Submission to Financial System Inquiry

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I wish to comment on two issues, related:
* the subject of small business (SME) and family farmer finance – covered in the Interim Report (henceforth IR) pp.2-59 to 2-71.
* bank malpractice against its small business and family farmer customers, curiously missing from the IR.

SME and family farmer finance

The coverage in the IR of SME/farmer finance lacks accuracy. It has a bookish character, flavoured only with a brief flirtation with aggregate RBA/APRA statistics. The only brush with reality is in the brief citation of informed opinion from the NSW Business Chamber.

The IR notes: 'Interest rates on SME loans are generally higher than those for large business loans and mortgages. This largely reflects the higher costs and risks associated with bank lending to SMEs. … Since the GFC, interest rate spreads on small business loans have increased relative to other loan types, which reflects the generally higher price of risk.'

This characterisation imparts a rationality to SME lending that does not exist in practice. A corporate-SME margin has reigned by convention, but rarely examined for intelligibility. It is more probable that the margin is a product of what the market can bear. Banks charge SMEs/farmers higher interest rates because they can. Banks compete more actively for corporate business.

Moreover, there is no clear evidence that the banks lose more heavily on SMEs/farmers. Bank provision for bad debts is not merely discretionary but arbitrary (a factor ignored by APRA). What evidence exists from the aftermath of the 2008 GFC is that the significant realised bad debt categories of Australian banks were in corporate business (ABC Learning, Allco Finance, Centro) and in loans to shonky managed funds operations (the CBA and City Pacific).

A priori, the notion that SMEs/farmer loans demand higher margins because of higher risk (and more resources per loan dollar) doesn't cut the mustard. Certainly there is substantial risk in rural loans because of global market seasonality and the diabolical weather factor. But higher interest rates merely put potentially viable enterprises under additional pressure. If a bank finds a potential borrower proposition overly risky, then why make the loan at all? Usurious penalty interest rates imposed when a bank has decided to default a SME/farmer borrower is merely an extreme reflection of the same dysfunctional principle.

The IR notes: 'Banks may have to invest resources to acquire sufficient information to make a well-informed lending decision, which increases the cost of assessing and approving a loan application.' Quite – so why don't they? The potential rewards are there down the track, but that's beyond the current bank supremos' time perspective.

The hard truth is that the banks have not been prepared to devote resources to building a loan book that combines viable propositions, sustainable borrower relationships and risk minimisation. The NAB and the ANZ, in particular, have advertised far and wide of their purported investment in personnel trained for a specialist SME or farmer service. It's hot air. The misleading representation is compounded by the fact that the typical SME/farmer borrower is still carrying a pre-financial deregulation mentality that bank lending managers are imbued with professionalism and trustworthiness. The customer has not been re-educated to confront that banks are now money lenders, and the *leitmotif* of the sector is *caveat emptor*.

In the SME/farmer sector, the convention has been to lend on assets and default the borrowers at the drop of a hat. The IR mentions, on the basis of the APRA submission, that there are loans both without and with security. But APRA provides no quanta for the categories. My understanding is that it is a *sine qua non* that loans of other than trivial sums are made on the basis of security.

In the SME/farmer sectors asset lending (sometimes called balance sheet lending) is the banks' *modus operandi*. In bank senior management mindsets, asset lending precludes the necessity for the commitment of substantial resources to the making of functional loans. Asset lending was the flavour of the month in the years leading up to 2008, especially in the rural sector. With respect to the latter, Rabobank, which should know better, was an integral part of the asset lending pack.

The IR notes: 'Many lenders are requiring more security, usually residential property, against business loans. Requirements for collateral to be held against SME loans can result in allocative inefficiencies, where loans are made to businesses with the best collateral, rather than those that are the best business prospects.' Quite, and the allocative inefficiency applies not merely to prospective borrowers without 'bricks and mortar' collateral but with those with that collateral as well.

With this background, the IR claims that 'Access to external debt funding is not a major issue for most SMEs. In general, the majority are successful in getting a loan application approved.' This claim is highly misleading and utterly glib. The phenomenon of slovenly and predatory lending is hidden behind such a perspective. The unconscionable prevalence of lending manager remuneration linked to the manager's loan book quantum adds a poisonous ingredient to the loan determination process. Thus a crucial, neglected, dimension is the character of the relationship – are the facilities functional and is the relationship sustainable (with symmetric understanding of its nature) – including through difficult periods. Where are the default and foreclosure statistics compared to loan numbers? They aren't collected.

