



**AUSTRALIAN BANKERS'
ASSOCIATION INC.**

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Inquiry into impairment of customer loans

21 August 2015





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1. Preamble

The Australian Bankers' Association (**ABA**) is pleased to provide comments to the Parliamentary Joint Committee (**PJC**) on Corporations and Financial Services' inquiry (**inquiry**) into the impairment of customer loans.

With the active participation of 25 members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

2. Introduction

This submission addresses the key issues for the inquiry, including business lending in Australia, bank lending practices and the responsibilities of banks in providing loans to businesses, the role of third parties and existing protections for customers.

Banks are required to make prudentially responsible lending decisions. The occurrence of problems is low given the substantial number of business loans in Australia. It is not industry practice for banks to use non-monetary processes or triggers such as loan to value ratios (**LVR**) to impair customer loans or to 'construct a default'. It is not financially beneficial for banks to adopt the practices described in paragraphs (a) and (c) of the terms of reference.

Banks make substantial efforts to work with business and agribusiness customers when they experience financial difficulties to restore the loan to a satisfactory position. There is no financial incentive for a bank to deliberately undervalue an asset or lose a customer. Actions to repossess properties are rare and a last resort.

The suggestion that there is collaboration between banks and third parties, such as property valuers, to engineer non-monetary default is incorrect. This would be a breach of the *Corporations Act 2001*. Furthermore, irrespective of the legal obligation, and as noted above, there is no commercial interest or financial incentive for a bank to act in this way.

The ABA's Code of Banking Practice (**the Code**) sets standards for fairness, transparency, behaviour and accountability beyond legislative requirements that customers – individuals and small businesses – can expect from their banks. Banks are committed to acting fairly, responsibly and transparently.

Improvements to the Code were made in February 2014 following a public consultation process and extensive discussions between the banking industry and consumer, community and small business organisations. The Code obligates a bank, with the agreement and cooperation of its small business customer, to try and help the customer overcome difficulties with its credit facility, including working with the customer to develop a repayment plan¹.

The ABA has advocated for some additional processes to make sure that borrowers are dealt with fairly, such as the implementation of a nationally consistent farm debt mediation model across Australia.

3. Business lending in Australia

The banking industry makes a significant contribution to facilitating business investment and activity and promoting Australia's economic growth and prosperity. Australia's banks provide a range of financial services to businesses, both large and small.

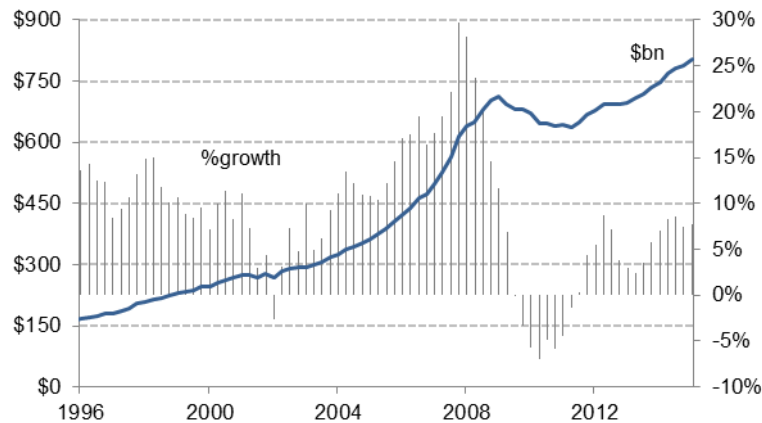
¹ See *Code of Banking Practice*, clause 28.2 at <http://www.bankers.asn.au/Industry-Standards/ABAs-Code-of-Banking-Practice/Code-of-Banking-Practice-2013--Online-Version>



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Banks provided loans to an estimated 987,000² businesses with total loans outstanding of \$805 billion as at March 2015³.

