Executive summary

1.1 The terms of reference for this inquiry into the impairment of customer loans required the committee to consider the practices of banks towards borrowers who they judge may be in financial difficulty and may have breached the terms of their loan contracts.

1.2 The majority of the evidence received by the committee addressed small business and commercial loans, so the committee has focussed its attention on those areas, rather than residential loans which were considered in the post-GFC banking inquiry by the Senate Economics References Committee in 2013. The Committee notes that business lending spans a large range of disparate parties. Some borrowers are publically listed entities with considerable resources to conduct due diligence prior to entering into a contract with a lender. Many, however, are small family businesses—who may still have to borrow millions of dollars to achieve their commercial objectives—yet be run by an individual, family or partnership that has significant personal exposure due to the use of personal assets such as the family home as security.

1.3 The bulk of the evidence received in relation to lenders also related to banks and therefore so does much of the committee's report. However, to ensure consistency across all relevant lenders, the committee's recommendations should be interpreted as applying to all lenders listed as authorised deposit taking institutions by the Australian Prudential Regulation Authority.

1.4 The terms of reference drew particular attention to:

- constructive or non-monetary defaults which include breaches of loan contract terms other than borrowers not meeting repayment requirements; and
- the role of other service providers including valuers and receivers.

1.5 From the evidence it has received, the committee has been able to determine that there has been—albeit in a minority of cases—a persistent pattern of abuse of the almost complete asymmetry of power in the relationship between lender and borrower.

1.6 Many submitters and witnesses alleged that banks had engaged in a range of illegal actions, or actions that breached the Banking Code of Practice. The committee has not been able to discover evidence that demonstrates that there was widespread or systematic illegal behaviour by banks or that there were deliberate impairments of loans motivated solely by clawbacks or warranties associated with acquisitions of banks. However, the committee does consider that there are four factors that create an environment in which small business borrowers are very vulnerable and that banks are able to exploit this vulnerability.

1.7 These factors are:

- that there is a wide variation of conduct that is deemed acceptable by lenders due to the significant level of discretion and commercial judgement available

to the banks for both initial lending and the management of loans in financial difficulty;

- complex, non-negotiable loan contracts, coupled with gaps in existing legislation and regulations, give banks the power to behave in ways that—in relation to loans—are unethical, unreasonable and lack transparency;
- in many cases, borrowers in financial difficulty are unable to pursue their rights though the courts because the process in either unaffordable, or they have lost control of their financial assets due to the appointment of receivers; and
- there are significant gaps in the coverage of mediation and external dispute resolution schemes leaving borrowers without the means to have their disputes with banks tested.

1.8 This inquiry has been conducted at a time when there has been substantial activity in relation to financial services generally, including the Financial Systems Inquiry, reforms arising from a major parliamentary inquiry into the performance of Australian Securities and Investments Commission (ASIC), the ASIC capability review and law reforms relating to insolvency and unfair contract terms. The Australian Small Business and Family Enterprise Ombudsman (ASBFE Ombudsman) was established in March 2016.

1.9 In addition, in April 2016 the government made a range of announcements relating to regulation of banks and lending practices. Commendable as each of these initiatives or reforms are individually, there is a very real risk that significant resources will be committed to processes that may operate in isolation, or worse, at odds with each other. This could leave small business consumers still having to engage in relationships with lenders that are neither transparent nor fair and still facing gaps in their access to effective and affordable dispute resolution.

1.10 The committee considers that to address the vulnerability of small business and commercial borrowers it is essential that a single body be empowered to:

- lead and/or coordinate the implementation of the outcomes of this inquiry and the aspects of the above reforms (government and financial services sector) that relate to small business in order to avoid the significant risk that major gaps and flaws in the protections for small business would remain;
- bring together a team with expertise in financial services, ethics and education to establish standards for the conduct of bank management and their employees in relation to small business loans and to work with the banking industry to implement those standards and appropriate mediation and dispute resolution schemes;
- to work with the banking industry to develop nationally consistent standardised loan contracts; and
- where gaps in the implementation of those standards and appropriate dispute resolution schemes remain, to act as a small business loans dispute resolution tribunal.

