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

Commonwealth Bank of Australia and its associated Australian entities (CBA)

Round 3 Hearing - Loans to small and medium enterprises

Closing Submissions

PART B - QUESTIONS ARISING FROM THE CASE STUDIES

Topic 1: Responsible lending

Question 1: 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?

1. CBA considers that, by way of summary:

   (a) The borrower has primary responsibility for determining their financial needs, accurately assessing and disclosing their cash flow and financial position to the lender, and ultimately deciding whether or not to enter into the loan contract. There is an expectation that the borrower is open and honest in relation to the disclosure of the borrower's financial position. Borrowers have an obligation to be truthful in the information provided as part of, and in relation to, their loan application. This obligation is generally reflected in declarations given by borrowers in their loan applications and in the loan contract. Lenders are also able to rely upon common law principles of misrepresentation and statutory prohibitions against engaging in misleading or deceptive conduct as a legal basis for an obligation to this effect. CBA submits that this is a fundamental obligation that underlies the provision of cash flows and other material by small businesses to lenders, and therefore this obligation is a key responsibility of borrowers.

   (b) Small business lending always involves a level of risk. It is axiomatic that a small business applicant must assess the level of risk and determine whether they are prepared to accept it.

   (c) Similarly, lenders will formulate policies which reflect the level of risk they are prepared to accept and, in assessing applications, have a responsibility to apply these policies in order to consider the borrower's financial needs, cash flow and financial position, servicing capacity and suitability for the proposed product.

2. Further details are provided in the paragraphs below.

3. **Determining financial needs:** The borrower must determine whether they have a relevant financial need for a loan. This determination is assisted by information from the lender, including through online, self-service product tools and calculators, product disclosure information and exploratory conversations. At CBA, this is typically achieved by business banking relationship managers having a 'needs based conversation' with the proposed borrower to understand their requirements, objectives and financial situation. The borrower may also decide to obtain specialist advice, for example, accounting, legal or taxation advice. It is important to note that, for a range of reasons, the lender may choose not to satisfy the change of the borrower's need. The reasons may include, for example, the purpose, character of the borrower, or the industry.

4. **Understanding cash flow and financial position:** The primary responsibility for assessing the cash flow (both historical and forecast) and other factors to be taken into account in making a loan application rests with the borrower.

5. With an existing business, CBA considers that the borrower is best placed to know their own business' financial position and performance and is the subject matter expert as to the relevant industry in which the business operates. Further, the principals/officeholders of a corporate borrower have duties as directors to ensure that the financial records reflect a true and fair view of the company (where an historical perspective is applied to financial statements). Principals of any business would need to have a reasonable basis for making forecasts in respect of cash flow and earnings when applying for a loan, as that would form part of the basis of any loan application.

6. With a prospective business acquisition requiring finance, the borrower should take steps to verify any cash flow forecasts or other financial factors that may influence the performance of the business provided by third parties. Again, it is the borrower's prospective business and the borrower should accept responsibility for the accuracy of financial information provided to a lender that may inform a credit application.

7. CBA acknowledges that the lender is responsible for assessing the information provided by a borrower. CBA seeks to fulfil this responsibility through a range of policies and processes, including holding broader 'needs based' conversations with borrowers beyond the scope of the specific loan application; clarifying information provided as necessary and, at times, requesting financial forecasts and other relevant information.

8. The decision by a lender not to provide the loan requested by the borrower obviously does not in itself suggest the business will fail. It more often reflects that the loan is beyond the risk appetite of the lender. Other lenders may see it differently and choose to provide the loan.

9. **Servicing and other commitments:** The borrower and the lender must determine whether the borrower has the ability to service the loan for its full term, including with regard to existing and proposed financial commitments and any potential relevant increases in repayment obligations (e.g. interest rate changes, change to principal and interest repayments from interest only). The lender must communicate the minimum servicing obligations to the borrower who then bears an equal responsibility to satisfy themselves that they can meet these obligations.

10. **Entering the loan agreement:** The borrower has responsibility for determining whether to enter into the loan agreement and determine what (if any) advice they should seek prior to doing so. They have a responsibility to ensure that they fully understand the terms and conditions of the loan agreement. On the strength of the information provided by the borrower, the lender has responsibility for determining whether to offer the loan agreement. In fulfilling this responsibility, in addition to the items noted in paragraphs 1 to 9 above, CBA may also review prior account conduct, for example, a review of account balances, historical arrears, overdrawn accounts and covenant compliance, as available and applicable.

11. Beyond these principles, CBA submits that the question of the levels of responsibility which borrowers and lenders bear in assessing cash flows and other factors as part of determining whether to enter into a loan will depend on the circumstances of a particular application, influenced by factors which include:

    (a) the type of loan product the subject of the application and the timeframe;

    (b) the amount of the loan;

    (c) the nature of the small business;

    (d) the significance of the loan to the business;

    (e) the complexity of the contract;

(f) the lender's risk policies and current and forecast economic circumstances;

(g) whether the loan is to be secured and, if so, the nature of the security; and

(h) the nature of the existing relationship (if any) between the lender and the borrower.

12. Accordingly, CBA believes any regulatory approach to this issue must not be prescriptive and must involve sufficient flexibility to allow the market to operate freely. Prescriptive regulatory approaches increase the acknowledged risk of resulting in restriction of credit to small business.

