

IMPAIRMENT OF CUSTOMER LOANS

Submission by Legal Aid Queensland to Parliamentary Joint
Committee on Corporations and Financial Services Inquiry

Impairment of Customer Loans

Introduction

Legal Aid Queensland (LAQ) welcomes the opportunity to make a submission to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into the impairment of customer loans.

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.

Background

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 counsellors 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.

The FRLS does not provide representation in court proceedings.

The service has one lawyer, Denis McMahon, who travels throughout Queensland to remote locations to give legal advice. The service assists rural producers on the farm, at a venue of the farmer’s choice, at the local Legal Aid Queensland office or by telephone.

Demand for the services offered by the FRLS has increased in recent years, especially in Northern and Western Queensland, which has been particularly affected by drought. The lawyer for the service is no longer able to meet the demand.

As a consequence, LAQ has initiated an expansion of the FRLS from 1 July 2015. The expanded service will be delivered by three private legal firms located in Cairns, Mackay and Rockhampton.

The law firms were selected following an expression of interest process through the local District Law Associations and a notice by LAQ to lawyers that do legal aid work through LAQ's Grants Online website.

Overall there will be an additional \$150,000 available for lawyers to undertake additional mediations for Queensland rural producers facing financial hardship during this financial year. LAQ will need to review whether we can continue the expanded service beyond 2015-16, due to cuts to our funding from the Commonwealth Government.

The majority of the work undertaken by the FRLS is under the Queensland Farm Finance Strategy which is a voluntary code of practice negotiated between the Australian Bankers Association and various industry groups. Currently mediation must be offered if the debt is up to \$10 million. One major rural lender refuses to mediate but it still participates in negotiations with its customers and their representatives.

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.

Loans officers (normally agribusiness bankers) and credit managers at branch and office level normally approve the initial lending. 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.

Asset Management decides whether customers are able to trade out of difficulty or if the relationship is to end. The Queensland Farm Finance Strategy provides that mediation must be offered before the bank can take enforcement action. Enforcement action includes taking possession of secured assets, appointing receivers, sale by mortgagee-in-possession, or instituting court proceedings for recovery of money owing.

It is acknowledged that in most instances genuine attempts are undertaken by the banks to try to find a solution to issues. On many occasions there are no easy solutions. Neither the customer nor the banker is to blame for the problem. However, outcomes can often result in great financial and emotional loss for the farmer and sometimes significant loss for the bank. These circumstances are sometimes unavoidable.

Many of the 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 more potential obstacles and risks compared to most other businesses. Most farms are family operations where individuals provide most if not all their assets as security to banks for loans for their businesses.

Farm loans for the purchase of additional land or to undertake improvements require long term planning and lending. The *Code of Banking Practice* provides that bankers should exercise prudent care when assessing the loans to ensure borrowers have a capacity to repay the loan.

FRLS has had a number of matters where it would appear that the circumstances of the borrower at the time at which the application for the loan was made were such that it would have been more prudent for the lender not to have approved the loan application. Many such loans were taken out prior to the GFC but there are a number of matters where such loans have been taken out since the GFC.

Additionally, there have been certain trends emerging where the banks have adopted strategies which have ensured that the farmers' facilities would default or create circumstances where there is a greater risk of default. These actions are outlined in this submission.

FRLS recently had a client whose original application was declined by one branch but accepted by another branch within the same bank. Within 1 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 distinct 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.

Banks' letters of offer set out the various terms contained in the particular loan facility. Standard loan and mortgage documentation accompany the letter of offer and support the facility. The customers are required to sign all documentation. Throughout the term of the facility, the terms of offer can be varied. These variations should be signed by the customer. 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. Often substantial changes are made without these changes being brought to the attention of the customer. Banks will often unilaterally make changes without any discussion with the customer. These letters of offer are sent out with an accompanying letter advising "the bank is pleased to renew your facilities, etc." Nowhere in these letters is it outlined that changes have been made to the accompanying letter of offer (see separate comments within submission).

