

The banks' power over small business

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In early February KPMG Consulting produced a report for the Australian Bankers' Association on small business banking. With the claim of 57 institutions offering 720 debt products, the implication is of a competitive utopia, with everything in perfect working order.

On the ground, the story is more complex and troublesome. Let's take a case study, that of Lynton Freeman and the National Australia Bank. Freeman's experience merits recounting as a reflection of the unequal relationship that small businesses experience with the major banks.

Freeman was a grazier, with a 10,000 hectare property out of Gladstone, Queensland. In 1992, Freeman borrowed \$540,000 from the NAB on a property that the Bank valued at \$2 million, consolidating debt previously owed to other lenders. Freeman had been improving the property for ten years and had recently managed a divorce settlement. Over the next few years he borrowed another \$400,000 to finance improvements and herd expansion, especially breeders, all with the Bank's support.

A long drought had him successfully gain a subsidy from the Queensland Rural Adjustment Authority annually from 1994 to 1996 (applicable to early 1997). To get this subsidy, the client has to undergo a review that satisfies the Authority that the client is long-term viable. Freeman passed this test.

In July 1996, Freeman's NAB branch acquired a new manager – Mr. 'Birch'. In his first credit report in August, Birch upped Freeman's interest rate another 3/4% above the base rate and demanded that Freeman reduce his overdraft by \$30,000 by November 1996, to claw back previous extensions of his overdraft limit.

Freeman pointed out that, if Birch would do the Bank's contribution to the annual review for the QRAA subsidy, the subsidy would reduce his overdraft for 1997 significantly below the reduction desired.

Birch's October 1996 budget was cavalier on cattle sales, and didn't include the potential subsidy, nor the additional expected income from mining rights and timber sales. This inaccurate budget became the fulcrum for Freeman's later treatment.

Freeman put together a QRAA application in early 1997 with assistance from a Department of Primary Industry consultant. There were delays with the Bank signing and returning the application. The QRAA belatedly approved the subsidy (worth \$54,000) in April, pending the Bank's formal review.

Birch then reported to superiors as if the QRAA approval had not taken place (NAB document D1-57, 10 June 1997). Birch never completed the review and Freeman never received his subsidy. In a letter of July 1998 to Liz Cunningham, the State Independent Member for Gladstone, the Bank denied knowledge of the favourable QRAA report.

Freeman's accounts were moved to the Asset Structuring Unit in June 1997. In November his facilities were not renewed and he was forced into mediation.

Bank-farmer mediation was established with Queensland Farmer's Federation assistance in 1996. In practice, mediation has acted to enhance the substantial asymmetry of the bank-customer relationship.

Freeman's four facilities were consolidated into one commercial accommodation bill. He has never received closing statements for these facilities. Freeman was instructed that he had until early April 1998 to refinance or suffer foreclosure. As no other institution will offer finance under these circumstances, the pain is merely prolonged.

There appears to have been internal differences in the Bank hierarchy over Freeman's treatment. In early March 1998 he was made a verbal offer by the Brisbane Asset Structuring Unit that the Bank would accept repayment of half of the debt.

To satisfy this new arrangement, Freeman paid in \$2205 as partial interest payment. However, Freeman was defaulted anyway. The \$2205 was put into a suspense account and not credited to Freeman for another 36 days. The Bank issued demand on April 20th.

The Bank then devalued Freeman's securities. In 1992 Freeman's property had a market value in the NAB's books of \$2 million. In 1996, it was down to \$1.75 million, but no documents have been discovered to explain the downgrading. Security schedule documents were not discovered by the Bank during litigation, including schedules for Freeman's stock.

On 14 April 1998, market value was put at \$1.4 million, and another \$600,000 arbitrarily knocked off for the 'effects of mining involvement and Freeman's possible effect on price' (NAB document, D1-48). Market value of stock was not included. With receivership expenses, Freeman's net worth had been reduced from over \$1 million surplus to a deficiency of \$250,000 at several strokes of the pen.

