

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

**SUBMISSIONS OF BENDIGO AND ADELAIDE BANK LIMITED  
IN RESPONSE TO COUNSEL ASSISTING'S CLOSING SUBMISSIONS  
ON CASE STUDY 5, ROUND 4 (RUBRIC 4-36)**

## Introduction

- 1 Bendigo and Adelaide Bank Limited (**BAB**) makes the following submissions in response to the invitation to provide written submissions addressing each of the findings Counsel Assisting identified as open in closing submissions in relation to the fifth case study examined in the fourth round of the Commission's public hearings (based upon Rubric 4-36 (**Rubric**)). This case study focused upon certain loans made by Rural Bank Limited (**Rural Bank**) to customers in the Queensland cattle industry.
- 2 Rural Bank is a dedicated agribusiness bank. In December 1998, BAB established Rural Bank, then known as Elders Rural Bank, as a joint venture with Elders. In May 2009, BAB acquired a further 10% interest in Rural Bank, and in late 2010, Rural Bank became a wholly owned subsidiary of BAB.<sup>1</sup>
- 3 In BAB's submissions to the Commission, dated 29 January 2018 and 18 May 2018, the then Managing Director of BAB, Mr Mike Hirst, identified issues in relation to a number of Rural Bank loans taken out by customers in the Queensland cattle industry.
- 4 The Commission asked BAB to provide a witness statement in response to questions asked under the Rubric, focusing upon Rural Bank loans to customers in the Queensland cattle industry referred to by Mr Hirst in BAB's submissions to the Commission.
- 5 Ms Alexandra Gartmann, Chief Executive Officer and Managing Director of Rural Bank since 2015, gave a witness statement dated 20 June 2018 on behalf of BAB and Rural Bank in response to the Rubric. Ms Gartmann was cross-examined by Counsel Assisting.

## Proposed findings of misconduct

- 6 Counsel Assisting submitted that on the evidence it is open to the Commissioner to find that Rural Bank may<sup>2</sup> have engaged in misconduct in a number of ways.<sup>3</sup>
- 7 The foundation for Counsel Assisting's submission in relation to misconduct appears to be that, although Rural Bank was not a signatory to the Code of Banking Practice when the conduct in question occurred (Rural Bank became a signatory in December 2017), the Code of Banking Practice was a professional standard and a recognised and widely adopted benchmark for conduct throughout the relevant period, such that a finding of non-compliance with the Code of Banking Practice would constitute misconduct.<sup>4</sup> The presently relevant Code of Banking Practice is the 2004 iteration (hereafter the **Code**).<sup>5</sup>
- 8 In that regard, the definition of "misconduct" in the Letters Patent relevantly includes conduct that breaches "a recognised and widely adopted benchmark for conduct".
- 9 BAB submits that, in circumstances where adoption of the Code was voluntary and at all relevant times Rural Bank, as it was entitled to do, had determined not to adopt it, findings of misconduct (which by their nature are serious) for any non-compliance with the Code would be inappropriate and unsound. A norm of conduct must be applicable to the person said to have contravened it,

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<sup>1</sup> Exh bit 4.120: BAB.9000.0002.0001 – "Witness Statement to Alexandra Gartmann" dated 20 June 2018 (**Gartmann Statement**), [12]-[14].

<sup>2</sup> Although Counsel Assisting submitted to the Commissioner that it is open to find that Rural Bank *may* have engaged in misconduct, Rural Bank responds on the basis that the Commissioner is being asked to make findings of misconduct.

<sup>3</sup> T4124.35-36.

<sup>4</sup> T4124.31-33.

<sup>5</sup> Although, on the evidence (Gartmann Statement, [53]), some of the loans in question were made before 2004, such that the 2004 iteration of the Code, tendered by Counsel Assisting, could not have any potential application in respect of the making of such loans.

and at all relevant times the Code was not applicable to Rural Bank. Rural Bank makes this overarching submission in response to each of Counsel Assisting's submissions as to findings of misconduct being open to the Commission.

- 10 Certainly, however, Rural Bank has accepted in its earlier submissions to the Commission, as it does in this submission, that in some respects its conduct has fallen below community standards and expectations.

**Alleged misconduct by breach of clause 25.1 of the Code**

- 11 Counsel Assisting submitted to the Commissioner that Rural Bank may have breached the obligation in the Code to exercise the care and skill of a diligent and prudent banker in selecting and applying credit assessment methods and in forming opinions about customers' ability to repay in two distinct ways.<sup>6</sup>
- 12 Although it was not identified, BAB understands the obligation in the Code being relied upon for these submissions to be clause 25.1, which sits within Part D: Principles of Conduct, and provides: "Before we offer or give you a credit facility (or increase an existing credit facility), we will exercise the care and skill of a diligent and prudent banker in selecting and applying our credit assessment methods and in forming our opinion about your ability to repay it".

