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Senate Committee on the Lending to Primary Production Customers
Department of the Senate
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AUSTRALIA

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Senate Select Committee Inquiry into Primary Production Lending

The Westpac Group (Westpac) thanks the Committee for the opportunity to lodge a submission with the Inquiry. In addition, we endorse the submission lodged by the Australian Bankers' Association (ABA).

1 Executive Summary

Westpac's vision is 'to be one of the world's great service companies, helping our customers, communities and people to prosper and grow'. We remain committed to the primary production sector as a core component of Australia's future economic prosperity and success. Across Westpac's Business Bank and Westpac Institutional Bank there are close to 19,000 primary production connections with over $10.2 billion to the agricultural, fisheries and forestry sectors. We provide a wide range of services to these customers including lending, deposits, transaction and risk management services.

Westpac notes the Inquiry is particularly concerned with the application of loan defaults, including non-monetary defaults, for agricultural loans. In relation to those defaults:

(a) Westpac does not engage in practices to artificially engineer a business default, including revaluation of security.
(b) Further, prudential requirements for impairment provisioning do not create a commercial incentive to increase loans in default or construct defaults. An increase in impaired credit exposures can adversely affect Westpac's liquidity, capital resources, financial performance and financial condition.
(c) It is rare for Westpac to use a decreased loan to value ratio (LVR) or other non-monetary default, as a sole default trigger to commence enforcement action. A recent review of our files suggests that enforcement on the sole basis of a non-monetary default in the agricultural sector has not taken place since our merger with St. George in December 2008.

We are concerned that an increase in regulatory requirements may result in reduced lending to Australian primary producers. We have a shared objective to make Australian businesses stronger and this relies on continued access to credit and maintaining strength in the banking system. In addition, it relies on supporting customers during times when they are experiencing financial difficulty.

Once we identify issues in relation to a loan to a primary producer, our priority is to work with the customer to find solutions that will, as far as possible, seek to ensure the customer's business is sustainable and can be returned to good health. This is in the interests of both the customer and Westpac. We have a strong track record of working with our agribusiness customers. For example, out of over 30,600 agribusiness customers in our Business Bank we have only appointed receivers and managers to 15 customers over the last 2 years.

1.1 Key Submissions to the Inquiry

I. Westpac considers that there are opportunities to enhance transparency and certainty for customers. This includes information about the appointment of third parties such as insolvency practitioners. As a member of the ABA, Westpac supports the industry's commitments under the ABA Six Point Plan and the 'Better Banking' initiatives to ensure high standards of conduct across the industry. Key reforms include a revised Code of Banking Practice with enhanced obligations for banks to agribusiness customers and industry guidelines on valuation practices and the appointment of third parties, including receivers and managers and investigative accountants.

II. Westpac is always looking at where improvements could be made to service our customers. This includes reviewing and enhancing our documentation. Westpac currently has a funded project underway to amend small business lending documentation, including limiting events of non-monetary default and removing financial covenants from non-specialist loans. This ensures we not only continue to meet minimum legal requirements but also will meet a higher standard which aligns to expectations of our small business primary production clients and the community and promotes good customer outcomes.

III. Westpac strongly supports the national harmonisation of farm debt mediation to enhance consistency for primary production customers experiencing financial difficulty. For example, the Farm Debt Mediation Act 1994 (NSW) and the Farm Debt Mediation Act 2011 (Vic) each requires formal mediation, where the customer has elected to mediate, before a mortgagee can take enforcement action under a farm mortgage. In Westpac's experience, the involvement of an independent farm debt mediator increases the likelihood of a mutually successful outcome.

IV. Westpac proactively supports our business customers' success by providing access to information and skills development. For example, insights to customers about their cash flow movements or, in the agribusiness sector, demonstrating that business reserves and equity remain an essential component of risk mitigation measures, including natural disasters and seasonal changes. In our experience, financial difficulty can often be related to management skills within the business.

Opportunities for business and government partnerships should be examined to facilitate primary producers' access to important tools and information that can assist with business management. For example, the launch of a central Government portal with links to industry and other third party information.

2 Westpac approach to business lending

2.1 Commitment to lending responsibly

At Westpac, we are committed to responsible lending. We design and market our products responsibly in line with the expectations of customers and the community.

