



Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

16 March 2016

Dear Sir/Madam

Commonwealth Bank Group (CBA)

I refer to my attendance before the Joint Committee on 16 February 2016 and the Committee's verbal request that I consider two further matters. My response is set out below.

The Chair of the Committee requested feedback from PwC in relation to the report by Lawrence Tomlinson to the UK parliament ("Tomlinson report") in relation to long term customer relationships and short term incentives within the banking industry.

I have read the Tomlinson report, which I understand relates to the UK experience (with a particular focus on RBS and Lloyds Bank). The report suggests there were commercial incentives for these UK banks to place some of their loans into a distressed debt management group in order to generate some form of additional income, rather than allowing the loan to proceed to term.

The suggestion in that report is at odds with my own experiences. I have not observed such practices in Australia, and I fail to understand a lender's commercial incentive to terminate a loan where there is an opportunity for a loan to go to term and provide full repayment to the lender. My observation is that large financial institutions work closely with borrowers to explore the steps that can be taken to turn a non-performing (or potentially non-performing) loan into a performing one. In my view it is in a lender's (and borrower's) interests to do so.

The Chair of the Committee also asked PwC to take on notice the question of how the Australian accounting and or auditing standards could be amended to provide greater protection to individuals.

As the Committee will know, accounting standards are designed to ensure the financial statements of a company are true and fair. I do not believe a change to the standards (which of themselves govern financial statements) would be an effective tool to secure reform (which the Committee seems to be considering as a possibility) of current contractual lending arrangements between financial institutions and their clients.

In any event, Australian accounting and auditing standards are aligned with international accounting and auditing standards. I believe amendments to Australian standards to include different criteria to international standards, would place Australia at a competitive disadvantage.

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Transcript

You have also provided a copy of the transcript of the hearing before the Committee on 16 February 2016. There are two matters that I wish to draw to your attention:

- Page 52 line 14 from the bottom “PLN” should be P and L; and
- Page 58 line 7 from the bottom refers to “hose” should be “those”.

Additional questions on notice

By letter dated 18 February 2016, the Committee provided me with a detailed list of questions. In my responses, attached, I have answered those questions from my knowledge gained from discussions and my review of some of the work undertaken by the firm at the relevant time, which I did in advance of my recent appearance before the Committee. As I explained to the Committee, my first year of leading the CBA Group audit and signing the Group financial statements was the year ending 30 June 2013.

In some of the questions set out in the letter of 18 February 2016, I am asked to comment on things which go to matters known to CBA, HBOS or others, or which proceed on a misapprehension as to the role PwC had (for instance one question suggests, incorrectly that PwC had a role in designing the Bankwest Share Sale Deed). At best, any reply I might make would involve me speculating on matters and I do not believe this would assist the Committee in its deliberations. For that reason I am not able to respond meaningfully to the Committee in relation to questions 7, 9, 10, 11, 12, 13, 14, 15, 22, 26, 27, 28, 29, 32, 33 and 36.

I trust the information in this letter and the attachment is of assistance to the Committee.

Yours faithfully

Marcus Laithwaite
Partner

Encl. 1

Attachment: Parliamentary Joint Committee on Corporations and Financial Services

Draft Completion Balance Sheet Dispute

(Included Mr O'Brien, Mr Cavassini and 65 other customers)

- 1. The CBA provided evidence that PwC were engaged to assist in assessing price Adjustments proposed by HBOS, due to concerns around Bankwest provision levels.**

The CBA also stated that PwC concluded that the loan impairment provisions relative to Bankwest's peers were understated relative to Bankwest's peers.

Due to concerns around Bankwest provision levels, Commonwealth Bank engaged PwC to assist in assessing the price adjustments proposed by HBOS. PwC concluded that the loan impairment provisions in the DCBS relative to Bankwest's peers were understated in the range of \$119.7 million to \$232.4 million (net of tax)⁴. (Refer to page 2 of the PwC letter contained in Appendix 1 which confirms the scope of work performed and findings in relation to the DCBS.) Accordingly, Commonwealth Bank disputed the loan impairment provisions in

(CBA Response to Questions on Notice 8 October 2015, p.4)

- 2. Did PwC conclude this independently, or did they work in conjunction with CBA staff? Or did they rely solely on information provided by CBA staff.**

The Committee will appreciate that as CBA's auditor, PwC is required under the Corporations Act to maintain its independence. Whilst we were provided with underlying data from Bankwest, such as risk grades and historical losses, our calculations were performed independently of Bankwest and CBA staff.

