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TRANSCRIPT OF PROCEEDINGS

O/N H-896296

THE HONOURABLE K. HAYNE AC QC, Commissioner

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

MELBOURNE

9.45 AM, MONDAY, 21 MAY 2018

Continued from 27.4.18

DAY 20

MS R. ORR QC appears with MR M. HODGE QC, MR A. DINELLI and MS E. DIAS as Counsel Assisting with MS C. SCHNEIDER
MR M. DARKE SC appears with MS P. NESKOVCIN and MR J. ARNOTT for Westpac

THE COMMISSIONER: Just before we begin, ladies and gentlemen, as with previous rounds of hearing, those who have been given leave to appear have been notified, and those parties have then indicated who will be appearing for them. There is therefore no occasion to take or announce appearances. For this round of hearings there was a large number of applications for leave to appear which I did not allow. And although the solicitors have written to those applicants trying to explain why I got to that answer, I just want to add something now, because I think it very important.

Almost all of the applications that were refused were by individuals who want to say that they, too, have been affected by conduct of a kind that falls within the Terms of Reference. It was conduct relating to dealings with small or medium enterprises. I understand that they want to have what happened to them publicly examined and publicly acknowledged. Many of those who sought leave, but were refused, have made online submissions. I encourage any of them who have not to take that step, because those online submissions form an important – I would say very important – part of the material that has been, is being, will continue to be considered by the Commission.

We have now received more than 5500 online submissions. We do read them, we digest them, and we do learn from them. But I remain of the view that proceeding by way of case studies, as we have in the past and will in this round of hearings, is the best way of finding out what has happened, finding out what was done or not done in response to what happened, and trying to identify what could have been done, what should have been done, in response, and then thinking about what follows from those conclusions. Mr Hodge.

MR HODGE: Commissioner, today we commence the third round of public hearings. These hearings will explore issues in relation to small and medium enterprises in their dealings with financial services entities and particularly in relation to the provision of loans. There will be a particular focus on small businesses, on how we define them, and the extent to which we ought to regulate the provision of credit to them. This module will not include consideration of lending to farmers. Lending to farmers will form a part of – or one part of the next round of hearings for module 4.

As will become apparent during the course of these hearings, business loans raise very different issues to home loans. A bank is generally subject to fewer obligations in determining the appropriateness of a business loan when compared with the making of a home loan. That is the case even for loans to small businesses. And that is, as we will explain, the approach that is desired by significant voices in the small business community. The concern is that to impose responsible lending obligations on banks when lending to small businesses would dry up or further dry up the provision of credit to small businesses. There is also a significant difference between the circumstances in which a business loan might be enforced and the circumstances in which we would expect a home loan to be enforced.

An issue raised in various forums, and in many public submissions to this Commission, is banks taking enforcement action because of non-monetary defaults. That is, the borrower has made whatever payments of principal and interest the borrower is required to make, but is in default because, for example, the loan to value ratio of the security for the loan has been breached, or the borrower's earnings have fallen below a minimum interest cover. When compared with the circumstances in which a home loan might go into default, it might seem surprising that a bank would rely upon a non-monetary default in a business loan to take default based action.

However, non-monetary defaults need to be considered in the particular context of the particular business loan. Take, as a simplified example, a loan for property development. It may be the case that a facility is to be paid out when the development is completed. If the market changes and the value of the property falls, then the loan to value ratio may be breached, and the bank and the borrower may have to confront the risk that if the property falls any further, it will not be possible to pay out all creditors, including the bank, when the development is completed. Now, perhaps the market will recover in the immediate future; perhaps it will not.

The question will be what should the bank and the borrower do in those particular circumstances. How should the risk be managed? And does this give rise to issues in relation to whether or not the conduct is either misconduct or conduct falling below community standards and expectations. Having regard to those and other distinctions between personal lending and business lending, there are, at least, three overarching questions that we expect that you will wish to consider during the course of this module.

First, what obligations in relation to responsible lending ought to apply to small businesses? Secondly, in what circumstances might the exercise by a bank of default-based contractual rights become unfair, unconscionable, or below community standards, when the relevant loan is a small business loan or a business loan? Thirdly, how have the banks and the regulators responded to calls for higher calls for higher standards for dealings with small business and the introduction of legislative prohibitions on unfair terms in small business contracts?

In this opening submission, we will traverse a number of topics that we hope will assist the Commission, the public, and those that have been granted leave to appear, to understand better the case studies that will be explored over the following two weeks, together with the background and purpose for this exploration. The first topic that we will look at is to provide a snapshot of the scale of small business in Australia to contextualise the importance of this topic to the Australian economy. Secondly, we will briefly explore the funding sources for small businesses in Australia. Third, we will explore some of the prevailing definitions of small business.

Fourth, we will explain some of the key features of the regulatory framework in which lending to small business occurs, including upcoming reforms and accused suspended sentence to redress mechanisms. Fifth, we will summarise what small

business owners have told the Commission about their experiences with financial services entities. Sixth, we will touch on what regulators and other bodies working in this area, such as ASIC and the Financial Ombudsman Service have told the Commission. Seventh, we will summarise what past reviews and inquiries have found, including those of the Australian Small Business and Family Enterprise Ombudsman or Small Business Ombudsman.

Eighth, we will make observations about our approach to cases related to Bankwest and its takeover by CBA. Ninth, we will consider what financial services entities have acknowledged to the Commission as to their own misconduct and conduct that has fallen below community standards and expectations in relation to small businesses. 10th and finally, we will briefly introduce the case studies to be explored in this round of hearings. We will return to highlighting the potential themes and questions that are likely to emerge for close consideration by you.

I start then with the first topic: small businesses in Australia. The Australian Bureau of Statistics defines a small business to be one with less than 20 employees. Data from the ABS shows that the end of the 2017 financial year, there were just under 2.2 million businesses in Australia that would fall into that category. This represents 97.5 per cent of all businesses at the relevant time. Of those 2.2 million businesses, 1.37 million had no employees. Small and medium enterprises are also significant employers within certain sectors of the economy. In 2015 to 2016, small businesses with 20 employees or less employed 4.7 million people in Australia, which represents 44 per cent of the total number of people employed in the private sector in Australia.

Small businesses are the predominant private sector employer in the agriculture, forestry, fishing, and construction industries. A number of case studies that we will deal with in the following two weeks deal with or involve franchises. According to the Franchise Council of Australia's 2016 report, the number of franchise businesses operating in Australia also continues to grow, having almost doubled over the past 20 years. In 1998 there were approximately 44,000 franchise businesses operating in Australia. By 2016, that had risen to approximately 79,000. As at 2016, almost half a million Australians were employed in the franchising sector.

Most, though not all, of the case studies that you will hear about involve the closure of a business. There is little robust data on the causes of closure of small businesses in Australia. It is important to note first that a small business ceasing to trade is not necessarily synonymous with business failure. Many businesses cease to operate on their own terms. In its 2015 inquiry report on business set-up, transfer and closure, the Productive Commission found that over 90 per cent of business exits are not the result of formal insolvency, and the majority are voluntary and do not involve business failure. In the same report, the Commission also observed that voluntary business exits include successful exits such as selling the business for a profit or merging with another business. ABS data shows that more employees – that the more employees a business has, the more likely it is to survive.

The second topic, that I now turn to, is the availability of funding. Which, of course, is going to be critical for many small businesses from inception to operation. There is little data available on lending to small business, but RBA data published in December 2017 suggests that approximately 27 per cent of the aggregate value of credit provided by banks to all businesses in Australia is provided by way of facilities in respect of which the credit outstanding is $2 million or less, and it might be inferred that for facilities of less than $2 million, that's more likely to be a small business than a large business.

Banks are the main source of lending for businesses in Australia, with 90.5 per cent of commercial finance commitments in January 2008 being made via banks. ASIC has further observed that the majority of small business customers are with the four major banks. A recent Productivity Commission inquiry found initial funding for new businesses, whether debt or equity, was usually provided by the personal resources of business founders. That is, by personal savings, personal credit cards, or equity and personal assets, such as real estate. However, many new businesses also seek finance from banks in the form of business loans, trading facilities and overdrafts, and including on the basis of personal capital or equity being provided.

In this way, small business lending is often intermingled with the finance of the business owner or the owner's family. For example, although precise data is not readily available, the Productivity Commission's draft report into competition in the Australian financial system cites data that shows that around 80 per cent of the value of small business lending by the major banks was secured by some form of real estate. Data provided by the major banks to the Productivity Commission shows that around 33 per cent of all small business lending by the major banks is secured by residential property. These figures illustrate the importance of providing security to the ability of small business entrepreneurs being able to access finance.

The third topic we will address is one that has vexed many regulators and industry participants. How is a small business defined? A related question is: what purpose is served by a definition of small business? Small businesses are defined in various pieces of legislation and industry codes for the purpose of providing certain protection, rights or benefits to businesses that fall into whatever is the defined category. These protections, rights and benefits accrue to the small businesses that meet that definition, but not to any other businesses, and legislation and industry codes often use different definitions of small businesses.

Generally, Commonwealth statutes employ definitions of small business that turn upon the number of employees. In the Corporations Act, for example, small business is deemed to be ones that have less than 20 employees or 100 employees in the case of manufacturers, and they are deemed to be retail clients in relation to insurance and other financial products or services for the purpose of Chapter 7 of the Act. However, that approach is not used consistently throughout legislation. In some cases, there is little distinction drawn between different sizes of business, while in others, small businesses may be treated as retail clients or even as consumers.

In addition to the number of employees, the scope of legislative protection may be limited by reference to the value of the contract in question, and the recently extended unfair contract terms regime in the Australia Securities and Investments Commission Act applies to businesses that employ less than 20 employees, or 100 employees for manufacturing businesses, where the contract has either an upfront price of less than $300,000 or in the case of a contract which has a duration of more than 12 months, the contract price is less than $1 million.

Other legislation uses the annual turnover of an entity to determine whether the entity is a small business. The Australian Small Business and Family Enterprise Ombudsman Act provides for an ombudsman with advocacy and assistance functions in relation to small businesses that have less than 100 employees and an annual revenue of $5 million or less. The Income Tax Assessment Act provides access to certain concession treatments in the tax laws for small entities which have a turnover of less than $10 million. In the contrast, the prohibition on unconscionable conduct in the ASIC Act is not limited by any of these factors. It applies to the acquisition of financial services by any business that is not a listed public company.

These definitions are also replicated in voluntary industry codes such as the current Australian Banking Association's Code of Banking Practice which adopts the Corporations Act definition of small business. And that code is, in turn, linked or used in internal bank policies. Westpac, for example, applies its financial hardship policy to customers with a total committed exposure of up to $1 million and to customers who satisfy the banking Code of Practice definition of small business. Some debate has arisen in recent years about this apparent inconsistency in the – and the plethora of definitions across the legislative landscape.

However, in its 2013 research report into regulator engagement with small business, the Productivity Commission found little merit in the idea of merging into a single harmonised definition for small business, noting that this could lead to inflexibility and higher costs. It concluded the policy-makers and regulators are best placed to define small business for their regulatory area. This returns to the second question we noted above: what purpose is served by a definition of small business? And having regard to what has been found by the Productivity Commission, what is the particular legislative regime under consideration?

Ultimately, whichever approach is adopted, the rationale for delineating smaller business entities from larger ones is to extend certain consumer protections or akin protections to entities that may be relatively unsophisticated and lacking in the bargaining power and resources of a larger entity, such as access to lawyers or specialist advisers. For example, where a business is a sole trader, it is owned and run by one person. The sole trader is personally responsible for the debts of the business, and there is no legal distinction between the sole trader and the business. In other circumstances, small businesses are undertaken through a company in which one person is the sole shareholder or in which all of the shares are held by members of one family. As already noted, there is extensive use of personal assets, such as the family home, to secure a business loan.

Such traits may make small businesses akin to consumers in the power imbalance that they are under when negotiating with and dealing with financial services entities. Therefore, they may be in need of the same or similar protections against misconduct that are afforded to consumers. But, if such protections are extended, what will be the costs and consequences for small businesses? Will it lead to a reduction in the availability of credit and, if so, why? Will it lead to an increase in the cost of credit, because of an increase in the risk of lending by the entity?

The fourth topic to which I will now turn is the legal framework in which small business lending takes place. The Commission's background paper number 10 Credit for Small Business, an Overview of Australian Law Regulating Small Business Loans by and drew Godwin, Jeannie Marie Paterson and Nicola Howell, at Melbourne University Law School provides a great deal of detail on the legislative and regulatory regimes applicable to small business and is available on the Commission's website. The Commission's background paper number 11, Request for Information Reforms to Small Business Lending, by Treasury, identifies reforms affecting SME lending that have been introduced since 2007. The Commission welcomes comments on the papers which may be provided to the Office of the Solicitor Assisting the Commission.

As will be apparent from those papers, there is little regulation of small business lending in Australia. There are no legislative codes or protections that are specifically directed to small businesses in Australia. As we have already said, the responsible lending obligations under the National Consumer Credit Protection Act do not apply to small business credit products. Proposals to extend that regime to small business credit have previously been considered but not adopted or recommended, mainly due to concerns expressed by small business representatives that such a move would restrict flexibility on the part of lenders, and, therefore, limit the access of small businesses to credit.

Since the GFC, the conversation on regulating small business in Australia has focused on questions about the appropriate balance between access to credit and imposing standards on the provision of that credit to protect borrowers. We have heard from a range of stakeholders, including the Small Business Ombudsman and the Council on Small Business Australia, that there is a correlation between regulatory burden and the ability of small businesses to have access to credit, including increased credit costs for access to that credit. Further adding to the complexity of the regulation of small business lending is the question of how sophisticated and well-resourced small business operators can be expected to be in relation to seeking credit and dealing with situations of default.

However, there are some protections that apply to small business lending. The ASIC Act applies to provide protection against misleading and unconscionable conduct. What constitutes unconscionable conduct in a finance to business context will be determined by a court on a case by case basis which may have regard to a range of circumstances. But it is undoubtedly the case that a high bar is generally imposed by courts when a commercial borrower alleges that a lender has acted unconscionably.

The mere existence of a disparity in bargaining power does not make the conduct of the stronger party in promoting its own interests unconscionable.

The ASIC Act also implies a number of terms into contracts for the supply of financial services to consumers. Somewhat confusingly, the ASIC Act then defines acquisition in connection with a small business to be acquisition by a consumer, and in that way the end result is that there are mandatory warranties in contracts for the supply of financial services to small businesses that (a) the services will be rendered with due care and skill and (b) that the services will be reasonably fit for any purpose or required result made known to the supplier by the consumer. In 2015, Parliament also extended the unfair contract terms provisions of the ASIC Act to standard form small business contracts entered into or renewed on or after 12 November 2016.

Small businesses usually enter into loan agreements through standard form contracts. That is, the terms are not subject to negotiation and they are offered on a take it or leave it basis. The 2016 reforms were generally supported by consumer advocacy organisations, but small business organisations and the financial and leasing sectors raised concern with the extension of the regime to small businesses on the basis that it would increase burden and lending costs. The unfair contract terms provisions apply, as I have said already, where the upfront price payable does not exceed $1 million if the contract is for longer than 12 months, as would most often be expected in the case of lending.

Following the commencement of the unfair contract term reforms, ASIC and the Small Business Ombudsman conducted a review of small business loan contracts of up to $1 million offered by the four major banks. Following this intervention, the four major banks agreed in August 2017, some eight months after the commencement of the amendments, to further change the standard terms in their small business loan contracts by removing a number of standard clauses, including entire agreement clauses, broad indemnification clauses, unilateral variation clauses, and financial indicator covenants save for and in respect of certain specialised industries such as property development.

Evidence will be presented in these hearings as to the oversight by ASIC of the legislative changes and their implementation by affected entities. The four major banks also agreed to extend unfair contract term protections from the $1 million required by legislation to loans of up to $3 million. In making this announcement, the Small Business Ombudsman, Kate Carnell, noted that recent reviews have consistently raised that a small business loan facility of $5 million is the correct benchmark, including her own inquiry into small business lending. General law doctrines such as the law of contract may also apply to small business contract transactions and these duties will, of course, exist alongside statutory obligations.

Given the small number of specific protections relating to small business lending, borrowers must largely rely on self-regulation by the banks to provide additional protections. The Code of Banking Practice is a voluntary code published by the Australian Banking Association that has been adopted by most banks offering retail

products in Australia, including credit products. Although the code does not have the force of law independently, the terms of the code may form a part of any contract that a subscribing bank enters into with its customers and will apply to loans to small business where the business falls within the definition of small business contained in the code.

A key provision of the current code is clause 27, by which a bank undertakes to exercise the care and skill of a diligent and prudent banker in selecting and applying credit assessment methods and in forming an opinion about the customer's ability to repay the credit facility before giving or increasing such a facility. Other important provisions concern the obligations on banks in procuring guarantees of small business loans. The protections include an obligation to give a prominent notice in relation to various matters before the guarantee is taken, including that the guarantor should seek independent legal and financial advice on the effect of the guarantee. The bank must also tell the guarantor about certain matters such as a service of a notice of demand on the debtor and provide copies of the credit contract and other documents.

In a decision of the Victorian Court of Appeal in Doggett v The Commonwealth Bank of Australia, in which an earlier version of the code was considered, it was held that the earlier clause 27 was a relevant provision under the equivalent of clause 31.3 which applies the code to guarantees and was, therefore, incorporated into the terms of the guarantee. As a result, guarantors have the right to rely on a bank's promise to act as a diligent and prudent banker in assessing the relevant loan before its approval. Noncompliance with the Banking Code can be examined by the Banking Code Compliance Monitoring Committee.

Banks that have adopted the banking code are required to report to this committee about their compliance on an annual basis. Although at present there are few sanctions available to the committee in respect of breaches of the banking code, a small business can rely on an applicable breach of the code as a breach of its contract with the relevant bank and seek the intervention of the committee.

The first witness from whom the Commission will hear evidence today will be Mr Philip Khoury, who conducted an independent review of the code in 2016 and 2017. Shortly after Mr Khoury's report was published, it was announced that a revised code would provide small business customers with longer notice periods around changes to loan conditions or a bank's decision whether to renew a loan facility, as well as simpler contracts. In addition, the revised code will be compulsory for all members of the ABA. In December 2017, the ABA announced that a revised code had been provided to ASIC for approval.

This is the first time ASIC has been asked to approve the code which means it must meet the criteria for codes in the financial services set out in section 1101A Corporations Act, and ASICs regulatory guide 183, including in relation to compliance monitoring and enforcement. The revised code has not yet been approved and, before these hearings, the drafts had not been made public. The state

of the code and its contemplated approval by ASIC will be considered in a case study next week. Access to redress for small business customers is an issue of ongoing reform by the government. It has been the topic of significant consideration in recent years, including the report of the Ramsay review which we will discuss further.

Partly due to the existence of jurisdictional and compensation caps that can operate to exclude small business from alternative dispute resolution, and leave costly court action as the only option for redress of a business that has a dispute with its bank, small businesses that have less than 20 employees, or 100 employees in the case of manufacturers, are included in the definition of retail clients in the Corporations Act, which means they must be covered by an internal dispute resolution procedure. Small businesses may also have access to an ASIC approved external dispute resolution scheme if the lender is an Australian credit licensee.

Lenders that do not provide consumer credit are not required to hold an Australian credit licence and are, therefore, not required to belong to an EDR scheme. The consequence of this is that small businesses that borrow from non-bank lenders will not have access to an EDR scheme. The two EDR schemes that presently deal with small business lending are the Financial Ombudsman Service and the Credit and Investments Ombudsman. From 1 November 2018 there will be a single EDR scheme for financial complaints: the Australian Financial Complaints Authority. FOS and CIO presently have overlapping functions. The ability of a business to take a dispute to one or the other body will depend on the scheme and the financial services provider.

Both FOS and the CIO may consider disputes between a financial services provider that is a member of their scheme. FOS may not consider a dispute under the following conditions: where the value of the applicant's claim in the dispute exceeds $500,000, or where the dispute is about debt recovery against a small business where the contract provides for a credit facility of more than $2 million. CIO may not consider a dispute under similar conditions where the value of the claim exceeds $500,000 or the financial services provider had, before the complaint was received by the CIO, commenced legal proceedings against the small business complainant in relation to a credit facility having a credit limit of more than $2 million.

There is also a limit on the amount of compensation that FOS and the CIO can provide which is set by ASIC and aligned to the retail client definition set out in the Corporations Act and the regulations. The current limit on compensation is $323,500. FOS and CIO will have their jurisdiction taken over by the new Australian Financial Complaints Authority which will have jurisdiction to hear small business disputes. AFCA will have expanded jurisdiction because it will have an expanded definition of small business which will be any business with fewer than 100 staff and will be able to consider disputes and claims in relation to credit facilities of up to $5 million. It will also have an expanded compensation cap of $1 million for small businesses and $2 million for primary producers.

Commissioner, the fifth topic that we will now address is information that we have received from members of the public in relation to business lending. As at 5 pm on Friday, 18 May 2018, the Commission had received 5540 submissions from Australians through the Commission's website, a figure that is up significantly from the approximately 1850 submissions that had been received at the time of the first public hearing in February. Over 2000 of the additional submissions have been received since the opening of the second round of public hearings on 16 April. Just over 11 per cent of the public submissions received to date have indicated that they relate to small business financial dealings, totalling 633 submissions.

