Inquiry into Lending to Primary Production Customers

Submission by Legal Aid Queensland

Legal Aid QUEENSLAND

TRIM no 2017/061484

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Introduction

Legal Aid Queensland welcomes the opportunity to make a submission to the Senate inquiry into lending to primary production customers.

LAQ provides input into State and Commonwealth policy development and law reform processes to advance its organisational objectives. Under the *Legal Aid Queensland Act 1997*, LAQ is established for the purpose of “giving legal assistance to financially disadvantaged persons in the most effective, efficient and economical way” and is required to give this “legal assistance at a reasonable cost to the community and on an equitable basis throughout the State”. Consistent with these statutory objects, LAQ contributes to government policy processes about proposals that will impact on the cost-effectiveness of LAQ’s services, either directly, or consequentially through impacts on the efficient functioning of the justice system.

LAQ always seeks to offer policy input that is constructive and is based on the extensive experience of LAQ’s lawyers in the day to day application of the law in courts and tribunals. We believe that this experience provides LAQ with valuable knowledge and insights into the operation of the justice system that can contribute to government policy development. LAQ also endeavours to offer policy options that may enable government to pursue policy objectives in the most effective and efficient way.

Legal Aid Queensland’s Farm and Rural Legal Service (FRLS) provides advice and assistance to Queensland rural producers and rural based businesses who have severe debt related problems or are in dispute with their lenders, or are otherwise facing financial hardship directly related to their business of primary production. The service is free of charge. No income or asset tests apply.

The service works closely with rural financial counselors and professional advisors, such as agribusiness consultants, accountants and private legal advisors and represents rural producers in farm debt mediations as well as other debt negotiations with their financiers but does not provide representation in court proceedings.

Background

The majority of the work undertaken by the FRLS is under the Queensland Farm Finance Strategy (QFFS) which is a voluntary code of practice negotiated between the Australian Bankers Association and various industry groups. The *Farm Business Mediation Act 2017* is due to commence in July 2017. It will replace the QFFS. It provides that mortgagees must offer farm debt mediation to farmers before taking enforcement action.

All banks have specialist units which manage customers’ files if their accounts trade outside of their limits or they have been referred by the branch. Commonly, these units are called “asset management”, “credit restructuring” or similar names. FRLS generally deals with bank officers within these units. Asset management sections are not responsible for granting the original loans.

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Loans officers (normally agribusiness bankers) and credit managers at branch and credit level normally approve the initial lending and deal with ongoing financial business of customers. They have day to day contact with customers negotiating loans, managing loan increases, conducting reviews, and conducting general bank business. It is at this level that most decisions are made which affect the conduct of the customer's account until problems arise when it is referred to the bank's asset management section.

Asset management decides whether the bank will continue to offer support to the customer or if the LAQ relationship will be terminated.

Many FRLS clients' financial difficulties arise as a result of circumstances beyond the control of either the client or the bank. There are many issues which can affect the financial well-being of a farming business, including flood, fire, drought, cyclones, product market collapse, market manipulations, over-supply, disease and financial market collapse.

Farmers are "price takers" for their products which are often perishable in nature. As a group, rural producers face significantly greater risks compared to most businesses. Most farms are family operations where individuals provide most, if not all, their assets as security to banks for loans for their businesses. The assets provided as security will in most cases include the home or homes where the farmer and members of his family reside. Loss of the asset results not only in loss of livelihood but also security of accommodation and a sense of community and wellbeing.

Banks' letters of offer set out the various terms of the loan facility. Standard loan and mortgage documentation accompany the letter of offer and support the facility. Throughout the term of the facility, the terms of offer can be varied. The variations occur either at predetermined times for review or when additional finance is being sought or being repaid. It is at these times of review that facilities are often varied in significant ways.

A fundamental principle of the finance industry is trust. Banks rely upon the honesty and integrity of its customers and require them to be honest in all the dealings. Failure to do so can be catastrophic for the customer. Once the banker losses trust, then the relationship is likely to be terminated or seriously compromised.