It is not in Westpac's interests to extend credit that cannot be repaid. Westpac'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 customers.

In addition to our own credit assessment policies, Westpac complies with all local legislation, relevant codes of practice and relevant guidelines published by the Financial Ombudsman Service.

2.2 Management of Credit Risk

Authorised Deposit-Taking Institutions (ADIs), including Westpac, are regulated by the Australian Prudential Regulation Authority (APRA). APRA Prudential Standard APS 220: Credit Quality (APS 220) requires ADIs to control credit risk1 by adopting prudent credit risk management policies and procedures. In addition, APS 220 requires a 'current' assessment of the value of collateral held.

Westpac's credit risk framework and policies encompass all stages of the credit cycle, including: origination, evaluation, approval, documentation, settlement, ongoing administration and issues management. For example, we have established product-based standards for lending to businesses including minimum serviceability standards and maximum loan to security value ratios.

Westpac's credit risk management framework also incorporates the assignment of risk profile to individual customers and our credit risk appetite (which can vary over time).

For larger customers, Westpac evaluates credit requests by undertaking detailed individual customer and transaction risk analysis (the 'transaction-managed' approach). Such customers are assigned a customer risk grade representing Westpac's estimate of their probability of default. We focus on the performance of key financial risk ratios, including interest coverage, debt serviceability and balance sheet structure.

For all borrowers we typically obtain security, including a mortgage over property, a general security agreement over business assets and/or guarantee(s) from the director(s).

The effectiveness of our credit risk management framework is demonstrated in our low default and arrears rates and number of distressed customers. For example, in our commercial agribusiness segment of over 30,600 customers we currently have:

- 70 'farm gate customers'[2] (0.23% of agribusiness customers) under the management of our specialist risk management unit, this includes customers showing early signs of stress and on the 'watch list'; and

[1] Credit risk is the risk of financial loss and arises from the possibility that some customers will be unable to honor their financial obligations to us, including the repayment of loan principal and interest.
[2] Farm Gate loans are defined as customers designated with ANZSIC Code Agriculture Division 01, sub 400 Codes.

- Commenced recovery action and appointed a receiver & manager or agent for the Mortgagee in Possession against 15 customers over the last two years. Four of these customers remain in occupancy of the property.

While this is a statistically small segment, we are sensitive to the effect this can have on the welfare of the affected customer and their families. Westpac is engaged in industry initiatives to improve the capability of our staff to support customers in financial distress and associated mental health issues.

3 Ongoing credit risk assessment

3.1 Covenant monitoring

As required by regulation, once a credit contract is established, Westpac undertakes ongoing risk assessments to ensure the application of a correct credit risk grade to the customer[3]. This assessment is informed by a number of conditions and reporting obligations that a customer agrees to meet under the terms of the loan contract i.e. 'covenants'.

Covenants are a contractual requirement or restriction placed on a borrower, setting minimum standards for their future conduct and performance. Covenants utilised by Westpac are defined, measurable, anticipatory of deteriorating credit and reasonable in purpose. They provide an early warning of deteriorating risk profiles and form an important part of our broader risk management framework, by highlighting the need for a discussion around stabilising and improving business performance, and therefore risk profile.

There are two broad categories of covenant that may be included in our Loan Facility Agreements:

1. **Financial covenants,** normally expressed as financial ratios that a customer is required to observe.

For example, measures around financial leverage, minimum profitability, liquidity, serviceability or net worth such as minimum interest coverage ratio, maximum gearing ratio, minimum shareholder's funds to total assets, and maximum LVR.

These are tested on a regular basis and act as an effective early warning mechanism that a customer's financial position or the value of its assets has deteriorated which may adversely impact the customer's ability to repay their loans.

These may be an essential part of an agricultural loan product, such as if we lend up to a certain percentage of a harvest. In those cases, the borrower covenants to report to us on the harvest and that the loan drawings will remain below a percentage of the harvest.

