ORTON, Mr Paul, Director Policy and Advocacy, New South Wales Business Chamber

CHAIR—We welcome the New South Wales Business Chamber, which has put in a submission numbered 33. Would you like to make an opening statement?

Mr Cartwright—Just to put some perspective around the New South Wales Business Chamber, we are the largest business organisation in New South Wales. We have about 120 affiliated local chambers of commerce. Local chambers in New South Wales would have about 14,000 small business members altogether. But we also represent the interests of regional chambers such as the Sydney Business Chamber, Hunter Business Chamber, Illawarra Business Chamber and the Canberra Business Council.

Directly and indirectly this chamber speaks on behalf of about 30,000 employing businesses across New South Wales. The New South Wales Business Chamber is also part of the Australian Chamber of Commerce and Industry, which has made a separate submission to this inquiry, and nationally the chamber movement represents more than 350,000 Australian businesses and is the voice of business at a local, state and federal level because of the various tiers of the chamber movement.

Firstly, I would like to begin by welcoming the decision of the Senate to hold an inquiry into small business access to finance. It is an important inquiry for the Senate to be conducting and we look forward to seeing the recommendations and the actions that arise from the inquiry itself.

Small business is the lifeblood of Australian business. There are over 750,000 small businesses that employ staff across this country, and small business employs over 5.1 million Australians. That represents more than half of all private sector employment. In the financial year 2007-08, this particular sector of the business community contributed over $300 billion to the national economy.

While the focus of media and other commentators is usually on larger companies, those that make up the ASX 200, it can be easily forgotten that the largest sector and the largest employer in Australia is in fact small business. Also, it should be remembered that you cannot become a big business without first starting life as a small business. The primary difference between large companies and small businesses is that small companies are owned and operated by their owner, and management is not outsourced. It is something that is done by the owner themselves. Small business owners by their nature are passionate and heavily invested in their business, both financially and emotionally. They do not leave work at one minute past 5 and forget about it till they turn up the next day. In fact, they actually work harder and longer each week than most people, including the extremely well paid executives from the banking industry. As I said before, they are emotionally invested in their business and it is their hope, their dream and in most cases it is also their only retirement fund.

How do I know all of this? As I mentioned a moment ago before the inquiry started, I used to be a small business owner. Prior to joining the New South Wales Business Chamber nine months ago, I started and built two successful businesses, one of which is now a public company listed on the Australian Stock Exchange and employing over 1,200 staff across Australia, but it started life as a small business.

The reason I mention this is really to emphasise the point that small business owners are not by their nature fly-by-nighters. They are people who want to build and create. They are in our workforce of 11 million people 750,000 people who get up every day absolutely driven by an intention to build and expand our economy.

The ABA and others often suggest that small business owners are a risk to banks. In fact, they emphasise the fact that small business owners are a big risk to banks. My question to you is: who is actually taking the bigger risk? The person who is working 12 hours a day and has their house mortgaged in order to fund the operations of their business, or the banks who seek and hold high levels of security for most, if not all, of the small business finance they provide. I start from the premise that as a group small business owners are a good investment and are some of the best customers that our banks actually have.

Let me make it clear from the beginning that, in entering into this debate about access to finance, we do not in any way argue against the right of banks to make their own decisions about creditworthiness. Indeed, there is a substantial amount of evidence coming out of the US to suggest that a prescriptive approach to finance that opens the floodgates can and does do enormous damage.

Today we do not seek to bash banks. We do not seek to argue for more regulation. We do not seek to disrupt or weaken the stable foundations of our banking system. We are arguing for greater competition in the marketplace and more innovative thinking from government about how we can open up the opportunities for finance to the small business sector.

I accept that in the banking sector the normal rules of completion do not apply and they should not apply. That might seem a strange statement from somebody who actually is committed to free markets, but I would like to explain what I mean. The normal forces of competition inevitably see businesses rise and fall depending on the product, business model and strategy of that particular business. In any given day businesses merge, incrementally expand, downsize and even possibly close. Yet to allow those free market forces to apply unabated to financial markets and the banking sector is to expose the broader economy to a greater risk than we would be able to withstand.

Whilst competition thrives through the changing fortunes of businesses and the changing needs of consumers, such forces need to be tempered in the banking sector. However, the challenge is to have sufficient competitive pressure to ensure that the sector is operating optimally, efficiently and in the best interests of the broader economy.

Our belief is that we do need more competition within the banking sector, and such competition will benefit the broader Australian economy. The fact is that the Australian banks through a confluence of circumstances have by and large fared relatively well throughout the global financial crisis. Prior to the GFC the major banks generated approximately 60 per cent of all new owner occupied loan approvals in Australia. By the end of 2009 their share of the new mortgage market has increased to around 80 per cent.

The major banks have also increased their net interest income by more than 20 per cent over the last 12 months, reflecting both the increasing market share that they are enjoying and the increasing margins between the cost of borrowing and the borrowing rates to customers.

Our banks have performed better than overseas banks, and to quote the RBA, they have had only a modest decline in profitability. Indeed, bank share prices have almost fully recovered from the GFC, a remarkable outcome in the circumstances.

Of course, if one reads the words of Australian bank CEOs in the press you would get the feeling that it is a big, bad world out there for banks in Australia. The reality is it is not. The sun is shining on our banks and it is something that we need to remember.

Our premise is essentially that Australia needs more competition in the banking sector. The sun might be shining on our bankers, but lethargy is never the foundation for growth or innovation.

Firstly, we simply restate our view that our marketplace must stay open to new entrants. Secondly, we must show more scepticism about claims that the merger of second and third tier financial institutions will not lessen competition. It does, it has and it will. Thirdly, the government must act as it did in the household mortgage sector to reduce the barriers to switching providers. We believe the Productivity Commission should do a full review of the costs and constrains faced by small business when they engage with banks to secure finance. Fourthly, the government, the opposition and the media have all been very effective in holding the banks to account in relation to home loan mortgage rates.

The strategy of naming and shaming banks has ensured that householders receive in full the RBA interest rate cuts, and when the cycle turned that those increases have largely been held to official levels. Yet this has not occurred in the small business sector. Indeed, there is an argument that following an increase in the banks' own costs of finance we have seen some cross-subsidisation between small businesses and the home mortgage market.

Since mid-2008 we have seen the spread between small business loans and the cash rate increase from around 200 basis points in 2008 to over 400 basis points in 2010. To put this into some perspective, if that skimming of the 200 basis points occurred in the residential mortgage market, it would be akin to the banks adding an additional 40 basis points for each of the five interest rate increases that we have had over the past seven months. I suspect that, if this had actually happened, there would have been riots in the streets. The fact that this has not happened in relation to the gouging of small businesses is in part because no-one within government feels any compulsion to name and shame the banks on this particular issue. This is despite the fact that small business directly employs over five million Australians.

Fifthly, we do believe that there is scope for the Australian government to take on a role as guarantor of the small business finance market as a temporary means by which we can free up access to small business finance. This is not a revolutionary concept. Such government guarantee schemes already operate in Canada, the UK and the US. Under our proposal such a scheme would be self-funding, ensuring absolutely no cost to taxpayers. The guarantee would be priced. It would share the risk between government and the banks and it would ensure that Australian banks could once again feel relatively confident about lending to the small business sector.

