Chapter 2
Practices of banks

Introduction

2.1 This chapter discusses allegations and issues regarding lending practices of banks that were raised with the committee during the inquiry. The first section lists the issues identified by submitters and witnesses. Following that, examples of lending practices put forward by submitters and views from industry bodies and banks are summarised. Where available, observations from the Financial Ombudsman Service (FOS) and ASIC are also discussed.

2.2 In summary, the main allegations raised by submitters and witnesses to the inquiry related to the practices of banks and include:

- the use of non-monetary defaults[1] including loan to value ratios;
- charging excessive fees, default interest and penalty interest;
- insufficient notice periods for decisions not to roll over term loans leading to difficulty in refinancing loans;
- insufficient time to address financial difficulties or consider alternative solutions to foreclosure;
- irresponsible lending; and
- using the bank's power advantage to the detriment of borrowers.

2.3 This chapter focuses on evidence received and considered by the committee in relation to the practices of banks. Submitters also raised issues relating to dispute resolution (chapters 3 and 4), the role of valuers and valuations (chapter 5), and investigative accountants and receivers (chapter 6). Another smaller group of submitters made allegations of deliberate impairment and defaults to pursue financial advantage from contract clauses associated with bank acquisitions. Those allegations are discussed in chapter 7.

2.4 During the inquiry, the banks disputed many of the allegations discussed in the following sections. In summary, the banking industry indicated that a number of the cases considered by the committee during the inquiry were caused by customers being unable to meet the terms of their loan agreement, rather than as a result of the deliberate impairment of the loan by the bank. The Australian Bankers' Association (ABA) informed the committee that:

> The proportion of business customers with loans in difficulty is very low. For the year ending March 2015, less than one per cent of business and agribusiness customers had impaired loans, and a tenth of one per cent were in recovery action. Banks have well-established practices for helping

1 Non-monetary defaults include defaults other than borrowers meeting repayment requirements set out in loan contracts. Further details are provided later in this chapter.

> consumers and small businesses in financial hardship with their credit facilities. There is no financial incentive for a bank to deliberately undervalue an asset or lose a customer. Banks are bound by strict legal and prudential requirements, as well as being subject to legislative disclosure and conduct obligations towards their customers.[2]

2.5 In turn, this position of the ABA and banks was disputed by many witnesses and submitters.

2.6 Around 40 Bankwest customers provided submissions to this inquiry. The committee notes that at the time of acquisition by the Commonwealth Bank, there were approximately 26 000 commercial customers who had loans with Bankwest.[3] The Commonwealth Bank responded in general terms to relevant submissions and provided detailed responses to the allegations in eight cases selected by the committee. The Commonwealth Bank's responses to the allegations are discussed later in this chapter and in chapter 4.

2.7 ANZ informed the committee that it had reviewed the 11 submissions related to ANZ customers, of which five are related to Landmark. ANZ acknowledged there were some cases where it could have done a better job of working with customers; in particular to ensure that lawyers, receivers or others behaved in a way that is acceptable to the bank and to customers. In December 2014, ANZ announced a 12-month moratorium on farm repossessions in drought-declared regions of Queensland and north-west New South Wales. The moratorium, an interest rate freeze and other measures, have now been extended to December 2016, and apply nationally.[4]

2.8 NAB informed the committee that it has an early engagement approach whereby each customer is assessed and managed in response to their specific circumstances. NAB advised the committee that:

- NAB's aim is to raise concerns with customers at the earliest opportunity with a view to resolving these issues as part of a mutually agreeable strategy;
- NAB's objective is always to retain its customers if at all possible; and
- more than 85 per cent of customers who are referred to a workout[5] area avoid some form of external administration or mortgagee sale.[6]

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2 Mr Anthony Pearson, Chief Economist and Executive Director, Industry Policy, Australian Bankers' Association, *Committee Hansard*, 18 November 2015, p. 29.

3 Mr David Craig, Group Executive for Financial Services, and Chief Financial Officer, Commonwealth Bank of Australia, *Committee Hansard*, 2 December 2015, p. 2.

4 Mr Graham Hodges, Deputy Group Chief Executive Officer, ANZ, *Committee Hansard*, 13 November 2015, p. 64.

5 Workout activities are discussed later in paragraph 2.26.

6 Mr Timothy Williams, General Manager, Group Strategic Business Services, National Australia Bank, *Committee Hansard*, 18 November 2015, p. 8.

2.9 The committee heard from witnesses and submitters that while this process, described above by NAB, but also similarly described by other banks, may sound appropriate, in practice it may not work as intended:

> It was annoying but if the banks tell you to do something, you do it so I just went ahead and provided those as required. It was in our loan documentation that I had to provide it so I kept doing it. We did get a phone call one day saying that they felt they needed a specialist—a.k.a. an investigative accountant—to come and have a look at our books. I said, 'Why, when you get all that information you need straight from my MYOB files and also from our accountant?' They said it was a specialist in the area and that they wanted to do that. They said, 'By the way, it will cost you.' I asked how much would it cost and they said about $25,000. I said 'No, you are not doing it.' And then I got threatened that I had no choice and I had to let them in and let them do that.[7]

2.10 The committee also heard from several other submitters who had disputes with NAB.[8]

2.11 Submitters raised concerns in relation to a range 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.

2.12 As the versions of events and matters in dispute between some borrowers and banks differed significantly in the evidence provided to the committee, in many cases the committee was unable to form a view as to which version was accurate. The committee considered it important to try to establish if there were some disputes in which the allegations were accurate and therefore selected four cases and referred those to ASIC for consideration. ASIC's response to the committee is discussed later in this chapter. The committee notes that consideration of these cases is not intended to influence any court or dispute resolution process that may formally consider these cases.

Non-monetary defaults

2.13 This section summarises some information brought to the committee's attention on non-monetary defaults. Many submitters allege that their loans were placed into default and foreclosed on the basis of non-monetary defaults.[9]

2.14 The ABA provided information on monetary and non-monetary defaults:

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7 Mrs Danielle Schaumburg, *Committee Hansard,* 19 November 2015, p. 26.

8 Mr Dario Pappalardo, *Submission 13,* p. 1; Mr & Mrs Mytton-Watson, *Submission 29,* p. 1; Ms Deborah Perrin, *Submission 30,* p. 2; Mr & Mrs Kruetzer, *Submission 39,* p. 1; Bank Reform Now, *Submission 116,* p. 1.

9 Mr & Mrs Lock, *Submission 14,* p. 2; Department Agriculture, *Submission 44,* p. 1; Tasmanian Small Business Council, *Submission 61,* p. 21; Ms Robyn Toohey, *Submission 62,* p. 2; Mr Peter Ward, *Submission 98,* p. 2; Mr Trevor Eriksson, *Submission 101,* pp 2–4; Mr Trevor Hall, *Submission 109,* p. 43; Mr Jim Martinek, *Submission 153,* p. 2.