The IR also notes: 'Some submissions raise concerns about the nature of covenants in loan contracts for SMEs. In particular, submissions suggest that some non-monetary loan covenants are unfair, and the application of some clauses, particularly non-monetary default clauses, could be more transparent.' In my view, these concerns are entirely justified. My reasoning is outlined in a submission, dated 5 June 2014, to the Treasury 'Unfair Contract Terms' review – attached to this submission. (The submissions to that review are not readily uploaded onto the review website.)

The IR also notes: 'However, some of these covenants are used to deal with the difficulties in bridging the information asymmetries involved in SME lending, and therefore facilitate greater access to lending for businesses.' It would be more accurate to say that these covenants are used to compensate for the banks' reluctance (as noted above) to invest the resources necessary to offset what those in ivory towers call 'information asymmetries'. The 'difficulties' are mostly of the banks' own making.

As for the claim (representative of ABA propaganda) that such covenants 'facilitate great access to lending for businesses' – there is no evidence for that whatsoever. Covenants, universally not understood by SME/farmer borrowers (with the banks wilfully enhancing 'information asymmetries'), are essentially means of facilitating more ready bank predation against SME/farmer borrowers.

As for rural finance, I note several claims in the IR:

- Although financial issues affect the rural sector, submissions do not identify significant structural issues related to rural finance.
- Rural businesses have access to a range of insurance products to protect against income loss, as well as financial instruments to hedge against commodity price and exchange rate losses.
- Many lenders work closely with farmers in times of financial hardship, often accommodating arrangements such as repayment holidays and using independent mediators to help resolve issues with their customers.

These claims are radically inappropriate regarding the family farmer.

Claim #1 is dramatically inaccurate.

Claim #2 is rubbish. Hedging facilities have always been far beyond the capacity of the typical family farmer borrower and have been a source of more suffering and losses than salvation – little has changed since the foreign currency loan scandal of the 1980s. Note that the current environment in New Zealand rural lending is awash with the 'interest rate swap' scandal. Here is a hedging facility par excellence sold to the perennially harassed and out-of-their-financial-depth farmer which was spectacularly inappropriate and which has gone spectacularly wrong. And the culprits, of course, are subsidiaries of Australian banks – three of the Big 4 (not including the NAB, although the NAB is up to its neck in an identical scandal in its UK subsidiaries). Curiously, these shenanigans have been completely ignored in the Australian media, and presumably by Australian regulators.

And claim #3 is a lie – representative of perennial ABA propaganda, and it is embarrassing that the FSI review should repeat this baseless claim without attribution. One notes in passing that the farm debt mediation schemes of New South Wales and Queensland are now thoroughly dysfunctional and are part of the problem, having been rorted by the banks and facilitated by complacency or complicity of mediation scheme personnel.

In general, there ARE ‘significant’ structural issues related to rural finance’. The escalation in rural debt (compared to farm income) is dysfunctional and unsustainable (cf Ben Rees, paper to Rural Debt Roundtable, 17 October 2012). Farm foreclosures are at (and promise to continue at) intolerable levels, especially in Queensland and NSW with long-term drought conditions.

I wrote an article on the then parlous situation in rural finance (and its evolution) in 2002 – ‘Rural Finance in Australia: A Troubled History’, *Rural Society*, 12/2, 2002. By default, this article turned out to be seminal because nothing of comparable scope has been written on the subject since. There has been a comprehensive and inexplicable absence of interest in this crucial arena by the rural bureaucracies and farmer representative bodies (including the National Party). The situation has deteriorated in the ensuing decade.

The typical rural loan facility is not fit for the purpose. Here – take this bill facility, even though you don’t know how bill facilities work, and we’ll change the terms on rollover whether you like it or not. Here – take this interest only facility, which we promise to turn over in three years, save that we probably won’t do so when the time comes (pointing to the fine print in the contract which the borrower never read or understood). And so on.

The banks do not seem to have transcended their origins as trading banks in developing appropriate capacities, facilities and cultures relevant to long-term lending, lending that accommodates variable environmental conditions.

Part of the problem is the legacy of the poisoned chalice of the 1981 Campbell Report into the Australian Financial System. The relevant Chapters 26-28 on Government-Owned Financial Institutions and Chapters 36, 38 & 39 on Sectoral Finance are a masterpiece of unexamined ideology covering for ignorance and vested interests. Australian financial history is significant by its absence in the report.

