

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

SMALL-MEDIUM ENTERPRISE LENDING

ANZ SUBMISSION IN RESPONSE TO THE COMMISSION'S LETTER DATED 5 APRIL 2018

A. INTRODUCTION AND GENERAL OBSERVATIONS

Introduction

1. By a letter dated 5 April 2018, the solicitors assisting the Commission invited ANZ to identify features of its Submissions dated 29 January 2018 (**January Submission**) and 13 February 2018 (**February Submission**) that relate to certain aspects of its business lending activities and, if it wished, to add to the Submissions as they relate to those activities.
2. Appendix 1 contains the defined terms used in this Submission.
3. Broadly, ANZ's business lending activities can be divided into two parts:
 - (a) Corporate and Institutional lending which generally involves lending to large and relatively sophisticated business customers whose requirements can be complex and/or require bespoke solutions (these lending relationships are generally administered using ANZ's CACHE IT system); and
 - (b) Commercial lending to small to medium-sized business (**SME**) customers, whose lending requirements typically involve amounts up to \$10 million in most sectors and up to \$50 million in the case of larger customers and customers in particular sectors such as agriculture and property (these lending relationships are generally administered using ANZ's CAP IT system).
4. ANZ's core business lending products comprise business overdrafts, term loans, commercial bills, bank guarantees and asset finance products.¹ The majority of ANZ's business lending activities proceed without dispute between the parties and with low levels of delinquency.
5. For consistency, ANZ has prepared this Submission on the same basis as the Commission has agreed² that ANZ should produce documents and evidence in respect of its business lending operations: by limiting its Submission to its core business lending products as they relate to its commercial lending activities (**SME lending**).

SME lending at ANZ

6. ANZ's SME lending is typically advanced to small to medium-sized business customers with total business lending (**TBL**) of up to \$10 million (or higher in the case of customers of its Specialist Distribution (**SD**) team). It is managed by ANZ's Small Business Banking (**SBB**), Business Banking (**BB**), SD and Private Banking³ teams. Each of these teams has its own General Manager, sales and operational support teams.

¹ For the purposes of this Submission, non-core business lending products include commercial credit cards, commercial margin lending and trade finance products. Other IT systems will also apply to some of ANZ's core lending products. For example, ANZ's provision of asset finance products is generally administered using ANZ's ELS/AMBIT IT system.

² Please see: (a) the letter dated 23 March 2018 from Ashurst to the solicitors assisting the Commission in relation to the scope of NP-131; (b) the email timed at 4.53pm on 26 March 2018 from the solicitors assisting the Commission to Ashurst in respect NP-131; and (c) the letter dated 12 April 2018 from Ashurst to the solicitors assisting the Commission in relation to the scope of the Commission's witness statement request in respect of Rubric 3-2.

³ Private Banking relates primarily to sophisticated, high-net worth individuals. While it involves a small amount of business lending to its customers, this lending is incidental to the other services provided to those customers.

7. SBB and BB together account for most of ANZ's commercial lending customers, by both volume and TBL. Whether a particular customer⁴ is managed by SBB or BB principally depends on the TBL. SBB typically deals with customers who have TBL of up to \$1 million. BB typically deals with customers who have TBL of between \$1 million and \$10 million.
8. There are exceptions to these monetary thresholds. For example, some customers with TBL below \$1 million are required to be managed by BB, rather than SBB. These include: (a) customers whose loans call for ongoing management or supervision by ANZ (such as construction loans, which require the monitoring of progressive payments) or involve a more complex product not distributed by SBB (such as a commercial bill); and (b) customers who for other reasons (including relationship continuity, growth potential or industry specialisation) are more appropriately managed by BB rather than SBB, despite the amount of their TBL.
9. SD deals with the following types of customers, who typically have TBL of between \$5 million and \$50 million and whose lending requirements are generally more complex than other SME lending customers:
 - (a) "Emerging Corporate": medium-sized business customers.
 - (b) "Specialised Agribusiness & Commercial": typically ANZ's larger agricultural or commercial customers who are located or operate in regional areas.
 - (c) "Property": generally specialised property business customers engaged in either property development activities or larger property investment transactions.
 - (d) "Health": customers engaged in the health services industry, such as medical practitioners, childcare providers, dentists and pharmacies. Unlike most other SD customers, health customers may have TBL of less than \$5 million, but are managed by SD primarily by reason of the specific industry in which they operate.

