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

SUBMISSIONS OF BENDIGO AND ADELAIDE BANK LIMITED IN RESPONSE TO ROUND 4 GENERAL QUESTIONS

Introduction

1 Bendigo and Adelaide Bank Limited (***BAB***) and its subsidiaries, including Rural Bank Limited (***Rural Bank***) make the following submissions in response to the invitation to provide written submissions addressing each of the general questions raised in Counsel Assisting's closing address in the fourth round of the Commission's public hearings.

> *Question 1*
>
> *(a) What does it mean for a bank to act fairly and reasonably towards a customer in a consistent and ethical manner?*
>
> *(b) What does that obligation require of a bank in relation to agribusiness customers in an enforcement context?*

2 Clause 3.2 of the Code of Banking Practice (***Code***) provides that:

> *We will act fairly and reasonably towards you in a consistent and ethical manner. In doing so we will consider your conduct, our conduct and the contract between us.*

3 BAB considers that this obligation requires a bank to disclose relevant information to its customers, have the right discussions, and consider customers' interests in every decision.[1] It means that the bank should display the right mix of capability, character and conscience in dealing with each customer, and that the bank should "do the right thing".[2] Relevantly, BAB stated in its letter to the Commission dated 29 January 2018 that it believes that the community expects that it will strive to:

(a) act honestly and fairly;

(b) act for the long term benefit of community;

(c) promote financial inclusion;

(d) listen to its customers and respond to their needs; and

(e) securely hold customers' money and personal information.[3]

4 In the context of agricultural lending, what is required to act fairly and reasonably towards customers is the same as it is in other lending. However, the knowledge that is required by the bank in the agricultural context is different.[4] As described in BAB's letter to the Commission dated 18 May 2018, agricultural lending involves distinct characteristics, including:

(a) generally involving family businesses that involve multiple family members with different levels of knowledge and risk appetites;

(b) intergenerational ownership structures, including planned debt across generations;

(c) seasonal or sometimes annual income;

(d) vulnerability to environmental factors such as drought, disease, pestilence, flood and fire; and

(e) vulnerability to global market forces, including commodity markets.[5]

---

[1] T3623.13-19.

[2] T3623.21-25.

[3] Exh bit 4.123: RCD.0001.0024.0002 – "Response to Royal Commission", at .0017 ([59]-[60]).

[4] T3623.27-31.

[5] Exh bit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0002 ([3]).

5 Many of these characteristics are outside the control of the farm business or lender, and can be difficult or impossible to mitigate.[6] As noted by Ms Gartmann in her statement provided to the Commission, Australian agriculture is characterised by long climatic and production cycles, often 5-7 years in duration.[7]

6 In order to ensure that a bank can meet the obligation to act fairly and reasonably towards customers in this context, the bank should have a thorough understanding of the industry. This is achieved through recruitment, training and management of staff.[8]

7 It is important that customers are dealing with people who know their industry,[9] however industry knowledge is required at all levels of the business, even for those who are not directly interacting with agribusiness customers.[10]

8 When dealing with agribusiness customers in an enforcement context, Rural Bank considers that the obligation to act fairly and reasonably towards a customer in a consistent and ethical manner requires that it:

(a) consider customers' interests, including the balance between giving customers time to bring the loan into order, and the risk that the customers' equity will erode over time;[11]

(b) communicate with customers at all times, including consistent communication between customers and relationship managers about financial difficulties both before and after any involvement of Rural Bank's asset management unit (***AMU***);[12]

(c) provide customers with opportunities to preserve their equity and any underlying loan security,[13] including by inviting customers to submit a repayment proposal to bring the loan into order;[14]

(d) where appropriate, work with customers over time periods consistent with agricultural cycles, which may be years rather than days or months;[15]

(e) ensure customers are aware of the various avenues outside of the bank that may assist them including:

(i) rural financial counsellors;

(ii) external dispute resolution schemes including the Financial Ombudsman's Service; and

(iii) farm debt mediation; and

(f) resort to enforcement action only as a last resort,[16] and realise the value of non-residential property assets before the principal place of residence.[17]

---

[6] Exh bit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0002 ([4]).

[7] Exh bit 4.120: BAB.9000.0002.0001 – "Witness Statement to Alexandra Gartmann" dated 20 June 2018 (***Gartmann Statement***), [47].

[8] T3623.45-3624.32.

[9] T3624.20-22.

[10] T3624.30-33.

[11] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0003 ([11]). See also T3618.41-47.

[12] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0003 ([11]-[17]); T3628.15-23.

[13] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0002 ([7]).

[14] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0003 ([13]).

[15] T3618.22-47.

[16] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0005 ([26]).