The CBA response extracted above I believe refers to work undertaken by PwC in about March 2009 where PwC was engaged to perform agreed-upon procedures in accordance with Australian Auditing standards to assist CBA in identifying matters which indicate where the Adjusted Purchase Price may have been overstated.

As the Committee may know, an agreed-upon procedures engagement involves the performance of procedures determined by a client as ones which they wish to be performed and from which factual findings are reported. No conclusion or opinion is expressed and no assurance is provided to intended users. PwC, in agreeing to undertake these procedures, is required by auditing standards to consider the needs and objectives of the intended users –in this case, CBA.

Our report identified matters for CBA's consideration including a potential uplift in collective loan loss provisions of Bankwest (net of tax) of \$119.7m - \$232.4m.

- 3. Were PwC informed by the CBA, that the CBA had instructed Bankwest credit staff to perform a review of performing commercial loans on a 'Downside', 'worst-case' scenario? (Refer Table 1)**

PwC understood that there was a review of the Bankwest loans by Bankwest and CBA but I have not seen anything to suggest CBA instructed Bankwest to downgrade performing loans.

4. **Were PwC aware, the commercial loan review ‘papers’ provided by Bankwest to CBA and PwC for review were compiled (under instruction by the CBA), on a ‘downside risk representative of insolvency / enforcement of security’? (Refer Table 1)**

See response to question 3 above.

5. **Further, were PwC aware that Bankwest staff advised CBA staff the ‘strategies’ in the papers were ‘not representative of anticipated likely outcomes currently being pursued’?**

24. An email from Michael Hayes (National Manager – Portfolio Groups – BankWest) to Kathryn Porteous (Commonwealth Bank) on 27 March 2009 – 12:04PM states:

"Kathryn as per our telephone conference call on Wednesday I have been asked to remind all that the papers have been prepared, as instructed, on the basis of downside risk – in most cases representative of insolvency/enforcement of our security and these strategies are not representative of anticipated likely case outcomes currently being pursued."

(Table 1)

See response to question 3 above.

PwC were copied into an email from Bankwest credit staff to CBA senior credit and risk managers.

FYI - copy of instructions that went out this morning to my team following our discussions and subsequent discussions with Steven Lim & David White @ PwC.

With regards to the templates themselves we are removing the reference to risk grade and the section on Basis for HBOS provision. We are also reviewing language given document is now intended to go outside the group.

(Table 2)

The email also stated:

Each sheet needs to be reviewed to ensure that the language used is appropriate. i.e. rather than using the words "conservative downside" or "worst case" we should be using "given the current environment" or similar.

The CBA provided the committee with the following evidence:

The Share Sale Deed¹ required the DCBS (including the loan impairment provision) and proposed adjustments to be determined in accordance with:

- **Bankwest's accounting and credit policies at 31 December**

(CBA Response to Questions on Notice 8 October 2015, pp. 2-3)

- 6. Surely the various instructions around reviewing commercial loans on the basis of “conservative downside”, “worst case” and using information “not representative of anticipated likely outcomes currently being pursued” is not in accordance with Bankwest’s accounting and credit policies at 31 December 2007 as required by the Share Sale Deed.**

See response to questions 2 and 3 above.

- 7. Is the reason the ‘language was being changed given the document was now going outside the group’ that the CBA wanted to avoid alerting HBOS that a different accounting and credit policies at 31 December 2007 was instructed by the CBA?**

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question.

- 8. Did PwC question whether the basis of the review instructed by the CBA was different to Bankwest’s accounting and credit policies at 31 December 2007 as were required by the Share Sale Deed?**

See response to questions 2 and 3 above.