2. **Non-financial covenants**, which may be:

    - Restrictions that a customer must comply with. For example, not to dispose of, or grant security over, substantial assets without Westpac's consent; or
    - An action that a customer must cause to occur. For example: regulatory and legislative compliance; the provision of financial information to Westpac such as annual and half yearly financial statements, interim management accounts, cash flow forecast and associated covenant compliance certificate; a requirement to

[3] The Westpac credit risk rating system has 20 risk grades for non-defaulted customers and 10 risk grades for defaulted customers.

protect inventory (e.g. properly store grain); a requirement to properly secure a farmer's position in relation to customers (e.g. if grain is sold on credit to a buyer, then to make a Personal Property Security registration against the buyer to protect the farmer's grain); and a requirement to return equipment leased or rented by us.

Covenants contained within a customer's loan facility agreement are based on an assessment of the customer's credit risk as well as standard and sector-specific guidelines and the product design.

Many agricultural loan products contain financial and non-financial covenants which are key in managing and mitigating risks associated with the product. Non-financial covenants, such as the provision of financial statements and management accounts, provide valuable and transparent information to the lender about a business' performance on an ongoing basis. This is particularly important where the customer is required to make limited scheduled repayments, for example, seasonal crop financing.

In addition, ensuring asset value and cashflow is sufficient in the business at all times reduces the risk of the bank needing to enforce against our securities including calling upon Directors' Guarantees for any shortfall.

If covenants could not be applied the risks associated with some agricultural facilities would increase. This would impact lending appetite, including a re-assessment of the level of facilities we would be prepared to extend and the terms on which those facilities were extended. For example:

- Appetite to extend unsecured credit to customers would reduce, resulting in smaller facilities;
- Additional security coverage required;
- Increased requirement for facilities to be amortising; and
- Increase in interest expense and associated charges to compensate for the increased risk.

All of the above may adversely impact a primary producer's ability to successfully pursue its business strategy.

3.2 Covenant breaches

The breach of a covenant does not necessarily lead to an immediate acceleration of the loan and commencement of enforcement action to realise security. Rather, a review of the customer's financial position and consideration of other appropriate options would be a common response.

In addition, it may also be appropriate for Westpac to engage professional firms (generally with the customer's consent and co-operation) such as investigative accountants, particularly where there is a pattern of covenant breaches.

Westpac may also offer to engage in mediation with the customer, involving a neutral third party, to assist the customer formulate and agree to acceptable outcomes.

4 Default and recovery action

4.1 Events of monetary and non-monetary default

Westpac notes this Inquiry is particularly concerned with the application of defaults in a primary producer loan contract. For example, whether financial institutions engineer events of non-monetary default when the customer is still making repayments and is not in monetary default.

Westpac does not engage in practices to artificially engineer or create a business default, including revaluation of security. For example, we do not deliberately reduce, through valuation, the value of securities held by the bank e.g. to decrease the LVR, thereby resulting in the loan being in non-monetary default.

A customer monetary default occurs when:

- the customer does not make a payment on time in full; or
- a customer has drawn loans above an advised limit.

However, as noted above, Westpac's Terms and Conditions include a number of ongoing covenants that can give rise to a loan being in default for other reasons (i.e. non-monetary default) notwithstanding all payments are up to date.

In practice, the consequences of any event of default (monetary or non-monetary) are not usually an immediate acceleration of the loan and commencement of enforcement action to realise security and/or take possession of assets (which could include the appointment of an Administrator/ Liquidator or Receiver and Manager).

Often there will be a substantial period of negotiation where the default may be remedied before it reaches the stage of enforcement.

In considering how to respond to a default, Westpac assesses the nature of the default including, among other things:

- the stress under which the customer is placed;
- whether the default is capable of being rectified;
- The likelihood of success of the rectification strategy; and
- The customer's overall approach to addressing the event of default.

It is Westpac's preference to work with customers to restore their financial position and resolve defaults without relying on legal rights in loan contracts. After all, our original credit assessment is based on the customer's ability to service the loan ('the first way out') not the enforcement of security ('the second way out').

Across our business portfolio, collections activity to enforce security due to a monetary default occurs in a small proportion of the overall primary production portfolio each year.

In addition, it is rare for Westpac to use a non-monetary default (e.g. financial covenant such as a LVR) as a sole default trigger to commence enforcement action.

