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TRANSCRIPT OF PROCEEDINGS

O/N H-896303

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, WEDNESDAY, 30 MAY 2018

Continued from 29.5.18

DAY 27

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 C. SCERRI QC appears with DR R.C.A. HIGGINS SC for CBA
MS W. HARRIS QC appears with MR R. CRAIG and MS R. BURD for NAB
MR F. LIPPETT appears for Shaun Bassett
MR M. TEHAN appears for Ross Dillon

<DAVID ANTONY KEITH COHEN, ON FORMER OATH [9.45 am]

<CROSS-EXAMINATION BY MR HODGE

THE COMMISSIONER: Yes, Mr Hodge.

MR HODGE: Commissioner, we are continuing with the evidence of Mr Cohen.

THE COMMISSIONER: Yes. Is Mr Cohen in court? Yes. Thank you, Mr Cohen. I should get out of the habit of saying "is Mr Cohen in court", shouldn't I? He's not. Yes, Mr Hodge.

MR HODGE: Thank you, Commissioner.

Mr Cohen, there's just a few more documents I wasn't to take you to concerning Project Magellan. The first is document CBA.0002.1566.7527. It should be exhibit DC-69 to your statement?---Yes, I have it.

Thank you. That will hopefully come up on the screen in a moment. This is a report to Bankwest's audit committee by PricewaterhouseCoopers?---That's correct.

And if you go to the second page, which is .7528, you see it's for the year ending 30 June 2010, and completed by about the end of July 2010. It's dated 29 July 2010?---Yes.

And you've obviously reviewed this document for the purposes of preparing your evidence?---That's correct.

Do you want to just explain to the Commission what it was that PricewaterhouseCoopers was asked to do?---Yes. In the context of preparing the financial statements for Bankwest for the period ended 30 June 2010, PricewaterhouseCoopers specifically looked at the process and the outcomes of Project Magellan. And I understand they did that so as to satisfy themselves that the contribution made by Project Magellan to the calculation of collective provisions for the purposes of inclusion in the 30 June 2010 financial statements were correct, or accurate, or had been undertaken in an appropriate way.

And can I just identify a few parts to that. So the first thing is the role of PricewaterhouseCoopers was obviously to audit the financial accounts for the year ending 30 June 2010?---Yes, that's correct.

One of the things they needed to satisfy themselves of is effectively the accuracy of the information that they're provided with in relation to those accounts?---Yes.

And one part of the accounts is the provisioning that's made for losses that might be made on loans that Bankwest then had outstanding?---Yes. In the sense that an element of the financial statements are loan impairment expenses and loan impairment expenses are in part made up by collective provisions.

If we go to page .7531, this is a section of the audit report where PricewaterhouseCoopers deals specifically with the credit provisioning that had been made?---Yes.

And the opinion of PricewaterhouseCoopers was that a prudent approach had been used in calculating loan loss provisions?---That's correct.

And you see under 2.1, PwC identifies that the total provisions had increased from $1.28 billion to almost $2.1 billion over the financial year?---Yes.

And then there's a reference there to this being largely the outcome of Projects Magellan and the continued deterioration in the business portfolio. We then turn over the page to 2.2, which is – thank you – 7532, PwC specifically considered Project Magellan and reviewed or conducted a review of Project Magellan?---Yes.

And then if we then go to the document which is DC-71 to your statement, which is CBA.0517.0091.0500. This is a draft, but a draft of a presentation seemingly for the board, dated 15 July 2010, dealing with the outcomes of Project Magellan?---Yes – yes.

And if we go to the page .0501 there's a summary of findings which sets out a number of the difficulties that had been identified in the – both in credit provisioning but also the management of loans within Bankwest?---Yes.

And I just want to, for the benefit of the Commissioner, note a few specific points. You see there's an – say the fourth bullet point, fifth bullet point on the page, prior to this, that is prior to the provisional collective:

> *There is evidence both loan management and business credit held an overly optimistic assessment of ongoing customer viability on certain exposures.*

?---Yes.

And that was one of the issues that was identified by mid-2010 which was there had previously been a level of perhaps unjustified optimism on the part of Bankwest in managing its exposures?---Yes.

And then there's then an explanation that as a result of Project Magellan there's a 15 to 20 per cent reduction in security valuations across the portfolio?---Yes.

And that specifically reflects the poor quality security for loans on the east coast?---Yes.

And we discussed that yesterday about the issues that – with the east coast part of the book?---Yes.

And then if we go over the page to .0502, there's an identification of another specific issue in relation – that gave rise to that problem, which was that independent valuations had been relied on to support business, but that's underwritten at or near the top of the cycle. So that is 2006 to 2008?---That's correct.

And that was a particular problem as it turned out with the Bankwest loan book, which was that there were a lot of business loans made on the east coast in the lead-up to the GFC when the market was at its peak?---Yes, amongst other problems.

And then there's a further issue that's identified, which I just want to call out a little further down the page, which is the third last bullet point that:

> *There is evidence of a failure to take decisive action on early warning signs such as covenant breaches and earnings short falls against expectations to instruct independent review and/or revaluation of assets.*

I'm just wondering if you might be able to explain your understanding of that point to the Commissioner?---Yes. My understanding is, as alluded to in evidence I gave yesterday, the ongoing management of loans during their life cycle, in other words prior to reaching TIA status, had been lacking, and I believe this third last dot point on that page is referring to the fact that the lack of active ongoing monitoring of a loan had led to a failure to take action when early warning signs arose. Those early warning signs being, as suggested in that third last dot point, where there had been covenant breaches. And I believe that's a reference to financial ratio covenant breaches.

And there's a couple of different types – or few different types of financial ratio covenants that that might be, but that include an LVR ratio covenant?---It would include that amongst others, yes.

And it would also include an ICR covenant?---Yes.

And the DSR covenants?---DSR covenant, that's correct.

Then the last bullet point on the page is:

> *Wholesale approach to improve risk culture, commenced under Sonic program, with immediate direct action to strengthen control framework and revamp policies, practices, training and compliance.*

Do you know what the Sonic program was?---Yes, I do, and I'm happy to explain it.

Yes. Could you explain that to the Commissioner?---Certainly. Project Sonic was the implementation of a new strategy by Bankwest Business Bank. That new strategy was known as straightforward banking and it was, in effect, a return to the basics of business banking by Bankwest business banking. Project Sonic involved the implementation of that strategy which incorporated, amongst other things, training of business bankers, a change of risk appetite in relation to the types of business loans that Bankwest business would write. Monitoring systems, ongoing measurement of things like ratios in order to improve the performance. It also included changes in the types of loans and the amounts of loans and the tenor of loans. So it was quite a wholesale change of strategy and Project Sonic was implementation of that at that strategy.

And was any part of that to try to bring the approach of CBA to risk management into Bankwest?---Project Sonic was focused largely on the business bank section of Bankwest, namely the business itself rather than risk management, but there were parts of project sonic in which the risk management team of Bankwest were involved and which required changes in the way that the risk management team of Bankwest interacted with the Bankwest business banking division.

All right. Can we go to the page .0508, page 9 down the bottom. This is setting out or attempting to summarise graphically and with key messages what has happened in relation to the balance sheet provisions as at 30 June 2010?---That's correct.

And we can see there, consistent with what we have been speaking about now for some time, this increase in the troublesome and impaired assets?---Yes.

And the key point reflective of all of the documents that we've seen thus far, or the first key message, is provisions more than double worst performing peers, more than four times the average of the Big Four?---Yes.

And in some ways is it fair to say that sort of gets to the heart of the issue with the Bankwest business book? Which was that it was, in terms of the level of provision, well outside the range of what was consistent with both peers and also with the Commonwealth Bank?---It was well outside that range, yes.

And then if we go over to page .0510, this then sets out what's described as the key learnings identified during the Magellan review?---Yes.

And again I think these are all consistent with things we have discussed with – but I will highlight them for the Commissioner. First, that there had been this aggressive risk appetite during 2006 to 2008 for Bankwest?---Yes, that's correct.

Second, that there was poor quality business written on the east coast and this lack of ongoing management which you have spoken about a number of times?---Yes.

Third, that there was a significant deterioration in security valuations?---Yes.

And then there's a couple of other points on page .0511 but can I skip that and go to .0512 and highlight the specific issue about property lending, which is that this was a particular part of the business portfolio which was problematic for Bankwest, the property lending?---Yes.

And as we saw from various documents it had, by mid-2009, risen to being over 50 per cent of the Bankwest business book?---Commercial property, yes.

Commercial property?---Yes.

And one of the problems, then, that arose and was continuing to arise by 2010 was the substantial decline in the value of the assets that were securing those loans?---That's correct.

And hence the short-term action that we see there is the implementation of a property lending cap?---That's correct.

And then can we jump forward to 2013 and bring up CBA.0001.0359.0781. I think this will come up in a moment but this is a – you've got the hard copy in front of you?---I do.

This is a report to the Commonwealth Bank's Executive Risk Committee dated 5 March 2013?---Yes.

And I think you've seen this document overnight?---I have. Thank you.

And if we go to – I'm sorry, I might give the – there we go. This is giving a report to the Executive Risk Committee on where Bankwest commercial property was at?---Yes.

And if we go to the page which is .0784, we can see what has now happened to commercial property for Bankwest over the course of the preceding few years?---Yes.

And it has dropped off from a peak as at July 2009 of 14.79 billion dollars down to, by the end of 2012 just under 10 billion dollars?---Yes.

But held steady at that level of about $10 billion since around January 2011?---Yes.

And it may be helpful if you are able to explain, Mr Cohen, does exposures reflect the level of loans still on the book taking into account provisions or not taking account provisions?---The exposures are the same regardless of what provisions are taken. So this graph represents exposures that were existing throughout, inclusive of – well, sorry, when I say inclusive, I should say the exposures remain constant, whatever provisions might occur would rise or fall, as the case may be. But the exposure that the bank held towards commercial property was as depicted here.

Thank you. Commissioner, I tender that document.

THE COMMISSIONER: Report to CBA executive risk committee, 5 March 13, CBA.0001.0359.0781, exhibit 3.120.

EXHIBIT #3.120 REPORT TO CBA EXECUTIVE RISK COMMITTEE DATED 05/03/2013 (CBA.0001.0359.0781)

MR HODGE: Mr Cohen, I want to now move to another topic, which is to deal with the evidence of Mr Stanford?---Yes.

You've been put forward by the Commonwealth Bank as the witness to respond to Mr Stanford's evidence?---Yes.

And, in the course of preparing to give evidence, you have reviewed documents held by the Commonwealth Bank in relation to Mr Stanford?---Yes, I have.

And we just run through some basic things to begin with. You know that the original facility that was granted to, or provided to, the Stanford brothers was entered into in 2006?---Yes.

And the amount of that original facility seems to have been $1.2 million?---Yes.

And the purpose of the loan was to assist Mr Stanford and his brother to purchase the Coronation Hotel at Portland?---Yes.

And, in support of their application for a loan, the Stanford brothers provided a valuation report prepared by one of Bankwest's panel valuers?---Yes, that's right.

The report valued it at $1.6 million in 2006?---That's right.

And before the facility was approved, there was a credit risk submission prepared by Bankwest?---Yes, that's correct.

And can we bring up CBA.0001.0285.0944, which is exhibit DC-83. This is that credit risk assessment?---Yes.

And you see the risk grade in the top quarter of the page is 5?---Yes.

And you've given some evidence in your statement about what the credit risk grade system was that was employed by Bankwest?---Yes.

And under that system, Bankwest was using a scale of one to 10 to grade its risks?---That's correct.

And a risk grade of 5 meant that the loan was considered performing?---Yes.

Unsurprisingly, given that you were making the loan or Bankwest was making the loan?---Yes, it was in the middle of the range.

And what that meant was it had – when you say it's in the middle of the range, it had some risk of default, but not a high risk of default?---There was an acceptable risk default. So the probability of default as reflected in that risk grade was medium.

And then if we go over to page .0950, we see under the Risk Assessment heading there's a section which is Security and the LVR is said to be 75 per cent, in line with lending policy guideline?---Yes.

And do you know, did the lending policy guideline for LVRs for pubs change at Bankwest at some point in time; that is was 75 per cent always acceptable or did it later become unacceptable?---To my understanding, there was a change at Bankwest. I can't tell you exactly when that was, but depending on the type of property loan that was undertaken it reduced from 75 per cent to a lower percentage.

All right. And then can I just ask you one thing which you may not be able to help us with. Can we go to page.0949. Can we blow up the last line which is DSR. That's debt service ratio; is that right?---That's correct.

And this is just a point of curiosity, it won't take us anywhere, but do you know how it is that you can have a debt service ratio of 1.68 for 2004, sorry, 1.64 for 2005, 1.65 for 2006 and an average of 2? I'm just wondering if there's something we are missing in the calculation of that. It's not a criticism of the bank?---No, I don't.

No, okay. And then can we go, then, to exhibit DC-81. This is the letter of offer that was sent by Bankwest to the Stanfords?---That's correct.

And if we go to page .5117, this was what's described as a fully amortising principal and interest loan?---Yes.

And that means the principal would be paid off over the life of the loan?---That's correct.

And the amount of the loan is $1.2 million, we can see?---Yes.

And the expiry date is 20 years?---Yes.

So the expectation for the loan is that it will be paid off over the course of 20 years?---That's correct.

And if we go to 6.3 on page 5120, you see the – sorry, just before we go to that, if we look at 5.2 we see what the securities are that are given for the loan. So the first is a mortgage that is going to be given over the property that is to be purchased by the Stanford brothers?---Yes.

Then there's a fixed and floating charge to be given by Let It Rain?---Yes.

And Let It Rain, as we understand it, was the entity that was actually going to run the business?---That's my understanding too, yes.

And then there's also a mortgage that is to be given over the – a New South Wales mortgage over the business?---Yes.

A charge over the liquor licence?---Yes.

You see then clause 6.3 is:

> *We may require that any secured real property or any of your other assets or those of a guarantor be revalued every three years or at more frequent intervals determined by us by a valuer appointed and instructed by us, at your expense.*

?---Yes.

That was a standard clause, was it in Bankwest loan documents at the time?---Yes, as I understand it.

And in a case like this, what would be the expected purpose if the loan is to be repaid over the course of 20 years, revaluing the asset every three years?---So when a loan is written, a number of factors are taken into account in order – in the assessment of whether to make the loan or not. One of those factors is the value of the security being offered. In this case was primarily the mortgage over the hotel. The pricing and the view of whether or not the loan was a loan that should be made is influenced, to a large degree, by the value of that security. The purpose of the clause 6.3 was to enable the bank to get an updated view of the value of the security in order that it could determine whether the pricing for the risk that the bank was taking in making that loan continued to be appropriate, firstly. And secondly, whether the value of the security continued to be sufficient to enable the bank to consider that its prospects of recovering the loan in the event that the borrower failed to make repayments would continue to be sufficient.

And as to the second point, what would be the consequence if the bank formed the view that the value wasn't sufficient to cover its – what it had loaned out if the borrower stopped making repayments?---So if I can address that at a general level rather than the specific case.

Yes?---At a general level, the consequence would normally be a discussion with the borrower to ascertain how the bank and the borrower might work together in order to come to an arrangement that would enable the bank to feel that it was still sufficiently covered in the event that the borrower failed to repay as scheduled. Those arrangements might include, for example, the borrower paying down the debt owed to a greater agree than it has been. So, for example, increasing the amortisation of the loan beyond what was originally scheduled. Or it could mean that the additional security might be offered by the borrower to enable the bank to feel that its coverage of the debt was then sufficient. Or it could be that some assets might be sold, perhaps some assets associated with the loan might be sold in order to be applied to repayment, again to leave the bank in a position where it felt that its ability to be repaid the loan was sufficient in the event that the borrower failed to make repayments as scheduled.

So a purpose of getting the revaluation done every three years, even where the loan is for 20 years, is so that the bank can identify a risk to itself that it might not be able to recover fully in the event that there was a default in payment?---That is one of the purposes, yes.

And then to take steps to attempt to mitigate that risk in advance?---Yes. Particularly if the valuation was to show that the borrower was experiencing some financial difficulties and valuations can quite often be strong indicators of that.

And the first point you made was about pricing for risk?---Yes.

When the bank decides on the interest rate that it will charge to a borrower, it takes into account the risk of the particular loan that it's writing?---That's correct.

And so when, in this case, the loan was written, the particular margin that was to be applied to BBSY would take into account the risk grade that the borrower was classified within?---That's correct.

And so, in this case, if we go back to page .5117, we see the interest rate was to be bank bill rate plus a margin of 1.18 per cent per annum or fixed rate?---Yes.

And we leave aside the fixed rate for a moment: in the event that in three years time the loan was regraded as a risk grade 6, would you expect then that there would be a change that the bank would make to the margin that it was applying to the BBSY?---Not necessarily, just because of a change to a risk grade of 6. That per se would not automatically drive a change. It may, depending on other circumstances relating to the particular borrower, but per se not of itself.

And the contractual basis for making that change is that something that is contained within the general conditions or terms that apply to the loan?---I understand so.

All right. And is it a general clause that permits the bank to vary any clause or provision, including the interest rate, or is it something specific; do you know?---No, I believe it's in reliance on a more general clause.

All right. And then if we go over the page to .5121. These are the financial undertakings that are given in respect of the – of this loan?---Yes.

And one of them is an interest cover ratio?---Yes.

And that means the EBITDA for the business needs to be at least two times the interest expense?---Yes.

And the other is a debt service ratio?---Yes.

And CAFDS, what does that stand for?---Essentially, that's the net operating income.

And that has to be at least 1.5 times the total debt service?---That's correct.

Now, there's no LVR financial undertaking in relation to this loan?---No, there is not.

And is there any observation you want to make about whether that is unusual or not unusual in relation to this type of loan?---I would say that, probably more often than not, this type of loan would have had an LVR to it. It's not highly unusual, however, that it does not. I think in the context of a going concern business, namely the operation of a hotel, whilst the LVR is relevant and banks will always look at it, nevertheless in the context of a going concern business what's very important is to understand the EBITDA or the earnings of the business and hence an ICR and a debt service ratio are two very important ratios.

I understand – I think I understand what you are saying. Can I make an observation to you and then we will see if we're agreeing with each other. For a business like this, the value of the business will largely – though not solely – depend upon a capitalisation of the maintainable earnings?---That's correct.

Do you agree with that?---Yes, I do.

So as the earnings of the business drop the value of the enterprise, if it was to be sold, drops?---That's correct.

And therefore it's a bit different from just saying there's a piece of real property here, like a block of land with a house built on it, or vacant land, where you are not concerned with maintainable earnings, you are just concerned with what is the value of that property if it was put on the open market, depending upon the inherent value of that piece of property?---Yes, those two are different.

And so these financial undertakings, which link back to the earnings of the business, ultimately reflect, in some fashion, the total value of the business if it was to be sold?---That's correct.

And then if we just – if I just ask one other thing about the split of this loan. Do you understand that at some point in time this loan was split into a fixed interest and variable interest loan?---Yes, I do.

And do you have an understanding of when that happened?---Actually, my understanding was better informed as a result of Mr Stanford's evidence yesterday. I didn't know the exact period. I think Mr Stanford said he seemed to recall it happening in 2007.

Yes. All right. So at some point in time, in any event, the loan was – seemingly early in the life of the loan, it was split into a variable interest component and a fixed interest component?---Yes, that's right. And my understanding was that was pursuant to clause 3.3 of the loan agreement.

And the particular point you're making is the way in which it is split is to use a hedging facility as part of having the fixed interest; is that right?---Yes, that's right. My understanding is that the interest rate swap, as it was called, was implemented which fixed the interest rate for a portion of the total loan of 1.2 million.

Now, I want to then go forward in time. You know that in March 2010 Bankwest received a request from the Stanfords for an overdraft facility?---Yes.

And it seems as if that request may have originally been made in 2009 and then repeated again in 2010 or you're not aware of that?---I'm not particularly aware of the 2009 request, no.

In any event, you know that in 2010 there was this request for a $20,000 overdraft?---Yes.

And the overdraft was to be attached to the Bankwest business bonus account that Let It Rain was operating?---Yes.

And Bankwest approved the $20,000 overdraft in April 2010?---Yes, it did.

And, in the period prior to approving the overdraft, Bankwest had completed a number of regular credit risk assessments in relation to the Stanford's loan account and Let It Rain's business account?---Yes, it had.

You have referred to some of those credit risk assessments in paragraph 168 of your statement?---That's correct.

And the credit risk assessments were completed by a relationship manager of Bankwest; is that right?---Yes. The credit risk assessment itself is undertaken normally by the relationship manager, in this case that occurred, and then there is a response to that credit risk assessment separately provided by the business credit team within the risk management function.

It goes to a manager to approve the credit risk assessment; is that right?---That's correct.

And it's the relationship manager who performs the credit risk assessment initially, who has the ongoing contact with the borrower; is that right?---That's correct.

And it seems as if those assessments were completed on about a quarterly basis for this business?---Yes. Yes.

Is that, do you know, normal or was that a reflection of any particular risk in relation to this business?---No, my understanding this was in the relatively normal cycle of preparation of credit assessments.

Now, in the months leading up to the approval of the overdraft, Bankwest made an offer to the Stanfords to vary the terms of their business loan?---Yes, in January 2010.

And that wasn't accepted by the Stanfords?---That's as I understand it, yes.

And then subsequently there was another letter of variation that was issued by Bankwest?---That's correct.

And that appears to have been in identical terms?---Yes.

And it was then that second letter of variation that was accepted and signed by the Stanfords?---Yes, in July 2010.

And if we bring up paragraph 165 of your statement, which is on page 40, CBA.9000.0045.0040, and can we pop out 165. Just to take this in parts, the above offer – that was the offer in January 2010 which hadn't been signed?---That's right.

And then the July offer is the one that was signed?---That's right.

And you say:

> *…were made as part of Bankwest's strategy to provide a simple to understand product range to its customers.*

Could you just – I wonder if this ties back to a point you were making earlier about trying to simplify the offerings. Perhaps it doesn't. Could you just explain what you mean by that statement, that it was part of trying to provide a simple to understand product range?---Yes. In conjunction with the Bankwest straightforward banking strategy, the decision was made to discontinue a number of products, loan products that had existed to that point, and replace them with new products that were regarded as being more suitable for the type of lending that Bankwest would embark upon in the future, being more straightforward lending to less complex businesses. And the particular product that the Stanfords first took out in 2006 was one of the products that was withdrawn and was replaced with one of these newer products, and it was intended that the products would be more suitable in a number of respects. One of the respects that was relevant here for the Stanfords' loan was the base rate that was used for a portion of this loan. The fixed rate portion of the loan that the Stanfords had taken up was not based on the bank bill swap rate, and so the new documentation in both January and July 2010 moved the fixed portion of the loan to the bank bill swap rate base, which was a much more appropriate base for swaps or hedges than the rate – sorry, than the base that the Stanfords had been on previously since 2006.

And what was the base they had been on?---So the base they were on was the bank bill rate. And the base that the January and July 2010 documents put forward was what's known as the BBSY, which is the bank bill swap rate, which is typically the base used for interest rate swaps or interest rate hedging.

