The Senate

# Economics References Committee

## The post-GFC banking sector

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# Senate Economics References Committee

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# Abbreviations

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| ABA | Australian Bankers' Association |
| Abacus | Abacus-Australian Mutuals |
| ACCC | Australian Competition and Consumer Commission |
| ADI | Authorised deposit-taking institution (i.e. a bank, building society or credit union) |
| AFMA | Australian Financial Markets Association |
| AGAAP | Australian generally accepted accounting principles |
| AIFRS | Australian equivalents of the International Financial Reporting Standards |
| ANZ | Australia and New Zealand Banking Group Limited |
| AOFM | Australian Office of Financial Management |
| APRA | Australian Prudential Regulation Authority |
| ASF | Australian Securitisation Forum |
| ASIC | Australian Securities and Investments Commission |
| ASIC Act | *Australian Securities and Investments Commission Act 2001* (Cth) |
| ASX | Australian Securities Exchange |
| ATO | Australian Taxation Office |
| Basel Committee | Basel Committee on Banking Supervision |
| BBSW | Bank Bill Swap Reference Rate |
| BBSY | Bank Bill Swap Bid Rate |
| BCBS | see Basel Committee |
| CBA | Commonwealth Bank of Australia |
| CEO | Chief Executive Officer |

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|---|---|
| CMB | Canada Mortgage Bond |
| CMHC | Canada Mortgage and Housing Corporation |
| Corporations Act | *Corporations Act 2001* (Cth) |
| CSLF | Committed secured liquidity facility |
| CUBS | Credit unions and building societies |
| Dodd-Frank | *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (Pub. L. 111-203, 124 Stat. 1376) (US) |
| ECB | European Central Bank |
| EDR | External dispute resolution |
| EU | European Union |
| FATCA | *Foreign Account Tax Compliance Act of 2010*: subtitle A of title V of the *Hiring Incentives to Restore Employment (HIRE) Act of 2010* (Pub. L. 111-147, 124 Stat. 71) (US) |
| FOS | Financial Ombudsman Service |
| G8 | Group of Eight |
| G20 | Group of Twenty |
| GDP | Gross domestic product |
| GFC | Global financial crisis |
| GST | Goods and services tax |
| HHI | Herfindahl–Hirschman Index |
| IMF | International Monetary Fund |
| LCR | Liquidity coverage ratio |
| Libor | London inter-bank offer rate |
| LVR | Loan-to-valuation ratio |
| MFAA | Mortgage and Finance Association of Australia |
| NAB | National Australia Bank Limited |

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| National Housing Act | *National Housing Act*, R.S.C., 1985, c. N-11 (Canada) |
| NCCP Act | *National Consumer Credit Protection Act 2009* (Cth) |
| NHAMBS | National Housing Act Mortgage-Backed Securities |
| NIM | Net interest margin |
| NOHC | Non-operating holding company |
| NSFR | Net stable funding ratio |
| RBA | Reserve Bank of Australia |
| RICS | Royal Institution of Chartered Surveyors |
| RMBS | Residential mortgage-backed securities |
| ROE | Return on equity |
| RWA | Risk-weighted assets |
| SME | Small and medium-sized enterprises |
| UK | United Kingdom of Great Britain and Northern Ireland |
| US | United States of America |
| WBC | Westpac Banking Corporation |

# Glossary

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| Additional tier 1 capital | Components of capital that are not included in common equity tier 1 capital but nonetheless are high-quality. |
| Asset-backed security | See securitisation. |
| Basel I | *International convergence of capital measurement and capital standards* (Basel Capital Accord); a 1988 agreement between the central banks of G10 countries that applied common minimum capital standards to participating banking sectors. Replaced by Basel II. |
| Basel II | The 2004 agreement *International convergence of capital measurement and capital standards: a revised framework* which replaced Basel I and introduced a more risk-sensitive framework based on three pillars (see pillar 1, pillar 2 and pillar 3). Basel II came into effect in Australia on 1 January 2008. |
| Basel 2.5 | Amendments to Basel II that were finalised in July 2009 and commenced at the end of 2011. Basel 2.5 was focused on the better management of resecuritisation exposure, introduced higher risk weightings for securitisation exposures and other measures to strengthen pillars 2 and 3. |
| Basel III | Revised global banking regulatory standards published in 2010 and developed in response to the global financial crisis. It builds on the Basel II framework and is comprised of measures intended to increase the quality and quantity of capital held by banks, as well as introducing a framework for liquidity risk measurement, standards and monitoring. |
| Basel Committee on Banking Supervision | A committee comprised of the banking regulators of 27 countries based in Basel, Switzerland. The committee aims to improve the quality of banking supervision worldwide and develops guidelines and supervisory standards to achieve this, such as Basel III. |
| Bullet bond | A debt instrument where the entire face value is paid at once on the maturity date—i.e. it cannot be redeemed prior to maturity. |
| Capital | Equity and debt instruments held by a bank to provide a buffer against unexpected losses. See regulatory capital. |

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| Capital adequacy ratio | Minimum prudential capital requirements expressed as a percentage of total risk-weighted assets (RWA). Under Basel III, capital ratios will be in place for common equity tier 1 capital, tier 1 capital and total capital. |

$$\text{Common equity tier 1 ratio} = \frac{\text{Common equity tier 1 capital}}{\text{Total RWA}}$$

$$\text{Tier 1 capital ratio} = \frac{\text{Tier 1 capital}}{\text{Total RWA}}$$

$$\text{Total capital ratio} = \frac{\text{Tier 1} + \text{Tier 2 capital}}{\text{Total RWA}}$$

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| Capital conservation buffer | Basel III requires that outside of periods of stress, banks will need to hold a capital conservation buffer of 2.5 per cent (of common equity tier 1) to withstand future periods of stress. If the capital levels of a bank fall into the buffer range, capital distribution constraints will be imposed (such as restrictions on the payment of dividends, share buybacks and discretionary bonus payments to staff) that increase in severity as the buffer reduces. |
| Common equity tier 1 capital | Comprised of the highest quality components of capital that includes, among other things, paid-up ordinary shares issued by an ADI, retained earnings, undistributed current year earnings and other disclosed reserves. |
| Competition Inquiry | Senate Economics References Committee's inquiry into competition within the Australian banking sector (2011). |
| Countercyclical buffer | Under Basel III, regulators will be able to require banks to hold additional common equity tier 1 capital of between zero and 2.5 per cent of total risk-weighted assets when excess aggregate credit growth is judged to be associated with an unacceptable build-up of system-wide risk, such as when credit growth is occurring at a rate which, historically, financial system stability has been undermined. |
| Counterparty credit risk | A type of credit risk which applies to a bank's trading book activities (e.g. interest rate swaps, foreign exchange swaps and credit derivatives). It is the risk that the counterparty does not meet their obligations, usually because of financial distress. |

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| Covered bond | An instrument issued by an ADI where, in the event that the issuing ADI defaults on its payment to the bondholder, the bondholder may recoup their investment either from the issuing ADI or through a preferential claim on a specified pool of high quality assets. |
| Credit risk | The risk that a counterparty will not settle an obligation for full value, either when due or thereafter. |
| Derivative | A security whose value is dependent upon or derived from one or more assets or a market index. |
| Henry Review | Australia's Future Tax System Review (2009), chaired by Dr Ken Henry AC. |
| Impaired asset | In accounting, an asset is described as impaired (and the company recognises an impairment loss) if its carrying amount exceeds the amount to be recovered through use or sale of the asset. |
| Interest rate swap | An agreement between two parties to exchange fixed and variable interest rate payments on a notional principal amount over an agreed period of time. |
| Johnson Report | The 2009 report of the Australian Financial Centre Forum, *Australia as a financial centre: Building on our strengths*, chaired by Mr Mark Johnson. |
| Leverage ratio | A minimum ratio of tier 1 capital to total exposure required under Basel III. |
| Liquidity coverage ratio | A requirement under Basel III for banks to have sufficient high-quality liquid assets to withstand a stressed funding scenario that is specified by the regulator (based on the stock of high quality liquid assets and the capacity of these assets to cover expected cash outflows over the 30 day scenario). |
| London interbank offer rate | A rate that indicates the cost of unsecured borrowing in the London interbank market. It is used as a benchmark globally for short term interest rates. |
| Low-doc loan | A loan that requires less financial documentation than that required for other loans. Primarily for borrowers who do not meet the standard loan application criteria, such as the self-employed and other borrowers whose income could not be readily verified. |

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| Market risk | The risk of loss owing to changes in the general level of market prices or interest rates. |
| Market value | Often defined as the price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller acting at arm's length. For property valuations, it is the estimated amount for which an asset should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion (*International Valuation Standards 2011*). |
| Net stable funding ratio | A longer-term structural ratio under Basel III intended to encourage banks to use stable funding sources (i.e. reduce their dependency on short-term wholesale funding). |
| Non-performing asset | From a lender's perspective, a debt obligation where the borrower has not been making any previously agreed repayments (principal or interest) for an extended period of time. |
| Operational risk | The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. It includes legal risk, but excludes strategic and reputational risk. |
| Pillar 1 | The measures contained in Basel II and III that relate to the core amount of capital that banks are required to hold against credit risk, operational risk and market risk. |
| Pillar 2 | The principles in Basel II and III for supervisory review of banks' internal assessments of the risks in their business. |
| Pillar 3 | The measures contained in Basel II and III intended to encourage greater market discipline by improving the degree of transparency in banks' public reporting. |
| Price-to-book ratio | A measure which compares a firm's share market value to its book value. |
| Regulatory capital | Total amount of capital determined by regulators that an ADI must hold for a certain level of risk-weighted assets. It consists of tier 1 and tier 2 capital. In Australia, it is imposed by prudential standards made by APRA. |
| Repo | See repurchase agreement. |

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| Repurchase agreement | Often referred to as repos. They involve the sale or purchase of securities with a commitment to reverse the transaction at an agreed date in the future and at an agreed price. The RBA uses repos to conduct its domestic market operations (i.e. to ensure that the actual cash rate is close to the target cash rate). |
| Residential mortgage-backed securities | A type of security backed by a pool of residential mortgages. See securitisation. |
| Risk-weighted assets | Measure of a bank's assets in terms of risk that is used to calculate required regulatory capital. Assets that are considered to be riskier are given a higher weighting. |
| Securitisation | Securitisation involves bundling illiquid assets and converting them into a package of securities that can be issued into the capital markets. The cash flow from the securitised exposures is used to service obligations to different tranches of creditors where one class of creditors is entitled to receive payments from the pool before other subordinated creditors. |
| Tier 1 capital | Core capital, such as ordinary shares and retained earnings; intended to be capable of absorbing losses while the ADI continues to operate. It is comprised of common equity tier 1 capital and additional tier 1 capital. |
| Tier 2 capital | Supplementary components of capital that do not qualify as tier 1 but nonetheless contribute to the overall ability of an ADI to absorb losses. Tier 2 capital includes subordinate debt and preference shares. |
| Tier 3 capital | A capital tier allowed under Basel I and II (although not recognised by APRA) but abolished by Basel III. It included instruments that cover some market risks, such as foreign currency and commodities risk. |
| Volcker rule | Section 619 of the US Dodd-Frank Act. Will prevent banks that take retail deposits that are federally insured in the US from: (a) engaging in proprietary trading that is not directly related to the market making and trading they do for customers; and (b) owning or sponsoring hedge funds or private equity funds. |
| Wallis Inquiry | The 1997 Financial System Inquiry, chaired by Mr Stan Wallis. |

# Executive summary

Australia's banks weathered the turbulent events that shook the international financial system in 2007 and 2008 relatively well. While the Australian government did have to act during the global financial crisis to shore up the sector and crisis-related acquisitions took place which have left the sector more concentrated, lending continued and the government did not have to take an ownership stake in any financial institution. Today, Australia's financial sector continues to demonstrate its resilience in the face of ongoing uncertainty in international markets.

Much has already been written about the impact of the crisis on Australia. This inquiry differs from others in that it examines the state of the sector a number of years after the key events of the crisis. This allows the developments that have proven more sustained to be identified and examined. The major international regulatory response to the crisis, which will further change how Australian banks operate, is also examined. The committee has made a number of recommendations that it considers will facilitate the further strengthening of the sector and, more immediately, will address some consequences arising from the imbalances that exist in the relationship between certain borrowers and banks.

***An independent inquiry is needed***

The key finding of the committee is that an independent, well-resourced and comprehensive inquiry into the Australian financial system is required. It has been fifteen years since the previous such inquiry reported (the 1997 Financial System Inquiry, better known as the Wallis Inquiry). While the onset and ramifications of the global financial crisis provided an argument for a new inquiry to be postponed, this argument is now less compelling. The shape of the future international regulatory environment is becoming clearer with the Basel III reforms agreed to and being implemented in Australia from 2013 onwards. The overall stability of Australia's banking system compared to other economies has been demonstrated, but has the impact of the crisis and the emphasis on stability weakened competition in the sector and limited the benefits that strong competition provides for consumers? While Australia avoided the worst of the crisis, this should not be allowed to result in complacency about the structure and performance of our financial system. There is now an opportunity to conduct a comprehensive examination of the banking sector and to debate what the post-crisis sector should look like and whether it is delivering what Australians want from it.

The crisis demonstrated the volatility of the international debt markets to which Australian banks remain significantly exposed. In response to this unstable environment, Australian banks have shifted away from short-term wholesale funds towards more reliable, but more expensive, long-term wholesale debt. A key feature of the new funding mix is that Australian banks are seeking to obtain greater amounts of term deposits. Competition among banks to attract these more stable funds has noticeably intensified since the crisis, increasing the interest rates banks have to offer depositors, relative to the cash rate, and therefore the cost of these funds. While this is a welcome development for deposit holders, the sustainability of it and the implications for competition in the sector need further consideration. Further, there is a clear disconnect between Australia's growing pool of superannuation savings and the significant amounts of funds that banks need to raise in offshore markets. Whether there are policies that can encourage greater interaction between the banks and superannuation funds, in a way that is viable and in the interests of both sectors, also warrants examination by an independent inquiry.

***The implementation of Basel III in Australia***

Important changes to how regulators require banks to be able to absorb shocks are underway. These changes are driven by Basel III, the latest iteration of international standards on capital adequacy and banking supervision and the major international regulatory response to the global financial crisis. This inquiry facilitated a constructive public discussion about these technical changes and how they will be implemented domestically by the Australian Prudential Regulation Authority (APRA).

The committee supports APRA's overall approach to Basel III at this stage. Assuming the reforms are widely implemented internationally, and the committee acknowledges that Australia is ahead of many other countries in this regard, they will improve the stability of the international banking sector and will address some of the issues evident from the global financial crisis. Australian banks are well-placed to comply with the capital requirements of Basel III within the timeframe being followed by APRA. Some of the liquidity requirements under Basel III may be more challenging for Australian banks to comply with; however, the banks will have to work towards this. Being just one component of the global banking system, coupled with the need for Australian banks to raise funds offshore, it is clear that Australia cannot deviate significantly from what other international financial centres are doing. Any significant changes to Basel III will occur at an international level and the implications for Australia will have to be considered at that time.

The committee does consider that APRA could be more proactive in some areas. A particular issue is that Australian banks may appear less capitalised than their peers as a result of the different regulatory capital calculations that APRA requires. While the banks have a role in explaining this difference to international investors themselves, and the standardised reporting template developed by the Basel Committee may also assist, in the meantime APRA should facilitate the publication of headline capital ratios that are calculated according to the Basel Committee's standard requirements. The committee also encourages APRA to look at other ways that it could improve the understanding internationally of the Australian banking sector's underlying strength to ensure that Australians receive the full benefits of this.

There are some additional issues that have been identified. Given the increasing prevalence of internet-based accounts and the apparent differences between how

APRA proposes to treat these accounts for liquidity purposes compared to the treatment applied by regulators in other jurisdictions, the committee suggests that APRA reviews its approach in this area. Also, the committee recommends that APRA addresses the unique issues that Basel III may pose for mutual ADIs as a result of their corporate structure without further delay, and that it publishes a document which sets out how these problems have been addressed.

***Funding challenges and implications for stability and competition***

As a result of the disruption in international markets triggered by the crisis, banks reassessed the risks associated with their funding mix and have moved towards more stable sources of funds. Investors also reassessed the risk of banks globally and repriced the risk associated with wholesale bank debt. Consequently, there have been multiple upward pressures on the cost of funds since the crisis and it is likely that costs will remain elevated. Banks continue to adjust to higher post-crisis funding costs as they compete for available deposits and rollover longer-dated wholesale funds obtained at lower pre-crisis prices. However, the overall increase in costs appears to have stabilised recently (although developments in Europe provide ongoing uncertainty).

The independent inquiry referred to above would consider the consequences of these developments. In the interim, steps can be taken to address policy inconsistencies that distort behaviour in the marketplace and which may impact the stability of the banking system and the ability of smaller financial institutions to compete with the major banks. Two issues examined by the Henry Review remain particularly relevant. First, the taxation of interest earned from deposits held in ADIs differs unfavourably to the taxation arrangements applied to various other methods of saving. These arrangements should be made more consistent to remove any distortions affecting saving decisions. In addition to these efficiency benefits, this would enable banks to compete more effectively for household savings helping ensure that lending activity can be funded when demand for credit increases and if other means of savings become more attractive. Second, the interest withholding tax that applies to financial institutions operating in Australia distorts funding decisions and is an impediment to foreign banks competing in the Australian banking sector. The tax burden may also be simply passed on to borrowers. Although removing the application of this tax to financial institutions creates a direct financial cost to the government, by providing an impetus for greater competition in the banking sector such a reform would have wider long-term benefits for the economy. Accordingly, the committee supports the removal of the application of interest withholding tax to financial institutions although it acknowledges that such action would need to be sensitive to the government's budget position.

An additional challenge for competition and funding mix diversity is the state of the securitisation market. Prior to the global financial crisis securitisation played a key role in supplying funds for smaller lenders. It therefore helped enable stronger competition in the sector. The securitisation market is recovering from the crisis with the support of the Australian Office of Financial Management's RMBS program, but the recovery could be further assisted if foreign currency bonds collateralised by Australian assets were again accepted by key foreign central banks in their repurchase agreements. This could strengthen investor demand and enhance the liquidity of Australian asset-backed securities. While this is a matter for the central banks concerned—the European Central Bank was put forward as an example—the Australian government could push for wider acceptance of Australian securitisation.

***Changes to lending practices and the attitudes of the banks***

The inquiry also examined the impact of the crisis on lending practices. As an overarching observation, the committee considers that the regular collection and publication of additional information about market developments could provide a useful and timely indication of the state of the lending market for regulators, policy makers, market participants and market observers. The committee notes that a senior officer loan survey is conducted by central banks in a number of other countries and recommends that the Reserve Bank of Australia conducts one in this country on a quarterly basis and publishes the results. The committee also recommends that, following the Australian Small Business Commissioner's appointment becoming effective, the Commissioner provides an annual report to the Senate on small business finance issues.

***The experiences of certain Bankwest small business customers since the crisis***

A particular focus of the inquiry was whether there have been any changes in the attitude of lenders to certain categories of borrowers and whether these borrowers were treated unfairly. Most of the evidence received by the committee was from aggrieved borrowers of Bankwest who alleged mistreatment by the bank after Bankwest was acquired by the Commonwealth Bank of Australia in 2008 at the height of the global financial crisis. The inquiry provided an opportunity to air grievances about particular actions of banks and to consider whether the regulatory settings governing lending by the financial sector are appropriate. It is, however, fundamentally important to recognise that this committee is not a court. Disputes between individual parties to a contract that cannot be resolved through other means need to be dealt with through the judicial process. The committee has accordingly reviewed the evidence from a broader, systemic perspective.

It is not automatically the case that a collection of disputes, even if they share certain characteristics, should trigger regulatory change that would impact entire groups of borrowers. While there are many sad and distressing stories now on the public record, the committee cannot help but observe that, in some cases, although the aggrieved borrower may have been able to operate successfully during periods when the business environment was relatively good, the more challenging times presented by the global financial crisis placed extra stress on less robust and more speculative projects. In many cases, loans were sought for ventures that were a considerable risk even during the more stable economic environment that existed prior to the global financial crisis. This of course does not apply to every case, nor does it excuse Bankwest—under its previous owners Bankwest was willing to enter into these loans. When its small business borrowers are experiencing difficulties, Bankwest has a duty to make genuine attempts to work with the borrower, to clearly explain what is happening and why, and to treat them with courtesy.

Nonetheless, while most dealings between small businesses and banks are not problematic from a regulatory perspective, the evidence received by this inquiry and previous inquiries indicates that there are still issues with current arrangements. Small business owners are busy individuals focused on the day-to-day operations of their business. They may not have the time or expertise needed to fully consider how certain actions, such as changes to facility terms, will impact them. Small businesses are also confronted with a significant imbalance in negotiating power with large financial institutions and face difficulties in seeking to have any disputes with these institutions considered.

The committee wishes to ensure that the regulatory settings in the financial sector relating to small business lending encourage entrepreneurial activity and allow sufficient flexibility for parties to enter into agreements that best suit the particular circumstances of the commercial operation. Rather than government intervention for small business finance, the committee considers that it would be preferable for the industry to commit to solving the evident problems. The committee calls on the Australian Bankers' Association (ABA) to meet with small business representatives to develop a code of practice specifically relating to lending to small businesses. At a minimum, the code should require:

- changes to facility terms to be accompanied by a document that clearly explains the changes to the borrower;
- any initial valuation reports associated with the purchase of a small business be relied on by the bank for a reasonable amount of time, such as for the first two years of the loan, unless a major defined shock or event occurs;
- borrowers to be automatically provided with copies of valuation reports that they have paid for or which the bank intends to rely on to demonstrate that the borrower is in default, and that all instructions given by banks to valuers be provided to the borrower on request;
- notices of demand from lenders to small business borrowers include a minimum deadline of 14 days for repayment, but that a further reasonable period of time should also be available to allow for the finalisation of necessary contracts if refinancing has been secured, or to allow negotiations to continue if an offer of finance is reasonably likely;
- banks to cooperate with any reasonable requests for information made by the borrower that would assist the borrower secure refinance; and
- default interest rates to be clearly specified in the facility terms, not linked to other documentation.

Failure by the ABA and the banks to develop an appropriate code of conduct for small business lending may strengthen the case for more prescriptive government regulation in this area. Given the arguments from the sector about the cost and burden of added regulation in general, the committee is of the view that if banks genuinely have these concerns they have both the obligation and opportunity to demonstrate that the sector takes concerns about small business finance issues seriously and is willing to proactively develop a stronger self-regulated solution.

The options available to small business owners for seeking redress is another area of concern to the committee. While the sector's external dispute resolution scheme, the Financial Ombudsman Service (FOS), may consider small business disputes there are a number of limitations on FOS which limit its relevance and effectiveness for these disputes. Accordingly, the committee recommends that the caps on the value of the claim and maximum compensation for small business disputes considered by FOS be increased to $2 million.

The committee also considers that there is a specific flaw in the current external dispute resolution framework as when a receiver is appointed by a secured creditor, FOS cannot review their actions or require them to stop enforcement action such as selling the company's assets. This is not to say that FOS should be required to review the conduct of receivers—a receivership is a fundamentally separate issue to the provision of a financial service—however, the current arrangements could be improved if borrowers have, and are aware of, the opportunity to seek a review of the substantive matters of a dispute by FOS before the lender takes enforcement action. Further to the committee's recommendation that notices of demand should include a reasonable minimum deadline for repayment, such a notice should also be required to include information about FOS.

The committee is also concerned about some outcomes that can arise once a receiver is appointed. While legislation is in place that imposes an obligation on receivers to take all reasonable care to sell properties of a company at market value or the best price that is reasonably obtainable, it is inherently difficult for borrowers to challenge such actions. The committee considers that when a business is placed in receivership, the receiver should be required to demonstrate to the borrower that they have considered every unconditional offer when exercising their power of sale in respect of a property. If the borrower can produce sufficient prima facie evidence that indicates that the sale process may not have been in accordance with section 420A of the *Corporations Act 2001*, the receiver should bear the burden of proof for demonstrating that they fulfilled their obligations. The committee also considers that further investigation of the challenges that small businesses face in pursuing review of actions taken by banks, receivers and other bodies is warranted.

# List of recommendations

**Recommendation 3.1**

**3.72 In light of the evidence that international observers are misinterpreting the level of capital held by Australian banks due to the Australian Prudential Regulation Authority's (APRA) requirements, the committee recommends that APRA:**

- **ensures it initiates consultation on the common disclosure template developed by the Basel Committee in early 2013;**
- **in the interim before the common disclosure template is adopted, facilitates the publication of headline capital ratios for Australian ADIs that are calculated according to the Basel Committee's standard methodology and are therefore easier to compare internationally; and**
- **be more active in promoting internationally that Australian banks are well-capitalised.**

**Recommendation 3.2**

**3.73 That APRA review its approach to how internet-based accounts should be treated under the Basel III liquidity requirements.**

**Recommendation 3.3**

**3.74 That APRA addresses, without further delay, the unique issues Basel III may pose for mutual ADIs as a result of their corporate structure and that it publishes a document which sets out how these problems have been addressed.**

**Recommendation 5.1**

**5.10 Inconsistencies between the taxation arrangements applying to interest earned by individuals on deposits held in authorised deposit-taking institutions compared to other methods of saving should be addressed.**

**Recommendation 5.2**

**5.27 That interest withholding tax applying to financial institutions be abolished as fiscal circumstances permit.**

**Recommendation 5.3**

**5.39 To enhance investor demand for Australian securitisation, the committee recommends that the government encourage central banks in other jurisdictions to accept Australian asset-backed securities denominated in foreign currencies for repurchase agreements in the foreign jurisdiction.**

**Recommendation 6.1**

**6.35 That the Reserve Bank of Australia conducts, on a quarterly basis, a dedicated senior loan officer survey and publishes the results of these surveys.**

**Recommendation 8.1**

**8.57 That the Australian Taxation Office (ATO) investigates allegations that GST revenue was not handled appropriately by banks and receivers and that, if necessary, the ATO makes recommendations to the Australian government about legislative changes in this area.**

**Recommendation 9.1**

**9.8 That a voluntary code of conduct for small business lending, developed by the Australian Bankers' Association, be established. The code should, at a minimum, require that:**

- **changes to facility terms must be accompanied by a document that clearly explains the changes to the borrower;**
- **initial valuation reports associated with the purchase of a small business should be relied on by the bank for a reasonable amount of time, such as for the first two years of the loan, unless a major defined shock or event occurs;**
- **borrowers be automatically provided with copies of valuation reports that they have paid for or which the bank intends to rely on to demonstrate that the borrower is in default, and that all instructions given by banks to valuers be provided to the borrower on request;**
- **notices of demand include a minimum deadline of 14 days for repayment, but that a further reasonable period of time should also be available to allow for the finalisation of necessary contracts if refinancing has been secured, or to allow negotiations to continue if an offer of finance is reasonably likely;**
- **banks cooperate with any reasonable requests for information made by the borrower that would assist the borrower secure refinance; and**
- **how default interest rates will be determined should always be clearly specified in the facility terms, not linked to other documentation.**

**Recommendation 9.2**

**9.9 That the Australian government takes any necessary action to facilitate the establishment of the code of conduct for small business lending referred to in recommendation 9.1.**

**Recommendation 9.3**

**9.11 That the terms of reference for the Financial Ombudsman Service (FOS) be amended so that:**

- **FOS may consider disputes from small business applicants where the value of the claim is up to $2 million; and**
- **the cap on the maximum compensation that FOS can award be increased to $2 million when the dispute relates to a small business.**

**Recommendation 9.4**

**9.12 That the terms of reference for the Financial Ombudsman Service (FOS) be amended so that FOS may consider disputes from small business applicants that relate to matters from 1 July 2008 onwards under the new caps outlined in recommendation 9.3. The staffing levels and funding of FOS should be reviewed to ensure it has sufficient resources available to perform this function.**

**Recommendation 9.5**

**9.15 That the code of conduct for small business lending referred to in recommendation 9.1 stipulates that lenders may not appoint receivers to a small business unless:**

- **a notice of demand to the small business has been issued by the lender and the 14 day period of time outlined in recommendation 9.1 has elapsed; and**
- **if the lender is a member of the Financial Ombudsman Service (FOS), the notice of demand clearly states that the borrower may apply to have a dispute related to the lender considered by FOS, but that FOS would be unable to review claims related to the actions of a validly appointed receiver. Disputes lodged under such circumstances should be treated as urgent and the dispute handling process expedited by FOS.**

**Recommendation 9.6**

**9.16 That receivers be required to cooperate with all requests from the Financial Ombudsman Service (FOS) that relate to a dispute between the bank and the borrower that FOS is considering.**

**Recommendation 9.7**

**9.19 That when a business is placed in receivership, the receiver is required to demonstrate to the borrower that they have considered every unconditional offer when exercising a power of sale in respect of a property.**

**9.20 If the borrower can demonstrate that an unconditional offer has been made by a party interested in purchasing a property and the receiver instead sells the property by a process that achieves a price that is less than that offer,**

**the burden of proof should be on the receiver to demonstrate that their actions were in accordance with section 420A of the *Corporations Act 2001*.**

**Recommendation 9.8**

**9.21 That receivers be required to cooperate with any reasonable requests for information made by the borrower that would assist the borrower secure refinance.**

**Recommendation 9.9**

**9.22 That the code of conduct for small business lending referred to in recommendation 9.1 requires that if a bank has appointed a receiver to the small business, then the bank must regularly inform the borrower about the costs and fees associated with the receivership. The bank must also take all reasonable care to ensure the costs and fees are reasonable.**

**Recommendation 9.10**

**9.24 An early priority of the Australian Small Business Commissioner should be to examine burdens for small businesses in pursuing litigation against banks and receivers and to report their findings and recommendations to the Australian government.**

**Recommendation 9.11**

**9.25 That, following the Australian Small Business Commissioner's appointment becoming effective, the Small Business Commissioner provide an annual report to the Senate on small business finance issues. In preparing this report, the Small Business Commissioner should receive any necessary support from relevant government departments and agencies.**

**Recommendation 10.1**

**10.29 That an independent and well-resourced root and branch inquiry into the Australian financial system be established.**

# Chapter 1

## Introduction

1.1 As the Senate's specialist committee for economic matters, issues related to the global financial crisis have been a focus of the committee's work in recent years. This inquiry continues the committee's examination of the impact of the crisis on the Australian financial sector and its implications for how the sector will function in the future. The committee has now produced a series of reports on the subject. The previous report, *Competition within the Australian banking sector* (hereafter referred to as the Competition Inquiry) concluded a comprehensive investigation by the committee into the state of competition in the sector following the crisis. The committee presented its report on that inquiry to the Senate in May 2011, but it considers that much of its analysis remains relevant. While this inquiry also touches on competition issues, readers interested in a detailed discussion of competition in the banking sector should refer to that report.

1.2 Other relevant inquiries conducted by this committee in recent years include:

- *Access of small business to finance* (reported 30 June 2010);
- *Aspects of bank mergers* (reported 17 September 2009); and
- *Bank funding guarantees* (reported 17 September 2009).

### Terms of reference

1.3 On 14 March 2012, the Senate agreed to refer to this committee a further inquiry related to the global financial crisis and the Australian banking sector. The terms of reference are as follows:

> An examination of recent developments in the banking sector arising out of the impact of the global financial crisis and subsequent events, including:
>
> (a) the impact of international regulatory changes on the Australian banking sector, particularly including changes to liquidity and capital holding requirements;
>
> (b) the impact on relative shares of specific banking markets;
>
> (c) the current cost of funds for lending purposes;
>
> (d) the impact on borrowing and lending practices in the banking sector both during and since the global financial crisis;
>
> (e) the need for further consideration of the state of the broader finance and banking sector; and
>
> (f) any other relevant matters.[1]

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1 *Journals of the Senate*, 2010–12, no. 81 (14 March 2012), p. 2238.

1.4 A number of distinct and complex issues are included in the terms of reference. One matter is Basel III—the internationally-agreed regulatory changes intended to address the identified weaknesses contained in the previous capital regulation and supervision arrangements. The current cost of funds for banks is also included; this is a controversial issue as the rising costs of funds is regularly cited by the major banks as the reason why their lending rates are not moving in step with the changes made by the Reserve Bank of Australia to the official cash rate, yet recently the major banks have been announcing record profits raising questions about their cost claims. Another significant and complicated issue is the impact of the crisis on lending practices. On this front, the evidence received was primarily focused on the allegations that, following the acquisition of Bankwest by the Commonwealth Bank of Australia in 2008, Bankwest's business loan portfolio was reviewed and in order to clear the books a number of existing small business clients of Bankwest were mistreated and deliberately made to default on their loans.

## Conduct of the inquiry

1.5 The committee advertised the inquiry in *The Australian* and on its website. It also wrote to financial institutions, industry groups, government departments and agencies, consumer and small business groups, academics and other interested parties to inform them of the inquiry and to invite submissions. During the course of the inquiry, updates about its progress were also publicised through the Senate's Twitter account.[2]

1.6 In total, the committee received 158 submissions. Details about this material can be found in Appendix 1. The public submissions can be viewed on the committee's website.

1.7 The committee held five public hearings: 8 August 2012 (Canberra), 9 August 2012 (Sydney), 10 August 2012 (Sydney), 21 September 2012 (Canberra) and 10 October 2012 (Canberra). The committee took evidence from the Australian Treasury, the Reserve Bank of Australia, other relevant government agencies, the four major banks (including separate evidence from representatives of Bankwest, a subsidiary of one of the majors), a foreign subsidiary bank, representatives of credit unions, building societies and mutual banks, a professor of finance, representatives of credit advisers, an insolvency services firm and a number of former customers of Bankwest. The witnesses who appeared at these hearings are listed in Appendix 2.

1.8 The committee thanks all of the individuals and organisations that provided evidence for this inquiry.

---

2 @AuSenate.

## Structure of the report

1.9 Reflecting the varied issues raised in the terms of reference, this report is divided into three parts.

### *Part I (chapters 2–5)*

1.10 The first section of the report focuses on sector-wide issues that fundamentally impact the way financial institutions conduct their operations. Chapter 2 provides an overview of the post-global financial crisis banking sector; it discusses the state of competition in the sector, regulatory changes in other jurisdictions that are impacting Australian banks and various other developments that emerged this year such as the Libor manipulation scandal. Chapter 3 examines the changes to capital adequacy and liquidity requirements brought about in response to the global financial crisis and contained in Basel III; the chapter particularly focuses on the approach taken to implementing Basel III in Australia. Chapter 4 outlines the changes to the funding mix used by Australian banks and funding costs since the crisis. The final chapter in this part—chapter 5—examines proposals to help address funding challenges and competition concerns in the sector.

### *Part II (chapters 6–9)*

1.11 Part II of the report focuses on the impact of the global financial crisis on borrowing and lending practices. Chapter 6 opens this section with an overview of the impact of the crisis on borrowing and lending preferences and supply and demand. This chapter also examines certain other borrowing and lending issues that arose during the inquiry, including allegations of predatory lending and fraud, and purported implications for the Australian Office of Financial Management's securitisation activities. Chapters 7, 8 and 9 examine the allegations related to Bankwest. Chapter 7 provides an overview of the evidence received on this issue, with a focus on the experiences that aggrieved borrowers appeared to share. Chapter 8 begins the committee's analysis of the evidence and the possible explanations as to why a significant number of small business borrowers and property developers had negative experiences with Bankwest. Chapter 9 contains the committee's findings and recommendations.

### *Part III (chapter 10)*

1.12 The final part of the report is comprised of one chapter which focuses on paragraph (e) of the terms of reference—the need for further consideration of the state of the broader finance and banking sector. It outlines the evidence put forward as to why a widespread, independent root and branch inquiry into Australia's financial system is warranted and includes the committee's view on this proposal.

# PART I

## Post-crisis developments in bank funding and regulation

# Chapter 2

## Overview of the post-GFC banking environment

2.1 This inquiry focuses on developments in the banking sector arising out of, and linked to, the impact of the global financial crisis. Much has been written about the causes of the crisis and the impacts it has had and continues to have on the international and Australian economies. For the purposes of this report, it is not necessary to restate these details. Some discussion of how the banking sector responded to the crisis at the time, however, is relevant for this inquiry. It can be concluded that the Australian banking system avoided the worst of the crisis. When compared to the events and disruption in the key international banking centres, Australian banks appeared strong and resilient. The crisis also highlighted the sound regulatory regime in place in the years leading up to the crisis and the effective performance of the regulators charged with supervising the system and ensuring its stability—the Reserve Bank of Australia (RBA) and the Australian Prudential Regulation Authority (APRA).

2.2 Nonetheless, an economic event the magnitude of the global financial crisis unsurprisingly had immediate and enduring effects on the Australian banking sector. This chapter provides an overview of the overall impact of the crisis on the sector and other relevant developments which have occurred in recent years. Distinct and significant issues arising out of the crisis, such as increased funding costs, changes by the banks to their funding mix, and the Basel III reforms, are examined in more detail in subsequent chapters.

### Impact on bank funding

2.3 As an immediate consequence of the global financial crisis, banks everywhere were perceived to be more risky while investors became more risk averse. Given that the major Australian banks continue to be significantly reliant on offshore wholesale funding, the increased risk premiums demanded for bank debt following the crisis has impacted Australian banks considerably. The Australian Bankers' Association (ABA) noted:

> As revealed around the world, a high level of reliance on foreign funding exposes a country to greater shocks. Investors that extend money do so because they are confident in getting it repaid, and in situations of uncertainty, there is a bias to investment in their home countries.[1]

2.4 When the RBA was asked about the impact of the crisis, the change in risk premiums was the main point made in response:

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1 Australian Bankers' Association, *Submission 46*, p. 13.

> Dr Debelle: … prior to 2007 risk premia right across the board were really low. Since 2007 they have gone right up, and that has affected the banks' cost of funds and, in the opposite direction, it has affected the government's cost of funds by pushing it down. That is probably the main source of transmission to the domestic financial system.
>
> Senator CAMERON: So it was a transmission. It was not a Northern American financial crisis; it did impact Australia?
>
> Dr Debelle: Yes. As I said, because our financial system is connected to that and the rest of the world it certainly had an impact.[2]

2.5 Westpac also put rising funding costs as the key post-crisis development:

> … without any shadow of a doubt, funding costs are the most substantial issue that the banks have faced in the past three to five years. The issues continue and we are in the midst of quite a profound structural change in the way that banks are funded and how they fund themselves. This situation has gone on probably longer than many of us suspected it would and it has certainly become more entrenched as a structural issue rather than a passing pricing issue. Among the strategic issues that we have to confront, without any shadow of a doubt, that is the main one.[3]

2.6 Changes to funding sources, mix and costs are examined in more detail in chapter 4.

## Market concentration and competition[4]

2.7 While stability is a feature of the Australian banking sector, the degree of genuine competition is less clear and has been questioned by market participants and other observers, particularly as the Australian banking sector is characterised by the large market shares enjoyed by the four largest banks—the Australia and New Zealand Banking Group (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Westpac.

### *Market share*

2.8 The market share of the largest firms is often used as a simple way of indicating a concentrated market; however, another measure of market concentration

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2 Dr Guy Debelle, Assistant Governor, Financial Markets, RBA, *Committee Hansard*, 9 August 2012, p. 43.

3 Mr Jim Tate, Acting Chief Operating Officer, Australian Financial Services, Westpac Group, *Committee Hansard*, 9 August 2012, p. 1.

4 The state of competition in the Australian banking sector was examined comprehensively by this committee in 2010–11. This section will provide a brief overview of the current state of the market, however, the information and analysis presented by the committee in 2011 is still relevant. Readers seeking additional information about competition in the banking sector should refer to Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011.

often used in the analysis of markets, particularly in the context of mergers and acquisitions, is the Herfindahl-Hirschman index (HHI). The HHI takes into account the market share of all participants in the relevant market. It is calculated by totalling the squares of each firm in the market (for merger analysis the post-merger share of the merged firm and each rival firm is used, and the increase in the HHI is also considered).[5] An HHI can be expressed in two ways—either as a number between zero (representing perfect competition) and one (a monopoly), or as a number between zero and 10,000.[6] The Australian Competition and Consumer Commission (ACCC) uses 0.2 (or 2000 using the alternative method) as a guide for its merger analysis.[7]

2.9 It is clear that the banking sector has become more concentrated in recent years, with the major banks increasing their share of assets, deposits and home loans (Table 2.1).

**Table 2.1: Measures of concentration in the Australian banking market**

| Date | Assets | | Deposits | | Home loans | |
|---|---|---|---|---|---|---|
| | *Share of 4 largest banks (%)* | *HHI* | *Share of 4 largest banks (%)* | *HHI* | *Share of 4 largest banks (%)* | *HHI* |
| 1890 | 34 | .06 | | | | |
| 1913 | 38 | .10 | | | | |
| 1950 | 63 | .14 | 64 | .15 | | |
| 1970 | 68 | .16 | 68 | .16 | 77[a] | .21[a] |
| 1990 | 66 | .12 | 65 | .12 | 65 | .13 |
| Oct 2008 (pre-mergers) | 65 | .11 | 65 | .12 | 74 | .15 |
| Oct 2008 (post-mergers)[b] | 73 | .14 | 75 | .15 | 86 | .20 |
| June 2009 | 75 | .15 | 78 | .16 | 86 | .20 |
| June 2010 | 77 | .16 | 78 | .16 | 87 | .21 |
| June 2011 | 78 | .16 | 78 | .16 | 87 | .20 |
| June 2012 | 80 | .17 | 79 | .16 | 86 | .20 |

[a] Assuming all owner-occupier housing loans were made by savings banks and accounted for all their loans.

[b] From 'Oct 2008 (post-mergers)' onwards, statistics for Bankwest and St George are counted as parts of the CBA and Westpac respectively.

Note: The table provides an indication of market share among ADIs—non-bank lenders are not included.

5 ACCC, *Merger guidelines*, November 2008, p. 37. See also Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011, pp. 41–42.

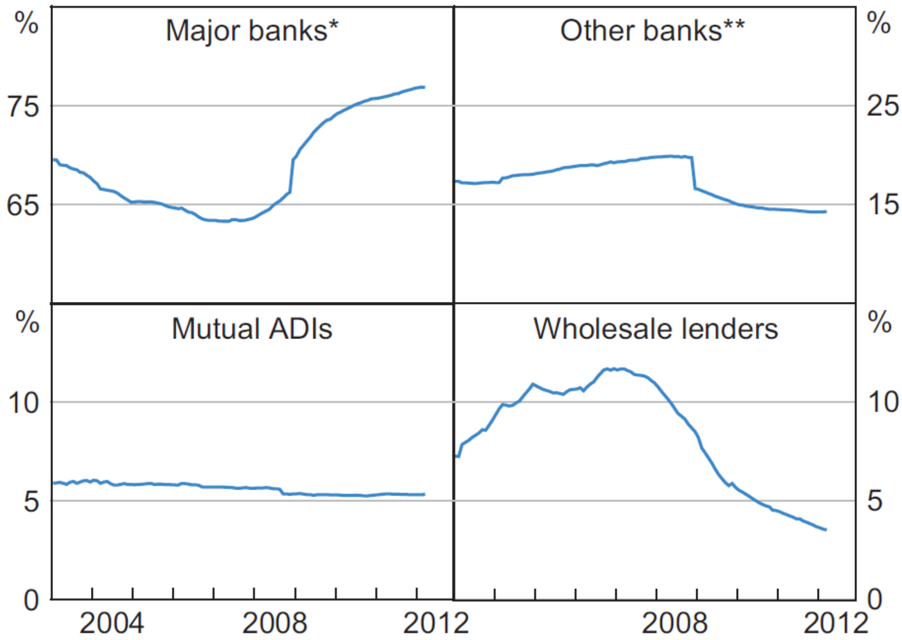
6 The different numbers yielded by the two methods arises as the market shares of the firms can be expressed either as proportions or as a whole percentage—e.g. the HHI of two firms with an equal share of the market (50 per cent) can be calculated as $0.5^2+0.5^2=0.5$ or $50^2+50^2=5000$.

7 ACCC, *Merger guidelines*, November 2008, p. 37.

Source: June 2009–June 2012 based on APRA data; other data reproduced from Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011, p. 42.

2.10 The major banks' increasing market share of housing finance has been at the expense of all other categories of lenders—i.e. smaller banks, building societies, credit unions and non-banks (Figure 2.1).

**Figure 2.1: Lenders' share of housing credit**



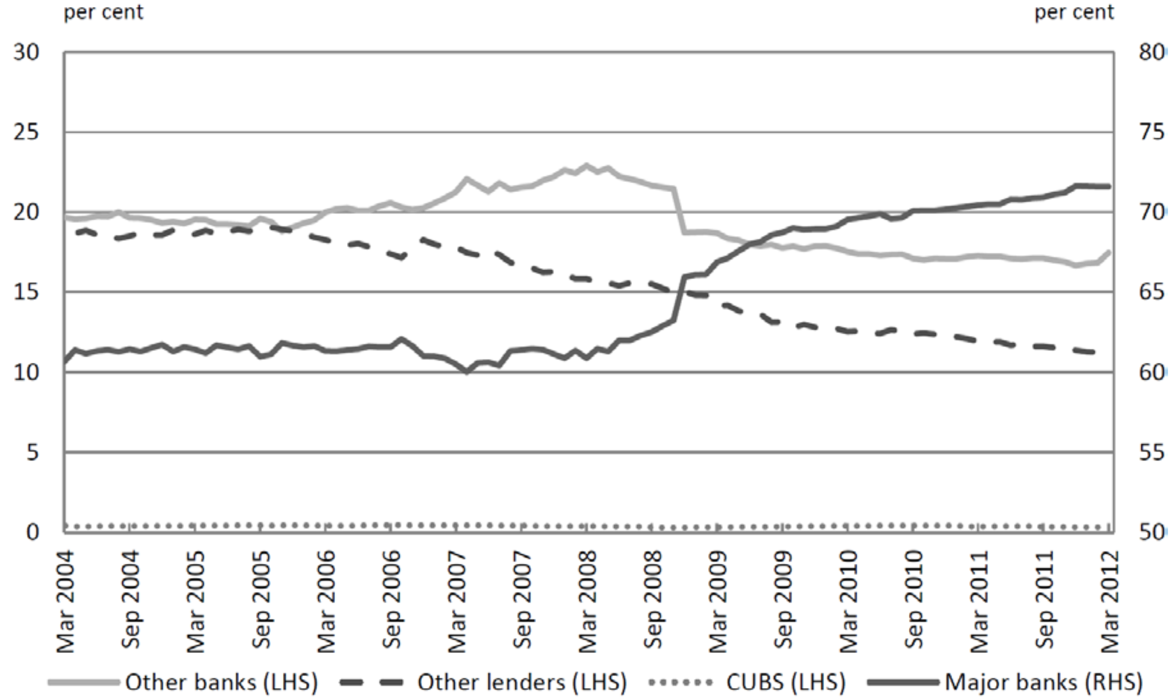

Source: RBA, *Submission 33*, p. 2; based on ABS, APRA and RBA data.

* Includes Bankwest from December 2008

** Excludes mutual banks

2.11 The major banks' increasing market share of business credit has also been observed (Figure 2.2).

**Figure 2.2: Shares of outstanding business credit (by lender type)**




Source: Treasury, *Submission 120*, p. 8; based on RBA data.

Notes: Major banks include Bankwest from December 2008; ANZ, CBA, NAB, St George and Westpac for entire sample. Other lenders includes cash management trusts, specialist credit card institutions and securitisers. Other banks include foreign banks as well as credit unions and building societies rebranding as banks.

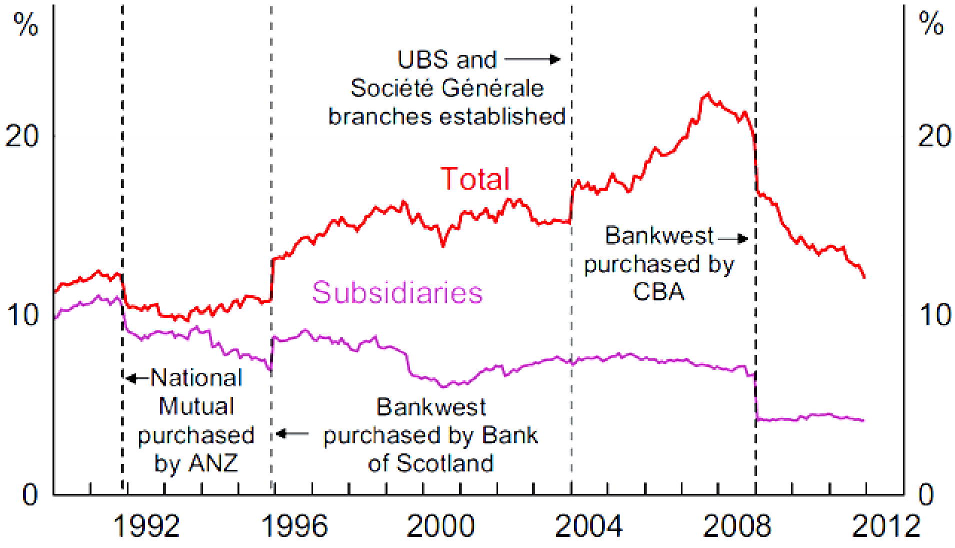
2.12 Acquisitions by the major banks of key competitors in 2008 explain much of the increase in the major banks' market share.[8] Meanwhile, the activity of foreign banks in Australia has also decreased (Figure 2.2). European-owned lenders, faced with mounting problems at home, have reduced their activity in Australia (although countering this to some degree, some Asian-owned banks have expanded their operations). Consequently, the market share of the major Australian banks increased as they filled any remaining gap in the market. The RBA concludes:

> Although the number of foreign-owned banks operating in Australia has more than doubled since the early 1990s, their share of bank assets at the end of 2011, at 12 per cent, was broadly the same. From around the mid 1990s to 2007, they noticeably increased their share of bank assets, from around 10 per cent to 22 per cent, due to a combination of acquisitions, new entrants and organic growth. Since the onset of the financial crisis, however, the foreign-owned banks' share of assets has fallen. Only part of this was due to CBA's purchase of Bankwest in 2008, which was the largest foreign-owned bank at the time. The foreign-owned banks that expanded

8 They were Westpac's acquisition of St George Bank (then Australia's fifth largest bank) and the CBA's acquisition of Bankwest. The Bankwest acquisition is discussed in more detail in chapter 7.

the most in the years leading up to the crisis have typically also seen the largest contractions in their assets in recent years.[9]

**Figure 2.3: Foreign-owned banks in Australia: Share of banking system assets (domestic books)**




Source: RBA, 'The Australian Financial System—Box A: Foreign-owned Bank Activity in Australia', *Financial Stability Review*, March 2012, p. 38.

2.13 Non-bank lenders provided increased competitive tension in the Australian banking system when they commenced operations in the 1990s. Besides competing on price, these lenders also introduced technological innovations for consumers, such as internet banking.[10] The non-bank institutions utilised wholesale funding by securitisation to fund their activities. The deterioration of the securitisation market during the global financial crisis challenged these models—while securitisation was funding over 20 per cent of home loans by mid-2007 this decreased rapidly once the crisis hit, returning to late 1990s levels (Figure 2.4). The consequence of many non-bank lenders being unable to obtain sufficient quantities of suitably priced funds is demonstrated by the experience of RAMS Home Loans, a key non-bank lender that grew substantially in the 2000s. In 2007 RAMS sold its franchise distribution businesses and brand to Westpac in return for cash and assistance in securing funding, after advising shareholders that, in the absence of this deal, it was 'unable to locate alternative sources of new funding in sufficient volumes to meet the ongoing needs of the business'.[11]

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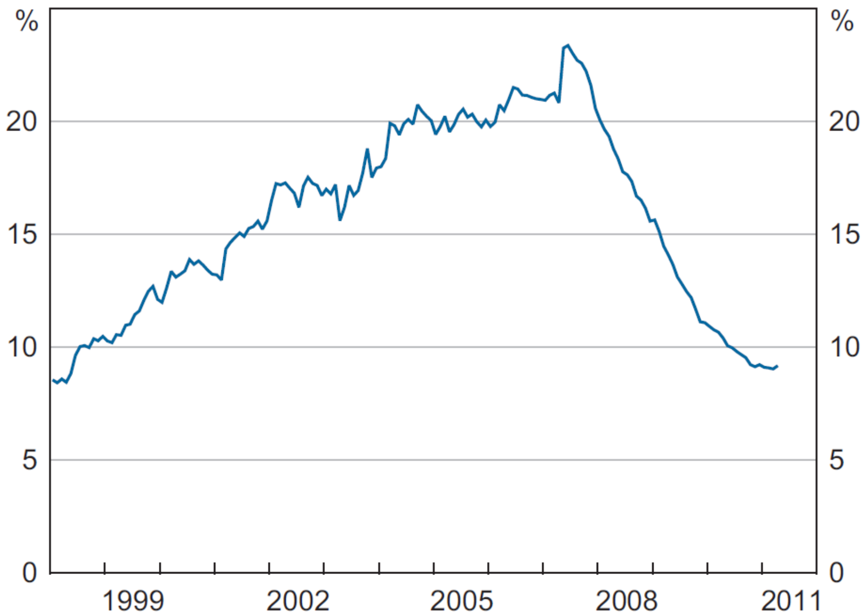
9 RBA, 'The Australian Financial System—Box A: Foreign-owned Bank Activity in Australia', *Financial Stability Review*, March 2012, p. 39.

10 Mortgage and Finance Association of Australia, *Submission 52*, p. 3.

11 RAMS Home Loan Group Limited, 'RAMS funding and annual general meeting update', ASX announcement, 20 November 2007, p. 2.

**Figure 2.4: Share of housing credit funded by securitisation**




Source: Bernadette Donovan and Adam Gorajek, 'Developments in the structure of the Australian financial system', *RBA Bulletin*, 2011, no. 2 (June quarter), p. 39.

2.14 Other factors contributing to the major banks' increased market share include the 'flight to quality' during the crisis, where nervous customers moved their deposits and business to the major banks, perceiving them to be safer due to their size and longevity.[12]

***Market contestability and indicators of competition***

2.15 In addition to market share, there are many factors which influence competition in a market. The CBA considers that, for the banking sector, determinants include the barriers to entry and exit, the level of customer demand for banking products and the impact of regulatory reforms.[13]

2.16 There are signs of the banks competing on several fronts. Treasury is of the view that competition between the major banks 'remains strong', with 'NAB and ANZ being particularly aggressive in housing credit over the last year'.[14] The RBA expressed a similar view, noting that in the housing lending market 'the major banks have been competing for most of the past year for market share in an environment of slower credit growth'; although since early 2012 it has observed that competition has

12 As the committee observed in 2011, government responses to the crisis such as the wholesale funding guarantee, while overall a sensible and well-intentioned measure, may have exacerbated the 'flight to quality' due to the differential pricing for the guarantee based on credit rating. See *Competition within the Australian banking sector*, chapter 12.

13 Commonwealth Bank of Australia, *Submission 81*, p. 9.

14 Treasury, *Submission 120*, p. 5.

eased partly due to increased funding costs.[15] The Mortgage and Finance Association of Australia (MFAA) noted that, despite funding challenges, non-bank lenders were still competing with the major banks on standard variable interest rates, with the average non-bank rate in May 2012 0.63 percentage points lower than the average rate of the major banks.[16]

2.17 Regarding deposits, competition among authorised deposit-taking institutions (ADIs) has noticeably increased as they seek to secure more stable funding sources. In the ABA's view, 'Australian banks have competed ferociously for household and business domestic deposits in order to fund growth in credit. This has been a bonanza for savers who are enjoying very good deposit deals'.[17] While more restrained in his comments, evidence from a senior officer at the Treasury broadly supported this contention:

> … at the moment … deposits are tight. Everyone is competing to build deposits up, so again, on that transition point, the major banks are seeking to move up their level of deposits to provide a stable funding source—they are paying for it—to reduce their dependency on offshore funding. You have got a number of people competing in the same space for deposits and, again, to some extent that is of benefit to the consumer. They are getting the benefit of that competition.[18]

2.18 Competition for small business loans, however, has decreased in intensity since the crisis. Treasury provided the following overview of competition in this market:

> On the competition angle in terms of small business loans you have to factor in from the lender's point of view that there is a higher risk with a business loan than there is with a mortgage. You have to factor that in. Secondly, what we see from our analysis and hear from the major banks is that between 80 to 90 per cent of borrowers get accommodation from a lending institution.[19]

2.19 Issues associated with small businesses accessing finance following the global financial crisis were examined by this committee in 2010, and more recently by the Parliamentary Joint Committee on Corporations and Financial Services.[20] To the

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15 RBA, *Submission 33*, pp. 1, 2.

16 Mortgage and Finance Association of Australia, *Submission 52*, p. 9 [table 3; based on Canstar data].

17 Australian Bankers' Association, *Submission 46*, p. 13. The issue of increased competition among ADIs for deposits is examined further in chapter 4.

18 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 4.

19 Mr Jim Murphy, Treasury, *Committee Hansard*, 8 August 2012, p. 11.

20 See Senate Economics References Committee, *Access of small business to finance*, June 2010; Parliamentary Joint Committee on Corporations and Financial Services, *Access for small and medium business to finance*, April 2011.

extent that it is relevant to lending practices and other matters being examined by this inquiry, however, the issue is examined further in chapter 6.

### *Profitability of Australian banks*

2.20 Profitability is another indicator of the level of competition in a market. For financial institutions, profitability can be indicated by three main measures:

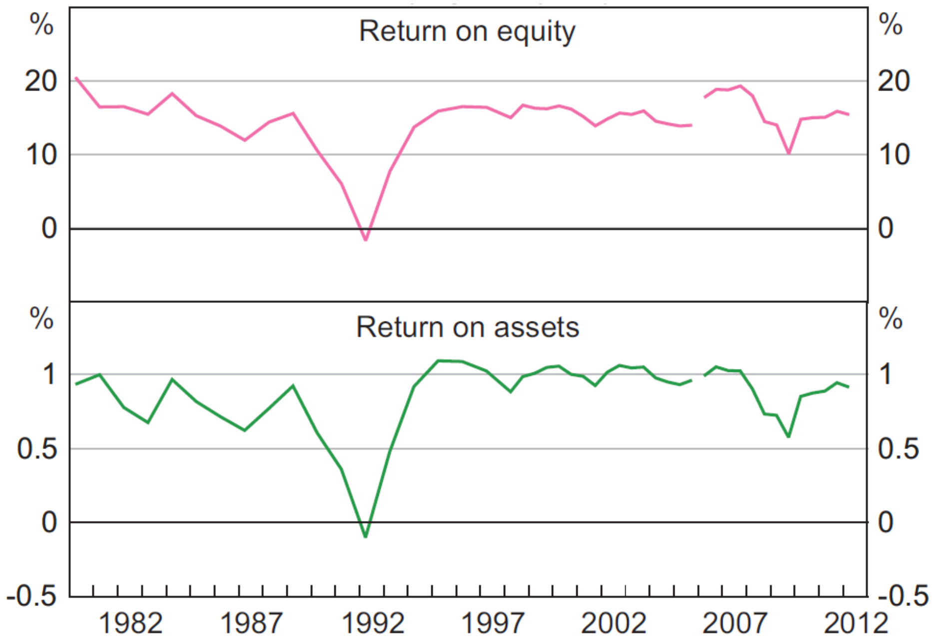
- return on equity (ROE)—the net income returned as a percentage of money invested by shareholders—i.e. how efficiently the shareholders' investments are being used to generate income;
- return on assets—the net income returned as a percentage of assets—i.e. how efficiently assets are generating income;
- net interest margins (NIM)—the difference between what a bank on average receives in interest payments compared to what it pays on average in funding costs.

2.21 The following paragraphs will examine the profitability of Australia's major banks compared to their profits prior to the global financial crisis, other major Australian companies, international banks, and other ADIs.

#### *Comparison with pre-crisis profits*

2.22 The RBA provided the committee with information indicating that the ROE of the major banks is currently around its long-term average (Figure 2.5).

