Australian Government
The Treasury

14 December, 2015

Ms Toni Matulick
Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Parliament House
CANBERRA ACT 2600

Dear Ms Matulick

INQUIRY INTO IMPAIRMENT OF CUSTOMER LOANS – RESPONSE TO QUESTIONS ON NOTICE

Thank you for your letter of 1 December 2015 regarding questions on notice from the Parliamentary Joint Committee on Corporations and Financial Services to inform their inquiry into the impairment of customer loans.

The Department of the Treasury's responses to the Committee's questions are contained at Attachment A. I note, however, that some of the Committee's questions would be best directed to other government agencies or private sector institutions. Our responses indicate where the Department believes that this would be appropriate.

If you have any questions please contact me on or by email: .

Yours sincerely

Diane Brown
Principal Advisor
Financial System Division
Department of the Treasury

ATTACHMENT A

DEPARTMENT OF THE TREASURY'S RESPONSE TO QUESTIONS ON NOTICE

1. *Please provide a summary of the overall policy framework for the protection of customers who borrow money from authorised deposit taking institutions. Please include information on:*

   a. *consumer protection policy, including residential, small business and commercial customers;*
   b. *dispute resolution mechanisms for residential, small business and commercial customers;*
   c. *regulatory and self-regulatory measures;*
   d. *any areas for reform that are under consideration.*

Answer: There are a number of protections in place for consumers who borrow from authorised deposit-taking institutions (ADIs). These are detailed below.

General obligations

The *National Consumer Credit Protection Act 2009* (NCCP Act) applies to credit provided wholly or predominantly for personal, domestic, or household purposes, or for residential property used for investment purposes. It therefore regulates residential lending for personal use. However, the NCCP Act does not extend to lending to small business and commercial customers.

Since it came into force in 2010, the NCCP Act requires all providers of consumer credit, including brokers and intermediaries to:

- hold an Australian Credit Licence;
- meet responsible lending conduct requirements so that they do not provide credit products and services that are unsuitable, either because they do not meet the consumers' requirements or because the consumer does not have capacity to meet the repayments; and
- have an internal resolution mechanism and be a member of an external dispute resolution scheme.

Dispute resolution mechanisms

The law requires Australian credit providers to put in place a dispute resolution system consisting of an internal dispute resolution process as well as membership of an external dispute resolution (EDR) scheme. Therefore, should they wish to, consumers can submit a complaint to the licensee on whose behalf the service was provided through their internal dispute resolution system. If the consumer is not satisfied with the response received from their licensee, they may then submit a complaint to the external dispute resolution scheme to which it belongs.

ADIs are members of the Financial Ombudsman Service (FOS). FOS is an independent EDR, overseen by the Australian Securities and Investments Commission.

FOS can hear complaints that are within its Terms of Reference. This means it can hear some complaints about lending to small businesses or commercial lending.

While determinations made by FOS are binding on credit providers, FOS' decisions are not binding on the complainant. As such, they are free to seek recourse through the court system should they be unhappy with the external dispute resolution process.

There are no reforms to the consumer credit laws currently being considered in this space.

Unconscionable conduct

The Australian Securities and Investments Commission (ASIC) administers the *Australian Securities and Investments Commission Act* 2001 (ASIC Act), which contains prohibitions on unconscionable conduct and false or misleading representations in relation to financial services, including credit. These ASIC Act provisions are not limited to consumer credit, and extend to credit for business and commercial purposes.

Whether particular conduct is unconscionable turns on the specific facts of the case.

Self-Regulation

There are two primary sources of self-regulation for the Australian banking industry: the Code of Banking Practice and the Customer Owned Banking Code of Practice.

The Australian Bankers' Association (ABA) manages the Code of Banking Practice (the Code) that applies to their members.

The ABA describes the Code as the banking industry's customer charter on best banking practice standards. It sets out the banking industry's key commitments and obligations to customers on standards of practice, disclosure and principles of conduct for their banking services. The Code applies to personal and small business bank customers.