Our members are very clear when they say access to finance is a major concern. I would like to just read very briefly to you a letter from one of my members who operates in Kings Langley in Sydney's greater west who recently wrote to me and stated:

> I own and run a company that designs specialised transport warehousing, distribution and management systems for distributors of goods and services throughout Australia. My business is profitable and has been growing strongly for the last 14 years. Over those years I have borrowed successfully from financial lenders to purchase additional properties to expand my business. In more recent times I have been frustrated by the lack of support and fairness from financial lenders when I have required additional financial assistance. For example, a few years ago my business experienced a temporary slowdown as a result of several of my then employees starting up a rival company and poaching customers and staff from my company. Twelve months after this occurred I attempted to get a $200,000 overdraft loan from my bank, which was refused. As our cash flow was extremely stressed, I was forced to seek alternative finance. I remortgaged both of our industrial properties with two financial institutions, who would only provide an interest only loan, and charged up to five per cent more interest than the bank, and forced me to renew the loan annually. The high annual refinancing costs and the higher interest rates placed even more stress on my business and on me on a continual basis. Since the advent of the GFC the banks have continued to put the screws on my business by withdrawing several flexible financial options that my business used to ensure suppliers and staff were paid promptly. Without any notice, my bank withdrew a flexible overdraft that provided me with additional time to pay the monthly balance and the ability to write cheques against deposited funds. In response to this change of policy I was forced to sell my home and downsize to a home unit and put the balance into my business. Yet again I received no support from my financial institution. I have also had two major customers go into liquidation, owing my business $350,000. To cover this loss I increased the borrowing against one of my industrial properties from an alternative financial lender. This cost my business $60,000 in fees to end the first loan and to establish the second. One third of the increase in borrowing was actually these fees. I love running my business. I am proud of the fact that I have got great relationships with my customers, suppliers and the people we employ, but sometimes I wonder if it is all too much. I wonder if the banks and the politicians know how challenging and stressful it really is, how worrying it is to fear someone else will pull the rug out from under you and from under a lifetime's worth of work. I am not suggesting the banks throw their money around stupidly. I am simply saying that they ought to look up from their balance sheets and treat their smaller and long-term customers more fairly.

I think Wayne's words summarise why this issue is so important and why it is so personal for small business. Livelihoods across this country depend on resolving this issue. I sincerely thank you for holding the hearing and for your patience today. I understand that you do have a copy of our full submission, but we would be delighted to answer any questions that you might have.

CHAIR—One of the issues you raise in your submission is the idea of the government guaranteeing loans to small business. I believe these are in place in various other countries, including the United States and Canada.

Mr Cartwright—Yes.

CHAIR—You say the guarantees should not cover 100 per cent of the loan. In many cases, it is only 75 per cent or 85 per cent, as you say in your submission. Earlier today, though, when we were talking to other witnesses and raised this issue they said that the question has to be asked as to why the individual cannot obtain a loan in any case from a conventional source, and that implies that perhaps they are not creditworthy or the prospect is not regarded as being sound. Even though these loans exist elsewhere, what do you say to that sort of criticism?

Mr Cartwright—I can answer that question from personal experience, having dealt with banks for 20 years as a small business owner and then a large business owner. What they deem to be creditworthy from a business perspective is almost akin to saying that, until you can prove you do not need to borrow the money, we will not lend it to you. Because of the concentration of the provision of finance there is not a lot of competition to change that view of the world. If you need it there are really only a few places you can go to get it. What we are suggesting that a government guarantee would achieve is to essentially create two tiers within the banking system of assessment. There is an assessment which says: under our current banking criteria you make it, anyway, in which case there is a particular percentage cost for that, and that is what the banks currently do. So, one group of small business borrowers will fit within the existing requirements of the banking sector, and they will be granted the loans on as attractive rates as possible. The second tier would be the one secured by the government guarantee, which would see businesses that may not meet the first set of criteria that the banks put forward meet the second criteria, because the banks are more prepared to go to that level because of the existence of the bank guarantee, and there would be a pricing differential associated with access to that second tier of capital. But in our opinion, that is the preferable model to run. There would be no downside for the banks. They essentially would be using the government's backing in order to extend the level of finance they are prepared to make.

The other point I would make is this. Recently I have had two commercial properties assessed by bank valuers. The valuations that came back were ludicrously low. If that is the premise upon which they then assess what is appropriate to loan money to you, by basing it on a bank valuation of properties and other assets that you have available to secure borrowings, it is no wonder that small business is finding it difficult. Seriously, the valuations that came back on these properties were ludicrous.

Senator WILLIAMS—Commercial or residential?

Mr Cartwright—One was commercial and one was residential. You just sit there and say, 'I understand that the world has changed and I understand the need to be conservative, but this is 50 per cent of what we paid for the property.' It is just ludicrous. If that is the way in which the banks are assessing risk, then it is no wonder that finance is tightening up.

CHAIR—What you are really saying is the assessment processes of the banks are too conservative and that there is a niche for this sort of government loan; as you have said, you have some experience of them. Can you tell us a bit about your experience of them?

Mr Cartwright—Certainly. I will tell you one interesting story. In a second company that I built we had a large requirement for cash flow funding, and on any given day we had about $100 million of debtors that we were using to secure borrowings. If you want to scale this back to $10 million—it is identical; our company had grown by this stage to a larger size. At that point we had about $60 million of cash flow funding that we were using against the $100 million of debtors. They were largely blue-chip debtors, BHP, Rio and Qantas. They were not exactly the sorts of companies you have to worry about—although I did say that about Ansett.

In terms of that facility, it had been operational for about 15 years with one of the larger banks. We actually had a proposal from one of the other banks; they thought our balance sheet was undergeared. We had $100 million worth of assets. They were blue-chip assets. The other bank came in and made a proposal to us that we could actually afford to increase our borrowings, because our balance sheet was lazy and they felt that we should take on more debt.

About three months later, after the GFC had suddenly hit, not only did that bank that told us that our balance sheet was lazy suggest to us that they were actually not interested anymore in forwarding any finance to us, but the bank with whom we had the $60 million with the $100 million of coverage also decided that it was not necessarily comfortable providing that level of gearing anymore. You are talking about a significant amount of cover over and above what was being owed to this institution, but the internal policies of the bank simply went conservative. There was no consideration of history, of performance or of creditworthiness. They just changed their policies. It seems to me that coming out the other side the banks have decided that there is an opportunity here to actually gouge some more profit. The way in which small business is now exposed, it is simply an opportunity for them to take some more profit out of small business.

Senator WILLIAMS—In your submission you make many points. One was that it has become apparent in Australian markets that the global financial crisis allowed the major banks to improve their market share and profitability at the expense of smaller banks and financial institutions. You made the point about the spreads and the margins of small business going from 200 to 400 basis points. You go on to say that it is important that the government is proactive in fostering the ability of these small businesses to operate and grow. When interest rates went down—they commenced on 3 September 2008, when I think we had a four per cent reduction—I saw many small businesses and farmers only get two per cent or a 1.75 per cent reduction.

Mr Cartwright—That is correct.

Senator WILLIAMS—You said in your opening statement you believe they were cross-subsidising the home loan portfolio. Are you saying that the banks were losing profit by reducing the home loan rates so they kept the rates up on small and medium businesses to subsidise what they were missing out on with the home loan rates?

Mr Cartwright—I am saying that I think that is what is happening now. I actually do not think it was a large feature of what happened on the way down, but what we are saying is we believe that is what is happening now. The pressure that has been exerted on banks to stay in line with the official—

Senator WILLIAMS—Political pressure?

Mr Cartwright—Political pressure and pressure from the media that the banks are to stay in line with the official increases in interest rates from the RBA; there is a level of cross-subsidisation occurring where business loans are being used to essentially fund some of the increased costs of funding for the banks so they can keep their housing mortgage rates at a lower level.

Senator WILLIAMS—I think this financial year's forecast is a $21 billion profit for the four major banks, which is pretty good considering the economic conditions we have seen in the last 18 months or so. Do you remember the days of the Commonwealth Development Bank?

Mr Cartwright—Yes.