*First alleged breach of clause 25.1 of the Code*

- 13 As to the first alleged breach of clause 25.1 of the Code, Counsel Assisting submitted that, "as KPMG found, Rural Bank staff had engaged [in] a number of breaches of lending standards in relation to serviceability, including a failure to properly assess serviceability and by supressing information pertinent to credit and by mis-representing data into the Rural Bank systems."<sup>7</sup>
- 14 BAB submits that, even if a breach by Rural Bank of the Code constitutes misconduct, which is denied, in any event no finding of misconduct by reason of breach of clause 25.1 of the Code is open, or should be made, on the evidence.
- (a) The KPMG Report was a report commissioned by Rural Bank's internal auditors to provide assistance with Rural Bank's Credit Risk Internal Control Program.<sup>8</sup> The focus of the work was the adequacy and quality of information provided by specific Elders District Banking Managers (*Elders DBMs*) to Rural Bank's Credit & Lending team to support its credit decision making process.<sup>9</sup> Importantly, the staff the subject of the work were Elders staff, not Rural Bank staff, and the focus was on the conduct of Elders staff in their dealings with Rural Bank.
- (b) KPMG's engagement was limited, and the approach undertaken involved consideration of only 10 credit files, based upon documentation and inquiry with personnel at Rural Bank, but without inquiry of any of the relevant Elders DBMs or the customers to whom the 10 credit files related.<sup>10</sup> Further, there is no evidence about the responses to the KPMG Report, if any, of either the Elders DBMs or of Elders (to whom Rural Bank had referred

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<sup>6</sup> T4124.36-39.

<sup>7</sup> T4124.40-43.

<sup>8</sup> Exh bit 4.125: BAB.5022.0001.0001 – "1008145856\_1 (1) (3)".

<sup>9</sup> Exh bit 4.121.8: BAB.5022.0001.0254 – "Exhibit AEMG-8-A letter report prepared for Rural Bank by KPMG dated 27 September 2010 entitled "Assistance with Rural Bank Limited's Credit Risk Internal Control Program" (KPMG Report)" (*KPMG Report*), at .0254.

<sup>10</sup> KPMG Report, at .0255.

the report, for Elders' response<sup>11</sup>). In these circumstances, the preliminary views in the KPMG Report ought not be adopted as findings by the Commission.

- (c) KPMG selected – in a manner that is not identified in the report, or otherwise – 10 credit files to review against 16 behaviour checks set out in the report, with reference to the “Lending Standards Code of Conduct”.<sup>12</sup> Ms Gartmann gave evidence that she had made inquiries about the Lending Standards Code of Conduct, and could not identify any information about this code, including its country of origin.<sup>13</sup> As the source of this code and the content of the provisions in it are unknown, the KPMG Report's preliminary views as to breach of it by Elders staff ought not be given any weight. Further, absent knowing, with precision, the obligation or obligations in the Lending Standards Code of Conduct said to have been breached, on no view can the KPMG Report's preliminary views as to such breach be used to support a finding of breach of what is almost certainly a differently worded clause in the 2004 Banking Code of Practice.
- (d) Consistently with the focus of the KPMG Report, it identified Elders staff withholding information from Rural Bank's Credit & Lending team, but there is no evidence that this translated into a poor credit decision for any customer. Of the 10 credit files the subject of the KPMG Report, only one was within the 62 loans to customers in the Queensland cattle industry to which the Rubric related.<sup>14</sup> The Commission issued no notice to produce to Rural Bank for any part of those credit files, nor were any of the customers in question called to give evidence.
- (e) Elders and the Elders DBMs the subject of the putative findings of misconduct were not interviewed by KPMG,<sup>15</sup> not informed that their conduct was to be the subject of examination by the Commission, and not given an opportunity to give evidence or make submissions.

*Second alleged breach of clause 25.1 of the Code*

- 15 As to the second alleged breach of clause 25.1 of the Code, Counsel Assisting submitted that the five Elders DBMs referred to in the KPMG Report had engaged in a significant number of different types of breaches in respect of loan origination, and referred to two specific loans.
- 16 In response to the global submission that the five Elders DBMs referred to in the KPMG Report had engaged in a significant number of different types of breaches in respect of loan origination, BAB submits that, for the same reasons it sets out at [14] above, no finding of misconduct, particularly by Rural Bank, is open, or should be made, on the evidence. Further, BAB notes the generality of Counsel Assisting's submission and the non-identification of the breaches said to have occurred in respect of loan origination. These features both constrain BAB in responding with particularity to the submission and militate against the finding of misconduct that the submission invites.
- 17 The first specific loan referred to by Counsel Assisting related to the Queensland farmer whose loan application was approved in circumstances where it was known that \$1 million had been provided by his aunt, sourced from a margin loan that created further liabilities. In relation to this file, Counsel Assisting submitted that the relevant Elders DBM had misrepresented the Bank's position to the borrower and had acted dishonestly both towards the Bank and towards the

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<sup>11</sup> See exhibit 4.127: BAB.5034.0001.1708 – “Letter from APRA re Prudential Review 070111”, at .1710.

<sup>12</sup> KPMG Report, at .0255.

<sup>13</sup> T3646.15-24; P3650.22-34.

<sup>14</sup> T3660.38-39.

