

Re: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Written Submissions of the Australian Prudential Regulation Authority (APRA)

Round 4: Experiences with financial services entities in regional and remote communities

Introduction

1. Pursuant to an application made by APRA on 15 June 2018, APRA was granted leave to appear and make submissions at the Royal Commission hearings commencing on 25 June 2018 (Round 4).
2. The focus of Round 4 has been on issues affecting Australians who live in regional and remote communities which relate to finance provided to agricultural businesses, and interactions between Aboriginal and Torres Strait Islander people and financial services entities.

Interests of the bank and of the agribusiness customer

3. The Royal Commission has sought submissions on the balancing of interests that may be in competition with each other when an agribusiness customer is experiencing financial difficulties. Related questions include what does it mean for a bank to act fairly and reasonably towards agribusiness customers in an enforcement context, and what weight should a bank give to an interest of the customer when making a decision about agribusiness customers experiencing financial difficulties?
4. A banking institution (in Australia, an authorised deposit-taking institution or ADI) is in the business of accepting financial risk to earn a return. At its most basic level, an ADI's business is to take money on deposit and make loans to generate a profit. As with any other business, it seeks to maximise returns and minimise losses on its business operations.
5. Overlaid on this commercial interest are an ADI's prudential obligations, which are intended to meet broader policy objectives of depositor protection and, ultimately, financial stability. Achievement of these obligations is where APRA's regulatory attention is primarily focussed.

6. In furtherance of these objectives, the prudential framework imposes both explicit financial capital-based minimum requirements and broader risk management requirements on ADIs. These prudential obligations may influence decisions an ADI makes about its lending activities over the lifecycle of its loans. However, it should be noted that APRA's prudential framework does not explicitly require an ADI to, for example, take a particular course of enforcement action in relation to a particular loan exposure or scenario, such as whether to realise collateral or renegotiate loan terms.
7. As a general observation, when engaged in lending activities an ADI should act prudently (for the benefit of its shareholders/members and depositors), and fairly and reasonably (for the benefit of the borrower), regardless of the industry to which they are lending. That standard of conduct should apply throughout the life of the loan; not just at the point of making a loan, or just at the point of enforcement. However, what will constitute prudent, fair and reasonable conduct may differ depending on a range of internal and external considerations, which may vary over time. Ultimately, the directors and managers of an ADI have a duty to act in the best interests of the company, within the parameters of the applicable legal and regulatory framework, and conscious at all times of the obligation to return depositor funds. They should not take risk without the prospect of an adequate return.
8. A key internal consideration is the ADI's risk appetite—the degree of risk that it is prepared to accept in pursuit of its strategic objectives and business plan— which will influence the type of lending (to whom and on which terms) it is prepared to offer. So too is its business plan, such as whether it is seeking to expand in a particular industry or geographic location. Other factors may be its financial position, which may include the composition of its lending book and corresponding capital position or, if a loan is impaired or non-performing, the amount of capital that is held against that higher risk.
9. Other considerations will inform the ADI's credit risk assessment: in agribusiness lending, for example, the ability of the ADI to recoup the money it is owed is likely to be influenced by factors (climate, pests, disease and market volatility) that are beyond the control of the borrower or itself. The ADI's assessment of these factors will be relevant both at origination and when a borrower may be in financial difficulty. That assessment may well—indeed is likely to—differ between ADI and borrower.
10. When a loan is extended, both the ADI and the borrower have an interest in the success of the venture. An agribusiness borrower wants the farm business to be prosperous to generate income and wealth, while the ADI wants the money owed to it to be paid in full,

and to earn interest on the funds in the meantime. Proper consideration must be given, at inception and over the life of the loan, by both the lender and the borrower, and having regard to the external risks attendant on the business of agriculture, as to how these aspirations will realistically be achieved. Prudent banking generally requires assessing a borrower's ability to repay as the primary means of recouping a loan, with collateral used as a backstop.

11. However, in circumstances when conditions deteriorate and the borrower's ability to service the loan is threatened, the parties' interests—and assessment of how to protect those interests—may diverge. The borrower is not simply interested in repaying its debt but may also want to minimise the loss of, for example, the family home or business. For a farmer, there is also likely to be an interest that is not strictly financial: retaining what may be a longstanding connection to a particular farm or community. The ADI on the other hand will remain primarily concerned to ensure repayment of the loan within a reasonable time and to minimise the risk that this may not occur.
12. Even if interests are examined purely on a financial basis, minimising the aggregate financial loss from the venture may not always equate to minimising the loss for each party. In particular, the strategy that minimises the overall financial loss to both parties may not be the strategy that minimises the loss to the ADI (and vice versa). Typically in a lending relationship, the borrower receives the upside, but shares the risk of downside with the ADI and thus an ADI will naturally tend to be more risk averse. Subject to not acting unethically, unfairly or unlawfully, the ADI will quite reasonably put its interest in achieving repayment first, and focus on downside scenarios. As outlined above, it will make an assessment of a range of commercial and regulatory considerations, including exercising judgment about the future outlook that may well differ from the borrower's assessment of that future. While pursuing enforcement action is usually viewed as likely to itself produce a loss of economic value, the ADI will need to weigh up and make a judgement as to whether the future prospects for the repayment of the loan (and earning an adequate rate of interest in the meantime) are within its risk tolerance, or whether pursuing immediate recovery action is preferable. A borrower, however, may be of the view that there is a long term value in retaining the property that will not be realised with a near term sale.
13. In APRA's view, an ADI acting fairly and reasonably in balancing its interests with those of its agribusiness borrower would be expected to:
 - make a proper credit risk assessment of the borrower before making the loan;

