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Asymmetric information and price competition in small business lending

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ABSTRACT

This paper examines the relationship between bank lending rates and their cost of funds in New Zealand. Our results show that on average mortgage rates respond more quickly to changes in the cost of funds than base business lending rates. We also find an asymmetry in the initial (short-run) response of banks to changes in funding costs; in particular, our results show banks adjust mortgage rates downwards faster than upwards. The speed to which lending rates revert back to their equilibrium relationship with funding costs varies across the lending markets. We find the adjustment speed is faster when mortgage rates are below equilibrium, whereas it is slower when business lending rates are above long-run levels in relation to funding costs. Our analysis suggests that banks prefer the plain-vanilla type of lending such as mortgages in comparison to small business lending consistent with asymmetric information associated with business loans.

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1. Introduction

During the recent global financial crises, while financial institutions in the US, UK and Continental Europe were fighting for their survival due to massive exposures to sub-prime mortgages and related mortgage derivatives such as CMOs, banks in New Zealand (and Australia) remained relatively profitable in the face of significant external shocks (see Table 1). In fact, out of the 20 or so banks rated AA in the world in 2009, four banks come from Australia who also control about 90% of banking assets in New Zealand.

The contrasting fortunes of the major Australasian banks when compared with those of financial institutions in many other countries have put the spotlight on the lending behavior of these banks, in particular in New Zealand. A main concern is the issue of whether banks have been too slow to pass on reductions in official interest rates and/or cost of funds to borrowers and whether the Australian-controlled banks were profiting at the expense of their New Zealand customers and the economy. Central to the public policy debate has been the issue of whether high concentration in the banking industry compromises the degree of effective competition between banks.[1]

During the period July 2008 to May 2009, the official cash rate (OCR) in New Zealand, an overnight policy rate similar to the federal funds rate in the United States, was reduced drastically from 8.25% to 2.5% as the economy entered into a recession. While banks have passed on, to a large extent, interest rate cuts to mortgage borrowers, much less was passed onto business customers. For example, the average floating mortgage rate went down from 10.9% to 6.4% (a reduction of 450 basis points), but the base business lending rate decreased from 12.2% to 9.8% (a mere reduction of 240 basis points). Not only were business lending rates kept high, the amount of business lending has also been reduced as banks tighten their lending standards when the economy deteriorates and default rates increase.

As businesses, especially the smaller ones are the biggest sources of employment in New Zealand, high business lending rates and/or lack of credit may result in significant job losses. Against this background, in a rare move on 9 June 2009, the Finance and Expenditure Select Committee of the New Zealand Parliament issued a report criticizing banks in New Zealand for failing to pass on interest rate cuts. The report states that it is "vital that banks neither insulate their profit margins nor charge excessively high interest rates at the expense of the real economy and taxpayers."

Senior government officials and civil servants have issued stern warning to banks regarding the sluggish pass-through of interest rate cuts. For example, the Finance Minister, Bill English, raised concern that banks were slow in dropping mortgage rates, but said

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[1] See the Report of the Parliamentary Inquiry into Banking, November, 2009 (http://img.scoop.co.nz/media/pdfs/0911/report_of_the_parliamentary_banking_inquiry.pdf).

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Table 1
Financial performance of New Zealand banks (in NZD millions). *Source*: Reserve Bank of New Zealand.

Years ended 31 December	2005	2006	2007	2008
Net interest income	5425	5914	6160	6905
Total income	8031	8467	8987	9708
Less non interest expenses	3846	3702	3870	4171
Less bad and doubtful debt expense	195	162	258	881
Net profit after tax	2791	3199	3237	3255
ROA	0.011	0.011	0.010	0.008
ROE	0.145	0.159	0.151	0.143
Tier 1 capital adequacy ratio	0.087	0.081	0.076	0.084
Capital adequacy ratio	0.109	0.107	0.105	0.113

that the government could not force them to lower interest rates. Similarly, the New Zealand central bank governor, Alan Bollard, has repeatedly called on banks to pass on wholesale interest rate cuts to borrowers and reminded banks not to underestimate the amount of "corporate anger" with regards to the banking system. In May 2009, the Auckland Chamber of Commerce conducted a survey which found that 394 out of 494 business respondents believed that there was a lack of support for business from banks. Banks in New Zealand responded by arguing that the overnight official rate is not a good measure of the cost of funds and lending rates were high because cuts in official rates have been offset by higher marginal funding costs for deposit and wholesale funding.

Are the comments by politicians, civil servants and businesses just pure bank bashing? Do banks prefer certain market segments such as plain-vanilla mortgages to business loans in their lending practices? These are the issues we are interested in addressing in the current study.