<sup>15</sup> KPMG Report, at .0255-0256.

customer, and that this had led to a loan being originated in circumstances where Rural Bank lacked material information about whether the debt could be repaid.<sup>16</sup>

- 18 BAB submits that, even if a breach by Rural Bank of the Code constitutes misconduct, which is denied, in any event no finding of misconduct by reason of breach of clause 25.1 of the Code is open, or should be made, on the evidence. In this regard, BAB repeats its submission at [14(a)] above, and further says as follows.
- (a) The customer applied for a loan in November 2007 for \$2.784 million in order to purchase land on seven titles, of which five titles were then to be on-sold in order to repay the facility.<sup>17</sup> That is, the customer had a strategy to increase his land holding by retaining two and selling five of the seven titles, and he needed a bridging loan to execute that strategy.
  - (b) Rural Bank initially declined the application, including because Rural Bank was being asked to fund 100% of the transaction, and the customer had no existing cash flow to service that debt if the implementation of the strategy was delayed.<sup>18</sup>
  - (c) The customer made another application, for a loan of \$2.154 million, which included \$1 million sourced from the customer's aunt and the pre-sale of 2 blocks to the local council for \$1 million. With the support of the Elders Regional Banking Manager and the Elders General Manager Sales and Distribution, the loan was approved.<sup>19</sup>
  - (d) Counsel Assisting's summary includes the statement, "the district banking manager had misrepresented the bank's position to the borrower", which it may be inferred is intended to summarise the KPMG Reports' statement, "DBM also misrepresented RBL by advising the customer that the Bank required the customer to source \$1 million from another source as a condition of approval".<sup>20</sup> It is unclear that the Elders DBM made any such misrepresentation: by reason of the borrower sourcing the \$1 million from the customer's aunt, the Elders DBM was able to support the application and it was duly approved.
  - (e) Counsel Assisting's summary then states that the Elders DBM "had acted dishonestly both towards the bank and towards the customer". As to the alleged dishonesty to the customer, that would appear to relate only to the asserted misrepresentation addressed in (d). As to the alleged dishonesty to Rural Bank, that would appear to relate to the Elders DBM's non-disclosure to Rural Bank that the aunt's funds came through a margin loan secured against the aunt's shares.<sup>21</sup> Whilst the lack of disclosure was an omission, there is insufficient material for a conclusion that it constituted dishonesty.<sup>22</sup> Further, given the essential role that equity from family plays in the banking system (as highlighted in paragraphs 3, 5 and 6 of the letter from BAB to the Commission dated 18 May 2018)<sup>23</sup>, that arrangement as between the customer and his aunt would not necessarily have affected the lending decision.

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<sup>16</sup> T4124.47-4125.6.

<sup>17</sup> KPMG Report, at .0259.

<sup>18</sup> KPMG Report, at .0259-0260.

<sup>19</sup> KPMG Report, at .0260.

<sup>20</sup> KPMG Report, at .0261.

<sup>21</sup> KPMG Report, at .0261.

<sup>22</sup> In relation to the answers of Ms Gartmann given at T3648.37-3649.2, Ms Gartmann was responding to propositions put to her in relation to assertions in the KPMG report relating to a customer which was not the subject of the Rubric, and with no background or opportunity to review the customer's file.

<sup>23</sup> Exhibit 4.124: RCD.0014.0021.0001 – "Response to RC 180518", at .0002.

- (f) Finally, Counsel Assisting concludes that “this had led to a loan being originated in circumstances where Rural Bank lacked material information about whether the debt could be repaid”. In circumstances where the customer’s strategy was to on-sell some of the purchased land to repay the facility, Rural Bank had an appropriate basis to believe the customer would be able to repay the loan. And given that Rural Bank had lent to the customer at less than the value of the purchased land, it was lending at an appropriate loan to value ratio. By the nature of bridging finance, and as Ms Gartmann said in evidence, where a facility was provided as a bridging loan, serviceability was not a strong consideration.<sup>24</sup>
- (g) Importantly, there is no evidence that the customer was impacted in any way by any non-disclosures by the Elders DBM to Rural Bank, and the loan did not become non-performing (as is evident from the fact that, although it was a loan to a Queensland cattle producer, it was not within the 62 loans the subject of the Rubric, namely Rural Bank’s loans to Queensland cattle producers that became non-performing).

- 19 As to the second specific loan, Counsel Assisting submitted that, in respect of a Victorian farmer with a livestock mortgage, Rural Bank had lent this customer more than the value of his security and that the Elders DBM responsible for the initial valuation should not have increased the customer’s facility in circumstances where the customer had been experiencing significant financial difficulty and there were reasons to doubt the correctness of the valuation upon which the increase was based.
- 20 BAB submits that, even if a breach by Rural Bank of the Code constitutes misconduct, which is denied, no finding of misconduct by reason of breach of clause 25.1 of the Code is open or should be made. In this regard, BAB repeats its submission at [14(a)] above. Moreover, as Rural Bank’s files record, the customer was a surgeon, not a full time farmer, with disclosed assets to Rural Bank at 2009 of over \$26 million and total liabilities of over \$15 million; there is no evidence that the customer was experiencing significant, indeed any, financial difficulty; and the customer failed to comply with obligations to provide annual financials in order to enable an Annual Review, which led the Bank to not allow any further debt, as a result of which the customer refinanced and repaid the loan to Rural Bank.

#### **Alleged misconduct by breach of clause 2.2 of the Code**

- 21 Counsel Assisting submitted to the Commissioner that it was open to find that Rural Bank may have breached the obligations under the Code to act fairly and reasonably towards its customers in a consistent and ethical manner.<sup>25</sup> Although it was not expressly identified, BAB understands that the obligation in the Code being relied upon is clause 2.2, which provides “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”.
- 22 Counsel Assisting submitted that it was open for the Commissioner to find that Rural Bank may have breached that obligation in three distinct ways.
- 23 In relation to these submissions, BAB repeats the submissions above at [9] in relation to the inapplicability of the Code, and says further as follows.

