The Demise in the Craft of SME Banking

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Overview

This paper argues that there has been a market failure in the provision of bank debt to the small-to-medium-sized-enterprise (SME) sector. Linked to this market failure has been the Demise in the *craft* of SME Banking, a competency which is progressively being lost to the Australian economy. This loss is not analogous to the Demise in the blacksmith threatened by the advent of the motor vehicle; this is a loss of a *craft* central to how a nations SMEs flourish. It is akin to the loss of the local GP to on-line self-help medical advice, which may diagnose routine symptoms but lacks personal knowledge to diagnosis serious issues, or to to take early steps if things deteriorate. Extending this analogy, many SMEs decide not to seek advice because of a lack of trust in this impersonal approach.

At the core of this argument is the belief that a nation's financial system is central to its economic prosperity. The nature of that financial system, particularly its banking system, matters. Banks are different from normal businesses. A concentrated banking system protected by a public policy framework and implicitly subject to a government guarantee, is a banking system that is granted special privileges and with those privileges comes obligations and responsibilities to society. In a corporate governance sense, this goes to the heart of *purpose* – why the banking firm exists. This is an important theory of the banking market.

Post-Basel II, coinciding with an 'industrialisation' of the operating models within banks, including credit decisioning, a significant operational and cultural shift took place in the way that banks operated, which has had a material impact on SMEs.

Six inter-related factors explain this systemic shift:

(i) largely driven by ROE based performance incentives, there has been a bias towards lower capital risk weighted household mortgage lending (currently at an eye-watering $1.6trn up from ~280bn in 2000),[1] growing at ~3.5x GDP, whilst, SME lending through the banking system (currently at a stock of ~$250bn) has barely grown as a share of GDP since the GFC. This compares to a long-term growth in SME bank credit at an average of 1.8x GDP pa. In 2000, every $1000 of home lending was matched by $1000 in SME lending. By 2017, every $1000 in home lending was matched by $130 in SME lending.

(ii) given the largely commoditised nature of household lending, a largely oligopoly-structured market has sought to build greater economies of scale, in a drive to further increase the high economic rents already earned.

(iii) banks have 'industrialised' their operating model with a significant underinvestment in customer facing personnel as relationship banking has been devalued and banking 'dehumanised.'

[1] Australian household debt is ~200% of disposable income, with total household liabilities at $2.466bn, representing one of the highest indebted household sectors in the world. www.businessinsider.com.au 18/01/2018

(iv) a largely ‘one-size-fits-all’ approach to SME lending evolved from these changes which has seen property-based security (collateral) dominate in the 4Cs (character, capacity or cash flow, capital and collateral) of credit decisioning.[2]

(v) the emergence of an aggressive sales culture that has prioritised product sales over customer needs.

(vi) a decline in the *craft* of relationship banking and credit decisioning in SME banking, is linked to the progressive decline in *professionalism* within the industry. Credit risk management skills, once seen as a core competency of any banker and a critical condition of career progress, are no longer viewed that way.

This decline in professionalism can be understood by the prevailing underlying culture that has become deeply rooted within the industry where there is no professional accreditation needed to practice as a banker and in many parts of the industry, a proliferation of mid-career hirers from other professions and particularly from management consulting. These talented professionals came with no practical knowledge of or training in banking. They enjoyed the intellectual challenge of complex organisations and the potential in the ‘financialization’ of the economy.[3] This financialization of the economy and conglomerate nature of the banking model coincided with the decline in traditionally trained bankers[4] and the decline in professionalism in banking (or what it meant to be a banker). The financialization of the sector manifested itself in many forms, including a bias towards ‘selling and cross-selling products’ as bankers are charged with making sure that customers support the economics of the conglomerate nature of the firm. Many of the new breed of bank executives had no technical or intuitive skill in understanding risk management. One aspect of this de- professionalisation of banking, has been a breakdown in the risk culture, and with the emergence of a ‘sales culture’ system failures such as evidenced by the level of ‘liar loans.’[5] The decline in professional standards is also evident in the many ethical and conduct issues that have plagued the banks[6]. These cultural issues have been highlighted by the Royal Commission and by widespread customer and societal dissatisfaction with banks.

