A Review of Recent Developments in SME Banking Services and Debt Financing

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SCHOOL OF COMMERCE
RESEARCH PAPER SERIES: 02-4
ISSN: 1441-3906

Abstract

This paper reviews recent developments and trends in the accessibility, affordability, and efficiency of SME banking services and debt and equity financing. In an environment of continuing financial sector restructuring, downsizing, branch closures, and growing bank revenues and profits, anecdotal evidence indicates considerable community concern exists with regard to the fees and charges levied on small medium business and the availability of capital.

This review of recent research indicates competition in the financial sector is limited with major banks dominating 80 to 90% of small business deposit and lending assets. Maintenance of the status quo suggests that small businesses are either satisfied with their overall banking arrangements or that the perceived benefits of switching provider do not outweigh the costs, which include full service provision, branch location and convenience, financial cost of switching providers, credit risk management expertise and brand power. The possible consequences of a lack of competition are detrimental effects on the rate of improvement in product innovation and small business service and satisfaction levels.

While the cost of basic business banking account transactions has not decreased, the cost of basic business cheque transactions has decreased for small businesses adopting new technology telephone and Internet banking. Credit card merchant schemes, which are dominated by the major banks levying higher fees on small business, will undergo sweeping reforms.

Relatively greater competition is evident in the provision of small business debt finance with 53% supplied by major and regional banks and overall fees on individual loans having decreased since the mid 1990's. Due mainly to falling interest rates, the weighted-average interest rate paid by small businesses over all types of variable-rate loans has decreased, despite an increase in the margin between small business interest rates and the cash rate.

The impact of these findings on SMEs are summarised and recommendations to policy-makers are made to mitigate any adverse effects.

INTRODUCTION

There is considerable community concern that banks are generating increased revenues and profits through higher fees and charges on transaction account banking and other services provided to small medium enterprise (SME) and the household sectors. Additionally, anecdotal evidence suggests small business continues to be constrained by a lack of capital, in particular equity capital (Australian Society of Certified Practising Accountants, 2000). This paper reviews recent developments and trends in the accessibility, affordability and efficiency of SME banking services and debt and equity financing, that have taken place since a previous review by Stanger (2001a & b) that included the findings of the Financial System Inquiry (1997).

The first section considers the level of competition in the banking sector, and bank fees and charges on transaction account banking and merchant credit card schemes. Following this, a review of bank product innovation, customer service requirements, customer satisfaction levels, impediments to bank switching and the effects of branch closures is undertaken. Next, developments and trends in intermediated debt financing are assessed with regard to total loans outstanding; the providers of financing, changes in the type of financing used, and interest rates. Recent developments in equity financing are then considered. Finally, the possible impact of these developments and trends on small business are outlined and recommendations are made for policy-makers with the view of minimising any adverse effects.

COMPETITION IN THE BANKING INDUSTRY

Competition in the Australian banking system continues to be limited with the 'big four' Australian banks continuing to dominate the small business deposit and lending with 80 to 90% of these assets in each state. Credit Unions and Building Societies have 4% of this market and second tier banks and finance companies have the balance (Connolly and Hajaj, 2002). International comparisons of data for 1997 and 2001 indicate that Australia, along with Canada, France and Belgium and the Netherlands, have a relatively high market share concentration in the hands of the largest five banks of approximately 70 to 80% (Connolly and Hajaj, 2002). This is considered to

> *lead to a situation where the top tier of banks does not compete with each other, and develops a barrier to competition by new entrants .... [and] opportunities for the big four players to (wittingly or unwittingly) distort normal price competition (Connolly and Hajaj, 2002, p. 8).*

BANK FEES AND CHARGES

Total bank fees for the small and large business and household sectors have grown by 51.7% between 1997 and 2000. Sector data indicates banks are generating a greater proportion of their revenues and profits from small business (44.3%) and households (75.1%) as compared to large business (39.1%) over the same period (Reserve Bank of Australia, 2001 in Connolly and Hajaj, 2002, p. 13).

With regard to small business individual bank product fees, annual growth rates over the period of 1997 to 2000 (in 2000) for deposits were 18% (20%), loans 8% (1%), Bank Bills –2% (5%), credit card merchant fees 24% (25%) and other fees 12% (-13%). The large increase in merchant fees is inline with the increase use of credit cards by consumers according to the RBA (2002a). The aggregate fee income growth for the above small business bank products was 11% in 2000, slightly less than the annual growth of 13% between 1997 and 2000 (RBA, 2002a).