Question 2: What are the outer limits of a bank's duty to act as a prudent and diligent banker in assessing a business loan application? Should that outer limit or should the outer limit of this duty be codified?

13. The current Code of Banking Practice (**Code**)[1] requires that before providing credit to a borrower (either by way of a new loan, or an increase to an existing loan), a bank must exercise the care and skill of a diligent and prudent banker. The Code is in the process of being revised, however the same obligation is contained in the latest version of the new draft Code (**New Draft Code**).[2] The New Draft Code also proposes a new obligation that, in relation to small businesses, a bank will consider the appropriate circumstances reasonably known to the bank about the borrower's financial position or account conduct.[3] Contractual relationships between the small business borrower and the bank incorporate these obligations.

14. The relationship between the borrower and the lender is one of creditor/debtor, not one of client and adviser. The borrower is legitimately entitled to expect that the lender will assess the credit application in a prudent and diligent manner. However, the content of that standard changes depending on the particular circumstances of the proposed loan. It will vary depending upon the circumstances of a particular situation based upon factors such as those referred to in paragraph 11 above. It also varies over time, as matters such as prudential requirements, technology, banking practices and community expectations change. For example, a lender may fulfil this duty when offering an unsecured loan of $50,000 by having regard to the behavioural or transactional history of a customer, as opposed to a more manual analysis of business documents such as information lodged with the Australian Taxation Office. A more rigorous process would be required to fulfil this duty with regard to higher value loans.

15. For small business lending, the *"care and skill of a diligent and prudent banker"* is appropriate because it is not fixed and allows flexibility. This ensures that prescriptive approaches are not taken which would unreasonably restrict the access of small business to credit. Accordingly, it is neither appropriate nor possible to ascribe a more precise outer limit to this standard, nor would it be desirable to attempt to describe and codify an outer limit.

16. However, it should be noted that any purported obligation on the lender to the borrower for the fate of the business subsequent to the loan being made is beyond the outer limit of this

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[1] Exhibit 3.144.2 (ABA.001.007.1128) at .0022, clause 27- Exhibit AB-1-2 to the Witness Statement of Ms Anna Maria Bligh in response to Rubric 3-20 dated 17 May 2018 (WIT.0001.0048.0001) (**Bligh Statement**).

[2] In December 2017, the Australian Banking Association lodged the new draft Banking Code of Practice with ASIC for approval. The New Draft Code was developed throughout 2017 following an independent review completed by Mr Khoury. Following lodgment of the New Draft Code, the industry has made further changes. A copy of the code with these further changes shown in mark-up is at Exhibit 3.4.3 PGK-3 (WIT.0900.0003.0290) - Exhibit PGK-3 to the Witness Statement of Mr Phillip George Khoury dated 18 May 2018 (WIT.0001.0033.0001) (**Khoury Statement**). See .0307, clause 47.

[3] Exhibit 3.4.3 (WIT.0900.0003.0290) at .0307, clause 51 - Exhibit PGK-3 to the Khoury Statement.

duty. Similarly, any linking of liability for the credit assessment to subsequent performance of the business is likely to inhibit lenders from making positive credit assessments, especially for start-up businesses where the likelihood of business failure is greater.

Question 3: 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 commerce. If so, why and to which small and medium business customers? If not, why not?

17. CBA considers that a responsible lending regime similar to that under the *National Consumer Credit Protection Act 2009* (**NCCP Act**) should not be implemented with respect to small and medium sized business lending for the following reasons:

(a) the introduction of such responsible lending obligations would likely have adverse consequences for small and medium sized businesses, including:

(i) access to credit for small and medium sized businesses could be reduced;[4]

(ii) increased cost of credit;[5] and

(iii) a lack of flexibility in the provision of credit to small and medium sized businesses.[6]

(b) there are already protections in place to facilitate the responsible provision of credit to small business customers, which strike the correct balance with regard to the different policy considerations that arise in the context of lending to a business rather than a consumer, including:

(i) the Code, and in particular clause 27, which requires the bank to exercise the care and skill of a diligent and prudent banker in selecting and applying its credit assessment methods and in forming

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[4] See, for example, the evidence given by Mr Clive van Horen at T2371.20-25 and the submission to the Royal Commission by Small Business Australia dated 17 April 2018, at page 2 (available at www.cosboa.org.au). See also Exhibit 3.4.1 (WIT.0900.0003.0001) at .0049 - Exhibit PGK-1 to the Khoury Statement, which includes the following statement:

> *In fact, concern was expressed to me by small business representatives that, if the Code is amended to import NCCP Act responsible lending-type requirements for small business, there could be undesirable consequences, that this could restrict small business access to credit. This could particularly be the case for a new business, without an established profit record, where access to credit depends, at least in part, upon reliance by the bank on security or guarantee arrangements*.

See also the evidence of Mr Khoury at T2029.35-43.