No sector has suffered more from the industrialisation of the banks and the decline in professional standards than SMEs, who heavily rely on the banks for access to capital, cash management and risk management services. The paucity of the service proposition to SMEs has benefited the broker market which is increasingly disintermediating banks. Brokers now account for ~30% of all new SME loans. This trend (disintermediation) has only had limited benefits to SMEs however as the banking market is concentrated and lacking in meaningful competition. The major banks have a stranglehold on the market and are largely undifferentiated in nature. One former bank director observed: “There is a huge sameness about our banks…. you could switch the brand names of our banks and no one would know the difference. It is very incestuous.”[7]

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[2] ~95% of all SME lending in many banks is property secured

[3] A term used to describe the growing size and influence of finance in the economy

[4] Kay, John (2015) Other People’s Money, profile books, p165

[5] UBS equity research has estimated that this problem could be as high as ~$500bn in the $1,6trn residential mortgage market

[6] ASIC accuses banks’ financial advisers of working against customers interests. www.the guardian.com. 24/01/18. Australian Banks Accused of Rate Rigging www.bloomberg.com. 22/10/17. Probe exposes Australian banks’ abuse of customers. Financial Times 1/5/18

[7] John Dahlsen, Regulators Running Riot, May 31, 2018 p5

The Australian commercial banking is a powerful oligopoly industry, protected by special privileges, allowing the major banks can earn well above their risk-adjusted cost of capital. The trust deficit that has emerged has resulted from an abuse of the privileged position. As with any social licence, there is an expectation that banks will also be guided by the interests of the community when allocating and monitoring credit rather than just that of maximising shareholder value. A fundamental reason why the changes to the way the banks operate has impacted SMEs more than any other segment, is because SME banking must deal with the problem of an information inefficient market, unlike retail or large corporate banking. To deal with this asymmetric information problem banks have largely insisted on real estate security rather than deal with the transaction costs of having bankers close to the customer and able to apply judgement on all the 4C's of credit decisioning. Whilst this approach to SME banking has served the banks well, it has failed their customers. It has resulted in a significant credit gap in the SME sector which Macquarie Bank have estimated to be ~$70bn.[8] This could be viewed as a form of market failure, which is one reason why some experts believe SME financing should be a public policy matter and has resulted in others suggesting that a state sponsored Business Bank is established as has happened in the UK.[9] In the absence of meaningful competition, the banks have leveraged their power to maximise profits, and everything else is secondary.

The economic opportunity cost of how the banks allocate capital is difficult to estimate but the relation between economic growth and SME access to finance is well established.[10] That there is an issue in financing Australian SMEs and that there are associated economic costs has been acknowledged by the Reserve Bank of Australia (RBA).[11]

The composition of a nation's financial system matters and the role that the banking system plays in allocating and monitoring credit is central to the economy. A banking system that has a bias to allocating scarce funding to the household sector because of capital risk weighting advantages which are fundamentally linked to remuneration incentives and that has lost the skills to lend to the SME sector, builds up costs and risks that eventually will become apparent. There is an argument that the Australian banking system, sometimes described as a 'building society system', is susceptible to this risk.

Banking System Overview

Australian banks have profited from a relatively insulated, largely domestic oligopoly. In 2017/18, the four major Australian banks made profits totalling more than ~$34 billion in a market of just 28 million (including New Zealand). These major banks dominate SME lending with ~85% market share, a position boosted by post-GFC market consolidation.

There is no banking system anywhere in the developed world that earns such high economic rents because as former Treasurer Peter Costello succinctly stated: "Our banks are

8 Macquarie Bank Research, The Computer Says Yes, March 2015

9 Affordable Capital for SME Growth. www.asbfeo.gov.au/inquiries/affordable-capital-sme-growth

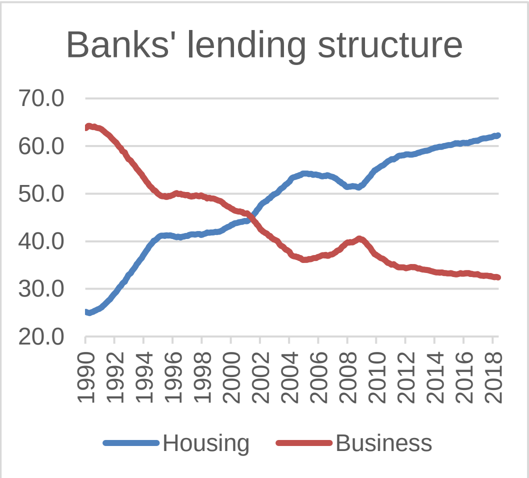
10 Access to finance: SMEs effects on Economic Growth. Lund University www.lup.lub.lu.se

11 Debble, Guy, Business Investment in Australia, UBS Australasia conference 2018

absolutely immune from market discipline, living in a highly profitable cocoon; they think all these high returns are from their own brilliance, but what they haven't understood is they have a unique and privileged regulatory system which has delivered this to them".