While total bank fees and individual bank product fees for small business have grown considerably between 1997 and 2000, this aggregate data does not take into account the total volume of loans and the number of individual loans made. For example, small business loan and Bank Bills loan fees (which include establishment, overdraft and term loan fees) grew by a modest 3% in 2000. This is just less than the growth in credit outstanding in 2000, and is consistent with the decline in fees on individual loans and Bank Bills between 1997 and 2000. In 2001, establishment and account keeping fees increased, however these increases are small relative to the decreases since the mid-1990s (RBA, 2000, p. 61).

Table 1 provides more recent data depicting the difference between the loan establishment fees, overdraft fees and term loan fees for loans of $100,000 and $500,000 in 1997, 2000 and 2001. As could be reasonably expected, economies of scale are clearly evident (except for loan establishment fees in 2001). In an environment where banks have generally encouraged a shift in financing from overdrafts to term loans, somewhat paradoxically, loan establishment and overdraft fees have decreased overall for both small and larger loans since 1997, while term loan fees have increased. The average cost saving on a $100,000 ($500,000) loan from a reduction in the loan establishment fee is $170 ($545), which is likely to be more than offset by the ongoing annual administrative cost of $90 ($150) imposed by the higher term loan fee.

Table 1: Average Major Bank Loan Fees Paid by Small Business

	Loan size $100,000			**Loan size $500,000**		
	1997	**2000**	**2001**	**1997**	**2000**	**2001**
Loan establishment fee ($)	925	738	755	4475	3275	3930
Overdraft fee (% pa)	1.12	0.93	0.95	0.93	0.57	0.57
Term loan fee (%pa)	0.37	0.45	0.46	0.15	0.17	0.18

Source: Table 3, RBA (2002a, p.62)

Business Banking Account Fees

The following description of basic business banking account and basic business cheque account fees faced by the majority of small businesses is based on the fees charged by the 'big four' banks which, as mentioned above, dominate small business deposit and lending with 80 to 90% of assets. Table 2 indicates that 'there is no evidence of competition on price between the four banks' (Connolly and Hajaj, 2002, p. 12). Connolly and Hajaj (2002) identify some other characteristics:

- The main choice is between paying fees 'up front' or 'as they go';
- Banks paying interest on accounts with balances over $5,000 do so only on the funds in excess of $5,000;
- All accounts incur a setting up (business name search) fee which varies between $35 and $50;

- The NAB, CBA and ANZ waive the monthly service fee if a minimum account balance of $5,000 is maintained; and
- The CBA charges a small business cash handling fee of 0.25% on all deposits and withdrawals made over the counter on amounts above $3,000.

Table 2: Basic Business Banking Account Fees

	Monthly Service Fee	Number of Free Transactions	Excess Transaction Fees: Over Counter	Excess Transaction Fees: Electronic	Interest Paid
CBA	$15	40	$0.95	$0.25	No
NAB	$20	50	$0.60	$0.45	Yes ($5,000+)
ANZ	$10	50	$0.60	$0.40	Yes ($5,000+)
Westpac	$4.40	12	$2.20	$0.71	No

Source: Connolly and Hajaj (2002, p. 12)

Business Cheque Account Fees

A current snapshot of bank fees on cheque accounts is shown in Table 3. These fees have changed little over last year with the exception of periodic pay deductions to other banks increasing by over 8%. Longer-term trends are evident with 'old technology' cheque transaction fees increasing and telephone and Internet transaction fees decreasing to a point where they are about one-third of cheque transactions (RBA, 2002a). Thus small business owners not taking up phone and Internet banking face higher cheque account fees.

Table 3: Basic Business Cheque Account Fees

	Monthly Service Fee	Number of free Transactions	Excess Cheque Fee	Excess Fees: Over Counter	Excess Fees: Electronic	Interest Paid
CBA	$2	No	$0.55	$0.95	$0.25	No
NAB	$5	10	$0.45	$0.60	$0.45	No
ANZ	$15	40 (10 branch)	$0.40	$0.60	$0.30	No
Westpac	$5.50	16	$0.44	$0.93	$0.18	No

Source: Connolly and Hajaj (2002, p. 13)

In a broader assessment of transaction account pricing of the ‘major’ banks and 9 other regional banks, building societies and credit unions, KPMG Consulting (2002, pp. 33-5) reports that a diverse range of competitive alternatives available to small business exists. It also notes that while prices vary between institutions and between the channels offered, small business customers may be able to negotiate some fee structures. Although pricing is important, the ultimate market share of small business banking appears to be determined by factors other than price. These factors include the provision of full service, branch location and convenience, the cost of switching providers, credit risk management expertise/experience and brand power, of which the ‘majors’ have 4 of the 5 most valuable brands (KPMG Consulting, 2002, pp. 35-6).