- 9. Were HBOS made aware of the significantly different accounting and credit policies used to review Bankwest commercial loans (as instructed by the CBA) than Bankwest’s accounting and credit policies at 31 December 2007 as required by the Share Sale Deed?**

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question.

- 10. Were the independent experts (KPMG) made aware of these significantly different accounting and credit policies used to review Bankwest commercial loans (as instructed by the CBA)**

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question.

I note for completeness that the reference to KPMG was probably intended to be a reference to Ernst & Young.

CBA Misleading 2012 Inquiry – Paid an Additional \$26 Million

- 11. Was the BankWest Share Sale Deed designed to achieve a zero- sum outcome for both parties in relation to the Purchase Price? (Mr Cohen Gave evidence in 2012 that this was the case.)**

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question.

12. **Do PwC consider reductions or savings on the purchase price ranging from \$156 to \$464 million as zero-sum outcomes ?**

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question. I note that the adjusted purchase price was calculated in accordance with the terms of the Share Sale Deed.

13. **Is it accurate to say that the CBA ultimately reduced or saved \$156 million on the Purchase Price of BankWest through the Draft Completion Balance Sheet Dispute Notice Process ?**

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question. As a matter of logic, I do not consider it can be said the adjustment is a "saving". It is a reflection of a purchase price adjustment referable to the value of what had been acquired.

14. **Did PwC allow items into the dispute notice, which were outside the contracted terms of the Share Sale Deed? Specifically, why did PwC allow include information only available after February 19, 2009 to be included in the dispute process? e.g. in Rory O'Brien's loan claim, CBA and PwC included information from April 2009.**

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question. For completeness, I note PwC did not prepare the dispute notice.

Project Magellan – (Between 1100 and 1900 customers were affected)

In CBA's 8 October Response to Questions on Notice a letter from PwC letter to CBA 6 October was included as Appendix 1.

Project Magellan Performing loans on 1100 loans. You stated in evidence that you:

'Considered 'Loss events' as defined in AASB139, and 'such assessment are not necessarily dependent on the delinquency status of the loans'.

15. **In simple language, these people reviewed were for the most part (or all) were making their loan repayments - is that correct? (A: It must be correct – they were classified as 'performing loans' by Bankwest.)**

The loans reviewed pursuant to Project Magellan were those in the part of the non-retail portfolio for which a collective provisions was held. Loans in this category and with these risk grades are typically not identified as being in default.

In CBA's evidence, they stated that in a 12 week period, 1100 Bankwest files had their files re-graded and security values were reviewed. In PwC's evidence, it is stated that you reviewed the CBA's process in and deemed it to be 'robust'.

16. **Can you provide details of the how you assessed processes used to re-grade loan files, and reviewing security valuations as 'robust' ?**

I understand our work initially focused on discussions with management, reviewing the key assumptions made around loans that had been downgraded, assessing and understanding the basis of the revised collateral values, understanding and assessing extrapolation methodology and reviewing the basis of the management overlay. I

understand subsequent procedures included a detailed review of a number of files in the Magellan review and analytics to assess the collective provision associated with the non-retail lending portfolio.

17. What was the form of the data you reviewed? Could you provide the committee with the copies of each review .

The audit file does not contain copies of the original Bankwest loan files considered but a record of the audit procedures undertaken.

The documentation included in our files is in accordance with the audit documentation standard ASA 230 and is of such a kind as to enable an experienced auditor, with no prior connection to the audit, to understand the nature, timing and extent of procedures performed, the results of the procedures and the audit evidence obtained and the significant matters arising during the audit, the conclusions reached on those matters and the significant professional judgments made in reaching those conclusions.

18. Specific to security valuations. Were new valuations sought as part of Project Magellan for the 1100 loans affected? Were all of these valuations conducted by independent valuers? Were all valuations received by the bank and reviewed by PwC prior to 10 August 2010?

