



18 May 2018

Simon Daley
Solicitor Assisting the Royal Commission

Dear Mr Daley

Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry – Response to letter dated 11 May 2018

We refer to your letter of 11 May 2018 advising that future hearings of the Commission will include consideration of lending for agribusiness purposes (the **Commission Letter**).

Our agricultural lending business is predominantly conducted through our Rural Bank business, although there is a relatively small portfolio of agricultural loans managed through our Bendigo Bank business.¹ Our comments in this response relate to our Rural Bank business.

You have identified issues raised by various reports in relation to agribusiness lending practices and we have commented on these below in Part A.

You have also asked, in relation to our letter of 29 January 2018 responding to the Commissioner's letter of 15 December 2017 (**Response**):

- (a) whether there is any feature of the Response that the Bank wishes to point to as relating to agribusiness lending; and
- (b) whether there is anything that the Bank wishes to add to its Response specifically in relation to agribusiness lending.

We set out our response to the Commission's questions in Part B.

Part A: Issues identified in paragraphs (a)-(i) in the Commission Letter

- 1 We address the issues we consider have direct relevance to our Rural Bank business below, including examples of changes to policies and procedures in response to relevant issues. We do this having regard to our ongoing consideration of recommendations of the Select Committee on Lending to Primary Production Customers (**Select Committee**) published in December 2017.
- 2 The Bank understands that a number of submissions were made by our agribusiness customers to the Select Committee. While the Bank does not consider that its conduct in relation to those complaints comprised misconduct, it accepts that, in some cases, there was conduct falling below community expectations and standards as defined in our Response, including the expectation that we assist customers when they are in difficulty and take account of individual circumstances (including unforeseen hardship) when collecting on money loaned out. Following the release of the Select Committee's report and recommendations, the Bank has begun a review of its policies and procedures to ensure its conduct meets or exceeds community standards and expectations. This review is ongoing, however the Bank expects to implement a number of changes to policies and procedures having regard to Select Committee recommendations. If there are any specific matters considered by the Select Committee that the Commission would like the Bank to respond to, please let us know and we would be happy to respond.

¹ As at 30 April 2018, Rural Bank's agribusiness portfolio included approximately \$5.5b of loans outstanding, while Bendigo Bank's direct agr business portfolio included approximately \$330m of loans outstanding.

(a) The appropriateness of the current agribusiness lending regulatory regime

- 3 While agribusiness lending is subject to substantially the same regulatory regime as general business lending, agribusiness involves distinct characteristics, including:
- generally involving family businesses;
 - intergenerational ownership structures, including planned debt across generations;
 - it is common that farming land is held in a personal capacity, with the customer's main residence on the farm property;
 - seasonal or sometimes annual income;
 - long lead times between investment and production;
 - vulnerability to environmental factors such as drought, disease, pestilence, flood, and fire;
 - vulnerability to global market forces, including commodity markets;
 - high capital costs of land, plant and equipment; and
 - low returns on assets.
- 4 Many of these characteristics introduce risks outside the control of the business or lender, which are difficult or impossible to mitigate. It is important for the regulatory regime, and any changes to it, to take into account specifically these characteristics in order to avoid unintended consequences for both customers and lenders. We have not undertaken a comprehensive review of the adequacy of the current regulatory regime having regard to these characteristics, though our experience with some aspects of the regulatory regime are described in the responses that follow. An example of a change that would be helpful in this context is a mandatory, nationally consistent farm debt mediation (*FDM*) scheme across Australia, discussed below (at paragraphs 33 and 34).

