

Chapter 1

Introduction and background

Introduction

Duties of the committee

1.1 The Parliamentary Joint Committee on Corporations and Financial Services (the committee) is established by Part 14 of the *Australian Securities and Investments Commission Act 2001* (the ASIC Act). Section 243 of the ASIC Act sets out the committee's duties as follows:

- (a) to inquire into, and report to both Houses on:
 - (i) activities of ASIC or the Takeovers Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or
 - (ii) the operation of the corporations legislation (other than the excluded provisions); or
 - (iii) the operation of any other law of the Commonwealth, or any law of a State or Territory, that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); or
 - (iv) the operation of any foreign business law, or of any other law of a foreign country, that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); and
- (b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and
- (c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.¹

Referral of the inquiry

1.2 On 4 June 2015 the House of Representatives referred an inquiry into the impairment of customer loans to the committee for inquiry and report by 31 March 2016.² On 4 June 2015 the committee resolved that:

1 *ASIC Act 2001*, s. 243.

2 House of Representatives, *Votes and Proceedings*, No. 122, 4 June 2015, pp 1362–1363.

- in conducting the inquiry the committee would not investigate or seek to resolve disputes between customers and banks; and
- where the experiences of customers may inform the committee about the practices of banks, the committee welcomed submissions that explicitly addressed the terms of reference.

1.3 On 2 March 2016, the House of Representatives extended the reporting date until 20 May 2016. On 15 April 2016, the inquiry lapsed due to the prorogation of the House of Representatives.³ On 19 April 2016, the committee resolved to re-adopt the inquiry using the same terms of reference as the original inquiry referred by the House of Representatives on 4 June 2015 but with a reporting date to be determined by the committee.

Terms of reference

1.4 The terms of reference are as follows:

- (a) practices of banks and other financial institutions using a *constructive default* (security revaluation) process to impair loans, where constructive default/security revaluation means the engineering or the creation of an event of default whereby a financial institution deliberately reduces, through valuation, the value of securities held by that institution, thereby raising the loan-to-value ratio resulting in the loan being impaired;
- (b) role of property valuers in any constructive default (security revaluation) process;
- (c) practices of banks and other financial institutions in Australia using non-monetary conditions of default to impair the loans of their customers, and the use of punitive clauses such as suspension clauses and offset clauses by these institutions;
- (d) role of insolvency practitioners as part of this process;
- (e) implications of relevant recommendations of the Financial System Inquiry, particularly recommendations 34 and 36 relating to non-monetary conditions of default and the external administration regime respectively;
- (f) extent to which borrowers are given an opportunity to rectify any genuine default event and the time period typically provided for them to do so;
- (g) provision of reasonable written notice to a borrower when a loan is required to be repaid;
- (h) appropriateness of the loan to value ratio as a mechanism to default a loan during the period of the loan; and

3 His Excellency General the Honourable Sir Peter Cosgrove AK MC (Retd), Governor-General of the Commonwealth of Australia, *Proclamation*, 21 March 2016.

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- (i) conditions and requirements to be met prior to the appointment of an external administrator; and
- (1) in undertaking this inquiry, the Committee take evidence on:
- (a) the incidence and history of:
- (i) loan impairments; and
- (ii) the forced sale of property;
- (b) the effect of the forced sale of property in depressed market conditions and drought;
- (c) comparisons between valuations and sale price;
- (d) the adequacy of the legal obligations on lenders and external administrators (including s420A of the *Corporations Act 2001*) to obtain fair market value for the forced sale of property; and
- (e) any related matters.⁴

Conduct of the inquiry

1.5 The committee advertised the inquiry on its webpage and in relevant national and regional newspapers and invited submissions from a range of relevant stakeholders. The committee set a closing date for submissions of 24 July 2015 and subsequently extended the due date for submissions to 21 August 2015. The committee received 195 submissions, with the public submissions being published on the committee's website. The committee held public hearings in Melbourne on 16 October 2015, Sydney on 13 and 18 November 2015, Brisbane on 19 November 2015, Canberra on 23 November 2015 and 2 December 2015, and in Sydney on 16 February 2016 and 4 April 2016.

Structure of this report

This report is structured as follows:

- The remainder of Chapter 1 provides background to the inquiry;
- Chapter 2 discusses the practices of banks relevant to the terms of reference;
- Chapters 3 and 4 discuss dispute resolution schemes;
- Chapter 5 discusses the role of valuers in relation to loans;
- Chapter 6 discusses the role of receivers and investigative accountants; and
- Chapter 7 discusses allegations put to the committee regarding the acquisition of Bankwest by the Commonwealth Bank and Landmark by ANZ.