9 In dealing with customers in an enforcement context, Rural Bank's relationship managers and members of AMU strive to:

(a) conduct face to face meetings with customers and their advisors;

(b) gather information and validate this when considering customer proposals;

(c) maintain an objective and unbiased approach, avoiding moral judgements about the circumstances that led to financial difficulties;

(d) keep records and communications to customers clear and concise;

(e) provide customer service that is courteous and professional at all times;

(f) be purposeful and fair in terms of arrangements and time lines that are agreed with customers; and

(g) provide realistic, timely, and transparent decision making.

10 Rural Bank, in turn, expects its customers to work with the Bank to seek to achieve mutually agreeable outcomes. This includes the requirement that customers acknowledge their financial difficulty and confirmation of their willingness to work with the Bank. Both parties are expected to make every effort to do what they say they will do.

Question 2

What weight should a bank give to the interests of the customer when making decisions about agribusiness customers experiencing financial difficulty?

11 As stated in BAB's letter to the Commission dated 29 January 2018, BAB's strategy, and the rationale that underpins it, has its genesis in one of the reasons banks were first started: the notion that everyone should benefit from a financial transaction – the investor who provides the funds, the borrower, the bank's shareholders who bear the risk of the borrower not paying, and society itself.[18] This is not a philanthropic approach or even one of a social venture – it is a business model that recognises that the contribution of all stakeholders must be fairly rewarded for the effort and resources they apply. Management's role is to ensure that balance is maintained and to take action to return equilibrium when that is not the case.[19]

12 When an agribusiness customer experiences financial difficulty, there is a balance between giving the customer time to bring the loan into order, and the risk that the customer's equity will erode over time.[20] Understandably, a customer will often want to trade out of periods of financial difficulty in the hope that the next season will be better, sometimes at the risk of eroding all equity in their farm. In this regard, a customer's risk appetite may not be fully aligned with that of the bank. In some instances, banks may be too accommodating of customers attempting to trade out of a stressed situation, where earlier action may have preserved equity in assets.[21]

13 There are also wider considerations as to banks' prudential requirements, and the interests of depositors and shareholders,[22] as discussed in response to Question 11 below.

14 A customer experiencing financial difficulty should be subject to ongoing assessments by the bank as to the nature and cause of the issues involved. The bank should have regard to the

---

[17] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0002 ([8]).

[18] Exhibit 4.123: RCD.0001.0024.0002 – "Response to Royal Commission", at .0004.

[19] Exhibit 4.123: RCD.0001.0024.0002 – "Response to Royal Commission", at .0005.

[20] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0003 ([11]). See also T3618.41-47.

[21] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0005 ([27]).

[22] T3618.38-47.

customer's interests in light of the cyclical nature of the agricultural industry,[23] the customer's personal circumstances,[24] and external industry-wide events.[25]

15 If the customer's position has developed as a result of temporary events, the bank should consider applying a hardship policy.[26] An assessment in such circumstances would allow for the restructure of borrowings and the potential extension of further credit to facilitate continued farm operations, on the basis that normal farm profitability and serviceability would return within a reasonable timeframe.

16 While Australian agriculture does provide a reasonable return, it is only realised over a longer-term horizon, due to the distinct characteristics and challenges of the industry (as described in response to Question 1 above), which does not always align with shorter term investment horizons.

Question 3

In what circumstances is it both best for the customer and best for the bank to appoint an external administrator?

17 Banks should appoint an external administrator such as a receiver only when, despite everybody's best endeavours, there is no viable operating entity or ability for the customer to trade out of the situation, or where there is an urgent need, for example if animal welfare is a concern, or because of the need to manage an ongoing operation.[27] BAB's letter to the Commission dated 18 May 2018 describes the approach taken by Rural Bank in relation to customers experiencing financial difficulty.[28] An external administrator should be appointed only following exhaustion of those processes.

18 As discussed at paragraph [12] above, when an agribusiness customer experiences financial difficulty, there is a balance between giving the customer time to bring the loan into order, and the risk that the customer's equity will erode over time,[29] and sometimes it will be in the interests of both the customer and the bank for the bank to appoint an external administrator to avoid the customer's equity being further eroded.

19 The circumstances a bank should consider in determining whether it is appropriate to appoint an external administrator should include:

(a) the emotional and physical health of the customer;

(b) the welfare of the customer's livestock;

(c) the willingness and ability of the customer to engage with the bank and to pursue an agreed repayment strategy;

(d) disputes between the customer and third parties, such as business partners, spouses or family members; and

(e) where in order to preserve the business, it has to be proactively managed, such as a horticultural operation with daily picking, or a dairy operation with twice daily milkings.

---

[23] T3618.22-24.

[24] T3618.29-33.

[25] T3618.33-37.

[26] Rural Bank's Hardship Policy is Exhibit 4.121.1: BAB.5015.0001.0087 – "Exh bit AEMG-1-Copy of the Rural Bank Hardship Policy dated 2 November 2017".

[27] T3619.30-38.

[28] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0003 ([11]-[17]).