A recent review of our files suggests that enforcement on the sole basis of a non-monetary default in the agricultural sector has not taken place since our merger with St. George in December 2008.

Nevertheless, immediate enforcement of security due to a non-monetary default may occur in certain appropriate circumstances, such as an Insolvency Event i.e. external administration (the appointment of an Administrator/Liquidator or Receiver and Manager), bankruptcy, the loss of a trading licence or where there is evidence of fraud or other illegal activity.

Absent these kinds of circumstances, Westpac'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. This may involve the use of a mediator, as an independent third party, to assist the customer understand its options.

4.2 Working with customers in financial difficulty

There are a variety of factors that may lead a business to experience financial difficulty, including economic downturn, business management capability or internal conflict, change in personal circumstances, fraud, overtrading and specific events such as flood, drought and fire. We acknowledge the stress these events place on primary producers, their families and communities.

We understand that lending to primary producers requires a long-term view on the position of our customers through cycles and seasons. We have a long history of working with farmers through business, weather and seasonal cycles and changes in market conditions.

Our experience indicates that it takes business customers in difficulty an average of two to three years to restore their credit standard back to an acceptable level of financial viability. However, in some circumstances, including primary production loans, it can take longer for a customer to rectify their financial position.

As mentioned above, every matter of financial difficulty in a business is dealt with on a case-by-case basis to ensure Westpac can respond flexibly to the circumstances of individual customers and a customer-specific strategy can be determined and agreed. There is no standard time period provided to borrowers to rectify a default event. Nor is there a standard form of assistance offered.

Apart from being the right thing to do, working with our customers to restore their financial position is also in our commercial interests. For example, a customer who is able to recover their financial position is more likely to be able to repay their principal loan amount. It also reduces costs to the bank and the customer (e.g. by avoiding the costs associated with insolvency practitioners) and maintains value in the business.

An increase in customers in default can lead to an increase in impaired credit exposures. This can adversely affect Westpac's liquidity, capital resources, financial performance and financial condition. In particular, there are implications for the amount of regulatory capital we are required to hold against impaired loans. This reinforces that our success relies on our business customers' success and highlights the absence of any commercial justification to 'artificially construct' a default or impair a credit exposure.

Support may involve renegotiating the customer's loan facilities either through a Forbearance/ Standstill Arrangement, whereby the customer acknowledges default and is given 'breathing space' by way of an agreed extended period of time to resolve their financial difficulties, provided performance milestones are met. For example, this may include the extension of loans that have or will expire, waiver of scheduled loan repayments or an agreement on a period of time where no principal repayments are made. It may also include freezing credit card and home loan repayments for a period of time to provide some additional breathing space.

Westpac has a comprehensive disaster relief package to assist customers through unforeseen events such as floods, drought and fire. The package is designed to ensure that viable operators are able to stay on their properties and underpin the long-term sustainability of their farms. In addition, as part of our approach to agribusiness financial difficulty, we encourage our customers to use Rural Financial Counsellors and use independent mediators to help reach agreement on a debt reduction strategy.

Importantly, the majority of Westpac Group customers are in a strong position to respond to weather events (e.g. ongoing drought) and market changes (e.g. dairy industry). This is reflected in our current portfolio. For example, out of 30,600 agribusiness commercial customers:

- our stressed assets are below 1% of the portfolio;
- we are actively working with 70 customers in our specialist unit;
- we have commenced recovery action against 15 customers in the last 2 years (appointment of receivers) and had one forced eviction; and
- one instance where the customer appointed an Administrator and the Bank then appointed a Receiver & Manager. At the time the customer appointed an Administrator there was no monetary default.

4.3 The appointment of third parties

Where third party insolvency practitioners are appointed, it is important to distinguish between bank-initiated recovery action and customer-initiated recovery action. Sometimes the directors of a company customer may decide to appoint Administrators to the company. We need to be able to adequately respond.

Westpac has a risk assessment process in place, when considering commencing recovery action against a customer, such as approval by senior members of the specialist risk management team.

In most instances, Westpac reacts to the appointment of an Administrator or Liquidator by the Directors of the company i.e. customer initiated recovery, by Westpac:

- appointing its own Receiver and Manager;
- becoming Mortgagee in Possession (for real property); or
- allowing the Administrator/Liquidator to realise the assets of the customer.