Within the 633 submissions, five key issues have been most frequently raised. First, a large number of submissions raised concerns about the process for assessing and approving applications for credit made by small businesses. Many of the submissions identify concerns about loans or other credit having been provided to small businesses without the relevant financial services entity first undertaking a proper assessment of the viability or profitability of the small business, and its capacity to service the credit product on offer. Next, some Australians have raised concerns about the circumstances in which they have provided personal guarantees or used their family home as security for their business loan, and the consequences that follow from such requirements.

Thirdly, the Commission has received a number of submissions from the public which raise concerns about the processes for rolling over or renewing business facilities. These submissions highlight concerns about the imposition of additional conditions as a condition precedent to rollover and the period of notice that has been given by financial services entities of a decision not to renew the relevant facility. Fourthly, many submissions received by the Commission concern business loans that have been placed in default or terminated for breach of non-monetary obligations by the borrower, such as reporting obligations or loan to value ratio covenants. These submissions raise concern about business facilities being terminated even where the business has continued to make all payments due and owing under the facility on time.

Finally the Commission has received a large number of submissions concerning the availability of adequate dispute resolution mechanisms for small businesses in their dealings with financial services entities. These submissions suggest that many small business owners who are in dispute with a financial services entity are forced to walk away from their business because they cannot afford to pursue court proceedings. In the case studies which will be presented over the next two weeks, evidence will be presented on a number of these themes.

Many of the themes are also identified in a submission received by the Council of Small Business Australia. In its submission, the council raised concerns about behaviours and practices engaged in by the enforcement and recovery teams within financial services entities, and the effect that these behaviours and practices have on the mental health and well-being of small business owners. It was evident from the public submissions and individuals that we have spoken to in the course of preparing

for these hearings that the effect of business lending issues can extend beyond the borrower.

The Commission was told by a number of consumer advocacy bodies, including Legal Aid Offices, of examples of the effect on family members of small business lending issues, particularly parents guaranteeing small business loans for their children using their homes as security. In such situations, there are questions to be asked about whether guarantors fully understand the risks associated with providing the guarantee once the business gets into financial difficulty. In some circumstances highlighted by Legal Aid Queensland, guarantors were not told of extensions of business facilities for which they were providing security.

Guarantees are often older Australians who can then face repossession of their homes when the banks seek to enforce these guarantees in the event that the bank fails. This can also lead to conflict between the rights and obligations of the borrower and the rights and obligations of the consumer who has provided the guarantee, which can place, obviously enough, immense pressure on familial relationships. The Commission also heard about the importance of the business relationship between the bank and the SME customer. In particular, there were many submissions that evidenced a view that the further away from the branch the loans were managed, the less satisfactory the outcomes to borrowers.

An associated issue that was raised by a number of individuals and entities was the management of businesses in difficulties by individuals located in bank's central offices who had limited knowledge of the individual business or its circumstances. The South Australian Business Commissioner noted that local account management is a thing of the past, and there is no local knowledge or understanding of the business and its needs. The sixth topic that we will now address is the work of Australian regulators in this area and the observations that they have shared with the Commission over the past six months.

ASICs work in respect of small business lending has been primarily limited to overseeing the implementation of the unfair contract terms legislation, and in administering consumer protection provisions that apply to small business such as the unconscionable conduct provisions in the ASIC Act. ASIC has said that its assessment of reports of misconduct affecting small businesses is aimed at identifying cases to enable identification of possible test cases where misconduct may be harming the interests of small business and where it will provide certainty and fairness to all small business. Approximately 96 per cent of all Australian companies and businesses registered with ASIC are small businesses, being defined as those with fewer than 20 employees.

In March 2017, ASIC established an Office of Small Business intended to increase ASICs focus on and engagement with the small business sector. ASICs new small business strategy introduced in August 2017, will require all ASIC internal teams to assess how their work might affect small businesses. In a submission to the Commission, ASIC has observed concerns about the conduct of banks in providing

small business finance since the GFC particularly in relation to the enforcement of loans by banks during and following the crisis. As we have already said, in early 2017, ASIC collaborated with the Small Business Ombudsman to review and consult with banks following the November 2016 extension of the unfair contract term provisions under the ASIC Act to small businesses.

In its recent 2018 report, ASIC details the changes made by the big four banks to their small business loan contracts to comply with the legislation. As the competition regulator, the ACCC has a role in competition across all industries, including the financial services sector. While the ACCCs role is to enforce the Competition and Consumer Act, ASIC is the agency responsible for enforcing consumer protection laws in relation to financial products and services and the ACCC generally refers such matters to ASIC. The unfair contract terms regime is incorporated into both the Australian Consumer Law and the ASIC Act.

The enforcement of the Australian Consumer Law is the responsibility of the ACCC. In anticipation of the extension of the unfair contract terms provisions to small business taking effect on 12 November 2016, the ACCC undertook an education campaign beginning in November 2015 which included consultation with stakeholders. The 2017 ACCC compliance and enforcement policy lists insuring small business receives protections of the new unfair contracts terms law as an area of work it is prioritising. These efforts of the ACCC to date have, obviously, enough not focused on the issue of lending to small businesses because, that is within the remit of ASIC rather than the ACCC.

The Financial Ombudsman Service deals with about 83 per cent of all disputes brought by consumers and small businesses within the current three schemes of external dispute resolution. In 2016/17, 1431 disputes were brought to FOS by small businesses in relation to credit issues which represented a high watermark for these types of disputes being brought to FOS. In its 2013 independent review report FOS noted a number of issues that affect small businesses including maladministration in lending, fees and interest rate disputes, financial difficulty and issues pertaining to the realisation of security. FOS provided data to the Commission including an overview of what it termed its systemic issues investigations.

These issues are those which FOS considers will have an effect on people beyond the parties involved in a dispute. The FOS submissions notes that since 2007 and 2008, 39 systemic issues have been identified in relation to business finance. For business finance, the largest number of systemic issues relates to policies with dealing with customers members in financial difficulty. We will hear from one of the ombudsmen during these hearings in respect of a case involving a finding of irresponsible lending. The Commission published background paper number 9, The Regulatory Capital Framework for Authorised Deposit Taking Institutions by the Australian Prudential Regulation Authority on 27 April 2018.

It provides a great deal of detail on the regulatory capital framework and is available on the Commission's website. The Commission has also published on Friday, 18

May 2018, a further background paper from APRA, background paper number 13, on impairment provisioning and enforcing of security. We will return to that second paper later. The capital adequacy framework has an effect on the costs and conditions of SME lending and on the types of security guarantees that are needed to secure this type of lending. Capital adequacy requirements are based on the framework developed by the BASIL committee which is the primary global standard setter for the prudential regulation of banks.

Assessing capital requirements by financial institutions on the basis of these requirements involves categorising assets into separate classes and weighing their value according to their relative riskiness. Assets weighed in this way are referred to as risk-weighted assets. The capital adequacy framework requires that a bank hold a minimum amount of regulatory capital as a proportion of its total risk-weighted assets. In its first background paper APRA identifies that under the current regulatory framework loans to small and medium enterprise businesses which are secured by a residential property receive the same capital treatment as consumer loans secured by residential property. That is, they attract the same risk weights as consumer loans.

However, loans to SMEs which are secured by other forms of collateral, including by commercial property, are treated differently. Such loans are currently risk weighted at 100 per cent. In February 2018, APRA commenced a consultation on proposed changes to the capital adequacy framework. In relation to small business lending, the discussion paper released by APRA contains a proposal to change the risk weight requirements for SME lending with SMEs being relevantly defined as a business that has annual group sales of less than $50 million.

Under the new approach, APRA is proposing to reduce the risk weight attached to SME loans secured by commercial property and SME loans which are not secured by either residential or commercial property from 100 per cent to between 60 to 85 per cent. If implemented, this proposal will have the effect of reducing the minimum amount of regulatory capital which must be held by banks against lending to SMEs. APRA is also proposing to change the risk weightings for SME loans that are secured by residential property to attract the same risk weights as for interest only loans and loans to purchase investment property from between 35 to 75 per cent to between 30 to 85 per cent, depending on the loan to value ratio.

Treasury has noted in background paper number 11 that any additional constraints on the ability of a bank to realise collateral held against SME exposures as a result of legislation or additional protections for SME borrowers could have an effect on the amount of regulatory capital required by authorised deposit taking institutions, and that may in turn have pricing implications. We turn now, Commissioner, to consider other important inquiries that have considered issues facing small businesses in respect of financial service providers.

At the outset, we should explain that our discussion of this topic today is limited by Parliamentary privilege, which means that evidence given to Parliamentary inquiries

cannot lawfully be adduced into evidence before this Commission, nor can statements, submissions or comments be made in relation to that evidence. For that reason, we will not address today the reports of various Parliamentary inquiries. We will begin then with the treasury consultation in relation to the unfair contract terms regime. The regime was extended to small businesses with effect from November 2016, but was preceded by a 2014 treasury consultation.

Over 80 submissions were received in response to the consultation, as well as around 300 responses to the online business survey. The majority of submissions were supportive of extending unfair contract term protections to small businesses, including small business groups such as the Tasmanian Small Business Council and the Victorian Small Business Commissioner. A notable opponent of extending unfair contract term provisions was the ABA, which expressed the strong view that standard form contracts for the provision of financial services to small businesses by banks should be exempt from any extension of unfair contract term protections, including because this could have an effect on compliance costs of financial institutions and flow-on effects for access to credit. Nonetheless, these protections were extended to small business in November 2016.

The Australian Small Business and Family Enterprise Ombudsman was established in March 2016 to assist and advocate for small business and family enterprises. In December 2016, the ombudsman published her report into the adequacy of the law and practices governing financial lending. In this report, the ombudsman observed that sudden changes in support by banks on agreed lending strategies for small business borrowers can result in the borrower not having sufficient time to seek alternative arrangements. Moreover, banks' unrealistic timeframes for debt reduction can force the SME borrower to restructure or downsize their business operations which ultimately renders the business commercially unsustainable.

The ombudsman's recommendations included the strengthening of the ABAs 6 point plan of measures designed to assist and ensure that member banks meet the expectations of their customers and the community, approval in administration of the revised Code of Banking Practice by ASIC, a minimum 30 day business notice period to all changes to general restriction clauses and covenants to give small business borrowers more time to respond and react to potential breach of conditions, and at least 90 days' notice on decisions relating to the rollover of loans so the borrowers can organise alternative financing if loans are not renewed by their bank.

The ombudsman has also recently published reports into transparency and disclosure practises of Fintech lenders and the barriers to investment of those small to medium enterprises. The ombudsman's inquiry for affordable capital for SME growth will be published later this year. On 20 April 2016, the Australian Government commissioned a review into the financial system external dispute resolution and complaints framework led by Professor Ian Ramsay, Julie Abramsom and Alan Kirkland. The final report of the view panel was published on 9 May 2017. The panel found that, while small business can access advice and advocacy services from small business specific organisations, such as the Small Business Ombudsman, these

bodies are unable to provide comprehensive dispute resolution procedures which small business requires.

The review panel made various recommendations as to monetary limits and compensation caps, and the establishment of AFCA and its jurisdiction and compensation caps will reflect the recommendations that were made by the Ramsay review. Under the Corporations Act, under the amendments to the Corporations Act, ASIC may direct AFCA to require that the limit on the value of claims that may be able to be made under the scheme and the limits on the value of remedies that AFCA may determine be increased. AFCAs jurisdiction will also permit complaints in relation to non-monetary covenants to be heard. For disputes about whether a guarantee should be set aside, where it has been supported by a mortgage or other security over the guarantor's primary place of residence, there will be no monetary limits or compensation caps.

Commissioner, the eighth topic we will address this morning will be issues arising from the takeover of Bankwest by CBA in 2008. A number of former customers of Bankwest have made public submissions to the Royal Commission concerning their treatment after Bankwest was acquired by CBA. We will have case studies next week that concern actions taken with respect to customers of Bankwest after that acquisition. The relevant customers were reviewed as part of what was referred to as Project Magellan, an internal project of CBA. Those case studies will, we anticipate, allow you to consider the exercise by the bank of its contractual rights in circumstances in which it wished to mitigate the risk to itself of exposure to a particular loan or lending to a particular industry.

To return to the second overarching question that I flagged at the outset, the case studies will be relevant to the question of in what circumstances, if any, the exercise of contractual rights by a bank might be unfair, unconscionable, or below community standards. The case studies that we have chosen do not raise any of the ulterior motive theories that have circulated from time to time about CBAs dealings with the Bankwest loan book. There are various ulterior motive theories and they are not consistent with each other, however, the common element is that they attribute to CBA in its dealings with the Bankwest loan book an ulterior motive to systematically default loans and to default loans for reasons not concerned with what CBA perceived, rightly or wrongly, to be the risk of a particular loan or lending to a particular industry.

Outside of these hearings, significant work has been undertaken by the Commission to look at the history of the raising of various ulterior motive theories, their consideration or the consideration of those theories in other forums, and the extent to which there is any evidence to support them. In consultation with you, we have made the decision that none of these ulterior motive theories warrant further consideration by case studies during these hearings. We will say a little more about two of those theories to illustrate the consideration that has been undertaken, but before I turn to those two theories, it will be helpful to provide some factual context to the acquisition of Bankwest by CBA in December 2008.

In 2003 a UK bank, HBOS, acquired Bankwest. Bankwest had been the State bank in Western Australia. In the years that followed Bankwest's acquisition by HBOS, Bankwest was heavily dependent on funding by its UK-based parent. In 2008, HBOS found itself exposed to the global financial crisis. Indeed, in mid-September 2008, Lloyd's announced a proposal to acquire HBOS with the UK government to take a 40 per cent stake in the merged entity. At around that time HBOS determined to sell Bankwest. On 8 October 2008, CBA entered into the sale agreement for which it purchased Bankwest for an initial purchase price of $2.1 billion which was to be paid on 19 December 2008.

The sale agreement set out a purchase price adjustment process. By the relevant provisions, the initial price paid by CBA for Bankwest could increase or decrease by reference to the financial accounts which were to be prepared for Bankwest as at 19 December 2008. Any adjustment was the subject of a process by which HBOS was to provide its calculations and, in the absence of agreement, there was to be a resolution of disputes and finalisation of the adjustment by expert determination. After receiving the relevant financial information from HBOS, CBA disputed certain items, and the matter eventually proceeded to be determined by an expert in accordance with the contractual process. Ernst & Young were appointed as the expert for this purpose.

Pursuant to the process, on 19 February 2009 HBOS had provided a draft completion balance sheet for Bankwest as at 19 December 2008. The draft balance sheet was accompanied by price adjustment calculations and an unqualified audit report from KPMG. CBA was required to give notice to HBOS that it either agreed or disagreed with the content of the draft balance sheet and the price adjustment calculations by 20 April 2009. It did so, and identified 22 items in the balance sheet with which it disagreed. There followed a process of negotiation before Ernst & Young was instructed on 5 June 2009 to resolve the disputed items.

While initially there were 22 disputed items, by the time Ernst & Young came to make its determination, some had been resolved. Ernst & Young received further submissions from each of HBOS and CBA as to the still disputed items. On 7 July 2009, Ernst & Young completed its determination. The result was an increase in the price paid by CBA of $26 million. The final price for Bankwest was, therefore, $2.126 billion. The net increase of $26 million took into account price increases and decreases arising from the disputed items. Only two of the 22 disputed items related to impairment of loans. One was to specific provisions, and the other to general provision.

Taken just by themselves, the two items relating to impairment of loans accounted for a $156.6 million price decrease, but they were more than netted out by other items that ultimately increased the price. The first ulterior motive theory that I will address in a little detail is what is often referred to as the clawback allegation. The clawback ulterior motive theory is that CBA acted deliberately after it acquired Bankwest to impair some loans so that it could claw back the amount of the impairment from HBOS under the price adjustment mechanism. For reasons that I

will explain in a moment, this ulterior motive theory is not supported by either the facts or the operation of the contractual mechanism.

However, before I come to the Commission's own analysis, I wish to say some things about the views that have been expressed by others who have looked at this particular theory. As I have already said, by reason of Parliamentary privilege, it is not appropriate to say anything about the treatment of such theories in reports of any Parliamentary committees. However, the clawback allegation has been referred to in court proceedings. In 2013, Hammerschlag J of the New South Wales Supreme Court gave a judgment in the matter of International Skin Care Suppliers v Commonwealth Bank of Australia. During the course of that proceeding allegations were made that CBA had dishonestly defaulted a loan motivated by the clawback provisions in the sale agreement with HBOS.

The relevant borrower had gone into voluntary administration in January 2009 and Bankwest had appointed a receiver on 11 December 2009. CBA had not sought any further provision in respect of that borrower as part of the price adjustment process. That is, this loan had not even been subject to the clawback mechanism. The plaintiff abandoned the clawback allegations during the course of the proceeding. Nevertheless, his Honour addressed the abandoned allegations in his judgment and concluded there was no proper basis for the charges of dishonesty against the bank of its officers which were levelled in the clawback arrangement claim:

> *It is difficult to see how the view could properly have been formed that there was any basis for the allegations. They should not have been made.*

The clawback allegations also appear to have been raised and then abandoned in another proceeding in the New South Wales Supreme Court which is Neale v Bank of Western Australia Limited. In that case, also before the same justice, his Honour noted that the plaintiff informed him that he, the plaintiff, had read Hammerschlag Js judgment in International Skin Care and the plaintiff had concluded that Hammerschlag J was correct. The plaintiff had thereafter run a different claim as to CBAs described as the "deliberate destruction strategy" which was also rejected by Hammerschlag J. Staying with the clawback ulterior motive theory, this has also been considered by the Small Business Ombudsman.

We have engaged with the ombudsman. The view she has expressed in writing to the Commission about the clawback ulterior motive theory is unequivocal. She describes it as false and explains that, in her view, there was no capacity in the share sale deed for a clawback of performing loans that were present in acquisition and which most acquisition became impaired. Based on our own analysis we share the views of the ombudsman that the clawback ulterior motive theory is incorrect. I will summarise only some of the relevant matters that might have been misunderstood about the facts and the contractual mechanism.

First, the price adjustment mechanism in the sale agreement was concerned with the state of Bankwest's accounts as at 19 December 2008. For an adjustment to be made

to the purchase price based on the provisioning of an impaired loan, it meant that provision or further provision for the loan ought to have been made in the accounts as at 19 December 2008, but the amount of provision provided for in HBOSs draft balance sheet on 19 February 2009 was inadequate. Merely calling it a loan after 19 December 2008 could not affect the state of facts as at 19 December 2008.

Secondly, it is important to understand the difference between four terms: impairment, provisioning, default, and enforcement. The terms have sometimes, unfortunately, been used inaccurately in documents that we have seen and in a way that leads to misunderstandings: perhaps most significantly, the term "impairment" is sometimes used as if it is synonymous with default or enforcement. It is not. A loan is impaired if there are doubts about whether the bank will recover the full amount of money owed by the borrower to the bank. A borrower may be up to date on payments, but the loan may, nevertheless, be impaired because there are doubts about timely and full repayment.

On the other hand, a borrower may be behind but the loan is not impaired because the bank has sufficient security to cover the full amount of the loan. If a bank forms a view that a loan is impaired, then it ought to make a provision to cover its expected shortfall and recovery from the loan. It should hold a provision against the estimated loss. This will be recorded on the bank's balance sheet. Impairment and provisioning are separate and distinct from default and enforcement. In perhaps overly simplistic terms impairment and provision error concerned with the bank's management of its capital adequacy and balance sheet.

Default enforcement and enforcement are concerned with the relationship between the bank and the borrower. A default means there has been some breach of the loan contract by the borrower. Enforcement action is some action taken by the bank, such as appointment of receiver or manager the commencement of a court proceeding, based on a default. As we have just explained, it is possible that a borrower is not in default but, nevertheless, the bank must treat the relevant loan as impaired because the bank is ultimately unlikely to recover the full amount it has loaned to the borrower.

Conversely, a borrower might be in default but the loan is not impaired, and no provision needs to be made, because the bank has sufficient security. Once the distinction between these terms is understood, the difficulty with the suggestion that CBA and Bankwest were defaulting loans after 19 December 2008 in order to render them impaired as at 19 December 2008 becomes immediately apparent. Thirdly, most of the complaints that we have seen have been by Bankwest customers about their treatment by CBA or Bankwest in respect of events that occurred after 7 July 2009 and, in fact, in 2010 or later. That was the situation being addressed by Hammerschlag J in International Skin Care.

However, the claw back ulterior motive cannot have anything to do with events after July 2009 because, after that date, Ernst & Young had delivered their determination and the price adjustment mechanism had no more work to do. Fourthly a review of

the process in relation to the price adjustment mechanism does not support the ulterior motive theory. For the one disputed item concerned with provision for specific loans there were 67 loans that CBA said ought to have been provisioned for or further provisioned for as at 19 December 2008, which had not been provisioned or adequately provisioned for in the HBOS draft balance sheet.

Of these, once CBA raised the issue, HBOS ultimately agreed that seven should be provisioned in the full amount sought by the CBA. 60 remained in the dispute, but of the 60 in the dispute HBOS agreed that 18 should be provisioned in part of the amount sought by CBA. We have reviewed the submissions made by the CBA and the Ernst & Young determination. On our review of the 67 loans identified by CBA as acquiring additional provision, in many of them receivers and managers had been appointed prior to 19 December 2008, there had been significant monetary defaults prior to 19 December 2008, guarantees had declared bankruptcy or were in liquidation prior to 19 December 2008 or the loan file was already under credit management prior to 18 December 2008.

