

Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Response to RFI-7 – Westpac Banking Corporation

CONFIDENTIAL

Response of Westpac Banking Corporation to Royal Commission request regarding agribusiness lending dated 11 May 2018

Royal Commission into Misconduct in the
Banking, Superannuation and Financial
Services Industry

23 May 2018

Introduction to Westpac's approach to agribusiness lending

1. Westpac welcomes the Royal Commission's invitation dated 11 May 2018 to provide information about its practices of lending to agribusiness customers (the **11 May Request**). The Commission's invitation follows a number of related requests and responses outlined below which are relevant to this response. Westpac commences this response with a brief introduction to its approach to agribusiness lending.
2. Westpac is committed to the primary production sector as a core component of Australia's future economic prosperity and success. As at 30 September 2017, Westpac had approximately 30,000 customers in the agricultural, fisheries and forestry sectors with business loans totalling over \$10.4 billion. Westpac provides a range of services to those customers including lending, deposits, transaction and risk management services.
3. For the purposes of this response, Westpac adopts a definition of agribusiness as being the business of "agriculture, forestry and fishing", as that expression is understood and used within the Australian and New Zealand Standard Industrial Classification – Codes and Titles.¹
4. Westpac seeks to design and offer products responsibly to meet the needs of agribusiness customers in line with the expectations of those customers and the community.
5. Authorised Deposit-Taking Institutions (**ADI**), including Westpac, are regulated by the Australian Prudential Regulation Authority. APRA Prudential Standard APS 220: Credit Quality (**APS 220**) requires ADIs to control credit risk by adopting prudent credit risk management policies and procedures. In addition, APS 220 requires a 'current' assessment of the value of collateral held.
6. Westpac's credit risk framework and policies encompass all stages of the credit cycle, including: origination, evaluation, approval, documentation, settlement, ongoing administration and issues management. For example, Westpac has established product-based standards for lending to businesses including minimum serviceability standards and maximum loan to security value ratios.
7. Westpac's credit risk management framework also incorporates the assignment of a risk profile to individual customers and Westpac's credit risk appetite (which can vary over time).
8. For larger customers, Westpac evaluates credit requests by undertaking detailed individual customer and transaction risk analysis (the 'transaction-managed' approach). This analysis considers year-in-year-out budgets for new business proposals to determine the long term

¹ The ANZSIC Codes, as they are known, were jointly developed by the Australian Bureau of Statistics and Statistics New Zealand to make it easier to compare industry statistics between the two countries and with the rest of the world. In summary, the Codes are organised by Division, Subdivisions, Group and Class Codes and Titles. Division A of the ANZSIC Codes is titled "Agriculture, Forestry and Fishing". These businesses are sometimes referred to as "Primary Producers". More information about the ANZSIC Codes can be found at the Australian Government's Department of Industry, Innovation and Science website (<https://industry.gov.au/science/internationalcollaboration/acsr/Pages/ANZSICCodes.aspx>) and the Australian Bureau of Statistics website (<http://www.abs.gov.au/ausstats/abs@.nsf/0/20C5B5A4F46DF95BCA25711F00146D75?opendocument>).

financial viability of the agribusiness operations and also the equity position of the business. Such customers are assigned a customer risk grade representing Westpac's estimate of their probability of default. Westpac focuses in particular on the performance of key financial risk ratios, including interest coverage, debt serviceability and balance sheet structure.

9. For all borrowers, Westpac typically obtains security, including a mortgage over property, a general security agreement over business assets and/or guarantee(s) from the director(s).
10. The effectiveness of Westpac's credit risk management framework is demonstrated in its low default and arrears rates, low number of 'impaired' customers and low numbers of recovery actions. As at 30 September 2017, the percentage of Westpac's Australian agribusiness portfolio assessed as impaired represents 0.17% of the overall Australian agribusiness portfolio total committed exposure.²

² Total committed exposure is the maximum amount of credit exposure which Westpac is committed to incur to a customer.

Part A - Previous responses to the Royal Commission

11. In its 11 May Request, the Royal Commission requested Westpac provide information as to whether there is any feature of Westpac's responses of 29 January 2018 and 13 February 2018 that Westpac wished to point to as relating to agribusiness lending, or anything Westpac wished to add to its responses specifically in relation to agribusiness lending.
12. Westpac notes that, similarly, by letter dated 5 April 2018, the Commission requested that Westpac provide information as to whether there is any feature of Westpac's responses of 29 January 2018 and 13 February 2018 that Westpac wished to point to as relating to SME lending, or anything Westpac wished to add to its responses specifically in relation to SME lending. On 20 April 2018, Westpac provided its response (the **20 April 2018 Response**).
13. Issues relevant to agribusiness lending were covered in the 20 April 2018 Response because SME lending includes a portion of Westpac's agribusiness lending activity. The majority of Westpac's agribusiness lending customers would be classified as SME. The themes set out at paragraphs 85, 87, 88 and 90 of the 20 April 2018 Response that arise out of SME lending are themes that also arise in respect of agribusiness lending.
14. The items in Westpac's 29 January 2018 or 13 February 2018 responses that relate to agribusiness lending are found in tranche 3 of Westpac's Production to the Royal Commission dated 27 February 2018 in rows 34 and 102 of the Business Bank schedule, and row 65 of the BTFG schedule.
15. Westpac does not seek to add anything further to its 29 January 2018 and 13 February 2018 responses other than the matters set out in the 20 April 2018 Response and Part B below.