- monetary defaults may include non-payment of interest or principal and interest, debt amortisation schedules, expiry of facilities, non-clearance of excesses or frequent requests for temporary assistance.
- non-monetary defaults may include:
    - changes in the legal structure of the entity;
    - breakdown or dispute within the borrowing group;
    - legal action by an external party or arrears action by the Australian Taxation Office;
    - substantial decline in business performance;
    - changes in the value of the security and the Loan to Value ratio (LVR);
    - client fraud breaches of legal obligations; and
    - customer initiated insolvency appointments.[10]

2.15 An accountant informed the committee about the experience of some of his clients for whom banks reviewed their portfolios and for those clients who were on tighter LVRs, valuers were engaged:

> As an example of this occurring, our practice acts for clients who had not defaulted on any payments…their properties were valued at approximately $5m. Their lender insisted that a revaluation be undertaken of these properties. The same valuer was engaged who had valued the properties less than 12 months previously and returned with a reduction of over $1.2m in value. The bank then advised that the client was outside the terms of their agreement and they should seek an alternate financier.[11]

2.16 Legal Aid Queensland informed the committee of a case that they became aware of:

> the agribusiness banker engaged a particular valuation firm to conduct valuations in both 2011 and 2012 when it approved increases in loan facilities. These valuations resulted in a value of around $7.5 million which included improvements valued at $1.9 million dollars. After the farmer experienced cash flow difficulties, the asset management team within the bank engaged a different firm of valuers in 2013. This valuer valued the assets at $3.4 million including improvements at $340,000.00. Although there were other matters also affecting decision making between the farmer and bank, the reduced valuation provided the bank with justification to encourage the farmer to sell the property at the greatly reduced price to "meet the market".[12]

2.17 The Department of Agriculture informed the committee that while adverse climate or market conditions can impact the ability of farmers to service their debts,

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10 Australian Bankers' Association, *Submission 47,* pp 7–8.

11 Mr Bill Ringrose, *Submission 31,* p. 2.

12 Legal Aid Queensland, *Submission 55,* p. 5.

there have also been allegations that banks are using non-monetary conditions in loan contracts to foreclose on farms, despite those farmers not having missed any principal and/or interest payments.[13]

2.18 The Department of Agriculture also noted that it had been informed of allegations relating to declining land values and impacts on loan to value ratios, allegedly unsound property evaluation processes, use of higher interest rates on riskier loans, and potentially unreasonable use of other loan covenants and provisions to foreclose on farm properties.[14]

2.19 The committee notes however, that while nominal broadacre land values in northern Australia have declined by 20 per cent on average since 2008 and by greater amounts in some parts of Queensland, this followed an increase in nominal broadacre land values of over 400 per cent over the previous decade.[15] The committee considers that these dramatic changes to land values shows that borrowers and banks should take care to set realistic LVRs when real estate prices are rising rapidly.

2.20 FOS informed the committee that it considers it unusual for a financial services provider to rely on a non-monetary default alone when calling in a loan. FOS noted that non-monetary defaults occur from time to time, but it is more likely that a bank will rely on a payment default to call in a loan. FOS also noted that there is usually only a short period of time given to comply with the notice, however, in most cases this follows a longer period of negotiation.[16]

2.21 Some witnesses, however, argued that monetary default was triggered by actions or inaction by the banks such as excessive fees associated with investigative accountants, delays in notification of a decision to not roll over a facility or directions to take certain actions such as reducing the LVR through disposal of income producing assets or incurring fees through forced rate-swaps or hedging.[17]

ABA information on banks practice regarding non-monetary defaults

2.22 The ABA argued that data collected from a selection of ABA members shows that the proportion of customers with loans which are in difficulty is very low:

> For the year ending March 2015 less than 1 per cent of business and agribusiness customers had impaired loans and a tenth of 1 per cent were in recovery action. In only a handful of cases were substantial changes to LVRs the major factor that created impairment of the loan. The overwhelming majority of defaults were a result of monetary breaches of

13 Department Agriculture, *Submission 44,* p. 2.

14 Department Agriculture, *Submission 44,* p. 3.

15 Department Agriculture, *Submission 44,* p. 5.

16 Mr Philip Field, Lead Ombudsman, Banking and Finance, Financial Ombudsman Service Australia, *Committee Hansard,* 16 October 2015, p. 8.

17 Mr Rory, O'Brien, *Committee Hansard,* 13 November 2015, p. 4; Mr Roy Lavis, *Committee Hansard,* 19 November 2015, pp 2–6; Mr Trevor Eriksson, *Committee Hansard,* pp 54–55.

the loan covenant or a combination of both monetary and non-monetary breaches.[18]

2.23 The ABA submitted that banks are required to make prudentially responsible lending decisions and that the occurrence of problems is low given the substantial number of business loans in Australia. The ABA argued that:

- it is not industry practice for banks to use non-monetary processes or triggers such as LVRs to impair customer loans or to construct a default;
- it is not financially beneficial for banks to adopt the practices described in paragraphs (a) and (c) of the terms of reference;
- banks make substantial efforts to work with business and agribusiness customers when they experience financial difficulties; and
- the ABA's Code of Banking Practice (the Code) sets standards for fairness, transparency, behaviour and accountability beyond legislative requirements that individuals and small businesses can expect from their banks.[19]

2.24 The ABA also informed the committee about monetary and non-monetary factors that are considered when loans are reviewed, noting that business loans are assessed and graded according to credit risk in line with the Australian Prudential Regulation Authority's (APRA) prudential requirements. The ABA argued that it is standard practice for banks to review loans either periodically, if there has been a change in customer circumstances, or if there are significant changes in account behaviour. The ABA submitted that if the risk profile has deteriorated below an acceptable credit standard, the loan may be placed on a 'watch list'[20].

2.25 The ABA explained the actions of banks when a customer is placed on a 'watch list':

- the bank works with the customer to try and overcome the financial difficulties with their credit facility, including developing a repayment plan to rectify the default;
- the aim is to support the customer in difficult times and help them to restructure the business;
- management of the account generally stays with the customer relationship manager, however, the account is reviewed more frequently;
- a business remediation plan is developed and agreed with the customer, the objective is to return the loan to a satisfactory credit position;
- there is close communication and sourcing of additional information from the customer; and

18 Australian Bankers' Association, *Submission 47,* p. 5.

19 Australian Bankers' Association, *Submission 47,* p. 1.

20 Australian Bankers' Association, *Submission 47,* pp 7–8.

- if the customer's remediation plan does not achieve the expected outcome and there is a further deterioration of business fundamentals or the customer decides not to communicate with the bank, most banks will transfer the account to a 'workout' area.[21]

2.26 According to the ABA, a workout area is a specialised unit within the bank made up of staff with skills in accounting, business restructuring, commercial management, insolvency and legal expertise. The ABA summarised the role of the workout area as follows:

