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Australian Securities and Investments Commission v Westpac Banking Corp

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On 1 March 2017, the Australian Securities and Investments Commission (ASIC) commenced civil penalty proceedings in the Federal Court of Australia against Westpac Banking Corporation (Westpac) for alleged contraventions of home loan responsible lending laws under the National Consumer Credit Protection Act 2009 (Cth) (NCCP).[1] During the period between 12 December 2011 and March 2015 inclusive (relevant period), ASIC alleges that Westpac failed to properly assess whether customers could meet their repayment obligations before entering into loan contracts with consumers who sought interest-only home loans.[2] While the litigation commenced this year and is still ongoing, this article analyses the claims made by ASIC on 1 March 2017 and Westpac's defence filed on 2 June 2017 with the view of guiding banking and finance institutions and their counsel in identifying potential responsible lending risks within their businesses.

Background — ASIC's industry-wide review findings on interest-only loans

On 20 August 2015, ASIC released their findings[3] in relation to an industry-wide review across 11 credit providers who settled residential home loans for customers between 2012 to 2014 with the characteristics of an initial interest-only repayment period reverting to principal-and-interest repayment for the balance of the loan term. In ASIC's review, they specifically requested credit providers to clarify how they applied the NCCP's responsible lending regime for credit assessments conducted for interest-only loans during this period.

ASIC's review focused on home loans with an initial interest-only period because such loans, they believe, are likely to be more expensive in overall interest costs to the customer over the loan term than loans with principal-and-interest repayments. ASIC tested aspects of the responsible lending laws including the credit provider's obligation to make reasonable inquiries about a customer's requirements and objectives[4] and financial situation,[5] verification of the customer's financial situation,[6] and the credit provider's obligation to form an assessment that the loan was not unsuitable for the customer having regard to the inquiries and verifications made.[7]

Based on the information gathered by ASIC as part of this inquiry and bolstered by additional information from credit providers that flowed, on 1 March 2017 ASIC filed a claim against Westpac, seeking relief in relation to interest-only home loans settled between December 2011 and March 2015 which were mainly underwritten through automated serviceability assessments.

Status of ongoing proceedings

By way of a brief status update on the ongoing proceedings, on 1 March 2017 ASIC filed its originating application and on 18 April 2017 it filed its statement of claim. Westpac filed its defence on 2 June 2017. This article will focus on these two main court documents. On 2 August ASIC filed its reply, and two amended statement of claims on 26 September 2017. After multiple adjourned hearings over the last couple of months, a case management hearing was scheduled on 5 December 2017 in front of Perram J, before which Westpac had to file and serve any further defence to the amended statement of claim by 17 October 2017.

ASIC had until 24 October to file and serve any reply to the further defence and Westpac had to then, by 31 October 2017, file and serve any application for summary dismissal or strike out of ASIC's amended statement of claim. If Westpac brings no summary dismissal or strike out application by that date, then the parties had to agree to a statement of agreed facts by 28 November 2017.[8] Having been in litigation for only 8 months, it is a timely reminder for banking and finance compliance lawyers of the lengthy, protracted and costly exercise litigation can become and the importance of staying, as much as possible, under ASIC's radar.

Summary of ASIC's claim against Westpac

ASIC is essentially seeking an order that Westpac pay to the Commonwealth of Australia such pecuniary penalties as the court determines to be appropriate in respect of contraventions of ss 128 (obligation to assess unsuitability), 131(1) (reasonable inquiries and verifications) and 133(1) (prohibition on entering into unsuitable credit contracts) of the NCCP.

ASIC is seeking a declaration under s 166 of the NCCP (declaration of contravention of civil penalty provision), or alternatively s 21 of the Federal Court Act 1976 (Cth) (declarations of right), that during the relevant period, as regards to loans secured against residential property entered into by Westpac which were not referred for manual assessment, and relying on home loans A to G (as labelled in their claim), Westpac failed to comply with s 128 of the NCCP in that the serviceability assessment for all such contracts relied on statistical data from the 2009–10 Australian Bureau of Statistics (ABS) Household Expenditure Survey (Household Expenditure Measure (HEM) benchmark figures) for monthly expenses and did not assess monthly expenses having regard to the customer's actual living expenses as declared by the customer to Westpac.