**Figure 2.5: Major banks' profitability**

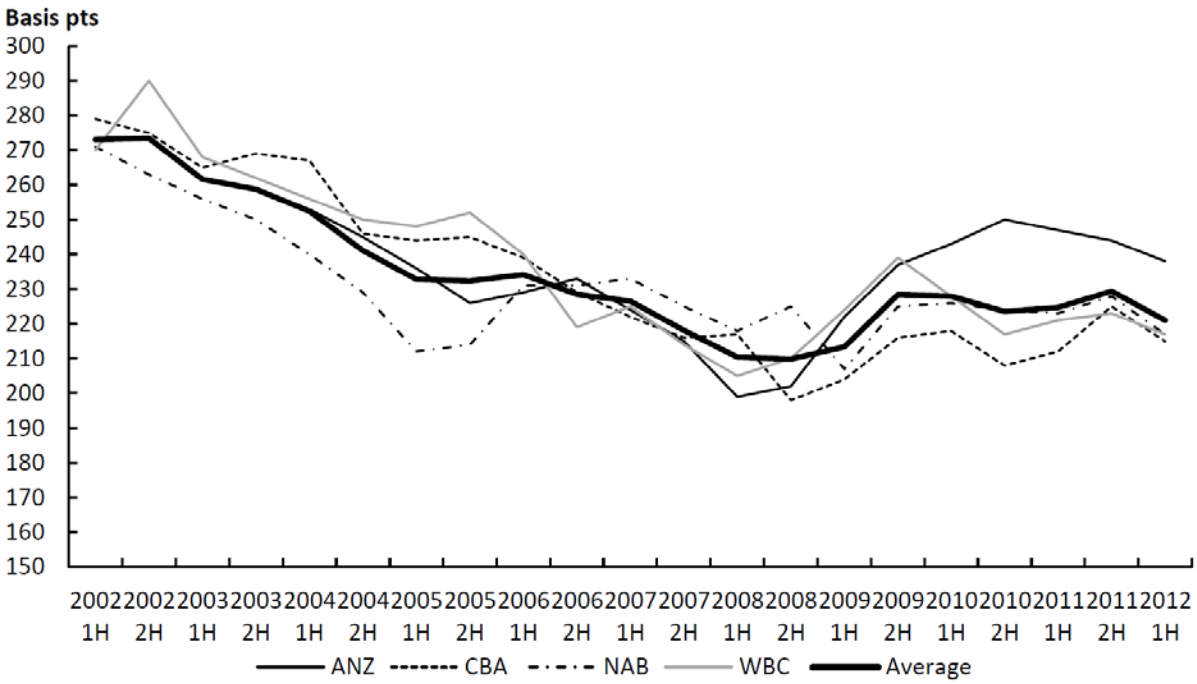



Notes: The chart shows underlying half-yearly profitability. In 2006 the banks began reporting on an AIFRS rather than an AGAAP accounting basis; data prior to 1998 are on a yearly basis.

Source: RBA, *Submission 33*, p. 7; based on RBA data and banks' annual and interim reports.

2.23 Treasury similarly provided information regarding changes to the major banks' NIMs over the past decade. Treasury observed that the major banks' NIMs were reduced during the global financial crisis but are currently, on average, around pre-crisis levels.[21] As Figure 2.6 shows, since the peak of the crisis there has at times been significant variation in the individual NIMs of the major banks, particularly during 2010.

**Figure 2.6: Major banks' net interest margins**




Notes: Data is half yearly and calculated as net interest income to average total interest earning assets on a group basis. ANZ data unavailable prior to 2004.

Source: Treasury, *Submission 120*, p. 11; originally sourced from major banks' financial disclosure documents.

2.24 While Treasury considers that NIMs provide 'useful, although lagging, indicators of the impact of funding costs on profitability',[22] the CBA questioned the usefulness of comparing pre-crisis NIMs with current levels. The CBA acknowledged that NIMs are 'one of the key drivers of profitability', but argued that they are inflated by the higher levels of capital banks now hold and that pre-crisis NIMs have not been adjusted for the under-pricing of risk at that time which, in the CBA's view, 'makes that a misleading reference point'.[23] The CBA also gave evidence that they have been

21 Treasury, *Submission 120*, p. 10.

22 Treasury, *Submission 120*, p. 10.

23 Commonwealth Bank of Australia, *Submission 81*, p. 39 (emphasis omitted).

seeking to increase their productivity, allowing the bank to maintain its profits despite higher funding costs.[24]

*Comparison with other Australian companies*

2.25 A bank's ROE can be compared against many other sectors and points in time. The RBA considers that the ROE of Australia's major banks are similar to those of other major corporations in Australia.[25] The CBA asserted that, although it is ranked second for market capitalisation on the ASX, by ROE it is ranked 34th.[26] The ANZ argued that, given that Australia's major banks are among the largest companies in the country, 'the dollar amount of profits made by the four major banks is a reflection of the size of the companies and the amount of capital employed'.[27] The ANZ continued by pointing out that its 2010–11 statutory ROE of 15.3 per cent is lower than that of the resources and telecommunications sectors and similar to the healthcare and supermarket sectors.[28]

2.26 Comparing bank profits with those of mining companies during a mining boom, however, is not a helpful comparison (and one purposely avoided by Treasury).[29] Additionally, as similarly observed by this committee in 2011,[30] one could counter that these comparisons are with other businesses operating in oligopolistic industries or otherwise have limited competition due to high barriers to entry or other obstacles, and thus have the opportunity to earn abnormally high profits. There are, however, factors unique to banking that affect the approach to profits, such as regulatory requirements. The CBA noted differences between how banks are expected to manage their business compared to other companies:

> … banks need to earn profits in excess of their cost of capital so that they can build up a buffer of equity which can be called upon, if necessary, in difficult times. If there is no buffer, the institution is more likely to fail in the first downturn. Banking is a cyclical and highly leveraged industry so that buffer must be significant.[31]

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24 Mr David Cohen, Group General Counsel and Group Executive, Commonwealth Bank of Australia, *Committee Hansard*, 9 August 2012, p. 25.

25 RBA, *Submission 33*, p. 6.

26 Commonwealth Bank of Australia, *Submission 81*, p. 36. The CBA also advised that it is ranked 80th by return on assets, however, it should be noted it is more difficult to meaningfully compare returns on assets of companies in different sectors.

27 ANZ, *Submission 78*, p. 25.

28 ANZ gave the following ROE figures for those sectors: resources sector (28 per cent); telecommunications (26 per cent); healthcare (14.4 per cent); and supermarkets (13 per cent). ANZ, *Submission 78*, p. 26.

29 See Mr Jim Murphy, *Committee Hansard*, 8 August 2012, p. 7.

30 See Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011, p. 52.

31 Commonwealth Bank of Australia, *Submission 81*, p. 36.

*Comparison with major international banks*

2.27 The Bank for International Settlements has published figures showing that the major Australian banks are the most profitable in the developed world, with 2011 pre-tax profits equal to 1.19 per cent of total assets. Canadian banks, in second place, were the only others to have pre-tax profits above one per cent.

**Table 2.2: Profitability of major banks**

| | Pre-tax profits | | | Net interest margin | | | Loan loss provisions | | | Operating costs | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2009 | 2010 | 2011 | 2009 | 2010 | 2011 | 2009 | 2010 | 2011 |
| Australia (4) | 0.93 | 1.14 | 1.19 | 1.88 | 1.89 | 1.83 | 0.54 | 0.31 | 0.19 | 1.20 | 1.24 | 1.17 |
| Austria (2) | 0.60 | 0.82 | 0.23 | 2.45 | 2.62 | 2.56 | 1.23 | 0.94 | 0.93 | 2.05 | 2.01 | 1.96 |
| Canada (6) | 0.73 | 1.01 | 1.08 | 1.72 | 1.64 | 1.60 | 0.44 | 0.25 | 0.18 | 2.04 | 1.88 | 1.87 |
| France (4) | 0.18 | 0.44 | 0.26 | 1.01 | 1.03 | 1.02 | 0.36 | 0.23 | 0.22 | 1.09 | 1.16 | 1.12 |
| Germany (4) | 0.02 | 0.20 | 0.20 | 0.84 | 0.87 | 0.88 | 0.29 | 0.15 | 0.12 | 1.24 | 1.23 | 1.21 |
| Italy (3) | 0.36 | 0.37 | –1.22 | 1.91 | 1.77 | 1.81 | 0.77 | 0.63 | 0.69 | 1.76 | 1.70 | 1.80 |
| Japan (5) | 0.34 | 0.51 | 0.54 | 0.94 | 0.87 | 0.82 | 0.25 | 0.11 | 0.02 | 0.76 | 0.75 | 0.85 |
| Netherlands (2) | –0.39 | 0.30 | 0.41 | 0.84 | 0.98 | 0.98 | 0.28 | 0.13 | 0.24 | 1.14 | 1.26 | 1.18 |
| Spain (3) | 0.98 | 1.02 | 0.61 | 2.47 | 2.42 | 2.38 | 1.00 | 0.84 | 0.82 | 1.57 | 1.61 | 1.72 |
| Sweden (4) | 0.34 | 0.61 | 0.60 | 1.02 | 0.89 | 0.83 | 0.46 | 0.11 | 0.03 | 0.95 | 0.88 | 0.79 |
| Switzerland (3) | 0.22 | 0.60 | 0.33 | 0.56 | 0.54 | 0.53 | 0.10 | –0.0 | 0.01 | 1.97 | 1.97 | 1.74 |
| United Kingdom (6) | 0.18 | 0.37 | 0.33 | 1.09 | 1.19 | 1.15 | 0.90 | 0.59 | 0.46 | 1.32 | 1.37 | 1.41 |
| United States (9) | 0.36 | 0.80 | 0.93 | 2.65 | 2.73 | 2.49 | 1.89 | 1.14 | 0.54 | 2.98 | 3.22 | 3.23 |

Notes: Largest banks in each country by total asset size. The number of banks in the 2011 data is indicated in parentheses. Operation costs consist of the sum of personnel and other operating costs. For Japanese banks, no personnel costs included.

Source: Bank for International Settlements, *82nd annual report*, 24 June 2012, p. 79; Bankscope.

2.28 It should be recognised that these data provide comparisons of post-crisis profits where, given the ongoing problems in other banking sectors and economies, Australian banks have clearly outperformed most of their international counterparts. When asked about the relative profitability of Australian banks, a senior Treasury officer's immediate response was to ask 'is it very surprising'? He went on:

> The traumas that other countries have had with their banking systems, to me, probably reflects the market and that they are being reasonably well run. We have had strong prudential regulation. The banks came through the GFC in a very strong position and that means that the whole ADI sector—I am not saying just the majors. One would think that you have got to get some benefit out of that.[32]

2.29 On a pre-crisis basis, the RBA considers that the returns on equity of Australia's major banks are similar to pre-crisis ROE of banks in other countries.[33]

32 Mr Jim Murphy, Treasury, *Committee Hansard*, 8 August 2012, pp. 6–7.

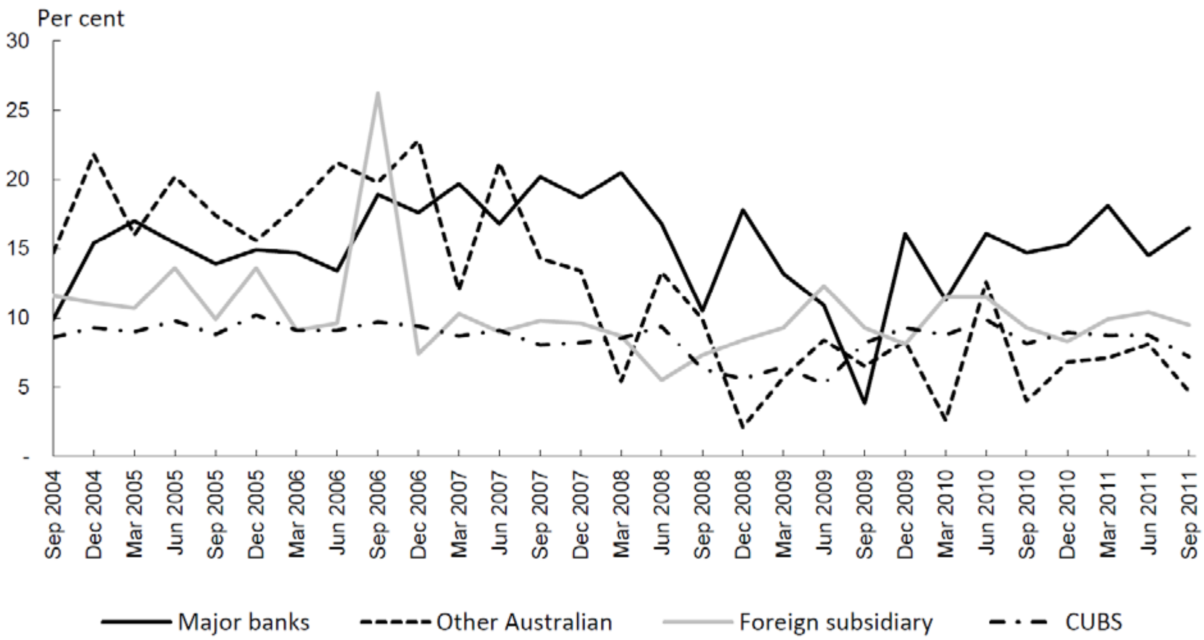
33 RBA, *Submission 33*, p. 6.

This point was also made by the CBA in relation to the United States and some European countries.[34]

*Comparison with smaller banks, credit unions and building societies*

2.30 Another basis for comparing the major banks' profits is by examining how they compare to their smaller competitors. Treasury provided the committee with some information about this (Figure 2.7).

**Figure 2.7: ADIs' return on equity**




Source: Treasury, *Submission 120*, p. 12; based on APRA data.

2.31 Treasury's submission stated that '[o]f note, other Australian banks were consistently more profitable than the majors in the period leading up to the GFC'.[35] However, the chart also shows that the other Australian banks have been consistently *less* profitable than the majors in the period following the crisis. Also of interest, the gap between the major banks' profits and other Australian banks has widened significantly, with other Australian banks achieving an average ROE of approximately five per cent in September 2011, compared to the more than 15 per cent obtained by the majors.

## International regulatory changes

2.32 Another feature of the post-crisis banking sector is the amount of regulatory change from various international sources. This was a topic raised by a number of banks and their representative groups. They did not argue about the merits of the changes—Westpac argued that it had been 'very forthright in supporting the whole

34 Commonwealth Bank of Australia, *Submission 81*, p. 37.

35 Treasury, *Submission 120*, p. 12.

regulatory reform agenda in terms of its philosophy'[36] but warned about the pace of the reforms, and implications of the changes in terms of added costs—costs that may be compounded by inconsistency between different jurisdictions. The CEO of the ABA provided a useful overview of the sector's view that the benefits of added regulation and its costs need to be carefully considered. He acknowledged that some changes are not unreasonable because 'if we learnt anything out of the global financial crisis it is the extent of the harm that can be caused by instability and collapse in parts of the financial system', however:

> One of the things that policy makers need to continually bear in mind is that stability, as desirable as it may be, does come at a price. What the banking system is really about is managing risk. At its most simple level, we take the risk of lending money to people and the risk of being able to pay money back to those who have given us money to look after for them. You cannot remove risk from the banking system—that is what it is about. The more that you try to do that the more you are going to have these impacts around the availability of credit, the price of credit and the willingness of banks to fund marginal parts of the economy particularly—and in marginal I am including things like the entrepreneurial parts of the economy. We have to constantly check that balance between very desirable stability and the consequences of pursuing that stability.[37]

2.33 Westpac added:

> Regardless of any debate on the need or merits of the elements of the reform agenda, it must be taken into consideration that the impacts of such reforms will undeniably be that credit will be more expensive, and supply constrained relative to the experience of previous decades.[38]

2.34 Accounting for different regulatory regimes and changes can be particularly challenging for foreign banks, as they have to comply with the requirements of multiple regimes, which may place them at a competitive disadvantage in some markets. ING Direct stated:

> … the fact is that in the end the group itself is subject to specific regulation by its home regulator, the Netherlands. Here we are subject to our regulation that comes to capital. There are differences between the two systems but the fact is though, we have to comply with both, so in the end

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36 Mr Richard Gray, Executive Director of Regulatory Reform, Group Finance, Westpac Group, *Committee Hansard*, 9 August 2012, p. 8. Perhaps borrowing a famous quote from *Yes, Minister*, Mr Tate from Westpac acknowledged that it would be a 'courageous decision' for a bank to rally against greater regulation following the global financial crisis.

37 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 17.

38 Westpac, *Submission 34*, p. 3.

> we have to take the strictest interpretation or the most severe interpretation of the legislation.[39]

2.35 The most significant of the regulatory changes is Basel III, the latest iteration of the Basel Accords. Chapter 3 focuses on Basel III and its implementation in Australia, however, some of the banks' observations about the Accord are relevant here. A main argument put forward by the banks is that Australia was diverging from how Basel III was being implemented in other jurisdictions, and that this inconsistency was posing compliance challenges and increasing their costs. The ANZ Deputy CEO provided a summary of his bank's view:

> One of the concerns that we had about the fragmentation that was happening around Basel III, and the different rules, was that we were starting to see different regulatory regimes across many countries. We operate in 32 countries. So, if you have to build a bank across multiple regulatory regimes, it increases your costs and the complexities of doing business—which is not good.[40]

2.36 In addition to the Basel reforms, the committee was advised of a number of regulatory changes in other countries which, through extra-territorial effects, have impacted Australian banks. Legislation from the United States in particular was highlighted. Mr Tony Burke from the ABA explained why the US legislation was being framed in this way:

> The US is constructing very complex laws and is determined that smart bankers and their lawyers will not find ways around those laws. So it cast them very widely and inadvertently captures a whole range of activities outside of the US's borders or unrelated to US entities. The laws have quite strong punitive clauses as well and it effectively brings in operations overseas.[41]

2.37 Examples provided in submissions include:

- the US *Dodd-Frank Wall Street Reform and Consumer Protection Act* (particularly the Volcker rule);
- the US *Foreign Account Tax Compliance Act* (FATCA); and
- the UK *Bribery Act 2010*.

2.38 The Volcker rule would prevent banks that take retail deposits that are federally insured in the US from (a) engaging in proprietary trading that is not directly related to the market making and trading they do for customers; and (b) owning or

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39 Mr Vaughn Richtor, Chief Executive Officer, ING Bank (Australia), *Committee Hansard*, 10 August 2012, p. 31.

40 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 23.

41 Mr Tony Burke, Policy Director, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 18.

sponsoring hedge funds or private equity funds. The ABA argues that the drafting of the rule effectively captures any connection whatsoever with the US. An example given was the use of exchanges based in the US by non-US banks when the exchange relates to foreign transactions and does not pose a risk to US taxpayers.[42] For these and other reasons, a number of foreign governments have questioned the extra-territorial implications of the Volcker rule. The US Securities and Exchange Commission's website lists submissions on the Volcker rule from, among others, the Canadian Finance Minister, the UK Financial Services Authority and the European Commission.[43] Formal public representations by the Australian government or its agencies do not appear to have been made. It was perhaps with this in mind that NAB felt obliged to write in its submission:

> Industry associations in the US have advised that direct government to government/regulator comments are affective [sic] at influencing the way the regulators in the US approach final regulation. Any additional support the Australian Government could provide to the industry, either directly or via regulators would be appreciated.[44]

2.39 FATCA was another piece of US legislation whose extraterritorial effects were highlighted by Australian banks. In its submission, the ABA explained that the objective of this Act is to recover lost US tax revenue, but to help achieve this aim it places customer identification and reporting obligations on foreign financial institutions globally.[45] A further explanation of the implications for Australian banks was given as follows:

> … because of connections that Australian banks have with the US, it requires us—we are still sorting it out—to identify American citizens here in Australia and report directly from the banks to the Inland Revenue Service in the US the banking activities of US citizens. We run into all sorts of difficulties with going to Customs and asking if you are a US citizen or not. Of course, there are big penalties if we do not find all the US citizens … It is inadvertent but is very problematic for us. It is fair to say the US administration does not the rate the concerns of other countries terribly highly in its own issues at the moment.[46]

2.40 ING Direct also highlighted FATCA, noting that the US government is the only beneficiary of the law and that it was requiring Australian banks to incur costs

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42 Australian Bankers' Association, *Submission 46*, pp. 5–6.

43 See www.sec.gov/comments/s7-41-11/s74111.shtml.

44 National Australia Bank, *Submission 79*, p. 7 (emphasis omitted).

45 Australian Bankers' Association, *Submission 46*, p. 6

46 Mr Tony Burke, Policy Director, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 18.

'that are not actually relevant to our being good at providing the services to our customers locally'.[47]

2.41 There have been recent developments regarding the compliance burden imposed by FATCA. In July 2012, France, Germany, Italy, Spain, the UK and the US announced a model intergovernmental agreement to address these issues. The agreement seeks to minimise compliance costs by establishing:

> … a framework for reporting by financial institutions of certain financial account information to their respective tax authorities, followed by automatic exchange of such information under existing bilateral tax treaties or tax information exchange agreements. It addresses the legal issues that had been raised in connection with the Foreign Account Tax Compliance Act, simplifies its implementation for financial institutions and provides for reciprocal information exchange.[48]

2.42 The Australian government recently announced that it is 'is exploring the feasibility of an intergovernmental agreement with the US' as an alternative to individual agreements between financial institutions and the US Internal Revenue Service. Treasury initiated a consultation process on this proposal on 28 August 2012.[49] Formal discussions on an agreement have commenced.[50]

## Libor-fixing scandal

2.43 During the course of this inquiry, a number of international banking scandals occurred. A US Senate committee released a report revealing that HSBC, which it had selected as a case study, failed to act on laundering of drug money and other suspicious funds.[51] Standard Chartered was accused by a New York state authority of hiding transactions with Iran—in contravention of US law—and accepted a fine of US$340 million.[52]

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47 Mr Bart Hellemans, Chief Risk Officer, ING Bank (Australia) Ltd, *Committee Hansard*, 10 August 2012, p. 33.

48 *Joint communiqué by France, Germany, Italy, Spain, the United Kingdom and the United States on the occasion of the publication of the Model Intergovernmental Agreement to Improve Tax Compliance and Implement FATCA*, 26 July 2012, www.treasury.gov/press-center/press-releases/Documents/joint%20communique.pdf (accessed 6 September 2012).

49 See www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Intergovernmental-agreement-to-implement-FATCA.

50 The Hon. Wayne Swan MP, 'Australia and the US commence discussions on Foreign Account Tax Compliance Act', *Media release*, 7 November 2012.

51 US Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, *U.S. Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing: HSBC Case History*, July 2012.

52 'Bank Standard Chartered settles Iran probe for $US340m', *Sydney Morning Herald*, 15 August 2012, www.smh.com.au/business/world-business/bank-standard-chartered-settles-iran-probe-for-us340m-20120815-2479j.html (accessed 6 September 2012).

2.44 The most dramatic scandal, however, was the admission that Barclays Bank had been manipulating Libor (the London interbank offered rate). Libor indicates the cost of unsecured borrowing in the London interbank market and is a key benchmark globally for short term interest rates.[53] While the integrity of Libor had been the subject of some earlier speculation, in June 2012 it was publicly confirmed that traders at Barclays had been submitting false rates. Barclays acknowledged that, generally between 2005 and 2008, certain traders requested rates that would benefit their position and requested traders at other financial institutions to also arrange for favourable submissions for their institution. Further, to avoid media speculation that the bank's high US dollar Libor submission might reflect liquidity problems, between 2007 and 2009 Barclays' management ordered its submission to be lowered.[54] As a result, various US and UK authorities imposed fines on Barclays totalling around £290m.[55] However, as it seems that a bank acting alone would have a limited ability to influence Libor, a number of other investigations by regulatory authorities have commenced.[56]

2.45 Given the importance of Libor, the committee was concerned about possible implications for Australian consumers and financial institutions. The RBA was questioned about this; Assistant Governor Dr Guy Debelle provided his analysis of the possible consequences for Australia:

> There is an Australian dollar Libor; banks in London are asked what their Australian dollar borrowing costs are. Very few financial products that we can work out actually reference that. There are some but it is a handful. The impact here is not a big deal. Do Australian entities, including the banks, borrow or have contracts which reference Libor? Yes they do. Australian banks raise money in the US and borrow at a rate that would be Libor plus some spread. They then take those US dollars and swap them back into Australian dollars. That swap contract is also Libor. From the Australian banks' point of view, Libor basically washes out. That is true of an Australian funds manager who is hedging something or BHP when it is borrowing in US dollars and swapping them back to Australian dollars or any Australian corporates that do that. I am sure there are some people who

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53 The Libor for each currency is calculated based on submissions from a selection of large, active banks, which respond to the question: 'At what rate could you borrow funds, were you to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 am?'. A certain number of the highest and lowest submissions are omitted and an average rate is calculated from the remainder.

54 US Department of Justice, 'Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to Pay $160 Million Penalty', *Media release*, 27 June 2012, www.justice.gov/opa/pr/2012/June/12-crm-815.html (accessed 6 September 2012).

55 'Timeline: Barclays' widening Libor-fixing scandal', *BBC News*, www.bbc.co.uk/news/business-18671255 (accessed 7 September 2012).

56 Private proceedings have also been instituted; in August 2012 *The Economist* reported that at least 28 lawsuits had been filed, with cases brought by small banks and mutual funds; 'Suing the banks: Blood in the water', *The Economist*, 4 August 2012, p. 59.

> have products which are affected by Libor but a fairly large chunk of Australian borrowing would not be that affected by it.[57]

2.46 The committee was also concerned about the likelihood of similar conduct occurring with Australia's equivalent, the BBSW. The BBSW is referenced in many financial contracts in Australia, however, the RBA advised that how the BBSW is calculated by the Australian Financial Markets Association (AFMA) differs from how Libor is set. The two major differences are:

- the composition of the panel—for calculating BBSW, AFMA uses a panel which consists of the four major banks (as the issuers of bank paper) and ten dealers (the buyers of bank paper); and
- the question that the panel responds to—'what is the rate that a prime bank in Australia can borrow at?', whereas Libor asks the banks what they think they can borrow at.[58]

2.47 Accordingly, in the RBA's view, the BBSW is less susceptible to manipulation than Libor, although the RBA noted that AFMA is examining BBSW in light of the developments in the UK.[59]

### *Committee comment*

2.48 The admission that Libor, a benchmark rate referenced in an enormous number of contracts globally, was being manipulated for a number of years during the global financial crisis is a troubling development and indicative of the worst types of conduct in the financial system. The committee understands that the Australian benchmark rate, BBSW, is calculated in a fundamentally different manner to Libor and that regardless, the process for calculating BBSW is being examined by AFMA. However, the committee considers that AFMA should make public the results of its review of BBSW to ensure that there can be greater public confidence in the Australian equivalent of Libor.

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57 Dr Guy Debelle, Assistant Governor, Financial Markets, RBA, *Committee Hansard*, 9 August 2012, p. 39.

58 Dr Guy Debelle, RBA, *Committee Hansard*, 9 August 2012, p. 39.

59 Dr Guy Debelle, RBA, *Committee Hansard*, 9 August 2012, p. 39.

# Chapter 3

# Basel III

3.1 The global financial crisis revealed a number of fundamental issues with the international banking system, including that many banks had built up excessive leverage and had a capital base that was inadequate and of insufficient quality. Other banks also encountered problems because of how their liquidity risk was managed. Due to the interconnectedness of global capital markets the problems of individual banks quickly spread, resulting in far-reaching economic ripple effects. This chapter examines one of the most significant reforms that emerged from the crisis—the international agreement to strengthen global capital rules and liquidity buffers collectively referred to as 'Basel III'. As the overarching intent and features of the accord have been agreed to at an international level and are broadly supported, this chapter has a particular focus on how the details of Basel III will be implemented in Australia.

## Overview of capital regulation and the Basel Accords

3.2 The level of capital a bank holds indicates the future ability of the bank to grow, as well as its ability to withstand unexpected losses without becoming insolvent. On this basis, minimum capital requirements play a key role in the regulatory supervision of banks across jurisdictions. However, the appropriate level of capital that a bank should be required to have to provide a sufficient buffer against unexpected losses necessarily requires the balancing of a number of factors:

> If capital levels are too low, banks may be unable to absorb high levels of losses. Excessively low levels of capital increase the risk of bank failures which, in turn, may put depositors' funds at risk. If capital levels are too high, banks may not be able to make the most efficient use of their resources, which may constrain their ability to make credit available.[1]

3.3 International supervisory standards are developed by the Basel Committee on Banking Supervision (Basel Committee), which has the objective to 'enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide'.[2] The Basel Committee does not have the authority to impose the standards it develops, instead:

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1 Bank for International Settlements, 'G10 central bank governors and heads of supervision endorse the publication of the revised capital framework', *Media release*, 26 June 2004, www.bis.org/press/p040626.htm (accessed 21 March 2012).

2 Bank for International Settlements, 'About the Basel Committee' www.bis.org/bcbs/about.htm (accessed 2 April 2012).

> … it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements—statutory or otherwise—which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries' supervisory techniques.[3]

3.4 In Australia prudential regulation, including the implementation of the Basel Accords, is the responsibility of the Australian Prudential Regulation Authority (APRA). The chairman of APRA has noted that APRA generally takes a 'more conservative approach' to capital than the minimum requirements, but that this approach has been 'widely acknowledged as an important contributing factor in the relative success of our banking institutions in negotiating the global financial crisis to this point'.[4]

### *Basel I*

3.5 The first major supervisory framework proposed by the Basel Committee was the *Basel Capital Accord* announced in 1988 (Basel I, also known as the 1988 Accord).[5] Basel I sought to promote a standard approach across banks in different countries. It required a minimum capital standard of eight per cent by the end of 1992 and introduced a system of measuring credit risk.[6] The minimum capital ratios are based on capital in relation to risk-weighted assets, not total assets. Basel I introduced the classification of regulatory capital into tiers to determine minimum requirements:

- Tier 1 capital—core capital, such as ordinary shares and equity; intended to be capable of bearing loss on a 'going-concern' basis (i.e. capital that can be depleted without placing the bank into insolvency).
- Tier 2 capital—supplementary capital, such as subordinate debt and preference shares. Tier 2 capital is 'made up of funding sources that rank below a bank's depositors and other senior creditors, but in many cases are only effective at absorbing losses when a bank is being wound up. In this way,

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3 Bank for International Settlements, 'History of the Basel Committee and its Membership' www.bis.org/bcbs/history.htm (accessed 2 April 2012).

4 Dr John F Laker, Chairman, APRA, 'APRA's Basel III implementation: introductory remarks', APRA Finsia Workshop, 23 November 2011, Sydney, www.apra.gov.au/Speeches/Documents/APRA-Finsia%20Basel%20III%20Implementation%2023%20November%202011.pdf (accessed 17 July 2012), p. 2.

5 Basel Committee on Banking Supervision, *International convergence of capital measurement and capital standards*, July 1988.

6 Bank for International Settlements, 'History of the Basel Committee and its Membership' www.bis.org/bcbs/history.htm (accessed 2 April 2012).

Tier 2 capital provides depositors with an additional layer of loss protection after a bank's Tier 1 capital is exhausted'.[7]

- Tier 3 capital—instruments which cover some market risks (such as foreign currency and commodities risk) that could be allowed by regulators to be included as regulatory capital. Tier 3 was not recognised by APRA and is abolished internationally under Basel III.

3.6 A bank's total risk-based capital ratio is determined by the following equation:

$$\text{Total capital ratio} = \frac{\text{Tier 1+Tier 2 capital}}{\text{Risk weighted assets}}$$

3.7 Under Basel I (and II) requirements, banks needed to ensure that their capital ratio was equal to or greater than eight per cent, including a minimum of four per cent tier 1 capital.

### *Basel II*

3.8 Although Basel I had some success in aligning the capital requirements of banks with international operations, developments in banking markets in the 1990s made the simple approach of Basel I to measuring capital less appropriate, as well as creating 'opportunities for regulatory arbitrage and potential distortions in the provision and pricing of banking services'.[8] According to one observer, the Basel I framework became 'a rapidly expanding work-in-progress as the regulators attempted to keep up with developments in banking, finance, and financial risk management'.[9]

3.9 In June 2004, an agreed text of the *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, better known as Basel II, was released. Basel II built on the Basel I requirements, but focused on the capital adequacy of internationally active banks and notably introduced a capital framework based on "three pillars" (retained in Basel III):

- Pillar 1 (minimum capital requirements)—kept the minimum capital ratio requirement at the eight per cent set by Basel I, but refined the calculation to make it more closely aligned to credit, market and operational risks—e.g. higher levels of capital for those borrowers thought to present higher levels of credit risk;

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7 Adam Gorajek and Grant Turner, 'Australian Bank Capital and the Regulatory Framework', *RBA Bulletin*, September quarter 2010, p .44.

8 Dr John F Laker, Chairman, APRA, 'The Basel II Framework – Some thoughts on Pillar 2', address to the Economic Society of Australia, Melbourne, 28 September 2005, www.apra.gov.au/Speeches/NewDocLib2/The-Basel-II-Framework-Some-thoughts-on-Pillar-2.pdf (accessed 2 April 2012), p. 1.

9 Kevin Dowd et al., 'Capital inadequacies: the dismal failure of the Basel regime of bank capital regulation', *Policy Analysis*, Cato Institute, no. 681, 29 July 2011, p. 2.

- Pillar 2—contained principles for supervisory review of banks' internal assessments of their overall risks;
- Pillar 3—designed to encourage greater market discipline by improving the degree of transparency in banks' public reporting.[10]

3.10 Basel II was implemented in Australia at the start of 2008, a similar timeframe to that taken by the EU.[11] The US had not introduced the new regime before the global financial crisis commenced.[12]

## The GFC and development of Basel III

3.11 Although the origins of the global financial crisis existed before Basel II was implemented by key countries,[13] the crisis highlighted various deficiencies in the framework. The regulation of the quality of capital and the risks covered by the Basel frameworks was particularly subject to criticism. One observer suggested that over the past 30 years 90 per cent of failed financial institutions had reported capital ratios at or near the minimum regulatory requirements just prior to failure. In his view:

> This raises the question of the requirement's adequacy, if the purpose of the capital requirement is to prevent bank insolvencies … The main lesson of the GFC for Basel II is that bank capital is a necessary but not *sufficient* requirement for a bank's stability.[14]

3.12 In the UK and elsewhere, the capital requirements did not mitigate the impacts of the crisis:

> In the run up to the financial crisis, the leverage of UK banks increased significantly. The Basel II capital requirements offered no brake on this trend because requirements were calculated on risk-weighted assets, the value of which tended to rise during the boom. These risk-based models systematically underestimated the risks being built up.[15]

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10 Bank for International Settlements, 'G10 central bank governors and heads of supervision endorse the publication of the revised capital framework', *Media release*, 26 June 2004, www.bis.org/press/p040626.htm (accessed 21 March 2012).

11 House of Commons Treasury Committee (UK), *Banking Crisis: regulation and supervision*, fourteenth report of session 2008–09, July 2009, p. 31.

12 Kevin Dowd et al., 'Capital inadequacies: the dismal failure of the Basel Regime of Bank Capital Regulation', *Policy Analysis*, Cato Institute, no. 681, 29 July 2011, p. 2.

13 However, Professor Moosa argues that Basel II actually contributed to the global financial crisis and the current European debt crisis as the banks worked on compliance with the accord from 2005, with most fully compliant from 2008. In doing this, banks were encouraged to accumulate more asset-backed securities and sovereign debt. See *Submission 100*, p. 11.

14 Associate Professor Chris Terry, 'The new Basel Capital Accord: A major advance at a turbulent time', *Agenda*, vol. 16, no. 1, 2009, ANU, pp. 32, 33 (footnotes omitted).

15 House of Commons Treasury Committee (UK), *Banking Crisis: regulation and supervision*, July 2009, p. 32.

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> While capital is a necessary condition for bank resilience, it of course is not sufficient. Northern Rock had one of the highest capital ratios in the UK when it failed.[16]

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> One of the main contributing factors to the global financial crisis was the excessive leverage (borrowing) built up by banking systems in a number of countries, accompanied by a gradual erosion of the level and quality of regulatory capital held. Liquidity buffers in many global banks were also insufficient. As a consequence, banking systems in a number of countries were unable to cope with large trading and credit losses, particularly in structured credit instruments, or with the massive contraction of liquidity as investors lost confidence in the solvency and liquidity of many banking institutions.[17]

3.13 In addition to appropriate capital rules being in place, others noted the importance of adequate supervision by national regulators:

> … my reading of the crisis was that in many jurisdictions there might have been regulations but there was not much supervision around the regulations … One of the differences between the Australian model and some of the models in other countries is that we have a relatively 'intrusive'—I use that word in a kind way—regulator, who is regularly in at the organisation asking questions of middle management to senior management and the board.[18]

3.14 Some amendments to the Basel Accords were made through Basel 2.5, which was finalised in July 2009 and commenced from 1 January 2012.[19] Basel 2.5 focused

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16 Stefan Walter, Secretary General, Basel Committee on Banking Supervision, 'Basel III and Financial Stability', address to the biennial Conference on Risk Management and Supervision, Bank for International Settlements, Basel, 3–4 November 2010 www.bis.org/speeches/sp101109a.htm (accessed 2 April 2012).

17 APRA, *Submission 55*, p. 2.

18 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, pp. 22–23.

19 Notably, the United States has not yet implemented the amendments brought in by Basel 2.5. A key reason is the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, which prohibits reference to, or requirement of reliance on credit ratings, in U.S. regulations. Credit rating agencies have a role in calibrating capital charges under Basel 2.5. 'Bank capital: Half-cocked Basel', *The Economist*, 7 January 2012, vol. 401, no. 8766, p. 69; U.S. Securities and Exchange Commission, 'Credit Rating Agencies', www.sec.gov/spotlight/dodd-frank/creditratingagencies.shtml (accessed 18 May 2012).

on accounting for the inherent risks of securitisations, re-securitisations[20] and complex financial instruments. The changes included the introduction of higher risk weights for resecuritisation exposures and strengthened requirements for credit analyses of externally-rated securitisation exposures.[21] Amendments were also made to pillars 2 and 3. APRA advised the committee that Basel 2.5 has so far 'had only a limited impact on ADIs in Australia, which largely avoided higher-risk trading activities in the lead-up to and during the global financial crisis'.[22]

3.15 At the September 2009 G20 Leaders' Summit held in Pittsburgh, the G20 countries agreed to develop 'by end-2010 internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage'.[23] Following this declaration, the Basel Committee was tasked with developing the reform package. Initial agreement on the overall nature of the package was reached in July 2010. G20 leaders committed to the broad elements of the reforms at the Seoul Leaders' Summit in November 2010[24] and re-emphasised the commitment and the need to implement Basel III at Cannes in November 2011.[25] In APRA's view, the involvement of key world leaders is a key element of Basel III compared to its predecessor accords:

> If you want to go back in time, you could perhaps call the Basel committee a bit of a club of like-minded central bankers from around the world. This one [Basel III] has much more of a political and G20 drive. In some ways the Basel committee is delivering some of those G20 commitments, which is completely appropriate because that is the committee that has the

20 Resecuritisations are securitisations that have underlying securitisation positions. The Basel Committee defines them as 'a securitisation exposure in which the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation exposure. In addition, an exposure to one or more resecuritisation exposures is a resecuritisation exposure'. An example of a resecuritsation exposure would be a collateralised debt obligation (a security backed by a pool of assets) backed by residential mortgage-backed securities. Basel Committee on Banking Supervision, *Enhancements to the Basel II framework*, July 2009, p. 2.

21 Basel Committee on Banking Supervision, 'Enhancements to the Basel II framework', *Media release*, July 2009, www.bis.org/publ/bcbs157.htm (accessed 18 May 2012).

22 APRA, *Submission 55*, p. 3.

23 *Leaders' Declaration*, Third G20 Leaders' Summit (Pittsburgh, USA), 25 September 2009, www.g20mexico.org/images/stories/docs/eng/pittsburgh.pdf (accessed 21 March 2012) [p. 8].

24 *Leaders' Declaration*, Fifth G20 Leaders' Summit (Seoul, South Korea), 12 November 2010, www.g20.utoronto.ca/2010/g20seoul.pdf (accessed 21 March 2012), p. 2.

25 *Final Declaration*, Sixth G20 Leaders' Summit (Cannes, France), 4 November 2011, www.g20-g8.com/g8-g20/g20/english/for-the-press/news-releases/cannes-summit-final-declaration.1557.html (accessed 23 July 2012) paragraph 23.

expertise in the area. The GFC has created that additional dimension now which was not the case in the past.[26]

## Details of Basel III

3.16 The Basel III Accord strengthens capital and liquidity requirements. Importantly, it targets both the resilience of individual banks as well as system-wide risks. The stated aims of the measures are to improve:

- the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source;
- risk management and governance; and
- banks' transparency and disclosures.[27]

3.17 The Basel III reforms contain six broad categories of measures, five of which relate to capital and one to liquidity:

- higher regulatory capital requirements and amendments to the definition of capital to adopt a more conservative approach to what can be counted as regulatory capital;
- improved risk coverage through strengthened capital requirements for complex securitisations, trading and derivative activities, and strengthened requirements for measuring counterparty credit exposures;
- containing leverage through the introduction of a non-risk-based leverage ratio as a 'backstop' measure to the risk-based framework;
- measures related to risk management and supervision;
- revised disclosure requirements; and
- two global minimum liquidity standards and supervisory monitoring.

### *Capital requirements under Basel III*

3.18 The measures of the Basel III framework that relate to capital requirements build on the existing tier 1 and tier 2 framework outlined in paragraph 3.5, and the three pillars outlined in paragraph 3.9. The capital measures are summarised in Table 3.1. The overall capital ratios are outlined in Table 3.2.

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26 Mr Keith Chapman, Executive General Manager, Diversified Institutions Division, APRA, *Committee Hansard*, 9 August 2012, p. 50.

27 Basel Committee on Banking Supervision, 'International regulatory framework for banks (Basel III)', www.bis.org/bcbs/basel3.htm (accessed 28 March 2012).

**Table 3.1: Summary of the Basel III capital measures**

| *Areas of focus* | *Measure* |
|---|---|
| Increasing the quality of capital | A stronger definition of regulatory capital that will mean the predominant form of tier 1 capital will be common equity, the highest form of loss absorbing capital. The minimum common equity requirement will be increased from 2% to 4.5% of risk-weighted assets. |
| | Deductions from capital must generally be made from common equity tier 1 and available tier 1 capital must be determined after deductions rather than before. |
| | The remaining tier 1 capital (additional tier 1 capital) 'must be comprised of instruments that are subordinated, have fully discretionary noncumulative dividends or coupons and have neither a maturity date nor an incentive to redeem';[28] that is, among other things, it must be more loss-absorbing and not have an incentive to redeem prior to maturity. |
| Increasing the quantity of capital | Outside of periods of stress, banks will need to hold a capital conservation buffer of 2.5% (comprised of common equity tier 1) to withstand future periods of stress. Combined with the increased common equity requirement noted above, this brings the total common equity requirement to 7%. If capital levels of a bank fall into the buffer range, capital distribution constraints will be imposed that increase in severity as the buffer reduces.[29] |
| | Total regulatory capital (tier 1 capital plus tier 2 capital) must be at least 8% of risk-weighted assets at all times. |
| | Overall tier 1 capital must be at least 6% of risk-weighted assets at all times. |
| Countercyclical buffer | A countercyclical buffer, varying between zero and 2.5% of risk-weighted assets, will be available to regulators when excess aggregate credit growth is judged to be associated with an unacceptable build-up of system-wide risk, such as when credit growth is occurring at a rate which, historically, financial system stability has been undermined. The buffer will be implemented through an extension of the capital conservation buffer and met by common equity tier 1 capital. |
| Reduced leverage | A non-risk-based leverage ratio will be introduced to serve as a backstop to the risk-based capital requirement and to prevent banks building-up excessive on and off-balance sheet leverage. A minimum tier 1 leverage ratio of 3% of bank exposure is being tested. |
| Risk coverage | A number of changes to ensure that all material risks, particularly counterparty credit risk, are captured in the pillar 1 framework. Complex trading, derivative and securitisation activities will require more capital and banks must determine their capital requirement for counterparty credit risk using stressed inputs. |
| Other measures | Higher standards for supervisory reviews (pillar 2) and public disclosures by banks (pillar 3). |

28 Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 (revised June 2011), p. 2.

29 The capital distribution constraints are restrictions on the payment of dividends, share buybacks and discretionary bonus payments to staff. See Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 (revised June 2011), p. 56.

**Table 3.2: Minimum capital ratio requirements under Basel III**

| Category | | % of RWA |
|---|---|---|
| Common equity tier 1 capital | Minimum | 4.5 |
| | Minimum plus conservation buffer | 2.5 |
| | Total common equity | 7.0 |
| | If needed, an additional countercyclical buffer to be met by common equity tier 1 capital | 0–2.5 |
| Tier 1 capital | Total tier 1 capital | 6.0 |
| | Minimum plus conservation buffer | 8.5 |
| Total capital | Total capital (tier 1 + tier 2) | 8.0 |
| | Total capital plus conservation buffer | 10.5 |

### *Liquidity measures under Basel III*

3.19 The liquidity reforms are comprised of quantitative and qualitative requirements. The quantitative requirements are global minimum liquidity standards that will be introduced to make banks more resilient to potential short-term disruptions in their ability to access funding and to address liquidity mismatches on banks' balance sheets. Two standards will be introduced:

- Liquidity coverage ratio (LCR)—the LCR is intended to improve short-term liquidity coverage. It will require banks to have sufficient high-quality liquid assets to withstand a stressed funding scenario that is specified by supervisors (based on the stock of high quality liquid assets and the capacity of these assets to cover expected cash outflows over the 30 day scenario); and
- Net stable funding ratio (NSFR)—the NSFR is a longer-term structural ratio intended to encourage banks to use stable funding sources[30] (i.e. reduce their dependency on short-term wholesale funding). The NSFR requirement is:

$$\frac{\text{available amount of stable funding}}{\text{required amount of stable funding}} > 100\%$$

3.20 The qualitative requirements are measures designed to strengthen governance and risk management of liquidity risk in banks.

30 Stable funding is defined as the portion of those types and amounts of equity and liability financing expected to be reliable sources of funds over a one-year time horizon under conditions of extended stress. Basel Committee on Banking Supervision, *Basel III: International framework for liquidity risk measurement, standards and monitoring*, December 2010, pp. 25–26.

## Views on Basel III and its overall impact

3.21 APRA commenced consultation on the implementation of Basel III in December 2010 by advising the ADIs of its support of the reforms.[31] In September 2011 it released a consultation paper on the capital reforms, followed by a discussion paper on the liquidity reforms in November. On 30 March 2012, APRA released its response to the submissions on the capital reforms. On 28 September 2012, APRA released the final prudential and reporting standards for most aspects of the capital reforms. The remaining standards were published on 13 November 2012.

3.22 Evidence received from the major banks and their representative organisations acknowledged their overall support for the intent of Basel III and instead focused on specific aspects of how Basel III will be implemented in Australia:

> We agree with the broad thrust of the Basel III regulations. We agree with the idea around international harmonisation. We do not want Australia and Australian banks to be again affected by lax banking practices elsewhere in the world when we feel we run a prudent system here in Australia and a very well regulated and well supervised system.[32]
>
> * * *
>
> We are putting Basel III in place and we are largely willingly putting in Basel III in place. We have had some technical issues and we have a disagreement with APRA, which is fine, because APRA gets the final say, about the pace at which some of those changes have been made. As I have said several times, we absolutely need to learn from the lessons of overseas, but just because banks and bankers and regulators failed in some other jurisdictions and therefore need major overhaul to their regulatory systems does not mean that that is the appropriate situation for Australia.[33]

3.23 Westpac submits that the liquidity reforms, rather than the changes to capital requirements, are more likely to impact Australian banks by 'increasing the cost of, whilst constraining the capacity for, credit provision by the banking sector':

> The LCR will require that a greater proportion of deposits and other liabilities are held in the form of high quality liquid assets, which by definition therefore means a reduced lending capacity for a given deposit base. The NSFR will require that lending activity is supported to a greater extent by more stable funding, in general directing liability raising activities towards retail deposits and long term wholesale funding. The price impact has been readily apparent to all observers, particularly in the retail deposit

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31 APRA, *Discussion Paper: Implementing Basel III capital reforms in Australia*, September 2011, p. 10.

32 Mrs Lyn Cobley, Executive General Manager, Group Treasury, Commonwealth Bank of Australia, *Committee Hansard*, 9 August 2012, p. 30.

33 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 25.

> space, but price alone may not be sufficient to address the capacity of the market to supply stable funding to support credit growth.[34]

3.24 At a public hearing, a Westpac representative further explained their bank's concern about the costs associated with the liquidity measures:

> The rules will work by stating if you have high-risk deposits, online deposits and the like, you have to keep a certain percentage of that in liquid assets to cover in case something goes wrong. Let us say we have $100 of online deposits. Under the rules you have to keep $30 of that in highly liquid government securities and the like. The cost comes from the rule stating that for the $100 you have as a deposit, and let us say you are paying five per cent, on the $30 of liquid securities you have you are probably earning half a per cent less than that because it is in highly liquid government securities. The cost is the difference between what you have on the deposit side and the low government yield on the other side, so the 50-point difference which is what the drag is. If you have that drag then other assets, other forms of borrowing, are going to have to pay for that gap. That is where the cost comes in.[35]

3.25 In a general sense, there are other possible risks. The Deputy Governor of the RBA, Phillip Lowe, recently noted concern that current efforts to tighten regulation could actually create new risks through increased 'shadow banking' as activities are pushed off banks' balance sheets. Further, the means by which banks respond to increased costs of financial intermediation, partly contributed to by new regulatory requirements, could also be of concern if lower returns on equity increase the incentive for banks to take on new risks, or lead to cost-cutting in risk-management areas at banks.[36]

3.26 Academics held a broad range of views about the implementation of Basel III in Australia. Professor Moosa questioned the need to implement Basel III at all, describing the Basel Accords as having a 'miserable history' and arguing that financial regulation 'should be a domestic issue, tailor-made for the domestic economic conditions and financial environment'.[37] Professor Milind Sathye raised a number of possible consequences. Some of these included increased cost of bank funds (with the possibility of this being passed onto their customers), the heightened need to preserve capital impacting the allocation of capital to different lending categories, such as small business lending, depending on rates of delinquency and an impact on the mortgage

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34 Westpac, *Submission 34,* p. 3.

35 Mr Jim Tate, Acting Chief Operating Officer, Australian Financial Services, Westpac Group, *Committee Hansard*, 9 August 2012, p. 3.

36 Philip Lowe, Deputy Governor, RBA, 'Bank Regulation and the Future of Banking', address to the 41st Australian Conference of Economists, Melbourne, 11 July 2012, www.rba.gov.au/speeches/2012/sp-dg-110712.html (accessed 17 July 2012).

37 Professor Imad Moosa, *Submission 100*, p. 4.

loan market due to higher risk weights for securitisation.[38] Professor Kevin Davis noted that the capital reforms, while piecemeal, were a response to particular identified problems. On the liquidity measures the professor was less enthusiastic:

> To some extent the requirement for a minimum liquidity coverage ratio which says that banks have to hold a certain amount of government securities ignores the fact that, if we do have a liquidity crisis, the central bank has to step in and provide liquidity facilities and, in doing that, it will accept either government securities or private sector securities in repurchase agreements—taking an effective haircut off the collateral to make sure that the central bank does not have an exposure to default.
>
> A similar sort of issue arises with the net stable funding ratio. What that is doing is effectively reducing the ability of banks to undertake liquidity transformation—borrow short and lend long—which, from all economic textbooks, is one of the major economic functions that the banks carry out. So one has to be a bit careful about the extent to which that reduces the ability of banks to do the real functions that are key to them.[39]

### *Impact on the Australian economy*

3.27 Accompanying the initial announcement of Basel III, the subsequent release of details about the reforms, and the early stages of its implementation are some concerns about the impact it will have on the economic output of particular countries. In Australia, however, the impact on economic output may be different. Australian banks are already well-capitalised, particularly the non-major ADIs. APRA notes that because the transition process to Basel III has not yet begun it is difficult to assess what impact it will actually have,[40] although the ABA points out that banks 'have been anticipating the changes in prudential requirements as a result of Basel III', including the need to expand their stable funding.[41]

3.28 At a global level, the Basel Committee considers that the effects of Basel III on the banking sector and the broader economy will potentially have a 'modest impact' on economic growth.[42] Domestically, the RBA considers that the imposition is not going to be 'particularly large'.[43] Although Basel III may prove to have some

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38 See Professor Milind Sathye, *Submission 31*, pp. 4–7.

39 Professor Kevin Davis, Australian Centre for Financial Studies, *Committee Hansard*, 8 August 2012, p. 36.

40 APRA, *Submission 55*, cover letter from Dr Laker dated 31 May 2012.

41 Australian Bankers' Association, *Submission 46*, p. 30.

42 Basel Committee on Banking Supervision, *The Basel Committee's response to the financial crisis: report to the G20*, October 2010, p. 2. See also *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, August 2010.

43 Dr Guy Debelle, Assistant Governor, Financial Markets, RBA, *Committee Hansard*, 9 August 2012, p. 39.

economic cost, the chairman of APRA recently expressed his view—shared by the Basel Committee and many others—that the economic benefits of Basel III should be 'seen from a longer-term perspective in the form of higher output that would be enjoyed from a reduction in the frequency and severity of banking crises':

> The economic benefits of a safe banking system accrue as both private and public benefits. As the world is being painfully reminded, the losses in output during a crisis and in subsequent years are substantial, and some of the losses may be permanent. In the United Kingdom, as just one example, the cumulative loss of output since the crisis began is likely to be at least 25 per cent of annual GDP already, and the eventual loss could be a multiple of this.[44]

3.29 Of course, Basel III will not make the international banking system bulletproof:

> It will provide a more secure banking system worldwide, yes—no doubt. Will it prevent future financial problems? I do not know that anything can prevent future financial problems. We are dealing with an industry which is dealing with risk, and everything prudent and appropriate and farsighted that we can do to ensure that we never have another experience like the GFC needs to be done, recognising that all of that comes at a cost and that we need to balance that.[45]

3.30 To some extent, while the economic cost of Basel III to Australia and the international economy more broadly is debatable, at this point in time it is essentially an academic discussion. As the Basel III reforms encompass the largest international banking sectors and have the backing of the G20, Australia has little flexibility regarding the broad reforms. However, how the reforms are implemented domestically is an issue that is worthy of scrutiny and discussion. This point was well articulated by Professor Davis:

> If we did not follow the Basel Accord and the rest of the world is doing so, our financial sector would suffer in terms of its image in the rest of the world. There is much more emphasis now through things like the Financial Stability Board and their peer assessments of countries on how well or how closely various countries are following the international agendas. So, in a sense, we are stuck with that as a constraint within which we operate … We cannot deviate too much, but we need to ask the question as to how they fit best into the structure of the Australian financial sector, particularly because

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44 Dr John F Laker, Chairman, APRA, 'Bank regulation and the future of banking', address to the 41st Australian Conference of Economists, Melbourne, 11 July 2012, www.apra.gov.au/Speeches/Documents/John%20Laker's%20%20Australian%20Economic%20Forum%2011%20July%202012.pdf (accessed 23 July 2012).

45 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 28.

our banks were not heavily engaged in the trading activities and so on previously but they might in the future.[46]

## Implementation of Basel III in Australia

3.31 As noted above, while the ADIs are broadly supportive of Basel III, some issues regarding the approach to implementing Basel III in Australia and certain unique characteristics of Australia's financial system that would impact its implementation were noted. These included the:

- implementation timetable in Australia compared to other jurisdictions;
- treatment of certain capital instruments;
- treatment of mutual ADIs;
- consequences of limited sovereign debt;
- definition of a 'basic deposit product'; and
- application of the countercyclical capital buffer.

3.32 These issues will be discussed in the following paragraphs.

### *The implementation timetable in Australia*

3.33 Globally, Basel III is required to be fully implemented by 1 January 2019, with a transition to the arrangements commencing in January 2013.[47] Within this broad timetable, different aspects of the reforms have different minimum implementation dates. In Australia, APRA will follow aspects of this timetable but has announced an 'accelerated' timetable for some key elements of the reforms,[48] namely that:

- the revised Basel III minimum requirements for minimum common equity tier 1 capital of 4.5 per cent will commence on 1 January 2013, rather than the Basel Committee's timetable of 1 January 2015; and

46 Professor Kevin Davis, Australian Centre for Financial Studies, *Committee Hansard*, 8 August 2012, p. 36.

47 Reforms to the counterparty credit risk framework become effective on 1 January 2013.

48 While the implementation timetable in Australia is often described as 'accelerated', an APRA official claimed that this characterisation 'is not quite reality'. He stated that 'We [APRA] are starting the Basel reforms on the earliest date that Basel agreed they should be started. Basel has allowed countries to choose to start later, but there is no need in the Australian case to do so'; Mr Charles Littrell, Executive General Manager, Policy, Research and Statistics Division, APRA, *Committee Hansard*, 9 August 2012, p. 51. However, the phrase 'accelerated timetable' has been used by the APRA chairman to describe APRA's approach; see Dr John F Laker, Chairman, APRA, 'APRA's Basel III implementation: Introductory remarks', address to the APRA Finsia workshop, Sydney, 23 November 2011, www.apra.gov.au/Speeches/Documents/APRA-Finsia%20Basel%20III%20Implementation%2023%20November%202011.pdf (accessed 29 August 2012), p. 6.

- the capital conservation buffer will be introduced in full on 1 January 2016, rather than being phased in between 1 January 2016 and 1 January 2019 as proposed by the Basel Committee's timetable.[49]

3.34 APRA has indicated that in 2015 it will advise whether a countercyclical buffer will apply from 2016 and whether transitional arrangements are required.[50] APRA also advised that the Basel Committee has not finalised measures to address counterparty credit risk and to enhance disclosure requirements, but that APRA will consult on the implementation of these measures in Australia once they have been finalised.[51] APRA will follow the Basel Committee's timetable for the liquidity reforms (LCR to be introduced on 1 January 2015 after an observation period which began in 2011 and the NSFR introduced from 1 January 2018).[52]

*Impact of the accelerated implementation timetable*

3.35 Since Basel I, Australian banks have consistently held capital well above the minimum requirements.[53] APRA submits that the larger banks currently have a common equity tier 1 capital ratio well above the minimum that Basel III would require to be phased in by January 2015 (see Figure 3.1). Accordingly, APRA has used these results to support its accelerated implementation timetable. APRA argues:

> The larger banks already meet the 2013 target and need take no action. APRA believes that they will be readily able to meet the 2016 target through prudent earnings retention policies. The accelerated timetable is

49 The chairman of APRA has described the accelerated timetable as 'a vote of confidence, on APRA's part, in the strength of the Australian banking system', although he acknowledged that 'not everyone saw it that way'. Dr John F Laker, Chairman, APRA, 'APRA's Basel III implementation: Introductory remarks', address to the APRA Finsia workshop, Sydney, 23 November 2011, www.apra.gov.au/Speeches/Documents/APRA-Finsia%20Basel%20III%20Implementation%2023%20November%202011.pdf (accessed 3 April 2012), p. 5.