- the workout area will assess the customer's financial and business situation with a view to restoring the credit facility to a satisfactory position or minimising the potential loss;
- options identified by the bank are discussed with the customer and the strategy adopted is dependent on the individual circumstances;
- it may be appropriate to allow the customer more time to address certain key actions within a mutually agreed strategy;
- if the account is successfully remediated it is transferred back to the customer relationship manager; and
- if there is no improvement over time, further options will be explored with the customer, including further asset sales, winding up a company or recovery action on a property, with the enforcement of security being very much a last resort.[22]

2.27 The Customer Owned Banking Association (COBA) argued that its members had a good record in relation to non-monetary defaults and that the need to adjust its code of practice is not urgent.[23]

Information from banks on non-monetary defaults

2.28 This section summarises the responses by banks to allegations relating to non-monetary defaults.

2.29 The Commonwealth Bank indicated that, in its view, it is exceedingly rare for a bank to instigate recovery proceedings on the basis of LVRs or 'non-monetary' covenants alone, and in the absence of missed payments, more commonly, both types of contractual breach occur before a bank takes legal steps to recover money it is owed.[24] The Commonwealth Bank provided detailed information on 36 cases submitted to the inquiry indicating which cases were in monetary default:

> Of the 36 customers reviewed, 33 were in monetary default. Of the remaining three customers in one case, no enforcement action was taken, in

21 Australian Bankers' Association, *Submission 47,* p. 8.

22 Australian Bankers' Association, *Submission 47,* p. 9.

23 COBA, *Submission 51,* p. 2.

24 Commonwealth Bank of Australia, *Submission 48,* p. 2.

the second case, the customer appointed a voluntary administrator and as a result of this significant default a receiver was appointed and in the third case, Bankwest appointed a receiver after the customer invited Bankwest to do so.

We provide the table below to assist the Committee to understand the variety of defaults that were evident in these cases. Categories are not mutually exclusive (i.e. if a customer was in interest arrears they might also have breached other financial covenants and their loan to value ratio obligations).

Reason for Default	Customers
Interest arrears	27
Failure to repay expired facilities	22
Loan to value ratio breach	14
Financial covenant breach	12
Failure to supply financial information	5
Other (e.g. administrator appointed)	21

The average number of defaults for these customers was greater than three.[25]

2.30 The Commonwealth Bank also provided further information for 59 borrowers associated with the price adjustment mechanism for the Bankwest acquisition[26] which indicated that 53 borrowers were in monetary default. Of the remaining six borrowers, no receiver was appointed in three cases, a voluntary administrator was appointed in two cases and another creditor commenced liquidation proceedings in court against the borrower in the other case.[27]

2.31 The committee questioned the bank in relation to the causes of monetary defaults in the cases discussed above. In response, the Commonwealth Bank indicated that:

- for the 36 cases submitted to the inquiry, only two had interest rate increases prior to a monetary default;
- of the 59 cases examined in relation to the Bankwest acquisition only 5 had interest rate increases prior to a monetary default;
- in seven cases where default interest was charged, the full rate was only charged in one case, which involved a voluntary administrator and in the other 6 cases the reasons for interest rate increases included:

25 Commonwealth Bank of Australia, *Answers to questions on notice*, taken on 12 November 2015, received 16 December 2016.

26 The Bankwest acquisition and price adjustment mechanism are discussed in Chapter 7.

27 Commonwealth Bank of Australia, *Answers to questions on notice*, taken on 12 November 2015, received 16 December 2016.

- the business performing below expectations;
- material breaches, such as non-remittance of bond proceeds; and
- increases in funding and/or restructure/extension of facilities.[28]

2.32 ANZ stated that it does not engage in the practice of constructing a default as suggested in the terms reference. ANZ indicated that it only takes possession of property held as security for a loan where there has been a monetary default and after working with the customer. It is only in extraordinary circumstances where action is taken outside of monetary default such as where directors appoint a voluntary administrator.[29] ANZ submitted that, in its view, non-monetary covenants in lending contracts serve as an 'early warning sign' that a customer may be experiencing difficulty meeting their obligations, or that they may do so in the near future.[30]

2.33 ANZ argued that its examination of all borrowers in ANZ-enforced insolvency administration as at 31 March 2015 provides evidence that ANZ does not use non-monetary conditions of default to move to impairment or enforcement action:

> Of the 116 commercial customers identified, 113 were in monetary default at the time of ANZ enforcement and the monetary default was relied upon to take possession of property held as security by ANZ. Of the remaining three customers, there were specific and compelling reasons for ANZ to take action following the occurrence of other significant defaults (for example, the appointment of a receiver by another financier).[31]
>
> The data did not identify any instances of ANZ relying on the breach of a LVR covenant as the primary default. Of the 116 customers, only two had been in default of their LVR covenant and in both of cases, the default relied upon for the enforcement was a monetary default and not the LVR breach.[32]

2.34 ANZ also informed the committee that it supported the development of an enforceable industry standard on the use of non-monetary default covenants, to ensure that contracts with small business are fair and appropriately balance the contractual rights and obligations of the parties.[33] ANZ suggested that customers would benefit from clearer information upfront regarding what events constitute a default and that an industry standard might be appropriate.[34]

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28 Commonwealth Bank of Australia, *Answers to questions on notice,* taken on 9 March 2016, received 31 March 2016.

29 Mr Graham Hodges, Deputy Group Executive Officer, ANZ, *Committee Hansard,* 13 November 2016, p. 64.

30 ANZ, *Submission 49,* p. 2.

31 ANZ, *Submission 49,* p. 2.

32 ANZ, *Submission 49,* p. 2.

33 ANZ, Submission 49, p. 14.

34 Mr Graham Hodges, Deputy Group Chief Executive Officer, ANZ, 13 November 2016, p. 64.

2.35 NAB submitted that it would not object to changes to the Code of Banking Practice to provide greater transparency around the use of non-monetary defaults. NAB indicated that it only uses non-monetary events of default in limited circumstances to commence enforcement action where the customer, its directors or a third party has placed the customer in external administration. NAB also argued that if enforcement of non-monetary defaults was somehow restricted, it may impact the provision of funding and have unintended commercial consequences. NAB also submitted that banks are required by APRA Prudential Standard APS 220 Credit Quality policy and accounting standards to recognise impairment as and when it occurs.[35]

2.36 NAB submitted that non-monetary defaults provide an early warning of deteriorating risk profiles, and that this provides opportunities for financiers to have discussions with their customers and work with customers so as to avoid monetary defaults arising. NAB also argued that non-monetary defaults are essential to identifying risk relating to a certain range of loans which require customers to make only limited scheduled repayments (sometimes with lengthy time periods between repayments). These loans include commercial property construction loans, certain forms of asset based finance, margin lending and products which support export focussed industries and some agriculture.[36]

2.37 Westpac informed the committee that in the majority of cases a non-monetary default, including LVR, is not the sole reason for enforcement action, even where that option is available under the terms of the contract. Westpac indicated that it does not have any current matters under recovery subject solely to an LVR default in either the farm or non-farm sectors. Westpac also noted:

> …enforcement of security due to a non-monetary default may occur in certain circumstances, such as the appointment of an administrator by a third party or where there is evidence of fraud. Absent these circumstances the Westpac Group's preference is to work with the customer to reach a mutually agreed work out position taking into consideration the customer's business plan, forecasts and cash flow.[37]

Committee view

2.38 The committee acknowledges suggestions from banks in the course of the inquiry regarding the development of an enforceable industry standard on the use of non-monetary default covenants to ensure that contracts with small business are fair and appropriately balance the contractual rights and obligations of the parties. The committee considers that the best way to achieve this is for the industry to work with an independent body as soon as possible to develop nationally consistent standard loan contracts. At the end of this chapter the committee makes recommendations to address this.

