BUSINESS BORROWING COSTS

In this article Bernard Hodgetts and Bryan Chapple examine recent trends in business borrowing costs.

Executive Summary
The question of the interest rates and associated costs of finance that some small and medium-sized business borrowers are facing has been a topic of discussion recently. Debate has centred on whether the interest rates these borrowers are charged have increased relative to the base lending rate and bank funding costs, and whether bank fees have increased.

Interest rates faced by most small and medium-sized business borrowers will generally be somewhat higher than banks’ published base lending rates. That margin will reflect, among other things, the profitability and riskiness of the borrower’s industry, the borrower’s own track record, and the quality of the security offered. Because small businesses generally have a relatively high failure rate, the margins on loans to those entities are likely to be relatively high.

However, the sparse formal evidence that is available provides at best only limited support for the notion that business borrowing margins have increased substantially in recent years, or that fees have been raised to achieve the same effect. Empirical data are not comprehensive, but the available data suggest that the standard risk margin has been relatively stable in recent years. There is also little evidence of a systematic widening of borrowing fees. Good quality customers appear to be in a relatively strong position to secure fee discounts, and to ensure that fees reflect no more than the true cost of providing the service.

In an aggregate sense these conclusions on interest rates and fees are supported by evidence on the profitability and earnings of banks. Data from a representative sample of banks indicate that bank gross earnings (i.e. earnings before operating costs and bad debts) have fallen in recent years as a share of total assets. In conclusion, there does not appear to be evidence of a significant widening in the cost of finance to small and medium-sized business borrowers relative to bank funding costs. However, there is little doubt that, given the current state of the economy, banks are exercising greater caution than was the case a few years ago. Potential borrowers also appear to be relatively more cautious than might have been the case in the mid-1980s.
Recently announced reductions in base lending rates - to around 12.5-12.75 per cent - have seen business borrowing rates fall by almost 4 percentage points since late last year. If short-term wholesale interest rates remain at around 8 per cent (the level at the time of writing in early November), and retail deposit rates fall further - to establish the normal relationship between retail and wholesale funding costs - then there should be scope for further gradual falls to base lending rates, perhaps to around 10-11 per cent. Given normal margins, small to medium businesses would then, on average, be facing actual borrowing rates from banks of around 13-14 per cent.

Introduction
Much discussion in recent years has focused on the interest rates and associated costs of finance facing small and medium-sized businesses. There has been a widespread perception that margins for these business borrowers have increased. This article addresses some of these issues. It is concerned with the interest rates prevailing in the retail market for loans provided by the banking system to the small to medium-sized business sector. (In many cases, large corporate borrowers will be able, in part at least, to access funds directly in the wholesale money markets, such as the commercial paper market, or from offshore. The levels of local retail interest rates are therefore of less direct significance to these borrowers.)

There has also been debate about the access of firms to bank finance, but there is little evidence regarding this matter. Accordingly this article does not address this issue in detail. (Nor does the article address the relationship between business borrowing costs and the decisions or performance of borrowers.)

The article first reviews the level of borrowing costs that small to medium-sized businesses might be expected to face - both in principle, and in the current economic environment. The second section reviews what the evidence is in New Zealand, and the third section looks at the question of bank fees and charges. Rigorous and consistent information is hard to come by, but the available information provides only limited support for concerns that overall credit costs have altered in a way inconsistent with the state of the economy.

Base Lending Rates and Actual Borrowing Rates
Interest rates faced by most small and medium-sized business borrowers will generally be somewhat higher than the published ‘base’ lending rates of a bank or other financial institution. The base lending rate itself will normally be some margin above the banks’ cost of funds, reflecting the normal costs of banking operations. The base rate is best thought of as a benchmark interest rate for a wide range of loans, to which lenders will usually add some margin to reflect the risks inherent in a particular loan.
These margins, in general, reflect two factors. The first is the lender’s judgement about the relative risk of lending to the business in question. This risk assessment can be expected to vary depending on the perceived profitability and riskiness of the industry to which the borrower belongs, and on whether or not the particular borrower has a proven track record of creditworthiness and/or of operating successfully in the industry. The second major factor determining the interest rate borrowers face is the quality of the security offered for the loan. All other things being equal, the poorer the security, the higher the interest rate (relative to the base rate) a borrower is likely to be charged.

