



**SUBMISSION TO THE JOINT COMMITTEE ON CORPORATIONS AND
FINANCIAL SERVICES INQUIRY INTO
THE IMPAIRMENT OF CUSTOMER LOANS**

AUGUST 2015

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SUMMARY

1. ANZ aims to work with commercial customers in default to help them get back on track. Legal or recovery action is costly for all parties and only considered when all other avenues are exhausted. On average, the time between ANZ first issuing a default notice and actual enforcement is about 1.5 years for non-Agribusiness customers and over 2.5 years for Agribusiness customers.
2. ANZ understands there are extraordinary circumstances which may lead to customers experiencing difficulty. In particular, ANZ has taken a number of steps to assist rural customers in difficulty including our December 2014 drought support measures that placed a 12 month moratorium on farm repossessions in drought declared regions of Queensland and North-West New South Wales.
3. ANZ has policies and processes which govern our approach to managing customers who are in default or with impaired loans. While ANZ has strong compliance functions to ensure these are followed, there may be instances where best practice is not achieved. If and when any exceptions are identified, we aim to deal with these exceptions fairly and expeditiously.
4. Circumstances where enforcement action is undertaken are often very challenging and stressful for customers and other stakeholders. There will inevitably be circumstances where our best endeavours fall short of customer expectations and relationships deteriorate.
5. Stakeholders have raised a number of concerns with the transition of customers from Landmark to ANZ. ANZ would be pleased to discuss specific customer circumstances with the Committee (with the customer's permission).
6. The terms of reference state that banks may use non-monetary conditions of default to impair customer loans, such as loan to value ratio (LVR) covenants. Non-monetary covenants in lending contracts have a primary role of being an 'early warning sign' that a customer may be experiencing difficulty meeting their obligations, or that they may do so in the near future. They are not a trigger to move directly to impairment and enforcement action.
7. Our examination of all customers in some form of ANZ enforced insolvency administration as at 31 March 2015 provide evidence that ANZ does not use non-monetary conditions of default to move to impairment or enforcement action. Of the 116 commercial customers identified, 113 were in monetary default at the time of ANZ enforcement and the monetary default was relied upon to take possession of property held as security by ANZ. Of the remaining three customers, there were specific and compelling reasons for ANZ to take action following the occurrence of other significant defaults (for example, the appointment of a receiver by another financier).
8. The data did not identify any instances of ANZ relying on the breach of a LVR covenant as the primary default. Of the 116 customers, only two had been in default of their LVR covenant and in both of cases, the default relied upon for the enforcement was a monetary default and not the LVR breach.

A. INTRODUCTION

1. ANZ welcomes the opportunity to provide this submission to the Joint Committee on Corporations and Financial Services Inquiry into the impairment of customer loans. The Inquiry aims to examine circumstances where customer loans have become impaired and whether banks are in a position to, or actions may have the effect of, putting a customer into default using non-monetary circumstances.
2. ANZ seeks to take a pragmatic, commercial and empathetic approach in its management of customers at risk of, or in, default. Central to this approach is the early detection of problems and ongoing dialogue to preserve the customer relationship.
3. We seek to work through difficult situations with the primary aim to get the customer back on track. Only after all other avenues of working with the customer have been exhausted, often after a number of years, does ANZ seek to take steps to recover the debt. Legal or recovery action is costly for all parties and is only contemplated as a last resort.
4. ANZ has policies and processes in place that underpin our approach to managing customers who are in default or with impaired loans. While ANZ has strong compliance functions to ensure these are followed, there are times when our actions may not meet our best practice. It is our aim to ensure that if and when any exceptions are identified, we deal with them fairly and expeditiously.
5. Even when our policies and processes have been followed, there can be circumstances where our best endeavours fall short of customer expectations and relationships deteriorate.
6. ANZ understands there can be extraordinary circumstances which may lead to customers experiencing financial difficulty. In particular, ANZ has taken a number of steps to assist rural customers in financial difficulty including our December 2014 drought support measures that placed a 12 month moratorium on farm repossessions in the drought declared regions of Queensland and North-West New South Wales. Another example was the establishment of a team that managed customers impacted by the Queensland floods in 2011. This ensured dedicated resources could consistently identify and work with our customers impacted in areas of Queensland, with the aim of helping customers to return to business as usual operations.
7. ANZ's approach is underpinned by specific governmental, regulatory and compliance obligations set out by the Australian Prudential Regulation Authority (APRA), the Basel Committee on Banking Supervision and the Australian International Financial Reporting Standards (AIFRS) that require ANZ to actively manage credit exposures. As an Authorised Deposit-taking Institution (ADI), ANZ is subject to ongoing supervision by APRA to ensure it is meeting its prudential requirements (including capital provisioning), proactively identifying, managing and communicating risk. In order to meet these obligations, ANZ not only has to assess the credit risk of a customer at the time finance is extended, but on an ongoing basis.