Approach

10. In preparing this Submission, except where otherwise stated, ANZ has adhered to the approach described, and the definition of "misconduct" set out, in sections 4A and 4B of the January Submission, and has adopted the defined terms in the January Submission.

Community standards and expectations for SME Lending

11. While there is considerable overlap in community standards and expectations (**CSEs**) with respect to consumer lending and SME lending⁵, there are also some important points of divergence. Differences in the regulatory regimes and protections applicable to each type of lending, as well as recognition of the desirability of entrepreneurial enterprise and economic growth in the SME sector, give rise to a community expectation of greater flexibility in approach with regard to SME lending. That flexibility is necessary because of the vast array of circumstances and business opportunities that ANZ's SME lending customers present. Further, CSEs will vary depending on the type of SME lending customer in question, having regard to the nature of the business undertaken and the volume and complexity of the lending.
12. The *Australian Securities and Investment Commission Act 2001* (**ASIC Act**) provides general protections for SME borrowers, through the prohibition of unconscionable and misleading or deceptive conduct. The ASIC Act was amended to extend the unfair

⁴ The term "customer" in this context may refer to a corporate group that contains a number of borrowers who are related by, for example, ownership, influence and/or security structure. Applicable monetary limits relate to the total value of all ANZ business facilities advanced to such a group.

⁵ For example, SME lending customers expect, and are entitled to expect, the same standard of service as consumers in relation to the operation of ANZ's policies, systems and processes.

contract terms jurisdiction to small business contracts from 12 November 2016.⁶ ANZ has removed certain terms from its small business loan contracts.⁷ The current (2013) Australian Bankers Association (**ABA**) Code of Banking Practice (**CBP**), which ANZ regards as an encapsulation of CSEs,⁸ sets out standards of good banking practice with respect to consumer and SME lending. These include, for example, acting fairly and reasonably towards customers, having regard to prudential requirements in the provision of services, and exercising the care and skill of a diligent and prudent banker in relation to the provision of credit.⁹ The CBP is subject to independent review from time to time to keep pace with changing CSEs.¹⁰

13. The responsible lending obligations imposed on consumer lending under the *National Consumer Credit Protection Act 2009* and the *National Credit Code* do not apply to SME lending, under the CBP or otherwise. The recent independent review of the CBP¹¹ recommended against an amendment to apply responsible lending provisions to SME lending.¹² This recommendation was in part informed by consultations with small business representatives, which highlighted the need for banks to provide customers with flexibility, in the interests of facilitating commerce. Small business representatives expressed concern that responsible lending-type requirements could restrict access to credit, particularly for new businesses that lack established profit records and where access to credit often depends, at least in part, on security or guarantee arrangements.¹³
14. Consistent with these observations, in ANZ's experience the mechanics of SME lending differ from consumer lending in several respects. *First*, the types of enquiries and verification steps involved in SME lending vary according to the type of business and borrower involved and the source of the income that is expected to service the borrowing. *Second*, SME lending often requires consideration of projected income, in addition to or in the absence of relevant evidence of past income (particularly in the case of start-up businesses). *Third*, SME lending is, by its nature, more 'judgmental' than consumer lending, taking into account a wide range of considerations including the borrower's industry and its economic outlook, the organisation and projected growth of the borrower's business, and the quality and experience of its management. CSEs with respect to SME lending necessarily take account of these realities.

B. RELEVANT FEATURES OF THE JANUARY AND FEBRUARY SUBMISSIONS

15. The January and February Submissions identified misconduct or conduct that has fallen below CSEs in relation to lending without, in all instances, distinguishing between conduct relating to consumer lending and SME lending respectively. The purpose of this section is to identify the features of the January and February Submissions which relate to SME lending.

System, process and human failures

16. ANZ's technical systems and processes have, at times, failed in a way that led to ANZ charging fees that it was not entitled to charge, or under or over-calculating interest in

⁶ *Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Act 2015*.

⁷ See further [39] and [41] below. See also [6.67] of the January Submission.

⁸ January Submission, [4.6].

⁹ CBP, clauses 3.2, 3.3 and 27.