Increases in rural producers with severe debt problems

Many FRLS clients have had properties which have been in their families for generations. Despite farmers being given time to sell properties by banks, many have been unable to sell them. If sales are achieved, it is often at significantly reduced prices. Often the clients have little to no equity remaining and are often left with significant debts still owing to banks and unsecured creditors. Many of these unsecured creditors are local businesses providing services to the farmers in the district. These losses compound many problems.

Most rural areas across Queensland are affected. Approximately 80 % of Queensland is currently drought declared. Some areas have long term debt issues and it is difficult to conceive how many producers will be able to trade out. Often the producers worst affected are those who purchased before the GFC when land

prices rose to record levels having little relationship to the income potential of the properties. Credit was readily available and bank managers were given targets to meet.

Some rural producers in financial difficulties have negative equity in their properties. The FRLS lawyer has worked on matters where there has been negligible interest in the property market in some areas. In some cases, banks have asked farmers to remain on as caretakers while buyers are sought for the property. Some banks are not advertising sales as forced sales (receiver or mortgagee in possession) presumably due to the extremely low prices having been achieved by properties marketed as forced sales.

Terms of Reference

- a. Practices of banks and other financial institutions using a constructive default (security revaluation) process to impair loans, where constructive default/security revaluation means the engineering or the creation of an event of default whereby a financial institution deliberately reduces, through valuation, the value of securities held by that institution, thereby raising the loan-to-value ratio resulting in the loan being impaired;**

The Farm and Rural Legal Service has had matters where property values have halved. Many reasons can be suggested for these declines but location of the property is very relevant.

The pastoral areas of north and western Queensland declined substantially due to the decline in the beef industry following the live export ban. Extreme drought and, in some areas, fire also contributed to declining land value. Significantly, the banks' lack of appetite to lend also contributed to this problem, greatly reducing the number of potential buyers in the market. Furthermore, the inability of producers to refinance (in circumstances where they had sufficiently strong cash flow projections to warrant refinance but could not do so as they are in asset management) forced more properties onto the market further depressing an already distressed market.

In other matters, valuations were not obtained by banks when properties were purchased but shortly after the loan imposed conditions upon the facilities requiring the farmers to trade within a certain loan to value ratio. Failure to maintain these levels due to declining property prices can provide the bank with an event of default.

- b. Role of property valuers in any constructive default (security revaluation) process**

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

Valuers sometimes provide differing estimates of value when providing valuations for “mortgage security purposes”, “forced sale” purposes, 90 day marketing etc. The valuations from differing valuers are used by different sections of the same bank to justify the bank’s particular stance at the time. The question must be raised: do these valuations truly provide an accurate assessment of the true market value of the property? A recent trend has been to obtain market appraisals from real estate agents as they are more directly in contact with the market and not required to apply valuation principles such as the use of historical data where there are few recent sales to use for comparison.

c. Practices of banks and other financial institutions in Australia using non-monetary conditions of default to impair the loans of their customers, and the use of punitive clauses such as suspension clauses and offset clauses by these institutions;

Some letters of offer from banks and financial institutions do not accommodate farmers’ needs. Even when farmers have raised questions about the terms of offer, their concerns are generally ignored. Farmers have a distinct lack of bargaining power. In a number of matters farmers have instructed the Farm and Rural Legal Service that the lending officers advised them to accept a particular letter of offer and that they would vary the terms of offer to better suit their needs after the loan has been created. These producers placed great trust in their bankers. The banks later refused to alter the terms of offer which placed the facilities out of order.

Examples of lending practices which can disadvantage borrowers include:

Offering market rate facilities which are effectively short term loans

Banks sometimes offer market rate facilities which are effectively short term loans which expire in one to five years. These types of facilities are inappropriate in most circumstances where the loan is to finance the full purchase price of a farm. At the expiry of these short term facilities, the banks have no legal obligation to extend them. Unfortunately some farmers have been disadvantaged by loans of this nature when the bank decides not to extend the facility.

If the short term facility is only part of the loan structure, an event of default under one facility such as a short term facility will trigger an event of default in respect of all other facilities. The bank is then in a position to seek repayment of all monies. This is not an unusual event. It is not uncommon for farmers to instruct that their bank manager advised them, at the time of the loan approval, that the facilities would be rolled over at the expiry date and not to worry. In one matter, a loan in excess of \$10 million was approved to finance the full purchase price of a grazing property where the facility expired in 5 years. The bank did not renew the loan on expiry despite the bank manager having assured the borrowers that it would simply be rolled over. The farmers would not have accepted the loan had they not been assured that the facility would be rolled over.