[29] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0003 ([11]). See also T3618.41-47.

Question 4

Is it appropriate for financial services entities to conduct internal appraisals, as opposed to obtaining independent valuations of farms and other rural property? If so, in what circumstances is it appropriate?

20 Valuations are required to determine the value of properties being taken (or already held) as security by a bank. Historically, valuations have been undertaken by either external firms or by bank staff (generally referred to as 'appraisals' to distinguish them from formal valuations). Internal appraisals or external valuations are required at the commencement of the loan, as well as at regular review intervals. These intervals are generally once every three years. Assuming a 20 year loan period, there would be a minimum of seven valuations required over the life of the loan. As a result of the cost to the customer and the increased timeframe generally associated with engaging external valuers, Rural Bank uses a combination of internal appraisals and external valuations.

21 In conducting internal appraisals, Rural Bank considers that:

(a) staff members conducting the appraisals should be appropriately qualified or experienced, and conduct internal appraisals in an area with which they are familiar;

(b) the security being appraised should not be specialised (i.e. an operation such as a vineyard, winery, dairy or broiler farm with generally only a single use); and

(c) appropriate information should be available to determine comparable sales upon which to base an appraised value.

22 Rural Bank's approach to appraising property is for qualified or experienced staff, who have knowledge of the local area and the relevant property, to prepare an appraisal based on a physical inspection of the property and other property transactions in the area. Over a certain financial threshold, the appraisal is then reviewed by a qualified real estate agent, and then by a staff member in the bank's credit team, who is not involved in the loan origination process. It is not Rural Bank's policy to make internal appraisals available to customers.

23 Internal appraisals can provide significant cost and time benefits to customers through the involvement of Bank staff. Customers may otherwise be expected to meet the costs of external valuations (which are generally greater than $5,000), and experience delays of waiting on valuations advice (the average timeframe for an independent valuation is 30 days, which can be an issue when property purchase or sales is the objective).

24 Rural Bank also maintains a panel of valuers, in accordance with its Panel Valuers Policy.[30] The Bank engages a valuer from its panel where:

(a) the criteria for a real estate market appraisal are not met;

(b) total aggregated exposure is greater than $3 million in the Rural Bank portfolio; or

(c) the customer is a self-managed superannuation fund.

25 Rural Bank maintains an in-house valuations team independent of the origination team to engage and instruct all valuations, and to review all valuation reports.[31] Farmland values are influenced by many variables including climatic conditions, location, agricultural industry, productivity, land quality, sentiment, interest rates, commodity prices, the performance of the wider economy, as well as the sample of properties that sell in a given year. Recognising the importance of farmland values to the agricultural sector, Rural Bank produces an industry-recognised annual report that analyses and tracks the median price of commercial farmland in dollars per hectare based on

[30] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0005 ([29]).

[31] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0005 ([30]).

data collected by relevant state and territory agencies since 1995. In 2017 this analysis drew on 239,000 transactions, covering 288 million hectares of land with a combined value of $139.8 billion. This report is shared with customers, the wider farming community and agricultural industry to help inform knowledge of the trends in Australian farmland values.[32]

26 Rural Bank's approach of using internal appraisals instead of independent valuations is primarily employed to provide cost benefits to customers. Without an internal appraisal process, all customers would incur the costs of independent valuers, regardless of their total aggregated exposure.

Question 5

Is it appropriate for staff involved in origination of the loan to conduct or otherwise be substantively involved with such appraisals?

27 BAB considers that it is appropriate for staff involved in loan origination to conduct or otherwise be substantively involved in internal appraisals if the circumstances set out in paragraph [21(a) to (c)] are present, and there are sufficient controls in place to ensure that any potential, actual or perceived conflicts of interest are carefully and properly managed. These staff members are generally located near the relevant property and have knowledge of other property transactions in the area. As has been highlighted through the Commission' s fourth round of hearings, the physical presence of financial institution staff across rural and regional Australia has declined. Ensuring farmers have access to these services is important, but should be balanced with oversight and management of such staff.

28 Loan origination staff are also likely to have a better understanding of the customer's management capability, which is an important consideration in assessing loan serviceability. There is debate in the valuations field about using comparable sales, as opposed to productive capacity, in conducting a valuation. Valuers are generally reluctant to look at productive capacity because this can be largely influenced by the management capability of the farmer.[33]

29 It is appropriate to mitigate against potential conflicts of interest. Rural Bank approaches this by:

(a) requiring input on valuations from local real estate agents with rural expertise;

(b) referencing relevant comparable sales data to support the valuation;

(c) requiring oversight and input from the credit team (which is not involved in loan origination) to verify property data, the comparable sales data used, and the appropriateness of the valuation analysis; and

(d) staff involved in loan origination not being involved in any appraisals in which the bank acts for both purchaser and vendor.

Question 6

Should there be minimum levels of qualifications, skills and experience before a bank employee can be authorised to conduct appraisals? If so, what are the appropriate levels?

