ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

ROUND 3 HEARINGS – LOANS TO SMALL AND MEDIUM ENTERPRISES

SUBMISSIONS OF BANK OF QUEENSLAND LIMITED

12 JUNE 2018

A. INTRODUCTION

1. During closing submissions for the round 3 hearings, Senior Counsel Assisting invited all parties with leave to appear to provide written submissions addressing a number of general questions arising from each of the case studies heard by the Commission.

2. Senior Counsel Assisting also invited Bank of Queensland (**BOQ**), as well as all parties with leave to appear, to provide written submissions in response to the question of the likely consequences of owner manager branches of BOQ being recipients of trailing or other commissions particularly having regard to the findings of the Sedgwick report into retail banking remuneration.

3. This submission responds to a number of the general questions posed by Senior Counsel Assisting[1], as well as the specific question directed to BOQ in relation to its owner manager branch commissions[2].

4. This submission is provided pursuant to the grant of leave given to BOQ by the Commissioner pursuant to paragraph 1 of the order granting leave to appear dated 15 May 2018.

B. RESPONSE TO SENIOR COUNSEL ASSISTING'S GENERAL QUESTIONS

RESPONSIBLE LENDING TO SMALL BUSINESS

Question 1 at T3034.18-20: *How much responsibility does the borrower and lender bear in assessing the cash flow forecasts and other factors when deciding whether to enter into the loan contract?*

5. Currently, BOQ is required to comply with the 2013 Australian Banking Association's (**ABA**) Code of Banking Practice (**2013 Code**) when assessing a small business customer's application for lending. Paragraph 27 of the 2013 Code requires BOQ to exercise the care and skill of a diligent and prudent banker in selecting and applying its credit assessment methods and in forming its opinion about the customer's ability to repay the credit facility.

6. This obligation has been enhanced under the proposed new Banking Code of Practice (**New Code**) and is detailed at paragraph 63 of the witness statement of Ms Anna Maria Bligh dated 17 May 2018 (**Bligh Statement**)[3]. Relevantly, the New Code provides that:

> "*If you are a small business, when assessing whether you can repay the loan we will do so by considering the appropriate circumstances reasonably known to us about:*
>
> *a) Your financial position; or*
>
> *b) Your account conduct.*

[1] Senior Counsel Assisting at T3034.18-20, T3034.22-24, T3035.10-13, T3041.13-19, T3043.11-18, T3053.5-9 and T3055.12-18

[2] Senior Counsel Assisting at T3032.42-46

[3] Statement of Anna Maria Bligh dated 17 May 2018 in response to Rubric 3-20 tendered as exhibit 3.144

Where reasonable to do so, we may rely on the resources of third parties available to you, provided that the third party has a connection to you…"

7. Aside from the obligations in the 2013 Code and the New Code, there are no other specific regulatory requirements which set out the consideration BOQ must place on cash flow forecasts or any other factors when assessing an application for a loan to a small business customer.

8. BOQ's view is that the lender and the borrower each bear separate responsibility for assessing the cash flow forecasts of a small business.

   (a) In order to satisfy its obligation to act as a diligent and prudent banker, BOQ will select and apply credit assessment methods that will assist its determination of whether the borrower has the capacity to repay the loan. These methods include making reasonable inquiries of the borrower for information and documents that are appropriate based on the size of the proposed loan.

   (b) Cash flow forecasts are developed based on a number of assumptions and circumstances, and part of the banker's obligation of diligence is to reasonably question these assumptions for accuracy to ensure the resulting serviceability calculations are reliable and accurate. However, as a cash flow forecast is only one input into a lender's overall assessment of serviceability, further inquiries are necessary to ensure a lender has a complete view of the borrower's financial position. This may include inquiries relating to full financial statements, management accounts and valuations.

   (c) In the banker-customer relationship, a banker relies on a customer acting honestly and disclosing all information that may be relevant to the banker's assessment of a loan. While a banker should reasonably question information provided by the customer and make further inquiries where appropriate, it is not the role of the banker to act akin to an accountant or auditor when assessing the information provided by the customer.

Question 2 at T3034.22-24: *What are the outer limits of the bank's duty to act as a prudent and diligent banker in assessing a business loan application? Should the outer limit be codified?*

9. BOQ's view is that the content of this duty, and the outer limits of the duty, should not be codified.

10. The level of diligence and prudence that is required when assessing an application for a loan is subjective and often varies for each loan. The lender and borrower ought to engage with each other on an arm's length basis and various factors such as the size of the loan, the complexity of the borrower's requirements, the type of business and the business' operations, the financial position of the borrower, the lender's security requirements, and a lender's risk appetite are all relevant when determining how to discharge the obligation to act diligently and prudently.