Senator WILLIAMS—Do you think it was a sad day when it went?

Mr Cartwright—Absolutely. Absolutely.

Senator WILLIAMS—It would be there sponsoring AgQuip Field Days at Gunnedah each year. It was a well-known institution. Did the Commonwealth Development Bank actually take more risk with business? Were they a gamer lending institution that sort of got behind business perhaps more than the traditional bank?

Mr Cartwright—I have no statistical or empirical evidence to give you an answer on that, other than to say that I am aware that Bendigo and Adelaide Bank set up a relationship with Elders to create Rural Bank. I am being told that it is not so much that the lending criteria are different than they would have been if you applied directly to Bendigo and Adelaide Bank, but the representatives who run Rural Bank are much closer to the rural businesses that they provide funding to and therefore can make a better, faster assessment of the reliability of that lender than would be the case where you have centralised banking operations. As we know, most of our banking institutions have gone to much more centralised banking, and so you do not have that personal relationship. You do not have the bank manager who has the history with your company. It is all done by processing of forms, and the difference between that bank that you were referring to and the Rural Bank that has been set up now with Elders is that they are much closer to their clients. Therefore, they can assess the creditworthiness in a much more direct sense.

Senator WILLIAMS—I am going to run an idea past you. You say here—and I think they are very important words—'It is important that the government is proactive in fostering the ability of these small businesses to operate and grow.' Imagine if the government made Australia Post a bank, and I say that because I believe their CEO comes from a banking background. Almost every country town in Australia has a post office. I live in Inverell. Little towns like Bingera, Barraba, Ashford, et cetera, could deposit their money there. They could go to a regional centre like Inverell to apply for a loan, et cetera. If the government were to be proactive and issue Australia Post with an ADI licence and actually make them into a bank, that would offer more competition. Perhaps the government could say: you will concentrate especially on small business banking to grow business and to grow jobs, and we know the importance of it. What would your reaction be if I were to suggest to you that perhaps the government should consider licensing Australia Post, which would be backed by the government? It would be safe and secure. It would return more profit to the government; it is owned by the government. What would be your reaction if I ran the idea past you that Australia Post be given a banking licence and set up?

Mr Cartwright—It would explain to me the appointment of the new chief executive, for a start. I might let Mr Orton answer that, because I think he has thought about this issue more than I have.

Mr Orton—Just picking up on what Mr Cartwright has said, the distinguishing factor of the Commonwealth Development Bank and indeed the Elders, Bendigo and Adelaide Bank relationship is the knowledge of individuals making assessments about the businesses and the people.

Senator WILLIAMS—Close to the coalface.

Mr Orton—That is right. That would be the question I would be asking about the Australia Post model in dealing with business lending: to what extent would they already have relationships with businesses and therefore be close enough to them to be able to make quick, insightful judgments? For me, there would be a question mark about that.

Senator WILLIAMS—What if they employed local bank officers from the area who know the area?

Mr Orton—Possibly if they did a deal with somebody who was already working with small businesses, yes. That is not unlike the model that Mr Cartwright outlined, where an existing business that has relationships with and knows local businesses lines up with somebody who has the sources of funding.

Senator WILLIAMS—At least Australia Post would have the infrastructure in place. They have branches everywhere—

Mr Orton—Certainly.

Senator WILLIAMS—They would be at the coalface and would provide competition of a very strong bank backed by the government; would you agree?

Mr Orton—It is certainly an option that is worthy of examination, definitely.

Senator HURLEY—I was working in a couple of merchant banks in the early 1980s. It was in a very junior role a very long time ago. But my memory is not of the Commonwealth Development Bank as particularly active or having branches all over the place.

CHAIR—Did or did not?

Senator HURLEY—Did not.

Mr Orton—I am not personally familiar in a detailed sense with how the development bank worked. But from the bit of research I have been able to do I did get the sense that the people involved in making decisions actually looked at the individual businesses and were not applying sector-wide credit criteria. It is a case of looking at each business's circumstances on their own merit. I guess whether you do that from afar or whether you do it using people on the ground it perhaps does not matter so much. The point is, though, that you are not applying sector-wide credit criteria that we think is what happens today.

Senator HURLEY—I might do a bit of my own research on that and as to why it was closed down. It seems to me that the model you are proposing for a kind of a guarantee or assistance for small business financing is closer to Canada's model. You say that the Canadian government guarantees 85 per cent of eligible small business loans. Can you give me a brief rundown on who is eligible for those loans?

Mr Green—To give you a bit of background on the Canadian model, as I understand it from the research we have done, there are some limitations in the Canadian model in terms of small business eligibility. They do have to be for-profit businesses. Not-for-profits and charitable and religious organisations are not eligible. I believe there are also some limits on what the loans can actually be used to finance. They cannot finance goodwill, working capital, inventories, franchise fees or research and development. However, they do provide financing for a range of small businesses for a range of clients.

Senator HURLEY—So, they are limited in what they can finance and the guarantee is provided to small business in exchange for a fee?

Mr Green—That is correct.

Senator HURLEY—Can you tell us how that fee is calculated?

Mr Green—The fee is calculated in Canada by the financial institutions that approve the loan. In Canada the fee, as I understand it, is up to 300 basis points for the government guarantee.

Senator HURLEY—Small business are not going to go there unless they really cannot get anything from the bank, are they?

Mr Green—We would not be proposing that the government guarantee be provided for free and we—

Senator HURLEY—Would you be thinking about 300 basis points?

Mr Green—I notice that the UK, which has another similar scheme, has quite a different pricing arrangement from the Canadian system. Their pricing range is from around 150 to 200 basis points.

Senator HURLEY—In setting this up presumably you would try to keep the bureaucracy at a minimum. Would you see it working from within government or would it be set up as a kind of statutory authority?

Mr Green—I think one of the important principles that we make in our submission is that it is critically important that the bank remains responsible for assessing the small business loans. I do not believe we see a role for the government to play in assessing small business loans. By ensuring that it remains with the bank I think a scheme of this nature minimises the risk of a sort of government failure. I think that is one of the important principles we see; that it is largely an arrangement similar to what already exists. The arrangement remains between the small businesses and the banks. In effect, you have the government stepping in behind the banks almost like an insurance player insuring some portion of a small business loan in exchange for a fee.

Senator HURLEY—Would that not go back to the problem that we have heard on this committee about the wholesale funding guarantee, that it gives an advantage to the banks and so people do not go to other institutions? Would not small business then tend to go to the established banks for financing? We have been talking about improving competition in the banking sector, and so that newer entrants might suffer from that.

Mr Green—Absolutely. We are strongly supportive of increasing levels of competition in the banking sector. What I would say to that is that the wholesale funding guarantee, as I understand it, had different rates based on the strength of the financial institution taking out the wholesale funding guarantee. Indeed, the larger banks were able to access that guarantee on much more favourable terms than the smaller banks. There have certainly been quite persuasive arguments made that that differential in pricing has had the unintended consequence of strengthening the financial position of the large banks relative to the smaller players.

In relation to the government guarantee of a small business loan, we do not see any reason why that facility should be limited in use to only the big four or anything like that. We would see it as something that could be used by a range of players in the banking space.

Senator HURLEY—Conversely, might you not get some financial institutions starting up to try to take advantage of that and be overly generous in their risk assessment to try to get business, with a resulting failure of a large number of businesses and possibly the financial institution itself?

Mr Green—Are you suggesting that you might get a fly-by-nighter bank entering the sector and taking on too much risk?

Senator HURLEY—A financial institution starting up might try to get business and overreach.

Mr Green—I think that is why we have quite a strong presence with APRA ensuring that those sorts of banks that would seek to come in and compete in the market meet prudential standards and cannot take on that level of risk.