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35 NAB, *Submission 50*, pp 4–7.

36 NAB, *Submission 50*, pp 4, 6.

37 Westpac, *Submission 126*, p. 11.

Penalty interest, default interest and fees

2.39 This section summarises evidence presented to the committee in relation to penalty interest, default interest and fees. A large number of submitters alleged that they were subject to excessive penalty interest, default interest or fees.[38]

2.40 Some submitters indicated that in their view, the banks do work with business clients, however, they charge exorbitant penalty interest rates of up to 15 per cent. It was also alleged that when the banks are working with a client, they are still charging unjustified penalty interest rates.[39]

2.41 Another submitter described the interest rate changes that they experienced:

> The rate of interest went from 7.9% to 8.9% within a few months. Their explanation for this interest rate hike was that we were now a high risk client and they were applying a risk penalty, effectively meaning our interest rate had risen 3% in around 12 months to 10.95%. This was during a period when the Reserve Bank was continually lowering the cash rate. Overdraft interest rates increased from 11.55% in early 2010 to as high as 17.62% later that year, with a 21.62% rate on overdraft "excess" created by disadvantageous distribution of funds by the lender. They would also require a full document application every 6 months if the loan was to be renewed.[40]

2.42 The committee also heard that, in relation to a Bankwest customer, a penalty rate prevented them from being able to refinance their loan facility, and that Bankwest managers acknowledged that the interest rate of 17.51 per cent was not helping their situation.[41]

2.43 Another submitter claimed that his interest rate was increased from 6.98 per cent to 18.26 per cent as a penalty for default. The penalty interest was increased to 18.56 per cent in September 2010, increased again to 18.81 per cent in November 2010 and continued until December 2011 when the appointed receivers sold the properties.[42]

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38 Name withheld, *Submission 5,* p. 7; Name withheld, *Submission 10,* p. 4; Mr Anthony Rigg, *Submission 15,* pp 6–7; Mr & Mrs Courte, *Submission 17,* p. 2; Name withheld, *Submission 26,* p. 3; Mr Michael Sanderson, *Submission 28,* p. 4; Mr & Mrs Kreutzer, *Submission 39,* p. 9; Department of Agriculture, *Submission 44,* p. 2; Dr Evan Jones, *Submission 83,* p. 2; Mr & Mrs Bennette, *Submission 85,* p. 5; Danielle & Peter Schaumburg, *Submission 95,* p. 5; Mr Peter Ward, *Submission 98,* p. 6; Mr Trevor Eriksson, *Submission 101,* p. 2; Ms Faye Andrews, *Submission 102,* pp 2–6; Mr Peter McNamee, *Submission 107,* p. 13; Mr Sean Butler, *Submission 113,* p. 8; Ms Rita Troiani and Ms Janine Barrett, *Submission 114,* p. 6; Bank Reform Now, *Submission 116,* pp 6, 9, 13; Name withheld, *Submission 152,* p. 1; Mr Jim Martinek, Submission 153, *p. 12.*

39 Mr Peter McNamee, *Submission 107,* p. 13.

40 Mr & Mrs Courte, *Submission 17,* p. 2.

41 Name withheld, *Submission 184,* p. 4.

42 Mr Trevor Eriksson, *Submission 101,* p. 14.

Views of industry bodies and banks

2.44 This section summarises responses from industry bodies and banks to allegations regarding penalty interest, default interest and fees.

2.45 The ABA submitted that excessive interest is cited as a cause of loan failure in less than 5 per cent of business insolvencies.[43]

2.46 The Commonwealth Bank advised the committee that APRA requires banks to hold much more capital against loans in default, therefore requiring the bank to dedicate resources to working with a customer in default. The Commonwealth Bank informed the committee that:

> There are many cases where we do not apply the default rates, as we recognise that higher interest rates can impinge on the cash flow of our customers. However, there have clearly been some very high rates charged, so we would be happy to see a standard industry practice for default interest rates.[44]

2.47 Westpac submitted that while it is entitled to charge default interest following a non-monetary default, it is usual for a review to be undertaken and where possible, other arrangements agreed with the customer before an adjustment to the interest rate is made. Westpac argued that default interest generally only applies where the borrower is late with repayments or has failed to meet their account limit obligations. Westpac indicated that it would be unusual for it to charge default interest in situations where it is working cooperatively with the customer.[45]

2.48 NAB informed the committee that it often waives default interest rates in order to maximise the chances of the customer being able to trade through their difficulties.[46]

2.49 As noted at the beginning of this chapter ANZ has announced some measures to assist borrowers.

Committee view

2.50 The committee notes that some banks appear willing to support standardising practices in relation to default interest. The committee acknowledges that when loans are impaired or in default, there are additional costs to banks associated with increased engagement with the customer and meeting prudential requirements. However, the committee is concerned that evidence indicates that banks may make significant profit by charging fees, default interest and penalty interest greatly in excess of the costs to the bank. The committee considers such profit taking or price gouging, to the

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43 Australian Bankers' Association, *Submission 47,* p. 3.

44 Mr David Craig, Group Executive for Financial Services, and Chief Financial Officer, Commonwealth Bank of Australia, *Committee Hansard*, 2 December 2015, pp 2–3.

45 Westpac, *Submission 126,* p. 13.

46 Mr Timothy Williams, General Manager, Group Strategic Business Services, NAB, *Committee Hansard,* 18 November 2015, p. 10.

extent alleged or indicated by evidence, to be unethical and is making the following recommendation to restrict such practices.

Recommendation 1

2.51 The committee recommends that appropriate regulation and legislation be put in place to prevent banks profiting from defaulted or impaired loans by requiring banks to:

a. levy additional costs that the bank incurs when a loan is in default or is impaired in accordance with a schedule or process approved by the Australian Small Business and Family Enterprise Ombudsman.

b. provide transparent and accountable information to borrowers on the additional costs that the bank incurs when a loan is in default or is impaired; and

c. where a bank charges additional fees or interest of any kind associated with a defaulted or impaired loan;

a. the increased costs incurred by the bank must be disclosed in the loan contract, where possible, as a flat dollar figure; and

b. any amount charged that exceeds the increased costs incurred by the bank is to be paid off the loan principal.