30 BAB considers that bank employees should have appropriate qualifications or expertise in order to be authorised to conduct appraisals. Appropriate qualifications and expertise include:

(a) previous appraisal or valuation experience;

(b) an understanding of appraisal or valuation processes and methodologies;

(c) knowledge of the geographic area in which they will operate; and

---

[32] See https://www.ruralbank.com.au/for-farmers/ag-answers/farm-land-values.

[33] T3629.47-3630.3.

(d) access to local industry resources and market data.

31 Additionally, these employees should be provided with appropriate training at regular intervals, to ensure they have a sufficient understanding of valuation theories and that correct processes and procedures are followed. Appropriate training should consider:

(a) the importance of property inspections;

(b) how to determine property use and any alternative uses;

(c) how to determine the arable area;

(d) how to assess the land boundaries, pasture quality, fertiliser history, encumbrances and property access;

(e) how to assess the quality of management;

(f) how to identify comparable sales;

(g) how to determine location, quality and marketability/value of improvements;

(h) how to leverage local knowledge; and

(i) the systems available to support research such as mapping tools and sales databases.

> *Question 7*
>
> *Should there be a code that sets out the requirements for the conduct of internal appraisals by financial services entities, either in respect of rural properties or more generally? If so, what form should that code take?*

32 A further code would be unnecessary if financial services entities have internal codes of conduct which set out the behaviours and conduct expected of staff, including staff that conduct internal appraisals. Further, staff who are members of a valuations industry professional body will be bound by the code of that body. For example, the Australian Property Institute requires that its members adhere to its Code of Professional Conduct.[34] Accordingly, bank staff conducting internal appraisals should have appropriate qualifications and expertise (as discussed as paragraphs [21(a)] and [30] above).

33 If a further code is established for the conduct of internal appraisals by financial services entities in respect of rural properties or more generally, it could include the following requirements:

(a) staff conducting appraisals should:

(i) be properly trained and overseen;

(ii) manage any potential, actual or perceived conflicts of interest;

(iii) act impartially;

(iv) act without prejudice or preconceived notions;

(b) internal appraisals conducted should be based on fact with minimal subjectivity; and

(c) data used to prepare the internal appraisals should be verifiable by an independent party without reference to the original appraiser.

[34] https://www.api.org.au/code-of-professional-conduct.

Question 8

If it is inappropriate for financial services entities to conduct internal appraisals of property to be taken as security, what should be done to stop or discourage that practice?

34 As outlined in response to questions 4 and 5 above, BAB considers it is appropriate for financial services entities to conduct internal appraisals of property in certain circumstances, particularly in rural, regional and remote Australia.

Question 9

Are the legislative obligations on financial services entities to provide documents prior to a farm debt mediation such as the obligation in section 21 of the Farm Business Debt Mediation Act in Queensland sufficient? Should they be extended to oblige financial services entities to provide information on request, as well as documents?

35 A farmer may give notice to the mortgagee asking the mortgagee for copies of documents related to the farm business debt and the farm mortgage pursuant to section 21 of the *Farm Business Debt Mediation Act 2017* (Qld). Examples of the documents provided to farmers are letters of offer, terms and conditions, security documents, bank statements, application forms, cash flows, asset and liability statements, licenced valuations and information sent to and received by the farmer.

36 BAB considers that this provision works well and is sufficient to prepare the parties for participation in a farm debt mediation. BAB considers that such a provision should be included in any national farm debt mediation scheme, as discussed in response to question 15 below.

37 Other information generated by banks, such as internal credit assessments and customers' credit risk rating, is not designed to be shared with customers and should not be required to be provided. Doing so would reveal commercially sensitive information, including the bank's risk frameworks and formulas, and may be prejudicial to the lender/customer relationship, including because of the potential for it to be misinterpreted. These documents are largely for internal purposes.[35]

Question 10

Do remuneration and incentive policies that reward bank employees for the volume of loans sold create an unacceptable risk that bank employees will prioritise the sale of loan products:

(i) over the bank's responsible lending obligations

(ii) over the banks' statutory obligations including to provide loans in a manner that is efficient, fair and honest and to have in place adequate arrangements to ensure that customers are not disadvantaged by any conflict of interest that may arise in relation to the provision of loans, and

(iii) over the bank's obligations to act fairly and reasonably towards customers, in a consistent and ethical manner?

38 BAB considers that remuneration and incentive policies that directly reward bank employees for the volume of loans sold may create an unacceptable risk that bank employees will prioritise the sale of loan products if the weighting is inappropriate. BAB has historically remunerated its staff differently to many of its peers, and removed sales-based incentives for its branch staff and financial planners in 2002.[36]

---

[35] T3686.9-16.

[36] Exhibit 4.123: RCD.0001.0024.0002 – "Response to Royal Commission", at .0024 ([98]).