Reliance on HEM benchmark figures

Specifically, ASIC alleges that Westpac used the HEM benchmark figures rather than looking at actual expenses declared by customers in assessing their ability to repay the loan, and declared figures which it claims in home loans A to G were higher than the HEM benchmark figure used by Westpac.[9] ASIC alleges that Westpac approved loans where a proper assessment of a customer's ability to repay the loan would have shown a final net monthly shortfall.[10] Further, for home loans with an interest-only repayment period, Westpac failed to have regard to the higher repayments at the end of the interest-only period when assessing the customer's ability to repay.[11]

Section 128(c) of the NCCP requires that the credit provider must, before entering into a credit contract, have made an assessment that is in accordance with s 129 of the NCCP and that covers the period in which the credit day occurs, and must have made the inquiries and verification in accordance with s 130 of the NCCP.[12] Under s 129(b) of the NCCP, a credit provider is required to assess whether or not the credit contract is unsuitable for the customer. Under s 130 of the NCCP, the credit provider must make reasonable inquiries about the customer's requirements and objectives;[13] make reasonable inquiries about their financial situation;[14] take reasonable steps to verify the financial situation;[15] and make any inquiries or take any steps prescribed by the regulations.[16]

ASIC alleges that under s 128(c) and (d) of the NCCP, if properly construed, Westpac was not permitted to enter into a home loan contract without making an assessment that the home loan was not unsuitable for the customer;[17] and without making reasonable inquiries about the consumer's financial situation and taking reasonable steps to verify the consumer's financial situation.[18]

ASIC alleges that the assessment under s 128(c) of the NCCP was required to be conducted by reference to information obtained as the result of inquiries made under s 130, including taking into account the customer's living expenses (declared living expenses). For context for banking and finance advisors, ASIC's Regulatory Guide 209 includes guidance from ASIC on the use of expense benchmarks, including its use to test reliability of information declared by customers, and for it not to be a substitute for reasonable inquiries, nor is it a replacement of the assessment based on the customer's verified information.[19]

ASIC alleged that Westpac had contravened s 128 because Westpac's serviceability assessment and system rule assessed the suitability of the home loan and enabled the automated approval of home loans A to G by reference to HEM benchmark figures as to expenses, but without any regard to the customer's declared living expenses. ASIC therefore alleged that all home loans which had not been manually assessed by Westpac were in contravention of s 128 of the NCCP.

Declared expenses higher than HEM benchmark figures

In addition, ASIC alleged that s 128 of the NCCP had been contravened by Westpac because the customer's declared living expenses were greater than the HEM benchmark figures used in serviceability assessments for home loans A to G, and claimed that if Westpac had conducted the assessment using the benchmarks, the final net monthly shortfall would have been in excess of $400 per month for these loans. Generally, ASIC accepts the use by banking and finance institutions of HEM benchmark figures to verify living expenses as long as the higher of the HEM benchmark figures and customer's declared living expenses are used in serviceability calculations.

Assessment after the interest-only period

In relation to the interest-only loans A to E in ASIC's claim, it also alleges that Westpac did not consider the residual monthly payments in conducting the serviceability assessment and did not therefore assess whether the loan would be unsuitable after the interest-only period. ASIC claims that if Westpac's serviceability assessment did have regard to the residual monthly payments, the final net monthly shortfall would have been in excess of $400 per month.

ASIC alleges that by using the full term method, Westpac did not assess whether the loans would be unsuitable having regard to the additional costs of interest-only loans and that if the serviceability assessment had regard to the additional costs of interest-only loans, the final net monthly shortfall would have been in excess of $400 as set out in Sch 5. Depending on the outcome of this case, and the success of Westpac's defence which is summarised below, one lesson for credit providers and their advisors might be to take a conservative position on factoring into all serviceability calculations the additional interest-only interest costs over the loan term, and assuming that no additional repayments will be made into the loan or an offset account.

