BANK LENDING TO SMALL BUSINESSES

INTRODUCTION

It is widely recognised that small businesses have an important role to play in economic growth. They provide a crucial source of entrepreneurship, innovation, jobs and exports. One factor often cited as impeding the growth of small businesses is inadequate access to capital - both equity and loans. A lot of attention is given in this context to problems in the relationship between banks and small businesses.

This article focuses on some of these issues. In doing so, it draws upon some additional sources of information which the Bank has initiated to help it get a better handle on matters affecting small businesses and their banks.

(i) In the middle of last year, the Bank established a small business advisory panel which consists of principals of small businesses operating in all States and covering a range of industries, including some engaged in exporting. Panel meetings in August 1993 and February 1994 have provided the Bank with an opportunity to hear first-hand from practising small business people about their financing needs and their relationships with banks. This, in turn, has assisted the Bank in its regular discussions with banks on small business issues.

(ii) Last year the Bank also instituted a new quarterly collection of statistics from banks on their lending to small businesses; the first results, which pertain to December 1993, are now available.

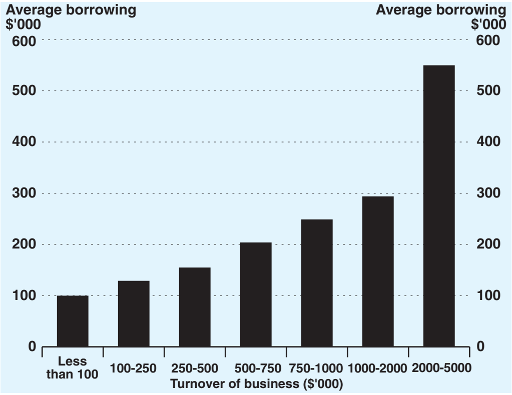
(iii) The Bank commissioned a survey of small and medium sized businesses in metropolitan areas to provide information on their attitudes to, and experiences with, banks. This was supplemented by results from a survey of rural businesses.

STATISTICS ON BANK LENDING TO SMALL BUSINESSES

A lot of data are available on banks' loans to businesses but few deal specifically with small businesses. The Bank's new collection is designed to fill that gap. Its first task was to define a 'small business'. Two obvious yardsticks are size of turnover and number of employees, but banks do not routinely collect this information from their customers when making loans. For practical reasons, therefore, it was decided to base the collection on the size of loan, the assumption being that size of loan is correlated with size of business. This seems to be a reasonable assumption on the basis of a cross-check with the survey results reported in the next section. In that survey, firms were asked to provide information on their turnover and the size of their borrowings. The results are shown in Graph 1 and suggest a strong correlation between the two. In quantitative terms, it is reasonable to identify borrowings of up to about $500,000 as being for businesses with turnovers of up to about $5 million, which seems a suitable cut-off point for small business.

Graph 1

Small Business Borrowings by Size of Business



In the new statistical collection, small business loans can be thought of as loans of $500,000 or less, although data are also presented for larger loans. At the end of December 1993, banks' loans of $100,000 or less to businesses amounted to $15.4 billion and loans of between $100,000 and $500,000 to a further $29.2 billion. Together, these small business loans accounted for about a third of total business credit provided by banks. In terms of numbers of loans, small business loans account for the majority of the banks' business loans.

The main feature of the new statistical collection is a classification of size of loans by the average interest rate charged. This is collected separately for variable interest rate loans, fixed interest rate loans and bill facilities. Business lending is also classified by sector and by purpose of borrowing. These results are shown in Table 1, which will be published each quarter from now on as Table B.16 in the Reserve Bank *Bulletin*. These data will, over time, assist in the analysis of trends in banks' lending to small businesses.

While the 'snapshot' presented by the December 1993 data does not say anything about trends, it does permit some general observations on lending to small businesses.

(i) Smaller businesses rely more heavily on variable rate loans than do larger businesses (Table 2). For small businesses (with loans under $500,000), 39 per cent of borrowing at December 1993 was at variable rates, compared with 15 per cent for larger businesses (with loans over $500,000). Variable rate loans include overdrafts and fully drawn loans where the interest rate is adjusted in line with an indicator rate, frequently called a 'prime lending rate', plus a margin for risk. Smaller businesses make slightly more use of fixed rate loans than larger businesses, but the variation here is less marked. In the case of bill finance, however, smaller businesses make much less use of it (29 per cent) compared with larger businesses, for which it is the major source of finance (62 per cent).