PART B – Issues raised by the Royal Commission

16. In the 11 May Request, the Royal Commission has noted particular issues raised in previous inquiries and also in submissions received by the Royal Commission. Westpac has addressed those particular issues in this section of its response. The specific issues noted by the Commission are as follows:

- (a) the appropriateness of the current agribusiness lending regulatory regime;
- (b) the use of personal assets (including the assets of family members of the borrower) to secure a loan to an agribusiness customer;
- (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;
- (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;
- (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;
- (f) the use of unilateral variation clauses;
- (g) dealings with agribusiness customers in financial distress;
- (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; and
- (i) the reach and efficacy of external dispute resolution schemes available to agribusiness customers.

17. Westpac addresses those issues adopting the numbering in the 11 May Request.

Item (a) of the 11 May Request - the appropriateness of the current agribusiness lending regulatory regime

18. Westpac considers that there are opportunities to enhance transparency and certainty for customers in the agribusiness sector by changes to some aspects of the existing regulatory regime. Westpac supports key reforms including:

- (a) a revised Code of Banking Practice with enhanced obligations for banks to agribusiness customers (the revised code was lodged with ASIC on 19 December 2017 and is currently awaiting approval);

- (b) publication of industry guidelines on valuation practices and the appointment of third parties (including receivers and managers and investigative accountants); and
- (c) the creation of a nationally consistent farm debt mediation model to (i) ensure that primary producers in all states and territories have access to it, (ii) enhance consistency for primary production customers experiencing financial difficulty, (iii) create more procedurally efficient processes for borrowers who might have multiple properties across different states and territories, and (iv) ensure better outcomes for both lenders and borrowers.

Items (b) to (h) generally of the 11 May Request

19. As noted in paragraph 13 above, the majority of Westpac's agribusiness lending customers are classified as SME. As such, Westpac adopts parts of the 20 April 2018 Response and in particular Part A of the 20 April 2018 Response in response to Items (b) to (h) of the 11 May Request.
20. In relation to Items (c), (g) and (h) of the 11 May Request, Westpac also notes the following additional points in relation to agribusiness lending specifically.

Item (c) of the 11 May Request - 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 covenants

21. Westpac does not have a practice of engineering a business default. For example, it does not have a practice of deliberately reducing, through valuation, the value of securities held by the bank to increase the loan-to-value-ratio (**LVR**) for the purpose of putting the loan in non-monetary default (see further pages 11 and 12 of the 20 April 2018 Response).
22. Immediate enforcement of security due to a non-monetary default may occur for an Insolvency Event i.e. the appointment of an Administrator/Liquidator or Receiver and Manager or bankruptcy.
23. Westpac's preference is to work with the customer to reach a mutually agreed work-out position taking into consideration the customer's business plan, forecasts and cash flow (as to which, see further below), and it is in both Westpac's and the customers' interests that this occur, as outlined further in paragraph 30 below.
24. Default events cannot be restricted to 'monetary events of default' as other appropriate non-monetary events of default need to be retained by necessity. Examples would include insolvency, illegal behaviour or fraud, change in ownership, loss of licence or supply agreement.
25. Agricultural loans less than \$3 million have had financial covenants removed e.g. LVR and Interest Coverage Ratio and other non-monetary defaults other than those permitted by the unfair contracts legislation (see further paragraph 47 of the 20 April 2018 Response).

26. As part of its response to the recent Inquiry into Business Lending by the Australian Small Business and Family Enterprise Ombudsman (**ASBFEO**), Westpac has implemented a new simplified, plain English small business lending contract for certain core business lending products which it plans to ultimately expand to all small business lending products across its brands. These will be available to small agribusiness customers.
27. In addition to Westpac updating the new small business loan documentation, Westpac is developing a supporting one page summary for small business loan facility agreements which will provide greater clarity on events of default, applicable covenants and relevant pricing under the terms of the contract. This summary will become available once the new Banking Code of Practice comes into effect.

Item (g) of the 11 May Request - dealings with agribusiness customers in financial distress