It is only once it is clear that a customer is in default, without the possibility of the customer's financial position and risk profile being rectified, and once Westpac has sought to mediate with the customer, that Westpac would move to recover the outstanding amount it is owed through enforcement of any security.

Therefore, if Westpac appoints a Receiver and Manager without the prior appointment of an Administrator/Liquidator, it is normally after all other efforts to resolve the situation have been exhausted. In this instance, Westpac acts to protect its position from further deterioration.

In addition to our own internal policies and procedures the bank complies with all local legislation, relevant codes of practice and relevant guidelines published by the Financial Ombudsman Service. This includes clause 28 of the Code of Banking Practice and compliance with the obligations governing the sale of real property under the Corporations Act 2001 (for companies) or State real property statutes (for individuals).

5 Dispute Resolution

The handling of customer complaints is a major factor in customer trust in their financial institution. It is important that customers have adequate forums to have their voices heard. This includes complaints about third parties and insolvency practitioners.

5.1 Internal Dispute Resolution

Westpac has processes and policies in place to govern the provision of support and assistance to our customers in financial distress. Our dedicated customer relations and dispute resolution teams provide an important avenue for our customers to raise any concerns or complaints. These Internal Dispute Resolution (IDR) mechanisms comply with the Australian Securities and Investment Commission's (ASIC) requirements including Regulatory Guide 165 Licencing Internal and External Dispute Resolution.

In November 2016, we appointed a Customer Advocate for retail and small business customers. The Customer Advocate can conduct an independent review and make binding decisions about individual complaints that have previously gone through the IDR process. In addition, the Customer Advocate has the authority to overturn decisions made by our internal dispute resolution process and will recommend how our existing complaint handling process can be improved and other improvements to broader business practices and policies.

5.2 External Dispute Resolution

In addition to IDR, retail and small business customers have access to External Dispute Resolution through the Financial Ombudsman Service (FOS)[4]. Westpac is obligated under the ABA Code of Banking Practice to provide customers with access to an independent external dispute resolution (EDR) service. FOS provides an important forum for customers to have IDR decisions reviewed.

Customers may also make complaints related to compliance with the ABA Code of Banking Practice with the Code Compliance Monitoring Committee.

6 Opportunities for improvement

To continue to enhance our existing practices outlined in this submission, Westpac is committed to continuous improvement in the way we service our primary production customers. We are in the process of implementing improvements in how we service our customers in a number of areas. These include our loan contract terms and notice periods for customers when we make changes to their contract terms or decline to refinance their loan. In addition, we support further improvements across the industry including better information for customers on valuations, guidelines on the appointment of third parties by banks and improved dispute resolution arrangements.

6.1 Loan Contract Terms

As part of our response to the recent Inquiry into Business Lending by the Australian Small Business and Family Enterprise Ombudsman (ASBFEO), Westpac will be making a range of amendments to our small business lending contracts.

[4] FOS Terms of Reference (current as of 15 January 2015) specifically exclude disputes involving recovery of a debt from a small business involving a credit facility that exceeds $2 million. However, FOS and financial institutions can agree for FOS to determine a matter outside the FOS Terms of Reference.

We expect that many of our small agribusiness customers will receive the benefit of these changes.

All businesses that meet the applicable thresholds will receive the benefit of the removal of:

1. material adverse change clauses ; and
2. some current non-monetary events of default (as agreed by the ABA).

Default events cannot be restricted to 'monetary events of default' as other appropriate non-monetary events of default need to be retained by necessity. For example, insolvency, illegal behaviour or fraud, change in management (e.g. a new director is appointed, and he or she has history of poor farm management), loss of licence or supply agreement, failure to monitor and protect stock levels, agistment of cattle without notice to us. These are broader than the 'illegal activities' carve out suggested by the ASBFEO e.g. voluntary administration by directors of a business, or agistment without notice which is not an unlawful act.

Most agricultural loan products offered to small businesses will have financial covenants removed e.g. LVR and Interest Coverage Ratio (ICR) and many other kinds of non-monetary covenants removed.