- adhere to the terms of the loan contract, taking account of regulatory hardship and other consumer protection obligations;
- not impose unreasonable requirements on the borrower that are unsuitable to the circumstances (for example, acknowledging that cash flows for agribusinesses may be seasonal, considering providing longer timeframes for realising collateral than may be applied for a residential mortgage loan) and
- subject to securing the ADI's interests, pursue repayment of debts in a manner that avoids unnecessary diminution in the value attributable to the borrower.

However, an ADI should not be expected to provide forbearance to a borrower in financial difficulties where it is clearly apparent that doing so will generate a larger economic loss for the ADI relative to the likely outcome of enforcement action.

14. As APRA noted in its submission to the Commission on the Round 3 hearings on loans to small and medium enterprises, there is a balance to be struck between the benefit of affording business borrowers additional protection and the costs of doing so. This balancing involves a determination as to the level of risk borne by each party, which, if unduly placed on the ADI, may ultimately limit borrowers' access to funding, either at all or at an acceptable price.

Internal valuation

15. APRA's prudential requirements relating to security valuation do not distinguish between valuations of farms and other rural property, and other types of security. Under the current *Prudential Standard APS 220 Credit Quality* (APS 220), in determining the fair value of security, an ADI may utilise the valuations of suitably qualified internal appraisers or external valuers and must have policies and procedures that address the circumstances in which such valuations would be sought.¹
16. APS 220 also notes that, given the importance of valuations to the estimation of the fair value of security, an ADI must have policies and procedures directed at ensuring the reliability of the valuation processes and valuations received in respect of security held.

¹ APS220, Attachment B, paragraph 17

This may involve internal reviews of valuations by appropriate management or audit staff and formal reviews by an independent valuer.²

17. Where an ADI uses internal appraisers, APS 220 requires it to have policies and procedures that address:

- when security values would be provided by internal appraisers; and
- the qualifications and experience required of internal appraisers when conducting valuations.³

18. Policies and procedures must also provide for instructions for the conduct of valuations and each valuation request must be the subject of specific instructions.⁴ For real property valuations, ADIs must ensure that valuers and appraisers adopt the valuation standards and practices of the Australian Property Institute (API) or equivalent local or offshore body.⁵

19. APRA does not consider it necessary to prohibit valuations from being conducted by suitably qualified internal appraisers, subject to the ADI meeting the above requirements. However, APRA's longstanding position is that it is better practice for valuations to be undertaken independently of staff involved in origination, to remove the potential for real or perceived conflicts of interest, which may affect the valuation.

20. To formalise this in its prudential standards, APRA is intending to incorporate this position in its proposed revisions to the credit risk capital framework by adopting the Basel Committee on Banking Commission's requirement that real property valuations are appraised independently from an ADI's mortgage acquisition, loan processing and loan decision process.⁶

² APS 220, Attachment B, paragraph 22

³ APS 220, Attachment B, paragraph 18

⁴ APS 220, Attachment B, paragraph 20

⁵ APS 220, Attachment B, paragraph 21

⁶ Basel Committee on Banking Supervision in December 2017: *Basel III: Finalising post-crisis reforms*, December 2017, paragraph 64 of the Standardised Approach to Credit Risk measures, available at: <https://www.bis.org/bcbs/publ/d424.htm>. APRA commenced consultation on its proposed revisions in its discussion paper, *Revisions to the capital framework for authorised deposit-taking institutions*, 14 February 2018, available at: <https://www.apra.gov.au/implementing-basel-iii-capital-reforms-australia>

Funeral expense products

21. The Round 4 Hearings have included a focus on the treatment of Aboriginal and Torres Strait Islander people, particularly in relation to funeral insurance.