Overdraft review

Another method of calling in loans is for the bank to undertake a review of the overdraft. Typically these facilities can be called in on the review date which is generally conducted on an annual basis. If called in and the farmer is unable to payout the facility it will trigger an event of default under any other facility the borrower may have with the bank. This can happen even if all other conditions and payments have been met. There does not need to be an event of default in either the overdraft or the loan payments to give the bank justification to call in the facilities. Although this is a rare event, it does happen.

It is not unusual for banks to reduce overdraft limits. The effect of this reduction is to cause a cash flow crisis for the business possibly creating an event of default. Legal Aid Queensland has also noted many occasions where banks have changed the terms of the loans without any discussion or advice to the customer. Examples include where there is a facility which may be expressed as having a 20 year term. After one or two years into the term the bank can require a large payment of the principal sum. These facilities do not have set principal and interest payment arrangements. Often this reduction can be of a very significant sum which can only be achieved by asset sale. No event of default need occur for banks to place these types of requirements in the letters of offer. The farmer is neither aware of these intended changes, nor given an opportunity to negotiate or discuss them. The banks should be aware that the farmer has no capacity to comply with the conditions as it would have reviewed the financial position of the business to conduct the review. Legal Aid's FRLS has noted that these issues have often occurred after natural disasters when the farmer has sought additional assistance from the bank. It was clear from the farmer's financial material that there was no possibility that the farmer could meet the conditions. Sometimes these conditions are not prominently set out in the letter of loan offer or otherwise brought to the attention of the farmer.

In a recent matter, the farmer obtained a refinance from a bank to pay out a small debt owing to another bank as well as providing the whole purchase price for the purchase of large grazing property which was subject to a short lease. Upon the expiry of the lease after two years into the loan, the farmer sought additional finance to purchase livestock to stock the property (as had been discussed and agreed by the original lending officer). The bank provided a letter of offer approving the advance to purchase cattle but included a clause requiring the farmer to repay \$1 million within 12 months. The inclusion of this clause was never discussed with the farmer nor was the farmer made aware that it was included in the new letter of offer when it was signed. This condition was not able to be met unless the farmer sold the property.

d. Role of insolvency practitioners as part of this process

The Queensland Farm Finance Strategy provides that enforcement action including the appointment of receivers should not occur until after the moratorium period negotiated has expired. 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 are under no obligation to 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 clear from the results of many sales achieved by receivers that most often the sale price is much less than would otherwise be achieved in a "normal" market. Farmers are often not provided with sufficient information concerning the receivership. They are generally not privy to the valuations obtained, the discussions which took place between the bank, real estate agency, valuers and receivers. Farmers are

ultimately responsible for the payment of the huge fees usually incurred by receivers. Receivers must comply with various regulations which add to the expense of the appointment.

In most matters involving receiverships where FRLS has been involved, the farmer's financial position becomes completely compromised. Often the debt is not fully recovered. Receivers are appointed in preference to negotiating a more commercially rewarding outcome for both parties. Most banks' policy is not to agree to write down debt with the borrower even if a similar or better financial outcome would be achieved and the farmer would not lose the farm. The other problem emerging is that even if debt write downs are offered, other banks are not prepared to consider applications from prospective lenders where debt write down is involved or borrowers are in asset management, as banks do not want other banks' problems. This has been a source of frustration for clients who have been able to demonstrate, by past economic performance and good cash flow projections, justification for approval of the amount sought.

e. Implications of relevant recommendations of the Financial System Inquiry, particularly recommendations 34 and 36 relating to non-monetary conditions of default and the external administration regime respectively:

The extension of unfair contract term protections to small businesses would assist to address some of the huge power imbalance that currently exists between bankers and their rural customers. Banks have teams of lawyers who draft contracts and security documents in terms which favour the bank. Customers are unable to negotiate changes to any of the terms and conditions. It is a "take it or leave it" approach. LAQ has seen circumstances where farmers have legitimate complaints about the banks either when the loan was initially taken out or during the course of the loan when the bank has decided unilaterally to require the facility to be repaid. The farmer's bargaining position is extremely weak. They do not have the financial means to take legal action against the bank even if there is a strong case. The banks' documentation is drafted in such a way as to enable the bank to create events of default in the facilities. In most circumstances, farmers are unable to force the bank to continue to fund the farming operation. Farmers most often have overdraft facilities which are renewable annually. The farmer cannot force the bank to continue providing the overdraft.