The heavier weighting of variable rate loans in the smaller business category reflects the convenience of overdraft credit for many very small businesses where the need for credit fluctuates over time and results in overdrafts being by far the most common form of borrowing for small businesses. Fixed rate loans are also widely used, many in the form of leases. Bill facilities lack the flexibility of overdrafts and the simplicity of leases and for these and other reasons are accessed less by small businesses.

(ii) On average, variable rate loans (such as overdrafts) tend to be more expensive than other facilities (Table 3). The average cost of variable rate loans of all sizes in December 1993 was 10.5 per cent, compared with indicator rates for variable rate business loans of between 8.95 and 9.5 per cent. This implies an average customer risk margin of between 1 and $1^1/_2$ per cent. Average

Table 1: All Banks Lending to Business (a)

As at December 1993

($ million)

Variable-interest rate loans outstanding by size and by interest rate (b)

Per cent per annum	Under $100,000	$100,000 to $500,000	$500,000 to $2 million	$2 million and over	Total
Under 8%	117	205	336	2 336	2 994
8% to less than 9%	207	526	581	1 113	2 427
9% to less than 10%	981	1 705	1 094	2 213	5 994
10% to less than 11%	2 020	2 348	913	615	5 896
11% to less than 12%	4 276	3 112	1 109	1 220	9 717
12% to less than 13%	622	545	254	362	1 783
13% and over	291	364	295	1 058	2 007
Total	8 514	8 804	4 583	8 916	30 818

Fixed-interest rate loans outstanding by size and by interest rate (b)

Per cent per annum	Under $100,000	$100,000 to $500,000	$500,000 to $2 million	$2 million and over	Total
Under 6%	17	303	88	4 583	4 991
6% to less than 7%	55	175	172	1 582	1 985
7% to less than 8%	283	713	964	2 084	4 044
8% to less than 9%	712	2 022	1 409	2 087	6 231
9% to less than 10%	1 581	2 666	1 183	1 567	6 996
10% to less than 11%	753	999	605	676	3 032
11% to less than 12%	689	882	472	995	3 037
12% to less than 13%	374	406	243	352	1 375
13% and over	719	810	770	1 818	4 117
Total	5 183	8 974	5 906	15 744	35 807

Bills outstanding by size and by interest rate (c)

Per cent per annum	Under $100,000	$100,000 to $500,000	$500,000 to $2 million	$2 million and over	Total
Under 5%	6	28	82	2 179	2 293
5% to less than 6%	16	309	752	12 948	14 026
6% to less than 7%	104	655	2 625	17 698	21 082
7% to less than 8%	708	5 201	6 190	4 962	17 062
8% to less than 9%	497	2 877	1 338	1 266	5 978
9% to less than 10%	140	593	712	1 014	2 459
10% and over	214	1 735	2 259	2 493	6 700
Total	1 685	11 398	13 959	42 559	69 601

Table 1: All Banks Lending to Business (a)

As at December 1993

($ million)

Total credit outstanding by size and by sector (d)(e)

	Under $100,000	$100,000 to $500,000	$500,000 to $2 million	$2 million and over	Total
Agriculture, fishing, etc	2 888	4 666	2 130	2 330	12 014
Mining	74	230	244	2 195	2 744
Manufacturing	1 208	2 144	2 495	10 031	15 878
Construction	1 179	1 758	1 595	4 071	8 603
Wholesale trade, retail trade and transport & storage	3 949	5 996	4 081	8 516	22 542
Finance & insurance	1 311	4 089	5 208	23 231	33 839
Other	4 774	10 294	8 696	16 844	40 608
Total	15 383	29 177	24 449	67 218	136 226

New credit approvals by size and by purpose (f)