50 APRA, *Discussion Paper: Implementing Basel III capital reforms in Australia*, September 2011, p. 8.

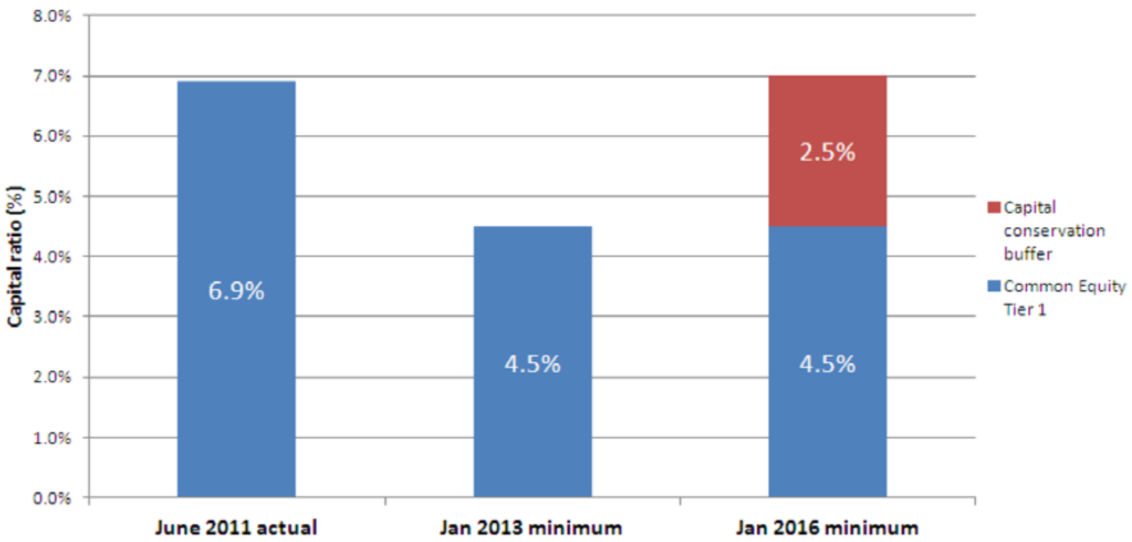
51 APRA, *Submission 55*, p. 4. In August 2012, APRA released a discussion paper on the counterparty credit risk capital framework and other aspects of the capital reforms in August 2012. The final prudential standards, reporting standards and guidelines on these matters were released in November 2012. Although the counterparty credit risk framework becomes effective on 1 January 2013 under the Basel Committee's timetable, given the relatively short time between the Basel Committee's release of the final counterparty credit risk measures and the effective date of these measures, APRA has indicated that ADIs may 'prepare counterparty credit risk capital calculations on a "best endeavours" basis until their first annual reporting period beginning on or after 1 July 2013. APRA, *Response to Submissions: Implementing Basel III capital reforms in Australia—counterparty credit risk and other measures*, November 2012, p. 15.

52 APRA, *Submission 55*, p. 6.

53 Associate Professor Chris Terry, 'The new Basel Capital Accord: A major advance at a turbulent time', *Agenda*, vol. 16, no. 1, 2009, ANU, p. 33.

unlikely to impose any burden on smaller ADIs, given their current high capital ratios and generally lower level of regulatory adjustments.[54]

**Figure 3.1: Actual capital v Basel III minimum capital requirements, selected larger banks (end June 2011)**




Source: APRA, *Submission 55*, p. 5.

3.36 The ABA, however, argued that Australia 'should not put itself at a competitive disadvantage by implementing ahead of its major trading partners'. Doing so, in its view:[55]

> … could put pressure on the prices that banks are able to offer households and business. Additionally, these costs may come at a time of heightened uncertainty in international money markets. It has been argued that the costs of accessing wholesale funding for Australian banks will reduce as they hold more capital and become less risky. The current reality is banks are being asked to raise additional capital in an environment where capital is becoming increasingly difficult and more expensive to obtain.[56]

3.37 The ABA also raised issues about the likelihood of other jurisdictions implementing Basel III in the near future, and questioned the benefits of Australia being so out of step with those countries:

> Mr Münchenburg: … I understand APRA's argument, which is that the banks can get there. It is a very good way of sending a signal to the rest of the world about how well capitalised banks in Australia are if we comply with the Basel III capital requirements early. Our concern is when we look around the rest of the world we do not see the same levels of enthusiasm for

54 APRA, *Submission 55*, p. 5.

55 Australian Bankers' Association, *Submission 46*, pp. 4, 6.

56 Australian Bankers' Association, *Submission 46*, pp. 6–7.

implementing Basel III as we see here in Australia. A number of jurisdictions are less well advanced with developing their regulation than we are, including most notably the US which is yet to release—

CHAIR: It has not even implemented Basel II properly yet, has it?

Mr Münchenburg: Indeed. And it is yet to indicate in any clear way how it proposes to implement Basel III whilst maintaining that it will. Again, the issue for us is one of balance. We are not disputing the need to move to Basel III. Our own banks would not want to be not Basel III compliant because, when they go out to raise funds overseas, that is a box that investors would want to see very firmly ticked.[57]

3.38 NAB raised similar concerns given the current European crisis:

CHAIR: Basel III seems to have been pretty well accepted. Do you think there is a risk that other countries will not go through with it?

Mr Joiner: I am waiting for Europe to say that it is unaffordable at this pace … You come back to this industry profitability point. If you are like we are—we have 15 per cent or 16 per cent return on equity—when we need to recapitalise, we go to the market and we raise it from shareholders. If you are like the German banks or the UK banks and you have no or negligible return on equity, you cannot go and recapitalise in the markets. The only way to comply with Basel III is to sell assets, stop writing loans and shrink your balance sheet until your ratios are good. But that destroys the economy around you and you get into a negative spiral. There is no clear evidence of it, but I have always had the view that, at some point, Europe is going to say, 'This is not the right time to do this.'

CHAIR: Given that the US has traditionally been slow on this—

Mr Joiner: The US, at the end of the day, rarely does anything which is bad for business. [58]

3.39 As the implementation of Basel III in Australia should make it clearer to international investors that Australian banks are well-capitalised, there is a possibility that early adoption would mean that banks could raise funds from international wholesale markets at a lower cost. APRA's chairman has argued:

Surely, given the recurring global market turbulence, nothing could be more positive for the competitive standing of ADIs in Australia, or for investor confidence in these institutions, than being early in displaying the Basel III

57 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 17.

58 Mr Mark Joiner, Executive Director and Chief Financial Officer, National Australia Bank, *Committee Hansard*, 10 August 2012, pp. 70–71.

> equivalent of the Heart Foundation's Tick … for the health of their capital position.[59]

3.40 Whether these advantages would eventuate was an issue pursued by the committee with the ABA. Its CEO acknowledged 'that is an argument'; however:

> … I understand from my discussions with the banks that it does not quite work in the sense of you are well advanced with Basel III so therefore we will give you an extra tick. It is more the case you will be penalised if there was no evidence that you were going to be Basel III compliant. It is well known that the Australian banks are well capitalised. It is well known around the world that Australia, Canada and a few other jurisdictions came through the GFC relatively unscathed. It is easy to overstate the extent to which early adoption of Basel III gives a competitive edge or a price edge in raising money internationally.[60]

3.41 Treasury dismissed arguments regarding the possible impact on the banks' international competitiveness if Australia implements elements of Basel III earlier than other jurisdictions:

> We cannot be concerned about what other countries do. We have to make sure that this trade-off on stability and competition ensures that we have got the best prudential requirements we can have that suit our circumstances. I think that is what APRA is seeking to achieve. There are other countries in Europe that have higher capital requirements on their banks so APRA is well apprised of the issues.[61]

3.42 Other observers also consider there will be little practical impact. Professor Davis described the likely impact of earlier implementation as 'next to nothing'. In addition to the fact that the major Australian banks are already holding capital at levels near the Basel III minimum requirements, and that the capital levels of smaller ADIs are above the threshold, Professor Davis noted the benefits from Australia's dividend imputation tax system:

> The argument that would be posed as to why that might reduce international competitiveness would be the standard argument that says that the more equity you have to use, the higher will be your total cost of funding. If I put my academic's hat on again … I could refer to a whole lot of theory that says that there are only certain situations in which equity is actually more expensive than debt. The standard argument is that as a bank gets more

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59 Dr John F Laker, Chairman, APRA, 'APRA's Basel III implementation: Introductory remarks', address to the APRA Finsia workshop, Sydney, 23 November 2011, www.apra.gov.au/Speeches/Documents/APRA-Finsia%20Basel%20III%20Implementation%2023%20November%202011.pdf (accessed 23 July 2012), p. 6.

60 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 17.

61 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 6.

> levered, then yes, they are using more deposits or debt—which looks cheaper—but the cost of their equity is going to go up. Shareholders are going to demand a higher return because of a higher risk.
>
> The critical thing in the case of the Australian banks that distinguishes them from banks in almost every other country in the world is that we have a dividend imputation tax system. One of the big incentives for companies and banks to use debt and deposits is the tax deductibility of interest. Then the problem they face is that when they pay dividends, the dividends are effectively taxed twice under a classic tax system. We do not have that. We have a situation, with dividend imputation, whereby—to the extent that the tax is paid at the company or the bank level—when shareholders receive the dividends they get tax credits, if they are Australian shareholders. So any sort of tax induced costs, which is one of the main effects to the Australian banks, is pretty small, I think. Again, that is a debatable issue, because some people would say that the tax credits—the franking credits—are not worth much; others would say they are worth a lot. It is an empirical question, but it is certainly not as significant an effect for Australian banks under the imputation tax system as it would be for banks in other countries under the classical tax system.[62]

### *Committee comment*

3.43 The committee recognises that prudential regulation necessitates an appropriate balance between stability and competition being found. However, it does not accept the argument put forward by Treasury that Australia should not be concerned about the prudential regulation in place in other countries. Given the implications for the competitiveness of Australia's banking sector and the possible consequential effects on the price of credit and the economy, Australian policymakers need to take into account what other countries are doing when developing prudential standards and making an informed decision on where the appropriate balance lies.

## ***Domestic regulatory discretion exercised in Australia***

### *Overview of APRA's intent*

3.44 As acknowledged and supported by Treasury, APRA has continuously taken a conservative approach to implementing the Basel Accords.[63] While the Basel Committee gave national regulators the discretion to provide limited recognition of certain items for calculations of common equity tier 1, such as investments in the common shares of non-consolidated financial institutions (other banking or insurance wealth management businesses) and certain deferred tax assets, APRA is not

62 Professor Kevin Davis, Australian Centre for Financial Studies, *Committee Hansard*, 8 August 2012, p. 42.

63 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 6.

proposing to change its current policies to allow banks to include these.[64] Accordingly, such items would need to be deducted in full from common equity tier 1 capital.

3.45 In addition, the CBA identified two other key areas where APRA's proposals differ from the approach taken by overseas regulators—namely that APRA takes a more conservative approach:

- in calculating the amount of capital required to be held against mortgages; and
- to the amount of capital required for interest rate risk within the banking book.[65]

3.46 On the liquidity reforms, APRA is proposing that all ADIs meet the qualitative requirements, but that only the larger ADIs will need to meet the new LCR and NSFR requirements. APRA is intending to implement the Basel III liquidity rules with only minor modifications to address unique aspects of Australia's financial system, such as the volume of retirement savings in self-managed superannuation funds.[66]

*Treatment of investments in non-consolidated financial institutions*

3.47 The concessional arrangements for investments in non-consolidated financial institutions that the Basel rules allow national regulators to implement, but which were not endorsed by APRA, was a specific issue commonly raised by financial institutions. An APRA official explained how this decision would impact banks with wealth management arms:

> There are always exceptions to the rule, but the core rule is that if a bank has an investment in such a business it is normally 100 per cent deducted from capital. What will happen under Basel III is that the deduction will be from the common equity proportion of capital as opposed to being spread across a broader set of capital. So the impact of the deduction will be more conservative, but the size of the deduction will be the same.[67]

3.48 APRA is of the view that such arrangements 'would represent a double use of capital, which does not strike us as prudent', while the concession for deferred tax assets 'allows an asset that is unlikely to exist in the case of a failed or severely

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64 APRA, *Submission 55*, p. 4.

65 Commonwealth Bank of Australia, *Submission 81*, p. 3 (footnotes omitted).

66 Dr John F Laker, Chairman, APRA, 'APRA's Basel III implementation: introductory remarks', address to the APRA Finsia Workshop, Sydney, 23 November 2011, www.apra.gov.au/Speeches/Documents/APRA-Finsia%20Basel%20III%20Implementation%2023%20November%202011.pdf (accessed 17 July 2012), p. 3.

67 Mr Charles Littrell, Executive General Manager, Policy, Research and Statistics Division, APRA, *Committee Hansard*, 9 August 2012, p. 53.

troubled institution, and again, this does not strike us as prudent'.[68] Another APRA official further explained the guiding rationale behind this approach:

> Effectively, what we are saying is that if a bank is invested in these sorts of businesses then the shareholders are invested in it, not exposing the depositors to the potential risk. That is the important reason why we have always gone for the deduction element, to stop there being depositor exposure, which is after all our primary function protecting the interests of the depositors themselves.[69]

3.49 The ABA and the CBA argued that the divergences between APRA's Basel III proposals and the minimum Basel III requirements will result in Australian banks reporting lower capital ratios than their international peers. The ABA claimed that this will mean 'Australian banks will *appear* less capitalised than their peers':

> While in theory perfect information and adequate capacity allows for (overseas) investors to fully analyse the differences between APRA's approach and that undertaken by overseas jurisdictions, what happens in the real world can be quite different.[70]

3.50 The CBA argues that, even with a common disclosure template being proposed by the Basel Committee, investors will need to undertake more detailed analysis in order to accurately compare bank capital ratios. A CBA executive advised that the difference between how capital is reported under APRA requirements compared to the international approach results in more than a two per cent difference in headline ratios.[71] To emphasise the issues with headline capital ratios, the CBA pointed to an international report which erroneously stated that Australian banks were less capitalised compared to northern European and US banks.[72]

3.51 From the ANZ's perspective, APRA's different approach was particularly perceived to be an issue given the bank's regional expansion strategy:

> … some of the rules which are being applied—for example, the rule around associates—mean that, if we are looking to expand into Asia, the capital treatment in the approach that we would take in expanding into that market would be different to competitors who are operating in different

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68 Mr Charles Littrell, APRA, 'APRA's Basel III Implementation: Rationale and Impacts', address to the APRA Finsia Workshop, 23 November 2011, www.apra.gov.au/Speeches/Documents/APRA-Finsia%20Basel%20III%20Implementation%2023%20November%202011%20CWL%202.pdf (accessed 17 July 2012), pp. 2–3.

69 Mr Keith Chapman, APRA, *Committee Hansard*, 9 August 2012, p. 53.

70 Australian Bankers' Association, *Submission 46*, p. 7. See also Commonwealth Bank of Australia, *Submission 81*, p. 3.

71 Mrs Lyn Cobley, Executive General Manager, Group Treasury, Commonwealth Bank of Australia, *Committee Hansard*, 9 August 2012, p. 26.

72 RBS Macro Credit Research, *The Revolver*, 24 May 2012, p. 7; cited in Commonwealth Bank of Australia, *Submission 81*, p. 4.

jurisdictions, and we would see that potentially we could be at a competitive disadvantage … The issue around giving zero benefit for capital in associates has a material business impact and therefore does affect both the strategy and the cost of doing business.[73]

3.52 When questioned by the committee about this issue, APRA officials stated that they have given it consideration but suggested that, empirically, the markets appear to understand the position of Australian banks. APRA considers that Australian banks are relatively welcome in international equity and debt markets; an important observation given that the bond investors who provide bank funding are sophisticated financiers. Further, the strong credit ratings held by the major Australian banks also reflect an understanding of APRA's approach:

> On the ratings side, I do not think anyone could say that the major ratings houses are cursory or naive investors, and they perfectly well understand this. As it happens, we meet with them from time to time and go through all this in great detail. The substantial banks in this country, their collective rating, puts them in the top three national banking groups in the world. So pretty clearly on the credit ratings side they are not suffering because we hold them to a firmer standard. If you look at the equity side and compare the market capitalisation of our banks to any set of Western nation peers, our banks relatively are at historic highs. The equity market seems to understand what is happening.
>
> There are some commentators in the market who you could characterise as—I would think 'lazy' is not the right answer but let us say something else—cursory or distant, who do pull the headline numbers and not look behind them. But I would suggest that those are not the investors that make the market. The margin in markets is made by the smarter, more active investors. They are not the ones that sit back and do not do the work.[74]

3.53 The difficulty with comparing capital ratios across jurisdictions was discussed in a 2010 IMF report relating to the implementation of Basel II, which supported APRA's overall approach to these matters.[75] Additionally, APRA pointed out that the banks can be proactive in demonstrating that their capital ratios are not effectively

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73 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 19.

74 Mr Charles Littrell, APRA, *Committee Hansard*, 9 August 2012, pp. 51–52.

75 The IMF report stated 'APRA has done well to take national circumstances and experiences into account to make the appropriate choices of national discretion items in Pillar 1 of the Basel II framework. This has led to the view that reported minimum Tier 1 capital ratios for the major banks are lower than would otherwise be the case. However, actual levels of capital held by banks in various jurisdictions are affected by many factors. Great care is needed in interpreting these results. APRA is correct to distance itself from the type of specific comparison between countries that banks are publishing'. International Monetary Fund, *Australia: Basel II Implementation Assessment*, May 2010, p. 3.

lower than their international counterparts, an option acknowledged by ANZ that it exercises:[76]

> … there is nothing to stop the banks—and some of them have been doing it—publishing a comparable number that they have calculated. So, using the example of eight versus 10, I guess it depends which bank you are reading from. There is nothing to stop them saying, 'We're an eight on an APRA basis and a 10 on what we calculate on a Basel basis.' Also, the Basel committee has recognised this issue, so there is now a template which tries to take a standardised disclosure approach so that the banks around the world can use that template and demonstrate where they would sit on a comparable basis.[77]

3.54 In September 2012, APRA published a statement that 'acknowledges industry's continuing concerns about the comparability of capital positions of banking institutions across other jurisdictions'. Accordingly, APRA advised that in 2013 it will consult on the Basel Committee's proposals for disclosure requirements for the composition of capital, which includes the common reporting template 'that will enable investors and analysts to make cross-border comparisons for banking institutions in a straightforward and efficient way'.[78]

### *Treatment of mutual ADIs*

3.55 Being an international agreement, Basel III will clearly pose some challenges for implementation at a domestic level as some unique features of individual banking markets and jurisdictions will need to be accounted for. Abacus-Australian Mutuals, the peak industry body representing Australian building societies, credit unions, mutual banks and friendly societies, noted that:

> Basel III is actually a capital framework that is meant for large internationally active listed institutions. It is written with those institutions in mind.[79]

3.56 Australian mutual ADIs already face different regulation than their international counterparts, given that APRA has applied Basel II to all ADIs and has otherwise taken a conservative approach to implementing the Basel Accords. Abacus commented on the Basel III requirements for mutuals in other jurisdictions:

> There is a very mixed implementation across Europe and the United States. The United States does not even apply it to all its banks, let alone some of

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76 See Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 19.

77 Mr Keith Chapman, APRA, *Committee Hansard*, 9 August 2012, p. 52.

78 APRA, *Response to Submissions II: Implementing Basel III capital reforms in Australia*, September 2012, p. 10.

79 Mr Mark Degotardi, Head of Public Affairs, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 12.

> its cooperative or mutually owned institutions. Some parts of Europe are implementing Basel III in part to our sector, but are providing some concessions that recognise the difference of the governance model that we have.[80]

3.57 A particular issue for mutual ADIs under Basel III is that although they are well-capitalised, they will likely find it difficult to meet the common equity tier 1 ordinary shares requirements as they are unable to issue ordinary shares. Abacus also noted issues with the treatment of mutual additional tier 1 and tier 2 capital instruments.

3.58 Abacus indicated that APRA is consulting on the ordinary shares issue.[81] When questioned by the committee, APRA officials acknowledged the issue and updated the committee on progress to resolve it, advising that the mutuals have engaged a consultant to work with APRA to help develop a solution. According to a senior APRA official, such a solution 'will not necessarily be received joyfully but will achieve the outcome'.[82]

### *Limited sovereign debt*

3.59 As sovereign debt is a high-quality liquid asset, it will play a key role in allowing international banks to meet their Basel III liquidity requirements. However, Australia has insufficient sovereign debt to satisfy Australian ADIs' liquidity requirements. To address this, the RBA and APRA announced in December 2010 that an ADI will be able to establish a committed secured liquidity facility (CSLF) with the RBA to help meet any shortfall in minimum LCR requirements.

3.60 Some issues with how ADIs will utilise the CSLF have been anticipated by the regulators and other observers. To address them, APRA noted that it 'will require participating ADIs to demonstrate that they have taken all reasonable steps towards meeting their liquidity requirements through their own balance sheet management, before relying on the RBA facility'.[83] However, some submitters question how the CSLF arrangements will change the role of the RBA. Professor Sathye argued that the CSLF:

> … essentially provides a life line even before a stressed situation so the lender of the *last resort* role becomes lender of the *continuing* resort. The banks would pay a fixed fee of 15 basis points on both drawn and undrawn amounts. Basically, the banks are *purchasing* the LCR compliance.[84]

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80 Mr Mark Degotardi, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 14.

81 See Abacus-Australian Mutuals, *Submission 150*, p. 3.

82 Mr Charles Littrell, APRA, *Committee Hansard*, 9 August 2012, p. 60.

83 APRA, *Submission 55*, p. 6.

84 Professor Milind Sathye, *Submission 31*, p. 7.

3.61 Continuing this reasoning, Professor Sathye argued that it may lead to 'LCR games' because banks would seek as much of the committed secured liquidity facility as they could, and invest other assets which they would have to hold, such as cash, into assets which would earn interest. The professor suggested that banks could invest in sovereign debt of other countries and the securities of international organisations such as the IMF.[85]

### *Treatment of internet-based accounts*

3.62 ING Direct questioned the different approach APRA is taking to internet-based accounts compared to other national regulators, as APRA's draft liquidity prudential standard assumes that internet accounts will be more vulnerable if there was a run on a bank during a crisis. ING Direct objected to this assumption, observing that 'over the 30-day horizon on which the assumptions are drawn you can get your money out of any bank any way you like'. ING Direct also advised that it considers APRA's approach is 'fairly unique' compared to that taken by other regulators.[86]

### *Definition of 'basic deposit product'*

3.63 Basic deposit products are currently excluded from the product disclosure statement regime (as long as the product's cost and future payment requirements are disclosed) and advisers do not need to give a statement of advice to their client. However, only term deposits that are breakable on 31 days' notice would achieve recognition of the 31-day term under the Basel III liquidity standards. In other words:

> Under Basel III banks will be required to hold more liquidity if their funding is not locked in. If a term deposit can be broken without any notice, as is currently the case, banks will have to hold more liquidity than they would if that term deposit did have a notice period.[87]

3.64 In November 2011, ASIC released a consultation paper after identifying that regulatory 'relief may be required due to potentially significant regulatory uncertainty about whether term deposits that are only breakable on 31 days' notice can qualify as basic deposit products under the Corporations Act'.[88] Abacus suggests that ASIC's interpretation is 'controversial and at odds with current market practice'. Abacus notes

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85 Professor Milind Sathye, *Submission 31*, p. 8.

86 Mr Glenn Baker, Chief Financial Officer, ING Bank (Australia) Ltd, *Committee Hansard*, 10 August 2012, p. 32. Mr Baker noted that although other regulators 'have a concept for less stable deposits', in his view 'APRA seems to add internet as an additional category over and above stable, less stable et cetera'.

87 Mr Michael Saadat, Senior Manager, Deposit Takers and Issuers, ASIC, *Committee Hansard*, 8 August 2012, p. 53.

88 ASIC, 'Term deposits that are only breakable on 31 days' notice: Proposals for relief', *Consultation Paper 169*, November 2011, p. 5.

that many ADIs currently issue basic deposit product term deposits of two years that are only breakable at the discretion of the ADI.[89] Abacus recommends that the 'basic deposit product' definition be amended to:

- remove doubt that term deposits of up to two years, where early withdrawal is at the discretion of the ADI, are covered; and
- also cover term deposits of up to five years where early withdrawal is at the discretion of the depositor but is subject to a notice of withdrawal period of up to 31 days.[90]

3.65 In August 2012, ASIC advised the committee that it is 'getting very close to finalising the advice to industry on how we are going to treat that relief, the time period for the term deposits in question and what sort of information deposit taking institutions that issue those term deposits should provide to their customers'.[91]

### *Application of the countercyclical capital buffer*

3.66 The RBA and APRA have indicated that they will use a different method to other national regulators when considering whether to trigger the countercyclical capital buffer—an additional capital requirement of up to 2.5 per cent of total risk weighted assets available to regulators to help deal with credit boom and bust cycles. Under Basel III, the buffer is to be imposed when credit growth is occurring at a rate at which, historically, financial system stability has been undermined. The Basel Committee has put forward a common reference guide based on an aggregate private sector credit-to-GDP gap,[92] however, the two Australian authorities indicated that they will not adopt the Basel approach as they disagree with the reasoning behind the Basel Committee's guide:

> While credit booms typically precede periods of financial instability, the ratio of credit to GDP can change trend for other reasons, including that the onset of financial deregulation or rapid economic development can spark financial deepening at a faster pace than previously. In these situations, the suggested detrending method will incorrectly detect a credit boom that might not necessarily be problematic. It is also not clear that the detrending procedure or the specific parameterisation presented in the BCBS

89 Abacus-Australian Mutuals, *Submission 150*, pp. 7–8.

90 Abacus-Australian Mutuals, *Submission 150*, p. 8.

91 Mr Peter Kell, Commissioner, ASIC, *Committee Hansard*, 9 August 2012, p. 53.

92 The Basel Committee notes that '[r]ather than rely mechanistically on the credit/GDP guide, authorities are expected to apply judgment in the setting of the buffer in their jurisdiction after using the best information available to gauge the build-up of system-wide risk'; although it does not consider that the internationally-consistent credit/GDP guide should be 'totally ignored'. Basel Committee on Banking Supervision, *Guidance for national authorities operating the countercyclical capital buffer*, December 2010, pp. 3, 4.

> documents is the appropriate technique for detecting a genuine credit boom that might require a policy response.
>
> The procedure is designed to detect cycles of a particular frequency, which must be pre-specified and therefore might not be appropriate for the actual data. In addition, it has been shown in the literature to sometimes detect cycles that are not there. The results of the procedure are also very sensitive to small changes in its parameterisation.
>
> For these and other technical reasons, the Australian authorities do not propose to restrict their analysis to a single indicator or small number of pre-specified indicators. The full array of available data and analysis will be marshalled to support the detection of a harmful credit boom, and the full suite of prudential tools—including but not limited to this buffer—remain available for use in response.[93]

## Committee view

3.67 APRA's regulatory and supervisory activities in recent years have been widely praised. APRA's approach, including its conservative attitude when applying domestically the details of past Basel Accords, has served Australia well. Following the global financial crisis it is clear that Australia has some of the strongest and safest banks in the world; yet, as demonstrated by post-crisis outcomes, the regulatory environment that helps ensure this stability is not so burdensome that the banks cannot earn large returns for their shareholders or expand into other markets.

3.68 The committee supports APRA's overall approach to Basel III at this stage. Assuming the reforms are widely implemented internationally, they will improve the stability of the international banking sector and will address some of the issues evident from the global financial crisis. It is not a big step for the major Australian banks to comply with the new minimum capital requirements by the deadline set by APRA, and smaller ADIs already hold capital in excess of the necessary ratios. The stable funding requirements may be more challenging for the banks to comply with; however, Australian banks will have to work towards this. Any significant changes to Basel III, including if there are questions about the timing of the liquidity reforms, will occur at an international level and the implications for Australia will have to be considered at that time. Some of the other recommendations of this inquiry, however, may assist the sector in meeting the stable funding requirement at a lower cost.

3.69 The committee does consider that APRA could be more proactive in some areas. A particular issue is that Australian banks may appear less capitalised than their peers as a result of the different regulatory capital calculations that APRA requires. While the banks have a role in explaining this difference to international investors themselves, and the standardised reporting template developed by the Basel

93 RBA and APRA, *Macroprudential Analysis and Policy in the Australian Financial Stability Framework*, September 2012, pp. 19–20 (footnotes omitted).

Committee may also assist,[94] in the meantime APRA should facilitate the publication of headline capital ratios that are calculated according to the Basel Committee's standard requirements. The committee also encourages APRA to look at other ways that it could improve the understanding of the Australian banking sector's underlying strength internationally, to ensure that Australians receive the full benefits of this.

3.70 Given the increasing prevalence of internet-based accounts and the apparent differences between how APRA proposes to treat these accounts for liquidity purposes compared to the treatment applied by regulators in other jurisdictions, the committee suggests that APRA reviews its approach in this area.

3.71 Finally, the committee recommends that APRA addresses the unique issues that Basel III may pose for mutual ADIs as a result of their corporate structure without further delay, and that it publishes a document which sets out how these problems have been addressed.

**Recommendation 3.1**

**3.72 In light of the evidence that international observers are misinterpreting the level of capital held by Australian banks due to the Australian Prudential Regulation Authority's (APRA) requirements, the committee recommends that APRA:**

- **ensures it initiates consultation on the common disclosure template developed by the Basel Committee in early 2013;**
- **in the interim before the common disclosure template is adopted, facilitates the publication of headline capital ratios for Australian ADIs that are calculated according to the Basel Committee's standard methodology and are therefore easier to compare internationally; and**
- **be more active in promoting internationally that Australian banks are well-capitalised.**

**Recommendation 3.2**

**3.73 That APRA review its approach to how internet-based accounts should be treated under the Basel III liquidity requirements.**

**Recommendation 3.3**

**3.74 That APRA addresses, without further delay, the unique issues Basel III may pose for mutual ADIs as a result of their corporate structure and that it publishes a document which sets out how these problems have been addressed.**

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94 The committee notes that APRA intends to consult on this measure in early 2013; APRA, *Response to Submissions II: Implementing Basel III capital reforms in Australia*, September 2012, p. 8.

# Chapter 4

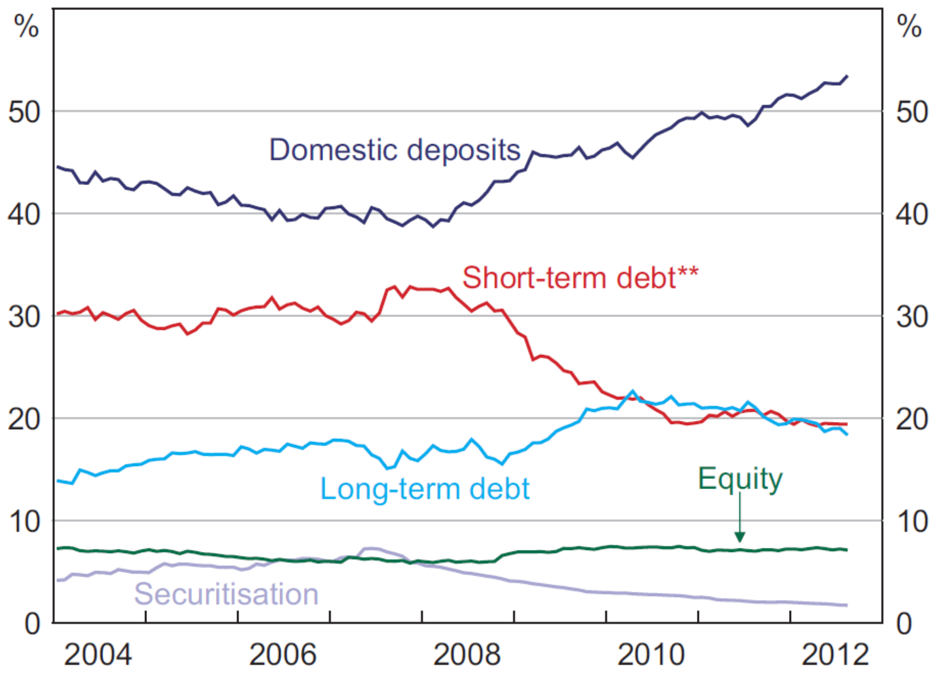
## The sources and costs of bank funds post-GFC

4.1 In recent years, the rising cost of funds has often been cited by the major banks as to why they have not always strictly followed changes to the official cash rate made by the RBA. As these decisions impact the large number of Australians with variable rate mortgages, this explanation has been controversial and not generally well-understood in the community. This chapter explores the changes to Australian banks' funding mix and costs since the global financial crisis. It also discusses the relationship between the cash rate and funding costs, and examines various options put forward to help address funding cost issues.

### Overview

4.2 The main sources of funds for Australian banks are deposits, with other major funding sources being long-term and short-term wholesale debt. Equity and securitisation provide other sources of funding. Figure 4.1 shows how Australian banks' reliance on each funding source has changed since the global financial crisis, with a significant shift towards deposits and long-term debt, and away from short-term debt and securitisation.

**Figure 4.1: Funding composition of banks in Australia (as a percentage of funding)**




** Includes deposits and intragroup funding from non-residents.

Source: RBA; based on data from APRA, RBA and Standard & Poor's. Data are adjusted for movements in foreign exchange rates.

4.3 The change can largely be explained by banks reassessing the risks associated with some funding sources during the global financial crisis and the repricing by investors of the risk of banks generally. The tightening of international funding markets during the midst of the crisis meant that banks encountered difficulties in rolling over their short-term debt.[1] Consequently, Australian banks have increased their utilisation of more stable funding sources such as domestic deposits and long-term wholesale funding (in place of short-term debt). This development is likely to be sustained as banks prepare for the Basel III stable funding requirements that will be imposed in 2018. However, these more stable funding sources have proved more expensive for Australian banks with competition for domestic deposits becoming more intense and the cost of long-term wholesale funding steadily increasing since the global financial crisis (relative to the official cash rate set by the RBA).

### *Relationship between funding costs and the official cash rate*

4.4 It follows that a bank's overall funding costs depend on the balance of funding sources it utilises, and the cost associated with each source. Before examining the changes to the funding sources, and given the continued public debate on this issue, it is helpful to discuss how movements in the official cash rate set by the RBA impact the cost associated with each funding source.

4.5 The prevalence of variable-rate residential mortgages in Australia means that movements in the cash rate can be expected to have a more direct impact on new and existing lending than in other countries.[2] From the mid-1990s until the onset of the global financial crisis, bank lending rates closely adhered to changes in the RBA's official cash rate (Figure 4.2).[3]

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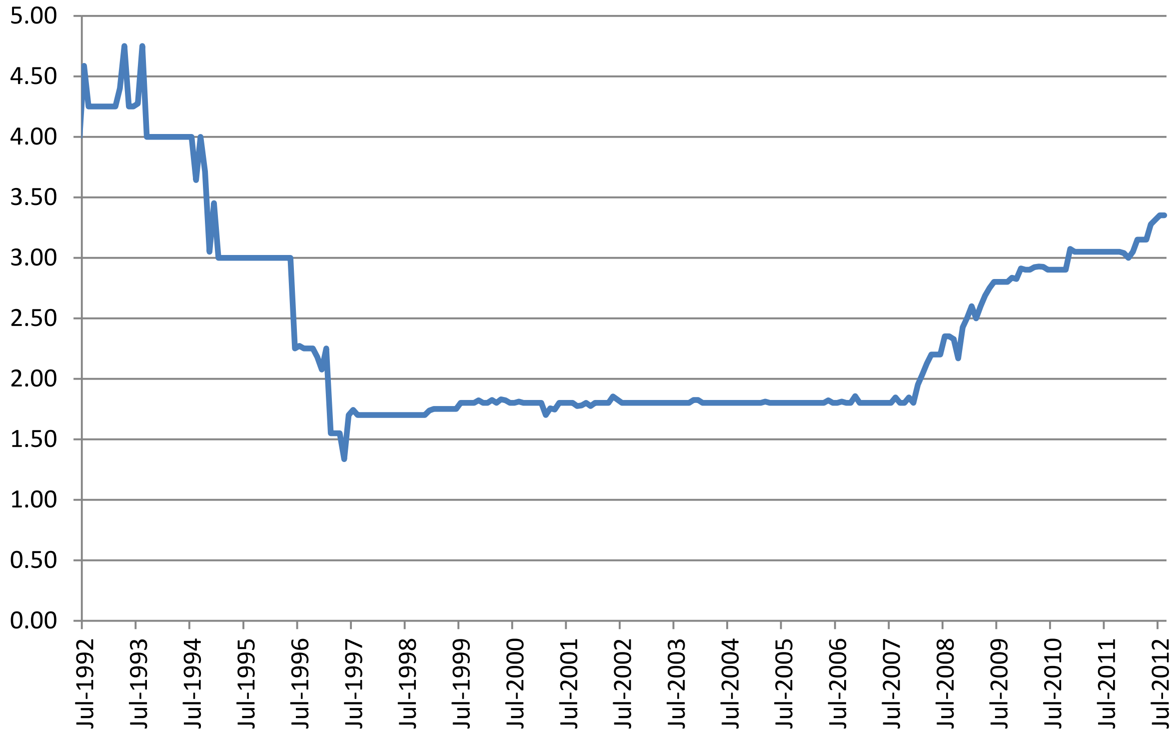
1 Owen Freestone et al., 'The rise in household saving and its implications for the Australian economy', *Treasury Economic Roundup*, 2011, issue 2, p. 71.

2 For example, Dr Guy Debelle, Assistant RBA Governor, Financial Markets, observes that in the US, changes to the federal funds rate by the Federal Reserve have less direct influence on existing mortgages, such as 30 year fixed rate mortgages; Dr Guy Debelle, 'Bank Funding', address to the Australian DCM Summit 2012, Sydney, 22 March 2012, www.rba.gov.au/speeches/2012/sp-ag-220312.html (accessed 25 July 2012).

3 Although RBA Assistant Governor Dr Guy Debelle observed that while the standard variable interest rate mostly moved in line with changes to the cash rate, banks increased the discounts they offered on home loans between decisions on the cash rate. Dr Guy Debelle, *Committee Hansard*, 9 August 2012, p. 37.

**Figure 4.2: Spread to the cash rate—standard variable housing loans**




Source: Based on RBA data (F01, F05).

4.6 The close relationship over many years between movements in the cash rate and lending rates, particularly variable mortgage rates, has created a public expectation that changes to banks' standard variable mortgage interest rates should only be influenced by the RBA's decisions on the cash rate. In recent years, however, while banks have followed the direction of the RBA's decisions on the cash rate, they have not always altered their interest rates by the same percentage point change in the cash rate.

4.7 The RBA provided the following explanation about the role of the cash rate and how it interacts with banks' funding costs:

> The level of the cash rate set by the Reserve Bank is a primary determinant of the level of intermediaries' funding costs and hence the level of lending rates. It is the short-term interest rate benchmark that anchors the broader interest rate structure for the domestic financial system. However, there are other significant influences on intermediaries' funding costs, such as risk premia and competitive pressures, which are not affected by the cash rate. At various points in time, changes in these factors can result in changes in funding costs that are not the result of movements in the cash rate.[4]

4.8 RBA Assistant Governor Dr Guy Debelle expanded on the impact of risk premiums:

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4 RBA, *Submission 33*, p. 4 (footnotes omitted).

> The longer you borrow at, the more people want a bit of compensation for that. As you move beyond overnight and further out in time, you get a premium to compensate you for that. On top of that, if you are a bank, you are a more risky proposition than we [the RBA] are, and so people want to be compensated for that as well. So the cash rate still plays a very important role in the cost of the banks' borrowing, but there are other risk premia and term premia, reflecting how long they are borrowing at, which move around with market conditions—and they have certainly moved around a lot over the past five years.[5]

4.9 The RBA also noted that since the onset of the global financial crisis in 2007 'there has been a lift in the whole structure of interest rates in the economy relative to the cash rate' due to increased competition for deposits and higher wholesale credit spreads.[6] Dr Debelle observed that during the 2000s up to the onset of the crisis, 'risk premia were incredibly low and did not move'.[7] This allowed for changes to variable interest rates to follow movements in the official cash rate during that period.

4.10 To enable an analysis of how the cost of individual funding sources for banks has changed, Dr Debelle was asked whether changes to the official cash rate are more relevant to either retail deposits or wholesale funding. Dr Debelle considers the effect to be 'roughly the same':

> Dr Debelle: … As I said, those other influences I talked about earlier have moved around a bit differently for some of those other types of funding—deposits versus wholesale funding. In particular, actually in the deposit market, there has been a lot of competition over the last couple of years, which has driven up the costs of deposits relative to other sources of funding, including wholesale funds. But, beyond movements in those different premia, the cash rate has roughly the same influence on all, regardless of the source of funding.
>
> CHAIR: It feeds into the cost of deposits as well as the cost of wholesale funding to a roughly equivalent level.
>
> Dr Debelle: Yes. As I said, those other things move around and they move around at different times, but, once that has all settled down, yes.[8]

4.11 What impact have the decisions by banks not to adjust their lending rates by the same degree as revisions to the cash rate had? Dr Debelle has stated that it has not significantly impacted the ability of the RBA to conduct its monetary policy functions:

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5 Dr Guy Debelle, Assistant Governor, Financial Markets, RBA, *Committee Hansard*, 9 August 2012, p. 36.

6 RBA, *Submission 33*, p. 1.

7 Dr Guy Debelle, RBA, *Committee Hansard*, 9 August 2012, p. 37.

8 Dr Guy Debelle, RBA, *Committee Hansard*, 9 August 2012, p. 36.

> … the Reserve Bank Board takes these developments into account in its setting of the cash rate to ensure that the structure of interest rates in the economy is consistent with the desired stance of monetary policy.[9]

4.12 And as this committee observed in 2011:

> … if the banks increase their loan rates by more than the Reserve Bank's adjustment to its cash rate, it does not mean that borrowers are paying higher rates on their loans (in any other than a very short-term sense). The average loan rate is essentially where the Reserve Bank believes it should be in order to meet its medium-term inflation target. If the banks expand their margin over the cash rate, then the Reserve Bank will set a lower cash rate than they would otherwise have set.[10]

4.13 The issue is more one of public perception and widespread scepticism of the banks' arguments, not helped by some of the banks' actions.[11] During the Competition Inquiry, the CEO of the National Australia Bank reflected that, although the RBA's cash rate decisions influence the market by setting the trend for the direction of rates, they are not the main factor taken into account by banks when deciding their interest rates. Accordingly, in his view, the banks 'have made a problem for themselves here by continually moving in line with the Reserve Bank':

> When spreads were very narrow, you must bear in mind that pre the global financial crisis we were borrowing in the spread range of perhaps 15 to 20 basis points over a benchmark. When that blew out to 250 basis points in the crisis, it was clearly even a broader disconnect, if you like, between our funding costs and the RBA. I have got a lot of empathy for the public who say, 'Hang on a second. For 15 years you have moved your rates in line with the RBA up and down. Suddenly there's a disconnect there. In some way you're taking a profit because you're not borrowing at that point in time.' The reality is that that is not the driver of our funding but we have, for many, many years, created that perception in the public's mind, so we have got to face the fact that this is something we have created through our own poor communication on the issue. I am hoping that, as we start to have these sorts of discussions going forward, people will start to see there is a different driver of funding. But I certainly do not blame the public at the moment for being upset about moves they see as not in line with the RBA.[12]

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9 Dr Guy Debelle, RBA, 'Bank Funding', address to the Australian DCM Summit 2012, Sydney, 22 March 2012, www.rba.gov.au/speeches/2012/sp-ag-220312.html (accessed 25 July 2012).

10 Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011, p. xvii (emphasis omitted).

11 Such as Westpac's 2009 attempt to explain its funding costs through a video based on the cost of bananas: see Julian Lee, 'Westpac goes bananas with email on rationale behind rate rise', *Sydney Morning Herald*, 10 December 2009, www.smh.com.au/business/westpac-goes-bananas-with-email-on-rationale-behind-rate-rise-20091208-khog.html (accessed 31 August 2012).

12 Mr Cameron Clyne, Chief Executive Officer and Managing Director, National Australia Bank, *Committee Hansard*, Competition Inquiry, 13 December 2010, p. 51.

4.14 Since the Competition Inquiry, banks have started to change how they review and announce their pricing decisions. On 8 December 2011, ANZ differentiated itself from the other major banks by declaring that any changes to its retail and small business variable interest rates would be announced on the second Friday of each month.[13]

## Overall funding costs

4.15 It is recognised that assessing the funding costs that banks face, even at a sector-wide level, is difficult:

> [O]verall funding is a mix of various bank liabilities across differing maturities. Funding costs reflect two components, the general level of interest rates and credit spreads over and above the risk free rate (government rates) … Moreover, particular funding costs, such as deposit rates may vary relative to the cash rate and government risk free rates, depending upon the degree of competition and movements in the relative cost of other forms of funding. The cost of those other forms, such as wholesale debt market funding, will depend upon the credit spreads which banks must pay for such funds and which can vary markedly over time in response to changes in general market confidence as well as assessments of individual bank risk. How bank funding costs vary over short periods of time is difficult to assess, because banks may be changing their mix of funding and rolling over maturing sources of longer term funding where movements in both the general level of rates and credit spreads since that debt was initially issued need to be taken into account.[14]

4.16 Figure 4.3 illustrates the RBA's estimate of how the major banks' overall funding costs have changed since mid-2007.

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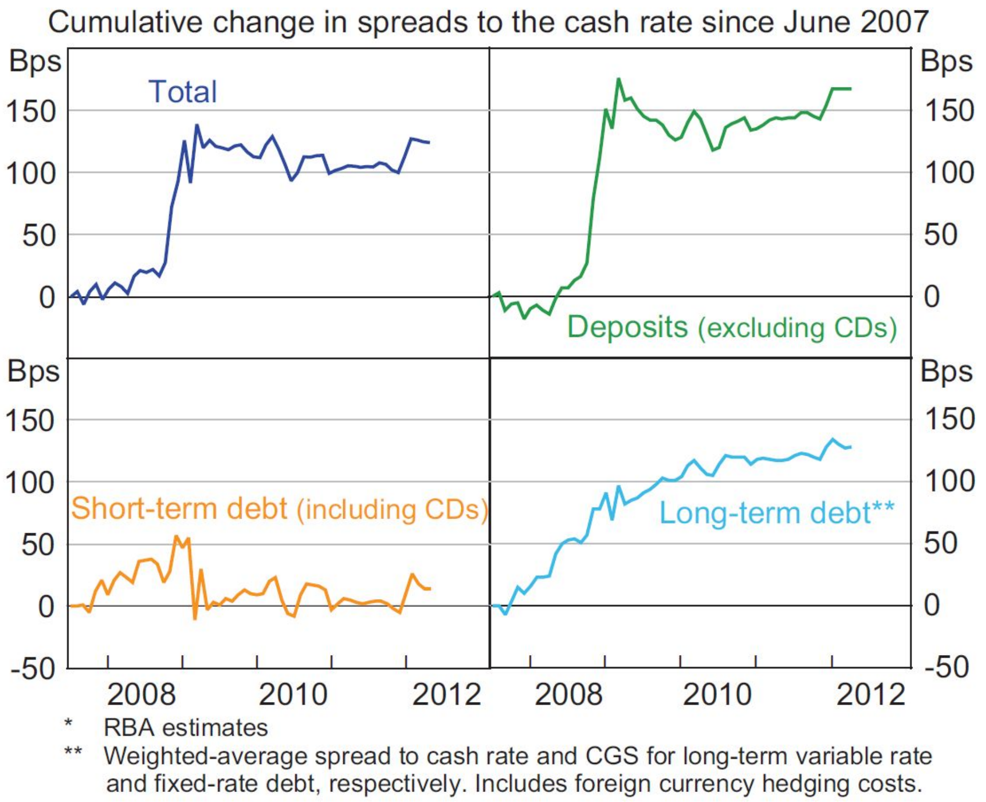
13 ANZ, 'ANZ cuts interest rates for mortgages and small business lending by 0.25% pa', *Media release*, 8 December 2011, p. 1.

14 Australian Centre for Financial Studies, *Submission 49*, pp. 13–14.

**Figure 4.3: Major banks' funding costs***




Note: CDs refers to certificates of deposit, which are negotiable bearer debt securities with a fixed interest rate and maturity date issued at a discount to their face value.

Source: Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, 2012, no. 1 (March), p. 41; Bloomberg, RBA and UBS AG (Australia Branch) data.

4.17 As Figure 4.3 indicates, it is estimated that the major banks' funding costs have risen significantly since mid-2007. Overall, the RBA estimates that the major banks' funding costs have increased by about 140–150 basis points, relative to the cash rate, since mid-2007.[15] The RBA also considers that, for regional banks overall, the rise in the cost of funds has been even greater:

> The available evidence suggests that, in aggregate, the increase in the regional banks' funding costs since the onset of the financial crisis has been larger than that experienced by the major banks. This reflects the fact that smaller banks have experienced a larger increase in funding costs and have made a larger shift in their funding mix towards deposits.[16]

4.18 From the perspective of individual major banks, ANZ and the CBA provided the following charts of how their funding costs have changed and how much of this increase has been recovered. NAB advised:

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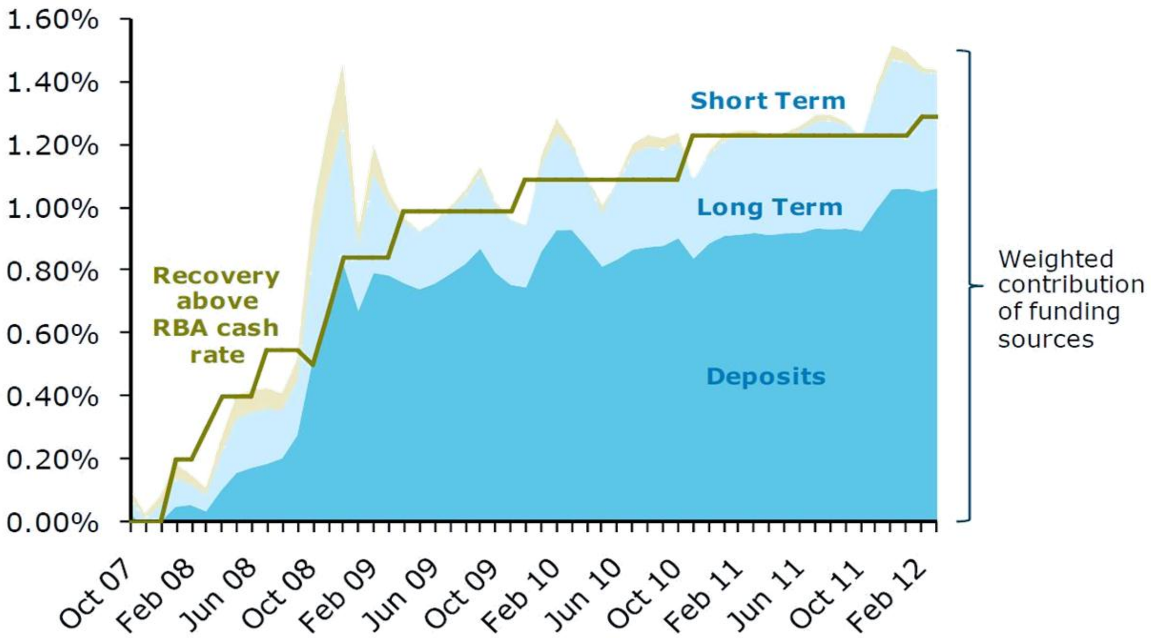
15 RBA, *Submission 33*, p. 5.

16 RBA, *Submission 33*, p. 5.

Our costs of funds has risen, let us say, 140 basis points over that period. We have recovered 125. So there has been some compression in that. Then various business products are repriced similarly but not in the same way. So the net is that there has been some degradation, certainly for us, over that period.[17]

**Figure 4.4: Change in ANZ's funding costs relative to the cash rate**

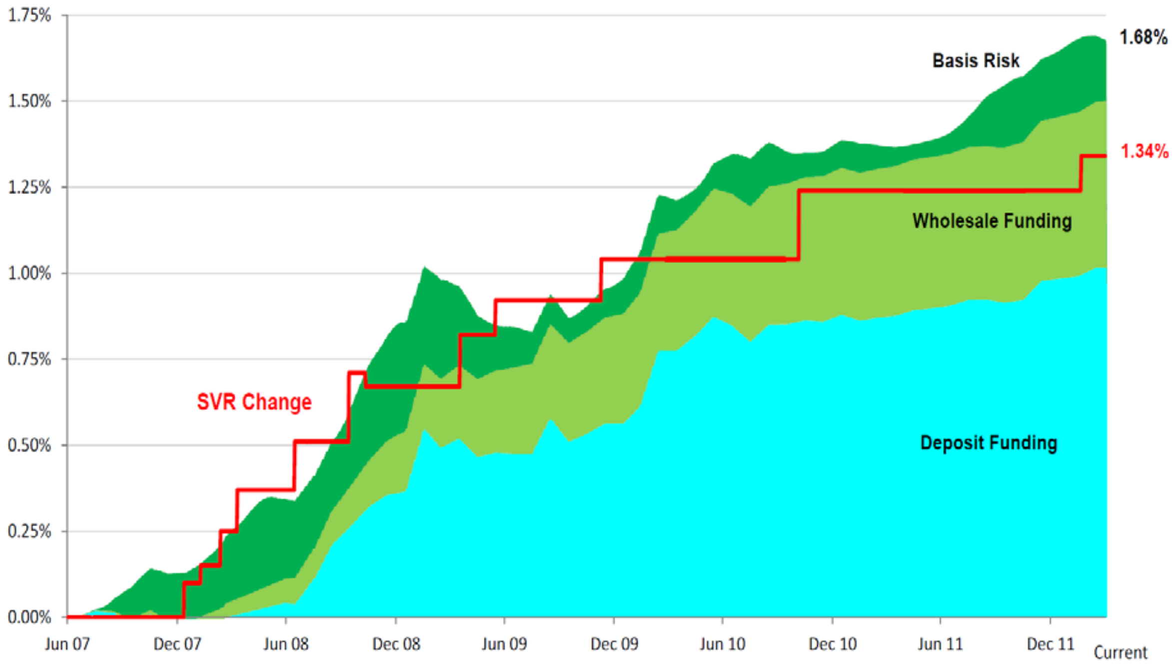



Note: The chart depicts the average change in cost of funding relative to the cash rate over the 12 month period ending September 2007.

Source: ANZ, *Submission 78*, p. 14.

17 Mr Mark Joiner, Executive Director, Finance, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 68.

**Figure 4.5: Change in CBA's retail bank funding costs relative to the cash rate**




Source: Commonwealth Bank of Australia, *Submission 81*, p. 23.

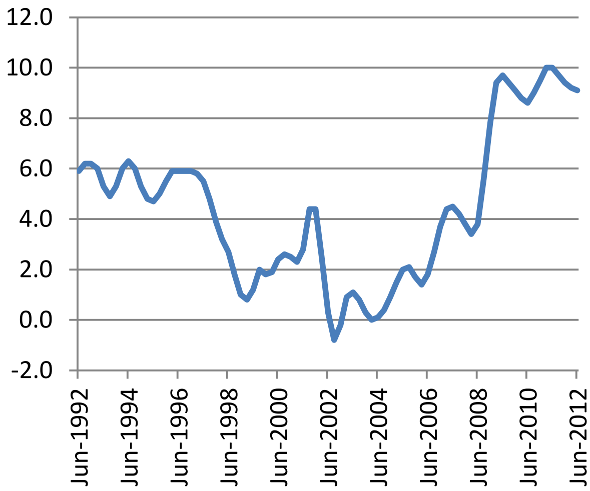
4.19 The following paragraphs examine the changes in the utilisation and cost of each funding source, and the factors influencing these changes.

## Deposits

4.20 The turmoil of the global financial crisis has had a sustained impact on saving behaviour. As illustrated by Figure 4.6, the level of household saving increased significantly with the onset of the crisis. Households also began to adjust their investment patterns, moving towards lower risk methods of increasing their savings such as term deposits, at the expense of investments associated with higher risk such as shares.[18] This is shown in Figure 4.7.

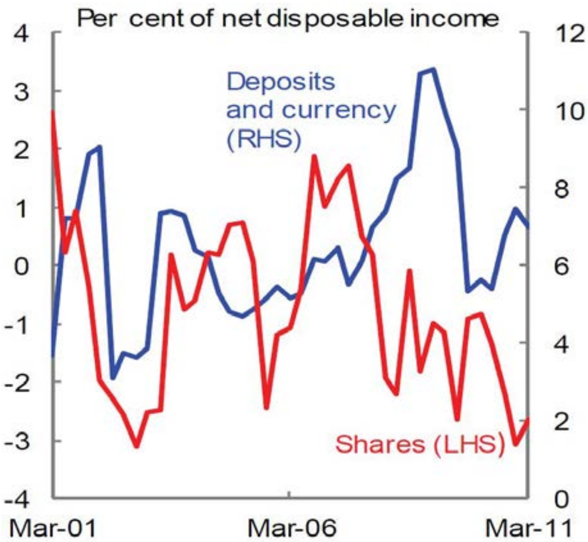
18 Owen Freestone et al., 'The rise in household saving and its implications for the Australian economy', *Treasury Economic Roundup*, issue 2, 2011, p. 62.

**Figure 4.6: Household saving ratio**




Source: Australian Bureau of Statistics, cat. 5206.0.

**Figure 4.7: Annual net asset purchases**




Source: Owen Freestone et al., 'The rise in household saving and its implications for the Australian economy', *Treasury Economic Roundup*, issue 2, 2011, p. 64.

4.21 It is apparent that competition for term deposits has become more intense following the global financial crisis. The ABA provided the following account of how the crisis has affected the demand for deposits:

> As revealed around the world, a high level of reliance on foreign funding exposes a country to greater shocks. Investors that extend money do so because they are confident in getting it repaid, and in situations of uncertainty, there is a bias to investment in their home countries. In order to reduce this risk, the Australian banks have competed ferociously for household and business domestic deposits in order to fund growth in credit. This has been a bonanza for savers who are enjoying very good deposit deals. Further, foreshadowed regulatory changes for liquidity are giving banks incentives to further focus deposit competition onto term deposits.[19]

4.22 Businesses have also contributed to deposits:

> … strong business profits and business caution have resulted in larger corporate cash holdings, which have been increasingly invested in deposits rather than other financial instruments, particularly short-term bank paper.[20]

4.23 Figure 4.8 compares the interest rates for term deposits compared to retail online savings accounts and government bond yields, and it is clear that there has been a significant change to the returns associated with these products. The RBA notes that while deposit rates and yields on bank debt generally declined between mid-2011 and

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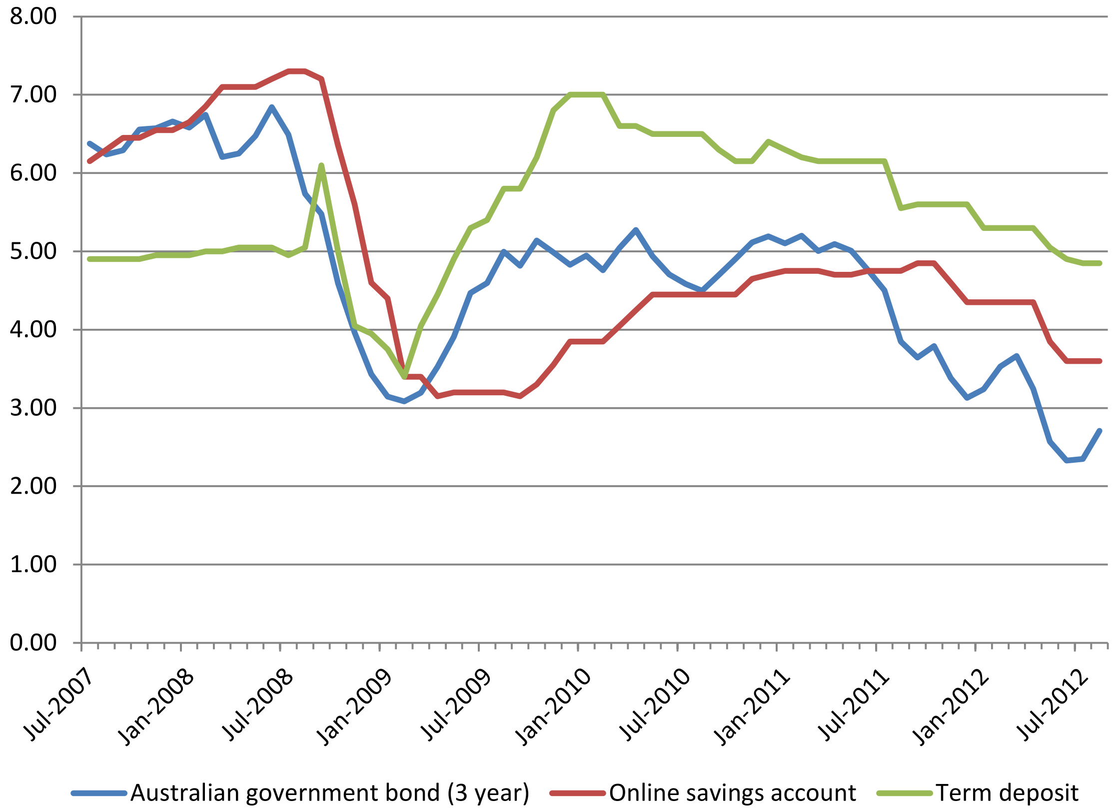
19 Australia Bankers' Association, *Submission 46*, p. 13.