Risk is a key reason why smaller-sized businesses often face higher borrowing rates than larger companies (i.e. why their borrowing rates are higher relative to the base lending rate), or than the rates charged on residential mortgages. Small businesses historically have a higher failure rate than do larger businesses, particularly in their earlier years; hence the average risk of default on a loan to a small business is higher. The problem is accentuated by the difficulties and expense lenders face in obtaining reliable and ongoing information on the viability of a small business.

In lending to small businesses, banks are providing an intermediation service, channelling the required funds from depositors to borrowers, for firms who are not able to tap equity or loan markets directly. Small firms are generally unable to access equity markets, partly because of the cost or the difficulty potential investors would have in securing reliable information. Risk margins reward the lender for providing these intermediation services. Because of the greater risks of small business lending, much of the lending has some of the characteristics of equity finance or venture capital. Such loans carry the downside risks of equity finance - a significant risk of losing part or all of the capital - generally without the compensating potential for large profits should the business succeed. As a result, banks are likely to charge a premium for the risks involved in providing these sorts of funds to small businesses, particularly in the early years of any enterprise.

It is both appropriate and desirable that financial institutions set interest rate margins with regard to the risks associated with the particular borrower and industry. By contrast, if lenders were forced to charge the same interest rate to all borrowers regardless of risk, then it is highly likely that those intending borrowers that the banks perceived to be relatively risky would be denied finance. Rather, banks would choose to channel funds to those considered prime customers. This was the experience in New Zealand during the pre-deregulation period, when financial institutions frequently faced interest rate ceilings and controls. New borrowers - especially those outside the traditional industries - often faced particular difficulty in obtaining loans from the banking system. Such an environment also discouraged the development of finely-tuned credit assessment skills.

By contrast, deregulated interest rates allow lenders to charge higher interest rates to relatively less creditworthy businesses, and force lenders to develop the skills to judge and price those risks accurately. Nevertheless, lenders are still likely to employ restrictions on the quantity of credit to protect themselves against particularly risky loans. This behaviour occurs because very high interest rates will tend to increase
further the likelihood that a business will be unable to service its debt (by increasing the firm's outgoings). As a result, banks may refuse borrowing lines to some businesses in preference to simply charging a higher interest rate.

Typically, banks tend not to alter the schedule of margins added to the base lending rate very frequently, because assessments of relative industry risk and of the overall state of the economy are likely to change only gradually. Most variations in the interest rates charged to business customers result from changes in the underlying funding costs faced by the banks - as reflected in both wholesale and retail deposit interest rates. Movements in these funding costs will normally flow through reasonably rapidly to changes in the base lending rate of the institutions. However, the base lending rate itself, relative to funding costs, will tend to reflect the banks' overall assessment of corporate risk. If, for instance, banks perceive that business lending has, on the whole, become more risky than residential mortgage lending, then base lending rates are likely to increase relative to mortgage rates.

For example, Table 1 shows that, since 1987, although both business and household rates have fallen substantially (by between 6 and 7 percentage points), base rates have generally fallen a little less rapidly than mortgage rates.\(^1\) Heightened perceptions of business risk may be one reason for the increased gap between base lending rates and mortgage interest rates. However, the introduction in 1989 of capital requirements for registered banks, stipulating a higher capital backing for business lending relative to household mortgage lending, may also account for the lesser declines in base lending rates since then. Moreover, given that declines in interest rates have at times been substantial, business and mortgage lending rates may have adjusted at different speeds.

### TABLE 1

<table>
<thead>
<tr>
<th>Base Lending Rate (1)</th>
<th>Mortgage Interest Rate (2)</th>
<th>Gap (1)-(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1987</td>
<td>19.0</td>
<td>18.5</td>
</tr>
<tr>
<td>Jan. 1988</td>
<td>19.3</td>
<td>19.4</td>
</tr>
<tr>
<td>Jan. 1989</td>
<td>16.1</td>
<td>15.7</td>
</tr>
<tr>
<td>Jan. 1990</td>
<td>15.8</td>
<td>14.8</td>
</tr>
<tr>
<td>Jan. 1991</td>
<td>15.8</td>
<td>14.7</td>
</tr>
<tr>
<td>Sep. 1991</td>
<td>13.1</td>
<td>11.8</td>
</tr>
<tr>
<td>Oct. 1991</td>
<td>12.7</td>
<td>11.3</td>
</tr>
</tbody>
</table>

\(^1\) Average base lending rate charged by the largest four registered banks, and the average first mortgage interest rate for new borrowers charged by the nine major providers of mortgage finance.