1.11 The committee considers that the most appropriate body to undertake this role is the ASBFE Ombudsman. The committee therefore recommends that the government bring forward legislation and other measures to give the ASBFE Ombudsman the relevant powers to carry out this role, and to do so retrospectively where appropriate

1.12 The provisions of the ABSFE Ombudsman Act prevent the ABSFE Ombudsman from recommending the use of commercial arbitration. Commercial arbitration could provide a viable alternative to courts for those businesses and commercial borrowers that do not qualify for external dispute resolution schemes. The committee considers that commercial arbitration may be appropriate in some circumstances and is therefore recommending that the ASBFE Ombudsman be able to direct parties to participate in commercial arbitration for larger commercial loans outside of its jurisdiction.

1.13 The committee also noted suggestions for the development of a nationally consistent farm debit mediation scheme. The committee recommends that a national farm debt mediation scheme should be established. The committee further recommends that a similar nationally consistent mediation scheme be put in place for small business.

Conduct of the inquiry

1.14 The committee has examined the evidence it received in the context of a number of existing legislative, regulatory and other requirements relating to loans including:

- the role of the Australian Prudential Regulatory Authority in protecting financial stability and the interests of depositors;
- the role of ASIC including:
    - licensing and consumer protection for financial services;
    - authorisation and oversight of external dispute resolution schemes;
- the role of the Australian Small Business and Family Enterprise Ombudsman in relation to disputes between small business borrowers and banks;
- industry peak bodies, self-regulatory functions, codes of practice and other roles that these bodies perform relating to banks, other lenders, valuers and receivers;
- the role of the Australian Competition and Consumer Commission in making public competition assessments of acquisitions of banks by other banks; and
- the role of the Commonwealth government in approving acquisitions.

1.15 The committee is aware that the matters raised in this inquiry have been examined previously and despite previous examination, allegations continue to be raised. In order to ensure that the issues raised during the inquiry were thoroughly examined, the committee has:

- conducted this inquiry over a period of approximately 11 months;
- received and published 195 submissions, including submissions received after the closing date and considered more than 11 000 thousand pages of evidence;
- held eight public hearings leading to more than 450 pages of transcribed evidence;
- asked and received answers to over 300 written questions on notice from banks, industry bodies, government bodies and others;
- requested that the Commonwealth Bank provide documents and then used these documents to:
    - consider the behaviour of the Commonwealth Bank in relation to 95 borrowers, including 36 submitters to the inquiry and 59 cases associated with the acquisition of Bankwest by the Commonwealth Bank;
    - consider in detail eight disputes between borrowers and banks and considered responses and counter responses to information provided by both parties to the disputes; and
    - formally referred four disputes to ASIC for consideration and response to the committee.

1.16 At the start of the inquiry, the committee resolved and stated publicly that while it welcomed submitters' experiences with banks to inform the committee's report to the Parliament, the committee would not investigate or seek to resolve disputes between individual borrowers and banks. As the committee has concluded this inquiry, it notes that for some submitters, their grievance remains unresolved and that a number of them have called for a Royal Commission.

Recent announcements

1.17 The committee acknowledges the Commonwealth government's release of the ASIC Capability Review, the government response and a new policy announcement on 20 April 2016. The government announced that five of the Capability Review recommendations would be implemented, and that it expected ASIC to provide an implementation plan for the other 29 recommendations. The announcement identified a user pays industry funding model to deliver $127 million in additional funding for:

- deepening the surveillance and enforcement capability of ASIC with a specific focus on investigating financial advice, responsible lending and life insurance;
- enhancing data analytics and surveillance capabilities as well as modernising data management systems; and

- strengthening ASIC's powers.[1]

1.18 The committee acknowledges the government's policy announcements on 20 April 2016 including an additional ASIC commissioner, bringing forward law reforms recommended by the Financial System Inquiry, a review of the jurisdiction of the Financial Ombudsman Service and possible consolidation of disputes and complaints functions in the financial system.[2] However, the committee does note that it is disappointed with the pace of the implementation of other related reforms, including recommendations made by this committee during earlier inquiries.