The Financial Ombudsman Service will not consider a matter where farm debt mediation has been offered and accepted. Often the loans fall outside of the jurisdiction of the Financial Ombudsman Service. The creation of mechanisms where the power imbalance is reduced may result in contractual terms less weighted in favour of banks.

Banks do not take a long term approach to this area of lending. They offer services and facilities which do not accommodate the wild fluctuations in production and income that occur from time to time within most agricultural industries. The banks' short term imperatives are not suited to the long term needs of the producers. When major weather events occur such as extreme droughts, floods and cyclones banks often do not have the flexibility to support producers to get back on their feet. If this is the case they have not taken these fluctuations into consideration when assessing the loan applications in the first instance. It is accepted that in some instances where there have been catastrophic weather events the business will be rendered unviable. However the concern is that current lending practices do not sufficiently provide for the vagaries of agricultural production and a more prudent lending approach may need to be taken to ensure businesses have the capacity to withstand inevitable difficulties associated with primary production.

f. Extent to which borrowers are given an opportunity to rectify any genuine default event and time period typically provided for them to do so.

If the default has occurred as a result of the bank changing the terms of the letter of offer, then it is difficult to describe it as a genuine default. As previously outlined, this form of default may happen in many ways such as calling in the overdraft, reducing limits within the overdraft, producing an increased accelerated repayment arrangement of a long term facility (e.g. altering a 20 year facility and requiring that 75% of capital be repaid over a period of 5 to 10 years).

In the absence of any of the above changes, which generally occur at branch level, the FRLS experience is that asset management generally provides realistic timelines to satisfy defaults such as extending time to enable crops to be harvested or livestock sold. The bigger problem arises in relation to timelines considered for the sale of land or other assets such as machinery.

g. Provision of reasonable written notice to a borrower when a loan is required to be repaid

Most often banks will give customers reasonable time to resolve matters. Prior to the GFC, farmers were more readily able to sell or refinance their properties. Since the GFC, many farmers have been unable to either sell their properties or refinance. The FRLS has been advised by finance brokers that major banks will not refinance clients in asset management. They also report a significant tightening in lending practices which has effectively created a shortage of money. The FRLS is of the view that these actions have had the effect of greatly reducing the number of eligible buyers for properties and ultimately placing downward pressure on land prices. It is clear from the financial information available that land prices became too high and had no correlation to the income able to be generated from them.

The FRLS has seen many instances over the past few years where farmers have been unable to achieve sales within the timelines that banks were prepared to offer. Banks sometimes ignore the accepted marketing period set out in valuations provided by registered valuers and instead, impose shorter time frames for property sales.

h. Appropriateness of the loan to value ratio as a mechanism to default a loan during the period of the loan

The FRLS has observed loans requested to be paid early despite no overall increase in debt exposure. The appropriateness of applying a loan to value ratio depends upon the location of the assets and the income capacity of the business. In some businesses such as horticulture, the short term requirements of the business could balloon during harvest and planting periods. Generally speaking, an ability to continue to trade and meet financial obligations should take precedence over loan to value ratios, particularly in a depressed rural property market.

i. Considerations and requirements to be met prior to the appointment of an external administrator

Under the Queensland Farm Finance Strategy the banks will not appoint external administrators during the term of the moratorium negotiated at mediation or other agreement. If the farmer has not elected to mediate, the bank may appoint receivers at any stage after the expiration of the acceptance period for mediation.

If a company operated by a farmer is placed into administration by the farmer, the bank may appoint receivers over the secured assets in response to the appointment of administrators.

If the debt is over \$10 million dollars the bank can appoint receivers at any stage, although it would normally enter into negotiations with the farmer beforehand.