¹⁰ A newly revised (and renamed) 'Banking Code of Practice' (**New Code**) is in final draft form and is due for adoption in early 2019.

¹¹ P Khoury, *Independent Review Code of Banking Practice Final Report*, 31 January 2017 (**Khoury Review**): <http://cobpreview.crkhoury.com.au/wp-content/uploads/sites/2/2017/02/Report-of-the-Independent-Review-of-the-Code-of-Banking-Practice-2017.pdf>

¹² Instead, the Khoury Review recommended that clause 27 of the CBP be modernised to create a clearer and more meaningful promise to individual and business customers alike: see Khoury Review, [8.4.3].

¹³ Khoury Review, [8.4.2]-[8.4.3].

relation to deposits or credit.¹⁴ Some of those instances related to SME lending.

17. A number of linkage errors had the result that deposit accounts were not properly linked to commercial loan facilities, such that customers did not receive the benefit of offsets.¹⁵ Some of the affected accounts were associated with SME lending.
18. In addition, ANZ inadvertently retained positive balances in a number of SME lending accounts, where the account ought to have been closed.¹⁶
19. Process failures occurred in respect of certain life, disability or trauma insurance policies taken out with ANZ or another insurer by SME borrowers over their key personnel as a condition of ANZ lending.¹⁷ Because of these failures some borrowers continued to pay premiums for policies after discharging their loans. ANZ is in the process of writing to customers affected by this and related issues. The precise extent of customer detriment is currently unclear but could be material.
20. Of the system, process and human failures identified as 'other issues' in [6.28] of the January Submission,¹⁸ the following involved some aspect of SME lending:
 - (a) the incorrect charging of fees and/or interest on some overdrafts, internet banking for business, commercial bills and indemnity guarantee products;¹⁹
 - (b) some commercial lending accounts did not receive the full benefit of offset arrangements due to the way the offset sub-system calculated interest as compared to the loan sub-system;²⁰
 - (c) some ANZ customers did not receive benefits in relation to their Business Select and Community Select packages;²¹ and
 - (d) as a result of a system coding change, some customers were permitted to redraw amounts from their loans in excess of the amount of principal that they had paid in advance.²²

Lending-related fraud

21. ANZ has identified some instances where its staff or representatives were involved in submitting false information in connection with loans and loan applications²³. Of the cases specifically identified in the January Submission and the February Submission, at least one affected an SME lending customer.²⁴

Sales conduct

22. The January Submission referred to instances where frontline staff engaged in

¹⁴ January Submission, [6.4]–[6.34].

¹⁵ January Submission, [6.13], [6.28]; February Submission, Part 1, items 140 and 151.

¹⁶ This issue predominantly arose in relation to commercial credit cards, which are outside the scope of the Submission, as explained in [5] above. See January Submission, [6.20]–[6.23]; Item 142 of the table included at Part 1 of the February Submission.

¹⁷ Some borrowers owned the policies and mortgaged them to ANZ. Others took out policies in ANZ's name.

¹⁸ See also February Submission, Part 1, items 144 – 151.

¹⁹ February Submission, Part 1, items 144 and 145.

²⁰ January Submission, [6.28]; February Submission, Part 1, item 151. This kind of error was referred to in the evidence of Sarah Stubbings, see ANZ.999.001.0001 at [108-124].

²¹ January Submission, [6.28]; February Submission, Part 1, item 147.

²² January Submission, [6.28]; February Submission, Part 1, item 150.

²³ January Submission, [6.74]; February Submission, Part 1, items 158 and 169.

²⁴ The incident described at [6.74(b)] of the January Submission and in the February Submission, Part 1, item 158.

inappropriate sales practices in an effort to increase incentive payments.²⁵ Some of these instances involved SME lending. As set out in the January Submission, ANZ does not believe that conduct of this type is systemic or widespread.

23. The January Submission stated that ANZ had ceased the use of 'flex commissions' in consumer motor vehicle finance.²⁶ ANZ continues to undertake some SME lending transactions which involve 'flex commissions'. 'Flex commissions' in SME lending transactions are not covered by the *ASIC Credit (Flexible Credit Cost Arrangements) Instrument 2017/780*.