20 Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, 2012, no. 1 (March), p. 38.

early 2012, these declines have not matched the reduction in the cash rate during this period.[21] Term deposits now represent a greater share of overall deposits than prior to the global financial crisis.

**Figure 4.8: Comparison of retail deposit rates with government bonds**




Note: Online savings account and term deposit rates based on balances of $10,000. Term deposits rates based on three year deposits.

Source: Based on RBA data (F2 and F4).

4.24 Westpac explained that competition among banks was particularly intense for term deposits, compared to online on-call deposits, as term deposits are regarded by regulators as a more stable source of funding, and banks want to have a greater proportion of their funding mix in a stable funding base.[22]

4.25 The ANZ was asked how its expansion into several Asian countries, which generally have higher saving rates than Australia, is affecting the bank's overall funding needs. The ANZ acknowledged that its proportion of loans to deposits in Asia was 60 per cent, whereas it is 134 per cent for the ANZ Group overall, and that on occasion it had remitted surplus funds from Asia to fund its Australian operations. However the ANZ's Deputy CEO advised that 'our strategy is not to fund our domestic

21 RBA, *Submission 33*, p. 5.

22 Mr Jim Tate, Acting Chief Operating Officer, Australian Financial Services, Westpac Group, *Committee Hansard*, 9 August 2012, p. 2.

bank, if you like, from our Asian business; it is really to fund our Asian expansion through the deposits in Asia'.[23]

4.26 Given that smaller ADIs traditionally have been more reliant on deposits as a funding source than the major banks, Abacus was asked how the increased competition for deposits among all ADIs was affecting mutual ADIs. Abacus advised that, under present market conditions, their members are able to secure a sufficient level of deposits. However, they raised some concerns about the long-term implications for mutuals:

> Part of that is because lending demand is probably a little bit subdued at present … should economic conditions or confidence increase and people take on more risk, you have that money leaving the deposit market. You also have increased demand for loans, so you have increased demand for funds. I think that is pretty interesting. So at the moment our liquidity is very high. It has always been very high and remains so. This is about the price point. The only distinction I would make between us and the banks, and why the deposit cost is so critical for us, is that we do not have the same diversity of funding that the major banks have, for instance, and therefore we do not get to spread that cost—it is all largely in one bucket.[24]

4.27 The ANZ, however, does not consider competition for deposits will ease any time soon:

> While we continue to see volatility in the global markets, in the interests of maintaining stability and certainty of our funding we expect the banks to continue to work very hard to raise domestic deposits. We would see those being at least at current level or, if we can achieve it, slightly higher levels as a proportion of our total funding than where they are today. I do not see that intensity for competition in the domestic deposit market easing off in the near term at all. I think, therefore, the likelihood that you are going to see an easing in those costs is small.[25]

## Wholesale debt

4.28 While deposits have always formed a large component of the major banks' funding mix, the overall shortfall in domestic funding sources means that banks have to participate in domestic and global debt markets. Smaller banks make less use of offshore borrowing than the major banks and instead rely more on other funding sources. The global financial crisis caused significant disruption and volatility in international financial markets. Following its feature role in the crisis in the United States the securitisation market collapsed, including in Australia even though we

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23 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 18.

24 Mr Mark Degotardi, Head of Public Affairs, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 13.

25 Mr Graham Hodges, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 17.

suffered no failures here. Increased risk and risk-aversion has led to higher risk premiums for wholesale debt. Accordingly, following the global financial crisis both the cost of wholesale funds and the ways that these funds are utilised have changed.

### *Unsecured long-term and short-term wholesale debt*

4.29 As noted earlier, the proportion of wholesale funding in the overall funding mix has decreased, with deposits being increasingly utilised (see Figure 4.1). Within the wholesale debt category, there has been an important development. Although the cost of long-term wholesale funding has increased significantly more than the cost of short-term funding, banks are increasingly utilising their proportion of long-term funding instead of short-term debt.[26] In doing this, banks are seeking to secure more stable funding sources and reduce the risk associated with replacing maturing wholesale debt. A Westpac executive told the committee that, from a risk-management perspective, the unstable nature of the markets has proved to be more challenging than the higher prices:

> As you know, about 30 per cent of the money we raise comes from offshore markets. We are a price taker in those markets and the price of credit in those markets not only has stayed high but is extremely volatile. In fact, if there were an issue that really underpins the riskiness of it, it is more the volatility of the price rather than the absolute level of it.[27]

4.30 As shown above in Figure 4.3, while the costs associated with short-term wholesale debt (relative to the cash rate) increased during the height of the global financial crisis and briefly at the start of 2012, for much of the period since the crisis there appears to have been a relatively small increase in the cost of short-term wholesale debt (relative to the cash rate) compared to the price banks faced prior to the crisis. However, the difference between the price of long-term wholesale debt and the cash rate has steadily grown compared to June 2007. Treasury's assessment is as follows:

> In terms of the actual dollar figure, we can say aggregate funding costs in recent times have probably gone down. Relative to benchmarks, relative to the cash rate, they are still elevated.[28]

4.31 The duration of long-term wholesale funding and the timing of its maturity affects the exposure of a bank to changing funding costs. Long-term funding is, by definition, obtained for some years. Higher costs at present for long-term funds

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26 Long-term debt securities are usually bought by larger institutional investors for a fixed term, generally of up to five years. Short-term debt securities are issued with less than 12 months to maturity. The most common securities issued by banks are short-term certificates of deposit with maturity dates of up to three months. The 30-day and 90-day bank bill swap rates (BBSW) price the major banks' short term debt securities.

27 Mr Jim Tate, Westpac Group, *Committee Hansard*, 9 August 2012, p. 2.

28 Mr Ian Beckett, Acting General Manager, Financial System Division, Treasury, *Committee Hansard*, 8 August 2012, p. 5.

impacts the cost of *new* funds, whereas the banks' *average* long-term wholesale funding costs are influenced by the maturity date of their existing funds and the need to source new funds:

> While the relative cost of new long-term wholesale funds is currently higher than that of maturing funds, this has had only a moderate effect on the major banks' average bond funding costs relative to the cash rate to date … This reflects the fact that it takes at least 3 to 4 years for the major banks' existing bond funding to be rolled over. Since spreads began to rise sharply in August 2011, the major banks' issuance of new bonds amounts to about 12 per cent of their outstanding bonds. As a result, the cost of the major banks outstanding long-term wholesale debt is likely to have risen by about 25 basis points relative to the cash rate over the past year.[29]

4.32 The timing and volume of this rollover is clearly important. Australian banks have been replacing cheaper, pre-crisis, debt with new debt at higher prices. The RBA recently observed:

> While spreads on new wholesale debt have declined so far this year, banks' funding costs are about 50 basis points higher than they were in mid 2011 relative to the cash rate. In part, this reflects banks gradually rolling over their maturing long-term funding at higher spreads.[30]

4.33 Other influences on the cost of wholesale funding are the strategies employed by Australian banks for obtaining and utilising long-term wholesale funding. Some banks are increasing the duration of their long-term funding; ANZ has increased their average duration from four to five years. While this provides greater stability to the funding mix, it generally comes at a higher cost.[31] The management of interest rate and exchange rate risk also impacts funding costs. The banks enter into interest rate and cross-currency swaps, effectively hedging almost all of their bonds which were issued in foreign currencies back into Australian dollars. The banks also:

> … tend to issue in markets where it is cheapest to borrow Australian dollar equivalent funds at that time. In this way, they take advantage of pricing differentials between alternative funding markets, using derivatives to manage the associated exchange rate risks.[32]

4.34 Accordingly, while the relative cost of new long-term wholesale funds is currently higher than that of maturing funds, the effect of this is moderated 'if fixed-rate wholesale debt is assumed to be swapped back into variable-rate obligations. The extent of the rise in relative costs for individual banks varies

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29 Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, 2012, issue 1 (March), pp. 40–41.

30 RBA, *Submission 33,* p. 5.

31 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 18.

32 Susan Black, Anthony Brassil and Mark Hack, 'Recent Trends in Australian Banks' Bond Issuance', *RBA Bulletin*, 2010, issue 1 (March), p. 29 (footnotes omitted).

according to each bank's use of interest rate derivatives'.[33] For the example given in paragraph 4.31, the rise in funding costs relative to the cash rate may only be around ten basis points in the year to March 2012 rather than 25 points if it is assumed that fixed-rate wholesale debt is swapped into variable-rate.[34]

### *Covered bonds*

4.35 A recent development in wholesale funding was the 2011 amendments to the *Banking Act 1959* which allowed ADIs to issue covered bonds.[35] A covered bond is an instrument issued by an ADI where, in the event that the issuing ADI defaults on its payment to the bondholder, the bondholder may recoup their investment either from the issuing ADI or through a preferential claim on a specified pool of high quality assets. Treasury submitted that since the relevant legislation was passed in October 2011, banks have raised around $30 billion through covered bonds.[36] Research by the RBA suggests that the issuance of covered bonds has not impacted the overall funding mix, although it has enabled funding of a longer duration—covered bonds issued so far have been for terms of five to ten years, rather than the three to five years applying to unsecured bank bonds.[37]

4.36 The legislative amendments included provisions for smaller ADIs to pool their assets together to issue covered bonds and therefore take advantage of the higher credit ratings generally associated with these bonds.[38] ING Direct were asked how attractive this option was to smaller banks, but advised that they consider it to be something 'extremely difficult to do':

> Mr Hellemans: … considering the complexity that you have about combining a pool of mortgages—to be able to determine the standards of those mortgages and everything else, and the consequences. So it is actually extremely difficult. I think that a lot of people are just daunted by the complexities and the compliance issues that would be related to that kind of structure.

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33 Dr Guy Debelle, 'Bank Funding', address to the Australian DCM Summit 2012, Sydney, 22 March 2012, www.rba.gov.au/speeches/2012/sp-ag-220312.html (accessed 25 July 2012).

34 Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, 2012, issue 1 (March), p. 41.

35 This policy was announced as part of the government's 2010 *Competitive and Sustainable Banking System* package—the legislative amendments commenced on 24 October 2011.

36 Treasury, *Submission 120*, p. 16.

37 Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, 2012, issue 1 (March), p. 39. That covered bonds are being issued for terms of five to ten years was supported by the ANZ's evidence; see *Committee Hansard*, 9 August 2012, p. 18.

38 The explanatory memorandum for the legislation notes this process involves the participating ADIs establishing a new entity, called the aggregating entity (that is not an ADI), which would issue a debt instrument secured by covered bonds issued by each of the ADIs to the aggregating entity. Explanatory memorandum, Banking Amendment (Covered Bonds) Bill 2011, paragraphs 1.41–1.44.

> CHAIR: So the suggestion that was raised at the time that covered bonds really would only assist the majors and effectively, again, provide them with yet another advantage in the competitive environment is probably accurate?
>
> Mr Baker: Yes.[39]

### *Securitisation*

4.37 Securitisation involves bundling illiquid assets and converting them into a package of securities that can be issued into the capital markets. The resulting bonds are known as asset backed securities, a common type being residential mortgage-backed securities (RMBS) where various residential mortgages are the illiquid assets. As canvassed during the Competition Inquiry, the securitisation market has in the past been important for competition in the Australian banking sector. In particular, non-bank lenders relied on securitisation to compete with the major banks, as it allowed them to expand quickly without having to establish a large network of branches and compete for retail deposits.[40]

4.38 One of the clear effects of the global financial crisis was the collapse in the securitisation market, as illustrated in Figure 4.9 below. APRA officials have commented that up until around 2004, securitisation 'generated clear benefits for competitiveness, efficiency, contestability, and neutrality' in Australia:

> … for safety and systemic stability, in its earlier and simpler incarnation, securitisation was not a problem. The ADIs participating in this market generally maintained good lending discipline, abetted by the lenders mortgage insurance companies supporting the market. In Australia at least, unregulated lenders generally exercised some common sense in their lending and loan management.
>
> We saw in America and Europe, however, that securitisation in the 2000s increasingly became a vehicle which supported over-complexity, reckless and too often fraudulent lending, and gross conflict of interest. The 2007–08 phase of the global financial crisis was not caused by securitisation, but securitisation structures and re-securitisation structures featured prominently in the capital losses and illiquidity associated with that crisis.[41]

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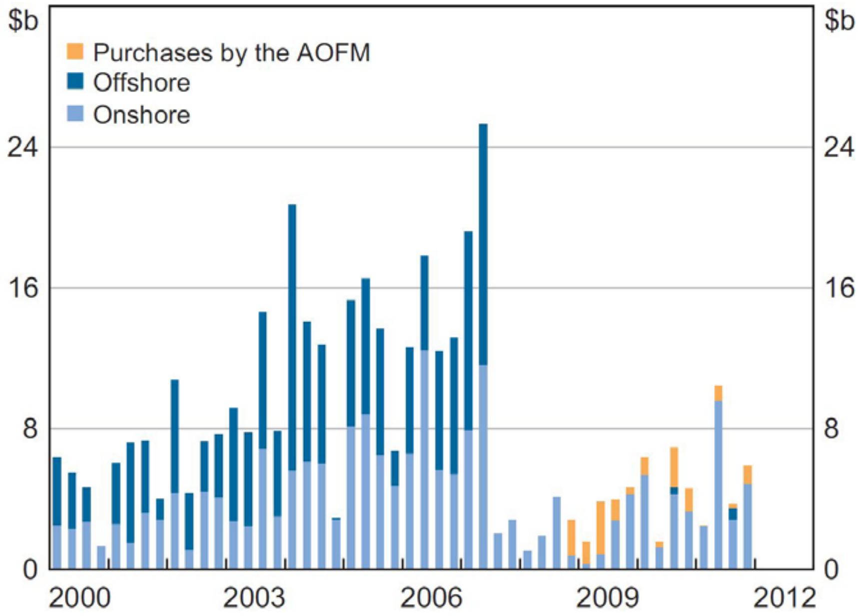
39 Mr Bart Hellemans, Chief Risk Officer; Mr Glenn Baker, Chief Financial Officer, ING Bank (Australia) Ltd, *Committee Hansard*, 10 August 2012, p. 38.

40 See Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011, p. 243.

41 Mr Charles Littrell, Executive General Manager, Policy, Research and Statistics, APRA, 'Prudential issues in securitisation', address to the Australian Securitisation Forum, Sydney, 21 November 2011, www.apra.gov.au/Speeches/Documents/speech%20PRUDENTIAL%20ISSUES%20IN%20SECURITISATION%20ASF%2021%2011%2011.pdf (accessed 30 March 2012).

**Figure 4.9: Australian RMBS issuance (A$ equivalent)**




Source: RBA, *Statement on Monetary Policy*, February 2012, p. 52

4.39 The Australian government supported the securitisation market during and after the global financial crisis by instructing the Australian Office of Financial Management (AOFM) to temporarily invest in AAA-rated Australian RMBS. In total, the AOFM has been instructed to invest up to $20 billion. As of 12 September 2012, it has participated in just under $15.5 billion worth of transactions.[42]

4.40 The future strength of the securitisation market is still an open question. The CEO of the AOFM noted that while the infrastructure for securitisation has been persevered, demand for RMBS transactions has 'ebbed and flowed'. He observed:

> There is no getting away from the fact that RMBS is a credit product. If credit globally is struggling as an asset class then so will RMBS, and no amount of buying by the Australian government is going to change that.[43]

4.41 While a Treasury officer noted that securitisation 'has lost its bad odour from previously', he mused:

> To some extent, it is still disappointing that the securitisation market has not got going again as strongly as we would like. It was always going to be around five per cent of funding in the whole system, but it is important because it does help some of the smaller lenders. But I will just finish on

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42 AOFM, 'AOFM participation in RMBS transactions' www.aofm.gov.au/content/rmbs.asp (accessed 26 July 2012).

43 Mr Robert Nicholl, Chief Executive Officer, AOFM, *Proof Committee Hansard*, 21 September 2012, p. 7.

> that point. I think internationally people are now seeing that they need to have a securitisation market, so I am hopeful that it will pick up again.[44]

### *Are debt markets recognising the fundamental strength of Australian banks?*

4.42 An interesting topic examined by the committee was the risk premiums for wholesale debt paid by Australian banks compared to banks in other jurisdictions. The Australian banking system is well-regulated, the major banks are the most profitable in the developed world and are among the most highly rated, and the broader economy is performing strongly compared to other developed countries; however, are these factors being adequately recognised by the wholesale markets?

4.43 At one of the public hearings, an argument was put forward that foreign government agencies have recognised the strength of the Australian economy and financial system, and are eager to buy Australian government bonds because they are low-risk and have a positive return, yet Australian banks were not being received with similar enthusiasm by wholesale markets. The head of Treasury's Markets Group suggested that, in his view, the soundness of Australia's financial system was not being fully reflected through lower funding costs. However, he added:

> I think sometimes the way international markets look upon it is, 'A bank's a bank.' It is an Australian bank, and it is competing with Canadian banks and with Europeans, but it is a bank. And I think what you will find in markets now is that there is a greater risk in investing in a bank than there was pre-GFC. It does not matter what bank it is.[45]

4.44 Treasury also pointed out that international lenders seek to diversify their risk, and accordingly would have a limit on the amount of money that they would be willing to invest in bonds that are linked to the Australian economy.[46] Perhaps explaining the apparent disconnect, the ANZ identified that Australian government debt would be more attractive as it is AAA rated whereas bank debt is AA rated.[47]

4.45 RBA Assistant Governor Dr Guy Debelle indicated that there was a decreased willingness generally among bond holders to hold private debt compared to well-rated government debt—noting that the borrowing costs for the Australian government recently were the lowest since Federation—however, Dr Debelle pointed out that Australian banks are still benefiting in terms of funding costs due to their reputation relative to other banks, particularly European banks.[48] Westpac's evidence supported this contention, noting that they pay a premium of around 150 basis points, while an

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44 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, pp. 3, 9.

45 Mr Jim Murphy, Treasury, *Committee Hansard*, 8 August 2012, p. 7.

46 See *Committee Hansard*, 8 August 2012, p. 7.

47 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 20.

48 Dr Guy Debelle, RBA, *Committee Hansard*, 9 August 2012, p. 40.

A-rated bank in London or New York, in its view, would likely be paying around 200 basis points. Westpac's evidence also highlighted how differences in base rates can conceal the advantage from debt markets that Australian banks receive compared to many of their international peers:

> If I was the treasurer of RBS, NatWest or some other bank at the moment I would probably be paying well over 200 over the base rate … Their base rate, Libor, is half of one per cent. I am paying 3½ on my base rate—that is, my 90-day bill rate—and I add 150 to that, so that is five per cent. If I were at RBS, London or Citibank, New York—that is, an A-rated bank—I would probably be paying 200 over, but my base rate, Libor, is only half of one per cent, so I am only paying 2½ per cent in absolute terms. But the spread over my base rate, because I am borrowing in US dollars, is actually higher.[49]

## Future direction of funding costs

4.46 It appears that funding costs will remain elevated for some time, on both the wholesale debt and deposit fronts. On the wholesale debt side, it has been observed that although the cost of issuing new unsecured wholesale debt fell during early 2011, relative to other benchmarks,[50] the cost has again increased since mid-2011 as investors demand more compensation for taking on bank credit risk globally.[51] A senior Treasury officer reflected on the short-lived decline in costs, noting that 'everyone looks for light at the end of the tunnel'. In his view, however:

> It will never go back to the lowest levels it was pre-GFC, which is probably a good thing. People thought things had settled down but this is a market and the market factors in risk.[52]

4.47 RBA officials have noted that, for short-term debt, while the cost can increase for major banks during times of global uncertainty, it should stabilise when conditions improve:

> Short-term issuance is somewhat of a buffer for the major banks. When global markets are dislocated, they tend to issue more onshore short-term debt. This tends to drive up the cost, which may also be rising at the same time because of the tensions which are causing the dislocation globally. Conversely, when conditions improve and term wholesale issuance picks

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49 Mr Jim Tate, Acting Chief Operating Officer, Australian Financial Services, Westpac Group, *Committee Hansard*, 9 August 2012, p. 4.

50 Such as Australian government bonds and the overnight indexed swap rate.

51 Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, 2012, no. 1 (March), pp. 40.

52 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 5.

> up, short-term issuance declines, reducing the spread with further downward pressure from the improved market sentiment.[53]

4.48 There are two key elements to future wholesale funding costs—the amount of pre-crisis debt that is due to mature and be replaced at a higher post-crisis cost, and the direction of wholesale debt prices generally. The ANZ and NAB advised that they still had longer-dated (7–10 year) debt issued pre-crisis that is due to mature and which will need to be replaced.[54]

4.49 Regarding the likely direction of wholesale funding costs, there was a general consensus that it would depend on global economic sentiment:

> … is Europe going to collapse; is the US era over? Those sorts of things keep it high and those spreads move out very quickly when people get scared and then they just come in very slowly.[55]

4.50 Westpac considers that the risk premium of around 150 basis points for a AA rated bank, compared to pre-crisis premiums of around 25 basis points, could conceivably 'be the new normal':

> The question of whether 150 turns itself back into a quarter of a per cent is driven by investor preference, if they love us and are happy with the level of return.[56]

4.51 Westpac also pointed out that with the international regulatory changes and continued de-leveraging, based on previous experiences of market downturns investors could be five years away from becoming comfortable with a lower risk premium:

> You would like to think that there would be some longer-term reward for being well run. There should be a differential between a AA bank and a single-A bank. You would think that under normal, ongoing, quite predictable growth arrangements, that spread would come in. But we are not at that point. We are a good five years away from being at that point …
> bear in mind that we have a lot of regulatory stuff that is going to flow through. It will not really flow through until 2015. There are other forms of regulation that will not come on until 2017–18. Until those regulatory impacts flow through and people are comfortable with them, I think people are always going to hold a bit in reserve in terms of price. That is why I say it will be five years—not because there is no macroeconomic improvement. It is just that these other discontinuities in the market are going to take some

53 Dr Guy Debelle, RBA, 'Bank Funding', address to the Australian DCM Summit 2012, Sydney, 22 March 2012, www.rba.gov.au/speeches/2012/sp-ag-220312.html (accessed 25 July 2012).

54 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 17; Mr Mark Joiner, Executive Director, Finance, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 74.

55 Mr Mark Joiner, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 74.

56 Mr Jim Tate, Westpac Group, *Committee Hansard*, 9 August 2012, pp. 4–5.

> time to really feed through and settle down. We have not been in this situation for a long time. I reckon there will always be a degree of premium in the price until people feel 100 per cent confident in the new regime.[57]

4.52 The Deputy CEO of the ANZ speculated that 'there is a prospect that we could see the premium come in a little', but it would depend on a number of factors:

> It has obviously come in from where it was in the worst parts of the crisis. If you are an international bond investor, in your mind is: 'I'm looking at return for risk.' They have really moved the pendulum to be lower risk but still reasonable return. I think they see the Australian market as being a lower risk market but not without risk. The sorts of concerns that you hear about from the bond investors include: the housing market here—whether it is sustainable, and we have heard for a number of years international concerns about whether we are going to see a sharp decline in the value of mortgages; we do not think that is the case and we tell them that—and Australia's dependence on China and the growth of China, so if China were to suddenly slow, what might that mean for Australia? There are those sorts of issues. There are some questions around the commercial property market here, particularly in some states where it has been particularly soft.[58]

4.53 Turning to deposits, it is clear that competition for term deposits among the banks has intensified for some time, leading to higher costs for banks (although obvious benefits for depositors). Abacus argues that, while this is being managed by mutual ADIs at present, it raises some questions about the long-term funding stability of that household deposit market:

> … one of our concerns is not so much about us competing with much larger institutions right now but about what would happen should, for instance, economic situations change and people have more risk appetite and want to take their money out of banks and put them into, for the sake of argument, equity. If we are continuing to fight ferociously over a shrinking pool of deposits that is a far different scenario than the one we are facing right now.[59]

### *Other issues which may impact the cost of funds*

4.54 As the previous chapter noted, the implementation of Basel III and other regulatory changes may have an impact on funding costs, particularly the stable funding requirements. However, in addition to global market developments and regulatory change, certain characteristics of the Australian financial system and the broader economy may also have an impact.

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57 Mr Jim Tate, Westpac Group, *Committee Hansard*, 9 August 2012, p. 5.

58 Mr Graham Hodges, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 20.

59 Mr Mark Degotardi, Head of Public Affairs, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 13.

*Perceptions of risk*

4.55 A paper prepared by KPMG and the Australian Centre for Financial Studies identifies three key characteristics of the Australian banking system that could be perceived to be areas of risk. They are:

- the relatively heavy reliance on foreign wholesale funding compared to other banking systems, which could leave the system vulnerable to upward pressures on funding costs resulting from international developments;
- that investors may consider there is a greater risk of contagion or systemic shocks as a result of the dominance of the big four banks and their similar funding patterns; and
- the large emphasis on residential property lending compared to other banking systems could be perceived to be a risk (the paper argues the low-risk nature of this is 'not fully appreciated in international circles').[60]

4.56 Professor Milind Sathye also noted the reliance on residential loans, submitting that the proportion of housing loans within gross loans has risen from approximately 51 per cent in 2004 to 59 per cent in 2011. Professor Sathye argued that this exposure of the Australian banks to the mortgage market may pose some risks:

> A sharp decline in house prices could be disastrous for our [systemically important financial institutions] as well as for the Australian economy. Are house prices in Australia inflated? While a study by *The Economist London*, [a] couple of years back stated that Australian houses are overvalued by more than 60 per cent, econometric analysis by IMF Economists in December 2010 found that the overvaluation was between 5–10 per cent. Estimates may differ but the fact remains that there is a bubble in the market.[61]

4.57 In a 2010 report, the IMF also noted that the major Australian banks were significantly exposed to other economies, particularly New Zealand:

> Home-host relations between Australia and New Zealand are particularly important, as approximately 90 percent of New Zealand's banking system assets are controlled by the four major Australian banks. Conversely, all four of the major Australian banks are materially exposed to New Zealand risks.[62]

4.58 Further, the ANZ's Deputy CEO observed that bond investors would consider the reliance of Australia's economy on China, and implications for Australia if China suffered an economic shock, although he added that 'most bond investors worry a lot

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60 KPMG and the Australian Centre for Financial Studies, *The future of Australian bank funding*, March 2011, pp. 3, 4. The International Monetary Fund has previously noted similar issues—see *Australia: Basel II Implementation Assessment*, May 2010, p. 3.

61 Professor Milind Sathye, *Submission 31*, p. 11.

62 International Monetary Fund, *Australia: Basel II Implementation Assessment*, May 2010, p. 29.

and they are always finding new things to worry about, but, in the range of worries they have, Australia is a relatively small worry'.[63]

*Funding advantages from being a large ADI*

4.59 There are other aspects of the Australian financial system which could be more positive for the major banks in securing their offshore funding. The Australian Centre for Financial Studies submitted that the major Australian banks could be receiving a competitive advantage compared to other banks as 'they are widely perceived as having implicit government support and will not be allowed to fail':

> In most cases of troubled financial institutions which are prudentially regulated, APRA is able to arrange a "smooth exit" by way of an arranged merger. The Financial System Stability Special Account established following legislation in 2008, provides a budget appropriation available to facilitate the potential costs involved. However, this is unlikely to be feasible in the case of the "big four" banks due to the sheer size and complexity of their balance sheets and operations. They are "too big to swallow" by other financial institutions in a situation of financial distress when the risks involved are likely to be substantial and hard to assess.[64]

4.60 This would have domestic competition implications. IMF researchers have estimated the value of these perceptions for large international banks to be a funding advantage of, on average, around 20 basis points.[65]

*Credit rating agencies*

4.61 While the reputations of credit rating agencies were clearly damaged by the global financial crisis, the ratings they issue are still closely observed. The major rating agencies (Standard & Poor's, Moody's and Fitch) currently give the Australian major banks a AA- rating. The ANZ's 2011 annual report includes a useful discussion of how credit ratings affect its funding costs and operations more generally:

> ANZ's credit ratings have a significant impact on both its access to, and cost of, capital and wholesale funding … A downgrade or potential downgrade of ANZ's credit rating may reduce access to capital and wholesale debt markets, potentially leading to an increase in funding costs, as well as affecting the willingness of counterparties to transact with it. In addition, the ratings of individual securities (including, but not limited to, Tier 1 Capital and Tier 2 Capital securities) issued by ANZ (and banks globally) could be impacted from time to time by changes in the ratings methodologies used by rating agencies. Ratings agencies may revise their

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63 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 20.

64 Australian Centre for Financial Studies, *Submission 49*, p. 5.

65 International Monetary Fund, *A fair and substantial contribution by the financial sector: Final report for the G20*, June 2010, p. 14; cited in Australian Centre for Financial Studies, *Submission 49*, p. 6.

methodologies in response to legal or regulatory changes or other market developments.[66]

4.62 The importance of a high credit rating for obtaining lower cost funding was made by a major bank. It used this to argue why increased funding costs had to be passed on:

> Mr Joiner: You could ask: why don't you eat more margin and why do you feel the need to pass those things on? We always have a cautious weather eye to the general health of the banking system, at least as perceived by the ratings agencies. We are one of seven or eight AA banks left in the world and we are barely in that category.
>
> CHAIR: Four of them are the Australian big ones.
>
> Mr Joiner: Yes. We are AA-. We have been marked down to the bottom category in AA. I think the rating agencies take a good deal of comfort in the profitability of the banks as well as in the regulatory regime, the state of the sovereign and so on. I think that, if you allow the profitability of the industry to drift away, you will quite quickly find that you do not have a AA banking system. And, if you do not have a AA banking system, it typically puts pressure on the sovereign rating.[67]

66 ANZ, *2011 Annual Report*, p. 78.

67 Mr Mark Joiner, Executive Director, Finance, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 69.

# Chapter 5

## Where to from here? Possible responses to changing funding mix and costs

5.1 Submissions to inquiries into the banking sector generally raise a number of possible regulatory changes or issues that need to be addressed which, in the view of the individual or organisation supporting them, would benefit the system as a whole in some form. This inquiry received a number of specific proposals. Significant and complex issues such as the interaction of superannuation savings with the banking system were also raised. This section examines these matters.

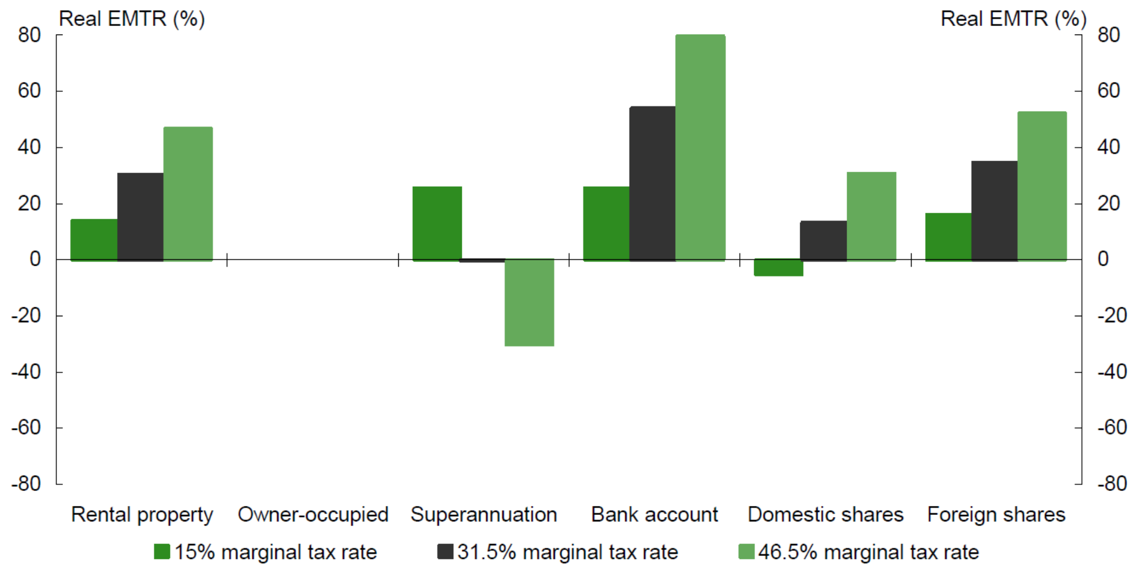
### *Tax treatment of deposits*

5.2 The Henry Review found that tax liabilities for different types of savings vary considerably, noting that the effective tax rate on income from interest-bearing deposit accounts offered by ADIs exceeds a taxpayer's marginal statutory rate. The report argued:

> A tax system for the future would tax these different forms of investment as consistently as possible, and also take account of the way inflation affects the effective tax rate on savings.[1]

5.3 The relatively unfavourable tax treatment of deposits compared to other savings and investments is demonstrated by Figure 5.1.

**Figure 5.1: Real effective marginal tax rates on savings depend on asset class**




Source: *Australia's future tax system: Report to the Treasurer*, part 2: detailed analysis, vol. 1, p. 67; based on Treasury estimates.[2]

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1 *Australia's future tax system: Report to the Treasurer*, part 2: detailed analysis, vol. 1, p. 4.

5.4 In the 2010–11 Budget the government announced a 50 per cent income tax discount of up to $1,000 of interest earned by individuals, to commence on 1 July 2011. The policy was subject to a number of revisions; later in 2010 it was announced that the eligible cap would be lowered to $500 for income earned in 2012–13; in 2011 it was announced that it the measure would be delayed until 1 July 2013. Finally, in the 2012–13 Budget the measure was abolished altogether.

5.5 The ABA called for distortions in the tax treatment of various savings options to be minimised so as not to significantly affect an individual's investment decision:

> We would be very keen to see government policy that removes tax distortions against people saving and investing through deposits. At the moment, of course, we are seeing very strong savings rates in Australia and incredibly strong competition for deposits as banks seek to try to minimise that reliance on overseas money. But, in the longer term, Australia does not have a strong record of saving through the banking system and we think part of the answer lies there.[3]

5.6 Abacus expressed a similar view:

> The unfair taxation of deposits must be addressed to reduce pressure on ADI funding costs, to reduce distortions and biases in the taxation of savings, and to ease the burden on Australian households who choose the simplest and safest savings vehicle.[4]

5.7 While deposits are more expensive for banks as a funding source compared to the past decade, and this is currently beneficial for deposit holders, if the higher cost of deposits is sustained it may have an impact on competition in the long-term. The RBA was questioned about how the major banks were able to maintain their net interest margin despite rising funding costs, yet regional banks and credit unions, which source a greater proportion of their funding from deposits, were not able to:

> Dr Debelle: The regional banks, and particularly credit unions and the like, have a much larger share of their funding coming from deposits.

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2 Notes: Real effective marginal tax rates show the tax levied on the normal real return to saving, and reflect the tax treatment of the income from which savings are made (where it deviates from tax payable if that income had been immediately consumed), earnings on those savings, and the final use of the accumulated savings. A zero effective tax rate corresponds to an expenditure tax benchmark, with the investment funded out of post-tax wages, and earnings and the subsequent realisation of the investment untaxed. The negative rate for superannuation reflects the reduction in tax otherwise payable on wages by making contributions out of pre-tax income. The estimates do not model interactions with the transfer system. Assumptions: 6 per cent nominal return; 2.5 per cent inflation; for rental property, 50 per cent of the return is attributable to capital gain and 50 per cent to rental income and the rental property is held for seven years then sold; shares are held for seven years then sold; superannuation is held for 25 years and the individual is eligible for a tax-free payout at the end of the period.

3 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 15.

4 Abacus-Australian Mutuals, *Submission 150*, p. 7.

Particularly over the last year or so, the competition in the deposit market has been pretty intense, so the relatively high cost of deposits has a bigger effect on someone who uses more deposits to fund themselves, which is the regionals and the credit unions.

CHAIR: That makes sense. Their costs have gone up by more, but they have not been able to maintain their net interest margins. The large banks' costs have also gone up, but they have been able to maintain their net interest margins.

Dr Debelle: Because over that period they potentially had other sources of funding which have not gone up as much as deposit costs have gone up.

CHAIR: So that is the answer? They have a degree of market power that enables them to maintain their profits?

Dr Debelle: No. As I said, there is plenty of competition in deposit rates. They pay varying amounts, but they are all pretty much paying the same amount. In the lending rates, again, there is not much variation between all the lenders. It just matters if you have more deposits in your funding base as to whether that means your costs are relatively high.

…

CHAIR: So if there is a competitive impact at play, it is probably forcing those banks that have the higher funding costs to have a lower net interest margin whilst the others can maintain theirs at the level they have because they have a lower cost base?

Dr Debelle: Yes. That is not a bad way of putting it.[5]

*Committee view*

5.8 The higher than usual interest rates on term deposits and to a lesser extent other savings products (relative to other benchmark rates) that the banks have been offering since the global financial crisis is good news for deposit holders, although some of the costs are ultimately passed on through other banking activities, such as lending.

5.9 The degree to which different banks, depending on their size, are able to address these developments without impacting their profitability is an issue that the committee has been concerned with from a competition viewpoint. The committee examined this issue in the report of its 2011 Competition Inquiry. It concluded that the taxation arrangements applied to bank deposits and mutual ADI deposits should be reviewed by a broad-ranging inquiry into the financial system. In the committee's view, nothing has alleviated the committee's earlier concerns. Encouraging domestic deposits would provide banks with a larger source of stable funding, reducing some of the risk from sourcing funds from unstable international wholesale debt markets. Further, an increased pool of deposits may help alleviate any long-term competition

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5 Dr Guy Debelle, Assistant Governor, Financial Markets, RBA, *Committee Hansard*, 9 August 2012, p. 38.

implications arising from the major banks encroaching on a funding source relied on by smaller ADIs.

**Recommendation 5.1**

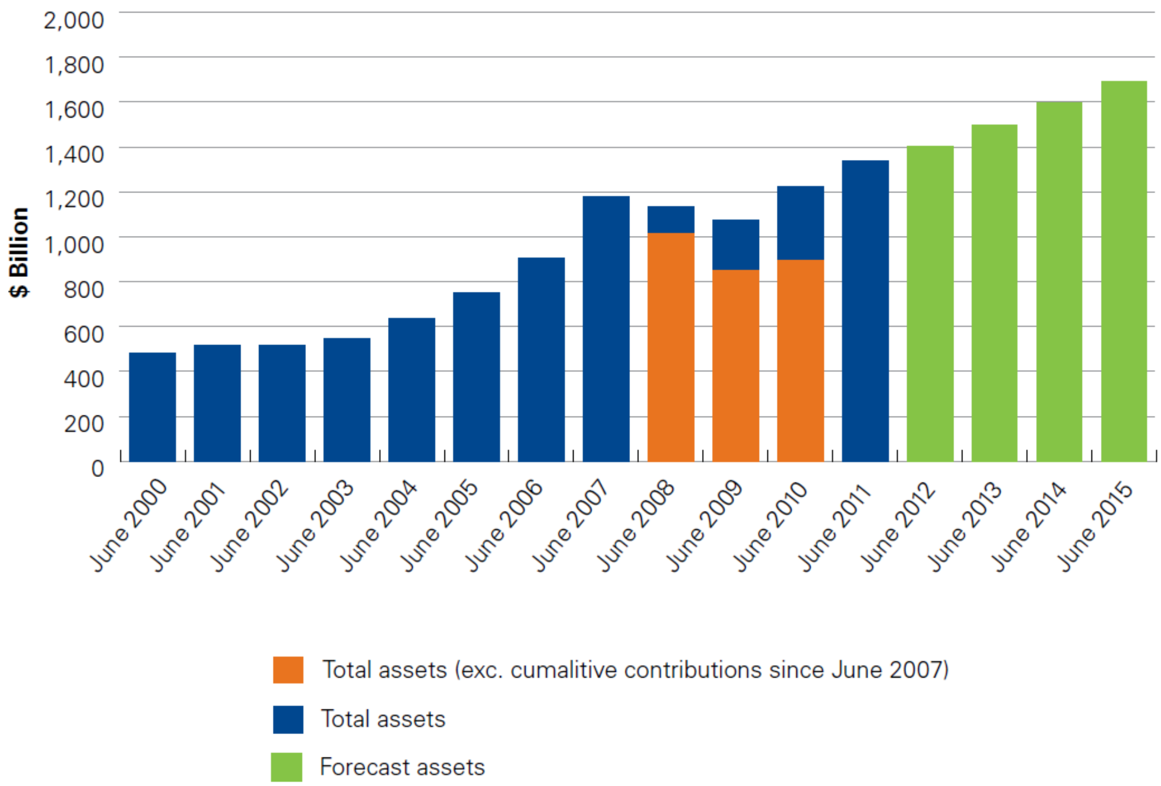
**5.10 Inconsistencies between the taxation arrangements applying to interest earned by individuals on deposits held in authorised deposit-taking institutions compared to other methods of saving should be addressed.**

### *Interaction of the superannuation and banking systems*

5.11 Australia has substantial domestic savings within the superannuation system. While some of these savings return to the banking system through the investments made by superannuation funds, banks remain significantly reliant on offshore borrowing in volatile wholesale debt markets. Whether there are changes that could be made to encourage additional superannuation savings to be directed towards the banking system in a way that helps meet the banks' funding needs was an issue discussed.

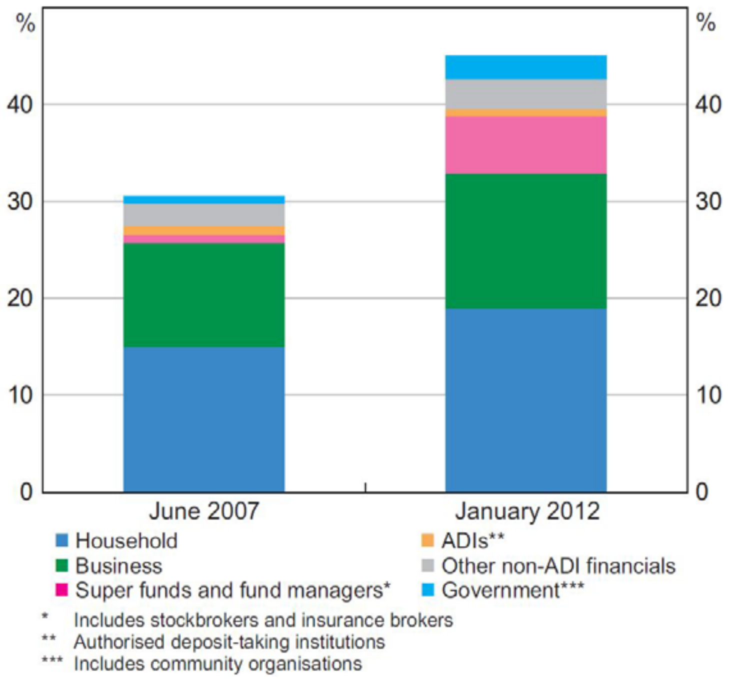
5.12 It is an interesting time for this discussion, as superannuation assets have grown significantly and will grow at an increased rate in the coming years due to the gradual increase in the superannuation guarantee (from nine per cent to 12 per cent by 2019–20 starting from 2013–14) (see Figure 5.2). Depending on the future average propensity to save among households and the attractiveness of other savings vehicles, this could place pressure on the level of deposits while, at the same time, banks will need to rely on more stable funding sources such as deposits due to Basel III. The degree to which deposits will be able to meet the banks' requirements will be impacted by the behaviour of household and superannuation funds—while households are currently risk-averse and deposits are an attractive investment option, an improvement in economic sentiment could change this. Superannuation funds are also investing in term deposits at a heightened level at the moment (Figure 5.3), however, the extent to which this will be sustained is unclear.

**Figure 5.2: Total superannuation assets**




Source: KPMG and Australian Centre for Financial Studies, *Superannuation trends and implications*, November 2011, p. 5; cited in Australian Centre for Financial Studies, *Submission 49*, p. 15. Based on APRA data.

**Figure 5.3: Term deposits with banks in Australia (as a percentage of total A$ domestic deposits)**




Source: Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, March 2012, p. 38; based on data from APRA.

5.13 Abacus predicts that:

> Competition for deposits will intensify further when the current period of global instability and uncertainty comes to an end. Households and other savers will look to alternatives to deposits that are more favourably taxed, such as equities and superannuation.[6]

5.14 The ABA observed that while the level of savings is relatively high at the moment, from a long-term perspective 'Australia does not have a strong record of saving through the banking system'. It argues that 'appropriate ways' of encouraging some superannuation savings into the banking sector need to be examined as the superannuation sector is more inclined towards investing in equity compared to deposits and other fixed income securities:

> We know that the Australian super industry for whatever reason is heavily weighted towards equities by international comparison and underweight things like fixed income products. Were super funds to invest in some of those products, it would mean money flowing through the banking system into the economy rather than chasing further returns in the equities markets here or overseas. What we are not suggesting in any way is that the trustees of those super funds be under any direction or requirement to do that.[7]

5.15 Some banks are already coming up with ways to utilise superannuation savings to meet their funding needs; at its hearing in August 2012 ING Direct advised the committee that it would enter the market by launching a basic superannuation savings product (which it did in September).[8]

### *Corporate bond market*

5.16 In Australia, companies have been inclined to turn to banks for funds rather than to issue bonds. This increased during and since the global financial crisis when many companies found accessing funds through bond issuance too difficult or costly.[9] The corporate bonds that are issued are generally in overseas markets. The Australian Financial Markets Association (AFMA) advised that at the end of March 2012, $146 billion in bonds were on issue in those overseas markets. The AFMA gave some insight into where these issuances were targeted and why:

> The US private placements market is particularly attractive to Australian companies and an important source of finance to them because it has good

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6 Abacus-Australian Mutuals, *Submission 150*, p. 6.

7 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 16.

8 Mr Vaughn Richtor, Chief Executive Officer, ING Bank (Australia), *Committee Hansard*, 10 August 2012, p. 30.

9 Susan Black, Anthony Brassil and Mark Hack, 'Recent Trends in Australian Banks' Bond Issuance', *RBA Bulletin*, 2010, no. 1 (March), p. 28.

> liquidity, long dated debt finance is available and deals may be brought to market quickly.[10]

5.17 A number of submitters called for the development of a stronger corporate bond market in Australia. The ASF argued that such a market could potentially reduce the banking system's reliance on offshore funding, thus insulating 'to some degree, Australia's vulnerability to shifts of sentiment amongst offshore investors'.[11] This is linked to the superannuation system as, assuming the bonds are attractive to the superannuation funds, they could invest in these bonds rather than offshore investments and equity. NAB explained that, rather than lending directly to large Australian corporations, if it could lead them to a developed Australian bond market with superannuation funds willing to invest in the bonds, it would 'not put stress on the bank balance sheets'.[12] NAB also contended that Australia's superannuation is 'poorly allocated at the moment':

> … arguably, by international standards, typically at least 50 per cent of superannuation money should be in fixed income securities like bonds, government securities and the like. In Australia it is not—the vast majority is in equities.[13]

5.18 As Professor Davis put it in a March 2012 article:

> On the one hand, almost everyone seems to support initiatives to develop a local corporate bond market to broaden corporate funding sources. On the other, almost everyone believes that super funds have an excessive equity bias and need more fixed interest (bond) investments.[14]

5.19 However, Professor Davis noted some issues that, in his view, would impede the development of a stronger corporate bond market in Australia:

> If banks focus more on leading corporates to the debt markets rather than on-balance sheet lending, their funding requirements also decline. One possible adjustment process could be reduced bank reliance on international capital markets, with more of our balance of payments financing involving direct foreign purchase of Australian assets such as equities. While that might help super funds reduce their equity bias, it is only one among a wide range of adjustment possibilities (about which we understand relatively little).

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10 Australian Financial Markets Association, *Submission 87*, p. 6.

11 Australian Securitisation Forum, *Submission 150*, p. 7.

12 Mr Mark Joiner, Executive Director, Finance, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 67.

13 Mr Mark Joiner, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 68.

14 Kevin Davis, *Can a Corporate Bond Market solve the Super Equity Bias?*, 19 March 2012, www.australiancentre.com.au/publications-and-articles/2012/03212012-davis-corporate-bond-market-super-equity-bias-commentary.pdf (accessed 13 September 2012), p. 1; cited in Australian Centre for Financial Studies, *Submission 49*, p. 7.

> Another possibility could be less bank reliance on domestic term deposits, with investors switching from deposits to corporate bonds. And here is a real killer in terms of the much desired retail corporate bond market. What yield must be offered to individual investors (including self managed super funds) to encourage them to invest in risky corporate bonds rather than bank deposits which are guaranteed up to $250,000 at each bank.[15]

5.20 The 2009 Johnson Report recommended that regulatory requirements on corporate debt issuance to retail investors be reduced. It concluded that a deeper domestic corporate bond market would improve the diversity of potential funding sources for companies and place added competitive pressure on banks as a source of corporate finance.[16] Since that report, there have been some policy announcements regarding the development of a bond market—as part of the 2010 *Competitive and Sustainable Banking System* package, the government announced that it would streamline disclosure requirements and prospectus liability regulations.[17] However, the steps to implement this have taken some time. In December 2011, a year after the initial announcement, a discussion paper was released by Treasury on streamlining disclosure and liability requirements.[18] Submissions closed in February 2012.

*Committee view*

5.21 That Australian banks need to obtain a significant share of their funding from volatile offshore wholesale debt markets when Australia has substantial, and growing, savings in its superannuation system is a curious aspect of the financial system. Attempts to influence this apparent imbalance must be carefully considered. Superannuation trustees need to make investment decisions that are in the best interest of the funds' members. The committee supports measures to encourage the growth of a more diverse range of attractive domestic investment options, such as the regulatory changes underway to help facilitate a deeper and more liquid corporate bond market. However, the committee considers that the interaction of the superannuation system and the banking system warrants further consideration. This issue is discussed further

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15 Kevin Davis, *Can a Corporate Bond Market solve the Super Equity Bias?*, 19 March 2012, www.australiancentre.com.au/publications-and-articles/2012/03212012-davis-corporate-bond-market-super-equity-bias-commentary.pdf (accessed 13 September 2012), p. 2; cited in Australian Centre for Financial Studies, *Submission 49*, p. 7.

16 Australian Financial Centre Forum, *Australia as a financial centre: Building on our strengths*, November 2009, p. 40. The report also noted that a deeper corporate bond market could assist financing of large scale, long-term infrastructure projects.

17 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p. 24. The government also announced that it would facilitate the trading of Commonwealth Government Securities (CGS) on a securities exchange. Legislation to facilitate CGS retail trading was introduced in June 2012 (Commonwealth Government Securities Legislation Amendment (Retail Trading) Bill 2012). In July 2012 ASIC released a consultation paper on market integrity rules for the CGS retail trading.

18 See www.treasury.gov.au/ConsultationsandReviews/Submissions/2011/Development-of-the-Retail-Corporate-Bond-Market-Streamlining-Disclosure-and-Liability-Requirements.

in chapter 10, which examines whether a broad-ranging independent inquiry into the banking system is required.

### *Interest withholding tax*

5.22 Another issue also examined by the 2011 Competition Inquiry was interest withholding tax, and the implications this has for competition in the banking sector. Interest withholding tax is a tax levied on interest paid by an Australian borrower to a non-resident lender. The tax is particularly relevant to bank funding costs and competition in the banking sector as it applies to interest paid by Australian subsidiaries of foreign financial institutions when they borrow money through their offshore parent and use that money in Australia.

5.23 Both the Henry Review and the Johnson Report recommended that financial institutions operating in Australia should generally not be subject to interest withholding tax on foreign raised funds. The Johnson Report observed that the application of the tax on offshore borrowing by financial institutions:

> … sits uneasily with the Government's desire to develop Australia as a leading financial centre and is putting Australia at a competitive disadvantage with respect to overseas financial centres, which increasingly do not charge interest withholding tax on such transactions.[19]

5.24 The government has announced changes to the application of interest withholding tax, but they have not yet been implemented. In the 2010–11 Budget it was announced that interest withholding tax on financial institutions would be phased down from 2013–14.[20] In November 2011, however, the government announced that this would be deferred until 2014–15.[21]

5.25 ING Direct argued that interest withholding tax inhibits its ability to bring an offshore pool of funds into Australia in a more cost-effective manner:

> Mr Richtor: … one of the challenges is that if we look to the offshore capital markets, unless we meet certain strict conditions, if we bring the funds back in we have to pay withholding tax, which makes it unattractive for somebody to lend us those funds. Basically, we have to go out to funds that are capable of wide distribution—and, forgive me, I have forgotten the detail of this—whereas there are many investors who would happily give us money but they are not going to wear the withholding tax. If we pay the withholding tax—and I think that is the same for all banks; it is not just for

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19 Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths,* November 2009, p. 68.

20 As announced in the 2010–11 Budget, the tax rate applying to foreign bank branches would be reduced from the five per cent to 2.5 per cent in 2013–14 and to zero from 2014–15. The rate for other financial institutions would be reduced from 10 per cent to 7.5 per cent in 2013-14 and to five per cent from 2014–15, with an aspirational target of zero. See Australian Government, *2010–11 Budget: Budget paper no. 2,* pp. 43–44.

21 Australian Government, *Mid-year economic and fiscal outlook 2011–12,* p. 166.

> us, it is more of an Australian issue—then of course it is much more expensive.
>
> Mr Baker: The key point that we would just add is that there are means. There is the section 128F exemption that allows us to do wide distribution debt issues, but it is the rule that inhibits associates from giving you funds. That is the block that puts the inability to bring ING funds from other jurisdictions into Australia.
>
> Senator WILLIAMS: So if you go to do that you have to pay the withholding tax.
>
> Mr Baker: That is right, yes.[22]

### *Committee view*

5.26 Interest withholding tax distorts funding decisions and is an impediment to foreign banks competing in the Australian banking sector. Although removing this tax from applying to financial institutions creates a direct financial cost to the government, by providing an impetus for greater competition in the banking sector such a reform would have wider benefits to the economy. Accordingly, the committee supports the removal of interest withholding tax applying to foreign bank branches and other financial institutions, although it acknowledges that such action would need to be sensitive to budgetary circumstances.

**Recommendation 5.2**

**5.27 That interest withholding tax applying to financial institutions be abolished as fiscal circumstances permit.**

### ***The Canadian securitisation model***

5.28 Non-banks have previously played a key role in injecting competition into the market for residential lending. As discussed in chapter 2, one of the results of the global financial crisis is the significantly diminished market share that non-bank lenders now have. To address this development, the MFAA called for the securitisation market to be supported in a way similar to the model adopted in Canada and administered by the Canada Mortgage and Housing Corporation (CMHC)[23]:

> The Australian Government, if it is serious about attacking the hard issues, must closely examine the success and characteristics of the Canadian

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22 Mr Vaughn Richtor, Chief Executive Officer; Mr Glenn Baker, Chief Financial Officer, ING Bank (Australia) Ltd, *Committee Hansard*, 10 August 2012, p. 36.

23 The CMHC was created in 1946 to house returning war veterans and to lead Canada's social and rental housing programs. It currently has three broad objectives: (1) help Canadians in need; (2) facilitate access to more affordable, better quality housing for all Canadians; and (3) ensure the Canadian housing system remains one of the best in the world. See Canada Mortgage and Housing Corporation, 2012–2016 Summary of the corporate plan, www.cmhc-schl.gc.ca/en/corp/about/anrecopl/upload/2012-2016CPSCMHC_E.pdf (accessed 3 September 2012), p. 3

> Mortgage and Housing Corporation's securitisation programs, viz Mortgage backed Securities and Canadian Mortgage Bonds. These programs provide a proven efficient and effective template for competitively priced mortgages, whose features should be incorporated into the Australian mortgage market.[24]

5.29 The CMHC undertakes two securitisation programs under its mission to promote housing quality, affordability and choice for all Canadians. The first program, National Housing Act Mortgage-Backed Securities (NHAMBS), commenced operation in 1987. As its name suggests, the program follows the passage of the National Housing Act (in 1985) which was during a period of high interest rates and associated concerns about housing affordability. The NHAMBS program was intended to respond to these high interest rates, instability of rates and the prevalence of one year mortgages.[25] The second program is the Canada Mortgage Bonds (CMB) program, which was introduced in 2001. As CMBs are bullet bonds,[26] it was intended that CMBs would be a more attractive option for investors than NHAMBS instruments.[27] The proceeds of the bonds are used to purchase mortgage backed securities issued under the NHAMBS.

5.30 Both securitisation programs provide a guarantee to investors, ultimately backed by the Canadian government, that payments of interest and principal will be timely. As the MFAA explained, the government guarantee lends the sovereign rating to the instruments (currently AAA) and for this guarantee, the government profits through the premium charged:

> Mr Naylor: The key feature is that the government guarantees it. The funds that go into the securitised system in Canada have a AAA rating. They produce funds that are lower than any other source of funding except for the price of deposits in Canada. So they are lower than what we have heard many times from the banks in the global wholesale lending market. The margins are much lower. They produce a benefit to investors, because they are pretty close to guaranteed—they are very low-risk investments—and they produce a surplus for the government.
>
> Senator WILLIAMS: Just to add to that, at what cost to government would that come at—to do what you just suggested in terms of the Canadian model?

24 Mortgage and Finance Association of Australia, *Submission 52*, p. 2.

25 KPMG, *Canada Mortgage Bonds Program evaluation: Final report*, June 2008, www.cmhc.ca/en/hoficlincl/in/camobo/upload/CMB-Evaluation-Jun08.pdf (accessed 3 September 2012), p. 7.

26 Bullet bonds are debt instruments that cannot be redeemed prior to maturity. The face value of the bond is paid on the maturity date, rather than a series of payments occurring over several dates.

27 KPMG, *Canada Mortgage Bonds Program evaluation: Final report*, June 2008, www.cmhc.ca/en/hoficlincl/in/camobo/upload/CMB-Evaluation-Jun08.pdf (accessed 3 September 2012), p. 9.

Mr Naylor: The government makes a profit out of it.[28]

5.31 The MFAA provided further evidence on how aspects of the programs, including risk, are managed:

> They have a reverse auction so they say, 'We have $25 billion in the pool' and they invite people to tender for it. The big banks, the small banks and the non banks can all tender for it. There are a lot of requirements around the integrity of the process. No one lender can access more than 25 per cent of the pool so that means the smaller guys can get a chop at it. I think the minimum tender has to be $20 million … This is not a free handout. You have to be able to show that you are part of the system, that you have skin in the game so that you are assuming some of the risk. If you are interested, there are reams and reams of rules about how the system works and the type of loan that is acceptable, who can invest and all that sort of stuff.[29]

5.32 The Canadian approach to securitisation may be particularly instructive given the similarities in the Australian and Canadian economies and financial sectors, such as the similar population size, number of major banks and size of the mortgage market, as well as that the banking sectors of both countries avoided the worst of the global financial crisis.[30] While the MFAA is strongly supportive of such schemes being adopted in Australia, others are less sure. Professor Davis argues:

> I would suggest that we should stay away from it, because it involves governments providing guarantees in various forms. The Canadian system is a very complex one, as far as I can see—it is not simple. And I think the last thing governments should be getting into is providing guarantees. It is very hard to price them, and very hard to operate them, I think. So I think there are other ways in which we could get the securitisation industry back into a better position to provide greater competition in the housing market than going down that route.[31]

5.33 In 2009, Treasury noted that a Canadian-style program 'could potentially enhance smaller lenders' access to funds', however it balanced this view with the following statement:

> However, it is not clear that such an intervention would necessarily result in substantially greater choice and lower interest rates for mortgage borrowers,

28 Mr Phil Naylor, Chief Executive Officer, Mortgage and Finance Association of Australia, *Committee Hansard*, 8 August 2012, p. 30.