On any view, these were already distressed loans. By way of example, in one case receivers and managers had been appointed in 2007 to a property development group with three incomplete residential and industrial developments. As at 19 December 2008, the receivers and managers had completed and sold off two developments but there were various complications and costs associated with completion and sale of the third. The guarantors had been declared bankrupt. There was no disagreement between CBA and HBOS, unsurprisingly, that the loan was impaired. The only dispute was as to the amount of provision. CBA sought an increase in provision and HBOS ultimately accepted this increased provision.

Our review also suggested that in respect of only a few of these loans did CBA point to the appointment of receivers and managers between 19 December 2008 and the EY determination in its submissions to Ernst & Young. That said, even where it did so, it was not necessarily the case that CBA had sought to rely on those appointments as evidence that the loan should have been impaired at 19 December 2008. In one case, Ernst & Young agreed with CBA that there was sufficient evidence that the loan was impaired at 19 December 2008 but there was a workout strategy in place at that time and, therefore, no specific provision was required.

The appointment of receivers and managers, while noted by Ernst & Young, was not relevant to their determination. In another case, the decision to appoint receivers and managers in February 2009 was made only after the borrower advised CBA of a winding-up order that it did not intend to defend. CBA and HBOS agreed that the facility was impaired at 19 December 2008. The disagreement was as to the amount of the specific provision. Ultimately, Ernst & Young's determination was closer to CBAs figure. CBA referred in its submissions to the appointment of a receiver and it would seem that CBAs figures as to the amount of provision was based on its assessment of the security value, as well as realisation costs which included some receivership costs and, hence, the reference to the receiver and manager.

In the third case, processes were already underway to appoint receivers and managers and take possession of the relevant property as at 19 December 2008. After acquisition, the receivers were appointed and the property sold. HBOS ultimately agreed with CBAs proposed specific provision so Ernst & Young was not required to make any determination. In a couple of other cases determined by Ernst & Young, CBA pointed to action taken as mortgagee in possession after 19 December 2008. In one case, as at 19 December 2008, the borrower could not be located and had already declared bankruptcy. CBA entered into the property as mortgagee in possession in March 2009, and the property was sold in April 2009.

There was no disagreement that the loan was impaired. HBOS agreed with CBAs proposed specific provision which reflected the shortfall between the amount of loan exposure and the sale price. Again, Ernst & Young was not required to determine the provision. In another case there was no disagreement that a loan was impaired at 19 December 2008 as the borrower, a hotel proprietor, had been declared bankrupt on 18 December 2008. CBA entered the property as mortgagee in possession in February 2009 and the property was sold. HBOS and CBA differed by a couple of hundred thousand dollars as to the amount of provision and ultimately EY adopted the figure proposed by HBOS.

Finally, for one other loan, CBA pointed to default notices to argue that a loan was impaired at 19 December 2008. Ernst & Young determined that the borrower was not in technical default at 19 December 2008, even though the borrower subsequently failed to repay the $16.72 million facility when it fell due in January 2009. As a result, the loan was not impaired or provisioned as part of the price adjustment mechanism. In summary, none of the foregoing and – of the analysis that we've just gone through is consistent with CBA seeking to systematically default borrowers and take enforcement action against those 67 borrowers so as to rely on the price adjustment mechanism.

Commissioner, the second ulterior motive theory that I will mention is one that CBA impaired loans on the Bankwest loan book to improve its tier 1 capital ratio. There are various permutations of this theory, and the one example that we will deal with today has the following elements: the board of CBA resolved in February 2009 to lift its internal tier 1 capital ratio target to above 7 per cent from a previous range of between 6.5 per cent and 7 per cent. This created pressure on CBA management to improve its tier 1 capital ratio. CBA did not wish to raise capital to improve its capital ratio. Therefore, CBA impaired or wrote off loans to improve its capital ratio.

These elements arise from a misunderstanding of a number of matters. First, CBA did not need to improve its tier 1 capital ratio to get it above 7 per cent as at February 2009. Its tier 1 capital ratio was already well above 7 per cent as at that date. At our request, APRA has prepared a table setting out the tier 1 capital ratios of the big four banks and Bankwest until it was absorbed into CBA over the period from 30 June 2008 to 30 July 2015, and we will bring that up now. It's RCD.9999.0030.0001. And, consistently with what I have just said, you will see Commissioner that as at December 2008, CBA had a tier 1 capital ratio of 8.4 per cent.

Indeed, it was the highest of the big four banks at that time. And you will also see that the final figure under Bankwest for that same period was a ratio of 7.5 per cent. There was no need as at February 2009 for CBA to engage in any process in relation to its business loan book to improve its tier 1 capital ratio to bring it above 7 per cent. It was already well above that ratio. I tender that table Commissioner.

THE COMMISSIONER: Exhibit 3.1 will be tier 1 capital ratios June '08 to June '15, RCD.9999.0030.0001.

EXHIBIT #3.1 TIER 1 CAPITAL RATIOS JUNE 2008 TO JUNE 2015 (RCD.9999.0030.0001)

MR HODGE: Thank you, Commissioner. Secondly, CBA was not avoiding raising capital to improve its tier 1 capital ratio at the relevant time. Indeed it raised significant amounts of capital and that is publicly disclosed in CBAs capital adequacy and risk disclosures. They demonstrate that CBA raised significant amounts of tier 1 as follows: CBA issued $405 million and $688 million of ordinary shares, in March and September 2009 respectively, to satisfy the dividend reinvestment plans. CBA issued $865 million of ordinary shares in March 2009 with respect to a share purchase plan, CBA issued $2 billion of PERLS V securities in October 2009 which, by reason of regulatory rules, $1.6 billion was eligible for inclusion in the bank's tier 1 capital.

Thirdly and most significantly: impairing and provisioning alone does not improve a bank's tier 1 capital ratio. Rather, it reduces the bank's tier 1 capital ratio. As we mentioned earlier we sought a paper from APRA explaining how impairment provisioning and enforcement of loans affects the tier 1 capital ratio. That was published on the Commission's website on Friday. The consequence of systematically impairing loans would be to reduce the tier 1 capital ratio. There has also been some suggestion that a write-off of a loan might improve the bank's tier 1 capital ratio. What that means exactly is unclear: a bank's capital position does not improve by writing off assets.

In any event, a write-off happens at the end of an enforcement process, and as we will see with a document we will bring up in a moment, almost all of the relevant completion of enforcement action and writing off of loans in the Bankwest loan book occurred on or after 1 July 2010. Can we bring up CBA.0001.0032.0490. And if we go to the second page of that document and blow up the chart at the bottom of the page you will see, Commissioner, this is a chart explaining the amounts of write-offs that occurred in relation to what was defined as the performing book as at December 2008. The performing book just means that part of the book that was not impaired and provisioned for as at December 2008. And you will see that although there is a limited number of write-offs in financial years 2009 and 2010, there are then significant write-offs in 2011, 2012, and 2013 and 2014 and 2015. I tender that document, Commissioner.

THE COMMISSIONER: How do I describe it, Mr Hodge?

MR HODGE: It can be described, Commissioner – well, strictly, it's a letter that was originally produced by the Commonwealth Bank to the Parliamentary Joint Committee but, in fact, it's now been produced in various ways so that it doesn't attract - - -

THE COMMISSIONER: Letter CBA dated?

MR HODGE: 10 November 2015.

THE COMMISSIONER: 10 November '15, CBA.0001.0032.0490 becomes exhibit 3.2.

EXHIBIT #3.2 LETTER CBA (CBA.0001.0032.0490) DATED 10/11/2015

MR HODGE: Thank you, Commissioner. In summary, we have not seen any primary evidence from primary sources that support these ulterior motive theories, and their logic appears to be premised on misconceptions of the facts to which we have referred. For that reason, they will not be pursued as part of the case studies. Can we add one final observation: there is a hidden bias in these types of theories which is that they create a distraction from the substantive questions that are worthy of consideration. They allow the convenience of avoiding grappling with the risk presented by a particular borrower or industry.

They, therefore, avoid asking how a bank might or might not legitimately respond to its perception of increased risk in respect of a particular loan or lending in a particular industry, and in what circumstances such conduct might be unconscionable or below community standards. And the view that we have formed is that if we do not ask the right questions, then we cannot hope to assist you to arrive at the right answers.

The ninth topic that we will address is information provided to us by financial services entities about whether their own conduct in relation to small businesses has constituted misconduct or conduct falling below community standards and expectations. As you know, Commissioner, you have written to various entities in the financial services industry and related representative bodies and asked them to address a number of questions. You invited each of those entities to identify any misconduct or conduct falling below community standards and expectations that it had engaged in since 1 January 2008. After receiving responses in late January, Commissioner, you wrote to a number of those entities again and asked them to provide more specific information about instances of misconduct in the past five years.

A further request specific to small businesses was sent to ANZ, Bank of Queensland, CBA, Macquarie Bank, NAB and Westpac on 5 April 2018 asking whether there was any feature of those earlier responses that those entities wish to point to as relating to SME lending, and inviting those entities to add to their responses specifically in relation to SME lending. That further request was sent by the Solicitor Assisting the Commission. We will deal with the responses from the entities that will be giving evidence in these hearings in alphabetical order.

ANZ has provided three submissions to the Commission. The last one of which is specific to SME lending. ANZ told the Commission that its SME lending is typically advanced to small to medium-sized business customers with total business lending of up to $10 million. ANZs small business banking team typically deals with customers who have total business lending of up to $1 million and its business banking team deals with customers who have total business lending of up to $10 million. ANZ acknowledged that it has engaged in misconduct and conduct falling below community standards and expectations in relation to SME lending.

We give some examples of ANZs acknowledgements. First, ANZ acknowledged misconduct or conduct falling below community standards and expectations in relation to applications for business loans. ANZ has identified instances where frontline staff engaged in inappropriate sales practices in an effort to increase incentive payments, including selling or referring customers to unsuitable products, some of which involved SME lending. ANZ identified instances where its staff or representatives were involved in submitting false information in connection with loans and loan applications. For example, ANZ acknowledged that in 2017, two ANZ business banking managers were found to have been colluding with external third parties to make 47 fraudulent loans. One was dismissed, the other resigned during the disciplinary process.

ANZ also acknowledged misconduct or conduct falling below community standards and expectations, in relation to where business loan arrangements had been varied or come to an end. ANZ identified that in some instances dealings between its collection team and customers breached the Code of Banking Practice and the ASIC debt collection guidelines. ANZ also identified concerns raised by the financial services ombudsman of systemic issue in failing to suspend collections activity once a dispute was before the ombudsman, including in connection with SME lending.

In identifying for the Commission what it considers community standards and expectations are in relation to SME lending, ANZ told the Commission that there are important points of differences between the expectations of consumer lending and SME lending, stating that there is a community expectation of greater flexibility in approach with regard to SME lending. ANZ cites the desirability of entrepreneurial enterprise and economic growth in the SME sector as well as differences in the regulatory regimes and protections as reasons why this is the case. This difference in approach is reflected in ANZs policies in relation to SME lending. For example, ANZ told the Commission that its policies and procedures do not specifically address

the taking of security over personal assets such as a family home. Rather, the principles applicable to all forms of security apply to these types of guarantees.

Next, we come to Bank of Queensland. Bank of Queensland provided two submissions to the Commission, including one specific to SME lending. Bank of Queensland has identified the following in relation to applications for business loans: following the initiation of a product review program, a number of issues were identified with relating to the incorrect charging of fees and interest which also affected business customers. Instances in which guarantees for SME loans were taken from and sought to be enforced against guarantors who claimed not to have understood the effect of the guarantee or their waiver of independent legal advice including where guarantees were given by relatives of the SME borrower and instances prior to the implementation of risk framework developments and enhancements in 2012 in which a complaint has been made concerning BOQs assessment of the ability of an SME borrower to service an SME loan.

Bank of Queensland has also identified the following circumstances where business loan arrangements have been varied or come to an end: instances in which it did not provide an extensive period of notice before taking action against a borrower in default, giving rise to complaints about the adequacy of the notice provided, and instances in which it did not provide an extensive period of notice of the expiry of a small or medium enterprise facility giving rise to complaints about the adequacy of that notice. In identifying these instances, Bank of Queensland stated that the bona fide reliance on contractual terms should not be seen as conduct falling below community standards and expectations.

Approximately 3200 external dispute resolution cases involving FOS have been taken against Bank of Queensland in the period 2009 to 2017, some of which have included complaints by SME lending customers which were resolved in favour of the borrower. Nevertheless, Bank of Queensland told the Commission that it does not consider that it has identified any systemic problems in the conduct of its SME lending business.

We turn now to the Commonwealth Bank of Australia. CBA provided four submissions to the Commission, including one specific to SME lending. CBA told the Commission that it undertakes SME lending primarily through the business and private banking business unit, and, to a lesser extent, the retail banking services business unit. Business lending is also provided by Bankwest as a business unit of CBA. CBA has identified instances in which customers have raised concerns in relation to applications for business loans. The first is in respect of two decisions of the Supreme Court of Victoria and the Victorian Court of Appeal in relation to Doggett v Commonwealth Bank of Australia, and Doggett and Doggett v Commonwealth Bank of Australia in which the court ruled, both at first instance and on appeal, that CBA had breached clause 25 of the then-code of the banking Code of Practice and that the guarantors in that case were not bound by a guarantee provided to CBA as part of a business facility, because CBA had not exercised due care and skill in its credit assessment of the borrower.

CBA also identified in its risk insight data 59 instances of provision of a business lending product for a potentially ineligible purpose which did not comply with a policy or business rule, 17 instances of inadequate or inaccurate disclosure being made to customers in relation to an SME lending product, and 16 instances relating to loan conditions including servicing. CBA has also identified instances in which customers have raised concerns relating to account management. CBA identified 25 incidents in its risk insight data relating to fee and interest inaccuracy including some incidents that involved multiple customers.

For example, on 6 October 2017, FOS notified CBA of a systemic issue in overdraft double debit interest being charged on business transaction accounts on both overdrafts and simple business overdrafts. The defect was first identified in CBA in 2013 with manual remediation being carried out until 2015 when it was thought a systemic fix had been put in place. Additional cases relating to the systemic defect were identified as a result of the FOS dispute in 2016, and an enhanced system fix was introduced in 2017. In total, CBA has refunded $2.7 million in relation to the issue. The Small Business Ombudsman has written to CBA a letter requesting CBAs rationale for not reporting this issue to ASIC as a significant breach.

We are aware that CBA has now reported this issue to ASIC as a significant breach, and one of the case studies that you will hear, Commissioner, will be concerned with this issue. CBA has also notified the Commission of a recent incident in which it was identified that CBA and Bankwest merchant customers may have been charged fees for merchant facilities provided to them despite the customers not using or ceasing to use those facilities. CBA has notified ASIC of this issue and is continuing to investigate. CBA further acknowledged concerns where business loan arrangements had been varied or come to an end. CBA provided details of 24 cases where FOS had a view adverse to CBA, including business customers experiencing financial difficulty.

CBA acknowledged that the experience of one customer, who had made a submission to the loan impairment inquiry conducted by the Parliamentary Joint Committee, had been poor. The submissions provided by CBA identified that since 2010, there have been 196 cases involving CBA and FOS relating to business financial or SME lending issues with FOS having a view adverse to CBA in 86 of those cases. We turn now to the National Australia Bank. NAB provided three submissions to the Commission including one specific to SME lending. NAB did not aggregate instances of misconduct or conduct falling below community standards and expectations in relation to SME lending, instead identifying 180 events recorded in their internal risk smart reports relevant to business lending.

A review of those events identified by NAB illustrate the following issues being raised on multiple occasions. First, incorrect disclosure of interest rates and interest calculated incorrectly resulting in clients being over charged. Secondly, duplication and incorrect disclosure of fees. Thirdly, defects with the provision of customers and guarantor consent, including consent forms missing from files or being provided after a loan had been granted or consent received after application, and fourthly,

failure to complete credit checks. In relation to applications for business loans, NAB acknowledged the following specific instances of misconduct in relation to SME lending: in 2015 in NAB v Rice and NAB v Rose the Victorian Supreme Court failed that NAB failed to give a customer prominent notice of certain matters before execution of the guarantees, including that the customer ought seek independent legal and financial advice.

NAB also identified in 2016/17, as part of a program to review Code of Banking Practice compliance, that it may not be able to evidence that appropriate warnings and disclosures to guarantors had been made in compliance with clause 31 of the code. This matter was reported by NAB to the Code Compliance and Monitoring Committee in its annual compliance statements. The code compliance and monitoring committee found that NAB had breached the Code of Banking Practice when procuring guarantees prior to 2016.

Suncorp has provided two submissions to the Commission which admitted to instances of conduct falling below community standards and expectations, two of which relate to business banking. Between 14 November 2015 and 10 March 2016, Suncorp failed to issue approximately 54,000 system-generated letters to retail and small business loan customers due to human error. This affected approximately 31,000 individual accounts. Suncorp reported this as a breach of the National Consumer Credit Code to ASIC on 14 March 2016, and provided a further update on 8 April 2016. On 13 December 2016, Suncorp agreed to ASIC issuing 20 infringement notices with a non-negotiable penalty of $270,000 to resolve the matter. In 2015, an error was identified in relation to Suncorp's systems and controls that resulted in a business banking error relating to a margin loan facility which exposed the borrowers to an approximately $4 million margin call.

Finally, we turn to Westpac. Westpac has made seven submissions to the Commission. The business bank division of Westpac is responsible for providing lending products and services to micro, small and medium enterprises and commercial business customers. Business lending through this typically extends to the provision of lending products of facilities from under $250,000 to $20 million, although there are some cases where customers have facilities over that level. The business bank division categorises levels of lending broadly as follows: less than $250,000 is considered micro SME lending, up to $3 million is SME lending and above $3 million is commercial lending.

Business lending is provided under the Westpac, St George, Bank SA, Bank of Melbourne and Capital Financial Australia brands. In relation to applications for business loans, Westpac recently identified examples where business bank customers – customer loans for personal purposes may have been offered and credit assessed as a business loan when they should have been offered and assessed as loans within the scope of the National Consumer Credit Protection Act. Westpac is in the process of identifying the scope of the issue and has engaged with ASIC. Westpac acknowledged the following in relation to where business loan arrangements had been varied or come to an end.

First, issues relating to collection functions performed by Westpac and third parties on Westpac's behalf, including three instances of inappropriate enforcement action being taken against borrowers. Secondly, incidents where it did not verify the customer's financial information, did not appropriately test serviceability, did not follow appropriate process in meeting the customer face-to-face, or made errors in the origination of loans in the incorrect stream. Thirdly, several FOS cases identified that, on occasion, Westpac has failed to properly consider or respond to a customer's notification to the bank about their financial distress. This resulted in Westpac continuing with enforcement action rather than working with the customer. Westpac has recently identified 98 instances of matters being referred to external dispute resolution related to business banking in material that was submitted to the Commission on about 17 May 2018.

Commissioner, the 10th and final topic that we will address as part of this opening are the case studies which are to be explored in this round of hearings. This first week of hearings will focus predominantly on the conduct of financial services entities in connection with applications for business loans and the approach of the entities to hardship. The issues to be explored include how banks assess such loans and whether such practices meet community standards and expectations. We also will consider case studies where potential financial abuse was apparent, and we explore what community expectations are enlivened in such situations, including where spouses or family members find themselves as co-debtors or guarantors.

The first case study concerns Ms Carolyn Flanagan who provided a personal guarantee and mortgage to Westpac in relation to a business loan taken out by her daughter and daughter's partner. Westpac sought to repossess Ms Flanagan's loan after the borrowers defaulted on the loan. Ms Flanagan and her Legal Aid solicitor will give evidence to the Commission about the taking of the guarantee and security from Ms Flanagan and what happened when they pursued a complaint with FOS.

The next three case studies relate to the entry into loans for the purposes of purchasing franchise businesses. The first of those concerns business credit facilities provided by ANZ in relation to the purchase of a gelato franchise. ANZ will give evidence about its approach to the assessment of the serviceability of the loan and the profitability of the business. In the second of those case studies, a borrower will give evidence about Westpac's assessment of the suitability of a loan provided for the purposes of purchasing a Pie Face franchise and the effect on her financial wellbeing when the franchise failed. In the third of those case studies, a borrower will give evidence about the credit assessment undertaken by Bank of Queensland in relation to her entering into a business loan to purchase two franchises in a shopping centre in Adelaide.

All three of these case studies will allow the exploration of the approach of banks to assessing the suitability of a business loan and the potential profitability of a business, particularly where personal assets are used to secure the loan. The fifth case study concerns the provision by CBA of business overdraft facilities and, in particular, its charging a number of clients double interest on those facilities for a

period of time. This case study will explore this misconduct, its discovery by CBA, the approach to remediation for affected customers and the conduct of CBA generally in relation to this issue.

The sixth case study relates to the grant of a residential loan to a business borrower by Westpac, which was subsequently discovered to have created a security shortfall. This case study considers whether the bank's conduct in seeking to rectify – I'm sorry, this case study considers the bank's conduct in seeking to rectify the security shortfall by withholding funds obtained through the borrower's sale of a separate property. The seventh case study concerns a family affected by various debts to Suncorp on the death of the father. One of the loans was a business loan which FOS determined had been irresponsibly made by Suncorp.

The case considers Suncorp's conduct following the FOS determination, as well as the FOS process and outcomes for applicants who have received a loan which was irresponsibly approved by a bank. Evidence will be heard not only from a family member and from Suncorp, but also from one of FOSs ombudsmen. The second week of hearings will turn to consider a number of cases in which small business' arrangements with their banks have been varied or come to an end. As part of that, as I have mentioned, we will hear from some former Bankwest customers about their experiences with that bank after the – after the bank's acquisition by CBA. This will include consideration of the relevance or effect of Project Magellan.