39 BAB supports all of the recommendations in the "Retail Banking Remuneration Review" by Stephen Sedgwick AO dated 19 April 2017[37] (***Sedgwick Report***). The report provided a comprehensive review of remuneration and incentives of bank employees, and identified elements of remuneration and incentive policies that carry an unacceptable risk of promoting behaviour that is inconsistent with the interests of customers.

40 BAB considers that its remuneration and incentive arrangements for its employees are already consistent with the relevant recommendations in the Sedgwick Report. The Bank is on track to finalise the implementation of the remaining recommendations prior to the deadline in 2020.

Question 11 *To what extent does default interest reflect the cost to financial services entities of carrying impaired loans?*

41 There are various costs incurred by financial services entities when a loan is categorised as impaired. Typically, the Australian Prudential Regulatory Authority (***APRA***) requires that the bank carry 150% of its normal capital requirement for an impaired loan through higher risk weighting of impaired loans.[38] In addition, when a loan is transferred to a bank's asset management unit, it will generally be managed more intensively, requiring more resources and time from a staffing perspective, and representing an additional cost to the bank.[39]

42 Rural Bank applies a default interest rate of 3% on the excess amount of seasonal accounts. A 3% default interest rate is applied by exception on term loans. As at June 30, 2018, there were only two customers with term loans being charged default interest by the Bank. These loans totalled approximately $15.5 million, with $15.1 million relating to one customer (representing 8.4% of the Bank's past due and impaired portfolio).

43 The majority of loans in the past due and impaired portfolio attract a 150% risk weighting. This represents an additional capital requirement in excess of 6%.

44 As at June 30, 2018 Rural Bank's impaired term loan portfolio was $186 million. The additional capital held against this portfolio (as required by APRA) was $9 million, with an approximate cost to Rural Bank of $927,000.[40] As described in paragraph [42], the Bank collected just $466,000 in default interest against this portfolio – representing just 50% of the cost of carrying these impaired loans. This analysis does not take into account non-capital costs such as those referred to in paragraph [41].

Question 12 *Should there be a moratorium on the charging of default interest in respect of farm debts secured by farm debt mortgages during periods when the farm property is affected by natural disaster? If so, how should such a moratorium be implemented – by legislation, by an industry code or by some other means? In what circumstances should the moratorium come into effect? In what circumstances should it be lifted?*

45 Rural Bank does not consider that a moratorium on default interest would, on balance, provide a benefit to farmers affected by natural disaster. An industry-wide or mandatory moratorium may have the effect of:

---

[37] https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report.pdf.

[38] T3618:38.41.

[39] T3618:41-42.

[40] Assuming a weighted average cost of capital of 10.2%.

(a) distorting or increasing the risk to financiers providing debt to the agricultural sector which, in turn, is likely to increase the cost of bank finance for Australian farmers, and/or limit the provision of debt to the sector; and

(b) preventing the application of default interest in circumstances where it remains appropriate. For instance, to partially offset the cost of a loan that is in arrears or default due to behaviour of a customer that is wilfully in breach of their contractual obligations.

46 Banks presently have sufficient scope to waive default interest under existing hardship provisions on an as-needs basis.

47 It is unclear how the imposition of a moratorium would be decided, by whom, and who would bear the cost of the moratorium. The imposition of a moratorium that placed all of the cost on the banking sector, without being shared by the broader industry and/or government, would provide further disincentive to provide debt into the agricultural sector.

48 As described in response to Question 11, Rural Bank applies a default interest rate of 3% on the excess amount of seasonal accounts and a default rate of 3% to term loans only in exceptional cases. Even then it does not cover the additional cost borne by the bank in funding its defaulted loan portfolio. Rural Bank does not, therefore, consider it is reasonable or practical to impose a mandatory moratorium that would further increase this cost (with potentially significant additional costs to the sector). Rural Bank considers there are other more appropriate ways to provide this support, including those contemplated by hardship policies.

Question 13

Similarly should there be a moratorium on enforcement? How should it be implemented? In what circumstances should in come into effect, and lifted?

49 Rural Bank does not consider that a moratorium on enforcement would, on balance, benefit the agricultural sector, for the reasons described at paragraphs [45]-[48] above.

50 In addition, a moratorium on enforcement may have the unintended consequence of eroding the equity a farmer has in their property, therefore serving to increase financial hardship. Timely decisions around enforcement are sometimes more effective at preserving the borrower's equity.[41]

51 It may also be difficult to determine when a moratorium on enforcement should be lifted. As a general rule, a droughted property is likely to need as many good seasons as it had poor seasons before it fully recovers. This may mean that a moratorium would have to be in place for many years. During that time, holding costs, operating costs and interest expenses would continue to accrue. This ongoing accrual erodes customer equity and can lead to a customer retaining no residual assets following a realisation.