29 Mr Phil Naylor, Mortgage and Finance Association of Australia, *Committee Hansard*, 8 August 2012, p. 34.

30 Mortgage and Finance Association of Australia, *Submission 52*, p. 20.

31 Professor Kevin Davis, Australian Centre for Financial Studies, *Committee Hansard*, 8 August 2012, p. 43. In its submission, the Australian Centre for Financial Studies also argues that it would be unlikely to easily achieve "fair pricing" of the government guarantee; *Submission 49*, p. 12.

> or that the benefits of the proposal would outweigh the associated risks and costs.[32]

5.34 The RBA expressed similar reservations, noting that the mortgage market in Australia is 'reasonably competitive at the moment' and advising the committee that it was aware of issues being raised about the Canadian programs:

> Dr Debelle: … The Canadians at the moment are dealing with a situation where they are a bit concerned about where their housing market is going, particularly in terms of the lending side of things. So that might be a reasonable test of the resiliency of the system they have had, over the next couple years.
>
> Senator CAMERON: On the up side or the down side?
>
> Dr Debelle: On the up side.
>
> Mr Aylmer: In fact, they are concerned about the exposure of taxpayers, now, to the Canada Mortgage and Housing Corporation, because it is a government financed thing.[33]

*Committee view*

5.35 While it is desirable for the securitisation market to be reinvigorated to enhance competition in the sector, the committee is aware that a Canadian-style scheme would be a significant change to the Australian banking sector; and one that would commit the government to be involved in the securitisation market on an ongoing basis. The committee is particularly concerned about the transfer of risk from the private sector to taxpayers.

5.36 The committee is not dismissing the scheme entirely, as the Canadian scheme has apparently operated effectively for some time. In the report of its 2011 Competition Inquiry, this committee recommended that further research be done into how the Canadian model could be applied in Australia so that it could be implemented quickly in case of future deterioration in the securitisation market. At this time, the committee maintains this view. The potential benefits and costs of such a scheme would need to be closely examined, and this could perhaps take place as part of a broad-ranging inquiry into the financial sector.

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32 Treasury, *Submission 167* to House of Representatives Standing Committee on Infrastructure, Transport, Regional Development and Local Government's inquiry into the impact of the global financial crisis on regional Australia, August 2009, p. 8. As at February 2011, this submission still reflected the views of Treasury (which directed this committee to this submission during the Competition Inquiry); see Treasury, answer to question on notice, Competition Inquiry, no. 14, 4 February 2011, pp. 3–4.

33 Dr Guy Debelle, RBA, *Committee Hansard*, 9 August 2012, p. 44.

### *Other securitisation issues*

5.37 The Australian Securitisation Forum (ASF) advised the committee that demand among investors for Australian securitisation has been impacted by changes in the attitude of central banks in key jurisdictions towards what securities are eligible for repo operations.[34] The ASF advised that up until 2010 the European Central Bank (ECB) accepted Euro-denominated bonds collateralised by Australian assets (such as RMBS), but since then the ECB has restricted eligible bonds to those where the collateral is from Europe or G8 countries outside Europe.[35]

*Committee view*

5.38 Investor demand and the liquidity of Australian asset-backed securities could be enhanced if foreign currency bonds collateralised by Australian assets were "repo-eligible" in foreign jurisdictions. While this is a matter for the central banks concerned, the government could push for wider acceptance of Australian securitisation.

**Recommendation 5.3**

**5.39 To enhance investor demand for Australian securitisation, the committee recommends that the government encourage central banks in other jurisdictions to accept Australian asset-backed securities denominated in foreign currencies for repurchase agreements in the foreign jurisdiction.**

34 Repurchase agreements (commonly shortened to 'repos') involve the sale or purchase of securities with a commitment to reverse the transaction at an agreed date in the future and at an agreed price. The RBA uses repos to conduct its domestic market operations (i.e. to ensure that the actual cash rate is close to the target cash rate).

35 Australian Securitisation Forum, *Submission 153*, p. 7.

# PART II

## Borrowing and lending

# Chapter 6

# Implications of the crisis on borrowing and lending practices

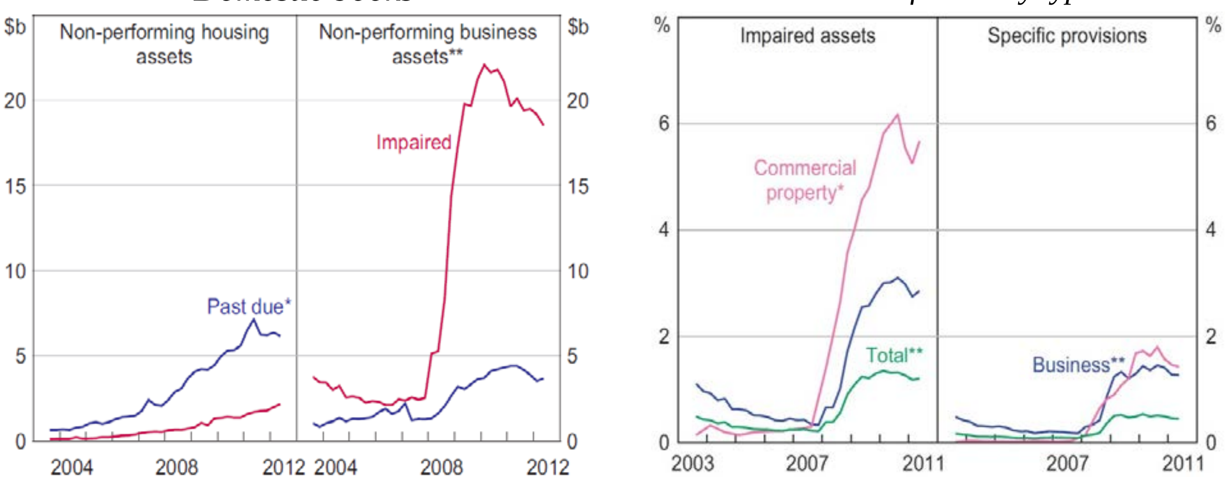
6.1 The global financial crisis affected the behaviour of businesses and households in a number of ways, but it particularly adjusted attitudes towards risk, credit and levels of debt. Financial institutions also re-evaluated their attitude to risk as it was clearly exposed that risk was under-priced globally in the years leading up to the onset of the crisis in 2007. The subsequent repricing of risk and rising funding costs for banks has impacted both the ability of borrowers to access funds and the attitude that lenders have to certain categories of borrowers. Most submissions to this inquiry have focused on the conduct of Bankwest following its acquisition by the CBA at the height of the global financial crisis in 2008. That matter is examined in the following chapters. This chapter provides an overview of the impact of the crisis on borrowing and lending practices, and examines other issues raised during this inquiry regarding lending practices.

## Reaction of financial institutions

6.2 The global financial crisis led to significantly less appetite for credit among households and businesses. Banks generally tightened their lending criteria. On banks' balances sheets, one clear outcome is the heightened level of impairment and non-performance of loans, particularly business loans and those related to commercial property (Figure 6.1).

**Figure 6.1: Banks' asset quality**

*Domestic books* *Per cent of loans by type*




* 90+ days but well secured

** Includes lending to financial businesses, bills, debt securities and other non-household loans.

Source: RBA, *Financial Stability Review*, September 2012, p. 25; based on APRA data.

* Consolidated Australian operations; sample of 26 banks.

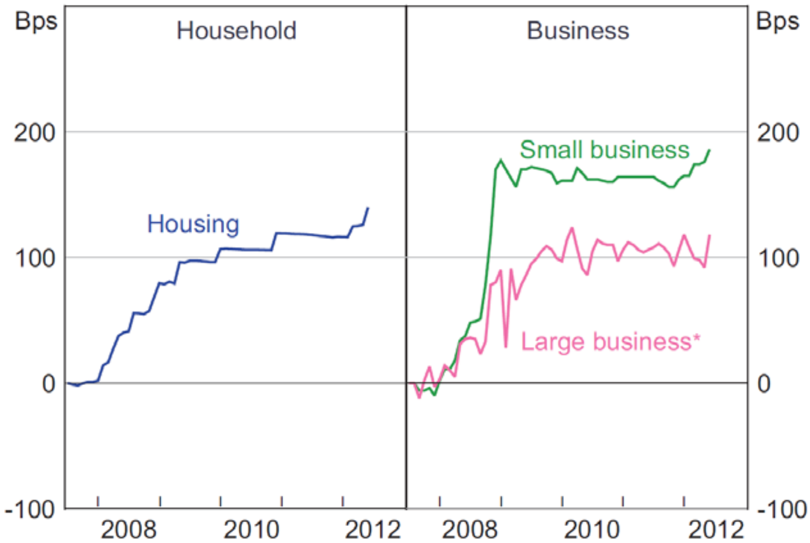
** Domestic books; all banks; includes lending to financial businesses, bills and debt securities, and other non-household loans.

Source: RBA, *Financial Stability Review*, September 2011, p. 31; based on APRA data.

6.3 Excessive risk taking and the inadequate pricing of risk were two of the key contributing factors to the global financial crisis. As a result, both wholesale markets and the banks repriced risk. One apparent outcome was an increase in the price of small business loans relative to movements in the cash rate and the interest rate for residential mortgages and large business loans (Figure 6.2). This could simply reflect acknowledgement of the greater risks associated with these loans,[1] although an additional factor could be the developments which impacted competition in the sector, such as Bankwest, which was an aggressive small business lender pre-crisis, being unable to secure funds from its UK parent and being taken over by the CBA in 2008. In any case, as Treasury noted, a noticeable impact on the banks' approach to lending is not surprising:

> You cannot have a recalibration of a reassessment of risk without it having the downstream effect of what contains risk for banking institutions—that is, their lending and the way they value the assets which are the collateral for those loans.[2]

**Figure 6.2: Variable lending rates: cumulative change in spreads to the cash rate since June 2007**




* Loans greater than $2 million; includes bill lending.

Source: RBA, *Submission 33*, p. 4; based on ABS, APRA, Perpetual and RBA data.

6.4 While it can be seen that interest rates for small business loans have increased, relative to the cash rate, due to higher funding costs and risk-margins on these loans, how else did banks respond to concerns about risk? The CBA submitted that the

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1 As noted by NAB's executive director of finance during the Competition Inquiry, business lending has a lower return on equity than housing lending: both 'regulatory assumptions and the loss history models suggest you will have a lot more problems on the business side than on the housing side'. Mr Mark Joiner, Executive Director, Finance, National Australia Bank, *Committee Hansard*, Competition Inquiry, 13 December 2010, p. 54.

2 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 2.

global financial crisis has not impacted the general criteria against which it assesses loan applications, although since the crisis commenced it has:

- changed the maximum loan-to-valuation ratio for residentially-secured mortgages;
- changed limits for some types of counterparties and credit exposures; and
- applied concentration limits to certain industry sectors.[3]

6.5 Westpac advised that following the global financial crisis it has not changed its credit standards or lending practices.[4]

## Customers' perspectives

6.6 Compared to pre-crisis levels, consumers have reduced their debt and changed their attitude to debt. ANZ advised that almost half of its variable rate mortgage customers are ahead of their repayment schedule, which its Deputy CEO described as a 'very unusual number'.[5] ING Direct advised that in its case over half of its customers are ahead of the monthly repayment schedule, and that this proportion is increasing.[6]

6.7 The number of disputes with financial institutions escalated to an external dispute resolution process has grown. Information provided by the Financial Ombudsman Service (FOS), an external dispute mechanism for the banking sector, shows that it received 30,283 disputes in 2010–11 including around 14,500 disputes about credit. FOS noted that there has been a sharp increase in disputes about financial difficulty in recent years, mainly about consumer credit products. These disputes have increased from around 2,640 in 2009–10 to over 6,100 in 2010–11.[7] Of the disputes resolved in 2010–11, the most common outcome was by agreement between the parties (18,388 matters), with FOS being required to make a decision in just over 3,000 matters.[8]

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3 Commonwealth Bank of Australia, *Submission 81*, p. 32.

4 Mr Jim Tate, Acting Chief Operating Officer, Australian Financial Services, Westpac Group, *Committee Hansard*, 9 August 2012, p. 1.

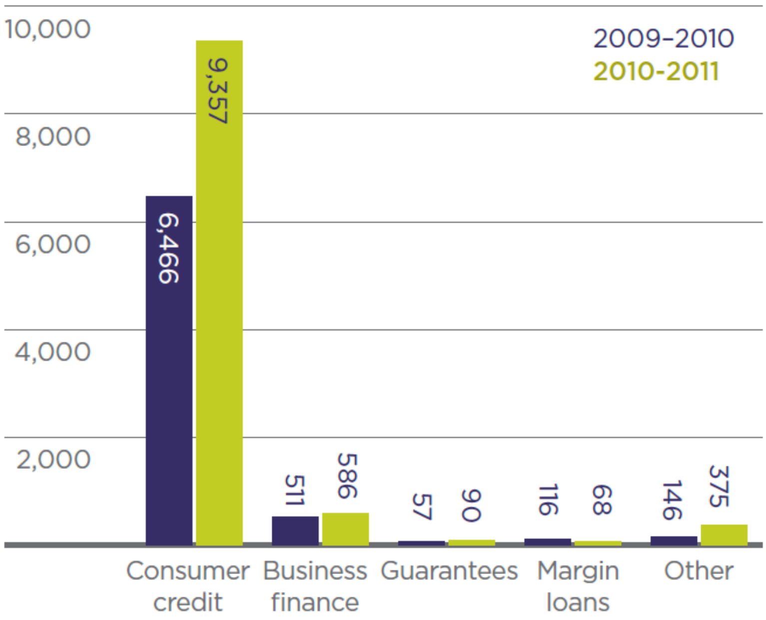
5 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 16.

6 Mr Bart Hellemans, Chief Risk Officer; Mr Glenn Baker, Chief Financial Officer, ING Bank (Australia) Ltd, *Committee Hansard*, 10 August 2012, p. 37.

7 FOS, *Submission 50*, p. 3.

8 FOS, *2010–2011 Annual Review*, p. 23. Thirty-eight per cent of these decisions were in favour of the applicant.

**Figure 6.3: Credit disputes accepted by FOS by product category**




Source: FOS, *2010–2011 Annual Review*, p. 33.

6.8 There are a number of factors which, in FOS's view, led to the increased number of disputes in 2010–11. The global financial crisis is one factor to which the increase is attributed. Other factors include the increases in interest rates in 2009–10, the commencement of the *National Consumer Credit Protection Act 2009* (NCCP Act), the expansion of FOS's jurisdiction at the start of 2010, increased awareness of FOS and a lack of confidence among consumers in financial institutions' dispute resolution processes.[9]

6.9 The committee also received information specifically relating to small business finance. CPA Australia provided the results of roundtable discussions it conducted in late 2011 and early 2012. CPA Australia's report noted various improvements compared to its 2009–10 study, including increasing access to finance over the past three years, however it concluded:

> The SME lending landscape has not changed dramatically since CPA Australia’s previous work on the topic in 2009–10. The key theme at that time was that SMEs were subject to tightened lending conditions they were not prepared for, and that the difficulty in accessing finance had impacted business operations and performance. The other important issue was the demise in the relationships between banks and SMEs.[10]

9 FOS, *Submission 50*, p. 5.

10 CPA Australia, *Submission* 51, attachment A: *SME access to finance: recent experiences of SMEs in accessing finance*, May 2012, p. 3.

## Predatory lending and incentives for bank employees

6.10 Some unease about the direction in which certain aspects of consumer lending in Australia was headed pre-crisis was expressed, although it was noted that recent changes to consumer credit legislation may address some of the identified issues:

> In the case of, for example, predatory lending, not being privy to the details of individual loan contracts, it is clear that our banking system was moving towards the situation of excessively high loan-to-valuation ratios and various lending practices that were perhaps not in the best interests of customers. But we had not got anywhere near I think the situation of other countries, and here we have had legislation about know your customer and more emphasis on banks being able to assess the suitability of loans.[11]

6.11 In the ABA's view:

> We are not pure, but also I do not think we have a systemic problem with predatory lending. It is not actually in the banks' interest to lend money to people who cannot repay it.[12]

6.12 The ABA was also questioned about the incentive structures for lending. Its CEO, Mr Steven Münchenberg, noted that bank employees may be incentivised to sell certain products as part of their remuneration, and acknowledged that 'we need to be very careful about that', but he did not consider bank employees are incentivised to take risks.[13] When questioned about attitudes to risk in the banking sector more generally—specifically whether financial sector employees systematically underestimate risk and whether investors don't understanding the risk of leverage and underestimate its consequences—Mr Münchenberg contended that if this was a phenomenon in Australia 'we would have absolutely found out in the last few years':

> Our banking system in Australia and banking systems worldwide have been through the most robust and thorough stress testing over the last few years you could possibly imagine. Many of those systems and many of those banks have fallen short. Ours has not … it was not through accident that our banking system did as well as it did; it was through careful management of risk in Australia and very good regulation and supervision—all of which was in place before the GFC. Should we look at improving on that? Absolutely, and we have been over the last couple of years. The government has introduced a whole range of measures and a whole range of measures are coming from offshore.[14]

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11 Professor Kevin Davis, Australian Centre for Financial Studies, *Committee Hansard*, 8 August 2012, p. 40.

12 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 23.

13 Mr Steven Münchenberg, *Committee Hansard*, 8 August 2012, p. 24.

14 Mr Steven Münchenberg, *Committee Hansard*, 8 August 2012, p. 24.

6.13 The discussion shifted from the abstract to the specific when representatives of the major banks gave evidence. Examples of low-doc loans and reverse mortgages were raised with Westpac, where a bank manager signed up elderly clients to long-term mortgages, and encouraged them to invest in a developing company:

> Senator WILLIAMS: … I will give you an example. Mrs Heather Simmers, who is now 101 years old, was signed up personally by your bank manager for a 30-year mortgage, for $440,000, at the Clem Jones nursing home in Brisbane … according to this lady who worked for the company, 'as witnessed by me and her daughter, Mrs Del Black, approximately 70 years old, who had a similar Rocket loan. Both mother and daughter are aged pensioners with no other income. I was ordered by Tony and Brad Silver to drive the bank manager to that location. I picked him up at Oxenford that day and also saw the vehicle which he had been awarded for his valuable contributions to the company, CGIC Pty Ltd. This was [a] white Mazda CX-9 vehicle, a 2010 model worth about $50,000. This gift was confirmed by Tony Silver, who stated that a sale was concocted again, according to Silver, to protect the bank manager from any consequences from accepting such items.' Well, this company went broke. This lady is now 101 years old.
>
> Mr Tate: The bank manager got a Mazda?
>
> Senator WILLIAMS: Yes.
>
> Mr Tate: Who did he get it from?
>
> Senator WILLIAMS: From the company that he was telling all his clients to invest in. I think this is a police matter.
>
> Mr Tate: It certainly sounds like it.[15]

6.14 A Westpac executive later stated 'it was an outright fraud, there is no question about that. Obviously the bank will be disgusted about it, and we would want to take action directly against the person involved, if it has not already been taken'.[16] The Westpac executive also committed to look into and address this matter:

> Senator WILLIAMS: … I am deeply concerned about this, and I ask you to address it. If what this lady says is correct—and I have no reason whatsoever to doubt her truth; she has just recently recovered from a brain tumour operation—then I think this should be righted, Mr Tate.
>
> Mr Tate: You have my assurance that that will be the case. It is unconscionable; I am not going to defend it. The reason I asked about WA is that there was a firm of brokers in WA that similarly engaged in a range of fraudulent activity, and we made restitution to the people affected by that. Using the same principle, I have no drama in taking that on.[17]

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15 Mr Jim Tate, Acting Chief Operating Officer, Australian Financial Services, Westpac Group, *Committee Hansard*, 9 August 2012, pp. 5–6.

16 Mr Jim Tate, Westpac Group, *Committee Hansard*, 9 August 2012, p. 6.

17 Mr Jim Tate, Westpac Group, *Committee Hansard*, 9 August 2012, p. 7.

6.15 A senior APRA official pointed out that there are a large number of employees in the Australian financial services sector, and that they obviously deal with a lot of money. However, he noted that from APRA's perspective, any nefarious practices appear isolated and are not affecting the stability of the sector:

> Mr Littrell: Neither we nor anyone else is going to be able to say there will never be misbehaviour in the financial services industry by the providers or the customers. We can say to you that in terms of our role, which is ensuring the institutions are financially sound, we do have systems in place to give us good feedback about whether there is a substantial or systemic problem. For example—again, pulling a number somewhat out of the air—let us say there are three million home loans and over 99 per cent of them were being paid back without, apparently, much difficulty.
>
> Senator CAMERON: A lot of mortgage holders would say that is not true. Lots of them have difficulty.
>
> Mr Littrell: Difficulty in the sense of collection, not in the sense of payment. From the point of view of the prudential regulator, some of those loans were made in error but not enough to threaten the solvency of the institutions—not even close. We could run similar sorts of things on credit cards or small business loans.[18]

6.16 Another APRA official made the point that the issues raised appear to be instances of fraud that should be investigated by the police, rather than being a matter of prudential regulation.[19] The committee has not been advised by APRA as to whether or not it has referred any such instances to police for investigation.

### *Low-doc loans, allegations of fraud and implications for the AOFM program*

6.17 During the course of this inquiry, specific issues regarding low-doc loans were raised. It should be noted that most of the issues raised are, strictly speaking, beyond the scope of this inquiry given that this is an inquiry into developments arising out of the global financial crisis and some of the specific issues raised relate to the pre-crisis period. However, as the allegations were raised in evidence, and further claims were made regarding how the AOFM's post-crisis securitisation program may be impacted—an issue relevant to this inquiry—these matters are discussed in this section. Recent media reports that suggest certain lenders are enthusiastically offering low-doc loans with high LVRs also makes the general topic of low-doc loans relevant.[20]

6.18 Low-doc loans are loans that require less financial documentation—such as proof of employment and income—than standard loans. They are intended for

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18 Mr Charles Littrell, Executive General Manager, Policy, Research and Statistics Division, APRA, *Committee Hansard*, 9 August 2012, p. 56.

19 Mr Keith Chapman, Executive General Manager, Diversified Institutions Division, APRA, *Committee Hansard*, 9 August 2012, p. 55.

20 Anthony Klan, 'Low doc risks rise in loans scramble', *The Australian*, 26 September 2012, p. 3.

borrowers that find it difficult to demonstrate their capacity to repay, such as the self-employed. The Banking and Finance Consumers Support Association, headed by Ms Denise Brailey, alleged that there is the potential for a significant amount of loan application fraud and lending maladministration for low-doc loans. Of serious concern to the committee were Ms Brailey's alarming allegations of widespread fraud related to the loan applications, based on additional pages to the application forms being filled out by a person other than the borrower with exaggerated statements made about the borrower's income. Ms Brailey was asked about the application forms at a public hearing:

> Senator WILLIAMS: Let us just go through the application form. Normally an application form is three pages.
>
> Ms Brailey: The banks have told us they were three pages. The banks gave the courts documents to say the loan application form was three pages. They were not; they were an 11-page document—always.
>
> Senator WILLIAMS: So when the customer signed off the loan application form, the customer signed three pages not 11?
>
> Ms Brailey: Three pages, that is right.
>
> Senator WILLIAMS: You are saying that after the customer signed those application forms, figures were altered on the 11-page form?
>
> Ms Brailey: Yes. The way it worked was that the other pages of the application—and I have this complete one here—were inserted and that would be faxed through to the bank. The people would never see the rest of the document.[21]

6.19 The individuals affected by these allegations are generally asset-rich, income-poor individuals (such as pensioners or low-income families) who were encouraged to take out large loans to make investments intended to increase their income. However, they did not have the financial capacity to repay the loans and this led to hardship when the investments went bad. The use of 'ABNs for a day' was also discussed, where lenders allegedly urged brokers to apply for an ABN for their clients to indicate that they were self-employed.

6.20 The regulation of low-doc lending has changed in recent years. The NCCP Act, which commenced on 1 July 2010, introduced a national framework for the regulation of consumer credit, which included a responsible lending obligation on lenders. This obligation requires lenders and mortgage brokers to make reasonable inquiries into and verify a potential borrower's financial situation to assess whether the credit contract is not unsuitable for the borrower's requirements, and that the borrower has the capacity to comply with the contract's financial obligations without substantial hardship. Evidence taken by the committee indicates that the responsible lending obligation is having an impact. A Westpac executive advised that low-doc lending

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21 Ms Denise Brailey, President, Banking and Finance Consumers Support Association, *Committee Hansard*, 8 August 2012, p. 47.

represented around two per cent of its new loans at the moment, down from around ten per cent before the NCCP Act.[22] The Westpac representative also commented that, as a result of lenders being required to make reasonable inquiries regarding income, it has transpired that self-employed borrowers do have 'quite a substantial amount of documentation', such as business activity statements and other accounting information.[23] Information provided by the RBA supported Westpac's evidence:

> Low-doc loans currently comprise around 5 per cent of housing loans on banks' balance sheets, and only 1 per cent of banks' housing loan approvals. The decline in low-doc lending over the past few years has been associated with a tightening in credit standards, slower business credit growth (since low-doc loans are designed for the self-employed) and the introduction of the National Consumer Credit Protection (NCCP) laws.[24]

6.21 ASIC stated that it had taken enforcement action regarding low-doc loans over a number of years[25] and that it has been active in regulating low-doc loans since the NCCP Act commenced, noting that it undertook a review of low-doc loans within the first six months of obtaining responsibility under the NCCP Act for these lending practices.[26] It noted some areas for improvement among brokers, but that:

> ASIC saw improvement, continues to see improvement and is monitoring things. ASIC has followed up individual cases where it felt that the conduct fell short. It continues to be a focus for ASIC given the risks in the market are probably most acute in the market that promotes low-doc lending.[27]

6.22 Recently, ASIC also was successful in the first criminal charges brought by it under the NCCP Act when a former mortgage broker pleaded guilty to ten offences including providing false documents to banks and assisting clients to apply for loans that were unsuitable for them.[28]

6.23 On the specific claims raised by Ms Brailey, ASIC advised that it 'has not identified widespread evidence of systemic misconduct in the banking sector along the lines suggested':

> In response to previous general allegations made by Ms Brailey ASIC has requested her on a number of occasions to provide ASIC with any

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22 Mr Jim Tate, Westpac Group, *Committee Hansard*, 9 August 2012, p. 7.

23 Mr Jim Tate, Westpac Group, *Committee Hansard*, 9 August 2012, p. 5.

24 RBA, answer to question on notice, 9 August 2012 (received 20 August 2012), p. 1.

25 For examples of this enforcement action, see ASIC, answer to question on notice, 8 August 2012 (received 20 September 2012), pp. 4–6.

26 See ASIC, *Report 262: Review of credit assistance providers' responsible lending conduct, focusing on 'low doc' home loans*, November 2011.

27 Mr Michael Saadat, Senior Manager, Deposit Takers and Issuers, ASIC, *Committee Hansard*, 8 August 2012, p. 54.

28 ASIC, 'Former mortgage broker pleads guilty to first charges laid under the National Credit Act', *Media release*, no. 12-237, 25 September 2012.

> additional information and specific evidence of falsification of documents in the banking sector. This evidence has not been forthcoming. Following her testimony to the Committee, ASIC has again requested Ms Brailey to provide any such evidence.
>
> More recently, ASIC has received a number of letters from members of Ms Brailey's Banking and Finance Consumers Support Association, Inc (BFCSA), some of which raise general concerns about low-doc loans and call for a Royal Commission, and others which raise concerns about their own loan transactions. However, these letters generally make broad allegations of misconduct and do not contain any specific evidence of the alleged misconduct. We are therefore encouraging these people to provide us with additional information and documents to assist us in assessing the matters.
>
> We also understand that a number of BFCSA's members obtained loans from finance broker Mortgage Miracles. The Western Australian Police has charged Mortgage Miracles' director, Ms Kate Thompson, with fraud offences in relation to her conduct as a mortgage broker and it is understood that a hearing on whether Ms Thompson is fit to stand trial is scheduled to be held on 12 November 2012.[29]

6.24 In response to ASIC's testimony, Ms Brailey wrote to the committee where she vehemently denied ASIC's allegations:

> ASIC wants the Senators to believe it only has 17 cases of imprudent lending to deal with regarding the Low Doc Scandal … ASIC suggests it investigates every case. It certainly does not. Such assertions are false.
>
> * * *
>
> ASIC is clearly telling the Parliament it's the Brokers providing incorrect figures and we have been constantly advising ASIC it is the ADI's to blame not the brokers. My files prove the above assertion by ASIC is plainly false. ASIC answered all 300 letters by suggesting they fell under the 1 July 2010 criteria that ASIC has set to rid its files of all the complaints stockpiled 2005–2010.
>
> My files are full of ASIC letters of refusal to investigate claims, acquired since 1998.
>
> Once again ASIC has told the Inquiry under Oath it sees "no systemic issues" … I am continually reminding ASIC it is their job to investigate complaints, not mine.[30]

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29 ASIC, answer to question on notice, 8 August 2012 (received 20 September 2012), p. 7.

30 Ms Denise Brailey, correspondence to the committee dated 9 October 2012, p. 5 (emphasis omitted).

6.25 The committee is concerned about the obvious discrepancies between ASIC's claims and Ms Brailey's claims and believes it warrants further investigation.

6.26 The Australian Securitisation Forum (ASF) forcefully disputed the claims made by Ms Brailey. In the ASF's view, 'these assertions lack credibility based on the absence of significant defaults arising from such loans'. It argued that any loans entered into prior to 2008 would now have been in existence for more than four years and that issues with delinquency would be clear by now:

> For loans included in securitisations, performance issues relating to a borrower's inability to service the loans would now be evident through the monthly reporting of arrears and defaults that is provided to investors in RMBS issues. As a general statement, fraudulently originated loans typically exhibit early term delinquency, usually within the first six months of their life. There is no evidence of the occurrence of systemic fraud in relation to low-doc lending despite the product being generally available for in excess of a decade, aside from the allegations that have now surfaced.
>
> S&P produces a quarterly report of the performance of all pools of securitised residential mortgages, both full and low-doc. The most recent S&P report for the quarter ending 31 March 2012 indicates only 3.28% of low-doc loans are 90+ days in arrears. This is a small percentage of all low-doc loans. To put this into perspective, low-doc loans that are 90+ days in arrears represent only around 0.2% of the total residential mortgage loans in the financial system. It is also noteworthy that the loss rates on residential mortgages in Australian RMBS before claims under mortgage insurance are less than 0.22% and there has been zero historical losses or charge-offs against any Australian Issued prime RMBS.[31]

### *Possible impact on the AOFM securitisation program*

6.27 The possible implications of widespread loan application fraud for the AOFM's securitisation program were also raised. As noted in chapter 4, the Australian government started to support the securitisation market during the global financial crisis by instructing the AOFM to temporarily invest in AAA-rated Australian RMBS. Ms Brailey argued that the securities purchased by the AOFM would be affected by the fraudulent conduct she alleged has taken place. Ms Brailey is of the view that:

> … the government is holding tainted securities and profiting from that fraud. We believe there is about $57 billion involved. And, judging by the average loans, which go above FOS's jurisdiction—we are talking about maybe 100,000 families affected—a government cannot, or at least cannot be seen to be profiting from that fraud of its constituents and must rectify that situation.[32]

31 Australian Securitisation Forum, *Submission 153A*, p. 3.

32 Ms Denise Brailey, *Committee Hansard*, 8 August 2012, p. 44.

6.28 AOFM officers were questioned by the committee about the allegations. The CEO of the AOFM stated that:

> We are aware through the media and this inquiry that allegations have been made regarding fraudulently originated mortgages, although we have not seen or heard of any evidence of this in connection with the mortgages underpinning AOFM's RMBS portfolio.[33]

6.29 AOFM officers advised the committee that it takes a number of measures to address risk associated with RMBS. There is the overriding requirement contained in the Treasurer's directions that the securities be AAA-rated. The size of the LVRs and whether the loans have lenders' mortgage insurance are also considered. The AOFM requires the pools of mortgages backing the RMBSs it invests in to have an LVR of 95 per cent, unless the pool consists of more than ten per cent low-doc loans, in which case the AOFM requires an LVR of 80 per cent and that the loans be covered by lenders' mortgage insurance (although they noted there has only been one case of this).[34] The officers noted that lenders' mortgage insurance covers the vast majority of pools, with the weighted average coverage rate being around 98 per cent across the AOFM's RMBS portfolio.[35] Other measures that provide some protection for the AOFM's investments include:

- a risk-based due diligence program;
- 'pool' and 'tie back' audits;[36] and
- the tranching of investments.[37]

6.30 The AOFM representatives advised that at 31 July 2012, the 30+ days arrears for the AOFM portfolio was 1.1 per cent (they observed that this is below the 1.5 per cent 30+ day arrears rate for all prime pools reported by Standard & Poor's in June

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33 Mr Robert Nicholl, Chief Executive Officer, AOFM, *Committee Hansard*, 21 September 2012, p. 2.

34 Mr Robert Nicholl, Chief Executive Officer; Mr Michael Bath, Director, Financial Risk, AOFM, *Committee Hansard*, 21 September 2012, pp. 1, 4.

35 Mr Robert Nicholl, AOFM, *Committee Hansard*, 21 September 2012, p. 2.

36 These independent audits seek to confirm the conformance of the pool with the AOFM's minimum edibility requirements (pool audit) and that a representative sample of mortgages in the pool can be traced back to loan documentation (tie-back audit). See AOFM, 'Purchase of RMBS – Program update', no. 2, 2011 (8 April), www.aofm.gov.au/content/notices/02_2011.asp (accessed 26 September 2012).

37 As the AOFM invests in AAA-rated securities, these typically are also senior or mezzanine tranches that are repaid before subordinated tranches. The CEO of the AOFM stated that 'this means that the owners of more heavily subordinated, or 'first loss' tranches, provide additional protection to the AOFM's interests'. Mr Robert Nicholl, AOFM, *Committee Hansard*, 21 September 2012, p. 2.

2012).[38] On a hypothetical basis, the CEO of the AOFM entertained the consequences of fraudulently originated mortgages. He advised that less than two per cent of the AOFM's investments are linked to low-doc loans.[39] He argued that because of the ranking of tranches, however, the maximum loss for the AOFM in an extreme scenario would be around half a per cent of its total investment. The CEO added:

> Finally, because the AOFM only invests in RMBS that contain mortgages that have already been originated, it has neither involvement in nor control over how the practice of mortgage lending is undertaken. This is clearly a matter for the financial industry to organise, practise and monitor. Furthermore, it would simply not be practical or reasonable for the AOFM to employ the substantial resources required to vet the detail of every mortgage behind every RMBS transaction which it has been or may be asked to support. We estimate that there are over 129,000 mortgages that underpin the RMBS transactions that we have been asked to analyse and support, and, of this total, about 2,000 would have been low-doc loans.[40]

### *Committee view*

6.31 The committee is concerned that there has been a consistent abuse of low-doc loan facilities, albeit in a small percentage of total low-doc loans issued. The responsible lending requirements contained in the credit reforms that commenced in 2010 appear, at this time, to be effective in placing much greater obligation on lenders and brokers to verify income and the borrower's capacity to repay a loan. It should be recognised that there is a role for low-doc loans in the marketplace to meet the needs of self-employed workers who would struggle to obtain finance otherwise. There are, however, greater risks for lenders and potentially for the financial system as a whole if this type of lending activity is not carried out responsibly. The committee considers that ASIC should very closely scrutinise developments relating to these products, particularly if demand for credit becomes less subdued.

6.32 The committee notes the allegations regarding a number of possible cases of fraud that occurred pre-crisis. As a result of this inquiry, ASIC has publicly called for *detailed* evidence regarding these claims to be provided to it. The committee is similarly aware that many organisations and individuals, most notably Ms Denise Brailey, feel as though their complaints to ASIC have been met with a singular lack of cooperation. The committee is of the view that ASIC, upon receipt of allegations that present an arguable case, should undertake its own investigations to establish whether a prima facie case of fraud exists. Evidence of fraudulent lending practices can also be dealt with by the police. While the committee acknowledges that this is not without its

38 Mr Robert Nicholl, AOFM, *Committee Hansard*, 21 September 2012, pp. 1, 2. The Standard & Poor's figures consisted of 1.26 per cent for prime full-doc loans and 6.07 per cent for prime low-doc loans.

39 $400 million out of the $25 billion in mortgages backing the AOFM's investments are low-doc loans. See Mr Robert Nicholl, AOFM, *Committee Hansard*, 21 September 2012, p. 2.

40 Mr Robert Nicholl, AOFM, *Committee Hansard*, 21 September 2012, p. 2.

challenges, borrowers may also have legal recourse available to them as the allegations, if proven correct, would raise questions about the ability of a bank to rely on the loan application documents.

## Information on conditions in the lending market

6.33 An issue raised during the inquiry was the improvement of information regarding lending activity. ASIC suggested that a dedicated senior loan officer survey be introduced in Australia to improve the examination of supply and demand conditions in the lending market. ASIC noted that these types of surveys are conducted in a number of other jurisdictions, including the US, UK, Japan and Europe, and 'have been useful in researching the lending demand and supply dynamics for bank loans for businesses and households'.[41] One of ASIC's commissioners advised the committee:

> It is beneficial for regulatory agencies to understand the conditions in the market, what sorts of practices are being pursued by lending institutions and how they are seeing the state of play in terms of the ability of borrowers to repay, what sorts of challenges borrowers might be facing in different economic conditions and that sort of thing. It adds to our understanding of any emerging risks in the market and for that reason it also helps us to, if you like, be a bit more proactive about the regulatory work we could do.[42]

### *Committee view*

6.34 A senior loan officer survey on lending practices may provide some useful and timely information about the state of the lending market for regulators, policy makers, market participants and market observers. The committee notes that such a survey is conducted by central banks in a number of other countries and does not consider that undertaking such a survey in Australia would be particularly expensive or burdensome. The committee supports further information about the state of the lending market being made publicly available.

### Recommendation 6.1

**6.35 That the Reserve Bank of Australia conducts, on a quarterly basis, a dedicated senior loan officer survey and publishes the results of these surveys.**

41 ASIC, *Submission 97*, p. 5.

42 Mr Peter Kell, Commissioner, ASIC, *Committee Hansard*, 8 August 2012, p. 53.

# Chapter 7

# Allegations regarding Bankwest

7.1 This chapter begins the report's examination of one of the most prominent issues examined by this inquiry—certainly the subject addressed by the majority of written submissions—namely, allegations that Bankwest grossly mistreated a number of its business lending customers after the bank was acquired by the CBA during the height of the global financial crisis. Specifically, it has been alleged that a review of Bankwest following its acquisition by the CBA (dubbed "Project Magellan") resulted in the reassessment of many commercial loans to small businesses, particularly loans linked to property and property development. In many cases, aggrieved borrowers have alleged that Bankwest required the property associated with their loan to be revalued, with the outcome being an assessed value of the property that was significantly lower than the valuation that was undertaken before the loan was agreed to, which placed the borrower outside their LVR. This led to extraordinarily high rates of default interest being imposed, in most cases creating an unsustainable situation and leading to the loans being terminated. Questions about the conduct of individual bank employees, receivers and the relationship between the bank and valuation firms were also raised.

7.2 This chapter provides an overview of how the global financial crisis impacted the operations of Bankwest under its previous owner, and how that led to the CBA's acquisition of Bankwest in 2008. The chapter then outlines the evidence received from aggrieved business borrowers of Bankwest. The following chapter analyses the terms of the acquisition and the evidence further.

## Bankwest's expansion prior to the global financial crisis

7.3 Under the ownership of UK bank HBOS plc, which acquired Bankwest through its Australian subsidiary in 2003,[1] Bankwest embarked on an aggressive growth strategy focused on the east coast states with the aim of opening 160 branches over four years. The ACCC described this expansion as 'unprecedented in Australian banking'.[2] It has been reported that in 2007 Bankwest's lending increased by 36 per cent.[3] Some submissions from small businesses and property developers noted that Bankwest was the only bank that would consider their loan applications, even as the

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1 HBOS's predecessor, the Bank of Scotland, had a majority interest in Bankwest from 1995.

2 ACCC, 'Commonwealth Bank of Australia—proposed acquisition of BankWest and St Andrew's Australia', *Public Competition Assessment*, 10 December 2008, p. 10.

3 Eric Johnston, 'BankWest cool as HBOS falters', *Australian Financial Review*, 23 June 2008, p. 64.

global financial crisis was at its height.[4] How responsible this lending was has been questioned. In his submission, Mr Geoff Shannon stated that the Unhappy Banking group (which he formed in response to Bankwest's actions) includes members who had experienced Bankwest modifying information to obtain credit approval and another member who borrowed at a LVR of 127 per cent.[5]

## The global financial crisis and developments in the UK

7.4 Under the ownership of HBOS, Bankwest was very dependent on funding secured by its UK-based parent. Bankwest representatives advised that at this time 65 per cent of Bankwest's funding was self-funded from Australian deposits, with the remainder ($17 billion) funded through wholesale funding secured by HBOS:

> So obviously at the point where HBOS got into difficulty, whilst that funding was not immediately threatened because most of that funding would have been longer dated, it did put HBOS under serious pressure.[6]

7.5 HBOS, however, was particularly exposed to the global financial crisis and in 2008 found itself with a vulnerable funding position and experiencing a run on its shares. In June of that year, a number of upbeat statements attributed to Bankwest executives regarding the safety of Bankwest were reported in the media; additionally Bankwest announced new branches and jobs in Victoria that month.[7] The situation in the UK, however, became dire. In September 2008, at a time when the crisis had taken a dramatic turn[8] and HBOS's position had substantially worsened, a deal for

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4 For example, one borrower noted that Suncorp referred them to Bankwest after declining their application. Other examples were provided by Mr and Mrs Gilbert and Sylvia De Michiel (*Submission 5*, p. 3) and another borrower whose name has been withheld from publication (*Submission 66*, p. 2).

5 Mr Geoff Shannon, *Submission 118*, p. 8.

6 Mr Ian Corfield, Chief Executive, Bankwest Business, Bankwest, *Committee Hansard*, 10 August 2012, p. 53.

7 For example, Mr Ian Corfield, a senior Bankwest executive, was reported as stating '[o]f course customers want to know their money is safe but we've been able to assure them HBOS is one of the safest banks in the world and HBOS fully underwrites what Bankwest is doing … People who are investing in, or saving money with, BankWest are absolutely safe. This business is supported by a very strong balance sheet of its own and in turn is backed up by the HBOS balance sheet. People, in my view, are safe as houses'. Katherine Jimenez, 'BankWest parent committed to Australia despite sub-prime woes', *The Australian*, 12 June 2008, www.theaustralian.com.au/business/bankwest-parent-committed-to-australia/story-e6frg8zx-1111116606559 (accessed 19 April 2012).

8 Other key events during September 2008 included the rescue of Fannie Mae and Freddie Mac by the US government, the collapse of Lehman Brothers and the announcements by the US government of the Troubled Assets Relief Program (TARP) and a US$85 billion rescue package for AIG.

Lloyds TSB to acquire HBOS was negotiated.[9] The UK government subsequently announced it would make a capital investment into the merged firm, acquiring a stake of approximately 43.4 per cent.[10] At a hearing for this inquiry, one of the Bankwest executives to whom the positive statements reported in the media in June 2008 were attributed acknowledged the pressures that HBOS was under during that time, but maintained that 'the reason HBOS had to sell Bankwest was more about its difficulties in the UK than its position in Australia'.[11]

7.6 Overall, it is clear that there were serious issues at Bankwest; a previous managing director of the bank (appointed following the acquisition by the CBA) stated during his evidence to a 2009 inquiry that 'the previous owners had to stop writing business; they could not continue to write business given the funding pressures they were under'.[12] This statement was supported by anecdotal evidence taken during this inquiry:

> One former employee said to me: 'As a former employee of the bank I have to be careful what I say, but I think you might be onto something about their solvency, capital adequacy and risk provisioning. This was another reason I had to leave. I had more than $75 million in deals declined by the credit team in 2008—pre-GFC. They would've normally all been approved, but none of them were. So were Bankwest taking application fees and valuation fees off clients with no way of approving these loans? It's an interesting thought.'[13]
>
> * * *
>
> At a meeting with an employee from Bankwest, I said to a guy from Treasury that it must be interesting working within Bankwest and juggling the cash flows and he said, to my surprise, that at times they did not have money. He actually told me that there were times when Bankwest did not have money they were juggling things around behind the scenes. At that time I did not know how serious it was. At a meeting with a Bankwest business manager in Bunbury they told me that Bankwest Business Bunbury had not lent any money since the start of the GFC and they said something to the effect of, 'We call ourselves business banking'—referring

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9 This is a summary of Lloyds plc's submission to UK regulators as the proposed acquisition was being considered; Office of Fair Trading (UK), *Anticipated acquisition by Lloyds TSB plc of HBOS plc: Report to the Secretary of State for Business Enterprise and Regulatory Reform*, 24 October 2008, p. 10.

10 HM Treasury (UK), 'Treasury statement on financial support to the banking industry', *Media release*, 13 October 2008, webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/press_105_08.htm (accessed 11 April 2012); Financial Services Authority (UK), Final Notice: Bank of Scotland plc, 9 March 2012, www.fsa.gov.uk/static/pubs/final/bankofscotlandplc.pdf (accessed 11 April 2012), p. 32.

11 Mr Ian Corfield, Bankwest, *Committee Hansard*, 10 August 2012, p. 53.

12 Mr Jon Sutton, *Committee Hansard*, Senate Economics References Committee, Inquiry into aspects of bank mergers, 2 July 2009, p. 8.

13 Mr Guy Goldrick, *Committee Hansard*, 10 August 2012, p. 41.

> to how ironic it was. So they were saying they were business banking but they had basically turned off the tap.[14]

7.7 After analysing a revised version of APRA's banking statistics, litigation funder IMF Australia suggests that the RBA or, less likely, other financial institutions, intervened to support Bankwest during the months leading up to the acquisition.[15] The committee questioned RBA officials about this claim:

> Senator WILLIAMS: During the time that Bankwest was under enormous pressure when HBOS had collapsed in the UK, did the Reserve Bank lend any money to Bankwest to keep it afloat? Did you give any funds then to finance their loans in any way whatsoever?
>
> Dr Debelle: All banks in Australia conduct repurchase operations with us where they bring in mostly government securities, or other bank paper, and borrow, and we give them cash against that. Bankwest or HBOS had access to that just like any other bank, and we would have provided funding to them as with any other bank. We do that every single day of the week. Bankwest participated in our market operations just like any other bank in Australia did, and on exactly the same terms and conditions as every bank and any financial institution in Australia.
>
> Senator WILLIAMS: So there was no special treatment for Bankwest from the RBA?
>
> Dr Debelle: No.
>
> Senator WILLIAMS: Was there a case where Bankwest did a huge drawing on that sort of money, or anything out of the ordinary from the everyday events of the banking system?
>
> Dr Debelle: No.[16]

## The acquisition of Bankwest by the CBA

7.8 On 8 October 2008, the CBA announced that it had purchased Bankwest and St Andrew's Australia (also owned by HBOS at the time) for $2.1 billion.[17] This

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14 Mr Sean Butler, *Committee Hansard*, 8 August 2012, p. 66.

15 This is based on APRA's statistics on the liabilities due to clearing houses and financial institutions, which indicate that Bankwest began to owe $29 million in August 2008, $859 million in September and $3.75 billion by December. IMF Australia, 'Introduction', *A timeline for Bankwest*, 6 February 2012, www.imf.com.au/pdf/aTimelineForBankwestComplete.pdf (accessed 14 August 2012), pp. 3–4.

16 Dr Guy Debelle, Assistant Governor, Financial Markets, RBA, *Committee Hansard*, 9 August 2012, p. 42.

17 Commonwealth Bank of Australia, 'Commonwealth Bank of Australia to acquire Bank West and St Andrew's', *Media release*, 8 October 2008, www.commbank.com.au/about-us/news/media-releases/2008/081008-news-bankwest-acquisition.aspx (accessed 17 April 2012).

represents a price-to-book ratio of 0.8, significantly less than the average of 1.9 for recent acquisitions in the Australian banking sector.[18]

7.9 On 10 December 2008, the ACCC announced that it would not oppose the acquisition. On 18 December 2008, the Treasurer announced approval of the proposed acquisition, subject to certain conditions which were imposed for three years.[19] The acquisition was seen as essential for financial system stability. During the Competition Inquiry, the RBA Governor stated:

> Bankwest was in a situation where it had a struggling parent. It was going to be sold one way or another. In the environment that we were in, you do not want an institution with a weakened parent to be sort of twisting in the wind while they work out in the UK what they are going to do. That was the situation that we were facing. They found a suitor and, in my opinion, in the conditions of that time—this was October 2008, if I recall—stability was key.[20]

7.10 Also during the Competition Inquiry, the CBA gave evidence that it provided $17 billion in funding to prevent the collapse of Bankwest.[21] The CBA is of the view that, because it replaced Bankwest's funding liabilities, 'the Australian economy was spared a potentially significant financial shock, because of CBA's ability to acquire Bankwest'.[22] Evidence given by Treasury supports this position; the head of Treasury's Markets Group stated that if Bankwest was not taken over by someone the government would have had to let it fail, with the resulting winding up likely to cause 'great difficulty and big concerns not only for Bankwest customers and the business

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18 Price-to-book ratios for other notable acquisitions include 1.7 paid by CBA to acquire Colonial First State (2000), 1.9 paid by HBOS to acquire Bankwest (2003) and 2.7 for Westpac to acquire St George (2008). CBA Investor Pack, 8 October 2008; cited in ACCC, 'Commonwealth Bank of Australia—proposed acquisition of BankWest and St Andrew's Australia', *Public Competition Assessment*, 10 December 2008, p. 5.

19 In addition to the restrictions on mergers and acquisitions contained in the *Competition and Consumer Act 2010*, under the *Financial Sector (Shareholdings) Act 1998* financial sector companies are subject to a 15 per cent shareholding limit although the Treasurer may approve a higher percentage limit on national interest grounds. The Treasurer may also impose conditions on the higher percentage limit. The conditions related to CBA maintaining and growing the Bankwest brand, ATM fees, maintain the Bankwest head office, managing director and core functions in WA, not closing WA branches and also concerned arrangements for affected staff. The Hon. Wayne Swan MP, 'Proposed Acquisition of Bank of Western Australia and St Andrew's by the Commonwealth Bank of Australia', *Media release*, attachment A, 18 December 2008.

20 Mr Glenn Stevens, Governor, RBA, *Committee Hansard*, Competition Inquiry, 13 December 2010, p. 18.

21 Mr Ralph Norris, Chief Executive Officer, Commonwealth Bank of Australia, *Committee Hansard*, Competition Inquiry, 15 December 2011, p. 76.

22 Mr David Cohen, Group General Counsel and Group Executive, Commonwealth Bank of Australia, *Committee Hansard*, 9 August 2012, p. 24.

but also for the rest of the financial system—it would have raised huge worries and concerns in the community'.[23]

## Actions by the CBA following the acquisition

7.11 During the Competition Inquiry, then CBA Chief Executive Officer Ralph Norris summed up the CBA's view of Bankwest's lending behaviour:

> Bankwest was, to a large extent, a failing bank. It would have been a failing bank if we had not bought it, because it was owned by an organisation that had carried out lending practices that were highly, I believe, inappropriate.[24]

7.12 The CBA initiated a review of the Bankwest portfolio which was described in the CBA's 2009–10 results presentation as 'comprehensive and in-depth'. By the end of June 2010, around 1100 loans had been reviewed with the review observing issues predominantly with loans on the east coast due to 'unrealistic security valuations'.[25] On the business banking portfolio, the CBA:

> … identified many pre-acquisition loans reflecting poor asset quality, high loan to value ratios and insufficient covenant coverage. This resulted in significant risk grade reassessments and security revaluations with loan impairment expenses increasing $304 million. These loans are confined to the pre-acquisition business banking book.[26]

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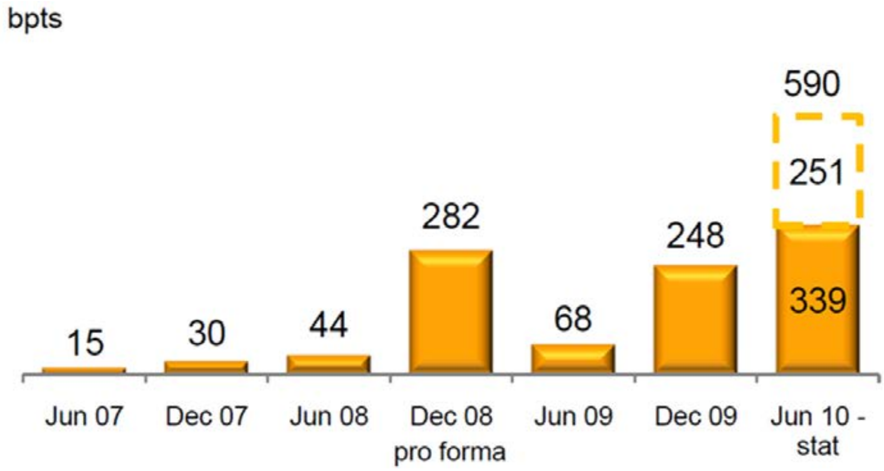
23 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 8.

24 Mr Ralph Norris, Chief Executive Officer, Commonwealth Bank of Australia, *Committee Hansard*, Competition Inquiry, 15 December 2010, p. 69.

25 Commonwealth Bank of Australia, *Results presentation for the full year ended 30 June 2010*, 11 August 2010, p. 99.

26 Commonwealth Bank of Australia, *Profit announcement for the full year ended 30 June 2010*, 11 August 2010, p. 30.

**Figure 7.1: CBA's impairment expense to gross loans, Bankwest business category**




Notes: The pro forma information for December 2008 assumes, for comparative purposes, that the acquisition of Bankwest and St Andrew's Australia was completed on 1 July 2008.

Source: Commonwealth Bank of Australia, *Results presentation for the full year ended 30 June 2010*, 11 August 2010, p. 42.

7.13 Risk management practices were 'significantly strengthened' and aligned with CBA policies as a result.[27] The CBA changed senior management and made known its criticism of Bankwest's lending practices. In August 2010, the *Sydney Morning Herald* reported:

> Commonwealth Bank has dismissed several Bankwest executives, including a former risk officer, claiming the lender "systemically" inflated the credit quality of hundreds of commercial property loans and mortgages when it was owned by the British group HBOS.[28]

7.14 Under the CBA's ownership, Bankwest also shifted away from certain business lending activities that it previously engaged in. Bankwest's exposure to commercial property (as a proportion of its total portfolio) decreased to 13.5 per cent in June 2010, compared to 15.4 per cent in June 2009.[29] The CBA's profit announcement for the 2009–10 financial year contained the following statement on how Bankwest's business lending portfolio changed following the acquisition:

27 Commonwealth Bank of Australia, *Results presentation for the full year ended 30 June 2010*, 11 August 2010, p. 99.

28 Eric Johnston, 'BankWest bad loans prove a headache', *Sydney Morning Herald*, 12 August 2010, www.smh.com.au/business/bankwest-bad-loans-prove-a-headache-20100811-11zrn.html (accessed 18 April 2012).

29 Commonwealth Bank of Australia, *Results presentation for the full year ended 30 June 2010*, 11 August 2010, p. 100.

> Business lending balances decreased 3% on the prior year to $24 billion due to weaker market demand and a strategic shift in focus away from the property sector. Lending margins were broadly in line with the prior year.[30]

7.15 Reviewing aspects of a new subsidiary would be sound commercial behaviour—in fact, it would be surprising if some form of review was not undertaken. This point was strongly made by the CBA's representatives at a public hearing, who noted that the CBA had a certain amount of knowledge about Bankwest's position prior to the acquisition but, with only three days due diligence prior to the acquisition, its detailed knowledge was 'absolutely scant':

> So, as a prudent business owner would do, having acquired a business, we undertook a general review to get to know that business much, much better. In the course of that review it became clear to us that there were some questions around the quality of the commercial property loan book in particular, but commercial loans in general. We had a new managing director of Bankwest appointed—Jon Sutton—who was from CBA. Jon led a project within Bankwest to thoroughly review the commercial loan book. That was a particular detail that we got into via Bankwest. Bankwest did carry that out. The distinction that I am drawing is that it was not a team of CBA people who were flown in from the east to pore through the books. That was not the case at all.[31]

7.16 A Treasury official also mused that he 'would have thought that anyone in the same situation would do that'; and noted that APRA would oversee any review in terms of its impact on capital and liquidity requirements.[32]

7.17 In addition to the review of the existing loan book, a shift away from new business lending in the commercial property sector may also have been an appropriate commercial decision. However, the submissions received by the inquiry do raise questions about the specific actions taken by the CBA and its Bankwest subsidiary against existing Bankwest customers.

## Experiences of Bankwest business customers following the acquisition

7.18 Before outlining the allegations made against Bankwest, it is useful to briefly describe some characteristics of small business lending. The nature of the securities required and the conditions imposed during the life of the loan (known as covenants) are two important elements of lending to small business. Common securities for a business loan include the applicant's personal residence and assets of the business. As with residential mortgages, lenders' mortgage insurance may also be required. This is

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30 Commonwealth Bank of Australia, *Profit announcement for the full year ended 30 June 2010*, 11 August 2010, p. 30.

31 Mr David Cohen, Group General Counsel and Group Executive, Commonwealth Bank of Australia, *Committee Hansard*, 9 August 2012, p. 33.

32 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 8.

insurance paid for by the borrower when the LVR of the loan is above a certain threshold and which protects the lender.[33] The inclusion of certain covenants is also common to enable a bank 'to monitor the customer's capacity to repay and the value and quality of the collateral for the loan'.[34] Default interest rates may be applied as a result of a covenant breach. Typical covenants require borrowers to:

- provide operational or financial information to a lender;
- refrain from incurring further debt during the life of the loan;
- ensure that the LVR does not go above a certain percentage;[35] and
- maintain adequate free cash flow to meet interest (interest cover ratio) and total debt service obligations (debt service ratio).[36]

7.19 As noted previously, most of the submissions received by the committee were from aggrieved former business customers of Bankwest. Submissions generally came from small businesses and individuals involved in the development of residential and light-industrial property, businesses in the tourism, accommodation and food services sectors (such as hotel, resort, restaurant and café owners), small shopping centres, childcare centres and farms. Submissions were also received from individuals involved in larger property developments.

7.20 In addition to the similar nature of the businesses involved, across submissions there are a number of common issues raised about the nature of the borrowers' experiences with Bankwest and the specific actions that were taken. These include:

- the property securing the loan being revalued leading to the borrower being outside their LVR—questions were raised in submissions about the valuation process, including allegations that revaluations were used to trigger defaults;
- agreed funds for property developments not forthcoming, jeopardising the ability of the development to proceed;
- high rates of default interest being imposed once a default occurred, and at a rate that was not clearly disclosed in the loan documentation;
- disadvantageous changes to facility terms simply issued and not explained;
- a general unwillingness by Bankwest to work through issues and unrealistic notices of demand for repayment;

33 Australian Bankers' Association and CPA Australia, 'Applying for a loan: information for small business', *Fact sheet*, May 2009, www.bankers.asn.au/ArticleDocuments/192/ABA-111090-v1-Fact_Sheet___Applying_for_a_Loan.pdf.aspx, p. 4 (accessed 16 May 2012).

34 Bankwest, *Submission 80*, p. 3.

35 Australian Bankers' Association and CPA Australia, 'Applying for a loan: information for small business', *Fact sheet*, May 2009, www.bankers.asn.au/ArticleDocuments/192/ABA-111090-v1-Fact_Sheet___Applying_for_a_Loan.pdf.aspx, p. 4 (accessed 16 May 2012).

36 Bankwest, *Submission 80*, p. 3.

- deeds of forbearance with confidentiality clauses being required;
- the unnecessary appointments of law firms and receivers; and
- properties being sold below market value, in some cases at what appears to have been at a significant discount or 'fire sale'.