Senator HURLEY—Would you see it as an ADI having to set up with all the prudential requirements for that?

Mr Green—I think it could be both the ADI and the non-ADI sector.

Senator HURLEY—A non-ADI would not be covered by APRA.

Mr Green—No. That is correct.

Senator BUSHBY—I note in your submission that you have raised a number of issues in respect of small business financing, some of which has been touched on already. In your opening comments as well you used the term 'gouging'; that the banks might be gouging profit effectively by shifting risk out of their portfolio. We have had a significant discussion with Westpac and also the ABA earlier today. What they tell us is the reason for the premium in terms of small business loans compared with residential loans, which are both secured, is because of the risk. But if they are shifting the risk out, as you suggest, do you think then that they should perhaps be reducing the premium?

Mr Cartwright—What we are suggesting is that it seems very odd that the level of risk attached and therefore reflected in the pricing of loans has changed by 200 basis points from what it was before we went into the GFC to what it is today, given the strength of the economy.

Senator BUSHBY—That is the first point, that the spread has increased?

Mr Cartwright—Yes.

Senator BUSHBY—But at the same time you are saying that the risk has probably decreased?

Mr Cartwright—I am saying that I do not think the risk profile for small business has changed, despite the increase in margin—

Senator BUSHBY—But the lending criteria have changed.

Mr Cartwright—The lending criteria have changed, and our suggestion is that they may be using some of that additional margin to offset having to hold the line on mortgage rates even though the cost of funding has increased, thereby providing the cross-subsidisation.

Senator BUSHBY—You also mentioned that, in respect of the tighter lending criteria—I am paraphrasing here to some extent so correct me if I am wrong—your analysis reveals a range of instances of banks tightening lending criteria and undermining the viability of otherwise profitable small businesses?

Mr Cartwright—That is correct.

Senator BUSHBY—Are you saying that through the tightening of the lending criteria some profitable small businesses are being undermined in terms of their ongoing viability?

Mr Cartwright—Their viability is being threatened by the changes; that is right.

Senator BUSHBY—You actually provided an example in your opening statement of one where that appeared to be the case.

Mr Cartwright—Yes.

Senator BUSHBY—In respect of this whole inquiry—and you may have been present when I was talking to the previous witness—my major concern is that there are businesses out there that are viable or would be viable if given finance, start-up businesses, but particularly those already in existence. The example you used is a classic example, where they have existing financial arrangements, whether with banks or previously with non-ADIs. They have been operating, paying their bills, making profits, employing people and operating quite successfully and contributing to the Australian economy. Some of these businesses are either facing restrictions on the financial assistance that they can get or alternatively are not able to get continued funding, which threatens their viability.

Mr Cartwright—Yes, that is correct.

Senator BUSHBY—I raised this earlier. I think we have all raised it with witnesses as they have come through today. I think the ABA indicated that you could always find examples like that, but on the whole that is not what is really happening. Is that something that you accept? Are you cherry-picking the examples or is this something that your membership is facing in a more general sense?

Mr Cartwright—We do surveys of our entire membership on a regular basis, and those survey results are absolutely demonstrating that this is an across-the-board problem.

Senator BUSHBY—Do you have any actual survey breakdowns that you can actually provide, the questions asked and the responses that you have received?

Mr Green—I have one I can share with you now if you would like.

Senator BUSHBY—Yes.

Mr Green—Our most recent survey, which was conducted last month, has not been released quite yet. We are just finalising the crunching of the data. But what I can share with you is that 29 per cent of our small business respondents said that their access to finance had deteriorated over the last quarter. Taken in isolation it is difficult to say too much about that. But what I can also say is that when you look at the exact same period 12 months ago, at the height of the GFC, when we asked our constituents that same question again, in March 2009, 33 per cent of small business respondents said that access to finance was an issue for them, or had got more difficult over the past quarter. So, from the darkest days of the GFC till now we have seen only a marginal improvement, from 33 per cent to 29 per cent, and still a very large number of our members saying it is—

Senator BUSHBY—We had evidence earlier today from the AIG. They had conducted a survey as well, but asked a slightly different question. Rather than how has it been over the last quarter, it was what were they anticipating for the coming quarter. They had a similar sort of percentage considering that finance will be an issue for them.

Mr Cartwright—AIG’s membership tends to be a bit larger than ours in many cases.

Senator BUSHBY—In terms of the size of the business?

Mr Cartwright—Yes. In terms of the voice of the small business sector, local chambers and then our regional chambers and ourselves would be an accurate bell weather of what is going on with small business in New South Wales.

Senator HURLEY—What was the percentage before the GFC? Do you go back that far? Unfortunately AIG did not.

Mr Green—Ours does not either, unfortunately.

Senator BUSHBY—Is the fact that you had not been surveying on this particular issue an indication that, from your membership's perspective, this issue has become worse in the last couple of years?

Mr Orton—Obviously with the advent of the GFC it was clear that, based on previous recessions, there would be difficulty in access to credit. I guess it has become more apparent when you look at the results for the last 12 months that as businesses recover from the immediate impact of the GFC, think more about expansion and the coming good times, the demand for finance becomes greater. I guess the point about that big number in this most recent survey is that these are businesses looking to expand on the upside part of the recovery or the economic cycle. I guess that is why we would say it is a bigger concern than on the downside.

Senator BUSHBY—We have had evidence today that two years ago there was a range of additional options for small businesses looking to finance. A lot of non-ADI options that existed then, with the onset of the global financial crisis, became less viable. And the bank guarantee for ADIs for not non-ADIs was also a nail in the coffin, so to speak, in terms of their ability to be able to fund small businesses. That option no longer exists, or to a far lesser degree than it did, and it may well be rebuilding. But I would suggest it is not rebuilding at a rate that would meet the demand for businesses looking to take advantage of our coming out of the global downturn. What do you think could be done to actually help facilitate non-ADI competition, particularly in the space where small businesses may not meet the tighter lending criteria of banks, which is really where the non-ADIs used to serve? They used to service those small businesses that would not otherwise meet criteria for lending from banks.

Mr Green—I think we have broadly gone through what our proposals are to try to encourage—

Senator BUSHBY—Most of those seem to be ADI related, though.

Mr Green—They are largely ADI related. The other point I would make in relation to them is that they are proposals that I guess will take time to increase competition in the market. Certainly we would be looking for anything we could that would help address competitive issues in the shorter term.

Mr Orton—Certainly one of those issues would be to better inform small business potential borrowers of what the options are, say, for example, factoring and discounting as an alternative source of business finance, which has grown phenomenally in the last 10 years. It did taper off as the GFC hit. One wonders to what extent businesses perhaps consider some of those options as much as they could. There are more providers than there ever used to be. But, on the other hand, maybe there is a little bit of financial literacy education that might help open up some more opportunities that businesses do not think about.

Senator BUSHBY—Do you see a role for your organisation in that?

Mr Orton—Definitely.

Senator BUSHBY—Would you need assistance to do that or is that something you could do with your existing resources?

Mr Orton—I think it is something that government should be taking into account. It certainly puts a lot into financial literacy from the consumer credit point of view. I think some of those arguments probably also apply to small business finance.

Senator BUSHBY—In those recommendations you state the government should put greater pressure on banks to keep small business lending rates down. What sort of pressure could or should they be applying? Should they actually be using regulatory pressure or should they actually be carrying a big stick or just use public pressure?

Mr Cartwright—I think you have seen how effective public pressure has been in the home residential mortgage market area. I think if we heard senior government figures coming out and naming and shaming in the same way they do in the housing market that would be a big step forward.