Timeframes for customers including notice to roll over loans

2.52 This section summarises some cases brought to the committee's attention in which submitters identify concerns about the amount of time they were provided to attempt to resolve financial difficulties or seek refinance if the bank decided not to roll over a term loan. A significant number of submitters alleged that banks did not meet their expectations and provided:

- insufficient notice periods for decisions not to roll over term loans leading to difficulty in refinancing loans;[47] and
- insufficient time to address financial difficulties or consider alternative solutions to foreclosure; [48]

47 Mr Anthony Rigg, *Submission 15,* p. 4; Mr Michael Sanderson, *Submission 28,* p. 2; Mr & Mrs Kreutzer, *Submission 39,* pp 1, 5; Legal Aid Queensland, *Submission 55,* p. 6; Mr & Mrs Bennette, *Submission 85,* p. 10; Mr Peter Hall, *Submission 109,* pp 7, 41.

48 Name withheld, *Submission 5,* p. 5; Mr & Mrs Randles, *Submission 8,* p. 5. Mr Anthony Rigg, *Submission 15,* p. 5; Name withheld, *Submission 21,* p. 5; Ms Deborah Perrin, *Submission 30,* p. 2; Name withheld, *Submission 32,* p. 8; Mr Greg Bloomfield, *Submission 34,* p. 4; Mr & Mrs Kreutzer, *Submission 39,* pp 1, 9; Ms Robyn Toohey, *Submission 62,* p. 3; Mr Robert Barr, *Submission 78,* p. 10; Mr Robert Johnson, *Submission 84,* p. 7; Mr Roy Lavis, *Submission 82,* p. 2; Ms Charalambia Evripidou, *Submission 93,* p. 1; Danielle & Peter Schaumburg, *Submission 95,* p. 7; Mr Peter Ward, *Submission 98,* pp 6, 8; Mr Trevor Eriksson, *Submission 101,* p. 13; Mr Vittorio Cavasinni, *Submission 103,* p. 2; Mr Bruce White, *Submission 104,* p. 2; Bank Reform, *Submission 116,* pp 10–14.

2.53 Legal Aid Queensland informed the committee that, in its experience, banks generally provide realistic timelines to satisfy defaults such as extending time to enable crops to be harvested or livestock sold, however, timelines considered for the sale of land or other assets such as machinery are more challenging. Legal Aid Queensland noted that despite farmers in financial difficulty being given time to sell properties, many farmers have been unable to sell their farms.[49] Legal Aid Queensland also drew the committee's attention to the impact that term loans can have on long term businesses, such as farms:

> Banks sometimes offer…short term loans which expire in one to five years. These types of facilities are inappropriate in most circumstances where the loan is to finance the full purchase price of a farm. At the expiry of these short term facilities, the banks have no legal obligation to extend them. Unfortunately some farmers have been disadvantaged by loans of this nature when the bank decides not to extend the facility.
>
> In one matter, a loan in excess of $10 million was approved to finance the full purchase price of a grazing property where the facility expired in 5 years. The bank did not renew the loan on expiry despite the bank manager having assured the borrowers that it would simply be rolled over. The farmers would not have accepted the loan had they not been assured that the facility would be rolled over.[50]

2.54 A submitter alleged that many former Bankwest customers state that their relationship managers had assured them that the bank was favourably considering rolling over their facilities, and then provided them with as little as 48 hours to fully repay their facilities.[51]

2.55 Another submitter indicated that during discussions with its bank, his company was told to bring its borrowings down from approximately $160m to $120m by the end of May 2008, then down to $80m by the end of October 2008.[52]

2.56 A witness argued that a six month notice period should be required, suggesting that six months prior to the expiration of a loan the bank should be required to tell a borrower whether they will roll over the term loan to provide the borrower with an opportunity to seek alternative finance.[53]

2.57 Another witness argued for a period of 6 to 12 months:

> There should be a minimum period, if the bank does not want you, of 12 months. You need that to refinance and regroup. You cannot do it on three days notice.

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49 Legal Aid Queensland, *Submission 55,* pp 4, 9.

50 Legal Aid Queensland, *Submission 55,* p. 6.

51 Mr Trevor Hall, *Submission 109,* p. 7.

52 Mr Roy Lavis, *Submission 82,* p. 2.

53 Mr Peter McNamee, *Committee Hansard,* 13 November 2016, p. 47.

> I think, by the time they instruct a valuer and he gets around, and then you get your accounts up to date and you go in—you might be able to do it in three months, but you are leading yourself short on any contingency that might happen. I think six months is fair.[54]

Views of industry bodies and banks

2.58 This section summarises the responses from industry bodies and banks to allegations regarding timeframes and notice periods for borrowers.

2.59 The ABA informed the committee that the timeframe over which banks work with borrowers in financial difficulty varies depending on the circumstances of the loan. The ABA indicated that, in its view, the average length of time that a borrower's loan remains in financial difficulty is over 12–18 months for non-farm gate loans and around 12–24 months for farm gate loans. Larger commercial loans typically have more complex business operations and may take several years.[55]

2.60 ANZ informed the committee that the difference between the time of default and when there is a demand of payment can be quite a long time, but the time between a demand for payment and recovery action can be relatively short. ANZ argued that once a demand for payment is made, there is a high risk that the business is trading while insolvent, necessitating quick action.[56]

2.61 ANZ also informed the committee that on average, the time between first issuing a default notice and recovery action is about one and a half years for non-agribusiness commercial borrowers and over two and a half years for an agribusiness borrower.[57]

2.62 The Commonwealth Bank informed the committee that receivers were appointed in 28 of the 36 cases it examined in response to questions on notice from the committee. For those 28 cases the average number of days between the first default and the appointment of receivers was 539 days. The Commonwealth Bank noted that for the 36 receivership appointments examined in relation to the Bankwest acquisition, the average number of days between the first default and the appointment of receivers was 395 days.[58]

2.63 The Commonwealth Bank informed the committee that it considers options such as repayment holidays or interest free periods to relieve distress to customers, and in the case of natural disasters has a range of special assistance initiatives. The Commonwealth Bank also advised that:

> In the year to 31 March 2015 more than 40 per cent of commercial customers rated as troublesome or impaired returned to a satisfactory

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54 Mr Trevor Eriksson, *Committee Hansard*, 13 November 2016, p. 62.