1.19 The committee also notes the announcements made on 21 April 2016 by the Australian Bankers' Association including a review of commissions and product based payments, improving protections for whistleblowers, improving complaints handling, and better access to external dispute resolution.[3] The committee will monitor the progress of the above announcements and the coordination of their implementation.

Practices of banks

1.20 With the benefit of hindsight (post GFC) and based on the evidence it has received, the committee observes that for many failed loans, including those with Bankwest, it is likely that irresponsible lending was the primary or significant cause of loan failure in a number of cases. However, the committee considers that the manner in which the banks facilitated the defaulting of loans, and the subsequent treatment of customers, was in many cases unconscionable. In making its recommendations, the committee is seeking to prevent this type of conduct by banks in the future.

1.21 While mechanisms have been put in place to require banks to meet improved standards of responsible lending for residential and related loans, this inquiry has identified that these standards are only implemented on a voluntary basis in relation to small business and commercial loans. The committee is therefore recommending that responsible lending provisions, including ASIC's monitoring under the *National Consumer Credit Protection Act 2009*, become mandatory and be extended to small business loans. The committee is disappointed that banks have not chosen to implement these standards voluntarily.

1.22 The committee considers that the banks' compulsion to deliver ever-increasing returns to shareholders has become the overriding driver of behaviour and culture in the banks. As the margins on business loans reduce, this culture is evidenced by some customers being offered high risk credit facilities such as credit cards, instead of secured loans.

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1 Australian Government Factsheet, *Improving Consumer Outcomes in Financial Services*, 20 April 2016, p. 1.

2 The Hon Scott Morrison MP, Treasurer, joint media release with the Hon Kelly O'Dwyer MP, Minister for Small Business, Assistant Treasurer, *Turnbull Government bolsters ASIC to protect Australian Consumers*, 20 April 2016.

3 Australian Bankers' Association, Media Release, *Banks act to strengthen community trust*, 21 April 2016.

1.23 The committee is deeply concerned that more than three years have elapsed since the conclusion of the post-GFC banking inquiry by the Senate Economics References Committee in which a number of recommendations were made to improve banking practices. Since this time, the banking industry has not addressed matters as simple as providing borrowers with copies of valuation reports.

1.24 The current inquiry into impairment of customer loans has amply demonstrated that the provision of valuation reports to borrowers has not been written into the Banking Code of Practice, or become universal practice by banks.

1.25 The committee has also received evidence that borrowers perceive that banks provide inconsistent information and advice between the bank's lending departments and their credit management departments. Evidence considered by the committee indicates that there is the potential for lending departments in banks to be more optimistic about valuations than credit management departments. The committee is concerned that this may be influenced by inappropriate or conflicted remuneration incentives and cultures in those departments. The rules that exist in the financial advice space, which restrict conflicted remuneration and require financial advisers to act in the customer's best interest, do not extend to small business loans. The committee is very concerned about the lack of any obligation on lenders to provide consistent information in the best interests of borrowers.

1.26 The committee also heard a large number of concerns about the appointments of and instructions to valuers, investigative accountants and receivers. These concerns related to inconsistent information, as already discussed, but also included concerns about transparency and accountability.

1.27 To address these issues, the committee is therefore recommending that appropriate legislation and regulations be put in place to:

- prohibit conflicted remuneration for all bank staff;
- require bank officers to act in the customer's best interests for small business loans;
- require officers from lending and credit management departments to provide consistent information to borrowers, including:
    - copies of valuation reports and instructions to valuers; and
    - copies of investigative accountants' reports and instructions to investigative accountants and receivers;
- require banks to ensure that the valuation instructions do not change during the term of the loan agreed in the loan contract, and that businesses are valued as the market value of a going concern, not just a collection of business assets, and that the market value of all security supporting the loan are taken into account, not just real property.