Of those witnesses, the majority will be from the east coast. Despite Bankwest being a Perth-based bank, much of its business lending at the relevant time was – or much of the business lending of complaint at the relevant time was a consequence of its expansion onto the east coast, and that is reflected in the composition of the witnesses from whom you will hear evidence. Next week will conclude with evidence concerning the new proposed banking code presently under consideration by ASIC, and ASICs implementation and enforcement of the unfair contract terms provisions in the ASIC Act once they were extended to small businesses in 2016.

Commissioner, at the start of this opening we outlined three overarching questions that we expect you will want to consider in the context of this module. These relate to responsible lending obligations with respect to small businesses, the exercise of contractual rights of enforcement by the bank, and how banks and the regulator have responded to calls for tighter controls over dealings with small business. Underlying those overarching questions are many subsidiary questions which we think it might be useful to identify some of now. How do we define a small business for these purposes? What is the rationale for distinguishing between small business loans and other business loans?

What meaningful difference in outcome would be expected if the requirements for lending to small businesses, as distinct from the bank's compliance and application of existing requirements, was changed? Should the obligations with respect to SME loans be adjusted to more closely reflect the obligations in relation to consumer loans, particularly where residential or other family assets are used to secure the

loan? Would this result in any meaningful difference of outcome for small business customers or the guarantors? What is the right balance between protecting SME borrowers through regulation and not creating barriers to business financing, and what does the community expect in this regard?

Is the current policy setting for SME lending right, whereby there is minimal regulatory oversight of banks in relation to SME lending and banks are effectively left to regulate in this space through the Code of Banking Practice? How do significant power imbalances between the banks and SMEs in relation to lending affect the conditions for entry into and exit from these types of loans? How sophisticated and well-resourced can SME customers be expected to be in their dealings with banks? What is the right balance between banks being able to exercise their contractual rights to protect their interests and those of their shareholders and creditors and their promise to act fairly and reasonably towards an SME in a consistent and ethical manner?

Have banks responded effectively to relevant legislative changes, including the unfair contract terms provisions in the ASIC Act? What has been the regulator's role in implementing these changes? Are SMEs able to obtain efficient and cost-effective redress in their dispute with lenders? The case studies across the two weeks will collectively, we hope, present an opportunity to consider each of these questions. Commissioner, that concludes the opening address. Would it be convenient to have a 15 minute break before - - -

THE COMMISSIONER: If we come back at, say 11.40.

MR HODGE: Thank you, Commissioner.

THE COMMISSIONER: You say 15, I say 12.

ADJOURNED [11.27 am]

RESUMED [11.40 am]

THE COMMISSIONER: Mr Hodge, old habits die very hard. I say 11.40, I come back at 11.40. I should get out of those old habits, I suspect. Yes, Mr Hodge.

MR HODGE: Commissioner, the first witness is Philip Khoury.

THE COMMISSIONER: Thank you.

<PHILIP GEORGE KHOURY, AFFIRMED [11.41 am]

<EXAMINATION-IN-CHIEF BY MR HODGE

THE COMMISSIONER: Thank you very much. Do sit down. Yes, Mr Hodge.

MR HODGE: Thank you, Commissioner.

Your name is Philip George Khoury?---Correct.

And you have provided your address to the Commission?---I have.

And you've received a summons to give evidence today?---I have.

You have that with you?---I do.

Commissioner, I tender the summons.

THE COMMISSIONER: Exhibit 3.3 will be summons to Mr Khoury.

EXHIBIT #3.3 SUMMONS TO MR KHOURY

MR HODGE: Mr Khoury, you've prepared a witness statement for the Commission?---I have.

And the relevant witness statement – and I will come to this in a moment – is one dated 18 May 2018?---Yes.

And, again, you've got that – a copy of that here with you today?---I do.

Commissioner, I tender Mr Khoury's witness statement dated 18 May 2018.

THE COMMISSIONER: Exhibit 3.4, witness statement, Khoury, 18 May '18 and its exhibits.

EXHIBIT #3.4 WITNESS STATEMENT OF PHILIP KHOURY AND EXHIBITS DATED 18/05/2018

MR HODGE: Mr Khoury, you're a principal of Cameron Ralph Khoury?---Yes.

And – sorry, could you just – just because it is being recorded, could you speak up a little bit?---Sure. Yes.

Thank you, Mr Khoury. And can you tell the Commission what services your firm provides?---We provide governance services. So governance advice, design of governance systems, board evaluations and director evaluations, also provide in the space of – would loosely call self-regulatory activity. Complaints handling, external disputes resolution, codes of conduct, etcetera.

And your firm has conducted a number of independent reviews of financial sector external dispute resolution bodies?---Yes.

And not just in Australia but also overseas?---Also overseas, Canada and New Zealand.

And what is your background, Mr Khoury?---Relevant to this, my background is I worked for the Australian Securities Commission and Securities and Investments Commission for around nine years.

I see. And how long have you been a principal of Cameron Ralph Khoury?---Since 2002.

Thank you. And you were commissioned to carry out a review of the Code of Banking Practice?---I was.

And I mentioned earlier that the correct statement is dated 18 May 2018. We surprised you a little bit on Friday of last week by giving you a new draft of the code?---Yes.

And so what you've been provided with is the most recent draft of the code that we have that's presently under consideration by ASIC. And you've had a look at that?---I have had a look at that, yes.

And I think you've updated some of your views based on what has been your review of the new code – or the further version of the code; is that right?---Yes, that's right.

Okay. Now, what I wanted to do is to just talk through, to begin with, the process that you went through in reviewing the code as it was in 2016. It was back then about the middle of 2016 that the then-named Australian Bankers Association approached you to review the code?---Yes, that's right.

And at that stage the current version of the code was the 2013 code?---Yes, that's right.

And your engagement was publicly announced in the beginning of July 2016?---That's right. The 7th, I think.

And ultimately your finalised report was delivered on the – I think you say "substantially finalised" on 31 January 2017?---Correct, yes.

There had been a short extension given, had there, to produce the report?---Yes. We had promised to do – do our best to make it 31 December, which we couldn't make in the end, and asked for an additional month to complete the report.

And in terms of the approach that you took to reviewing the code, was the – was there an initial process that you had in mind, what you would try to do?---Look, we – having worked with the disputes resolution schemes extensively, we were familiar with some of the – the points of contention around consumer protection in the space. And we had hoped to use as much evidence as possible to settle some of those arguments. So we had hoped to get data from the banks and from other sources that would – would help to provide us with evidence-based resolution of some of the contentious issues. As it turned out, that data didn't end up working out to – to help us as much as we would have hoped. So the – within a couple of months, it was evident that we would need to use a bit of a different approach.

And what was the different approach that you adopted?---We had originally been asked to review the code from the perspective of what stakeholders wanted from banks and what would help restore trust in the banking industry. And in the absence of – of compelling precise data on a lot of the issues, we just retreated back to that logical equation: what are stakeholders asking for, what would be reasonable for the banks to offer, you know, on our – on our recommendation.

I see. And I think you say in your statement that there was an emphasis placed on the importance of – or a particular way in which the code needed to be approached in order to achieve that trust or the rebuilding of trust? Can you just explain that to the Commissioner?---My – I suppose, initial criticisms of the existing code at the time were that it was really written from the point of view of the banks very much, and the language wasn't accessible for consumers. It certainly – it wasn't accessible for small business. It wasn't clear in many cases, really, what the promise was. And we took the code to be a document that was a promise from the industry to its customers, and that the language should really be much more framed in terms of those – what customers should expect from the banks.

And could you explain the idea that you explain about paragraph 6 of your statement, that changes or the recommendations would need to be significant or transformational to overcome scepticism?---In our – in very initial conversations with stakeholders, as we began the process, a number of people put to us that – and they subsequently echoed this in their written submissions – that there would have to be quite a leap, in terms of the code's framing and the code's provisions, for it to impact on their trust in the banks, that if the – at the time the messages on the ABA website were, "We are listening and we are improving", and people quoted those directly to us and said, "This will have to be transformational in nature to have that impact that the ABA are looking for."

And that was another thing, then, that you were taking in mind in assessing what recommendations you ought to make?---Indeed.

All right. Now, what I want to do then is work through a few particular issues in relation to small – in relation to small businesses and the way in which the code deals with small businesses. The first is the definition of what is a small business. And in your statement you refer to that as a threshold issue?---Mmm.

Again, you will just need to say it, just - - -?---Yes – yes.

And can you just tell the Commissioner what that threshold issue is?---Look, the – the – the law doesn't really provide a huge number of protections for small businesses in their – in their dealing with banks in lending and so forth. So the code is quite an important vehicle for protection for small business. It already, in 2013, extended some protections to small business they wouldn't otherwise have received. And so the question of who is a small business and who would be caught by the code becomes pretty important as a starting position. In other countries, there are quite different definitions of what is a small business. They more frequently distinguish between a micro enterprise and small to medium enterprise, and so on. So we had already encountered a number of arguments that would tend to – would argue to exclude businesses on – on the basis of their scale or complexity, or sophistication. So we thought it was pretty important to just get clear about who we are talking about in the first place.

And did the member banks have a particular approach to the definition of small business that they presented to you?---There were a couple of things going on at the time, which I think affected the – the position that the banks put to us. The 2013 code had nothing more than an employment test, in terms of whether someone was to be treated as a small business. The – there were practical issues outside of the code which go to – you mentioned earlier FOS' jurisdiction or the CIOs jurisdiction. And so I think these were influencing the way the banks responded to it. But we – we had previously come to a view that the – the cap on whether a business qualified as a small business under the – under the code, and also when they went to an external dispute resolution service, could certainly be higher than it was cast at the time. We accepted the argument that the banks put to us that at some point, as you go up the scale of a small business, you no longer use standard form contracts, the businesses are more sophisticated, the terms of the credit may be more complex, and so on, and so there is a point at which what's appropriate to a small business should stop and, you know, the normal provisions in the law apply. We just thought that should be higher. And so when we put, quite early in the piece, put the proposition of a $5 million cap on the – on qualifying as a small business, the industry came back with a new proposal for defining small business, fairly early in the piece.

And I just want to just break that down a little bit. When you talk about a $5 million cap, you mean a $5 million cap on the value of the facility that would be covered - - -?---Correct.

- - - by the code; is that right?---Yes, correct.

Okay?---Yes.

As opposed to a cap on annual revenue or anything like that?---Yes. Or – or a cap – as it turned out, the industry's proposition was to retain the employment test – this is during the review – retain the employment test to put a cap of a total of $3 million – $3 million of credit exposure for a company, and a – and a $10 million turnover test as well. So the industry at that point were, I think, pretty keen to rein in the definition of small business.

And did you have a discussion or receive any submissions from the Australian Small Business and Family Enterprise Ombudsman about the definition?---Indeed. The Small Business Ombudsman put a definition, making one point being the employment test should be 100 employees without any complication over manufacturing and so on, which would line up with the Small Business Ombudsman's jurisdiction.

And what about the value of facilities to be covered?---That wasn't part of the test – from her submission, at any rate, yes.

I understand. And in terms of the view that you took about $5 million, can you – we know, obviously, ultimately, your recommendation was that it would be $5 million. Can you just explain to the Commissioner how you arrived at $5 million?---Well, I – I have to say we had sort of come to that view much earlier. We did the independent review of the Financial Ombudsman Service in 2013, and the issue arose then about the ombudsman's jurisdiction. And we had interviewed a number of people in the industry in the ombudsman service, consumer advocates and so on, around the – where the limit ought to be. And had examined a number of case files as part of our review and had come to the view that it could certainly be much higher, and we thought $5 million was reasonable at that time. Made a recommendation to that effect for the FOS independent review, and we found in the course of the banking review that – well, we agreed with ourselves, really, the – didn't find anything that caused us to think differently about that.

And I should just clarify, when you say "we" you had somebody assisting you in carrying out the review; is that right?---I did, yes.

And when you say "we", you were the leader but the – you and the person assisting you, is that right?---My colleagues, that's right.

Okay. And I just want to understand one point, which is about the – that sort of casting the line at $5 million, and your review of the case files. Did they tell you anything about the complexity of loans, or did you form any judgment about the complexity of loans above and below that threshold?---Look, that – that's a difficult thing to do with any certainty. Our feeling, having looked at them, was that there is certainly great variation in terms of – of the loans on either side of that line, but most of the loans below five we felt were pretty – really aimed at the unsophisticated small business which we thought was the purpose of the code. Once you got over 5 million, a significant number of the loans were more complex than that and – and really aimed at a different market, we thought.

And during the course of your consultations, presumably you put to the member banks this idea of a $5 million limit?---Yes. Definitely, yes.

And what was the response to that $5 million limit?---Industry indicated they weren't happy with it. They thought it was too high, and indicated to us that they had come up with a different way of – of framing it that had the multiple tests in it, as described before. So tests for total exposure, tests for turnover, and a test for employment.

And we will come to some of the other tests in a moment, but just in relation to the – to choosing between $5 million or $3 million, what was the rationale, as you understood it – obviously you ultimately didn't accept it, but what was the rationale for bringing it lower down to $3 million?---Look, we understood the banks' position was – was really based around their current practices. So we – we heard evidence that they structure internally different divisions or sections of the bank largely on the strength of the amount of money involved. And so some banks would have a upper limit of $1 million and loans would be dealt with by a different area other than the retail section. Others 3 million, and so on. So we got the impression that a big factor for the banks was just the internal organisation, and – and how they managed their own compliance, and – and risk management internally. I think banks said to us that they felt that loans became more complex above that $3 million. And I think they also – another argument put to us was that if the – if the provisions for protection of small business increased banks' risk, that they would – the availability of loans would – would reduce, and potentially the cost would increase if those protections were – were too onerous.

I see. But in the end, having considered those various arguments, that wasn't the view - - -?---No.

- - - that you took?---No, we didn't take that view. It doesn't take very long, looking at examples of small business loan files, to see that the zeros can come on quite quickly without changing whether a small business is a sophisticated operation or not.

That is, a loan for $50,000 versus a loan for $500,000, versus a loan for $5 million?---Indeed. That – that – there were many that were really targeted at – at the classic small business, unsophisticated operator, but with significant amounts of money involved.

And now then the other thing you referred to is this idea of extra tests in relation to what qualifies as a small business loan. I may have misunderstood this, but your initial instinct, would it have been limited to the monetary cap without any other qualifications on what constituted a small business?---Look, we – we thought – we agreed with the Small Business Ombudsman's proposition that a simpler employment test would make it easier for small business to know whether they were in or out, so we began from that point. The $5 million was really – we proposed it as a protection for the banks, because there's no upper limit in the 2013 code. So that was a protection for banks to say once it got beyond five, these provisions would –

would evaporate, would no longer apply, and banks also put to us that there could be gaming of the limit with 100 employees and corporate groups could put their – divide their employees up into groups of 99, for example, in order to gain protections that they ought not gain. So we put in an additional qualifier as protection for the banks to simply say if it was a corporate group then the total number of employees in the group would be what you would count.

All right. Now, you've seen – you've seen two different drafts of the code that was submitted to ASIC? You – I think when you prepared an original statement you had only seen the draft that was submitted in December 2017?---Yes.

And then, as I say, last week we provided you with the more recent version from April 2018?---Correct. Yes.

And you've looked at – perhaps we might just bring this up. Can we bring up tab 3 of Mr Khoury's – the exhibits to Mr Khoury's statement. It should be exhibit PGK-3. Do you want a document ID? It's WIT.0900.0003.0290. And if we go to page 5 of the document. I'm sorry, numeral 5, rather than (v). It's .0299. Thank you. We can see here the definition of what is a small business, and the tracking indicates the change between December 2017 and April 2018?---Yes.

And so, in part, there has been a movement since December 2017 to reflect your recommendation that the employment test just be 100 full-time equivalent employees?---Yes, correct.

And I want to ask you then about the other two elements of the test. The first is element C which is the $5 million limit. That's – that's obviously less than the – sorry, $3 million limit. That's less than the $5 million limit that you had recommended?---Well, it's less in two ways. Firstly a smaller number, but secondly, that it is – it is intended to take into account all the loan exposures of the small business rather than the facility that's in question.

And all loan exposures not only to the particular credit provider but to any credit provider?---Indeed, yes. So significantly different to what we recommended.

Yes. Significantly different to the recommendation that you had made, which is that the monetary limit is $5 million for the particular facility; is that right?---Correct.

Okay. And then there's also subparagraph (a), an annual turnover limit that is not something that you had recommended?---Correct, yes. That's - - -

And do you have a view about the incorporation of this annual turnover limit?---Look, I think it complicates the definition. At various times over the last few years in – a number of arguments have been put to us that the turnover test is – is too onerous for banks to administer. Clearly, that's not the case in other countries, a turnover test is not uncommon. But we had not recommended it because we thought it was just unnecessarily complicated and sort of made – there are practical issues

about that for someone like the Financial Ombudsman Service, for example, or AFCA now, of having to decide what the turnover is and obtain evidence about the turnover through tax returns or some other means, making the process of figuring out whether a small business is in or out, lengthier and – and more complicated.

And to figure it out as at the time they were borrowing the money in the first place?---Indeed. Yes, indeed.

And that criticism of complexity then, does that also apply to $3 million in total debt to all credit providers?---Look, I think so. I mean, I think it could – if you go back to the original premise that the code is a promise from the banking industry to its customers in plain speaking language that will engender trust, my recommendation is that you would say it more simply than that.

And I think in your – in your statement you were contemplating a slightly simpler question which is what would happen if you just moved from $3 million for the facility up to $5 million for the – as a facility limit and what the effect on that would be? This is at paragraph 17 of your statement?---17 of my statement. Sorry, I am going to need to refresh my memory on that.

That's all right. I'm sorry, it has now moved to be paragraph 18 of your 18 May statement?---Yes.

So I think you explain two things there. The first is that your proposed definition was something that you thought would have a relatively small effect, extending coverage to an additional 10,000 to 20,000 businesses?---Mmm.

And, secondly, that you took the view that the comparatively minor concessions to fairness that the code represents would not substantially alter the balance of power between a $900 billion bank and a business with a few million dollars of financing. Could you just explain to the Commissioner what you meant by comparatively minor concessions to fairness?---Look, most of the concessions that the code talks about are providing notice, providing information, providing access to external dispute resolution. These are things – our assessment of community expectations is simply around fairness. It's not tilting the balance of power dangerously away from the banks, so that we didn't think the concessions were so enormous that – that the argument that this would be grossly unfair to banks was particularly compelling. In terms of our estimate for how many additional businesses it would cover, that's quite a difficult thing to do, as no doubt you've noticed looking at the statistics, but on the – on the information that the banks gave us at the time, that was our guess about how many additional businesses would be scooped up by that change.

And did the banks suggest to you that it would be a significant number of businesses that would be affected if they moved from 3 million to 5 million?---Look, that wasn't a bone of contention. So the information was provided to us. The banks had a chance to review what was said in the report and didn't take exception to it.

And is that 10 to 20,000 businesses – is that based on the simple premise of a facility limit of $3 million versus a facility limit of $5 million, as – well, as you can say, as - - -?---It was – it was five. Our estimate was – looking at the stats that we could find, was that about that many extra businesses would be scooped up if you made it a $5 million facility. Now, we did not – that was at the stage of thinking about it in terms of a simple test for the facility rather than the more complicated test that's been put forward.

And the particular part of the more complicated test you are referring to, I am assuming, is the $3 million in total debt?---Yes.

From all credit providers which would be - - -?---And the turnover question, which again we couldn't find any useful statistics to help us with that at the time.

Thank you. I want to move then to the second topic that I want to explore with you, which is your consideration of responsible lending to small businesses. And the code, as you – at the time you were reviewing it, the 2013 code, contained an obligation in clause 27 on a signatory bank to exercise the care and skill of a diligent and prudent banker in selecting and applying credit assessment methods and forming an opinion about the ability to repay the credit facility?---Yes.

And, as you note in your statement, it's – that's not the same as the responsible lending provisions provided in the National Consumer Credit Protection Act?---Correct, yes.

And those provisions in the National Consumer Credit Protection Act don't apply to a loan entered into for a business purpose?---Correct, yes.

And you explain in your statement that one of the things that you considered as part of the review was whether clause 27 struck the right balance between, on the one hand, access to credit and on the other hand responsible lending?---Yes.

And can you just help us – or help the Commissioner to understand what's the – first, what were the views that were coming from small business representatives to you about that?---This was a very important issue for them. The – the – access to credit is – is certainly priority number 1 put to us by the representatives of small business that we spoke to, and while they wanted – were also interested in some protections for business they, in particular, did not want to import an onerous responsible lending obligation that would cause access to credit to dry up. So there was a big issue about whether that was the correct balance or not. And we were urged by most of those representatives to – not to – not to overdo recommendations in terms of responsible lending.

That is most of the small business representatives?---Yes.

Not to overdo it?---Yes.

All right. And what was the view that was expressed to you by banks about that?---Look, I think the banks were in furious agreement with the small business reps on that front. We put to them some issues about accessibility and – and understanding from small business and so on, but I think they had the same view that their preference was that – that whatever protections were put in place would not materially change the access to credit for small business.

And there was a submission made to you by CPA Australia in relation to lending. Could you just explain that submission to the Commissioner?---I think CPA also thought that was a critical issue for small business. So they didn't differ from – I am having to do this from memory – they didn't differ from the rest of the small business submissions put to us in terms of that access to credit. They were much more concerned about the conduct of the loan during its course and, if there was a need to vary any conditions, what would happen at the end of the loan, what would be the conditions for rollovers, of – of credit facilities and so on. So that was their – from my recollection, that was their focus.