Also note the fact that the Financial System Inquiry Committee indicated in its final report dated November 2014 that a number of its recommendations *"aim to assist small and medium-sized enterprises in obtaining better access to funding"* (at xvi). Its recommendations to facilitate innovation *"aim[ed] to … [r]emove unnecessary regulatory impediments to innovation, particularly in … fundraising for small businesses"* (at xix): Financial System Inquiry Committee, *Financial System Inquiry Final Report* (November 2014), xvi and xix. The report supported the extension of unfair contract terms protections to small businesses and encouraged the banking industry to develop standards on the use of non-monetary default covenants (at xxvii) but did not consider the imposition of obligations akin to those in the consumer responsible lending regime for small business credit.

[5] See, for example, the Regulation Impact Statement for the Bill that proposed to introduce some responsible lending obligations for small business in 2012, which suggested that the reforms would have *"impacts on all borrowers, primarily through the risk of higher costs"*: Australian Government, Department of the Prime Minister and Cabinet, *Small Business Credit - Regulation Impact* Statement, page 2 <https://ris.pmc.gov.au/sites/default/files/posts/2013/01/RIS-Consumer-Credit-Small-Business-Credit.pdf>.

[6] See Exhibit 3.4.1 (WIT.0900.0003.0001) at .0050 - Exhibit PGK-1 to the Khoury Statement, which includes the following statement: "*The NCCP Act responsible lending provisions would restrict flexibility in a way I think would be undesirable. I am not recommending that the Code mandate this for small business customers"*.

opinions about a customer's ability to repay the credit facility.[7] The New Draft Code is proposing to introduce provisions specific to lending to small business;

(ii) direction from industry bodies, for example, from the Financial Ombudsman Service (**FOS**), which has indicated *"The ASIC Act also implies into most credit contracts the requirement for an FSP to exercise reasonable care and skill when it provides its financial services to a consumer. We consider that this requirement means that when an FSP is assessing a consumer's loan application, it must exercise the care and skill of a diligent and prudent lender"*.[8]:

(c) Small business representatives are generally not in favour of this.[9]

18. The issue has been considered on a number of previous occasions by different bodies and has been rejected. These include:

(a) in 2012, the Government released an exposure draft of the *National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012* (**Bill**) for consultation which, if enacted, would have applied modified responsible lending obligations to *"small business credit contracts"*. Following the receipt of submissions highly critical of the proposal, including submissions from small business, in February 2013 the then government announced that it would defer the small business finance reform proposals. These specific reforms have not been revisited subsequently;

(b) the Financial System Inquiry, which considered issues concerning small business and made recommendations on the conduct of lenders in relation to small business, such as the extension of unfair contract terms protections to small business, made no recommendations in its final report in 2014 to extend the NCCP Act responsible lending provisions to small business;[10]

(c) the Australian Small Business and Family Enterprise Ombudsman's Small Business Loans Inquiry was conducted in 2016. The Terms of Reference included to "*ascertain whether there are any deficiencies in the regulation of authorised deposit taking institutions in lending to small business*" and "*recommend if additional reform measures should be implemented … so products perform the way they should, considering that consumers are responsible for their financial decisions, including market losses, when they have been treated fairly, and considering the impact on the availability and cost of credit to small business*."[11] It did not recommend that responsible lending obligations ought apply to small business.

(d) the Report of the Khoury Review into the Code of Banking Practice in 2016, specifically considered whether the NCCP Act responsible lending provisions

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[7] Exhibit 3.144.2 (ABA.001.007.1128) - at .0022, clause 27- Exhibit AB-1-2 to the Bligh Statement.

[8] Financial Ombudsman Service Australia, *FOS Approach to Responsible Lending Series - How we approach responsible lending disputes taking into consideration legal principles, industry codes and good industry practice* (July 2014), at [25] <https://www.fos.org.au/custom/files/docs/3-fos-approach-responsible-lending-industry-codes.pdf>.

[9] See, for example, the submissions recorded at .0049 and .0050 of Exhibit 3.4.1 (WIT.0900.0003.0001) - Exhibit PGK-1 to the Khoury Statement, and the evidence given by Mr Khoury at T2029.33-43.

[10] Financial System Inquiry Committee, *Financial System Inquiry Final Report* (November 2014).

[11] K Carnell, Australian Business and Family Enterprise Ombudsman, 'Inquiry into small business loans' (12 December 2016), Appendix A: Terms of reference.

should be incorporated into the Code of Banking Practice and concluded that they should not.[12]

19. There have been no additional circumstances revealed by the evidence given to the Commission that supports the extension of the NCCP Act responsible lending provisions to small and medium businesses.

Topic 2: Third party guarantees for a business loan

Question 1: Is there any inadequacy or gap in those established protections? If so, what is it? Is it possible for a solicitor to give sufficiently substantive advice that goes beyond merely explaining that the documents are legal documents and have legal consequences, without additional information? Would requiring banks to provide additional financial information to a solicitor advising a guarantor, such as information concerning serviceability, address that problem?

Question 2: 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 into a guarantee? And, if so, what might those steps be? What difficulties will be created for banks or borrowers by steps that require more information to be provided to legal or financial advisers of a guarantor before the guarantee is signed?

20. Counsel Assisting referred to the established set of legal protections capable of being relied upon by third party guarantors to business loans such as Ms Flanagan, including the equitable principles in relation to unconscionability (other equitable grounds which may be relied upon are undue influence and lack of capacity), the statutory prohibition against unconscionable conduct and statutory remedies which may be applicable under the *Contracts Review Act 1980* (NSW).[13]

21. Broadly speaking, CBA agrees that it is desirable to increase the likelihood that a third party guarantor of business borrowings is properly advised and makes an informed decision.