And was changing from the BBR to the BBSY likely to increase or decrease the interest rate payable by borrowers?---I don't know actually at that time. I can't tell you what the relative rates were at that time.

And why was that likely to simplify the product range or the product from the perspective of the borrower?---From the perspective of the borrower, in this particular case, I don't see a great deal of difference in terms of simplification. Although, the new rate – sorry, the new facility terms of July 2010 reflected, in fact, the loan that the Stanfords had taken out. And I say that because the original facility had been based on a single amount of 1.2 million as the principal sum. A portion of that sum was subsequently fixed and so, in terms of the original facility, the Stanfords had a portion of their sum at floating rate, another portion at fixed rate. The July 2010 facility sought to simplify that by having part of the loan, approximately $601,000, at the floating rate, which reflected the then circumstances. And at the bank bill rate, being the base. And the second portion of the loan being approximately $460,000, I believe, at the BBSY rate. And that reflected the actual fixed portion that the Stanfords had at that time under the original facility.

All right. We will come to the detail of the Stanfords' facility in a moment. Just so we can assist the Commissioner to get a better understanding of the simplification of the product range, the original facility which was the commercial advance multi – I'm sorry, was the commercial advance, is it "int"?---Int, yes.

At maturity, that was being withdrawn?---That's correct.

What does that mean in the sense that you've obviously got a number of borrowers that or that facility, why is it necessary to switch them to a different facility rather than just letting them see out their existing facility?---It was regarded as – as I understand it, it was regarded as preferable to have the borrowers switch out because in moving to a new product, there would be new systems that underpin that product. And I understand that it was considered better to try and have all of the products or as many of the products as possible on the new system rather than having – running two systems at once; namely, the system dealing with the legacy products and a new system underlying or underpinning the new product. So it was, from an operational perspective, I understand, regarded as preferable to have as many products as possible on the one system.

It sounds like, from the answer you are giving, it's simpler for the bank to have everything moved onto the new system; is that fair?---I think that's a fair statement.

I'm just wondering whether it's – there's any simplification from the borrowers' perspective?---The simplification from the borrowers' perspective, as I understand it, was in the better monitoring and administration of the simpler products. So, from a benefits perspective, if I can call it that, no, I don't see significant differences. But in the sense of how the loan was administered by the bank, statements, interest rate calculations, etcetera, it was regarded as better overall if the loans were on the new system that enabled better administration.

And as we understand it then, for many loans, if they were already on the commercial advance int at maturity, they would be – the bank would seek to switch them over to this commercial advance multi limit; is that right?---That's correct, yes.

And so in general, regardless of anything else, the bank would have sought with the Stanfords to switch them over to this new facility?---That's my understanding yes.

Do you understand there were some other things that the bank were seeking to achieve by switching the Stanfords over to this new facility?---Not that I'm aware of, no.

If we bring up paragraphs 166 and 167 of your statement, which is on the following page, – just the next page. Thank you. You're explaining here your understanding of the nature of the variation that was offered to the Stanfords?---Yes.

And you say at the end of the chapeau of paragraph 166:

> *The new facility split the original facility.*

?---Yes.

And does that mean your – perhaps I should go back a step. As you understood it, it was already split in the sense that there was a fixed and a variable interest part of the loan?---That's correct.

And so the change that's made with this new letter of offer is what, as you understood it?---The change made was that that original facility, comprising a total of 1.2 million loan, had not formerly previously been split into two loans, one for the fixed, one for the variable. This July 2010 facility formally split them into two distinct loans, one for 601,000 being at the variable rate, one for 460,000 – 464,000, being at the fixed rate. And each of them using different base rates given that one was variable and one was fixed.

And perhaps we will need – I think we will need to go to the documents to see this in a bit more detail, but at a general level, the point that you are making is you understand that although there was a fixed and a variable component, there had not been a formalisation of the splitting of those loans into a fixed and a variable component; is that - - -?---Not the underlying loan. There had been a formalisation, as I understand it, of the fixed portion in the form of an interest rate swap. So that was formal.

Yes?---But the underlying loan that backed, if you like, the interest rate swap was not specific to that interest rate swap. It was a loan of a much larger amount than the amount of the interest rate swap.

I see. The interest rate swap only affected a portion of the loan, not the whole of the loan?---Of the original loan, that's correct.

The original loan. The effect of it was that as at this date, July 2010, $464,930 of the loan was fixed?---Correct.

That was the existing effect of the interest rate swap?---That's correct.

But there hadn't been a formal split into two separate loans, one of 601,000 and one of $464,930?---That's correct.

So in substance this formalisation of the split didn't change the position of the Stanfords?---No, that's my understanding.

And then you say in paragraph 167 that it was a condition of this new facility that there would be additional standard reporting requirements?---Yes. Some of them were not additional. Some of them were putting in place in the new facility arrangements that had already existed. For example, in 167(b), the requirement for quarterly management accounts was not a new requirement. It was an existing requirement, but it was formalised in this facility.

And I just want to understand what you mean by that. We can go back to the 2006 loan if that would assist, but there wasn't a quarterly reporting requirement formerly in the 2006 loan?---No, there was not. That came later.

And when do you understand that came in?---My understanding is that the first requirement for quarterly reporting occurred in around August 2009. And then that was an informal arrangement, as I read the documents. It's one of my exhibits. I think it's DC-88. There was an informal arrangement struck between the relationship manager and Mr Michael Stanford to provide quarterly management reports and that was discussed with – between the relationship manager and the Stanfords' accountants in order to provide those quarterly management accounts. That was the first occasion. And the second occasion was in the overdraft facility of April 2010, when the quarterly requirement was formally documented for the first time, as I understand it.

As part of the overdraft?---As part of the overdraft, that's right.

And just if we take the first part of your answer which was relating to 2009, in 2009 you understand that the relationship manager was seeking quarterly reports from the borrower?---Yes.

And also, it seems, from the accountant?---Yes, as I understand it. And as I understand the commentary in that particular exhibit, that was agreed to by Mr Michael Stanford.

But there wasn't a contractual term of the existing facility that required the Stanfords to provide those reporting – those quarterly reports?---That's correct, yes.

And so a failure to provide the quarterly reports wasn't a breach?---At that point, no.

All right. And so the effect then, of this new 2010 loan, was to include a formal requirement for quarterly reports, a formal contractual requirement for quarterly reports?---In the facility for the two Stanford brothers, yes, but the previous contractual obligation was in the overdraft facility.

Yes?---With Let It Rain.

Yes. For the $20,000 overdraft?---Correct. That's right.

This now included a quarterly reporting in relation to the loan that was made to the Stanford brothers?---Correct. The larger loan, yes.

And I don't think we are disagreeing, but that was a new contractual obligation on the brothers?---In respect of that loan, yes.

All right. And another effect of the new facility agreement was that it brought in an increase to the margin being charged on the variable portion of the loan?---That's correct.

And if we bring that up it's CBA.4000.0037.5077. So this is the 2010 – this is the July 2010 offer?---Yes.

And if we go to page .5078 - - -?---Yes.

We see the interest rate for the variable portion is now bank bill rate plus a margin of 1.93 per cent per annum?---That's correct.

And the previous margin had been – was it 1.18 per cent per annum?---That's correct, yes.

And the change in margin, do you know what the reason for that was?---My understanding, from my review of the documents is that it was felt at that point that there were concerns around the business, the operations of the business, the trading performance of the hotel and, as I understand it from the documents, there was a concern that the risk that was being taken by the bank as a result of that deteriorating trading performance was greater and, therefore, that was reflected in the new pricing, which was a .75 per cent increase.

And perhaps if we go to DC-93 which is CBA.0001.0285.0518, so this is a response from the relevant manager to the submission of a report or credit submission by Mr Goldsmith; is that right?---Yes, that's right.

And this is the response in December 2009?---Correct.

And we see here that what occurs is that the risk grade is downgraded to six plus?---Yes.

And you recall we have looked already, the original risk grade was 5?---Yes.

And then we see in the fifth bullet point pricing to be increased now?---Yes.

And it says:

> *As LOV –*

that's letter of variation; is that right?---That's correct.

Continuing:

> *…needs to be issued for change of product in line with matrix to cover long-term funding premium.*

?---Yes.

And so this suggests that as at December 2009 what the manager was requiring, as a condition of the approval of the credit submission, was that the letter of variation that was to be issued to the Stanfords would have an increased margin. Do you agree with that?---Yes.

And we will see – we will come to this in a little bit more detail, but what happens is that that letter of offer that goes out in January 2010, it has the increased margin in it?---That's correct.

But the Stanfords don't sign that letter?---That's correct.

And if there was no attempt being made to have the Stanfords sign a new letter – sign a letter of variation, would you have expected that the pricing would nevertheless be increased?---I'm not sure that I can – I would be speculating, but if you don't mind me speculating.

Yes?---I would expect that at some point, given the concerns that were expressed at this stage, being December 2009, I would have expected that at some stage – and I say this with the benefit of hindsight, because I've seen what happened in 2010 – but I would have expect at some point there would have been a discussion between Bankwest and the borrower about pricing in view of a concern about the increased risk that the bank was taking.

And does that carry with it the notion that it would need to be a consensual agreement to increase the pricing?---I think, again, I'm sort of speculating as to what would generally happen, but generally speaking there would be a discussion where I think it's fair to say the bank would suggest – rather than ask permission, the bank would suggest that the interest rate would increase in order to reflect the view that the bank had at that stage of the credit risk that it was taking.

And if the borrower didn't take up the suggestion, what then would Bankwest have to do?---Again, at a general level if you don't mind me sort of speculating, because I'm not tying it to this specific case. At a general level, Bankwest would make a decision as to whether or not the price should be increased. That might depend on a number of factors. The strength of the relationship with the borrower would definitely be one. As I've mentioned, Bankwest's view of the credit risk that it was taking in view of the deteriorating circumstances would be another. Those factors would go into the mix and Bankwest would then decide whether it was going to implement – as opposed to seek permission, whether it would implement a price increase or not.

By exercising the unilateral power of variation?---That's correct.

Under the contract?---That's correct.

If we go to DC94, which is CBA.0001.0285.0983. Now, this is the – what appears to be quarterly credit risk assessment performed by the Stanfords' relationship manager?---Yes.

And it's – if we go to page .0988 we can see it's completed on 26 March 2010?---Yes.

And then if we go back to the first page, .0983, we can see the risk grade for each of the facilities is given as six plus?---Yes.

And that reflects the memorandum we saw before from the manager?---Yes, that's right.

And a six plus risk grade, as we understand what you've set out in your evidence, means it's still a performing loan?---That's correct.

And I just want to understand one aspect of some evidence you gave earlier. You see this is listing three facilities?---Yes.

And the third facility is that business bonus account that's to have an overdraft. The first facility is what appears to be the variable interest rate facility. The second facility, is that just the swap facility? It's not – is that right?---That's correct.

And I'm just trying to understand that idea or the point you made before, which is that before they signed the letter of variation, there was no split into two facilities of what was originally $1.2 million, and had now been paid down, because on the face of it, it looks like it has been already split in some way?---Well, it has been split in the sense that a swap was put in place and that's why it's separately itemised in this list. Because it had a separate interest rate applying to it, it was necessary to separately itemise it.

All right. And then we see there's a heading about a third of the way down the page, which is Safety?---Yes.

And you see that number 7 is:

> *Loan is secured 100 per cent by value of security at SLM.*

What does SLM stand for?---SLM means the safe lending margin, sometimes called the secured lending margin.

All right. So it says:

> *Loan is secured 100 per cent by value of security at safe lending margin?*

And the answer is "Yes"?---Yes.

And so that means as at this point in time, March 2010, the loan to the Stanfords was still within Bankwest's lending policy margins?---That's correct.

And then at the bottom we see number 10:

> *Financial and information undertakings adhered to?*

?---Yes.

That says "Yes." I'm not sure that that's actually correct, is it? By then there had been – there had been some delay in providing annual reports; is that right?---Yes, that's my understanding.

But not something that presumably materially affected anything concerned with the viability of the loan?---I think that's probably right. I think it more goes to the general conduct of the account, which I think is why the answer to question 3 on that page was "No".

Yes. That is:

The general account conduct has been satisfactory over the last 12 months.

And the answer is "No"?---That's correct.

Then if we go over the page to .0984. So we see the second bullet point under Change Sought is "request for overdraft"?---Yes.

And then three quarters of the way down the page, there's a paragraph that begins, "Since date of last report"?---Yes.

And that seems to be explaining that since the last report, which was at the end of 2009, the new letter of variation to change the product over has been issued?---Yes.

And that was delayed until 15 January because of a backlog at CSE. What is CSE?---CSE, I understand, is the administration area of Bankwest that was responsible for issuing documentation.

The letters of variation?---Yes.

And it's then explained that Mr Goldsmith had attempted to contact the Stanfords, with no real success, and finally arranged a meeting for 10 March 2010?---Yes.

And then if we blow up the remaining section of the page from "In this meeting". What Mr Goldsmith is recording is that in the meeting Mr Stanford expressed a concern that the bank was looking to exit the pub?---Mr Michael Stanford, yes.

And – that's right. The witness yesterday was Brendan Stanford?---Yes. Yes.

And that the reason Michael Stanford held that that suspicion was because of various matters that are listed there?---Yes.

And Mr Stanford thought that the transfer of him from the old account to the new account was part of the effort to move him on?---Yes.

But Mr Goldsmith assured him that that wasn't the case?---Yes.

And, certainly at this point in time, there's nothing to suggest that Mr Goldsmith, the relationship manager, was looking to move on the Stanfords from Bankwest?---No, not that I'm aware of.

And if we go then to page .0986, and can we just blow up the section which is Ratios, about three quarters of the way down the page. What Mr Goldsmith is recording is that the ratios – which is that ICR and DSR that we've looked at earlier?---Yes.

They've been met for this quarter, but that's the first time that they had been met since Bankwest has been measuring the ratios?---Yes.

But even though the ratios were below the guidelines in 2008 and 2009, it hadn't been to an extent that caused concern about the viability of the hotel?---That's right.

And then if we go over the page to .0987, we see there's a section at the top of the page which is ATO Arrears?---Yes.

Can we blow that up. Bankwest had been made aware by the Stanfords, or by Michael Stanford, that they had arrears in their payments to the ATO?---Yes.

That, I imagine, is typically a sign of concern to a bank if one of their borrowers is in arrears to the ATO?---It can be of concern, primarily because it can suggest that even if the payments by the borrower are up to date with the bank, it can suggest that other obligations are not being met in order to fund the payments to the bank. And it therefore gives an indication that there is some financial difficulty that the customer may be experiencing, albeit that's not translating into a shortfall of payments owing to the bank. And so the concern is that perhaps while the bank payments are being met, other payments are not being and that indicates a – in this case, a potentially a trading difficulty.

In this case the borrowers had explained that they had entered into a payment arrangement with the ATO?---Yes.

And they had provided copies of the tax portal statements?---Yes.

And they showed – those statements showed that they were up to date?---Correct.

With their payment plan?---That's right.

And you see there's then a heading which is Request for Overdraft, $20,000 on account?---Yes.

And there's a setting out of a number of numbers showing the run of the account?---Yes.

And then it's explained – or the summary from Mr Goldsmith is excesses are usually of a short duration and clearances come from receipt of ATM clearances and BWAMS fees?---Yes.

Do you know what BWAMS fees are?---Yes. I understand that was – BWAMS, I believe, was the provider of the merchant facility. So the merchant facility attached to, say, the EFTPOS terminals that were used in the pub. So fees would have been payable to that provider of the merchant facilities. I believe that's what that's referring to.

Sorry, you think the business Let It Rain is making a payment to the provider of the merchant facilities?---Well, I think what it's saying is that the excesses are cleared in due course, usually not after a very long period, when the merchant facility provider, namely BWAMS, sends payments through. Quite often, merchant facility providers don't make the payment on the same day that the payment is made by, say, a patron of the hotel. So if a card payment is made at the hotel, the card payment is processed through the payment system by the merchant acquirer, in this case BWAMS, but the payment isn't necessarily forwarded to the account of the merchant, in this case the pub, on the same day. It might be several days later. And so there's a delay in receipt of that money and I think that's what this is referring to.

All right. And the overdraft, in any event, was granted by Bankwest?---It was.

And then if we go to exhibit DC-95, which is CBA.0001.0285.1113, so this is again the manager business credit form that's provided in response to that report that we've just looked at for Mr Goldsmith?---That's correct.

And he is approving the decision by Mr Goldsmith to be able to provide the overdraft facility?---Yes.

And he notes some concerns, though?---He does.

And one of the conditions he opposes is that the account is to be maintained on the early warning watchlist?---Yes.

And we spoke about that yesterday afternoon, the introduction of the watchlist by Bankwest in order to properly monitor and manage its loans?---That's right.

And he also makes the comment that:

> *While servicing is seen as acceptable –*

I think this is saying –

> *existence of ATO liabilities do not provide comfort.*

Does that mean he is concerned or you're just not sure?---I have interpreted that to mean that the ATO liabilities of $61,000 make him uncomfortable.

Yes. That's right. It's "do not provide comfort"?---Yes.

Yes. All right. And then if we go to – I'm sorry, I should just confirm. There's then – once the overdraft facility is granted there's a guarantee provided by each of the Stanford brothers?---That's correct, yes.

Right. And as at March 2010 the Stanfords had continued to make all of the principal and interest payments they were required to make under their loan from Bankwest?---That's correct.

And, in fact, they had paid down more principal from their loan than they were required to just making the ordinary payments?---That's right.

And then in April and May, the Stanfords' business loan and the Let It Rain overdraft were reviewed as part of Project Magellan?---Yes, that's right.

And we go to DC-103, which is CBA.0001.0285.1114. This is the Project Magellan file review in respect of the Stanfords?---Yes.

Can I ask a question about total assessed exposure. The total assessed exposure is said to be $1.161 million?---Yes.

Is that – is there some other amount that gets added on in addition to just the outstanding loan balances in order to arrive at a total assessed exposure?---Commonly, total assessed exposure would include the amount which the borrower could borrow from the bank, even if at that point it had borrowed less. So the limit, if you like, might still exist even though the amount borrowed is less than the limit. I'm not sure if that's the case here.

And this also then ties into something which is – you see the first bullet point under credit events?---Yes.

What's said is that a CRS, which is a credit review submission; is that right?---Yes.

Was submitted seeking TAE 1.416 million. So that is back in August 2006. We know the – and it says that was approved, but the loan was for $1.2 million?---That's correct. Yes.

Is there – it may be you can't help us with this, I don't expect you to be able to – but is there some explanation for what that difference is?---I don't know the actual facts. When I first saw this, I wondered whether the loan application at the time had been for $1.416 million, but the loan actually granted was less than that, namely, $1.2 million. But it doesn't say that. It was just my guess.

And then on that first page, we see covenant compliant and the answer is "Yes", but there's then some details. It says "See below for details"?---Yes.

And if we go, then, to page .1115 you see the third bullet point notes the tax arrears?---Yes.

The fifth bullet point says that financial information is provided directly by accountants who have been timely with information?---Yes.

And then the sixth bullet point is that the clients have breached the ICR and DSR covenants?---Yes.

And what that sets out, consistent with something we looked at before, is they appear to have been breaching those covenants in 2008 and 2009?---Yes.

And then if we go to the bottom of the page, we see the overall summary being:

> *We see connection is performing okay in the current environment. However, requiring a higher degree of management as clients are upset at the closer management of the account.*

?---Yes.

And am I right in understanding this part of the report is something that's prepared by the relationship manager or somebody that the relationship manager reports to?---Yes. This part, which I think I referred to in my statement as step 1 of the Magellan review process, was prepared by the relationship manager.

All right. And then if we go to .1117, so this is the independent review, what you refer to as step 2?---Correct.

And this is being carried out by a partner of Ferrier Hodgson?---That's right.

And we see, about halfway down the page, that there's a point which is:

> *In light of current trading maintainable earnings for valuation purposes are seen as being $190,000.*

?---Yes.

And that's the EBITDA plus $51,000 in add-backs for directors' fees?---Yes.

And then at the bottom of the page, we see:

> *Going forward, current earnings are sufficient to marginally service the debt.*

?---Yes.

And then over the page, on .1118, there's a section which is Safety Assessment?---Yes.

And the last two bullet points highlight something of concern, which is that the value of the hotel is likely decreasing given the decrease in EBITDA?---That's correct.

And that reflects something we were discussing a little earlier, which is something like this: it's an asset that effectively trades on a capitalisation of the maintainable earnings?---That's correct.

And so as the EBITDA goes down, which reflects the – assuming you use that as the measure, or in some fashion the measure related to maintainable earnings goes down, then also the value of the property will go down?---Yes. And in conjunction with changing capitalisation rates, if that is present at the same time, it has a multiplier effect.

And one of the things that was happening, or does happen, is that the capitalisation rate which had been – as this notes – 16 to 17 per cent in the region, started to increase?---That's correct.

So that the capitalisation rate went from 16 to 17 per cent to over 20 per cent?---That's correct.

And then that also means that the – that when you are applying that capitalisation rate to maintainable earnings, even if maintainable earnings remain the same, the value of the property would decrease?---That's correct.

And it's said the current LVR is now seen as 90 per cent?---Yes.

And then a little further down we have a section which is Risk Assessments, Risk Mitigates?---Yes.

And it again notes in the third bullet point the ATO issue, which might indicate working capital difficulties?---Yes.

And then explains there's limited prospect of refinancing current market given the high LVR?---Yes.

And that there's a risk that the value of what is the security will further deteriorate unless performance can be lifted?---Yes.

And then, as a consequence, the recommendation is that the risk grade be reduced down to seven?---That's right.

Sorry, and I should perhaps qualify that. It's – numerically it's an increase from six plus to seven, but in terms of the risk that means it's a worse risk than if it was a six plus?---That's correct. We refer to it as the credit rating being downgraded although the number goes up, as you say.

Then if we go over the page to .1119, these are the recommendations that come out from the independent review, and the project recommendation classification is double red?---Yes.

Could you just explain to the Commissioner, what does double red mean?---The ratings assigned to each loan reviewed under Project Magellan were green, red or double red. Red and double red indicated loans or loan files that were considered to be higher risk.

And was there any difference in the way a red or double red loan was managed?---Well, for the purposes of the Magellan review, it was just an assessment as opposed to a management of the actual loan. Management of the loan would occur after the assessment.

The grading of red or double red would affect something you were talking about yesterday afternoon which is when you come to make a collective provisioning, how do you consider these particular loans; is that right?---That's correct. That's correct.

As distinct from it affecting any particular management step that you might take?---That's correct.

Which was always going to happen after Project Magellan?---That's correct.

And then if we go to page .1121, this is the panel decision which you've referred to as the third step of the Project Magellan process in your statement?---Yes.

And the panel decision in relation to this loan is to accept the risk grade of seven?---Yes.

To classify the loan as red rather than double red?---Yes.

And the recommended actions are said to be as recommended in reviewers future actions?---Yes.

And if we then just go back to page .1119, so the future actions that have been outlined by the reviewer are (1) to obtain confirmation about trading in May 2010?---Yes.

(2) to ascertain an update on cash flow of repayment arrangements?---Yes.