52 It could also distort the market for customers seeking to increase the scale of their operations and grow their business, by artificially reducing property sales.

53 Consideration would also have to be given to the role that the government would play in the provision of liquidity to address the funding impact on banks that would be unable to undertake legitimate and reasonable enforcement.

54 Further consideration should also be given to the role of government (in the form of drought or disaster assistance) in these extreme instances of natural disaster. This is particularly true in the

[41] T3633.19-23.

Australian context, where farmers (who are competing in a global marketplace) receive some of the lowest levels of government support and market protection in the world.[42]

Question 14

Should provision be made in the farm debt mediation schemes or other regulations to require earlier intervention?

55 BAB considers that provisions for earlier intervention in farm debt mediation schemes or other regulations are not likely to be effective. Farm Debt Mediation schemes are often utilised after an extended period of engagement and intervention, and is not an appropriate place to regulate earlier intervention.

56 For example, Rural Bank generally conducts annual reviews and look for signs of improving or deteriorating customer performance. Its Hardship Policy provides for earlier intervention in the form of payment delays, interest deferral, debt consolidation or possible interest rate concession. Early warning detection may aid to identify possible signs of distress/hardship and drive customer conversations earlier when more potential solutions are available.

57 At present rural financial counsellors (***RFCs***) are restricted by their funding grant criteria to engaging with farmers only after they enter financial hardship. This protects private rural financial counsellors who would otherwise have to compete with government-subsided services, but creates a risk that customers will fall into difficulty before help is available, and limits access to customers who are less financially literate, or who don't have the appetite to pay for private counselling. Enabling RFCs to work with a wider range of farm businesses and allowing their use prior to farm debt mediation would assist customers to engage constructively in the process. The number of and qualifications of RFCs could also be uplifted to meet these needs.[43]

58 As farm businesses grow in scale and complexity, capturing efficiencies of scale and managing an increasing number of risks, financial literacy and business acumen becomes more important. Government could expand the provision of financial literacy programs within the agriculture and farming sector that provide independent business advice and assistance to farmers. This may include improving skills in financial management and planning, asset management and business performance and preparation for drought and other risks. Improvements in farm business management, including financial capability and tools, are the most effective way to prepare for drought and other potential risks.

Question 15

Should there be a uniform farm debt mediation Act? If so, are any of the current Acts in a suitable form for uniform adoption?

59 BAB, including Rural Bank, strongly supports a national scheme for farm debt mediation.[44] BAB considers that farm debt mediations are the most effective avenue in working with agricultural customers and their advisors to reach an agreement that is acceptable to all parties.

60 BAB submits that the current New South Wales *Farm Debt Mediation Act 1994* (***NSW Act***) provides the most suitable framework for adoption at a national level including for the following reasons:

---

[42] See Gray, EM, Oss-Emer, M and Sheng, Y, *Australian Agricultural Productivity Growth: Past Reforms and Future Opportunities*, Australian Bureau of Agricultural and Resource Economics and Sciences, Research Report 14.2, Canberra, February 2014.

[43] See the National Rural Advisory Council's *Report on the Review of the Rural Financial Counselling Service Program* (2014): http://www.agriculture.gov.au/SiteCollectionDocuments/ag-food/drought/rfcs/rfcs-programmereview/nrac-review-rfcs.pdf.

[44] Gartmann Statement, [48] and Exhibit 4.124; RCD.0014.0021.0001 – "Response to RC 180518" at. 0002 ([4]), .0006 ([33]).

(a) the NSW Act provides for a pre-mediation conference to support customers in the preparation for the mediation and to provide the opportunity for customers to resolve any preliminary queries and obtain any additional information required; and

(b) the mediation process under the NSW Act is managed by the NSW Rural Assistance Authority, a statutory body established specifically for the purposes of administering a wide range of assistance measures to the rural sector.

61 More broadly, BAB considers that a national farm debt mediation scheme should include the following characteristics:

(a) the mediation should last no more than one day;

(b) there should be no obligation on the parties to reach an agreement;

(c) the parties should be under an obligation to conduct the mediation in good faith;

(d) the scheme should encourage the early engagement by a rural counsellor with the customer with a view to the rural counsellor attending the mediation;

(e) the customer should have the right to request attendance at the mediation by the customer's solicitor and accountant;

(f) if an agreement is reached, the mediator should prepare a template heads of agreement (as occurs in NSW);

(g) consideration should be given to interest rates and third party lending costs within the heads of agreement to establish common expectations of all parties;

(h) the legislation should provide scope for the state governments to participate in the farm debt mediation process through administration of the scheme; and

(i) as we have explained at paragraphs [32] and [33] above, the procedure for supplying and requesting information under the Queensland Act is helpful and should be adopted in a national scheme.

62 To this end, BAB supports the preparation of draft national legislation in line with the NSW Act by the Commonwealth Department of Agriculture and Fisheries. BAB expects that the exposure draft of this legislation will be presented to various state rural assistance departments and to the Australian Banking Association for consideration and consultation.