Conventional theory states that banks exist because of asymmetric information between borrowers and lenders that leads to adverse selection and moral hazard problems. Banks can overcome these problems by acting as delegated monitors. They possess specialized skills in collecting and processing insider information related to the credit-worthiness of potential borrowers and are able to monitor them through on-going banking relationships. Further, transaction costs can be lowered due to economies of scale and scope and risks can be reduced through diversification. Empirical studies show that bank debt is somewhat special in the sense that stock markets react positively to the announcement of bank lending agreements. Bank loans provide signals to outside investors regarding the underlying ability of firms to service their debt obligations (James, 1987).

When it comes to lending to small and medium-sized enterprises (SMEs), the problem of asymmetric information is even more acute. SMEs have higher failure rates and there is also lack of economies of scale in lending to these businesses. For example, Berger and Udell (1995) show that business relationships play an important role in small business lending. The longer the relationship, the lower the loan rates and the fewer the loan covenants. Although Petersen and Rajan (2002) conjecture that in the United States the greater and more timely availability of borrower credit records and the greater ease of processing the information have enabled banks to reach more distant SMEs, it remains to be seen if lending relationships can indeed be displaced.

In this paper, we examine if banks in New Zealand price their SME loans and mortgage lending differently. Specifically, we examine how mortgage rates and business lending rates respond to changes in banks' funding costs in the long-term as well as in the short-term. We further examine whether banks adjust these lending rates in an asymmetric manner; in other words, whether loan rates are fast to go up and slow to come down.

The New Zealand case is interesting because the banking system while concentrated is highly contestable and the economy is dominated by SMEs. 91% of firms are considered small and medium-sized enterprises. Firms with less than five full-time employees are considered small size and those with 5–19 employees are considered medium-sized enterprises. The New Zealand economy has been consistently ranked as being one of the most deregulated in the world and deposit and lending rates are freely determined by banks and other financial institutions. Hence, the New Zealand experience should shed some light on bank lending behavior toward small businesses.

Our results show that mortgage rates respond more quickly to changes in the cost of funds than base business lending rates. We also find evidence of asymmetries in the short-run and long-run response of banks to changes in funding costs. In particular, we find that banks adjust initially mortgage rates downwards faster than upwards, but the speed to which mortgage rates revert back to their long-run equilibrium relationship with funding costs is faster when they are below than above equilibrium. On the other hand, the speed to which business lending rates revert back to equilibrium is faster when they are above than below equilibrium. We surmise that mortgages comprise a more competitive segment of the lending market. Further, the evidence suggests that banks prefer the plain-vanilla type of lending such as mortgages to small business lending consistent with asymmetric information associated with business loans.

The remainder of the paper is organized as follows: Section 2 provides some institutional background on New Zealand banks and small and medium-sized enterprises. Section 3 outlines our methodology. Section 4 discusses the results and the final section concludes the paper.

2. Bank lending and SMEs in New Zealand

The banking system in New Zealand plays a predominant role in the provision of credit to businesses and households. The industry has been extensively deregulated since the mid-1980s. Interest rate regulations and controls were abolished. Liquidity ratios were removed. Restrictions on foreign exchange dealing were eliminated. Entry into the banking system was opened up. The number of banks increased dramatically from four to about 20 and the market is more contestable. There are also a number of non-bank financial institutions. These institutions are allowed to conduct banking businesses as long as they do not call themselves banks (see Grimes, 1998).

As of November 2009, there were 18 registered banks in New Zealand. Among them, eight are locally incorporated banks and the remaining 10 are branches of overseas banks (see Table 2). The banking system is dominated by the big four banks; namely, ANZ National, ASB, BNZ and Westpac. Together they control about 90% of bank assets in the industry and all big four banks are subsidiaries of Australian banks (see Table 3).

Bank lending in New Zealand is dominated by housing loans, accounting for 54.5% of total lending as at April 2009. Non-farm business lending accounted for 26% of total lending (see Table 4). As mortgages are highly secured and required less regulatory capital, competition for mortgage business has been intense. New Zealanders are very keen on property not only for owner-occupation but also for investment largely due to the preferential treatment of real estate by the tax system and the historical underperformance of the country's capital markets. Hence, demand for mortgages is very high.

Compared to mortgages, business loans are more difficult to evaluate as each business is different in terms of management skills and capability, cash flows, competitive edge, and employee relations. This is particular true in the case of New Zealand due to the prevalence of SMEs in the economy. According to Alexander

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