



PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Inquiry into impairment of customer loans – questions on notice

1. In your evidence in Sydney on 18 November 2015, you stated that you complete annual reviews of business loans to make sure they are ok.
 - a. How many clients are involved in this process?

All commercial banking customers are subject to a periodic review. The timing for that review depends on the size and nature of the customers lending arrangements. For example, the review may occur monthly, quarterly, half yearly or annually.

SME customers are reviewed using automated behavioural triggers such as transaction and repayment behaviour.

- b. How many staff are allocated to the process?

All Account Managers and Credit Officers in Commercial Banking are involved in the review process for customers they manage. The level of involvement will vary with the nature and frequency of that review.

- c. How do you make sure individuals who have loans at risk are not slipping through this process?

Commercial loans 'at risk' are monitored via various diary systems and automated account control reports that ensure required reviews are completed or accounts outside arrangements are reported.

Activities in this regards are generally undertaken by Account Managers with independent review by Credit Officers and a Credit Control unit which ensures customers at risk are not overlooked.

SME customers are reviewed using automated behavioural triggers such as transaction and repayment behaviour. There are specific responses for these behavioural triggers e.g. letters and outbound collections phone calls. If financial hardship is identified by the Account Management Centre (AMC), a warm referral is made to our specialist hardship Assist team. If an SME customer is relationship managed, the AMC will advise the relevant local business banker (relationship manager) of any concerns and potentially involved in developing assistance mechanisms e.g. restructuring debt, changes to repayments, etc.

2. When valuations and revaluations are sought does the bank use registered certified property valuers?

The bank does not have internal valuers. All valuers are independent external valuers.

We have a panel of external valuers that provide an independent view of the value of properties, in accordance with the bank's valuation instructions and valuation standards.

This includes compliance with the Australian Property Institute (API) Valuation Practice Standard and the API Mortgage Security Valuation Practice Standard.

In appointing a valuer for a particular property the bank would take into consideration location, type and value and seek to match with a valuer who has experience in this type of property and is accredited for this location and value.

3. Where the committee has received submissions relating to Westpac matters, could you advise the committee if the valuers used by the bank in those cases were registered certified valuers?

As noted previously, our panel of external valuers are required to comply with the Australian Property Institute (API) Valuation Practice Standard and the API Mortgage Security Valuation Practice Standard.

Our review of the submissions received by the Committee referring to Westpac, indicates that the valuers utilised in each matter would have been one of our approved panel valuers. The eligibility requirements to be included on the Bank's panel are as follows:

- Signed a Commercial Mortgage Valuation Services Agreement with the Bank;
- Use qualified valuers that are members of the Australian property Institute (API) or Royal Institute of Chartered Surveyors;
- Satisfied the Bank that it has appropriate Quality Assurance (QA) processes in place;
- Provided evidence of an acceptable and current Professional Indemnity (PI) Insurance policy;
- Satisfied the Bank's enquiries in respect of a company search on www.austlii.edu.au (reported court decisions in Australia) for any PI claim issue; and
- Provided a Certificate of Registration of Business Name or Certificate of Incorporation.

In relation to commercial property, it is Westpac's general practice not to accept or use valuations prepared by valuers that do not meet the minimum standards that Westpac requires.

Instructions to valuers are given via a standardised template and process to ensure consistency. The firm must only use valuers who have the required experience in the asset class and geography. A regular review of valuers' performance is also undertaken.

4. What are the incentive structures that apply:

- a. for staff who set up loans; and

From 2010 onwards, reward arrangements across the Group have been designed and managed in line with the Westpac Group Remuneration Policy and the Group Variable Reward (VR) Plan Rules. This provides a consistent framework and broad management discretion to ensure, amongst other matters, that variable remuneration appropriately takes accounts of risk management considerations and continues to support the financial soundness of the Group and its entities. Prior to 2010, similar management discretion provisions were included in each divisional plan.

Relationship managers have a target VR opportunity reflective of market practice. VR outcomes are informed by the achievement of agreed financial and non-financial targets as set out in a balanced scorecard. All relationship managers are required to meet minimum standards on compliance, risk, performance and behaviours (in line with our values) to be eligible to participate in VR.

A review suggests there were no special incentive arrangements for relationship managers during the period in question.

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

Westpac staff are trained to operate within the bounds of our Customer Charter, our internal Code of Conduct and the Code of Banking Practice. Credit managers are incentivised to rehabilitate files for return to the front line.

The staff performance appraisals include objectives with a zero tolerance for substantiated customer complaints and also a Behavioural Assessment in terms of acting with integrity in the best interest of both the customer and the bank.

5. What incentive structures applied since 30 June 2008, including any special arrangements that may have occurred at particular times, such as during the GFC or following acquisitions of other banks?

There have been no special incentive structures during particular times. The incentives for staff dealing with distressed loans have been, and remain, discretionary and focused on quality of work and portfolio management coupled with the behavioural assessments.

6. Please provide information on the extent to which receivers are seconded into banks to work with distressed, defaulted or impaired loans.

- a. Please also set out the arrangements for ensuring that there are no conflicts of interest in the appointment of investigating accountants and receivers.