Sections 131 and 133 of the NCCP

Under s 131(1) and (2) of the NCCP, Westpac had an obligation to assess that the home loan was unsuitable for the customer if the consumer will be unable to comply with the consumer's financial obligations under the contract, or could only comply with substantial hardship in the period covered by the assessment; or the contract will not meet the consumer's requirements or objectives in the relevant period.[20]

Under s 131(4) of the NCCP, the only information that can be taken into account by Westpac is information that it had reason to believe was true at the time of the assessment; or it had reason to believe was true if it had made the inquiries or verification under s 130. Section 133(1) prohibits Westpac from entering into a credit contract if it is unsuitable, using a similar assessment for suitability as under s 131(2).

In summary, ASIC alleges that all loans which had not had a manual assessment by Westpac failed to comply with ss 131 and 133 of the NCCP. It also claimed that each of home loans A to G were unsuitable for the consumer and that Westpac contravened ss 131(1) and 133(1) because if Westpac had used the customer's declared living expenses instead of the HEM benchmark figures, the final net monthly shortfall would have been in excess of $400.

Further, if Westpac's serviceability assessment had used the residual term method rather than the full term method of serviceability, it would have assessed a monthly shortfall for each loan of greater than $400. Alternatively, if the serviceability assessment had been calculated using the full term method but taking into account the additional costs of interest-only loans over the term of the loan, it would have assessed a final net monthly shortfall for each loan of greater than $400.

Summary of Westpac's defence

Construct of loans with an interest-only period

Regarding the construct of loans with an interest-only period, Westpac submits in its defence that a customer's rights and obligations under an interest-only loan differed if the loan was a variable rate or a fixed rate loan.[21] The customer was able to draw down the home loans in full or in part. A loan with a fixed interest rate needed to be drawn in full at the time of settlement, and those customers were only able to pay between $3000 and $15,000 per year over the required interest-only repayments during the fixed interest rate period (depending on the conditions of the loan product contract).[22]

For customers on a variable rate loan and therefore not impacted by the fixed rate principal restriction, payments over and above the interest-only repayments required under the loan contract during the interest-only period could be made (including payments into an offset account), thereby, according to Westpac's defence, potentially creating a surplus within the loan or offset account.[23] At the end of the interest-only period, this surplus, Westpac submits, could go towards either meeting the principal-and-interest repayments, or making a principal reduction to the loan (by application to Westpac). In this situation, effectively, the customer would have been making principal-and-interest repayments throughout the loan term, which, according to Westpac, could satisfy the customer's loan obligations, as assessed by Westpac.[24]

Westpac further submits in its defence that if a customer did make payments over and above the required interest-only repayment during the interest-only period, the customer would have most likely been in an even better position than if the loan was principal-and-interest from settlement of the loan, because interest is calculated on the outstanding balance and not the credit limit.[25]

Westpac does admit that the residential monthly payments comprised the applicable interest rate, the credit limit at the time, the length of the residual loan term and applicable fees, but denies that the residual monthly repayments were necessarily higher than the monthly payments if the loan was principal-and-interest from its drawdown date, in circumstances where the customer did make extra payments into their home loan or offset account. This therefore would have decreased the interest payment due each month, as interest is only calculated on the outstanding balance and not the credit limit.

If in fact the customer did make payments equal to the assessed monthly repayments, and drew on those excess funds to meet the residential monthly payments, then the loan would be repaid in full at the end of the loan contract term without the customer needing to make any extra payments over and above the assessed monthly repayments, provided no redraws were made on the home loan and provided the interest rate remained unchanged for the loan contract term.

Westpac claims that customers with these loans did make payments higher than required during the interest-only period and retained those funds in an offset, and this could have therefore satisfied the previous construct of meeting the repayments based on Westpac's full term method.