4 House of Representatives, Votes and Proceedings, No. 122, 4 June 2015, pp 1362–1363.

Background and previous inquiries

1.6 In conducting this inquiry, the committee was acutely aware that many of the issues raised were not new, and that many of the issues and fact scenarios have been considered by earlier parliamentary and other inquiries. A number of submitters to this inquiry have also had their matters considered in other forums, including earlier parliamentary inquiries. Despite this, as part of assessing systemic issues within the small business lending environment, the committee devoted time to examine submissions from Bankwest customers who alleged that the acquisition of Bankwest by the Commonwealth Bank in 2007 had adversely affected them. The Committee also took evidence from customers of a number of lenders including ANZ, NAB, Westpac, Macquarie Bank, Rabobank, Landmark, Elders, Suncorp, Bank of Queensland, AMP, Rural Bank, Adelaide Bank, AMP Bank, Members Equity Bank, St George Bank and the Uniting Church.

1.7 The committee notes that this inquiry has been conducted at the same time as a number of relevant and significant reforms were being considered by government. Therefore previous inquiries relevant to this inquiry, as well as recent policy announcements made in relation to the powers and reach of the Australian Securities and Investments Commission (ASIC), are set out below.

Inquiry into the post-GFC banking sector

1.8 In 2012 the Senate Economics References Committee conducted an inquiry into the post-GFC [global financial crisis] banking sector, which devoted three chapters to issues related to Bankwest customers. That committee considered the appropriateness of regulatory settings governing the financial sector and whether the government agencies charged with administering and enforcing these regulations were effectively performing their role. That committee noted that while there were many sad and distressing stories, the borrowers may have been able to operate successfully when the business environment was relatively strong, however, the GFC placed stress on less robust and speculative projects. In many cases, loans were sought for ventures that posed a considerable risk even during a stable economic environment. That was evidenced by the cases where banks other than Bankwest had refused to finance the initial loans. The Senate Economics References Committee stated that:

This of course does not apply to every case, nor does it excuse Bankwest—under its previous owners Bankwest was willing to enter into these loans that other financial institutions, acting more prudently, chose not to. When its small business borrowers are experiencing difficulties, Bankwest has a duty to make genuine attempts to work with the borrower, to clearly explain what is happening and why, and to treat them with courtesy.⁵

5 Senate Economics Reference Committee, *The post-GFC banking sector*, November 2012, pp 163–164.

1.9 During that inquiry, that committee was advised by ASIC that it had not received evidence to suggest that Bankwest had engaged in systemic misconduct, and nor had they received a significant number of complaints from Bankwest customers.⁶

Relevant inquiries in the United Kingdom

1.10 In the United Kingdom (UK), the Independent Commission on Banking was established in 2010 and reported in 2011. This Commission considered structural and related non-structural reforms to the UK banking sector to promote financial stability and competition. It made a number of recommendations that led to the release of a white paper in June 2012. A key recommendation from the inquiry was the ring-fencing of banks so that retail activities such as deposit-taking are made separate from international wholesale and investment banking operations.⁷

1.11 Another relevant UK inquiry, conducted by the Parliamentary Commission on Banking Standards (PCBS) was published in June 2013 on failures of accountability of senior bankers in the wake of the global financial crisis. The PCBS found that there was a loss of trust caused by profound lapses in banking standards. The PCBS argued that no single change, however dramatic, could address the problems of banking standards and that reform across several fronts was required. The PCBS therefore made the following proposals to restore public confidence in the banking sector:

- requiring individual responsibility in banking at the most senior levels;
- reforming governance within banks to reinforce each bank's responsibility for its own safety and soundness and for the maintenance of standards;
- creating better and more diverse banking markets in order to empower consumers and provide greater discipline on banks to raise standards;
- reinforcing the responsibilities of regulators in the exercise of judgement in deploying their current and proposed new powers; and
- specifying the responsibilities of the government and Parliaments.⁸

1.12 The UK government's response to the PCBS was released in July 2013 and noted that banks in the UK have not done enough to carry out their core role of financing economic growth. The UK government response was also critical of banks for failing taxpayers, customers and shareholders. The UK government announced plans to implement the major recommendations including:

- a new banking standards regime governing the conduct of bank staff;
- a criminal offence for reckless misconduct by senior bank staff; and

6 Mr Peter Kell, Commissioner, ASIC, *Senate Economics Committee Hansard*, Inquiry into the post-GFC banking sector, 8 August 2012, p. 59.