11. Given the range of factors to be considered in the course of each lending application, it would be undesirable for both borrowers and lenders to place any limits or restrictions on the manner in which lenders have regard to each of these factors. This is particularly important when considering a lender's credit risk appetite as this plays a critical role in determining the availability of credit to small business. Any restrictions or limitations on the lender's ability to determine this risk appetite, and change it as appropriate, will likely restrict credit availability and increase the cost of credit to small business.

Question 3 at T3035.10-13: *Should any of the provisions of the National Credit Act which apply to consumer credit contracts also apply to credit contracts with small and medium sized business customers? If not, why not?*

12. Senior Counsel Assisting submitted that it is not open to the Commissioner to conclude that it is necessary or desirable to increase the obligations of banks making small business loans to

make those obligations akin to the responsible lending obligations imposed by the National Credit Act[4] (**Credit Act**).

13. BOQ agrees with Senior Counsel Assisting's submission. As outlined at paragraphs 9-11 of this submission, any attempt to codify or regulate the way in which a lender assesses a small business' application for credit creates the risk of limiting credit availability and increasing the cost of this credit.

14. However, BOQ considers there are other provisions of the Credit Act that could usefully apply to small business lending and provide benefits and protections for both lenders and borrowers:

    (a) the application of a licensing regime[5], which might require all ADI and non-ADI small business lenders to hold a licence from ASIC, meet similar regulatory and conduct obligations[6] as Australian Credit Licence holders and be subject to ASIC's regulatory oversight. This may help ensure a level playing field in the provision of credit to small business and provide consistent protections for small business borrowers irrespective of their chosen lender;

    (b) the obligations relating to disclosure and content of credit contracts[7], which might prescribe minimum contract and disclosure requirements for small business lending and address matters relating to variation of loan contracts, application of fees and interest and the specific obligations of a borrower. This may help ensure consistent and appropriate contract terms are afforded to borrowers, irrespective of their chosen lender; and

    (c) the process for ending and enforcing credit contracts, mortgages and guarantees[8], which might impose minimum requirements on small business lenders prior to commencing enforcement proceedings. This may help clarify and standardise the lender's enforcement steps and bring clarity to the rights and obligations of guarantors.

THIRD PARTY GUARANTEES FOR BUSINESS LOANS

Question 1 at T3041.13-16: *Is it desirable to take steps to increase the likelihood that a third party guarantor of business borrowings will be properly advised and make an informed decision before entering the guarantee? And if so, what might those steps be?*

15. During closing submissions, Senior Counsel Assisting outlined the current equitable principles, legal precedents and legislation that offer protections to guarantors in Australia[9]. As noted by Senior Counsel Assisting, each of these legal protections depend on successfully seeking the intervention of a court to prevent a financial institution relying on and enforcing the guarantee[10]. While these protections afford a legal remedy for guarantors faced with enforcement action, some guarantors may view this as an emotionally or financially prohibitive step.

16. BOQ's view is that it may be desirable to take additional steps for certain third party guarantors in certain circumstances. For example, additional steps may be appropriate where a lender holds a reasonable belief that the guarantor may be suffering some form of vulnerability.

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[4] Senior Counsel Assisting at T3028.40-44 and T3034.9-12

[5] *National Consumer Credit Protection Act 2009* (Cth), Chapter 2 - Licensing of persons who engage in credit activities

[6] See clause 47 *National Consumer Credit Protection Act 2009* (Cth)

[7] See Part 2, Schedule 1 (National Credit Code) of the *National Consumer Credit Protection Act 2009* (Cth)

[8] See Part 5, Schedule 1 (National Credit Code) of the *National Consumer Credit Protection Act 2009* (Cth)

[9] Senior Counsel Assisting at T3040.12-19

[10] Senior Counsel Assisting at T3040.26-29

Additional steps may also be appropriate where a guarantee is solely supported by an asset that is the guarantor's principal place of residence.

17. In these circumstances, additional steps may include enhanced mandatory disclosure (for example, a plain English-style Key Facts Sheet summarising the guarantor's rights and obligations, and the key risks of entering the guarantee) or an extended cooling-off period before a lender will accept a signed guarantee.