Senator PRATT—We have talked about the consolidation of banks and a decrease in competition in the lending sector. To what extent do you think that consolidation of the banks and their place in the market has actively contributed to a lack of access to finance?

Mr Cartwright—I think our view is that banking has consolidated in this country. When you see—what did someone the other day refer to it as, a functioning oligarchy, or something—that level of concentration occur then obviously it is going to be an issue in terms of the provision of competition so, yes.

Senator PRATT—To what extent do you think the big four banks are internally competitive against each other in this sector? Our regulators seem to think they are.

Mr Orton—I do not think they would say they are not competitive. I think the issue is more potential competition between the big four oligarchy and whatever else the other options are. That is where the issue is. There are not too many other alternatives.

Senator PRATT—I would be interested in your having a look—hopefully, there will be time before the end of this inquiry once the *Hansard* becomes available—at the statements of APRA, the Reserve Bank and the ABA in relation to how they have characterised the state of the problem. Because the argument seems to have come out that naturally there will always be isolated cases of businesses that are suffering, but the current assessments are truly based on risk and that is generally why the market has contracted.

Mr Cartwright—We are absolutely happy to look at those comments and give you our further views on it, but can I just say that what we may be seeing here is an overreaction in terms of the change in assessment of risk.

Senator PRATT—It is slightly contradictory. At the same time they are also acknowledging that a lack of competition will naturally tighten up the lending standards. So, it is a bit of a loop.

Mr Orton—Yes, and unfortunately the official data does not tell you about discouraged lenders—those people who do not get into the data collection system and do not make applications for loans. I think that is the sort of thing that our survey does reveal.

Senator PRATT—We seem to have a problem with the data in terms of it not being a true indication of what has happened over the cycle. It was expected that business would find credit more difficult to get, and this is not an unexpected situation. But the extent to which it is legitimate and businesses are not able to get finance they should have access to seems to be underreported, and we have not been able to interrogate that information adequately. Have you any views you would like to put on the record about how that information should be collected in order to mitigate against that in the future?

Mr Cartwright—If we could include those in our response to our review of the other submissions that would be appreciated.

CHAIR—Thank you for appearing today.

[4.14 pm]

BAYER-ROSMARIN, Ms Kelly, Executive General Manager, Business Products, Commonwealth Bank of Australia

BREWIS-WESTON, Mr Symon, Executive General Manager, Local Business, Commonwealth Bank of Australia

McLENAGHAN, Mr John, Head of Government and Industry Affairs, Commonwealth Bank of Australia

NAREV, Mr Ian, Group Executive, Business and Private Banking, Commonwealth Bank of Australia

CHAIR—Welcome. Would you like to make an opening statement?

Mr Narev—I would like to thank you and the committee for the opportunity to appear before you today. I will just summarise very quickly some of the points made in our submission to underline our primary point, which is that we do believe the bank has been actively supporting the small business sector in terms of the provision of credit and the other services that we have been providing the sector.

Before I do that I would like to make a couple of contextual points. Firstly, we and the small business sector actually have a comity of interest. We both benefit from interaction with each other. We are in the business of lending and if we do not lend we will cease to exist, as will the businesses that depend on our credit. There is a fundamental need for my business to support small business.

Just as importantly, we have an obligation to lend prudently, and while we understand that much of the discussion at the committee has been appropriately about access to lending, what we must also point out is that we are the guardians of upwards of $10 billion of small business's deposits. This is a deposit-rich sector. A large number of small businesses are entrusting us with their deposits and expect us to lend prudently. We are the guardian of those funds. Without proper risk management and responsible lending criteria our small businesses as depositors will inevitably suffer, as would the broader economy. We have seen some of the consequences of that with the global financial crisis.

The Commonwealth Bank recognises the critical economic and social contribution that small businesses make to the economy. We recognise and take extremely seriously our responsibility to help those businesses. Accordingly, we support fully the terms of reference of the committee and we welcome the opportunity to appear before the committee.

We have a small to medium enterprise book of over 130,000 small business customers. We have upwards of $25 billion of loans outstanding to those customers and, as I said, upwards of $10 billion in deposits. We have over 60 business banking centres in Australia, providing a range of services to those customers.

There is a misconception that banks have stopped lending to small enterprises. It is, of course, a misconception; I can only talk to it insofar as it relates to the Commonwealth Bank specifically. We have leant and continue to lend to small business customers. At a time between July 2008 and December 2009 when by the APRA definition of loans under $2 million the market grew at 0.3 per cent our lending to these customers grew at 8.6 per cent. We have made no material changes to our lending policies for small business, nor have we undertaken any unilateral rerating of profitable businesses.

As part of our strategic imperative, our business lending approval rates are between 93 per cent and 95 per cent consistent with the rates they were prior to the global financial crisis and through the global financial crisis. This is the only business banking which is specified among our five business priorities. All the rest of them are organisation wide.

There has also been a lot of discussion about the cost of these funds and the particular relationship between home loans and residentially secured business loans. I would draw the committee’s attention to the last page of our submission, which shows that the difference for the Commonwealth Bank between a standard variable rate and a residentially secured home loan is 50 basis points, significantly lower than the differences of our major competitors.

Since the period that the cash rate peaked in July 2008, we have reduced our residentially secured business reference rate by 2.53 percentage points, and over the same period comparative rates by other major banks have been reduced by less than 2.1 percentage points. In addition, you will see from the last page of our submission that we have made an investment above the line to tell the market about the difference in those rates. That is not consistent with the perception that we do not want to be competitive and we do not want to talk about being competitive.

It is important to understand how we have arrived at that 50 basis points differential. The difference between the residentially secured business rate and a standard variable mortgage rate is due to a difference in the risk profile of a home loan and a residentially secured business loan taken out for business purposes. We derive that 50 basis points difference through a statistical model that analyses 20-plus years of history and the difference in the probability of default for a business loan versus a home loan, despite the same type of security.

I would like to finish my opening remarks by acknowledging that some small businesses have found credit harder to access or more expensive in recent times, and provide our understanding of context for that. In the period leading up to the global financial crisis new financial services business models arose built around a glut of cheap wholesale funding. Lenders who employed these business models were more concerned with overall lending volumes than with credit standards and pricing for risk. Accordingly, they were willing to fund some small business customers that would not normally meet credit lending standards. Many of these lenders have now exited or at least scaled back their activities in the Australian small business market. Their customers have no doubt found it more difficult to get funding now. Institutions that have acted prudently are still serving their small to medium sized enterprise customers while those that did not can no longer support theirs. I believe that covers the major points we wish to convey, and we now look forward to addressing your questions.

CHAIR—I must say that is a very impressive and interesting record. It is interesting because you have been so successful in maintaining your rate of lending to small business, and obviously successful since your client base has responded so well. What sorts of factors led you to these particular solutions, which differentiate your approach from other banks?

Mr Narev—I obviously cannot talk from the point of view of how other banks might think differently, but from the Commonwealth Bank's point of view I think there were two primary factors at play here. Firstly, when our current chief executive Mr Norris took his position in 2005 he realised early on that relative to other positions that the bank has in the market it was relatively weaker in business banking and he established this, as I said, as one of five strategic priorities.

Secondly, as we came through the global financial crisis, the bank realised that it has a responsibility to continue supporting the small business customers and that it should use the strength it had as one of the major financial institutions to keep supporting those customers. These were discussions which I was explicitly part of as a member of the bank's executive committee. They were had at our board level, our executive committee level and across the business.

CHAIR—That is very commendable. It is very interesting.

Senator XENOPHON—You have said that there is a difference of 50 basis points between commercial loans and residential loans, which is a significant difference from some of your competitors; is that correct?

Mr Narev—Correct.

Senator XENOPHON—As to those commercial loans, is that averaged over small business loans and the bigger commercial loans?