55 Australian Bankers' Association, *Submission 47*, p. 9.

56 Mr Graham Hodges, Deputy Group Chief Executive Officer, ANZ, 13 November 2016, p. 73.

57 Mr Graham Hodges, Deputy Group Chief Executive Officer, ANZ, 13 November 2016, p. 64.

58 Commonwealth Bank of Australia, *Answers to questions on notice*, taken 12 November 2015, receiver 16 December 2015.

> position. These data demonstrate our willingness to give customers time to address arrears and return to sustainable payment arrangements.[59]

2.64 The Commonwealth Bank suggested that in future, they would consider allowing a minimum of one month between when a customer defaults on loan and when a bank requires full repayment of the loan as result of default.[60]

2.65 NAB informed the committee that it considers exercising its rights in response to any event of default on a case by case basis, considering the customer's financial position and particular circumstances. The time period provided by NAB to rectify an event of default depends on these factors as well as an assessment of:

- whether the default is capable of being rectified;
- the likelihood of rectification;
- other actions agreed with the customer as part of an overall plan to address the event of default; and
- whether the assets of the business and the security are deteriorating or have a limited life or there are other factors such as animal welfare.[61]

2.66 NAB argued that it does not consider that there is any need to impose further compulsory notice periods in addition to the currently applicable statutory notice periods.[62]

2.67 Westpac advised that it employs a variety of mechanisms to assist customers resolve financial difficulties. Westpac informed the committee that terms renegotiated with the customer in the loan facility agreement include the loan term, loan pricing, repayment arrangements, financial covenants, forecasts for cash flow and any undertaking to sell assets, and the ability to raise additional equity or security or provide security. Westpac also noted that in practice, there is no set time period for refinancing or the sale of assets and that the time period for refinance or the sale of assets would usually be 90 to 120 days.[63]

2.68 Evidence received from customers of these banks disputed many of the claims made by the banks. This only further highlights the need for:

- a mandatory code of practice which includes ethics, conduct and related protocols; and
- an independent body to mediate contested disputes.

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59 Commonwealth Bank of Australia, *Submission 48,* p. 8.

60 Mr David Craig, Group Executive for Financial Services, and Chief Financial Officer, Commonwealth Bank of Australia, *Committee Hansard*, 2 December 2015, p. 2.

61 NAB, *Submission 50*, p. 10.

62 NAB, *Submission 50*, p. 10.

63 Westpac, *Submission 126*, pp 12–14.

ASIC & FOS

2.69 ASIC informed the committee that one of the difficulties faced by a lender is determining how much time must be allowed after delivering a demand on the borrower before appointing a receiver. Often the speed of appointment is crucial to allow the lender to safeguard the assets in question. ASIC advised that although the appointment of a receiver may occur quickly after a formal demand is made, it is likely this action would follow a relatively lengthy period during which there have been ongoing discussions between the borrower and the bank about the status of the loan facility. ASIC also noted that borrowers must be given reasonable time for payment after the notice of demand. What constitutes reasonable notice will depend on a range of factors including:

- the nature of the security and the amount owed;
- the risk to the secured party (i.e. whether the secured assets are in jeopardy);
- the period of the relationship between the secured party and the debtor;
- the circumstances leading up to the demand; and
- the debtor's ability to satisfy the demand.[64]

2.70 The FOS informed the committee that banks generally work with the borrower for some time before default notices are served, trying to work with the borrower to solve the problem, whether it is through the sale of assets, refinancing, restructuring or other options to overcome financial difficulties.[65]

Committee view

2.71 The committee accepts that the majority of business loans proceed without dispute between the parties. It further accepts that statistically, the average time between initial dialogue commencing and default is generally in excess of three months. The committee remains concerned however by evidence it has received regarding the lack of notice being given to a number of borrowers about the impending expiry of loan terms and decisions by banks not to roll over term loans. The fact that this practice is possible, albeit limited, indicates a systemic and unreasonable imbalance of power in the business lending relationship. Banks should be well aware of the timeframe required to refinance loans in general, but especially small business and commercial loans. The committee is therefore making the following recommendation to provide appropriate protections to borrowers.

64 ASIC, *Submission 45*, p. 28.

65 Mr Philip Field, Lead Ombudsman, Banking and Finance, Financial Ombudsman Service Australia, *Committee Hansard*, 16 October 2015, p. 9.

Recommendation 2

2.72 The committee recommends that the banking codes of practice administered by the Australian Bankers' Association or the Customer Owned Banking Association and other regulatory arrangements be revised to require that:

a. authorised deposit taking institutions must commence dialogue with a borrower at least six months prior to the expiry of a term loan. Further, where a monetary default has not occurred, they must provide a minimum of three months notice if a decision is made to not roll over the loan, even if this means extending the expiration date to allow for the three months following the date of decision;

b. if a customer is meeting all terms and conditions of the loan and an authorised deposit taking institution seeks to vary the terms of the loan, the authorised deposit taking institution should bear the cost associated with the change and provide six months notice before the variation comes into effect;

c. customer protections relating to revaluation, non-monetary defaults and impairment should be explicitly included in the code; and

d. subscription to a relevant code becomes mandatory for all authorised deposit taking institutions.

Irresponsible lending

2.73 This section discusses some further information brought to the committee's attention on irresponsible lending. Responsible lending obligations require credit licensees to make inquiries into a consumer's objectives and financial situation and verify their financial situation. Credit licensees must assess this information and not provide or suggest credit to a consumer if that credit will not meet the consumer's objectives or the consumer will not be able to meet their financial obligations without substantial hardship.[66]

2.74 The committee received evidence from some submitters that banks had acted in a way that was inconsistent with their responsible lending obligations.[67]

2.75 The Consumer Credit Legal Service WA Inc (CCLSWA) advised the committee that some consumers will readily accept loans with unnecessarily high LVRs, while being unaware of the inordinate level of risk associated with loans of that nature. CCLSWA submitted that:

> Our experience is that [financial service providers] do not actively inform consumers of the risks associated with loans with LVRs above 80%. A high

66 ASIC, *Submission 45*, pp 6–7.

67 Name withheld, *Submission 18*, pp 5–6; Consumer Credit Legal Service (WA) Inc, *Submission 56*, pp 5–6; Ms Suzi Burge, *Submission 63*, p. 7; Ms Jean Andersen, *Submission 99*, p. 1.

> LVR effectively means that the consumer is purchasing a home or investment property without paying a deposit, and retaining little to no equity. A lack of equity presents both short-term and long-term problems. In the short term, a lack of equity will often result in higher initial interest rates on the home loan, making it far more difficult for the consumer to make repayments. The long-term risks are far more pronounced. If a consumer is not in a very strong position to service a high-risk loan, they are far more susceptible to fall into a pattern of default if they encounter temporary financial difficulty.[68]

Views of industry bodies and banks

2.76 This section summarises the responses from industry bodies and banks to allegations regarding irresponsible lending. Information provided by ASIC and FOS is discussed in chapter 4.

2.77 The ABA argued that banks are required to make prudentially responsible lending decisions and that the occurrence of problems is low given the substantial number of business loans in Australia.[69]

2.78 The Code Compliance Monitoring Committee (CMCC) indicated that it intended to conduct an own motion inquiry into banks' compliance with the provision of credit obligations. The CCMC noted that clause 27 of the code requires banks to be prudent and diligent in assessing a customer's ability to replay a credit facility. The CCMC also asserted that many of the submissions to the inquiry relate to loans that should not have been provided:

> We have reviewed the submissions made to this inquiry by individuals and small businesses. In many of the submissions, the issues raised appear to relate to the provision of credit and whether or not it should have been granted in the first place. We have been able to identify only two instances where a person making an allegation to the CCMC has also made a submission to this inquiry. In one case an investigation is currently ongoing, and in the other case it was identified that the bank had breached its obligations relating to the provision of copies of documents.[70]

2.79 The Commonwealth Bank informed the committee that it applies loan serviceability tests when assessing an application for a loan and that staff are trained in serviceability calculations. The Commonwealth Bank argued that it makes no commercial sense from a bank's point of view, or the customer's point of view, to enter into a loan where the customer is unlikely to be able to service a loan.[71]

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68 Consumer Credit Legal Service (WA) Inc, *Submission 56,* pp 5–6.