B. TRIGGERS OF DEFAULT AND IMPAIRMENT LEADING TO ENFORCEMENT

8. ANZ Corporate and Commercial Banking delivers business banking services including Corporate Banking, Business Banking, Regional Business Banking (including non-metropolitan commercial and Agribusiness), Small Business Banking and Esanda. As at March 2015, total Corporate and Commercial lending was \$68.4 billion and total deposits were \$49.7 billion. Default rates for Corporate and Commercial Banking were low, with 90+ day delinquencies at 1.04% as at March 2015.
9. ANZ has an extensive process for managing and assisting commercial customers in default and experiencing difficulty. We go through a number of steps with the customer with the primary aim of bringing the customer back to financial health (see section D for further detail).
10. The terms of reference state that banks may use non-monetary conditions of default to impair customer loans, such as loan to value ratio (LVR) covenants. Non-monetary covenants in lending contracts have a primary role of being an 'early warning sign' that a customer may be experiencing difficulty meeting their obligations, or that they may do so in the near future. They are a tool used to assist in monitoring a customer's financial health, not a trigger to move directly to impairment and enforcement action. These breaches are used as a trigger for discussion about what is happening in a business and corrective actions by a customer.
11. ANZ has conducted an examination of all customers in some form of ANZ enforced insolvency administration as at March 2015 (for example, Receiver & Manager, Voluntary Administration, Mortgagee in Possession, etc.) to determine the nature of the default relied upon by ANZ in taking possession of property held as security.
12. A total of 116 customers were identified as being in some form of ANZ enforced insolvency administration (29 Agribusiness, 87 Non-Agribusiness).¹ While individually significant, as a whole this represents 0.08% of over 140,000 commercial customer accounts.
13. The 116 customers represent only 4.74% of the 2,445 customers being managed by Lending Services or Commercial Collections. While ANZ is recognising likely losses on 979 impaired accounts, only 116 of these are subject to ANZ enforced insolvency administration.
14. In the vast majority of cases, ANZ takes enforcement action based on a monetary default. Of the 116 customers identified, 113 were in monetary default at the time of ANZ enforcement and the monetary default was relied upon to take possession of property held as security by ANZ.
15. Of the remaining three customers where there was no monetary default, one was a large sophisticated Institutional customer and two were Business Banking customers, where there were specific and compelling reasons for ANZ to take action following the

¹ Any customer that was in a form of voluntarily induced insolvency administration, such as appointment of a Liquidator or a Voluntary Administrator by the directors, was excluded from the population on the basis that these were initiated by the customer and not by ANZ.

occurrence of other significant defaults (for example, the appointment of a receiver by another financier).

16. Importantly, the data has not identified any instance of ANZ relying on the breach of a LVR covenant as the primary default to enforce or take possession of property held by ANZ as security. Out of the population of 116 customers in some form of ANZ enforced insolvency administration, only two of these had been in default of their LVR covenant and in both of cases, the default relied upon for the enforcement was a monetary default and not the LVR breach.
17. ANZ's primary aim is to work with customers to help them get back on track. Legal or recovery action is costly for all parties and only considered as a last resort, when all other avenues are exhausted. In examining the 116 customers identified, for those instances where the data was available, on average it took 552 days (1.5 years) between the first default and final enforcement for Non-Agribusiness customers, and 984 days (2.7 years) for Agribusiness customers.

C. ANZ ACQUISITION OF LANDMARK

18. On 1 March 2010, ANZ acquired Landmark Financial Services' loan and deposit books.
19. The transition of former Landmark customers and their accounts to ANZ and its systems commenced in March 2010 and continued through to early 2011. The transitioning arrangements and integration of customers from Landmark to ANZ were the subject of discussions between ANZ managers and their customers, and were also set out in a number of written communications. There was also a dedicated support team set up to assist with any queries from former Landmark customers.
20. We acknowledge that a number of former Landmark customers did experience difficulties in operating their accounts during this transitional period, but we believe that these issues were rectified.
21. We also accept that some Landmark customers could have benefited from further and more detailed communication explaining what ANZ's acquisition of the loan portfolio meant to them and outlining what changes they should expect in the management of their accounts by ANZ.

D. ANZ'S APPROACH TO COMMERCIAL CUSTOMERS EXPERIENCING FINANCIAL DIFFICULTY

22. ANZ has two dedicated teams that manage commercial customers experiencing financial difficulty. ANZ Commercial Collections manages those customers with lending under \$1 million and select customers with lending between \$1 million and \$3 million who are experiencing financial difficulty. Larger customers experiencing difficult are managed by ANZ Lending Services.
23. ANZ's lending business is segmented into retail and wholesale customers where different types of modelling is used to assist ANZ in determining the level of credit risk associated with a transaction or relationship. Retail customers include personal lending (personal loans, credit cards, mortgages) and small business lending. Wholesale customers include

larger businesses, Agribusiness, corporate and institutional clients, banks, governments and project finance.

24. ANZ applies a risk grading for wholesale customers. The modelling used to determine a customer's risk grading takes into account four primary factors:
- Financials including company size and growth, profitability, leverage and interest cover, liquidity and efficiency of the business;
 - Account behaviour over time;
 - Industry specific information including the industry segment, industry trends and government policy impacts; and
 - Structural characteristics such as management quality, reliance on suppliers and dependence on customer geography or parent company.
25. The benefits of risk grading is that it enables the bank to monitor customer performance and to identify customers whose financial position is deteriorating so that early intervention can occur and appropriate assessment, corrective actions and support provided to the customer. The following outlines the staged approach.

STAGE 1: MONITOR AND MANAGE

26. For wholesale credit customers, including Agribusiness, front line relationship managers and their credit counterparts monitor the performance of customers on an ongoing basis and review the risk grading at least annually, as per prudential regulatory requirements. If there are early signs of a deterioration, a review of the risk grade may be conducted and consideration given to ways to assist the customer and mitigate the increased risk.
27. A higher risk customer may be monitored in the front line for some time before being transferred to Lending Services.