Esanda loan administration charge

24. For some of ANZ's irregular, fixed-term asset finance contracts, a loan administration charge was erroneously included when constructing the amortisation schedule. In some cases, this resulted in an incorrect calculation of break costs and the overcharging of customers.²⁷ ANZ's investigations into this matter identified other related overcharging issues. Of the customers affected by all such issues, approximately 63% in number (approximately 11.4% in value) were SME lending customers.

Agribusiness issues - Landmark

25. As outlined in the January Submission, the Landmark loan book was acquired by ANZ in March 2010.²⁸ All Landmark loans acquired by ANZ involved SME lending.

Collections practices

26. ANZ's Collections team deals with both consumer and SME lending customers when they are in default of their loan obligations. In the vast majority of cases, these dealings arise from an actual or likely monetary default. ANZ accepts that, in some instances, dealings between its Collections team and customers breached the CBP and the ASIC Debt Collection Guidelines.²⁹ Some of these instances will have related to SME lending.
27. In its February Submission, ANZ identified concerns raised by the FOS as to whether ANZ's processes were sufficiently robust to ensure that collections activity was suspended upon referral of a dispute to the FOS. Of the 35 instances of improper collections activity identified,³⁰ at least three related to SME lending.

Other issues

28. The January Submission identified around 120 consumer and small business lending complaints which proceeded to the FOS, of which about 50 were decided against ANZ.³¹ The SME lending related FOS complaints were summarised in items 29 – 42 in the table of Consumer and Small Business lending FOS cases in Part 1 of ANZ's February Submission.

C. OTHER MATTERS

29. As a result of events or investigations that post-date the January and February Submissions, ANZ has identified two further relevant SME lending-related matters which it wishes to add to its previous responses.

²⁵ January Submission, [6.69].

²⁶ January Submission, [6.71].

²⁷ January Submission, [6.16]–[6.19]; February Submission, Part 1, item 141.

²⁸ January Submission, [6.78]–[6.84].

²⁹ January Submission, [6.97].

³⁰ February Submission, Part 1, item 162.

³¹ January Submission, [6.57].

7-Eleven class actions

30. On 20 February 2018 two related class actions were commenced in the Federal Court of Australia by a 7-Eleven franchisee to whom ANZ provided SME lending, and associated persons, against 7-Eleven Stores Pty Ltd (**7-Eleven**) and ANZ. Essentially, the claims against ANZ are that ANZ: (a) through a relationship with 7-Eleven, had access to information relating to, and knowledge of, the way the 7-Eleven franchise system operated; (b) breached terms of the CBP in providing SME lending to the franchisee by allegedly failing to act fairly and reasonably, failing to have regard to its prudential obligations, and failing to exercise the care and skill of a diligent and prudent banker; and (c) acted unconscionably in view of its alleged knowledge of matters including allegedly inaccurate financial information supporting the application for the relevant SME lending.
31. ANZ has not, to date, identified any misconduct, or conduct falling below CSEs arising from the allegations. ANZ intends to defend the action and is in the process of considering the allegations made against it for that purpose.

Commercial facility fees issue

32. On 1 March 2018, ANZ notified ASIC of an issue relating to commercial facility fees. The issue appears to have affected customers who held certain commercial facilities, being indemnity guarantees, commercial overdrafts and commercial bills. ANZ has become aware of situations where fees, such as annual or quarterly facility fees, have continued to be processed after closure of these facilities. The extent of the issue has not yet been ascertained, however the amount of overpaid fees is likely to be material.

D. MATTERS OF INTEREST IDENTIFIED BY THE COMMISSION

Overview

33. The Commission's 5 April 2018 letter identified seven issues raised in the course of the Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into the Impairment of Customer Loans (**Impairment of Customer Loans Inquiry**) and the Australian Small Business and Family Enterprise Ombudsman Small Business Loans Inquiry (**Small Business Loans Inquiry**). ANZ participated actively and made submissions in these inquiries, as well as in the Australian Senate Select Committee On Lending to Primary Production Customers (**Lending to Primary Production Customers Inquiry**), which covered similar issues. ANZ also refers to paragraphs [6.64] – [6.67] of the January Submission in relation to these matters.
34. ANZ considers that CSEs in relation to the identified issues have shifted significantly in recent years and continue to do so. The discussion that follows is intended to identify, at a high level, ANZ's general position in relation to the issues of interest identified by the Commission. The ABA has considered the various recommendations made in the inquiries mentioned at paragraph [33] above, which informed the industry position set out in the New Code.