More detailed questions on the Code should be directed to the ABA.

The Customer Owned Banking Association (COBA) manages the Customer Owned Banking Code of Practice (COBCOP). COBCOP is described as the code of practice for Australia's credit unions, mutual banks and mutual building societies.

More detailed questions on COBCOP should be directed to COBA.

Unfair contract terms for small business

Consumers are also protected from unfair terms in standard form consumer contracts. The ASIC Act allows a Court to declare void a term in a standard form consumer contract for certain financial products or financial service that it finds to be unfair. A term is unfair if it:

- would cause a significant imbalance in the parties' rights and obligations arising under the contract;
- is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term; and
- would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

From 12 November 2016, these unfair contract term protections will also be available to small businesses (businesses employing fewer than 20 people) when they engage in standard form contracts worth no more than $300,000, or $1 million if the contract duration is longer than 12 months.

2. *Can you set out the Commonwealth's policy in relation to receivers, including section 420A of the Corporations Act 2001?*

Answer: Receivers of corporate property are required to be registered by ASIC as registered liquidators.

The Government introduced the Insolvency Law Reform Bill 2015 (the Bill) into the House of Representatives on 3 December 2015. The Bill addresses weaknesses identified in previous Senate Economics References Committee inquiries regarding the regulation of the insolvency profession through a range of measures including:

- improving the ability of ASIC to undertake surveillance of the profession proactively;
- enabling ASIC to refer the matter to a three-person committee which will be required and able to make decisions quicker than currently occurs through the Companies Auditors and Liquidators Disciplinary Board; and
- requiring persons wishing to now be registered as a liquidator to satisfy a three-person panel that they are fit to be registered as a liquidator, instead of simply being assessed on the basis of a form and the payment of a fee.

Section 420A of the *Corporations Act 2001* (the Corporations Act) imposes a duty on receivers exercising a power of sale to take all reasonable care to obtain the market price or the best price reasonably obtainable. The explanatory memorandum to the Corporate Law Reform Bill 1992 (at paragraph 406), which introduced section 420A of the Corporations Act, explains the policy behind the provision:

> "It is sometimes said of receivers that they are prepared to sell property at a price less than the best obtainable, so long as it is sufficient to cover the debt of the chargeholder who appointed them. Proposed section 420A will make it clear that, in selling company property, a controller (to be defined in section 9 to mean a receiver and any other person who has control of company property under a charge, such as a mortgagee in possession) must take all reasonable care to sell the property for its market value (if, when sold, it has a market value) or otherwise for the best price that is reasonably obtainable, having regard to the circumstances existing when the property is sold. The controller's duty under proposed subsection 420A(1) will be owed to the company. Proposed subsection 420A(1) will not affect any duties the controller may owe to others under the common law or otherwise.[1]"

The introduction of the provision was a response to the recommendations of the Harmer report which found that:

> "The duty of a receiver, a chargee who takes possession and the agent of the chargee should be expressly stated to be to take reasonable care in the exercise of that person's power. In particular, the duty would be to take reasonable care in the management of property and, if the property is sold, to ensure that it is not sold at a price below the best price reasonably obtainable.[2]"

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[1] At paragraph 406

[2] At page 42

3. *On 18 December 2008 the then Treasurer announced that the approval of the Commonwealth Bank acquisition of Bankwest was subject to several conditions including maintaining and growing the Bankwest brand and branches.*[3]

   a. *Who first proposed the Commonwealth Bank acquisition of Bankwest? Was it proposed by the government or by Commonwealth Bank?*

      i. *If the Government approached Commonwealth Bank: Was Commonwealth Bank given anything in return for agreeing to acquire Bankwest?*

Answer: On 8 October2008, the Commonwealth Bank of Australia announced its proposal to acquire the Bank of Western Australia Limited (BankWest) and St Andrew's Australia Pty Ltd (St Andrew's) from HBOS Australia and its UK-based parent, HBOS. This proposal was conditional on the receipt of all necessary competition, regulatory, and government approvals.