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1 It should be noted that these particular series are only available since 1987. Consequently, it is difficult to assess how mortgage interest rates and base lending rates have moved relative to each other over longer periods of time.
Recent Behaviour of Margins

The extent to which changes in the cost of funds typically flow into base rates can be seen in Figure 1, showing movements in the base lending rates of the four largest banks and in a proxy for their average funding costs. Figure 1 illustrates the significant falls in base lending rates that have occurred since 1987 and, in particular, the fall of over 3 percentage points since late 1990.

Amidst the extreme financial sector optimism of the mid-1980s, many loan margins did not appear to adequately reflect objective riskiness. This may have been a particular problem in respect of loans to large speculative borrowers heavily exposed to asset price fluctuations. Following the significant and unforeseen increase in loan losses in many sectors of the economy since the 1987 sharemarket crash, banks will have increasingly faced pressure to reflect, in interest rates, the true risks associated with business lending. In an economy with a weak business sector (albeit with growth evident among some industries—for example, exporting industries), institutions could have been expected to have further raised the risk margins applying to lending to businesses in order to adequately reflect the heightened riskiness of such loans.

Figure 1

Interest Rates

\[
\text{%}
\]

\[
\text{March Years}
\]

- Average base lending rate
- Estimated average cost of funds

2 Average funding costs are a weighted average of the wholesale and retail deposit interest rates that banks are estimated to have been paying at a given time, and is itself only an approximation.

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### TABLE 2
ESTIMATES OF AVERAGE BUSINESS BORROWING RATES
OF SELECTED FINANCIAL INSTITUTIONS

<table>
<thead>
<tr>
<th></th>
<th>Estimated Business Average Lending Rate&lt;sup&gt;1&lt;/sup&gt;</th>
<th>Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Published Base Rate</td>
<td>(1)</td>
</tr>
<tr>
<td>1989</td>
<td></td>
<td>(2)</td>
</tr>
<tr>
<td>Sept.</td>
<td>15.75</td>
<td>18.08</td>
</tr>
<tr>
<td>Dec.</td>
<td>15.75</td>
<td>18.44</td>
</tr>
<tr>
<td>1990</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mar.</td>
<td>15.75</td>
<td>18.45</td>
</tr>
<tr>
<td>June</td>
<td>15.75</td>
<td>18.51</td>
</tr>
<tr>
<td>Sept.</td>
<td>16.08</td>
<td>18.98</td>
</tr>
<tr>
<td>Dec.</td>
<td>16.25</td>
<td>19.17</td>
</tr>
<tr>
<td>1991</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mar.</td>
<td>15.25</td>
<td>17.74</td>
</tr>
<tr>
<td>June</td>
<td>14.42</td>
<td>17.53</td>
</tr>
<tr>
<td>Sept.</td>
<td>13.63</td>
<td>16.15</td>
</tr>
</tbody>
</table>

<sup>1</sup> Calculated as a weighted average interest rate for lending undertaken at the base lending rate or higher.

However, such data as there are, give no support for this proposition. Table 2 contains estimates of the average business lending rates in recent years for two large banks.<sup>3</sup> The table shows the difference between this average business lending rate and the base lending rate. It can be seen that the actual rates that businesses face have been, on average, around 2.5-3.5 percentage points higher than the base lending rate in recent years, consistent with quoted normal margins for a small business of around 3 percent above the base rate. For these banks, there is little evidence that a trend increase in margins has taken place since 1989. While some general increase in margins cannot be ruled out by looking at a subset of banks over a relatively short period, the evidence - such as it is - suggests that a significant widening in the margins facing business borrowers is unlikely to have occurred over recent years. Nevertheless, base rates do appear to have fallen a little less rapidly than banks’ costs of funds and mortgage rates. To the extent that this is not simply an anomaly arising from the data, the divergences may well reflect the increased riskiness of lending in a weaker economy.