7.21 Bankwest provided the following summary of its response to the evidence received by the committee:

> Lending policies – the Bank's lending policies and procedures require an appropriate assessment of a number of matters. Prior to and since the GFC Bankwest, like many financial institutions, has continually reviewed and adjusted its lending policies.
>
> CBA acquisition – the CBA sale agreement and purchase price adjustment process did not have any impact on Bankwest's approach to dealing with customers. The acquisition did not cause any change to existing contractual arrangements between Bankwest and its customers.
>
> Defaults – it is not in Bankwest's interests, and it makes no commercial sense, to "manufacture" defaults or to cause or increase losses.
>
> Customers in financial difficulty – customers in difficulty have been dealt with appropriately and on an individual basis, not on a global basis.
>
> Receiverships – Bankwest's level of receivership appointments have not been unreasonable or aggressive and are in line with its market share.
>
> Valuation process – where Bankwest uses valuers they are independent and have in place proper standards and processes.[37]

7.22 The following paragraphs discuss the specific actions taken against individual Bankwest borrowers from 2008 onwards and provide a sample of the evidence received. Possible explanations put forward for why this occurred to a significant number of Bankwest customers, such as the terms of the CBA's purchase agreement for Bankwest and the deterioration of the property market, are discussed in the following chapter.

### *Revaluation of property*

7.23 The revaluation of the property securing the loan was a recurring theme in submissions. Many submitters noted that, following Bankwest's acquisition by the CBA, Bankwest required a revaluation to be undertaken. The outcome of the new valuation generally placed the borrower outside their LVR, causing the borrower to default. Some individuals alleged that the defaults were planned through the revaluation; they also questioned the methods undertaken to value the property and the independence of the valuer from the bank.

37 Bankwest, *Submission 80*, p. 2.

7.24 To demonstrate the types of concerns put forward by submitters, the following is an extract from a submission lodged by a property developer in the Australian Capital Territory who purchased a property to redevelop with finance from Bankwest in July 2008:

> In January 2010 the bank surprisingly requested an updated valuation in relation to the Land even though … I still had a current valuation from Herron Todd White that was only 6 months old. The bank commissioned Knight Frank Australia Pty Ltd to carry out this valuation. The valuation dated 1 February 2010 put the Land at a decreased value which put me in breach of the allowable lend to value ratio (LVR) under the facility. This valuation had significant flaws such as inflated sales commission rates. That inflation alone took $4 million dollars off the value. I went to great lengths to analyse the valuation, to point out to Knight Frank where they used inaccurate data and I set this all out for the bank as well. Both Knight Frank and the bank refused to adjust the data and insisted on leaving the facility in breach of the LVR. They then charged me interest at the default interest rate.
>
> …
>
> Since development approval was granted I have obtained an updated valuation for the Land from CB Richard Ellis Australia valuing the land at $16 million. Throughout the course of the proceedings the bank was owed approximately $8,500,000.00. Their interest was always secured and well protected. They still did whatever they could though to put strain on me and quite frankly, it is working.[38]

7.25 The extracts from submissions below provide a further snapshot of this issue—they relate to a residential property development, a child care centre, the construction of a retirement village and a hotel respectively:

> Bankwest required us to revalue all of our land holdings in March 2009 and this resulted in loan values falling between 20% – 50% taking our group from a comfortable risk position of 45% – 50% to one that was no longer tenable with Bankwest or any other at 75%.[39]
>
> * * *
>
> … Bankwest sent a valuer from a large firm and he valued the Centre at $2.4 million with 32 children per/day, a 41% occupancy at that time, he stated in his report that if the attendance increased to 90% capacity the value would [be] $3.0 million and more … According to that report Bankwest gave me two loans … for the real estate and building of $1.138 million … In the year 2008 the same valuer come [sic] to the Centre by "Order from Bankwest" and said the Centre had improved its ratio of

38 Name withheld, *Submission 94*, pp. 3, 5.

39 Mr Robert Iannello and Ms Nicola Pagano, *Submission 76*, p. 2.

> occupancy to 70% and in his report the value of the Centre is now $2.0 million only.[40]

* * *

> On the 14th November 2010 we submitted a loan application to the bank. It was met with verbal approval and a $200,000 advance to start civil works on 7 homes (6 of these with deposits). The bank then came back and asked for a valuation despite a previous valuation by Nelson Partners only 11 months prior. The valuation was ordered by the bank with CBRE and the value came in some $7 million less, equating from $190,000 residual land value per site to just $50,000 per site.[41]

* * *

> In 2007, our main property, the Lighthouse Beach Resort, was valued at $20 million. That was at the peak of the property boom, I suppose. A few years later, in 2009, it was revalued at $14.7 million, which was a substantial discount but we thought that was fair enough given the way the property market had gone … At that stage, everything with our business was fine. We were going extremely well. Just five months after the reduced valuation, Bankwest advised us that they needed another valuation, at our cost, that being $9½ thousand. The new valuation came in at 22 per cent less than the valuation of just five months before.[42]

7.26 A common grievance from submitters was that their requests to view the new valuation reports were denied, even though Bankwest relied on that report to demonstrate that the borrower was outside their LVR, which in turn was related to the imposition of default interest and the ultimate termination of the loan facility. Submitters were particularly outraged by this because it is the borrower who pays for the valuation and with no say over who the valuer is, the costs borne by the borrower have often been substantial:

> We were fully aware that, according to the relevant section in the Memorandum of Mortgage, Bankwest was not obligated to provide us with a copy of this Valuation, but could do so at their discretion. However each time we politely requested a copy from them, they refused. To this day we still have no idea what that Valuation Report (for which we paid over $5,000!) contained and this remains a constant source of annoyance and frustration considering we put our heart and soul into that property only to have it snatched away from us so that someone else can now enjoy the benefits of our hard fought efforts.[43]

* * *

40 Mr Nashaat Sedhom, *Submission 20*, p. 4.

41 Mr Frank Galea, *Submission 21*, p. 3.

42 Mr Sean Butler, *Committee Hansard*, 8 August 2012, p. 61.

43 Mr Gilbert and Mrs Sylvia De Michiel, *Submission 5*, p. 9.

> Incidentally, we requested a copy of the minutes of the meeting and copy of their valuations, which the bank promised to give us and which we never received.[44]
>
> * * *
>
> The Bankwest employee sent through an email to say a valuer had been appointed. A fee of $14,000.00 plus GST was chosen, but said I had to pay the valuers fee, and that I could not view the valuation. I have never agreed to this, in my experience the fee was excessive …[45]

7.27 Others questioned the nature of the bank's instructions to the valuer. Mr James Neale noted that the executive summary of the report of his revaluation stated:

> Although the highest and best use of the subject site is for redevelopment, I have been instructed to value the property 'as is' as a single residential site…[46]

7.28 Mr Geoff Shannon submitted that the Unhappy Banking group he founded has received examples of valuations where the instructions given differ to what was in the facility terms. Mr Shannon submitted that the difference between an 'as is' valuation of current market value and an 'in one line'[47] valuation was generally 35 per cent. Mr Shannon suggested this could be a breach of the loan contract by Bankwest.[48]

### *Changes to facility terms and agreed funding not forthcoming*

7.29 Disadvantageous changes to terms being issued without notice or explanation was another common issue raised in evidence. Several submissions stated that disadvantageous revisions to the facility terms were made by Bankwest and simply issued to the borrower ("congratulating" them that their facility had been revised), without the borrower being aware that changes were being made and without the changes highlighted or explained:

> Bankwest … sent us a Letter of Variation of Facilities in May 2009, congratulating us that Bankwest had agreed to vary our facilities. We had not requested a variation but came under increasing pressure via phone calls, letters and e-mails from our Bankwest Representative, to sign and return the documents as soon as possible.[49]

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44 Mr Neil Mackay, *Submission 77*, p. 6.

45 Mr David Bone, *Submission 71*, p. 2.

46 Mr James Neale, *Submission 54*, p. 2 [emphasis omitted].

47 A sale in one line valuation is based on the assumption of a single transaction for the total holding or a sale in one line to one buyer. See Australian Property Institute, *Australia and New Zealand valuation and property standards*, January 2012, paragraph 4.21.

48 Mr Geoff Shannon, *Submission 118*, p. 10.

49 Mr Nicholas Murphy, *Submission 15*, p. 2.

7.30 One example was given where a number of letters of variation were issued over time, including one which significantly brought forward the expiry date of their facilities:

> On going through my files and finding the paperwork of the variation letter of October 2009 I noted with horror that Bankwest had altered my two loans from 18.5 years and 28.5 years to run, to 6 months indeed expiring in April 2010.[50]

7.31 For property developers more generally, any loans that are agreed to in order to facilitate construction or development are clearly essential for the value of the asset to reach its potential and to enable the borrower to realise a return. However, the committee received evidence that Bankwest reneged on agreements to provide construction loans. As a property developer constructing a retirement village put it:

> The bank failed to do what they are in business to do: lend money. From day 1 Bankwest failed to lend sufficient funds to roll out the stages of development in such a way that stock would be sold and confidence among residents and prospective residents would be high. Confidence in retirees is what equates to sales. The bank also failed to deliver on promises that the clubhouse funding would be forthcoming at the conclusion of Stage 1.[51]

7.32 The experience of Kelgon Development Corporation Pty Ltd combines the issue of important changes not being disclosed in a clear manner and agreed essential funding for construction not being released. Kelgon had finance with Bankwest to fund the construction of an office/warehouse after a suitable tenant had been found. Such a tenant was found, but after 33 weeks without funding being forthcoming, Bankwest informally advised that it did not want to continue with the loan. Bankwest then sent Kelgon:

> … a cleverly worded Letter of Variation which began with "We are pleased to advise that we have agreed to provide additional Facilities to you." At first sight, it appeared that these facilities offered were in addition to the original land and construction loan offer of 14 August 2008. But a closer look revealed that, whilst the bank had increased the current land loan by $20,000, it had completely excluded the vital construction loan which was the very purpose of my original loan application. In other words Bankwest was saying that they will provide me with an additional $20,000 so that I could afford to pay their interest until maturity, and therefore avoid default on the land loan, if I relinquished my claim on the $2,450,000 construction loan despite having tenants in hand who were ready to occupy

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50 In July 2010 the borrower was informed that the facility would be terminated. Ms Fiona Howson, *Submission 39*, p. 5. Regarding this matter, Bankwest countered that the changes came about in response to additional funding for construction that was requested and reflected the anticipated date of completion of the construction. It also argued that the changes were 'the subject of discussions, emails and documentation with the customer'; Bankwest, answer to question on notice, 10 August 2012 (received 7 September 2012), p. 5. The committee makes no judgment on these competing claims.

51 Mr Frank Galea, *Submission 21*, p. 6.

> in 6 months, potentially paying a handsome net annual rental of $1,287,000 for a 10 year initial term.[52]

### *Default interest*

7.33 Another common theme in submissions, and a key issue directly impacting the ability of the affected businesses to survive or to have sufficient time to seek refinance, is the imposition of default or penalty interest once a default has occurred or the expiry date in the facility terms has passed. In a number of cases, the default interest rate was around 18 per cent. For any business, interest rates at this level would be challenging and in many cases ultimately untenable. One hotel owner stated that 'Bankwest seem determined to put me into receivership now by charging me default interest which no business can sustain for any length of time':

> Bankwest will now not rollover my loan and are charging me default interest rates, even though I have not been late or missed a payment of interest. I am sure they are determined to put me into receivership without any real cause. I have tried to sell the hotels at a fair and reasonable price, and spent a considerable sum of money on advertising, but because of the market at present I have been unable to achieve a fair price. I would like time to sell the hotels for a fair price to cover my debts. I will not be able to meet the default interest rate charge, which means that my debt will be increasing with Bankwest. This is most unfair, as previously my LVR was well within the limits, but with Bankwest charging the Default interest rate and adding this to the principle [sic] of the loan, my LVR will in no time be out of the acceptable range.[53]

7.34 Mr Sean Butler, whose Perth hotel properties were financed with Bankwest, explained how the interest rates for his loans changed once a further revaluation was undertaken. In his view, Bankwest imposed unreasonable rates of interest:

> On 10 August [2010]—just a few weeks after the valuation was given to us—Bankwest advised us that our interest rate margins would double, from bank bill swap rate plus 1.25 per cent to bank bill swap rate plus three per cent. So our interest rate doubled within a few weeks of getting that valuation. I appealed to Bankwest to see if they would negotiate that, and they just said there was no room for negotiation and that we just had to wear that. So basically we decided to either refinance or sell the properties.
>
> In January 2011 we had further discussions with Bankwest. They said they would not budge on the higher interest rates being charged. In February 2011 we got a purchase offer for the Lighthouse Beach Resort at $14 million, that being 22 per cent higher than what the [r]evaluation was. In other words, we got an offer for it that was closer to the original valuation. It has almost proved them wrong. At that point our business partner, himself a banker, advised that he would match the $14 million offer and buy that property.

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52 Kelgon Development Corporation Pty Ltd, *Submission 4*, p. 4.

53 Name withheld, *Submission 14*, pp. 2, 3.

> On 31 March Bankwest advised us that if they did not get all their money back by 31 May it would get ugly. They advised us that if arrangements were not made to pay all the money back in one lot then penalty interest rates of 18 per cent would apply. Our business partner—the banker—then advised that he had changed his plans and did not want to buy the property anymore. So I advised Bankwest that our business was still capable of paying all the interest on all the loans and that we would put things back on the market. We had four separate properties we could sell. But they refused. They said they wanted all their money back in one lot. Our profits were at record levels, but I said we just could not afford to pay the 18 per cent interest rate.[54]

*Rationale for default interest*

7.35 In general terms, if a business is struggling because of a difficult business environment or other factors outside its control, the imposition of default interest by a bank appears counterintuitive in that is likely to secure the downfall of the business, as opposed to other actions which could assist the business through the more challenging times. Bankwest provided the following rationale for default interest being imposed:

> Obviously, clients in default have contractual obligations and when clients are then put into a team that is more intensive in terms of working with them there is an additional cost to that and also in terms of default there is increasing capital attributed to servicing and supporting that customer. So that is the logic for the default rates.[55]

7.36 While Bankwest's explanation may apply generally, and additionally there probably needs to be a direct financial disincentive to encourage borrowers not to breach covenants in the contract, witnesses were less well-disposed to Bankwest's motives:

> Bankwest have mastered the art of implementing penalty interest where they can through various technical defaults. I tender to the committee a transcript of a recorded message left on a commercial borrower's phone by two business development managers of Bankwest. The most interesting part of the transcript occurs after the point where the Bankwest managers thought they had successfully terminated the phone call, but it was still on … I am reading from the transcript: 'John: I will have to talk to my colleagues'—John is the BDM of Bankwest—'and my colleagues have something to think about. We've got 16 default rate.' There is no emotion about the fact that that is hurting. 'If you're going to write off money, that 16 per cent doesn't reduce your write-off; it increases it probably.' That sentence alone highlights that the bank knowingly use the default interest rate as a tool to force customers to go broke.[56]

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54 Mr Sean Butler, *Committee Hansard*, 8 August 2012, p. 61.

55 Mr Robert De Luca, Managing Director, Bankwest, *Committee Hansard*, 10 August 2012, p. 57.

56 Mr Geoff Shannon, *Committee Hansard*, 10 August 2012, p. 21.

7.37 Bankwest was asked about any tax benefits it may receive from using high rates of default interest to increase the debt of borrowers that the bank has decided it does not want to continue in business with. After repeated questioning, Bankwest acknowledged that increased losses would be tax deductible, but denied that there was an overall benefit.[57] Following the hearing, Bankwest provided a detailed statement regarding taxation arrangements for default interest on impaired loans:

> All interest income (including default interest) that the Bank accrues is taxed accordingly as income meaning an increased tax liability. If this interest is subsequently written off the impact is tax neutral, i.e. the tax liability on the interest is offset by the tax written off. Where a property that is held as security is sold for less than the corresponding debt, the bank writes off capital and the negatives of this far outweigh any interest income written off.
>
> When a customer loan is assessed as impaired the outstanding loan is classified as non-accrual. From this point any interest incurred is added to the loan but not recognised as income. Instead of recognising as income the interest is capitalised on the balance sheet (the capitalised interest is known as "interest reserved"). If the loan is subsequently written off, the interest added to the loan after impairment does not increase write-off expense as it is offset with the matching interest reserved account, and this is an offset between two balance sheet accounts. As such, the Bank does not receive any tax benefit from this process.[58]

*Disclosure of default interest*

7.38 Another issue raised in submissions regarding the imposition of default interest by Bankwest were claims that the default interest rates were not clearly disclosed—i.e. the rates that would apply were not stated in the facility terms related to the loan contract, rather they were imposed by reference to other bank documents and interest rates:

> A Bankwest employee explained to me that the Facility Terms do not refer to default rates in any way. The General Terms define the Overdue Rate as the rate which is so defined in the Facility Terms. The General Terms go on to say that where the Overdue rate is not defined in the Facility Terms, and it is not, it is 7% over the overdraft rate. That was 12% over my base rate which was 1.65% over the BBSY rate. Given that the bank pays about 0.8% to deliver and manage the loan this penalty increased their profit in my case from 0.85% to 12.85% or about 14 times what I had agreed to. I was paying Bankwest to borrow money and lend it to me.[59]

57 Mr Robert De Luca; Mr Ian Corfield, Bankwest, *Committee Hansard*, 10 August 2012, pp. 57–58.

58 Bankwest, answer to question on notice, 10 August 2012 (received 7 September 2012), p. 4.

59 Mr James Neale, *Submission 54*, p. 4. See also Mr Geoff Shannon, *Submission 118*, p. 9.

7.39 A senior Bankwest executive was asked about these claims and expressed their view that the default rates were not concealed:

> I would say our default interest levels are spelt out clearly within our contracts. However, the reality of commercial loan contracts is that these are long and extensive documents, which is why our customers very often get lawyers to review them. I would be surprised if a lawyer was saying that they could not identify where the default interest was in a contract.[60]

### *Unwillingness of Bankwest to work through issues and unrealistic notices of demand*

7.40 A number of borrowers suggested in their submissions that Bankwest was unwilling to engage with them to develop a remedy once a default occurred, with receivers instead appointed (even in non-monetary defaults). Borrowers also noted a short period of time (one to seven days) between when the notice of demand for the facility to be repaid was issued and when the bank appointed receivers. This left the borrower unable to refinance amounts often totalling millions.[61] Some borrowers claimed that Bankwest also did not cooperate with refinancing or restructuring attempts, with offers of finance from other banks expiring because of inaction at Bankwest, or not being fulfilled because Bankwest took possession of the property after being notified of the refinance offer.[62]

7.41 An instructive example of a business attempting to refinance but thwarted by a lack of co-operation from Bankwest was provided by Mr Trevor Eriksson. Mr Eriksson was involved in an industrial development in Orange, New South Wales that obtained finance from Bankwest in March 2008. In May 2010, receivers were appointed following a letter of demand with a seven day deadline. After mediation in December 2010, Bankwest agreed that the business could refinance the loan by the end of May 2011 and the receivers were withdrawn. The subsequent events were, in Mr Eriksson's view, as follows:

> During the first quarter of 2011, I entered the loan market. Traditional banks (ANZ and St George) were approached by a finance broker. All required a written reason from Bankwest as to why a receiver had been appointed. Further the lenders wanted a set of accounts.
>
> Requests were made, for the receiver to provide details for my Public Accountant to prepare a set of accounts and to Bankwest for support on the reason for the appointment of the receiver. Both entities denied assistance stating that the Deed of Release did not require them to assist with this information. They refused to cooperate and assist with the raising of funds to payout Bankwest … By April 2011 my Public Accountant managed to

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60 Mr Ian Corfield, Bankwest, *Committee Hansard*, 10 August 2012, p. 62.

61 In his submission, Mr Victor Seeto stated that he was issued a notice of demand which required $21 million to be repaid within 24 hours; Mr Victor Seeto, *Submission 106*, p. 2. See also Mr Guy Goldrick, *Submission 56*, p. 5.

62 For example, see Mr Nicholas Murphy, *Submission 15*, p. 3.

extract some information from the receiver which assisted with a draft set of accounts. I received loan offers from both the ANZ and St George Banks which were submitted to Bankwest. These loan offers were conditioned upon more information such as valuations etc. The indication was both could settle CIE's loan with Bankwest during mid June, 2011; about two weeks after the agreed settlement date. I had kept Bankwest informed of the funding proposals and expectations.[63]

7.42 Receivers were again appointed to take control of Mr Eriksson's business, and both the ANZ and St George consequently withdrew their offers of finance.[64]

7.43 Borrowers also faced other practical issues in their attempts to seek refinance, particularly after previously committed funds were not made available:

> … Bankwest had left me with insufficient funds to finance an establishment fee, let alone the valuation and other costs required to lodge a new application. Also working against me was that I owed money to architects, engineers and others who had assisted with the project development while the Bankwest loan application was pending. But most importantly I lost my prime tenant, Fernhurst Cold Storage, who understandably declined to proceed after I informed them that my bank had withdrawn their construction loan facility and I could not meet their January 2010 occupancy deadline.[65]

7.44 Complaints were also received about the conduct of specific Bankwest relationship managers, with allegations of intimidation, harassment and general unprofessional conduct. Some borrowers faced persistent demands for information from the bank or its law firm, with information required on a frequent (in some cases, daily) basis:[66]

> Bankwest, through Norton Rose, added an additional condition during the period January 2011 to April 2011. I had to report to Norton Rose by 3pm every day. A bizarre and humiliating requirement. I was treated as if I was on parole. This condition was insulting, humiliating and reflected on the contemptible [mindset] of Bankwest and its legal representatives.[67]

### *Deeds of forbearance*

7.45 Some borrowers noted that they were required to sign a deed of forbearance when they experienced difficulties. In his submission, Mr Sean Butler stated that the deed he signed included a $200,000 fee to extend facilities for five months, a default

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63 Mr Trevor Eriksson, *Submission 37*, p. 9.

64 Mr Trevor Eriksson, *Submission 37*, p. 10.

65 Kelgon Development Corporation Pty Ltd, *Submission 4*, p. 4.

66 For example, see Mr Tony Mollison, *Submission 18*, p. 2, Diane and Max Lock, *Submission 32*, p. 3, Chadoora Pty Ltd, *Submission 35*, p. 2.

67 Mr Trevor Eriksson, *Submission 37*, p. 9.

interest rate of over 18 per cent if not repaid as agreed, a requirement to pay for all valuations and legal fees, and a confidentiality clause.[68]

7.46 In the CBA's view, confidentiality agreements are not unusual. Its General Counsel observed:

> Quite outside the realms of banking, whenever parties enter into a settlement agreement it is standard practice to include a confidentiality clause. The reason is that both parties are generally compromising their legal position to some degree and their commercial position to some degree. It is usually not in either party's interest to have that compromise publicly known.[69]

### *Unnecessary appointments of receivers and law firms*

7.47 Borrowers asserted that receivers were needlessly appointed, and sometimes without warning:

> The receivership was a complete surprise as just a few weeks earlier, [a] Bankwest representative confirmed the previously approved course of action, i.e. sell the most valuable asset to reduce or eliminate the loans.[70]
>
> * * *
>
> Bankwest/CBA's rush to appoint receivers following the takeover of Bankwest literally eliminated any chance of refinancing and continuance with a viable business.[71]

7.48 Bankwest explained the general factors it considers before deciding to appoint a receiver:

> Any decision by Bankwest to appoint receivers is not taken lightly and is based upon the particular circumstances of the matter. The ability to appoint receivers only arises if the customer is in default of their financing agreements with the Bank. In addition a number of the characteristics below are usually present before Bankwest makes a decision to appoint a receiver:
>
> - The customer breaches their monetary or other contractual obligations
> - Interest is not met when due
> - The customer's debt levels are increasing and unsustainable
> - A third party creditor (e.g. ATO) has initiated recovery action against the customer

68 Mr Sean Butler, *Submission 111*, p. 2.

69 Mr David Cohen, Group General Counsel and Group Executive, Commonwealth Bank of Australia, *Committee Hansard*, 9 August 2012, p. 32. Bankwest supported this view: see Bankwest, answer to question on notice, 10 August 2012 (received 7 September 2012), pp. 8–9.

70 Name withheld, *Submission 115*, p. 1.

71 Mr Trevor Eriksson, *Submission 37*, p. 3.

- Loss making operations or holdings are deteriorating the customer's equity position
- The underlying project or development has stalled or costs have blown out
- The customer is unable or unwilling to deliver an appropriate strategy to resolve the matter
- Further delay or inaction would only compound the problem.[72]

7.49 In response to claims that it was too eager to appoint receivers, Bankwest stated:

> Bankwest's level of receivership appointments have not been unreasonable or aggressive and are in line with the bank's market share. Since 2009 the number of Bankwest Business customers placed in receivership has been small (less than 85 in each year) and, when compared with the overall number of industry wide receivership appointments, are consistent with Bankwest’s market share during that period (in the range of 4% to 6%).[73]

7.50 The 'often vexed issue of insolvency practitioners' fees' is a topic that is familiar to the committee as it was considered in detail as part of the committee's 2010 inquiry into liquidators and administrators.[74] The fees charged by receivers were challenged in some submissions to this inquiry. For these borrowers, the size of the fees charged by the firm appeared to be unrelated to the cost of the task performed, as well as being unchallenged by the bank (and simply added to the borrower's debt). Similar concerns were raised about the use of law firms by the bank, with arguments made that passing control of the account on to a law firm, requiring all communication to go through the firm, was unnecessary.

7.51 On the fees charged by law firms, AJC Enterprises Pty Ltd complained of $500,000 in legal fees being charged for the conveyance costs of selling two hotels.[75] While this aspect of his submission was not related to Bankwest, one submitter noted that during a previous dispute with Westpac they were billed $26,000 for a meeting to inform them that the bank did not want their business.[76]

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72 Bankwest, *Submission 80*, p. 5.

73 Bankwest, *Submission 80*, p. 5.

74 The committee observed that there were 'fairly weak current incentives for practitioners to become more price-competitive' and concluded that the best way to resolve problems of overcharging and over servicing is to open the profession to more entrants. See Senate Economics References Committee, *The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework*, September 2010, p. 114, chapters 8 and 11.

75 AJC Enterprises Pty Ltd, *Submission 108*, pp. 2–3.

76 See Mr Trevor Eriksson, *Submission 37*, p. 5.

7.52 Given the number of submissions which addressed the issue of Bankwest terminating loans and sending in receivers, the fees charged by the receivers was a recurring issue. In his case, Mr Sean Butler advised that initially during the receivership he was unaware what the receivers where charging:

> Mr Butler: … On 8 June this year, for the first time since their appointment, as a result of our lawyers getting involved, they admitted to what they had charged us for 9½ months. For 9½ months of doing what I used to do they had charged us $1,055,000.
>
> Senator EGGLESTON: What cost would you have incurred for doing that work?
>
> Mr Butler: As I said, I was paying myself $87,000 a year. I just could not believe it. On 11 June justification of the fees was requested—and I have tabled this document. I could not believe it, so I requested justification of the fees. We got a letter back and I will briefly read it. It says: 'The receivers are not under any obligation to provide you with further information or documentation referred to in this letter. The fees and charges are subject to legal and professional privilege and, on that basis …'. Basically, they said go away and shut up.[77]

7.53 Others also objected to the fees charged by receivers:

> The Receivers and Managers are trying to sell the rest of the property at a reduced price just to clear the bank and earn their fees, about $100,000 per month … The Receivers and Managers have done nothing to earn their exorbitant fees, as we have arranged all sales so far, and they refuse to accept two offers of part of the subdivided property that is left which would clear all the loan amount and their fees to date. They appear to be deliberately slowing any transactions down, just so they can charge more fees.[78]

7.54 Mr Geoff Shannon outlined how the cumulative impact of default interest and the fees charged by law firms and receivers could quickly reach an astonishing level, relative to the size of the initial debt:

> At this point the Debt was climbing at a rate of about 19% per annum and was around $7m, which included an estimate of $3m for penalty interest, Receiver fees and various other charges.[79]

7.55 Bankwest argued that as receivers are often appointed in circumstances where both it and the customer may incur a loss, it is in its interest to ensure that receivers and other costs 'are as reasonable as possible'.[80]

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77 Mr Sean Butler, *Committee Hansard*, 8 August 2012, p. 65.

78 Mr Robert Laut, *Submission 28*, pp. 2, 3.

79 Mr Geoff Shannon, *Submission 118* , p. 6.

80 Bankwest, *Submission 80*, p. 5.

### *Properties sold below market value*

7.56 Related to revaluations of properties are allegations that properties were sold or required to be sold in a way that could not achieve true market value.[81] Others expressed concern about the lack of communication regarding the sale of their properties. In their submission, Mr and Mrs Hathaway stated that they had not been contacted in any way by Bankwest or the receivers since their motel and three residential properties were sold, leaving them to rely on second-hand reports indicating that the properties were sold for around half of their market value.[82]

> We have had no correspondence or phone calls from the Bank or the receivers—PPB since. The properties have subsequently been sold; to this day we have had no notification from the Bank or PPB. We have heard via informal sources that the properties have been sold for approximately half of their market value.[83]

7.57 The committee was also made aware of cases where the sale price for the property and other assets didn't cover the widely accepted value of some of the assets. The sale of the Grand Hotel in Cobar, New South Wales, and related assets which included poker machines, was put forward as an example:

> Senator WILLIAMS: … How much did the hotel sell for?
>
> Mr Reiher: $700,000, I believe. It was valued at the worst time, when we were evicted, at $1.1 million. We wanted a revaluation, probably six months after that because we knew the trade went up by $5,000 to $7,000 a week over that time.
>
> Senator WILLIAMS: It sold for around $700,000 to the best of your knowledge. How many poker machines were there?
>
> Mr Reiher: Nine.
>
> Senator WILLIAMS: If you had sold nine poker machines, you give three to the government and leave yourself with six to sell at $125,000, that is $750,000. So they have sold the freehold to the building and the licence. Was the stock included?
>
> Mr Reiher: Yes.
>
> Senator WILLIAMS: Walk in, walk out; the price of six poker machines.
>
> Mr Reiher: Yes.
>
> Senator WILLIAMS: That does not appear to be a very good sale.

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81 These types of concerns were raised regarding banks other than Bankwest as well: the owner of a restaurant in Newcastle submitted that the valuation report for the property stated that the likely period required to sell would be 12 months, but that the CBA demanded that it be sold in five months. Mr Alan Harrison, *Submission 9*, p. 3.

82 Mr and Mrs Bruce and Linda Hathaway, *Submission 122*, p. 3.

83 Mr and Mrs Bruce and Linda Hathaway, *Submission 122*, p. 3.

> Mr Reiher: They were just washing their hands of us.[84]

7.58 The duty of care required of receivers in exercising their power of sale is examined further in the next chapter.

### *Burden for government and personal implications*

7.59 Finally, across many submissions was a common thread of personal hardship and an increased burden for the broader community. Following their experience with Bankwest, many borrowers encountered personal stress, severe medical problems, relationship breakdowns, and divorce. There were also cases of individuals being required to seek government assistance. A substantial number of borrowers stated that they have now had to apply for Centrelink benefits for the first time as a result of Bankwest's actions.[85] Unemployment for their employees also resulted and, given the nature of the loans involved, this was predominately in regional areas. To illustrate, a painting contracting business in Forbes, New South Wales which had 60 employees (and was the largest employer in the town) had to close its doors after almost 100 years in operation.[86]

## Committee comment

7.60 While the committee has received a significant amount of material from aggrieved borrowers, the bank's view on the circumstances of a matter can differ significantly and in the context of the matters before this committee, some of the evidence regarding individual cases has been contradicted by evidence presented by other parties. Bankwest also stated that it did attempt to work with its customers:

> In many cases where customers were impacted the Bank entered into agreed arrangements with the customer to achieve an improvement in their financial position, and the Bank provided extensions of time or other favourable terms to assist them. Unfortunately, in a small number of cases the customer could not deliver an improvement in their financial circumstances and / or failed to comply with the principal terms of their agreements and a decision was taken by the Bank to take enforcement action.[87]

7.61 Banks are large organisations. No bank will be able to control the actions of each individual manager and, based on probability alone, there could easily be individual cases of questionable conduct by the bank's employees. Another point that

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84 Mr Geoffrey Reiher, *Committee Hansard*, 10 August 2012, pp. 5–6.

85 See Kelgon Development Corporation Pty Ltd, Submission 4; Mr Gilbert and Mrs Sylvia De Michiel, *Submission 5*; Mr Nashaat Sedhom, *Submission 20*; Mr David Crisp, *Submission 23*; Mr Tim Bowman, *Submission 57* (relating to the situation of Mr Bowman's parents); and Name withheld, *Submission 66*.

86 Name withheld, *Submission 29*.

87 Bankwest, *Submission 80*, p. 5.

needs to be recognised is that many commercial and business clients get into difficulty due to market factors, unreasonably optimistic expectations about the strength and potential of their business, poor management or inexperience and other reasons not related to their relationship with the bank. These borrowers may not be willing to recognise or accept these explanations, although this broad point was acknowledged by the Unhappy Banking group formed by Mr Geoff Shannon.[88] The committee is also aware that certain actions by some of the borrowers may have inadvertently compounded their problems, particularly when the sale of income earning assets or other assets securing the loan was involved. Illustrating this issue generally, in the context of farm debt mediation processes prescribed in some states and territories, NAB submitted that the process 'is often the catalyst to help a customer understand the true extent of their financial difficulties'.[89]

7.62 Nonetheless, while the CBA attempted to minimise the impact of some of the evidence received by the committee as being the result of a 'well orchestrated' campaign that 'has drummed up a number of submissions',[90] there are a large number of disturbingly similar cases put before the committee which necessitate scrutiny. The following chapter continues the committee's examination of this issue.

88 Mr Shannon's submission stated that Unhappy Banking 'fully accepts not all people with a grievance against Bankwest have genuine cause to blame the Bank or its actions for the failure of their businesses'. Mr Geoff Shannon, *Submission 118*, p. 1.

89 NAB, *Submission 79*, p. 11.

90 Mr David Cohen, Group General Counsel and Group Executive, Commonwealth Bank of Australia, *Committee Hansard*, 9 August 2012, p. 32.

# Chapter 8

# Further examination of the Bankwest allegations

8.1 The previous chapter outlined the key common grievances that certain business customers had with Bankwest. This chapter utilises that evidence to explore whether there was an unusual incentive for the CBA-owned Bankwest to act as it did or, alternatively, whether developments in the economy or in specific sectors during and following the global financial crisis help explain the bank's approach. Specifically, this chapter includes a discussion of:

- the terms of the CBA's acquisition of Bankwest, a factor that a number of aggrieved borrowers consider directly influenced Bankwest's actions;
- other considerations, including the downturn in the property market and business activity in some sectors of the economy;

8.2 The chapter also examines the opportunities available for aggrieved borrowers to resolve their dispute or to seek redress, and considers the effectiveness of these options.

## The terms of the CBA's purchase of Bankwest

### *Warranties in the purchase agreement*

8.3 As noted in the previous chapter, the CBA's proposed acquisition of Bankwest and St Andrew's Australia[1] was announced on 8 October 2008. The CBA completed the acquisition on 18 December 2008. Some submissions received by the committee focused on speculation regarding the terms of the purchase agreement; in particular, whether an unusual "clawback" provision or warranty exists that provided an incentive for the CBA to act against existing Bankwest business customers. To put it another way, whether a clause in the agreement exists that either allowed the purchase price for Bankwest and St Andrew's to be reduced by an amount related to the bad debts on Bankwest's books, or otherwise acted as a warranty that could be called upon to the CBA's benefit. Such a provision, according to those who are convinced of this, would explain Bankwest's purging of its commercial property loans once it passed into the CBA's ownership.[2]

8.4 HBOS's 2008 annual report indeed reveals that there was a warranty of some form:

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1 St Andrew's Australia is a specialist provider of wealth management and insurance products. St Andrew's is now a wholly owned subsidiary of the Bank of Queensland.

2 AAP, 'Class action considered against Bankwest', 11 April 2012, www.news.com.au/money/banking/law-firm-considers-action-on-bankwest/story-e6frfmcr-1226323461827 (accessed 20 April 2012).

> Under the share sale agreement HBOS plc has provided certain warranties to Commonwealth Bank of Australia, that all relevant, material circumstances and facts in relation to the sale have been disclosed and described in agreement. The share sale agreement provided for adjustments to the initial purchase price based on the risk weighted assets of Bank of Western Australia Limited and the net assets of St. Andrews Australia Pty Limited. As a result, the loss on sale of these businesses may be subject to adjustment for the contingent element of the commitment receivable.[3]

8.5 On 30 April 2009, Bankwest announced a loss of $139 million for 2008. This result included loan impairment expenses totalling around $825 million, nearly ten times the level in 2007.[4] In a statement to the ASX on the same day, the CBA announced:

> As advised at the time of acquisition of Bankwest, the Group is purchasing a bank which is appropriately capitalised and provisioned. The final purchase price for Bankwest will be determined over the next two months taking into account its capital position and provisions for bad and doubtful debts.[5]

8.6 The *Australian* reported in May 2009:

> In the $2.1 billion sale deal struck last year, CBA retained an agreement that Bankwest had to be appropriately provisioned when the WA institution came under its ownership. It is understood the new provisioning level is split evenly between collective and individual provisions.
>
> CBA is expected to claim about $400 million, the individual provision amount, from HBOS.
>
> The process is to go to an arbitration hearing, and most analysts expect the full-year loss and provision spike to reduce the total sale amount that is yet to be paid by CBA.[6]

8.7 The purchase price for Bankwest was finalised in early July 2009.[7] Submissions that focused on the warranty speculation argued that the CBA managed to successfully use the clause and obtained an additional discount on the purchase price from the new owners of HBOS (Lloyds Banking Group) by improperly increasing the impairments on Bankwest's books. Some submissions also claimed that, after the price adjustment process, the CBA still needed to ensure that impairment of

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3 HBOS plc, *Annual Report and Accounts 2008*, p. 63.

4 Bankwest, 'Bankwest records 2008 loss, now trading profitably', *Media release*, 30 April 2009.

5 Commonwealth Bank of Australia, 'Bankwest acquisition update', *Statement to the ASX*, 30 April 2009.

6 Scott Murdoch, 'Bad debt provisions crush BankWest result', *The Australian*, 1 May 2009, www.theaustralian.com.au/business/bad-debt-crushes-bankwest/story-e6frg8zx-1225705532461 (accessed 23 April 2012).

7 Commonwealth Bank of Australia, *Submission 81*, p. 21.

the loans could be demonstrated.[8] The following statement by Mr Geoff Shannon details the argument:

> The 2008–09 figure for the impaired loans is estimated at around $850 million—$620 million or so as the discount of the purchase price, and a further $200-plus million in that first part of 2009. The 2009–10 figure for the impaired loans was another $754 million … as a result of an internal Bankwest audit known as 'Operation Magellan', a code named operation. This figure of $750 million is on top … of the previous impairment charge of around $850 million … it appears to me that, for at least the $850 million figure, there was a dollar-for-dollar reward for these impaired loans.[9]

8.8 Mr Geoff Shannon also argued that the CBA would further benefit through tax deductions associated with the impaired loans and, because it has allegedly claimed a price adjustment based on the impaired loans it has demonstrated, it also would profit through the sale of any impaired assets.[10] The contentions appear based on media reports (such as the article cited earlier) and the financial statements of Bankwest's former owners.[11] The 2009 reports and accounts for HBOS and the Bank of Scotland report a loss on the sale of Bankwest and St Andrew's Australia of £845 million in 2008, and a further loss of £100 million in 2009. Both reports include the following statement:

> On 8 October 2008, the Group agreed the sale of part of its Australian operations, principally Bank of Western Australia Limited and St. Andrews Australia Pty Limited, to Commonwealth Bank of Australia Limited. The sale completed on 19 December 2008 and resulted in an estimated pre-tax loss on disposal of £845 million (including goodwill written-off of £240 million). The agreement provided for adjustments to the consideration received in certain circumstances and as a result a further loss of £100 million has been recognised in the current year.[12]

### *The CBA's response*

8.9 The CBA strongly denied claims that the purchase agreement allowed it to benefit from terminating the loans of certain Bankwest business customers:

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8 Mr James Neale argues that 'if the properties had been sold for their true value the exaggerated impairment by CBA would have been exposed', and the CBA would face claims from Lloyds and the affected borrowers: *Submission 54*, p. 3.

9 Mr Geoff Shannon, *Committee Hansard*, 10 August 2012, p. 21.

10 Mr Geoff Shannon, *Submission 118*, p. 11.

11 Although in addition to these sources, Mr Geoff Shannon noted that he has been informed by 'a very good source that Mr Jon Sutton was in a mad panic to get as many loans as possible into the impairment section prior to June 2010': *Committee Hansard*, 10 August 2012, p. 21.

12 HBOS, *Report and Accounts 2009*, www.lloydsbankinggroup.com/media/pdfs/investors/2009/2009_HBOS_R&A.pdf (accessed 2 August 2012), p. 40; Bank of Scotland, *Report and Accounts 2009*, www.lloydsbankinggroup.com/media/pdfs/investors/2009/2009_BOS_R&A.pdf (accessed 2 August 2012), p. 35.

> It has been suggested that CBA gained a commercial benefit from putting some Bankwest commercial loans into default which then allowed CBA to recoup subsequent losses from HBOS. Let me say categorically that that suggestion is simply untrue.[13]

8.10 The CBA argued that speculation about the sale agreement is 'based on an erroneous understanding of the purchase price adjustment process and the alleged "clawback" the CBA received from Bankwest's former ultimate parent, HBOS plc'. It is useful to reproduce the relevant statement from the CBA's submission at length:

> The sale agreement set out a purchase price adjustment process, which is standard practice in this type of sale scenario. Under the purchase price mechanism, the initial price CBA paid for Bankwest could increase or decrease by reference to the financial accounts which were to be prepared for Bankwest as at 19 December 2008.
>
> As part of this process, the parties agreed HBOS Australia Pty Ltd (as seller of the Bankwest shares) would prepare draft financial accounts for Bankwest to reflect its financial position as at 19 December 2008. The headline values reflected in the draft accounts for Bankwest would, in part, be impacted by the level of provisions which HBOS Australia Pty Ltd allowed for when preparing them.
>
> Under the sale agreement, CBA would review the draft financial accounts and raise any issues with HBOS Australia Pty Ltd.
>
> If the parties could not agree the final accounts between themselves, the sale agreement provided for a final determination by an independent expert to assist them resolve any outstanding issues.
>
> Ultimately, the parties were unable to agree on a number of items, including that the level of individual provisions reflected in the 19 December 2008 accounts were appropriate in all cases.
>
> Ernst and Young was appointed as the independent expert to determine these disputed items. Ernst and Young's determination was final and binding.
>
> We are aware of speculation that HBOS plc paid CBA some $200 million as a result of the price adjustment process. This is not correct. The purchase price adjustment process was finalised by early July 2009 and resulted in a small increase in the purchase price for Bankwest.
>
> The price adjustment process was designed to achieve a "zero sum" outcome. It could not, and did not, deliver any windfall gains. If the financial accounts finalised by Ernst and Young reflected an increase in value, CBA was to pay more and vice versa.
>
> CBA paid for the independently determined value it acquired in Bankwest, and Bankwest, under CBA ownership, has borne any losses it has

13 Mr David Cohen, Group General Counsel and Group Executive, Commonwealth Bank of Australia, *Committee Hansard*, 9 August 2012, p. 25.

> subsequently incurred from loans that were not assessed to be impaired or in default as at 19 December 2008.[14]

8.11 During their evidence to the committee at a public hearing, the CBA representatives expanded on this statement and advised that the CBA paid an additional $26 million for Bankwest as a result of the price adjustment process.[15] For absolute clarity, the CBA later confirmed in writing that the final price it paid was $2.1261 billion.[16]

***Reconciling the competing arguments***

8.12 As the preceding paragraphs show, in 2009 both HBOS and the CBA reported that they incurred further costs related to the finalisation of the acquisition—HBOS an additional £100 million and the CBA an extra $26 million. The question naturally arises as to how this could be so.

8.13 There do appear to be difficulties in comparing the financial statements of HBOS given it was itself acquired around the same time as its subsidiary Bankwest. The CBA observed:

> We do not know what accounting policies or accounting treatment that Bank of Scotland plc applied to its accounts in order to determine (historically or at the relevant times) the carrying value of the Bankwest Entities. Consequently, CBA is unable to comment on the level of write offs disclosed in Bank of Scotland's 2009 Report and Accounts.[17]

8.14 HBOS's books were seemingly subject to more conservative treatment under its new owners; for example, shortly after the acquisition Lloyds increased the impairment losses from £3.3 billion (year to 30 November 2008) to approximately £7 billion (year to 31 December 2008).[18] The UK's financial regulator concluded that, under its previous owners, 'there was a collective denial within the Corporate Division of the impact of the financial crisis on the portfolio' which impacted the ability of the independent auditor to fully assess HBOS's accounts:

> The culture of optimism which pervaded the business impeded the identification and effective management of transactions as they became stressed and delayed the referral of stressed transactions to the High Risk team. There was a significant risk that this would have an impact on

14 Commonwealth Bank of Australia, *Submission 81*, pp. 20–21.

15 Mr David Cohen, Group General Counsel and Group Executive, Commonwealth Bank of Australia, *Committee Hansard*, 9 August 2012, p. 27.

16 Commonwealth Bank of Australia, answer to question on notice, 9 August 2012 (received 12 September 2012), p. 3.

17 Commonwealth Bank of Australia, answer to question on notice, 9 August 2012 (received 12 September 2012), p. 3.

18 Financial Services Authority (UK), Final Notice: Bank of Scotland plc, 9 March 2012, www.fsa.gov.uk/static/pubs/final/bankofscotlandplc.pdf (accessed 11 April 2012), p. 32.

> HBOS's capital requirements. It also meant that the full extent of stress in the Corporate portfolio was not visible to Group, auditors and regulators … Throughout [April 2008 to December 2008], HBOS's auditors KPMG agreed that the overall level of the Firm's provisioning was acceptable. However, in relation to Corporate, they consistently suggested that a more prudent approach would be to increase the level of provision by a significant amount. The Firm consistently chose to provision at what KPMG identified as being the optimistic end of the acceptable range for Corporate. KPMG's view of what constituted the acceptable range was informed by management's assessment of the degree of credit risk in particular transactions. Further … the slow migration to High Risk meant that the full extent of stress in the Corporate portfolio was not visible to KPMG.[19]

8.15 Notwithstanding the statements in HBOS's report and accounts, the CBA added that it 'categorically confirms that the initial price agreed by HBOS Australia and CBA for the Bankwest Entities was not reduced by an amount equal to £100 million or by any other amount'.[20]

## The post-GFC property market and business environment

8.16 Another possible explanation for the actions taken by Bankwest can be based on the types of business loans held by Bankwest and the impact of the global financial crisis on the businesses and assets related to these loans. As the relevant submissions were largely from individuals involved in enterprises where the nature of the property is a key feature (such as hotel owners and property developers), it is necessary to consider the state of the market for these types of properties.

8.17 The CBA provided an overview of how it considers the crisis impacted the position and options of many business:

> The economic environment since the commencement of the GFC has adversely impacted the financial profile and flexibility of many enterprises, as well as some individuals. As a result, these enterprises and individuals have found it increasingly difficult to meet normal (unchanged) criteria relating to maintaining existing debt facilities or loans. Since the commencement of the GFC there has been a reduction in second tier lenders who would ordinarily consider these enterprises and individuals a suitable refinance proposition. In some cases this has resulted in overall borrowing increases (both working capital and term debt in the case of enterprises) from larger lenders such as the CBA. Normally, however, this is only if the borrower has shown a continued ability to meet commitments and/or pledged additional collateral. In the main, the aggregate debt offered to borrowers of a stable credit profile would have remained the same over

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19 Financial Services Authority (UK), Final Notice: Bank of Scotland plc, 9 March 2012, www.fsa.gov.uk/static/pubs/final/bankofscotlandplc.pdf (accessed 11 April 2012), pp. 30, 32.

20 Commonwealth Bank of Australia, answer to question on notice, 9 August 2012 (received 12 September 2012), pp. 3–4.

> the GFC, but many borrowers with stable credit profiles would have reduced their indebtedness based on their more conservative settings for leverage.[21]

8.18 It is also significant that Bankwest, under its previous owner and prior to the global financial crisis, was approving business loan applications that other banks were not. During the period following the crisis, the new owner is likely to be additionally sceptical of the quality of the loans that they were unwilling to finance prior to the crisis.

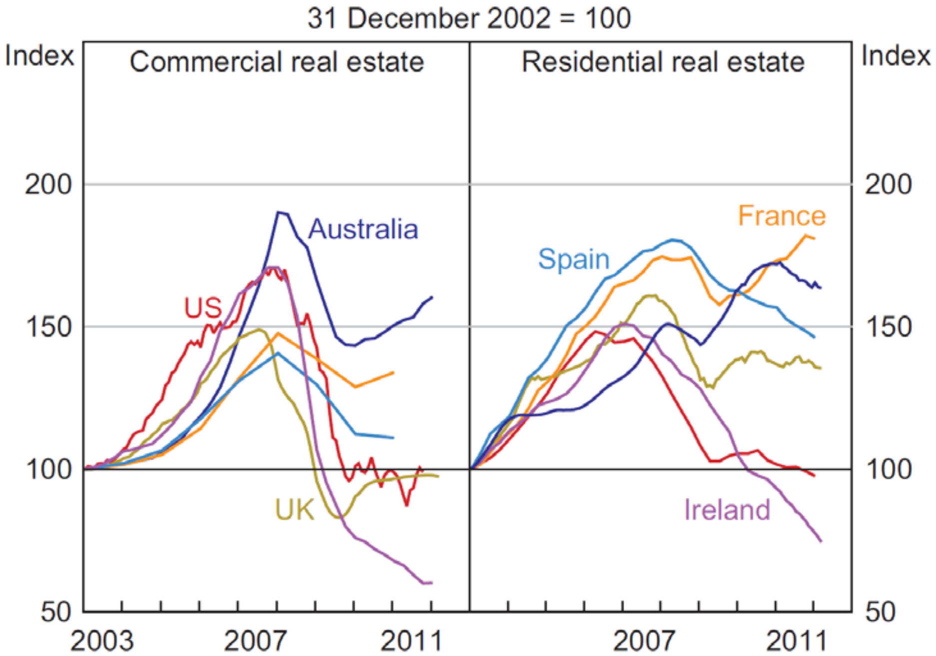
### *Property market*

8.19 In a letter to the committee, a senior manager at the Australian division of Colliers International stated:

> The demand for residential development properties deteriorated significantly as a result of the global financial crisis ("GFC"). In many instances, values of en-globo parcels of land decreased by approximately 70% due to the GFC.[22]

8.20 Figure 8.1 shows the scale of the downturn in commercial real estate prices that occurred during the global financial crisis.

**Figure 8.1: Property price indicators**




Source: RBA, *Financial Stability Review*, March 2012, p. 16; based on Bloomberg, Jones Lang LaSalle Research, Property Council of Australia, RBA, RP Data-Rismark and Thomson Reuters data.

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21 Commonwealth Bank of Australia, *Submission 81*, p. 33.

22 Mr Robert Wall, General Manager, Legal and Risk, Colliers International Holdings (Australia), response to *Submission 28*, 13 April 2012, p. 1.

8.21 The overall property values of hotels were particularly affected—a development which has also been relatively sustained. Developments in major Australian hotel markets are relevant to some of the evidence received by the committee. In its 2011 assessment of these markets, hotel advisory firm Dransfield concluded that hotel values have 'partially recovered' to pre-crisis levels, however it added the following observation:

> Many assets offered remain on the market with sellers unwilling to meet the market (where values have not fully recovered to pre-GFC levels) and with supply far exceeding demand. Again a significant proportion (estimated at around 20%) is distressed assets under administration, with the majority of these in leisure based/resort destinations.[23]

8.22 Bankwest's submission discusses how, in its view, its business lending portfolio was particularly impacted by developments in regional property markets:

> A reasonable proportion of Bankwest's loan impairments were contained in its property lending portfolio and in particular a number of residential, hotel, aged care and land development exposures in regional Queensland and New South Wales. These sectors and regions in general have been suffering difficult financial circumstances since the GFC began such as lower revenues and earnings and a diminution in the value of the underlying assets.[24]

8.23 Bankwest advised the committee that up to 7.23 per cent of its east coast property developer, property operator and pub customers became impaired between December 2008 and 30 June 2012.[25] Concerns about the commercial property market were also expressed by other banks, such as HBOS which largely attributed an increase in impairment losses of 67 per cent in 2009 (the year after it divested Bankwest) to falls in the value of commercial real estate, noting in particular that '[s]ignificant provisions were required against the Group's Irish and Australian commercial real estate portfolios'.[26] NAB noted similar issues with hotels and other properties on the east coast:

> On hotels generally that has been a problem area for us as well. You would have thought that it would not be a problem running a pub in Australia, but it has become one in some instances. On property development, particularly in south-east Queensland and in those areas that are exchange rate impacted that rely on tourism, we do have issues … The hotel market will sort itself out. New buyers will come in at a lower price, I guess, and they will make the most of them work. On the property side there is some oversupply that

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23 Dransfield, *Hotel futures 2011: A review of the revenue performance of major Australian hotel markets with forecasts to 2019*, December 2011, p. 9. The major hotel markets are comprised of the capital cities, Cairns and the Gold Coast.

24 Bankwest, *Submission 80*, p. 5.

25 Bankwest, answer to question on notice, 10 August 2012 (received 7 September 2012), p. 1.

26 HBOS plc, *Report and Accounts 2009*, p. 2.

> will need to be cleared out, particularly in south-east Queensland, and that market should revert to something a little bit more normal, but it might take a little while.[27]

8.24 In this context, that revaluations were required by Bankwest does not appear unusual, particularly as the terms of the loans provide Bankwest with the ability to update the valuation at least once a year.[28] ANZ submitted that such risk management processes were actually required by the government's prudential supervisor:

> APRA believes it's important to have more specific 'triggers' in lending policies as part of risk management procedures, to ensure that real estate held as security is revalued when there is a material change in the market value of real estate within an area or region.[29]

8.25 Of course, this is a high-level discussion on the commercial property market. Assumptions that the value of commercial property decreased across the board are contestable. For example, in his submission Mr James Neale declared that his five acre industrial property at Mount Kuring-gai was sold for $635,000, although prior to the sale he had refused a $4.1 million offer from an apartment developer and after the sale the property was valued at $3.58 million.[30]

### *Impact on business revenue*

8.26 The Australian economy performed better than most advanced economies during the global financial crisis, with a significant factor being the mining boom caused by the increased demand in China for certain mineral resources. The crisis did have an immediate impact on the Australian economy, an impact also reflected by other measures such as unemployment, surveys of consumer and business confidence and household savings. The below charts provide some indication of the economy-wide impact.

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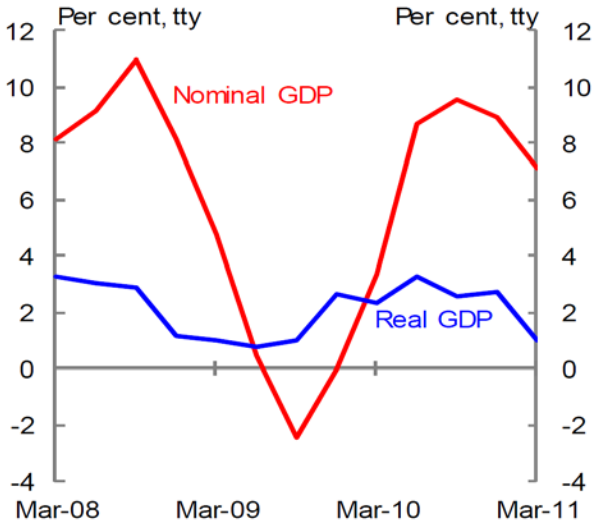
27 Mr Bruce Munro, Group Chief Risk Officer, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 74.

28 Mr Robert De Luca, Managing Director, Bankwest, *Committee Hansard*, 10 August 2012, p. 53.

29 ANZ, *Submission 78*, p. 21. See APRA, 'The management of collateral and foreclosures', *APRA Insight*, 2011, issue 2, pp. 12–14.

30 Mr James Neale, *Submission 54*, p. 2.

**Figure 8.2: Nominal and real GDP growth**

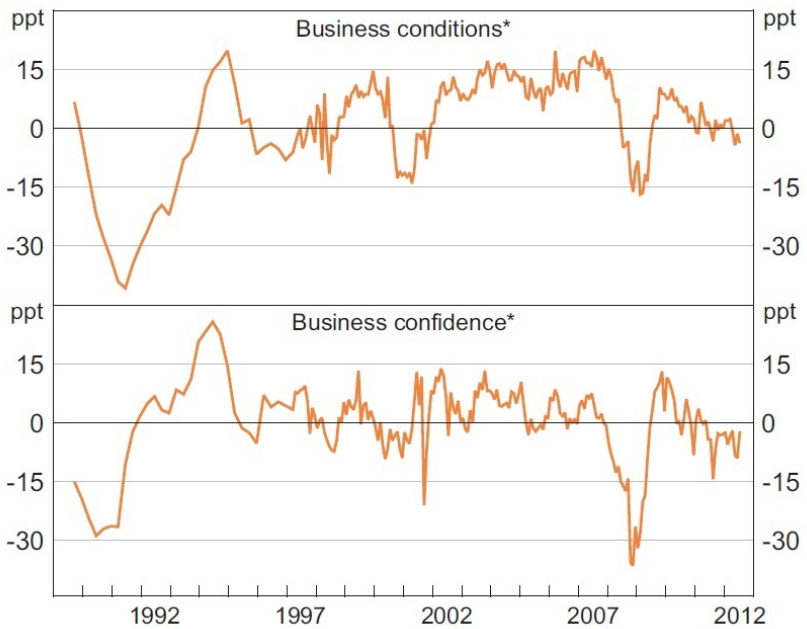



Source: Tony McDonald and Steve Morling, 'The Australian economy and the global downturn Part 1: Reasons for resilience', *Treasury Economic Roundup*, 2011, issue 2, p. 12; based on ABS cat. 5206.0.

**Figure 8.3: Unemployment rate**


Source: ABS cat. 6202.0.

**Figure 8.4: NAB business survey**




* Net balance; deviation from average since 1989.

Source: NAB, RBA.

8.27 These economic developments affected industries differently. For hotel businesses in the major markets, it is estimated that overall revenue was reduced by 6.8 per cent as a result of the economic downturn arising from the global financial crisis.[31] This would be a factor considered by lenders when assessing whether marginal hotel businesses are likely to be viable. As a number of aggrieved Bankwest borrowers operated pubs and small hotels in regional areas, some analysis of that sector is useful. To illustrate, Mr Geoffrey Reiher explained how the cash flow of the hotel he co-owned in Cobar, New South Wales was affected following the global financial crisis:

> We entered into a two-year interest only deal when the GFC hit. We made sure our commitments were all up to date. The hotel was doing up to $25,000 a week in the good times and through the GFC we went down to probably $11,000 a week. In that time the hotel bar takings actually went up 10 per cent; our downfall was gaming. From that we managed to get it back up to about $18,000 a week, until our termination.[32]

### *Value of property developments under construction*

8.28 It is an acceptable premise that the value of a property is only proven when someone actually pays that amount. However, when a bank has been financing a property development that is partially or substantially completed, as a general principle it would appear to be in the bank's interest to work through any difficulties to the extent possible to ensure that the construction is completed, thus ensuring the best opportunity for the debt to be recouped. There is also an apparent contradiction between Bankwest's submission and evidence relating to individual cases. Bankwest's submission states that one of the characteristics often identified before it decides to appoint a receiver is that 'the underlying project or development has stalled or costs have blown out'.[33] However, borrowers counter that it was because previously committed funds were not forthcoming that construction had stalled. Additionally, selling projects that are nearing completion does not seem to maximise the value that could be recouped; one borrower argued that they had $8 million worth of committed pre-sales for a project that was 70–80 per cent completed, but which was ultimately placed in receivership and sold for $2.215 million.[34]

8.29 Mr Guy Goldrick, who was involved in a development linked to Bankwest, explained that:

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31 Dransfield, *Hotel futures 2010: A review of the revenue performance of major Australian hotel markets with forecasts to 2018*, December 2010, p. 9.

