Bank Subsidy Disclosures Lacking

It is hardly surprising that Bank CEOs like the latest iteration of the Federal Government's SME loan guarantee scheme (relabelled SME Recovery Loan Scheme). And they also must appreciate the Term Funding Facility (TFF) providing cheap finance from the Reserve Bank.

And as a bank shareholder, I suppose I should also like them. But, as a tax-payer, I have concerns – even though the objectives of both schemes have merit.

My concerns are of two types. One is whether the schemes are as well designed as they could be. The other is the lack of transparency about the operations of the schemes.

Let's start with the latter concern. In both schemes, the government is providing large subsidies which ideally pass through the banks to the benefit of business and individual customers of banks via increased availability and lower cost of borrowing.

But how do we know that is happening – rather than the subsidies accruing to the banks and increasing their profits? At the moment, we do not know, since there is virtually zero disclosure of any information enabling an answer to that question.

In the case of the loan guarantees, the public is not told which banks are making use of the scheme, nor how many loans they are making and at what interest rates. With the government taking eighty percent of the default risk, following the recent change to the scheme we should expect to see two outcomes.

One is that lower risk small business borrowers should now be charged interest rates markedly below what they would otherwise have paid. (And that should be reinforced by the cheap finance provided by the TFF – where individual bank access to it is linked to business lending).

The second possible effect is that banks increase their lending to high risk borrowers, at high interest rates – since it is the government that bears most of the default risk, while the banks get the benefits if the borrowers don't default. The moral hazard associated with the scheme is high!

Surely we deserve to know the answers to three questions. How much is the expected cost to the government and tax-payer? Are the subsidy benefits flowing through to the economy or being captured by (particular) banks? How much of any increased bank lending is to good risks versus bad risks?

We do not have any information on any of these matters. Even finding out how much in aggregate is being lent under the scheme is very difficult.

The same lack of disclosure applies to the TFF. Some banks may provide some information about participation in their financial disclosures. But why aren't official statistics of individual bank participation from the RBA (rather than just aggregate information) a required component of operating such a subsidisation program.

The RBA has such information readily available. And it is hard to think of any good arguments as to why such information shouldn't be public.

Turning now to scheme design, the moral hazard in the loan guarantee scheme is very worrying. Even though an interest rate cap of 7.5 per cent applies to loans made, this creates very bad incentives for lenders.

Suppose the loan officer's KPIs are to maximise expected profit for the bank without undue increase in risk to the bank. Compared to recent small business loan rates of around 4.5 per cent (or 3 per cent for medium business), at the 7.5 per cent cap rate and with government bearing 80 per cent of the default risk, the loan officer would be incentivised to make loans with default rates many, many, times higher than usual.

Only if the KPIs included some penalty for loan failure rates, or losses imposed on the government, would incentives be socially appropriate. Maybe banks have learnt from past experience that it makes sense reputationally to incorporate such considerations, but….

Likewise, the TFF can create moral hazard issues by linking cheap funding available only to the size of lending and not its quality or cost to borrower. Combined with the loan guarantee scheme, banks have an incentive to make loans that they would otherwise reject to increase their access to cheap funding.

The objectives of the schemes are laudable. But assessing whether they are fit for purpose requires suitable disclosures such as should accompany any subsidy scheme.

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