

Commonwealth Bank Group

Commonwealth Bank of Australia

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Reply
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Mr Tim Bryant
Committee Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

BY EMAIL

Dear Mr Bryant

Document tabled during 4 June 2013 budget estimates hearing

I refer to your letter to me of 24 June 2013 in which you informed me that the Senate Economics Legislation Committee had published a document entitled Tabled Document No. 9 - 'Understanding CBA/Bankwest Benefits' on its website (**Document**). The author of the Document is not named.

Issues of concern

The Document is a continuation of conspiracy claims made by various former customers of Bankwest raised at, and dealt with by, the Senate Economics References Committee Inquiry into the Post-GFC Banking Sector in August 2012 (**Inquiry**). It is surprising that the Senate Economics Legislation Committee, comprising as it does the same members as the Senate Economics References Committee, saw fit to accept the Document given the same subject matter was considered, and dealt with by the Senate Economics References Committee in its report.

The author of the Document and certain former Bankwest customers claim in essence that Commonwealth Bank of Australia (**CBA**) received a benefit in the form of a reduced purchase price for Bankwest as a result of Bankwest defaulting commercial loans. CBA provided a detailed written submission and gave evidence at the Inquiry to the effect that the purchase price adjustment mechanism agreed between CBA and HBOS, the seller of Bankwest, contemplated, among other things, the level of provisions for loan impairments in Bankwest's accounts at the date CBA acquired Bankwest (ie 19 December 2008). I gave evidence at the Inquiry that the level of provisions for loan

impairments recognised in Bankwest's accounts at 19 December 2008 was such that CBA paid an additional \$26 million in purchase price to HBOS. I also gave evidence to the effect that any loans not considered impaired at 19 December 2008 did not trigger an adjustment to the purchase price and in fact resulted in Bankwest, and therefore ultimately CBA, bearing the loss associated with the impaired loan. I fully stand by that evidence.

This evidence was surprising to some members of the Committee who had been led to believe otherwise by the inaccurate and misleading material provided by former Bankwest customers organised under the banner of Unhappy Banking. Those former customers find the truth as provided by CBA to the Inquiry inconvenient because it does not fit their myopic belief that somebody other than themselves must be responsible for how events unfolded. Inconvenient to those former customers as it may be, it is nevertheless the truth.

The Document attempts to counter the inconvenient truth through constructing an elaborate façade of reasoning. As is shown in this response below, the Document contains critical errors of logic and factual inaccuracies and demonstrates the unknown author's ignorance of basic principles concerning impairments, accounting and regulatory capital.

The Document's misdescription of events, its gossamer of reasoning and its fictional assertions are highly misleading. It is sadly ironic that the unnamed author of the Document falsely accuses me of intentionally misleading the Committee and then purports to support this baseless allegation by putting forward material that is itself misleading in the extreme.

I refute absolutely the claim in the Document that I intentionally misled the Senate through statements I made at the Inquiry. That claim is highly defamatory and it is extremely regrettable that the anonymous author has used a venerable institution such as the Senate and the shield of parliamentary privilege to pursue these unfounded, misleading and dishonest claims.

I request that this response be made a public document.

Critical flaws with the claims set out in the Document

Set out in the Document are a number of wildly incorrect assertions concerning matters that occurred prior to or after the acquisition of Bankwest by CBA. Two central erroneous assertions contained in the Document are effectively that CBA:¹

- was 'over extending [itself] financially to purchase Bankwest and its funding obligations'; and
- the 'purchase was only made possible by defaulting large numbers of productive customers'.

CBA categorically denies these assertions. The author of the Document attempts to support the erroneous assertions through a patchwork of guesswork and speculation. Examples of egregious errors in logic and in fact in this context are set out below.