And in the end then, what was the view and recommendation that you formed about responsible lending?---Look, our view was that, firstly, it was quite inaccessible to talk to most small businesses in terms of you know what a diligent and prudent banker would do was pretty meaningless from what we could see. Probably the second biggest issue that small business put to us was the fact that they couldn't understand – found it incredibly difficult to understand bank procedures, legal terms the banks would use, contract provisions, and so on. So some – you know, a move to some plain speaking in that space was clearly a priority. So we thought you could do – you could certainly do something around that, provide them with – with better assistance. We also thought that the responsible – there were some risks in the way the code operated at the moment on responsible lending because it didn't actually spell out the sorts of tests or work that a bank would need to do to be a diligent and prudent banker, so we thought the code could helpfully do that in plain English. And we were also concerned about guarantors. So it was put to us by a number of people – and we – again, we were unable to find real evidence for this – that banks were relying too heavily on the presence of a guarantor's assets and not doing sufficient homework on the underlying sustainability of the business loan. In – and the argument was that the banks were happy because their risk was attended to by a mortgage over someone's house or some – some other kind of asset, and were not being as diligent as they ought to be around the assessment of the loan – underlying loan itself. So, again, we wanted to do some work around the guarantor provisions because we think that's, you know, a particular vulnerability.

And we will come to the guarantor provisions in a moment, but you made a – you made general recommendations about what was clause 27 of the – of the code, and can you just explain to the Commissioner what was the – in terms of the recommendations that you were making, what was the idea? What were the things you were trying to achieve?---Well, so that – the clause would be written in a way that small business could understand what the – what the code would offer them in terms of the obligations on the bank when they were framing a loan or making an

offer in that space. Some more specific setting out of the work that the bank would do to assess the loan. Some provision of information to the small business around what the bank had considered and, if they were refusing a loan, to provide – you know, provide reasons for why the loan was refused.

And that – I should just clarify. Clause 27, as it was, it wasn't – it wasn't limited to small business lending, was it?---No. That's – that's right. I mean, that's been a sort of an issue throughout which – which parts of the code are specifically written to – for small business and which are not. But I will have to refresh my memory, I'm afraid, on – on our recommendation. Do you have the page reference there?

I don't think we've got the 2013 - - -?---No, I meant in my report. That's - - -

That's all right. Why don't we deal with this in a different way. Which is if we bring up tab 3 of the exhibits to your statement, which is the one we were looking at a moment ago, which is WIT.0900.0003.0290. And go to page 13 of that document, which is .0307. And so this is part of the new draft code that's currently being considered by ASIC?---Yes.

Can you have – you have had a look at this?---Yes.

And the – perhaps if we start with a general point. This sets out a responsibility in relation to lending not only to small businesses but also to individuals. It's all dealt with under the one section?---Yes. Yes.

And it appears to impose the care and skill of a diligent and prudent banker test to a number of different – or both to individuals and also to small businesses?---Yes.

But then it contains a specific provision in clause 51 about assessing appropriate circumstances?---Yes.

And are you able to tell the Commissioner, from your perspective, is this a move towards what you had in mind in - - -?---Yes.

- - - your report?---Yes. It's – it at least sort of sets out what is expected of a diligent and prudent banker test. Have I got that in the right order? So look, it's a step in the direction we recommended. We would have preferred to see much more specificity in their setting out more clearly what the bank would do but that is a step in the right direction.

And you will see, though, there's an additional part that deals with the resources of third parties?---Yes.

And do you have a view about that?---Yes. I – we think that's a backwards step, that that in effect, on our read of it, it provides the banks with, you know, clear authority to take into count a range of third party resources in – in how they will assess, you know, the – the viability of the loan. In a practical sense, I guess they have been

doing that in any event. My suspicion is that that is in there to put beyond doubt their ability to rely on the guarantee.

And - - -?---That's how I read it, in any event. I should - - -

And in terms of your – based on your consideration of an evaluation of what sort of tests might be applied by the diligent and prudent banker, is that something that you expected to continue to form part of the consideration?---Look, I think it – it should. This is a question of trying to strike the right balance between relying on – being able to bring in a guarantor's assets as a – as a risk management mechanism, but not to the extent of – of not paying enough attention to the – the affordability and sustainability of the underlying loan. So – and it's a difficult thing to strike the balance exactly right on. Small businesses will tell you when they start up there isn't any other way that they can get – get a loan, without having some security that the bank can rely on, because they have no track record, no cash flow records, no tax returns to rely on in terms of viability of the business. So the need for, you know, reliance on guarantor's assets is there. This is set out – we think it's set out in a way that's really designed to protect the banks.

I want to just make sure we distinguish between two things. One is the assets of the guarantor which might be offered up as security. The other is the income of the guarantor which might be relevant to servicing the loan?---Yes.

And do you have – or did you have any expectation – or have any expectation as to whether or not the income of the guarantor would be factored into assessing the serviceability of the loan?---We – we think that's – we argued against that. Our – our view was that the – unless there was sort of unusual circumstances, the – the income shouldn't be taken into account unless the person was actually a co-borrower and getting a benefit from the loan. But, again, we accept that it is – it is a – a difficult area to – to be entirely precise around in terms of those sort of resources. It – a guarantor may put up an asset, but in the event that it's called on, may prefer to – to satisfy the security by some other way, and that might be through their income. They might be able to negotiate a solution like that. So while we didn't want to, you know, rule out every possible arrangement, we did want to have a code that said we will deal with this in a way that makes it clear where the priority should be in terms of responsible lending.

I want to move now to the topic of – specifically the topic of guarantors. You considered the protection of guarantors under the code?---We did.

And did you hear from any particular groups or public advocacy groups about the problems of parental guarantees?---Very many submitters raised the issue of – of family guarantors.

And what was the particular issue that was raised with you?---Really, guarantors offering up their guarantee without understanding the risks. In the extreme end, this could be a product of abuse, elder abuse, familial abuse. In fact, even the guidelines

that the banks have put together for this alert bank staff to the possibility of coercion in obtaining guarantor – guarantees for – for someone else's loan. So this was clearly an issue. It's also – you know, without necessarily crossing over the line into abuse, it is very clear that people were wanting to help family members or associates and getting themselves into a highly risky position, that they were not clear about as a result of – of, you know, goodwill.

And one of the things that you considered was whether the – whether the signatory bank should be required to – or obliged to do more to have potential guarantors obtain independent legal and financial advice?---Yes. So we wanted that strengthened, and the code – the new draft code certainly goes a fair way towards strengthening those protection for guarantors. So there's a three day cooling off period proposed, better information provided to the guarantors. Prior to signing up, commitment to providing information to them of any underperformance of the loan during its life, and providing them with some – with assurance that, should the guarantor be sort of called in or the loan be called in, that the banks would begin with the borrower's assets and – rather than going straight to the guarantor's assets. So I am not sure if that's exhaustive, but that was the intention.

Sorry, if we just break down that last point, your – the issue was that the bank might call on the guarantee and the property that secured the guarantee before it actually called on the assets of the borrower, is that - - -?---Correct, yes.

And there might be practical reasons why the bank wanted to do that, because it might think the guaranteed property might cover the entire value of the loan?---Indeed. So sometimes – sometimes there could be no alternative, the borrower may not be able to be found or the borrower has no assets or been made bankrupt. So there's lots of reasons why the bank may need to go to the guarantor's assets or security, but the – we wanted to make sure that the code set that out as a second resort rather than the first.

And in terms of your view about the new code, do you have a view then as to what extent it picks up those things?---Look, I think it's gone a long way towards those. I mean, there are still some things in there that we would – you know, I would – would rather were – were framed, you know, slightly differently, but it does go a long way towards – towards the sort of guarantor protections that we wanted in the code.

One of the things that we were talking about a moment ago is this idea that the banks ought to encourage guarantors to go and seek independent legal and financial advice. And I'm wondering if you have a view or whether there were submissions made to you about what would actually be involved or what is necessarily involved in a guarantor getting proper independent legal advice?---Look, the code sort of sets out a few safeguards in terms of signing the documents not in the presence of the borrower, a few other provisions like that. The problem – the problem with the legal and financial advice issue is that at – at the beginning when the loan is being contemplated, far too often, particularly if it's a family member, people are unwilling to seek that advice. They would prefer to take the sort of optimistic view that's been

put to them by their family members, and so on. So there's – there – I'm told there's quite some resistance to seeking that advice from guarantors. While they can be encouraged to do it, at this stage there's no compulsion.

I wanted to move then to - - -

THE COMMISSIONER: Just before you do that, you spoke of the changes in the code providing for better information being given to potential guarantors before they signed up?---Mmm.

Can I understand, better than I now do, what the changes were? What was the better information that is proposed?---Okay. Well, let me just.

MR HODGE: Would it help if we brought up the - - -?---Sure. That would probably help.

If we go to WIT.0900.0003.0290. And going to part 7 of the code that should be at page .0313. I don't know if it would be helpful, Mr Khoury, in addressing the Commissioner's question if you also wanted to refer to the particular part of your report. Would that assist you?---Sure.

I might let you know where that is, so we can bring that up as well. If we bring up the document which is exhibit 1 to Mr Khoury's statement, WIT.0900.0003.0001. And go to page .0112. Perhaps over the page .0113 is the recommendation that you made about information?---So the code – as the code is at the moment, they drafted the – we wanted to spell out the information that had to be provided to the guarantor beforehand, so information about the financial position of the borrower. You know, the terms of the loan, the sort of information that would be provided to the guarantor during the course of the loan. So that the code has been quite – you know, my – my assessment is that the provisions that are in the – that part 7 of the code have gone a long way towards what we recommended. We had one recommendation which the banks were very clearly opposed to, which had come to us from the Financial Ombudsman Service which did not get picked up in here, and that was the – the recommendation that the code explicitly say that if the guarantor provisions had not been adhered to, the loan could – the guarantee could be set aside, that it would no longer apply. And Financial Ombudsman Service's argument for that was although it – I will come back to it in a second – the argument was that there needed to be a very serious consequence for the banks in order for them to adhere to the guarantor provisions religiously. The banks were opposed to that. They think it – you know, didn't take account of causation, and so you could have an environment in which some minor breach of the code guarantor provisions resulted in the entire liability being set aside, which they thought was unfair, and would be gamed by some customers. We made the recommendation in any event, because we thought it was a – an issue that deserved to be considered by the banks and put in the domain. So that was the main one that we didn't – that didn't appear in the code afterwards as main provision.

THE COMMISSIONER: Is the guarantor given any information about why the bank is asking for third party support? Banks saying to the borrower, "I will lend, but only if you give third party support in the form of a guarantee." Either an unsupported guarantee or a supported secured guarantee. Does the guarantor know why the bank is asking for third party support loan?---That's not specifically requested in the – in the drafting of the code as it is now.

MR HODGE: And - - -

THE COMMISSIONER: Because that bears upon what legal advice can be given. The lawyer who is confronted by the would-be guarantor, if it happens – and I understand there's a big caveat about "if it happens" – the would-be guarantor sits there and says, "Should I, should I not, enter this?" At least there's an available point of view that question 1 for the lawyer would be, "Well, why is the bank looking for third party support? Unless I know that, how can I tell you whether you should or shouldn't"?---Look, I would have to – it's not specifically identified. It wasn't in our recommendation, nor is it in the current code. I think the – I would have to check. It's possible that other provisions in the code would – would oblige that information to be provided.

MR HODGE: Can I just help you out with that, Mr Khoury?---Sure.

If we go to page 0314 in the document on the left-hand side of the screen. So this is – you see the heading Guarantee Documents. And there's clause 99 and it sets out what documents have to be given in relation to the borrower. And you see subparagraph (e) requires the bank to give to the guarantor:

> *Any financial accounts or statements of financial position that the borrower has given in the previous two years for the purposes of the guaranteed loan.*

And subparagraph (f) requires:

> *The latest statement of account.*

But then you see subparagraph (g) is:

> *Other information we have about the guaranteed loan that you reasonably request, but we do not have to give you our internal opinions.*

?---Opinions, yes.

So that what – I really am just putting this to you – you can agree with it or disagree with it – but certainly as it appears, you hadn't made a recommendation that dealt with the specific nuance of the issue that the Commissioner has raised?---No.

That's the first thing?---Correct.

And the particular piece of information, which is the basis upon which the bank has made its decision that it requires the guarantee, appears to be something that is left at the bank's option as to whether it would have to be required, and only if it was requested?---Indeed. I think that's correct, yes.

Commissioner, did you want to ask any further questions about guarantees?

THE COMMISSIONER: Yes, but I won't.

MR HODGE: Can we move then to the issue of loan contracts and simplification, which is another issue you raised in your review. And do you recall what were the issues that were raised with you by small business representatives about the simplification of loans?---Well, the first one is that documents at the time were described as impenetrable and far too difficult to understand the impact of each of the clauses, so I think that was a sort of a first principles issue put to us. The second one which has been raised with other reviews is small businesses' horror as discovering to which banks could unilaterally vary contract terms, and probably another dimension of that was the extent to which small business borrowers were shocked to discover that the extent to which non-monetary clauses could be breached and cause – trigger sort of default action or unilateral variations to the terms of the loan, so increased interest rates or demands for more information, other – other sort of obligations. So they were – they were probably the main ones put to us about that. And then there was another set that – that come to bear in terms of the end of the loan, if you like, the sorts of things that might happen at the end of the loan.

Well, if we take the first issue, which is simplification, and making them impenetrable, you made a recommendation as to what should be done to try and address that. Could you explain to the Commissioner what the recommendation was?---At the time, as part of the unfair contracts legislation being introduced, the banks assured us that they were redrafting – you know, in consultation with ASIC, they were redrafting their standard small business loan contracts and that they would come out much simpler and easier to understand, which we took them at their word for. We did add in one recommendation on that, which was to require a short form summary of the key aspects of the loan contract, that that would be in one place and a – one or two page takeaway for the – for the small business person, where the critical dimensions of the loan were set out in simple language for them. So that was one other one around that very first issue of – of understandability, I suppose.

And we will bring up the clause in a moment, but just to focus on that issue of understandability, one of the other issues that was raised with you was understanding why finance was refused; is that right?---Yes. That's true too, yes.

And so if we bring up again on tab 3, WIT.0900.0003.0290, and go to page .0310, and if we blow up first clause 73. That seems to be the implementation of that first recommendation you were talking about, about - - -?---Yes.

- - - having some simple summary?---Yes.

And do you have a view about whether that meets the requirement you were after?---Look, it's a step in the right direction. We were a little bit concerned about the proposition that it be a separate document or part of the loan document. I have had no chance to sort of test the intent of – of the code's clause, and so that may or may not be successful. I'm assuming that the intention there is to allow each bank to have some flexibility about how they implement. So it's a step in the right direction.

And then as to the issue of explaining why finance was refused, that was something you also made a recommendation?---We did.

And what was the recommendation that you made?---That – and this was something asked for by the small business advocates – that if a bank refused a loan, an application for a loan, they should provide the – the applicant with enough information for them to understand why it was refused, and without a promise of – of providing a loan in different circumstances, give the applicant an idea of what would have to be improved in order for the loan to be successful – the application to be successful.

And if we blow up clause 74 of the proposed new code. That seems to be adopting that recommendation?---Yes. So it's a bit of a sensitivity with the banks about just how much information they will provide at – at the end of that process. I take exception to the language, probably, but I think it is, yes, adopted.

Sorry, when you say you take exception to the language, what do you mean by that, Mr Khoury?---Look, I just don't think that – I think small business, reading that, would – would treat it as weasel words, really, "if appropriate, general reason why" and so on. We did urge the banks to try and be as plain speaking as possible in all of this and not to guard against, you know, rare occurrences that – that might be - - -

THE COMMISSIONER: A bit hard to require the bank to say, "We don't trust you." I mean, at some point a bank has got to make a judgment about the customer?---Of course.

There may be cases where that's the real reason?---Indeed. And we understand that that would be the case sometimes.

MR HODGE: Now, the second issue you raised before in relation to the simplification of terms and the drafting of terms was the issue of unilateral variations. And you made a recommendation about unilateral variations?---We did. Do you have that there, the - - -

I can do that, but might I just bring up the actual draft code so that we can just have a look at that and you can tell us your view about that. That's in the same document, page .0321. So this is chapter 9 dealing with when we change our arrangements?---Yes.

And as you will see in clauses 152 and 153, there's provision for changing interest rates. And otherwise then there's separate provisions dealing with what are referred to as unfavourable changes?---Unfavourable changes, yes. Look, we – this is an area where I think we didn't – we didn't do as much as we should have done in – in this sort of question of unilateral variation. So we – again, there were changes afoot at the time, but I think, as I look back on it now, I – I think we've probably not done as much as we could have in the area. So we've ended up with a – with a provision which says, "We will give you plenty of notice, but we can still unilaterally vary the terms of the contract", and I suspect that's an area where I would have like to have had my time over if I had understood how it would all land.

I understand that. And then the last point that you raised then was about enforcement of loans, and I think you were referring specifically to non-monetary defaults?---Mmm.

Is that right?---Yes.

And what were the issues that were raised with you by small business people about non-monetary defaults?---Well, aggravation that what they saw as – as possibly minor variations in the non-monetary terms resulting in – in quite significantly adverse changes to the terms of the loan. So interest rates being increased or calling in the loan in – in extreme environment, demands for quarterly or monthly extensive financial reporting. Those – those were the sorts of issues that had been raised with others and were raised with us in terms of the non-monetary default provisions within the contracts. The Small Business Ombudsman, prior to the release of our report, had come out with her recommendation that this be, you know, dramatically scaled back in terms of, you know, what – what – whether default action could be taken as a result of non-monetary breaches of the contract terms. And, in the end, we made a recommendation that was consistent with hers.

And just explain, what was that recommendation, if you could explain that to the Commissioner?---It was that other than illegality there should be no grounds for defaulting a loan providing the borrower was continuing to pay their – meet their payments.

Although was there a qualification about specialist type - - -?---Specialist finance, yes, yes, that's right.

And just so the Commissioner can understand that, that might mean, for example, property development finance or something like that?---Yes. Yes.

And I want to then ask you about your view about how the draft code has implemented that. So if we go to page .0311. You will see clause 80 begins:

> *If you are a small business and you have met all your loan payment terms, we will not take default based action against you unless –*

and then there are 12 subparagraphs of exceptions?---Yes.

What's your view about the extent to which this lines up with the recommendation that you had made?---Look, I suppose I was initially pretty concerned about the – the way that's framed. I think that's – that's a classic example of the way in which the language and the framing of the code is – is small business unfriendly, if you like. So that was the sort of first – I don't have a solution for it, of course, yet – but having – having read that, I think that was sort of my first reaction to it, was this would read badly as a small business customer. And I think the – the array of provisions there, on my read – and, again, I am not a lawyer, but on my read of it, it – it looks as if there's enormous discretion for the bank to use one or other of those circumstances to justify taking default action.

It is qualified by clause 83, which says it is only if it is material or is reasonably considered to be material that it's to be relied upon. Do you have a view about that?---Look, I think it's – it's a – it's a step in the right direction to use the word "material", and I think that was a – a bone of contention from a number of the small business people that we spoke to, was that, you know, they felt that some of these things were not material and were being used to the bank's advantage.

Thank you?---Unfairly used to the bank's advantage.

And I might just ask you about two further questions. The first is have you considered or did you consider any overseas examples in considering the code?---Look, we – we did some research on – on what was available overseas. The three examples that we found most useful were the Canadian, Irish and UK lending codes. And they were part of our – they influenced us in terms of – of arriving at the conclusion that the code could do much more in this space. So the – I think it's the – the UK lending code, to begin with that one, was – has sections in it that are much more sort of clearly directed to small business – identifying what's – what applies to small business within that code. It directly addresses the issue of financial difficulty for small businesses. The other two codes are directed – are directed only at small businesses, and so they apply for lending for small businesses. The Irish – the Canadian code is fairly short and requires each bank to come up with its own code based on the model. The Irish code is much more extensive. Its main focus is on financial difficulty and how a – how a business could be dealt with when it's under financial difficulty. So we – they spoke much more directly to a small business customer, and so we, you know, drew some comfort that our recommendations were – had been applied in other areas, and – and we, you know, copied language and such like from it.

And do you – having had the chance – although as it turns out, not a very long chance to review the most recent version of the code being considered by ASIC. Do you have a view as to the extent to which it reflects the recommendations you made, but also achieves the objects that you understood it was designed to achieve?---Look, overall, I think it's a big step forward. It's a mix of things, from my point of view. Some excellent, some very good, and some where I'm a little disappointed about it,

but I think overall, it's a – it's a big step forward in terms of how it's framed, its accessibility and language, and the substantive protections that are proposed under it. I – I think you would have to concede that it was, you know, a substantial step forward.

Commissioner, I have no further questions for this witness.

THE COMMISSIONER: Thank you, Mr Hodge. Does any party with leave to appear seek leave to cross-examine Mr Khoury? No. Very well.

Thank you very much, Mr Khoury, for your evidence. You may step down. You're excused?---Thank you.

<THE WITNESS WITHDREW [12.50 pm]

THE COMMISSIONER: Now, we have a video link at 2, do we, Mr Hodge?

MR HODGE: We do, Commissioner. So if we could adjourn until then.

THE COMMISSIONER: 2 o'clock.

ADJOURNED [12.50 pm]

RESUMED [2.00 pm]

THE COMMISSIONER: Yes, Mr Hodge.