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<sup>24</sup> T3673.45-3674.1-2.

<sup>25</sup> T4125.13-16.

*First alleged breach of clause 2.2 of the Code*

- 24 As to the first way, Counsel Assisting stated, “Rural Bank failed to act fairly and reasonably towards a number of its customers whose loans were not adequately managed”.<sup>26</sup>
- 25 BAB submits that, even if a breach by Rural Bank of the Code constitutes misconduct, which is denied, in any event no finding of misconduct by reason of breach of clause 2.2 of the Code is open, or should be made, on the evidence.
- (a) Counsel Assisting did not identify which customers she was referring to, which loans were not adequately managed, or how Rural Bank failed to act fairly or reasonably in relation to these customers and loans. The subject matter of the submission is unclear.
  - (b) Having regard to the content of the case study, Rural Bank infers that the customers and loans being referred to are some subset of the 62 Queensland cattle loans the subject of the case study. (If this is not the case, Rural Bank requests an opportunity to put on a further short submission concerning such other customers as are in issue.)
  - (c) Ms Gartmann’s evidence was that loan management issues may be said to have been present in respect of 13 of the 62 Queensland cattle loans.<sup>27</sup> By this, Ms Gartmann meant that Rural Bank was not adequately monitoring loan performance.<sup>28</sup>
  - (d) Accepting that, in this manner, 13 customers’ loans “were not adequately managed”, it does not follow that Rural Bank failed to act fairly and reasonably in its dealings with those customers. For such a finding to even be open some unfair consequence must fall upon the customer by reason of the inadequate loan management, alternatively Rural Bank’s dealings with the customer arising from the inadequate loan management would need to be said to have been unfair or unreasonable towards the customer.
  - (e) In this regard, consideration must be given to the reason for the inadequate loan management. Ms Gartmann gave evidence that the cause of poor loan management could be where customers refused to give information;<sup>29</sup> it could also occur where customers refused to engage during times of financial distress.
  - (f) There was no evidence in relation to any of the 62 loans that inadequate loan management caused any unfair consequence to a customer, nor that Rural Bank’s dealings with any customer whose loan management was inadequate were in any way unfair or unreasonable.
  - (g) Further, and having reviewed the loans, Ms Gartmann gave evidence that inadequate loan management did not exacerbate the loan performance; it simply meant that at times Rural Bank was late in identifying when the loan may have become non-performing.<sup>30</sup>

*Second alleged breach of clause 2.2 of the Code*

- 26 As to the second way, Counsel Assisting stated, “as KPMG found, Rural Bank advanced credit to individuals and entities without undertaking a proper serviceability assessment. It was not fair to do this, because this placed those individuals in a position that – where they were unlikely to be able to fulfil their obligations under the loan.”<sup>31</sup>

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<sup>26</sup> T4125.19-20.

<sup>27</sup> Gartmann Statement, [74].

<sup>28</sup> T3636.9-11.

<sup>29</sup> T3669.32-34.

<sup>30</sup> T3636.9-11.

<sup>31</sup> T4125.20-24.

- 27 BAB submits that, even if a breach by Rural Bank of the Code constitutes misconduct, which is denied, in any event no finding of misconduct by reason of breach of clause 2.2 of the Code is open, or should be made, on the evidence.
- (a) In relation to the KPMG Report, BAB refers to and repeats the submission at [14] above. For those reasons, BAB submits that the Commission cannot adopt the preliminary views in the KPMG Report as findings of the Commission.
  - (b) Even if the preliminary views in the KPMG Report were capable of adoption as findings of the Commission, there is no evidence that any of the 10 customers whose credit files were the subject of that report were caused any unfairness by reason of the alleged inadequate serviceability assessment, nor that Rural Bank's dealings with those customers were unfair or unreasonable by reason of the alleged serviceability assessment.
  - (c) And on no view is it open for the Commission to find, on the evidence, that any of the 10 customers whose credit files were the subject of that report were placed in a position where they were unlikely to be able to fulfil their obligations under the loan.

*Third alleged breach of clause 2.2 of the Code*

- 28 As to the third way, Counsel Assisting stated, "after identifying customers who had been affected by internal issues within Rural Bank, including the misconduct of the district banking managers, Rural Bank failed to communicate with those customers about those internal issues, which was not fair or reasonable."<sup>32</sup>
- 29 BAB submits that, even if a breach by Rural Bank of the Code constitutes misconduct, which is denied, in any event no finding of misconduct by reason of breach of clause 2.2 of the Code is open, or should be made, on the evidence.
- (a) As set out above, BAB submits that there was no misconduct.
  - (b) As addressed below at [32]-[42], Ms Gartmann's review of the 62 Queensland cattle loans identified no customer in respect of those loans who has been adversely affected by any internal issue identified by Rural Bank. There is no contrary evidence before the Commission.
  - (c) Finally, in circumstances where the customer is economically unaffected by an issue internal to a bank, it could not be said that the bank's failure to inform that customer of such internal issue is unfair or unreasonable within the meaning of clause 2.2 of the Code.