What is more likely to have changed is the stringency of the standards adopted by banks in deciding whether or not to lend at any given interest rate or margin. As noted above,

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<sup>3</sup> These are the only large banks for whom a relatively long series is available. Data provided by the banks on interest rates charged does not differentiate between lending to business (nor between businesses of different size) and lending to households; thus it was necessary to construct estimates of the proportions lent to businesses at various interest rates. Some variation in the margins calculated from this data can be expected to occur from quarter to quarter, due to changes in the composition of bank lending. The data are indicative only and should be treated with caution.
it is rational in some situations for banks to limit the quantity of credit to particular borrowers, and not simply to attempt to price the risk. The existence of tighter credit standards is difficult to demonstrate formally, but anecdotal indications are that potential borrowers without a proven track record have experienced increased difficulty obtaining funds for some business propositions, and that higher quality collateral, or improved cash-flow prospects are being required. (It is worth noting that the margins above base rates and the changes in credit standards are not exclusive to New Zealand: similar margins are charged, for example, in the United Kingdom and Australia - and similar concerns have also been voiced in other countries over tightening credit standards during the current recession.)

Further evidence that banks are unlikely to have widened margins significantly in recent years, relative to the objective risks in the economy, is provided by some measures of earnings and profitability shown in Table 3, for a representative sample of five registered banks (those for whom 1991 data are available). The table shows that profitability and gross earnings (effectively net interest receipts and fee income), as a percentage of total assets, have not shown a trend increase over the last four years. This is despite a reduction in both operating costs and the proportion of bad debts since 1989, and the fact that off-balance sheet activity has generally been growing in significance in recent years. These trends are likely, at least in part, to be indicative of increased efficiency and competition in the financial sector - though possibly also of the reduced flow of new business.\(^{4}\)

**TABLE 3**

**INDICATORS OF BANK PROFITABILITY\(^1\)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Costs</td>
<td>4.4</td>
<td>4.6</td>
<td>4.1</td>
<td>3.6</td>
</tr>
<tr>
<td>Bad Debts</td>
<td>1.1</td>
<td>4.6</td>
<td>0.8</td>
<td>0.3</td>
</tr>
<tr>
<td>Profits before Tax</td>
<td>1.7</td>
<td>-2.5</td>
<td>0.8</td>
<td>1.1</td>
</tr>
<tr>
<td>Gross Earnings</td>
<td>7.2</td>
<td>6.7</td>
<td>5.8</td>
<td>4.9</td>
</tr>
</tbody>
</table>

\(^1\) Weighted averages for a sample of five registered banks for whom 1991 data are available. This sample appears to be representative of the full group of retail banks, on the basis of 1988-1990 data.

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\(^{4}\) Caution should however be exercised in making comparisons with the frenzied years of the mid-1980s regarding absolute rates of earnings and profits, i.e. it is not clear what appropriate long-term benchmark rates are.

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In the current economic climate a number of constraints may have been operating to limit any increase in margins applying to business borrowers. In particular, the value of total lending to businesses has remained flat over the past year. Accordingly, institutions are likely to have been more reluctant to increase margins, especially on loans provided to high quality business borrowers. Further, it should be noted that retail bank loans do not represent the only avenue for borrowing for many of the medium-sized business borrowers. Increasingly, businesses borrowing upwards of around $100,000 appear able to access cheaper funding through the wholesale money markets - at least for shorter-term finance. For example, banks are willing to issue bank bill paper on behalf of larger customers. The customer then pays the interest rate prevailing in the bill market, together with a risk margin charged by the issuing bank. This facility allows borrowers to take advantage of the cheaper borrowing rates available from the wholesale money markets. Although these facilities are not available to small borrowers, the provision of this service by some banks represents a constraint on the retail interest rates they are able to charge the larger of their small to medium sized business customers.

Furthermore, small business operators may also have access to alternative forms of finance to the traditional form of business loan. For example, some business-owners may opt to finance business operations via a residential mortgage secured on their own home - thereby benefiting from the lower interest rates applying on this form of loan. From a taxation perspective, the deductibility of interest expenses on such loans is generally treated in the same manner as those for traditional business loans.

Fees on Business Borrowing
In addition to the interest rate charged to business customers, banks also charge fees. In general, two types of fees prevail - establishment fees, relating to the establishment of a borrowing facility; and some ongoing form of fee, such as the service commitment fee charged on overdrafts.

The procedure of charging front-end fees makes it costly for customers to transfer between institutions. Some have argued that banks use this practice to explicitly reduce customer mobility. But it is also the case that charging these fees - rather than simply incorporating them into the margin - reflects the fact that the costs involved in establishing lending facilities are unlikely to be closely related to the size of the loan.

