"Banks, Business Lending & the Economy II"

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Earlier this year I addressed a Melbourne American Chamber of Commerce luncheon on the topic of Banks, Business Lending and the Economy. I highlighted the critical role small to medium-sized businesses, or "SMEs", play in our economy, and discussed how many SMEs do not feel well served by our banking system. I also raised the issue of whether the apparent bias of our banking system towards home lending is ultimately best serving Australia's long-term economic interests.

I am grateful to have the opportunity today to expand on my thoughts and respond to the discussion my comments have generated. In doing so, I also want to draw in a connected theme and highlight the potential impacts of the Australian banking system's reliance on international wholesale funding.

My thinking on this topic stems from the fact that there is a real concern from SMEs that access to bank lending has become a big issue. Whilst banks will each individually say that they have not stopped lending to SMEs, the reality is that during the Global Financial Crisis (GFC), business lending did decline, in part due to demand, in part, evidence would suggest, due to difficulties accessing credit. The Australian Chamber of Commerce and Industry (ACCI) noted that banks have become more risk averse since the GFC: "whilst the cost of finance is an issue …, an immediate and greater concern for small businesses is the availability of finance from major lenders"[1]. These views are echoed by the Council of Small Business Organisations of Australia (COSBOA).

I believe Robert Gottliebsen got it right when he argued that "this is a matter too serious for bank bashing. The Australian banking industry, as it is presently structured, is unable to fund the needs of SMEs".[2]

Today I also want to address what I believe is a serious misconception when it comes to business lending; that is that the margin charged to businesses by lenders is unjustly high relative to other forms of credit, in particular, the margin charged on residential mortgages.

Let me start with my key theme, the availability of finance to SMEs. The term so often used to describe SMEs, "the engine room of the economy", is not a throw-away line. It is an economic reality. SMEs are Australia's largest employers and largest contributors to GDP.

Given that we have a strong banking system, it is legitimate to ask why some SMEs are finding it difficult to access credit. To understand this, we need to consider the distinctive characteristics of our banking system:

First, Australia has a low deposit to loan ratio – less than 60 per cent of all lending is funded by domestic deposits - and thus a significant reliance on wholesale and in particular offshore funding. The GFC highlighted this as a material structural issue. The collapse, or near collapse, of many banks around the world had much more to do with poor funding models exacerbated, in some cases, by rapid asset growth, than it did with problems within their lending portfolios (though there were problems there also). In other words, rapid growth required a high dependence on wholesale funding at a time when those markets closed and this highlighted the fact that such an approach may not be a prudent way to run a bank. In this sense, the GFC was a classic 'Black Swan' event.

Second, a segment of the Australian lending market, foreign banks, minor banks and non-bank financial institutions (NBFIs), grew strongly in the decade up to 2009, reaching close to one third of Australia's lending system and ~20 per cent of lending to SMEs. But in many cases these players were ill-equipped to cope with the shocks of the GFC and they were either acquired or withdrew lending capacity from our domestic market. This undoubtedly impacted business' borrowing and SMEs in particular.

Third, Australia has in relative terms a high exposure to, and arguably a lending bias toward the household sector, which has been particularly evident since the introduction of Basel II and the GFC, where the evidence suggests that bank capital has been aggressively redirected into the higher return/lower risk retail banking market and away from business lending. This concentration in home lending has some potentially important consequences for our financial system and our economy.

Let me explore this third point a little further. The efficiency of capital allocation by the banking system is important to the long-term growth potential of the economy, and any bias towards one asset class over

[1] ACCI submission to the Senate Inquiry, March 2010 p11
[2] 'Where the banks are failing Australia' Eureka Report, Robert Gottliebsen, 30 April 2010

another is potentially harmful. A bias towards allocating capital to home lending may mean there is less credit to allocate to business, the most productive area of the economy. This is ultimately bad for growth, bad for competition, bad for jobs, bad for business and in the end bad for Australia.

This is not to say that there are not considerable benefits for the economy and society from lending to households, such as residential mortgages that allow for consumption smoothing over a life cycle. However, different forms of credit (e.g. real estate versus small business lending) can have materially different economic implications, both positive and potentially negative.

It is difficult to argue against the premise that Australia has a bias towards home lending when you consider the following facts. Since 2000, Australian home lending grew from ~$280 billion to $1.1 trillion today.[3] In 2000, every $1000 of home lending was matched by a roughly equivalent amount of business lending. By 2010, for every $1000 of home lending, there was only around $600 of business lending.

Australia's ratio of household debt to income is close to 150 per cent and amongst the highest in the developed world. The debt levels in our household sector now exceed our GDP and the average home price is now six times average income.