In the Westpac Group it is not common or normal practice to second insolvency practitioners to deal with distressed loans. It has happened on isolated occasions, for example, during the early nineties when the Bank found itself with insufficient staff with the appropriate skills to deal with the volume of matters. However, the arrangement with the respective firm from where the practitioner would be drawn as follows:

- The secondee may not decision or be directly involved in any communication for matters that involve their firm;
- The secondee must sign a customer confidentiality agreement;
- The secondee must complete the mandatory training and accreditation which deals with Code of Conduct and Conflict of interest; and
- Appointment of Receivers is made by a credit officer on an arms-length basis in terms of the Banks credit authority requirements.

Secondments in recent years have mainly been for junior development reasons in support roles as opposed to directly dealing with distressed loans.

- b. Please provide information on the number of occasions in w the above arrangements have been breached and what consequences were applied to those responsible.

There have been no known breaches of these requirements which are supervised at a senior level.

7. Could you explain to the committee the different methods that are used to value properties and whether Westpac gives any direction to valuers on which method to use.

The bank requires the valuer to indicate the basis upon which the Valuation has been assessed. Selection of the method of Valuation is generally the responsibility of the Valuer, however typically it would be envisaged that at least two (2) methods would be needed to be adopted.

The bank requires details of all valuation calculations (ie. actual and / or estimated rentals, itemised property expenses, capitalisation rate, rent reversions and letting up / rent incentives) which result in the assessed value.

Valuations methodologies are generally based on the available market evidence and using one or more of the following methods as appropriate:

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- Sales Comparison Approach, which includes direct comparison on a unit basis or the summation approach
 - Income Capitalisation Approach
 - Discounted Cash Flow

A sensitivity analysis of the value based on the major variables is also normally required.

8. Where Westpac requires a property used as security to be revalued and the borrower is required to pay for the valuation:
 - a. could a copy of the valuation and the bank's instructions to the valuer be provided to the borrower?

The Westpac Group's current policy is that we generally do not provide the valuation to our customers. However, we will provide the valuation on occasions upon request for specific purposes, provided there is agreement that the valuation has been provided for the Bank's purposes.

It is common that there is a reasonable level of information exchange between the Bank and the customer in regards to valuations, and in some instances the customers gets full access to the valuation.

- b. what review processes are available to the borrower if they disagree with the valuation?

In its review of the valuations received, if the Bank believes there has been an obvious omission in the valuation it would correspond with the valuer to address the issue.

On occasions customers may disagree with a valuation. In these instances, there is likely to be a reasonable level of information exchange between the Bank and the customer in regards to the valuation. For example, in the event of a dispute, the relationship manager and property risk manager will normally meet with the customer to seek to resolve the dispute.

If a difference in view still exists, it is likely the customer(s) would get full access to the valuation. Should disagreement continue to occur, an additional valuation could be sought from another panel valuer. In some cases, the bank has paid for this alternate valuation.

If a company is in Receivership, the Receiver is the agent of the company and the directors do not have any standing to require copies of the valuations of company owned property assets. For third party security e.g. provided by directors to support guarantees, the bank

could provide a copy but it would need to have the agreement of the valuer and be qualified given that it has been prepared under Bank instructions and for Bank purposes.

9. In situations where Westpac appoints an investigative accountant, what guidelines or rules does Westpac have regarding receivers that may subsequently be appointed? For example, to avoid conflicts of interest, are there any requirements that the investigative accountant cannot be appointed as a receiver?

A conflict of interest cannot be automatically assumed from an investigative accountant subsequently being appointed as a receiver. For example:

- An investigative accountant is usually appointed to ascertain information so the Bank can make better informed decisions about a distressed loan. As noted in our submission, in most instances, workout and rehabilitation is our priority. Receivership tends to diminish value so it is not in the Bank's commercial interest to allow this to happen without exploring all other options first.
- Westpac uses insolvency firms with the highest integrity which are aligned to the Group's own values.
- Westpac employs experienced workout specialists who scrutinise the scope and work of the investigative accountant and then obtain arms-length approval.
- The reports of the investigative accountant are provided to the customer to validate the information.
- It is common for the investigative accountant to be retained by the Bank, with the cooperation of the customer, to overview the implementation of the turn-around plan.
- Appointment of a Receiver will require the approval of an arms-length credit authority.

If all other options have been explored and an appointment is to be made, the appointment of a different practitioner would incur substantial additional cost and time, given the expansive knowledge that an investigative accountant would have gained.

10. The Code Compliance Monitoring Committee informed this committee that the Banking Code of Practice does not include any requirements regarding revaluations or impairment. Would it be possible for the Code of Banking Practice to include revaluation and impairment in future?

The Westpac Group notes that 'impairment' is not correct terminology. We will therefore consider the Committee's suggestion in light of 'valuations' and 'defaults'.

Internal and external dispute resolution processes referred to in the Code already enable independent external oversight of the processes in relation to default, including limitations on enforcement once a matter has been referred to FOS. We therefore do not believe it is necessary for further enhancements to be made by the Code with additional oversight by the CCMC.