Mr Narev—I should say to be clear—

Senator XENOPHON—Could you clarify that? This inquiry is about small business finance, so could you clarify what the difference is?

Mr Narev—In relation to the loans that we are talking about here the clearest comparison between a retail product and a business product is our residentially secured business loan. The difference between that and a home loan is 50 basis points. This is a major product for small businesses lending under $2 million. Outside of those there are other products we have. The prices for those are a lot more dependent on, firstly, the term of the loan, secondly, the use of the loan and, thirdly, the type of security offered. That varies more significantly.

Senator XENOPHON—The differential may not be as great with your competitors in relation to that?

Mr Narev—That is correct. Our goal in relation to our competitors is always to be very competitive. That has normally meant that we are either the cheapest or the second cheapest across a range of products. But what I have talked about here is specifically against a reference product of a residentially secured business loan.

Senator XENOPHON—You have said that some small businesses have found finance hard to find. You referred to other lenders. You may have seen today's *Financial Review* and an article headed 'Small business doing it tough' by Sam McKeith. For instance, RSM Bird Cameron partner Peter Marsden stated that small business insolvencies were 'skyrocketing at the moment as banks' finance dried up'. He said that many firms had depleted their working capital in the downturn but were now unable to access finance, because banks have tightened their credit policies. Another insolvency partner said that the economic recovery has brought more liquidity and buyers into the market and banks are likely to get a better price for distressed assets. Is it a case that we are going to see things getting worse before they get better; that now is the time to realise those assets because you cannot carry those people any longer?

Mr Narev—I will ask Mr Brewis-Weston to answer more specifically as he runs the small business segment, but if I could just outline my own view on this. Throughout the crisis and particularly in contemplation of this inquiry I have made inquiry of our credit management unit. They have confirmed to me that the number of cases that they are seeing both now and through the global financial crisis have been very consistent with historic norms. So we, as far as the Commonwealth Bank is concerned, are not seeing a major spike. I think there is a number referred to, that number of 79—

Senator XENOPHON—A 13 per cent increase.

Mr Narev—And some increase. Bear in mind this is 79 cases off a base of 130,000 clients. I acknowledge that for each of those 79 it does not matter how many there are; that causes pain for the individual. But we are not expecting, as we look at things today, any significant increase in that number.

Senator XENOPHON—Before Mr Brewis-Weston answers that, I do not want to be misquoting them, but we have had the Australian Bankers' Association and your competitor Westpac giving evidence earlier today. I am sure my colleagues will pick me up on this if I am wrong, but they are basically saying, 'Look, we have carried them so long. Things could be getting worse in the next few months because there is time lag before we call in loans or whatever because essentially there is a tipping point.' Are you saying that the Commonwealth Bank is different from your competitors and from the view of your peak association?

Mr Narev—As you can imagine, I am asked this question, and was asked this question just about every week by our chief executive during the crisis. As we look at our book today, which has performed relatively well, even relative to our peers' through the crisis, we consider the biggest risk to the current trajectory of small business defaults to be ongoing macroeconomic risk. In other words, if the economy turned southward for some reason we could expect that that could lead to a spike again in small business difficulty, or small business defaults. But as at today, in terms of the narrative that says, 'We have been holding them for as long as we can. The dikes are about to break', that is not consistent with our experience.

Senator XENOPHON—Your position seems to be somewhat different from that of your peak association and Westpac.

Mr Narev—Again, I cannot comment on their position, but that is an accurate reflection of our own position.

Mr Brewis-Weston—That is an accurate reflection of our book. Pre, post and during the GFC we have not seen any significant change in the credit quality of our book, nor the rate of arrears and the number of people that we pass on a monthly basis to what we call our credit services—businesses that are struggling go across to that unit first off—has not changed at all over the last two years. We are still seeing historical norms of what we would expect to see in a given year. We are very happy with the performance of our book and it shows that our credit decisioning on the people coming in to borrow from the Commonwealth Bank has indeed been quite good.

Senator XENOPHON—You are not expecting any spike in the next six to 12 months?

Mr Brewis-Weston—We are not expecting any spike in that, unless there were some significant macroeconomic change to the current outlook. The outlook is for growth at the moment, so unless we saw some deterioration in the macroeconomic economy, no, we would not expect to see any spike in the level of default.

Senator XENOPHON—If interest rates go up, say, one percentage point in the next 12 months, would that be a tipping point for some businesses?

Mr Narev—As you can imagine, on our small business book as with our retail book, we do stress testing on the ability of businesses to meet interest cover ratio covenants at different interest rate levels. Again, based on current forecast interest rate rises this year, should they occur, in the official cash rate, we would not consider that would lead to a spike in small business defaults. There may be a slight incline, but from the point of view of our book we would not consider that would precipitate a spike.

Senator XENOPHON—If the difference in your commercial and residential rates is only 50 basis points given the qualifications that you have made, are you suggesting that your competitors are gouging?

Mr Narev—I cannot make any suggestion on their risk model. All I can say to you is that we arrive at that 50 basis points difference analytically looking at our experience over 20 years. I can only assume that they have their own reasons for having a higher number.

Senator HURLEY—I have some questions about fees. You mention in your submission that the bank has reduced a number of business banking fees for transaction accounts, just in October 2009, including its overdrawing approval fee from $30 to $10, and dishonour fees from $35 to $5. Do you expect your overall fee income for the bank to drop or is that being made up in another area?

Mr Narev—I might ask Ms Bayer-Rosmarin, who is head of business products, to comment in a minute. What I will say—and this comes back to a question that I know has been discussed here—is that we do consider we operate in a pretty competitive market. There is no doubt that the topic of fees across different parts of the book, including the business book, has been the subject of an increase in competition in recent times. We have responded, as we would expect to, in a competitive situation. I can tell you categorically that what we have not done is look for different ways to be able to add that back somewhere else where people cannot see it. The reduction in fees that you have seen is a genuine reduction in fees.

Ms Bayer-Rosmarin—Yes, that is right. We would expect to see a reduction in those sorts of fees. They are a very small proportion and we do actively market to our customers how they can avoid those fees as well.

Senator HURLEY—There is a reduction in fees in those areas; you are not intending to make it up either in the small business area or any other areas of bank fees?

Ms Bayer-Rosmarin—No.

Senator PRATT—You have had an increase in your lending to small business and it seems that that is because of the other players that have exited the market. It would seem to me that, as you have said, they were the sorts of players that did have looser lending criteria. I am interested in the statistic that pretty much the same proportion of applications are currently being approved. That would seem to contradict some of the other evidence other players have been giving us about what is happening in the market.

Mr Narev—We have looked a number of different ways at our credit models and our credit processes. What I can tell you is that the criteria for lending to small businesses relative to where they were during the crisis and prior to the crisis have had no material change. I use the word 'material' because there have been some very minor tweaks, as there always are, in our risk models, but there has been no significant change.

Senator PRATT—That is borne out by the number of applications that seem to be approved. Would you argue that banks are being unfairly blamed for the contraction that has taken place elsewhere?

Mr Narev—We have heard a great deal from a number of different industry sources and sources out in the market expressing frustration from the small business sector. We do not believe that we particularly as the Commonwealth Bank have done as good a job as we could have in actually getting out and telling our story. As I said before, we cannot speak for competitors. I do not know the extent to which people's observations are unfairly or fairly levelled at our competitors. What I can say are the facts that we have outlined to you in as transparent a way as possible; we believe we have continued to support an important sector during a difficult time.

Senator PRATT—How do you think the parliament, in terms of this committee, and the government should go about getting a true picture of that? Clearly this inquiry is part of that.