	Under $100,000	$100,000 to $500,000	$500,000 to $2 million	$2 million and over	Total
Commitments under fixed loan facilities:					
Construction finance	106	213	156	351	827
Purchase of real property	349	942	400	561	2 252
Wholesale finance	30	31	11	143	215
Purchase of plant & equipment	218	95	30	184	527
Refinancing	179	501	202	475	1 356
Other	275	382	197	704	1 558
Commitments under revolving credit facilities:	947	1 220	948	5 184	8 297
New lease commitments	276	109	40	151	576
Total	2 381	3 492	1 984	7 753	15 610

(a) Totals may not add precisely due to rounding.
(b) Within each interest band, the interest rate charged on loans includes a margin for credit risk. The cost of loan fees and charges is not included.
(c) Bills include acceptance and endorsement facilities. Within each interest band, the annual cost of bill finance is expressed as a percentage of the face value of the bill. It includes the bill discount plus certain ongoing fees associated with bill lines. Amounts for bills outstanding include loan facilities on which interest rates are tied to bank bill reference rates.
(d) Includes variable and fixed-interest rate loans outstanding plus bills outstanding.
(e) Industry categories are based on the Australian and New Zealand Standard Industrial Classification (ANZSIC) groups of industries.
(f) Gross new lending commitments to business during the relevant calendar quarter, classified by purpose. A lending commitment is a firm offer to provide finance which has been or is normally expected to be accepted by the borrower.

Table 2: Outstanding Borrowings by Type of Facility
(per cent of total)

	Smaller Businesses			Larger Businesses			All Businesses
	Under $100,000	$100,000 to $500,000	Average	$500,000 to $2 million	Over $2 million	Average	Average
Variable rate loans	55	30	39	19	13	15	23
Fixed rate loans	34	31	32	24	24	23	26
Bill facilities	11	39	29	57	63	62	51

interest rates for all loans were 9.2 per cent for fixed rate credit and 7.2 per cent for bill financing. In each case, the average rates were highest where the loan was smallest.

The higher cost of overdrafts in part reflects the fact that these facilities incorporate an option to draw down (within approved limits) and repay at will. This option is valuable to the borrower, involves some cost to lenders, and results in a higher interest rate on such loans. The cost of bill financing varies from day to day according to rates in the money market. Fixed rate loans are renegotiated infrequently on the basis of relevant medium-term rates at the time so that the average loan rate responds to movements in market rates with a lag; many fixed rate loans currently in existence were probably taken out in the late 1980s and early 1990s when market rates were higher than they are now. With medium-term rates higher than bill rates, fixed rate loans, on average, are more expensive than bill facilities.

(iii) Smaller borrowings tend to involve higher interest rates. The differences in interest rates between large and small borrowings are not large, however - eg. for variable rate loans, the average rate paid on loans of under $100,000 is 1.3 percentage points higher than the average paid on loans over $2 million. For fixed rate loans and bill finance, the differences are 2.1 and 1.7 percentage points, respectively.[1]

Two main factors are at work here. One is that smaller businesses are perceived by banks as involving higher risk, which seems a reasonable assessment *on average*, since smaller businesses tend to be newer and to have a much higher ratio of

Table 3: Weighted Average Interest Rates
(per cent)

	Smaller Businesses			Larger Businesses			All Businesses
	Under $100,000	$100,000 to $500,000	Average	$500,000 to $2 million	Over $2 million	Average	Average
Variable rate loans	11.1	10.7	10.9	10.3	9.8	10.0	10.5
Fixed rate loans	10.4	9.7	10.0	9.7	8.3	8.7	9.2
Bill facilities	8.3	8.2	8.2	7.9	6.6	6.9	7.2

[1] There is reason to believe that the average interest rate on large (over $2 million) loans understates the true picture. This is because there is a higher proportion of non-performing loans in this category, many of which have zero or below market rates applying to them during the workout phase.

borrowings to turnover than larger businesses. Secondly, there are economies of scale in lending. The basic costs of establishing and monitoring smaller loans are similar to those for large loans and, given that such costs are not recovered fully through establishment and maintenance fees, banks tend to compensate for these costs by charging higher interest rates.