Just pausing on that: there hadn't been any default in making repayments as at May 2010, had there?---No. No, there had not. I had read that, perhaps incorrectly, as an update on the ATO repayment arrangements.

The ATO repayment arrangements. I understand?---Yes.

And in any event, there hadn't been any default on the ATO repayment arrangements either?---No.

The third thing was to discuss the trading results with valuer to form an indicative view on value?---Yes.

The fourth point was to meet the customer to discuss the situation?---Yes.

The fifth point was to encourage the customer to put the hotel up for sale?---Yes.

And the sixth point was to maintain principal payments?---Yes.

And does it surprise you that the recommendation was to encourage the customer to put the hotel up for sale?---Not entirely, no.

And do you want to just expand upon that and explain why you say that?---Yes, certainly. I say that because looking at the situation as it existed at this point in time, in 2010, given that there were concerns about the level of trading of the hotel, which was adversely affecting the EBITDA, and as we were discussing earlier an adverse change in EBITDA together with a higher capitalisation rate meant that the value of the hotel was deteriorating. I'm not surprised at this recommendation because, in light of those facts, I would have expected Bankwest to have formed the view that potentially the only way for the borrower to be able to repay the loan was to sell the hotel and to sell it sooner rather than later, given the deterioration in EBITDA and the deteriorating capitalisation rates.

And then if we go to DC-96, which is CBA.0001.0285.1152. So this is another of these reports that are prepared by Mr Goldsmith?---Yes.

As the relationship manager?---Yes.

And this one, if we go to page .1155 is one that was prepared by him on 15 July 2010?---That's correct.

And if we go back to the first page, we see now the risk grade has changed to seven?---Yes.

And, in terms of the margins, the margin for the variable interest facility is – it was 1.18 and it is proposed to be 1.95?---Yes.

But the swap rate is to stay at 1.18?---That's correct.

Which presumably reflects what it has been fixed in at?---That's correct.

And if we then go over the page to .1153, if we look at the bottom of the page, which is non-receipt of 31 March 2010 financials?---Yes.

And the issue being raised by Mr Goldsmith is that despite numerous requests from his office, he hasn't been provided with the financial information?---That's correct.

And then you see the statement at the bottom of the page, which is:

> *Regrettably, as clients have not signed new letter of variation, we are not in a position to breach clients despite his acknowledgement that this information will be required on an ongoing basis.*

?---Yes.

That might be a regrettable choice of words, as it turns out. When he says "regrettably", what do you understand from that?---My understanding is that Mr Goldsmith is of the belief that he is unable to send a breach letter in respect of the failure to provide the accounts for the period for March and for the end of FY2010. He believes that he can't send a breach letter because the new facility agreement, which contains the formalisation of the requirement to deliver quarterly management accounts, has not yet been signed by the Stanfords.

And when you say he believes, does that mean you think he was incorrect, that he could have breached them for it?---Well, as I mentioned before, the overdraft facility contained the requirement to – the contractual requirement to provide quarterly management accounts, and it appears that he has forgotten that or was not aware of that.

And perhaps you might help the Commissioner to understand: what would be the reason why he wants to be able to send a breach notice?---He would – my understanding is that he would want to have sent a breach notice in order to do two things. One, at a commercial level, to remind the customer or prod the customer to provide the accounts because there was a formal notification that the facility had been breached, which was serious, and that the customer would therefore take on board the seriousness of that as a way of encouraging the customer to provide the missing financial statements. And the second, at the more technical, legal level would have been to reserve Bankwest's rights in respect of that breach so that it could take action in respect of that breach in the future if it needed to.

Then if we go over to page .1154. At the top of the page, Mr Goldsmith is making the point that he thinks that he has an issue with not getting back the letter of variation signed?---Yes.

And then the next point he makes is about making a request to increase the interest rate margin and decrease the commercial advance limit?---Yes.

And it appears as if what he is asking is for the margin to be increased notwithstanding that the letter of variation hasn't been signed?---Yes.

And he says that he is seeking approval for that to happen at the next rollover?---Yes.

Could you just explain to the Commissioner what that means?---The rollover there is a reference to the base rate at which the commercial advance was calculated. It was calculated on the bank bill rate. The loan was funded through bank bills being issued and taken out by Bankwest. Those bank bills have a tenor, depending on the period. And the – when the bank bill rolls over, that's the reference here to rollover, in other words when the bank bill expires and a new bank bill is issued in the same amount for the same tenor, that's the rollover date.

So is there any reason to think that merely by the rollover of the bank bills that that would, by itself, mean that the margin on the bank bills – on the bank bill rate could be increased?---Not by itself. My understanding is that the reference here to increasing the margin on the next rollover date is to avoid any break of that then existing bank bill, because a break incurs a break fee, which would be to the customer's account. And here the relationship manager is, as I read it, suggesting that any increase only occur at the time the rollover so that no break fee is incurred mid bill, if I can call it that.

And the – I'm sorry, I'm not sure I understand. Why would increasing the margin on the bank bill rate cause a break of the bank bill?---Because the bank will is for a fixed amount at a fixed rate for a fixed period.

Yes?---And so to increase the rate during that bill is changing one of those three fixed elements, and a change of a fixed element incurs what's called a break of the bill and, therefore, there's a cost attached to breaking it.

We might be getting into something that takes us well beyond what we need to, but isn't the thing that is being – that is of concern here to Mr Goldsmith the margin that is being charged on top of whatever is the bank bill rate?---That's right, yes.

And so the bank bill rate is the rate that has been locked in as part of that bank bill?---Well, the bank bill and the margin because you take out the bill for the rate - - -

I see, I understand?--- - - - that you are charging the clients. In this case, the base rate attached to the bank bill and the margin specific to this transaction.

And in order to do this, this would, in your view, just have to be the exercise of the unilateral power of variation; is that right?---As I understand it, yes.

And then we see the next section is Magellan Report?---Yes.

And Mr Goldsmith is explaining his response to the various things that were the recommended actions that we looked at earlier?---Yes.

And, as to that fifth one, which is encourage customer to put the hotel up for sale, he explains:

> *Not seen as practicable.*

?---Yes.

And says:

> *Client is aware that it is an option.*

?---Yes.

And is it your understanding that the reason he says it's not seen as practicable is because of this issue in the relationship where the Stanfords or Michael Stanford at least already thinks that the bank is trying to get him to sell up or you're not really sure?---I'm not really sure, I can't say, I'm sorry.

All right. And can I just ask one other thing. Can we bring up related to this document, CBA.4000.0037.5077, which is the variation of facilities. And if we go to page .5079 – have you got that?---This is DC-87.

Yes?---Yes.

So if you go to the third page which is 5079?---Yes.

And at the top of the page is the variable facility?---Yes.

And do you see the interest rate is BBSY plus a margin of 1.23 per cent per annum?---Yes.

Do you know why it is that the margin was going from 1.18 per cent to 1.23 per cent for the variable facility?---I don't know exactly why. I can hazard a guess though, if you would like.

Is it because the bank bill swap rate is lower than the bank bill rate?---Directly tied to the use of the bank bill swap rate as opposed to the bank bill rate, yes.

And if we then go to exhibit DC-97 which is CBA.0001.0285.1143, so this is the response from the manager to that report that we just looked at from Mr Goldsmith?---Yes.

And he approves the recommendations that were made by Mr Goldsmith, but he attaches some additional comments and makes some comments?---Yes.

And he also seems to think that quarterly data is not – he says:

> *Quarterly data is not part of our letter of variation and as such breach notice cannot be issued.*

?---Yes.

Your view is they've just misunderstood this?---I believe so.

And then the comment he makes is:

> *I note amortisation is continuing, but lack of assistance from customers in providing data, non-return of letter of variation, etcetera, will result in bank withdrawing assist, ie, transfer to CAM with exit sought.*

?---Yes.

And he notes the comment:

> *Encourage customers to put the hotel up for sale.*

?---Yes.

And then if we then go to what happens in the next quarter of 2010, can we bring up CBA.0001.0285.1221. I'm not sure that this is an exhibit to your statement, Mr Cohen?---I think it might be DC-100, I'm not positive. It's a bit faint in this copy I've got.

I'm sorry, you are right. It has a different – has a different – no?---It's hard to tell from my copy. Thank you.

It appears to be a different document. So this is what's described as a Bankwest credit risk form executive summary?---Yes.

And you see under customer overview, about a third of the way down the page, it says:

> *The industry has pubs and bars and the industry attractiveness is amber.*
> .

?---Yes.

Can you just explain what that means?---Yes. I understand that to be an assessment using the red, amber, green measurement that pubs taverns and bars were considered by Bankwest at this stage, being September 2010, to be a sector that was regarded as of some concern, but not the highest concern.

And the risk grade is seven?---Yes.

And the risk grade is seven, that is still a performing loan; is that right?---Yes. A risk grade of seven is just before the stage of – we call watchlist.

Right. And then if we go to the page .1225, this is dealing with the Magellan report. You see that about halfway down the page?---Yes.

And then you see there's again a response to this issue of encourage customers to put hotel up for sale?---Yes.

And it said:

> *Previously this was not seen as practicable and as BC will acknowledge will be a difficult conversation.*

Do you know with who BC is?---I believe that's a reference to business credit.

Continuing:

> *However, I now consider that this is a live option following issues in the production of these figures, the results themselves of the sometimes contrary nature of the client.*

?---Yes.

And if we go back to page .1222 we see a section which is management ownership?---Yes.

About a third of the way from the bottom of the page you see:

> *Credit history with BWA is mixed.*

?---Yes.

Continuing:

> *Compliance history is mixed particularly with reference to the provision of financial information.*

?---Yes.

However:

> *Repayment history first class with no missed payments.*

?---Yes.

Continuing:

> *Overdraft operating within arrangements, connection extensively reported upon since transfer to portfolio August 2009.*

?---Yes.

And what I'm interested is your view as to whether it seems surprising that a borrower who has taken out a 20 year loan, and is described as having a first class repayment history, is under contemplation to be approached to sell their asset?---No. It's not surprising to me in this case.

Right. And that is because you've identified already there's obvious risks associated with the performance of the business going down?---Yes. The financial indicators provided by the ratios, for example the arrears with the Tax Office, the deteriorating performance of the hotel, all would have been very live indicators to Bankwest that, although payments were being maintained, nevertheless the underlying risk associated with this loan was increasing and the underlying financial condition of the borrower and the business were deteriorating.

Right. And then if we go to DC-101, which is CBA.0001.0285.1220. So this is the approval by the state manager of business credit in relation to the Stanfords?---Yes.

And do you see the comment is:

> *This connection needs to be exited ASAP. Please discuss files with customers and provide an orderly exit strategy by 30 October 2010.*

?---Yes.

And then:

> *In the absence of an acceptable exit strategy the file will most likely to be transferred to CAM at next review.*

?---Yes.

And is it fair to say that from this point, that is from September 2010, Bankwest had made the decision that it wanted to be out of the loan with the Stanfords?---No, I don't think so. I don't think that is fair to say that entirely.

Not entirely, did you say?---No, not entirely.

What do you mean by that?---By that I mean that Mr Beshara in this case, the author of this particular document, clearly does have that view. But Mr Goldsmith, the relationship manager, at various stages, has disagreed with that view and at this stage, as is evident from other documents, disagreed with that view.

And perhaps if we have it – I'm sorry, you're right then. I think I've put that badly. Let's have a look at some of that disagreement. Can we bring up CBA.0002.1959.7114. Commissioner, I should tender that document that I looked at before, which is CBA.0001.0285.1221.

THE COMMISSIONER: That's not the same as exhibit DC-100?

MR HODGE: It's not, no.

THE COMMISSIONER: Exhibit 3.121 will be credit risk form executive summary 16 September 2010, CBA.0001.0285.1221.

MR HODGE: This is one of those documents, I think that you are referring to, Mr Cohen, an email sent by Mr Goldsmith?---This is one of those documents, yes.

And he is responding to that recommendation by the state manager?---That's right.

And says:

> *In short can look to have a report by end of week without too much problem, but do not agree with the fact we have to exit file.*

?---That's right.

I tender that document.

THE COMMISSIONER: Email Goldsmith to state manager, 25 October 2010, CBA.0002.1959.7114, exhibit 3.122.

EXHIBIT #3.122 EMAIL GOLDSMITH TO STATE MANAGER DATED 25/10/2010 (CBA.0002.1959.7114)

MR HODGE: And then if we go to CBA.0002.1959.8134. This is a further email sent by Mr Goldsmith to Daniel Hensman?---Yes.

And in this email Mr Goldsmith again expresses the view, he says:

> *I would like to reemphasise that we do not see this as an account for CAMs and/or exiting.*

?---Yes.

Continuing:

> *Debt is reducing and accounts are in order, with clients highly committed to the hotel.*

?---Yes.

So that was the view of the relationship manager?---That's right.

And when you referred to it not being the view of Bankwest from September 2010 that the account needed to be exited, you were referring specifically to the views expressed by Mr Goldsmith?---That's correct.

Was there anybody else that you've seen expressing a similar view?---As Mr Goldsmith?

Yes?---No, I don't believe so.

I tender that document, Commissioner.

THE COMMISSIONER: Email Goldsmith to Hensman, 15 November 2010, CBA.0002.1959.8134, exhibit 3.123.

EXHIBIT #3.123 EMAIL GOLDSMITH TO HENSMAN DATED 15/11/2010 (CBA.0002.1959.8134)

MR HODGE: And then if we go to DC-108, which is CBA.0001.0285.1252. This is a further submission, again by Mr Goldsmith, and this is for the quarter, for the last quarter of the 2010 year, not financial year, calendar year?---Yes.

And Mr Goldsmith, you will see in Credit Risk Grade, said:

> *The existing credit risk grade is F3.*

And he proposed that it be E2?---Yes.

Now, that's switching, it seems, from the system that had been used to the Bankwest – by Bankwest to the system that was used by CBA; is that right?---Yes, that's right.

And E2 is a – means the credit risk is improving rather than being downgraded, is that right, compared to - - -?---In comparison to F3?

Yes?---That's correct.

So what Mr Goldsmith is suggesting is that the risks associated with the loan to the Stanfords are decreasing?---That's correct.

And then if we go to page .1253 he, at the end of the section on Relationship Strategy, explains the reasons for his request. And his request, you will see in number 1 and 2 at the top of the page, one is update BC, that is business credit, on the production of the 30 September 2010 management accounts?---Yes.

And, two is remove the account from the weak list?---Yes.

And he explains his reasons for that. You presumably looked at this document, because you have exhibited it?---I have, yes.

And that's not accepted – we will see if we go to DC109, which is CBA.0001.0285.1262, and the manager's position is that the file is to remain on the weak account list with a risk grade of F3?---That's correct.

And can I suggest about that, that's not necessarily surprising that there would be a difference of opinion between the relationship manager and the senior manager of business credit in relation to the risk of the file?---There are sometimes differences of view between the business credit team and the business team in this case, the relationship manager. So it's not entirely surprising, no.

Ultimately, it's a matter of judgment and opinion?---It is.

And - - -

THE COMMISSIONER: You said "not entirely surprising", what do you mean by "entirely". What's the qualification conveying, Mr Cohen?---The "entirely", Commissioner, is referring to the fact that this sort of difference does arise from time to time. In other words, I'm not totally surprised that such a difference of opinion would exist.

Yes.

MR HODGE: And then if we go to DC-112, which is CBA.0001.0285.1310, and we go to page – I should clarify something. This is again – this is a document prepared by Mr Goldsmith?---Yes.

And if we go to page .1311, for relationship strategy, Mr Goldsmith has now switched to a recommendation which is to transfer the file to CAMs with joint control?---Yes.

And in the end of that section on relationship strategy, he explains why that's seen as a necessary step?---Yes.

And then says:

> *The only counter to this is the fact that our debt is amortising and the clients have the expertise to run the hotel.*

?---Yes.

And again, as at this point in time, which is the beginning of 2011, the Stanfords are still making their principal and interest payments?---Yes.

And the debt is still reducing?---Yes.

And they have a history of having successfully managed a previous pub?---Yes.

And if we then go over to .1316, the recommendation is that there be approval of the review of the financial statements that had been provided for the September and December quarters of 2010, is the first part?---Yes.

And the transfer of the file to CAMs with joint control?---Yes.

The risk grade to remain at three?---Yes.

And the client to remain unaware of joint control?---Yes.

Do you know why it would have been recommended that the client remain unaware of joint control?---No, I don't.

Is that something that you would typically expect to happen in relation to the management of a borrower, that they wouldn't know that they had been moved into CAM in the case of Bankwest or the GCS in the case of CBA?---No, I would not. In fact, the policy in GCS is to specifically inform the client.

One possible reason – this is just speculation – but one possible reason is, as we have seen from the documents, Michael Stanford was very sensitive to the idea that the bank was trying to end its relationship with him?---Yes.

So it's possible that Mr Goldsmith, who is obviously the person who is quite concerned about the relationship with Mr Stanford, was concerned about what effect it would have on Mr Stanford if he knew the file had been moved to CAM?---Yes, that is possible.

You obviously – you haven't been able to speak to Mr Goldsmith, he doesn't work at the bank anymore?---No, he doesn't, no.

And then if we go to the DC-11 4, which is the inward transfer credit paper, and that's CBA.0001.0285.1318, this is the transfer memorandum that gets prepared to send the file over to CAM?---Yes, it is.

And it's prepared by Mr Goldsmith?---Yes.

And then if we go to page .1322, where it's additional issues, we see the fourth point:

> *Have raised issue of sale of hotel. However, clients are not prepared to sell in the short to medium term.*
>
> .

?---Yes.

And then it says:

> *Nil chance of refinance with breach fees charged on overdraft.*

?---Yes.

Are you able to explain to the Commissioner what that means?---The nil chance of refinance?

Yes?---I understand that to mean that Mr Goldsmith believes that another lender is unlikely – or actually not unlikely – will not refinance this loan. And my understanding is that he had that view on account of the deteriorating trading performance of the hotel with the resultant diminution in the value of the property. And, therefore, another lender would be unwilling to lend the amount that the Stanfords owed to Bankwest on the security of that hotel which had decreased in value.

Do you understand what the reference to breach fees charged on overdraft is?---Yes. I've seen comments in some of these documents that upon a breach of an undertaking or a covenant by the Stanfords on a number of occasions, Bankwest charged a breach fee of $250 and I understand this to be a reference to one of those charges.

All right. Do the charging of breach fees have any effect on the likelihood of refinance?---I don't believe so, no.

All right. And then the file was transferred into CAM when, do you know?---Well, it seems to be at some stage between the date of this inward transfer memorandum in April, through until June, at some stage between April and June 2011.

And what is it that happens in June 2011 that suggests that it has been transferred over?---I've seen a reference in a document that refers to the fact that it was transferred in June.

All right. And then having been transferred into CAM, CAM then commissioned PPB to do an investigative accountant's report?---That's correct.

It appears that that was done without having first consulted with the borrowers?---It appears that Bankwest did not consult at all first with the borrowers, yes.

Before the accountants were appointed and arrived at the hotel?---That's right. I have seen the PPB engaging with Michael Stanford before they visited the hotel, but I've not seen Bankwest engage with the customer at all.

And let me ask about that. Does that approach of appointing an investigative accountant without having first engaged with the borrower, is that something that CBA would do now?---No, definitely not.

Its policy has changed?---Yes, it has.

And when did that change occur?---I believe that policy first changed in 2016.

And is that a recognition that it is unfair to appoint an investigative accountant without having first consulted with the borrower?---I think it is. I think – I should say that the policy did not change the practice. Although the policy came into place in 2016, it was not the practice prior to 2016 to never engage with the customer prior to the appointment of an investigative accountant. However, I believe the policy was brought in, in 2016, to underscore the fact that engagement must occur on all occasions with customers.

There must be a discussion with the customer about what it is that the bank is trying to achieve, for example?---Correct. And - - -

When – sorry, go on?---Well, the policy goes further. The policy stipulates that the customer must be informed as to why the bank considers that an investigative accountant should be appointed. Secondly, the customer is to be engaged around the scope and actually shown the draft scope of the investigative accountant's work. And thirdly, there's to be a discussion with the customer about the draft report. And then lastly, a discussion with the customer about the recommendations that flow from the draft report.

And in terms of your view about what was – what occurred in this case, where the investigative accountant was appointed without there having been any consultation with the borrower, does it follow that you regard that as having been unfair on the part of the bank in its dealings with the borrower?---Yes.

And can we go, then, to DC-115 which is CBA.4000.0037.4936. So this is the report that was prepared by PPB?---Yes.

And if we go to page .4940, this is the At a Glance section of the report which sets out the two recommendations from PPB?---Yes – yes.

And recommendation 1 was:

> *The borrower to put hotel on market for sale.*

?---Yes, that's right.

And recommendation 2 was:

> *If the borrower is not cooperative, the bank should immediately enforce its security.*
>
> .

?---Yes.

And at this stage, when this recommendation is made, are the Stanfords still making their capital and interest repayments?---I understand so, yes.

And does it strike you as odd that the IAs would recommend that, if the borrower won't put the hotel up for sale, the bank should immediately enforce its security, given that the borrowers are still making their principal and interest payments?---No. No, it does not.

And why is that?---Because the investigative accountant, in this report, has looked at the operation of the hotel business and has observed the lack of management skill in the operation of the hotel, has observed that there's a lack of basic financial disciplines, and generally the investigative accountant observed that – a number of concerns about the operation of the hotel. So, in the context of concerns about the operation of the hotel, firstly. Secondly, concerns about the lack of a plan to improve the operations of the hotel. And I think in light of those, the investigative accountant took the view that the prospects for the borrowers to be able to satisfy their obligation to repay the loan, as opposed to continue to service the loan, in the context of a deteriorating trading performance was poor. And, therefore, I believe they felt that the only way for the borrower to be able to repay the loan was to sell the hotel and use the sale proceeds to pay back the loan.

Now, I just want to make sure we've identified some aspects of the opinion expressed by PPB. One is they raise concerns about the management of the hotel, which is what you've referred to?---Yes.

And that is whether the actual operation of the hotel is being managed adequately?---Yes.

And then a second issue connected to management that they raise is a concern about whether the financial management of the hotel is adequate?---That's correct.

And then a third issue that they raise is that there's a risk that the ATO will take steps to recover its debt?---That's correct.

Now, on that third issue, it appears as if they were unaware of the repayment plan; do you agree?---Yes. I can't see any reference to the repayment plan in the IAs report.

And, as far as you understand, were the Stanfords continuing to make their repayment – comply with their ATO repayment plan at this time?---I'm not aware of the status of their repayment plan at this stage, being September 2011.

All right. Commissioner, is that a convenient time? I just noticed I'm perhaps longer than I ought to have, if you were going to take a short break.

THE COMMISSIONER: Yes, perhaps if I come back at shortly after midday, Mr Hodge.

MR HODGE: Thank you, Commissioner.

ADJOURNED **[11.55 am]**

RESUMED **[12.02 pm]**

THE COMMISSIONER: Yes, Mr Hodge.

MR HODGE: Thank you, Commissioner.

Now, Mr Cohen, what then happens is if we bring up DC-118 which is CBA.0517.0074.0003, there's a Gadens Lawyers – who are the solicitors engaged by Bankwest – send a couple of notices, and perhaps if we start with the one on, which is CBA.0517.0074.0007. This is a notification to terminate the overdraft account?---Yes.