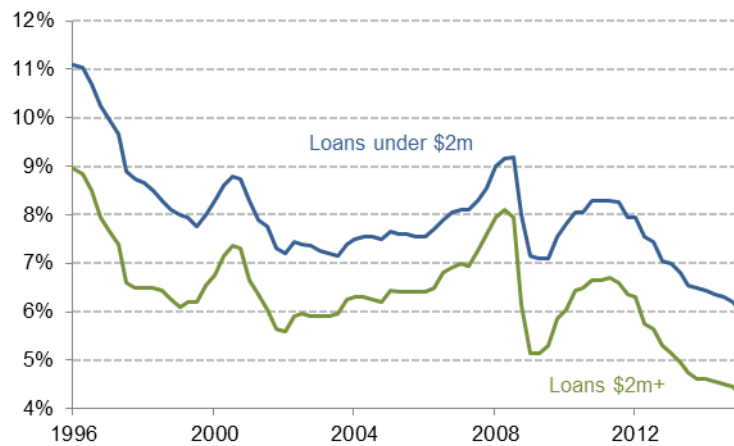
Figure 1: Business loan outstandings



Source: RBA

Businesses are benefitting from record low interest rates (the data series commenced in 1993). As at March 2015, the average weighted interest rate for outstanding business loans under \$2 million was 6.00 per cent with the average weighted interest rate for outstanding business loans over \$2 million at 4.25 per cent.⁴ This lower cost of borrowing assists businesses to borrow more cheaply to fund their operating expenses as well as to expand their operations and employ more Australians.

Figure 2: Business lending – average weighted interest rates



Source: RBA

Latest data for 90+ days non-performing loans for businesses shows that there has been a significant fall in the arrears rate since the high in September 2010, which followed the global financial crisis. The 90+ days arrears rate at June 2014 was 1.3 per cent.

² ABS 81550D0001_201213, Table 6

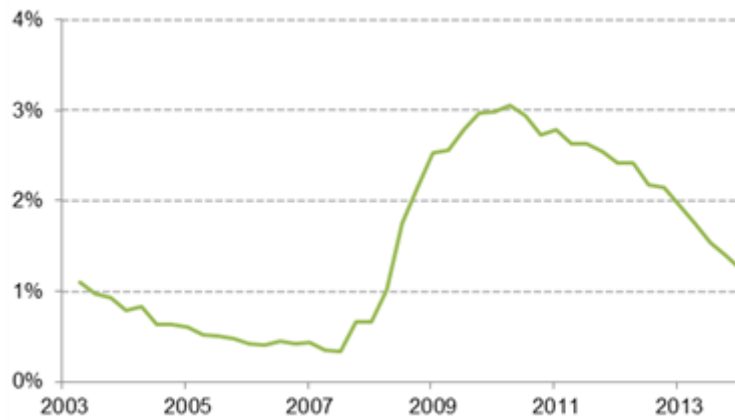
³ Total business loans outstanding as sourced from the RBA

⁴ RBA



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Figure 3: Non-performing business loans (90+ days)



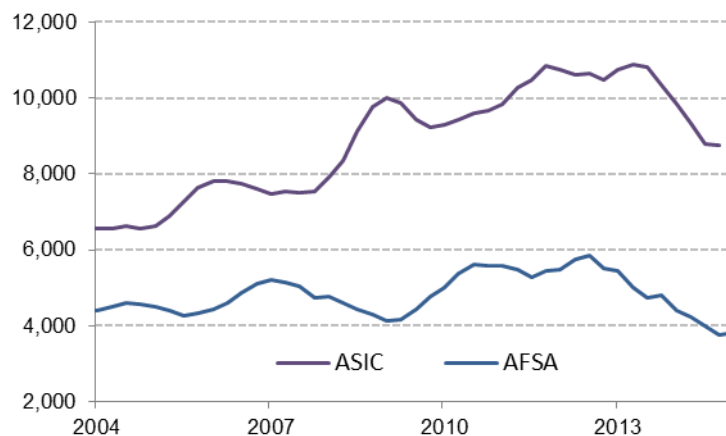
Source: RBA

An insolvent company is one that is unable to pay its debts when they fall due for payment. Insolvency data are collected by the Australian Securities and Investment Commission (**ASIC**) and Australian Financial Security Authority (**AFSA**).

ASIC data shows that there were 8,751 business insolvencies over the year ending March 2015, a fall of 20 per cent since the peak of 10,887 over the year to September 2013.