The iconic Commonwealth Development Bank was grafted from long experience of what the pundits are wont to call ‘market failure’ (here and overseas), but the CDB (and PIBA, and the numerous State banks with a historic partial rural orientation) disappeared in the post-Campbell orgy of corporatisation, privatisation and the seeming imperative of elevated oligopolistic private sector profit rates. The recent takeover of the publicly-owned Rural Finance Corporation of Victoria by Bendigo Bank (that bank now mimicking the slovenly and predatory practices of the Big 4) will find the existing RFC customers in for a shock in the near future.

Wholesale privatisation has, of course, been accompanied by rampant concentration within the sector, facilitated by a derelict Trade Practices Commission cum ACCC – thus inhibiting borrower options. In particular, the damnable, inexplicable ACCC 2008 approval of Westpac’s takeover of St George deprived SMEs of an alternative that was just getting into its stride and promising greater integrity in that borrower category. The much vaunted ‘competition’ at work.

The promises of the Campbell Report in this domain have since been proven pitilessly and pitifully erroneous, but nobody in authority is learning from the history of their own epoch because it is not in their private interest to do so.

In passing, I would like to offer strong negative sentiment on two suggestions mooted in the IR.

One, the prospect of broker intermediaries in substantive SME/farmer finance promises mostly further and dysfunctionality and heartache. Witness the adverse role of brokers in financial planning and funds management, and also in the ‘two-tier’ investment property scams of an earlier period. The adverse role of brokers has also been prominent in the bread-and-butter home mortgage finance arena. Apart from an inbuilt tendency to spivery in the brokerage sector, the opportunity for the ultimate bank funder to avoid responsibility for failed outcomes driven by incompetence and corruption (Storm Financial as Exhibit A) is a licence for that bank funder to be even less concerned with cleaning up such tendencies to incompetence and corruption.

Two, the suggestion to ‘facilitate development of an SME finance database to reduce information asymmetries between lenders and borrowers’ is a very bad idea. The current Veda credit data operation, a de facto SME/farmer finance database, has been subject to serious misuse and corruption, including from gangster interests – in which the personal details of uninvolved parties have been stolen and used for fraudulent loans (with at least the NAB and CBA failing to rectify their involvement in the crimes to the detriment of the hapless victims themselves). More, the banks themselves cannot be trusted (with the Big 4 acting as a de facto cartel in this arena) to utilise personal financial data of potential borrowers in an honest fashion.

Bank malpractice

Malpractice by the banks against its SME/farmer customers is rife. The clean-out, currently rampant, of family farmers facing climatic adversity is particularly diabolical. The ongoing malpractice highlights that bank lending practices, bank culture, indeed the dominant banking institutions themselves, are not fit for purpose.

The problem is compounded by little to no media coverage, by a complicit legal profession and a judiciary possessed of a training and culture prejudiced against the victims, and a regulatory apparatus resolutely inactive.

I have laid out in some detail my arguments supporting the above propositions in numerous articles, but recently in my submission to the Senate Economics References Committee’s ASIC Inquiry, Sub #295, 3 September 2013 – accessible on the Senate Economics Committee’s inquiry website.

This Financial System Inquiry will have failed its brief if it fails to acknowledge this issue. Behind this issue is an implicit indictment of the uncritically comprehensive post-Campbell Report deregulation of the finance sector, incorporating but not limited to the elements noted above. If one takes as axiomatic the erroneous premise that the process put in place in the 1980s in Australia was universally beneficial, one assumes away this particular running sore. The victims are well aware of the problem, and they are not amused. They are as disgusted with the political class that ignores their plight as they are disgusted with the banking system that has destroyed their livelihoods.

Exhibit A for this phenomenon is the mass default by the Commonwealth Bank of Australia of BankWest customers shortly after the CBA purchase of BankWest in late 2008. The process was and is transparently fraudulent, and it is a shocking indictment (coupled with other contemporary peccadilloes) of the transformation of a historic pillar of public interest banking to an institution evidently totally devoid of any business ethics or accountability. Moreover, the CBA BankWest default affair, if large scale, is not a unique instance, but representative of a broader and unchecked problem.

The ancillary lesson from this story is the comprehensive failure of the so-called self-regulation regime put in place after the 1991 Martin banking inquiry. The Code of Banking Practice is all window-dressing (it has been strategically disembodied of substance), and the Financial Ombudsman Service is (save for the odd exceptional case) complicit with its banking financiers.