(b) The use of personal assets to secure a loan to an agribusiness customer

- 5 Rural Bank's customers are primarily family-owned businesses. These businesses have various business operations and structures. For example, some are run by individuals, others as family partnerships, and others through trust arrangements. Sometimes, businesses use a combination of these structures within one family business, with land ownership spread across various parties.
- 6 The most common security provided by Rural Bank customers is agricultural or pastoral land. In light of the ownership structures used, it is common that farming land is held in a customer's personal capacity. In the majority of cases, the customer's main residence is on the farm property. We also have a significant number of Rural Bank customers who provide livestock mortgages, and a smaller number with crop liens. In some cases, we hold a separate residential property, or separate investment property, as security.
- 7 Rural Bank has hardship and asset management policies which emphasise providing its customers with opportunities to preserve their equity and any underlying loan security. Enforcement is taken only after communication with the customer, any required or agreed mediation process, and after all other avenues have been exhausted.
- 8 If enforcement action is taken, Rural Bank will typically seek to realise the value of non-residential property assets, including livestock, crops, rural (non-residential) land, and equipment, before residential property assets.

(c) The placing of loans to agribusiness customers in default for a breach of a non-monetary default clause, material adverse change clause or financial indicator covenant

- 9 Rural Bank does not place loans to agribusiness customers in default solely for a breach of one or more non-monetary default clauses, such as a material adverse change clause, or breach of financial indicator covenants (although these may be listed along with a monetary default in default notices).
- 10 The new proposed Code of Banking Practice limits the circumstances in which non-monetary default-based action can be taken. Rural Bank is reviewing non-monetary default clauses having regard to these changes, and the Carnell Inquiry into small business loans recommendations about non-monetary default provisions.

(d) The length, or communication, of notice given by a bank to repay a loan to an agribusiness customer once the loan is placed in default

- 11 When a loan falls out of order, there is a balance between giving the customer time to bring the loan into order, and the risk that the customer's equity is likely to be eroded over time.
- 12 When the loan falls out of order, the relationship managers will typically speak with the customer to ascertain the cause and plans to deal with excesses and arrears. Relationship managers send a letter to the customer when the debt balance has been outstanding for more than 30 days and no arrangements are in place. Subsequent arrears letters are sent after 45 days, 75 days and 90 days. Rural Bank may extend the timeframes when letters are sent.
- 13 After 90 days, Rural Bank will typically issue a default notice, normally allowing a further 60 days to remedy the default. At this stage, the management of the account may be transferred to Rural Bank's asset management unit (**AMU**). Rural Bank's AMU procedures require the AMU manager to send a letter to the customer explaining that AMU is involved and inviting the customer to submit a repayment proposal. The AMU manager may also seek updated budgets, valuations and appraisals.
- 14 In NSW, Victoria and Queensland, both lender and customer are compelled to participate in a farm debt mediation process in relation to security comprising farm property or farm equipment. This process provides the customer with the opportunity to engage an independent advisor, usually a rural financial counsellor, to assist in preparation of budgets, perform a review of farm operations and performance, and discuss these with their bank in a formal mediation setting. At mediation, a strategy is usually agreed between the customer and Rural Bank to avoid further enforcement action. If the strategy to remedy the default is successfully achieved, no further action takes place. The FDM process also has prescribed notices and notice periods that must be observed by all parties.
- 15 In jurisdictions where FDM is not compulsory, Rural Bank offers to meet with customers and their advisors to, wherever possible, agree a way forward to remedy any default in much the same manner as would be achieved via a formal FDM process.
- 16 In addition to any FDM notice periods, there are further notice requirements and notice periods for mortgagee action against real property, as prescribed by respective state-based legislation.
- 17 In some circumstances, Rural Bank may agree to an extended period to remedy the defaults if it can substantiate how the default will be remedied. Should animal welfare be a concern, Rural Bank may shorten the period. Rural Bank often works with customers for years to ensure all avenues for rehabilitation are considered before taking recovery action.

(e) The refusal to roll-over loans to agribusiness customers on maturity, including the length, or communication, of notice given to agribusiness customers of such a decision

- 18 Rural Bank would not decline to rollover a loan to a customer unless extraordinary circumstances applied. In these instances, a review has been undertaken with communication between the customer and Rural Bank already taking place, and FDM requirements being observed.