Customers also rely on their bank to be honest and forthright in its dealings with customers. A common comment made to FRLS by clients is "we trusted the bank manager and believed that what he said would be honoured by the bank" and "if you can't trust your bank manager who can you trust?" Unfortunately where trust has been eroded by bank behaviour, the customers may have not have anywhere to go with the complaint to shield off defaults, termination of facilities, and recovery action which the bank might take. Examples of this behaviour include a bank officer suggesting to "accept the offer and we will deal with the other matters later" or "the bank will roll over the market rate facility when it expires". FRLS has had a number of clients with complaints of this nature.

Another fundamental principle is one of confidentiality. Often, very personal information is provided to the bank officer. Examples of breaches of confidentiality often observed are when bank officers contact real estate agents or livestock agents regarding sales of assets by clients without client's knowledge or consent. In these circumstances, the agents become aware that the sales are forced which can compromise the sale process. A breach of either trust or confidentiality has serious and long lasting financial implications.

The terms of the loan approval are contained in the letter of offer (LOO). This document is signed by the farmer before the loan is settled. This document along with the standard terms and conditions and those in the mortgage and other security documents form the terms of the contract.

Typically the facilities farmers require include overdrafts or lines of credit, term loans or fixed loans or combinations of all these and others for livestock or equipment finance. It is uncommon for a client to have the loan for a term of say 20 years payable by equal monthly or quarterly payments of principal and interest. The combination of facilities within letters of offer are often quite complex and varied. A high level of commercial sophistication is required to be able to understand and unravel the arrangements.

There was a large increase in the amount of lending to farmers during the period from 2000 to 2008. It corresponded with large increases in property sales price. This was during the millennium drought when there was no appreciable increase in income. Many farmers were encouraged to borrow to increase their holdings. Movements and changes to land values can impact the equity position, either positively or negatively. A positive change in value has no impact on the income that can be derived from that asset. Whereas a negative change in value can result in loans being called in even though the income producing capacity of the property has not changed.

Changes to bank policy and external regulatory requirements may play a part in what happens in the market. Banks must report to the Australian Prudential Regulatory Authority when loans are out of order and must take certain steps to correct them. Additionally, banks make provision for bad debts. This may explain why some banks take steps to enforce their rights or appoint receivers when it is apparent that both the bank and the clients will lose substantial money. Clients are often left with nothing in these circumstances. Some banks show more consideration for their client's position in these circumstances than others. FRLS has observed that with the inevitable turn around in conditions, clients fortunate enough to remain in control of their properties can experience significant changes in financial position. Some can exit with some assets and the bank receiving all money owed while some are able to refinance and remain on the land.

Terms of Reference

a. Lending, and foreclosure and default practices, including constructive and non-monetary default processes

Banks are members of the Australian Bankers' Association and agree to abide by the terms and conditions attached to the Code of Banking Practice (Code).

Clause 27 relates to the provision of credit and provides:

> *"Before we offer, give you or increase an existing, credit facility, we will exercise the care and skill of a diligent and prudent banker in selecting and applying our credit assessment methods and in forming our opinion about your ability to repay the credit facility."*

Bank LOO refers to the Code and assures customers that the bank will comply with all obligations contained in the Code. Failure to do so has been found to be a breach of contract and enable customers to seek damages. In FRLS experience, most farmers do not have the financial capacity to fund court action to enforce or test their legal rights in a court. Nor will court action address the urgent needs of the client.

Additionally, breaches of the code can be referred to Code Compliance Monitoring Committee and the Financial Ombudsman Service. These have limited scope and functions in what they can provide farmers.

Prior to the loan being approved, the bank will require an application form to be completed accompanied by an asset and liability position statement, cash flow projections, business plan, historical and other submissions in support of the application. Each bank has its own format for these documents. Cash flow projections provide details of the anticipated financial performance of the business and its funding requirements into the future while the submission often contains detailed history of the business and a business plan for its future needs.

Sometimes these documents are completed by a finance broker or banker in conjunction with the customer. Cash flow projections and other supporting material can often be prepared by the farmers or their agents such as accountants, rural financial counselors, and the like. In these circumstances, the customers have control over the accuracy of the information being presented to the bank. Each party can rely upon the accuracy of the information being processed by the credit section within the bank. On balance, most credit applications are managed with due diligence and care and are not the source of dispute between banks and farmers but there are always exceptions.

