# Pricing transparency is the elephant in the room issue for non-bank SME lenders

Borrowing from a non-bank lender costs more than borrowing from a bank and to be clear, it ***should*** cost more because non-bank lenders have higher cost of funds, they take more risk and very often they don't take hard assets as security which means if the borrower fails, they usually face a 100 per cent write off. The problem is small business owners have little sense of ***how much more*** it might cost.

The banks offer the same products with much the same interest rates but rates offered by non-bank lenders vary enormously from around 10 per cent to as high as 50 per cent and even beyond. Many SMEs would be surprised if they knew just how much they were actually paying and this can be way more than they need to.

The lack of transparency in non-bank SME lending needs to be addressed if non-bank lenders are to provide the funding support which has not been forthcoming from the banks. Judo Bank, the challenger bank taking on the big banks in this SME space, says the SME lending gap is $90b.

So why aren't non-bank lenders more transparent about their rates? Here are two possible explanations:

There are lenders that don't believe pricing transparency is in fact an issue. They maintain SMEs are quite prepared to pay to engage with user friendly lenders who make it easier for them to get credit. The argument goes that these borrowers don't really care about the interest rate, they just want to know that they can quickly access funds without getting put through the hoops and that they can afford the periodic repayments.

2. “It can’t be done”.
Even if a borrower did want to know just how much a loan would cost, it is not possible to provide an accurate quote without a proper assessment of the borrowers capacity to service and repay a loan.

***Are these explanations fair or just a smokescreen?***
The alternative view goes like this….. non-bank lenders don't disclose rates on their websites and in marketing material because they don't want borrowers to know how much they really charge. They’re aware this is a contentious issue and figure if they don’t talk about rates, they can’t be accused of being misleading.

This begs the question “what is more helpful, or less unhelpful, to potential borrowers - making a potentially misleading statement about pricing or making no statement at all?”

When lenders do talk about rates they might talk about “rates from…” and express rates using different terms that many time por and financially unsophisticated small business owners don't understand like simple interest rate, nominal interest rate and annualised percentage rate (“APR”).

Here is an example. A $100,000 loan for 12 months with interest payable of $10,000 equates to a simple interest rate of 10 per cent. That looks fine provided it is an interest only loan but if the loan is amortised over the term, as most small business loans are, the borrower still pays $10,000 of interest even though they have not had the use of the full $100,000 for the whole year. The interest they pay on the actual amount they owe over the year (the APR) works out at 18 per cent.

Lack of understanding of this significant difference may explain why some borrowers say they don't focus so much on the rate - they are confused and rather than admit they don’t understand, they say they base their decision on other factors like the customer experience and convenience.

Regardless of the extent to which price is or is not important, every borrower has the **right to know** how much it will cost to borrow before making the decision to proceed. It is debatable whether there should be a cap on what lenders charge but there should be no equivocation on the principle that lenders need to be transparent about pricing.

Whilst it is may not be feasible to provide a reasonably accurate indicative rate, or range of rates, without obtaining certain information, an indicative cost, or range of costs, could be made available at the enquiry stage based a few easy to answer questions like:

- How much do you want to borrow and for what term?
- For what purpose and when do you need the money?

- What industry are you in?

Online brokers ask these questions when matching borrowers with lenders and there is no reason why lenders couldn't do something similar at the enquiry stage to be able to quote at least a range of rates if not a specific rate.

To give credit where it is due, the seven fintech lenders who signed up to the Australian Finance Industry Association's (AFIA) Online Small Business Lenders Code of Lending Practice provide approved borrowers with "SMART Box", a report that displays multiple pricing metrics to help them better understand and assess the cost of a loan.

SMART Box is a useful tool but a major limitation is that it is provided at the end of the buying process. That is, this pricing information is only made available after the borrower has gone through the full loan application process. So to satisfy themselves that they are getting a fair deal the borrower has to repeat the process with other lenders and although this doesn't take a huge amount of time, it does create a Catch 22 situation where the more times you apply for a loan, the worse it is for your credit rating and therefore adversely impacts the prospects and pricing of a loan.

***Is industry regulation the solution?***
The level of regulation and scrutiny which banks are now under is not mirrored in the non-bank sector. The phrase "shadow banking" is telling as there are some less scrupulous operators in this largely un-regulated sector whose practices drag down the standing of all non-bank lenders.

The non-bank SME lending sector is so fragmented that it is unrealistic to expect participants to come together as the big four bank oligopoly do. Interests and motivations vary widely.

We also need to remember most of these lenders are relatively small, some are very new and yet to become cash positive so they lack the focus, time and resources to commit to lifting industry standards. Getting all parties to ultimately agree on pricing transparency initiatives would be like herding cats.

This is where industry associations have a critical role to play. The Australian Banking Association's (ABA) 22 member banks control over 90 per cent of the market and all members have signed up to the Banking Code of Practice which is endorsed by ASIC.

There is no ABA equivalent for the non-bank SME lending sector. The closest to it is AFIA which has over 100 members including the big four banks themselves as well as a wide range of personal lenders. AFIA is trying to improve transparency in non-bank small business lending as evidenced by the establishment some 15 months ago of the Online Small Business Lenders Code of Lending Practice. It has an Australian Car Rental Code and is currently launching another code for the burgeoning Buy Now Pay Later sector. AFIA's codes are not endorsed by ASIC and whilst they have independent compliance committees, these committees are appointed by and report to AFIA.

Some pundits maintain codes are not worth the paper they're written on citing concerns re be afforded the opportunity to deliver on their code commitments but broad buy-in is required and codes need to be, and be seen to be, independently monitored and enforced.

Whether codes are endorsed by ASIC or not, if self-regulation fails to deliver in this post Hayne era, sooner or later the regulators will intervene.

***Individual lender action.***
The vast majority of non-bank lenders are run by people who genuinely want to do the right thing by small business owners but they struggle in an increasingly crowded market where indistinguishable websites and value propositions abound.

Here are six ways lenders could improve pricing transparency:

1. Explain simply why it costs more – it is a compelling case.
2. Provide indicative rates based on responses to several simple questions.
3. Publish fixed pricing ranges based on specified parameters.
4. Offer a loan calculator which shows the difference between APR and simple interest rate.
5. Support industry self regulation efforts.
6. Periodic voluntary disclosure of average rates and other metrics.

It is worth noting that pricing transparency is not such an issue with Peer to Peer lenders who generate revenue by charging fees for matching borrowers with depositors. Other lenders such as Judo Bank that adopt similar product and pricing structures and terms as banks make it easier to make apples with apples comparisons.

It is also important to note that transparency is not just about interest rates. Other fees and charges especially related to missed payments, early repayments, defaults as well as commissions paid to introducers cannot be overlooked.

***Conclusion.***
The lack of pricing transparency continues to impinge on the standing of the non-bank SME lending sector and inhibit its prospects of bridging the lending gap. SMEs that fall into this gap need non-bank lenders, industry associations and regulators to deal with this elephant in the room.

Feedback is always welcomed.

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