AFSA data which relates to business insolvencies are collected on a different basis to the ASIC data but are useful in that AFSA also collect the reason for insolvency. Business insolvencies as collected by AFSA peaked over calendar year 2012 at 5,859. They have since fallen sharply to 3,838 for the year ending June 2015.

Figure 4: Business insolvencies



Sources: ASIC/AFSA

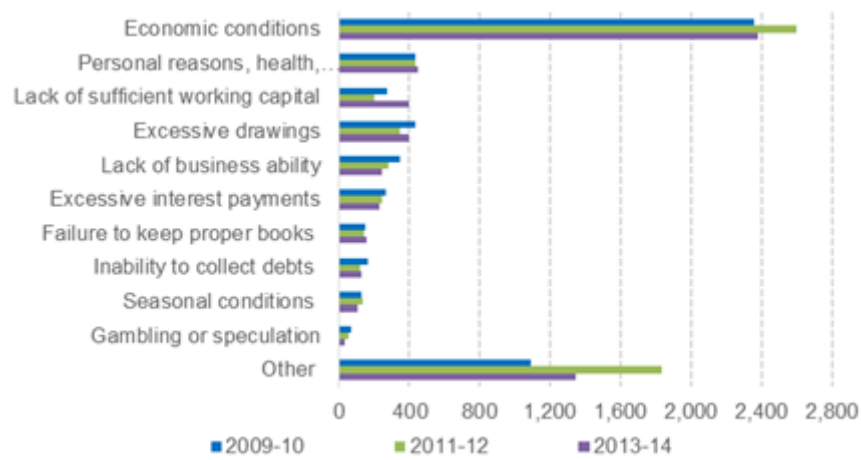
The AFSA data shows the main reason for a business-related insolvency is 'economic conditions'. The next most common factor is 'personal reasons and health', such as illness, accident or relationship breakdowns.

Excessive interest payments is cited as a cause in less than 5 per cent of business insolvencies.



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Figure 5: Causes of debtors entering a business related insolvency



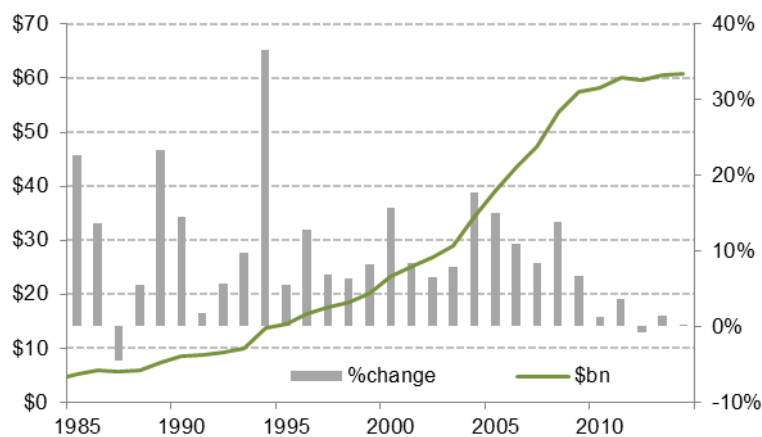
Source: AFSA⁵

Agricultural lending

The banking industry believes the long-term outlook for the Australian agriculture sector is positive with strong growth prospects. Australian farmers are well placed to benefit from domestic growth, improved access to trade markets from the recent free trade agreements with South Korea, Japan and China, and recent policy initiatives announced in the Federal Government's *Agricultural Competitiveness White Paper*.

The banking industry plays a significant role in supporting a competitive and profitable agricultural industry in Australia with current lending of almost \$61 billion.

Figure 6: Rural debt with banks



Source: RBA

⁵ Data also includes bankruptcies and debt agreements.