1. Error #1 – The purchase price of Bankwest was based on a carrying value of \$4.25b

The Document claims that the carrying value of Bankwest on HBOS plc's financial statements at the time that CBA acquired Bankwest was \$4.25b.² It then goes on to assert that the purported carrying value of \$4.25b was used to calculate the purchase price of Bankwest, namely that the carrying value of \$4.25b was discounted by an amount of \$2.153b to arrive at a purchase price of \$2.1b.³

The statements in the Document do not remotely accurately describe how the purchase price for Bankwest was calculated. The discount theory described above is fallacious. The fact is

¹ See page 1 of the Document.

² See page 6 of the Document.

³ See page 15 of the Document. Note also the \$3m error in this calculation.

that the purchase price for Bankwest was calculated based on the actual book value of Bankwest by reference to its own accounts (not the carrying value on HBOS plc's accounts).

In a merger and acquisition context it is not uncommon for a vendor of an asset to have a carrying value in its accounts which is not the same or even remotely similar to the price for which the asset is actually sold. The author of the Document has no knowledge of carrying values in the context of asset sales or, if he or she does, has chosen to adopt the most unlikely value for Bankwest in order to support the speculative assertions in the Document.

2. *Error #2 – A discount of \$2.153b represented a pre-agreed level of impairments*

The argument in the Document is that the \$2.153b represented a level of pre-agreed impairments.⁴ In respect to Bankwest, the Document argues that it actually impaired \$1.286b worth of customer loans in order to conceal its alleged insolvency.⁵ A crucial flaw in this logic is that the impairment of loans and the raising of provisions actually reduces the profit of an entity or increases its loss (as the case may be). Accordingly, impairment of loans would facilitate the onset of insolvency or exacerbate insolvency; it would not assist in concealing it.

In respect to CBA, the Document argues that it determined prior to completion of the acquisition to impair \$867m worth of Bankwest customer loans. The argument seems to be that CBA would benefit by doing this as it would have a commensurate reduction in the purchase price (ie, the argument suggests that \$867m together with the \$1.286b of impairments mentioned in the preceding paragraph were factored into a so-called upfront 'discount' to the purchase price for Bankwest⁶). Allegedly, it was then up to CBA to ensure that it impaired customer loans of a value equal to \$867m in order to ensure that it would not have to fund those loans and could also obtain tax and other benefits by doing so. This argument fails to take into account the fact that impairment of a loan does not impact the funding obligations of an acquiring bank in this context. The impairment provisions or expenses that existed at 19 December 2008 or at any time after that date had absolutely no impact whatsoever on the funding obligations that CBA assumed under the share sale agreement. This is due to the fact that the funding had already been injected into Bankwest by HBOS and it was therefore incumbent on CBA to repay that amount (unaffected in any way by impairments) to HBOS.

A further critical flaw relating to the so-called 'discount amount' relates to the manner in which the \$2.153b figure is calculated. A table setting out how the author of the Document asserts the figure is calculated is set out below:⁷

Pre-acquisition Bankwest Impairments	
Impairment Period	Impaired Amount
At time of Acquisition 19-Dec-08	
Reported in year-end Jun 2009	\$770m
Reported in half-end Dec 2010	\$212m
Reported in half-end Dec 2010	\$304m
TOTAL	\$1,286m
Pre-acquisition CBA Impairments	
Impairment Period	Impaired Amount
19-Dec-08 to 30-Jun-09	\$113m
01-Jul-09 to 30-Jun-10	\$754m
TOTAL	\$867m
TOTAL IMPAIRMENTS	\$2,153m

⁴ See page 15 of the Document.

⁵ See page 15 of the Document.

⁶ See pages 3 and 15 of the Document.

⁷ See page 14 of the Document.

The amount of \$770m listed in the first row of the column entitled 'Impaired Amount' is incorrectly described as an impairment amount. The figure of \$770m is the amount of acquired Gross Impaired Assets (ie, the headline value of all loans which had some level of impairment at the balance date). The actual sum of all acquired provisions for the total Bankwest portfolio (including the impaired loans) at the relevant date was \$630m. The amounts of \$212m and \$304m listed in the second and third rows of the same column relate to the same impairment expense reported for the June 2010 financial year; \$212m is the after tax figure and \$304m is the pre-tax figure. By including both amounts in the table, the author of the Document is either deliberately double counting or is unable to recognise pre and post tax amounts. After incorporating the above corrections, the aggregate amount that should be shown in the table above is \$1.801b, not \$2.153b. While this error discredits the 'discount theory' put forward in the Document, other factual matters are also fatal to the arguments embraced by the author.