**ALLEGED CONDUCT FALLING BELOW COMMUNITY STANDARDS AND EXPECTATIONS**

- 30 Counsel Assisting submitted that it was also open to the Commissioner to find that Rural Bank engaged in conduct that fell below community standards and expectations in three regards.<sup>33</sup>

*First allegation*

- 31 As to the first, Counsel Assisting submitted that the conduct, policies and procedures of Rural Bank materially contributed to the 62 loans becoming non-performing. In her statement, Ms Gartmann accepted that five aspects of Rural Bank's conduct – which contributed to the issues

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<sup>32</sup> T4125.24-27.

<sup>33</sup> T4125.29-30.

relating to securities and valuations, loan serviceability and loan management – fell below community standards and expectations.<sup>34</sup>

- 32 In relation to Counsel Assisting's submission that the conduct, policies and procedures of Rural Bank materially contributed to the 62 Queensland cattle industry loans becoming non-performing, BAB submits that the conduct, policies and procedures of Rural Bank did not cause any of those loans to become non-performing.
- 33 Between 2008 and 2017, Queensland cattle producers were severely affected by a sequence of significant external events that were virtually impossible to predict:<sup>35</sup>
- (a) a major decline in property prices for Queensland cattle properties, of about 30% from 2007 prices, particularly occurring in 2008, together with a significant drop in cattle prices;
  - (b) severe droughts across much of Queensland in 2008-2009 and during the 2013 to 2017 period;
  - (c) widespread cyclone Yasi related flooding across parts of rural Queensland in the summer of 2010-2011;
  - (d) in relation to northern Queensland properties, the ban on live cattle exports to Indonesia, announced with immediate effect by the Commonwealth government in June 2011. In many cases, affected Queensland cattle producers had no other viable market for their cattle.
- 34 It was this "almost perfect storm scenario" that caused the 62 loans to become non-performing.<sup>36</sup>
- 35 As a preliminary observation, Ms Gartmann's evidence was that after reviewing the 62 loans there appeared to be no issue relating to serviceability, security/valuations, or loan management in respect of 15 of those loans. Ms Gartmann formed the view that one or more of these issues may be said to have been present in respect of the other loans.<sup>37</sup>
- 36 In relation to loans in which it may be said issues of serviceability were present, Ms Gartmann stated that she had identified instances where the information provided by the loan originator was not appropriately challenged by Rural Bank's credit team.<sup>38</sup> Ms Gartmann also identified loans designed for a bridging purpose, but stated that in such cases serviceability assessment is impractical and not appropriate because the customer's strategy is to pay down debt via an asset sale.<sup>39</sup> Based upon her review, Ms Gartmann nonetheless considered that the loans in which it may be said issues of serviceability were present were serviceable.<sup>40</sup>
- 37 Further, based upon her review, Ms Gartmann's evidence was that serviceability was not the driving factor behind, or causal of, any of the loans becoming non-performing.<sup>41</sup>
- 38 In relation to loans in which it may be said issues of security/valuation were present, Ms Gartmann gave evidence that, in some cases, there was a failure to make appropriate inquiries by the credit department before offering a loan.<sup>42</sup>

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<sup>34</sup> T4125.30-35.

<sup>35</sup> Gartmann Statement, [57].

<sup>36</sup> Gartmann Statement, [58].

<sup>37</sup> Gartmann Statement, [74].

<sup>38</sup> T3635.28-37.

<sup>39</sup> T3673.45-3674.1-2.

<sup>40</sup> T3675.6-7.

<sup>41</sup> T3684.19-21; 34-36.

<sup>42</sup> T3635.43-44.

- 39 Taking account of both serviceability and security/valuation issues, Ms Gartmann's evidence was that, for the 62 loans, origination was appropriate,<sup>43</sup> and that there were only a very small number of those loans that Rural Bank would not write today.<sup>44</sup> It follows, as Ms Gartmann stated, that the loan origination assessment then undertaken was not causal of the loan becoming non-performing.<sup>45</sup>
- 40 In relation to loans in which it may be said issues of loan management were present, Ms Gartmann gave evidence that there was poor loan management and follow-up with individual customers, but that this did not exacerbate the loan performance.<sup>46</sup>
- 41 In her witness statement at [60], Ms Gartmann's stated:
- "I do consider that the issues [of serviceability, security/valuations, and loan management] may have meant that some of the loans were more susceptible to the cumulative effect of external stresses than they otherwise would have been".
- 42 It was this sentence to which Ms Gartmann was referring in the following exchange with Counsel Assisting:<sup>47</sup>
- "But you have conceded in your witness statement that the conduct of Rural Bank contributed to those loans becoming non-performing? ---Correct. So we had not adequately assessed to leave sufficient resilience to weather a perfect storm of live export ban impacting markets for a substantive period of time and a five-year drought."<sup>48</sup>
- 43 The evidence does not support a finding that the conduct, policies and procedures of Rural Bank materially contributed to the 62 loans becoming non-performing.
- 44 Nonetheless, Ms Gartmann accepted in her witness statement that in certain respects Rural Bank's conduct in relation to the 62 loans fell below community standards and expectations. In relation to the five aspects identified in paragraphs 48 to 50 of BAB's submission to the Commission dated 18 May 2018 and described in paragraph 12 of the Rubric as five separate failings, Ms Gartmann addressed them as involving the three interrelated issues considered above, being serviceability, security/valuations, and loan management.<sup>49</sup>
- 45 Ms Gartmann stated that these three interrelated issues principally occurred as a result of:<sup>50</sup>
- (a) poor judgments in the exercise of discretions delegated in accordance with the Policy & Procedures Manual authorising individuals to proceed outside of normal policy parameters;
  - (b) inadequate management oversight of the manner in which those discretions were being exercised and policies being applied;
  - (c) inadequacies in staff training;
  - (d) insufficient performance management of some individuals; and

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<sup>43</sup> T3673.33-34.