69 Australian Bankers' Association, *Submission 47,* p. 1.

70 Mr Christopher Doogan, Independent Chair, Code Compliance Monitoring Committee, *Committee Hansard,* 16 October 2016, p. 12–13.

71 Mr David Cohen, Group Executive for Corporate Affairs, and Group General Counsel, Commonwealth Bank of Australia, *Committee Hansard,* 4 April 2016, p. 39.

2.80 Westpac outlined its approach to responsible lending, submitting that it acknowledges its obligation to design and market products responsibly in line with the expectations of customers and the community:

> The extension of both consumer and business credit is also underpinned by the Westpac Group''s own "Principles of Responsible Lending", including the principle that we seek to lend only what our customers can afford to repay. It is not in the Westpac Group's interests to extend credit that cannot be repaid. The Westpac Group's interests and the interests of our customers and the broader national economy are ultimately aligned; our success relies on the success and prosperity of our business customers.[72]

2.81 ANZ informed the committee about its approach to responsible lending:

> We would want to assess a loan on its serviceability in the first instance. Is that customer able to comfortably service that loan?…There will be some examples where the cash flows are not there but there is a prospective cash flow or there is an asset being created which will then be sold to repay the loan, so you could see some circumstances where serviceability is not immediately apparent but a means of paying back the loan is quite evident in front of you. There are obviously going to be exceptions around that, but we would always want to ensure that there is a sufficient cash flow and a sufficient buffer for issues that a customer would deal with.[73]

Committee view

2.82 The committee considers that the current situation in which responsible lending provisions are only voluntary is not satisfactory. The committee is therefore recommending that responsible lending protections be extended to small business borrowers. However, the committee wishes to ensure that the protections do not impede business that are well informed, have a strong business case and are prepared to back themselves in taking on a venture. The committee therefore suggests that the responsible lending provisions for small business should include a threshold test for a level of responsible lending whereby the bank will not allow a borrower to exceed this level unless:

- the borrower is able to demonstrate that they have sought independent advice as to their capacity to manage the extra debt; and
- is willing to sign a clearly documented front page to the loan contract that informs them of the conditions to which they will be subject if they do not meet the terms of the contract.

Recommendation 3

2.83 The committee recommends that responsible lending provisions, including ASIC's monitoring under the *National Consumer Credit Protection Act 2009,* be extended to small business loans.

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72 Westpac, *Submission 126,* p. 4.

73 Mr Graham Hodges, Deputy Group Chief Executive Officer, ANZ, *Committee Hansard,* 4 April 2016, p. 33.

Power imbalance between customers and banks

2.84 This section summarises evidence raised by a number of submitters in relation to the power imbalance between borrowers and banks.[74] Many submitters throughout the inquiry told the committee harrowing stories about the devastating financial situations that they found themselves in. This was compounded by the frustration that they did not have the means left to pursue their disputes through the courts. Some submitters suggested that because of the significant resources of banks, borrowers may be entering into risky loans or conditions on these loans because they perceive they have limited options. Some further examples are discussed in Chapter 3 under the section on alternatives to dispute resolution.

2.85 A submitter argued that the problem for small businesses is that when it comes time to borrow money the bank writes the loan contract, the loan contract is not negotiable and the contract documents are large and difficult to understand. These factors combine to place the bank in a much more powerful position than the borrower. The submitter indicated that that his loan document was 53 pages long, and contained obligations on the borrower that included positive undertakings, negative undertakings, default conditions and standard terms. In the submitter's view, the banks have perfected loan contract documents so that is virtually impossible for a small to medium enterprise to challenge a bank in a court:[75]

> And it is all because of the initial contract between the bank and the borrower, and we have to change that. If we do not change that, the voluntary codes of conduct are not worth anything, and oversights are not worth anything. We have to change that contract. If we cannot change the balance of power at the contractual level, between the bank and the borrower, then this will repeat itself forever.[76]

Committee view

2.86 The power imbalance between banks and borrowers as a result of the loan contract appears to the committee to leave borrowers in an extremely vulnerable position. Even in those circumstances where a customer may have a legal case to take to court, the capacity of the banks to 'deep-pocket' or out-spend and out-wait the borrower means that court action is often not a viable mechanism for addressing disputes. The committee notes that the above arguments add further weight to the

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74 Mr & Mrs Lock, *Submission 14,* p. 6; Name withheld, *Submission 18,* p. 5; Mr Brent Renouf, *Submission 42,* p. 4; Legal Aid Queensland, *Submission 55,* pp 4, 8; Tasmanian Small Business Council, *Submission 61,* p. 8; Ms Robyn Toohey, *Submission 62,* p. 1; Mr Lynton Freeman, *Submission 64,* p. 14; Dr Evan Jones, *Submission 83,* p. 11; Mr John Dahlsen, *Submission 87,* pp13–14; Mr Peter McNamee, *Submission 107,* p. 11; Name withheld, *Submission 11,* p. 5; Mr Sean Butler, *Submission 113,* p. 11; Bank Reform, *Submission 116,* pp 9, 27. JMA Parties, *Submission 120,* p. 3.

75 Mr Peter McNamee, *Committee Hansard,* 13 November 2016, p. 46; Mr Peter McNamee, *Submission 107,* p. 21.

76 Mr Peter McNamee, *Committee Hansard,* 13 November 2015, p. 54.

earlier recommendation made by the committee for nationally consistent standard loan contracts that have been developed by an oversight body consisting of representatives from industry, consumers and ethicists.

ASIC's examination of misconduct reports

2.87 ASIC informed the committee that in the five years from 1 July 2010, it considered 66 reports of misconduct in relation to loans and determined not to pursue further regulatory action because there was insufficient evidence of misconduct on which to base an enforcement action against the relevant lender. ASIC noted that for the 66 cases, questions of fact in relation to the lender's conduct were in dispute. ASIC noted common features across these 66 cases:

- relevant loans were not covered by consumer protections in the *National Consumer Credit Protection Act 2009*;
- half of the matters occurred in 2009–10 or 2010–11;
- the borrowers were likely to have received advice about the loan terms or were expected to have sought advice and elected not to;
- the borrowers' financial circumstances changed significantly;
- changes to the value of security resulted in breaches of LVR covenants;
- banks determined not to rollover commercial facilities at their discretion;
- concerns that the banks had imposed unfair terms or used their strong bargaining position to disadvantage debtors could not be made out on the evidence presented;
- lenders had been willing to renegotiate loans, but borrowers sought more generous arrangements; and
- banks or borrowers had initiated legal action in relation to the dispute.[77]

ASIC's examination of four cases

2.88 As noted earlier in this chapter, information provided to the committee indicates that dissatisfied borrowers disagree with the banks on the facts of their cases. The committee is not able to discern which version of events is accurate however the committee has made its best efforts to establish whether genuine disputes exist. The committee selected four cases and formally referred those cases to ASIC for review in relation to relevant legislation, regulation and codes of practice.