A directionally similar trend was evident in the UK, which prompted Lord Turner to comment that:

> "The easy availability of mortgage credit can generate a credit/asset price cycle, and can encourage households to select levels of income leverage which . . . increases vulnerability to employment or income shocks . . . And it can tempt some individuals, in pursuit of prospective capital gain, into debt contracts which harm their individual welfare rather than maximise it."[4]

The collapse of the US housing market over 2008-09 should remind us of the broader economic and societal damage that a severe deterioration in home lending credit quality can cause, and, that 'Black Swan' events do happen. Expert views should not get in the way of critical thinking from others. Remember, Messrs Greenspan and Bernanke dismissed concerns about the property market in the US, just prior to its meltdown.

The balance sheet composition of the four major Australian banks further proves the bias towards home lending; particularly at the large Sydney-based banks which both have more than 60 per cent of their total loans in mortgage lending. NAB's tilt toward business lending means less than 50 per cent of our total loans is home lending. In 2000, home lending was 43 per cent of all lending; today it is 57 per cent, whereas business lending in the same period has fallen from 46 per cent to 35 per cent.

Little wonder Don Argus recently quipped that Australian banks have become more like "building societies".

What ultimately drives biases in credit allocation within any economy is complex, and can include demand related influences reflecting social factors, such as the worthy and great 'Australian dream' of owning one's home, as well as government policy, taxation and, in recent times, fiscal stimulus, particularly through the government's First Home Owner's Grant.

There is a related issue, which is the role bank lending can play in fuelling asset prices, which in turn drives credit supply in a self-reinforcing and potentially destabilising manner. The risk is that lending biased to one sector may crowd out lending to other sectors that are more critical to ensuring longer term growth. In a banking sector (and economy) heavily reliant on offshore wholesale funding, this is an issue that warrants consideration, which I will come back to.

Ultimately though, the bias towards home lending has clearly been influenced by the international Basel II capital adequacy rules which took effect in Australia in 2007-08.

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[3] Today approximately 70 per cent of this is for owner occupied housing, with 30 per cent for investment housing.
[4] 'What Do Banks Do, What Should They Do And What Public Policies Are Needed To Ensure Best Results For The Real Economy?' Lord Turner, 17th March, 2010

These rules implicitly encourage banks to favour residential mortgage lending over business lending as residential mortgages attract a lower capital charge under both standardised and advanced accreditation frameworks.

This means that banks can do on average three to four times more mortgage lending relative to business lending in terms of capital management. All other things being equal, we have a system that makes it more attractive for banks to lend the marginal dollar on a weekend holiday home than to a small business! One could reasonably regard this outcome as perverse.

This is important because it is well known that Australia has, and will continue to have, a reliance on international term debt to fund its current account deficit. The question this raises for the Australian economy is: does it make sense to pour the lion's share of the marginal funding dollar into mortgages, rather than business lending and infrastructure development? Is this really in the best interests of improving the long-term performance and productive capacity of the Australian economy and living standards of the Australian people?

This is not a theoretical question on trade-offs.

In a recent piece of research, UBS asked, "How can Banks Fund Australia's growth?"[5] They highlighted potential capacity constraints and suggested that if credit growth hits 8.5 per cent pa, then new wholesale term debt issuances will need to rise from ~$140bn pa in 2010 to >$300bn pa by 2014 to fill the gap. This would take the wholesale term funding balance from $257bn to $800bn by 2014. Australian banks are already amongst the largest issuers in the global debt markets and this financing challenge will be exacerbated if or when other global banks start repairing their AA ratings.

The risk that foreign investors, faced with substantial borrowing demands from banks in other markets, governments (many of whom are running sizeable deficits) and corporates, may have a limit on their appetite for Australian bank paper, should not be lightly dismissed. To assume that the appetite is limitless would be cavalier.

If there is a concerted effort to reduce reliance on wholesale funding and increase the net stable funding ratio as proposed by APRA, together with the steps proposed under potential new international bank regulations constraining bank leverage, then one possible consequence is that there will be pressure on Australian banks to shrink their balance sheets. This is an issue as the link between debt and economic growth is well established. According to one expert[6], the global economy probably needs around $4 to $5 of debt to create $1 of GDP growth. With even less money to lend, there is a risk that the bias towards home lending will only increase, given the opportunity cost on marginal capital.

If banks do alleviate their own funding pressures by constraining credit, that would not only dent economic growth, but also raise credit risk for all banks.

In our economy, larger firms have many financing options open to them from equity raising, various debt capital markets, including the intention to grow the corporate bond market, and the banks. However SMEs largely rely on the banks and near banks.

Very small businesses often find themselves in a particularly difficult position, which warrants special consideration. Banks often struggle to provide credit to businesses with a limited track record and little in the way of tangible security, such as a residential home. At the same time, entrepreneurs can be reluctant to put at risk their family home in pursuit of a new business idea. Banks that push residentially secured business loans as the preferred option, without appreciating and understanding the considerations for each particular small business customer, demonstrate a lack of affinity with the demands of small business financing (and highlight their natural affinity with residential mortgage lending!). The idea of venture capital can be even more unappealing for many entrepreneurs.