(f) The use of unilateral variation clauses

- 19 Rural Bank's standard facility terms include scope for Rural Bank to change certain fees and charges, including a loan's interest rate, unilaterally with a prescribed notice period of 30 days. This form of unilateral variation provision is standard across the industry and is essential to respond to changing circumstances, including changes in market rates or changes in risk profile. It is an expectation of prudential regulators that banks appropriately charge for risk.
- 20 Although other provisions in Rural Bank's standard facility terms allow unilateral variation (for example, where an adverse change occurs to the customer's or guarantor's ability to comply with their documented obligations, the value or enforceability of security provided, or the financial position, management or operations of the business) they are not generally used. Rather, Rural Bank's preferred approach is to negotiate facility changes with its customers to agree amended contractual terms (including matters relating to facility limit, security, loan term, repayment amount and repayment frequency). Rural Bank usually documents agreed changes by way of a letter of offer or letter of variation, or by way of a deed of forbearance, which its customer signs after having the opportunity to review the relevant document and seek independent advice.

(g) Dealings with agribusiness customers in financial distress

- 21 Rural Bank works with customers in financial distress to minimise the impact of adverse circumstances, sometimes taking several years to progress difficult cases through to resolution. Rural Bank's Hardship Policy and Asset Management Policy emphasise Rural Bank's commitment to helping customers who are experiencing financial hardship, and to strive to provide customers with opportunities to preserve their equity and any underlying loan security.
- 22 Rural Bank's Hardship Policy, introduced in 2014, recognises that financial hardship can be caused by various factors including:
- unexpected changes in income and expenditure;
 - changes in employment status (such as loss of employment, reduced working hours);
 - significant life events (such as relationship breakdown, death in the family);
 - injury or illness; and
 - emergency events or natural disaster.
- 23 Rural Bank's policy is to provide hardship assistance to its customers who are willing to meet their repayments, but are unable to meet their current contractual debt obligations. A customer receiving financial hardship assistance from Rural Bank is expected to have the capacity to meet their obligations in the foreseeable future.
- 24 Rural Bank has developed and continues to evolve procedures to detect early signs of financial distress, including:
- monitoring principal and interest repayments to ensure the customer is meeting expected payment terms;
 - annual account reviews;
 - half-year portfolio reviews based on risk criteria;

- monitoring temporary limit increases and/or repeated loan limit requests to ensure appropriateness of purpose and/or ability to repay; and
 - stress testing of portfolios according to geographic area or industry to understand and predict broader financial stressors.
- 25 By way of example, Rural Bank conducted a stress test on its dairy portfolio in November 2015, stressing production costs, fodder and water. Any customers identified as 'at risk of financial hardship' under these stressed conditions were contacted to discuss how they might strengthen their position. Therefore when the Murray Goulburn milk price dropped in May 2016, Rural Bank had clarity of which customers needed additional support to manage financial hardship, and was able to immediately deploy relationship managers to proactively contact customers with a view to what (if any) hardship or cash-flow issues they might expect.
- 26 When a customer does experience financial distress, the procedures explained above (at paragraphs 11 to 17) apply. Enforcement is considered a last resort, and is taken only after communication with the customer, any required or desirable mediation process, and after all other avenues have been exhausted.
- 27 In other instances Rural Bank may have been too accommodating of customers attempting to trade out of a stressed situation, when earlier action may have preserved equity in assets. The industry as a whole could increase awareness of the impact that mental health, relationship breakdowns and death have on family farming businesses. The presence of these factors are over-represented in farming businesses that are in financial stress. Conversely, family farms that are not experiencing these factors appear to be more resilient in dealing with financial stress caused by seasonal and/or commodity price fluctuations that customers experience.
- 28 As an example of initiatives in this area, Rural Bank has entered into a partnership with the National Centre for Farmer Health (**NCFH**). Under this partnership, Rural Bank has engaged the NCFH to train bank staff to identify (and appropriately refer to professional help) those customers suffering from emotional stress or mental health issues. The bank has also recently rolled out training to frontline and credit staff on understanding hardship. This training program has been completed by more than two-thirds of credit and frontline staff, and is ongoing.