Assessment after the interest-only period

Regarding their assessment of the loans for suitability under the NCCP, Westpac describes how the applicant is required to complete and submit an application for credit, called a personal finance inquiry.[26] Part of this form is for the declaration of debts owed or declared living expenses, and the form is designed with such specificity so as to flag in the mind of the applicant the debts they have, which may not have otherwise been front of mind (for example, Higher Education Contribution Scheme (HECS), mobile, internet, and pay TV).[27]

Westpac admits that an automated decision system,[28] with no less than 216 in-built credit decisioning rules,[29] was part of the wider loan application assessment process which also included an initial "needs" discussion with a home finance manager, verification of the applicants' information, and any manual checks required. At the end of this process, the automated decision system would provide one of three possible decisions: approved, declined or referred to manual review.

One of the credit decisioning rules, the serviceability rule, calculated net monthly surplus income, by subtracting outgoings and assessed monthly repayments from the discounted monthly income (where the discounted monthly income was after tax income from verified sources allowed under Westpac's credit policies and subject to discounting (also known as shading) depending on income sources), under the full term method, which is based on the drawdown of the entire credit limit being paid with principal-and-interest repayments to a zero balance at the end of the full loan term.[30]

Westpac confirms that declared living expenses did not form part of the serviceability rule calculation to determine the net monthly surplus, instead Westpac applied the HEM benchmark figure, citing that HEM was complied by reference to the 2009–10 ABS Household Expenditure Survey, updated quarterly, and scaled as to the location of the security property, number of dependants and marital status.[31]

Westpac, in its defence, describes their use of HEM benchmark figures as it was an independent, objective, broad-based measure, developed by the University of Melbourne, of expenditure levels for various types of households calculated as the sum of the median expenditure on basic items and the 25th percentile of expenditure of discretionary basic items.[32]

The required minimum monthly surplus, Westpac describes, was calculated by adding the figure derived from the HEM benchmark figure (plus a buffer, where the buffer was calculated as a percentage of the proposed credit limit), all existing Westpac's secured and unsecured liabilities, and external secured liabilities, which varied during the period under scrutiny from 1.56% to 2.16% for variable rate residential loans.[33]

The required minimum monthly surplus was subtracted from the net monthly surplus or shortfall to give the final net monthly surplus or shortfall, and it was this figure, Westpac explains, that was used to determine whether the application passed the serviceability rule.[34]

The application was also given an application score which measured the likelihood the applicant could meet their financial obligations under the proposed residential home loan and depended on a number of algorithmically weighted variables, including credit bureau reports, occupation, number and balance of loan and savings accounts held under Westpac brands, number of debt refinances on the application, repayment history and worst recent delinquency.[35] Further, aligned risk grading was applied based on behavioural predictive risk models.[36]

All these credit decisioning rules and others formed part of the automated decision system that assessed each loan application, with Westpac citing in their defence that there was also a rule which automatically declined a loan application if the applicant stated they expected a significant change to their financial situation which would impact their ability to meet their loan repayments.[37]

Based on its assessment rules, Westpac's core defence as submitted on 2 June is that if the assessed monthly repayments, which included the principal portion, were made during the interest-only period, then assuming a static interest rate, the customers' residual monthly payment post the end of the interest-only period would be equal to the assessed monthly repayment, and therefore the loan application assessment used by Westpac was a "reasonable and appropriate means of assessing the ability of the consumer to comply with their financial obligations under the proposed Home Loan".[38]

Westpac's Chief Executive of Consumer Bank, George Frazis, has publicly stated in relation to ASIC's claims that:

> It is not in the bank's or customers' interests to put people into loans that they cannot afford to repay. It goes hand in hand that we have robust credit approval processes while helping customers purchase their home.
>
> …
>
> [Westpac] include[s] a consideration of customers' specific circumstances, including income and expenditure, previous repayments history and the overall customer relationship. We build into our processes a range of conservative inputs, including the addition of buffers to take into account possible future interest rate increases.[39]

Conclusion

Westpac has stated publicly that it will defend the Federal Court proceedings and confirmed to the market that it does not concern Westpac's current lending policies or practices. It claims that, of the seven specific loan applications ASIC references in its proceedings, all loans are currently meeting or ahead of their schedule in repayments.[40] While the outcome is far from clear at this early stage in the proceedings, this case should be a warning to all Australian banking and finance institutions and their advisers that ASIC will pursue an Australian credit licensee in relation to loans it feels were assessed or entered into in contravention of the NCCP responsible lending laws, regardless of whether or not the loan itself turned up to be suitable and able to be serviced by the customer. All ASIC guidance on responsible lending including Regulatory Guide 209, and ASIC reports including their *Review of Interest-Only Home Loans* should be considered carefully in implementing an institution's policies, systems and processes.