A Bias to Household Lending

Amongst Anglo-American economies, a unique characteristic of the Australian financial market is the dominance of the banking system, and the relatively limited fixed income market. The banking system has progressively since the GFC, exhibited a strong bias to household lending predominantly in the owner-occupied market, but increasingly in the higher risk investor market ('buy-to-let'), which accounts for ~30% of all household lending. This bias, which plays to the one-size-fits-all industrialised business models of the banks has resulted in one of the world's most highly leveraged household sectors.



Source: IMF 2018

The Basel II motivated bias of the Australian banks to household mortgage lending, creates a distortion in the system toward household lending relative to business lending. This was a rational response by individual banks given relative ROEs, but arguably irrational for the economy or the risk profile of the system as it can create asset bubbles which can have significant systemic ramifications in the event of a pricing correction (the level of investor-based lending adds to nature of this risk).

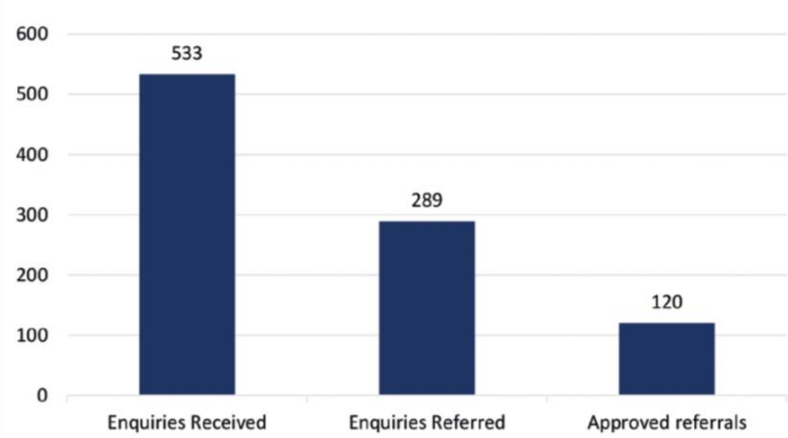
The Demise in the Craft of SME Banking

There is a growing body of research suggesting that as banks grow, and one-stop-shop financial service conglomerates created, that the fundamentals of banking have shifted away from the customer.

Evidence of this can be found in the centralisation of credit decision-making, the continued 'thinning' of banker coverage, the centralisation of customers into call centres, the increasing application of technology, and the introduction of "one-size-fits-all" policies in the quest for standardization, all of which are fundamentally aimed at achieving economies of scale and lower cost-to-income ratios. This however has resulted in a 'dehumanising' of the customer service proposition,[12] which has impacted SMEs more than any other customer segment.

Statistics from MoneyQuest Finance Specialists on the experience of SMEs seeking finance found that 46% of enquiries do not go further than an initial conversation and of the 54% that are considered, only 41% are approved. This leaves just under 22.5% of enquiries resulting in an extension of credit. The rate of early rejection reflects the conservative credit appetite of the banks, the preference for a one-size-fits-all approach and the insistence of real estate security. What these statistics don't measure is the decision by SMEs not to pursue credit for investment purposes given their perception of the challenges involved.[13] A similar picture is evident in the UK. Data on loan application rates shows a continuing decline in the share of SMEs seeking new loans to 1.7% of smaller businesses. Only 43% of UK SMEs are confident that that they will get a bank loan, and attitudes against borrowing are becoming entrenched.[14]

SURVEY RESULTS OF SME FINANCE ENQUIRIES



Source: MoneyQuest Finance Specialist, SME Survey, 1 July 2017 – 20 June 2018

At the source of this problem and arguably an unintended consequence of the industrialisation of the banking business model, has been a diminution in the core skills that once defined the traditional banker, where judgment or "soft information" has been replaced by a policy bias on "hard information" (quantitative data) such as credit scoring outcomes, audited financial statements and the value of available security. Traditionally, well trained bankers had a good sense for what *counts* (qualitative measures such as reputation, track record, integrity) as well as what is *counted* (hard information). Credit assessment was based around the 4Cs of credit – character, capacity or cash flow, collateral and capital. The first criteria - character - always viewed as pre-eminent with an experienced banker assessing the business acumen, management skills and integrity of the business stewards.