STAGE 2: ESCALATION IN OVERSIGHT

28. If a customer's risk profile deteriorates further, the situation is given a higher level of oversight, while still being managed by the front line relationship manager. Where certain parameters are met, a Lending Services manager will also be appointed to support the front line manager in assessing options. The front line team continues all interactions with the customer.
29. A Lending Services manager reviews difficulties that a customer is facing and works with the front line manager to formulate a 'turnaround strategy'. This may include the provision of additional working capital to cover urgent funding requirements (such as refreshing stock), restructure of debt, the sale of non-income producing assets to reduce debt to a serviceable level, and/or the need to provide additional security to mitigate the additional risk. ANZ works with the customer and comes to an agreement as to the way forward.
30. A customer, including those in default, may continue to be given greater oversight and be managed by the front line for some time, before either improving or eventually being transferred to Lending Services, who have capacity to spend more time managing a customer's issues. The transfer to Lending Services only occurs when it has become

apparent that a customer requires the specific skills and expertise that can be brought by Lending Services management.

STAGE 3: COMPLETE DUE DILIGENCE, AGREE CUSTOMER TURNAROUND STRATEGY, MONITOR AGAINST STRATEGY

31. Once it has been agreed that a customer can benefit from the additional management by our Lending Services team, ANZ will discuss with the customer the cause of the deterioration and listen to what strategies the customer has in place to turn their business around. Often the customer will have identified remedial strategies as well as whether any assets should be sold to reduce debt to a sustainable level. The adoption of this strategy relies on customers' willingness to engage and work constructively with ANZ Lending Services.
32. ANZ's Lending Services team may seek further information on cash flow forecasts and budgets and may utilise the services of an Investigative Accountant (IA) to independently review the business. This further information is used to improve ANZ's understanding of the customer's business and financial health and used to assist in decision making with our customers. For example, to support a customer's request for additional working capital or the deferment of scheduled interest or principal payments. We acknowledge that requests for further information may concern some customers, but believe that further information is necessary so that we can reach agreement with the customer on a reasonable and realistic restructuring strategy.
33. It is ANZ's policy to revalue property security, typically within 6 months of an account transferring to Lending Services, and every 12-24 months thereafter depending on the risk profile, including whether ANZ needs to allocate an Individual Provision for the customer. In certain circumstances, ANZ may defer these valuations with formal exemption requiring approval. Where required, an individual provision is used to meet our prudential obligations to ensure enough capital is held to cover any risk of loss. Paragraph 23 of APRA Prudential Standard APS 220 Attachment B on *Impairment, Provisioning and the General Reserve for Credit Losses* outlines that:

An ADI's policies and procedures must provide for regular assessment of security values so as to ensure that the fair value of security underpinning provisioning, and any security coverage measures applied to facilities, is timely and reliably reflects values which an ADI might realise if needed.
34. As such, the primary purpose of the valuation is to enable the bank to assess whether an Individual Provision is needed and if so, how much that provision should be.
35. A turnaround plan will then be agreed and documented with the customer and monitored over time. The turnaround plan is specific to the circumstances of each individual customer and can include a number of options such as deferral of principal repayments, reduction in interest rates, debt restructure and debt forgiveness. In the case of Agribusiness customers, the need to fund the next season's plantings is also a key consideration.
36. The amount of time allocated to work through the plan will vary depending on the industry but is likely to be a minimum of 12 to 18 months in duration. Turnaround plans with farmers, for example, will be given more time as consideration needs to be given to planting seasons, rain seasons, droughts and floods.

STAGE 4: DETERMINING ALTERNATIVES

37. If a customer's situation (performance and risk profile) does not improve, then ANZ's Lending Services team will meet with the customer again to discuss alternatives. If a new plan can be agreed on, which will be specific to the circumstances of each individual customer, this may take another 12 months or longer to work through.
38. Where debt issues arise, if we have been unable to resolve those issues with the customer directly, we then encourage the involvement of an independent mediator to assist. For our farming customers, that involves engaging in farm debt mediation. We take into account factors such as produce prices and outlook, gearing and finances, land quality and succession and business capability.

STAGE 5: THE LAST RESORT – TAKING POSSESSION OF PROPERTY

39. In a very small number of cases, a customer may be unable to improve their business and cannot meet previously agreed commitments. After all avenues for improvement have been exhausted, ANZ may then elect to exercise its rights to take possession of the property or appoint an insolvency practitioner over the company or security property. In many cases, it would take a number of years to reach this point.
40. As highlighted earlier, it is extremely unlikely that ANZ will exercise its rights to take possession based on breach of a non-monetary default such as an LVR covenant. Other than in exceptional circumstances, action would only be taken where there is a monetary default, once all other avenues have been exhausted.
41. We endeavour to ensure a 'no surprises' approach so our customers are aware of their position with the Bank and ensure a fair notice period is given before any enforcement. This is evidenced by the lengthy average time between issuing a default notice and enforcement for customers outlined in paragraph 17 above.
42. Our approach is that in formulating a turnaround strategy consideration should be given to other stakeholders that may be impacted. We consider our customer, first and foremost but also, the employees and the unsecured creditors.