I understand that the need for updated valuations was identified for some loans reviewed as a part of Project Magellan. Based on my review, I do not know whether all valuations were undertaken by independent valuers, however PwC observed it was Bankwest's usual practice to do so. I cannot comment on whether all updated valuations requested by Bankwest were completed prior to 10 August 2010. I do not believe all were reviewed by PwC.

19. In relation to re-grading of loan files? Can you provide the committee with details of the 'robust' processes undertaken by the CBA?

I understand there was a file review process undertaken by management whereby instructions to the review teams were provided and were clear. Bankwest's process appeared to focus on assessing the appropriateness of the risk grade ascribed to loans selected for review. These included updating its assessment of the financial condition of the borrower, using internal and external specialists and forming a view on the current values of collateral where these were dated. There were additional reviews of files by panels in certain circumstances. The work was subject to a controlled process so that risk grades and collateral data were updated in source systems used to determine the collective provisions.

20. What was the risk scale used? (E.g. Risk Grade 1 to 10, Risk grade 1-8, other?)

I understand that the risk grade was 1 to 10.

21. What was the range of risk grades of the loans reviewed prior to re-grading by this review?

If the question is whether the available range (within the Bankwest system) was the same – I understand that the risk grade range was unchanged by Project Magellan albeit that there was a review of whether loans were correctly categorized within that range.

22. What was the range of (re-graded) loan risk grade which had insolvency practitioners engaged re-graded to?

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question.

23. You also stated a 'prudent and rigorous approach had been undertaken, erring on the downside...'. When reviewing loss events does this mean the CBA could have been too aggressive in their reviews?

I don't believe so.

24. In Project Magellan, the bank was reviewing loan files and security values coming out of a GFC. Hypothetically, your submission could support allegations that the CBA engaged in mass-constructive defaults couldn't it? Especially if the initial 'loss-event' was low valuation or expired facility?

I do not agree that our submission supports allegations that the CBA engaged in mass-constructive defaults.

The level of a collective provision in financial statements is different in nature to circumstances of default that the bank's customers may find themselves in.

Our work was focused on the reasonableness of estimates of likely losses that the bank had incurred and was required to provide for in its financial statements. The standing of a customer's loan, whether it be in arrears (including circumstances where the facility had expired and the customer was required to repay the loan) or whether other default events had occurred were factors that were considered when determining loan provisions. Loan provisioning does not cause defaults, but seeks to estimate the amount of loans that may not be recovered by the bank.

The Quentin Olde emails states on 7th July, 2010 (before the audit process was completed) that Project Magellan would result in 'the line' having to engage 100's of 'quick and dirty' IAs'

What is important here is actioned by the line means in most cases obtaining an IA report and liaising with Credit to determine if the file can be repatriated or needs to be escalated. The long and short of this is that the line (not CAMS or Credit) will be required to appoint hundreds of IAs in the next few months.

The bankers are furious as they say many of the files are fine and the cost is going to kill their clients. A number of senior guys I've known for years have resigned in Sydney in the last week or so - mainly gone to Westpac and NAB.

Grant Thornton have apparently tried to line up to do all the IAs but the bankers are revolting saying they have a conflict and should not do any work on these files as they made the recommendations.

The bankers will be wanting 'quick & dirty' IAs for \$10-\$15k - with the hope the recommendation is to do nothing more.

25. What is your understanding of an IA? (Is it an investigative accounting report?)

I understand that an "IA" is usually a reference to an investigating accountants report.

26. What does 'quick and dirty' mean in this context?

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question. In the normal course, I would speculate that the writer meant a high level exercise done expeditiously.

- 27. Why would all of these IA reports need to be done immediately after the 'review', if the processes referred to in Project Magellan were so 'rigorous and robust'?**

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question.

- 28. Were customers impaired and treated as Non-Performing for the purposes of the CBA 2010 annual statements, immediately following this review? If not what did happen to these loans?**

The CBA consolidated accounts for the period ended 30 June 2010 included a loss loan provision in relation to Bankwest.

Project Magellan identified increases to risk grades for the files reviewed and reductions in collateral values that, when combined resulted in an increase in the collective provisions held by Bankwest of \$451m. The loans that were downgraded as a result of Project Magellan were subsequently managed in a variety of ways, depending on the circumstances of each loan.