Mr Narev—In terms of its ability to speak to different protagonists in the sector and form an understanding of what is actually going on in the market I think this inquiry is critical. We have therefore supported this from day one to the fullest extent possible. To come back to my point at the start, I do believe there is a genuine alignment of interest between banks and small business and I do believe that the market should largely be able to sort this out depending on where the committee comes out in terms of what it is seeing that we cannot see. Our experience is obviously very limited to what the Commonwealth Bank has done and is doing. I am not sure what other things you might hear that we are not aware of in other parts of the market.

Senator WILLIAMS—Thank you for your presence and your submission. It is a very good submission. Turning to the reductions in interest rates for small business, on 3 September 2008 we saw a decline in interest rates from the Reserve Bank. Was it a total of 4 per cent or 4.25 per cent? I thought it was 4 per cent. So, over that period you reduced yours by 2.5 per cent?

Mr Narev—Yes, since the peak—

Senator WILLIAMS—Was that your home secured business loan?

Mr Narev—Since the peak in July 2008 we have reduced that residentially secured business reference rate by 2.53 basis points. That is the residentially secured rate.

Senator WILLIAMS—Is that of today?

Mr Narev—Yes, that is from July 2008 to today.

Senator WILLIAMS—I was getting a lot of feedback in my job that, with regard to many small businesses, farms especially, we had seen a 4 per cent reduction official interest rate and they were only getting 1.75 per cent and 2 per cent reductions. It appeared to me as though they were subsidising the home loan market, which was getting almost all of it—3.8 per cent. This is something that a previous witness put forward from the chamber; they think the business sector is actually cross-subsidising the home loan market, because of political reasons. No doubt the government, Mr Rudd and Treasurer Swan put a lot of pressure on banks about home loan interest rates. Is that exactly what happened?

Mr Narev—One thing I can tell you categorically is that our business pricing committee—which I think Ms Bayer-Rosmarin is the chair of, or a central character in—operates entirely independently of our retail pricing committee. Either in my capacity as the head of this business or in the executive committee I have not been part of a single discussion in my time at the Commonwealth Bank about a cross-subsidisation out of retail into business. The decisions Mr McEwen has made on his standard variable rate have been made by him and his team in relation to the retail market dynamic, and he has had no promise from me on my ability to recover more than that—much more than that—in terms of business lending.

Senator WILLIAMS—But you do agree that many small businesses and farmers did not get the reduction in interest rates through the global financial crisis as—

Mr Narev—To the same level; I agree with that. What I do think—and I think it is in our submission—is that banks did price more for risk coming through and out of the crisis, and that meant some differential between the amount of reduction in the retail sector versus the business sector. I accept that.

Senator WILLIAMS—You have your domestic investments and you obviously borrow a lot of money from overseas as well. When you borrow money from overseas are you exposed to exchange rate movements with those block lots of money you borrow?

Mr Narev—Yes, we are, but that is something that Ms Cobley, our treasurer, if she were here, would be in a position to answer as part of what our treasury function—

Senator WILLIAMS—If you, for example, borrowed money today from America at a 93c Australian dollar and you went to pay it back over a 12-month period and we might have gone to an 80c Australian dollar, would you have to pay that exchange rate loss?

Mr Narev—The way our balance sheet is funded is through a collection of transactions done over multiple years.

Senator WILLIAMS—So, it averages out?

Mr Narev—Yes.

Senator WILLIAMS—I have one other point, which has been one of my gripes in small business. Just let me know if this fee still applies. I have been in business. Someone would give me a cheque to pay their monthly account and their cheque would bounce. They might get hit $35 for a bounced cheque and I would get hit $15 from my bank for getting a cheque that bounced. It was not my fault that a cheque bounced. Does that fee still exist in small business?

Mr Narev—I will have to ask.

Senator WILLIAMS—Because I think that is so unfair where somebody—

Mr Narev—You being the recipient of a bounced payment had a fee charged?

Senator WILLIAMS—Yes, the recipient of the cheque. I do not know whether he has money in his account or not.

Mr Narev—I will need to take that question on notice.

Senator WILLIAMS—Obviously, the bank charges him for rejecting or bouncing the cheque, and then the small business that receives the cheque has to pay $10 or $15 to their bank. I think that is so unfair, because it is not the small business's fault that the person who gave me the cheque did not have the funds in their account. That is a fee that I would really like to see go.

Senator BUSHBY—I note that you say that your secured business lending rate is the lowest of all the major competitors, and I commend you for that. That is great to see. No doubt that is because you want to be competitive and no doubt you are in that particular space. But when you are being competitive in that space you are really competing for business from small businesses that are in the top end in terms of looking for finance, where they can meet the lending criteria that you put in place, which I imagine would be similar lending criteria to what the other major banks and probably most ADIs have when a small business says, 'I need some money for what I am doing.' But for the economy to be firing on all cylinders small businesses need to be able to get out there and do things which require funding. They do not necessarily have the ability to meet the lending criteria of the major banks and maybe other ADIs. One of the things that we have seen over the last two years is that segment of the market that actually did provide finance to a lot of those small businesses has dried up. How do we address that? I know it is not necessarily the Commonwealth Bank's responsibility to do that, but how do we address it? How can we as a committee make recommendations for changes that would actually foster or facilitate small businesses being able to access funding who would not, in the normal course of events, meet your lending criteria?

Mr Narev—There are a couple of different questions there that need thinking about. Firstly, post the global financial crisis there is a legitimate question to be asked about what at any stage of a small business's life, including in particular the stage you are talking about, which is more sort of the venture stage—

Senator BUSHBY—Not just venture. Sometimes it might be expanding an existing business or even refinancing a business that has been ongoing and successful for a number of years. It might not have the security that you require or otherwise might not meet your lending criteria.

Mr Narev—I think there are two different questions there. Firstly, what role does debt need to play in that answers versus equity? There is no doubt that in an environment where wholesale funding and funding generally is more scare than it was, people's expectations about how much of their balance sheet at different stages can consist of debt I suspect really have changed in business. That is part one of the question. Part two of the question is: we are obviously a conservative institution. We have been around for many years on the basis that we are a conservative institution and probably will continue to be a conservative institution. What I would expect would arise over time as and when funding becomes more available is that other institutions provide credit to those sorts of small businesses at what we would expect to be a higher interest rate to reflect the extra cost of risk. I do not expect that you will see us playing very aggressively in that part of the market. We may at some stage decide to do a little bit more than we are doing today, but as you have identified it is not the sweet spot for us, nor I suspect possibly the other major banks.

Mr Brewis-Weston—We are not a big player in that market. We do have an unsecured credit card, which of course is with a personal guarantee, and that has been a reasonably popular product. It does not make up a significant portion of our portfolio, and it is really lending up to $50,000. We also similarly have a simplified overdraft which relies on a personal guarantee, which has stepped away from having bricks and mortar security. It is not a large part of our portfolio. But I think Mr Narev is correct in suggesting that there has to be a role for small business access—perhaps an equity type investor fund. For the time being with the GFC they seem to be a little bit missing in action as well.

Senator BUSHBY—Do you think the government could have a role? We have had discussions today about some of the activities in other jurisdictions, where government might guarantee small business loans in return for a fee. There are clearly industrial development banks. Korea has a Korean Industrial Development Dank, which I think has a requirement that 70 per cent of its business must be written to small business. There are different things that governments do in different places. Do you think there is a role for government to intervene in some way to actually assist small businesses who do not meet normal lending criteria?

Mr Brewis-Weston—I think there quite possibly is. I think the challenge always for government is moral hazard and adverse selection when you get into these schemes. Some have been successful and some have failed. Ultimately I think that is a question for government and probably depends on the size of any problem, either real or perceived, that the market is failing to provide capital to small business.