MR HODGE: Commissioner, I'm sorry, the first witness that we're going to call is Ms Flanagan. But I am actually wondering if we might just – the video conferencing is ready to go, but I'm wondering if we might just adjourn for 10 minutes, the reason being I have just been shown some original documents by Westpac and I think it might be helpful if we can find a way to display those. And I would prefer to figure that out before we start Ms Flanagan. I am sorry about that inconvenience.

THE COMMISSIONER: Well, 10 past or quarter past?

MR HODGE: I think that should be – if we make it quarter past and we can figure out the method.

THE COMMISSIONER: All right. Okay. Quarter past two.

ADJOURNED **[2.01 pm]**

RESUMED **[2.15 pm]**

THE COMMISSIONER: Mr Hodge.

MR HODGE: Thank you, Commissioner. Commissioner, the first witness in the first case study is Carolyn Flanagan. She should be via video link. I will just bring her up now.

THE COMMISSIONER: Yes.

MR HODGE: Hello, can you hear us?

MS FLANAGAN: Yes, thank you, love.

MR HODGE: All right. Now, your name is Carolyn Joy Flanagan?

THE COMMISSIONER: Do we need to swear the witness?

MR HODGE: I'm sorry, Commissioner. Yes. I apologise, Commissioner.

<CAROLYN JOY FLANAGAN, SWORN **[2.16 pm]**

<EXAMINATION-IN-CHIEF BY MR HODGE

THE COMMISSIONER: Thank you, Ms Flanagan. Yes, Mr Hodge.

MR HODGE: Thank you. Your name is Carolyn Joy Flanagan?---That's right.

And you've provided your address to the Royal Commission?---Yes.

Now, Ms Flanagan, you have received a summons to attend and give evidence before the Commission?---Yes. But my doctor advised me not to fly.

I beg your pardon?---The doctor advised me I was not to fly. I am not well enough.

I understand. The doctor said you weren't well enough to fly. I tender the summons.

THE COMMISSIONER: Exhibit 3.5 will be the summons to Ms Flanagan.

EXHIBIT #3.5 SUMMONS TO MS FLANAGAN

THE WITNESS: I can't - - -

MR HODGE: It's all right, Ms Flanagan, you don't need to do anything.

THE COMMISSIONER: You don't need to worry about that. We will go through our little bit of formality and we will come to you in just a second?---Thank you.

MR HODGE: Ms Flanagan, you have made a statement to the Commission?---Yes, I think so. Yes.

Do you remember somebody got you – somebody read out to you a statement and then you signed it?---Yes, I can remember that, love.

I tender the statement, Commissioner.

THE COMMISSIONER: That will be exhibit 3.6, the statement of Ms Flanagan.

EXHIBIT #3.6 STATEMENT OF MS FLANAGAN

MR HODGE: And, Ms Flanagan, I think you were saying before you couldn't travel to Melbourne to give evidence today because you're not well enough?---My doctor said so, no.

All right. And if you need a break at any time, please just let us know and we will – we will deal with that. I'm sorry, can you not hear me very well, Ms Flanagan?---You are breaking up. I am not used to this sort of technology.

I understand. We will do our best and I will talk as loudly as I can?---Mmm.

Now, Ms Flanagan, I just want to confirm, just so everyone knows, at the moment you're with – in addition to a solicitor from the Australian Government Solicitor, there's also a lawyer - - -?---Yes.

- - - from Legal Aid New South Wales there?---Yes.

And also your ex-husband, who is your support person?---Yes.

Okay?---Yes.

Now, Ms Flanagan, I want to just ask you, before we get into the detail of this, some questions about your health. Perhaps the most significant thing, which is obvious, is you have – you can't see very well?---No.

You. I think you just - - -?---I suffer from glaucoma.

You suffer from what, sorry?---Glaucoma

Okay. And I think you described yourself as legally blind; is that right?---Yes.

And in order to read documents – are you able to read documents without any assistance?---No. I hand everything to him. Even my pills. I can't see a thing, love. I can't even see you.

And you've also got a number of other health conditions. You've had nasopharyngeal cancer?---Yes.

And depression?---Yes.

And chronic obstructive airway disease?---Yes. That would depress anybody.

And osteoporosis?---Yes.

And you had a fractured neck of the femur?---Yes.

And diverticulitis?---Yes.

And pancreatitis?---Yes.

And a high risk of suffering from new osteoporotic fractures?---Well, I have plenty of them to prove it.

And I think at the moment you are recovering from a fractured pelvis; is that right?---Yes.

And in 2004 you had an operation to treat your cancer which removed some tumours from your throat and also half of your tongue; is that right?---Yes.

All right. And your vision has been a problem for about 10 years; is that right?---Yes ..... worse.

I am sorry, could you say that again, Ms Flanagan?---It's getting – it's gradually getting worse.

Yes?---Every day.

Now, I want to turn to some events that occurred in 2010. And some of these events involve your daughter and your daughter's partner. I'm not going to name your daughter or your daughter's partner. And that's because - - -?---Thank you for that.

That's right. That's because the Commissioner has – or one of the reasons is the Commissioner has made a direction that their names not be published?---Mmm.

So I am going to refer to them as your daughter and your daughter's partner?---Yes.

Now, do you remember your daughter discussing with you a loan that she and her partner wanted to get in about 2010?---Yes.

Is it fair to say, Ms Flanagan, your memory is relatively vague about all of the detail of this now?---Well, it has been that long, though, love and since I have suffered the strokes and that.

I understand. And so doing the best you can, do you remember your daughter telling you that she needed help with a loan?---Yes, I do remember that.

And do you remember what it was that – what the loan was for?---It was for Poolwerx, wasn't it? Yes, Poolwerx.

All right?---It was their business.

It was for buying a business; is that right?---Yes.

And do you remember whether she told you at the time how much the loan was for?---Well, I thought it was for $50,000, but it turned out a lot more than that.

All right. And do you remember whether your daughter or her partner talked to you about working in the business?---No.

Do you remember - - -?---I have never even been.

I am sorry, say that again?---I have never even been in the factory.

All right?---In the business.

And do you remember whether your daughter or her partner talked to you about being a shareholder in the business?---Yes, I found that out just recently.

That you were a shareholder; is that right?---Yes, that was what – from one of you, I think.

Do you remember her talking to you about the idea that you might be a silent partner in the business?---That I do remember.

Okay. And can you remember what she said about that?---No, love.

All right?---I am no good remembering yesterday.

Are you – do you need – are you all right, Ms Flanagan? You want a break or are you fine?---No, I am right. I ..... done this.

Okay. I should probably just explain to the Commissioner, it causes you some pain to speak; is that right?---Yes. I get dry mouth and start to choke. I have got some .....

And at the moment you're receiving a disability support pension; is that right?---That's right.

And were you receiving that back in 2010? Were you receiving that back in 2010?---Yes. Yes.

Now, do you remember going to a Westpac branch with your daughter in 2010?---Yes. Vaguely, yes.

Can you remember – or how many times do you remember having gone to a Westpac branch?---Twice, I think.

Okay?---Twice or just the once? Twice.

Ms Flanagan, just if you – I'm sorry, I understand that there's people there to help you, but you need to just give your evidence to the Commissioner. So - - -?---Sorry.

That's all right. And when you went to the branch with your daughter, do you remember meeting with somebody else at the branch?---Yes. A woman and a man were there in a side office.

Okay?---We were let into.

And do you remember that the purpose of you going to the branch was to sign a guarantee?---Yes.

All right. And do you remember what you were told about the documents that you signed at the branch?---No.

Okay. Do you remember anybody reading out the contents of the documents to you?---Someone did that.

They read out the whole of the documents?---Well, I think so.

Okay. That was at the branch?---Yes.

And as I understand it, you think that you signed some documents that day?---Yes. In the office, yes. In the bank.

And are you able to remember now: could you read the documents yourself?---No.

Okay?---They had to read it out to me.

And could they – could you sign the document by just looking at the - - -?---It's on – no, they got to point to where I've got to sign. Sometimes it goes up the page, sometimes it goes down.

Okay?---Sorry.

I'm sorry, say that again?---I'm sorry if you're having trouble understanding me.

No, that's fine. Do you remember a valuer having come to your house at some stage?---Yes, I remember that.

Okay. Can you remember a discussion with the valuer?---No.

Okay. Do you remember having gone to see a lawyer about the documents?---No.

Do you think - - -?---All I remember – all I remember is going to the bank.

Okay. Do you think it's possible that at some time after the – and I'm sorry, let me go back a step and just explain something to you, Ms Flanagan. Moments before you gave evidence, Westpac managed to find the original copies of the guarantees and the mortgage. And they - - -?---Mmm.

- - - think – you know – I'm sure you've been told over many years that there's – that the odd thing about your guarantee and mortgage is that there are two witnesses who have signed the document. You know that?---Yes. No.

And – well, you know that there's – it's said by Westpac that the lawyer witnessed your documents?---No, I can't even remember a lawyer being there, love.

Okay?---Just the woman and the man on the other side of the desk.

All right. Do you – do you think, Ms Flanagan, that it – if you had been told – or if you could remember being told to get legal advice, that that would have made any difference?---I would have gone straight to Legal Aid. Definitely.

Well, that's now, you mean?---No, if I was told to get legal advice, I would have walked out of that bank and gone.

At the moment – and doing the best you can, given the way you felt about your daughter at the time, do you think that it was likely that you would have signed the guarantees in any event?---I would have signed anything, love, for her, in hindsight. I have to be honest about that.

All right?---If you can't help your children, who can you help?

Now, from about 2012, Ms Flanagan, you started to receive some legal documents from Westpac?---I never saw them. I was in the – with my daughter, after I had the strokes for a time, and I never received one letter from the bank.

All right. At some point in time, do you remember your – Ron, your ex-husband, reading out some documents that had arrived in the mail?---Did you?

It's okay, Ms Flanagan, if you can't remember you don't need to ask?---I can't remember, love.

Okay. And then at some point in time do you remember knowing that Westpac had brought a claim against you in court?---No. Everything was kept from me.

Do you remember, though, you went to Legal Aid New South Wales?---Yes, I think so.

And do you remember what – do you remember you met with Ms Beiglari?---Yes, she was nice.

And do you remember that the reason why you went to meet with Ms Beiglari was because you received a document?---Yes.

All right. And was that a document somebody read out to you?---Yes.

And do you remember that you understood from that that Westpac were trying to take action against your – or trying to effectively cause you to sell your house or cause your house to be sold?---Yes.

All right, Do you remember Ms Beiglari took or made a complaint for you to the Financial Ombudsman Service?---Yes, I think so.

All right. And do you remember that what you wanted was to be able to stay in your house?---Yes.

And you know ultimately an arrangement was reached with Westpac that allows you to stay in your house?---Yes. I know that until I die.

Until you die. And you know that if you – if you want to sell your house before you die, then Westpac will take some of the money from the sale of the house?---Yes, I understand that, love.

All right. Commissioner, I have no further questions for Ms Flanagan.

THE COMMISSIONER: Thank you, Mr Hodge. Mr Darke.

<CROSS-EXAMINATION BY MR DARKE [2.33 pm]

MR DARKE: Thank you, Commissioner.

Ms Flanagan, I only have a few questions for you - - -

THE COMMISSIONER: And you better explain who you appear for, I think, Mr Darke.

MR DARKE: Yes, yes.

THE COMMISSIONER: Just to keep it all above board.

MR DARKE: Certainly, Commissioner.

I appear for Westpac at the Commission. Do you understand that?---Yes, love.

THE COMMISSIONER: This is Westpac's lawyer who wants to ask you some questions, Ms Flanagan. Go on - - -

THE WITNESS: What did he say?

THE COMMISSIONER: Go on, Mr Darke.

MR DARKE: Thank you, Commissioner.

Ms Flanagan, do you recall that when you gave the guarantee that you gave to Westpac, you understood that you were putting up your house for security for a loan to a company?---No, I thought it was for $50,000. That's what I thought it was for.

But you understood, whatever the amount of the loan, that you were putting up your house for security for that?---Yes, love, yes.

And you knew that your daughter and her partner needed you to do that because they didn't have any assets of their own to put up as security; correct?---Yes. That's correct.

And your daughter told you that she and her partner would be able to repay the loan. Do you remember that?---Yes, I remember that.

And you understood - - -?---Otherwise I wouldn't have put the house up.

And that's because you understood that if they couldn't repay the loan, that Westpac could seek to recover it from you. That's right, isn't it?---Yes. Yes.

And that that could involve them trying to sell your house, which you were putting up as security for the loan?---Yes.

You were asked a little while ago about what happened when you went to the bank to sign the guarantee. Do you recall that?---Yes. I went into a little office and there was a woman and a man there.

Right. And I want to suggest to you that perhaps you are combining two meetings. Is it possible, Ms Flanagan, that when you went to the bank you met with a woman, and then at a later point in time you met with a man who was a solicitor?---Could have been, love.

Could have been?---Yes.

Thank you?---I have a memory like a sieve.

And – yes. And if you met with a solicitor about the guarantee that you gave to the bank, it's likely to be because the bank told you that you should get legal advice about it. That's right, isn't it?---Probably, yes.

Now, you mentioned before that you thought the loan was only for $50,000?---Yes.

But you know that you didn't mention that in the statement that you gave to the Commission?---No.

You recall that you've given a statement to the Commission?---Yes. I don't really.

I see. And do you recall that you made a statutory declaration in relation to a FOS application with the help - - -?---What's that?

- - - of the Legal Aid solicitor? Let me ask that question again?---No.

Ms Flanagan, do you recall making a statutory declaration in relation to an application to the Financial Ombudsman Service with the help of a Legal Aid solicitor?---Yes, I probably do, yes.

Yes. Okay. And you didn't mention in that statutory declaration that you thought the loan was only for $50,000. Do you recall that?---Yes. I recall that.

And you don't really have a clear recollection, as you sit there in the witness box now, do you, that you did think - - -?---No.

- - - at the time you gave the guarantee that the loan was only for $50,000?---Yes. No, I clearly believed that. And it was for only $50,000.

Even though you didn't - - -?---And it was - - -

Ms Flanagan, what I am trying to suggest to you is that your memory of what you knew at the time you entered into the guarantee is very poor. Do you agree with that?---Yes. Yes, very.

And you don't really remember, as you sit there now, how much the loan was for?---No, love, I don't.

Thank you. No further questions, Commissioner.

THE COMMISSIONER: Yes. Mr Hodge.

MR HODGE: No re-examination, thank you, Commissioner. Could the witness be excused?

THE COMMISSIONER: Thank you very much, Ms Flanagan?---Thank you.

You're excused and we can cut the video link, I think, can we not?

MR HODGE: Yes, thank you, Commissioner.

THE COMMISSIONER: Yes. Thank you.

<THE WITNESS WITHDREW [2.38 pm]

THE COMMISSIONER: Yes, Mr Hodge.

MR HODGE: Commissioner, the next witness is Ms Beiglari.

THE COMMISSIONER: Yes.

<DANA BEIGLARI, AFFIRMED [2.39 pm]

<EXAMINATION-IN-CHIEF BY MR HODGE

THE COMMISSIONER: Thank you very much. Do sit down. Yes, Mr Hodge.

MR HODGE: Thank you, Commissioner.

Your name is Dana Beiglari?---That's correct.

And you've provided your address to the Royal Commission?---I have.

And Ms Beiglari, you've received a summons to attend and give evidence before the Royal Commission?---I have.

Do you have a copy of the summons there with you?---Yes, I do.

Commissioner, I tender that summons.

THE COMMISSIONER: Exhibit 3.7 will be the summons to Ms Beiglari.

EXHIBIT #3.7 SUMMONS TO MS BEIGLARI

MR HODGE: And Ms Beiglari, you've also made a statement to the Commission dated 16 May?---I have.

Now, do you have any corrections you want to make to that statement, other than – I was going to direct you specifically to something – perhaps I will do that first. Your statement has been prepared based on your review of your file notes?---That's correct.

And were there some parts of your statement where you don't – you have had to draw it from your file note rather than any current recollection you have; is that right?---Yes, that's right.

And can I just clarify what those parts are. If you go to paragraph 16(d) of your statement, where you record that Ms Flanagan had instructed you that she does not remember signing any documents to become a shareholder of the company, but recalled she was to be silent partner in the business. Do you have a recollection of that conversation, or is that something that's drawn from your file note?---That paragraph is drawn from my file note.

All right. And if I just ask one question then about that. Do you – did you make any note about what Ms Flanagan's understanding was of what a "silent partner" meant?---To the best of my recollection in that file note, I recorded that Ms Flanagan understood that she was to be a silent partner, but she said that that – she didn't know exactly what that meant in terms of her role with the business, and she wasn't sure if she had signed any documents to make that happen in effect.

All right. And if you go to paragraph 19 of your statement. Is there some part of this paragraph that's drawn from your notes rather than from your refreshed recollection from your notes?---Yes. So this paragraph here is drawn from my file notes in terms of the level of detail that – that Legal Aid contacted ASIC, and then later contacted Castlereagh Accounting. I didn't make those inquiries myself, it was a paralegal who made those inquiries, and so that paragraph is drawn from my file note discussions with that paralegal after he had made those inquiries.

All right. And your statement also contains very detailed explanations of the dealings that you had and the communications that you had with FOS. And is that a result of being able to refresh your memory from the file notes you took of – in relation to those communications?---Yes, that's right. I have a memory of what happened during the FOS dispute resolution process, but the level of detail that I

provide in my statement is further to recordings to I make in my file notes about the particular discussions that were had in the course of that dispute resolution process.

Right. Are there any – with that qualification, are there any other parts, or any corrections that you wanted to make with respect to your statement?---There's one small correction at paragraph 58. In the first line, I repeat "in favour" twice. I would like to delete one of those in favours.

THE COMMISSIONER: You choose and delete one?---Thank you.

And initial?---And I have initialled it as well.

Thank you.

MR HODGE: And otherwise, is your statement true and correct to the best of your knowledge?---Yes.

All right. I tender that statement, Commissioner.

THE COMMISSIONER: Exhibit 3.8, statement of Ms Beiglari, 16 May '18.

EXHIBIT #3.8 STATEMENT OF MS BEIGLARI DATED 16/05/2018

MR HODGE: Now, Ms Beiglari, where do you work?---I work at Legal Aid New South Wales.

Okay. And how long have you been at Legal Aid New South Wales for?---Since September 2013.

And what's your role at Legal Aid New South Wales?---I'm a senior solicitor. I work in the Consumer Law Specialist Team which sits within the civil law division of Legal Aid New South Wales.

And how many solicitors are in that team altogether?---In the consumer law team there's approximately 12 solicitors, and in the general civil law division there's around 179 staff members.

All right. And the consumer law team deals with what sorts of matters?---We assist disadvantaged people with their credit and debt, general consumer protection, and insurance matters. So we provide case work advice and representation to those people. We also participate in a large amount of law reform and policy discussions, and manage a number of stakeholder relationships with industry, the ombudsman, regulators.

Now, Legal Aid has acted for parents who – or have provided guarantees to – for children's business loans; is that right?---That's correct.

Apart from this particular case?---That's correct.

And are you able to make any observations to us as to typically what sort of consumers are providing those types of guarantees?---So in – in our case work experience at Legal Aid, it's generally older people. So older parents who are using their homes as security for business loans for the benefit of a third party, who's usually a son or daughter.

And when do they typically come to you?---They – they come to – those people come to us for advice at the point where the bank is threatening to sell their home.

There's a specialist service within Legal Aid that can deal with some of these types of issues; is that right?---That's right, yes. So the Mortgage Hardship Service is a service which provides advice and case work assistance to people who are experiencing financial difficulty and who are at risk of losing their home.

And you have personally provided – apart from Ms Flanagan, you've provided assistance to older people in this sort of circumstance?---Yes, that's correct.

And what sort of issues have you observed in relation to the provision of advice to older people who have provided guarantees for their children?---There's a number of issues that I've observed in my own case work practice and from discussing my colleagues' case work with them. Firstly, it's that people often want to put family first, they consider that family is paramount, or they might feel some pressure to do what their child asks them to do in order to preserve the relationship. And so in those circumstances my clients might find it difficult to say no to a financial arrangement that has been put forward to them by their son or their daughter. And that means that they might be less inclined to receive independent legal and financial advice, particularly about the implications that using your home as security for a loan might have on their life. So some of those implications or risks are that the bank may sell the family home in order to satisfy the debt if – if the loan falls into arrears. It's very rare for clients to understand that their Centrelink pension payments may be reduced or cut off completely if the guarantee is called upon, due to the effect of the gifting rules that Centrelink has, and – and finally, a significant implication is that – is the emotional toll that the stress and stress that this may have on the family unit. It could cause a relationship breakdown between the parent and the child which can be devastating for a parent, particularly in their old age.

And you make some observations in your statement about the extent to which clients recall the circumstances in which they enter into guarantees. Could you just explain to the Commissioner what observations you've made about that?---So my clients – so Legal Aid clients generally in these sorts of matters often have a limited recollection of the circumstances of signing up to the guarantee. This might be because of their limited literacy skills, or other difficulties communicating. For

example, they may have a disability or not speak English as a first language. But very often it's because their child has done most of the logistics, and – and sorted out the paperwork with the bank or in some cases with a broker. I have seen some cases where a broker has been involved as well as a bank. And in those cases, my client very often can't describe the circumstances of signing up to the guarantee beyond going to the bank, usually just one time, accompanied by the son or daughter, who is receiving the benefit of the financial arrangement, and they can't provide much more information beyond that. In fact, I've had cases before where clients think that they are a guarantor but they, in fact, are a co-borrower which comes with a different set of obligations on their part. Very often, my clients haven't entered into complex financial arrangements like a mortgage or a guarantor before and don't understand what being a – having a mortgage or being a guarantor involves before they come to Legal Aid and speak to a Legal Aid solicitor.