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[5] How can Banks fund Australia's growth? UBS Investment Research, 22nd April 2010
[6] *GFC Cures – Placebo Effects*, Satyajit Das, 2009. See also Collateral Damage: Preparing for a Two-Speed World, Boston Consulting Group, 2010

So when the only avenue open seems to be debt, the argument that SMEs are being charged higher interest rates so that banks can subsidise the lower rates they charge to personal mortgage customers becomes an important one to address.

The ACCI in their submission to the Senate Inquiry into Small Business' Access to Finance highlighted that small businesses were paying a margin of 3.97 per cent above the official cash rate on average for bank finance, compared to a margin of 2.29 percent for larger businesses and 2.32 percent for mortgage customers[7], which indicates that SMEs are in fact paying relatively higher margins.

However, the assumption that product pricing in one business - such as residential mortgages - is directly related to, or being subsidised by, the product pricing in another – such as business loans - is simplistic and wrong for several reasons:

Firstly, as I have already noted, as a result of Basel II, the capital requirements for business lending are far more onerous than they are for mortgages. It is just simply more costly for banks to lend to businesses than to personal customers. As a guide, every 1 per cent of capital requirement represents an approximate 10bps cost to margins, so under Basel II, residential mortgages require on average 20bps of margin to fund capital costs, versus around 80bps for business lending[8]. Fact.

Secondly, another reason business customers are often required to pay higher interest rates is because history shows that the risks as measured by the probability of default (PD), the loss given default (LGD) and eventual loss rates, are much higher. Fact.

As a result of both the favourable risk and capital treatment on residential lending, the overall industry return on equity that banks are making on residential mortgages has been materially advantaged relative to business loans. Basel II has been a big boost to banks with a strong Retail Banking franchise, enhancing returns on what was an already very profitable segment by lowering the cost of capital required to be funded out of margins. Fact.

So in summary, in my view there is a sound economic justification for the difference in pricing for business and home lending and commentary alleging cross-subsidisation is unfounded.

Conclusions:

I have covered a lot of ground and would like to leave you with four key thoughts:

1. We shouldn't ignore the fact that businesses do not feel well served by our banking system. At NAB, we are proud to have loaned well over $100 billion to SMEs, but we are also very conscious of, and concerned by, any sense that credit is not available to support good businesses. Consideration needs to be given to what the long-term effects of this are and how this might impact Australia's longer term economic progress and growth.
2. Banks need to do better in explaining loan pricing differentials between business and residential mortgage lending, factoring in risk and regulatory capital differentials, to counter some of the currently popular but simplistic assumptions underpinning remarks on business lending.
3. Providing SMEs with access to credit is pivotal to a healthy economy. A banking system which does this plays a critical economic and societal role. Time will tell if our banking system's increasing bias towards home lending, with its significant reliance on wholesale funding with its potential future constraints, is ultimately best serving Australia's long-term economic interests.
4. Considering this, it is important that industry participants, policy makers and the business community question the extent to which the Basel II capital rules create an economically unhealthy bias towards residential lending (and retail banking) and distort capital allocation away from critical entrepreneurial and highly productive sectors of the economy. A key question is, how does the Basel II regulatory requirements reconcile with the wider economic and societal expectations of banks?

[7] Australiam Chamber of Commerce and Industry submission to The Senate Inquiry, March 2010, p6
[8] See APS330 Home Lending Data – Applications & Insights, Institute of Actuaries, Tim Gorst, May, 2010

It was pleasing to note that the recently completed inquiry by the Senate Economics Committee into Small Business' Access to Finance examined in some detail, the influence of Basel related capital rules on Australian lending patterns. Significantly, the report issued by the Government members of the Committee expressed concern that the Basel rules 'encourage banks to favour residential mortgage lending over business lending'; and more information on the significance of this problem has been requested by the Senators. This is an encouraging development.

When regulators and policy makers consider the future of the small business sector and their funding requirements, the issue of capital allocation required against their loans should be the focus of their efforts.

A final comment: the banking industry, which is central to our economy, has many stakeholders, often with different and sometimes competing expectations. During the financial crisis we saw a lot of cooperation between three of these stakeholders - APRA, the RBA and Treasury. As we move into the next phase of looking at the future growth of the Australian economy, it is important that these key stakeholders actively engage and communicate their expectations of the banking and financial system framework that will facilitate growth over the next few decades. They will need to recognise and reconcile a range of factors such as biases created by Basel II, credit needs of SMEs, essential infrastructure spend, Australia's reliance on and potential constraints of wholesale funding, the impact of compulsory superannuation on savings patterns and the proposed new regulatory requirements governing bank balance sheets and liquidity.

The challenges here are significant and quick-fix or headline grabbing solutions will not suffice.

As I mentioned earlier, my ultimate aim is to encourage a well informed discussion on the issues causing small businesses to feel that they are not being adequately supported. These are key public policy issues for Government, for regulators and for the industry.

Thank you again for your time today – I appreciate the opportunity to continue the debate and sincerely welcome the views of others.