(h) The arrangements that have been in place, from time to time, between banks and valuers, independent accountants, receivers and managers appointed or engaged by the entity

- 29 Rural Bank maintains a panel of valuers, in accordance with its Panel Valuers Policy. The panel comprises a small panel of specialist agricultural firms, which are required to demonstrate appropriate qualifications and professional requirements. The valuers are capped to specific valuation levels depending on expertise, experience and quality assurance processes.
- 30 Rural Bank maintains a centralised valuations team to engage and instruct all valuations, and to review all valuation reports. Since 2011, Rural Bank's valuation policies, procedures and practices have been subject to ongoing review and improvement.
- 31 Rural Bank does not maintain any formal agreements with independent accountants. On an infrequent basis, independent accountants are engaged to review a customer's business. When engaging independent accountants, Rural Bank ensures that the customer is agreeable to the engagement of the accountant. The role and purpose of the accountant is explained, and the scope of the work to be undertaken is outlined and sometimes negotiated between the parties.
- 32 Rural Bank maintains an approved list of appropriately qualified and experienced receivers and managers, which is reviewed annually in accordance with Rural Bank's asset management policy. Receivers are appointed in accordance with Rural Bank's policies and procedures and the

customer is informed in advance. The appointment of receivers is not a frequent occurrence – for example, between 2009 to 2018, Rural Bank has appointed receivers in relation to ten customers.

(i) The reach and efficacy of external dispute resolution schemes available to agribusiness customers

- 33 As discussed above (at paragraph 14), using farm debt mediation has been effective in the large majority of cases at avoiding enforcement. The adoption of a national FDM scheme would have the effect of compelling both Rural Bank and farm businesses to participate in good faith negotiations in instances of financial distress. This negotiation process would serve to reduce excessive delays and costs to the customer and in so doing preserve the equity and wealth of the farming business in question.
- 34 As explained above, farm lending disputes often involve specific issues distinguishing them from other small business financial disputes. For this reason, farm lending disputes require specialist expertise and knowledge to manage the potential complexity of the issues involved. FDM provides a forum through which specialist mediators endeavour to resolve farm lending disputes having regard to these difficult issues and restrictive time frames. Accordingly, farm lending disputes should be directed through the various existing state-based FDM processes in the first instance. Where such a dispute is directed to the Financial Ombudsman Service (**FOS**), FOS should exercise its general discretion to exclude the dispute from its Terms of Reference prior to the FDM process. For any dispute escalated to FOS as a result of either a refusal to mediate or following an unresolved mediation, it is our view that FOS should have a specialist internal team capable of dealing with the intricacies associated with agribusiness lending.

Part B: Features of the Response relating to agribusiness lending

- 35 The Bank's Response identified categories of conduct which may be considered to constitute "misconduct" or conduct falling below "community standards and expectations", together with illustrative examples as appropriate.
- 36 These categories of conduct were developed by reference to a review of the Bank's conduct including in relation to Rural Bank. As identified in your letter, Example 15 in our Response concerned issues we identified in respect of loans to certain Rural Bank customers in the Queensland cattle industry.
- 37 Further examples of conduct falling within the categories identified in our Response relating to agribusiness lending are provided below.

Dishonesty and fraud (Response 1.3(e))

Example 16

- 38 This example relates to matters that are the subject of Notice to Produce NP-306 issued by the Royal Commission to the Bank. In December 2013, a customer (Ms C) reported to Rural Bank that her signature had been forged by her husband (Mr C) on documents to increase the limit of their agricultural loan facilities, and that her signature on the documents had been improperly witnessed. Some of the applications had been witnessed by an agent of the bank, and others by Mr and Ms C's daughter. Ms C reported that the increases to the facility limit over a period of several years had been made without her knowledge.
- 39 Upon receipt of the allegations, Rural Bank advised Ms C to report the matter to the police. Ms C reported the allegations to the police approximately 15 months later, in early 2015. The bank did not proactively investigate Ms C's allegations itself, relying instead on the police investigation, which is yet to be concluded.