Now, you've referred a couple of times to independent legal advice. We will come to the detail of this case in a moment, but presumably in some of the cases that come to you, there's a certificate that's been signed by a solicitor or a statutory declaration that's been given in the presence of a solicitor about the giving of independent legal advice?---Yes, I have seen some cases like that.

And do those cases also give rise to – or have given – risen to issues in which you've been involved about the guarantee?---Sorry, I don't quite understand the question.

Let me put it in slightly a different way. In terms of the understanding that clients have, have you made any observations about the extent to which their understanding has been assisted by receiving independent legal advice?---I would say that nearly all of the cases that I have seen at Legal Aid, the client did not understand the detail of the financial arrangement that they were signing up to. For example, they might not have understood the amount of the loan or the type of the loan, say, a consumer law versus an investment or business loan, or they may not have been able to describe what it means to be a guarantor or have a mortgage. So in the cases where there has been independent legal and financial advice, I don't think that it has assisted people to understand what they're doing. One case in particular that I am recalling, the son or daughter was present at the time that that advice was given, the legal advice, and so there's real questions about whether it is independent in the first instance.

All right. Now, when these types of cases are brought to you, presumably one possibility is that you might go to court and have a dispute in court. Is that a realistic practical outcome?---Our – our first step is – is often to try to resolve the matter directly with the financial service provider, or in the Financial Ombudsman Service, or of the credit and Investment Ombudsman Service, so to try and resolve the matter in external dispute resolution. And we've had a really great experience in that regard. The Financial Ombudsman Service is a really professional and efficient way of resolving disputes in a fair and reasonable way for consumers. But in some cases, the matter is more appropriate to go to court. Say it's complex legally, or there are a number of other parties that might be involved, such as the third party beneficiary. So the son or daughter, or a broker. And in those cases, it's more appropriate to go

to court. But court has difficulties – some difficulties, including that it can be a stressful place for people to resolve their legal disputes. It can be expensive, time consuming, and legally complex.

All right. I want to now move from the general to the specific case that we are considering today, which is Ms Flanagan. And you first met Ms Flanagan in about June 2014; is that right?---That's correct.

And I think she had already, by then, spoken with another solicitor from Legal Aid?---That's correct. She had spoken with a solicitor – one of my colleagues at the Penrith Legal Aid Office. She had made an appointment – or she popped into the Penrith office to see a solicitor following receiving a statement of claim from – from the – the bank.

All right. And during the meeting with Ms Flanagan, she explained to you her medical conditions?---That's right. So during the first meeting that I had with – with Ms Flanagan and her support person they explained to me some of her medical conditions following the treatment of – of cancer a few years earlier which had affected her ability to speak, and also she had some difficulty seeing, she described it as – as near blindness, so really difficult to see objects in front of her. Everything was blurry, not able to read and write easily. And she also described to me that it was difficult for her to move around because of her osteoporosis. And I observed myself that Ms Flanagan's speech was quite restricted. She wasn't able to speak more than, say, a few sentences or a paragraph at a time without having a sip of water. And she wasn't able to read or write. So in the course of assisting her, I made sure that I read everything to her that was necessary. And I observed that her movement was quite restricted as well, not being able to get around without the use of a cane or a – or a walking frame.

Was she able to sign documents?---She was able to sign her name, but where I – she was able to do this when I indicated where she needed to sign, because she would say to me that she can't see the place where she's supposed to sign.

And was she able to, in a conversation with you, maintain eye contact with you?---No. When I was speaking with her, she wasn't able to make eye contact with me.

All right. Now, you obviously took instructions from her at the time, and you've set out those instructions in your statement. Are you able to comment on what her recollection is like now as compared to what it was like then when you were dealing with her?---At the time that I was dealing with Ms Flanagan – so some years ago now – her recollection was more detailed than what it is now.

All right. And you decided to – what you advised Ms Flanagan to do was to bring a FOS complaint; is that right?---That's correct. So my colleague in the Penrith office initially advised Ms Flanagan to make a FOS complaint. He gave her some advice about when the statement of claim – when the 28 days would – would lapse, and was

suggesting that it was important to make a Financial Ombudsman claim before that date. I met with Ms Flanagan and her support person prior to the 28 days lapsing and assisted her to make a Financial Ombudsman Service claim on the grounds of financial hardship on that day.

All right. And there was subsequently, in addition to the financial hardship complaint, also an issue about effectively the lending decision, whether a guarantee should have been taken in the first place; is that right?---Sorry, can you - - -

Was – the issue in front of FOS wasn't confined to financial hardship, it was expanded out. Could you just explain what the expansion out was?---Yes. Okay. That's correct. When I first made the Financial Ombudsman claim in late June, it was on the grounds of financial hardship, and once I had received more information – so some documents through the FOS process – I gave some advice to Ms Flanagan about expanding her claim to include a – an unjust contracts claim in respect of the guarantee, and also making a claim in respect of some of the Banking Code of Practice obligations, some breaches in respect of those obligations.

All right. And during the course of that FOS dispute do you remember Westpac having produced the original version of the guarantee or mortgage?---No.

Okay. So you haven't seen those before?---No.

All right. Now, the end result of that FOS – I'm sorry, I should go back a step. What you were seeking on behalf of Ms Flanagan through the FOS process was what result?---Her ultimate goal and our ultimate goal was for her to remain in her property for the rest of her lifetime. So it might be described as a life interest in her property. And we were hoping to achieve that in a way that the bank would agree to not enforce the guarantee until that – that time that Ms Flanagan passed away, or she chose to sell her property.

All right. And during the course of the FOS process, you communicated that desire to the ombudsman that you were dealing with?---That's correct.

And you understood that the ombudsman had communicated that desire to Westpac?---That's correct.

And what was Westpac's position during the course of the FOS process as to whether that was a possible outcome?---Westpac's position, which was communicated to me from FOS, was that it would not be a possible resolution to the dispute. I also had a conversation with a Westpac officer putting that proposal to him, and he also said that it was an unlikely settlement.

All right. And the FOS process concluded then with a determination in favour of Westpac; is that right?---That's correct.

And what happened after the FOS process?---After the FOS process, my manager at the time contacted another consumer advocate to ask if he had a senior contact at Westpac that we could escalate this matter to. Given our client was facing homelessness in her old age and given her medical difficulties as well, it would have been very hard for her. Shortly after my colleague sent that email to the consumer advocate, the consumer advocate copied a number of Westpac – sorry, one Westpac contact to that email. The Westpac contact then copied a couple of people from her team – I think it was the assist team at Westpac – to the email and asked for more information. At that point, I sent a letter that I had drafted on behalf of Ms Flanagan, outlining her personal circumstances, including her medical circumstances, and asking for a life interest in her property as a settlement. And within a day or two, Westpac had agreed to settle on those terms.

That's – and I think you might have dealt with a particular person within Westpac from the collections hardship area; is that right?---That's correct.

And what that employee of Westpac expressed to you was surprise at the thought that Westpac would be evicting and it wasn't in line with what Westpac would normally do?---Yes, that's correct.

And she suggested that in future, if these sorts of situations arose, that it might be worth approaching her directly; is that right?---That's correct.

All right. And there was then a deed that was drafted between you and Westpac; is that right?---Yes, that's right.

And the original deed, I think – I'm sorry, in the course of discussing the drafting of the deed, Westpac set out that the settlement figure that was required was 170,000 rather than 160,000; is that right?---That's correct.

And that reflected what they said were the extra costs that had been incurred after the – after the loan had been made?---That's correct.

And then the deed also provides that there'll be three per cent interest accruing on that per annum?---Yes.

Okay. And that deed has now been signed up by both Westpac and Ms – I'm sorry, by Ms Flanagan; is that right?---Yes, that's right.

All right. Commissioner, I have no further questions for Ms Beiglari.

THE COMMISSIONER: Yes. Mr Darke.

<CROSS-EXAMINATION BY MR DARKE [3.02 pm]

MR DARKE: Thank you, Commissioner.

Ms Beiglari, my name is Matthew Darke. I am a lawyer for Westpac. I just have a few questions for you. When you were acting for Ms Flanagan, do you recall obtaining a file from a lawyer whose name appeared as the witness on the guarantee and mortgage that she had executed?---Yes, that's right.

And do you recall that that file contained a declaration signed by Ms Flanagan and witnessed by the solicitor?---Yes.

I might just have that brought up on the screen if I may, Commissioner. The doc ID is WBC.407.001.0052, and that is exhibit DB-2 to Ms Beiglari's statement. And you recall that when you looked at that declaration, Ms Beiglari, that you recognised that it stated that Ms Flanagan had received independent legal advice before signing the guarantee and mortgage?---Yes, I understand that that's the effect of the document.

And for that reason, you regarded the declaration as being inconsistent with the instructions you had from Ms Flanagan that she never had received legal advice; is that right?---That – that's correct.

When you saw the declaration, did you consider speaking to the solicitor who had signed it in order to resolve the inconsistency between the declaration and what your instructions were?---I did write to the solicitor asking for information about the file, and once I received that information, I didn't take any further steps to contact the solicitor.

Yes. Thank you. I have no further questions.

THE COMMISSIONER: Just before you sit down, Mr Darke, Ms Beiglari, what do you understand paragraph 2 of that declaration to be telling you?---Commissioner, the paragraph says that Ms Flanagan had received independent legal advice regarding the loan and security documents referred to in the above paragraph.

It tells you nothing about the subject of the advice, does it?---No, that's right.

It doesn't tell you what the question is, it just says, "I've been to a lawyer"?---That's correct.

Yes. Mr Darke.

MR DARKE: There is nothing arising out of that, Commissioner.

THE COMMISSIONER: No. Mr Hodge.

MR HODGE: Nothing further, Commissioner. Could Ms Beiglari be excused?

THE COMMISSIONER: Yes, thank you, Ms Beiglari. You are excused?---Thank you.

<THE WITNESS WITHDREW [3.05 pm]

MR HODGE: Commissioner, the next witness is Mr Welsh from Westpac.

MS NESKOVCIN: Commissioner, Mr Welsh is in the hearing room.

THE COMMISSIONER: Yes.

<ALASTAIR DEREK DAWSON WELSH, AFFIRMED [3.06 pm]

<EXAMINATION-IN-CHIEF BY MS NESKOVCIN

THE COMMISSIONER: Thank you very much. Mr Welsh. Do sit down. Yes, Ms Neskovcin.

MS NESKOVCIN: Mr Welsh, is your full name Alastair Derek Dawson Welsh?---Yes.

And is your business address Tower 2, International Towers, 200 Barangaroo Avenue, Barangaroo, New South Wales?---Yes.

Your current position is general manager, commercial banking?---Yes.

Mr Welsh, have you received a summons to appear at the Commission hearing today?---Yes, I have.

Do you have a copy of the summons with you? The original is in court, I understand. If that could be handed up and tendered.

THE COMMISSIONER: Yes. Exhibit 3.9 will be the summons to Mr Welsh.

EXHIBIT #3.9 SUMMONS TO MR WELSH

MS NESKOVCIN: Mr Welsh, have you also prepared a witness statement in relation to a request for evidence regarding Rubric 3-12?---Yes.

And do you have a copy of – or the original statement with you?---Yes.

And the exhibits?---Yes.

And are there any changes that you wish to make to the statement?---No.

Mr Welsh, is your statement true and correct?---Yes.

I tender that statement, Commissioner.

THE COMMISSIONER: Exhibit 3.10 will be witness statement of Mr Welsh in relation to Rubric 3-12.

EXHIBIT #3.10 WITNESS STATEMENT OF MR WELSH IN RELATION TO RUBRIC 3-12

MS NESKOVCIN: Thank you, Commissioner.

THE COMMISSIONER: Yes, thank you, Ms Neskovcin. Yes, Mr Hodge.

<CROSS-EXAMINATION BY MR HODGE [3.07 pm]

MR HODGE: Thank you, Commissioner.

Mr Welsh, you're the general manager for commercial banking at the Westpac group?---Yes.

And you've been in that role since 2011?---Yes.

And prior to 2011, you held various roles in the business banking team with the bank?---Yes.

And that included being the national manager for commercial business, business financial services, from 2003 to 2006?---Yes.

And you've also been national manager of small to medium enterprises in business banking?---Yes, that's correct.

Now, you've been put forward by Westpac as its witness for this Royal Commission to respond to the evidence in respect of a guarantee given by Ms Flanagan in 2010 in respect of a business loan?---Yes.

And you've reviewed information relating to Ms Flanagan's case for the purpose of preparing your statement?---Yes.

And did you also hear the evidence given by Ms Flanagan?---Yes, I did.

And you heard the evidence given by Ms Beiglari?---Yes, I did.

And you've come to some conclusions, as I understand it, about whether the case should have been handled better based on your review?---That's correct.

And one of the conclusions you came to was that the case should have been handled better by the request for hardship having been progressed earlier?---That's correct.

And is it only with respect to hardship that you think Westpac ought to have done better in its dealings with Ms Flanagan?---Hardship is the – yes, correct.

All right. And just so we understand the bounds of what we're dealing with, your view is there's not a problem with Westpac having initially accepted a guarantee from Ms Flanagan?---Yes. It's correct that my review of the file shows that we followed up the process that I would have wanted the banker to follow.

I want to just break that down into two elements. The first element is having regard to Ms Flanagan's circumstances irrespective of what process was followed. Is it your view that there's no difficulty or no problem with Westpac accepting a guarantee from Ms Flanagan?---No, that's not correct.

You think there is a problem with Westpac accepting a guarantee from Ms Flanagan?---Sorry, I misunderstood the question. After just seeing Ms Flanagan it's pretty confronting really, isn't it.

I understand. And there's two different issues here. One is: should the bank ever have accepted a guarantee from Ms Flanagan? The second issue is is the bank's process in relation to the acceptance of the guarantees, was it adequately applied in this case. And those questions are obviously related. But the first question I want you to focus on is just the acceptance – the very fact of accepting a guarantee from Ms Flanagan in this case, irrespective of whether the particular procedural boxes were ticked or not. Is there a problem with Westpac accepting a guarantee from Ms Flanagan?---Technically, there's not a problem.

All right. And then I think that really brings us into the second question or the second part of this, which is: is there a problem with Westpac's processes in relation to the taking of the guarantee, and what's your view about that?---There wasn't a problem with the technical process of the process.

There wasn't a problem with the application of the process in this case; is that right?---Thank you, that's correct.

And in your view, is there any issue about whether, if the process was followed in that – in this case, that suggests there's a problem with the process?---Sorry, can you just repeat the question, so I am really clear.

Yes. In your view is there a problem with the formal process that Westpac has for assessing guarantees?---Is – no, there's not.

Okay. All right. I now want to go through that process. You set out in your statement the types of securities that Westpac accepts for business lending facilities?---Yes.

And that would include residential property or cash deposits?---Yes.

And it also includes guarantees?---Yes.

And Westpac will generally only allow lending of up to $50,000 to a small business to be unsecured?---Yes, that's correct.

And otherwise, it would insist on taking some form of security?---Apologies.

That's all right. Do you want a moment?---Thank you. Sorry, just repeat the question.

Yes. Generally, for lending above $50,000 to a business, it would insist on taking some form of security?---That's the normal practice, yes.

There's an exception, perhaps, which we will come to in a moment, which is in respect of approved franchises; is that right?---Yes.

All right. And in the absence of general security interest over the business's – sorry, the business' assets, the bank will seek security over freehold – freehold land; is that right?---Yes.

And that can be the business owner's home, if that's the only – the only real estate that's available?---Yes.

And in 2010, when Ms Flanagan provided her guarantee, Westpac had two credit manuals; is that right?---That's correct.

And you exhibit these to your statement?---Yes, I do.

All right. And I think at paragraph 26 of your statement you set out the steps involved in assessing a business loan application for a new customer? Have I misled you as to the paragraph number?---Number 26?

26?---Policies for micro and – yes.

Thank you. There we go?---Thank you.

And if we blow up step 2, that's collection of required customer and guarantor information and financials?---Sorry, Mr Hodge, I will just – it is a little embarrassing here.

It should be on the screen, if that would assist you, Mr Welsh?---That's my general statement that I'm looking at. So that's why I'm a little lost, but I will correct that problem.

THE COMMISSIONER: I am glad it happens to someone else other than me, Mr Welsh, so I wouldn't get too fussed by it.

MR HODGE: You've been given quite a number of statements?---That would be this one that I'm looking for.

Thank you?---Sorry about that.

By our count you've been given at least four statements for this round of hearings, Mr Welsh?---There has been a few.

Yes. You've got to come back a number of times?---I have got it. Thank you. Sorry about that, Mr Hodge.

No, no, that's fine. So if you have a look at paragraph 26 of your statement, which is on page 6 of your statement, this is dealing with the steps involved in assessing a business lending application for a new customer?---Correct.

And step 2 is:

> *Collection of required customer and guarantor information and financials.*

?---That's correct.

And as I understand it – I'm sorry, we should just go forward one step first. Which is in paragraph 27 you see that it's said:

> *After a customer approached Westpac seeking a business loan, a business banker engaged with them to make inquiries about the purpose of the loan, the customer's needs and their financial situation.*

?---Yes.

And is it also the business banker handling the loan who is expected to engage with the guarantor to seek information from the guarantor?---Yes.

Is it expected that the banker would engage directly with the guarantor in order to obtain information about the guarantor's financial position?---Not – not typically about their financial position.

Is it expected that they would engage directly with the guarantor at all?---They would engage with the guarantor at the time when they present the – what we referred to as the bundle of – of documents. So they have the information or they could send it to them, but – yes.

I just want to understand some things about the information that might be collected from the guarantor under what's referred to as step 2. Is it expected that the bank manager would understand what the relationship was between the borrower and the guarantor?---Yes.

And is it expected that the bank manager would understand – I'm sorry, the business banker would understand about the income of the guarantor?---No, it's not expected.

Is it expected that the business banker would understand or make inquiries about the health of the guarantor?---No, it's not.

Is it expected that the business banker would make inquiries about the assets of the guarantor?---No, it's not.

Presumably, though, when it comes to assets – and we will see in this particular case – they need to at least know that the guarantor is offering up some asset of security; is that right?---Yes, yes, I was referring probably – yes, yes.

You mean in general they don't need to know what all of the assets are of the guarantor, they just need to know - - -?---Thank you.

- - - whether they have a specific asset capable of satisfying the bank's debt if the guarantor is called on; is that right?---Thank you. Thank you.

Sorry, when you say "thank you", you say yes, I've summarised Westpac's position?---Yes – yes, I mean, yes. Far more elegant.

And I want to have a look at some parts of Westpac's 2010 credit manual. This is exhibit 2 to your statement. It's document number WBC.410.001.9483. That's very hopeful. Hopefully that won't keep happening. But this is – this is something that – it looks like it won't keep happening – this is something that sets out various policies in relation to different issues for a business banker who's assessing a loan, or some – or the provision of credit; is that right?---Yes, this is the start of the policies.

Okay?---Yes, that's correct.

And there's a whole series of policy documents - - -?---Yes.

- - - that deal with different aspects of it?---Yes.

All right. And if we go to 9503, page ending 9503?---Thank you.

This is the policy in relation to the Code of Banking Practice. And it explains, at the beginning, that the code is a voluntary code and sets standards of conducts and procedures to be followed when dealing with individual and small business customers and their guarantors. You see that, Mr Welsh?---I do.

And Westpac has adopted the code to ensure good banking practice and to protect its public reputation. You see that?---Yes.

All right. And one of the points that it makes, if we go over the page to 9504 – I am not sure why the second page of that policy is redacted. I can't imagine this is going to be an issue, but one of the points that's made, if you have a look on your page, is that Westpac doesn't treat a – shouldn't treat somebody who is really a guarantor as a co-borrower?---Yes, that's correct.

And can you just explain what's the difference – what's the difference between – from Westpac's perspective between a co-borrower and a guarantor?---The – there's a number of categories of – of guarantors. I think where we're talking about joint debtors, this is where someone will be implied to have – will be implied to be a debtor and they would give a guarantor in that situation. We don't accept them in that situation.

Okay. And if we go to page .9526. Commissioner, could you just give me one moment? All right. We will just read out the relevant - - -

THE COMMISSIONER: Well, is there some reason why this is redacted?

MR HODGE: Commissioner, I think the answer is at some point in time – I'm being told there's not. My understanding is there's some particular parts that Westpac was informed that we wanted to go to and therefore the rest of the document has been redacted. Presumably, there was an application for non-publication on the basis of commercial in confidence.

MS NESKOVCIN: Commissioner, an application for a non-publication order was made over certain parts of the manual, the response we received from the solicitor assisting the Commission was that there were a number of pages that the Commission – or that Counsel Assisting would take the witness to and the rest would be redacted, save in respect of a couple of discrete parts.

THE COMMISSIONER: And what's the position with this page?

MS NESKOVCIN: No difficulty with the two pages that my learned friend just showed me.

THE COMMISSIONER: Then why are they blacked out on the court book.

MS NESKOVCIN: That was the response from the solicitor assisting in response to the non-publication - - -

THE COMMISSIONER: Well, it might take – I won't take time to deal with it. It's unfortunate. Yes, go on.

MR HODGE: Thank you.

Now, Mr Welsh, if you have a look at 9526, you've got an unredacted copy. You see that there?---Yes, I do.