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According to the most current data on the distribution of farm debt (2012-13) from the Australian Bureau of Agricultural and Resource Economics and Sciences:

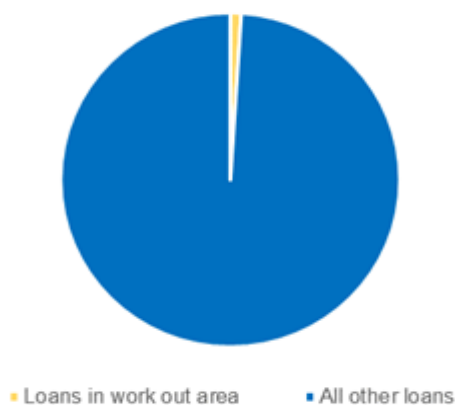
- Nationally, 38 per cent of farms have no debt (this varies across states).
- Approximately 25 per cent of farms with debt have a debt amount under \$50,000.
- Approximately 65 per cent of farms have an equity ratio of 90 per cent or above.
- 87 per cent of the value of farm debt outstanding is concentrated in those farms with debt of \$500,000 or more, accounting for 25 per cent of the number of farms.
- 6 per cent of farms with a debt of \$2 million or over account for almost half of the value of all farm debt.

Impaired loans

Data collected by the ABA from a selection of members shows that the proportion of customers with loans which are in difficulty is very low. This is true whether these are loans to businesses or agricultural businesses (farm gate). The proportion of loans in 'workout' and 'recovery' is higher for farm gate loans than for other businesses, but both are at very low levels.

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

Figure 7: Customers with loans in workout areas (2015)



Sources: ABA, selected banks



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Figure 8: Number of loans by type in workout and recovery (2015)



Sources: ABA, selected banks

4. Regulatory framework

Banks are prudentially supervised financial institutions regulated by the Australian Prudential Regulation Authority (**APRA**). APRA sets requirements on the risk management standards that banks must meet. For every loan application, a bank must consider the risks it is taking on. It must also consider the risks the borrower is taking on, including a borrower's ability to repay the loan and the various monetary and non-monetary factors that may affect their ability to repay the loan. These include the purpose of the loan, type of business and industry sector and type of security against which the loan is held.

APRA guidelines

It is important to understand that lending to a business is more complex and of higher risk than lending to consumers. To comply with APRA's guidelines, for business customers it is prudent for a bank to include in their credit contracts provisions that cover adverse changes in the business's financial condition; non-compliance with financial covenants; default interest clauses; insolvency and pre-insolvency events and increased costs clauses. These types of clauses are necessary to ensure compliance with banks' legal and prudential obligations and to ensure the agreed return on the bank's investment.

Importantly, many of these provisions provide the bank with better insight into the business customer. This benefits the business if it falls into difficulty with its credit facility. The bank is better positioned to assist the business and to develop a workout strategy. This is consistent with the Code when a small business customer experiences financial difficulty with its credit contract with the bank.

What is an impaired loan?

The APRA Prudential Standard APS 220 Credit Quality defines an impaired loan as any facility where there is doubt over the timely collection of the full amount of cash flows contracted to be received by the Authorised Deposit-taking Institution (**ADI**). Doubt exists where there is objective evidence of impairment of the facility as a result of one or more events that have occurred and that have an impact on the cash flows from the facility that can be reliably estimated.



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The existence of the following factors will, as a minimum, constitute doubt and require a facility (on- or off-balance sheet) to be regarded as impaired:

- a) A facility is 90 days past due unless otherwise well-secured;
- b) An entity to which facilities have been provided is subject to administration or bankruptcy proceedings, unless the facilities are otherwise well secured;
- c) A write-off has been taken on a facility even if the facility is not in breach of contractual requirements. This does not apply in the case of some restructured facilities and assets acquired through enforcement of security; and
- d) With respect to off-balance sheet facilities, the ADI is unlikely to receive timely payment of the full amounts which it has exchanged or is contracted to advance⁶.

APRA requires all ADIs to have policies and procedures to ensure the timely and reliable recognition of impaired facilities incorporating, as appropriate, the exercise of experienced credit judgement. Failure to comply with APRA's prudential lending standards could increase the level of risk within the financial system.

5. Management and review of loans

The inquiry's terms of reference canvass banks' practices in relation to the assessment and review of loans. The following section provides an overview of the general approach most banks take to business loan management.

