SME Borrowing Experiences

Variable and inflexible credit processes impact Australia's engine room

With heightened levels of competition taking place in the business lending markets, concerns around credit quality have been expressed by the Banking Regulator, the Federal Treasurer and the Central Bank. The worry has been that banks have relaxed their credit standards in their quest to protect and grow market share of business lending. Further, the rise in non securitised lending, relaxed collateral products such as low doc loans, and all lenders shaving their margins on secured lending, have only served to exacerbate concerns.

To find out whether such disquiet is warranted, East & Partners added a set of proprietary questions to the firm's most recent SME Banking Markets research, interviewing some 1447 SMEs nationally. It is in this segment that the brunt of lending activity is taking place in response to SMEs' growing appetite for debt. (The March 2006 JPMorgan/East & Partners Australian Banking Survey shows that 83.5 percent of SMEs are planning on additional borrowings over the next 12 months). We asked SMEs about their experiences in applying for loans over the past two years, whether or not they were successful, if not why not, whether they were able to source debt from elsewhere, and the impact being turned down for a loan had on their business. This information was then segmented by lender, which has resulted in a very revealing picture of individual bank lending behaviour.

Figure 1

Have you been declined over a loan application for your business in the last two years by your principal banker?

N: 1447	**% of SMEs**
Yes	38.8
No	44.0
No loan applications made	17.2
TOTAL	100.0

The first finding of note was that almost four in ten SMEs had had a loan application declined over the past two years. So despite concerns that lenders are dishing out money hand over fist, it is clear that strong credit assessment is occurring. That said, the findings revealed a great deal of variation in these credit processes between individual banks in terms of their willingness to provide debt. One major bank, for example, declined almost four times as many applications as a couple of its peers over the period. However, there was very little variance between banks when it came to why SMEs had been turned down for loan applications. Some 40 percent of SMEs said they had not received a clear explanation on why their application had been declined while another 31 percent said they were given only a partial explanation. More than two thirds of those who had been furnished with an explanation had been declined due to "inadequate security". This would indicate that for certain lenders much of the credit process is primarily based on automatic credit scoring, with bricks and mortar security still representing the credit gateway for SMEs. Such an inflexible attitude on the part of certain lenders might explain why churn levels are so high in the segment, particularly as SMEs continually ask their providers to "understand my business" and are increasingly looking for cash flow lending solutions.

One quarter of declined SMEs shelve growth plans

The knock on effect of being turned down for a loan in what is the engine room of Australia's economy is that almost a quarter of SMEs shelve their growth plans. Others had difficulties managing their cash flow, couldn't acquire assets to grow the business as they wished, while others went as far as selling the business altogether. In fact, just 24 percent said they weren't adversely affected by not sourcing more debt. Some 18 percent of SMEs that had been knocked back originally switched bank and almost 80 percent of these businesses found a new lender willing to provide the loan facilities they were seeking – a further illustration of variable credit processes. It is this near fifth of declined SMEs able to source debt elsewhere that might cause Australia's monetary and regulatory guardians the odd sleepless night.

Overall, three quarters of all SMEs interviewed described the experience of asking their bank for a loan application as "negative" with just a quarter saying they found it a "positive" experience. Quite a comment given that SMEs have purportedly been a major focus of all banks for almost two years and represent their greatest current source of growth and margin.

Figure 2

What was the primary reason you were given for the decline?

N: 162	**% of Declined SMEs**
Inadequate security	72.8
Bank didn't think we could service it	10.5
Poor business plan	8.6
Not with bank long enough	4.9
Other	3.2
TOTAL	100.0

No substantive variance by bank