32 Mr Geoffrey Reiher, *Committee Hansard*, 10 August 2012, p. 1.

33 Bankwest, *Submission 80*, p. 5.

34 Mr Geoff Shannon, *Committee Hansard*, 10 August 2012, pp. 26, 27. However, Bankwest subsequently contended that the project had seven pre-sales, where one of the pre-sales had a $1 deposit and another did not have a cash deposit. The bank stated that between September 2008 and July 2009 it provided the borrower in question 'with the opportunity to arrange a sale of the development himself and he made representations that he had a purchaser, but no sale eventuated'. Bankwest further stated that by the time receivers were appointed (1 July 2009), five of the pre-sales had expired with the remaining two due to expire in the coming months. Bankwest, answer to question on notice, 10 August 2012 (received 7 September 2012), p. 3.

> Our project was going well when, out of the blue, we were told to stop work. We were left hanging for nine months, all the while being told our development was fine and then, in 2009, we were given 24 hours to pay back $6.4 million.[35]

8.30 The project was sold in its incomplete form for around $3.2 million. The value of the completed project was estimated to be around $15 million.[36] Mr Goldrick argued:

> If they had worked with us in any way, shape or form, we could have finished the development and moved ahead. Maybe if we had sold two at a reduced price, we could have paid out the debt. Even if we had had to sell three to pay out the debt, we would not have been in the position where the bank were still owed money.[37]

8.31 Bankwest's general response to these types of cases was to state that 'it is not in our interest to sell an asset for a lower value and take a loss'.[38] Even so, as previously noted, the new owners of Bankwest had decided to redirect the focus of its business portfolio away from the property sector.[39] The tension between this decision and decisions about individual developments was highlighted by a senior Bankwest executive:

> When developments get into difficulties, there are debates between the bank and the customer as to whether or not it is better to put more money in to finish the development at that point. The reality of what was going on globally at that point was that all banks, because we were at the point where we entered the financial crisis, were looking at the sectors that they wanted to lend into. At that point in any cycle lending into development of property always starts to slope.[40]

8.32 Mr Corfield added:

> … there are of course a number of development customers where we have finished the development with those customers in order to make sure, as you say, that we can realise the value for the bank and for the customer … However, the reality is equally, unfortunately, that in some of these development cases putting in further money will not realise any extra value either for the customer or for the bank and unfortunately the reality of

35 Mr Guy Goldrick, *Committee Hansard*, 10 August 2012, p. 40.

36 Mr Guy Goldrick, *Committee Hansard*, 10 August 2012, p. 46.

37 Mr Guy Goldrick, *Committee Hansard*, 10 August 2012, p. 46.

38 Mr Robert De Luca, Bankwest, *Committee Hansard*, 10 August 2012, p. 61.

39 Commonwealth Bank of Australia, *Profit announcement for the full year ended 30 June 2010*, 11 August 2010, p. 30.

40 Mr Ian Corfield, Bankwest, *Committee Hansard*, 10 August 2012, p. 54.

> what happened in the GFC was that values fell very significantly, especially in regional development centres.[41]

## Revaluations, receivers and 'market value'

8.33 This section examines concerns about how valuations were conducted, the appointment of receivers and, from an overall viewpoint, whether the best price of the properties being sold was achieved.

### *Revaluations*

8.34 Revaluations were a recurring feature in the evidence from borrowers who feel aggrieved by Bankwest's actions. Some borrowers also posed questions about the relationship between Bankwest and its panel valuers[42] and the nature of the instructions from the bank about how the revaluation was to be conducted.[43] That valuers are independent from the banks was a point emphasised by many organisations in response to these suggestions. For the valuers it uses the CBA requires, among other things, that they hold associate membership of the Australian Property Institute, that the valuation report be signed by a valuer with at least five years' experience of valuing the relevant type of property (and be countersigned by the director of valuation in the firm if the amount of the valuation exceeds $1 million) and not have a direct or indirect interest in or association with the client or the property concerned.[44] The Royal Institution of Chartered Surveyors (RICS Oceania) stated that the valuation provided by professional valuers is done at a point in time and under professional standards, such as the RICS Valuation Standards and the International Valuation Standards Council.[45]

8.35 The previous chapter detailed some of the evidence regarding revaluations, and how the outcomes of revaluations were significantly lower than previous valuations conducted, placing the borrower outside their LVR. In its submission, RICS Oceania noted that the global financial crisis and the related fall in property prices presented challenges for valuers:

> The unfortunate and grim reality of the global financial crisis is the devastation to businesses and livelihoods, as property prices fell in response to the changing international financial environment. Through this period

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41 Mr Ian Corfield, Bankwest, *Committee Hansard*, 10 August 2012, p. 56.

42 ADIs generally maintain a panel of approved valuation firms for conducting the independent external valuations they initiate. The CBA argued that the use of panel valuers reduces risk and leads to greater consistency in valuations. See Commonwealth Bank of Australia, *Submission 81*, p. 34.

43 For examples, see Mr James Neale, *Submission 54*, p. 2; Name withheld, *Submission 109*, p. 4; Mr Geoff Shannon, *Submission 118*, p. 10.

44 Commonwealth Bank of Australia, *Submission 81*, p. 34.

45 RICS Oceania, *Submission 121*, p. 3.

> valuers and the valuation profession struggled to determine what a market value [was] in a market place that became so difficult so quickly.[46]

8.36 In addition to changes in market conditions related to the global financial crisis, RICS Oceania also stated that the outcome of revaluations could differ significantly from the initial valuation:

> Revaluations of properties may have some greater variance as valuers may not see the previous valuation. They are instructed to value the property as it is presented to them by the client. This may cause a variance of the valuation that may seem excessively different from the previous valuation.[47]

8.37 However, many borrowers had specific objections to how the initial valuation or the revaluation was conducted.[48] The integrity of these valuations is important given the evidence of significant detrimental consequences that an inadequate valuation can have for the borrower, such as termination of the loan and bankruptcy. Some submissions were critical of the interpretation of 'market value'. Agtion Consultancy Services director Mr Lindsay Johnston submitted that he is aware of up to five different methods that can be applied to value a property:

> Values of mortgagors' properties for mortgage lending purposes are invariably lowered to the bottom of the possible range and the terms of reference that are adopted deviate from the principle set out in the legal authority *Spencer v Commonwealth*. It appears that valuers acting conservatively under the influence of their bank appointers adopt a valuation based on a distressed sale outcome of the property being potentially sold as "mortgagee in possession" or by a bank appointed receiver.
>
> The highest value method appears to arise when a property is … being valued for a deceased estate. These valuations often exceed the likely market value.

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46 RICS Oceania, *Submission 121*, p. 4.

47 RICS Oceania, *Submission 121*, p. 3.

48 Although not a Bankwest customer, a useful example was provided by a customer of the CBA whose restaurant business suffered due to anti-social behaviour that took place immediately outside his premises. He argued that the strengths, weaknesses, opportunities and threats analysis contained in the initial valuation of the property 'made no reference to any social/law and order issues that would materially impact the capacity of the property to operate as a restaurant'. The borrower considers that the valuation over-estimated the property's value and 'provided a misleading basis for decision making regarding (a) the merits of purchasing at all, and (b) at the specific price that could be regarded as reasonable (c) that the CBA accepted as a basis for approval of the mortgage'. Mr Alan Harrison, *Submission 9*, pp. 2, 3. Mr and Mrs Gilbert and Sylvia De Michiel, customers of Bankwest, were also critical of the initial valuation undertaken of the motel property they purchased: see *Submission 5*.

> What happened to market value, within the meaning of *Spencer v Commonwealth*? Surely there is only one market value?[49]

8.38 Mr Geoff Shannon provided the committee with an example of a revaluation undertaken of a property at Nambucca Heads which also highlights the multiple methodologies available for valuing a property:

> … wherein the valuer describes two methods of establishing a valuation price. Method one, as is, gives the current market value of this particular project as $4.3 million. Method two, in one line, gross realisation, gives the value for the same project as $2.8 million. I highlight that that is two different values for the same property on the same day and on the same page. This is understandable, given the alternative sales options individually versus in one line. However, I draw your attention to the fact that the facility terms at the time of entering the loan contract describe the method that is required to be adopted. So why did Bankwest obtain a second valuation via the second method? I believe that Bankwest is instructing the valuers to value the property using different—and lower—valuation methods to those outlined in the original facility terms. This would mean that the bank has breached the client's loan contract by opting for an alternative method to that stated in the facility documents.[50]

8.39 As this is relevant for many of the examples put to the committee, the following is the Australian Property Institute's guidance for valuations of multiple properties in a single development:

> Where a Member undertakes a valuation of multiple properties in one development, such as lots in a subdivision or units in a building, the sum of the individual values or gross realisation assessed on the basis of an orderly marketing and sale program should be clearly defined as the total gross realisation.
>
> The valuation of multiple properties in one development should be completed on the basis of a single transaction or sale in one line to one buyer. This valuation approach should incorporate an appropriate discount to reflect the costs incurred in realising the proceeds from the sale of the individual properties. These costs normally include marketing and sale costs, holding costs and a profit and risk factor.[51]

### *Receivers*

8.40 Banks, to protect their position as a secured creditor, generally include in a loan contract the right to appoint a receiver and to sell the customer's assets if the customer defaults. Receivership:

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49 Mr D. Lindsay Johnston, *Submission 105*, p. 6.

50 Mr Geoff Shannon, *Committee Hansard*, 10 August 2012, p. 22.

51 Australian Property Institute, A*ustralia and New Zealand valuation and property standards*, January 2012, paragraph 4.21.

> … is an administrative procedure by which a person—who must be a registered liquidator—is appointed to administer property on behalf of a secured creditor … The appointment may be limited to mere protection of one particular item of property—for example factory premises—or it may extend to general control over all of the property and business affairs of a company—for example the factory and the engineering business carried on there. A receiver may be appointed privately under contract, or by the Court … the former … is by far the most common type of receivership and the type that is relevant to this inquiry.[52]

8.41 Receivers are subject to requirements under the *Corporations Act 2001*, general law,[53] ASIC regulatory guidance and, for members of the Insolvency Practitioners Association of Australia (IPA), the IPA's Code of Professional Practice.[54] While the receiver's primary responsibility is to the secured creditor the receiver has certain duties to the company. ASIC advises that case law indicates that receivers have the duty to:

> (a) exercise his or her powers in good faith (including a duty not to sacrifice the company's interests);
>
> (b) act strictly within, and in accordance with, the conditions of his or her appointment; and
>
> (c) account to the company after discharging the secured creditor's security, not only for the surplus assets, but also for his or her conduct of the receivership (including the duty to terminate the receivership as soon as the interests of the secured creditor have been satisfied).[55]

8.42 Some borrowers suggest that it is too easy for the bank to appoint receivers:

> There is a trend to liquidate rather than workout a loan. With liquidation comes downward pressure on asset values which in itself triggers further defaults through non compliance of loan covenants … Receivership is a "death warrant" to a borrower. Once this is on record it is impossible to attract first and second tier lenders to the funding table. The appointment of a receiver is all too hastily done. It destroys any creditability of both borrower and business.[56]

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52 Insolvency Practitioners Association of Australia, *Submission 45*, pp. 1–2.

53 Derived from the agreement under which the receiver was appointed; the agency relationship with the company (or more rarely with the secured creditor); if the receiver is court-appointed, from being an officer of the court; and being an officer of the company. ASIC, *Submission 97*, p. 18.

54 ASIC, *Submission 97*, p. 18.

55 ASIC, *Submission 97*, pp. 18, 19 (footnotes omitted).

56 Mr Trevor Eriksson, *Submission 37*, p. 3.

### *Market value and best price requirements*

8.43 The committee received evidence suggesting that the properties of a number of businesses, once placed in receivership, were:

- sold for a price substantially below the value stated in recent valuation reports;
- not being sold in a way that would maximise value; and
- ultimately sold at a price that was less than other unconditional offers that were not accepted.

8.44 Some examples of these concerns are below:

> The "market valuations" obtained by St George Bank, ANZ and the NAB were in excess of $10 million compared to the Receivers sale of the properties at approx. $5m.[57]
>
> * * *
>
> Senator WILLIAMS: Were you a company?
>
> Mr Butler: Yes.
>
> Senator WILLIAMS: Under section 420A [of the Corporations Act] they must make the best effort to get the maximum price.
>
> Mr Butler: Yes.
>
> Senator WILLIAMS: And it did not go to auction?
>
> Mr Butler: No.
>
> Senator WILLIAMS: They had offers of $14 million and it was sold for $9.5 million?
>
> Mr Butler: Yes.[58]
>
> * * *
>
> November 27, 2008 (9 months after the Bank received $500,000 from the proceeds of the sale of the Motel) the property was auctioned by a Receiver appointed by the Bank (Earnst [sic] & Young). At auction, the property passed in and a later offer of $2,850,000 was declined by the Receiver and ultimately sold for $1,000,000 less (ie: $1,800,000).[59]

8.45 When a receiver sells the property of a company, both legislation and professional standards govern their conduct. Subsection 420A(1) of the Corporations Act requires that all reasonable care be taken to sell the property at market value or the best price that is reasonably obtainable:

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57 Mr Trevor Eriksson, *Submission 37*, p. 12.

58 Mr Sean Butler, *Committee Hansard*, 8 August 2012, p. 64.

59 Ms Claudia Damato, *Submission 36*, p. 2.

> In exercising a power of sale in respect of property of a corporation, a controller[60] must take all reasonable care to sell the property for:
>
> (a) if, when it is sold, it has a market value—not less than that market value; or
>
> (b) otherwise—the best price that is reasonably obtainable, having regard to the circumstances existing when the property is sold.

8.46 A key concept is 'market value'. According to the *International Valuation Standards 2011*, market value:

> … is the estimated amount for which an asset should exchange on the valuation date between a willing buyer and a willing seller in an arms length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.[61]

8.47 The IPA explained how section 420A works in practice:

> The sale of assets at market value is a significant legal obligation of a receiver and it is one that is sometimes contested in the courts … The law generally requires receivers to engage in a competitive process, for example, involving tender or auction, and based on valuation and sale advice. Assets sold by receivers also attract those looking for a reduced price. Most court challenges to receivers' sales do not succeed.[62]

8.48 The actions taken by receivers in seeking market value were criticised, particularly when properties were sold by receivers for less than the amount of alternative offers the borrowers had secured but which were not accepted by the receiver. This issue was pursued when Bankwest appeared before the committee:

> CHAIR: We have also heard evidence through the course of this inquiry that some of the customers are aware of potential buyers, or alternatively have actually found them, for all or part of their businesses and have approached the receivers you have appointed and have either been ignored or had those offers rejected. Then, subsequently, the property on which the security was held was sold at a much lower level. Are you aware of stories along those lines?
>
> Mr Corfield: Yes. Obviously over the course of the financial crisis valuations fell very dramatically.
>
> CHAIR: That is right. But if your customer is trying to work with you to sort out their problems and comes to you and says, 'I have somebody who is willing to buy this part of the security for this amount of money,' and that would have substantially paid off a lot of the money that is owed to you, but then that is rejected and later on the whole of the security is sold for a price

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60 A controller includes a receiver or receiver and manager of the property (*Corporations Act 2001*, s. 9).

61 RICS Oceania, *Submission 121*, p. 3.

62 Insolvency Practitioners Association of Australia, *Submission 45*, p. 3.

that is even lower, it does not fit in with what you were saying about the GFC lowering prices, because in the midst of it they had somebody who was willing to pay more.

Mr De Luca: That sounds unusual.

CHAIR: Over the past few days probably two cases involving those issues have been put to us. They are cases where, particularly, the receivers—I do not know whether Bankwest was involved—just would not entertain it.

Mr Corfield: Again, there are very often two sides to every story.

CHAIR: Which is why I am putting this to you.

Mr Corfield: During the financial crisis we saw a lot of potential sales of assets, but ultimately those sales fell through because buyers were as spooked by the financial crisis as sellers were.[63]

8.49 From the evidence received, it is apparent that the sale of a partially completed development may not reflect the expenses spent on the project. Further, forced sales by a receiver are likely to result in a lower value than a stated valuation for a number of other practical reasons, such as a shorter period for marketing and because it is widely known that they must be sold. As one submission described the process:

… a Receiver Sale is taken by prospective buyers as a flag to a bargain because they are aware that the properties "must be sold". I challenge anyone to prove that a Receiver/mortgagee sale obtains a higher price than would otherwise be if the properties were market[ed] without notice of the receiver appointed.[64]

8.50 The same submission recommended that the concept of market value be amended to reflect a reasonable time for sale:

It is not accepted that just because an aggressive advertising program is implemented that the properties will fulfil "market value" status. Too many forced sales hide behind the "promotion activities" of receivers and banks to justify a "market value" and think that they have compiled with Section 420A of the Act.[65]

8.51 ASIC noted that the courts have taken an interpretation of section 420A that focuses 'more on what was the process taken, rather than focus on whether the best possible price was achieved'.[66] Further, the IPA contends:

… we find that the owners of the business often have an overly optimistic view of the value of the business, and a limited sense of their responsibility for its decline. Also, questions of market value are often contentious, more

63 Mr Robert De Luca; Mr Ian Corfield, Bankwest, *Committee Hansard*, 10 August 2012, p. 61.

64 Mr Trevor Eriksson, *Submission 37*, p. 12.

65 Mr Trevor Eriksson, *Submission 37*, p. 12.

66 Mr Peter Kell, Commissioner, ASIC, *Committee Hansard*, 8 August 2012, p. 59.

> so in what we may call a post GFC climate when expectations of sale price have to be adjusted.[67]

### *Treatment of GST revenue*

8.52 As GST is levied on the final consumer of a good or service, a business that supplies final consumers is required to charge GST on these goods and services. The business is then required to calculate, report and remit the GST amounts to the Australian Taxation Office (ATO) on a monthly, quarterly or annual basis. Effectively, the business collects the tax for the ATO.

8.53 Mr Iannello and Ms Pagano, who were involved in a residential property development in Western Australia, submitted that Bankwest would not release approximately $425,000 that was set aside in a bank account for GST. After the ATO demanded payment, the business appointed an administrator and Bankwest subsequently appointed a receiver.[68] Questions about what happens to any monies that a business has set aside for GST after a receiver is appointed to that business by a bank were asked by the committee. Whether the GST revenue incurred from the sale of developments was ultimately forwarded to the ATO was also a particular focus:

> Senator WILLIAMS: Why has Bankwest been so reluctant, because the receivers were selling these joints up and giving you all the money after their fees, to hand over the GST component to the Australian Taxation Office?
>
> Mr De Luca: I am not aware that we have been.
>
> Senator WILLIAMS: Let me make you aware of it. Lauderdale Projects Pty Ltd and the Bank of Western Australia—the sale went through for $9 million. Bankwest agreed to the sale contract. There was $900,000 of GST. So the sale price was $9.9 million. The receiver gave Bankwest $9.9 million. If Lauderdale did not get the $900,000 they could not pay the Australian Taxation Office in their quarterly or monthly BAS. You held on to the money. You would not hand over that $900,000. So what happened? The parties—and Bankwest agreed to this—called in a bloke called Ron Merkel, a former judge. You agreed to abide by Mr Merkel's decision as an expert … He said 'The GST amount is properly to be regarded as an expense occasioned by the sale rather than as part of the purchase price payable to the bank by the sale.' … He went on to say that 'Bankwest as secured creditor under its mortgage and charges is not entitled to the GST amount in priority to the ATO as of date of completion of the sale or at any time thereafter and the payment of the GST amount to Bankwest without making provisions for the payment to the Australian Taxation Office of the GST due on the sale of the property will in the circumstances of the present matter be unlawful' … When you got that $9.9 million, you clearly knew

67 Insolvency Practitioners Association of Australia, *Submission 45*, p. 3.

68 Mr Robert Iannello and Ms Nicola Pagano, *Submission 76*, p. 3.

> that $900,000 was the GST component. Why would Bankwest not hand that over to the ATO?
>
> Mr De Luca: I am not aware of that matter. I am happy to look into that one for you.
>
> Senator WILLIAMS: You had better look deep because I am sure that there are going to be other people looking into it as well.[69]

8.54 Bankwest subsequently provided a statement to the committee emphasising that it is not responsible for the GST liabilities of its customers and, although receivers are responsible for paying GST liabilities arising after their appointment, neither the receivers nor the bank are responsible for payment of GST liabilities that arise prior to this. A relevant extract from that statement is provided below:

> … in February 2010, Lauderdale exchanged contracts for the sale of its property with a purchase price of $9 million plus GST of $900,000. The Bank had not appointed receivers to the Company in question. As the sale proceeds were insufficient to repay the debt due to Bankwest, Lauderdale queried whether it was entitled to keep the GST component of the sale proceeds in the sum of $900,000 and later remit those monies to the ATO. At this time the Bank had concerns that the customer was diverting funds to related parties. Rather than allow this query to hold up settlement, Lauderdale and the Bank agreed to proceed on the basis that the funds would be paid into a solicitor's trust account at settlement and the parties would agree to abide by the views of Ron Merkel. Following Ron Merkel's opinion the $900,000 was released to Lauderdale. The money had never come into Bankwest's control. As the sale was made by Lauderdale prior to the appointment of any receiver, the operation of the GST law is such that any GST obligation is that of Lauderdale and not the Bank who had no obligation to account to the ATO for GST.[70]

8.55 The CBA advised that information it has received from insolvency firms indicates that businesses entering receivership do not generally have amounts specifically set aside to fulfil their GST obligations. The CBA also noted that, once a receiver is appointed, amounts owing to the ATO for unremitted GST would be treated as an unsecured claim and do not have priority under either the Corporations Act or relevant sections of the GST legislation.[71]

*Committee view*

8.56 The committee notes that there are disputes about particular cases where GST revenue had been collected, but was not ultimately passed on to the ATO. The committee would be concerned if these payments were not remitted to the ATO,

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69 Mr Robert De Luca, Bankwest, *Committee Hansard*, 10 August 2012, pp. 54–55.

70 Bankwest, answer to question on notice, 10 August 2012 (received 7 September 2012), p. 2.

71 Commonwealth Bank of Australia, answer to question on notice, 9 August 2012 (received 12 September 2012), p. 1.

particularly as the payments were made on the understanding that the purchaser was fulfilling a tax liability. While there are different viewpoints about the particulars of individual cases, there are sufficient issues for the ATO to examine. If the ATO considers that there are issues with the treatment of GST revenue but that it is unable to take enforcement action under current legislation, it should recommend appropriate policy changes to the government.

**Recommendation 8.1**

**8.57 That the Australian Taxation Office (ATO) investigates allegations that GST revenue was not handled appropriately by banks and receivers and that, if necessary, the ATO makes recommendations to the Australian government about legislative changes in this area.**

## Options available for borrowers to seek redress

8.58 The remainder of this chapter turns away from the possible explanations for why a significant number of small business customers of Bankwest had their loan terminated to examine options that aggrieved borrowers have available to them for their case to be heard.

### *Contract law and statutes*

8.59 For aggrieved borrowers, contract law based on common law and equity generally applies although additional legislative protections are contained in Commonwealth, state and territory legislation. Overall, the law is structured to generally allow lenders and borrowers 'to enter freely into agreements that they consider appropriate for their circumstances', although 'there are a number of legal protections for [consumers and] small business borrowers 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 assets is appropriate'.[72]

8.60 Protections for borrowers from various lending practices are currently directed toward consumer credit, rather than small businesses and other commercial activities. These provisions are contained in the *National Consumer Credit Protection Act 2009* (NCCP Act) and the Australian Consumer Law.[73] Some of the issues addressed include unfair contract terms, responsible lending by licensees and the right to apply for a repayment arrangement on the grounds of financial hardship.

8.61 Some statutory protections, however, apply to financial institutions' dealings with small businesses. The *Australian Securities and Investments Commission Act 2001* includes broad prohibitions against misleading or deceptive conduct and false and misleading representations in respect to the provisions of financial products and

72 Treasury, *Submission 120*, p. 18.

73 The provisions of the Australian Consumer Law related to financial services can be found in the *Australian Securities and Investments Commission Act 2001*.

services.[74] Specific unconscionable conduct[75] provisions also apply to dealings with consumers and small businesses:

> A person must not, in trade or commerce, in connection with:
>
> (a) the supply or possible supply of financial services to a person (other than a listed public company); or
>
> (b) the acquisition or possible acquisition of financial services from a person (other than a listed public company);
>
> engage in conduct that is, in all the circumstances, unconscionable.[76]

8.62 On the Bankwest issue, based on the legislative boundaries in place and the resulting matters that fall within ASIC's jurisdiction, as well as the number of complaints it has received, ASIC advised that it considers it has not 'received any evidence to suggest some sort of systemic misconduct by Bankwest', nor as at August 2012, has it received 'anything that warrants further pursuit'.[77]

### *Possible small business credit reform*

8.63 On 3 July 2008, the Council of Australian Governments (COAG) agreed to transfer responsibility for the regulation of consumer credit from the states and territories to the Commonwealth. This ultimately led to reforms such as the National Credit Code (a schedule to the NCCP Act). As part of these reforms, possible changes to the regulation of the provision of credit to small businesses were mooted.[78]

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74 *Australian Securities and Investments Commission Act 2001*, ss. 12DA, 12DB.

75 Unconscionable conduct is a concept found in common law and examined by Australian courts prior to the enactment of specific statutory unconscionable conduct provisions. In a decision of the High Court in 1983, Justice Mason observed that unconscionable conduct was 'an underlying general principle which may be invoked whenever one party by reason of some condition of circumstance is placed at a special disadvantage vis-à-vis another and unfair or unconscientious advantage is then taken of the opportunity thereby created. I qualify the word "disadvantage" by the adjective "special" in order to disavow any suggestion that the principle applies whenever there is some difference in the bargaining power of the parties and in order to emphasize that the disabling condition or circumstance is one which seriously affects the ability of the innocent party to make a judgment as to his own best interests, when the other party knows or ought to know of the existence of that condition or circumstance and of its effect on the innocent party': *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447, 462 (Mason J).

76 *Australian Securities and Investments Commission Act 2001*, s. 12CB.

77 Mr Peter Kell, Commissioner, ASIC, *Committee Hansard*, 8 August 2012, p. 58.

78 The credit reforms were divided into two phases. Phase one largely consisted of the NCCP Act. Phase two has been divided into two further parts—part one consisting of various reforms such as obligations applying to consumer leases and the regulation of short-term lending, reverse mortgages and credit cards. Part two of phase two includes issues such as the need to regulate the provision of credit to small business or lending for investment purposes. See Australian Government, 'Phase two of the National Consumer Credit Reforms: consumer leases and enhancements to the National Credit Code', *Regulation Impact Statement*, June 2011, p. 5.

8.64 In July 2010, the government released for consultation a green paper on the remaining proposals being considered as part of the credit reform agenda. The issue of credit to small business was covered in this paper. The paper noted:

> The reasons put forward in support of small business borrowers being afforded the same degree of protection as consumers include similarities in the types of securities used for small business loans (such as the primary residence); and similarities in the level of sophistication of small business borrowers' understanding of credit contracts and credit products.
>
> However, it is difficult to assess the significance of these issues due to the diversity of the small business sector and the relatively small number of small business complaints reported compared with complaints from individuals. Despite this, there is merit in examining whether small business borrowers would benefit from some statutory protections.[79]

8.65 The three options canvassed by the green paper for small business credit reform were:

- limited application of consumer credit protection regulations;
- full application of consumer credit protections regulations; or
- development of tailored regulations for small business lending.

8.66 A decision on the proposed reform has not yet been made or publicised. In its submission to this inquiry, Treasury stated that 'consultations to date have identified as a key concern the need to balance benefits to small businesses against any possible increase in the cost of credit or decrease in its availability'.[80] In its submission, CPA Australia stated that it strongly recommends that the proposals to extend the national consumer credit regime to small businesses not be pursued.[81]

### *Industry codes of conduct*

8.67 There are a number of voluntary codes of conduct that govern the lending activities of financial service providers and the dealings of these providers with their customers. The codes include the Code of Banking Practice, the Mutual Banking Code of Practice and the Mortgage and Finance Association of Australia Code of Practice. The most well-known and relevant code for this inquiry is the Code of Banking Practice administered by the Australian Bankers' Association, which is a voluntary code of conduct that outlines a bank's commitments and obligations to its personal and

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79 Australian Government, *Green Paper: National credit reform—enhancing confidence and fairness in Australia's credit law*, July 2010, p. 1.

80 Treasury, *Submission 120*, p. 20.

81 CPA Australia argues, among other things, that the policy would impact the supply of credit to small business and increase the cost of such credit, that no evidence has been presented that non-regulatory measures have been considered and that the proposal is an over-response to predatory lending. See CPA Australia, *Submission 51*, pp. 1–2.

small business customers. The Code was released in 1993 and is reviewed every three years, although the last review was concluded in December 2008.

8.68 The Code of Banking Practice includes provisions on:

- disclosure of fees and charges and other terms and conditions;
- changes to terms and conditions and fees and charges;
- disclosure of general information about banking services;
- privacy and confidentiality;
- statements of account;
- copies of documents;
- direct debits;
- credit card chargebacks;
- debt collection; and
- complaints handling.[82]

### *External dispute resolution—the Financial Ombudsman Service*

8.69 There are two main external dispute resolution (EDR) schemes relevant to the banking and financial sector. They are the Financial Ombudsman Service (FOS) and the Credit Ombudsman Service. As the evidence received by this inquiry refers to banks and FOS is the most relevant to the subject matter, this report will focus on FOS rather than the Credit Ombudsman Service.

8.70 FOS is an EDR scheme approved by ASIC which commenced on 1 July 2008 after the consolidation of other EDR schemes.[83] FOS is structured as a not-for-profit organisation governed by an independent board of representatives of consumers and the financial services industry.[84] FOS notes that it reports to ASIC quarterly on systemic issues and identifies financial services providers that have engaged in serious misconduct.[85]

## Difficulties in seeking redress

### *The judicial system*

8.71 A recurring theme in evidence has been the difficulties that aggrieved borrowers have faced in seeking to challenge the decisions and actions of banks and

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82 ASIC, 'Code of Banking Practice', www.asic.gov.au/asic/asic.nsf/byheadline/Code-of-Banking-Practice?openDocument (accessed 10 May 2012).

83 FOS, *Submission 50*, p. 1.

84 FOS, *Submission 50*, p. 2.

85 FOS, *Submission 50*, p. 2; *2010–2011 Annual Review*, p. 54.

receivers. Prior to any legal action being considered, attempts to resolve the situation can cost the borrower significantly:

> In one meeting it was me and my wife against two [receivers] and three lawyers all on about $500 per hour and being paid for from my company and they told us so!! In other words shut up and go away as every time you ask us a question we will charge you.[86]

8.72 In terms of the resources available to pursue and continue legal action, an individual engaging in legal proceedings against a major bank is undertaking an inherently unequal endeavour. As noted in the previous chapter, in many instances the result of the borrower's loan being terminated is that the borrower had been forced to seek government income support or assistance from family and friends. Accordingly, the prohibitive expense of mounting and sustaining legal action is beyond the reach of many, especially once the assets have been sold. Further, there are other factors which add to the difficulties; for example:

> … the legal system requests that the claimant put up surety for the bank's legal costs. An impossibility in most cases so litigation "dies on the vine". There is a practice of deferring proceedings which continually runs up costs to all. Remembering that all of the bank's legal costs are ultimately charged back to the borrower, the borrower in effect is doubled dipped with legal costs.[87]

8.73 There are also more practical challenges:

> I found that requesting the services of a major law firm to represent me against Bankwest was difficult. In [a] confession made by many large Sydney based firms it was stated that they would have a conflict as they have banks as their clients. One firm stated that the bank business is more profitable to them then my case. It shows that profit is the motive and selection for litigation cases.[88]

8.74 One borrower also alleged that, after their company's assets were sold and the debt to Bankwest was repaid, their company's receivership was prolonged until they agreed to discontinue legal action and not to take legal action against the bank in the future:

> [Bankwest] [c]onditions release of our funds with dropping all current legal action & undertaking not to hold either Bankwest or receivers accountable in future. Otherwise, Bankwest will continue to debit monthly costs to the said surplus funds until they are depleted. Receivers inform me their role was completed many times, and direct to Bankwest, all questions as to why receivers [were] not discharged from [the] companies.[89]

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86 Mr Sean Butler, *Submission 111*, p. 4.

87 Mr Trevor Eriksson, *Submission 37*, p. 6.

88 Mr Trevor Eriksson, *Submission 37*, p. 13.

89 Name withheld, *Submission 115*, p. 2 (emphasis omitted).

*Possible class action against Bankwest*

8.75 Indicating that the justice system may yet provide some comfort to ex-customers of Bankwest that feel aggrieved by the bank's actions, Slater & Gordon, in conjunction with litigation funder IMF Australia, has indicated that it is conducting due diligence with respect to a potential class action for aggrieved borrowers against Bankwest and the CBA.[90] In April 2012 it was reported that about 130 people had registered as claimants.[91]

### *Limitations of FOS*

8.76 In addition to difficulties faced by aggrieved borrowers in seeking examination of their case by the courts, limitations with EDR schemes such as FOS were identified. The terms of reference for FOS outline the types of disputes it may not consider. Of relevance, FOS may not consider disputes where the value of the applicant's claim exceeds $500,000.[92] The maximum compensation that may be decided by FOS is limited to $280,000. FOS notes that there is 'often confusion' as to whether it has jurisdiction in relation to small business disputes. It publishes the following explanation:

> In assessing whether we have jurisdiction to consider a claim about financial difficulty lodged by a small business, we will consider the amount of the loss that is claimed. The account balance or facility limit is not relevant when assessing jurisdiction. It is the amount of loss suffered that is significant. This potential loss usually encompasses the "moneys worth" of any variation sought, any default margin levied on the contractual interest being charged, enforcement expenses and costs of any Receiver or controller appointed over the secured assets.[93]

8.77 A number of former Bankwest customers who lodged submissions to this inquiry were critical of FOS. These criticisms were generally about the assessment of their case and the limitations about what FOS can examine. An instructive example was provided by Mr Sean Butler, who lodged a complaint with FOS that could not be examined because:

- the business was in receivership and FOS requires the authority of the receiver to consider the dispute;

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90 Slater & Gordon, 'Bankwest – Commonwealth Bank of Australia Class Action', www.slatergordon.com.au/areas-of-practice/victoria/general-legal-services/class-actions/bankwestcba (accessed 3 October 2012).

91 Natalie Gerritsen, 'Bankwest class actions', *Australian Financial Review*, 11 April 2012, p. 11.

92 FOS, *Terms of Reference – 1 January 2010 (as amended 1 January 2012)*, paragraph 5.1(o). Prior to 1 January 2010, the value of the claim could not exceed $280,000.

93 FOS, 'Dealing with customers in financial difficulty: small business', www.fos.org.au/centric/home_page/publications/the_circular/issue_2_april_2010/dealing_with_customers_in_financial_difficulty_small_business.jsp#Our_jurisdiction (accessed 4 July 2012).

- receivers are not a financial services provider—FOS can only examine the actions of entities that have provided a direct financial service and which are members of FOS;
- the loss claimed exceeds $500,000; and
- FOS is unable to consider the actions of a third party to the dispute.[94]

8.78 There were examples, however, where the involvement of FOS was clearly effective:

> In April 2010 Bankwest sent me a letter of demand for an extra $500,000 worth of charges that they claimed we still owed.
>
> Bankwest would still not speak to us.
>
> I contacted the banking Ombudsman and within 48 hours Bankwest phoned me and advised me that conditionally on me signing a document saying I would not take any legal action against them they would forgive the $500k.[95]

8.79 The founder of the Unhappy Banking group, Mr Geoff Shannon considers EDR schemes such as FOS to be 'a fantastic system' and advises aggrieved borrowers that contact him to lodge a dispute with FOS rather than with ASIC.[96] He suggests, however, that because banks are appointing receivers 'far more quickly now than they were before' a loophole exists because the receivers can refuse to grant authority for the dispute to be considered by FOS.[97]

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94 Mr Sean Butler, *Committee Hansard*, 8 August 2012, p. 65.

95 Name withheld, *Submission 44*, p. 4.

96 Mr Geoff Shannon, *Committee Hansard*, 10 August 2012, pp. 28, 29.

97 Mr Geoff Shannon, *Committee Hansard*, 10 August 2012, pp. 28, 29.

# Chapter 9

# Bankwest: Conclusions and recommendations

## How the committee approached this part of the inquiry

9.1 Before outlining the committee's conclusions and recommendations, it is necessary to explain how the committee approached the evidence about the alleged mistreatment of a not insignificant number of certain small business customers by Bankwest. The most crucial point is that this committee is not a court. While the committee has questioned Bankwest about particular cases and has utilised evidence relating to specific disputes to support its findings, readers of this report should not expect to find the committee's judgment on individual cases. Disputes between parties to a contract that cannot be resolved through other means need to be dealt with through the judicial process. Further, the committee has been very mindful of the undesirability of examining these cases in detail when some of them are before a court. The committee has accordingly reviewed the evidence from a broader, systemic perspective. Additionally, general comments made by the committee should not be interpreted to fully apply to every case; the committee received a number of submissions and it is inevitable that comments made by the committee, while applying to some cases, may not be relevant to all.

9.2 The main role of the committee in this inquiry has been to ensure that the regulatory settings governing the financial sector are appropriate and that the government agencies charged with administering and enforcing these regulations are effectively performing their role. It is not automatically the case that a collection of disputes, even if they share certain characteristics, should trigger regulatory change that would impact entire groups of borrowers. While there are many sad and distressing stories now on the public record, the committee cannot help but observe that, in some cases, although the aggrieved borrower may have been able to operate successfully during periods when the business environment was relatively good, the more challenging times presented by the global financial crisis placed extra stress on less robust and more speculative projects. In many cases, loans were sought for ventures that were a considerable risk even during the more stable economic environment that existed prior to the global financial crisis; this is evidenced by the cases where banks other than Bankwest had refused to finance the initial loans. Following the crisis, the decisions of the other financial institutions have probably been justified.

9.3 This of course does not apply to every case, nor does it excuse Bankwest—under its previous owners Bankwest was willing to enter into these loans that other financial institutions, acting more prudently, chose not to. When its small business borrowers are experiencing difficulties, Bankwest has a duty to make genuine attempts to work with the borrower, to clearly explain what is happening and why, and to treat them with courtesy.

9.4 While Bankwest may have been acting prudently by reassessing the risks of having certain loans on its books in the wake of its acquisition by the CBA at the height of the global financial crisis, there are legitimate concerns about some of the approaches adopted by the bank as a result of the reassessment. In examining the Bankwest issue, some individuals put forward the terms of the purchase agreement entered into by the CBA to acquire Bankwest as an explanation for what occurred. The committee notes these concerns but believes other factors such as the deterioration of the property market and general anxiety about the business and economic environment seem more significant based on the evidence available. In any case, the committee does not consider that it is necessary for it to definitively determine which factors may have influenced Bankwest's actions. The possible reasons provide some context, however, the concerns about Bankwest's approach and the regulatory responses required can largely be considered independently of these issues. That multiple potential explanations have been put forward supports this reasoning. While it can be conceived that situations similar to those that faced Bankwest's borrowers could be experienced by future customers of any lender, they could be caused by any number of events. The recommendations made by the committee are accordingly directed towards changes that will support more equitable dealings generally between small businesses and banks and that can apply to a broad range of future situations.

## A proportionate and balanced response

9.5 The committee wishes to ensure that the regulatory settings in the financial sector relating to business lending encourage entrepreneurial activity and allow sufficient flexibility for parties to enter into agreements that best suit the particular circumstances of the commercial operation. While most small business dealings with banks are not problematic from a regulatory perspective, the evidence received by this inquiry and previous inquiries indicate that there are still problems with current arrangements. Small business owners are busy individuals focused on the day-to-day operations of the business. They may not have the time or expertise needed to fully consider how certain actions, such as changes to facility terms, will impact them. Small business finance also shares many characteristics with consumer lending; for example, both small businesses and consumers face significant imbalances in negotiating power with large financial institutions. Yet while both small businesses and consumers receive some safeguards through the industry's Code of Banking Practice, consumer lending is also subject to the much stricter requirements of the statutory National Credit Code.

9.6 However, rather than recommend similar government intervention for small business finance, the committee considers it would be preferable for the industry to work on solving the evident problems. The committee has previously called for the Australian Bankers' Association (ABA) to meet with small business representatives to develop a code of practice specifically relating to lending to small businesses. The evidence received in this inquiry further confirms the need to give effect to this recommendation. Failure by the ABA and the banks to act on this recommendation may strengthen the case for more prescriptive government regulation in this area.

Given the arguments from the sector about the cost and burden of added regulation in general, the committee is of the view that if banks genuinely have these concerns, they have both the obligation and opportunity to demonstrate that the banking sector takes concerns about small business finance issues seriously and is willing to proactively develop a stronger self-regulated solution.

9.7 The committee does not consider the code of conduct for small business lending should interfere with the flexible nature of commercial agreements, but it envisages that it could set out some general principles for small business lending and address some of the particular conduct revealed by this inquiry. In particular, the committee recommends that the following issues be addressed:

- Changes to facility terms should be clearly explained to the borrower in writing, not simply issued. Small business owners may not have the capacity to review revisions to lengthy and complex loan documentation and identify what has changed. Documentation changing the terms of a loan should be accompanied with a cover letter clearly explaining what the changes are.
- Both borrowers and lenders take on obligations and responsibilities when they contract. Initial valuation reports provide security for lenders but changes to valuation reports pose serious threats to borrowers who are otherwise meeting all their obligations. In the absence of major economic shocks or unexpected events, small business owners should be entitled to expect that their dealings with the bank will be based on this initial assessment for a reasonable amount of time into the loan, such as for the first two years.
- It is generally the borrower that pays for costly revaluations that the bank requires. In many cases involving Bankwest valuation reports were used as a basis for placing businesses in receivership, yet borrowers were often denied access to the report and were left to speculate about the integrity of the valuation process. It is, therefore, difficult for the borrower to form a considered view as to whether the bank's instructions to the valuer and the valuer's actions were proper, or whether the receiver acted appropriately in exercising their power of sale according to the relevant requirements of the Corporations Act. Borrowers should, therefore, be automatically provided with copies of any valuation reports that they have paid for or which the bank intends to rely on to demonstrate that the borrower is in default. On request, borrowers should also receive copies of all instructions given by the bank to the valuer. This should apply even after a receiver has been appointed.
- Borrowers should also have the right to challenge a bank-ordered valuation by commissioning their own valuation. In the event that there is a disagreement about which valuation should be relied on, the disputed reports could be mediated by an industry body, such as the Australian Property Institute.
- The short period of time, such as 24 hours, between when notices of demand were received and when payment was required was another issue identified by the committee as inherently unfair. While there is some conflicting evidence regarding how aware (informally) the borrower was that a notice of demand

was going to be issued, it would be preferable that the formal notice include an added reasonable period of time for the borrower to seek refinance, such as 14 days. In addition to this 14 day period, further time should be available to allow for the finalisation of contracts if refinancing has been secured. This additional time should also be available to allow a borrower to continue negotiations for refinance if an offer appears reasonably likely. Banks and receivers should cooperate with any reasonable requests for information made by the borrower during this period that would assist the borrower reach an agreement for refinance.

- Given the substantial impact on the viability of the business that the imposition of default interest can have, how the default rates will be determined should always be clearly detailed in the facility terms provided to the borrower, rather than being linked to other documentation.

**Recommendation 9.1**

**9.8 That a voluntary code of conduct for small business lending, developed by the Australian Bankers' Association, be established. The code should, at a minimum, require that:**

- **changes to facility terms must be accompanied by a document that clearly explains the changes to the borrower;**
- **initial valuation reports associated with the purchase of a small business should be relied on by the bank for a reasonable amount of time, such as for the first two years of the loan, unless a major defined shock or event occurs;**
- **borrowers be automatically provided with copies of valuation reports that they have paid for or which the bank intends to rely on to demonstrate that the borrower is in default, and that all instructions given by banks to valuers be provided to the borrower on request;**
- **notices of demand include a minimum deadline of 14 days for repayment, but that a further reasonable period of time should also be available to allow for the finalisation of necessary contracts if refinancing has been secured, or to allow negotiations to continue if an offer of finance is reasonably likely;**
- **banks cooperate with any reasonable requests for information made by the borrower that would assist the borrower secure refinance; and**
- **how default interest rates will be determined should always be clearly specified in the facility terms, not linked to other documentation.**

**Recommendation 9.2**

**9.9 That the Australian government takes any necessary action to facilitate the establishment of the code of conduct for small business lending referred to in recommendation 9.1.**

## Making dispute resolution schemes more relevant to small business

9.10 The committee is also concerned about the options available to small business owners to seek redress. The committee notes that FOS may consider small business disputes, but there are a number of limitations on FOS which limit its relevance and effectiveness for these disputes. Most significant is that FOS is unable to consider claims that exceed $500,000. While consumer lending disputes of this magnitude may be best dealt with by other means—although the committee has not made a judgment on this—the evidence received indicates that disputes relating to small businesses can easily reach this level as they deal with high-value assets. However, for these businesses there are many competing pressures on available funds and it is not likely that a reserve is available to finance the institution of court proceedings. In any event, the appointment of a receiver leads to the business's funds being out of the control of the business owner. The committee believes that small business owners should not be restricted from seeking review by FOS because of this.

**Recommendation 9.3**

**9.11 That the terms of reference for the Financial Ombudsman Service (FOS) be amended so that:**

- **FOS may consider disputes from small business applicants where the value of the claim is up to $2 million; and**
- **the cap on the maximum compensation that FOS can award be increased to $2 million when the dispute relates to a small business.**

**Recommendation 9.4**

**9.12 That the terms of reference for the Financial Ombudsman Service (FOS) be amended so that FOS may consider disputes from small business applicants that relate to matters from 1 July 2008 onwards under the new caps outlined in recommendation 9.3. The staffing levels and funding of FOS should be reviewed to ensure it has sufficient resources available to perform this function.**

9.13 The committee also considers that there is a flaw in the current external dispute resolution framework as when a receiver is appointed by a secured creditor, FOS cannot review their actions or require them to stop enforcement action such as selling the company's assets. The committee is not of the view that FOS's terms of reference should be extended to cover receivers as it is not well-placed to consider disputes about the receivers' actions (which are taken as an agent of the company that they are appointed to). However, in situations where a genuine dispute exists being a borrower and a financial service provider, and the appointment of a receiver seems inevitable, the borrower should have the opportunity to seek a review of the substantive matters of the dispute before such an appointment is made.

9.14 Further to the committee's recommendation that notices of demand should include a reasonable minimum deadline for repayment (recommendation 9.1), such a notice should also be required to include information about FOS. Recognising that this could potentially be misused in cases where lodging a dispute could have limited merit (i.e. a last act of desperation by the borrower that could actually be disadvantageous for them if the dispute is prolonged and not resolved in their favour), the committee notes that under the existing terms of reference for FOS the financial services provider would still be able to seek FOS's consent to the proposed appointment of receivers or for the initiation of other enforcement action. That FOS would have to consider such a request would at least provide some external scrutiny of the decision.

**Recommendation 9.5**

**9.15 That the code of conduct for small business lending referred to in recommendation 9.1 stipulates that lenders may not appoint receivers to a small business unless:**

- **a notice of demand to the small business has been issued by the lender and the 14 day period of time outlined in recommendation 9.1 has elapsed; and**
- **if the lender is a member of the Financial Ombudsman Service (FOS), the notice of demand clearly states that the borrower may apply to have a dispute related to the lender considered by FOS, but that FOS would be unable to review claims related to the actions of a validly appointed receiver. Disputes lodged under such circumstances should be treated as urgent and the dispute handling process expedited by FOS.**

**Recommendation 9.6**

**9.16 That receivers be required to cooperate with all requests from the Financial Ombudsman Service (FOS) that relate to a dispute between the bank and the borrower that FOS is considering.**

## The role of receivers

9.17 The committee is also concerned about some outcomes that arise once a receiver is appointed. The committee notes that both the borrower and bank are subject to risk once a business is in trouble, however, there appears to be limited risk for receivers or accountability for the fees they charge. From the evidence received, banks do not seem inclined to challenge the receivers' actions or their fees, and there is little ability for the borrower to do so once their assets have been sold. While section 420A of the *Corporations Act 2001* imposes an obligation on receivers to take all reasonable care that property of a company is sold at a price not less than its market value if it has a market value at the time of sale (or otherwise the best price that is reasonably obtainable), it is inherently difficult for borrowers to scrutinise the receiver's actions. Therefore, if the borrower can produce sufficient evidence that indicates that the sale process may not have been in accordance with section 420A of the Corporations Act, the receiver should bear the burden of proof for demonstrating that they fulfilled their obligations.

9.18 The committee is also aware that, on occasion, inaction by receivers can also frustrate attempts by the borrower to seek refinance.

**Recommendation 9.7**

**9.19 That when a business is placed in receivership, the receiver is required to demonstrate to the borrower that they have considered every unconditional offer when exercising a power of sale in respect of a property.**

**9.20 If the borrower can demonstrate that an unconditional offer has been made by a party interested in purchasing a property and the receiver instead sells the property by a process that achieves a price that is less than that offer, the burden of proof should be on the receiver to demonstrate that their actions were in accordance with section 420A of the *Corporations Act 2001*.**

**Recommendation 9.8**

**9.21 That receivers be required to cooperate with any reasonable requests for information made by the borrower that would assist the borrower secure refinance.**

**Recommendation 9.9**

**9.22 That the code of conduct for small business lending referred to in recommendation 9.1 requires that if a bank has appointed a receiver to the small business, then the bank must regularly inform the borrower about the costs and fees associated with the receivership. The bank must also take all reasonable care to ensure the costs and fees are reasonable.**

## Small finance issues more generally

9.23 The committee also considers that further investigation of the challenges that small businesses face in pursuing review of actions taken by banks, receivers and other bodies is warranted. This is a complex issue not well-placed within this inquiry's terms of reference. The committee does not have a firm view as to which body should conduct such an investigation, although it notes that the Australian Small Business Commissioner who is due to take office on 2 January 2013 may be the appropriate office.

**Recommendation 9.10**

**9.24 An early priority of the Australian Small Business Commissioner should be to examine burdens for small businesses in pursuing litigation against banks and receivers and to report their findings and recommendations to the Australian government.**

**Recommendation 9.11**

**9.25 That, following the Australian Small Business Commissioner's appointment becoming effective, the Small Business Commissioner provide an annual report to the Senate on small business finance issues. In preparing this report, the Small Business Commissioner should receive any necessary support from relevant government departments and agencies.**

# PART III

## Further consideration of the banking and financial sector

# Chapter 10

## Need for a root and branch inquiry

10.1 In May 2011, after concluding a comprehensive inquiry into competition in the Australian banking sector, this committee recommended that an independent inquiry into Australia's banking and broader financial system be established.[1] Since this recommendation was made, there does not appear to have been any developments in the sector that would refute the need for a broad ranging independent inquiry. On the contrary, since this committee completed the Competition Inquiry, other sector-wide risks and long-term funding issues have been further highlighted.

10.2 This chapter briefly outlines some of the reasons as to why an inquiry into the financial system is warranted. It also identifies key issues that would be particularly worthy of examination.

### A banking sector in transition

10.3 The responses to the global financial crisis will fundamentally change the global banking system. Internationally-agreed regulatory changes intended to address key vulnerabilities exposed by the crisis have been finalised and work to implement them is now underway. At the same time, the Australian banking sector has been dealing with a number of other changes, including foreign legislation with extraterritorial effects as well as various domestic reforms. Professor Kevin Davis from the Australian Centre for Financial Studies described the cumulative effect as a 'virtual tsunami of regulatory change', much of which 'is a piecemeal response to problems identified in the GFC'. The professor indicated that this result strengthens the case for an independent inquiry:

> … a critical question is whether those changes are just papering over the cracks in a structure that is ultimately unstable.[2]

10.4 The head of Treasury's Markets Group considers that the Australian banking system is in a period of transition and will not return to how it functioned pre-crisis:

> I think that sometimes a lot of people seem to ignore the fact that we are in this transitional period and they are looking back pre GFC. In my view, we are not going to return to a pre GFC model for a financial system—primarily in other countries. When I say that, I do not mean our regulatory structure, which has proved quite resilient but I mean in terms of potential risks that banks may take in terms of their lending practices, the seeking of

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1 Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011, paragraph 3.91 [recommendation 1].

2 Professor Kevin Davis, Australian Centre for Financial Studies, *Committee Hansard*, 8 August 2012, p. 35.

> credit by consumers. I think we are seeing that in the number of consumers who are much more reluctant to leverage off their own credit.[3]

10.5 Although they recognised that the banking sector is in a period of transition, some witnesses questioned where the sector will end up:

> I would like to know where we are going. If I am going to go somewhere I would like to have an idea of what that destination might be. I would not want to leave it to whatever gods of the banking sector there might be to see where we end up before we decide what to do about it … I think there is a real opportunity for us. Because we are not in crisis, because we are in a good place, because the banking sector across all institutions is really sound, that is in fact a really good reason for us to hold an inquiry and to make some determinations about where that destination is. I certainly would reject one of those arguments and say that we have got a great opportunity to influence the course of where our banking sector goes and influence the outcomes for consumers in this.[4]

10.6 An ING Direct executive remarked 'transition is never going to stop … [w]hether it is regulatory or simply the dynamics of the global landscape or whether it is the domestic and the consumer landscape':

> There is a time at some point to determine that there is a need to review the landscape and see in general how the Australian public is being treated and whether they are getting a fair go or not.[5]

10.7 Other witnesses added that the government should consider its role in shaping the result of the transition, noting that it has performed this role in the past:

> The extent to which we should simply let evolutionary forces take their sway is that you cannot stop evolution, but governments certainly can influence it. One only has to look at the Australian financial sector to say that governments have influenced the development of the Australian financial sector over the course of the last 20 or 30 years, partly through tax changes, through superannuation, partly through other regulations. I think we need to be aware that financial institutions operate under a range of special privileges which governments concede to them or provide them. It is appropriate for governments to ask the question: are those privileges, those rights and those constraints they operate under the right ones in terms of the way in which the system is going to evolve?[6]

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3 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 2.

4 Mr Mark Degotardi, Head of Public Affairs, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 12.

5 Mr Bart Hellemans, Chief Risk Officer, ING Bank (Australia), *Committee Hansard*, 10 August 2012, pp. 33–34.

6 Professor Kevin Davis, *Committee Hansard*, 8 August 2012, p. 37.

## Over fifteen years since the previous inquiry

10.8 The last major comprehensive inquiry into the Australian financial system was the Financial System Inquiry chaired by Mr Stan Wallis (the Wallis Inquiry) which reported in 1997. The inquiry was asked to provide:

> … a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s. The forces driving further change will be analysed, in particular, technological development. Recommendations will be made on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.[7]

10.9 The inquiry fundamentally changed the regulation of the financial system in a number of important ways, particularly as it led to the creation of APRA. However, the nature of the banking system has changed significantly since the Wallis Inquiry. Obviously an important development was the global financial crisis and its flow-on effects, such as its impact on debt markets, funding costs and competition. Substantial internationally-driven and domestic regulatory changes have also taken place since the Wallis Inquiry, as well as other developments that are easier to overlook such as changes to technology and consumer behaviour. ING Direct observed:

> The challenge also is that, in addition to the regulation changing, not only has the world changed but also the way that consumers operate and think has changed. Consumers have more access to information. The challenge is that finance for most people is very important, but often it is a low-interest category, so financial education also becomes very important, and I think we need to invest more in making sure that people are financially literate. The challenge on our side is that, in many cases, our products sometimes become complex. One response to that is to say, 'Okay, you've got to give customers more documentation.' So you end up with a very big document that, frankly, most customers do not read. So the challenge for us is to make simpler products that the customers can understand.[8]

10.10 Following the global financial crisis, there have been a number of parliamentary inquiries into banking issues and a number of policy announcements and proposals by the government. The most recent is the consultation initiated by Treasury in September 2012 regarding APRA's crisis management powers. While these inquiries and policies may result in important improvements to the sector, they necessarily focus on specific groups of issues rather than the financial system as a whole. In other countries, debates have taken place regarding the desired structure and regulation of their banking systems in response to the global financial crisis. In the US, debate about its financial sector was widespread; an example of the formal consideration being the *Dodd-Frank Wall Street Reform and Consumer Protection*

7 Financial System Inquiry, *Final Report*, March 1997, p. 5.

8 Mr Bart Hellemans, ING Bank (Australia), *Committee Hansard*, 10 August 2012, p. 33.

*Act*. In the UK, the Independent Commission on Banking was established in 2010 and reported in 2011. The Commission, chaired by Sir John Vickers, was asked to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition. It made a number of recommendations that led to the release of a white paper in June 2012. A key recommendation from the Vickers Report being pursued by the UK government is the ring-fencing of banks so that retail activities such as deposit-taking are separate from international wholesale and investment banking operations.

10.11 While the effects of the global financial crisis were clearly more acute in the US and the UK, complacency in Australia would be unwise. Professor Davis argued that 'we should be thinking about designing the desirable financial sector of the future':

> In my view, 'if it ain't broke don't fix it' mentality needs to be replaced by asking the questions of while it may not be broke, could it be better and how do we ensure that it will not break in the future.[9]

## Competition

10.12 Given the focus of this committee's previous inquiry into banking issues, it should not be surprising that one of the key issues identified by the committee for consideration by an independent inquiry is the state of competition. Competition in the banking sector is a means to encourage increased efficiency, support the performance of the broader economy and enhance the welfare of Australians. Consumers benefit from greater choice in products, more innovation and lower prices. Increased competition in the sector has previously benefited consumers—the growth of non-ADI lenders in the 1990s and early 2000s challenged the major banks' lending rates and the expansion of foreign banks introduced new products such as online savings accounts with higher interest rates.

10.13 As discussed in chapter 2, market concentration in the financial sector has increased in a number of product markets. The major banks have increased their share of many banking activities due to the diminished role of foreign banks and the funding challenges facing non-ADI lenders due to the state of the securitisation market. The smaller banks also do not appear able to gain market share in the post-crisis sector:

> One would have thought that if competition was working, and working better than it was a few years ago, then the smaller banks, the nonbanks, the credit unions and the building societies would have started to take market share from those major four. It is clear from our submission, which has been based on research, that the interest rates that are being offered by the smaller lenders, the credit unions and the non-bank lenders are noticeably lower than those of the major four, but they just do not have access to sufficient funding to be able to have a critical mass in the market—as they did, certainly in the non-bank sector, pre-GFC. They needed to have only

9 Professor Kevin Davis, *Committee Hansard*, 8 August 2012, p. 35.

> about a 13 to 15 per cent share of the market to have the big four looking over their shoulders to see what they were doing. Now the big four do not need to worry about what the smaller lenders are doing, because they have 80 per cent of the market.[10]

10.14 Some witnesses questioned perceptions of competition in the sector. A representative of Abacus stated:

> We think there are real questions around competition and whether there is enough effective competition in a market. It strikes me as odd that the Bank of Melbourne would put out a press release saying how it is going to be taking it up to the big four. That seems kind of ironic to me. There are questions about whether consumers are well enough informed and what the industry, our regulators and the government can do to ensure that we get better informed consumers so that they can make a choice. But we also have to provide them with that choice in banking as well.[11]

10.15 More intense competition is presently observable in some markets, such as for retail deposits. However, this may have a long-term impact on smaller banks that have traditionally been more reliant on deposits.

## Regulatory structures and distortions currently in place

10.16 Related to competition are questions about the major banks being too big to fail and the benefits that they gain from this (the possible benefits for their funding costs were noted in chapter 4). As also identified earlier in this report, certain tax distortions impact foreign banks and may affect their ability to compete with the major established Australian banks.