ANZ'S SUPPORT MEASURES AND IMPROVEMENTS

43. In December 2014, ANZ announced a new support package for farmers impacted by drought stricken areas of Queensland and North-West New South Wales. The package included:
 - a moratorium on new farm reposessions until December 2015;
 - a 12-month commitment not to increase interest rates on distressed farms and interest rate relief in cases of extreme distress;
 - financial assistance to support farmers choosing to relocate off the land; and
 - increased funding for rural counselling focussed on towns hardest hit by drought.
44. In addition to the specific drought support measures, ANZ also offers other forms of support to customers at higher risk where needed. This includes counselling (at ANZ's expense) to assist borrowers facing hardship, payment of relocation costs where a borrower needs to vacate a property, and payment of costs to upkeep the property (e.g.

cleaning, mowing and general maintenance work). In rare circumstances, ANZ assistance may also include releasing part proceeds from the sale of Bank security property to support the purchase by our customer of alternate accommodation, and in some instances ANZ will agree to release its security over a family home. While difficult, on some occasions, closing a business is in the best interest of customers and their bank.

E. BANK OBLIGATIONS IN LENDING

LEGISLATIVE REQUIREMENTS

45. ADIs are granted the authority by APRA to operate a banking business in Australia and undertake activities prescribed by regulations made under the *Banking Act 1959*.
46. APRA is the prudential regulator of ADIs, foreign banks licenced to operate through a branch in Australia, credit card issuers and purchased payment facilities. To be authorised as an ADI by APRA, a banking business must meet requirements relating to capital, ownership, governance, risk management and internal control, compliance, information and accounting systems, external and internal audit and supervision by home supervisor. Once authorised, ADIs are to meet prudential requirements on an on-going basis. Prudential requirements are set out in Attachment 1 to this submission.
47. Banks hold an Australian financial services licence (AFS licence), regulated by the Australian Securities and Investments Commission (ASIC), which regulates providers of financial products and financial services (as defined in the *Corporations Act 2001* and the *Corporations Regulations 2001*). Banks also hold an Australian Credit Licence, regulated by ASIC, to engage in credit activities as defined under the *National Consumer Credit Protection Act 2009*.
48. Lenders and borrowers are generally free to enter into loan agreements that they consider appropriate for their circumstances. The loan contracts entered into between ANZ and its customers set out the terms and conditions of the loan, including events that will give rise to an event of default. ANZ's rights if an event of default occurs are set out, including the right to take enforcement and recovery action.
49. There are a number of legal protections for borrowers (consumers and small business) to ensure that they are not subject to treatment that is generally considered unfair, and that the process for lenders to exercise their contractual rights over secured property is appropriate. Legislative protections for borrowers are contained in the *Code of Banking Practice*, the *National Consumer Credit Protection Act 2009*, the *Australian Consumer Law*, the *Australian Securities and Investment Commission Act 2001* and the *Farm Debt Mediation Acts*.
50. Some of the issues addressed include unfair contract terms, responsible lending and the right to apply for a repayment arrangement on the grounds of financial hardship. The dispute resolution procedures available to borrowers and issues of financial hardship are discussed in more detail below.
51. The right of a lender/mortgagee to exercise a power of sale or appoint a receiver is usually provided for in the loan and security (e.g. mortgage or charge) document and it is also conferred by property law legislation (e.g. s77 of the *Transfer of Land Act (Vic)*,

s109 of the Conveyancing Act (NSW)) and in respect of receivers, the Corporations Act 2001.

52. In respect of land, before a mortgagee can exercise a power of sale, property law legislation requires that a mortgagor be issued with a default notice that must meet certain requirements. For instance, the default notice must be clear, accurate and unambiguous so that the defaulting mortgagor fully understands the problem and what action needs to be taken. The notice must explain the nature of the default and the steps that should be taken by the mortgagor to rectify or remedy the matter. The mortgagor must be given the opportunity to repay the loan before the property is sold. Generally, the mortgagee cannot exercise the power of sale until one month after the default notice has been issued.
53. In the event that ANZ does proceed to exercise its rights to sell a property either as mortgagee or by appointing a receiver to sell the property, ANZ or the receiver are legally obliged to act in good faith and owe statutory duties to take all reasonable care to ensure that the land or property is sold for its market value (where a market value exists) or otherwise for the best price reasonably obtainable, having regard to the circumstances existing when the property is sold.
54. Where borrowers are companies, the duty is set out in section 420A of the *Corporations Act* and similar provisions exist in most States in relation to the sale of property of individual borrowers (e.g. s77 of the *Transfer of Land Act (Vic)*, s85 of the *Property Law Act (Qld)* and s111A of the *Conveyancing Act (NSW)*) and in the *Personal Property Securities Act 2009*.
55. Whenever ANZ exercises its power of sale, valuers and agents with appropriate experience are engaged to advise on the advertising and sale process as well as provide reliable and updated evidence of the value of the property to be sold.

PROPERTY REVALUATION AND ROLE OF PROPERTY VALUERS

56. ANZ engages property valuers to assess value of the security underpinning the loan. This can occur at the initial approval of the loan, when reviewing existing facilities and when the security is to be sold.
57. The framework for the use of valuations in determining fair market value is underpinned by the prudential requirements for the use of valuations and international standards and practices on property valuations.
58. APRA Prudential Standard APS 220 Attachment B on *Impairment, Provisioning and the General Reserve for Credit Losses* outlines ADI requirements for valuation of security. In particular, paragraph 21 states that:

... the ADI must require valuers and appraisers in preparing their valuation reports to adopt the valuation standards and practice of any relevant professional bodies ... in the case of property valuations, the standards and practices of the Australian Property Institute (API) or equivalent ... must be used.
59. When ANZ instructs a valuer to determine the *current market value* of a property for a security, the valuer must apply the following definition of market value from the International Valuation Standards Council:

The estimated amount for which an asset or liability should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.