And then if we go back to CBA.0517.0074.0003, and this is a notification which raises a concern about the change in financial condition. We see that if we go to .0004 and it says:

> *Bankwest has received the independent investigative accountant's report into the trading position of the hotel.*

?---Yes.

Continuing:

> *Having reviewed this report Bankwest is concerned that has occurred in the business' financial condition which has had a material adverse effect on the value of its security property.*

?---Yes.

And then it invites the Stanfords to:

> *Let us know within seven days of today whether you are prepared to acknowledge that there has been a material adverse change in the financial condition of the hotel.*

?---Yes.

And asks them, if they don't agree, to outline the reasons why in their opinion there has not been a material adverse change and provide financial records to support the position?---Yes.

Now, as I understand it, at least one aspect of this you would regard as unfair and inconsistent with Commonwealth Bank's policies today, which is the seven days; is that right?---Yes. As I've said in my statement, the policy that we have today is to provide at least 30 days notice.

Do you also regard it as unfair to ask the borrowers to respond to a concern apparently arrived at from a report without providing a copy of the report?---Yes.

And so would CBA today provide a full copy of the investigative accountant's report to the borrowers?---We would provide a copy of the report to the borrowers. We may excise from that copy sections that would be regarded as sensitive, namely, commentary about the quality of management, because that can be quite emotionally confronting for a borrower. Secondly, we would probably excise any estimate of value of the security that would be realised on an enforced sale. And thirdly, we would definitely excise any commentary around the fraud of the borrower.

And so if we think about the report of PPB that we have looked at today, the section which is the recommendations, which are either the borrower sells the hotel or the bank exercise – enforce its security to cause the sale of the hotel, is that something that you would expect would be provided as part of the report to the borrower?---I would expect so, yes.

And the sections that express concerns about the quality of management, those are not sections you would expect would be provided to the borrower?---I would expect that those would probably be excised and not shown to the borrower.

And is one of the difficulties that that creates that if the opinion of the investigative accountant, and therefore the opinion of the bank, is derived from the comments that are made about the quality of management, that it becomes effectively impossible for the borrower to be able to respond to those concerns?---No. I don't believe so, because the discussion with the borrower about the report would entail a view being expressed by the bank as to the capability of the borrower to trade their way out of a difficult situation, for example. So, although the comments, written comments in the report, would probably not be shown to the borrower, the point of the policy that requires engagement with the borrower to talk about the report is aimed at ensuring that there is a discussion about the findings, albeit in not the black and white terms of the written report.

Is it possible, do you think – and we will see this a little bit further with this case – that if the bank has set itself on a course of wanting to exit the loan rather than manage the – become involved with the borrower so that the borrower's performance improves, that in that sort of situation, discussion of the quality of management would be irrelevant from the perspective of the bank?---No, I believe it would be relevant.

All right. And then you see the next part of the letter says that the bank requires payment of the costs of the investigative accountant?---Yes.

And the borrowers are asked to pay the costs of $9,900 within seven days?---Yes.

And again I just want to, if we can, isolate the parts of this conduct that you think are unfair. Is the seven days unfair?---I think so, yes.

And are there other aspects of this demand for payment that you regard as unfair?---Yes.

And what are they?---I think it's unfair to ask a borrower, or demand from a borrower, that they pay for a report that they've not received.

And if they received part, but not all of the report, would that change the issue?---No, I don't believe so, provided that what is supplied to the borrower does give the borrower a sense of why the view has been arrived at by the investigative accountant, and what the bank's response or intentions are in relation to the matter.

All right. Now - - -

THE COMMISSIONER: Well, I'm not quite sure what that means, Mr Cohen. Can you explain your last answer rather more fully?---Yes. I think it's - - -

You excise parts of the report?---Yes.

How is the borrower going to, at that point in the life of the loan, have any comfort that he or she has a full understanding of what the bank has - - -?---Through the discussion with the borrower.

Yes. Which would be conducted by whom?---That would be between the bank and the borrower.

The business relationship manager or someone who is new to the borrower?---It depends, Commissioner, on whether the file is being jointly managed by the business and the CAMs team or the GCS team, or whether it is being solely managed by the GCS team. If it was the former, then the conversation should be between the relationship manager, a member of the GCS team and the borrower. If it was the latter, it would be between the GCS team member and the borrower.

Yes.

MR HODGE: I want to show you another document, Mr Cohen, which is CBA.4000.0037.4966. I will just check whether that's in your statement. It's coming over to you anyway?---Thank you.

So this is an internal document prepared by, if we go to the last page, 4968, Mr Maxwell?---Yes.

And he is said to be Bankwest Risk Management, but that's within CAM; is that right?---That's correct.

And if we go to the front page, this is a document dated 28 November 2011?---Yes.

You see Mr Maxwell notes, at the bottom of the page, in relation to Project Magellan in May 2010:

Current earnings were considered insufficient to meet debt obligations. No free cash for CAPEX. LVR Concerns. ATO repayment plan present.

?---Yes.

So he is just summarising what it is that has been taken out of Project Magellan?---Yes.

And then if we go over to .4967 we see at the top of the page:

Matter accepted into CAM June 2011.

?---Yes.

And is this the document you think you had been looking at that suggested that it had come in, in June 2011?---That's correct.

And the risk is downgraded to H2?---Yes.

So it was F3, it's now H2?---Yes, that's right.

And what does that mean in terms of the change in risk profile?---So H2 is at the serious level of troublesome loan in terms of the risk gradings, with a probability of default, as it says here of 100 per cent. So the expectation is that there will be a default by the borrower in the next 12 months.

All right. Then if we go to the bottom of the page, we see:

IA report also draws attention to the lack of management ability demonstrated by the hoteliers, in particular their lack of internal reporting, inability to meet ATO requirements, and overall deterioration in trade.

?---Yes.

Can I ask: does it seem odd at all that the investigative accountants would have thought there was a lack of management ability by the hoteliers given that they had been managing hotels now for quite some time and have successfully managed an earlier hotel? Does this seem to be any perhaps lack of information on the part of the IAs that you would infer from that?---No, I don't believe so. My understanding is that the IA has made those observations based on their inspection of the hotel and its financial records, firstly, and have formed their view based on their experience in the hotel industry themselves. And in this case, the investigative accountant had specific expertise in the hotel industry.

Now, it doesn't appear at this stage as if there has been any actual failure to make repayments of capital or interest?---I think that's correct.

And we see in primary concerns in the middle of the page, the two primary concerns that are identified:

> *Are material decrease in trading performance with direct negative impact to the bank's security position and significant level of historical breaches.*

?---Yes.

But no reference to monetary defaults?---That's right.

And this is then referring to, or this refers to the fact that a meeting is sought between Bankwest and the borrowers and their respective accountants and lawyers?---Yes.

And then – I tender that document, Commissioner.

THE COMMISSIONER: Memorandum, 28 November 2011, Maxwell Bankwest risk management CBA.4000.0037.4966, exhibit 3.124.

EXHIBIT #3.124 MEMORANDUM MAXWELL BANKWEST RISK MANAGEMENT DATED 28/11/2011

MR HODGE: And then if we bring up CBA.0001.0285.0009. I'm told it's DC-117. This is a CAM strategy paper for Bankwest?---Yes.

In relation to the Stanfords?---Yes.

And it's dated, we can see on the front, 16 December 2011?---Yes.

And if we go over to page .0010, we – can I just note one thing: you see the entry for October 2011?---Sorry, I seem to have a different - - -

I'm sorry. 1493, page 2?---I see. Yes, thank you.

I'm sorry, I've got two different document IDs. You see there's an entry which is October 2011?---Yes.

And it's said:

> *CAM held telephone conversation with Michael* –

it says Stafford, it should be Stanford –

> *to discuss nature of findings, high level concerns, and the need for the client to commence formulating a proposal for the bank to consider as a suitable way forward.*

?---Yes.

So it does suggest that, after the IA report was received by the bank, the bank spoke to Mr Stanford?---Yes.

What it doesn't necessarily say is that they explained that there was a concern about the adequacy of what would be his management of the hotel?---Yes. I can't say from what's written here; it doesn't say that.

But I just want to understand what you would expect, at least now, the bank to do - - -?---Yes.

- - - is to actually have that frank conversation with the borrower to say, "We have a concern about the adequacy of your management of the hotel"?---That's correct.

Is that right?---That's correct.

All right?---Yes.

And you see at the bottom of the page it says:

> *Bankwest agreed to meet with the clients and their representatives. Bankwest also had Gadens present and also our agent PPB from an accounting perspective.*

?---Yes.

And then over the page it's said that:

> *Concurrent with the above meeting, the client –*

which is the Stanfords –

> *had submitted a FOS complaint?---Yes.*

Continuing:

> *And due to FOS complaint enforcement action has ceased until FOS complaint is resolved.*

?---Yes.

Do you understand what was the enforcement action that was under contemplation at this point?---I don't know what was in contemplation at this point, no.

If you look down under the heading Provision, you see there what is described as an upside case, a likely case and a downside case?---Yes.

And you see the upside case is:

> *Assumes no appointment over hotel, minimal legal fees on enforcement with borrower selling down.*

?---Yes.

Continuing:

> *Hotel after a period of trade on with new support structure and tight controls.*

?---Yes.

So the upside case that appears to be envisaged by CAM is that the borrower will sell the hotel?---That's correct.

And then the likely case is:

> *Assumes appointment over hotel, trade up period of five to six months.*

?---Yes.

And assumes appointment means the appointment of a receiver to the hotel?---I understand that, yes.

And then downside case is:

> *Assumes appointment over hotel, no improvement in trade.*

?---Yes.

And that is, again, assuming the appointment of a receiver?---Yes.

It doesn't appear to be the case that one of the options that CAM considered was that the borrower be able to continue to make payments of principal and interest of their 20 year loan. Do you agree with that?---Yes, I do.

And does that seem strange to you?---No, it does not.

And why is that?---Because it appears to me that at this stage the view had been taken that the deteriorating performance of the hotel business was going to – and other aspects, such as arrears with the ATO, was going to lead to a default in due course, notwithstanding the fact that at that point in time the principal and interest payments were continuing to be made on time as scheduled.

What I wonder about there is whether you would have an expectation, or the bank would have an expectation, that CAM in that circumstance would at least contemplate the possibility of trying to engage with the borrower to prevent a default?---Yes, indeed. And that's – that is one of the primary roles of the CAM or the GCS team is to try and rehabilitate a loan in order to avoid a default or in order to avoid a default leading to a worse situation.

And in this case have you seen anything to indicate that CAM attempted to work with the Stanfords to try to avoid a default?---The evidence that I have seen relates to the period from about this stage onwards, following discussions brought about by the FOS dispute raised by the Stanfords.

I'm sorry, you've – I'm not sure you are quite answering my question but you may be. Are you saying you have seen evidence, after 2011, of CAM attempting to work with the borrowers to prevent a default occurring?---Yes, by – but I should clarify – not by way of the borrowers improving trading to the point where it could continue to trade but, rather, by way of agreeing a timetable for a sale of the hotel, with the sale intended to prevent a default further down the track.

I understand. And that's in 2014, isn't it?---I think from about 2013, early 2013 onwards.

All right. Can we bring up CBA.0001.0285.0119. This is – I expect it's being handed over to you. It's a strategy paper dated 12 April 2013?---Thank you.

And it seems to be a strategy paper from and to Ms Fragar?---Yes.

And she is now, by this time, the senior manager from CAM in charge of managing the Stanfords?---Yes.

And you see in 1.1 she identifies the purpose of the strategy paper, which is to expedite the realisation of the asset, seek approval to enter a deed of forbearance with the borrower with the aim of exchanging contracts by 15 June 2013?---Yes.

With a further extension of up to three months to be considered with the borrower is able to demonstrate genuine hardship?---Yes.

And that, I think – as I understand what you say – is consistent with what you've observed about the approach of CAM in this case, which is insofar as it's a strategy of preventing default, it's preventing default by getting the borrower to sell the asset; is that right?---That's correct, yes.

And the reason, if we go over to page .0120, and we look down at paragraph section 4 at the very bottom of the page?---Yes.

The view that has been taken by Ms Fragar is:

> *The currently debt level is not sustainable therefore the strategy is to exit as soon as possible.*

?---Yes.

And therefore the only option is sale?---Yes.

And she then talks about how it might be possible to expedite the FOS claim so as to then bring about the sale of the property?---Yes.

And then if we go over the page to .0121, when she is talking about the timing of that, she notes in 4.4 that there may be a need to provide a further concession given the hardship of the borrower?---Yes, of Mr Brendan Stanford, yes.

Because he had been admitted to hospital?---That's right.

And I tender that document, Commissioner.

THE COMMISSIONER: Strategy paper 12 April 2013, CBA.0001.0285.129 is exhibit 3.125.

EXHIBIT #3.125 STRATEGY PAPER DATED 12/04/2013 (CBA.0001.0285.129)

MR HODGE: What appears to be the case, Mr Cohen, looking at these documents, is that the bank – with perhaps the exception of Mr Goldsmith – sets itself on the course really from September of 2010 to have the pub sold. Do you agree with that?---Yes. There are – the credit – business credit people seem to have that view from about that point onwards, yes.

And then when it comes to CAM, that's also the approach that CAM takes?---Yes.

It doesn't appear as if CAM contemplates the possibility of trying to, in some fashion, work with the Stanfords to rehabilitate the situation?---I think that's correct, yes.

And it may be, reflecting what we've seen in Ms Fragar's memo, that that's because they view the situation as hopeless?---Yes.

And I just want to understand, from the perspective of the bank now, is this method of managing a borrower something that the bank regards as acceptable?---Can I just clarify when you say "this method".

Yes?---Do you mean - - -

This approach?--- - - - not having as an option the borrower continuing to trade?

Yes?---In cases where the bank considers, with the benefit of expert advice but also on the basis of its own experience, that the situation is irretrievable for the borrower, I think it's acceptable for the bank to go down the course of – another course rather than repatriation, yes. I do think, however, that a full and frank discussion should be held with the borrower about that view and why that view has been arrived at.

And so, in terms of your view about the management of this case – and we haven't yet come to the offers in 2014, so set those aside for the moment – but when it comes to your view about the way in which the bank managed this case through to 2013, do you regard the management as acceptable?---I think the management of it was acceptable in some, but not all respects, and I do think that better management should have been applied here, particularly in terms of a more fulsome discussion with the borrower about the reasons why the bank considered that a sale of the hotel was the only viable option in order to enable the borrower to repay the loan.

THE COMMISSIONER: And should that discussion have related expressly to terms of the facility as they were agreed at the time of its making?---I think so, Commissioner, yes.

The terms as they were agreed and then varied, did they include any term as to LVR?---No, they did not.

Therefore, to speak in terms of irretrievable outcome is to speak about final discharge of the loan at what point? At term, before term? If it's before term, it must be on account of breach. So it's in anticipation of breach, is it?---So it would be before term, Commissioner, yes, it would.

And in anticipation of breach, because breach has not hitherto occurred has it?---Breach had not occurred in respect of LVR, because there was no LVR covenant, that's correct. Breach had occurred in respect of the interest cover ratio and the debt service ratio.

And do we find in any of the communications to the borrowers, other than the issue of notices, explicit reliance on default in those provisions as reasons showing why the bank wished to accelerate to the point of realisation?---Not that I'm aware of, Commissioner, no.

Should the bank have adverted to those matters in the course of its discussions with the customer?---I think that would have been helpful to the customer, yes.

Because the customer will, no doubt, have a particular point of view - - -?---Yes.

- - - about the dealing, and human nature, of course the customer will see it through a particular prism, but a dominant shaft of light through that prism I suspect, for the customer, will be "I kept paying my principal and interest"?---Yes, I agree.

Well, is it right that the bank should – or would it be better if the bank had said "Maybe so, you are paying principal and interest, but interest cover and debt servicing ratios are out of whack. Those are warning signs showing us that this is a path to disaster"?---Yes, I agree.

Go on, Mr Hodge.

MR HODGE: Thank you. And to be fair to you, Mr Cohen, it was the case, wasn't it, that after 2011 there were monetary defaults in relation to the loans?---Yes. There were, yes.

The principal continued to be paid but there was an issue around the interest?---That's right. Well, to be precise, principal at that point, 2011, continued to be paid. There were some interest shortfalls and then unfortunately, as the matter progressed into 2013 and 2014, there were some principal shortfalls as well.

But throughout that period, the bank was never – as far as we can see from the documents – engaging with the borrowers on the premise of, "Can we try to get this back to being a performing loan where you are making principal and interest payments"?---That's my understanding, yes.

The approach by the bank was unequivocally that they wanted to have this property sold?---That's right.

And do you accept that one of the consequences of a bank approaching borrowers in this way is that it imposes a lot of stress on the borrowers?---Yes, I do.

And do you accept that for the bank to take that approach is unfair in this case?---I think in this case the lack of discussion with the borrower, the lack of explanation about why the sale of the hotel was the only option, I think that was not reasonable and not fair to the customer. Unfortunately, the fact is that a sale of an asset is always going to be extremely difficult, the sale of the main undertaking is going to be extremely difficult and I think, from a human point of view in terms of the fact that undertaking a business such as this for the Stanfords was really at the centre of everything they did, everything they were focused on. I think better understanding of that position in the form of more open discussions around why the sale option was perceived to be the only viable option would have been far preferable, yes.

And do you think, in terms of what the community expects, that the approach of the bank would fall – in this case, would fall below community expectations of a bank?---I think community expectations today would require that the bank have a more open and transparent engagement with the borrower in circumstances such as this.

Do you think one of the difficulties, from the community perspective, with understanding the bank's approach in this case, might be the fact that the loan is a 20 year amortising loan. It's not a two year rolling facility for property development?---Yes. I think that might be one of the difficulties in terms of community understanding. I think another difficulty, which is I think very difficult to understand generally, is that the use of non-monetary events of default. or in this case financial ratios, can be a very powerful indicator of trouble to come. And that's not an easily understood concept, I acknowledge, and therefore is not necessarily embedded in community expectations. I think in this case the community expectation would be focused on the fact that payments were continuing to be made, at least up until a certain point. And the expectation, I think, is that if payments continued to be made then the bank should not be taking any action.

I am going to show you another document, which I think your legal team think might be relevant. Can we go to DC-125, which is CBA.4000.0037.5460. And this is Ms Schabel – I think that's her maiden name, she then becomes – she continues to be Ms Fragar, manager?---Yes.

And this is an email that she sends to herself on 14 November 2012?---Yes.

And it's a file note of a conversation with Brendan Stanford?---Yes.

And she is noting that the facility is currently outside of arrangements?---Yes.

And that they:

> *Need to determine whether we can return to the facilities to within arrangements, if not, need to sell the business.*

?---Yes.

And Mr Stanford, that is Brendan Stanford, is saying the strategy remains to sell the business?---Yes.

And Ms Schabel says her next steps are to seek approval to agree strategy providing borrower with one shot to sell the asset according to the strategy?---Yes.

Continuing:

> *If the asset does not sell, seek to enforce immediately with sale as soon as possible.*

?---Yes.

Ie, I'm not sure that that affects any of the observations that you have made, but your lawyers would like it pointed out to you. Is there anything that you want to comment on about that?---Well, the two comments I would make is that according to the note, the discussion with Mr Stanford, at least in part focused on whether the facilities could be returned to within arrangements, which I believed is a reference to ensuring that financial records were provided on time in accordance with the contractual arrangement. Secondly, to ensure that the interest cover ratio and the debt service ratio were within the measures set out in the agreement. So there does seem to be there a sense, at least in the discussion, that could the arrangements be returned to performing arrangements. The second thing is that it appears from this note that the borrowers did have an intention to sell the asset. So at least in that sense, the bank's view that the asset needed to be sold in order to repay the debt and the borrowers' intentions appeared to be somewhat aligned at that stage.

Yes. Although – I'm not sure why, but it's almost as if your lawyers are laying a trap for you, because the problem is this is the send of 2012, and by this stage there has been a year of the – or more, of the bank putting it on the borrower to sell the asset. Do you agree?---That's right. Yes, I do.

And you heard Mr Stanford give evidence yesterday, which is it was apparent to him what the bank wanted and he wanted to try and sell it on his own terms?---That's right, yes.

And certainly when you look at what the next steps are that are identified, there's no suggestion that there will be some focus, if the asset can't be sold by the borrower, in trying to rehabilitate it?---No, I agree with that entirely.

The strategy is, "If they won't sell it, then we will"?---That's correct, yes.

And then – I want to then ask you some questions about the offers that are made at the very death. Now, you know that what happens in January 2014 is that, consistent with the strategy we have seen already, a deed is entered into that gives the – gave the Stanfords until 30 June 2014 to auction the property?---Yes.

And there was engagement with an agent by both the bank and the Stanfords?---Yes.

And there was a marketing proposal put together?---Yes.

And the Stanfords at that stage had a debt to the bank of about $1 million?---Yes, I believe so.

And the marketing proposal suggested that the sale price of the property would be – at auction will be something a lot less than that?---Yes.

We will go to in a moment, but the asset sale would end up being between 550 and 615,000 dollars?---Yes.

And as it got towards 30 June, the property hadn't gone to auction and there was obviously a disagreement about the – what the – not a disagreement. The Stanfords wanted to realise something from the property different to what seemed to be a realistic assessment of the market price?---Yes. It appears so, yes.

And so an offer was made, which we saw in evidence yesterday, and we might bring that up, which is CBA.0617.0118.0001. And the offer made on 26 June 2014 was, there were a few different alternatives, but the primary alternative was to restructure the bank facilities. I'm not sure that that's in your documents, Mr Cohen. I don't think it is, but we tendered it yesterday. I think it's just being run over to you now?---Thank you.

This is the top of the page is the response from Bankwest but at the bottom of the page, the offer begins and if we go over the page to .0002, the bank is asked to consider a restructure of the facilities, with a few different elements, but one of it is that there be a $200,000 deposit made within what is roughly a week, a further $100,000 within 30 days and that then the loans be restructured as $700,000 to be refinanced over 15 years and for them – and it's explained by the accountant that this is affordable?---Yes.

And then the response, if we go back to the first page, is:

> *The bank has provided numerous concessions to Michael and Brendan Stanford. The bank is unable to accept the proposal.*

?---Yes.

And then if we go to a document that we haven't looked at yet, which is CBA.0517.0118.0007. Again, I don't think this is in your exhibits. So this is an internal email of Bankwest where Ms Fragar is explaining why she has rejected the offer?---Yes.

And she makes a number of points. The first is:

> *The borrowers have had over two years to work out the issues.*

Do you see that?---Yes.

The third is she doesn't have confidence that Michael and Brendan will be able to run the pub and meet ongoing principal and interest payments?---Yes.

The fifth is:

> *I have not been kept abreast or involved in any of their plans or thoughts. From my point of view they have not at any stage shown any genuine interest in selling the pub.*

?---Yes.

And then at the end, she says:

While the offer of $300,000 outside of current security is pleasing, I have concerns about the conditions on which the cash will be provided.

?---Yes.

