SME Financing: Joseph Healy, Co-CEO, Judo Bank

Executive Summary

Against the backdrop of the Hayne Royal Commission (Royal Commission), this paper reviews the state of SME Banking in Australia, provides evidence of a *market failure* and argues that without *more* public policy intervention, nothing will change. Why such a pessimistic view? Fundamentally, the banking industry has locked itself into a path dependent course of industrialising its operating model. The cultural and operational concrete has already set. This deterministic course of industrialisation makes sense for the banks acting in self-interest to maximise profits, but it disadvantages one important segment of the economy: SMEs.[1]

On the Royal Commission, it is important to remember that it was not a root and branch review of the banking industry. Instead it had a narrow focus (mainly addressing misconduct in Personal Banking and Wealth Management), constrained in time and with a charter that was largely influenced by the major banks, who had an incentive to minimise its scope having failed to prevent it.[2] The Royal Commission was not the *mea culpa* some thought it to be; it was at best the 'canary in the coalmine' highlighting systemic cultural, leadership and corporate governance problems (many of these issues had already been highlighted by the 2018 APRA inquiry into CBA[3]). There is no dispute however that the Royal Commission provided entertaining theatre and highlighted a burning platform for cultural change and greater regulatory direction. In many ways, it was a *de facto* review of the social licence held by banks. Whilst the final report made 76 recommendations, those relating to SMEs were largely limited to: (i) increasing the definition of 'small business' in relation to the Banking Code to firms with less than 100 full-time equivalent employees, where loans are less than $5m; (ii) providing greater protection for agricultural customers; and (iii) not expanding the operation of the NCCP Act to lending to small businesses. In sum, nothing of note from a SME perspective.

Many of the core issues that plague the banking industry were simply not covered. The fundamental question of what type of banking industry we deserve remains unanswered, though the 2018 Productivity Commission report[4] did a commendable job in highlighting many of the problems. It is regrettable that the royal commission findings have crowded out the more substantial and in an economic sense, important insights from the productivity commission inquiry. The cause and effect of the problems with the banking system and options for change will be addressed in a forthcoming book.[5] This paper is largely based on the analysis and insights from the book, weaving together four key themes: market failure; industrialisation; social licence; and path dependency. First, let's recap on the industry we have:

Highly Profitable Banking System

Australia's financial system is bank dominated. Despite having a ~$2 trillion pool of superannuation savings, the allocation to fixed income is at 10 percent which is low compared to other OECD

[1] SMEs are defined as business with a turnover of up to $50 million pa.
[2] Long, S., 'This letter from the big banks helped shape the royal commission' ABC News, 5 February 2019
[3] Prudential Inquiry into the Commonwealth Bank of Australia (CBA). www.apra.gov.au
[4] Productivity Commission, Competition in the Australian financial system: inquiry report, No.89, 29 June, 2018
[5] Healy, J. (2019), '*Breaking the Banks – What Went Wrong with Australian Banking?*' Ventura/Simon & Schuster

countries and the average for the OECD of 40 percent.[6] Given the structural nature of the financial system, the power of the major banks and the resilience of the domestic economy, Australia is ‘blessed’ with one of the most profitable bank sectors in the world:

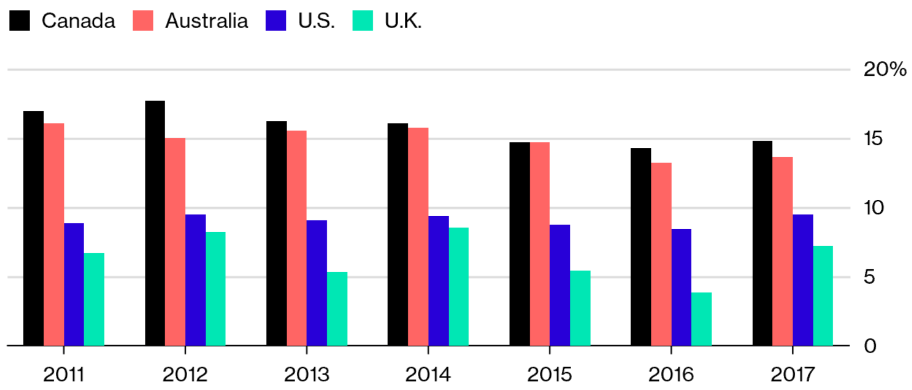
Table 1: Australia number one for bank profits

Rank	Nation	Bank profit share of GDP
1	Australia	2.9
2	China	2.8
3	Sweden	2.6
4	Canada	2.3
5	Netherlands	1.9
6	Spain	1.8
7	France	1.7
8	Japan	1.4
9	US	1.2
10	UK	0.9

Source: The Banker, IMF, TAI calculations (2017)

Measures of profit relative to GDP are also reflected in profitability, using Return on Equity (RoE) as a proxy for profitability.