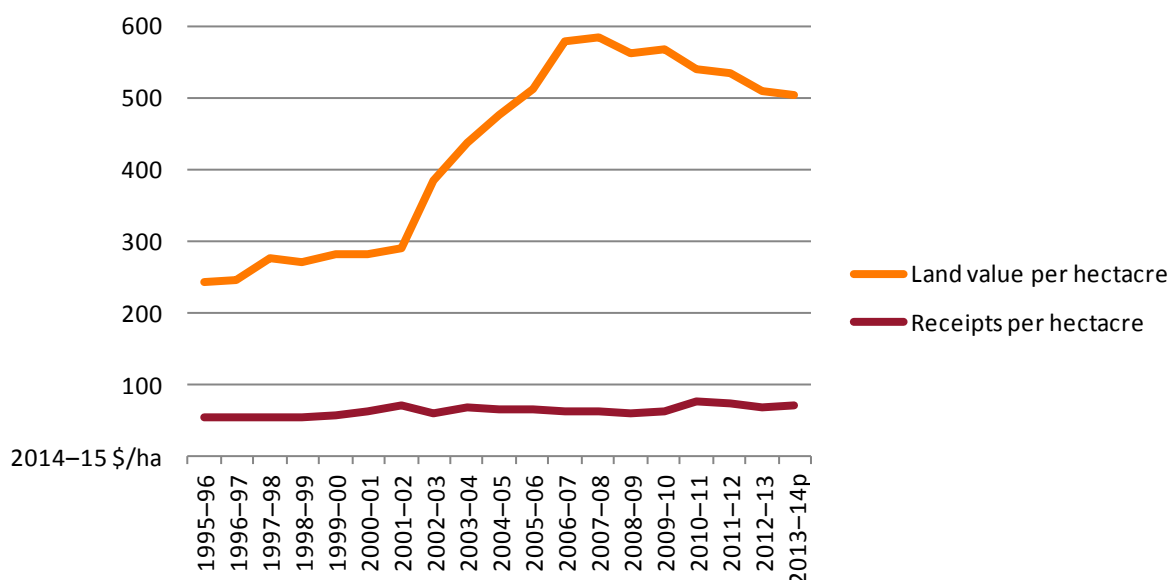
60. This definition places the equivalent emphasis on the interests of the purchaser and the vendor to obtain a fair market value. The valuer's role is to make a prediction of the most likely price a property would receive if offered to the market on the day of inspection, taking into account all material factors which may impact on the determination of that price.
61. The valuation process is independent of sales and lending decisions. ANZ uses a panel of approved commercial property valuers to provide independent expert advice to determine the acceptability and value of property held as security.
62. A valuer's place on the panel is subject to regular quality assurance checking. These requirements are designed to ensure suitably qualified consultants are appropriately engaged for commercial property or residential property.
63. ANZ also uses Manager Internal Appraisals for non-metro commercial property valuations up to \$1.5 million or agribusiness valuations up to \$20 million where a panel valuer does not exist in the area where the security property is located. These are conducted by a Frontline Manager who has completed the appropriate training and been accredited to conduct valuations. Manager Internal Appraisals of security property are then approved centrally by Risk.

Agribusiness/Farm gate valuations

64. ANZ has internal guidelines for Manager Internal Appraisals that require managers to take the following factors into account when determining market value of a property:
 - Recent sales of relevant properties in the district or state and the comparability of these sales to the implied current market of the subject property;
 - Condition of the property, including for rural properties soil fertility, competition from weed infestation, condition and maintenance of physical structures on the property; and
 - Climatic, seasonal and commodity impacts on the property including immediate past, current and prospective outlook.
65. Claims have been made that banks are in a position to engineer defaults by "deliberately reduc[ing], through valuation, the value of securities held by [the bank]". ANZ is required under its prudential obligations to ensure the value of the security of a loan is accurate and the risk associated with the facility is adequately capitalised. One way to achieve this is through conducting regular reviews of facilities and valuations of underlying security. ANZ's policies ensure that approval of valuations are held at arm's length from lending decisions and managed by Risk functions so that the valuation received is a true estimate of market value on a given day. Of course, once a valuation is established, other criteria contribute to an overall assessment of achieving a customer turnaround plan.

66. Data from the *Australian Farm Survey* conducted by the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) highlights the change in land prices for broadacre farms across Australia. Figure 1 shows a sharp rise in land values per hectare from 2001-02 to 2007-08 while receipts stayed relatively flat. Since 2008 there has been a steady correction in land values per hectare.

Figure 1: Land prices and receipts per hectare, broadacre farms (average per farm)



Note: p Preliminary estimate.

Source: ABARES Australian Agricultural and Grazing Industries Survey

67. There are circumstances where determining market value is more difficult, such as in times of drought. Sales evidence is more limited as buyers exercise caution and sellers initially hold out for more favourable prices. Properties also deteriorate during drought as farmers understandably compensate for lower incomes by deferring capital maintenance. As a farm deteriorates, it has an impact on the productivity of the farm and ultimately its market attractiveness.
68. This is exacerbated by a reduction in the pool of potential buyers, which is traditionally dominated by neighbouring farmers who are often experiencing the same difficulties as the vendor. They will tend to go into "care and maintenance" of their own properties and defer decisions to acquire more land in the district until conditions improve.
69. It is under these extreme circumstances that ANZ has placed a moratorium on farm repossessions in drought affected areas of Queensland and New South Wales.