- 29. Were customers contacted at this point and advised Bankwest / CBA had found problems with their loan? If so how?**

I don't know.

- 30. Could it be the case that Project Magellan (which CBA gave evidence was merely an 'accounting exercise') was (or became) a mass-impairment or constructive default exercise across the performing commercial loan book?**

I do not believe this to be the case.

- 31. Was an outcome of Project Magellan, or a linked project, that the entire Bankwest performing loan book (including investment grade loans) be transferred to a classification of Watch-list, Troublesome or Impaired? (Refer below)**

I do not believe that was an outcome of Project Magellan.

General

- Bankwest non retail exposure
- Basle II accreditation – extend for Bankwest
- Non-retail exposure migration
 - Watch list – S&P B- or better
 - Troublesome – S&P CCC+ to C plus D where no loss expected
 - Impaired – S&P D where loss anticipated
- Stress Testing

(Commonwealth Bank of Australia Investor presentations, Risk Management –Credit Risk, Alden Toews Group Chief Risk Officer, Ross Griffiths Chief Credit Officer, 16th and 17th November, 2010)

On 11 August 2010, the CBA reported that Insolvency practitioners were appointed to "1100 performing loans" as a result of Project Magellan.

- 32. Why would there be a need for mass-appointment of insolvency practitioners to performing loans, as a result of Project Magellan, which CBA characterised as purely an 'accounting exercise', when 'performing' customers were still making payments?**

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question. I note that there may be an incorrect premise in the question. See also my response to 28.

Bankwest Legacy Book Review

- A comprehensive, in-depth review:
 - ~1,100 individual files (66% of book now reviewed)
 - Results extrapolated to remaining, lower risk segment
 - Independent insolvency firms engaged
 - Specialist management team reviews across key industry sectors
- Profile of problem loans:
 - Legacy - 99% written pre-acquisition
 - Predominantly East Coast
 - Performing loans; average loan size \$8m
 - Unrealistic security valuations
- Risk management practices significantly strengthened:
 - Strengthened oversight regime (Board and Executive Risk Committees)
 - Guidelines and delegations tightened
 - Alignment with CBA policy and procedures



CBA Results Presentation For the full year ended 30 June 2010 Ralph Norris CHIEF EXECUTIVE OFFICER David Craig CHIEF FINANCIAL OFFICER 11 August 2010

- 33. CBA have given evidence they worked 'for a long period of time'. How did CBA work for a long period of time if insolvency practitioners were appointed directly as a result of Project Magellan?**

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question.

- 34. What independent checks did PwC conduct of the information provided by Bankwest? If Bankwest had constructively defaulted customers prior to the review by PwC, what processes did PwC have in place to check the**

integrity of the data used in that review? Could PwC have 'ticked and flicked' flawed data which was based upon 'constructive defaults' ?

When we examined the reasonableness of individually assessed provisions held by the bank against loans, we obtained and reviewed a range of information, including bank records and, where available, external evidence such as investigating accountants reports and independent valuations. We then formed an independent view of the reasonableness of the provision recorded, based on an assessment of the likely loss experienced by the bank. Customer defaults observed at Bankwest were essentially monetary defaults, where the customer has not repaid amounts to the bank in accordance with the requirements of the executed loan contract – I do not consider these to be circumstances which the bank can 'construct'.

- 35. Is there any possibility of misconduct by the CBA here? Can PwC categorically rule out that that any misconduct occurred in relation to the allegation of constructive impairments of commercial loans by the CBA?**

PwC undertook audit procedures sufficient to provide reasonable assurance as to whether the financial statements of the company give a true and fair view of the bank and the group's financial position and performance and whether they comply with Australian Accounting standards. I addressed our role in my opening.

There is nothing I have seen which would suggest misconduct by CBA.

- 36. What role did former Fitch ratings staff have in this 'accounting exercise'? Was Project Magellan related to APRA Basel II capital requirements? Was it related to the 'Extension of CBA Advanced Basel Accreditation' project?**

For reasons mentioned in my covering letter, I am not able to provide a meaningful response to this question.