The NAB took Freeman to the Queensland Supreme Court for possession, gaining assent in October 2000. The judgment relied upon a draconian caveat in the mediation deed that released the Bank from any claims against it to that date. Judge Ambrose inconsistently touched casually on Freeman's claims, only to conclude that one could hardly countenance claims against "bank officers of their experience and holding the offices that they did".

Freeman would not win prizes for social graces, antithetical to sympathy from an impatient loans officer or a status-conscious judiciary. But bank lending is not supposed to be determined on personality and refinement.

Freeman had made losses but was financing his interest bill and bank charges. His debt at worst was marginally outside 'Category A', the Bank's own classification for low risk. The Bank's documents had recorded the property sound and Freeman competent, and the QRAA had judged him long-term viable.

The property, inaccurately advertised, was sold in May 2001 for \$770,000. Cattle properties are now in demand across Australia. Whoever bought Freeman's place would be laughing all the way – but hopefully not to the bank.

Freeman appealed the Supreme Court judgment but the Court of Appeal rejected Freeman's appeal in December 2001. Again, Judge White declined to consider Freeman's substantive complaints. Affidavits incorporating relevant evidence were not admitted into the hearing.

The Bank filed for bankruptcy in January 2001, based on the spurious asset deficiency. The bankruptcy petition was recently granted on 12 March 2002. The judgment is not particularly coherent. Judge Spender deliberated on whether to look behind the Supreme Court decision, citing precedents that legitimise this option, and then declined to take this route. The matter of the existence of a debt is integrally tied up with the nature of the valuation of the property and the sale by the receiver. The Judge cited precedents that the law treats the receiver as the agent of the mortgagor (the borrower), but declined to follow the logic of the argument to infer that the Bank had interfered with this agency.

The thrust of Freeman's judicial experience is that, after three Court hearings, his complaints against the Bank have never been given a proper airing. The caveat in the Mediation deed facilitated this neglect, but possible avenues for examining the full nature of the relationship were not pursued by the presiding Judges.

Several days after the bankruptcy judgment, Freeman was pursued by the Queensland Stock Squad and arraigned in the Gladstone District Court with stealing cattle from his property. Freeman's documentation readily proved that the relevant cattle were not encumbered to Bank mortgages, and a jury found in his favour.

This event provides a small counter to a process relentlessly imbalanced against Freeman. Freeman is appealing the Bankruptcy judgment, in the hope that a Full Bench of the Federal Court will cast a jaundiced collective eye at the transparent fraud surrounding the valuation and sale of his property.

Freeman's treatment by the NAB (and by the Courts) is not exceptional. A case is pending in the Victorian Supreme Court involving a boutique brewery in Albury-Wodonga which the Bank foreclosed on in November 2000. The principals were not in default, no discussion had ever been had regarding viability, and the Bank's demand came out of the blue.

Queensland, however, appears to be a hot-house of NAB activity. The NAB sent down the Queensland Mary Ryan bookshop chain in 2001. Myriad northern dairy farmers have lost their properties. A case involving a Brisbane child-care centre is currently before the Courts. In this case, the Bank sold the child-care centre for about \$1.1 million, even though the client had a contract to sell for \$1.6 million.

The other major banks present similar stories – good reputations in some segments, but rough treatment of some farmers and small businesses. Erratic lending practices have replaced intelligent evaluation of customer viability.

In a recent book, *Straw Polls, Paper Money*, the economist author David Love claims that the Australian finance sector has created a ‘web of economic rationality’ that has underpinned Australia as a top-ranking modern economy. This claim, and the KPMG report, are representative of the ‘official’ banking community and the public representation in the respectable media of the sector’s contribution to the economy.

There is a seamier dimension to the banking sector’s operations, generally shunned by the respectable media. This dimension appears to have flourished rather than diminished in the age of financial deregulation. Perhaps KPMG should visit the coalface for its next report on small business finance.