While international pricing comparisons need to be viewed with caution due to the different regulatory environments and government intervention, the cost of transactions (banking and cheque account) was found to be generally low in Australia, compared with Australian dollar equivalents for the US, UK, Canada, France and Germany (Cruickshank, 2000 in KPMG Consulting, 2002, p. 36).

Credit Card Merchant Fees

The merchant fee is paid by a business to its provider of banking services for the clearing and processing of credit card payments, and includes a considerable interchange fee that banks charge each other for inter bank clearing facilities (Connolly and Hajaj, 2002, p. 18). With the exception of electronic debit card payments, the cost of credit card transactions is not standardised and is influenced by the bargaining power of the business (Connolly and Hajaj, 2002). ‘Big’ banks also dominate credit card schemes in Australia and have tended to exploit this relatively unregulated area by levying small business with a higher merchant fee than large business (SBMC, 2001). The higher fee is ultimately included in the price of the good or service and passed onto the consumer. Table 4 illustrates the higher merchant fees paid by small business, as compared to medium and large business. A possible explanation for this is the economies of scale principle, which is also evident in loan establishment fees, overdraft fees and term loan fees on bank loans, as discussed above.

Table 4: Credit Card Merchant Fees

Annual Turnover ($millions)	Average	Minimum	Maximum
0.10	2.53	1.36	4.00
0.25	2.30	1.25	4.00
0.50	2.10	0.90	4.00
1.00	1.75	1.00	4.00
2.50	1.68	1.00	3.00
5.00	1.53	1.19	3.25
10.00	1.51	0.90	3.00
25.00	1.47	1.00	3.00
50.00	1.38	1.25	1.50
100.00	1.35	1.25	3.00
500.00	1.3	1.00	3.00

Source: Australian Retailers Association in Connolly and Hajaj (2002, p. 18)

Mastercard and Visa currently restrict merchants' ability to pass the merchant fee onto credit card users. This causes price distortion as consumers paying cash face the same prices as credit card purchasers, which impose merchant fees on business.

The RBA has announced its reforms to credit card schemes, which include:

- An objective, transparent and cost-based benchmark for determining interchange fees. Average interchange fees are expected to fall from approximately 0.95% of the value of each credit card transaction to 0.55-0.6% in the second half of 2003. This should result in lower merchant fees and thus lower general prices;
- Freedom for merchants to recover from card holders the costs of accepting credit cards from January 2003; and
- Removal of restrictions on the entry of new specialist credit card service providers (RBA, 2002b, p. 1).

BANK INNOVATION, SERVICE, SATISFACTION LEVELS AND SWITCHING

Product Innovation

The Cruickshank Report undertook an international comparative study of the level of innovation in banking products for small business. Australia was ranked reasonably innovative with a score of 3 along with the UK and Canada, the US 1 and France and Germany 5, where 1 indicates most innovative and 6 least innovative (Cruickshank, 2000 in KPMG Consulting, 2002).

Service

Anecdotal evidence in Australia suggests that the erosion or transformation of traditional bank service through restructuring and branch closures is causing concern for small business. The replacement of personal branch managers with call centres and sales teams has broken down relationship banking and has reduced the flexibility of the bank to assist in times of cash flow difficulty such as in seasonal downturns. Additionally, there has been a decline in the level of understanding any one individual develops about a small business (Connolly and Hajaj, 2002). Relationship banking appears to be important for small business. Research from the U.K. indicates that for the question 'what characteristics are important in a bank?' *quality of relationship with a manger* ranked the highest at 24%, followed by *reasonable fees, charges and rates* (23%), *efficiency* (22%) and *location* (16%) (United Kingdom Competition Commission (2002) in Connolly and Hajaj, 2002).