28. There are a variety of factors that may lead a business to experience financial difficulty, including economic downturn, business management capability or internal conflict, change in personal circumstances, fraud, overtrading and specific events such as flood, drought and fire. Westpac acknowledges the stress these events place on primary producers, their families and communities. It understands that lending to agribusiness customers requires a long-term view on the position of its customers through cycles and seasons.
29. Westpac has a long history of working with farmers through business, weather and seasonal cycles and changes in market conditions. Every matter of financial difficulty in a business is dealt with by Westpac on a case-by-case basis to ensure Westpac can respond flexibly to the circumstances of individual customers and a customer-specific strategy can be determined and agreed. There is no standard time period provided to borrowers to rectify a default event. Nor is there a standard form of assistance offered.
30. Working with customers to restore their financial position is also in Westpac's commercial interests. Westpac's original credit assessment is based on the customer's ability to service the loan, not the enforcement of security. A customer who is able to recover their financial position is more likely to be able to repay their principal loan amount. It also reduces costs to the customer and the bank (e.g. by avoiding the costs associated with insolvency) and maintains value in the business.
31. Westpac's priority, wherever possible, is to work with its agribusiness customer to find solutions that will, as far as possible, seek to ensure the customer's business is sustainable and can be returned to good health.
32. In practice, the consequences of any event of default (monetary or non-monetary) are not usually an immediate acceleration of the loan and commencement of enforcement action to realise security and/or take possession of assets (which could include the appointment of an Administrator/Liquidator or Receiver and Manager). Rather, a review of the customer's financial position and consideration of other appropriate options would be a common response. Often

- there will be a substantial period of negotiation where the default may be remedied before it reaches the stage of enforcement.
33. In considering how to respond to a default, Westpac assesses the nature of the default including, among other things:
- (a) the stress under which the customer is placed;
 - (b) whether the default is capable of being rectified;
 - (c) the likelihood of success of the rectification strategy; and
 - (d) the customer's overall approach to addressing the event of default.
34. Support may involve renegotiating the customer's loan facilities through a forbearance/standstill arrangement, whereby the customer acknowledges default and is given 'breathing space' by way of an agreed extended period of time to resolve their financial difficulties, provided performance milestones are met. For example, this may include the extension of loans that have or will expire, waiver of scheduled loan repayments or an agreement on a period of time where no principal repayments are made. It may also include freezing credit card and home loan repayments for a period of time to provide some additional breathing space.
35. In addition, it may be appropriate for Westpac to engage professional firms (generally with the customer's consent and co-operation) such as investigative accountants, particularly where there is a pattern of covenant breaches. Westpac may also offer to engage in mediation with the customer, involving a neutral third party, to assist the customer formulate and agree to acceptable outcomes. Westpac also encourages its customers to use Rural Financial Counsellors and use independent mediators to help reach agreement on a debt reduction strategy.
36. Westpac has a comprehensive disaster relief package to assist customers through unforeseen events such as floods, drought and fire.³ The package is designed to ensure that viable operators are able to stay on their properties and underpin the long-term sustainability of their farms.
37. As noted above, the effectiveness of Westpac's credit risk management framework is demonstrated in its low default and arrears rates, low number of 'impaired' customers and low numbers of recovery actions. As at 30 September 2017, the percentage of Westpac's Australian agribusiness portfolio assessed as impaired represents 0.17% of the overall Australian agribusiness portfolio total committed exposure.

³ See information about Westpac's disaster relief on its website (<https://www.westpac.com.au/business-banking/industries/agribusiness/disaster-relief/>).

Item (h) of the 11 May Request - 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

38. In addition to adopting its 20 April 2018 Response on this issue, Westpac acknowledges that there are opportunities to enhance transparency and certainty for customers including information about the appointment of third parties such as insolvency practitioners and the valuation process.
39. As a member of the ABA, Westpac supports the industry's commitments under the ABA Six Point Plan and the Better Banking initiatives to ensure high standards of conduct across the industry. Key reforms include a revised Code of Banking Practice with enhanced obligations for banks to agribusiness customers and industry guidelines on valuation practices and the appointment of third parties, including Receivers and Managers and investigative accountants (as noted above, the revised code was lodged with ASIC on 19 December 2017 and is currently awaiting approval).

Item (i) of the 11 May Request - The reach and efficacy of external dispute resolution schemes available to agribusiness customers

40. In accordance with its obligations under the ABA Code of Banking Practice, Westpac provides customers with access to an independent external dispute resolution (EDR) service. Retail and small business customers of Westpac have access to EDR through the Financial Ombudsman Service. However, Westpac considers that EDR schemes for primary producers could be enhanced.
41. As noted in paragraph 18(c) above, Westpac strongly supports the creation of a nationally consistent farm debt mediation model to enhance consistency for primary production customers experiencing financial difficulty. In Westpac's experience, the involvement of an independent farm debt mediator increases the likelihood of a mutually successful outcome.
42. Westpac also supports the Government's establishment of the Australian Financial Complaints Authority (AFCA), with the new 'one stop shop' enabling more small businesses to have access to financial EDR if required.⁴ In particular, small business primary production producers can now apply to AFCA concerning disputes about credit facilities of up to \$5 million, with a maximum compensation of \$2 million available. It is expected that AFCA will start accepting complaints no later than 1 November 2018.⁵

⁴ See the *Treasury Laws Amendment (Putting Consumers First – Establishment of the Australian Financial Complaints Authority) Act 2018*. The Bill passed both houses of the Australian Parliament on 14 February 2018. AFCA will replace three existing EDR bodies: the Superannuation Complaints Tribunal, the Financial Ombudsman Service and the Credit and Investments Ombudsman.

⁵ ASIC, 'ASIC welcomes establishment of the Australian Financial Complaints Authority' (Media Release 18-04MR, 14 February 2018).