(iv) There is little evidence of new lending occurring at very high interest rates (such as the 17 or 18 per cent occasionally quoted in newspaper stories). Within the variable rate category of loans of under $100,000, only 3 per cent were at interest rates of 13 per cent or more. Some of these were overdrafts which had been drawn down in excess of approved limits, and hence attracted penalty rates. For fixed rate loans, the corresponding proportion is 14 per cent but, as explained earlier, this is a lagging measure and would reflect some loans taken out in earlier periods when interest rates were much higher than they are today. As these loans mature, the proportion of fixed rate loans at higher interest rates will tend to decline.

BUSINESSES AND BANKS: PERCEPTIONS AND REALITIES

The Bank commissioned two surveys to help gauge small businesses' general attitudes towards banks and their actual experiences with their bank. The survey of metropolitan businesses took place in 1992/93 and covered 6,000 enterprises with annual turnovers of up to $5 million, employing people other than the proprietor.[2] It had a broad coverage of industry sectors and of business structures (proprietorships, partnerships, franchises); about one-third of the surveyed businesses was engaged in international trade. The other survey covered a cross-section of 1,200 enterprises engaged in various forms of primary production in the five mainland States.[3]

(a) Businesses' attitudes to banks

Attitudinal surveys are subject to many qualifications and sometimes throw up what appear to be paradoxical results. In these surveys, when small businesses were asked whether they were satisfied with the performance of banks, a majority gave positive responses. When the same businesses were asked to indicate areas of dissatisfaction, however, a majority had no difficulty identifying aspects of banks' performances which they were unhappy about.

The first set of results are summarised in Tables 4a and 4b. Among metropolitan businesses, banks scored quite high marks for honesty, branch service and account management. Rural businesses, if anything, recorded higher levels of satisfaction than their metropolitan counterparts, and put a greater weight on personal relationships. At the other end of the scale, banks get few plaudits for innovation from metropolitan businesses.

When asked to specify areas of dissatisfaction with banks, metropolitan businesses were able to point frequently to a number of problem areas (see Table 5). The

Table 4(a): Satisfaction with Banks
(Metropolitan businesses)

Proportion of businesses satisfied:	(%)
Honesty and trustworthiness	78
Branch service	76
Account management	73
Support of the company	67
Competency and efficiency	66
Believing what banks say	64
Responsiveness and flexibility	61
Acting in the company's interests	57
Innovation	46

[2] This was conducted by the Financial Products Research Group Pty Ltd.

[3] This was conducted by Agri-Mark Consultants Pty Ltd in the second half of 1993.

Table 4(b): Satisfaction with Banks
(Rural businesses)

Proportion of businesses satisfied:	(%)
Helpful branch staff	88
Access to manager	86
Good relationships	82
Phone account access	82
Efficiency	80
Good rural knowledge	76
Understand business	76
Flexible	76
Sees problems	76
Product range	72
Financial reports	72
Problem solving	72
Advice	72
Interest rates	70
Farm visits	64
Fees & charges	62

Table 5: Dissatisfaction with Banks
(Metropolitan businesses)

Proportion of businesses claiming:	(%)
Too much security	73
Unreasonable fees	62
Lack of attention	55
Inconsistent charges	52
Lack of advice on rates	52
Insufficient warning	50
Insufficient information	50
Too much information requested	50
Don't know my business	49
Change managers too often	48
Poor attitude	46
Manager lacks authority	45
Unreasonable terms	45
Reluctant to lend	42
Slow to respond	39
Poorly trained staff	31
Renege on agreements	26
Difficult to see manager	21

two aspects that attracted most dissatisfaction were views that banks sought too much security and charged unreasonable fees; reluctance to lend and unreasonable terms came a long way down the list.

The issue of security for loans is a longstanding source of tension between small business customers and their banks. In many such cases, the tension often reflects shortcomings on both sides, with sometimes unreal expectations on one side and excessive caution and insensitivity on the other. Borrowers can point to cases where banks have adopted a 'belts and braces' approach and insisted on excessive security, but banks can also recount stories of borrowers wishing to keep their equity out of the business and expecting the bank to carry most of the risk. Unsecured lending based on cashflow projections is an attractive concept to borrowers, but difficult and costly for lenders to apply in practice, particularly to new businesses without much of a track record. It seems inevitable that banks will continue to seek security wherever possible in their lending to small businesses, and this will continue to be a bone of contention between them.