2.89 The committee notes that this is an unusual approach for parliamentary committees and in doing so, notes that it does not intend to publicly identify the four cases or any of the details associated with them. Furthermore, the examination of these cases is not intended to influence any court or dispute resolution mechanism that may formally consider those cases.

77 ASIC, *Submission 45*, pp 11–13.

2.90 ASIC informed the committee that overall, its consideration of the material provided did not indicate breaches of the existing regulatory obligations on lenders administered by ASIC.[78] ASIC noted that:

> …the case studies provided relate to business borrowers who obtained large commercial lending facilities from banks. It is difficult for ASIC to offer a comment on whether or not the conduct of the lenders in these case studies was unethical. This is because our regulatory role for commercial lending is limited, and relates to considering allegations of misconduct as opposed to judging questions of ethics.[79]

Committee view: practices of banks

2.91 The committee notes ASIC's advice that its role does not include judging questions of ethics. However, the committee also notes that it is not acceptable for the situation to continue to exist where banks are not required to meet minimum professional and ethical standards, and to be held accountable to those standards. The committee is therefore recommending that the ASBFE Ombudsman should draw together relevant expertise across small business, financial services, ethics and education to drive the development of appropriate professional standards for the conduct of banks in relation to loans.

2.92 The committee has no powers to investigate or resolve individual disputes, however the committee has used the cases presented to it to understand the practices of banks and makes the following observations:

- for many failed loans under the 2008 Bankwest commercial loan book, it appears likely that problems arose from irresponsible lending prior to the acquisition of Bankwest by the Commonwealth Bank;
- for many failed loans with other banks it is also likely that irresponsible lending was the primary or significant cause of loan failure; and
- there may be some individual cases for which there are legitimate disputes with banks.

2.93 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 not required of banks in relation to small business and commercial loans.

2.94 The committee has received evidence to suggest that borrowers perceive that banks provide inconsistent information and advice between the bank's lending departments and their credit management departments. The committee is concerned that this may be influenced by inappropriate incentives and cultures in those departments.

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78 ASIC, *Supplementary submission 45*, p. 3.

79 ASIC, *Supplementary submission 45*, p. 11. ASIC also noted that commercial and competitive drivers exist for lenders and their employees and representatives to serve the needs of customers.

2.95 ASIC informed the committee that:

- a lender providing conflicting advice to a borrower may not be in breach of its regulatory obligations;
- from a legal perspective, a lender's employees or representatives would have contractual, general law, and employment law obligations to act in the interests of the lender, as their employer or engager; and
- there is no overriding regulatory obligation on commercial lender employees or representatives to act in the best interests of the borrower.[80]

2.96 The committee is very concerned about the lack of any obligation on lenders to provide consistent information in the best interests of borrowers. The committee therefore makes recommendations to:

- prohibit conflicted remuneration for banks officers, especially those involved with lending and credit management;
- allow longer remuneration clawback periods for poor performance, such as those used in the US and UK; and
- require bank officers in lending and credit management departments to act in the best interests of the borrower.

2.97 The committee considers that the need to refinance loans may arise for reasons including that the existing banking arrangement is not constructive for either party, or the loan is a term loan that either party may not wish to roll over. Effective refinancing of loans, particularly for commercial loans, requires sufficient time. This is particularly important where the underlying business, such as a primary production business, runs for timescales much longer than loan terms. Once default or demand notices are issued, other banks are understandably reluctant to refinance.

2.98 The committee acknowledges the Commonwealth government's announcement on 20 April 2016 that it will enhance the surveillance and enforcement capability of ASIC for investigating financial advice and responsible lending.[81] The committee also acknowledges the announcement on 21 April 2016 by the ABA in relation to new measures to protect consumer interests, including:

- 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 whistle blowers 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

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80 ASIC, *Supplementary submission 45*, p. 12.

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

- bringing forward a review of the Banking Code of Practice.[82]

2.99 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 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. In addition, in April 2016 the government made a range of other announcements relating to regulation of banks and lending practices.

2.100 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 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 staff 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 that include a cover sheet summarising the obligations of the customer and the consequences of any breach; 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.

2.101 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.

Recommendation 4

2.102 The committee recommends that the government bring forward legislation and other measures to enable the Australian Small Business and Family Enterprise Ombudsman to:

a. lead and/or coordinate the implementation of the outcomes of this inquiry and all other reforms that relate to small business lending in order to avoid the significant risk that major gaps and flaws in the protections for small business would remain;

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

b. 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;

c. work with the banking industry to develop mandatory nationally consistent standardised loan contracts that include a cover sheet summarising the obligations of the customer and the consequences of any breach;

d. have the power to direct the parties to a dispute to participate in mediation or dispute resolution;

e. where gaps in the implementation of those standards and appropriate dispute resolution schemes remain, to act as a small business loans dispute resolution tribunal; and

f. direct the parties to a dispute to participate in commercial arbitration for larger commercial loans.

Recommendation 5

2.103 The committee recommends that appropriate legislation and regulations be put in place to:

a. prohibit conflicted remuneration for all bank staff;

b. extend the clawback period on any bonus or like incentives provided to management and senior executives involved in the line approvals or systematic oversight of lending;

c. require bank officers to act in the best interests of a small business customer;

d. require officers from lending and credit management departments to provide consistent information to borrowers, including:

i. copies of valuation reports and instructions to valuers; and

ii. copies of investigative accountants' reports and instructions to investigative accountants and receivers;

e. require lending officers and credit management officers to ensure that:

a. the valuation instructions do not change during the term of the loan agreed in the loan contract; and

b. 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.

Recommendation 6

2.104 The committee recommends that nationally consistent arrangements be put in place for:

a. farm debt mediation;

b. small business debt mediation; and

c. the professional standards and conduct of valuations in relation to small business loans.

2.105 The committee also heard that there is a problem caused by the failure of banks to notify creditors, such as builders who are building on a developer's land, when a loan is placed into default. The committee considered the case of Integrity New Homes, who were constructing housing on behalf of a client whose loan was subsequently placed into default. Integrity New Homes continued to build and add value to the secured asset which was then liquidated by the bank with no compensation for Integrity New Homes.

Recommendation 7

2.106 The committee recommends that the link between lenders and key creditors, such as builders who may be building on a developer's land, needs to be formalised so that lenders have an obligation to advise creditors once a loan is placed in default.