<sup>44</sup> T3685.4-8.

<sup>45</sup> T3685.4-8.

<sup>46</sup> T3632.20-27; T3636.9-11.

<sup>47</sup> T3686.36-T3687.6.

<sup>48</sup> T3684.23-26; see also T3635.16-19.

<sup>49</sup> Gartmann Statement, [54].

<sup>50</sup> Gartmann Statement, [69].

(e) matters of sales and credit culture, governance framework, approval process, and portfolio management, as elaborated in the Willis Report.

- 46 Ms Gartmann was asked to explain further some of these causes. The poor judgment in (a) was by Elders staff and related to how these staff assessed loan applications, noting that they were always operating within their authorised discretions under policies. Ms Gartmann considered that, from a judgment perspective, they were not adequately pushing back and taking account of the variability that might be inherent in, for example, the off-farm income or the customer's management capability.<sup>51</sup> The inadequate training referred to in (c) reflected that Ms Gartmann's investigations had not identified any training and development in place pre-2008, and that from 2011 there was a substantial increase and execution of training.<sup>52</sup> The sales and credit culture in (e) referred to a number of issues highlighted in the Willis Report and having an understanding of the credit appetite of the business and the information required to inform a credit assessment.<sup>53</sup>
- 47 Ms Gartmann, however, was quite clear in her evidence that the consequence of the foregoing culture and governance issues facing Rural Bank was not that loans were made to customers that ought not to have been made.<sup>54</sup> Ms Gartmann's evidence was that, having reviewed the 62 loans, there were very few that Rural Bank would not still write.<sup>55</sup> Further, her evidence was that the culture and governance issues did not necessarily of themselves have an impact on customers.<sup>56</sup>
- 48 Nonetheless, Ms Gartmann accepted in respect of the matters at [45]-[46] above that Rural Bank's conduct fell below community standards and expectations.<sup>57</sup>
- 49 Importantly, the conduct identified by Ms Gartmann as falling below community standards and expectations was internal to Rural Bank, and did not impact any customers.

#### *Second allegation*

- 50 As to the second allegation, Counsel Assisting submitted that, from recommendations made by APRA, Rural Bank should have been on notice from at least 2009, if not from 2006, of potential systemic issues within its loan serviceability policies and practices. It was submitted that Rural Bank failed to adequately engage with these warning signals, to recognise the issues as systemic and to take prompt steps to fix the issues.<sup>58</sup>
- 51 BAB submits that Rural Bank's conduct in addressing issues with its loan serviceability policies and practices was in accord with community standards and expectations.
- 52 In July 2009, APRA wrote to Rural Bank, with requirements and recommendations, including in relation to loan origination policies and practices.<sup>59</sup> The letter was sent in the immediate aftermath of the global financial crisis and conveyed that the regulator's priority was Rural Bank's maintenance of its liquidity and capital.

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<sup>51</sup> T3636.42-T3637.38.

<sup>52</sup> T3637.45-T3638.4.

<sup>53</sup> T3638.15-34.

<sup>54</sup> T3639.1-3.

<sup>55</sup> T3639.5-6.

<sup>56</sup> T3639.13-14.

<sup>57</sup> Gartmann Statement, [114].

<sup>58</sup> T4125.37-41.

<sup>59</sup> Exhibit 4.126: BAB.5034.0001.0026 – "APRA Prudential Review Report 010709".

- 53 Rural Bank took APRA's letter seriously, and its response was substantive and careful, including by highlighting the work that Rural Bank had undertaken in response to APRA's letter and the appropriateness of Rural Bank's systems and policies.<sup>60</sup> Rural Bank's response also identified, with reasons, matters upon which Rural Bank did not agree with APRA, such as that Rural Bank's lending was not outside policy or inappropriately outside general lending parameters.
- 54 Rural Bank's response to APRA's letter of July 2009 provided detailed information about each of the matters noted by APRA during its review and, in particular, about Rural Bank's credit assessment processes, its approach to monitoring and managing credit quality and its credit risk grading system, in order to provide APRA with an understanding of its loan serviceability policies and practices.<sup>61</sup> In the course of doing so, Rural Bank acknowledged that its Credit Policy needed to be more clearly and consistently articulated.<sup>62</sup>
- 55 By February 2010, Rural Bank considered its response to APRA's letter complete.<sup>63</sup>
- Ms Gartmann, looking back today, gave consistent evidence that she did not consider that there was any systemic issue with Rural Bank's loan serviceability policies and practices, and pointed to the fact that portfolio performance (especially under the stress of the global financial crisis, the tail-end of the Millennium Drought in south eastern Australia and the large property price decline in northern Queensland) conveyed that issues were localised.<sup>64</sup> Consistent with this, APRA's letter of 7 January 2011 stated that "Whilst there are several drivers behind specific cases of impairment and downgrades of credit risk ratings, the key driver throughout the portfolio appears to be adverse seasonal conditions affecting RBL borrowers."<sup>65</sup> Ms Gartmann stated that in 2011, out of the entire customer base, there was an increase of only 156 accounts being downgraded,<sup>66</sup> which is around only 2.4% of customers.
- 56 As matters transpired, from 2010, Rural Bank commissioned the KPMG Report, the Credit Structure Report, and the Willis Report, and introduced numerous and ongoing changes to improve and strengthen policies and procedures, and their oversight and implementation, with a particular focus on implementing the recommendations in the Willis Report.<sup>67</sup> Those recommendations included improvements to Rural Bank's loan serviceability policies and practices.
- 57 That said, Rural Bank's changes to its policies and practices do not evidence systemic problems with those policies and practices. By their nature such changes are general, but that does not mean that the fact of their making conveys that there were systemic issues. Continuous improvement requires systemic change, but it does not follow from the undertaking of such improvement that previously there were systemic problems. As Ms Gartmann explained in evidence, "There was certainly work and effort, as there continues to be, on policies and procedures, cultural alignment, training and oversight, that did take place. And they still take place, and it's not because we have a poor bank and poor practices, it's because there's continual improvement and there's always better ways of doing things."<sup>68</sup>