- 37. Why would insolvency professionals be required for an 'accounting exercise' review of loans that were subsequently foreclosed upon by the bank?**

In my experience, insolvency professionals are often appointed in the role as investigating accountants to review the financial standing of borrowers that may be exhibiting signs of potential financial distress. In some instances, these loans will subsequently result in the appointment of receivers to realise collateral provided by borrowers in the event repayment of the loan is unable to be made.

- 38. How did project Magellan tie into Extension of CBA's Basel advanced accreditation?**

We are not aware of any link between these two exercises.

Basel II Standardised / Tier I Capital

- 39. Did the introduction of Basel II Standardised require Banks to hold significantly more Tier One capital for non-investment grade loans, that is, loans with an S&P rating of B+ or lower?**

Not necessarily. It depended on the bank's overall portfolio at the time of transition.

Basel II introduced a new methodology and greater risk sensitivity into the calculation of credit risk weighted assets, which included a scale of risk weightings of between 20% and 150% for corporate obligors that have a credit rating issued by an External Credit Assessment Agency (ECAI rating 1 = 20%, rating 2 = 50%, rating 3 or 4 = 100%

and rating 5 or 6 = 150%, un-rated = 100%). This compares to Basel I where Corporate exposures were generally weighted at 100%.

My understanding is that the majority of Bankwest loans was un-rated and in this respect the transition to Basel II would not have had a significant impact on risk weightings for corporate exposures.

A corporate with a S&P rating of B+ corresponds to an ECAI long-term credit rating grade of 5, and hence attracts a risk weighting of 150%, however this increased risk weighting would be offset by any corporate loans with a rating of A- or better and hence the overall capital requirement for banks did not necessarily increase as a result of the adoption of Basel II.

40. Bankwest moved from Basel I to Basel II standardised on 1 January 2009, is that correct?

Yes

41. At the 19th December 2008, on Acquisition, I understand that Bankwest had approximately (\$18 billion) of S&P B+ (and lower) rated SME loans. Under Basel II Standardised accreditation, such loans attracted a Tier 1 Capital holding requirement of 100%. Is that correct?

These figures appear to be incorrect, because:

- SME loans are typically un-rated and hence we would not expect there to be any such loans with a S&P rating, let alone \$18 billion which was greater than the bank's total corporate loan exposures at the time
- Bankwest Pillar 3 report for 31 March 2009, shows total credit risk exposures to corporates of \$14.1 billion which were risk weighted at \$14.2 billion (i.e. close to 100% risk weighted). The risk weighting on \$18 billion of B+ or lower corporate loans would be \$27 billion.

In any case, the Tier 1 capital requirement in 2008 was 4% of Risk Weighted Assets, and hence the capital required to support sub-investment grade loans would have been $4\% \times 150\% = 6\%$ of any such exposures, not 100%.

42. Does that mean that Bankwest had to source and hold significantly more Tier One capital as a result of the Basel transition immediately after the acquisition in December 2008?

No. The Bankwest Pillar 3 report for 31 March 2009 discloses a Tier 1 ratio of 7.92% which is well above the minimum level of 4%, and hence no additional Tier 1 capital was required.

43. Would the approximately (\$18 billion) of S&P B+ (and lower) rated SME loans that make the Tier 1 Capital holding requirement for those loans \$18 billion?

No

44. Did the CBA ever raise that capital?

The question provides on an enormous premise as to CBA's capital raising.

45. Was the mass-impairment of customer loans a process engineered to avoid the need for the CBA / BWA to raise this capital?

I have seen nothing to suggest it was. As a matter of logic, the impairment or write-off of an asset would reduce the capital available to the institution, rather than avoid or mitigate the need for a capital raising.

- 46. Could it be a credible motive for the CBA and Bankwest to act ‘in concert’ this way – to avoid the need to raise the additional Tier 1 capital, at a time when wholesale markets were difficult to access and cost of available capital was high?**

For the reasons mentioned in 44 and 45, the answer is no.