And if we could just clarify some matters about this. It doesn't appear, does it, as if Bankwest had been engaging with the Stanfords about any plans they might have for continuing to run the pub?---I'm not aware of any, no.

And that's unsurprising, because what Bankwest was looking for was an exit by the sale of the pub?---Yes.

And I tender that document Commissioner.

THE COMMISSIONER: Emails between Fragar and Medway, 27 June 2014, CBA.0517.0018.0007, exhibit 3.126.

EXHIBIT #3.126 EMAILS BETWEEN FRAGAR AND MEDWAY DATED 27/06/2014 (CBA.0517.0018.0007)

MR HODGE: And then if we bring up RCD.0024.0015.0001. I'm sorry, I should – before we do that, can we bring up CBA.0001.0315.6416. So this is internal emails from Bankwest. It's not in your documents, Mr Cohen. It's being run over to you?---Thank you.

So these are internal emails of Bankwest. And what is being recorded on the 30 June 2014 is that Mr Hornstra has received a call from Michael Stanford?---Yes.

And on 30 June Michael Stanford has made the offer in the call to reduce the debt by $400,000 and restructure with Bankwest?---Yes.

And Mr Hornstra just notes "Declined"?---Yes.

And then says:

May consider to pay the $400,000 to Bankwest and seek a further six weeks.

?---Yes.

I tender that document, Commissioner.

THE COMMISSIONER: Email between Bates and Hornstra, 1 July 2014, CBA.0001.0315.6416, exhibit 3.127.

EXHIBIT #3.127 EMAIL BETWEEN BATES AND HORNSTRA DATED 01/07/2014 (CBA.0001.0315.6416)

MR HODGE: Thank you. Then if we go back to RCD.0024.0015.0001. So this is the email chain that was tendered yesterday. If we go over the page to .0002, and can we pop up on the one side of the page .0002, and on the other side of the page .0003. I don't know – you don't have a hard copy of that, Mr Cohen?---No. I will try and read the screen for the moment.

We will try to bring it over?---Thank you.

And so this is the email from Mr Medway, the accountant, to Mr Hornstra of the bank and you see on the – I'm sorry, we have got two copies of the same page on the screen. It should be the first page – it should .0002 and then .0003. Thank you. And at the end of the email on page .0003, this is where Mr Medway explains that, as had already been discussed with Mr Stanford, the parties had secured non-repayable moneys of $400,000?---Yes.

And if the bank was prepared to consider a refinance, they had that extra money to use?---Yes.

But, as he says, they don't want to just roll the money into the existing debt if the bank is not going to refinance with them?---Yes.

And he then makes a proposal, and then an alternative proposal, as to what might be done?---Yes.

And then if we go to the top of page .0002, the response from Mr Hornstra is:

> *Thank you for your email. And I note its contents. In short, we will not engage in a further banking relationship and simply require to be repaid.*

And then Mr Hornstra makes the offer that if the Stanfords want to pay $400,000 within the next two days, the bank may consider a further period of eight weeks to allow the Stanfords to go and seek refinance?---Yes.

And I'm interested in understanding your view about the bank's approach at this stage. Is this an approach that seems reasonable to you?---Can I deal with that in several aspects, because I think it depends on a number of aspects. Firstly, I find the email dated 2 July – I find the language of that somewhat curt and unfriendly to the – admittedly to the accountant, but effectively to the borrower. So I find that not acceptable. Secondly, in terms of the refusal of the offer, I do understand why it was refused, and I have made inquiries in the course of preparing for today about why it was refused, and my understanding is that there was significant concern about involving a third party who is going to provide up to $400,000 in circumstances where the bank, or Bankwest, considered that that money may very well be lost, or at least a good portion of it may be lost in the long run, given the view that the hotel was going to be unable to trade to a level that would enable repayment in due course. And, for that matter, there was concern that it would be unable to be refinanced as well. So the account manager had serious concern that the situation may be – may get worse for the Stanfords, admittedly for a partner of Michael Stanford, if that offer was to proceed as proposed.

And can I ask which account manager are you referring to there?---This is Ms Fragar.

All right. And so that we can – I think I asked some questions of Mr Stanford about this yesterday. And the risk, if I put it in my way, is that they could pay $400,000 and reduce at that point in time the level of debt owed to the bank. That would be the first step of what occurred?---That's right.

And the bank might then, or the premise of it would be the bank would refinance for a 15 year term, which was a slightly longer term than what was otherwise outstanding on the loan?---That's right.

And there would be repayments that would then have to be made?---That's correct.

But at the time the bank had the view that this was a depreciating asset, but it was a depreciating asset because the value of the asset reflected the value of the earnings that were being made?---That's correct, yes.

And so as the asset fell, that reflected a fall in the earnings of the business?---Actually, the other way around. As the earnings fell - - -

Sorry, as the – you are quite right?---Yes.

As the earnings fell, that resulted in a fall in the value of the asset?---That's correct, yes.

And if the earnings continued to fall then it might not be possible to make the payments under the refinance facility?---That's correct.

And then you might be right back to the point that you were in to begin with, which is that the bank is then going to inevitably have to take enforcement action?---That's correct.

And at that point in time the Stanfords, Michael and Brendan but together with their partners, end up being worse off because they've lost their $400,000, and if the value of the property hasn't improved in some fashion then they're also no better off in terms of paying out the debt?---That was the concern of the file manager, yes.

And in her note she makes the point, which I directed you to, which is she didn't have any confidence that they would be able to make principal and interest payments?---That's correct.

Now, I was then going to turn, Commissioner, to deal with some more general issues. Did you have any further questions you wanted to ask?

THE COMMISSIONER: Not in respect of this aspect of the matter. Is it better that we break off now or start on the general issues?

MR HODGE: I would be happy to break off now, Commissioner. And perhaps if we could – would it be possible to resume at 1.55. That is, we allow ourselves only one hour.

THE COMMISSIONER: I thought I was the slave driver, Mr Hodge. I've been giving a fair imitation of it. Yes. Well, we will adjourn until 1.55, if you can be back at that time, please, Mr Cohen.

ADJOURNED **[12.55 pm]**

RESUMED **[1.55 pm]**

THE COMMISSIONER: Yes, Mr Hodge.

MR HODGE: Thank you, Commissioner.

Mr Cohen, I wanted to finish off on a couple of minor things arising from the issues we were talking about before lunch about the offers. The discussions that you have had internally were discussions with Ms Fragar; is that right?---That's correct, yes.

And we looked at Ms Fragar's response to the offer. There was also the subsequent response that came from Mr Hornstra?---Yes.

And you will recall Mr Hornstra took a slightly different tack from Ms Fragar, in the sense that he suggested that if they would pay the $400,000 to the bank, then the bank would be prepared to consider allowing a period of eight weeks to renew the – or to refinance the facility?---May consider, yes. I think it referred to six weeks.

I think his – internally, he sent an email saying six weeks but then in the actual email that he sent – we can bring it up, if that would help?---Yes.

It's RCD.0024.0015.0001 and if we go to .0002 you will see:

> *Should you however wish to repay $400,000 before 4 July 2014 –*

so that's two days later –

the bank may consider a period of up to eight weeks to allow you to seek refinance, with the full residual debt being cleared at the end of that period.

?---Yes.

And I just want to make sure I understand your view about it. The view that Ms Fragar had expressed, the concern which is bringing in a third party and having that third party put, even though it's the partner, nevertheless putting personal borrowings on the line. I think when you were explaining Ms Fragar's view, that was a view that you approved of or shared; is that fair?---Yes, it's a – yes, that's fair.

And this tack of suggesting that the personal borrowings of now $400,000 be paid in and then the bank would consider a period of allowing eight weeks to refinance, that seems inconsistent with that approach of, or that view of Ms Fragar; do you agree?---Yes, it does. And my understanding is that Mr Hornstra was stepping in managing that file while Ms Fragar was on leave. So he may not have been - - -

May not have understood?---As fully up to speed, yes.

And is it fair to say the suggestion which he makes, which is the bank will take the $400,000 and then might consider allowing a period of eight weeks to allow them to seek refinance, is something that you would think that probably shouldn't have been done?---I tend to think it should not have been done because of the issues that we've discussed, namely involving a third party putting a substantial sum of money into the hotel operation where the prospects for success were doubtful.

And also all that's – this isn't even $400,000 to allow the business to continue with the refinance from the bank. This is $400,000 with the bank then being prepared to consider whether it would allow eight weeks to seek refinance from somebody else?---That's right.

Which would mean (a) the bank might then decide it didn't actually want to allow another eight weeks?---That would be one possibility.

And (b) it might allow eight weeks and then at the end of eight weeks it wouldn't have been possible to refinance anyway?---That's correct.

And, indeed, the internal notes suggest there was no expectation that it would be possible to refinance?---That's correct.

So that then, at the end of the eight weeks, the consequence would have been the bank would have then appointed a receiver?---That's likely, yes.

And the recovery – there still would have been more than $600,000 owed to the bank?---That's correct.

And the expected recovery was going to be $600,000 or less, essentially?---Yes, that's right.

So that the bank's debt would be cleared in this scenario or nearly cleared?---Nearly cleared, yes.

But the Stanfords would have lost both the hotel and also the partner would have lost the $400,000?---The $400,000 exactly. So the view taken, as I understand it, was that that was a worse outcome, potentially, for the Stanfords.

Well, that's – and again we just need to be careful about this, that was the view taken by Ms Fragar - - -?---Ms Fragar.

- - - when she rejected it. She just didn't entertain it at all; is that right?---That's correct, yes.

Whereas it wasn't rejected by the other person who came in?---That's correct.

But, for the reasons we have just talked about, do you agree it should never have been suggested?---I don't think it should have been suggested.

And what I then want to move from – we can take that document down – what I then want to move to from that is to understand something about the incentives that work for somebody in CAM and also for somebody in the GCS?---Yes.

And I understand you address some of this – some of the detail of this in your statement?---Yes.

And I – we don't need to go into the detail of it, I don't think, but is it fair to say that a significant performance measure for somebody who – we will take it at the time – as at 2013/2014, for somebody in what was CAM and had then become the GCS was, first, the length of time that they had had TAE within their portfolio, within their responsibility?---It was one of the performance measures, yes.

And what that means is a file would get transferred over from the ordinary business unit into what was CAM, and by this stage was the GCS; that's the first stage?---Yes.

And that would have a TAE which, as we have look at before, might not necessarily reflect – might not necessarily be the exact amount borrowed, it might be the potential amount that could be borrowed?---Yes.

So that file moving in would then increase the TAE that was under the responsibility of the particular manager?---Of the particular manager, that's right.

And one of the responsibility – or one of the measures that was applied to a manager was the age of files that were within their control and were adding to their TAE?---That was one of the measures, yes.

And another measure was the reduction in TAE during the course of the relevant measurement period?---That's correct, yes.

And so what that reflects is that the responsibility of a manager within CAM, and what was then – then became the GCS was to try to move on, as quickly as possible, a file out of CAM. Now, that could happen in two ways. We will come back that. But is that fair, that they need to try to move it out of their responsibility?---No, I don't think it's correct to say that the purpose or intent was to move it out as quickly as possible but it is correct that the spent was to move files through, so that they were either rehabilitated or exited. And the purpose behind that was to ensure that the particular file manager was active in their approach and just didn't leave matters dormant or unaddressed for long periods of time.

But that means, does it not, in order to meet the two metrics we've talked about, the manager needs to focus on either rehabilitating or exiting as many loans as possible during the course of the year?---No. No, that's not correct, because the assessment of the manager's performance will take into account the complexity of the particular files under the control of the file manager, so that if a file was particularly complex, it would necessarily take a lot longer to deal with and allowance would be made for that.

And just so I understand that: do you recall whether CAM and the GCS were using a balanced score card or something like that to measure the performance of their employees?---That's correct, they were.

And so was one of the components of that score card directly related to reducing the amount of TAE and also the – reducing the, effectively, the age of the TAE within the control of the manager?---So those two elements were part of the balance score card under the heading of Risk and Return.

And when you speak about the idea of taking into account the complexity of a loan - - -?---Yes.

- - - is that something that would feature as part of that element of the balance score card or of a different element?---No, it would be part of that element of the score card.

All right. And so the – does that mean that an adjustment is made according to whether or not the loan is particularly complex or not?---Yes, that's correct.

And so there would be a – it would be less important to move on a very complex loan than to move on a less complex loan?---I'm not sure that importance was the relevant factor. What was important was the circumstances of each individual loan which, in turn, would have a significant influence on how quickly that loan could be either remediated and moved back to pass grade or negotiated with a customer or enforced against.

And in the case of the Stanfords' loan, as at 2014, would one of the difficulties with the loan have been that even if the money had been accepted and even if there had been a refinance, that it was unlikely that the loan – that that, by itself, would return the loan to pass grade?---If I understand the question correctly, refinance of course would not return the loan to pass grade, because the loan would no longer be part of Bankwest's portfolio.

I'm sorry. If it was refinanced in the way – I use it in the way that it was put in the accountant's email which was that the loan would be restructured, is perhaps a better word?---I beg your pardon.

Which is the loan is restructured so that it's done as a 15 year loan to – for the Stanfords to pay out the balance to Bankwest, with the $400,000 money being used to pay down the capital. So if we take that as the premise a difficulty with that would be, even at that point, the LVR would not be within the lending policy of Bankwest?---Depending on the value of the property. So the reduction of the outstanding loan amount by $400,000 would obviously benefit the LVR calculation. That, however, would depend on the actual value of the property at that time.

Bearing in mind that would reduce the balance outstanding to a little over $600,000?---That's correct.

And the value being put on the property at the time was somewhere between 550 and $615,000?---That's correct.

So it's likely that the LVR would be close to, or exceed 100 per cent?---That's correct.

And that would put it outside of the lending policy?---That would put it outside the policy at the time. That per se would not automatically rule out that loan being restructured.

But if it was restructured in that way, it wouldn't follow that its risk grade would fall back to a point where it could be passed back to CAM?---Not automatically, no, that's correct.

And so one of the issues would be that if you were judging managers by the metric of have they managed to rehabilitate or exited a loan, this whole arrangement wouldn't achieve either of those outcomes?---It would not achieve the outcome of – well, it would reduce the outcome of reducing TAE. It would not necessarily achieve the outcome of finalising the file one way or the other within a timeframe.

All right. And my question then is: do you think that that's a problem with the way in which incentives are structured for CAM or the GCS?---No, I don't, for several reasons.

All right. And would you like to tell the Commissioner what those are?---Yes. The structure of the balance score card, particularly when it comes to the risk and return element of the balance score card, whilst it does obtain a measure which looks at the extent to which TAE is reduced over a 12 month period, and it does look at measuring the files being moved through the system over a period as well, ultimately, however, the assessment is made by a manager who has experience in how appropriate it is to deal with files in a certain way. And so whilst the incentive may, on its face, appear as if it gives a reason for pushing a file through to closure in one form or another quickly, ultimately the assessment is made by an experienced manager who usually has years of experience in understanding how these things work and taking into account what's feasible given the circumstances of the files within the file manager's control. And so, as I referred to earlier, if that file manager has particular files which are very complex, either because of the borrowing structure or because of the loan structure or because of the circumstances of the borrower, then a manager in making an assessment the file manager, will take that – those circumstances into account in determining how appropriate it is to measure the employee strictly against the TAE reduction or the file turnover.

I wonder though, and this perhaps helps to move us into the issue that – or the – one of the last issues I wanted to deal with you about: the issue I want to explore with you is the issue of negative versus positive incentives?---Yes.

And I think, as I understand it, the point that you're making is that the senior manager, who is making the assessment of the performance of the relevant person within CAM, would take into account whether a file was particularly complicated or not before effectively marking the manager down for not having managed to reduce their TAE or not having moved the file on?---Yes.

That's a slightly different thing, though, from whether there's any incentive in the case of, say, the Stanfords, to put in place or look to put in place an arrangement that is going to prolong the banking relationship with somebody who is in CAM or the GCS. Do you agree?---Yes, I do agree. It is different. There are, however, measures in the score card which do incentivise a file manager away from taking excessively swift action or even, in particular, taking enforcement action. So one of the requirements of the KPIs is that the file manager minimise loss to, in this case, Bankwest. The reason that's an incentive not to rush to enforcement is because invariably, when a bank enforces against a customer, it loses money. And so a file manager is incentive to minimise loss. That minimisation of loss is usually best achieved through rehabilitating a file or reaching an agreement with a customer about how to proceed, rather than going to enforcement, because invariably banks lose money when they enforce, as was the case in the Stanfords' matter.

Well, the type of incentive you are talking about, which is to minimise loss, I just want to understand the point that you're making. That might well encourage a file manager, as a first option, to try to push the borrower to sell the asset rather than the bank entering into possession or appointing a receiver or manager. You agree with that?---That could be an outcome, yes.

And that seems to have been the approach that was adopted by Bankwest in relation to the Stanfords?---Yes.

But, again, that seems to be a slightly different thing from incentivising the file manager to look to try to restructure the arrangement with the borrower and thereby prolong the relationship between the borrower and the bank?---No, I don't necessarily agree, because prolonging the relationship – well, if I can go back a step. The best outcome for a bank is for a customer to successfully repay the loan. So an incentive for a file manager here would be to potentially restructure the loan in such a way that there was a greater certainty that the customer would successfully repay the loan in due course. That would be a successful outcome for the file manager and the customer and the bank.

Now, what I wonder then is, apart from that incentive, which is to avoid making loss?---Yes.

Is there any other incentive, as you see the balanced score card, to try to find a way to restructure the arrangement with the borrower in a way that avoids having to force an exit by the borrower?---Yes. Another element of the score card, which from memory was on average worth about a 20 per cent weighting, was what was called customer focus. And that was a requirement that a file manager in GCS conduct themselves with the customer so as to satisfy the customer, and I'm talking about the external customer, satisfy the customer to avoid complaints from the customer, and to manage a customer's expectations along the way. So there was a positive incentive to engage well with a customer.

And how, for that 20 per cent for the customer relationship, how did that get measured? Was that by surveys of customers, counts of complaints?---It was a combination of some quantitative measures which were numbers of complaints or number of compliments and then qualitative measures, which was the assessment of the manager, the assessment of relationship managers who would obviously have the ongoing relationship with customers, particularly if it was a jointly managed file. So it was a combination of both quantitative and qualitative.

And the qualitative, just so I understand, is the assessment by the relationship manager of the performance of the CAM/GCS manager; is that right?---No, the input from the relationship manager. So, for example, the manager of the CAMs file manager would seek input from various people as to the performance of that file manager and one of the people they would seek input from would be the relationship manager. But I should stress that would be primarily where the relationship manager and CAM have ongoing involvement with each other in connection with the customer.

And if you think about the things that in this Stanfords case you think are either unfair or not done as well as they ought to have been and we take those in turn. So the first is the provision of the dealing with the bank between the bank and the customer about the appointment of an IA before the appointment was made - - -?---Yes.

- - - are there parts of the balance score card which you think incentivise the CAM manager to do that or the GCS Mr Goldsmith is recording to do that?---I think the customer focus element of the score card is an incentive yes.

That's the 20 per cent down by the relationship manager and the counts of number of complaints or compliments?---Yes, And the assessment of the GCS file manager's immediate manager.

All right. And similarly, when it comes to engaging with the customer about the outcome of the independent accountant's report, is there an incentive that you see in the balanced score card to encourage that sort of behaviour?---Yes. Again, I would put that in the category of the customer focus element of that score card.

The 20 per cent for the customer focus?---Yes. Yes.

And when it comes to communicating the bank's approach or the bank's concerns more generally about the file and how it should be managed, again, do you see an incentive within the balance score card to do that?---Yes, both within the customer focus element of the score card and also the risk and return element of the score card. The risk and return element of the score card included an obligation on the file manager to manage risks associated with the portfolio of files that they handled. And one of the risks, obviously, is that matters between the bank and the customer do not proceed well. For example, through a lack of engagement or a lack of communication or a lack of expectation management. And similarly, the risk and return element of the score card required compliance with policies. So, to the extent that a file manager did not comply with policy by engaging with a borrower, then there was an incentive in that component of the score card.

Now, I then want to step further back away from that and just try to put this in the context of your role now as the chief risk officer. Is the formulation of the balance score cards something that forms part of risk management for the bank?---Yes, it is. The score card that we use within risk management is derived from an overall score card approach used throughout the bank.

And – but when it comes to each individual sections balance score card is that something that your risk section has an input into?---Sorry, do you mean in the design of the score card?

Yes?---The design of the score card is generally determined at a bank-wide level. So the elements of the score card, or the categories, if I can call it that, of the score card are determined at a bank-wide level. Then when that is translated down into an individual area, such as risk management, the detail behind each element is then designed specific to the alternatives undertaken by that business area, in this case risk management.

And in this particular case that we have looked at, wearing your hat as the chief risk officer, do you see any failings in terms of risk management in relation to the file?---In relation to the Stanford matter?

Yes?---So the failings I think, as I've mentioned, are definitely in connection with customer engagement, yes, I think there should have been stronger communication with the customer and more transparent communication with the customer around the investigative accountant's report and the issues that concerned Bankwest.

Is that, though – sorry, the issues that concerned Bankwest?---Yes, the issues around the trading, the profitability of the hotel, the issues that concerned Bankwest about the future ability of the borrowers to repay the debt.

And that customer experience issue, is that a risk management issue or is that something separate?---Well, in this particular case, the communication with the customer was undertaken by members of the CAM team, and the CAM team were part of risk management, so yes it was part of risk management's responsibility.

Right. Now then, if we step back again even further, and you consider some of the things that the Commission has looked at in this module and in other modules in relation to misconduct that has been identified by CBA, does that reflect, in your view, an issue in relation to risk management?---I think there are some issues that are quite complex, because they involve a number of balancing of different factors. Sometimes competing factors. Some of those are very specific to customer engagement and, as I have said, I think there were shortcomings in respect of how the Stanfords were engaged on a number of aspects. However, there are very – there are some much broader and complex issues around how files such as this are handled. And I don't want to go into too discursive an answer, but there are three broad issues that come to bear in these types of cases. One is prudential obligations to appropriately provision which is borne out of the fact that it's depositor's money that is being lent. So 61 cent of every dollar that we lend belongs to depositors. So prudential are very focused on protecting depositors. Those in turn drive prudential standards about provisioning, for example. So there is one level of driver for risk management to focus on prudential standards. There's a second element, which is the role the banks play in funding the economy. And by that I mean because Australia is a net importer of capital, banks have a role in recycling capital, and recycling capital occurs through, for example, one loan finishing and a decision by a bank, for example, not to renew that loan but to lend the money to someone else, another business. And that's a very important role the banks play, but it does actually raise some difficult customer conversations sometimes when a customer is hoping or even expecting that a loan will be rolled over. The third element that competes with those two is customer interests. And I don't mean depositor's interests when I say that, I mean borrower's interests, because sometimes the obligation at the prudential level to protect depositor's funds – and that can translate into, for example, taking action against a borrower in order to protect a depositor's funds and satisfy prudential obligations. It might also mean that one should recycle capital, but that can have a devastating effect on the individual borrower, particularly if it's a small business. The intersection competing factors, almost like a Venn diagram if you will, lies right at the heart of some of the judgments that have to be made in risk management. And we seek to get those judgments right, but that's not always the case, and those judgments are not a black and white issue, they are often subjective.