Satisfaction Levels

Yellow Pages (1999) indicates that the proportion of small businesses 'happy with bank service' was 78% in 1993 and 1995, but declined to 68% in 1999. Similarly the proportion of small businesses 'happy with their main financial institutions' between 1995 and 1999 decreased for most institutions, remained the about the same for CBA and improved for Westpac.

When asked the question 'reason not happy' in both 1995 and 1999, small businesses indicated a decline in *poor/no service* (43 to 42%), *fees too high* (33 to 25%) and *don't understand SMEs* (24 to 11%), and an increase in *no personalised service* (18 to 27%), *not efficient* (5 to 7%) and *long* *queues/lack of staff* (2 to 7%) (Yellow Pages, 1999). The concern with the lack of *personalised service* is consistent with the importance small businesses place on relationship banking.

<u>Switching Provider</u>

Yellow Pages (1999) indicates that 16% of small businesses changed financial institution in the last two years (slightly more than the 14% reported in Yellow pages, 1995). Of these small businesses, 61% switched to a bank provider and 39% switched to a non-bank financial institution. Between 1993 and 2000 there has been an increasing number of small businesses using two or more providers (from 14 to 21%). Switching was more likely to have taken place by larger small businesses with 10 to 19 employees (Yellow Pages, 1999).

KPMG Consulting (2002) argues that this low rate of switching is due to the small business contentment with banking services. However, a study in the United Kingdom of SME banking services indicates a number of factors influence switching behaviour that are thought to be relevant in Australia:

- Complexity of banking products further compounded by switching;
- Uncertainty of interest rate risk margins generated doubt of the benefits of switching;
- Possibility of extensive delays in switching banks;
- Fear of damage to small business reputation if switching teething difficulties cause cheques to bounce;
- Fear of disruption to standing orders and direct debits, including penalty fees if payments are not made;
- Establishment and exit fees and charges;
- Impact on credit history;
- Bank perceptions of small businesses that switch too frequently;
- Perception of benefits of switching are poor or marginal due to lack of competition between banks; and
- Product bundling made it difficult to switch provider for just one product (United Kingdom Competition Commission (2002) in Connolly and Hajaj, 2002, p. 10).

BRANCH CLOSURES

Between 1997 and 2001 net bank branch closures have occurred at almost the rate of one per day (Connolly and Hajaj, 2002). In small suburban shopping centres that cater for staple products and possibly a few specialty shops, a branch closure can result in the migration of consumers to other shopping centres that cater for both their shopping and banking needs. The result can be terminal for individual small businesses and can even adversely impact on a local community economy (Connolly and Hajaj, 2002).

The effect of branch closures may be mitigated by the emergence of other providers of banking and financial services which generally operate in-conjunction with the banks and provide the 'local' facility which is important for small businesses dealing with cash and cheques (KPMG Consulting, 2002). These include GiroPost, which is offered by Australia Post as a joint initiative with a number of major and regional banks, and franchises, agencies and 'in-store' facilities.

DEBT FINANCE – INTERMEDIATED

Growth Trend in Total Debt Financing

The total amount of bank loans to small business was approximately $66 billion as at September 2001, with new small business credit approvals for the year to September 2001 being $25.5 billion (KPMG Consulting, 2002). Growth in financing provided by financial intermediaries to small business since 1995 has been an average of approximately 5% per annum. However, growth over the last year or so has fallen to about 1%. There is mixed evidence on whether this is due to supply (banks' reduced willingness to lend) or demand (business' reduced need to borrow) factors. While anecdotal evidence suggests some banks may be more reluctant to lend to business, business surveys have not indicated an increased difficulty in obtaining credit financing (RBA, 2002a). Indeed, Yellow Pages surveys of small business indicate that bank lending has not been a major concern since early 1999 (RBA, 2002a).

Debt Financing Providers

KPMG Consulting (2002) considers the provision of small business debt finance to extend significantly beyond the major and regional banks that provide 53%, followed by 'other' providers such as mortgage originators (21%), credit unions (18%) and building societies (9%). Notwithstanding this, major and regional banks have a very significant dominance in the provision of debt finance and current account servicing. This is due to the convenience of greater branch numbers and one-stop full service offerings. Additionally, customers tend to have a history with banks that contribute to their ability to better assess credit risk and provide support at reasonable cost (KPMG Consulting, 2002).