Question 16

How should banks balance the competing interests of strengthening the long-term relationships with their customers and being prepared to act decisively, where necessary, particularly to safeguard shareholder interests?

63 BAB places great value in maintaining long-term relationships with its customers. BAB and Rural Bank hold the view that successful customers and successful communities are key to a bank's ongoing success. In addition, for a specialist agricultural lender, having regard to the customer's long-term equity position in most instances aligns with shareholder expectations in relation to future growth and ongoing risk management.

64 As discussed at paragraph [12] above, where a customer is in financial difficulty there can be a difficult balance between giving the customer time to bring the loan into order, and the risk that the customer's equity will erode over time.[45] Sometimes decisive action may have preserved

[45] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0003 ([11]). See also T3618.41-47.

equity in assets,[46] while in others, a longer term approach should be taken. On average, Rural Bank works with customers in its asset management unit for about three years.[47]

65 Rural Bank will act decisively in the circumstances when ongoing support mechanisms for customers have proven unsuccessful, such that the customer's position has deteriorated to a point beyond which successful rehabilitation appears extremely unlikely. At this point, Rural Bank will act to preserve the customer's equity, and to protect the interests of its depositors and shareholders.

66 Where customers act decisively and quickly, outcomes can sometimes be more favourable. Outcomes can be positively impacted from early action due to:

(a) restructure potentially being less complicated;

(b) asset sales not occurring in distressed circumstances;

(c) property and livestock in better condition for sale;

(d) equity levels often being higher in early stages of hardship therefore affording greater opportunities to restructure farm operations and debt; and

(e) longer duration of AMU managed customers eroding customer’s equity due to the effects of accumulated ongoing operational costs and accruing interest.

Question 17

How should banks balance portfolio growth against the need to monitor and manage existing clients?

67 BAB does not consider that the desire for portfolio growth is inconsistent with the monitoring and management of existing clients. Often, portfolio growth is derived from existing customers who are themselves pursuing growth strategies. A consultation and review undertaken by Rural Bank in respect of its customers suggests that there is substantial alignment between these two needs.

68 Rural Bank customers are monitored and managed through an annual review process. As part of the annual review, the relationship manager will review the farm business, determine future cash flow forecasts, obtain appraisals and/or valuations and generally monitor account performance and risk attributes, in line with the relevant policies. The relationship manager will also consult with the customer to determine future funding requirements.

69 The number of farm businesses in Australia has declined over recent decades[48] as many farm businesses aim to increase their size, to capture the benefits of efficiencies of scale and to plan ahead for succession or business needs. Scale can be increased by increasing the farmland under management or by increasing operations along the value chain. Increasing the spatial scale of the farm business is generally via acquisition of neighbouring properties when they come on the market, enabling a greater land mass to be operated with the same machinery or infrastructure, or by acquisition of properties in different climate zones to spread climate and production risk. Either approach can work depending on the financial and management capabilities of the business operators, and appropriate access to capital. The timing of this strategy execution can be hampered by external events, as highlighted by the Commission's public hearings, but also requires banks to support existing customers in their growth and performance ambitions. In this respect, supporting existing customers and portfolio growth is not in conflict.

[46] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0005 ([27]).

[47] T3618.28-29.

[48] See http://www.agriculture.gov.au/abares/research-topics/labour.

70 As outlined in Ms Gartmann's statement[49] and in BAB's response to Questions 1, 3 and 16, Rural Bank takes a long-term approach to assisting agricultural customers facing financial challenges. The response to any finding of hardship identified during an annual review may be formulated, developed and implemented over the course of many months or years. This management and monitoring is considered alongside the customer's need for additional finance. In agricultural lending, the demands of livestock, crop cycles and impact of seasonal externalities mean that additional funding may be time-critical. In such circumstances, the bank must prioritise the provision of credit with other management requirements.

71 Ms Gartmann gave evidence to the effect that a bank is a business and, as such, growth is one of a several important priorities.[50] In specialist agricultural finance, portfolio growth through additional funding to existing clients or through the acquisition of new business is regulated through policy requirements. Rural Bank manages this process by undertaking due diligence on existing clients, stress testing the portfolio and imposing a target on the credit quality level for new business.

Question 18

Do banks have adequate policies in place to manage external events? If not, what should those policies entail?