Just step back for a moment from the lending decision to make a loan to the Stanfords and think about, as you know, CBA has over the course of the last few months acknowledged both here and in other forums misconduct of various kinds?---Yes.

And to take a specific example that has been dealt with in this hearing, you know that there was an acknowledgement in relation to the charging of what I think this is referred to as double interest, it seems to be actually be slightly higher than double interest, but double interest in relation to certain overdraft accounts is one example?---Yes.

But there are, as you know, many others that have been identified?---Yes.

And I just want you to focus, for a moment, on whether you see some intersection between the performance of the risk function within the bank and the extent of those identified problems?---Yes, I do. And particularly in two areas. Those are the areas of operational risk and compliance risk. If I can deal with each of those.

Yes?---Operational risk manifests itself when a bank acts in a way that exposes itself to some loss and, in the case of, if I can take the example of the overcharging of interest, that is an issue that occurred, as I understand it, as a result of some system or administration problems. A bank, with a sound operational risk system would seek to avoid those issues arising in the first place by putting – by doing a couple of things. First, identifying the risk. So in this case, identifying the risk of a system overcharge. Secondly, designing controls that would mitigate or eliminate that risk. And thirdly, testing those controls to see that they are effective and if they are not improving controls. Those three elements are the role of an operational risk function in a bank.

And sorry, just before you move on to compliance risk, did you say the way in which you see an operational risk is something that exposes the bank to some loss; is that - - -?---To a risk of loss or a risk of reputational harm, or to expose customers to loss or customers to some form of harm, yes.

And then you then were going to make a comment about compliance risk?---Yes. I was just going to finish quickly on operational risk, and that is simply to say that the operational risk team within risk management has responsibility for – not for doing all of that, but for certainly assisting the business. Because operational risk mitigation sits within business lines as well as in the risk management team. So the two have to work together. That's our lines one and two that we were referring to yesterday, working together. Compliance risk is similar. Compliance risk involves identifying compliance obligations. So legal obligations, regulatory obligations, guidelines, prudential standards, etcetera. Working with a business to design how compliance will be achieved, putting in place mitigants to avoid non-compliances. And that's designed to avoid obviously legal and regulatory penalties but also to avoid reputational harm that can flow from those incidents occurring in the first place.

So does it follow then, from what you are saying, if you are identifying some of the issues that have been faced by CBA as intersecting with the risk functions that there has been some failure of the risk function over time?---Well, I think it's fair to say that the risk function has not always performed as it should have. So, in that sense of a failure, yes. I think we've acknowledged that at CBA in a number of ways in the recent times.

And to assist the Commissioner to try to work through this more general issue, what are the things that might have contributed to that failure?---I think we need to be quite specific about what the failure is. I could probably talk for much longer than you would be willing to listen to me about aspects of this. But if we could be a little bit specific about the failures I could - - -

As I understand it, what you're positing is that there's two types of risk that the risk function is, or ought to deal with, which are operational risk and compliance risk which have then led to or have then been intersected with some of the issues that have arisen over the course of – or been revealed over the course of the last year or so?---Yes.

And I had thought that you were suggesting that what that reflected was, therefore, some inadequacies, which CBA is now seeking to address, in relation to how its risk function deals with operational risk and compliance risk; is that right?---Yes, that's correct. The risk function and the organisation as a whole.

And those aren't issues that are specific to any particular – to particular incidents of misconduct, they're more general than that; is that right?---They are more general to that, yes.

And so if we take the things that might have contributed to it, is one of them concerned with remuneration incentives?---I don't believe so, no.

And just to be clear, by what we are each meaning by that, you mean you don't think that has contributed to any failure within the risk function or you don't think that has contributed to any of the problems that have arisen?---I don't think that's a factor in the risk function, no. No.

And what about more generally in relation to the problems that have arisen, bearing in mind for some context, one of the things that is obviously of continued interest both in this Commission and outside of the Commission is the Sedgewick report in relation to incentives?---Yes.

So I just want to be clear: you are not suggesting you don't think remuneration incentives have some relevance to the problems more generally. You are just referring specifically to the risk function; is that right?---Yes, that's correct, that's correct.

All right. And in terms of the culture, then, within the risk area, is there – are there issues that you have identified, now that you are responsible for risk, in the culture of risk management at the bank?---No. I don't believe so, other than in one respect.

And what is that?---I think in the past, potentially, the risk function has not been sufficiently challenging of the business. In other words, I don't think the risk function has always challenged as vigorously as it otherwise might, and as a result, has potentially not put the business to a greater level of proof about the way it is doing things.

Is an issue that you've identified within, or a problem that you've identified with the carrying out of the risk function, being able to recruit the right people to work within your risk section?---It is the case today that recruiting is difficult. That's primarily because there is a higher demand than has been in existence in the last few years for suitably qualified people, particularly in operational risk and compliance risk and financial crime compliance. So the – it is more difficult to recruit today. I think financial institutions generally are much more aware of the need to have better risk management functions. The pool in Australia for highly qualified risk professionals in numbers is not deep and so there are some difficulties at the moment in recruiting, particularly in those three areas.

And in terms of what are, if I use the term major risk initiatives, does that have a meaning to you?---Yes, it does.

All right. Maybe if you explain to the Commissioner what would be meant by the term major risk initiatives?---Well, Commissioner, I've – since coming into the role in July 2016, I carried out an assessment of initiatives that I thought needed to be undertaken in order to address shortcomings in some of the ways in which risk was managed. And commenced a program in 2017 identifying nine key areas where I felt the risk management function needed to substantially improve its approach. And so I think that might be what you're referring to, Mr Hodge.

And could you give some examples of those types of nine areas?---Yes. In no particular order, one of the areas was what we call three lines of accountability. So a reference back to the three lines of defence model that we were discussing yesterday. Three lines of accountability is I identified that there was a lack of clarity between the business line and the risk function as to who did what. And my view has been and it remains that it's very, very important for the risk function to be performing true line 2 risk management activities not business operational activities. And it's only by performing two line risk activities that a risk function can concentrate on what it should be doing and to do that very well. And previously there had been a blurring. So that's one. Secondly, we've focused very much on policy simplification. And in particular, focusing on credit policies. So that for the lenders in the business, they can access policies very easily, credit policies that is, so lending policies. They can understand those policies very easily. They can apply them very easily. So that our standard of lending improves. I have – one of the initiatives is about the operational risk and the compliance risk operating model and by that I simply mean that we changed our models so that the operational risk team spanned the entire Commonwealth Bank group as a single team rather than in the past being a team that had a small centre or group team, with separate operational risk teams sitting in each business unit and we did the same for compliance. In fact, we pulled compliance out from under operational risk and made it a stand-alone risk type with a stand-alone leader. So those are some of the initiatives.

And have some of them been easier to implement than others since you've come in or – so of the – some of them, let me - - -?---Yes.

- - - put that a different way. Some of them you have implemented already?---Yes, we have. Our risk appetite strategy for example. So I felt it was very important that the organisation have a very clear view on what its risk appetite was, and whilst we had a risk appetite previously, it was quite a lengthy document. The average employee would not be able to pick it up and easily understand what was the organisation's risk appetite in areas such as profit, capital, liquidity and conduct. And I wanted to have some very clear statements in the organisation adopted from the board – by the board, sorry, and then cascaded through the organisation. Now, we have completed that. We completed that in August of last year, when the board adopted a new risk appetite statement. So that I now categorise as achieved, and now part of business as usual, and as part of business as usual we refine the risk appetite statement according to changes that we experience along the way, such as financial crime compliance, for example. Others are still in train, such as the line at least of accountability and the policy simplification.

And have there been challenges, or challenges that were unexpected, in implementing some of those initiatives?---I would say that one challenge in respect of three lines of accountability has been that, as we have gone into individual businesses and looked very closely at what the business people do and what the risk management function does, and as we have identified which activities are not risk management activities, then comes the question of moving those activities out of risk management into the business. We have not encountered differences of opinion as to whether the activities should sit in the risk function or the business. Where we have encountered challenges is in actually moving those people and deciding where they were going to sit, how they are going to be run in the business. Not insurmountable challenges, and challenges that we are dealing with, but they do take some time.

And do you have the view that the reforming of the risk management function within CBA has taken longer than you would have liked to after you took control of it?---No. I think I took a very realistic view that making these changes would take a significant period of time. Some less time than others. One of the initiatives was to significantly revamp our risk systems and by that I mean our computer systems and the systems that we use for measuring and reporting on risk. I always took the view that that was a three to five year project because significant investment would be needed and it takes time to invest in large projects like that.

So, from your perspective, none of the major initiatives that you've attempted to, or that you have set about putting in place, have – in terms of the time they're taking – taken any different timeline than what you had expected?---Not particularly, no.

All right. And the last thing that I want to ask you, just again stepping back even further from this, is the general function of what risk is about. Is it your view that the fundamental purpose of the risk function is to avoid bad things occurring and if they do occur, minimising the consequences, or is there something more to the risk function than that?---No, there is something more. I think it's important to understand that the risk function doesn't stop things happening, necessarily. Things happen in the business lines as well as in support units, but the people in the business line or in the support unit are there on the ground day-to-day dealing with matters. The risk function's role is to help those business lines identify the risks and then put in place controls. So the primary role of the function is to be able to identify risks, to raise those risks, to then help the business control those risks, to test whether those controls – or at least have an overview of a testing of those controls to see whether mitigation steps are working and then, if they're not, helping redesign so as to help avoid the risks. When a risk does occur, when an issue does occur, yes, the risk management function has a role in helping to minimise the fallout, whether that be an operational fallout, a financial fallout, a customer impact, is to help minimise, and the risk function works closely with the businesses in doing that.

And is the function of risk management then, in connection to the long-term reputation of the institution, to assist business units to try to identify things that might have some negative consequence for the long-term reputation of the institution. And, if those things are identified, to either take steps to prevent them occurring or to minimise the effect of them? Is that a fair summary of - - -?---I think that's a fair summary, with an emphasis on taking steps to try and avoid the issue arising in the first place because, particularly in the context of conduct, for example, conduct risk, once the conduct has occurred then the reputational damage, the financial loss, the customer harm, has started to flow already. So the emphasis therefore needs necessarily to be on preventing issues in the first place through accurate identification and strong controls.

Commissioner, I don't have any further questions for Mr Cohen.

THE COMMISSIONER: Can I just ask some other matters arising out of that same general subject matter. Mr Cohen, you spoke of revamping the risk system and that that was a task you foresaw as occupying years rather than weeks?---Yes.

Are you familiar with the fact that immediately after appointment I wrote to, amongst others, Commbank asking for submissions identifying misconduct?---Yes.

And are you familiar with the submission that Commbank then made on 29 January?---I saw it just before it was lodged, Commissioner, yes.

And as you know I wrote, after that and other submissions were received, a further set of inquiries to Commonwealth Bank and others asking the bank and others to identify misconduct events that had been identified in the preceding five years?---Yes.

Are you familiar with that fact?---Yes, I am.

And did you see the response that was made to that inquiry?---Yes.

Was the response to the effect that that was not information that the bank could readily supply?---That's correct, yes.

Are you familiar with the fact that during, I think it was the first round of hearings, Commonwealth Bank, having heard Counsel Assisting open the matter in a particular way, towards the end of that round of hearings produced two tables of identified misconduct relating to the previous five years?---Yes, I am.

What, if anything, does that course of events tell me about Commonwealth Bank's capacity at the start of this calendar year to identify events, including breaches of law, in the immediately preceding five or perhaps 10 years?---Commissioner, I think it tells you that the state of our systems that recorded and aggregated instances of misconduct, such as those that were eventually provided to you, were not particularly advanced. They were not particularly well connected. The difficulty that the bank experienced was that various incidents of misconduct were recorded on different systems in different business units, without necessarily being all encompassed in a single business unit. In the risk management function, we have a tool that you may have heard of called risk insight.

I've seen Excel spreadsheets generated by that, yes?---Yes. They're not always the easiest documents to navigate.

Yes?---I share that same difficulty, if it is any consolation. The risk insight tool is meant to be the single repository of all relevant issues.

You look at the printout and you discover that somebody has logged that at branch X, customer service officer was rude to customer sitting alongside an event that, at least if it happened to be recorded entirely accurately, would be of a - - -?---Serious.

- - - rather more serious kind?---I agree. And the – so while the risk insight tool seeks to be the sole repository, it unfortunately has not always been. It is highly dependent on people logging issues into that tool. That is partly the function of the risk management team, partly the function of business people. However, the great difficulty we had is that the ability to use that risk insight tool in order – for example, search and therefore get and deliver into a report instances of misconduct – is extremely limited.

I understand that, and that's not the detail of risk insight that I want to stay on. It is to move from that to an understanding of control of regulatory and reputational risk and whether the course of events that I have described bears in any way upon the way in which compliance risk and reputational risk was being managed, at least at the start of this calendar year, in Commonwealth Bank. And we will come in a moment to what, if anything, changes about that. But first does it tell me anything about the state of play at the start of the calendar year?---I think it does, Commissioner. So - - -

What does it tell me?---So, apart from – apart from the inability to aggregate at a tool level, so setting that aside, I think the other thing it tells you is that the forums, the governance forums, whether it be at management or board level, for escalating and bringing to attention reputational and conduct issues has not been strong enough in the past. And such a forum, and all of the lower level forums that feed up into it, would provide a better flow of information, a better flow of escalation of serious issues, reputational issues and conduct issues, and I think also would lead to a better ability to aggregate because one would have records of meetings and issues put before meetings and be able to aggregate all of those looking back.

But also to observe whether there is, in truth, a real problem that is bubbling away out in the branches or in the field?---That's exactly right. And I think one of the issues at the executive management level that we have lacked – and this has been pointed out by APRA – is that we have lacked a non- an executive non-financial risk committee for forum for considering non-financial risks. Because I think the organisation as a whole is relatively, not perfectly, but relatively good at logging and tracking and measuring financial risk. But the same emphasis has not been placed on non-financial risks such as conduct and reputational issues.

You spoke of the need for policy simplification, particularly in relation to credit policy, where people knew where to go, when they got there could understand what they found and, having understood it, could then apply it. Do I capture at least an important element of the essence of what you were saying?---That's – yes ..... Commissioner, yes. And we chose credit risk not because it was an area crying out for particular attention but because we thought we needed to deal with areas one by one and so credit risk was our first one.

What about compliance risk?---Yes.

An institution like Commonwealth Bank is subject to a very large number of quite distinct and distinctive regulatory provisions?---Yes.

Is it an area that would permit – is it an area that would benefit from simplification of the kind broadly analogous to that that you've described in credit policy?---I think in the area of compliance risk, Commissioner, the issue that we have faced in the past is we have not had a thorough enough identification of compliance obligations. So one of the things that we are addressing at the moment, as part of our revamped compliance team, is to establish a compliance register for every single business and support unit so that it is very clear exactly what obligations must be met. That then leads to the second stage, which is: how do we satisfy those obligations? So that is our effort at the moment is – so I don't think it quite leads to, yet, a simplification of policy. I think, Commissioner, it is probably fair to say that we have lacked compliance policy to some degree. We did have compliance policies, of course, but I do think we needed a degree more compliance policies to deal with issues and then, as I mentioned, a much greater level of detail about what obligations needed to be met.

Because underneath the very large raft of regulatory provisions we see, I wonder whether at least many of them can be seen as reflecting only about four or five readily grasped ideas. (1) don't mislead or deceive. (2) don't act unconscionably, or if you don't like the word don't act unconscionably, be fair. Should I – various ways of putting it?---Yes.

(3) is it fit for purpose? What's the other warranty that is ordinarily implied, fitness for purpose and - - -

MR SCERRI: Due skill and care.

THE COMMISSIONER: Due skill and care. Do your job with due skill and care, thanks, Mr Scerri. And then your responsible lending obligations. Now, strip a lot of the detail of the legislation and you won't capture all the nuances in those four or five ideas, but for a bank officer on the ground is that something that the bank officer needs to be told are the informing principles that lie behind compliance?---Yes, Commissioner, I think so. I think perhaps the tendency in the past has been to – not deliberately, but has had the effect of clouding some of those basic principles through multiplicity.

Yes?---And – and as I say, I don't think that has been deliberate. I think it has been an additive process and layer upon layer upon layer is introduced, is absorbed. Rules and policies are set around that new layer. And it is sometimes difficult to distil the very essence of the fundamental obligations out of all of that set of policies, procedures, processes, etcetera.

I don't pretend for a moment that the distillation that has just been tossed off the cuff is the last word on the subject. My question is whether an institution in the position of CBA, as part of its risk management, one could – but more relevantly, I suspect, should – think of moving down that path. Or is this to push down a path that is simply not useful?---No, I don't think – I don't think it's unuseful, Commissioner. I think it requires a sense of returning to the basics.

Yes?---And I think in the recent report issued by APRA you will be aware of the focus there on the organisation asking itself the question: "Should I?"

Yes?---And I think that is a return to a very important basic element that, in that layering that I've just referred to, has sometimes I'm afraid been a bit lost. And again, I don't think it's deliberate on any part, but I think it has been the result of an accumulation and maybe a case of not seeing the wood from the trees, to a certain degree.

Mr Hodge.

MR HODGE: Nothing from that, Commissioner.

DR HIGGINS: There's no re-examination, Commissioner.

THE COMMISSIONER: Thank you very much, Mr Cohen. You may step down. I think you are excused – is he not, Mr Hodge?---Thank you, Commissioner.

MR HODGE: Commissioner, he is excused, yes.

THE COMMISSIONER: Thank you, Mr Cohen?---Thank you, both.

MR HODGE: Can I do one thing before we change over to the next case study, which is at the conclusion of – in fact I said one, there are two things I'm going to do, one is at the conclusion of Mr Van Horen's evidence last week he was cross-examined on a document which couldn't be brought up on the screen, and I think was not tendered at the time. So I understand, by consent with CBA, we can now tender CBA.0001.0281.0806.

THE COMMISSIONER: And what description do I give it, Mr Hodge?

MR HODGE: Can we bring it up. CBA.0001.0281.0806. CBA.0001.0281.0806. It's a chain of emails, Commissioner, dated 12 - - -

THE COMMISSIONER: Emails 12 January '17 between Reeves, Leo and others.

MR HODGE: Thank you, Commissioner.

THE COMMISSIONER: With that doc ID becomes exhibit 3.128.

EXHIBIT #3.128 EMAILS BETWEEN REEVES, LEO AND OTHERS DATED 12/01/2017 (CBA.0001.0281.0806)

MR HODGE: Thank you. And then the other matter is, Commissioner, in the preparation for this module we asked each of ANZ, CBA, NAB, Westpac, Bank of Queensland and Bankwest to provide statements setting out an overview of their respective business lending including various monetary thresholds for small, medium and large banking, their policies and number of business customers and the proportion of their lending comprised of business lending. Can I now tender each of those statements. We are not calling the witnesses. So the first is a witness statement of Isaac Rankin from ANZ in response to rubric 3-2 and the document ID is ANZ.0009.009.0052.

THE COMMISSIONER: That document becomes exhibit 3.129.

EXHIBIT #3.129 WITNESS STATEMENT OF ISAAC RANKIN FROM ANZ IN RESPONSE TO RUBRIC 3-2 (ANZ.0009.009.0052)

MR HODGE: The second is a witness statement of Joanna White of CBA in response to rubric 3-1, the document ID is CBA.9000.0035.0001.

THE COMMISSIONER: That document becomes exhibit 3.130.

EXHIBIT #3.130 WITNESS STATEMENT OF JOANNA WHITE OF CBA IN RESPONSE TO RUBRIC 3-1 (CBA.9000.0035.0001)

MR HODGE: The third document is a witness statement of Howard Silby of NAB in response to rubric 3-4 and the document is WIT.0001.0034.0001.

THE COMMISSIONER: Becomes exhibit 3.131.

EXHIBIT #3.131 WITNESS STATEMENT OF HOWARD SILBY OF NAB IN RESPONSE TO RUBRIC 3-4 (WIT.0001.0034.0001)

MR HODGE: The fourth document is a witness statement of Alastair Welsh of Westpac in response to rubric 3-3 and the document ID is WBC.900.001.0464.

THE COMMISSIONER: And we didn’t tender that when Mr Welsh was giving his evidence?

MR HODGE: I don’t believe so, Commissioner, no.

THE COMMISSIONER: Then that becomes exhibit 3.132.

EXHIBIT #3.132 WITNESS STATEMENT OF ALASTAIR WELSH OF WESTPAC IN RESPONSE TO RUBRIC 3-3 (WBC.900.001.0464)

MR HODGE: The fifth document is a witness statement of Douglas Snell of Bank of Queensland in response to rubric 3-6, which is BOQ.0001.0071.0001. Again, I don't believe that was tendered at the time he gave evidence.

THE COMMISSIONER: Becomes exhibit 3.133.

EXHIBIT #3.133 WITNESS STATEMENT OF DOUGLAS SNELL OF BANK OF QUEENSLAND IN RESPONSE TO RUBRIC 3-6 (BOQ.0001.0071.0001)

MR HODGE: And the last document is a statement of Sinead Taylor from Bankwest in response to rubric 3-1, which is CBA.9000.0036.0001.

THE COMMISSIONER: I thought we did deal with Ms Taylor's.

MR HODGE: There was a – there was a different witness statement of Ms Taylor that has already been tendered.

MR SCERRI: There were two of her, your Honour – Commissioner.

THE COMMISSIONER: So the – has it gone in or not gone in?

MR SCERRI: One has, one hasn't.

MR HODGE: And that's the one I am tendering that now.

MR SCERRI: I am just querying, Commissioner, whether Mr Williams' statement has been tendered.

MR HODGE: There's another round of part C statements that will be tendered tomorrow.

THE COMMISSIONER: Yes. The last mentioned statement of Ms Taylor will become exhibit 3.134.

EXHIBIT #3.134 STATEMENT OF SINEAD TAYLOR FROM BANKWEST IN RESPONSE TO RUBRIC 3-1 (CBA.9000.0036.0001)

MR HODGE: Thank you, Commissioner.

THE COMMISSIONER: Now, are we changing brigades at the bar table?

MR HODGE: Yes.

THE COMMISSIONER: I will come back at before 10 past 3.

MR HODGE: Thank you, Commissioner.

<THE WITNESS WITHDREW [3.03 pm]

ADJOURNED [3.03 pm]

RESUMED [3.09 pm]

THE COMMISSIONER: Ms Dias.

MS DIAS: Yes. Commissioner, the first witness in this case study is Mr Ross Dylan.

<ROSS ALAN DILLON, AFFIRMED [3.09 pm]

<EXAMINATION-IN-CHIEF BY MS DIAS

THE COMMISSIONER: Thank you very much, Mr Dillon, do sit down. Yes, Ms Dias.

MS DIAS: Is your name Ross Alan Dillon?---It is.

And do you reside at an address known to the Commission?---I do.

Do you currently work as a director?---I do.

Mr Dillon, did you receive a summons to attend to give evidence before the Commission today?---I did.

Do you have that summons there with you today?---I do.