Changes in the Type of Debt Financing Used

The recent decline that has occurred predominantly in the area of overdrafts supports the argument that reduced demand for funds has been a significant factor associated with the reduced growth in debt financing. Contrary to this, the turnover in invoice discounting and factoring has been growing between approximately 13% and 45% per year respectively between 1998 and 2001, with an average annual growth of approximately 28% (RBA, 2002a). However, the impact of growth in invoice discounting and factoring has had little affect on total debt financing as it is used by a relatively small number of small business (less than 4,000) which represents less than 0.4% of all SMEs.

Interest Rates

Between 1994 and 2001, the proportion of small business loans funded by commercial bills has fallen from approximately 28% to 8%. During this time loans at variable rates have risen from about 40% to 50% and fixed interest loans have risen from about 32% to 42% (RBA, 2002a).

Variable-rate bank loans

In absolute terms, interest rates for small business loans between 1998 and early 2002 (except for 2000) have been the lowest since the early 1970s (RBA, 2002a). While this is primarily due to the easing of monetary policy and the effect on the cash rate, it is useful to consider the margin between the cash rate and small business loans rate. Table 5 indicates that the fall in the cash rate of 2% between January 2001 and early February 2002 was almost entirely passed onto residential secured term loans[1] (-1.95%). However, the flow-on has been less for other types of loans. This indicates that the margin between small business interest rates and the cash rate increased for all small business loans over this period, by as much as 30 basis points.

When considering the change in the margin between small business interest rates and the cash rate over a longer time period, February 2002 margins are higher for all types of small business loans by as much as 55 basis points when compared with 1998/1999. With two interest rate increases in the second quarter of 2002 and further increases possible during the year, the question begs whether this reversal in the interest rate trend results in reduced margins?

Table 5: Bank's Indicator Lending Rates for Small Business (per cent)

	Current level Early February 2002 (margin)	Change since January 2001 (margin at January 2001)	Cyclical low 1998/1999 (margin)
Small Business			
Residential secured:			
- Overdraft	6.80 (2.55)	-1.80 (2.35)	6.95 (2.20)
- Term loan	6.25 (2.00)	-1.95 (1.95)	6.65 (1.90)
Other security:			
- Overdraft	7.50 (3.25)	-1.70 (2.95)	7.45 (2.70)
- Term loan	6.85 (2.60)	-1.85 (2.45)	7.05 (2.30)
Cash Rate	**4.25**	**-2.00**	**4.75**

Adapted from RBA (2002a, p.59)

Although the margin between small business interest rates and the cash rate has increased, the weighted average interest rate paid by small businesses over all types of variable-rate loans has decreased. For example, the weighted-average interest rate at the end of September 2001 was 8.0% compared to 9.6% a year earlier. This reduction is greater than the fall in the cash rate for the same period, and occurred despite the margins on some loan products increasing over the period. The reason for this outcome is the shift in small business borrowings to lower cost bank products like loans secured by housing, and/or a shift to lower cost lenders. The former has had the effect of reducing the customer risk margins of banks, and combined with the latter, has more than counteracted the effect of increased margins for small businesses generally (RBA, 2002a). The shift to lower cost lenders could be the result of competitive forces amongst suppliers of debt finance.

Table 6 indicates the change in the distribution of variable-rate loans to small business between June 1994 and September 2001. Although the cash rates were equivalent, reductions in the weighted average, median range and minimum range interest rates are evident (with the exception of maximum range), consistent with the shift in small business borrowings to lower cost bank products and/or a shift to lower cost lenders.

Table 6: Variable-rate Loans to Small Business (per cent)

	September 2001	June 1994
Cash rate	4.75	4.75
Weighted average interest rate	8.0	10.9
Median interest rate range	6-7	11-12
Minimum interest rate range	<5	7-8
Maximum interest rate range	>15	13-14

Adapted from RBA (2002a, p.60)

Fixed-rate loans
Fixed-rate borrowing tends to be for a term of up to 5 years with 3 years being the most common (RBA, 2002a). In relation to the periods depicted in Table 6, small business fixed interest rates (based on the 3-year fixed indicator rate) were approximately 7% in 2001 and over 10% in 1994.

Proportion of Small Businesses with Loans
Although the aggregated data indicates that variable and fixed loan interest rates have decreased, this benefit will only extend to those small business bank customers that have loans. It is estimated that approximately 50% of bank customers have significant borrowings (term loan or consistent overdraft) and 20% have occasional borrowings (short term loans, occasional overdraft and credit card debt) (Connolly and Hajaj, 2002, p. 22). The remaining 30% have either borrowed from family and friends or have no borrowings.