On 5 December 2008, the Department of the Treasury received the Commonwealth Bank's application to acquire BankWest and St Andrew's Australia, made under the *Banking Act 1959* (the Banking Act), for approval under the *Financial Sector (Shareholdings) Act 1998* (the FSSA).

On 18 December 2008, the Treasurer announced his approval of the acquisition under the FSSA.

Was Treasury, ASIC, APRA or the ACCC consulted or involved in any way regarding the acquisition or the approval?

Answer: The Commonwealth Bank of Australia's acquisition of BankWest and St Andrew's was subject to two approval processes:

- the Treasurer's approval under the FSSA, based on the national interest; and
- clearance by the Australian Competition and Consumer Commission (ACCC) under the *Trade Practices Act 1974* (TPA).

On 10 December 2008, the ACCC announced that it did not oppose the proposed acquisition under the TPA. APRA advised the ACCC confidentially on the proposed acquisition.

On 18 December 2008, the Treasurer announced his approval of the acquisition under the FSSA.

The Department of the Treasury and the Australian Prudential Regulation Authority (APRA) provided the Treasurer with advice to help inform this decision.

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3 The Hon Wayne Swan MP, Deputy Prime Minister and Treasurer, Media release, *Proposed acquisition of Bank of Western Australia and St Andrew's by the Commonwealth Bank of Australia,* 18 December 2008.

b. *Was there any consideration or discussion with the parties to the transaction or Treasury, APRA, ASIC or the ACCC regarding:*

ii. the state of the Bankwest commercial loan book and the protection of those customers?

iii. the potential for the sale negotiations and the price adjustment mechanism to leave troubled loans without a definitive determination of impairment and access to workout strategies?

Answer: Matters relating to BankWest's financial position and the potential for the sale to negatively affect consumers – along with concerns about the effect of the sale on matters such as financial stability, competition, employment and innovation - were considered as part of the process of providing advice to the Treasurer on whether to approve the acquisition of BankWest under the FSSA.

To help address these concerns, a number of conditions were imposed on the Commonwealth Bank of Australia's acquisition of BankWest by the Government. These conditions included that, for a period of time:

- CBA would maintain and grow the BankWest brand;
- Foreign ATM fees for CBA customers using BankWest ATMs and vice versa would be removed;
- CBA and BankWest branches and business centres in Western Australia would not close as a consequence of the acquisition; and
- CBA would maximise internal redeployment opportunities available for affected staff, support external job placement where employee redundancies occur, and ensure that staff affected by the acquisition have timely access to their full entitlements under CBA or BankWest (as applicable) retrenchment arrangements.

Questions relating to the conduct of APRA, ASIC, or the ACCC should be directed to those agencies. The Department cannot comment on their activities.

c. *Once under Commonwealth Bank ownership, was Bankwest then eligible for the wholesale funding guarantee?*

i. If so, was the wholesale funding guarantee activated or used in any way and what support did Bankwest receive from the Commonwealth government?

Answer: On 12 October 2008, the Australian Government announced temporary arrangements to enable the provision of a guarantee for the deposits and wholesale funding of all ADIs.

Only senior unsecured debt instruments of a not complex nature issued by ADIs were eligible for the Government guarantee.

- For short-term liabilities, eligible instruments were: bank bills, certificates of deposit (including transferable deposits), commercial paper and certain debentures, with maturities up to 15 months.
- For long-term liabilities for terms to maturity of 15 months up to 60 months, eligible instruments were: bonds, notes and certain debentures.

Up until 28 November 2008, when the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding (the Guarantee Scheme) formally commenced, all wholesale funding instruments eligible for the guarantee were guaranteed without charge.

This necessarily included instruments issued by BankWest; however there is no data available on the value of securities covered by the guarantee for any ADI between 12 October 2008 and 27 November 2008.