It should be noted that there will be some variation between individual bank practices as each bank will use their own processes and risk assessment profiles to manage their loan book. The ABA is aware that some of its member banks will be making their own submissions. These submissions may be useful in facilitating a more detailed understanding of individual bank loan management procedures.

All loans are graded according to risk

All business loans are assessed and graded according to credit risk in line with APRA's prudential requirements. It is standard practice for banks to review loans either periodically, if there has been a change in customer circumstances, or if there are significant changes in account behaviour. Risk assessment allows for early identification of customers in distress.

If the risk profile has deteriorated below what would normally be considered to be an acceptable credit standard, the loan may be placed on a 'watch list' or similar categorisation.

Factors that influence risk

The reasons (often in combination) which influence the risk profile include:

Monetary factors

- Non-payment of interest or principal and interest
- Debt amortisation schedule
- Facilities on expiry/termination date
- Non-clearance of excesses
- Frequent requests for temporary assistance.

⁶ APRA Prudential Standard APS220 Credit Quality pp.7-8. <http://www.apra.gov.au/CrossIndustry/Documents/141120-APS-220.pdf>



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Non-monetary factors

- Changes in the legal structure of the entity
- Breakdown or dispute within the borrowing group (such as marital, partnership or shareholder group)
- Legal action by an external party
- Arrears action by the Australian Taxation Office (**ATO**)
- Substantial decline in business performance
- Changes in the value of the security against which the loan is held or significant changes to the LVR (such as, borrower has sold assets used as security for the loan)
- Client fraud and other events (such as breaches of legal obligations, e.g. money laundering)
- Customer initiated insolvency appointments.

What happens if a loan is placed on a 'watch list'?

Generally, if a customer is placed on a 'watch list' the bank works with the customer to try and overcome the financial difficulties with their credit facility, including developing a repayment plan⁷ to rectify the default. The aim is to support the customer in difficult times and help them to restructure the business.

Management of the account generally stays with the customer relationship manager, however, the account is reviewed more frequently.

A business remediation plan is developed and agreed with the customer. The objective is to return the loan to a satisfactory credit position. There is close communication and sourcing of additional information from the customer.

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

This process can take more than 12 months as every opportunity is provided to the customer before the 'workout' area becomes involved. This timing will vary based on the customer's circumstances. For larger more complex credit facilities the process may take several years.

It is extremely rare that a customer would be transferred to a 'workout' area due to a LVR breach alone. Furthermore, banks would be very unlikely to enforce their security if there is no monetary default, in particular where there is a potential loss should a sale be achieved.

That said, it should be noted there are circumstances that could see an account transferred immediately to a 'workout' area including:

- The director(s) places the company into voluntary administration.
- The company is placed into liquidation by the director(s) or creditors (ATO, other creditors, courts, etc.).
- Receiver managers are appointed by another financial institution.

⁷ See Code of Banking Practice clause 28.2 at <http://www.bankers.asn.au/Industry-Standards/ABAs-Code-of-Banking-Practice/Code-of-Banking-Practice-2013---Online-Version>



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What is the role of a 'workout' area?

A workout area is a specialised unit within the bank made up of staff with skills in accounting, business restructuring, commercial management, insolvency and legal expertise. The workout area will assess the customer's financial and business situation with a view to restoring the credit facility to a satisfactory position or minimising the potential loss. Options identified by the bank are discussed with the customer.

The strategy adopted is dependent on the individual circumstances; there is no one size fits all approach. It may be appropriate to allow the customer more time to address certain key actions within a mutually agreed strategy. If the account is successfully remediated it is transferred back to the customer relationship manager.

If there is no improvement over time further options will be explored with the customer, including further asset sale, winding up a company or recovery action on a property. Enforcing security is very much a last resort.

It is better for the customer to work with the bank voluntarily than for the bank to take enforcement action. Working with the bank may preserve value and reduce costs.

Mutual agreement cannot always be reached. In these circumstances, a bank may seek to enforce its security rights and recover the amount outstanding. These enforcement options may include the bank entering into possession of the security or seeking the appointment of an insolvency practitioner, as receiver, receiver and manager, voluntary administrator, liquidator or trustee in bankruptcy.