22. It is appropriate that banks should be required to provide prospective guarantors with relevant information that is currently covered by paragraph 31 of the Code (and Part 7 of the New Draft Code[14]).

23. Further, CBA considers that it is sufficient protection to require banks to recommend that prospective guarantors seek advice from a legal advisor independent of the borrower. Regulation 11 of the *Legal Profession Uniform Legal Practice (Solicitors) Rules 2015* prescribes obligations on solicitors who have been engaged by signatories to particular types of instruments, including prospective guarantors, to provide advice and who are asked to provide evidence of the provision of such advice.

24. It will be important to ensure that the provision of information on serviceability cannot be construed as the bank providing advice which could establish a duty of care owed by the bank to the guarantor: see *Beneficial Finance Corporation Ltd v Karavas* (1993) 23 NSWLR 256 at 276 per Meagher JA). CBA does not believe such a duty should be imposed.

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[12] Exhibit 3.4.1 (WIT.0900.0003.0001) - Exhibit PGK-1 to the Khoury Statement.

[13] T3040.12-21.

[14] Exhibit 3.4.3 (WIT.0900.0003.0290) at .0313.

Topic 3: Consumer re-dress systems

Question 1: 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?

25. If a business loan is determined to have been affected by maladministration (in the absence of any default), then the financial services provider (**FSP**) should not be permitted to unilaterally shorten the term of the loan. There may be certain circumstances where a customer is affected by maladministration and would like to shorten their business loan term (e.g. retirement or access to other funds such as superannuation), in which case it may be appropriate for the FSP to accept the customer's proposal, although in considering that proposal it will be important to consider whether the variation creates financial difficulty for the customer.

26. Practically, CBA considers that it is critical to ensure that remediation of any effects of maladministration on the borrower's obligations under the loan agreement (including the applicability of fees, interest or repayment obligations) place the borrower, to the extent possible, in the position they would have been in had maladministration not occurred. CBA is supportive of the current approach by FOS to remediation of maladministration, which is to consider such circumstances on a case by case basis.

Question 2: 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?

27. As noted in paragraph 26 above, FOS approaches each dispute on a case by case basis.[15] If FOS concludes maladministration has occurred, it will consider what loss the customer has suffered as a result. The aim of any compensation determined by FOS is to put the customer in the position they would have been in had the maladministration not occurred. FOS notes that lenders ought to take into account a customer's personal position and current financial circumstances to reach a resolution of any maladministration dispute which is commercially practical and does not cause unnecessary hardship.

28. CBA notes FOS's position in determining the remedy for maladministration in consumer cases.[16] This approach has regard to what the consumer used the loan funds for, and how much benefit they received from using those funds. This more tailored approach seems equally applicable and appropriate to business borrowers.

29. CBA considers that AFCA should adopt a similar position.

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[15] Financial Ombudsman Service Australia, *Responsible Lending Conduct Obligations & Maladminstration,* <https://www.fos.org.au/the-circular-5-home/responsible-lending-conduct-obligations-maladministration/>.

[16] Financial Ombudsman Service Australia, *The FOS Approach to Responsible lending series: How we work out a consumer's loss* <https://www.fos.org.au/custom/files/docs/fos-approach-to-responsible-lending-assessing-consumer-loss.pdf>.

Topic 4: Bankwest business lending book

Question 1: How, if at all, are banks to deal with circumstances in which, for reasons extraneous to the conduct of the borrower, the bank no longer wishes to fund a particular business or industry? That is, what is the bank to do if, for example, the market has changed such that its security is no longer adequate? What are the obligations, if any, on a bank in those circumstances?

Complex factors involved in risk management

30. Mr Cohen gave evidence in relation to the complex, and sometimes competing, factors that bear upon conduct of banks in respect of decisions made at a customer level: [17]

    (a) *prudential obligations and protection for depositors* - prudential obligations on banks to appropriately provision, which is borne out of the fact that the bank is lending depositors' money;

    (b) *role the banks play in funding the economy* - As Australia is a net importer of capital, banks have a role in recycling capital. This occurs through, for example, one loan finishing and a decision by a bank, for example, not to renew that loan but to lend the money to someone else, another business; and

    (c) *customer's interests.*

Changes to risk appetite and obligations on banks to act fairly and reasonably

31. In the context of paragraph 30 above, and in any event, banks are required to act fairly and reasonably toward borrowers, in a consistent and ethical manner.[18] As such, although CBA must necessarily alter its appetite for lending depending on its exposure to specific industries, sectors or geographical regions or to any specific customer base, it does so in a reasonable, diligent and prudent manner, for example, through developing considered and specific internal policies.

32. One of the implications of CBA altering its risk appetite is that it may vary its position over the life of a loan. Reasons include changes in market conditions, regulatory change and deterioration in a customer's credit worthiness. In those circumstances, CBA considers that it may be appropriate to adopt one of the following responses that are available to the bank, so long as they are deployed in an orderly, appropriate way (including, timely notification and accurate, transparent communication required to be given to the customer in each instance):

    (a) determination not to renew or 'rollover' facilities at maturity date; or

    (b) variation of pricing or repayment schedules (amount and frequency).