On 28 November 2008, eligible ADIs were able to apply to the Scheme Administrator (the Reserve bank of Australia) to have their new and/or existing eligible wholesale funding securities guaranteed under the Guarantee Scheme from this time.

Access to the Guarantee Scheme was voluntary and subject to an approval process and other conditions, including the payment of a monthly fee by the ADI on the amounts guaranteed.

BankWest had securities covered by the guarantee scheme from the scheme's commencement until February 2011. The average daily value (ADV) of BankWest securities covered by the guarantee during each month that BankWest participated is reported in Table 1.

Table 1: ADV of BankWest Securities covered by the Guarantee

Date reported	ADV of guaranteed securities (millions AUD)
31/12/2008	276.16
31/01/2009	459.76
28/02/2009	584.58
31/03/2009	568.45
30/04/2009	644.03
31/05/2009	603.30
30/06/2009	548.70
31/07/2009	339.12
31/08/2009	301.18
30/09/2009	296.90
31/10/2009	317.39
30/11/2009	325.66
31/12/2009	327.49
31/01/2010	353.42
28/02/2010	299.01
31/03/2010	258.41
30/04/2010	58.01
31/05/2010	18.87
30/06/2010	8.34
31/07/2010	1.38
31/08/2010	0.71
30/09/2010	0.73
31/10/2010	0.73
30/11/2010	0.71
31/12/2010	0.49
31/01/2011	0.08
28/02/2011	0

4. *Evidence before the committee indicates that prior to the Commonwealth Bank acquisition, Bankwest was pursuing a wildly ambitious growth strategy which led to significantly worse asset quality than competitors:*

   a. *What was Treasury's awareness of the Bankwest lending practices prior to June 2008?*

Answer: ADI's compliance with lending standards is the responsibility of APRA. Questions on the lending practices of individual institutions should be directed to APRA.

   b. *If a bank was observed to be pursuing a 'wildly ambitious growth strategy' that could lead to a situation like Bankwest, what role do Treasury, APRA, the ACCC and ASIC have and what actions could those bodies or another government body take?*

Answer: APRA is responsible for prudential supervision of individual financial institutions and for promoting financial system stability in Australia. APRA is a Commonwealth statutory authority established under the *Australian Prudential Regulation Authority Act 1998*. APRA's high-level powers for the prudential supervision of ADIs (which includes banks) derive from this Act and from the *Banking Act 1959*.

APRA has developed a comprehensive framework of prudential standards and prudential practice guides to promote sound financial and risk management and good governance across all supervised institutions. APRA's prudential standards set out minimum capital and risk management requirements, which are legally binding. Prudential practice guides provide guidance on how supervised institutions might best satisfy the prudential standards. APRA follows a risk-based approach under which institutions facing greater risks receive closer supervision.

APRA promotes financial stability by requiring institutions it supervises to manage risk prudently so as to minimise the likelihood of financial losses to beneficiaries. APRA's work falls into four main areas:

- establishing prudential standards to be observed by supervised financial institutions;
- assessing new licence applications;
- assessing the financial soundness of supervised institutions; and
- where necessary, carrying out remediation, crisis response and enforcement.

APRA's aim is to identify potential weaknesses in supervised institutions as early as possible. When it discovers weaknesses, it works with the institution to fix them. The primary responsibility for financial safety and soundness within an institution rests with its board of directors and senior management; APRA's approach is to ensure that boards and managers understand these responsibilities.

APRA has substantial legal powers that enable it to intervene where there is a threat that an institution may not be able to meet its obligations to its beneficiaries. APRA will also intervene where there is a threat to the stability of the financial system. In these contexts, APRA has the power to conduct investigations of supervised institutions and, in some cases, to give them directions of a wide-ranging nature.

The key elements of APRA's approach to prudential supervision are outlined in the APRA Supervision Blueprint, which is available on APRA's website (www.apra.gov.au). Detailed questions on APRA's powers should be directed to APRA.