The valuer's role involves the preparation of a valuation report containing the valuers opinions as to the Current Market Value of the Property in accordance with the Bank's Valuation Standard. The bank relies on these independent valuations for mortgage security purposes. It is therefore appropriate that banks continue to manage relationships with valuers directly, in line with valuation standards and the requirements set out under contractual law, rather than the Code of Banking Practice.

11. In its submission (page 4) NAB noted that 'Categorising a loan as 'impaired' has implications, including, the requirement for an ADI to hold a greater proportion of its capital against the loan, which ultimately adds to the cost of the ADI holding such loans'.

a. Could that create an incentive for banks to avoid impairing loans?

Although there may appear to be an incentive to hold less capital or provision from not impairing loans there would ultimately be a greater penalty in breaching prudential and accounting standards.

b. What mechanisms are there in place to ensure that banks do not avoid impairing loans in order to avoid the increased costs associated with holding extra capital?

Compliance with prudential requirements requires the Westpac Group to recognise, measure and report on, and provision for, impaired facilities.

Controls and governance are in place to ensure that these requirements are met including internal and external audit and strong prudential supervision from APRA.

A Credit Officer who is independent of the first line banker managing the loan approves all credit decisions within their lending authority including Credit Risk Grade and holding provisions.

12. In its submission (page 4) NAB indicated that 'If enforcement of non-monetary defaults was somehow restricted, it may impact the provision of funding and may have unintended commercial consequences, in the above circumstances'.

- a. Could you provide further information to the committee on the impact on the provision of funding and unintended commercial consequences?

Both financial and non-financial covenants are key in enabling the management and mitigation of the risks associated with extending credit facilities. Non-financial covenants, such as the provision of financial statements and management accounts, provide valuable and transparent information to the lender about how a business is performing on an ongoing basis. This is particularly important where the customer is required to make limited scheduled repayments, for example, asset based finance.

The breach of a financial covenant does not necessarily lead to an immediate acceleration of the loan and commencement of enforcement action to realise security. Rather, a review of the customer's financial position and consideration of other appropriate options would be a common response.

The Westpac Group submits that while financial covenants are often not the sole basis for accelerating a loan and proceeding to enforcement, they are an important and appropriate element of business credit contracts.

Breaches of covenants are a key indicator of financial distress and potential increases in the risks associated with extending facilities to a customer. This enables the Westpac Group to review its position, engage with the customer at an early stage to identify the cause of the deterioration, assess the impact this may have on the customer's ability to repay its loans and to implement a plan to resolve any issues and restore financial viability. This process can assist the customer to avoid monetary defaults. Such mechanisms are therefore prudent for both the Westpac Group and for the customer.

If covenants could not be applied the risks associated with extending facilities would increase, particularly for unsecured lending. This would impact lending appetite, including a re-assessment of the level of facilities we would be prepared to extend and the terms on which those facilities were extended. For example:

- Appetite to extend unsecured credit to customers would reduce, resulting in smaller facilities;
- Additional security coverage required;
- Increased requirement for facilities to be amortising; and
- Increase in interest expense and associated charges to compensate for the increased risk.

All of the above may adversely impact a customer's ability to successfully pursue its business strategy. We therefore do not consider that restrictions should be placed on the use of covenants in credit contracts.

13. How precise are the accounting standards that define whether or not a loan is impaired?

Compliance with prudential requirements requires the Westpac Group to recognise, measure and report on, and provision for, impaired facilities.

It is important to note that a loan is not automatically considered as 'impaired' if a customer has defaulted under the terms of their contract. Rather, impaired assets are formally defined under APS 220 as those exposures that have deteriorated to the point where full collection of interest and principal is in doubt, based on an assessment of the customer's outlook, cash flow, and the net realisation of value of assets to which recourse is held (i.e. the ability for full collection of interest and principal is in doubt). The decision of an ADI to categorise a loan as impaired does not impact the principal amount the customer owes.

The accounting standard, AASB 139 paragraph 59, states "A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated".

The accounting standard also provides examples of types of objective evidence that could lead to impairment for financial asset or group of assets.

Where Westpac has identified a set of loans that it considers to be impaired, are those accounts audited by an external auditor, and did the auditor recommend any variations to the impairment provisions?

PricewaterhouseCoopers is the external auditor of the Bank and they opine that the Annual Report is not materially misstated and provides a true and fair view. The impairment provision balance is included in their audit work. PWC did not recommend any variations to the impairment provisions.

14. Would Westpac support mandated notice periods?

Westpac does not support prescribed notice periods for commercial loans, due to the complex nature of commercial lending. However, we would engage in a consultation on the codification of minimum notice periods for enforcement action in relation to small business. This would require:

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- 1) Confirmation of the definition of 'small business'
- 2) Clarification of the definition of notice periods to be prescribed and taking into account the type of security and the respective risks of a resultant loss by a delay in enforcement

For example, existing forms of notice include:

- Default notice - notice that there has been a default and prescribing a period to remedy that default or reserving our rights if we plan to take no action;
- Enforcement notice - Prescribing the period after the default has not been remedied and when we plan to enforce our security.