Bank fees should, in principle, reflect the administrative costs of the particular type of loan taken. As much of the overhead cost of providing a loan occurs when it is first approved, it is reasonable to expect that banks would charge some set-up or establishment fee to cover the costs incurred. The risk associated with the loan, and the costs of raising the money which has been loaned, should be reflected in the interest rate that the customer is charged.

Competition in the banking industry is likely over time to ensure that banks and other financial institutions are not able to charge excessive fees. Some borrowers (and depositors) may have faced increased fees following deregulation as the pressures of competition encouraged banks to charge fees more closely matched to the true cost of
the services provided - thus eliminating cross-subsidisation between customers. Examples of this include the introduction of cash handling fees by some banks, and moves to link transaction fees more closely to the volume of transactions occurring. On the other hand, in earlier decades when interest rates were regulated, higher overall fees may have been one means of boosting bank income, in a manner unrelated to the cost of services. In the recent period of relatively intense competition, the level of fees charged appears to have become an important area of competition between banks. Many quality customers are apparently asking for, and receiving, discounts on fees charged, as banks compete to win and hold accounts. For instance, banks are now often willing to reduce the establishment fee that business customers are normally charged when a loan facility is set up. Indications are that some institutions are also willing to reduce the service commitment fee charged on business and farm overdrafts for certain categories of customers, especially where the security offered is good quality.

However, where a business does not have a proven track record, and the level of security offered is not great, a bank is less likely to be willing to negotiate fees downwards. Those existing bank customers who are not in a good financial position will have very little scope to demand lower fees since they cannot readily change banks.

Anecdotal evidence from institutions suggests that heightened competition may have led to something of a reduction in the levels of fees actually charged to customers, even if this is not always reflected in the scales of fees published. Overall, indications are that quality customers should be in a better position now, than in previous years, to negotiate reductions in fees charged. The notion that fees have, if anything, tended to ease slightly over the past year or so, tends to be borne out by the data in Table 3 where gross earnings as a share of balance sheet assets has been falling (even though off-balance sheet activity has generally been growing faster than the size of the balance sheet).5

**Outlook for Business Lending Rates and Conclusion**

Table 2 suggests that for the banks, average business lending rates are likely to have been around 2.5-3.5 percentage points higher than the published base lending rate. Since the June quarter, following the significant falls in wholesale rates, further falls in business lending rates have occurred, with the banks' most recent announcements having brought base lending rates down to around 12.5-12.75 per cent. Business borrowers now face borrowing rates between 3 and 4 percentage points below those prevailing at the end of 1990.

The recent reductions in base lending rates do not appear to fully reflect the declines in wholesale interest rates over the last few weeks. Setting aside the normal adjustment lags, this phenomenon appears to relate to the intense competition in the retail deposit market which has held many retail deposit rates above wholesale rates for comparable terms. If short-term wholesale interest rates remain at their current levels of around 8 per cent,6 and the traditional historical relationship between retail deposit rates and wholesale rates is re-established, then scope exists for further gradual reductions in base

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5 However, it is fair to note that given the range and type of income included in gross earnings, these numbers again are indicative rather than conclusive.
6 As at the time of writing, in early November.
lending rates, perhaps to around 10-11 per cent. Such reductions could be expected to further reduce the average retail borrowing costs of businesses to around 13-14 per cent, on the basis of the historical margin between base lending rates and average lending rates facing business borrowers.

In conclusion, the evidence presented in this paper does not point to a significant widening in the cost of finance to small and medium-sized business borrowers - either as a margin on the base lending rate, or as a margin over banks' funding costs. Similarly, there is no evidence to suggest that banks have been systematically increasing fees as an avenue to earn additional income from borrowers.

However, it is important to distinguish between cost of credit and its availability. There is little doubt that, given the current state of the economy, banks are exercising greater caution about the standard of loan proposition they regard as bankable, than was the case a few years ago, and that potential borrowers themselves are more cautious. Unfortunately, little evidence can be brought to bear to examine this phenomenon, but it is nevertheless likely to be of importance in the current environment.

Businesses that are able to obtain bank finance appear to be able to do so at reasonable margins over bank funding costs. Real interest rates remain relatively high, but those real costs of finance are likely to fall further over coming months as the entire interest rate structure adjusts to this year's unprecedented fall in wholesale funding costs.