18. BOQ agrees with Senior Counsel Assisting's observation[11] that there may be merit in requiring the lender to disclose information concerning the borrower's loan application to the guarantor's legal advisor to help ensure the guarantor receives meaningful legal advice. BOQ considers this step ought to be considered where a lender holds a reasonable belief that the guarantor may be suffering from some form of vulnerability.

Question 2 at T3041.16-19: *What difficulties will be created for banks or borrowers by steps that require more information to be provided to legal or financial advisors of a guarantor before the guarantee is signed?*

19. BOQ's view is that the provision of additional information may require additional time and result in a longer period for assessing, approving and settling the loan. The provision of additional information, depending on what is required, may also result in additional costs for the borrower.

20. This longer period may affect the borrower's ability to comply with, or take advantage of, other third party contract provisions (for example, satisfying finance conditions under a business sale agreement or exercising rights under cooling off periods). There is also the potential for delays to the settlement date which may give rise to other challenges or hardship for the borrower.

CONSUMER REDRESS SYSTEM

Question 1 at T3043.11-15: *If a business loan is determined to have been affected by maladministration, should the financial services provider be permitted to require the loan to be repaid within a timeframe shorter than the remaining term of the loan in circumstances where the borrower is willing and able to meet the repayment schedule under the loan?*

21. BOQ's view is that maladministration should not, of itself, result in a lender unilaterally reducing the repayment period in circumstances where the borrower is willing and able to meet their repayment obligations.

22. However, BOQ considers it should be open for a borrower and lender to mutually agree on a faster amortisation schedule and a corresponding shorter repayment term if this is acceptable to both parties.

Question 2 at T3043.15-18: *Could FOS improve its processes for dealing with loans that are determined to have been affected by maladministration and, if so, how? Should the incoming body, AFCA, adopt a different process?*

23. BOQ's view is that improvements could be made to the quality and clarity of correspondence and communication issued by FOS and the incoming Australian Financial Complaints Authority (**AFCA**).

24. For example, FOS and AFCA could make improvements to ensure customers:

    (a) understand the role of external dispute resolution and the customer's ongoing obligations while a complaint is being considered. BOQ has experienced several cases where a customer assumes that, by making a claim to FOS, their repayment obligations will be

[11] Senior Counsel Assisting at T3041.3-10

automatically suspended, or that FOS has the jurisdiction to waive a customer's debt entirely; and

(b) receive information that is clear, concise and written using plain English. The importance of clear and simple communications will become even more important once AFCA commences, given its increased jurisdictional limits will likely to result in borrowers submitting more complex small business lending claims.

25. BOQ also considers there is merit in utilising the panel determination model for complex cases rather than relying on a determination of a single ombudsman. FOS currently employs one ombudsman for financial services, and rarely utilises the panel determination, which has resulted in a determination 'bottleneck' and delays to complaint resolution. Multiple ombudsmen, or a panel determination model, may also serve to increase the level of effective challenge and objectivity in the determination process.

BANKWEST BUSINESS LENDING BOOK

Question 3 at T3053.5-9: *Is it appropriate for a bank to take enforcement action when no monetary defaults have occurred and the bank can rely only on non-monetary defaults? Why or why not? Should there be some additional protections for borrowers in these circumstances and ought the bank be obliged to explain such matters?*

26. BOQ's view is that the majority of non-monetary defaults (where a monetary default is not also present) should not result in enforcement action. However, notwithstanding the absence of enforcement action, BOQ believes a lender ought to retain certain rights under a contract with a borrower to issue a notice of default, apply default interest, and/or otherwise reserve the lender's rights under the contract.

27. There are limited circumstances where it may be appropriate to commence enforcement action for non-monetary default (where a monetary default is not also present). These circumstances are generally driven by the need to protect the value of an asset held as security for the loan. This action may be necessary when:

(a) there is suspected criminal activity;

(b) fraud has been detected;

(c) the borrower has abandoned the relevant asset (for example, walking away from management rights);

(d) an external appointment has occurred (for example, a liquidator);

(e) the director or controller of the borrower has died or lost control of the business; and

(f) the conduct of the borrower, deliberate or otherwise, has a material detrimental impact on the value of the asset held as security for the loan.

28. In these circumstances, prompt enforcement action is often required in order to prevent a further deterioration of the security asset's value.

POWER AND COMMUNICATION

Question 1 at T3055.12-15: *Should the sales culture for small business reflect that of consumer lending in that business bankers are discouraged from focussing primarily on financial incentives in their key performance indicators?*

29. BOQ's view is when a borrower wishes to apply for a small business loan, the banker's focus should not favour one part of the loan application process over another. For example, BOQ expects its bankers to focus on and understand their customer's needs, ensure the customer

is matched with the right product for those needs and receives an exceptional level of service at each step of that journey. BOQ considers that a sales culture focussed on the end sale, without paying proper regard to the quality and service elements of the customer interaction, creates an increased risk of an overall poor customer outcome.