FRLS has observed that disputes can arise when the bank prepares the documents supporting the loan application or makes alterations to them after the documents have been provided/approved/seen by the farmers. Documents such as cash flows, livestock schedules, historical backgrounds etc. have occasionally been prepared by bank staff. The customers are not aware of the contents of these documents. There have been circumstances where the farmer has later obtained copies of this material (after disputes arise or defaults have occurred). Cash flows have been found to be completely wrong. It may incorrectly overstate income or understate expenses and living costs and over-estimate livestock on hand, calving rates, projected cattle sales and ongoing crop returns.

In these circumstances, the information presented to the bank’s internal credit section does not accurately reflect the capacity of the business to meet its financial commitments required under the facilities. In extreme cases, cash flows have no resemblance to the financial performance of the business. On at least one occasion, clear mistakes made by the bank in preparing cash flows used to accompany the loan application were not noticed by the credit section despite the mistake being so basic as to completely compromise the financial performance and production of the business.

It may address this problem if this financial information intended to be provided to the credit section was also provided to the farmer and the farmer was given an opportunity to privately verify the accuracy of the information before signing any documentation. Simply having the documents signed and initialled by the customer at the time the application is signed does not provide the borrower with time to look through the document and satisfy its accuracy.

FRLS also is of the view that there can be very wide and self-serving assessments undertaken to assess the performance of the business. These assessments lack prudence and diligence. When issues regarding the diligence of the loan are raised in negotiations or at mediation, the bank can simply take the view that it did adopt a diligent and prudent approach without producing any supporting material. If the code had clear minimum guidelines to demonstrate a diligent and prudent assessment and an obligation to produce documentation regarding the process applied, it would assist each party. The assessment methods and documentation should also be available to the party to which it will apply in circumstances where there is a genuine dispute. If enforcement action is taken by the bank without having the matter contested in court, the customer has no option but to assume that the bank has applied a diligent and prudent assessment. The current process enables the bank to take action without having to establish compliance with the Code.

FRLS recently had a client whose original application was declined by one branch but accepted by another branch of the same bank on the basis of the same information. Within one month of the loan being granted, the facility was in default. This is in our view an example of non-prudent lending.

Farmers, like most borrowers, are at a disadvantage when negotiating loans or increases in facilities. Banks adopt standard documentation prepared by their in-house lawyers. These documents are non-negotiable and are drafted primarily to protect the bank's interest. Farmers have little to no bargaining power. At times of dispute, the power imbalance is very evident.

Inappropriate conditions in loans can often be a source of problems. By its very nature, agricultural production is seasonal and cyclical. Most enterprises have long periods with no income during which time most of the costs of production are incurred. These enterprises are best served by having their financial payments to banks coincide with receipt of income. Some banks disregard these issues and provide facilities requiring payments at times when income will not be received placing pressure on the business.

Timely provision of credit for businesses involved in horticulture is essential. They require massive injections of cash for wages, harvesting, packing, marketing, transport etc. while income can still be months away. Inexperienced bank officers have been found to delay decisions to temporarily increase facilities to accommodate these increases resulting in huge losses for both the farmer and sometimes the bank. Crops must be maintained and harvested within strict timeframes otherwise the crop will perish and income lost. Similar timeframes and concerns regarding perishability and income apply across the rural sector.

On other occasions, banks have not provided sufficient funds to operate the business. On settlement of the sale or restructure, there are insufficient funds to run the business leading to an early default resulting in the sale of assets required to operate the business. This could be livestock, machinery, or in extreme cases land including the asset just funded, indicating that the bank had not applied due diligence in the provision of credit.

Banks have placed conditions in LOO after reviews requiring properties to be sold. They can also approve an increase in facility to purchase an additional farm but require an existing holding be sold within a certain period such as 12 months. At the time of the application or review, no discussions took place regarding that prospect and it can come as a complete surprise to the farmer when this information comes to light. Often the farmer will already be committed to a contract and have no ability to question the condition. Clients have complained that they were unaware of these terms and that the bank did not bring them to their attention. The conditions often appear in the LOO containing many pages of information.