The concept that Bankwest and CBA 'pre agreed' impairments prior to completion so that they could use these to set off against a \$2.153b impairment provision given effect to through an alleged agreed discount mechanism requires a suspension of belief. The share sale agreement which gave effect to CBA's acquisition of Bankwest limited CBA's ability to recover any impairment expenses from HBOS. Such impairment expenses could only be recovered if:

- those impairment expenses had crystallised as at 19 December 2008; and
- the relevant impairment expense had not actually been reflected in the draft completion balance sheets for Bankwest.

Any loan impairment expense that CBA or Bankwest recognised during the balance of FY2009 or in any subsequent financial year did not have any potential whatsoever to influence any adjustment to the purchase price. All such impairment expenses created after 19 December 2008 (eg, the \$304m, \$113m and \$754m specified in the Document, as set out in the table above) had a direct negative impact on Bankwest's and CBA's profitability. Therefore Bankwest and CBA had no financial incentive to impair loans.

Indeed, the parties engaged an independent expert in order to assist the parties determine the correct level of impairment provisions that should be recognised as at 19 December 2008. The outcome of that process was an upwards adjustment of the initial purchase price by an amount of \$26m. The determination of the independent expert conclusively finalised loan impairment matters in this context. While the determination was delivered in July 2009, the impact of it was included in the accounts for FY2009.

For completeness, CBA categorically denies that any form of separate or collateral financial benefit was advanced to CBA prior to acquisition that would compensate it for any post acquisition impairments.

Viewed in this light, the 'discounting theory' and the 'pre-agreed impairment theory' lack any foundation. This is so because they are premised on being able to link the carrying value of \$4.25b on HBOS plc's accounts to the actual purchase price which is simply not the case.

3. *Error #3 – Purchase price adjustment provisioning misunderstanding*

The Document also contains speculation about a provision appearing in CBA's half yearly profit announcement made in February 2009. The reason why this speculation is erroneous is explained below.

HBOS and CBA agreed in October 2008 that the initial purchase price would be \$2.1b. They also agreed that the price could be adjusted upwards or downwards depending on the capital position of Bankwest as at 19 December 2008. The capital position of Bankwest at that date would be reflected in the final completion balance accounts which were to be settled mid-2009. In its half yearly profit announcement of February 2009 CBA made an estimate of the

total consideration it may have to pay HBOS for Bankwest. It had to make the estimate of this amount because the final completion balance sheets for Bankwest (as at 19 December 2008) were not available when it prepared its half yearly profit announcement. CBA's estimate was based on unaudited, draft management accounts for Bankwest which indicated that a provision of \$328m should be made. However, the final completion accounts settled by an independent expert reflected a much less favourable capital position than the unaudited, draft management accounts had provisionally indicated. Consequently, the ultimate adjustment to the purchase price was much less than would have been the case if the management accounts had been an accurate reflection of the capital position. The conjecture set out on pages 7-9 of the Document concerning the provision of \$328m is completely wrong.

4. *Error #4 – Misunderstanding concerning goodwill*

The Document notes that HBOS plc reduced the value of goodwill in its accounts by £240m post-acquisition of Bankwest by CBA.⁸ It then proposes the sensational theory that this goodwill reduction 'is another price adjustment mechanism to hide the allowance given for future induced impairment CBA would later create through manufactured defaults.' The author of the Document is led into error by confusing HBOS plc's reduction of goodwill in its own accounts with the value of goodwill reflected in the separate Bankwest accounts. These two values are independent of each other. They do not need to match and in any parent-subsidary relationship there is a multitude of accounting reasons why they would not match.