7 The Independent Commission on Banking, *The Vickers Report*, December 2013, pp 9–10; Senate Economics Reference Committee, *The post-GFC banking sector*, November 2012, p. 176.

8 Parliamentary Commission on Banking Standards, *Changing banking for good*, June 2013, p. 9.

- further steps to improve competition in the banking sector.⁹

1.13 On 17 November 2014, the former members of the PCBS released a statement noting their concerns about continued examples of misconduct in the sector, and expressing their disappointment about the slow progress in implementing reforms.¹⁰

Relationship to the inquiry into the impairment of customer loans

1.14 The committee's current inquiry into impairment of customer loans was triggered to some extent by allegations of issues arising between Bankwest and its customers. Prior to the acquisition of Bankwest by the Commonwealth Bank, Bankwest was owned by HBOS Australia. On 5 April 2013 the PCBS published a report on the failure of HBOS, titled *An accident waiting to happen*. The report drew a number of conclusions about HBOS, including that:

Whatever may explain the problems of other banks, the downfall of HBOS was not the result of cultural contamination by investment banking. This was a traditional bank failure pure and simple. It was a case of a bank pursuing traditional banking activities and pursuing them badly.

Another lesson is that prudential supervisors cannot rely on financial markets to do their work for them. In the case of HBOS, neither shareholders nor ratings agencies exerted the effective pressure that might have acted as a constraint upon the flawed strategy of the bank. By the time financial markets were sufficiently concerned to act as a discipline, financial stability was already threatened.¹¹

1.15 The report also noted that for HBOS's operations in Australia, the impairments totalled £3.6 billion, equivalent to 28 per cent of the value of the loan book there at the end of 2008, an even higher loss as a proportion of loans than incurred by the Corporate Division in the UK. The report argued that such a loss is all the more striking in view of the comparative resilience of the Australian economy in the global downturn. The PCBS report on HBOS also stated that:

In two markets alone—Australia and Ireland—it incurred impairments of £14.5 billion in the period from 2008 to 2011. These losses were the result of a wildly ambitious growth strategy, which led in turn to significantly worse asset quality than many of its competitors in the same markets. The losses incurred by HBOS in Ireland and Australia are striking, not only in absolute terms, but also in comparison with other banks. The HBOS

9 The government's response to the Parliamentary Commission on Banking Standards, 8 July 2013, p. 3.

10 *Statement by former members of the Parliamentary Commission on Banking Standards*, 17 November 2014, <http://www.parliament.uk/bankingstandards>, (accessed 9 July 2015).

11 Parliamentary Commission on Banking Standards, *An accident waiting to happen: the failure of HBOS*, 5 April 2013, p. 53.

portfolio in Ireland and in Australia suffered out of proportion to the performance of other banks. The repeated reference in evidence to us by former senior executives to the problems of the Irish economy suggests almost wilful blindness to the weaknesses of the portfolio flowing from their own strategy.¹²

Productivity Commission inquiry into business set-up, transfer and closure

1.16 The Productivity Commission inquiry into business set-up, transfer and closure published its final report in December 2015. The committee has noted that several of the findings of this report are relevant to this inquiry, and include the following:

- access to finance is not a significant barrier for most new businesses—most, with good reason, do not seek finance from external sources;
- most businesses are closed or transferred without financial failure;
- specific reforms to Australia's corporate insolvency regime are warranted, but a wholesale change to the system, such as the adoption of the United States' 'chapter 11' framework, is not justified nor likely to be beneficial; and
- formal company restructuring through voluntary administration should only be available when a company is capable of being a viable business in the future.¹³

The Financial System Inquiry

1.17 In December 2014 the final report of the Financial System Inquiry (FSI) was released. This report aimed to provide a blueprint for the Australian financial system over the coming decade. Previous financial system inquiries, including the Campbell Report in 1981 and Wallis Report in 1997, provided the catalyst for major economic reforms. The Campbell Report led to the floating of the Australian dollar and the deregulation of the financial sector, while the Wallis Inquiry led to streamlined financial services regulation, the creation of the Australian Prudential Regulation Authority (APRA), and the current form of ASIC.¹⁴

1.18 The FSI made the following two recommendations which were specifically included in the terms of reference for this inquiry:

- Recommendation 34: Unfair contract term provisions
 - Support Government's process to extend unfair contract term protections to small businesses.