What are seen as unreasonable fees is the second major area of dissatisfaction among metropolitan borrowers (and, by implication, a major concern to rural borrowers also). Customers no doubt resent the recent growth in fees, particularly where they have been introduced for services long provided free of charge. Banks respond by pointing out that fees still fall well short of full cost recovery in many cases and that the gap has to be closed through maintaining interest rate margins at higher levels than would otherwise be necessary.

(b) Businesses' experience with banks

The paradoxes implicit in some of the aforementioned responses become rather more stark when businesses' *general impressions* of banks are compared with reports of their *actual experience*. While perceptions are widespread among small businesses that banks are reluctant to lend or set too stringent conditions, the proportion of small businesses which have experienced a credit refusal appears to be quite small (see Table 6).

Table 6: Actual Problems with Banks
(Metropolitan businesses)

Proportion of businesses experiencing:	(%)
Refusal to lend money	7
Funds transfer errors	7
Account/administrative errors	7
Bounced cheque	6
Inflexibility/too many rules/too much security	5
Fees/charges too high	5
Errors in fees & charges	4
Communication/advice/notification	4
Approval/process delays	4
Lost/unavailable/late documents	3
Poor attitude	2
Payroll errors	2
Overseas transactions errors	2
Dishonoured agreement	1
No problems	31

These responses suggest that about 7 per cent of metropolitan businesses experienced a bank refusal to lend in 1992/93. It is hard to know how to interpret this figure, however, because we do not have a normal refusal rate to serve as a benchmark for small businesses (or other categories of borrowers, for that matter). Clearly, the figure should be greater than zero as we would not expect banks to accept every proposition that is put to them. The figure of 7 per cent does seem low, but this may be because a sizeable proportion of respondents had no reason to approach their banks during 1992/93. On the other hand, refusals by banks to lend has not figured prominently in other surveys. In The Yellow Pages *Small Business Index* survey, for example, the proportion of respondents indicating that lack of bank lending was a problem for their business has never been high; it was 5 per cent in the August 1993 survey, zero in the November 1993 survey, and 2 per cent in the February 1994 survey.

One point which has come out in the Bank's survey, and which has been evident from other sources is a strong perception of a lack of on-going contact with, and interest from, banks. This is linked partly to the frequency with which relevant branch or account managers are changed. Businesses believe that bank contacts are often not around long enough to get to know their customers, or for their customers to get to know them. Metropolitan businesses sometimes complain that banks forget about them once a loan is made - or at least until something goes wrong. By contrast, rural businesses generally regard contact with their banks as adequate.

These problems are real, and better relationships between banks and their customers depend on both parties developing and implementing appropriate education and training programs. As an illustration, some small business operators undertake little financial planning and have little understanding of the information which banks need to make new credit decisions and to monitor existing borrowers. Borrowers often do not distinguish clearly between debt and equity finance and perceive problems with the availability of bank finance when the true problem is more a lack of equity capital to support borrowing from banks. These problems have led to a number of initiatives, on the part of both banks and small business groups, aimed at increasing the level of financial knowledge available and at the creation of more standardised loan documentation for use by small businesses.

CONCLUSIONS

Small businesses pay more on average for a given type of bank loan than large businesses but the differences do not appear to be disproportionate, given the greater risks with smaller and newer businesses. The differences tend to be made more noticeable because small businesses can make only limited use of bill financing, and tend to rely more on fully-secured overdrafts. As a consequence, many small businesses believe the interest rates they have to pay are too high, and the security requirements too demanding.

In terms of the availability of credit, several sources point to a clear dichotomy between businesses' general attitudes and their particular experiences. Small businesses often express the general view that banks are letting them down and inhibiting their growth but their individual experiences with banks tend to be more satisfactory. In virtually all surveys where small businesses are asked to name the factors holding back their growth, lack of bank lending comes a fair way down the list.

There is obviously a good deal of scope for improving relationships between banks and their customers. Small businesses are often irritated by a host of actual and perceived problems which extend to the quality of the service provided, the amount of interest shown by the local manager, and so on. Real problems in these areas need to be addressed but, at the same time, things which are essentially irritants to many small businesses stemming from poor relationships (aggravated by the recent recession) should not be mistaken for major problems in the availability or cost of bank finance for the bulk of small businesses.