I tender the summons, Commissioner.

THE COMMISSIONER: Exhibit 3.135 will be the summons to Mr Dillon.

EXHIBIT #3.135 SUMMONS TO MR DILLON

MS DIAS: Mr Dillon, did you make a statement to the Royal Commission on 28 May 2018?---I did.

Have you read through your statement?---I have.

Is there a correction you want to make to your statement at paragraph 36?---Yes. There was a date that was wrong. There were two meetings held and I had the first one. It was not the 4th, it was in actual fact the 11th.

Do you have a pen there, Mr Dillon?---I do.

Can you turn to that paragraph, 36?---Yep.

Can you make that change, Mr Dillon, with your pen, and initial the change to change the 4th to 11 May?---Yes.

And with that correction are the contents of your statement true and correct?---They are.

I tender the statement, Commissioner.

THE COMMISSIONER: Exhibit 3.136, the statement of Mr Dillon, 28 May ’18.

EXHIBIT #3.136 STATEMENT OF MR DILLON DATED 28/05/2018

MS DIAS: Mr Dillon in 2003 you purchased a business that became known as National Music; is that correct?---I did.

And you became a director of the business with your wife and another person, Mark McMahon?---I did.

Can you please tell the Commission a little about National Music’s business?---National Music, we are an importing company. We import musical instruments from most parts of the world. We then have representatives on the road who sell those to the music stores around Australia in all states. That’s the essence of what it does.

And what kind of instruments do you impart?---Mostly guitars, violins, stringed accessories, stands, a few electronic devices that relate to guitars.

And how many employees has National Music had over the years?---About 10, normally.

And have you always been involved in the running – the day-to-day running of the business?---No. I – when I purchased the business I was involved for the first year. Then I stepped back from the business and Mike McMahon ran it. I semi-retired to Scone in New South Wales on Goanna Downs until 2015 when we came to Melbourne and I was fully back involved in February 2016.

And you mentioned Goanna Downs. That was your home, was it, until - - -?---It was.

Until the middle of 2015, is that right?---Yes, until June 2015.

And who manages the business and its finances?---Louisa Buchanan.

And how long has she been with National Music?---Since – I believe it's 2006.

And National Music has always had a number of facilities with the National Australia Bank; is that correct?---We have.

Can you please describe for the Commission the main facilities and what they are used for?---The most important one would be the trade facility. That facility enables us to purchase stock overseas and have a rolling delivery basis. Our industry, we have to actually order the stock. It's then manufactured in China or wherever it might be. It's then delivered. It's paid for at the dock. We get it in Australia, we then sell it to the customer. Then we have to collect the money – which is not always easy – and the period of time from order to collection can be anything up to nine months. So a rolling facility enables us to do that because the nature of our product is that we have to place large orders to comply with our suppliers' minimum requirements, and we have to order various stages of the year according to high demand. So, for example, Christmas is easily our largest period. And for Christmas stock we would normally order around about April to make sure it's in, in time.

So you have mentioned – sorry, you keep going?---That's the trade facility. The trade facility also – I should mention that the quantum of the trade facility is directly relative to the dollars that we actually turn over. So if you are turning over a much larger number, obviously your dollars have to be higher. Probably the second most important one would be the overdraft. For us, the overdraft is a buffer. We have an industry that is not renowned for good payers, and if you get hiccups where perhaps your major supplier – sorry, major client is delinquent, that puts stresses on your cash flow and then that's when we would call on things like the overdraft just to see you through those rocky periods.

And do you recall that the debts in respect of the company's facilities to the NAB were supported by a personal guarantee and indemnity provided by you and your wife?---They were.

And that guarantee and indemnity was supported over a mortgage over your home which you have mentioned is Goanna Downs; is that correct?---It was.

Can you tell the Commission a bit about how the business fared during the Global Financial Crisis?---We had been travelling reasonably solidly up until the GFC. Our business is what we would classify as a discretionary spend industry. When the GFC hit, people start tightening their belts. The discretionary spend is probably usually the first thing that gets hit. You don't have to have a new guitar or a new violin, you can make do with what you have. So we felt the impact reasonably severely. So yes in 2009 we experienced a downturn, as we did in 2010.

And was National Music able to keep up with its monetary obligations to the NAB under the facilities?---Always.

Its repayments of interest and fees, were they met?---Yes.

And even after the GFC have they always been met?---Always.

And in around 2010, National Music was placed into the strategic business services or SBS division of the NAB; is that correct?---That is correct.

And was that the first time that the facilities had been placed into SBS?---It was.

And did you know why the facilities were placed into SBS at that time?---Not really. I wasn't terribly sure. As I wasn't involved in the day-to-day then, Mike and Louisa were running it, but no, I never really fully understood it. We had a meeting with David Knight who was our SBS manager and at the time he commented, "Why are you guys here? Your BAS is up to date, your super is up to date, you are meeting your obligations with the bank." And basically I said, "I don't know."

Did you make any changes to the business after you first went into SBS in 2010?---We did. One of the main reasons that was given to me, which I'm sort of not sure about, but the balance sheet was a little bit weaker than it should have been, and we never denied that we could make change to improve things after the GFC had happened.

So what changes did you make, Mr Dillon?---Essentially, we went on a cost cutting exercise. That was the first cab off the rank. Then we started a process of reduction of stock, in particular overstocks and redundant stock.

And the facilities were then referred out of SBS back to the business banker relationship; is that right?---That's right.

Do you remember when about that took place?---It was the second half of 2011.

Now, Mr Dillon, I want to ask you about Goanna Downs. That was the property where you and your wife lived up until the middle of 2015. What sort of property was it? You did mention it was a brood mare property?---It was – we had turned it into a brood mare farm, basically a property that takes thoroughbred brood mares, has the mare put in foal, we foal them down, raise the yearlings and look after the brood mares for clients who live in Sydney or somewhere who haven't got farms, they will agist them with us and go through that process.

But you also lived there, your home was there; is that correct?---Yes, that's very much our home.

And did you have a mortgage to the NAB over that property?---We did.

Now, you sold the property in 2015. When did you first start thinking about selling Goanna Downs?---About 2011.

And did you discuss that potential sale with anyone at the NAB at that time?---We did.

Do you recall who you discussed it with and what you discussed?---Kevin Matthews.

Who is that, Mr Dillon?---Kevin Matthews had been our business manager or my business manager for probably 11 or 12 years by then, but ceased to be our business manager after we came out of SBS in 2011. But I still referred a lot to him, because he understands how the banks work, and we basically didn't scratch ourselves without asking Kevin if it was okay.

And the new business manager, after Kevin stepped away from that role, who was that?---Michael Swindell.

Did you discuss your plans to sell Goanna Downs - - -?---We did.

- - - with him?---We did.

And what was your intention in respect of the proceeds of sale from Goanna Downs?---Well, we put it up for auction in 2011, I think it was. Yes, I think so. And the intention was that we would inject a little bit of capital, probably two to three hundred thousand, into National Music. We would then move to Melbourne. My son was returning from England and had just got married, so there was an expectation of grandchildren being on the way, so we thought we will move to Melbourne, buy a smaller property with a much, much smaller mortgage, and move on.

And what did you hope to use to buy the small property?---The balance of the sale, once the sale had – of Goanna Downs had paid out the mortgage and the redraw facility, we had intended to use the residual to pay, as I said, two to three hundred thousand into National and what was left we would use as a deposit on a new home.

And did you discuss those specific plans with Michael Swindell and Kevin Matthews?---We did.

Mr Dillon, you also have a self-managed superfund; is that correct?---We do.

And does that fund own property?---It does.

Where is that property located?---Mooloolaba. We've got a unit in Northwind at Mooloolaba.

And for how long has the fund owned that Mooloolaba unit?---2002 or 1.

So prior to 2010; is that correct?---Yes, yes, a long way before that.

Okay. And was there ever an intention to sell that property?---Not at that time, no.

Do you mean not in 2011 or not in - - -?---Yes. Not in 2011, no.

Did you discuss selling that with anyone at the NAB?---Not in 2011.

And is that property still owned by the super fund?---It is.

Mr Dillon, I want to ask you about some events in 2015. What was the profits and losses of National Music looking like at that time, leading into 2015 and maybe the first few months of 2015?---We had been trading for 11 years. We had had two losses, one of which was in the financial year 2013/14. The loss that year was $13,000. In 2014/15, at the time sort of a lot of this transpired, we were on track in April to register a profit for that year of about $100,000. At the exact time all this happened, about four days before we were returned to SBS, Louisa submitted an email to Shaun Bassett giving our March quarter statement for the first quarter of 2015.

And just stepping in there, Mr Dillon, who was Shaun Bassett?---He was our business manager from, I think, early February 2015.

And you mentioned that documents were sent to him and that they show a profit?---Yes. the March quarter, we were 10 per cent up in sales on the previous year, 11 per cent up in profit. 120 per cent profit increase on the previous year. BAS was up to date, debtors were up to date, all the statutory obligations were up to date, and stock was as per budget.

And the repayment obligations of the - - -?---All up to date.

Now, in your statement, you refer to having a meeting with Mr Bassett on or about 2 March 2015?---Yes.

Can you tell the Commission what you recall about that meeting and what was discussed?---We met at a coffee shop just across the road from the NAB. I was a little surprised. Mr Bassett initially was quite firm, very early in the conversation, about the need for us to sell Goanna Downs. He was asking things like, "What are your marketing plans? Have you considered reducing the price? Can we get copies of all the advertising that you are doing to ensure that you are in actual fact trying to sell the property?" He was pretty insistent. I was pretty surprised, for a first meeting, he was that forceful about that issue. I then proceeded to explain to him – have a conversation with him about what our plans were, that we were trying very hard to selling Goanna. He indicated to me that he looked at the file and it definitely needed to be sold. We needed to inject two to three hundred thousand in cash into the business. I indicated that it was our desire to do that and then to move to Melbourne and purchase a new home to live in, obviously with a much smaller mortgage, and move on.

And did you discuss the National Music facilities with Mr Bassett at this meeting?---No.

And after the meeting there was an auction; is that right?---There was. It went to auction the first time in 2011. There wasn't enough interest for the auction to proceed, so it was cancelled and withdrawn from the market.

But after your meeting with Mr Bassett, sorry, in March?---Okay. No, that was earlier.

Yes?---No, there was an auction after the meeting in 2015. I think it was very early April. It went to auction. Shaun was aware that it was going to auction, he actually sent us an email wishing us luck. At the auction, it was passed in. We had bidders on it, but the bidders who were the highest bidder at that point had flown back to Brisbane. So the agents told us that they would pursue that bidder over the coming days to see if they could close a sale.

You mentioned that Mr Bassett wished you luck for the auction. There's an email that you exhibit to your statement at RD13, Mr Dillon, that – you've got your statement there, but I will read out the document which is NAB.134.009.3004. If we go to the page that's .3006, and maybe put the last two pages up on the screen. We see there Mr Bassett – his name has been redacted, but you can see the bottom – so the address has been redacted, but you can see his name at the bottom:

> *Hello Ross, I believe you have the property going to auction today. Just wanted to wish you well today. Hope it's a great result for you.*

Now, if we could have the two pages 3005 and 3006 put on the screen, you have written to Mr Bassett on 23 April:

> *Hi Shaun, not sold. Very strange day. Passed in without reaching the reserve. One interested party after two visits and pest inspection, etcetera. We were hopeful.*

You relay some of the information that I have recapped on just then. Then on the next page:

So we will press on trying to sell, but it is the last time I go to auction in my lifetime.

And then you say:

Dale and his wife are going to the Mooloolaba unit next week to provide some renovations. Two packing cupboards and new benchtops, etcetera, and it should be on the market very soon. Hopefully same people will be interested. Thanks for your good wishes.

Now, that Mooloolaba unit, is that the one that you mentioned before?---It is.

The trust. But that's the one you said before didn't – you haven't sold that?---No.

That never sold. I see. And then if we go to the very first page of the document, 3004, Mr Bassett has written back to you saying:

Very strange. No account of how people's minds work.

And then down the bottom he says:

Could I ask that you give me an update once waters have settled on the auction and as you move on Mooloolaba.

And you then write back shortly or later in the day:

Hi Shaun, I will keep you abreast of developments. We are not giving up on selling both.

Okay. Now, the other thing that Mr Bassett mentions in the email, in the middle of his email, is:

We are working towards a formal answer from the bank on the present funding request which will provide some assistance up until 30 September.

What is that in reference to, that funding request, Mr Dillon?---I wasn't actually running the business at the time but my understanding, from talking to Lou and Mike, was that we were going to hit a bump because ABH, Allans Billy Hyde, were in default with us. We knew exactly how far the overdraft would have to go, so Lou had made a request to the bank to get a temporary increase to the overdraft and the trade facility of 100,000 on each. And that's – yes, that's what that was about.

And did Goanna Downs sell after this email exchange. Did you sell Goanna Downs?---Yes.

And what did it sell for, Mr Dillon?---2.22 million.

Was that the price you wanted?---No.

What did you want?---Two and a half.

And did you sign a contract of sale?---I did.

And did you tell Mr Bassett that the property had been sold?---We did.

How did you tell him, in an email or a phone conversation or - - -?---I don't recall, but he was told, obviously.

And after the sale, your solicitor sent an email to Mr Bassett sending through a copy of the front page of the contract. You have exhibited that email to your statement and that's NAB.134.009.2526. So this email from your solicitor says:

> *I now attach a copy of the front page of the contract. Please note that I have forwarded the relevant discharge authority to the NAB in order to have the discharge process commenced in anticipation of settlement occurring within the next six weeks.*

What did you understand that to be a reference to, Mr Dillon?---I didn't really know. I don't know how property transactions go. I just assumed it was the normal process.

Now, you also exhibit to your statement, Mr Bassett's response to that email. And that is at NAB.134.006.4961. Perhaps if we put that one on the screen with 4962 it would be helpful. Have we got that document? Thank you. So we see there – the very bottom email that we can only see the bottom of, but that was the email from the solicitor sending through the first page of the contract and then Mr Bassett said:

> *Received, thanks Kate. Are you able to also forward the discharge authority through to myself.*

Now, we can see your response up there, but what did you think when you read that email from Mr Bassett to the solicitor?---I was concerned. I was concerned (a) that the bank was contacting my solicitor without asking me to do so, but I was also concerned because I sort of – Kate had indicated she had sent through the relevant documentation, which I had presumed had gone to some department in the bank that handles mortgages and discharges and all those sorts of things. I wanted to know why did he want a copy of it in his hands; what was the relevance?

And you have written to Mr Bassett after that saying:

> *Hi Shaun, I would like to know why these things are being requested by yourself. Is this normal? I am sorry, but I am very suspicious of NAB and its motives ever since I felt we were badly treated a few years ago.*

What is that a reference to, Mr Dillon?---The first visit to SBS in 2010.

Continuing:

The bank is the one who has been pressing us to sell Goanna Downs and now we have accepted a price below what I would have liked in order to fulfil the bank's request. I'm starting to feel there may have been a motive I have not been made aware of. I would appreciate a clarification of your role in the sale of our property. Our intentions have always been to do the right thing by clearing the mortgage, clearing the redraw facility, inject the requested 200,000 into National Music, and we will clear the lease on the Ranger and probably sell the Mazda Ranger and clear the lease on that as well. All this reduces the bank's exposure by over 1.4 million. I would have thought a good outcome for NAB. Please let me know the truth of the requests.

Did you receive a response to this, Mr Dillon?---Not – not by email, no.

Now, the next day you had a telephone discussion with Mr Bassett?---I did.

Can you – what can you recall from that telephone discussion?---I recall it pretty well. I was walking down the streets of Wagga with my wife. We were actually killing time. I had a horse running in the Wagga Guineas that afternoon. And we were just waiting for the track to open, and all that, so I guess it was around 11ish, something like that. Shaun rang me and said, "Ross, I'm sorry, but I've got to tell you we're taking all the money from Goanna and we're putting you back into SBS." I remember my reaction couldn't be printed publicly, because it was pretty blue. I was instantly furious, because I – as per that email, I had suspected he was up to something, I didn't know what – or the bank was up to something, I don't know who was up to something. But, yes, I – I sort of said, I think I said to him something to the effect of, "Well what are supposed to do when we move to Melbourne? How do we buy a house if we have got no cash left?" And he listened quietly. He didn't make a big song and dance. I did. And pretty much I hung up and that was that. My wife was with me. She had no idea, because she wasn't hearing his end of the conversation and with the language I was using, she couldn't understand what was going on. She knew something wasn't right but, yes, it was a pretty rugged conversation.

And a few days later you attended a meeting with Mr Bassett and there was someone else from the NAB. Do you remember what that was?---Margaret Moynahan.

What was her role?---She was our new manager in the SBS department to manage our file.

Was there anyone else at that meeting?---Mike McMahon and Louisa Buchanan.

What do you remember from that meeting, Mr Dillon?---Very little. I think all three of us were in an absolute state of shock.

Do you mean the three of you being Louisa - - -?---Louisa, Mike and I. Up to that point it had only been that we were going to lose the home, but it was made clear at that meeting that they were going to also reduce our facilities not only to the level that the payout would allow but even lower, and that was just disastrous for all at least of us. We were trying to process how we were going to get through this. One of the things I remember thinking at the time is that, "We have to comply, because if we fight this in any way they're going to pull the pin on us altogether." Now, having sold Goanna Downs, no bank would look at our business with no bricks and mortar behind it. And Margaret was saying, "Well, one of the reasons we're having to do that is because we have no security." I said, "Well, no you don't, you just sold it." So, yes, it was a difficult day, but I don't remember a lot of detail about who said what.

And the next day you received an email from Ms Moynahan. That's exhibited to your statement, it's NAB.134.009.2614. Was that sent to you and to – the email address is redacted, but Mike and Louisa, copy Mr Bassett:

> *Dear Ross, Mike and Louisa. Thank you for making time to meet with Shaun and I to discuss matters relating to National Music and Goanna Downs. This email deals with two topics of discussion. The application for funding for National Music and the distribution of settlement funds relating to the sale of Goanna Downs.*

Now, the application for funding, is that what you were mentioning before about the request for the uplift?---I believe so. The hundred for overdraft and a hundred for trade was the request.

Yes, and Ms Moynahan there says:

> *Your application for funding of 200,000 was processed by Shaun and referred to NAB credit for review. The review is completed and the file referred to SBS for further investigation. The file was categorised as an SBS file on Thursday, 30 April 2015 and is now being managed by myself with Shaun's assistance.*

And she sets out there below:

> *The reason for the referral is the level of risk for further funding is assessed as being high.*

And there are three bullet points there. Do you recall what you thought about those bullet points?---I do. The first bullet point she mentions is the fact that the previous year we had incurred a $13,000 loss. It doesn't mention the fact that we were about to make $100,000 profit, and I thought it was a little ironic, after 25 years with NAB having literally contributed millions in fees, charges and interest, that they would want to do this for a $13,000 loss. I was more than a little staggered. The balance sheet, they described as weak and we totally agreed with that. Always have done, we knew things had to change. There was no argument on that front whatsoever. A lack of working capital, return to the business from trading, "You have advised the forecast net profit in 2015 of 120." Well, we didn't make it, we got 100 instead of 120. But given where we had been, we felt that wasn't too bad at all.

And further down below, on that page, there's a heading Goanna Downs:

> *An unconditional scale contract has been secured on Goanna Downs for 2.22 million to settle mid-June 2015. Ross has indicated that he is willing to provide the following to NAB from the net settlement funds of 2.12.*

And there are some figures there. We might put the next page up on the screen as well, thank you, 2615, if we could have those two side by side. Now, what did you think when you read what was below there, below the heading?---Well, it says "Ross has agreed". It's not like I was asked the question, "Do you want to?" There was no agreement. It was we were told this is what's happening. I never agreed to anything. We agreed that they could do what they wanted because they had us under the thumb, so to speak, but yes, I found that an interesting comment that I was willing to do this. I was never asked. We were told.

And then further down on the page 2615, under the heading Goanna Downs:

> *The proceeds of the Goanna Downs property sale are to be applied to the NAB facilities as detailed above. This will leave a shortfall of 257,766 to be rolled into existing facilities.*

The figures that are set out here, do you understand these figures, or did you understand these figures, Mr Dillon?---No.

Do you understand them now?---No.

Okay. Thank you. So what did you do after that when you had that initial meeting and you got this email?---Well, Louisa, who is very good on numbers, she didn't understand them. Mike didn't understand them. From our point of view the maths didn't add up. So we thought of the best sort of path from here was to speak to Nigel Fischer who was a senior partner in Pitcher Partners in Brisbane, who was our accountants at the time, and we needed to get him involved to try and work out exactly where she was heading with all this.

And did you attend a further meeting with Ms Moynahan and Mr Bassett? You mentioned at the start of your evidence that there was another meeting on 11 May. Was that the meeting you attended?---That was the first meeting between Mike, Lou and I, Nigel Fischer, and Margaret and Shaun – actually, I'm not sure if Shaun was at that, but I know Margaret was.

Do you remember what was discussed at that meeting?---I didn't participate much in the discussion. I sat and listened. Louisa and Nigel led the discussions with Margaret about how to apportion the residual after the mortgage and the redraw facility had been paid. I think the residual was in the order of 950,000 or something. How to apportion that against what facilities and what would be the various impacts. At that stage, the trade facility – my recollection is it was about 1.5 million, and the discussion included a sum of around about 650,000. That rang alarm bells with Lou, because we couldn't see how we could trade at that, but at that point nothing was settled, it was just a discussion about how they were going to put it to the accounts.

So you mentioned alarm bells. Did you discuss with Louisa and Nigel how the business would function with that sort of level of facility, the trade facility?---Not during the meeting. We discussed it at length over time. But yes, the general consensus was we couldn't function with 650 and hope to do $5 million worth of turnover.

And did you raise that issue with the NAB at the meetings in May or one of the meetings in May?---I don't remember raising it myself. I know it was raised on multiple occasions. I know Louisa certainly expressed concerns. I can't truthfully say whether I recall raising it personally, but it was raised with them by National Music.

After that, Mr Fisher put forward a proposal for the facility levels working within the limits that had been originally proposed by the NAB. Is that correct, is that what happened?---He did.

Now, would you have done anything differently, Mr Dillon, if you had been told before you sold Goanna Downs that you would not receive any of the sale proceeds or that the National Music trade facility would be almost halved?---I wouldn't have sold, because I understand how hard it is to move somebody on who is up to date with their payments. We had an offer on the table from another gentleman who owns one of the most successful stallions in Australia, that was two and a half, but he couldn't fulfil that offer for probably up to a year because he had to wait until his stallion cheque came from the stud. And at that time we accepted because we felt under pressure from the NAB, but we wouldn't have even accepted, if we had known we weren't going to get a penny, no way. We would have waited.

And what happened with the profits of National Music after the trade facility came down to that much lower level?---It was a disaster. We – as I said, we had made a profit in the 2015 year of 100,000. So we had made, I think, nine profits out of 13 up to that point. The loss was 13,000. The first year after the facility was reduced we lost, and I've forgotten the exact numb, 70 or 80,000 in that vicinity, and the second year we lost, I think, $270,000.