Figure 1: Bank ROE comparisons



Source: Bloomberg
* Average return-on-equity for each country's biggest banks

On a per capita basis, there is no domestic banking system anywhere in the developed world that earns such high economic rents. This is not however due to superior management, but rather privileges, which are discussed later. This reality was summarised by former Treasurer Peter Costello: “Our banks are 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

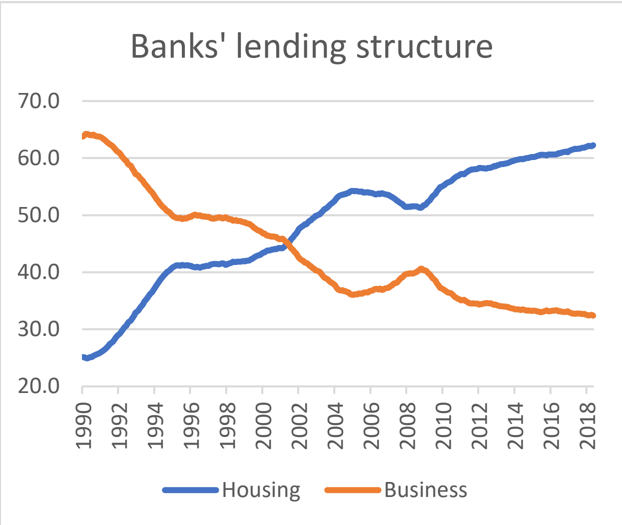
[6] Pension markets in focus. www.oecd.org/pensions/privat-pensions/Pension-Markets-in-Focus-2017

them".[7] Similar sentiment is on record from the Productivity Commission. *The Economist* was far from circumspect when it described our major banks as 'consumer-crushing oligopolies.'[8]

Banking System with a Lending Bias

Post Basel II, the bias of the banking system towards lower capital risk weighted (and therefore higher RoE) household mortgage lending intensified. One consequence of this is the stock of SME lending declined as a share of GDP and household debt reached eye-watering levels. Bank lending to the household sector reached $1.8 trillion, of which $1.68 trillion is to residential mortgages, with 33 percent of that ($557 billion) is to buy-to-let borrowers. [9] In contrast, the business banking market is estimated at $760 billion of outstanding loans (excluding lending to financial institutions) of which approximately 40 percent ($300 billion) is in SME lending. Total business lending within the banking system is at 49 percent of GDP, down from a peak of 62 percent in 2008, whereas housing lending sits at over 100 percent of GDP. Household debt is close to 200 percent of household income (in the US and the UK at the onslaught of the GFC, the comparative was 120 percent and 140 percent respectively[10]). Morgan Stanley in their report on global household debt levels, placed Australian households at the highest risk category across three metrics – Debt levels: household income; Debt: total assets and Debt servicing: household income.[11]

Figure 2: Bank lending – household and business



Source: APRA 2018

The effectiveness of banks in allocating capital is central to sustainable productivity of the economy. Not all lending is equal in its economic impact; different categories of debt play different economic functions and excessive debt in certain asset classes can create systemic risk, the consequence of which can have a long gestation period. Given incentives, a perverse reality is that it is more