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Leonie Chapman's experience extends to banking and finance, consumer credit and mortgage lending, contract negotiation, trade practices and fair trading legislation, intellectual property and trademarks, corporate and financial services. After completing her Bachelor of Laws and Bachelor of Commerce in 2002, Leonie went on to work both in private practice and as senior in-house lawyer supporting a specialist lender and then for 6 years, Macquarie Bank Ltd. Having achieved a Master of Laws in 2009 specialising in banking and finance law, Leonie's main focus now as principal of LAWYAL Solicitors is on regulation and compliance for banking and financial institutions.

Footnotes

1. NCCP, ss 128, 131(1) and 133(1).
2. ASIC "ASIC commences civil penalty proceedings against Westpac for breaching home-loan responsible lending laws" media release 17–048MR (1 March 2017) http://asic.gov.au/about-asic/media-centre/find-a-media-release/.
3. ASIC *Review of Interest-Only Home Loans* Report No 445 (20 August 2015) http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-445-review-of-interest-only-home-loans/.
4. Above n 1, s 130(1)(a).
5. Above n 1, s 130(1)(b).
6. Above n 1, s 130(1)(c).
7. Above n 1, s 129.
8. Commonwealth Courts Portal, Australian Securities & Investments Commission v Westpac Banking Corporation ACN 007 457 141, accessed 11 October 2017, www.comcourts.gov.au/file/Federal/P/NSD293/2017/actions.
9. Westpac's Notice of Filing, Concise Statement, Australian Securities and Investments Commission v Westpac Banking Corporation ACN 007 457 141, File No NSD293/2017 (1 March 2017) para 8(b) http://download.asic.gov.au/media/4167349/17-048-concise-statement-asic-vs-westpac.pdf.
10. Above n 9, at para 8(c).
11. Above n 9, at para 9.
12. Above n 1, s 128(d).
13. Above n 1, s 130(1)(a).
14. Above n 1, s 130(1)(b).
15. Above n 1, s 130(1)(c).
16. Above n 1, s 130(1)(d) and (e).
17. Above n 1, s 129.
18. Above n 1, s 130(1)(b) and (c).
19. ASIC "Credit licensing: responsible lending conduct" Regulatory Guide 209 (November 2014) paras 209.49 and 209.105 www.asic.gov.au/media/2243019/rg209-published-5-november-2014.pdf.
20. Above n 1, s 131.
21. Westpac's Defence, Form 33, File No NSD293/2017 (2 June 2017).
22. Above n 21, at para 4.
23. Above n 21, at para 5(a)(viii).
24. Above n 21, at para 5(a)(vx).
25. Above n 21, at para 5(b)(ii).
26. Above n 21, at para 6.
27. Above n 21, at paras 7 and 8.
28. Above n 21, at para 11.
29. Above n 21, at para 12(b)(ii).
30. Above n 21, at para 13.
31. Above n 21, at para 13(e) and (f).
32. Above n 21, at para 13(h).
33. Above n 21, at para 13(g).
34. Above n 21, at para 13(i).
35. Above n 21, at para 16(e).
36. Above n 21, at para 16(e)(v).
37. Above n 21, at para 16(l).
38. Above n 21, at para 18(e)(vi).
39. Westpac "Westpac to defend ASIC civil penalty proceedings in relation to responsible lending practices" media release (1 March 2017) www.westpac.com.au/about-westpac/media/media-releases/2017/1-march/.
40. Above n 39.