DISPUTE RESOLUTION AND FINANCIAL HARDSHIP

Financial Ombudsman Service

70. As a holder of an AFS licence, ANZ is required to have in place internal dispute resolution procedures and be a member of an ASIC approved external dispute resolution scheme.
71. ANZ is a member of the Financial Ombudsman Service (FOS), which provides an independent dispute resolution process for financial services disputes including banking, credit cards, mortgages, general and life insurance, financial planning and investment advice.

72. The FOS terms of reference outline the types of disputes that are within its jurisdiction. In general, it covers financial service provider disputes with individuals or small businesses (less than 20 employees or 100 employees for manufacturing businesses), where the value of the claim is less than \$500,000 or in the case of debt recovery against a small business, where the contract provides for a credit facility of less than \$2 million.
73. If a dispute is not resolved by agreement between the parties, then FOS can make a Determination about the dispute, taking into account all the information provided by the parties, fairness, applicable laws and industry codes of practice. A Determination is binding on a financial services provider.

Code of Banking Practice and the National Credit Code

74. Both the Code of Banking Practice and the National Credit Code contain provisions which banks must comply with for customers who are experiencing financial hardship. Financial hardship is when a customer is temporarily unable to pay what they owe due to a change in circumstances (e.g. ill health, loss of employment).
75. In general, the Codes require ANZ to try to help the customer overcome their financial difficulties (for example, by developing a repayment plan or converting the loan into an interest only facility for a period of time). ANZ must give proper and prompt consideration to any request for financial difficulty assistance and/or proposal put by a customer.
76. ANZ provides additional training to staff dealing with customers facing financial difficulties and to staff who may be in a position to recognise customers who may be in financial difficulty.

Farm Debt Mediation

77. Mediation typically takes place after attempts have been made by ANZ to resolve issues with its farming customers.
78. The *Farm Debt Mediation Act* (New South Wales and Victoria), the *Queensland Farm Finance Strategy* (QFFS) and the newly introduced Western Australian *Farm Debt Mediation Scheme* provide farmers with an opportunity to participate in mediation to address issues and resolve disputes regarding their loan agreements. Mediation is conducted by an independent and trained mediator in an impartial environment.
79. The legislation cannot be contracted out of and, where it applies, ANZ is required to take a number of steps before commencing any recovery or enforcement action.
80. ANZ's experience is that the vast majority of its farming customers are willing to participate in farm debt mediations and in almost all cases an agreement is reached at the mediation to resolve the dispute.

F. POLICY ISSUES

81. The Committee is seeking evidence on a number of regulatory matters. ANZ has the following comments on these.

FINANCIAL SYSTEM INQUIRY RECOMMENDATIONS

Regulation of contract terms found to be unfair

82. Recommendation 34 of the Financial System Inquiry (FSI) Final Report supports the extension of consumer protections against unfair terms in standard form contracts to small businesses. At the time of writing, legislation has been tabled in Parliament to extend these protections. The legislation as currently drafted renders void any term in a standard form contract that is found to be 'unfair', in that:
- It would cause significant imbalance in the parties' rights and obligations arising under the contract;
 - It is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the term; and
 - It would cause detriment to a party if it were to be applied or relied upon.
83. The legislation applies to standard form contracts with small businesses that have less than 20 employees, where the contract has an 'upfront price':
- Of less than \$100,000 (excluding interest in the case of a credit contract); or
 - Of less than \$250,000 where the contract has more than 12 months duration (excluding interest in the case of a credit contract).
84. There is little evidence to suggest that unfair terms legislation is needed for small business financial services contracts. Small business bank customers already receive the same protections as consumer customers under the Code of Banking Practice and have access to the Financial Ombudsman Service for disputes. Most other industries do not have this same level of protection. Moreover, the legislation as it is currently drafted, is likely to have unintended consequences of capturing more sophisticated businesses that have less than 20 employees.
85. If further protections are required, ANZ would support the development of an enforceable industry standard on the use of non-monetary default covenants, to ensure that contracts with small business are fair and appropriately balance the contractual rights and obligations of the parties.

Consultation on the external administration regime

86. ANZ supports the FSI Final Report's recommendation 36 to consult on possible amendments to the external administration regime to provide additional flexibility for businesses in financial difficulty.
87. ANZ agrees with the Final Report that a Chapter 11 regime should not be adopted in Australia and that there is little empirical evidence that Australia's voluntary administration regime is causing otherwise viable businesses to fail. The Chapter 11 regime produces few rehabilitated companies in the long term, is costly and involves long periods of administration. Chapter 11 effectively gives control rights to unsecured creditors, which is at odds with the Australian legal system which recognises the position of creditors with security.

88. ANZ believes that key reforms that would improve the current external administration regime include:
- a "safe harbour" for directors from insolvent trading laws where there are attempts by directors to facilitate genuine restructures, to be achieved by the adoption of a modified business judgment rule defence;
 - some form of limited protection on the operation of ipso facto clauses (provisions in contracts that allow one party to terminate the contract upon the insolvency of the other); and
 - reform of section 420A of the *Corporations Act*, so that non-core or obsolete assets can be disposed of quickly to facilitate a restructure. Currently, the section places undue focus on the process and discourages a quick sale even though there may be ample evidence that the proposed sale price exceeds market value.
89. ANZ is of the view that any "safe harbour" defence should promote the policy objective of obliging directors to obtain early restructuring advice from an appropriately experienced and qualified professional, such as a Chief Restructuring Officer (CRO). The CRO would be an employee of or contractor with the company, whose role would be to investigate, advise, negotiate and oversee the implementation of the restructuring. While the appointment of a CRO is currently possible, it is a rare occurrence in Australia due to concerns that a CRO could be personally liable for insolvent trading as a "shadow director". It is therefore important that legislative attention is given to the definition of director so that a CRO participating in the restructuring process is not taken to be a "shadow director" of the company.