- 40 Rural Bank, Mr C and Ms C conducted a FDM where an agreed outcome was reached to sell their assets with the proceeds to be paid to Rural Bank. After asset sales were completed, an outstanding debt remained, which Rural Bank ultimately waived in relation to Ms C.
- 41 Rural Bank acknowledges that its conduct after Ms C reported the alleged forgeries to Rural Bank fell below community standards and expectations as defined in our Response, including the expectation to listen to our customers and respond to their needs, and to assist customers when they are in difficulty and take account of individual circumstances (including unforeseen hardship) when collecting on money loaned out. We will initiate an immediate review of processes and procedures with a view to ascertaining appropriate remediation and take steps to prevent recurrence.

Interest and Fees (Response 1.3(f))

Example 17

- 42 In 2016, an incident occurred where a pro-rata quarterly account service fee was incorrectly charged on Season Overdraft and Agrimanager products. The full quarterly fee was being charged to the account at the end of the charge period, whereas the fee should have been charged on a pro-rata basis calculated by reference to the number of days remaining in the charge period.
- 43 An analysis of the financial and customer impacts was completed and it was concluded that the error impacted 2,164 customers and the overall financial impact was \$163,461. Letters were sent to affected customers. Customers were refunded the amounts they were overcharged and procedures have been strengthened to help limit the chance of another occurrence. The incident was reported to ASIC. ASIC responded and acknowledged the error.

Example 18

- 44 Rural Bank identified an incident where 81 customers were underpaid interest to their term deposit accounts for a period of up to five years, with amounts ranging from \$0.21 to \$2,579.94. The bank remediated the customers fully. The overall financial impact was \$10,166.10. A new process (and training) was implemented around manual intervention on term deposits and exception reporting is now run to identify any further errors, of which there have been none.

Failure to follow internal policies (Response 2.3(b))

Example 19

- 45 In October 2015, a relationship manager verbally approved a loan above the manager's designated lending authority. The customers, assuming their funding was approved, went to a property auction and successfully bid on the property. When the customers formally applied for a loan, the application did not meet the lending criteria and was declined. The customers threatened legal action.
- 46 Rural Bank settled the complaint by paying the deposit amount to the customers as compensation. This incident occurred due to a failure of a staff member to follow internal procedure. The staff member's employment was terminated and a communication was sent to staff reminding them to follow internal policy and procedures.

Lending practices (Response 2.3(c))

- 47 As stated in our Response, we have identified instances where Rural Bank's lending practices may have fallen below community standards on the basis that appropriate inquiries and verifications were not made prior to the approval of loans.

- 48 Example 15 in our Response referred to a number of loans taken out by customers in the Queensland cattle industry which became non-performing, in which contributing factors included an over-reliance on security values and loan serviceability not being appropriately established.
- 49 Furthermore, we have identified that loan performance was exacerbated by inadequate loan management, with evidence of a lack of follow up of excesses, arrears and out of order accounts, failures to conduct timely reviews or collect updated farm performance information, failures to otherwise detect signs of financial distress at an earlier point in time and failures in relation to our enforcement processes.
- 50 Another issue identified in relation to the loans referred to in Example 15 was a failure to make appropriate inquiries and verification of valuations and appraisals, including failures to ensure valuation accuracy, independence and integrity, and failure to physically visit and inspect livestock and properties. In some instances, the security provided included assets where the value was not indicative of the economic returns achievable, further impacting loan serviceability issues.
- 51 As stated in our Response, Rural Bank has implemented a number of changes to its policies and procedures in response to these issues. Since 2011, this has involved ongoing and continual review and amendments and improvements to policies, procedures and practices, including:
- rebalancing the bank's focus on loan serviceability through staff training and implementation of new processes and policies;
 - implementing new processes and policies relating to valuations and appraisals; and
 - implementing new governance practices, including the introduction of the Management Credit Committee to monitor the credit risk profile of Rural Bank and the Lending Standards Review Committee to investigate potential lending policy breaches.

We are pleased to continue to offer our cooperation to the Commission. Please feel free to contact me should you have any matters in our response that require clarification.

Yours sincerely



Mike Hirst

Managing Director
Bendigo and Adelaide Bank Ltd