A recommendation regarding the regulation of unconscionable conduct

I wish to highlight here merely one point of substantial policy relevance.

Amendments to the ASIC Act in August 2001 included the replication of s51AC Trade Practices Act, re business to business unconscionable conduct (legislated in 1998), into the ASIC Act, under ss12CB and 12CC.

The change was subsequent to a Wallis report recommendation looking for clean lines in finance sector regulation. Alas, the Wallis Committee made a mistake.

The move split the regulatory coverage of business to business unconscionable conduct between the ACCC and ASIC. ASIC has taken not a single action under 12CC since it acquired operational responsibility in early 2002 – a scandal of the first order.

Multiple complaints have been made to ASIC, but ASIC personnel perennially tell the victim complainants to go away – a compounding element of the scandal. Worse, ASIC personnel regularly respond to victim complainants in such correspondence that the organisation has no mandated responsibility in this arena. Here is an excerpt from ASIC personnel (designated 'Senior Executive Leader Stakeholder Services') to a Melbourne-based BankWest victim, dated 30 June 2014:

> 'As you may know, ASIC regulates the conduct of lenders and external administrators under the laws we administer, and we appreciate receiving reports of misconduct from members of the public about the people and entities we regulate. … However, ASIC generally does not act on behalf of individuals or businesses with respect to their private or commercial disputes. There are limited regulatory arrangements enforced by ASIC for commercial lending activity. ASIC's role is limited to administering the consumer

> protection provisions in the *Australian Securities and Investments Commission Act 2001* (ASIC Act).'

Atypically, this letter goes on to acknowledge (albeit in language so cryptic that its meaning would be missed by the ill-informed victim) that the ASIC Act extends to small business and misleading and deceptive conduct and unconscionable conduct by lenders. The letter then notes that the Courts 'impose a high evidentiary bar' in these matters (the only display of honesty and accuracy in the entire letter), and concludes (without saying so explicitly) that ASIC therefore will not go anywhere near that arena and thus it can do nothing for the complainant. The letter than proceeds to deflect the victim's complaints about the corrupt activities of BankWest's receiver which, claims ASIC (regarding an industry in which corruption is endemic), was merely exercising its 'commercial judgement'. In short, 'go away'.

This letter is not unrepresentative of treatment of SME/farmer complainants – indicating a comprehensive complicity of ASIC with corporate malfeasance in the financial services sector. The state of play is a disgrace.

Note that the recent Senate Inquiry into ASIC comprehensively ignored this dimension of ASIC's failure (preferring to concentrate on the CBA's CFP debacle), just as the same Committee ignored the CBA/BankWest scandal in its previous report from the Post-GFC Banking Inquiry. This is a complementary scandal.

If one ignores willful complicity on the part of ASIC personnel with ongoing bank malpractice, with the ongoing refusal to act on the institution's legislative mandate, one might infer that ASIC personnel lack the intellectual wherewithal to handle matters involving unconscionable conduct against SMEs/farmers. The area, admittedly, is legally demanding, but that is no excuse for inaction.

My recommendation is that the 2001-02 move be reversed. Namely, that legislative responsibility for business to business unconscionable conduct in financial services be returned to the ACCC. The ACCC itself has been weak on this front, but at least it knows the meaning of unconscionable conduct.

The stakes for SME/farmer borrowers

SME/farmer banking customers deserve functional institutions and functional relationships. SME/farmer victims of bank malpractice deserve justice, and sooner rather than later.

The relevant section of the IR under the sub-title 'Small- and medium-sized enterprises' opens with the paragraph:

'SMEs are major employers and drivers of economic growth. Australia's 2 million SMEs employ almost 70 per cent of the workforce, which is large by international standards. SMEs account for over half of the output of the private sector and tend to be a major source of innovation in the economy.'

Thus is trotted out on every relevant occasion this panegyric to the SME/farmer as the foundation, economic and spiritual, of our beautiful system. Like oaths on the Bible and gusty renditions of the national anthem at sporting fixtures, it is not taken seriously and is empty of content. Such homilies are an insult to the SME/farmer sector, whose always difficult business environment is made incalculably more perilous because it is surrounded by predators and substantively ignored by all those in authority. Homilies do not put food on the table.

Can this inquiry make some concession to the harsh reality facing this sector?