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[7] 'Peter Costello's blast at the banks: bring in some competition', The Australian, 19 August 2017, p26
[8] 'Australia's biggest banks are in the dock – the charge sheet,' The Economist, 6 October 2018, p58
[9] APRA statistics as at March 2019, <https://www.apra.gov.au>
[10] King, M. (2016), The end of alchemy – money, banking and the future of the global economy, Little Brown Books
[11] Letts, S., 'Australians face $700bn wealth wipe-out as debt levels rated riskiest in the world: Morgan Stanley' www.abc.news.au/news/2018-10-30/australia-most-country-to-risks-of rising-household-debt/10445814

attractive for banks to lend the marginal dollar to the purchase of a weekend holiday home than to small business that may employ an additional ten staff as a result. Is this what society wants its banks to do? This perverse incentive is because of the more favourable capital weighting determined by the regulatory prescribed Risk-Weighted Assets (RWA). The cause and effect formula can be understood to lend more into households, use less capital, generate higher ROE, drive higher bonuses. In 2018, mortgages represented 46% of bank profits in Australia, delivering a ROE of 36%.[12]

Table 2: Standardised credit risk weightings

Type of lending	Basel II Standard risk weightings	APRA Prudential standard 112	Basel III Standard risk weightings	APRA Discussion paper (in response to Basel III)
	%	%	%	%
SME lending covered under retail lending	75	100	75	85
SME corporate lending	100	100	85	85
Lending for/secured by commercial real estate	100		80-130*	
Residential property	35	35-75**	25-55*	30-85*

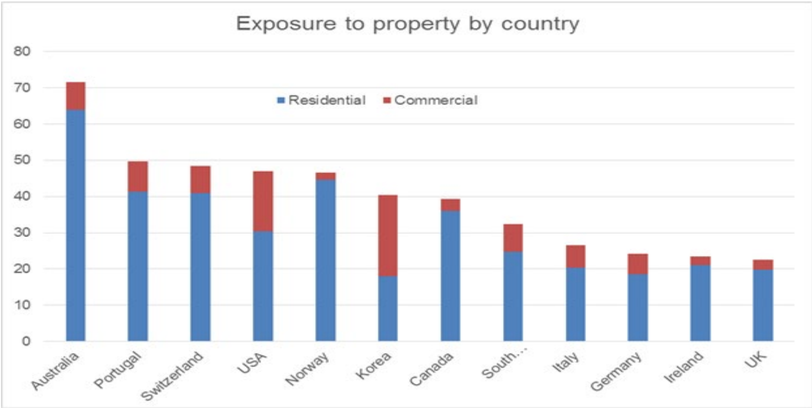
Source: Productivity Commission, 2018
LVR = loan-to-value ratio
* depending on LVR
**depending on LVR and mortgage insurance

The important point from Table 2 is that SME lending is normally 100% risk weighted, although it can be lower if appropriate residential security is held. This is one of the reasons why ~90% of all SME lending by the banks is real estate secured, often on the entrepreneurs' residence. Rather than taking a more granular approach, absent property as security, a single risk weighting of 100% is applied, with no delineation allowed for size of borrowing, the form of borrowing or the risk profile of the SME. Australian regulators apply higher risk weighting to SMEs than is the case in many other countries. Canadian regulators, for example, take a more positive approach to SME risk weightings where there is no property as collateral, making SME lending more attractive to their banks.[13] We have a banking system addicted to property, which the history of financial crises would inform us, is not a good place to be.

[12] Deutsche Bank Research, Australian banking sector, 17 January 2019.
[13] Productivity Commission, p435

Figure 3: Australian Banks addicted to property

Proportion of book exposed to Residential and Commercial Property – Australian Banks addicted to property



Source: IMF, Macquarie data Q1 2018

Social Licence

The concept of social licence is controversial when applied to the business sector generally, but it is highly relevant to banking. Banks are unique institutions. Expressing sentiment like that in the Royal Commission final report, the UK regulator, summed up why banks are different:

> Banks are different and society has a strong interest in bankers taking a different attitude to the balance between risk and reward to that which applies to the rest of the economy….their failure is of public concern, not just a concern for shareholders.[14]

Banks are also different from other private sector firms for several important reasons: firstly, they are protected from bankruptcy by the 'too big to fail' assumption, where banks effectively have a call option on tax payers, who act as the unpaid insurer; second, banks are protected from takeover by virtue of the *four pillar* policy. The third, by virtue of the sovereign credit rating, banks can borrow in the international wholesale markets at more attractive rates, which is estimated to be worth ~$4bn pa. Also banks can raise low cost deposits from the public which are subject to a government guarantee up to $250,000 per deposit. No other private sector industry enjoys such privileges. For these reasons, banks are essentially quasi-nationalised firms, hence they are 'special' and why the concept of a social licence is highly relevant. How banks conduct themselves and how they allocate capital across the economy is of legitimate public interest. To argue otherwise, as the banks do, is a fallacy.