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<sup>60</sup> Exhibit 4.130: BAB.5034.0001.0001 – "Letter to APRA 240809".

<sup>61</sup> Exhibit 4.130: BAB.5034.0001.0001 – "Letter to APRA 240809".

<sup>62</sup> Exhibit 4.130: BAB.5034.0001.0001 – "Letter to APRA 240809", at .0003.

<sup>63</sup> T3653.22-25

<sup>64</sup> T3653.33-41.

<sup>65</sup> Exhibit 5.127: BAB.5024.0001.1708 – "Letter from APRA re Prudential Review 070111", at .1709.

<sup>66</sup> T3668.5-10; Gartmann Statement, [27].

<sup>67</sup> Gartmann Statement, [70]-[71].

<sup>68</sup> T3676.4-8.

58 In the circumstances of Ms Gartmann's evidence that there were not systemic issues, and the fact that Rural Bank did take steps to improve its loan serviceability policies and practices from 2010, Rural Bank's conduct could not be said to have fallen below community standards and expectations in its handling of APRA's letter and its recommendations in relation to loan serviceability.

*Third allegation*

59 As to the third allegation, Counsel Assisting submitted that, in 2010, a decision was made by Rural Bank to "give priority to generating new business and additional lending to existing clients over no increase annual reviews." It was submitted that this was not fair and reasonable to existing Rural Bank clients, who were entitled to expect standard and careful loan management.<sup>69</sup>

60 This submission is without evidential foundation.

61 It relies upon, and misunderstands, a single bullet point in the minutes of meeting of the Rural Bank Credit Committee dated 16 March 2010.<sup>70</sup> The minutes relevantly record items from the Executive Summary Report being discussed, including:

"Queensland: -

- C & L personnel are undertaking increased AMU tasks;
- Priority is being given to new business and additional lending to existing clients over no increase annual reviews;
- Recent extensive rain over a large portion of the State has lessened the general public's mood of negativity;
- The number of properties being offered for sale is increasing and it may be advantageous for the Bank's clients looking to sell, to list early in the year as the market is likely to become saturated; and
- Mr Ormsby noted that unfavourable cycles have emerged over the years and whilst the issues need to be dealt with the Bank must also continue to focus on opportunities presented by these cycles."

62 As the context shows, and in particular the first bullet point, the second bullet point relates to back office staff prioritisation. C & L (credit and lending) staff, who were undertaking increased AMU tasks, were giving priority to assessing new business and loan increases to existing customers, in preference to annual reviews. All annual reviews still had to be undertaken, and there was no evidence that by reason of this decision back office staff stopped undertaking annual reviews.

63 The second bullet point in no way records a decision of Rural Bank to prioritise new lending, let alone at the expense of annual reviews of existing customers. In addition to the fact that (as submitted above) the wording of the bullet point, properly understood, is not to that effect, it was not for the Board Credit Committee to make any such decision, and the wording relied upon by Counsel Assisting is but one short bullet point in a section of the minutes devoted to the executive summary. Indeed, of the nine standard sections in the BCC pack, only one is solely focussed on new lending, and there are separate sections which deal with portfolio performance and credit quality and compliance, which form the majority of the pack.

64 In the circumstances, the reference in the minutes of the meeting of the Board Credit Committee in no way conveys a decision that was unfair or unreasonable to existing Rural Bank customers;

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<sup>69</sup> T4125.41-44.

<sup>70</sup> Exhibit 4.121.7.2: BAB.5022.0004.0001 – "Exhibit AEMG-7-A bundle of minutes of meetings of Rural Bank's Board Credit Committee held on 22 December 2009, 16 March 2010, 22 June 2010, and 2 February 2011", at .0002.

and certainly the decision would not fall below community standards and expectations. To the contrary, it would reasonably be expected that a bank should prioritise a decision about a new or further loan, that would likely be time sensitive, over an annual review for which a limited delay would not matter.