5. *Error #5 – The Commonwealth Bank, Bankwest or any other prudentially regulated entity can arbitrarily impair performing loans*

The Document incorrectly alleges that prudentially regulated authorised deposit-taking institutions such as CBA can arbitrarily impair loan assets.⁹ As an authorised deposit-taking institution CBA is subject to various prudential standards which govern how it recognises impairments. Its policies also reinforce these standards.

For example, CBA was required to comply with APRA's Prudential Standard APS 220 – Credit Quality (January 2008) and related Guidance Notes set out when a loan is to be considered impaired. The following extracts from APS 220 Guidance Notes outline APRA's expectations and requirements (for the relevant period) concerning impaired asset identification and reporting:

Guidance Note AGN 220.1 Jan 2008

The appropriate recognition and measurement of impaired facilities (e.g. assets) are key elements in the accurate reporting of an ADI's risk profile, in the assessment of the adequacy of an ADI's provisioning and reserving policies and, most importantly, in the assessment of its capital adequacy.

AGN 220.1 Paragraph 7

A facility must be classified as impaired regardless of whether it is 90 days or more past due, when there is doubt as to whether the full amounts due, including interest and other payments due, will be achieved in a timely manner.

AGN 220.1 Paragraph 4

Factors that affect the collectibility of facilities include, but are not limited to:

- (a) indications of significant financial difficulty of a party to a facility; or*
- (b) breach of contract, such as a default or delinquency in interest or principal; or*
- (c) likelihood of bankruptcy or other financial reorganisation of a party to a facility; or*

⁸ See page 7 of the Document.

⁹ See for example pages 2 and 15 of the Document.

- (d) concessions in terms of a facility (e.g. interest or principal payments) granted to a party to a facility relating to such a party's financial difficulties; or*
- (e) changes or trends in default rates on categories of facilities which might be assessed for impairment on a collective basis; or*
- (f) any identified changes in the value of collateral or other sources of security which might bear on the collectibility of facilities; or*
- (g) disappearance of an active market in assets (including derivatives) held by an ADI relating to a given counterparty; or*
- (h) any other matter which might reasonably suggest to an ADI that a party to a facility may be unlikely to meet their contractual obligations.*

In addition, a corporation such as CBA must by law also comply with accounting standards such as AASB 139 - Financial Instruments - Recognition and Measurement in relation to the recognition of impairment and the related provisions. Further, the financial statements which reflect impairment expenses and provisions contain are audited which means there is independent oversight of the items actually reported in the applicable financial statements.

Further, identifying an account as impaired is a reporting requirement for both regulatory and financial purposes. The recognition of a loan as impaired cannot of itself determine the action taken with the customer. This is determined by the contractual agreements between a bank and the customer. In this vein, Bankwest confirmed in its submission to the Senate Economics Committee Inquiry into Post-GFC Banking Sector that the share sale agreement and the purchase price adjustment process did not have any impact on Bankwest's approach to dealing with its customers. It also stated that the acquisition did not cause any change to existing contractual arrangements between Bankwest and its customers and that it was not in Bankwest's interests, and it makes no commercial sense, to 'manufacture' defaults or to cause or increase impairment losses.¹⁰

6. *Error #6 - Commonwealth Bank could improve its regulatory capital position by defaulting customers*

The Document claims that CBA could benefit from a regulatory capital perspective by defaulting customers.¹¹ All individual provisions for individually impaired assets within Bankwest must be booked in Bankwest's books. The raising of a provision within Bankwest results in a reduction in net profit for the applicable year which has flow on effects to equity and therefore capital.

Bankwest and therefore CBA incurred substantial impairment expense on Bankwest loans since the acquisition of Bankwest over a number of financial years. Contrary to the author's contention set out in the Document, these impairment expenses reduced (not improved, as the author misleadingly suggests) the Group's profitability and therefore capital levels.

Conclusion

Thank you for the opportunity to respond to the allegations contained in the Document.

Yours sincerely,

David Cohen
Group General Counsel
Commonwealth Bank of Australia

¹⁰ Bankwest submission dated 12 June 2012.

¹¹ For example see pages 3 and 18 of the Document.