EQUITY FINANCE

Equity capital may not be sought by the majority of small businesses because of self-imposed growth caps and the desire of owners not to share or relinquish control of the business. For these reasons, exposure to risk and potential conflict by being both an investor and a lender, equity capital investments are not likely to be attractive to banks. However, in the light of a relaxation in policy of bank investments in non-financial businesses, a small number of equity investments have been made by banks, predominantly in medium businesses (KPMG Consulting, 2002).

Private equity markets for SMEs continue to be limited with the RBA reporting that at least 6 business matching companies having ceased operating in the last year (RBA, 2002a). These companies matched businesses needing finance with ‘business angels’ wishing to invest. Additionally, the Australian Stock Exchange’s online Enterprise Market has also ceased operating early 2001. The two regional stock exchanges in Newcastle and Bendigo which opened December 2000 and August 2001 respectively, have currently 2 and 1 listings respectively (RBA, 2002a).

Against this background, the Australian venture capital market has operated with considerable success. It has experienced record strong growth with almost $1.4 billion invested in the year to 30 June 2001, representing a 40% increase on the previous year (RBA, 2002a). However, this amount is small relative to the gross loan approvals of $26 billion in 2000/2001 (RBA, 2002a). Approximately half of venture capital investment in 2000/2001 were in computer-related and consumer related industries i.e. computer software, Internet, electronics, communications and IT. The RBA believes that the Australian venture capital market has considerable scope to grow as it is only 0.2% of GDP (compared 0.4% of GDP in the US) and the ‘lack of overheating evident in the US market in 2000’ (RBA, 2000, p. 58).

OVERVIEW, IMPACT OF DEVELOPMENTS AND TRENDS ON SMEs AND RECOMMENDATIONS TO POLICY-MAKERS

Although there appears to be a sufficient number of institutions in the financial sector to promote competition, the fact remains that a high concentration (80 to 90%) of small business deposit and lending assets lies with the major banks. This suggests that small businesses are either satisfied with their overall banking arrangements or that the perceived benefits of switching provider do not outweigh the costs. A number of reasons have been suggested for the latter explanation including full service provision, branch location and convenience, cost of switching providers, credit risk management expertise and brand power.

The possible consequences of this high concentration is that competition between major banks is stifled, and competition between the major banks and other institutions is minimal, and is likely to remain so until sufficient market share change occurs to stimulate competition. The consequences of such competition could be an improvement in product innovation and small business service and satisfaction levels.

The data reviewed indicates that while the cost of basic business banking account transactions has not decreased, the cost of basic business cheque transactions has decreased for small businesses adopting new technology telephone and Internet banking. Credit card merchant schemes, which are dominated by the major banks levying higher fees on small business, are likely to undergo sweeping reforms in late 2002.

Table 7: Impact of Issues on SMEs and Recommendations for Policy-makers

<table>
<tr><th colspan="2">ISSUE</th></tr>
<tr><th>IMPACT OF ISSUE ON SMEs</th><th>RECOMMENDATION</th></tr>
<tr><th colspan="2">Lack of competition in banking industry</th></tr>
<tr><td>- is likely to hinder product innovation and lower fees, charges and interest rate margins.</td><td>Precludes dismantling of the ‘four pillar’ policy and necessitates thorough assessment by the ACCC of the implications of takeover of regional banks on competition, and monitoring of prices thereafter.</td></tr>
<tr><th colspan="2">Major and regional bank dominance</th></tr>
<tr><td>- in the provision of debt finance and current account servicing is likely to continue due to:
• the convenience of greater branch numbers and location
• one-stop full service offerings
• customers tend to have a history with banks that contribute to their ability to better assess credit risk and provide support at reasonable cost
• the costs and impediments to switching providers
• brand power.</td><td>• One-stop shop service should be encouraged for all second tier financial institutions in order to promote competition between providers and facilitate small business switching.
• Emerging providers of banking and financial services should be encouraged to develop the range of services offered and extend penetration in the market, particularly to rural and suburban commercial communities affected by bank branch closures.
• Ongoing monitoring of bank fees, charges and conditions of individual products like transaction accounts, cheques accounts and loans as well as new technology telephone and Internet transactions. Comparisons of aggregate dollar bank fee growth rates disguise the individual product fees and the volume of transactions and debt financing. Baseline data for ongoing comparison and trend analysis is provided by KPMG Consulting (2002), Connolly and Hajaj (2002) and RBA publications.</td></tr>
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Table 7 Impact of Issues on SMEs and Recommendations for Policy-makers (cont.)