And why do you think the profits dropped like they did?---Well, I know why they did: because we were consistently out of stock because under a regime of 650,000 Louisa was forced into a situation where she would order what she could, but we had to pay cash for anything else. Well, that means you've got to wait until you collect it. So consequently our ordering patterns dropped dramatically and when you are out of stock, you can't supply. That creates a problem with your retailers because if you're selling them product A, and they've been buying off you for several years, and all of a sudden they can't get it, they will switch to product B. So when it comes back into stock in three months time you have got to win them back from product B, and that is a real issue. The second thing that was a consequence of that is our suppliers overseas have expectations that you will purchase a certain amount each year. They are always very demanding, wanting growth every year. When your purchasing goes down, you run the risk of losing products to distribute, and we did lose a few products.

Do you think the business could have moved into different product lines?---We tried hard to focus more on high turnover lines. Things like strings for guitars and violins and things, because they're an air freight, you can bring them in 12 times a year. So you can get an order every month. So they sell quickly, you can rotate, it's much easier, but you can't do that with the main product lines like guitars and violins. And to just try and say, "Well, all right, let's replace and get another million dollar product," is nearly impossible. The main brand throughout Australia are very heavily guarded by every distributor like us, and picking up a new product that is successful in the marketplace is a difficult thing to do. So usually takes several years to achieve.

And how did you survive through this period of depressed profits, Mr Dillon. How did the business survive?---We wouldn't have survived other than the fact I have a brother who is reasonably comfortably off and was prepared to put in about half a million dollars into the business to try and carry us through those losses, because we had made a lot of changes and we could see there was light at the end of the tunnel but getting there, we couldn't make it unless we had a cash injection to cover those losses, and John did that for us.

That's your brother?---My brother.

And what changes did you make throughout this period. You mentioned changes?---We made a lot of changes. In February 2016, we had been going for six or seven months since they changed the facilities on us, and by then it had become clear that it was unsustainable. So we couldn't get an increased facility, so basically we had to remodel the business to drop our costs dramatically to try and accommodate this. Michael McMahon, who had been the managing director since we bought the business, he volunteered to leave the business because it was clear that it couldn't support both of us as well as the staff. And he was pretty stressed by then, so he was happy to go and try and do something else. That dropped a considerable sum of money out of the costs. We then had to find a new premises where we could get a cheaper rent deal. We saved about 50,000 a year on a different premises because the lease was up fortunately at the right time and we implemented all the normal sort of cost saving exercises. Eventually we ended up dropping having a rep in Victoria, which saved another bunch of money. I went back on the road to cover Victoria. So it was, yes, trying to do it as economically as we could.

And has National Music asked NAB to increase the trade facility since 2015?---We have.

How much have you asked, how many times, do you think?---Probably three or four with Tara. Tara is our new SBS manager. Yes, it was a few times.

And earlier this year you asked again. You asked – was it Tara?---Yes. In July last year, I asked Tara if we could get a $300,000 increase in the trade facility. And the answer was, "No. But if you can achieve a significant turnaround in the business," because you have to remember at that time we were losing a lot of money every month, "if you can achieve a significant turnaround over the next six or seven months and show us that you've got the business sort of back on track under the new facilities, then we will look at it again in January/February."

And did you speak with her again in January or February this year?---Yes. We had a meeting in February, and I put the figures on the table – which she knew anyway because we report to her regularly – but we had turned it around. We had turned – for the equivalent period in the previous year we had about $130,000 loss at that stage. At the same time period this year we are in a $70,000 profit. So we had achieved a $200,000 turn around profit-wise. I was actually pretty happy, because I thought that was a pretty good result given the stress we were under. Yes. So that was the situation.

And what happened during the meeting, what did you discuss?---Well, I said to her, "You know, like okay here are the numbers when do we get our increase." Basically, she didn't have to refer to anybody. She just said, "Look, I'm sorry, but we can't do it. We need to see another 12 months of continued improvement and then we will consider it again." At that point I expressed my displeasure because, having been told it would be considered, it clearly wasn't being considered. I then said to Tara, who is a lovely lady and has been trying hard to help us, but I said to Tara, "Look, there's a Royal Commission coming up. I've had enough of this. I'm going to tell my story."

And have you made a public submission to the Commission, Mr Dillon?---I have.

Why did you make that public submission?---Because I felt it might be cathartic to get it off my chest.

And what impact did the events that you've given evidence about here and in your statement have on your family?---Pretty devastating. I didn't sleep for two years. Just running numbers through my head, because it was always a fear that, "They're going to shut us down, they're going to shut us down, we have now not got a home, what are we going to do?" You try and run through the numbers of how you're going to exist. My wife has had an even worse effect. She has had some signs of memory issues back in 2014 and '15 and was tested by a specialist. We feared maybe early onset dementia. She was retested again three months ago. The specialist said she has got severe depression, which is accelerating the onset of dementia. She was tested and since the two tests from 2015 to 2018 there have been a 25 per cent drop in cognitive function. She struggled, really hard.

No further questions – I will just ask one further question. And you've now got the increase in the facility, is that correct, Mr Dillon?---After Tara said no, and I sort of went off my tree a little bit about coming to the Commission and what not, she did ask, "Is there anything I can help with the Commission?" She went away, I wasn't aware, but Lou told me later that she had actually been working behind the scenes to see what she could achieve and she was able to achieve 50 per cent of what we had asked for as an increase. So there was some result.

Has had a change or impact on the business, can you tell if that's made a difference?---Absolutely. We now have stock on order. Obviously, we have done all our Christmas orders already, and we now have enough stock in the pipeline that we can actually achieve a 5 million plus year in the following financial year. We will probably still register a small loss this year, nothing like last year, fortunately. But we're anticipating returning to the black next year.

Thank you, Mr Dillon.

THE COMMISSIONER: Thank you. Yes, Ms Harris.

<CROSS-EXAMINATION BY MS HARRIS [3.57 pm]

MS HARRIS: My name is Wendy Harris and I need to ask you some questions on behalf of National Australia Bank?---That's fine.

Mr Dillon, in paragraph 6 of the witness statement that you prepared ahead of today and also again in your evidence today, you say – you said that you put Goanna Downs on the market in 2011?---That's correct.

And that was part of a plan to move to Melbourne to be near your son and his wife and anticipated grandchildren?---Correct.

You haven't mentioned it in your evidence, but do you recall that you had in fact put the property on the market a year earlier in 2010 as a part of a strategy to reduce debt?---No, I don't recall that.

In paragraph 5 of your statement, Mr Dillon, and you touched on it again in your evidence today, you mentioned that National Music recorded a loss in 2010?---That's correct.

And that in 2010 your relationship banker was Kevin Matthews?---Correct.

And you say in your statement that Mr Matthews knew your business inside out?---He did.

You found him to be easy to deal with?---We did.

You found him to be careful?---We did.

You found him to be thorough?---We did.

And indeed Mr Matthews became a friend?---He – he has.

Mr Matthews, is it correct to say that in around early 2010 the business was experiencing significant cash flow and other financial problems?---That's – it was. That was at the start of the GFC downturn.

And were you aware Mr Matthews referred National Music's file to SBS?---In 2010?

In early 2010?---I – I never knew who referred it. I knew he was our business manager at the time. So I knew he would be fully aware of what was happening.

Yes. Just to be clear, Mr Matthews – Mr Dillon, and I will take you to the documents, but you have given evidence about a referral in the second half of 2010. I'm talking about a separate referral early in 2010. Were you aware of that?---No.

Can I show you document NAB.005.436.0003. Mr Dillon, you are aware I think that a witness statement has also been filed from a NAB employee, Ross McNaughton; are you aware of that?---I'm aware of it.

Have you seen that statement?---I have. I didn't actually see it until last night and as it's about 60 pages long, I haven't read it.

I understand?---I've seen bits of it, but not detail.

I understand. And so I take it, Mr Dillon, you haven't seen the exhibits to Mr McNaughton's statement?---No.

So the document I'm showing you is an exhibit to his statement at tab 58, and you will see it is headed Categorisation or Removal of Categorised Indicator referral form. Do you see that at the top?---I do.

And then in the box immediately below that, it says:

> *To SBS executive from Kevin Matthews.*

?---I see that.

And if you go to the next page, 0004, you will see there's a heading Background, a few lines down the page?---Yes, got that.

And then under that:

> *Business operations brief details refer portfolio review group Mark ..... report attached.*

?---Yes.

Sorry, before we leave that document, can we go back to the preceding page 0001, so that I can draw attention to the date, 0001?---I think it was January 2010.

It was – it was, Mr Dillon, 14 January?---I noted it at the time.

Could we then – with that having been established, can we then move to NAB.005.418.0039. Again, this is an exhibit to Mr McNaughton's statement. 005.418. Here we are. Do you see the heading Portfolio Review Group?---Yes.

Then below that National Music volunteered, below that a reference to Mr Kevin Matthews and then PRG reviewer Mark ..... which is the name we saw in the previous document?---Yes.

And so you can take it that Mr McNaughton's evidence will be that this is the report referred to in that categorisation form. Can we bring up, please, pages – page 0041.

THE COMMISSIONER: Sorry. What page number are you after, Ms Harris?

MS HARRIS: 0041.

THE COMMISSIONER: 0041.

MS HARRIS: Got the slow documents. Do you see there's a heading about a third of the way through the page Summary and Recommendations?---Yes.

And the second dot point – sorry, the third dot point. No, let's look at the second dot point. You see it says:

> *Overall, PRGs brief review suggests the business has significant cash flow issues generated from both P&L and balance perspectives, and if not corrected will result in business failure.*

?---I do.

Yes. And then below that:

Clearly a first option here is for the owner to inject further capital into the business but, failing this option, business performance issues need to be addressed urgently.

?---I do.

And then the – can you read the fifth and sixth dot points, the ones that refer to "PRG suggests" and then "specialist business advisor"?---Yes.

And so you see there that the report recommends that a business performance review be undertaken?---Yes.

And do you remember Mr Matthews communicating to you that suggestion?---Yes. They sent a specialist out.

And so you agreed to undertake the review?---Yes, yes.

Yes. Now, do you remember receiving the report of the reviewer?---No. I remember his comments on the day, because he was with us for a day.

Can I - - -?---But I don't remember seeing any report.

Do you remember that the person who undertook the review was Mr Fischer, who subsequently became your accountant?---No.

Can I bring up, please, NAB.005.379.0027. This is another exhibit to Mr McNaughton's statement. Do you see that's the review that was conducted of National Music dated 3 March 2010, the independent review. Do you recall seeing that document before?---No. It doesn't mean I didn't get it, but I certainly don't recall it.

Indeed. And, Mr Dillon, if at any time you want some time to read through what I'm showing to you, then you just need to let me know?---Yes, that's fine.

Can we go to the second and third pages of that document, which is 0028 and 0029. Can we put them side by side, please. Sorry. And so the part of the report that I wanted to direct your attention to, Mr Dillon, appears on the second of those pages in, starting at the fifth paragraph?---Yes.

Perhaps have a look at the third paragraph which refers to the management team of Buchanan, McMahon and Dillon?---Which page are you on? It's on the other page, sorry.

On the second of those pages, it's 0029?---Right.

So Mr Fischer is reflecting on his observations of that management team. And then in paragraph 5 he says:

We are advised it is also likely that the owner will contribute capital into the business prior to 31 December 2010 from the sale of personal assets.

?---I see.

Do you see that?---I do.

And then at the bottom of the page – the very bottom of the page that's picked up again where he says:

Owner needs to recapitalise the business. Quantum to be determined, however it may be in the order of 600,000 to $800,000. This outcome will reduce the required break-even turnover margin.

Do you see that?---I do.

And then Mr Fischer, from page 11 of the report, makes a series of operational findings and recommendations. You can see that from 0037. I'm sorry, that's 0035. You might even take my word for it, Mr Dillon, because the thing I really want to draw your attention to is on 0044, since the system is being very slow. So that's the first page. You see Operational Findings and Recommendations?---I do.

And then if we can skip to 0044 do you see there's a heading Financing?---Yes.

Continuing:

Existing bank covenants not being met. The business is heavily funded by bank debt, issues 19 and 20.

Do you see those?---Yes.

And in the right-hand column, the third paragraph says:

It's strongly recommended that funds are injected into the business by Ross Dillon to reduce the expense associated with bank debt. It's proposed that Ross inject funds upon the sale of non-business assets as the timing and quantum of this injection is unknown. It has not been included as part of our forecasting model.

Do you see that?---Yes.

Now, you didn't dispute any of the findings that had been made by the independent reviewer in this report, did you?---I don't actually remember the report.

Can I try and refresh your memory with a letter that you sent to Mr Matthews after having received the report. It's again exhibited to Mr McNaughton's statement at tab 64 and the document number is NAB.134.021.0035. Now, I probably need to show you – we will get to the last page. Can you take my word for it at the moment, Mr Dillon, that the last page is signed:

> *Kind regards, Ross Dillon, National Music.*

We will come to it in a minute?---I don't doubt that.

And so you see from the first two paragraphs you're writing in response to the Johnston Rorke report?---Yes.

And you say:

> *As you will be aware, Michael, Louise, and I were heavily involved with the accountants supplying the information that they required in order to formulate their report.*

And you go on to say that you are instigating change in response to the issues, some of which you had already anticipated?---Yes.

You see that. Can we skip then to pages 0038 and 0039, side by side, please. And do you see under the heading 19 and 20 Financing, which is about two-thirds of the way down through the page. You respond to those two items that I took you to the Johnston Rorke report, firstly with respect to bank covenants?---Yes.

You see that? And then in the second paragraph you say:

> *The injection of further capital by the owners is only possible upon the sale of Goanna Downs. It is an expensive property and we would like to ensure it returns the maximum possible in order to reduce bank debt. This will clearly take some time to achieve.*

Do you recall - - -?---Yes.

Do you recall writing this letter?---No.

And do you see on the last page you include, in effect, a personal message to Mr Matthews and can I draw your attention to the second last paragraph where you say:

> *My return to alternative duty in the business will ensure we do not fall into the same mistakes we have made in the last couple of years. Our reliance on debt driven growth will not reoccur.*

Do you see that?---I do.

And that was your intention, was it not, in 2010?---Yes. I increased by visits to Brisbane, basically.

But it was also your intention that your reliance on debt driven growth would not reoccur?---I have to confess to not fully understanding how the bank quantifies debt driven growth.

Mr Dillon, this is your letter?---I think that might be quoting them.

Well, Mr Dillon, I don't think those words appeared in the Johnson Rorke report. But do you agree with me that, even if they did, you have adopted them in your letter to Mr Matthews?---Yes, clearly I wrote it.

Indeed. And does that assist you to recall that the first time you put Goanna Downs on the market was not in fact 2011 but it was 2010?---No, it doesn't.

I see. So I take it, then, that you don't recall committing at that time to Mr Matthews to apply virtually all of the sale proceeds from the sale of Goanna Downs to the reduction of debt?---No, I don't.

Can I show you a document NAB.005.342.0022. Sorry, that was – should be 0032, I beg your pardon. No, no. I'm sorry – I'm sorry. It was 005.342.0022. It might be 0021, in fact. Now, again, this is exhibited to Mr McNaughton's statement and he deposes that this is what is known as an EBL submission, which is a business credit lending submission put together by a relationship banker in support of a change to a customer's facilities. And you see that it has been created by your banker, Mr Matthews - - -?---I do.

- - - in respect of National Music?---I do.

And the date of it is 14 April 2010?---Right.

Could we put – now, I don't know whether this is a challenge with landscape documents, but the pages that I want to show you are 0023 and 0024. So this is 0023 and you see under the Purpose, there's a reference to the market rate facility and then the second paragraph, it says:

> *This submission now seeks to further extend this facility until October 2010 and allow a redraw of funds repaid.*

And then he sets out the amounts and the dates which you were seeking by way of that redraw. Does that ring any bells with you, Mr Dillon?---No.

Let me then direct your attention to the second of the pages that now appears on the screen, 0024, and the second paragraph says:

> *Our security property known as Goanna Downs is on the market for sale by expressions of interest of 2.8 million to 3.2 million. There are currently two very interested parties –*

etcetera:

> *Whilst promising and principals are committed to quitting the property, this may take some time.*

Then he says:

> *Principals will retain $800,000 to 1 million to purchase another PPR –*

a principal place of residence

> *with the balance of settlement funds to be applied to debt reduction. This will see the PPCK –*

which is your personal borrowing –

> *cleared in full, 1.15 million and a significant reduction in the trade facility. The balance of business debts will be secured by the new property to be purchased. We are hopeful that this may occur by the next review date, December 2010.*

Now, Mr Matthews is recording there information that he must have obtained from you. Would you accept that, Mr Dillon?---I – I don't recall any of this. I haven't seen any of this in recent years. It's eight years old, obviously. We've had three reviews in that time. But it doesn't it say:

> *Principals will retain about 800 to a million dollars in order to purchase another principal place of residence.*

Which was - - -

It does, yes, it does, Mr Dillon?---That's what I thought.

And so can I revert to the question I asked you. I accept that you don't remember it?---No.

The question that I asked was: do you accept that Mr Matthews is recording there information that he must have obtained from you?---Not necessarily. I didn't have the day-to-day operational functions of things like the market rate facilities. That – it could well have come from Louisa.

Mr Dillon, I'm referring to the matters which appear in those three paragraphs at 0024. He must have obtained the information that Goanna Downs was on the market for sale by expressions of interest in the range of 2.8 to 3.2 million from you. Do you accept that?---I accept it's possible. My first recollection, because as I said it's eight years ago, my first recollection of selling or trying to sell the property was the auction in 2011.

I accept that, Mr Dillon, and can I make clear that I have absolutely no criticism of your memory. I can barely remember what I had for lunch yesterday. So I'm criticising your memory, Mr Dillon. I'm asking you to accept that the only place that Mr Matthews could realistically have obtained that information is from you?---About the sale of the property? No, not really. He could have got it from Michael or Lou, because if it was on the market they would have known. It probably did come from me, because Kevin and I talked regularly.

And - - -?---But I just don't remember it being on the property – on sale that early.

Mr Dillon, you said early in your evidence that Mr Matthews was a careful man?---As far as I know.

And that he was a thorough man?---As far as I know.

And he knew your business inside out?---He did.

Mr Matthews has recorded here that "the principals are committed to quitting the property". Do you think it's likely that he made that up or do you think it's more likely - - -?---No, no, we had always spoken to Kevin about we will sell the property. Always.

And you made the point to me about the principals, you and your wife, retaining 800,000 to a million in order to purchase another residential property?---Yes.

Is it likely that that information came to Mr Matthews from you?---Absolutely.

And looking at the balance of the paragraph, referring to a significant reduction in the trade refinance facility, is it likely that that was something that you and Mr Matthews had discussed that he then recorded here?---I think I said earlier I had discussed it with Kevin from the very beginning.

And that the balance of the business debts will be secured by the new property to be purchased. You accept that's something you are likely to have discussed with Mr Matthews?---Absolutely.

Thank you. Now, can I take you to a further EBL submission of Mr Matthews, again exhibited to Mr McNaughton's statement. It is NAB.005.342.0032. So this is – you see this is EBL submission 25 for National Music, again created by Mr Matthews, and the date of creation is 1 September 2010?---Yes.

And can I take you to page 0034. Can we have actually 0034 and 0035 up together. So that's 0034. And you see the first paragraph, there's an application to waive repayments due on facility P18, which you can take it from me, Mr Dillon, is your market rate facility, which had been scheduled at 200,000, 150,000, 100,000 on the three consecutive dates mentioned there. See that?---I do.

Now, if you look about halfway down the page, can you read to yourself from the line that says:

> *Overall, the business is well controlled.*

?---Yes.

Down to the bottom of the page and then the first two paragraphs on the next page?---Just to the bottom of the page?

And then the first two paragraphs on 0035, if you don't mind?---Done.

So going back to the start of that passage, Mr Matthews records that:

> *Overall, the business is well controlled. However, softness in sales has proven the weakness and that the forecast that in National Music had given NAB in February 2010 allowed for repayment amounts of the market rate facility, however this is now – this now cannot be achieved.*

The next paragraph says:

> *As a mitigant principals guarantor, you and your wife have now committed all funds received from the sale of our security, Goanna Downs, to debt reduction albeit that some $100,000 may be retained for personal expenses. The property has been on the market since February 2010, but is a specialised brood mare farm in the Hunter Valley and is taking considerably more time than anticipated to find a suitable buyer.*

And then he says:

> *Principals that provided the following report.*

And what follows is in quotes and italicised. Do you accept, Mr Dillon that what appears in italicised quotes was a report that you gave to Mr Matthews?---I do.

And - - -?---I don't remember the detail of writing that, but it looks - - -

Looks like you?---It does.

And can I draw your attention in particular to the very last line of the quoted italicised passage on the second of those pages:

> *Be assured we are keener than the NAB to see it sold and our debt levels drastically reduced.*

?---Which was true.

Which was true. It was an important motivating factor in putting Goanna Downs on the market in that period to reduce your back debt?---The first time we went into SBS was a shock and that was a big motivating factor.

Just to be clear, Mr Dillon, at this time you were not in SBS and had not been categorised. So while Mr Matthews had referred to SBS earlier that year, your file was not being managed by SBS at that stage and had never been. Do you follow?---I do, because I thought you had said we had been in SBS earlier in the year.

That's why I was careful to say Mr Matthews had referred you to SBS, but then after you implemented the recommendations of the Johnston Rorke report your file was not categorised, so you didn't get formally accepted into SBS and that will be Mr McNaughton's evidence. Do you follow?---Yes.

So at this stage you had not actually been categorised and your file brought within SBS?---Yes.

And so the proposition that I am putting to you is that during this period in 2010 and following it was a major motivating factor in selling Goanna Downs to drastically reduce bank debt?---Yes. I'm not sure of the relevance but, yes, we said we always wanted to sell it, so - - -

And you accept that that's what you told Mr Matthews?---Well, there's a line in there I disagree with. I do not recall ever having said we would contribute all the funds of the sale.

Mr Dillon, I accept you don't recall that. Do you accept that it is unlikely that Mr Matthews, the careful person that you found him to be, would have recorded that in this document if you had not told him that?---It's unlikely. Not impossible, but unlikely.

Commissioner, I have a way to go. I'm happy to continue as long as - - -

THE COMMISSIONER: How much is a way to go?

MS HARRIS: I suspect a good three quarters of an hour.

THE COMMISSIONER: Well, I won't sit on for that length of time, Ms Harris.

MS HARRIS: No, indeed.

THE COMMISSIONER: But I just ask you: to what end are we trying to get?

MS HARRIS: Commissioner - - -

THE COMMISSIONER: Trying to get the bank's files to say what they say? Are we getting beyond that?

MS HARRIS: Commissioner, we confine ourselves strictly in cross-examination to the propositions put against NAB in Mr Dillon's evidence. I can identify those propositions if the Commission wishes but we have been astute to only respond to things that we consider need to be responded to, having regard to Mr McNaughton's evidence and Mr Bassett's evidence.

THE COMMISSIONER: I will resume at 9.45 tomorrow.

<THE WITNESS WITHDREW [4.33 pm]

MATTER ADJOURNED at 4.33 pm UNTIL THURSDAY, 31 MAY 2018

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