72 Rural Bank's policies provide adequate guidance for the management of the impact of ‘normal’ external events on agricultural customers. However, if banks' policies truly contemplated the risk profile of Australian agriculture, which has limited government-subsidised support for farmers to buffer them against external events (such as an insurance market for agricultural risks), and has experienced droughts, floods, and adverse political decisions, it is possible that banks would decrease lending in Australian agriculture.[51]

73 Rural Bank's policies provide guidance for the management of external events as follows:

(a) the Rural Bank portfolio is stress-tested using actual and simulated external events. The severity of any adverse findings to a customer may lead to individual customer engagement to manage the impact. In the letter dated 18 May 2018 to the Commission, Rural Bank identified the stress testing of its dairy portfolio as an example of this process;[52]

(b) Rural Bank's policy underwriting standards including equity, servicing or interest cover and security cover include a contingency for the impact of external events;

(c) the Asset Management Policy, Asset Management Procedure and Hardship Policy[53] set out a consistent approach for the management of individual customers facing financial difficulty as a result of external factors including an emergency event or a natural disaster;

(d) the guidance in the Credit Policy Manual in relation to large exposures, geographic and industry concentrations assist with maintaining prudent portfolio concentration thereby limiting the impact of external events.

---

[49] Gartmann Statement, [44].

[50] T3664.4-8.

[51] T3685.16-26.

[52] Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0005 ([25]).

[53] Exhibit 4.121.2: BAB.5014.0001.0168 – "Exhibit AEMG-2-Copy of Rural Bank's Asset Management Policy dated 25 October 2017"; exhibit 4.121.3: BAB.5014.0001.0204 – "Exhibit AEMG-3-Copy of Rural Bank's Asset Management Procedure dated 2 November 2016"; exhibit 4.121.1: BAB.5015.0001.0087 – "Exhibit AEMG-1-Copy of the Rural Bank Hardship Policy dated 2 November 2017".

74 Ms Gartmann's witness statement states that Rural Bank's approach to managing customers in financial distress includes 'significant account of climatic, seasonal and economic factors'[54] in recognition that the operations of agricultural clients are subject to these external factors, which are beyond their control.

75 The management structure at Rural Bank was strengthened in line with the implementation of the recommendations of the Willis Report.[55] Ms Gartmann's statement expands on the ongoing changes within Rural Bank to improve and strengthen the implementation of policies more broadly, including the expansion of the remit, responsibility and membership of the Management Credit Committee to monitor the credit risk profile of Rural Bank.[56]

Question 19

Should banks have to contact customers when they become aware of misconduct relating to the accounts?

76 A bank should disclose misconduct in relation to a customer's account (breaches of laws, regulations, Code and/or the loan contract) to a customer, to the extent that the misconduct causes a material impact or detriment to the customer's interests.

77 For example, disclosure should be made where a bank employee engages in fraudulent activity against a customer. The bank ought to advise the customer of particulars of the fraudulent activity, provide confirmation of the security of the customer's personal information, and any impact on the customer, either directly or indirectly, and subsequent remediation arrangements.

78 Disclosure of misconduct is appropriate in the additional circumstances referred to by Counsel Assisting and confirmed by Ms Gartmann in her evidence, including where this has been a failure by bank staff to disclose, recognise and identify the true risk profile of the borrower in the assessment of a loan to that borrower, absent any countervailing external factors.[57]

79 BAB submits that a bank should not be under an obligation to disclose to a customer any misconduct resulting from a breach of an internal policy, where that breach has no material impact or detriment to the customer's interests or loan arrangements with the bank. It is more appropriate for a bank to endeavour to resolve a breach of policy through internal channels in the first instance, where the customer has not been impacted .

Concluding remark

80 While not the subject of questions from Counsel Assisting in the fourth round of hearings, Rural Bank wishes to take this opportunity to make the following observation.

81 The APRA standards which apply to agribusiness lending encourage banks to actively manage their credit risks through increased capital charges following "default" (for example, when an account becomes 90 days past due). Under current prudential standards the definition of default is the same for all asset classes, for example, as between residential and business loans.

82 Present standards do not allow for a different definitions of loan impairment in specific agricultural sectors (e.g. cropping or beef cattle). Given the long and infrequent cash flow cycles in many agricultural sectors, Rural Bank considers that 90 days past due is an inappropriate measure of

---

[54] Gartmann Statement, [45].

[55] Exhibit 4.121.10: BAB.5022.0003.0001 – "Exhibit AEMG-10-A report by HSW Partners entitled "Credit Framework and Operations Review" dated November 2011 presented Mr Graeme Willis of HSW Partners at a Board meeting of Rural Bank in December 2011 (Willis Report)".

[56] Gartmann Statement, [71].

[57] T3684.41-45; T3685.30-33.

default for many agricultural loans. There are some agricultural sectors where a 180 days past due figure may be more appropriate, and others where a 360 days figure may be more appropriate, given the annual and/or infrequent cash flows experienced by these businesses.

83 In the context of the Commission's fourth round of hearings, the Queensland beef cattle sector (and specifically those solely or predominantly exposed to the live export trade) is particularly relevant, with these businesses often having a single cash flow event on a 12-month cycle.

84 BAB is pleased to offer its cooperation to the Commission and offers its assistance in exploring these issues further if required.

16 July 2018