33. If the above changes are made, the customer is given 30 days' notice of the changes. If the borrower chooses not to accept the changes, they are able to repay their loan and cancel their facility.

34. Contracts with large business borrowers (borrowers with aggregated facilities greater than $3 million) may also have a number of terms which provides CBA with a mechanism to act. A large business borrower is subject to a material adverse change default and may also be

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[17] T2814.36-47 - T2815.1-12.

[18] Paragraph 3.2 of the Code. The New Draft Code proposes greater detail about the way in which banks must treat customers, for example, be setting out the "Guiding Principles" of trust and confidence, integrity, service and transparency and accountability.

subject to non-monetary defaults under their loan agreement. For example, where deterioration in the market value of their security causes a breach of the Loan to Value Ratio (**LVR**) covenant. In such circumstances, the breach may result in a range of potential actions including:

(a) restructuring the LVR covenant;

(b) additional security being required;

(c) revised amortisation schedule;

(d) reducing the value of the loan; or

(e) cancelling the loan.

35. Notice periods for default under a non-monetary covenant for large business customers will be governed by the underlying loan agreement.

Additional obligations that may be introduced

36. CBA is mindful of the significance of imposing any change to its dealings with a customer for reasons outside of the control of the customer. However, as the case studies in this round of hearings revealed, it may not be practical for this to be the outcome in every instance, and banks must have the ability to take action in order to meet their changing regulatory obligations, protect the viability of the loan and mitigate potential impending losses, including by taking the actions outlined in paragraphs 32 and 34 above. CBA considers that customers are entitled to expect that in doing so the Bank will communicate and be transparent in its dealings, and that this is a suitable level of protection for those customers in these circumstances.

Question 2: Is there any reason why valuations or investigative accountant's reports ought not be provided to customers in circumstances in which the reports have been paid for by the customer and the bank wishes to take reliance at least in part on such reports. Is there any reason why such transparency obligations should be limited by the size of the loan or limited to providing only parts of the reports?

Valuations

37. CBA's policy is to provide a copy of the valuation to the customer, where the customer has paid for the valuation, except in limited circumstances discussed below.[19]

38. The exception which CBA believes should exist is where the provision to the customer of the valuation may negatively impact the sale price of the asset. For example, in circumstances where the bank has had to take recovery action and sell the property and will be unable to recoup monies owed by the borrower, the borrower may seek to use the valuation to frustrate or limit the sale process in order to minimise the amount able to be recovered by the bank. [20] The likelihood of this is considered rare.

39. CBA follows the ABA industry guideline on the appointment of valuers, which allows the customer to select the valuer from CBA's approved panel of independent valuers: *Industry Guideline: Appointing property valuers when lending to small businesses and primary*

[19] Exhibit 3.102 (CBA.9000.0054.0001) at .0025, paragraph 92(b) - Witness Statement of Mr Peter Nathanial Clark in response to Rubric 3-25 (**Clark 3-25 Statement**); Exhibit 3.101 (CBA.9000.0055.0001) at .0041, [224(b)] - Witness Statement of Peter Nathanial Clark in response to Rubric 3-24 (**Clark 3-24 Statement**); Exhibit 3.111 (CBA.9000.0045.0001) at .0055, [231] - Witness Statement of David Cohen dated 17 May 2018 in response to Parts C to H of Rubric 3-13 (**Cohen 3-13 Statement**); Evidence of Mr Cohen at T2682.8-9.

[20] Ibid.

producers.[21] The exception referred to above is reflected in this guideline. CBA is continuing to expand its panel of preferred independent valuers, to create greater choice for customers.

Investigative Accountants (IAs) reports

40. CBA's Standard Operating Procedure entitled *External View - Investigative Accountant's Report* (**IA SOP**)[22], sets out (relevantly) CBA's procedure for engaging with customers in relation to IAs, namely:

    (a) discuss with the customer the reasons for the bank seeking an IA report;

    (b) ensure the customer understands that the costs of the IA report will be charged to them;

    (c) provide the customer with a summary of the proposed scope of the report and seek to resolve any customer questions in relation to the scope;

    (d) decide on a Chartered or Certified Practising Accountant to undertake the IA report who is ideally mutually acceptable to the customer and the bank.

41. The IA SOP also states that the bank:

    (a) should draft the terms of reference letter to the IA, which both the bank and the customer will execute; and

    (b) should issue a draft copy of the IA report to the customer to confirm the accuracy of the report. This is done to ensure customer engagement, and to ensure that the customer has an opportunity to comment on or correct any inaccuracies contained in the IA report.[23]

42. The process outlined above (contained in the IA SOP) is consistent with the ABA industry guidance: *Industry guideline: Appointing investigative accountants and insolvency practitioners to smaller businesses and primary producers* dated 24 November 2017.[24]

43. The IA SOP does not require CBA to provide to the customer sensitive areas of the report, such as comments on management, recommendations / options for the bank to consider or any estimates of loss that the bank may face.[25] CBA's reasons for not providing sensitive areas of the report may vary depending on the case, however, they include:

    (a) a desire to limit emotional harm to the customer if there is negative implications about management (borrower) capacity to effectively manage the business or if different options are outlined to the bank and the bank then elects to pursue an option which is at odds with the customer's view;

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[21] Exhibit 3.144.37 (ABA.002.001.0027) at .0028, third bullet point - Exhibit AB-1-39 to the Bligh Statement; Exhibit 3.144 (WIT.0001.0048.0001) at .0014, [69]-[71] - Bligh Statement.