1.28 This will require internal processes that ensure coordination between lending officers and credit management officers prior to making the initial offer to the borrower.

1.29 While inconsistent valuation instructions from banks are a significant concern, they are not the only concern. From the evidence presented to this inquiry, there is fragmentation of relevant professional standards, registration processes and dispute resolution arrangements that apply to valuers, and which are spread across three peak bodies and several state bodies. The committee notes recent media reports[4] which allege that banks are bullying valuers into accepting below cost fees, strengthening the need for greater oversight of the relationships between banks and valuers.

1.30 Prudential Standard 220 sets out substantial requirements for how banks must value property held as security for loans, including: regular assessment, bank procedures, marketing periods, determining fair value and the role of the bank's credit administration function. Evidence put to this inquiry suggests that cases may exist where the above requirements are not met. APRA's position is that it only considers systemic issues, it is not mandated to consider the relationship between banks and borrowers, and it may have a conflict of interest if it did consider the relationship between banks and borrowers. There is what seems to be an appropriate standard in place, but no way of ensuring that the standard is applied, or that borrowers are able to raise concerns about its implementation.

1.31 The committee is therefore recommending that a nationally consistent approach be developed for the professional standards and conduct of valuations in relation to small business loans, and which includes valuation of all assets, not just real property.

Bankwest and Landmark

1.32 The committee considered allegations that there was a deliberate strategy by the Commonwealth Bank to over-impair loans in order to seek financial gain through a range of mechanisms after the acquisition of Bankwest in 2007. After considering the evidence and responses it has received, the committee has not been able to determine that deliberate impairment of loans, solely motivated by clawbacks or warranties, occurred. While the contractual arrangements associated with the acquisition of Bankwest may have played a role, the evidence before the committee points strongly to a culture of placing profit and return to shareholders ahead of the interests of borrowers.

1.33 Loans associated with the price adjustment mechanism in the Bankwest acquisition by the Commonwealth Bank were separately assessed by three major accounting and audit firms. The fact that the three assessments differed by hundreds of millions of dollars would suggest that despite the same accounting and prudential standards being used, identifying which loans were impaired and the extent of the impairment was an uncertain process requiring commercial judgements in a significant number of cases. Such a broad discretion must be subject to appropriate monitoring and accountability. There are many loans for which the accountability is limited due to the lack of an applicable dispute resolution scheme. As discussed

4 Duncan Hughes, 'Bullying banks to force valuers out of business', *Australian Financial Review*, 27 April 2016.

earlier, the committee is therefore recommending substantial improvements to dispute resolution schemes, codes of practice and regulation and monitoring of lending.

1.34 The committee considered allegations regarding deliberate impairments or defaults of performing loans associated with ANZ's acquisition of Landmark. After considering the evidence and responses it has received, the committee has not been able to conclusively determine that this occurred. The committee welcomes ANZ's acknowledgement that its treatment of customers could be improved and that it is now implementing better practices. The committee will follow with interest developments in ANZ's approach to resolving issues with customers and encourages all lenders to take an open and constructive approach to helping borrowers to resolve their difficulties, especially in light of the significant power imbalance that may exist between lenders and borrowers.

1.35 In conclusion, the committee is struck by the different approaches employed by the ANZ and the Commonwealth Bank. The ANZ, after internal review, appears to have realised that their conduct was questionable, and have voluntarily sought to make recompense to their customers. The Commonwealth Bank, on the other hand, have consistently denied that there have been issues with their conduct and the way in which they have engaged with their customers. The evidence of witnesses and submitters to this inquiry has strongly called into question the Commonwealth Bank's denial of unreasonable or unethical conduct.