Regulatory framework for funeral products

22. APRA notes that the treatment of funeral products under the existing regulatory framework is complex:

- There are a wide range of funeral products available – they can take the form of insurance-type products or savings-type products.⁷ Pre-paid funeral plans offered by undertakers are also available.
- Some funeral products are issued by APRA-regulated life insurers and are regulated under the *Life Insurance Act 1995*. A common product structure is an investment-account provided by a friendly society – these products are used in conjunction with a pre-paid funeral plan in some cases. Historically, these friendly societies were regulated at the State level. Today, friendly societies are regulated by APRA under the *Life Insurance Act 1995*.
- Under paragraph 11(3)(e) of the *Life Insurance Act 1995* (Life Insurance Act), certain types of business are specifically excluded from being considered life insurance business. This includes benefits consisting of the provision of funeral, burial or cremation services, or the payment of money for the purpose of meeting expenses for funeral, burial or cremation. The effect of this provision is that certain types of business that would otherwise be considered life insurance business can be undertaken by entities other than APRA-regulated life insurers. Equivalent provisions in relation to the definition of ‘insurance business’ are contained in section 3 of the *Insurance Act 1973*. APRA understands that one reason for these provisions was to exclude pre-paid funeral plans offered by undertakers and subject to State-based regulation from the operation of the Life Insurance Act and *Insurance Act 1973*.

⁷ Under an insurance-type product an insurer promises to pay an amount of money on the occurrence of an event (such as the death of the policyholder) in exchange for payment of a premium. Savings-type products involve the policyholder accumulating an account balance in a product, with that account balance being paid to the policyholder at a future time or on the occurrence of a specified event. In some cases, the savings product may also have an embedded insurance element such as a guaranteed minimum payout on death even if the account balance is less than that amount.

- Benefits may also be offered by entities other than APRA-regulated life insurers in the form of interests in a discretionary fund. Under such a structure the promise to the policyholder is limited to paying claims to the extent that there are funds available in the fund. In some such structures, the fund takes out an insurance policy to support payments to members of the fund.
- Depending on the structure and the specific nature of the benefit being provided, funeral products may be financial products within the meaning of the *Corporations Act 2001* (Corporations Act) or they may be outside those provisions.

23. The applicable regulatory framework therefore varies widely depending on the specific type of product and issuer. Combined with the generic use of the terms ‘insurance’ and insurer’ discussed further below, this clearly has the potential to cause confusion for consumers – in particular, differences between insurance-type and savings-type products are not well understood or communicated in all cases.

24. Any decisions to revise the regulatory framework by, for instance, removing or modifying the exemption under 11(3)(e) of the Life Insurance Act or expanding the regulatory framework more broadly are ultimately matters for Government. APRA is of the view, however, that there is merit in consistent treatment under the Corporations Act for funeral products to facilitate a consistent level of consumer protection such as licencing of the provider, disclosure and dispute resolution is achieved regardless of the specific product or structure involved. Careful consideration would need to be given in the design of any law reform to the interaction of the various parts of the regulatory framework, including State and Commonwealth regulation. This is particularly relevant in the context of pre-paid funeral plans the provision of which is subject to state laws.

Financial Services Council Code of Practice

25. For funeral insurance written by life insurers, APRA supports the Life Insurance Code of Practice issued by the Financial Services Council, which includes provisions that go to some of the matters raised by the Commission.⁸ In particular in relation to funeral insurance, the Code provides for:

⁸ <https://www.fsc.org.au/policy/life-insurance/code-of-practice/life-code-of-practice>

- a 30 day 'cooling off' period;
- protections in the case of financial hardship; and
- a key facts sheet that includes (amongst other things) explanation of the premium structure (stepped or level), information regarding pre-existing condition exclusions, and information about whether the total amount of premiums payable under the policy has the potential to exceed the benefit amount.

26. The Code also provides for a range of other matters more generally regarding the conduct of life insurers, including in relation to product design, disclosure and sales practices. The protections offered by the Code apply only where the financial institution issuing the product is subject to the Code, and so will not apply in all cases where a funeral product is being issued. APRA supports making the Code applicable to all life insurers and for the Financial Services Council to seek ASIC's formal approval under its statutory powers..

Use of the term 'insurer' and associated terms

27. APRA notes that the entities involved in the case studies, while not undertaking insurance business, appear to have represented themselves, or been represented, as insurers. In APRA's view, this contributes to consumers' misunderstanding about the nature of the products involved.

28. Under the *Banking Act 1959*, use of the term 'bank' is generally restricted to authorised deposit-taking institutions. Consideration could be given to whether similar restrictions might be appropriate in the case of insurers, with the intent to firm up the perimeter between what is prudentially regulated insurance business and what is not. Any new requirements would need to be carefully designed to ensure that they address the need to assist consumers to understand whether they are dealing with an APRA-regulated insurer, while not unnecessarily constraining other businesses that may have a legitimate interest in using terminology regarding insurance such as brokers and other distributors of insurance.

Discretionary funds

29. As noted above, a possible structure for the issuance of funeral products (and other 'insurance-like' discretionary products) is through a discretionary fund. Such products may be perceived as being insurance products by consumers, even though, due to the discretionary nature of the financial promise involved, they do not constitute insurance.

30. Due to the potential consumer confusion and detriment that can arise if consumers mistakenly believe they are purchasing insurance from an APRA-regulated insurer when they are actually dealing with a discretionary fund, APRA supports requiring such a fund to clearly and prominently disclose that it is not an insurer and is not subject to regulation by APRA.

Australian Prudential Regulation Authority