[22] Exhibit 3.111.44 (CBA.0001.0243.0076) - Exhibit DC-44 to the Cohen 3-13 Statement. See also Exhibit 3.112 (CBA.9000.0047.0001) - Cohen 3-13 Statement, at .0018, [87].

[23] Cohen 3-13 Statement at.0018, [87]-[88]; Exhibit 3.111.44 (CBA.0001.0243.0076) - Exhibit DC-44 to the Cohen 3-13 Statement.

[24] Cohen 3-13 Statement at .0018, [89]; Exhibit 3.111.45 (CBA.0517.0075.0165) - Exhibit DC-45 to the Cohen 3-13 Statement; Exhibit 3.144 (WIT.0001.0048.0001) at .0014, [69]-[71] - Bligh Statement. See also Exhibit 3.102 (CBA.9000.0054.0001) at .0025, [92(c)] - Clark 3-25 Statement; evidence of Mr Cohen at T2790.01-07 and Counsel Assisting's closing submissions at T3052.18-21.

[25] Cohen 3-13 Statement at .0018, [88].

(b) to protect commercially confidential information such as scenarios outlining and estimates of potential loss to the bank; or

(c) if fraud or criminal activity is uncovered and the bank informs relevant authorities.

44. An additional reason to withhold particularly sensitive areas of a report may be to enable the investigating accountant to be completely open and transparent in what they say in the knowledge that the customer will not be provided with a copy of any particularly sensitive information.

45. CBA does not consider that there should be any variation to the above principles, regardless of the size of the loan.

Question 3: 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 protection for borrowers in these circumstances and ought the bank be obliged to explain such matters?

Purpose of non-monetary covenants

46. Before answering this question, it is necessary to consider what the available non-monetary defaults are and discuss how events of default are used.

47. There are two broad categories of non-monetary defaults:

(a) events that relate to the fundamental existence and solvency of the borrower, its business and/or the business assets (which often comprise CBA's security). These may include actions taken by the borrower, for example, insolvency appointments or loss of licence or permit to conduct the business; actions taken by the borrower, a guarantor or security provider, for example, fraud, illegality, cessation of business, failure to maintain business/secured assets, or realisation of security or raising additional debt without CBA's consent; and, the inability of the borrower to maintain specific funding conditions required under, for example, an equity margin or property development loan; and

(b) events that relate to a deterioration or uncertainty in relation to the financial status of the business. Such events may include a breach of financial covenants (such as loan to value ratio (**LVR**) covenants or interest cover ratio (**ICR**)), a failure to provide financial statements as contractually required, and/or events which could have a material adverse effect on the borrower or the secured assets.

48. Whilst it is true that, contractually, non-monetary defaults allow a bank to terminate a loan upon their occurrence, in practice the bank's reliance on a non-monetary default to terminate a loan is rare, and any action taken must be proportionate to the significance of the breach. Pursuant to CBA's *Default Notices and Letters of Demand SOP*,[26] the issuance of a letter of demand for a non-monetary default should only be considered in circumstances where failure to rectify the default may materially affect the prospects of the debt being repaid.[27]

49. The contractual right to terminate a loan on the basis of a non-monetary default arises because all terms are couched as conditions. This has the effect of making it appear harsh to a borrower that the lender possesses so much power but this is *"part pf the price*

[26] Exhibit 3.101.151 (CBA.0001.0243.0186) - Exhibit 148 to the Clark 3-24 Statement.

[27] Clark 3-24 Statement at .0040, [218(a)].

borrowers pay for the use of the money": *McMahon v State Bank of New South Wales* (1990) 8 ACLC 315 at 316 per Priestley JA.

50. As Mr Cohen stated in his evidence, non-monetary events of default can be a very powerful indicator of trouble to come.[28] They provide a means to monitor and measure performance of a borrower and can act as an 'early warning system' prior to actual monetary default as to any issues with the financial health of a borrower. They require a borrower to notify the bank of any likely or actual breach so that a conversation can be had between the borrower and the bank as to possible courses of remedial action short of the bank taking enforcement action. As a breach of a financial covenant can be an event of default it ensures the prudent management of the borrower and focuses minds of the principals of the borrower on compliance thus assisting the bank in ensuring it will be repaid.

