# Commonwealth Bank Group

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

Dear Ms Matulick,

**Re: Questions on Notice received from Committee on 17 December 2015**

Please find attached responses to the Committee's Questions on Notice received by Commonwealth Bank on 17 December 2015.

If you or members of the Committee would like to discuss our response do not hesitate to contact me on or Euan Robertson on .

Yours sincerely,

**David Cohen**
**Group Executive Group Corporate Affairs**
**Commonwealth Bank of Australia**

**1. Following the purchase of Bankwest on 19 December 2008, how many commercial loans went into default in the following 6 months because the period of the loan had expired and was not rolled over?**

As we have previously advised the Committee, 'reason for default' is not automatically stored in our systems. Providing a full response to this question would require a very large commitment of resources to identify and manually inspect files relating to customers in default seven years ago and would take considerable time.

Instead, in line with our approach to a previous question from the Committee, we have reviewed data for 36 Bankwest customers who have provided a submission or appeared before the Parliamentary Joint Committee in relation to this inquiry.

For these customers:

- 22 of the 36 were in default due to their facilities expiring;
- of these 22, in four cases the facility expired in the six months after 19 December 2008. Three were before this period and the remaining 15 were after this period;
- of the 22 customers, 16 were also in interest arrears prior to the expiry of their facilities;
- of the remaining six, other non-monetary defaults were evident in five of those cases;
- for the one case where the facility expired and no other defaults were evident, no receiver was appointed to the customer's business;
- of the 22 cases where facilities had expired, receivers were appointed in 18 of those cases; and
- in those 18 cases the average amount of time between the first default and the appointment of receivers was 385 days.

**2. In your opening statement to the public hearing on 2 December 2015, you stated that: "where possible, valuations should be prepared on the same basis going in as when an issue needs resolution in the event of a difficulty".**

**Can you explain under what circumstances this would be possible and wouldn't be possible?**

A number of circumstances could be different between a valuation at the time of loan origination and a valuation of a business in distress, leading to a different basis for a valuation.

For example:

- The circumstances of the business might be very different. A hotel might have gone from being fully operational to being in a state of disrepair; a pub might have disposed of all of its poker machines which formed the most profitable part of the business.
- In the case of property development, the loan origination valuation would be on an "as if complete" basis (i.e. the expected value of the property once constructed and finished). When selling an incomplete property, that same valuation is irrelevant because no prospective purchaser would pay an "as if complete" price. Instead the incomplete property is valued "as is".

**3. You also state "where we are the sole lender on a business loan, customers should be provided with a copy of a valuation they have paid for, so that both parties have all the facts on the table in a time of financial stress".**

**Can you explain to the committee why this could not apply in circumstances when you aren't the sole lender?**

In our opening statement we did not intend to imply that this arrangement could not apply in circumstances where we are not the sole lender, only that we cannot make commitments on behalf of other lenders.

It is common, particularly in larger corporate loans, for a number of financial institutions to form a syndicate of lenders.

If Commonwealth Bank is only one of a syndicate of lenders, particularly a minority provider of debt, then it is not possible for us to make commitments about providing a copy of valuations on behalf of those other lenders, whose consent may also be required.

**4. Your opening statement of 2 December 2016 noted that higher interest rates can be applied when a loan is in default. Can you advise how default interest rates are determined and provide some indicative scenarios that demonstrate what the normal and default interest rates may be under current market conditions?**

There are a number of additional risks and costs that arise in relation to a loan which is in default relative to a loan that is being appropriately serviced.

Examples of additional costs include:

- **Cost of capital:** the amount of capital that APRA requires a financial institution to hold for a customer that is in default is in general higher than one who is not in default.
- **Collective provisioning costs:** when a customer's credit grade deteriorates, this may increase the amount of collective provisions a financial institution is required to hold. This directly impacts the financial institution's profit and loss.
- **Account management costs:** customers in default require additional management, communication and oversight and this is a direct driver of additional cost.

While the precise flow through of these costs to default interest rates has varied over time, the current Commonwealth Bank and Bankwest practice involves a rate 4.5 percentage points above the applicable reference rate.

Decisions around when to apply a default interest rate, and the amount of the rate, are made on a case by case basis. These decisions are informed by factors such as the type, severity and duration of default as well as the conduct and history of the customer with the bank.

In current market conditions, if a small to medium sized business is in default and if the bank chose to exercise its right, a default rate around 13 to 14 per cent might apply.