NATIONAL APPROACH TO FARM DEBT MEDIATION

90. ANZ supports and encourages a national approach to farm debt mediation. At present only New South Wales and Victoria have legislated farm debt mediation schemes. Only voluntary schemes (such as the Queensland Farm Finance Strategy) or no formal schemes are in place in other states and territories.
91. ANZ's approach is to offer farm debt mediation in all cases, even if it is not mandatory. ANZ recognises the importance for all farmers, regardless of where they live or do business, to have access to the same mediation process.

ATTACHMENT 1 - PRUDENTIAL REQUIREMENTS

92. Banks must meet prudential requirements on an on-going basis and comply with APRA prudential standards. A major focus of the prudential standards is capital adequacy – ensuring that a bank has sufficient capital to withstand unexpected events up to a given statistical confidence level.
93. The recognition of impairment is one of the key planks of capital adequacy, as provisions for bad and doubtful debts reduce a bank's equity base.
94. The prudential standards most relevant to questions of default, impairment and collateral management are *APS 220 Credit Quality* and *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*. The prudential rules for the recognition and measurement of impairment align to Australian accounting standards.

DEFINITION OF IMPAIRMENT

95. Prudential Standard APS 220 on Credit Quality is the main standard which governs how ANZ manages credit risk. The key requirements of the standard are that an ADI must:
 - *have an effective credit risk management system that is appropriate to its needs;*
 - *regularly review its credit risk management systems, taking account of changing operating circumstances, activities and risks;*
 - *have a robust system for the prompt identification, monitoring, and accurate and complete measurement of its credit risk. This includes recognition and reporting of impaired facilities and estimated future losses on the credit portfolio; and*
 - *maintain provisions and reserves adequate to absorb existing and estimated future credit losses in its business given the facts and circumstances applicable at the time. This includes maintaining a prudent level of a General Reserve for Credit Losses.*
96. Paragraph 24 of APS 220 defines an impaired facility as a facility where:

...there is doubt over the timely collection of the full amount of cash flows contracted to be received by the ADI.
97. Attachment A, paragraph 7 of the standard then sets out the overarching definition of impairment as follows:

A facility must be classified as impaired regardless of whether it is 90 days or more past due, when there is doubt as to whether the full amounts due, including interest and other payments due, will be achieved in a timely manner. This is the case even if the full extent of the loss cannot be clearly determined.
98. Paragraphs 25 and 26 elaborate further on the paragraph 24 definition of impairment:

25. For the purposes of paragraph 24, doubt will exist with respect to a facility (on- or off-balance sheet) 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. In such circumstances, the estimated cash flows will fall short of the full amount of the cash flows contractually due to be received.

26. For the purposes of paragraph 24, 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 advance.*

99. Besides the above minimum indicators of “doubt”, the standard acknowledges that recognising impairment cannot be totally based on formulas or rules but includes the following guidance in Attachment A, paragraph 4 of APS 220 on some of the factors that affect the collectability of a facility:

- (a) *indications of significant financial difficulty of a party to a facility; or*
- (b) *breach of contract, such as a default or delinquency in interest or principal; or*
- (c) *the likelihood of bankruptcy or other financial reorganisation of a party to a facility; or*
- (d) *concessions in terms of a facility (e.g. interest or principal payments) granted to a party to a facility relating to such a party’s financial difficulties; or*
- (e) *changes or trends in default rates on categories of facilities which might be assessed for impairment on a collective basis; or*
- (f) *any identified changes in the value of collateral or other sources of security which might bear on the collectability of facilities; or*
- (g) *disappearance of an active market in assets (including derivatives) held by an ADI relating to a given counterparty; or*
- (h) *any other matter which might reasonably suggest to an ADI that a party to a facility may be unlikely to meet its contractual obligations.*

100. Attachment A, paragraph 16 of APS 220 further clarifies what is meant by a facility being 90 days past due:

A facility subject to a regular repayment schedule is regarded for the purposes of this Prudential Standard as 90 days past due when:

- (a) *at least 90 calendar days have elapsed since the due date of a contractual payment which has not been met in full; and*
- (b) *the total amount unpaid outside contractual arrangements is equivalent to at least 90 days’ worth of contractual payments.*

101. APS 220 Attachment B also sets out rules for collateral management. These include that banks must have policies and procedures that ensure collateral values are regularly reassessed and the valuations of collateral remains reliable (paragraphs 22-23). Paragraph 21 of Attachment B also requires banks to require their external valuers to adopt the valuation standards and practices of the relevant professional body (e.g. the Australian Property Institute).