Industrialisation

The bias towards property-based lending allows the banks to drive the industrialisation of their operating models to reduce costs and generate higher earnings. This was candidly acknowledged by the current ANZ CEO: 'We engineered a production line to maximise efficiency and deliver high returns...whilst it was an efficient process, it did fail some people badly'. He added that the systems that banks had set up to churn out strong profits were now being asked 'to deal with nuance, judgement and exceptions on an unprecedented scale.'[15]

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[14] Financial Services Authority Board, The failure of the Royal Bank of Scotland: report, December 2011, pp.4-5

[15] Maley, K., 'Healing the scars', Australian Financial Review, May 4-5, 2019, p19

As banks industrialised, many SMEs, once looked after by a relationship banker who would have a good understanding their business, received letters along the following lines:

> *Dear Joe,*
>
> *We know focusing on your business leaves little time for banking conversations that could help it grow. That's why we've introduced our Small Business Contact. A service team of banking experts with diverse professional experience.*
>
> *From this month, you'll no longer liaise with your current Relationship Manager. Instead, our Small Business Connect is available by phone or email to connect you with the business specialist best suited to answer your specific query. You can speak to the same or a different expert each time you call. And because every call is noted in detail, any specialist can pick up right where you left off simply by reviewing past information. All you need to do is call 15 17 16.*
>
> *This is just one of many new improvements we're making to better support your business needs.*
>
> *Kind regards,*
> *ABC Bank*[16]

A consequence of industrialisation, the low level of trust reflects the underinvestment in SME banking and a decline in the *craft* of relationship banking. The Royal Commission highlighted how professionalism including ethical standards were no longer core in an industry once defined by them. Core banking skills fell into disrepair, even though general educational standards (measured by the number of employees with graduate and undergraduate degrees) has seen an expediential increase. In hiring at Judo Bank, all candidates who progress through three interviews have to then sit a three-hour closed-book credit exam which tests technical knowledge and judgement, based on the Four C's of credit risk management (*Character* (reputation, integrity and track record), *Capacity* (cash flow), *Capital* (financial leverage) and *Collateral* (security). Close to 250 bankers have sat the exam and the overall pass rate has never exceeded 47 percent. A pass market is 60 percent.

Market Failure

While the industrialised approach to SMEs has served the banks well in terms of maximising RoE, it has failed their customers and the economy. It has resulted in a credit gap in the SME sector, which Macquarie Bank estimated to be between $50-$70 billion.[17] Separate research conducted in 2018 by East & Partners of ~3000 SMEs estimated the gap at $83 billion. Given that the stock of bank lending to SMEs is $300 billion, this is a material amount of unmet demand. The opportunity cost of how the banks allocate capital is difficult to estimate but the relationship between economic growth and SME access to finance is well established.[18] That there is an issue in financing Australian SMEs and that there are associated economic costs has been acknowledged by the RBA.[19]

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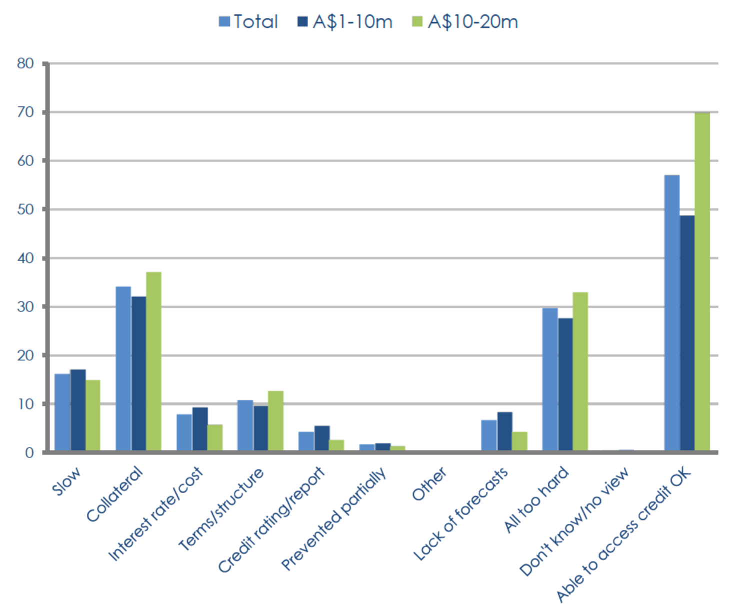
[16] This is an actual letter sent by a bank to an SME customer with appropriate name changes made to protect privacy and embarrassment to the bank.
[17] Macquarie Bank Research, 'The computer says yes', March 2015
[18] Lindgren, E., 'Access to finance: Small and medium enterprises effect on economic growth', Lund University, 2015, https://www.lup.lub.lu.se.
[19] Debbie, G., 'Business investment in Australia', *UBS Australasia conference*, 2018.