Overdraft facilities are reviewed regularly (usually annually) or at times when increases are sought. It is also reviewed when the farmer defaults by exceeding its limits or breaching other facilities. Banks can withdraw support for the overdraft on these occasions and can legally demand that the overdraft be paid out. Failure to do so will be an event of default enabling the bank to call in all other facilities and commence recovery action.

The conditions attaching to term loans and other facilities are also regularly used to call in the term facilities. It is common for term loans to be split into various facilities even though the letter of offer may contain a clause that the term is for a period of 20 years. Part of the loan could be on an interest only basis for a fixed period (such as 3 to 5 years) while other parts may be payable on a principal and interest basis and other parts of it can be on a market rate facility. Despite the facility being for a period of say 20 years, the bank can at its discretion determine how much of the principal which is to be paid out early at times of review.

Some FRLS clients have stated that when they questioned their bank manager at the time of the original offer, the bank manager advised that the bank would simply roll over the facility at the expiration of the term. It was not explained that the bank had discretionary powers and may not roll it over. Acting on these assurances, the clients accepted the letters of offer.

At the expiration of a fixed term, the bank can request that the whole or part of the facility be repaid or impose other conditions on the farmer. Examples may be requiring the farmer to sell a property and use the sale proceeds to reduce debt. FRLS has had clients who were unaware that banks had imposed such conditions on the facilities at times of review. The bank officers did not bring the new conditions to the attention of the farmer who understood that the loan was simply extended as had been discussed with the banker at the time of the review.

Banks have increased overdraft or other facilities after natural disasters but with conditions that this increase plus more is to be repaid within an unachievable time frame, of which the bank is likely to have been aware. There is no demonstrated capacity from the cash flow of the business to satisfy these demands yet the bank imposes these conditions on the farmer. These changes to conditions can ensure that the facility will fail.

An example of bank’s imposing conditions after a loan is granted is when the clients were advised by their bank manager that the bank would fund the future purchase cattle when a lease expired in respect of the purchase by them of a property. Acting on this verbal advice, they proceeded to purchase the property. By the time the lease had expired, the bank manager had been transferred and the new manager imposed a condition on the loan to purchase cattle was a condition that another farm must be sold.

Banks have standard conditions in their loan agreements that a material adverse change is taken to be an event of default. This enables the bank to use its discretion and determine in its opinion whether a change in circumstance may materially affect the borrower’s ability to perform obligations contained in the loan agreement. An example can be when there are significant changes in an industry such as when the dairy industry was deregulated in Queensland affecting their cash flow. Even though the farmer was not in default at the time of deregulation, this change was used by the banks to trigger a default.

The banking sector would better serve it rural customers by developing a better understanding of the nature of agriculture, particularly regarding its cyclical and seasonal nature, and that the long term planning and financial commitment. The risks associated with the business of agriculture need to be managed collaboratively to provide a more flexible and long term approach to lending. Changes to bank policy due to internal issues within that bank (such as takeovers and mergers) should not be grounds for the bank to unilaterally review and changed credit arrangements with the farmer.

b. The roles of other service providers to, and agents of, financial institutions, including valuers and insolvency practitioners, and the impact of these services.

Valuers

Most banks have their preferred panel of valuers for undertaking valuations. It is therefore natural for a close relationship to be developed between banker and valuer.

Valuers have certain criteria and methodology they adopt when undertaking valuations and professional guidelines.

Bank's terms and conditions in their standard documents provide that the bank can commission valuations at the customer's expense. Banks are entitled to retain these valuations and the farmer is not entitled to a copy although the bank may agree to provide a copy. The valuer is unable to provide a copy to the land owner without the bank's consent. A farmer may engage a valuer but the bank does not have to accept that valuation. It can do so if the valuer agrees for it to be assigned to the bank. It is uncommon for the bank to accept these valuations.

Valuations are guided by historical sales data, current market conditions, the carrying capacity of the property, soil types and water infrastructure. However, ultimately they are subjective opinions. Banks use valuations as a guide to value for loan approvals, reviews of facilities and or sale of assets by banks.