Use of personal assets as security

35. The availability of security is one of a number of inter-related commercial factors that will influence the terms on which ANZ can provide an SME loan, having regard to its prudential obligations. Generally speaking, if security can be provided by a borrower against a business loan, the bank's risk is reduced so that it can provide the loan at a lower interest rate. SME borrowers therefore often agree to provide security over their personal assets to secure a cheaper loan.
36. ANZ's SME lending customers may provide security for SME loans in a variety of ways, including by pledges of security over assets and by personal guarantees. ANZ's policies and procedures do not specifically address the taking of security over personal assets, such as a family home, as a standalone class of security – rather, the principles applicable to all forms of security apply.

Non-monetary event of default clauses

37. During the inquiries referred to above, concerns were raised about the event of default clauses in standard form loan contracts for small business customers, which entitled banks to take enforcement action, even where the customer had met all of their loan repayment obligations. Examples included material adverse change clauses, covenants linked to financial indicators (such as loan-to-value ratio) and other non-monetary covenants. Many of these clauses were not commonly used by ANZ.
38. As a result of those concerns, ANZ's approach to small business terms and conditions has been simplified. For example, in ANZ's new Finance Conditions of Use, the number and type of event of default clauses have been significantly reduced. Further, the Finance Conditions of Use now include materiality thresholds which must be satisfied before ANZ is entitled to act on some non-monetary events of default (such as the loss of a business licence). Similar changes have been made to other contracts used by ANZ for SME lending. ANZ considers that these changes reflect evolving CSEs relating to SME lending.
39. While ANZ continues to include monetary and non-monetary event of default clauses in its loan contracts, non-monetary default clauses are now significantly more confined, as are the circumstances in which ANZ can exercise event of default related rights.

Period and means of communication of notice of events of default

40. ANZ endeavours to give customers who are in default of their obligations a fair and reasonable period of notice before any legal recovery or enforcement action is taken against them. In considering the period of notice given by ANZ, it is important to distinguish between a (final) Notice of Demand for repayment, which is issued as a precursor to ANZ taking enforcement action, and a Default Notice, which is issued when ANZ becomes aware that an event of default has occurred. For customers managed in BB, for example, the period of time given to remedy an event of default in ANZ's (final) Notice of Demand is often short. However, the service of such a notice typically comes after a longer period in which ANZ has worked with the customer on the issues underlying the event of default.³²
41. ANZ's standard form loan contract has recently been updated to include a requirement that, if any applicable law or industry code (such as the CBP) requires a minimum notice period to be given before demanding repayment or taking any enforcement action, ANZ will give its customers at least that period of notice.

Roll-over of loans on maturity

42. ANZ agrees with the recommendation of the Small Business Loans Inquiry that a minimum of three months' notice should be given to a small business borrower if a decision is made not to roll-over a loan (with a longer notice period for loans secured over rural properties or complex businesses), even if this means extending the expiration date of the loan to accommodate the notice period following the date of the decision/notification. This recommendation was considered as part of the ABA's preparation of the New Code. ANZ is currently putting in place systems and processes for its adoption in 2019.

Use of unilateral variation clauses

43. ANZ has updated unilateral variation clauses in its standard terms and conditions, and has, in particular: (a) increased its disclosure of the types of changes ANZ may make unilaterally; (b) imposed a requirement to provide the customer with reasonable notice of any unilateral change; and (c) drawn the customer's attention to their right to end the loan agreement if they do not accept the change.
44. Other than for changes to variable interest rates or to government fees and charges, ANZ has changed its SME lending contracts to provide for a minimum of 30 days' notice of a

³² ANZ's Submission to the Impairment of Customer Loans Inquiry, [17].

unilateral variation to loan terms adverse to customers.³³

Dealings with SME lending customers in financial difficulty

45. ANZ has two dedicated teams that manage commercial customers experiencing financial difficulty. ANZ Commercial Collections manages customers with lending under \$1 million and select customers with lending between \$1 million and \$3 million who are experiencing financial difficulty. Larger customers experiencing difficulty are managed by ANZ Lending Services.
46. ANZ understands there can be a wide range of circumstances which may lead to SME lending customers experiencing financial difficulty. ANZ seeks to work through difficult situations with the primary aim of getting the customer back on track. ANZ endeavours to take an empathetic and pragmatic approach in its management of those customers. This approach has received increased focus in recent years.