Question 2 at T3055.16-18: *Should lenders be required to clearly draw the cross-collateralisation clauses and its effects to the attention of borrowers? If so, how should this be done?*

30. BOQ's view is that it would be a reasonable step, and consistent with a lender's obligation to act diligently and prudently, to draw a cross-collateralisation clause and its effects to the attention of small business borrowers.

31. The level of financial literacy and sophistication of small business borrowers is varied and the impact and effect of a cross-collateralisation clause may not be immediately apparent to many borrowers on the face of the contract documents.

32. The New Code requires lenders to provide a plain English document setting out the key general terms and conditions of the loan[12] to the borrower before the borrower accepts a loan offer. BOQ's view is that this document would be an appropriate and efficient way to draw the borrower's attention to the impact and effect of a cross-collateralisation clause without increasing the number of disclosure documents for the borrower.

C. RESPONSE TO SENIOR COUNSEL ASSISTING'S QUESTION ON BOQ'S OWNER MANAGER COMMISSION MODEL

Question 1 at T3032.43-46: *What are the likely consequences of owner manager branches of the Bank of Queensland being recipients of trailing or other commissions particularly having regard to the findings of the Sedgwick report into retail banking remuneration?*

33. A unique feature of BOQ is its owner-manager (**OM**) branch model, which comprises around two thirds of BOQ's total branch network.

34. Under this model, an OM enters into an agreement with BOQ to own and operate a BOQ branch as a small business. Under this agreement the OM is responsible for operating the branch, including processing customer deposits, facilitating the completion and submission of loan applications, managing consumer and business relationships and processing daily banking transactions. The OM is responsible under the agreement in meeting the usual operating costs associated with the operation of the branches.

35. OMs tend to have long tenure in their community and develop strong ties to their customers. This model helps drive behaviours that are focussed on ensuring good customer outcomes with a longer term perspective.

36. BOQ's experience indicates that the model of having highly-dedicated small business owners with this level of community connection and customer focus is an appealing approach to banking for many customers, and one which they see as an important relationship differentiator from the much larger Australian banks.

37. BOQ recognises that the payment of trailing commissions and other incentives in connection with the sale of financial products can in certain circumstances carry a risk of promoting behaviour that is inconsistent with the interests of customers as found in the Sedgwick report into retail banking remuneration (**Sedgwick Report**).[13]

[12] Part 6, clause 23 of the New Code

[13] Stephen Sedgwick AO, Retail Banking Remuneration Review Report (19 April 2017)

38. BOQ has a number of controls and systems in place for the OM network that are designed to mitigate many of the risks identified in the Sedgwick Report. In particular, the following limit those risks:

    (a) OM accreditation and training requirements;[14]

    (b) OM authority levels in respect of activities such as loan origination and approval;[15]

    (c) the OM agency agreements and the remuneration structure, particularly the "Balanced Scorecard" which applies to the calculation of remuneration for OMs;[16]

    (d) OM monitoring and management, including through the BOQ Monitoring and Supervision Framework, the Group Compliance Monitoring and Supervision Standard, the Operational Risk Management Framework, branch audits, "branch coaches" and "health checks";[17]

    (e) regular OMB Interlock meetings to increase transparency and collaboration between the BOQ Retail and Group Risk teams regarding OMB-related matters;[18] and

    (f) a formalised and structured consequence management system in respect of OMs, including consequence management outcomes such as commission penalties and suspension and termination measures.[19]

39. Whilst BOQ considers that these systems and controls are effective, it acknowledges that the recommendations in the Sedgwick Report will affect the OM remuneration structure. BOQ established a working group in 2017 in relation to the recommendations in the Sedgwick Report and is currently working through a number of proposed changes to align BOQ's practices with these recommendations.

[14] Statement of Douglas Robert Snell dated 15 May 2018 with Exhibit DRS-2 in response to Rubric 3-8 tendered as exhibit 3.34 (BOQ.0001.0087.0001) (**Snell Statement**), [257]-[258]

[15] Snell Statement, [66]

[16] Snell Statement, [261]-[272]

[17] Snell Statement, [273]-[284]

[18] Snell Statement, [285]-[287]

[19] Snell Statement, [288]-[292]