Following any sale of a security property where a shortfall arises (where the value of the debt exceeds the net proceeds recovered through the sale), the customer is usually contacted to consider options for repayment of the debt. These negotiations can include a repayment plan or commercial settlement of the debt at less than its face value.

Are agricultural loans managed differently?

There are differences between the management of 'farm gate' and 'non-farm gate' loans. All customers are offered time to reduce credit risks or rectify defaults, however, banks appreciate that agriculture is a cyclical industry and earnings for farming businesses can be volatile due to these cycles or other factors, such as seasonal activity. Special arrangements can be put in place to address the financial needs of farmers which may not be available to other businesses.

Farm gate loans are also generally afforded additional notice to facilitate mediation. Banks have found that farm debt mediation has generally delivered more positive (i.e. higher equity) outcomes for borrowers. It is only when agreed solutions or arrangements fail or are unable to be sustained that enforcement action is taken on farm-gate loans.

What is the timeframe for resolving a high risk loan?

The timeframe associated with the resolution of high risk loans varies. Individual circumstances for each and every loan and customer are assessed. A high risk loan may be resolved and either transferred back to the customer relationship manager or repaid in a relatively short period of time, but generally the period that a loan remains high risk is over 12-18 months for non-farm gate loans and around 12-24 months for farm gate loans. Larger exposures typically have more complex business operations and financial structures and may take several years.

6. Role of third parties – property valuers, receivers and external administrators

The following section explains standard industry practice with regard to the role of property valuers, insolvency practitioners and external administrators.



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Independent business reviews are sometimes required to assess the current financial and trading position of a company. This information is used to assist the bank in managing the relationship with the customer and its credit decisions.

Property valuers

Property valuers are engaged to value or revalue properties where it is necessary to assess the security value and safety of the loan. Valuations are generally undertaken for three reasons:

1. The initial funding approval process
2. During the course of a review of existing facilities
3. During the course of the sale of assets.

Valuations during the course of a review of existing facilities arise from time to time under the existing terms and conditions in the customer's contractual arrangements. The reviews are conducted to ensure existing obligations, such as repayment capacity and/or the security position and agreed LVR's are met and to re-test cash flow and asset values. This is standard industry practice and consistent with APRA prudential requirements. Valuations are based on a point-in-time assessment of property values and will change with prevailing market conditions.

It is standard industry practice for banks to use preferred lists (expert panels) of independent external valuers to undertake mortgage valuations under strict industry standards. This process ensures that valuations are provided by skilled and independent valuers with no coercive influence by the bank. In rare circumstances, for instance a property located in an isolated area where there are very few suitably qualified valuers available, a bank may rely on an internal valuation. The valuer's role is to provide a valuation based on what is happening in the marketplace and not look to devalue properties. In many cases, valuers will not know the customer's debt or reason for the valuation.

Receivers and insolvency practitioners

Receivers are appointed by a bank to take control of the assets under the bank's security after all other options for workout, or a voluntary recovery, have been exhausted. It could also be necessary where early action is needed to protect the bank's position, for example, a voluntary administrator has been appointed or liquidator has been appointed by court order. Receivership is the least preferred option as it tends to incur additional costs and may result in a lower net return.

Receivers are officers of the debtor corporation and have statutory duties owed to the corporation under the Corporations Act. Their primary obligations are to the company. These duties include exercising care and diligence, not to gain personally or for another party, or act to the detriment of the corporation. In the exercise of a power of sale of the corporation's property, under section 420A of the Act a receiver must take all reasonable care to sell the property:

- a) If, when sold, it has a market value – for not less than that market value; or
- b) Otherwise, for the best price that is reasonably obtainable, having regard to the circumstances existing when the property is sold.

Receiverships often arise where both the customer and the bank may incur a loss, so it is clearly in the bank's interests to ensure that property is sold at market value and that the receivers and other costs are as reasonable as possible.



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External administrators

Voluntary administrators are usually appointed by the directors of a company due to the insolvency or apprehended insolvency of the business and the personal liability that they can incur under the Corporations Act if they allow the company to continue to trade while insolvent. The voluntary administrator is responsible to all creditors and in such situations the bank must often act to protect its own position by the appointment of a receiver.