Arrangements with third-party professionals

47. Given the nature, volume and scale of ANZ's SME lending business, ANZ regularly engages a range of third-party professionals, including valuers, independent accountants and receivers and managers.
48. ANZ acknowledges that customers may perceive that the prospect of future engagements could give rise to a conflict of interest for those professionals in discharging their functions. To address this perception, ANZ seeks to engage professionals with high standards of independence and integrity and whom it believes are capable of providing services with proper levels of professionalism. A central team, independent of the lending business, maintains formal lists of third party professionals that ANZ will engage to provide services such as receivership.
49. In relation to commercial property valuations:
- (a) ANZ shares SME lending customers' interests in ensuring accurate and fair valuations of assets to which SME lending relates and over which it is secured. ANZ's practice is now to provide SME lending customers with a full copy of the instructions given to a valuer and a full copy of the valuation report if the customer has paid for the valuation.³⁴
 - (b) If a customer disagrees with a valuation, they can seek a second opinion from an alternative bank panel valuer, where the customer is prepared to pay for the second valuation.
 - (c) ANZ has formalised a process under which customers will be provided with two or three names from ANZ's valuer panel and the customer can choose which of those valuers is to be instructed.³⁵
50. Independent or investigative accountants³⁶ and receivers³⁷ are subject to various obligations directed to independence and integrity in the discharge of their

³³ This notice period is subject to an exception where 30 days' notice is not practical; for example, for variations required to reflect regulatory changes.

³⁴ An exception to this is where an enforcement process is underway and information about a valuation could potentially be passed to a prospective bidder impacting the sale price. In this case the valuation would be provided to the borrower at a later stage.

³⁵ An exception to this process may occur in circumstances where it may be difficult to identify more than one valuer (for example, in some rural and regional areas).

³⁶ ANZ has engaged investigative accountants in a small number of cases. The number of these cases in which a receiver is later appointed is smaller. SME lending customers typically find an investigative accountant can provide helpful advice to address business issues and turn around the business.

³⁷ Receivers are generally only appointed as a last resort.

functions.³⁸ ANZ considers that it is reasonable to expect them to carry out their obligations properly.

51. ANZ considers that perceptions of conflict are best addressed by working with the customer to understand why the perception has arisen and then communicating about whether there is any basis to engage a different professional.

³⁸ Receivers must be registered under section 1282 of the *Corporations Act* (the obligation to be registered arises from section 418(1)(d) of the *Corporations Act*). Forensic Accountants subscribe to standards promulgated by the Accounting Professional and Ethical Standards Board, including APEC 110 *Code of Ethics for Professional Accountants*.

APPENDIX 1 – DEFINED TERMS

ABA means the Australian Banking Association.

ANZ means the Australia and New Zealand Banking Group Limited, and its associated entities.

ASIC Act means the *Australian Securities and Investments Commission Act 2001* (Cth).

BB means the Business Banking segment.

CBP means the current (2013) Australian Bankers Association Code of Banking Practice.

CSEs mean community standards and expectations.

February Submission means ANZ's letter to the Commission dated 13 February 2018.

FOS means Financial Ombudsman Services.

Impairment of Customer Loans Inquiry means the Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into the Impairment of Customer Loans.

January Submission means ANZ's letter to the Commission dated 29 January 2018.

Khoury Review means the *Independent Review of the Code of Banking Practice Final Report* by Phil Khoury, published 31 January 2017.

Lending to Primary Production Customers Inquiry means the Australian Senate Select Committee On Lending to Primary Production Customers.

New Code means the newly revised (and renamed) "Banking Code of Practice" which is due for adoption in early 2019.

SBB means the Small Business Banking segment.

SD means the Specialist Distribution segment.

Small Business Loans Inquiry means the Australian Small Business and Family Enterprise Ombudsman Small Business Loans Inquiry.

Submissions means, together, the January Submission and the February Submission.

TBL means total business lending.