10.17 Some witnesses questioned the desired role, size and operation of the financial sector, and whether the current regulation of the sector is meeting its desired objectives. Professor Davis argued:

> There are two important considerations here. First, what is the underlying vision of how financial markets operate and the appropriate form for regulation? Second, can we design the structure of the financial sector to operate more efficiently and robustly or do we simply take as given the existing structure which historical evolution reflecting the interplay of market and regulatory forces has endowed us with? … My view is that there is an inherent dynamic within the financial sector towards increasing complexity, which, if accepted as a natural state of affairs, leads to increasingly complex, costly and intrusive regulations and which prompt

10 Mr Phil Naylor, Chief Executive Officer, Mortgage and Finance Association of Australia, *Committee Hansard*, 8 August 2012, p. 30.

11 Mr Mark Degotardi, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 11. The Bank of Melbourne was acquired by Westpac in 1997. In 2004 the separate brand name was discontinued, however, in 2011 Westpac rebranded its Victorian St George branches (acquired by Westpac in 2008), naming them Bank of Melbourne.

> innovative responses by financial institutions aimed at escaping the regulatory straightjacket. But I think there is a possible alternative. Legislation could design a simpler structure where some financial institutions face well-defined limitations on their allowable activities and consequently require simpler regulation. In such an alternative scenario, the other financial institutions could be less fettered provided that if or when they fail their exit is graceful with minimal disruption to the financial sector and at no cost to taxpayers.[12]

10.18 Another issue is the special privileges granted to the sector by the government and whether they strike the appropriate balance. Professor Davis argued:

> Any inquiry would have to look at the balance of the benefits of having a licence to operate in particular parts of the financial sector against the constraints that are imposed, and what is the appropriate balance of those. It would also have to look at what that balance of privileges and constraints does to the overall efficiency of the financial sector.[13]

## Funding mix and stability

10.19 The funding mix utilised and the cost of funds banks face has changed significantly following the global financial crisis. As a number of sections of this report have discussed, the sector is facing greater challenges in securing sufficient amounts of reasonably priced funds, either because of market developments or regulatory changes. Given that funding issues are interrelated with both competition and financial stability, the implications of these changes for the sector and the consideration of any risks associated with these funding models is clearly important.

10.20 As part of this, the interaction of the superannuation system with the banking sector could warrant examination. A large portion of Australia's savings are in superannuation where they are largely invested in equities. This pool of savings will grow further as the superannuation guarantee is gradually lifted to 12 per cent. However, Australia's banks are unable to secure sufficient funds domestically to support their lending activities, and need to turn to volatile international wholesale debt markets. An independent inquiry could examine this disconnect as well as proposals that could address this outcome in a way that is mutually beneficial for both the superannuation and banking sectors.

12 Professor Kevin Davis, *Committee Hansard*, 8 August 2012, p. 35.

13 Professor Kevin Davis, *Committee Hansard*, 8 August 2012, p. 37.

## Broad support

10.21 The establishment of a root and branch inquiry into the financial system has broad support. One of the major banks, NAB, indicated its support at a public hearing:

> … we would be conceptually supportive of a full inquiry. We would like to see the terms of reference being quite broad and covering all the issues that we think need to be covered.[14]

10.22 Abacus, the industry body for credit unions, building societies and mutual ADIs had the creation of a well-resourced independent inquiry as its main recommendation to the committee:

> It has been 15 years, as you know, since the last one and the world is a pretty different place to 1997, particularly in the banking sector. We have had 15 years of tumultuous change that includes the global financial crisis, the subject of this inquiry, and the subsequent massive economic and regulatory fallout.[15]

10.23 The MFAA was also supportive, although it emphasised the need to act quickly.[16] Professor Ian Harper, a member of the Wallis Inquiry panel has also recently publicly called for a new inquiry.[17] It would also appear that Treasury is supportive (or at least has been recently). In its incoming government brief following the 2010 election, it advised the government that:

> While there is considerable work being done in a number of areas, both domestically and internationally, to improve existing arrangements, there is a clear need for a comprehensive review of the financial sector regulatory framework … Such a review could draw together outcomes of the work currently being undertaken both here and internationally, and consider broader, more systemic issues, including the lessons from the financial crisis and the balance between the dual objectives of stability and safety, on the one hand, and competition and efficiency on the other.[18]

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14 Mr Bruce Munro, Group Chief Risk Officer, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 72.

15 Mr Mark Degotardi, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 11.

16 Mr Phil Naylor, Mortgage and Finance Association of Australia, *Committee Hansard*, 8 August 2012, p. 34.

17 Peter Martin, 'Call for rethink of RBA's role', *Sydney Morning Herald*, 6 August 2012, www.smh.com.au/business/call-for-rethink-of-rbas-role-20120805-23nuo.html (accessed 21 September 2012).

18 Treasury, *2010 Treasury Incoming Government Brief: Labor*, 'Overview', archive.treasury.gov.au/documents/1875/PDF/01_Overview.pdf (accessed 21 September 2012), p. 5 (emphasis omitted).

## Committee view

10.24 The committee considers that an independent root and branch inquiry into the financial system is required. While the onset and ramifications of the global financial crisis provided an argument for such an inquiry to be delayed, this argument is now less compelling. The nature of the future regulatory environment is becoming clearer. International regulatory changes have been agreed to and steps to implement them domestically have commenced. It is recognised that Australia's financial system is in transition, but to some extent it will always be in transition. There is now an opportunity to examine the state of the banking sector following the global financial crisis and to consider whether it is delivering what Australians want from it. Similar questions have been asked in other countries and have led to significant policy changes. While Australia avoided the worst of the crisis, this should not be allowed to result in complacency about the structure and performance of our financial system.

10.25 There are many issues that a comprehensive inquiry could review. The emphasis on financial sector stability has served Australia well, but has the crisis stifled competition and innovation? A highly competitive but unstable banking system is obviously undesirable—the benefits of competition would quickly vanish if the system could not withstand a crisis. A system that is only concerned with stability and does not adequately facilitate competition, however, would ultimately be detrimental to consumers in the long-term, as they may have to tolerate fewer choices of products, a lack of innovation and higher prices. While Australia's post-global financial crisis banking system scores well for stability, and there are competitive forces within the sector, there remains concern about the overall state of competition. Whether these concerns are being adequately considered—and what can be done to improve competition—remain important questions despite recent parliamentary inquiries and government policies regarding banking competition. A comprehensive inquiry could examine whether there are means to encourage greater competition without affecting stability.

10.26 Further, such an inquiry could also examine the regulatory arrangements imposed on the sector and consider whether the current system is appropriate. The global financial crisis has demonstrated that the major banks have a special role in the economy as they are not only too important to fail, but are also too important to stop or contract their lending activities. Whether the current regulatory structure acknowledges this appropriately should be debated. Additionally, a stocktake of the current collection of regulations could be undertaken to review whether they are achieving their objectives, and to assess their overall costs and benefits for the sector and for taxpayers.

10.27 Related to both stability and competition there are legitimate questions about the funding models being used by banks. Australian banks are significantly exposed to volatile offshore funding markets. While steps were taken by the government during the crisis to allow them to access funds, and changes to funding mixes have been made since the crisis, the ability of banks to secure sufficient quantities of stable funds in the future is an important issue. At present, demand for credit is subdued and households are saving more. The increased competition among banks for stable funds, such as deposits, is currently manageable for market participants and affected borrowers, but this may not be true in the future. It is not clear whether sufficient consideration of this new funding model has been undertaken. The role that Australia's growing superannuation savings could play in the financial system should also be considered.

10.28 Finally, the committee believes that the transition to the next stage in the development of the Australian financial sector needs to be guided by a clearly articulated vision of what the sector should look like and how it should function rather than being the accidental product of piecemeal regulatory responses. A full inquiry into the future shape of the financial sector will help articulate that vision. This future inquiry should give due regard and scrutiny to the evidence received by this Senate inquiry.

**Recommendation 10.1**

**10.29 That an independent and well-resourced root and branch inquiry into the Australian financial system be established.**

**Senator David Bushby**
**Chair**

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# Minority Report by Labor Senators

## Introduction

1.1 The strength of Australia's economy is the envy of the world. In recent years it has consistently outperformed other major advanced economies—for example, the Australian economy grew faster than every other major advanced economy in the June 2012 quarter and over the year to June.[1] According to the International Monetary Fund, since 2007 Australia has grown from being the 15th largest economy to now being the 12th largest.[2]

1.2 Similarly, the strength of Australia's banking system is also the envy of other advanced economies. Quick and decisive action by the Labor Government helped ensure that Australia's financial system was well-placed to deal with the turmoil resulting from the global financial crisis. The government has continued to act to strengthen and improve how the banking sector operates, particularly by implementing measures to increase competition in the sector and by enacting the first national consumer credit law.

1.3 The committee's report provides a good overview of developments in how banks source their funds and the costs of these funds. It also provides a useful outline of the Basel III reforms to capital and liquidity requirements, and highlights the careful and well-considered approach that the Australian Prudential Regulation Authority (APRA) is taking to implementing these reforms. The report also reflects the evidence received regarding lending practices since the global financial crisis well, including the evidence regarding Bankwest.

1.4 Labor senators, however, do not agree with all of the majority report's conclusions and recommendations. The views of Labor senators on these recommendations, and additional observations that Labor senators wish to make, are outlined below.

## The need for an independent inquiry

1.5 Labor senators do not agree with the rest of the committee that an independent inquiry into the sector is required at this time. The case for initiating such an inquiry has not been made. The government has been undertaking significant reform to the banking sector, such as its 2010 *Competitive and Sustainable Banking System* package. Developing these reforms has necessitated careful consideration of the sector and wide consultation. This is something the government is continuing with; most recently it initiated a consultation process on further improving the financial

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1 The Hon. Wayne Swan MP, *Treasurer's economic note*, no. 33, 2012 (9 September), p. 1.

2 The Hon. Wayne Swan MP, 'Australia becomes world's 12th largest economy', *Media release*, 9 October 2012.

regulation framework by strengthening APRA's crisis management powers.[3] The implementation of Basel III by APRA has also clearly involved careful consideration of the sector. Further, the sector has been subject to numerous reviews in recent years which have facilitated debate about the sector and informed policy development, such as the substantial inquiries that this committee has conducted.

1.6 It is clear that the regulatory structure established after the Wallis Inquiry has functioned well overall. The performance of Australia's banking regulators during this period is also difficult to question. In particular, the conservative approach to capital regulation that the Australian Prudential Regulation Authority (APRA) has maintained over a number of years, backed up by its robust supervisory activities, has undoubtedly served this country well. The combination of these factors has helped ensure that our banking system and economy emerged from the global financial crisis much stronger than most others.

1.7 Labor senators also note that the banks have been adapting to the changing environment following the global financial crisis, such as the implications the crisis has had for how they source their funds. The Governor of the Reserve Bank of Australia recently observed that 'Australian banks have had no difficulty accessing funding, including on an unsecured basis'.[4] The Governor has also observed that the adjustments taking place following the crisis will further strengthen the banking system and the Australian economy:

> Some of the adjustments we have been seeing, as awkward as they might seem, are actually strengthening resilience to possible future shocks. Higher—more normal—rates of household saving, a more sober attitude towards debt, a re-orientation of banks' funding, and a period of dwelling prices not moving much, come into this category.[5]

1.8 The case has yet to be fully made that an independent inquiry would be able to meaningfully contribute to these developments or other funding sustainability and cost issues.

## The cost of funds

1.9 The cost of bank funds is clearly an important issue that directly impacts millions of Australians. As the committee's report observes, the cost of funds sourced from international wholesale debt markets increased as a result of the global financial crisis. During the crisis, the government acted decisively by introducing wholesale funding and deposit guarantees to secure Australia's financial system. This action

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3 See www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/APRA.

4 Reserve Bank of Australia, 'Statement by Glenn Stevens, Governor: Monetary Policy Decision', *Media release*, 2012-33, 6 November 2012.

5 Glenn Stevens, Governor of the Reserve Bank of Australia, 'The Lucky Country', Address to the Anika Foundation Luncheon, Sydney, 24 July 2012 www.rba.gov.au/speeches/2012/sp-gov-240712.html (accessed 23 November 2012).

supported the wider economy as it allowed lending to continue with lower interest rates for borrowers.

1.10 Since then, Australian banks have been moving to more stable sources of funds that have proven more expensive. This is an understandable response to the crisis and also in line with the requirements of the upcoming Basel III liquidity reforms. However, further to the government's actions during the height of the crisis, the government has also implemented reforms to assist banks to secure their funding needs in a way which enables the provision of reasonably priced credit to households and small businesses. Legislation enacted in 2011 allowing the issuance of covered bonds by Australian banks, credit unions and building societies provides another way for financial institutions to access stable funds. The government has also created a legal framework that enables retail investors to participate in the market for Commonwealth Government Securities, which will help develop a deep and liquid corporate bond market in Australia.

## Competition

1.11 Competition in the banking sector will help ensure that pressure is applied to the banks as they make their interest rate decisions. The government is committed to boosting competition in the banking sector and has been acting on this by implementing a number of key reforms. Labor senators believe it is important to highlight the evidence received by the committee about the state of competition in the sector.

1.12 As part of its 2010 *Competitive and sustainable banking system* package, the government announced a range of measures that will empower consumers to get a better deal and support smaller lenders to compete with the big banks. Exit fees for new residential mortgages have been abolished, the disclosure of borrowing costs has been improved and it is now easier to switch transaction accounts. When asked in August 2012 whether the current state of competition is impacting on the decisions of the major banks to follow the official cash rate, the head of Treasury's Markets Group observed that 'the measures that the government has introduced are biting':

> … things we cannot get away from are the banning of exit fees, the switching package, better disclosure, giving consumer sovereignty, giving power back to the person to make their choice and follow the market. If they do not like the mortgage rate they are paying or they are not getting a good return on their deposits, they are in a much stronger position to transfer to another bank or turn to a mutual.[6]

1.13 Another Treasury officer advised that the major banks have lost an estimated $16.6 billion in home-lending business to smaller banks since the reforms were announced, and the small banks have increased their residential mortgage lending at

6 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 4.

twice the rate of the major banks.[7] The officer added that the value of refinancing has increased by 28 per cent since the government's reforms were introduced:

> Across the board, we have got the value of refinancing increased by 28 per cent since the reforms were introduced. We would not make the claim that that is solely driven by the reforms. I think there are a number of factors at work and that is a reasonable conclusion, but it shows that the reforms are having some influence on competitive tension, especially between the major banks as credit growth is slowing.[8]

1.14 A representative of Abacus-Australian Mutuals, the representative body for credit unions, mutual building societies and friendly societies, stated:

> There is no question that some of the government's efforts in the financial claims scheme and in making that a permanent feature of the landscape have been very beneficial. There is no question that other things in consumer protection, bans on exit fees and changes to credit card and consumer protection laws, have been very beneficial for Australian consumers. There has been great support and multi-billion-dollar funding for certain sections of the securitisation market to keep it afloat at various times during the GFC. These have all been useful and important reforms.[9]

## Basel III

1.15 Basel III is the major response of the international community to how banks should be regulated and supervised. The global financial crisis highlighted key weaknesses with the existing regulatory regime. Given the interconnectedness of the international banking system, and the need for Australian banks to obtain offshore funding, it is important that Australia implements these reforms in a timely fashion.

1.16 Nonetheless, this inquiry facilitated a useful public discussion about the implementation of these regulatory changes in Australia. Importantly, it highlighted the considered and balanced approach taken by APRA to implementing the reforms in Australia. It also demonstrated that the implementation of Basel III is broadly supported by Australian financial institutions. The CEO of the Australian Bankers' Association (ABA) stated that:

> I actually think our government and particularly our regulators, the Reserve Bank and APRA, have done a very good job in balancing the influence on where the international regulation is going, to the extent that they are able to do that, and its application here in Australia. By and large, we have been accepting of the impact of those changes here in Australia. We have

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7 Mr Ian Beckett, Acting General Manager, Financial System Division, Treasury, *Committee Hansard*, 8 August 2012, p. 4.

8 Mr Ian Beckett, Acting General Manager, Financial System Division, Treasury, *Committee Hansard*, 8 August 2012, pp. 4–5.

9 Mr Mark Degotardi, Head of Public Affairs, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 11.

> reservations about the speed of those changes; APRA feels that it is important to move quickly and we will no doubt continue to discuss and debate that with them.[10]

1.17 Labor senators are confident that the approach taken by APRA in implementing Basel III is appropriate. Australian banks are on target for meeting the capital requirements introduced by Basel III. The implementation of Basel III in the terms determined by APRA, including the proposed timetable, will further support the view that Australia's banking system is one of the safest in the world. APRA's approach to capital regulation and its active supervision activities have served Australia well to date and it should be commended for its work and engagement with the sector. Accordingly, Labor senators do not consider that the prescriptive recommendations contained in the committee's report regarding APRA's work (recommendations 3.1, 3.2 and 3.3) are necessary.

## Lending practices

1.18 Labor senators are sympathetic to the circumstances of borrowers who have had difficult experiences with financial institutions following the crisis. For lending to consumers generally, the government has implemented important reforms to strengthen the position of borrowers in their dealings with banks and other lenders. In particular, the government has developed and implemented a national consumer credit law that protects consumers from predatory lenders, targets unfair lending practices and establishes stronger standards for financial institutions for their lending activities. This law includes responsible lending obligations that require lenders and finance brokers to make reasonable inquiries about the consumer's financial situation and their requirements and objectives, as well as take reasonable steps to verify the consumer's financial situation.

1.19 Responsible lending is particularly relevant to some of the evidence received by the committee. There is evidence that the government's responsible lending reforms have been effective in tightening lending standards. On low-doc loans, a topic discussed at a number of hearings during this inquiry, a senior manager at Westpac advised that low-doc loans have now dropped to around two per cent of their total applications:

> Before the responsible-lending stuff, which got much more aggressive and brought licensing into the brokerage side of the argument, which was really important, it was probably running at about 10 per cent.[11]

1.20 The ABA also outlined the impact the responsible lending obligation has had, as well as the case for low-doc loans to remain available as a product:

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10 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 17.

11 Mr Jim Tate, Acting Chief Operating Officer, Australian Financial Services, Westpac Group, *Committee Hansard*, 9 August 2012, p. 7.

> Senator WILLIAMS: I mean, if someone has a house worth $1 million, they go to the bank, they get a $400,000 loan, a few questions are asked, it is approved, the bank takes security of the title of the house—just low doc or no doc. Are they still out there in the system?
>
> Mr Munchenberg: I am not aware of them in the terms that you have just described. Low doc loans were very much aimed at those people who do not have a regular income, who are self-employed or a contractor, and therefore did not meet the traditional banking approach of identifying your income and everything. I do not think that the scenario you have given me would be able to exist, simply because we have responsible lending obligations. We have legal obligations to make sure that you are in a position to manage the loan that we are giving you.[12]

1.21 Labor senators do not consider that the majority report provides a full picture of the regulation of low-doc loans. While much criticism was directed towards ASIC by certain witnesses, ASIC's role has not been fully explained. The following statement by Mr Peter Kell, a Commissioner at ASIC, is instructive:

> Although ASIC was not the primary regulator of credit prior to 1 July 2010, it did have concerns about aspects of the credit market including the low doc loans and conduct by brokers prior to that time. ASIC published reports and took actions prior to that time, most notably it published a report on mortgage broking in 2005 and a report in 2008 called Protecting Wealth in the Family Home, which identified concerns with the abuse of low doc lending and associated misconduct by brokers. The government relied in part on both of those reports, the issues set out and what had been found, to make its decision that credit should be regulated nationally, that brokers should be regulated including through licensing, that the responsible lending laws should be introduced and that regulation should extend to investment loans for residential properties. So ASIC has certainly been on the record very publicly in its arguments for the need for better regulation in this area for some time. That, as I said, helped drive the credit reforms which brought ASIC into play as the primary credit regulator from 1 July 2010 … Since ASIC became the primary regulator of the low doc sector, which is in effect post-GFC, the number of those loans in the market has substantially dropped. ASIC undertook a review of some of the lending practices in the first six months of its taking on this new jurisdiction with a focus on home loans promoted as low doc loans. The review at that time, which was published in November 2011, found that brokers were aware of, broadly speaking, responsible lending obligations and were taking steps to comply at that early stage. But ASIC did identify some areas for improving industry practice and understands a number of findings led to changes within the industry.[13]

12 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 25.

13 Mr Peter Kell, Commissioner, ASIC, *Committee Hansard*, 8 August 2012, p. 54.

1.22 Labor senators do not accept that there is evidence before the committee demonstrating that ASIC has not been active regarding low-doc loans. Labor senators note the majority report's observation that ASIC has publicly called for *detailed* evidence regarding these claims to be provided to it. Aggrieved individuals should take up this invitation and ASIC should act if these claims can be substantiated.

1.23 On the Bankwest issue, Labor senators acknowledge these are difficult and emotional issues for the individuals involved and are sympathetic to the experiences the borrowers have gone through. Nonetheless, we concur with the report's observation that this committee is not a court and that past disputes will need to be considered through the judicial process, either individually or through a class action.

1.24 The role that government should play in commercial finance offered to small businesses is a difficult issue. Treasury provided the committee with some information about the well-established framework in place:

> Generally, the law allows lenders and borrowers to enter freely into agreements that they consider appropriate for their circumstances. There are a number of legal protections for small business borrowers 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 assets is appropriate.[14]

1.25 Treasury's evidence demonstrates that achieving the right balance is clearly desirable. Further evidence from a Treasury official provided some additional context for the Bankwest issue:

> This may not be solace to people who feel aggrieved or who feel that they were not given a fair shake. But there is a framework there for them to be able to take action if they feel that, in terms of the current laws of the land and in terms of what is fair and reasonable, that did not occur. We have to face the reality that this a commercial contract between borrowers and lenders. I suppose the thing that makes us consider this matter is that, to some extent, you had an intervention—the GFC—that took a lot of people by surprise. I could well imagine that borrowers, before the GFC, were planning their business on the basis of what they had seen previously, and lenders were planning their business on the basis of what had been up to then. It is not surprising that some issues have been raised from this event.[15]

1.26 The recommendations of the committee about an industry-based code of conduct for small business lending is a balanced response and may have merit. It is important to ensure that any changes do not impact the ability of small businesses to access reasonably priced credit. There are over 2.7 million small businesses in Australia. While the global financial crisis presented a range of significant challenges

14 Treasury, *Submission 120*, p. 18.

15 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 8.

for all small businesses, concerns about access to finance appears to have been a more prevalent issue for these businesses overall.[16] This is not to say that there may not be a case for further work in this area. Labor senators note that the government is already considering whether reform of small business lending is required as part of phase 2 of the National Credit Reforms. Consultation has already been undertaken by Treasury on this issue. Accordingly, Labor senators consider that the need for further action in this area is already receiving appropriate consideration by the government.

**Senator Mark Bishop**
**Deputy Chair**

**Senator Doug Cameron**
**Senator for New South Wales**

16 As evidenced by parliamentary inquiries in recent years, such as the 2011 Parliamentary Joint Committee on Corporations and Financial Services inquiry into access for small and medium business to finance and the 2010 Senate Economics References Committee inquiry into the access of small business to finance.

# Additional Comments by Senator Cameron

1.1 As a matter of general principle, I agree that this committee cannot and should not act as a court or tribunal in which legal disputes between aggrieved borrowers and their lenders that pre-date this inquiry can be prosecuted.

1.2 I do however harbour grave concerns about the evidence before this inquiry concerning the conduct of financial institutions in relation to what are known as low-doc loans. There is no doubt in my mind that a number of institutions behaved in varying degrees to the detriment of their borrowers and in some cases, if the evidence is correct, with a reckless indifference to the ability of some of those borrowers to actually repay the loans extended to them. As a result, many individuals have and will continue to suffer financial hardship, stress and related illness.

1.3 I sincerely hope that in cases where the judicial process takes its course in relation to these matters, that financial institutions found to have not behaved in accordance with the law, equity or good conscience are severely punished and restitution is awarded to those individuals and businesses on which they have inflicted financial harm.

1.4 I note that the financial harm inflicted on a number of borrowers who made submissions to the inquiry has had the effect of putting the prospect of them taking what might be well-founded legal action against lenders beyond their financial means. In my view this heaps injustice upon injustice.

1.5 While I accept that the predatory lending practices complained of during the course of this inquiry have fallen somewhat into disuse both as a result of the GFC and changes to consumer credit laws, I am not prepared to accept that such practices would not re-emerge should financial and economic conditions return to their pre-2008 state sometime in the future.

1.6 One thing that legal action, either on behalf of individuals or in the form of a class action will shed light on, is the robustness of the law providing consumer protection against the type of lending practices complained of at length during this inquiry.

1.7 I will continue to monitor closely the outcome of any legal actions taken in relation to low-doc loans or predatory lending and encourage the government to do likewise with a view to ensuring that consumer credit laws offer robust protection to lenders who might otherwise fall victim to the practices of financial institutions that became prevalent prior to the GFC.

**Senator Doug Cameron**
**Senator for New South Wales**

# Additional Comments by Senator Williams

1.1 The following is compiled in support of the committee’s report and recommendations, and contains further recommendations.

1.2 The original catalyst for the Senate Economics References Committee's inquiry into the post-GFC banking sector was the concern surrounding the handling by Bankwest of its loan book. Evidence was beginning to emerge of Bankwest calling in its loans and the resultant selling up of many assets, some below market value. These issues were highlighted in a *Four Corners* television report, and this resulted in further allegations against the bank's practices. The Senate inquiry did not specifically target Bankwest but much of the evidence centred on its actions. It was disturbing to read and hear of people discovering their low doc loan application forms had been allegedly doctored to include inflated incomes and assets. It was also disturbing to hear and read of the "lend at all costs" attitudes to people who were at risk of being unable to repay. This practice has destroyed Australians lives. These and other issues are outlined below.

## Receivers and section 420A

1.3 The conflict between receiver and borrower is partly addressed in committee recommendations 9.18 and 9.19.

1.4 Of great concern is the continued selling of assets by receivers for below market value. Section 420A of the *Corporations Act 2001* states:

> (1) In exercising a power of sale in respect of property of a corporation, a controller must take all reasonable care to sell the property for:
>
> (a) if, when it is sold, it has a market value--not less than that market value; or
>
> (b) otherwise--the best price that is reasonably obtainable, having regard to the circumstances existing when the property is sold.
>
> (2) Nothing in subsection (1) limits the generality of anything in section 180, 181, 182, 183 or 184.

1.5 However, evidence given to the inquiry suggests this provision is either being breached, ignored or not considered when receivers are selling assets. Evidence given by Mr Jim Neale to the Sydney hearing emphasised the non-compliance:

> Senator Williams: So you were in discussions to sell a property for $4 million after it was sold. After it was sold, it was valued at $3.58 million, to the best of your knowledge. What was it sold for?
>
> Mr Neale: My account was credited with $195,000, which was sale proceeds of $635,000 from the bloke I was talking to in order to sell it to in the first place, less $440,000 for the receivers.
>
> Senator Williams: So this bloke you were talking to in order to sell it for $4 million – did he actually buy the block?

> Mr Neale: Yes.
>
> Senator Williams: That is a pretty good discount.[1]

1.6 Similar evidence was given by Mr Sean Butler of Perth. Mr Butler and his wife owned the Lighthouse Beach Resort in Bunbury and in 2007 it was valued at $20 million. In 2009, the property was re-valued at $14.7 million, but five months later at the direction of Bankwest and a cost of $9,500 to the Butlers, the property was again re-valued at 22 per cent less than the $14.7 million. Mr Butler indicated the property was still profitable and he was able to meet interest payments on all loans.

> Mr Butler: In January, 2011, we had further discussions with Bankwest … In February 2011 we got a purchase offer for the Lighthouse Beach Resort at $14 million, that being 22 per cent higher than what the [r]evaluation was. In other words, we got an offer for it that was close to the original valuation. It has almost proved them wrong. At that point our business partner, himself a banker, advised that he would match the $14 million offer and buy that property. [2]

1.7 Eventually Bankwest appointed Taylor Woodings as receiver-managers:

> Mr Butler: … Meanwhile, amidst all this secrecy and deception, our business partner, a prominent banker himself, negotiated with Taylor Woodings without our knowledge to buy it for $9.5 million—$4½ million less than what he had offered just a few months before. We have been advised that this conduct is illegal. That is one property.
>
> Senator WILLIAMS: Were you a company?
>
> Mr Butler: Yes.
>
> Senator WILLIAMS: Under section 420A they must make the best effort to get the maximum price.
>
> Mr Butler: Yes.
>
> Senator WILLIAMS: And it did not go to auction?
>
> Mr Butler: No.
>
> Senator WILLIAMS: They had offers of $14 million and it was sold for $9.5 million?
>
> Mr Butler: Yes.[3]

### Recommendation 1

**1.8 That the Australian Securities and Investments Commission (ASIC) initiate a wholesale review into matters raised during the inquiry relating to**

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1 Mr Jim Neale, *Committee Hansard*, 10 August 2012, pp. 13–14.

2 Mr Sean Butler, *Committee Hansard*, 8 August 2012, p. 61.

3 Mr Sean Butler, *Committee Hansard*, 8 August 2012, p. 64.

**breaches of the *Corporations Act 2001*, specifically section 420A and more broadly across the banking and insolvency industry.**

## Bankwest

1.9 In evidence to the inquiry, Bankwest maintained it worked with its clients and the problems only arose because of the economic circumstances, not through any inappropriate action of the bank: 'In cases where clients were impacted, we worked closely with them to try and improve their position'.[4] The major complaint about Bankwest from submissions and oral evidence was in relation to assets being revalued down when the business was clearly viable and meeting its commitments. Bankwest in its evidence defended its right to undertake valuations:

> CHAIR: So except for the contracted points of time or events or a customer clearly already being in difficulty, you would not undertake a valuation.
>
> Mr Corfield: We would not unilaterally be deciding in a given week, let's do a valuation on this.
>
> CHAIR: So you wouldn't sit down and say, 'Look, the GFC has happened. The value of hotels is suffering. We have some clients that have hotels. Let's go and send a valuer in to have a look at that just to see what is happening with their valuer.'
>
> Mr De Luca: As you know Mr Corfield stated, the terms and conditions provide us the ability to do a valuation update, let us say, on an annual or biannual basis, so at that point in time we may decide to do it earlier before the financial year finishes or after the financial year but within the terms and conditions. [5]

1.10 I believe that following the takeover of Bankwest by the Commonwealth Bank of Australia, Bankwest panicked and began having assets revalued. Bankwest had "begged" for business and targeted property developers on the eastern seaboard and hoteliers, but didn’t hesitate to "pull the plug" on those businesses after a rise in the LVRs. I question some of the valuations stated in the inquiry. The reasons for this action need to be scrutinised.

### Recommendation 2

**1.11 That the Australian Securities and Investments Commission (ASIC) review the purchase of Bankwest by the Commonwealth Bank of Australia and provide a report on compliance with all Acts and regulations.**

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4 Mr Robert De Luca, Managing Director, Bankwest, *Committee Hansard*, 10 August 2012, p. 50.

5 Mr Robert De Luca; Mr Ian Corfield, *Committee Hansard*, 10 August 2012, pp. 52-53.

## Pressure to lend

1.12 In its submission to the inquiry, the Finance Sector Union of Australia (FSU) pointed to the pressure bank officers are under to meet lending targets. The Union points out that '[c]ommissions and bonuses, as well as access to annual pay increases are built into performance pay systems that are designed to drive aggressive lending behaviour'.[6] The FSU stated that its members are concerned enough to have run three campaigns within their own banks about their lending targets, addressing unreasonable targets and the fact that 'employees were expected to make up their targets for any periods of absence from work including annual leave and sick leave'.[7] I believe this lies at the heart of what I regard as reckless lending.

1.13 Evidence was given by Mr Geoffrey Reiher of the time he was seeking finance for the purchase of the Grand Hotel at Cobar:

> We were pursued by Bankwest, taken to lunch and, in a whirlwind deal, we had finance for the hotel. We had tried other financial institutions and failed. They were talking a long-term commitment of 20 years and they were committed to helping out and making sure we got through the tough times.[8]

1.14 However, when the GFC struck, the bank was not so cordial:

> The hotel was doing up to $25,000 a week in the good times and through the GFC we went down to probably $11,000 a week. In that time the hotel bar takings actually went up 10 per cent; our downfall was gaming. From that we managed to get it back up to about $18,000 a week, until our termination. We had a valuation of the hotel done probably six or eight months prior to the termination of our agreement with Bankwest. That is when the hotel was down at its worst and we were asking for a revaluation. That never came to fruition.
>
> In the closing stages of our commitment with Bankwest, probably in the last three months, through telephone conversations with some of their senior officers they made it quite clear that they did not want our business and they basically told us to go somewhere else if we could.[9]

1.15 Mr Reiher reiterated the bank had changed the rules to get his business:

> Senator WILLIAMS: How much was the hotel valued at when you went to buy it?
>
> Mr Reiher: $2 million—$1.8 million.
>
> Senator WILLIAMS: How much did you request the loan for?

6 FSU, *Submission 156*, p. 6.

7 FSU, *Submission 156*, p. 6.

8 Mr Geoffrey Reiher, *Committee Hansard*, 10 August 2012, p.1

9 Mr Geoffrey Reiher, *Committee Hansard*, 10 August 2012, p.1

> Mr Reiher: $1.35 million.
>
> Senator WILLIAMS: You said in your opening statement that the bank shifted the goalposts to get the loan through. What do you mean by that?
>
> Mr Reiher: The valuation—I think they were loaning 80 per cent at the time.
>
> Senator WILLIAMS: So, in other words, if something was worth a million dollars they would lend $800,000?
>
> Mr Reiher: Yes. We did not fit the criteria. We fell short. I do not know the number but we did fall short by a small margin. It was said over lunch that we will just move the rate to fit you in.[10]

1.16 Following a revaluation, Mr Reiher said Bankwest appeared to want to end the agreement:

> Senator WILLIAMS: Are you saying that, for there to be an agreement, Bankwest said, 'Forget the 20 years as originally proposed; we'll set you up in a five-year loan where you'll pay the whole lot back in five years'?
>
> Mr Reiher: The way it was put to us, he said they would make it basically a five-year loan so that we could not make the payments. They wanted out; they did not want anything to do with us.[11]

1.17 It is my view that banks should not abandon a client when the loan-to-value ratio blows out. If a borrower is able to make interest payments, the banks should be encouraged to show patience and tolerance.

## Default interest rates

1.18 A number of submissions pointed to the trap of high default interest rates. Mr Sean Butler pointed out his default interest rate with Bankwest was 18.81 per cent if not repaid as agreed.[12] Where people are in financial trouble and miss repayments, the default interest rate can be too large a burden to overcome and the business or investment is doomed. Whilst the bank is entitled to retrieve its principal and interest, the excessive penalty interest rate is of concern. It was put to Bankwest in the inquiry that the higher penalty rates may in fact lead to a huge tax saving for the bank:

> Senator WILLIAMS: … Is it tax deductible for the bank if you have got a loss on a customer where they owe you a million, it compounds out to $1.2 million with these higher rates and you sell the asset for a million and you are $200,000 short. Is that $200,000 tax deductible?
>
> Mr De Luca: The interest income is income. It is not a tax deduction. It is income.

---

10 Mr Geoffrey Reiher, *Committee Hansard*, 10 August 2012, p. 2.

11 Mr Geoffrey Reiher, *Committee Hansard*, 10 August 2012, p. 4.

12 Mr Sean Butler, *Submission 111*, p. 2.

Senator WILLIAMS: But isn't that $200,000 loss on your books? If you have got a customer who on your book owes you $1.2 million and you have sold him or her up and cleaned them out or whatever for one million and there is a loss of $200,000, is that loss tax deductible?

Mr De Luca: The loss is. The loss is, not the interest income.

Senator WILLIAMS: By having huge default interest rates, surely that builds that amount to a situation where in some cases or in many cases of these bad loans that leads you to a greater tax deduction. Would that be the case?

Mr De Luca: Firstly it is in our interests actually to make profits, not to actually have losses. As Ian [Corfield] alluded to, also our interest there is aligned with the customer's where the customer is actually able to take it and actually able to pay to service their debt. As Ian alluded to, we negotiate and work with the customers on a case-by-case basis on what the right default rate is.

Senator WILLIAMS: You have not answered the question. If that money goes out, because the debt explodes by a very high interest rate level, then the more that goes out the more you have on your books that has not been repaid, so is that tax deductible? Yes, it is.

Mr Corfield: Technically, yes. If it causes a further loss then it would be tax deductible but, as we have said, those interest rates simply reflect the additional costs that are in the business. So the reality of what is happening through the PNL of the business is that actually we are no better off; in fact, we are worse off from customers that fall into this.

Senator WILLIAMS: I am seeing a situation here where the Australian Taxation Office might look at this and say, 'Okay, this loan has gone bad. You're sad about it and the client is sad about it.' But then when you can put up interest default rates to 18 or 20 per cent when official cash rates are at 3½ per cent and you can put that on your book, that is a big tax deduction, because that last 12 months of the dying period of the loan allows you to actually escalate your losses very quickly. You know you are going to lose dough. You know they have fallen over. I am not blaming Bankwest. Obviously, with this you can go right around the banking industry in Australia. Doesn't that allow you a greater tax deduction come the end of the year of doing your books?

Mr De Luca: As Ian alluded to, technically yes.

Senator WILLIAMS: You can determine the interest rate which then determines the level of loss. That is a pretty good business deal, isn't it?

Mr Corfield: Except the biggest cost at that point is actually the additional capital that we are holding against that business, so there is not some great benefit to us in jacking the interest rates up at that point because we are carrying that additional capital cost in any case.[13]

13 Mr Robert De Luca; Mr Ian Corfield, Bankwest, *Committee Hansard*, 10 August 2012, p. 58.

1.19 The above evidence confirms my belief the penalty (default) interest rates should be capped as indicated in recommendation 3.

**Recommendation 3**

**1.20 That the Australian Bankers' Association conduct an industry education campaign urging its members to re-evaluate their systems of incentives to curb aggressive lending. Further, that the Association consider an industry standard whereby its members are required to act in the best interests of the client generally, and by capping penalty (default) interest rates at no more than 50 per cent higher than the interest rate of the loan.**

## Low-doc and no-doc loans

1.21 Low-doc loans are good for self-employed people who are unable to provide documentation such as pay slips. There is no doubt they fill a void in the loans market.

1.22 But from evidence given to the inquiry it is clear there have been cases where loan application forms (LAFs) have been altered after being signed by the borrower. Whether this was by a broker acting to a bank's criteria or a by a bank officer themselves is unproven.

1.23 The President of the Banking and Finance Consumers Support Association, Ms Denise Brailey, claimed it was widespread:

> Ms Brailey: The banks provided commissions for mortgage manager, mortgage originators and mortgage introducers that came down in a chain to employing brokers. The brokers copped the full brunt of the blame that they were falsifying loan application forms … The four majors are in there. They are all responsible through a series of emails from banks to brokers, instructing the brokers how to get their deals across the line – 'make the deal fit' was their usual interpretation. They targeted older people, carers, people on parenting allowance and the aged pension.
>
> * * *
>
> We have the loan application forms from over 400 people in the last six weeks, During that time, not one of them is a clean document—each one has been fraudulently dealt with.
>
> * * *
>
> CHAIR: What you are saying is that those applications were doctored after they had looked at them?
>
> Ms Brailey: That is right. I have complained to each of the Chairmen and CEOs of the banks involved …
>
> CHAIR: They knew they were getting a loan though

Ms Brailey: But they did get the loan; the banks will argue that they got the benefit of the loan—however, there was a sustainability factor: there was never any affordability criterion in the process.[14]

1.24 The same issue was identified by Mr Lucas Vogel in his submission:

The bank made a $600,000 loan to us without a signed application form.

a. This means we were never afforded the opportunity to check and verify the basis upon which the loan was subsequently approved.

b. Dependent children (2 of) were not recorded in the banks computer record (or the records were altered) resulting in a reduction in calculable living expenses thus skewing the banks serviceability calculations in favour of the loan approval.

c. Income was attributed to my non-working wife using the ABN-for-a-day mechanism. This subterfuge had two benefits (to the bank), firstly it improved the apparent serviceability of the loans, and secondly it removed my wife as a dependant thus skew the serviceability calculations further in favour of the loan approval.

d. The bank holds and relies solely on a Low-Doc declaration form which was supplied blank to my wife for signing. Examination of that document clearly shows two or three distinctly different hand writings, only the signature of which is belonging to my wife. In other words the document was altered post signing. We know this because the income and asset figures entered on that document bear no resemblance to reality and match numbers detailed on a prior date within the banks file notes.[15]

1.25 It is imperative this issue be addressed.

**Recommendation 4**

**1.26 That the Australian Securities and Investments Commission (ASIC) conduct an investigation into low-doc and no-doc loans to determine if loan application forms as held by the Banking and Finance Consumers Support Association have been fraudulently completed. Further, that if ASIC determines that a criminal investigation is warranted, the matter be referred to the Director of Public Prosecutions.**

**Recommendation 5**

**1.27 That the government review the relevant legislation relating to low-doc and no-doc loans to ensure that the legislative framework currently in place adequately regulates these types of loans.**

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14 Ms Denise Brailey, Banking and Finance Consumers Support Association, *Committee Hansard*, 8 August 2012, pp. 44, 45.

15 Mr Lucas Vogel, *Submission 198*, p. 13.

## Payment of GST to the Australian Taxation Office

1.28 There were allegations that GST from the sale of assets by a receiver were not passed on to the Australian Taxation Office. This matter was raised during the appearance of the Bankwest executives:

> Senator WILLIAMS: Why has Bankwest been so reluctant, because the receivers were selling these joints up and giving you all the money after their fees, to hand over the GST component to the Australian Taxation Office?
>
> Mr De Luca: I am not aware that we have been.
>
> Senator Williams: Let me make you aware of it. Lauderdale Projects Pty Ltd and the Bank of Western Australia—the sale went through for $9 million. Bankwest agreed to the sale contract. There was $900,000 of GST. So the sale price was $9.9 million. The receiver gave Bankwest $9.9 million. If Lauderdale did not get the $900,000 they could not pay the Australian Taxation Office in their quarterly or monthly BAS. You held on to the money. You would not hand over that $900,000. So what happened? The parties—and Bankwest agreed to this—called in a bloke called Ron Merkel, a former judge. You agreed to abide by Mr Merkel's decision as an expert. It was not a mediation. Mr Merkel ruled these were the issues. 'Bankwest held a recent mortgage over the property. A dispute now exists between Bankwest and Lauderdale as to whether the GST amount is payable to Bankwest or to the Australian Taxation Office. Bankwest was required to discharge its mortgage over the property. Bankwest and Lauderdale have agreed to resolve this dispute.' He made a decision. He said, 'The amount payable to Bankwest is to enable Lauderdale to pay GST. Accordingly, the GST amount is required to be paid by the stakeholder to Lauderdale to enable it to meet its liability to the Australian tax office in respect of GST.' He gives court cases as examples. He said, 'The GST amount is properly to be regarded as an expense occasioned by the sale rather than as part of the purchase price payable to the bank by the sale.' He went on to say that, 'The special circumstances describe a clear intention on the part of the purchase of Bankwest and Lauderdale that the GST amount was to be paid to Lauderdale.' He went on to say that 'Bankwest as secured creditor under its mortgage and charges is not entitled to the GST amount in priority to the ATO as of date of completion of the sale or at any time thereafter and the payment of the GST amount to Bankwest without making provisions for the payment to the Australian Taxation Office of the GST due on the sale of the property will in the circumstances of the present matter be unlawful'. I put it to you that these receivers who have sold up so many of your customers have collected the GST component, and I believe you still have a lot of it to the tune of probably hundreds of millions of dollars. Why did that have to go on for a couple of years? Why did you have to get Justice Ron Merkel to hear this case? When you got that $9.9 million, you clearly knew that $900,000 was the GST component. Why would Bankwest not hand that over to the ATO?
>
> Mr De Luca: I am not aware of that matter. I am happy to look into that one for you.

> Senator WILLIAMS You had better look deep because I am sure that there are going to be other people looking into it as well. This is the thing that this committee must do as a regulator—make clear regulations seeing that in the case of receivers selling up commercial properties that have the GST component that that component goes to the proper authority, which is the Australian Taxation Office, and is then handed on to the states. I am very concerned about this issue about why there was a legal fight. It was not in a court room but both parties agreed to abide by the decision made by Ron Merkel. He makes it quite clear in the matter that Bankwest retaining this money is unlawful. As I said, I think this has been going on in a widespread fashion.
>
> Mr Corfield: We are obviously committed to meeting all of our obligations. In any receivership there are normally many creditors. Quite often it is complex to work through exactly what the position is, but—
>
> Senator WILLIAMS: The GST component is very simple. It is not complex. You sold the property for $9 million; you received $9.9 million. You did not want to give up the $900,000 to the tax office. It has gone on for years until, finally, an independent expert has made a judgement. What I am saying to you is this: I believe the receivers have done this right through your network of selling these commercial properties up and I believe you are hanging onto a lot of GST components of those sales. I want to go through those sales, contracts and collections of money you have had to see if there is a GST component there because, if you hang on to the money, the ATO will go after the business the receiver has sold up and they will bankrupt it. They will lose out with the Australian Taxation Office while you retain the money. To me, that is very wrong and very un-Australian. I want you to go through that. No doubt there will be other people going through and checking this very issue. As regulators we need to be assured that this loophole is patched right over.
>
> Mr De Luca: That is something we will obviously look into. It is not widespread. We have not got other—
>
> Senator WILLIAMS: It is not widespread?
>
> Mr De Luca: Not that we are aware of. [16]

1.29 Whilst this allegation could not be proved, those in the insolvency industry should be reminded of their obligation under the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act):

> Under the GST Act, liquidators, receivers, managers and administrators are all collectively referred to as "representatives of incapacitated entities." Such representatives are personally liable for any GST payable on taxable supplies that are made by a company post appointment. The ATO ranks as an unsecured creditor in respect of pre-appointment liabilities. This means that the ATO is at risk that it will not recover pre-appointment GST

16 Mr Robert De Luca; Mr Ian Corfield, Bankwest, *Committee Hansard*, 10 August 2012, pp. 54–55.

liabilities in full. However, if a representative is personally liable for the GST liability that arises post appointment, the ATO is likely to recover its GST liability on post appointment supplies in full.[17]

## Summary

1.30 Australia has a strong banking system. There is no dispute the cost of funds had been for some time increasing, but evidence to the inquiry suggests it has now plateaued. Compared to the number of loans approved each year, the number from which problems arise is very small. But what this Senate inquiry has revealed is problem areas in risky lending which in some cases lead to the loss of an asset and a severe effect on lives. The above recommendations combined with those in the Committee report should address many of the shortcomings.

1.31 If elected to government, the Coalition will undertake a full root and branch inquiry of our financial system. That inquiry should also address the imbalance between Authorised Deposit-taking Institutions (ADIs) and non-ADIs, whereby ADIs receive a government guarantee on deposits, but no such surety is given to non-ADIs.

**Senator John Williams**
**Senator for New South Wales**

17 Ashurst Australia, 'GST update for insolvency practitioners, *GST Bulletin*, August 2012, www.ashurst.com/page.aspx?id_content=8192 (accessed 28 November 2012), p. 1.

# APPENDIX 1

## Submissions received

| Submission Number | Submitter |
|---|---|
| 1 | Mr Lawrence Lyons |
| 2 | Mr and Mrs P. and L. Randles |
| 3 | Mr Graham Hyde |
| 4 | Kelgon Development Corporation Pty Ltd |
| 5 | Mr and Mrs Gilbert and Sylvia De Michiel |
| 6 | Mr Malcolm McKellar |
| 7 | Mr K. W. Grundy |
| 8 | Confidential |
| 9 | Mr Alan Harrison |
| 10 | Confidential |
| 11 | Mr Gregory Cadwallader |
| 12 | Name Withheld |
| 13 | Name Withheld |
| 14 | Name Withheld |
| 15 | Mr Nicholas Murphy |
| 16 | Name Withheld |
| 17 | Mrs Noeline Winton |
| 18 | Mr Tony Mollison |
| 19 | Mr and Mrs John and Maureen Monckton |
| 20 | Mr Nashaat Sedhom |

| | |
|---|---|
| 21 | Mr Frank Galea |
| 22 | Mr Hans Sprangers |
| 23 | Mr David Crisp |
| 24 | Mr Peter Davis |
| 25 | Mr Bernie Bourke |
| 26 | Mr and Mrs Moray and Maria McIntosh |
| 27 | The Hollioake Group |
| 28 | Mr Robert Laut |
| 29 | Name Withheld |
| 30 | Name Withheld |
| 31 | Professor Milind Sathye |
| 32 | Mr and Mrs Max and Diane Lock |
| 33 | Reserve Bank of Australia |
| 34 | Westpac Group |
| 35 | Chadoora Pty Ltd |
| 36 | Ms Claudia Damato |
| 37 | Mr Trevor Eriksson |
| 38 | Mr Victor Camp |
| 39 | Ms Fiona Howson |
| 40 | Name Withheld |
| 41 | Name Withheld |
| 42 | Name Withheld |
| 43 | Name Withheld |
| 44 | Name Withheld |
| 45 | Insolvency Practitioners Association |

| | |
|---|---|
| 46 | Australian Bankers' Association |
| 47 | Rabobank |
| 48 | Consumer Action Law Centre |
| 49 | Australian Centre for Financial Studies |
| 50 | Financial Ombudsman Service |
| 51 | CPA Australia |
| 52 | Mortgage and Finance Association of Australia |
| 53 | Confidential |
| 54 | Mr James Neale |
| 55 | Australian Prudential Regulation Authority |
| 56 | Mr Guy Goldrick |
| 57 | Mr Tim Boman |
| 58 | Kids Plus Childcare Centres |
| 59 | Name Withheld |
| 60 | Mr William Doherty |
| 61 | Name Withheld |
| 62 | Mr Renaldo Gaiety |
| 63 | Name Withheld |
| 64 | Name Withheld |
| 65 | Name Withheld |
| 66 | Name Withheld |
| 67 | Mr Terence Holmes |
| 68 | Mr Ralph Binks |
| 69 | Ms Lindie Mehan |
| 70 | Mr Ian Colquhoun |

| | |
|---|---|
| 71 | Mr David Bone |
| 72 | Name Withheld |
| 73 | Mr Robert Hutchinson |
| 74 | Mr A Walton |
| 75 | Ms Michele Fay |
| 76 | Mr Robert Iannello and Ms Nicola Pagano |
| 77 | Mr Neil Mackay |
| 78 | ANZ |
| 79 | National Australia Bank |
| 80 | Bankwest |
| 81 | Commonwealth Bank of Australia |
| 82 | Mr Jimmy Bieri |
| 83 | Name Withheld |
| 84 | Name Withheld |
| 85 | Mr and Mrs D and J Holmes |
| 86 | Mr Andrew Lawry |
| 87 | Australian Financial Markets Association |
| 88 | Mr Shayne Martens |
| 89 | Name Withheld |
| 90 | Mr Denis Ryan |
| 91 | Banking and Finance Consumers Support Association (Inc) |
| 92 | Mrs Karen Adams |
| 93 | Mr Peter McDougall |
| 94 | Name Withheld |
| 95 | Name Withheld |

| | |
|---|---|
| 96 | Name Withheld |
| 97 | Australian Securities and Investments Commission |
| 98 | Mr Luke Vogel |
| 99 | Professor Steve Keen |
| 100 | Professor Imad Moosa |
| 101 | Name Withheld |
| 102 | Mr Robert Bourne |
| 103 | ING Direct |
| 104 | Messrs Paul French and Geoffrey Reiher |
| 105 | Mr D. Lindsay Johnston |
| 106 | Mr Victor Seeto |
| 107 | Mr Ronald Cooper |
| 108 | AJC Enterprises Pty Ltd |
| 109 | Name Withheld |
| 110 | Name Withheld |
| 111 | Mr Sean Butler |
| 112 | Ms Ellen Brown |
| 113 | Mrs Maria Rigoni |
| 114 | Ms Lulu Mu |
| 115 | Name Withheld |
| 116 | Name Withheld |
| 117 | Mr Errol Opie and Ms Ann Marie Delamere |
| 118 | Mr Geoffrey Shannon |
| 119 | Mr Alan Griffiths |
| 120 | The Treasury |

| | |
|---|---|
| 121 | RICS Oceania |
| 122 | Mr and Mrs Bruce and Linda Hathaway |
| 123 | Mr Kimberley Burton |
| 124 | National Hotel Property Pty Ltd |
| 125 | Mr Mark McIvor |
| 126 | Confidential |
| 127 | Confidential |
| 128 | Confidential |
| 129 | Confidential |
| 130 | Confidential |
| 131 | Confidential |
| 132 | Confidential |
| 133 | Confidential |
| 134 | Confidential |
| 135 | Confidential |
| 136 | Confidential |
| 137 | Confidential |
| 138 | Mr Damien Morris |
| 139 | Confidential |
| 140 | Confidential |
| 141 | Confidential |
| 142 | Confidential |
| 143 | Confidential |
| 144 | Confidential |
| 145 | Confidential |

| | |
|---|---|
| 146 | Confidential |
| 147 | Cr John Wharton AM |
| 148 | Mr Ken Winton |
| 149 | Buranda Properties |
| 150 | Abacus - Australian Mutuals |
| 151 | Confidential |
| 152 | Confidential |
| 153 | Australian Securitisation Forum |
| 154 | Mr Tony Townsend |
| 155 | Confidential |
| 156 | Finance Sector Union |
| 157 | Confidential |
| 158 | Confidential |

# Additional information

1 Letter received from Fitch Ratings on 9 August 2012

2 Document received from Mr Guy Goldrick on 10 August 2012

3 Document received from Mr Raymond Weir on 14 August 2012

4 Letter received from Mortgage Choice Limited on 21 August 2012

5 Letter received from Ms Denise Brailey on 13 October 2012

# Tabled documents

1 Document tabled by ASIC at a public hearing in Canberra on 8 August 2012

2 Document tabled by Ms Denise Brailey at a public hearing in Canberra on 8 August 2012

3 Document tabled by Abacus Australian Mutuals at a public hearing in Sydney on 9 August 2012

4 Document tabled by Mr Geoffrey Shannon at a public hearing in Sydney on 10 August 2012

# Correspondence

1 Response to submission 11 received from Mr Shane Tregillis, Financial Ombudsman Service

2 Response to submission 27 received from Mr Mark Conlan, RSM Bird Cameron

3 Response to submission 28 received from Mr Robert Wall, Colliers International

4 Response to submission 147 received from Mr Bill Buckby, Kordamentha

5 Response to submission 148 received from Ms Denise North, Insolvency Practitioners Association of Australia

6 Reponse to submission 148 received from Mr Shane Tregillis, Financial Ombudsman Service

7 Response to submission 148 received from Mr Robert Moodie, Rogers Reidy

8 Response to submission 149 received from Mr Brett Gale, Westpac

9 Response to submision 149 received from Mr Robert Jackson, King and Wood Mallesons

10 Response to submission 154 received from Mr Morgan Kelly, Ferrier Hodgson

# Questions on Notice

| | |
|---|---|
| 1 | Received from the RBA on 20 August 2012; answers to Questions on Notice taken at a public hearing in Sydney on 9 August 2012 |
| 2 | Received from Westpac on 31 August 2012; answer to a Question on Notice taken at a public hearing in Sydney on 9 August 2012 |
| 3 | Received from Bankwest on 7 September 2012; answers to Questions on Notice taken at a public hearing in Sydney on 10 August 2012 |
| 4 | Received from Commonwealth Bank of Australia on 12 September 2012; answers to Questions on Notice taken at a public hearing in Sydney on 9 August 2012 |
| 5 | Received from Treasury on 11 September 2012; answer to a Question on Notice taken at a public hearing in Canberra on 8 August 2012 |
| 6 | Received from ASIC on 20 September 2012; answers to Questions on Notice taken at a public hearing in Canberra on 8 August 2012 |

# APPENDIX 2

## Public hearings and witnesses

**CANBERRA, 8 AUGUST 2012**

BECKETT, Mr Ian, Acting General Manager, Financial System Division, Markets Group, The Treasury

BRAILEY, Ms Denise, President, Banking and Finance Consumers Support Association Inc.

BURKE, Mr Anthony John, Policy Director, Australian Bankers' Association

BUTLER, Mr Sean Maurice, Private capacity

DAVIS, Professor Kevin Thomas, Research Director, Australian Centre for Financial Studies

KELL, Mr Peter, Commissioner, Australian Securities and Investments Commission

MIKULA, Mr Christian, Manager, Consumer Credit Unit, Retail Investor Division, Markets Group, The Treasury

MÜNCHENBERG, Mr Steven, Chief Executive Officer, Australian Bankers' Association

MURPHY, Mr Jim, Executive Director, Markets Group, The Treasury

NAYLOR, Mr Phil, Chief Executive Officer, Mortgage and Finance Association of Australia

SAADAT, Mr Michael, Senior Manager, Deposit Takers and Issuers, Australian Securities and Investments Commission

SIM, Ms Irene, General Manager, Retail Investor Division, Markets Group, The Treasury

STAMOLIS, Mr John, Director, Statistics, Australian Bankers' Association

**SYDNEY, 9 AUGUST 2012**

AYLMER, Mr Christopher Patrick, Head, Domestic Markets, Reserve Bank of Australia

BAYER ROSMARIN, Mrs Kelly, Executive General Manager, Corporate Banking Solutions, Commonwealth Bank of Australia

CANT, Mr Michael Andrew, Executive General Manager, Retail Products and Customers, Commonwealth Bank of Australia

CHAPMAN, Mr Keith, Executive General Manager, Diversified Institutions Division, Australian Prudential Regulation Authority

COBLEY, Mrs Lynette Elizabeth, Group Treasurer, Commonwealth Bank of Australia

COHEN, Mr David, Group General Counsel and Group Executive, Corporate Affairs, Commonwealth Bank of Australia

DEBELLE, Dr Guy, Assistant Governor, Financial Markets, Reserve Bank of Australia

DEGOTARDI, Mr Mark, Head of Public Affairs, Abacus-Australian Mutuals

GRAY, Mr Richard, Executive Director of Regulatory Reform, Group Finance, Westpac Group

HODGES, Mr Graham, Deputy Chief Executive Officer, Australia and New Zealand Banking Group

LAWLER, Mr Luke, Senior Manager, Public Affairs, Abacus-Australian Mutuals

LITTRELL, Mr Charles, Executive General Manager, Policy, Research and Statistics Division, Australian Prudential Regulation Authority

NASH, Ms Jane, Head, Financial Inclusion and Capability, Corporate Affairs, Australia and New Zealand Banking Group

TATE, Mr Jim, Acting Chief Operating Officer, Australian Financial Services, Westpac Group

**SYDNEY, 10 AUGUST 2012**

BAKER, Mr Glenn, Chief Financial Officer, ING Bank (Australia) Ltd

CORFIELD, Mr Ian, Chief Executive, Bankwest Business, Bankwest

DE LUCA, Mr Robert, Managing Director, Bankwest

GOLDRICK, Mr Guy, Founder, Bankwest Class Action; Private capacity

HELLEMANS, Mr Bart, Chief Risk Officer, ING Bank (Australia) Ltd

JOINER, Mr Mark, Executive Director, Finance, National Australia Bank Ltd

MUNRO, Mr Bruce, Group Chief Risk Officer, National Australia Bank Ltd

NEALE, Mr James, Private capacity

REIHER, Mr Geoffrey, Private capacity

RICHTOR, Mr Vaughn, Chief Executive Officer, ING Bank (Australia) Ltd

SHANNON, Mr Geoffrey, Private capacity

TINDAL, Ms Suzanne Maree, Chief Executive, Strategy and Reputation, Bankwest

**CANBERRA, 21 SEPTEMBER 2012**

BATH, Mr Michael Paul, Director, Financial Risk, Australian Office of Financial Management

NICHOLL, Mr Robert Bruce, Chief Executive Officer, Australian Office of Financial Management

**CANBERRA, 10 OCTOBER 2012**

ENGLEBERT, Mr Mark, Partner, Taylor Woodings