Banks can conclude that the facilities are out of order if the loan to value ratio (LVR) changes as a result of a revaluation and will seek that the clients address these circumstances. This may result in enforcement action even though the farmer has met all financial commitments.

Alternatively, banks will assess the file and place conditions on the facilities that assets are to be sold. Failure to do so will result in a default.

When a sale takes place following default, valuations are relied upon as a guide to sale price of the asset. The farmer is not made aware of these valuations or discussions which take place between the bank/receiver and valuer. FRLS has been advised by bankers that if the sale price offered (such as at auction) does not compare favourably with the valuation, the bank/receiver can discuss the lengths it took to market the property and seek information on the offer. It is understood that in many circumstances where there has been thorough marketing, the bank/receiver will accept a lower sale price compared to valuation. There is no obligation to wait for the market to improve to meet previous sale levels.

In depressed markets, an increase in forced sale numbers appear to exacerbate the downward spiral in prices affecting land values within a region which can impact on the entire farming community.

There have been a number of occasions when FRLS has become aware of detrimental conduct by a valuer. For example, a bank obtained a valuation when internal change occurred within the bank and it reviewed its rural clients. Shortly thereafter, the same valuer provided a fresh valuation which was substantially different (by millions of dollars). The bank used the change in valuation as a ground for default. The clients could not ascertain any change in market conditions which could have supported any change in value.

In another example, the lending section of a bank used one valuation firm to value a farming property when loan increases were sought. It was valued at $7.8m including improvements at $1.4m. This valuation was the second carried out on the property over a two year period by the same firm. When the farmer experienced financial difficulty approximately 12 months later, the asset management section of the same bank engaged its preferred valuer who valued the property at $4m and improvements at $340k. The wide variations in value cannot be explained by the clients. One value was used for lending purposes while the other was for a forced sale purposes.

Valuations are conducted using different criteria. Generally a valuation for mortgage security purposes will be higher than for a forced sale value.

Insolvency

Banks can appoint receivers over secured assets in accordance with standard conditions in the loan contract. The receivers when appointed are not the agents of the bank but are agents of the farmer. Despite the receivers being the agent of the farmer, most often very little contact is had between the farmer and the receiver regarding the sale process. The farmer is obligated to comply with certain requests for information from the receiver under legislation. But this is not in relation to the practical issues of sale or management of the property.

After a bank appoints receivers it is no longer legally involved in the sale process and is exempt and removed from any claims or actions by the farmer against the receivers. There is no obligation on the bank to ensure the receiver acts to obtain the best market price for the assets. The receiver assumes full responsibility for the process.

It is not uncommon for the receiver to have minimal contact with the farmer after serving them with compliance documents etc. Often there is little information sought from the farmer regarding the operation of the farm which might be useful in a practical sense regarding the operation of the business. Often receivers will reinsure the property, change locks, appoint managers and security over the property, engage contract musters and farmers and other “experts” to advise them in the conduct of the business. All of these activities are expensive and added to the debt of the farmer.

In some instances, a lot of these issues have been avoided by civil contact between the farmer and receiver. Where they can work cooperatively it can avoid significant costs for the farmer who is still responsible to the bank for all costs incurred. This requires the goodwill and trust of both parties.

The receivers will engage their own valuers and are not obliged to provide copies of these valuations to the farmer during the period of the insolvency even though the farmer will ultimately bear the costs of obtaining the valuation. It is understood that these valuations would be prepared on the basis of an early sale and not taking into account the period of time which would normally be required for a property to be on the market to sell. It is not uncommon for larger western properties to have an average marketing period of 12 months or more, but a sale by receivers usually occurs after about six weeks marketing campaign. Farmers are not made aware of discussions between the bank, receiver, and valuer during these periods. They do not receive copies of valuations obtained for sale purposes yet the outcome affects them directly as they are the ones responsible for any shortfall.

Typically, receivers are appointed by the bank if the farmer has been unable to achieve the agreed outcome negotiated either at mediation or beforehand pursuant to a negotiated agreement. Receivers often will not discuss the day to day functions of the receiver with the farmer or their representatives despite the legal principle that their appointment is that of an agent of the mortgagor and not the bank.