7. Existing protections for borrowers

Code of Banking Practice

The Code sets standards for fairness, transparency, behaviour and accountability beyond legislative requirements that customers – individuals and small businesses – can expect from their banks. Banks are committed to acting fairly, responsibly and transparently.

Thirteen banks subscribe to the Code which covers their brand entities for which the bank subscriber is responsible. The Code was recently reviewed with revisions commencing in February 2014. The provisions in the Code for assisting bank customers who experience financial difficulties with their credit facilities have been expanded (clause 28).

The Code recognises the right of a customer to be represented by a financial counsellor or other representative in dealing with these difficulties and includes proactively identifying if a customer is experiencing difficulties when the bank is dealing personally with the customer.

A bank will respond promptly to a customer's request for hardship assistance and will confirm in writing its decision whether it is able to provide assistance with reasons including the main details of the assistance, if any, to be provided. The provisions in the Code go well beyond what is required under the consumer credit hardship provisions in the legislated National Credit Code.

The Code covers the range of small business banking services in much the same way as it covers individual customers. Small business customers have access to internal dispute handling arrangements with their bank with respect to credit facilities. The Code also provides avenues for customers to take the matter further where they are not satisfied with the response from their bank.

If they believe the bank may have breached the Code, they can contact the independent Code Compliance Monitoring Committee (**CCMC**)⁸. If the customer is claiming a monetary loss, or potential monetary loss, then the matter can be taken to the independent Financial Ombudsman Service (**FOS**) which is the external dispute resolution scheme.

Both the CCMC and the FOS can investigate allegations of a breach of the Code.

The ABA acknowledges that banks are large institutions and on rare occasions errors can occur. Banks have appropriate and well established protocols for managing disputes when they occur.

Alternative dispute resolution

Banks must have an internal complaints handling procedure in place to deal with complaints from their customers. In many cases, the complaint will be resolved internally by the bank with no further action required. If the dispute cannot be resolved expeditiously, the small business customer is able to lodge the dispute with FOS.

⁸ Code of Banking Practice clause 36(b) provides that any person, not just the customer, and FOS can make an allegation to the CCMC that a subscribing bank has breached the Code. The CCMC has a Mandate which provides for the types of complaints it is able to consider.



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Financial Ombudsman Service (FOS)

The FOS is a free and independent dispute resolution service that considers complaints about financial services, including banking, credit, loans, general insurance, life insurance, broking, financial planning, investments, stock broking, managed funds or superannuation. The Ombudsman is able to investigate disputes and make determinations that, if accepted by the disputant, are binding on the financial services provider.

Farm debt mediation

Farm debt mediation is a mechanism to facilitate a discussion between a farmer and their bank or other lender so they can better negotiate their financial position. The process uses an independent mediator to help identify workable solutions.

The ABA believes that farm debt mediation can deliver positive outcomes for all parties. The process varies across jurisdictions. Currently NSW and Victoria are the only states with mandatory farm debt mediation schemes. The ABA has advocated for some time for the implementation of a consistent farm debt mediation model across Australia.

The Federal Minister for Agriculture has indicated support for a legislated and nationally consistent farm debt mediation scheme, modelled on the existing schemes in NSW and Victoria. The banking industry has been working with the Federal Government and agricultural stakeholders to help government deliver this initiative.

Financial literacy

The ABA and its members have also put in place a number of initiatives to improve the financial literacy and understanding of consumers.

Financial literacy is not just about numeracy; it is about people gaining a practical understanding of financial matters and the consequences of their own behaviours that will affect their financial wellbeing.

The ABA and its members have delivered a number of financial literacy tools and resources to bank customers and the broader community to improve awareness and understanding of retail banking.

Most recently, the ABA, in conjunction with CPA Australia, Council of Small Business Australia and the NSW Business Chamber, developed an online resource to assist small businesses in understanding what type of finance best suits their needs. The website will help small business owners assess if a bank loan is right for them and provide information on what banks look for when assessing loan applications.