As we and other banks have stated, once a customer's financial position has deteriorated to the level where a receiver is appointed it is common that the value of the security does not cover the amount of the outstanding debt. For this reason, frequently a default interest rate, if applied, simply adds to the amount that the bank ultimately writes off.

Commonwealth Bank and Bankwest have no targets for default interest rate revenue. As we have stated previously, it is in the interests of banks for customers to service their loans, not to go into default.

**5. Would you please provide further details responding to evidence from Mr Colin Power, including:**

a. **Information from the receivers regarding the steps and processes followed for the sale of the properties and businesses, setting out how the requirements of section 420A of the Corporations Act were met; and**
b. **Information on the involvement of Mr McFarlane and allegations that Mr McFarlane was both a valuer and a purchaser of one of Mr Power's properties.**

It is the responsibility of the receiver to meet the requirements of Section 420A of the Corporations Act so we have referred this question to Grant Thornton, the receiver in question, who will respond directly to the Committee.

However, to assist the Committee, we wish to correct a number of important elements where Mr Power's testimony is inaccurate.

**The Financial Performance of Mr Power's Businesses**

Mr Power makes various references in his own testimony to "things were tough" and "we were sweating because when that global financial crisis hit it was tough".

Mr Power said of the Imperial Hotel that it "slipped by 30 per cent. It had taken a $55,000 turnover back to $35,000 per week".

Our records also show that the New Royal Hotel's profit in 2009 was some $250,000 (around 45 per cent) lower than in 2007 when it was $557,000, largely due to reduced bar takings (gross profit was down $170,000) and higher expenses (wages were up $65,000).

The reduced sale price for these businesses is in part due to the deteriorating financial performance of the businesses while Mr Power was the licensee, as well as reduced demand for such businesses during and after the financial crisis.

**Mr Power's Record of Meeting his Loan Obligations**

Mr Power consistently missed interest repayments, was in arrears by over $90,000 and breached a range of loan covenants.

For the Imperial Hotel, loan payments were first missed in May 2008, and until December 2008 the monthly payments were consistently late. Between January 2009 and August 2009 the nominated account was constantly overdrawn, although was brought up to date for one day in September 2009. When receivers were appointed on 26 July 2010 arrears had increased to around $77,000.

The New Royal Hotel's arrears emerged in March 2010 when a quarterly payment of $11,500 was missed. By July 2010 arrears were around $15,000.

Mr Power also breached a range of loan covenants, including interest cover ratio, debt service cover ratio and minimum EBITDA. Mr Power was also in arrears on payments to the Australian Taxation Office.

**Bankwest's Willingness to Work with Mr Power**

Mr Power was granted a period from late 2008 to April 2010 to improve trading and demonstrate that the businesses could sustainably support the loans. The interest rate was not increased despite the increased level of risk resulting from deteriorating trading performance.

Bankwest ultimately wrote off $4.6 million in relation to these loans.

**The Appointment of an Investigative Accountant**

Mr Power claims that the appointed Investigative Accountants were “students” who had “no idea about pub arithmetic”.

Professional staff of the Investigative Accountant were qualified accountants, and included a partner who met with Mr Power at the hotel and inspected the financial records. The financial records were of a poor standard and were based on manually entered Excel schedules. Given the poor quality of the accounts, the Investigative Accountant recommended a bookkeeper be engaged.

**The Sale of the New Royal Hotel**

The receivers sold the hotels previously owned by Mr Power in mid-2011. Hotels were offered by tender, which included four to five week advertising programmes in national, state and regional newspapers as well as internet and direct marketing. Each hotel was sold to the highest bidder.

The New Royal Hotel was purchased by Mr Bruce McFarlane. Mr McFarlane had previously valued the hotel in 2007 and 2009 as a director of Landmark White. However Mr McFarlane did not value the properties for the receivers, nor was a loan to value ratio breach relied upon to appoint receivers.

Mr Power claims that the purchase of the New Royal Hotel by Mr McFarlane was a breach of Section 420A of the Corporations Act. Instead, given that Mr McFarlane was the highest bidder, the receiver may have breached Section 420A if it had refused to sell to Mr McFarlane.

**Other Relevant Information**

The receiver did not charge fees of over $3 million as Mr Power claims. Receivership costs were $1.1m. We note that the two hotels were in different States and were in receivership for 9 months and 11 months respectively.

Mr Power’s behaviour towards Bankwest staff and the receiver has been consistently poor, including threats of physical violence (written and audio records of these threats are available upon request).

Mr Power is also believed to have removed most of the stock from the Imperial Hotel following the appointment of receivers, thus adding to the cost of receivership and further damaging trading performance.