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[12] Less than 20pc of staff ever see a customer: ANZ boss on employees 'dehumanising work' www.abc.com.au. June 30, 2018

[13] This problem has been extensively discussed in the academic literature. See Myer and Maljuf (1984) 'Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have', Journal of Financial Economics, 13 (2), 187-221

[14] SME banking: Lessons from history, Euromoney, March 6, 2108. www.euromoney.com

For SMEs without substantial real estate backing, this assessment of the 4Cs of credit is pivotal to risk assessment[15].

The internal process and efficiency drive within banks has made it more difficult to provide credit facilities where credit information is more “informationally opaque” (i.e. not based on clear, quantitative data). The emphasis on ‘hard information’ has weakened the weighting given to judgment, and in doing so, has weakened the essence of relationship banking, particularly in the SME sector. This has been exacerbated by the de-skilling, loss of experience and lack of professional training and qualifications (particularly around credit risk management) in what it means to be a “banker.”

The ‘dehumanisation’ of SME banking is further underscored by the decision of several banks to remove relationship management coverage for SME exposures <$1m and centralise the ‘management’ of these customers through call-centre style platforms. Even with SMEs that remain part of the relationship management proposition, they tend to be covered by a banker with a portfolio of as many as 200 customers - double the level of pre-GFC, so the quality of that relationship proposition suffers accordingly.

Adding to the challenges faced by SMEs, is the dominant culture within major banks, evident in the language of “selling products”, as highlighted in the Royal Commission deliberations. One former employee of major bank summed this problem up: “It was all about the sale, not about the customer, and all about targets, statistics and increasing revenue.” [16] Core skills have become significantly devalued over decades as banks have placed greater emphasis on “product sales,” with fewer senior executive role models, trained in the fundamentals of banking. In some professions, “selling” has a negative connotation, particularly where there is a relationship based on trust, which is how banking was once defined – credit from the Latin *creditum* is “to trust, entrust, believe”. Would you want your dentist or doctor, for example, to “sell” you more treatment than you need? The retail emphasis in banking has created a deeply ingrained sales culture.

Consistent with a view that the FinTech model and big data holds the solution to this market failure, much is made of digitalisation and artificial intelligence (AI) in the way banks should think about SME banking. This perspective was underpinned in a survey of senior executives in the US by EY[17], where 81% of executives said that: “data should be at the heart of all decisioning-making”, which lead the authors to proclaim that, “big data can eliminate the reliance on ‘gut feel’ decision-making”. This emphasis on quantitive data prevails in the minds of many bank executives as they think about the “cost-to deliver” SME banking. What this scientific approach fails to capture is the quality of character, ambitions, concerns, need for advice, succession planning, plans to acquire, innovate and grow. What happens, absent informed human intervention (relationship banking), when the SME hits a difficult patch or requires understanding and support in navigating major transitional events? A science driven approach to SME banking has it role but it also has its limitations. Behavioural science has taught us much in the field of financial economics to know that

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[15] For more context on this, see ‘Banking on SMEs’, Healy, Joseph, Dun & Bradstreet ‘Giving Small Business Credit’ Conference, 12th May, 2011 and ‘Business Banking: Current Picture and Future Trends’, Healy, Joseph, AB+F Randstad Leader’s Lectures, July 12, 2011

[16] Sydney Morning Herald, Meddling with the Kids’ accounts not on, May 19, 2018 p24

[17] Harvard Business Review, Management is much more than a Science, Martin, R., and Golby-Smith, T., September-October 2017, pp129-135

human judgment matters particularly in information inefficient markets where asymmetry problems can be the norm rather than the exception.

Concluding Remarks

The Demise in the *craft* of SME banking can be linked to a cultural shift in the banks progressively since Basel II, which coincided with the banks 'industrialising' their operations in way that dehumanised the relationship proposition to the customer in the pursuit of greater levels of profitability.

This saw a progressive decline in SME relationship banking skills, professionalism more broadly and the Demise in the craft of SME banking, particularly in SME credit assessment using the 4C framework. The financing of SMEs is much more than reviewing numbers; it relies heavily on the judgement of the personality, reputation and capabilities of the individuals running the business. This is not something that readily lends itself to automation or to distance-based assessment.

Banking is not just like any another business. The relation of an economy's financial system to its savings and investment decisions is very important, especially the role that the banking system performs as allocators and monitors of capital. The bias in the Australian banking market towards household lending and the credit gap that exists in the SME market, are evidence of market failure, which requires a public policy intervention. Major banks, which are granted special privileges, need to be reminded of their social licence obligations.

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