51. ASIC and the ASBFEO have both expressed reservations about the existence of non-monetary defaults and their potential use. The banking industry has responded in part to these concerns over non-monetary defaults by limiting their operation with respect to loans to small business. CBA made a number of changes to its approach to lending contracts in the small business sector, including changes to the application of non-monetary covenants. Those changes were summarised in CBA's submission to the Commission dated 29 January 2018 as follows:

> *[197] We have responded to concerns we were hearing from the small business sector about our lending contracts and we have simplified the way we provide finance to them. For customers with total lending facilities below $3m we:*
>
> *• removed financial indicator covenants (excluding property development, foreign currency loans, loans to super funds, margin loans);*
>
> *• removed material adverse change "catch-all" clauses and reduced the non-monetary events of default down to seven key areas, which are all within the customer's control;*
>
> *• provided a minimum 30 day cure right where the default is capable of being remedied by the customer;*
>
> *• provided customers with 45…days' notice period when making changes to all general restriction clauses and covenants; and*
>
> *• provided 120 day notice prior to term loans maturing and providing an additional 90 day notice if a decision is made to not roll-over a term loan.*
>
> *[198] For all loans using standard documentation we are in the process of simplifying and rewriting in plain English the business funding documents, Letters of Variation and the standard Terms and Conditions for business lending, trade finance and corporate cards customers. A new one-page summary of default and key detrimental outcomes will also be included.*
>
> *[199] These changes impact 96% of our small business customers.*

52. As noted in CBA's SME lending submissions dated 17 April 2018, these amended, simplified terms and conditions better reflect both CBA's practices and evolving community expectations.

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[28] T2780.46 - T2781.40.4; T2800.2-4; T3051.37-40

Appropriateness of enforcement of non-monetary defaults

53. A breach of a non-financial covenant gives the bank a right to renegotiate the facility to reflect the changed risk profile it may be facing. It can be a trigger to call default and exercising rights upon default such as the appointment of receivers or exercising power of sale under a security. Frequently, this last purpose will be accompanied by other defaults, most commonly, a monetary default or actual insolvency.

Question 4: Is there a disconnection between what the banks are saying in their advertising, their annual reports, their other public documents and their conduct? And if there is a disconnection, what is to flow from that?

54. CBA does not consider that there is, generally, a disconnect between its advertising, annual reports and other public documents and its conduct and treatment of customers.

55. To the extent that there have been instances where CBA's conduct has fallen below community standards and expectations, CBA is committed to defining and implementing changes to address those instances and the potential for any reoccurrence. Such instances have also been acknowledged in relevant public documents.

56. These changes include expanding and enhancing an internal customer advocate function, revising key performance indicators, implementing recommendations from relevant third party reviews such as the Sedgwick Retail Banking Remuneration Review, Khoury Review of the Code of Banking Practice, Australian Small Business and Family Enterprise Ombudsman - Small Business Loans Inquiry and the APRA Prudential Inquiry in relation to governance, culture and accountability within CBA (**APRA Inquiry**). In particular, in relation to the APRA Inquiry, CBA is in the process of devising and implementing a comprehensive program in response to the findings of the APRA Panel.

Topic 5: Power and communication

Question 1: First, should the sales culture for small business reflect that of consumer lending in that business bankers are discouraged from focusing primarily on financial incentives in their key performance indicators? Secondly, specifically in relation to this case study, should lenders be required to draw the cross-collateralisation clauses and its effects to the attention of borrowers? If so, how should this done.

57. The sales culture for all business bankers should discourage a primary focus on financial incentives. Rather, CBA aims to achieve a balanced focus, having regard to customers, employees, shareholders and the communities within which CBA operates. In line with all employees across CBA, employees that support business banking activities are encouraged to focus on a range of objectives and targets that balance the needs of all stakeholders. CBA considers that it has achieved the right balance with its performance management framework to ensure that employees focus on a range of objectives rather than being focussed on financial outcomes and sales.

58. CBA's Performance Management Framework does not focus solely on financial performance or Key Performance Indicators (**KPI**) performance. Instead performance is measured equally against the *outcomes* staff achieve and *how* they achieve those outcomes.

59. KPIs measure the outcomes an employee achieves. How they achieve these is measured through the employee's demonstration of the CBA values of integrity, accountability, collaboration, excellence and service, and how effectively they manage risk. Similarly, not meeting risk management expectations regardless of KPI performance will lead to incentive outcomes being reduced including to nil, where appropriate.

60. KPIs are set/agreed at the start of the financial year typically across key result areas (**KRAs**) such Customer, Shareholder, People and Strategic Priorities. CBA has

deliberately increased the emphasis and weighting of the Customer KRA for its business banking (and other) teams. It has also sought to ensure the metrics used to reflect a focus on Customer are holistic in nature, for example, Net Promoter Score (reflecting both those customers most likely to recommend CBA, and those least likely to do so), customer complaints identification, and management and customer engagement (quality and frequency of contact).

Cross-collateralisation clauses

61. CBA does not believe that lenders should be required to draw cross-collateralisation clauses to the attention of borrowers, and is concerned that in singling out particular clauses they may be given more prominence from a borrower's perspective than other, equally important clauses. Rather, borrowers should be given sufficient opportunity to properly understand the totality of the contractual arrangement, including by obtaining independent advice if necessary in the circumstances.

Question 2: When and how much disclosure should a bank provide a director of a business in respect of a decision of the bank's work-out division, [in this case, the SBS division of NAB], where that decision will affect a customer's use of a personal asset which indirectly secures the obligations of their business to the bank?