12 Parliamentary Commission on Banking Standards, *An accident waiting to happen: the failure of HBOS*, 5 April 2013, pp 14–15.

13 Productivity Commission, *Business Set-up, Transfer and Closure*, December 2014, p. 2.

14 *Financial System Inquiry*, <http://fsi.gov.au/>, (accessed 21 April 2016).

- Encourage industry to develop standards on the use of non-monetary default covenants.
- Recommendation 36: Corporate administration and bankruptcy.
 - Consult on possible amendments to the external administration regime to provide additional flexibility for businesses in financial difficulty.¹⁵

1.19 Subsequent changes relating to the above recommendations are discussed further in chapters 4 and 6.

The ASIC Capability Review and other recent announcements

1.20 On 24 July 2015, the ASIC Capability Review commenced as part of the government's response to the FSI which recommended periodic reviews of the capabilities of financial and prudential regulators, commencing with a review of ASIC in 2015 to ensure it has the skills and culture to carry out its role effectively.¹⁶

1.21 The Capability Review found that many of ASIC's regulatory capabilities are in line with global best practice. However, the review recommended additional measures to support ASIC in delivering its mandate and ensuring it is fit for the future. The Capability Review found there were aspects of strategy, governance, IT, data infrastructure, management information systems and ASIC's approach to stakeholder engagement that required improvement.¹⁷

1.22 On 20 April 2016 the Commonwealth government released the ASIC Capability Review and its response to the review. 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.¹⁸ The announcement identified a user pays industry funding model to deliver \$127m 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

15 *Financial System Inquiry*, December 2014, p. xxvii.

16 *Fit for the Future, A capability review of the Australian Securities and Investments Commission*, <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2016/ASIC-capability-review>, (accessed 22 April 2016).

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

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

- strengthening ASIC's powers.¹⁹

1.23 The government also made the following policy announcements on 20 April 2016:

- appointment of an additional ASIC commissioner with experience in the prosecution of crimes in the financial services industry;
- bringing forward of law reforms recommended by the FSI, including product intervention powers, product distribution obligations, strengthening consumer protection for electronic payments and a review of ASIC penalties and the enforcement regime;
- a review of the Financial Ombudsman Service's (FOS's) small business jurisdiction, monetary limits and compensation caps;
- additional funding for the superannuation tribunal to deal with legacy complaints; and
- establishment of a panel to advise on consolidation of disputes and complaints functions in the financial system.²⁰

1.24 On 21 April 2016, the Australian Bankers' Association announced a range of new measures which they claim will protect consumer interests, increase transparency and accountability and build trust and confidence in banks. The new measures include:

- an independent review of product sales commissions and product based payments, with a view to removing or changing them where they could result in poor customer outcomes;
- improving protections for whistleblowers to ensure there is more support for employees who speak out against poor conduct;
- improved complaints handling and better access to external dispute resolution, as well as providing compensation to customers when needed; and
- supporting the Federal Government's review of the FOS.²¹

1.25 This inquiry has been conducted at a time when there has been substantial activity in addition to the announcements above, including the Financial Systems Inquiry, reforms arising from a major parliamentary inquiry into the performance of ASIC, and law reforms relating to insolvency and unfair contract terms that may interact with the above announcements. In addition the Australian Small Business and Family Enterprise Ombudsman (ASBFE Ombudsman) was established in March 2016.

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

20 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.

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

1.26 The announcements above identify the establishment of a panel to advise on consolidation of disputes and complaints functions in the financial system. 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 coordinate the implementation of the outcomes of this inquiry and the aspects of the above reforms and announcements 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. The committee considers that the most appropriate body to undertake this role is the ASBFE Ombudsman.

1.27 The committee further considers that additional funding should also be available for the ASBFE Ombudsman to deal with legacy complaints along similar lines to the recently announced funding for the superannuation tribunal to deal with legacy complaints.

1.28 The committee is therefore recommending in chapter 2 that the government bring forward legislation and other measures to give the ASBFE Ombudsman the relevant powers and resources to carry out the functions discussed above, along with other functions to address gaps identified by this inquiry.