Senator BUSHBY—You mentioned that your lending criteria have not changed significantly over the last few years. Has the application of those criteria changed at all? Has there been no instruction to decision makers on loans to make fewer exemptions or anything like that that you might otherwise have been doing?

Mr Narev—The heads of the business always look at their own balance between customer needs and the profitability of the shareholders, et cetera, which through different parts of business cycles say maybe you can give a few more waivers, maybe you can give fewer waivers. That has gone on pre crisis, during crisis and post crisis. From the point of view of any mandated instructions like that across the business, no.

Senator BUSHBY—What percentage of revenue of the Commonwealth Bank comes from small business activities?

Mr Narev—I will have to do some mental maths on that. We may need to come back to you on it.

Senator BUSHBY—Also, the percentage of loans written on your book from small business?

Mr Narev—It is probably roughly five per cent. That would be a real ballpark number.

Ms Bayer-Rosmarin—That includes home loans.

Senator BUSHBY—One of the reasons we are here is that we are being told that small businesses have problems in accessing finance. The Australian Chamber of Commerce and Industry, at a general council meeting of its 35 member groups about two weeks ago, as reported in the *Financial Review* on 27 March, made a couple of statements, namely, that ‘access to and renegotiation of affordable finance has now become the most substantial issue facing the day-to-day wellbeing of Australia’s small and medium business sectors’. It went on to say that ‘small businesses were heavily reliant on banks and other lenders for finance because they could not raise money in the market like large firms; that there will be no private sector led recovery amongst small and medium enterprises unless lines of credit are eased and retail banks demonstrate a greater sensitivity to their SME customers. That statement was backed up today by AIG. We have submissions from COSBOA. We had NARGA here today and they said the same sort of thing. Is that something that you agree with or do you disagree with those statements?

Mr Narev—What we have done on a number of occasions over the last 18 months as we have heard this feedback from the market is check the facts in our book. By ‘the facts’ I mean what percentage are our overall loan balances growing? Have our risk criteria changed? Have our acceptance rates changed? How is our pricing relative to competitors? What proportion of our small business loans are becoming troubled loans? Whichever we cut and dice our own data and get the facts on it within our book, it points to the same conclusions we have outlined here, which is, speaking solely from the position of the Commonwealth Bank, we believe that we have not been a major contributor to the effect that you have outlined there such that it exists.

Senator BUSHBY—You say that 93 per cent to 95 per cent of applications are approved, and that is consistent with what was happening during the global financial turmoil and prior to that. That seems very high to me. It is actually higher than what we have seen from the other major banks in the submissions that we received. Is there a vetting process?

Mr Narev—Obviously, these are loans that our business bankers at the frontline decide they want to put into the system. What I should point out is that obviously from the point of view of our frontline people what they are generally trying to do, from the point of view of both what they came to the bank to do and our performance expectations of them, is lend to small business customers. But the good bankers obviously know a deal when they see a deal and know a bad deal when they see a bad deal. Therefore, most of our bankers have the experience to be able to say, 'This is probably something that I wouldn't submit; it is not really a good deal.' But again, anecdotally having spoken to them, we do not believe that they have been doing that to a significant extent more than they were doing so pre the global financial crisis.

Senator BUSHBY—No, but small businesses probably have fewer options than they had pre the global financial crisis.

Mr Narev—I expect that is the case.

Senator BUSHBY—More of them may be coming to your business bankers and saying, 'How about it?' And they are sending them away without even going to the formal application stage, which may well be feeding into what—

Mr Narev—My expectation—although this would be purely impressionistic also—is that given our reputation as a pretty conservative institution I am not sure we would necessarily be the first port of call for a lot of those customers as well.

Senator BUSHBY—One of the things we discussed earlier today as well was a suggestion that there was a fall in demand by small businesses for lending and that that was at least in part caused by the fact that people were being more cautious because of the economic times. But also, would you disagree that there would be some small businesses that, because there are fewer options and because of the tightening of lending criteria in general with ADIs, which have been acknowledged by the RBA—I know you say that you have not changed yours, but because of the general tightening—are just not seeking money to expand, because they just do not think they are going to get it?

Mr Narev—I would suspect that is the case. I think that both causes you have identified—that one and also your previous one—we have certainly experienced, which is our clients saying, 'Look, previously I might have wanted to borrow this amount of money to expand but I will hold off on doing that for six to 12 months, two years.' We are definitely seeing that effect among our own customer base.

Senator BUSHBY—In a time when we are actually trying to recover that is probably not a good thing for the overall economy.

Mr Narev—And, frankly, a lot of the discussions often that we are having with our best customers, who we know to be creditworthy, are often, 'Look, this is actually a good time to be doing the expansion’, because to come back to my earlier point, it is in our interests to have those clients do more business with us.

Senator BUSHBY—A question I also asked of Westpac: you explained why from your perspective secured SME lending attracts a premium, and that is the risk involved, and Westpac made the same point. But from an actual financial perspective, what is the cost of that greater risk if you are ultimately secured and in the end you are going to recover the costs even if you do actually have to chase after it?

Mr Narev—That is a fair question. We look at two aspects when we are assessing the actual cost of risk. One is the likelihood that the customer will default. We call it probability of default. And the second is the likely loss we are going to incur if they do default. The reality is, as you have identified, when you have secured lending at the end of the day you are likely to get the substantial part or all of your money back. One of the major differences, though, is your cost of actually getting to that point. Once a customer defaults, which we know to be more likely from a historic model point of view in business loans versus residential loans, that automatically starts incurring costs from the bank in legal fees, recovery fees and all those sorts of things. So, it is not just a matter of saying it is $100,000 loan with $100,000 security.

Senator BUSHBY—But in most cases I would imagine that your legal people would have ensured that your contract that you have signed with a borrower contains clauses that allow you to recover those costs?

Mr Narev—I can assure you that in the cases where we are trying to recover assets there are costs that we incur that we cannot ever recover back from the customer.

Senator BUSHBY—That is what you build in—

Mr Brewis-Weston—Also, the time it actually takes to recover could be up to 12 months or longer. There is also the opportunity cost as well. There are costs associated with the ongoing management of that asset until you can realise that asset, and many of those costs we just cannot pass on.

Senator BUSHBY—We are trying to identify whether there are things that could be done to improve and facilitate greater access to finance by small business. Are there any regulatory constraints or regulatory issues that the CBA faces that actually make it harder for you to provide finance to small businesses in a cost-effective manner?

Mr Narev—Regulations germane specifically to the small business sector, no. The major regulatory changes that we talk about and are concerned about from the Commonwealth Bank group as a whole are regulatory changes relating to overall capital requirements, ability to access wholesale funding, et cetera. To the extent that there are material changes in those sorts of regulations they might flow through into the availability of credit to small business and indeed to home loans and other different types of lending. But in terms of regulations specific to small business—I do not know whether you want to add anything—the answer would be no.

Senator BUSHBY—The general stuff is what I am interested in. The Basel II requirements that may well be imposing obligations on you that from a conservative organisation’s perspective you consider are not necessary, but which actually add costs—potentially some of the stuff that they are talking about introducing internationally at the moment.

Mr Narev—There is no doubt that the regulation relating to either our ability to access wholesale funds, liquidity requirements or the cost at which we are able to access those funds can have an impact on this sector.

Senator BUSHBY—Do you have any specifics?

Mr Narev—In terms of numbers, we do not know, because as you can imagine the numbers at the moment in terms of potential outcomes are a moving feast. We are modelling all these things, but I do not have any specific numbers on that at the moment.

CHAIR—We thank the Commonwealth Bank for appearing. I have found your evidence very interesting, I must say. With that I close this hearing.

Committee adjourned at 4.52 pm