62. CBA is not able to give a view specifically in relation to the NAB case-study, given that it is not familiar with all of the facts and circumstances about the case. However, generally speaking, it is CBA's view that all teams, including our Group Credit Structuring (**GCS**) team (which is the equivalent team to NAB's SBS division) should have open and transparent conversations with customers regarding their banking and security arrangement at the commencement of the loan and through any work-out period. It is CBA's policy to provide at least 30 days' notice[29] to customers to repay the loan once it is defaulted unless:

(a) the borrower has committed an insolvency event;

(b) there is a fraud by the customer;

(c) urgent action is needed to protect CBA's security or where the customer has removed or disposed of the security without CBA's consent;

(d) a court authorises CBA to commence enforcement proceedings; or

(e) there has been a period of prior discussions and interactions with the business customer in relation to the default over a period of more than 30 days and, in CBA's view, no other resolution is practicable.

63. In circumstances where the Bank has direct security relied on in the agreement to grant a loan and the customer conducts credit accounts with the Bank, "all-monies" clauses are common arrangements.

Topic 6: Regulation and self-regulation

Question 1: Is ASIC's approach to the UCT provisions and the consumer protection provisions under the ASIC Act more generally appropriate and moulded to the risks of the contraventions and practical resources constraints on ASIC?

64. How regulators interact with their regulated community is vital to ensuring a strong working relationship exists between the two. Regulators use a variety of tools to bring about compliance with the law with the most common tools being: persuasion (sometimes called

[29] Cohen 3-13 Statement at .0054, [227(b)].

education or consultation), warnings (sometimes referred to as infringement notices that may or may not be accompanied by some form of penalty), enforceable undertakings, civil prosecutions, criminal prosecutions and loss of licence. The ACCC has issued a publication that highlights an enforcement pyramid that may be useful guide[30] for ASIC to adopt in conjunction with clear communication as to when it may cease to consult on any given initiative.

65. ASIC's approach has prioritised persuasion and engagement with its regulated community rather than reliance on other methods of enforcement. This has been effective, albeit potentially involves longer consultation than a mandated, regulated outcome. However, CBA considers this approach achieves a deeper understanding and response to the issues and ultimately a better outcome for customers.

66. With respect to the UCT introduction, ASIC engaged in broad consultation with the major banks and there was debate as to the appropriateness of various clauses in standard business documentation. CBA believes that this process gave both CBA and ASIC a deeper understanding of each other's positions and led to appropriate concessions on both sides.

67. An inflexible or mandated approach may have led to both banks and ASIC adopting entrenched positions that would have delayed implementation of changes whilst formal dispute resolution took place. This is both costly and of little benefit to small business borrowers.

68. CBA considers that additional consultation could be undertaken with non-bank lenders, which ASIC acknowledged make up 17 per cent of the market,[31] to ensure that a consistent approach is adopted across all industry.

Question 2: Has ASIC's approach been effective in ensuring compliance with the UCT provisions that came into effect in November 2016 and the consumer protection provisions of the ASIC Act generally?

69. Yes.

70. The bi-lateral discussions with ASIC were constructive in ensuring banks' compliance with UCT provisions. This process provided a two-way dialogue and enabled detailed understanding from ASIC's perspective of relevant clauses in our terms that were required to meet the genuine interests of the Bank. Conversely, it also provided opportunity for ASIC to provide CBA with proposed amendments to clauses to ensure terms are fair (for example, applying materiality into clauses).

71. CBA considers that ASIC's approach has been effective. In addition to the review of the Code of Banking Practice's focus on protections in the Code for small business borrowers, CBA has made changes to its processes and revised its standard form lending contracts offered to small business customers to ensure compliance with the UCT provisions.

72. ASIC acknowledged that its methodology was to try to get the big four banks to move, following which ASIC then intended to use this to influence the smaller banks. CBA considers that this was an industry wide legal obligation and that all lenders should have been required to take sufficient steps, regardless of market share or size. There is some concern that the larger banks were singled out.

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[30] Australian Government, Australian Competition and Consumer Commission, *Compliance and enforcement, how regulators enforce the Australian Consumer Law*, 12 <https://www.accc.gov.au/system/files/Copy%20of%20%28CD-17-49038%29%20--%20ACL%20Compliance%20%26%20Enforcement%20guide%20%28web%29.PDF>.

[31] Exhibit 3.163 (ASIC.0902.0007.0110) - Supplementary Witness Statement of Mr Michael Saadat dated 24 May 2018 in response to Rubric 3-22; Evidence of Mr Saadat at T3004.36-45.

Question 3: Is the proposed code, whether or not it is approved by ASIC, adequate to address any residual concerns about the coverage of obligations imposed on the banks? Would the absence of ASIC approval undermine the effectiveness of the code?

73. The intention of the New Draft Code (as it relates to small business) is to ensure relevant protections are provided to small business which reinforce and go beyond the law. It seeks to do so without significantly impacting the ability for small business to access funds. There has been significant effort, as it relates to small business lending, in ensuring banks meet prudential expectations of APRA as well as customer and community expectations by making credit available to small business.

74. ASIC's approval is very important. It would be an acknowledgement from the regulator that member banks, including CBA have made a significant commitment to industry standards as it applies to consumers and small business. While strictly speaking, it is not essential to the effectiveness of the Code, ASIC endorsement would be a welcome acknowledgement from the key regulator that, in lieu of regulation, the steps made by industry to self-regulate are a significant move to instil community trust and confidence.