It is probable that receiver sales result in lower prices being achieved compared to normal sales for similar properties. Buyers are aware that the property is being sold on a forced sale basis. News that a farm is under the control of receivers travels very quickly around rural communities.

Despite there having been many inquiries into the conduct of the insolvency industry, the persons directly affected by their conduct and who suffer the financial and emotional consequences of decisions made outside of their control, are often excluded from the process

c. The appropriateness of internal complaints handling and dispute management procedures within financial institutions.

Due to the provisions of QFFS, most matters are either negotiated directly with the financier or mediated, as banks offer farm debt mediation to farmers prior to our involvement. By accepting mediation, other forms of dispute resolution are not available. If farmers do not accept mediation, the banks can take enforcement action.

Where a matter can be considered by the Financial Ombudsman Service (FOS), the service will not consider the matter if it has been to farm debt mediation. Many matters are outside the jurisdiction of FOS due to the value of loans. Internal dispute resolution processes within banks are rarely used in the farm debt mediation process as it is often just around the time of mediation that issues arise which may warrant further investigation and banks are reluctant to provide information in those circumstances.

Although FRLS has not been involved in any internal dispute resolution processes, it may be possible to use this mechanism where concerns about the conduct of the bank have come to light as a result of the mediation process and have not been adequately addressed during the mediation. There may also be a place for this process where bank officers have conducted themselves poorly either during or following the mediation process. In this case this forum may provide the parties with an opportunity for the bank to have a fresh look at the allegations, bearing in mind that these issues arose during the mediation process.

FOS appears to be reluctant to become involved in matters after farm debt mediation has taken place. In such cases, the internal dispute resolution process within the bank may be the only financially viable option available to a farmer.

A lack of trust by the customer rarely has serious consequences unless the Financial Ombudsman Service or the Compliance Committee within the Code of Banking Practice is able to properly investigate the matter. In the absence of these monitoring bodies, the power imbalance ensures that this issue will not be addressed.

d. The appropriateness of loan contract terms particular to the primary production industries, including loan-to-value ratios and provision of reasonable written notice.

The appropriateness of loan contract terms has been discussed earlier in this submission.

In relation to the loan to value ratios, each bank has its own policy regarding what an acceptable loan to value ratio might be. Banks vary these ratios from time to time and may vary them from industry to industry.

When loans are being assessed, it is one of the criteria considered by the bank when assessing the loan. Some banks will take into account value of livestock as well as land. It can assess the position using different ratios for different assets.

Banks will engage valuers to undertake these valuations. These valuations are conducted on a mortgage security basis. Occasionally, the bank may decide to undertake an internal valuation. FRLS is unaware what circumstance determines which approach.

Examples of movements in LVR

A loan is approved using the equity of the existing unencumbered farm as security to assist in the purchase of a similar value farm borrowing the full sale proceeds. This transaction would result in an equity position of no more than 50%. If an increase in overdraft is required to fund additional expenses the equity position will decline by the value of the overdraft. If poor seasonal conditions occur requiring increases in overdraft then the equity position will be further reduced. A subsequent decrease in land values (as occurred after the GFC) will result in further loss of equity. When this is accompanied by a fall in income, it can result in a very distressed financial position. The equity position is further exposed if banks decide to withdraw support resulting in farmers being placed in a forced sale position. Valuations with a forced sale component are generally less than for mortgage security purposes. Farmers lose more equity when they are in a forced sale position. It is again further exacerbated when this is coupled with a depressed property market. FRLS has seen farmers lose all equity in these circumstances.

Where the LVR ratios are outside of the bank's current lending policy position, banks may take the view that it is an event of default enabling the bank to require the farmer to rectify the position. Failure to do so enables the bank to take recovery action. Banks may take different views from matter to matter.

The capacity of a farmer to meet on-going financial commitments when there is a change in LVR may not prevent a bank from treating the event as a default and taking recovery action. A bank's attitude to this position may vary from bank to bank and matter to matter. Fortunately many banks are prepared to continue to support the farmer where there is a strong cash flow. LAQ encourages banks to take this position enabling farmers to continue to meet the financial commitments.