ASIC, Treasury, and the Reserve Bank of Australia (RBA) do not have powers to direct banks in regards to risk management issues. Each of these institutions, along with APRA, however are members of the Council of Financial Regulators (CFR).

The CFR is the coordinating body for Australia's main financial regulatory agencies. It is a non-statutory body whose role is to contribute to the efficiency and effectiveness of financial regulation and to promote stability of the Australian financial system. The CFR does not have statutory powers of its own. Powers remain vested in each of its member organisations.

5. *Throughout the Bankwest deal negotiation process and price adjustment mechanism from July 2008 to July 2009, there was a group of up to 67 loans that were in financial difficulty, however the formal decision on whether they were impaired may have been left undetermined for many months throughout the sale negotiations and price adjustment process.*

   a. *Audits of the Bankwest loan book by three separate top tier accounting firms gave estimates for the level of impairment of loans that varied by up to 88 percent. Could you explain to the committee why the accounting standards permit such a wide variation?*

Answer: Questions relating to the requirements of the accounting standards and what those standards permit would be matters for the Australian Accounting Standards Board and should be referred to them.

   b. *How many, if any, of those loans could have been saved or rescued if the financial difficulties and workout strategies had been addressed in July 2008 and in December 2008?*

Answer: The Department of the Treasury cannot speculate on whether the suggested process would have resulted in improved outcomes for BankWest clients.

6. *Could you explain to the committee how much discretion banks have if they decide they do not want a group of loans on their books?*

Answer: Banks are able to manage the relationship with borrowers according to the terms of the contract between the lender and the borrower. This depends on the terms of the individual contract with a borrower (although it is common for a lender to use standard-form contracts with the same wording).

In practice this means that the lender can enforce or terminate the contract if there has been a default event by the borrower as defined in the contract.

If the customer's existing contract has come to the end of term, the lender is usually under no contractual obligation to provide ongoing finance, or enter into a new contract.

7. *If another bank acquisition was to occur in the near future, has anything changed to protect bank customers from the kind of situation that arose with Bankwest?*

Answer: Since the Commonwealth Bank's acquisition of BankWest in 2008 some changes have been made to better protect bank customers.

For example, the ABA has amended the Code and the government has introduced additional unfair contract term protections for consumers. Additional protections against unfair contract terms will soon also be extended to small businesses.

<u>Changes to the Code</u>

The ABA made some changes to the Code in 2013 to include a number of new provisions for small business lending. For example:

- banks are now required to give small business borrowers a reasonable period of notice (not less than 10 business days) in writing of a variation to terms and conditions of a credit facility, including a revaluation of the credit facility; and

- more details are provided on how banks must help clients, both individual and business, overcome financial difficulties through discussions and possible rearrangements.

In the former version of the Code banks could vary terms and conditions without providing written advice in advance of the new terms and conditions taking effect. The Code also did not use to include detail on how to help clients experiencing financial difficulties.

Changes to the ASIC Act

On 1 July 2010, new laws commenced under the ASIC Act to protect consumers from unfair terms in standard-form consumer contracts for financial products and services. As outlined in response to Question 1, these laws allow a Court to declare void a term of a standard-form consumer contract that it finds to be unfair.

From 12 November 2016, these protections will also be available to small businesses.

For authorised deposit taking institutions that operate under financial services licenses, what are the incentive structures that apply:

a. *for staff who set up loans;*

b. *for staff who are in credit management departments who are involved with loans in financial distress, default or impairment; and*

c. *what structures have applied since 30 Jun 2008, including any special arrangements that may have occurred at particular times, such as during the GFC or following acquisitions of other banks?*

Answer: APRA applies high-level prudential standards and guidelines regarding senior staff remuneration.

In particular, the ADI's remuneration policy's performance-based components must be designed to encourage behaviour that supports its long-term financial soundness and its risk management framework.

The ADI's board has ultimate responsibility for its remuneration arrangements.

Further questions on APRA's prudential standards regarding the remuneration of senior staff should be directed to APRA.