### CAUSE OF THE ALLEGED MISCONDUCT

- 65 Finally, Counsel Assisting submitted that it was open to the Commissioner to find that any misconduct of Rural Bank can be attributed to its culture and governance practices, to its remuneration practices, and to inadequate internal systems.<sup>71</sup>
- 66 As set out above, BAB denies that Rural Bank has engaged in any misconduct. If (which is denied) the Commission finds that Rural Bank engaged in misconduct, BAB submits as follows in relation to whether any such misconduct can be attributed to Rural Bank's culture and governance practices, to its remuneration practices, and to inadequate internal systems.
- 67 As to whether it would be open to the Commissioner to find that any misconduct (which is denied) can be attributed to Rural Bank's culture and governance practices, and to inadequate internal systems, Rural Bank accepts that the issues relating to serviceability, security/valuation and loan management, were attributable principally to the matters listed at [45]-[46] above.
- 68 As to whether it would be open to the Commissioner to find that any misconduct (which is denied) can be attributed to Rural Bank's remuneration practices, BAB submits that such a finding is not open because, as the evidence made clear, Rural Bank's remuneration practices did not relevantly shape staff behaviour. Ms Gartmann gave evidence about Rural Bank's KPIs and remuneration policies for staff. In relation to loan origination staff, one half of the KPIs are results driven, and one half based upon values, leadership and people elements.<sup>72</sup> In relation to the results driven KPIs, the key result areas include retention of customers, acquisition of customers, compliance and account conduct.<sup>73</sup> The areas are equally weighted.<sup>74</sup> As to acquisition of customers, the expectation is a 10 per cent portfolio increase, usually about four customers.<sup>75</sup> Whilst the role of sales staff is to grow the business, since 2002, BAB (including Rural Bank) has had no incentive program connected with its staff satisfying sales or volume based KPIs. If the business performs well, all staff share in a bonus pool, which for sales staff is a maximum of 10% of their salary, which largely does not go anywhere over \$10,000.<sup>76</sup> In relation to asset management staff, there is no incentive structure connected with asset management.<sup>77</sup>
- 69 Counsel Assisting then submitted to the Commissioner that two further findings were open, but which were not stated to be in relation to a finding of misconduct or conduct falling below community standards and expectations. Each is addressed in turn.
- 70 First, Counsel Assisting submitted that it was open to the Commissioner to accept the findings of the Credit Structure Report, which include a finding that Rural Bank had a culture of prioritising asset growth over careful loan origination and loan management processes.<sup>78</sup>

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<sup>71</sup> T4125.46-T4126.1.

<sup>72</sup> T3615.21-22; T3616.1-4.

<sup>73</sup> T3615.30-31.

<sup>74</sup> T3615.21-25.

<sup>75</sup> T3616.6-20.

<sup>76</sup> T3616.40-45.

<sup>77</sup> T3617.35-37.

<sup>78</sup> T4126.1-4.

- 71 In relation to the submission that it is open for the Commissioner to accept the findings in the Credit Structure Report, Rural Bank makes the following observations.
- (a) First, the Credit Structure Report was written to stimulate cultural changes in Elders staff and management, at the time BAB took control of Rural Bank.<sup>79</sup>
  - (b) Second, Mr Corolis was the Chief Risk Officer. His focus was risk to the business, as was appropriate for his role, but his views did not necessarily reflect and cannot be attributed to Rural Bank's leadership team.<sup>80</sup>
  - (c) Third, Ms Gartmann gave evidence that Mr Corolis' findings were, in her view, overstated based upon her own review of the work undertaken and the benefit of the passage of seven years.<sup>81</sup> In particular, Ms Gartmann did not consider that there was a systemic problem with Rural Bank's policies and procedures.<sup>82</sup>
- 72 In relation to the submission that it is open for the Commissioner to accept that Rural Bank had a culture of prioritising asset growth over careful loan origination and loan management processes, BAB submits that there should be no such acceptance. Ms Gartmann's evidence gives no basis for such a conclusion, especially expressed at that level of generality. Certainly there is no basis to conclude that Rural Bank's position in this regard was any more pronounced than the industry generally,<sup>83</sup> or at the expense of careful loan origination and loan management processes; indeed, the evidence is to the contrary. At most the evidence conveys that there was a need for Rural Bank's credit risk appetite to be clarified, and better understood by the Elders DBMs.<sup>84</sup> The statement in paragraph 93 of BAB's letter to the Commission dated 29 January 2018 related to industry approaches generally. There is no basis to consider that Rural Bank was focussing on asset growth in a way that was at the expense of careful loan origination and loan management processes. To the contrary, as the 29 January letter conveys, it was not.
- 73 Second, Counsel Assisting submitted that it was open to the Commissioner to find that the conduct of Rural Bank that contributed to the 62 loans becoming non-performing included the culture and governance issues to which she had previously referred, being poor judgments in the exercise of discretions, inadequate management oversight of the manner in which the discretions were being exercised, inadequacies in staff training, insufficient performance management and matters of sales and credit culture, governance framework, approval process and portfolio management.<sup>85</sup>
- 74 This submission has been addressed above, at [31]-[49].

13 July 2018

D J BATT

C O PARKINSON

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<sup>79</sup> T3661.26-39; T3671.43-45.

<sup>80</sup> T3678.44-T3679.2.

<sup>81</sup> T3661.41-T3662.2; T3670.25-26.

<sup>82</sup> T3675. 39-47.

<sup>83</sup> Figure 2 of *Background Paper 17: Department of Agriculture and Water Resources (Amended)*, 28 June 2018 (published on the Commission's website) demonstrates that the industry experienced a period of rapid growth in the period 2002-2007.

<sup>84</sup> T3638.18-45.

<sup>85</sup> T4126.4-11.