Credit card merchant fees	
- are likely to be a source of continuing fee growth for banks and small businesses' limited ability to pass the merchant fee onto credit card users causes price distortion as consumers paying cash face the same prices as credit card purchasers.	Reform plans of the RBA should be supported: • *An objective, transparent and cost-based methodology for determining interchange fees* • *Freedom for merchants to recover from card holders the costs of accepting credit cards* • *A more liberal access regime that allows for the entry of specialist credit card service providers, both issuers and acquirers, to be supervised by APRA* (Connolly and Hajaj, 2002, p. 20).
Increasing interest rate margins	
- between the cash rate and the small business loan rate since 1998/1999 has effectively meant that interest rate decreases have not been fully passed onto borrowers. In the current environment of rising interest rates, the extent of the flow-on effect of interest rate increases will be influenced by changes in the margin between the cash rate and the small business loan rate.	• Margins between the cash rate and the small business loan rate should be monitored in both rising and declining interest rate environments. Changes in risk premiums should also be monitored to ensure they are not merely the result of efforts to generate bank profit growth.
Product innovation	
- in the form of product bundling is likely to make switching provider(s) more difficult. - may be enhanced if barriers to switching are reduced.	• Could be enhanced through the analysis of US product innovation with a view to assessing suitability to the Australian market.
Decline in bank service	
- with the replacement of personal branch managers with call centres and sales teams has broken down relationship banking and has reduced the flexibility of the bank to assist in times of cash flow difficulty such as in seasonal downturns. Additionally, there has been a decline in the level of understanding any one individual develops about a small business. Transaction pricing disincentives are pushing customers away from over-the-counter transactions to telephone and Internet banking.	• Relationship banking should be encouraged despite bank restructuring, branch closures and the increasing use of call centers and cheaper telephone and Internet transactions. • Current data on bank service and satisfaction levels is required.
Actual and perceived barriers to switching banking provider	
- inhibit switching by small businesses dissatisfied with the services of the current provider(s). Facilitation of the switching process should have beneficial effects on competition and product innovation.	• Facilitation of switching by encouraging providers to outline details of the implication of switching up-front and/ or at the time switching is contemplated by a small business, and provide reasonable means and assurances of a smooth transition to an alternative provider(s). • Current data on rates of provider switching and associated barriers is required.

Table 7 Impact of Issues on SMEs and Recommendations for Policy-makers (cont.)

Branch closures	
- are likely to have two effects on small business: Direct effect - disruption of the client-bank manager relationship and the inconvenience of having to travel and/ or altering the way in which banking is conducted through the use of call centres and the Internet Indirect effect - in small suburban shopping centres that cater for staple products and possibly a few specialty shops, a branch closure can result in the migration of consumers to other shopping centres that cater for their shopping and banking needs with adverse consequences on individual small businesses and possibly the local community economy.	• Encouragement of emerging providers of banking and financial services which may compensate for the lack of presence of a bank branch by offering a limited range of financial services including cash and cheque hamdling. • The impact of takeovers of regional banks by the 'major' banks on branch numbers in regional areas should be thoroughly assessed by the ACCC.
Equity financing	
- is likely to continue to be constrained due to demand factors (self-imposed growth caps and desire to retain control) and supply factors such as lack of information, high search and transaction costs.	• Comprehensive financial reporting by SMEs should be encouraged to assist equity (and debt) financing.

Relatively greater competition is evident in the provision of small business debt finance with 53% supplied by major and regional banks and overall fees on individual loans having decreased since the mid 1990's. Additionally, the weighted-average interest rate paid by small businesses over all types of variable-rate loans has decreased, despite an increase in the margin between small business interest rates and the cash rate.

In light of the findings of this review, the possible impact of the identified developments and trends on SMEs are summarised in Table 7. Additionally, recommendations to policy-makers in order to mitigate any possible negative effects are made.

NOTE

1 Term loans are similar to a residential mortgage i.e. variable or fixed interest rate with repayments covering principal and interest over the life of the loan, but with shorter a term of 10-15 years

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