102. Paragraph 25 of Attachment B require ANZ (and by extension, its external valuers) to assume:
- (a) *a property would be accessed in the near future;*
 - (b) *the period for marketing a property would be up to 12 months, although a longer period (up to a maximum of 24 months) may be adopted for specialised or unusual properties when professional valuers advise that this is appropriate; and*
 - (c) *for the purposes of valuation, market conditions and thus asset values are assumed to remain static over the marketing period. To reinforce this point, marketing periods are to be assumed to have elapsed at the date of valuation (i.e. should be retrospective), thereby eliminating any possibility for improved market conditions to be factored into the valuations.*
103. Paragraph 26 rules out the valuers being able to include “elements of hope” for alternate uses:
- In determining fair values of security, property assets must, unless otherwise agreed with APRA, be valued on the basis of existing use. Any higher value related to an alternative use or ‘element-of-hope’ value arising from prospects of redevelopment, and any possible increase in value consequent upon special investment or finance transactions, must be disregarded. In determining values based on ‘existing use’, care must be exercised in imputing future income streams (e.g. lease payments) which are not already contracted.*
104. The prudential standard does recognise in paragraph 27 that there may be times where it is difficult to obtain a fair value, and points towards using future cash flows as the basis of the valuation:
- In some circumstances, it may be difficult to determine the fair value of property assets (e.g. new properties) that have not yet achieved a stable income, or properties that are experiencing drastic fluctuations in income. In such cases, a forecast of expected cash flows must be used to estimate the value of the property. The discount rates used in calculating the value of security must reflect the opportunity cost (determined by way of comparison with prevailing returns on competing investments) of holding the property, assuming a long-term holding. Capitalisation rates must reflect expectations about the long-term rate of return investors require under normal, orderly and sustainable market conditions.*

DEFINITION OF DEFAULT

105. Banks use the definition of default outlined in APS 113 Attachment A both operationally and in its estimates for calculating risk weighted assets for regulatory capital adequacy and expected loss purposes. It is not the same as an “Event of Default” under a customer’s loan documentation.
106. APS 113 Attachment A sets out the definition of default as follows:
- 76. A default is considered to have occurred with regard to a particular obligor when either or both of the two following events have taken place:*
- (a) *the ADI considers that the obligor is unlikely to pay its credit obligations to the Level 2 group in full, without recourse by the ADI to actions such as realising available security;*
 - (b) *the obligor is at least 90 days past due on a credit obligation to the Level 2 group.*
- 77. For the purposes of paragraph 76(a) of this Attachment, elements to be taken as indications of unlikelihood to pay include:*

- (a) *the factors set out in APS 220 relating to impairment irrespective of whether the ADI considers the credit obligations to be well secured;*
- (b) *the ADI sells the credit obligation at a material credit-related economic loss. For the purpose of this element, the ADI must have a policy requiring:*
 - i. *the maintenance of an internal register of credit obligations sold at a material credit-related economic loss;*
 - ii. *data contained in the register to be considered by the ADI in its rating system design and validation processes. The subsequent inclusion in, or exclusion from, those processes of any data contained in the register must be justified by the ADI and must not result in lower LGD estimates; and*
 - iii. *the creation and use of data contained in the register must be transparent to independent reviewers of the ADI's rating systems, such as the ADI's internal or external auditors and APRA.*

78. For the purpose of paragraph 76(b) of this Attachment, the criteria for the recognition of 90 days past due are the same as those detailed in APS 220.

- 107. The Committee's terms of reference describe a "constructive default" scenario, whereby:
... a financial institution deliberately reduces, through valuation, the value of securities held by that institution, thereby raising the loan to valuation ratio resulting in that loan being impaired.
- 108. A LVR is a common credit risk management technique used to manage exposure, as it can ensure that a customer has a set level of equity in the asset. This acts as a buffer to reduce the potential loss to the lender in the event of default.
- 109. LVRs may be used internally by banks to determine acceptable new lending proposals, and may also be used as a lending covenant with the customer. A LVR lending covenant may also include a "top up" mechanism, whereby the customer agrees to provide additional collateral to restore the agreed LVR in the event the value of the asset falls. These top up mechanisms are more commonly used for financial collateral, not for property. Depending on the contract with the customer, the breach of any lending covenant may be a default event, so a deterioration of a LVR may lead to a non-monetary default or may be accepted by the bank.
- 110. LVRs are not a substitute for sound credit analysis. ANZ's credit principles require that lending officers only lend what the customer has the capacity and ability to repay. From a credit assessment perspective, ANZ bases its capacity to service calculations on the customer's expected cash flow, not the value of assets pledged as collateral. Assets pledged as collateral help to reduce the loss in the event of default in the event that the expected cash flows do not materialise.
- 111. As outlined above, from a prudential standards perspective, a loan facility can only be placed in impaired status if the financial institution forms the belief that there is doubt that the full amount due will be paid in a timely manner. Similarly, a loan must be placed in default status (for regulatory capital adequacy and expected loss purposes) either when it is 90 days past due or there are indicators that the customer is unlikely to pay its obligations in full.
- 112. It is unlikely that the downwards revaluation of an asset held as collateral and consequent breach of a LVR would be by itself, an indicator of doubt that the full amount

would be repaid and thus constitute impairment. The reason for this is that impairment focuses on expected future cash flows – a provision is required because the expected future cash flows are in doubt. In simplistic terms, the future expected cash flows of a facility will include interest, fees or repayments as scheduled. If these payments are not met in full and on time, then there will be a loss and therefore an impairment charge.

113. The most likely scenario is that a customer not meeting obligations in full results in the bank needing to determine if the loan is “well secured”, so taking a “fresh” valuation is prudent and required. In this scenario, the future cash flow assessment will need to recognise the potential sale of the asset.
114. Another way to consider this is that in the normal course of business, ANZ receives updated valuations of assets held as security for repayment of loans. In some cases, the secured facility will have an LVR covenant and the ratio has deteriorated. Where this is the case, ANZ does not automatically treat these facilities as impaired. Each case will be judgementally assessed, as required by prudential standards.