Westpac has participated in discussions via the ABA on settling on which non-monetary defaults will be used in small business loan contracts. For non-specialist lending products, it was agreed that six types of non-monetary defaults will remain in small business loan contracts. Whereas for specialist lending products, additional non-monetary defaults (e.g. financial indicator covenants and other product-specific non-monetary covenants) may also be used.

In addition, we are reviewing small business loan documentation to ensure facility agreements are as short as possible and a plain-English standard is applied. This will be supported by the development of a one page summary for small business loan facility agreement to provide greater clarity on events of default, applicable covenants and relevant pricing under the terms of the contract.

6.2 Notice periods

Westpac strongly supports appropriate notice being given to borrowers of changes in terms and conditions. Banks require the ability to make changes to the terms of a contract. For example, this was required to implement the Unfair Contract Terms regime which commenced in November 2016. However, appropriate notice of changes should be given to customers.

In addition, where a customer breaches a term of their contract (including a covenant), the customer has a period of time to remedy the breach before further enforcement action is taken under the terms of the contract.

Westpac has committed to a 30 calendar day minimum notice period for these purposes. Additional carve-outs to those identified by the ASBFEO for fraud and criminal actions which require immediate action will be required. For example, animal welfare considerations, or an event of voluntary administration or double financing of inventory, whereby the bank must appoint an insolvency practitioner to preserve assets. In addition, a notice period should not be required where the customer is already in monetary default.

Finally, customers should be given an adequate opportunity to refinance with another financial institution where we decline to rollover the facility. This can reduce the likelihood that the customer will be in a position of monetary default at the end of their loan term.

Westpac has committed to implementing a 'maturity notice' 90 calendar days before the facility matures. If we decline to rollover the facility, we will provide customers 90 calendar days to refinance. The only exception will be where the customer has a pre-existing monetary default prior to the maturity of the facility.

6.3 Valuation

We require the right to revalue security to be maintained in our business lending contracts. As noted above, APS 220 requires a ‘current’ assessment of the value of the collateral held.

Nevertheless, we consider that the valuation process and findings could be more transparent to customers. Currently under our contracts, Westpac has the right to obtain a new valuation at any time and at the customer’s expense. In practice, we only revalue security for loans above $1 million if it is more than 3 years old and the customer is requesting additional borrowings.

We support borrowers being provided with a choice of valuer from a panel of expert valuers. This aligns with current practice, through consultation with the customer before the final appointment is made. It is important to recognise situations where choice may be limited. For example, due to the requirement for specialised regional or business knowledge. Westpac agrees borrowers should be provided with the instructions to a valuer and the full copy of the valuation report where they have paid for this directly. Exceptions for when the business is in receivership or third party security is involved may be required.

In addition, Westpac supports the development of industry guidelines and consumer materials to better explain the valuation process. These are currently being developed by the ABA.

6.4 The appointment of other third parties

Westpac supports the ABA working with the accounting industry on improving disclosure arrangements. For example, when a bank can appoint an investigative accountant, receivers and managers, administrators and liquidators.

Westpac agrees that the industry should work with the insolvency practitioners industry to reduce any perceived conflict of interest. Westpac is currently working with the ABA to develop best-practice guidelines.

6.5 Dispute Resolution

Westpac considers that dispute resolution for primary producers can be enhanced. We strongly support a nationally consistent farm debt mediation model across Australian agriculture. As a national corporation, Westpac is strongly supportive of a harmonised farm debt mediation model.

In addition, Westpac supports the Government’s proposed establishment of the Australian Financial Complaints Authority so more small businesses have access to dispute resolution if required. This includes increasing the monetary limit on the claims that the can be assessed and on the amount of compensation it can award. Westpac looks forward to the consultation process on this new body.

6.6 Supporting our business customers to be stronger

Finally, it is imperative to proactively support our business customers to be successful by providing access to advice, information and skills development. For example, providing insights to customers about their cash flow movements or in the agribusiness sector, demonstrating that business reserves and equity remain an essential component of drought and risk mitigation measures.

Westpac considers that there are opportunities for partnerships between government and industry to facilitate primary producers' access to important tools and information that can assist customers with sustainable business management.

If you require any further information about this submission please contact Jade Clarke, Senior Manager Government and Industry Affairs on or .

Yours sincerely

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