And this should be part of a document that's explaining the policy of Westpac in relation to lending to a company. If you have a look at the top of the page ending in .9526?---Yes, the top of the page.

And do you see Lending to a Company at the top?---Yes.

And it's explained that:

> *This policy sets out responsibilities and procedures exist to ensure that companies have the necessary authority to borrow/provide security and the transaction provides commercial benefit.*

?---Yes, I do.

All right. And then do you see there's then a heading Responsibilities, and it sets out what the responsibilities are of certain employees of Westpac?---Yes, I do.

And it sets out the responsibilities for business bankers and credit officers?---Yes.

And do you see it says:

> *When providing facilities to a company –*

and it has four bullet points?---Yes.

And the first thing the business banker and credit officer is to do is to consider whether the transaction is in the best interests of the company, and other things?---Mmm.

And then the second thing is to know that the people we are dealing with have the authority to commit the company to the transaction.

See that?---Yes, I do.

And then the third bullet point is:

> *Do not seek a copy of the company constitution.*

?---Yes, I do.

And then if you go over the page to .9527, you will see there's a heading Company Constitutions?---Yes.

And see there it explains that a company may not have its own constitution. It may operate under the replaceable rules. But you see that the third sentence of the first paragraph is:

> *Westpac will not seek or obtain a copy of a company's constitution. Instead, it will rely on assumptions it is entitled to rely on when dealing with a company pursuant to the Corporations Act 2001.*

?---Yes, I do.

And then it explains as a note:

> *In all instances where Westpac holds a copy of the company constitution, it will be reviewed to make sure the company has the necessary powers to complete the transaction.*

?---Yes, I do see that.

And it goes on to explain:

> *Where the company constitution might have previously been reviewed, it needs to be checked for any absolute prohibition or unusual restriction on management powers or directors.*

?---Yes, I do see that.

Now, this is the 2010 credit policy. Is it your understanding that this remains Westpac's approach in relation to whether it should or shouldn't seek to obtain a company's constitution where the company is the borrower?---I don't know, actually.

All right?---Sorry about that.

No, that's all right. And do you agree with me one of the things that might be identified in the company constitution is the circumstances in which the company might pay dividends?---Yes, hypothetically.

All right. And then if we go to the page .9531. Now, this is the policy in relation to commercial benefit. It should have, at the very top of the page in the top right corner, Mr Welsh, it will have WBC.410.001.9531?---Yes, I do see that.

Okay. So this is the policy in relation to commercial benefit that you are having a look at. Can you see that?---Yes, I can.

All right. And this explains Westpac's approach to the issue of – sorry, just before I ask you about this, can I just qualify – no, there is no issue with this document. Thank you. With respect to commercial benefit, this is explaining the term that Westpac uses to describe the duty of a director and trustees to act in the best interests of the company or the trust beneficiaries?---Yes.

And it, again, explains what the responsibilities are of the business banker. Do you see that, about a third of the way down the page?---Yes, I do.

And what it's explaining is the responsibility of the business banker in, amongst other things, circumstances in which a company or a trustee is giving a guarantee. So you see it says in the first bullet point:

> *Address commercial benefit with all company and trust borrowers and guarantors.*

?---Mmm.

See that?---Yes, I do.

And the second bullet point is:

> *Obtain a written statement from the directors of the company or trustees of the trust outlining the commercial benefit to be gained from the proposed transaction.*

?---Yes.

And then there's a – at the bottom of the page, from a third down, there is a heading which is Defining Commercial Benefit?---Yes.

And you will see it's explained:

> *The benefit will be something of value to the company where a trust is involved, something of value to all of the beneficiaries.*

?---Yes.

And it then sets out what might be tangible or intangible benefits that might be derived by a company or trustee?---Yes, I do.

And one of the intangible benefits is:

> *An anticipated future flow of dividends from a subsidiary financed by a parent company.*

?---Yes, I do.

And then over the page, it explains what the test is that is applied by a court in relation to directors or trustees, which is:

> *Would a reasonable –*

sorry in relation to directors:

> *Would a reasonable person in the circumstances of the company have given the guarantee having regard to the benefits, if any, to the company?*

?---Yes.

And then just to complete this, you will see about halfway down the page there's then a heading which is Commercial Benefit and Intergroup Guarantees?---Yes.

And, as you understand it, this policy in relation to commercial benefit to companies and trustees is intended to be followed within Westpac?---Yes, on the circumstances outlined here.

Yes. Well, one of those circumstances is where the company or the trust is either a borrower or a guarantor?---Where the company or the trust, yes, yes, yes, I think.

And are you aware of there having been any difficulty that has been raised with Westpac being able to provide finance because of a requirement to obtain a written statement from the directors of the company or trustees outlining the commercial benefit to be gained from the proposed transaction?---Am I aware?

Yes. Has there been any issue, as you've been in charge of the business banking section since 2011, has anybody said, "It is really obstructing the ability of Westpac to provide credit to certain business borrowers because we have to obtain a statement from the parent company or from a company or trust providing a guarantee"?---No, not – not – not in the circumstances that we're working through here.

All right. And sorry, when we say the circumstances – or when you say the circumstances we're working through here, is it any circumstances – the only relevant circumstance is that the company or the trust is providing – is either borrowing money or providing a guarantee; is that right?---That's my understanding of the sort of intercompany arrangement we're working through here.

All right?---You know, for businesses.

Could you foresee any difficulty if Westpac, where it was taking a guarantee not from a parent company but from a parent, required the parent to provide a statement setting out what commercial benefit the parent was going to get from the loan to the child?---Potentially, you – potentially, you could do that. But I think there would be some – might be some difficulties, though.

And just explain to the Commissioner what the difficulties would be?---So I think you've – where – I think – can I just – can you just – I think your question is does this – sorry, I'm a little bit confused here, but the policies that we've just worked through here are the sort of intercompany – you know, typically larger companies guaranteeing with a bit more sophistication with financials verifying things.

Mmm?---And the bridge you're taking me to – have I got this right – should that be the same for a mum and dad giving a guarantee like a company?

I am asking – yes – would there any difficulty from requiring a statement from the guarantor setting out what the commercial benefit would be?---I think there would be a bit of difficulty.

Okay. And what – for the benefit of the Commissioner, what would those difficulties with?---Well, you do – so it is possible. So it would be possible to do something like that, but you would have to be very clear on – on what you're looking for, you know, the type of financials, would you get tax returns, would you get their own company, would you get – you know, you would have to go through quite a due diligence to do that, which is – which is possible. Just off the top of my head, maybe a challenge with confidentiality with – as well. You would – you would also then, once you've got it, you would have to verify it, and – and work through it and work out whether it was valid and what the thresholds were. So it – it's possible.

But even the most basic requirement, which would apply if a parent company was trying to give a guarantee of a subsidiary, which is obtain a written statement from the directors of the company outlining the commercial benefit to be gained from the proposed transaction. That's – that's not something that applies if a parent wants to guarantee a child's loan?---Correct.

All right. But you do want parents to be obtaining a commercial benefit or a benefit, however that might be defined, from the loan before they're giving a guarantee?---That is correct.

But you don't require a statement from them explaining what that benefit is?---That – that's correct.

And is there any particular reason for that?---I can't think of a particular – a particular reason, apologies.

All right. Now, I want to then have a look at Westpac's franchising policy, which is at page WBC.410.001.9628?---9628.

Thank you. That one is not shaded blue. So we can bring that one up?---We're both good.

Sorry?---We're both good on that.

Yes. And you will see this is – we say the franchising policy. And, as I understand, it applies if a franchise is part of Westpac's accredited franchise system?---That's correct.

All right. And the particular franchise that Ms Flanagan was – or guaranteeing the purchase of, that was Westpac accredited franchise; is that right?---Yes.

Okay. And Westpac then has a particular policy in relation to lending to borrowers who are seeking to buy into an accredited franchise. And that's this?---Yes. Yes, this is the – their – this is the policy for the franchisees.

Yes. Well, this borrower that we were concerned with - - -?---Agreed.

- - - was seeking to become a franchisee?---Yes. Yes.

And the way in which the policy works is that it's possible to borrow under the policy based on cashflow of the accredited system rather than having to have real property as security; is that right?---That is correct.

And, of course, this – the loan in relation to Ms Flanagan, that wasn't assessed under this policy?---That is correct.

And – perhaps if you just explain to the Commissioner, what's the reason why it wouldn't have been assessed under this policy and would have, instead, been assessed under Westpac's general policies?---So the – the main reason why it wouldn't have qualified for this one is because they wanted to borrow 100 per cent of the value, and there's a – what we call in here a – a sector value ratio, we refer to good banking terms, SVR, and typically what that – that's a sort of debt capacity, how much can they afford, and it would typically be about 50 to 60 per cent. So given they were 100 per cent borrower, 100 per cent financing this particular Poolwerx franchise that it didn't qualify for – for the cashflow policy.

I just want to break that down, if we can, a little bit. The sector value ratio is set based on what cashflow – what cashflow Westpac has determined can be supported – I'm sorry, is that right? What borrowing can be supported from the cashflow?---It – it's – well, would – it's a debt sizing. So, you know, how much – what's the debt that you think you could – you could get to.

Yes?---Yes. So it's not so much a cashflow at that stage.

Yes. I understand. But it's based on an assessment of – by Westpac, a detailed assessment of the operation of that particular franchise system?---Yes.

And the franchise – the franchisor has to provide information to Westpac showing the – how well the business operates?---Among other things, yes.

Yes. And Westpac sets a sector value ratio depending upon having made this assessment of what sort of lending is likely to be supported by those types of – just from the – from that sort of business; is that right?---The – the capacity from that business after the analysis, yes.

Yes. Does that mean, therefore, that if a borrower is borrowing 100 per cent of the value of the business, Westpac wouldn't expect that the business would be – the business, taken by itself, would be able to support that level of debt?---The – yes, that's correct.

Now, I then want to look at Westpac's – I'm sorry?---I'm sorry, just thinking through that, because I don't – I don't – want to make sure I'm giving this information to you.

Yes?---The SVR gives a debt sizing of what's the total business, and the typical situation for that might have been, you know, they look at it and say, "You need this bit of equipment, you need this operation." They work out what the sort of value to set it up is. And then we will lend to a percentage of that, if we're going to just rely on a cashflow lending basis with no other security.

Yes?---So it's that – that – unlock the sort of cashflow policy.

Yes. I understand?---Okay. Apologies.

And then if we go to tab 5 or exhibit 5 of Mr Welsh's statement. That should be WBC.410.001.0215. And this is the third party security/guarantees policy?---Yes, it is.

All right. And the – perhaps if we just immediately jump down to what's described as Acceptable Third Party Relationships. Do you see that halfway down the page?---Yes, I do.

All right. And there's various relationships that are considered acceptable as third party guarantees, but the third one is:

Parents guaranteeing a consumer loan for one or more of their children.

Do you see that?---I do.

But this loan that we are concerned with that Ms Flanagan was guaranteeing, that wasn't a consumer loan?---That's correct.

And so it doesn't fall within one of the three specifically identified bullet points of acceptable third party relationships?---No, that's not correct.

Sorry, is it referred to somewhere in one of the three bullet points?---So the – I think the fourth – the line down the bottom is the important one here. This is the sort of

"if", if not this, then this. You know, it's – it's – so would you – would you like me to try and explain?

Sure?---So the – the top ones are tended to be – the top three, so that's directors and shareholders, guarantees, and then the spousal guarantee with a single applicant, and then the parents guaranteeing consumer loan, typically you don't have to verify commercial benefit. And that's read from that last line there that you can see just from the bottom of the page up here:

> *All other guarantee proposals are generally not acceptable unless a direct benefit can be established.*

So other guarantees are available, but you've got to establish the direct – there has got to be evidence that there's going to be a direct benefit.

All right. And we will come to direct benefit in a moment, but there's a specific warning that Westpac's policy gave at the time – this is back in 2010 – as to parents offering to guarantee the business borrowings of their children. Do you see that?---I do.

And it says:

> *Exercise extreme caution where parents are offering to guarantee the business borrowings of their children. Before accepting these types of guarantees, make sure that the guarantor demonstrates that they are making a fully informed decision and that they are fully aware of their potential liability. The account manager and credit officer are to be satisfied that the guarantor has the means –*

and then in brackets –

> *(realisable assets/cashflow) upon which they could rely if called upon to clear the borrower's liabilities to Westpac.*

I think you are underlining that you see that there?---I do indeed.

All right. And I take it this warning reflects a concern that Westpac had, even at the time, about the acceptance of parents guaranteeing the business borrowings of children?---That's correct.

And there continues to be a concern about that, I imagine?---Exercise caution, yes.

And – sorry, what did you say?---Exercise caution. Extreme caution.

Extreme caution. That's right. And just so I understand this, that presumably reflects a concern that there's a risk that parents are going to be taken advantage of; is that right?---I – that – that's one of the risks. That's one of the potential risks.

Yes?---It's a bit of an assumption but yes, yes.

And they might not be taken advantage of in the sense that there's any abuse or anything like that, but it's just as a matter of parental love and affection they will feel like they should guarantee their parents – their children's business borrowings?---Well, that – that – we heard that today. They can – you know, that can happen, obviously.

And the banker is – will presumably be alive to any signs of vulnerability on the part of the parent?---Yes, they should be.

And what isn't apparent on this policy is what is the process that the banker – I'm sorry, the account manager and credit officer are to be – are to go through to be satisfied that the guarantor has the means upon which they could rely, if called upon, to clear the borrower's liabilities to Westpac?---The process normally is some evidence of – typically an asset. A security of some kind.

Does that mean what's required is evidence that if Westpac needs to call on the guarantee, the guarantor will be good for it?---Sorry, just repeat the question, just - - -

When you say there needs to be evidence of some asset, that means an asset capable of discharging the liability under the guarantee to Westpac?---Yes.

So that the limits of what is of – in that last sentence:

> *The account manager and credit officer are to be satisfied that the guarantor has the means upon which they could be relied, if called upon, to clear the borrower's liabilities to Westpac.*

What I suggested to you before was you're saying all that that's limited – all that that means is that the account manager and credit officer have to be satisfied that the guarantor will be good for it if Westpac wants to call on the guarantee?---That's how I read that, yes.

And they don't need to be satisfied as to what financial position that would leave the guarantor in if the guarantee was called upon?---That's correct.

All right. And - - -

THE COMMISSIONER: And that the expression "realisable assets" means realisable by Westpac?---Thank you. Yes.

MR HODGE: And the policy says:

Before accepting these types of guarantees, make sure that the guarantor demonstrates that they are making a fully informed decision and that they are fully aware of their potential liability.

What is the process that the banker is to go through in order to do that?---To make sure they're – they're fully informed?

Yes. Making a fully informed decision and that they are fully aware of their potential liability, and that they have – I'm sorry, maybe we should break this down?---Mmm.

"Make sure that the guarantor demonstrates." Demonstrates to whom?---Make sure the guarantor demonstrates that they are making a fully informed decision, to – to the – to the banker.

All right?---At the first instance.

And so how does – what is the process by which of banker ought to have the guarantor demonstrate that they are making a fully informed decision and that they are fully aware of their potential liability?---They would typically meet with the – the guarantor. They would make sure that they gave them the appropriate information. So it will be the letter of offer in this – in this case. It would also be the security agreement. It might be the – the mortgage. We would also look at if there had been any notices of defaults, and potentially if this was a company that was up and running and already established, there would also be some historical financials from that company that would be there. So that's the sort of first test that they would be doing.

But it would be expected then that the banker would meet with the guarantor before the guarantor signed the guarantee; is that right?---That – that would be the normal practice where they would meet with them with the information.

And satisfy – that is the banker would satisfy him or herself at that time that the guarantor is making a fully informed decision?---Yes.

And understands and is fully aware of their potential liability?---Yes.

And is that process that the banker needs to meet with the guarantor in order to – in order to be satisfied of these things something that's set out in this policy?---I am just double-checking. So you've got independent legal advice, solicitor's certificate, information concerning the transaction, personal interview – yes, I think it is.

You think there's – just so we can all see, which is the bit which in your mind would set out the process by which the banker needs to meet with the guarantor?---So the bit – can I just explain where I'm reading from?

Yes?---Just give a little bit of – a bit of wider. There's two types of guarantors, there's a category A - - -

Yes?--- - - - and a category B.

Yes?---So under – on 0216 is the start of the explanation around the category B guarantor. So you can see that they're required to get independent legal advice, required to get a solicitor certificate, they're required consent to provide the information, and personally interviewed. So that's outlined there.

Yes. So in the – for a category B guarantor at the bottom – at the bottom of the page, is this the bit you're referring to:

Before completing the credit submission, inform the borrower that Westpac –

that's the part you are talking about?---Yes.

And this is about informing the borrower - - -?---The borrower.

The point you're referring to, I think, is that if we then go – bring up the following page, what is the fifth bullet point is that:

The banker will have to inform the borrower that the Westpac banker will need to personally interview the guarantor provide a copy of security documents and a copy of the facility letter and, where the Code of Banking Practice applies, other information concerning the borrower's accounts.

?---Yes.

And therefore – I want to be fair to you – your point is you would expect that as part of that meeting of providing information, that at that meeting the banker would assess and make sure that the guarantor demonstrates that they are making a fully informed decision and they are fully aware of their potential liability?---Yes.

Is that right?---Yes.

I am not trying to trick you, I just want to make sure I am correctly - - -?---No, you are doing – that's correct. That's correct. Yes, sorry.

So your point is simply, I think - - -?---Maybe I'm overthinking it, but you've nailed it.

Thank you?---Apologies.

The – and what I'm wondering about then is – and we will come in further detail tomorrow about the detail of Ms Flanagan's case, but in your view were there warning signs that the banker ought to have observed when it came to Ms Flanagan

in interviewing and assessing whether or not Ms Flanagan demonstrated making a fully informed decision and that she was fully aware of her potential liability?---Yes.

And perhaps if I just identify some. She suffers from – and we could see on the video quite obviously suffered from quite debilitating health conditions. Would that be a relevant factor?---Yes.

And she had difficulty speaking; could not read and could not write?---Yes.

And her daughter had brought her to the bank?---That's correct.

And, if Westpac was to call on the guarantee, she would be rendered homeless?---Yes.

And there might be other factors which we will come to, but just starting with those four, would you expect that a business banker complying with this policy would at least identify those factors?---Yes.

Would you expect that she would make a note of them?---Yes.

And in your review of the file, have you – have you found any note that the banker made in this case of those factors?---No, I haven't.

And having observed those factors, would you have expected the banker to take any particular course of action?---Yes.

And what would you have expected her to do?---I would have expected her to make sure that Ms Flanagan had someone appropriate supporting her that could – was there with her. I would expect that Ms Flanagan would be read out the information because, as you rightly point out, she has identified that she couldn't read and she had to be read the – the information. I would – I would also expect that my banker was really clear that she had to get both independent legal and – and, you know, financial advice. So I would be wanting to make sure that that was clear, and I would also want to make sure that the banker was really clear on the limit, so she understood. So you would sort of double down, so to speak, of working through this in a sensible and meaningful way.

THE COMMISSIONER: Can you play that out a bit more for me? What do you mean by that?---Well, obviously, we saw the sad situation that Ms Flanagan's in today, so you would expect that any person would – would be very thoughtful about that, and – and – and make sure that she was understanding what she was doing, and – and how she would – would – would do that would be to sort of take the care and – and talk her through that, and spend time. Now, that's not Ms Flanagan's evidence, which obviously is really disappointing, but that's what you would hope. You know, I would also hope that she got support from – from someone else, as in the external advice. You know, and I probably also think she was pretty nervous at that time because it might have been the first time – I can't see from the file – that she met Ms

Flanagan and she would have been wary of how much she writes down, she would be cautious of not wanting to discriminate against her because of her disability. So she would be sort of alive to that and she would be really wrestling with that challenge, I would imagine. I think that would be quite – it would be quite a confronting situation for all parties. So I'm sort of – I think that would be really, really, really tough. It would have been a tough conversation all round.

MR HODGE: Is there any record of the relevant Westpac banker having made a note of her meeting with Ms Flanagan on 8 December?---Not – not that I saw.

So just so we understand, is your – you haven't spoken to the Westpac bank manager, the relevant manager? She is no longer employed by Westpac?---That's correct, and correct. Two – correct on both.

You haven't spoken to her?---(a) I haven't spoken to her and (b) she's not employed.

All right. And so your speculation that she might have felt very nervous and didn't want to write down anything offensive, is that an attempt to explain why there are no notes kept of that meeting?---It's speculation. I – I don't know that. You're right.

All right. Commissioner, is that a convenient time?

THE COMMISSIONER: How are we going for time, Mr Hodge?

MR HODGE: Well, it's only the first day, Commissioner, so - - -

THE COMMISSIONER: That's why I'm asking on day 1, Mr Hodge.

MR HODGE: If tomorrow afternoon I'm offering to start at 9 am say, Commissioner, you will know you should have pushed me on.

THE COMMISSIONER: Do I take your lack of answer as indicating that we're travelling perfectly well, Mr Hodge? It's known as a verbal, in other circumstances?

MR HODGE: At the moment, Commissioner, I have no concerns about getting through the timetable in the way in which we expect to do it.

THE COMMISSIONER: A very guarded answer, Mr Hodge. 9.45 tomorrow.

MR HODGE: Thank you, Commissioner.

<THE WITNESS WITHDREW [4.02 pm]

MATTER ADJOURNED at 4.02 pm UNTIL TUESDAY, 22 MAY 2018

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