Many reasons explain this credit gap, including the insistence of property as security and the challenges in dealing with a bank where much of the decision-making is centralised (Figure 5). As banks have industrialised and dehumanised their service to SMEs, they have come to rely on 'hard' (quantitive) information and downgraded the value of 'soft' (qualitative), hence in part the reliance of property-based security and the increasing reliance of algorithm based credit decision tools. This in part deals with the information inefficient nature of SMEs, a problem that was once solved by an experienced banker, who was able to apply judgement to what *counts* (character, track record, reputation) as well as what is *counted* (financials and security). Such SME bankers are characterised by what Malcolm Gladwell described as the 10,000 hours of experience that is the hallmark of an expert.[20] The market no longer produces such bankers and letters such as that sent to 'Joe' becoming increasingly common.

Figure 5: Barriers to accessing credit



Source: East & Partners, SME banking insights report, September 2018

That there is a market failure problem in financing SMEs is a widely accepted truth. In late 2018, the government acknowledged this with the announcement of a $2 billion small business securitisation fund to support lending to SMEs. In announcing this initiative, the Treasurer noted that 'small business finds it difficult to obtain finance other than on a secured basis – typically against real estate. Even when small businesses can access finance, funding costs are higher than they need to be.[21] The Treasurer acknowledged, as Sir Robert Menzies had done some seventy years earlier, that Australia's SMEs have become the forgotten people, yet they are the backbone of the country.[22]

Concluding remarks

The Royal Commission was a missed opportunity to address wider issues and in many ways its theatre overshadowed the more informative, in an economic sense, substantial findings from the Productivity Commission, particularly the failings in the provision of finance to SMEs. Given the

[20] Gladwell, M. (2008), 'Outliers – the story of success,' Little, Brown & Co.
[21] https://jaf.ministers.treasury.gov.au/media-release/2018/.
[22] Frydenberg, J., '$2bn securitisation fund to back our "strivers"', *The Australian*, 15 November 2018.

unique nature of the social licence granted to banks, an opportunity was missed to diagnose what has gone wrong and to call for greater public policy intervention on matters such as: (i) mandating a target bank allocation of credit to SMEs; (ii) creating an even playing field amongst lenders (e.g. uniform RWA models); and (iii) increasing competition, which is badly need given industry structure.

The Australian banking system is financially strong having largely avoided the GFC, it is however now facing an Australian Financial Crisis (AFC), which is a crisis in confidence, trust, purpose and culture. Given the path dependent nature of banking and a belief that the cultural concrete has set, meaningful change within the industry is unlikely. Policy leadership will be essential if the banking system is to return to a time it was a servant and not master of the economy it is there to serve. Former ANZ CEO, John McFarlane understood the importance of social licence when he said: 'banks must return to the philosophy that banking is a profession as well as a business, and that contribution rather than reward is its centre of gravity.'[23] In a similar vein, to para phrase JFK: 'ask not what your country can do for you, but what you can do for your country.' Banks rather than asking what the economy might do to their performance, should always ask what their conduct and collective strategies might do to the economy, today and into the future. If banks understand this, then there is a prospect of addressing the current market failure. The industry path dependent thesis however suggests new solutions are needed. More Judo Banks and a more enlightened, pro-competition regulatory framework.

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[23] Boyd, T., 'Former ANZ CEO John McFarlane calls for a rethink of banking philosophy,' Australian Financial Review, 3 August 2016, p48