Sydney and Melbourne Property Bubbles:

An introduction to the law of asset lending, the Code of Banking Practice and the recent case of ASIC v Westpac.[1]

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Introduction:

1. Sydney property prices rose about 75% in the period 2012 – 2017.[2] Melbourne too experienced a similar phenomenon.[3] It was probably a great time to have been an property investor or home owner in the Sydney property market.

2. When property prices are rising, there are many stakeholders who benefit such as:
    a. The State Government of NSW which collects billions in stamp duty.
    b. The conveyancing practices of lawyers with generous transaction volumes.
    c. Real estate agents with ever increasing commissions and volumes.
    d. Developers who can justify building large apartment complexes to sell off the plan.
    e. Overseas investors desirous of speculating or investing in the Australian market.
    f. Banks who can lend greater and greater sums of money.
    g. Tradies who enjoy full employment and solid wages.
    h. The retail sector which can sell furnishings and electronics to fill the new apartments created, and which benefits from the 'positive wealth effect' (i.e. when people feel wealthy because their home is going up in value they spend more).
    i. Baby boomers who can retire by cashing in their equity and/or downsizing.

3. On the other hand, rising property prices disadvantage other stakeholders such as:
    a. First home buyers who are locked out of the market, and who may have to resort to the 'Bank of Mum and Dad'.

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[1] Australian Securities and Investments Commission v Westpac Banking Corporation (Liability Trial) [2019] FCA 1244.
[2] https://www.businessinsider.com.au/sydney-home-prices-surged-75-in-less-than-5-years-2017-3 https://www.businessinsider.com.au/sydney-house-price-cycle-2017-11
[3] https://www.smartcompany.com.au/industries/property/may-2019-update-property-markets/

b. The economy as a whole which is exposed to the risk of household debt as a percentage of GDP climbing to dangerous levels, and which is weighed down by so much of its productive capacity being tied up in housing.

4. There is theory that property price increases[4] are primarily due to Banks' willingness to lend, for example, on interest only loans, and not necessarily to supply and demand per se. This theory has some credence if one considers that wages growth did not match the boom in property prices in Sydney and Melbourne in the 2012 – 2017 period (i.e. the price rise could not conceivably be explained by wages growth).

5. Unfortunately, the 2012 - 2017 rise in property prices came to an end. Some say it was due to APRA (i.e. the Australian Prudential Regulation Authority) tightening the lending criteria in 2017.[5] APRA is essentially the regulator of the finance industry.

6. Whatever the reason, Sydney's property prices fell in the period from mid-2017 to mid-2019 by about 16%.[6] A similar phenomenon occurred in Melbourne.

7. Some say that this fall in property prices caused what is called a 'negative wealth effect' (i.e. consumers reduce spending because they feel less wealthy as their homes reduce or flatten in value). The consequences of this appear to be the per capita recession[7] and retail recession[8] that we are currently in.

8. Recently, a few things have happened that might, or might not, have put a floor under Sydney's property prices and/or stimulated its recovery:

    a. The Liberal Party won the 2019 federal election, noting that the Labour party was promising to remove, or significantly weaken negative gearing and change the capital gains tax exemption rules.

    b. The Reserve Bank has cut interest rates twice down to 1%. More cuts are foreshadowed.

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[4] Martin North, Digital Finance Analytics.
[5] https://www.apra.gov.au/media-centre/media-releases/apra-announces-further-measures-reinforce-sound-residential-mortgage
https://www.businessinsider.com.au/apra-has-announced-tighter-restrictions-on-australian-home-loan-lenders-2017-3
https://en.wikipedia.org/wiki/Australian_property_bubble
[6] https://www.abc.net.au/news/2019-03-19/house-prices-abs-december-quarter-2018/10915740
[7] https://www.abc.net.au/news/2019-03-06/gdp-q4-2018/10874592
[8] https://www.smh.com.au/business/the-economy/retail-sales-drop-to-levels-not-seen-since-the-1991-recession-20190813-p52gn3.html

c. The Liberal party has given income tax cuts.[9]

d. APRA has loosened the lending criteria.[10]

9. Recently, there have been signs that the Sydney property market is bottoming out, if not resuming its march towards ever increasing prices[11] (albeit others says it is a 'dead cat bounce'[12]).

10. The key point is that Banks are important actors in the Sydney (and Melbourne) property markets. How Banks lend money greatly affects which way prices move.

11. At one extreme, if Banks lend to anyone 'with a pulse', so to speak, and provide interest only loans generously, it is likely that property prices will rise. At the other extreme, if Banks carefully assess a borrower's ability to repay a proposed loan, and only lend what the borrower can comfortably repay, property prices are less likely to rise or may even fall.

12. The natural inclination of Banks is to lend money (albeit secured) because the more they lend the more interest they earn, and thus the more profit they potentially make.

13. The question then becomes '*does the law impose any limits or restrictions on the ability of Banks to lend money, or are Banks at liberty to do as they please when it comes to lending for residential property*'? In this context, one notes that we recently had a Royal Commission into Misconduct in the Banking Superannuation and Financial Services Industry.[13]

14. The purpose of this CLE is to introduce 3 areas of law which arguably restrain or curb the natural inclination of Banks to lend to proposed borrowers seeking to buy residential property.

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[9] https://www.theaustralian.com.au/nation/politics-now-46th-parliament-kicks-off-with-almighty-push-to-pass-scott-morrisons-full-tax-cuts/news-story/1078e53c69e0739989663810bcd9ed93
[10] https://www.apra.gov.au/media-centre/media-releases/apra-finalises-amendments-guidance-residential-mortgage-lending
[11] https://www.abc.net.au/news/2019-07-01/home-prices-still-falling-but-not-in-sydney-and-melbourne/11266364
[12] https://www.smh.com.au/politics/federal/fears-of-dead-cat-bounce-for-house-prices-as-economists-warn-of-retail-troubles-20190802-p52d6r.html
[13] https://financialservices.royalcommission.gov.au/Pages/default.aspx

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15. Such knowledge may prove especially useful if, or some say when, the Australian economy takes a turn for the worse with increasing job losses, increasing mortgage defaults, property repossessions, bankruptcies and recession.

16. Knowing about these 3 areas of law will help the practitioner potentially assist desperate clients who are being chased by a Bank for defaulting on their mortgage, or who are being chased for a personal guarantee given under the 'Bank of Mum and Dad'.

17. In such circumstances, the questions should at least be asked:

    '*Should the Bank have lent the money in the first place, and if the answer is 'no', what does the law have to say about that*'?

    '*Did the Bank properly assess the borrower's capacity to repay, and if not, what does the law have to say about that*'?

18. The 3 areas of the law are:

    a. The law of Asset lending.

    b. The Australian Banking Association's Code of Banking Practice.

    c. The National Consumer Credit Code.

<u>The Law of Asset Lending.</u>

19. Before looking at the law of asset lending, one should first look at the particular statute from which it came.

20. That statute is the Contracts Review Act 1980 (NSW) (**Contracts Review Act**).

21. The Contracts Review Act is unique to New South Wales.

22. There is a separate paper on the Contracts Review Act by the writer available upon request.[14]

23. The essential idea behind the Contracts Review Act is to give Courts power to un-do unjust contracts. Its statutory language is as follows:

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[14] *Ivan Leong*, Contracts Review Act 1980: General principles for relief and recent cases, 22 October 2014 & updated 2016.

(1) **Where the Court finds a contract or a provision of a contract to have been unjust** in the circumstances relating to the contract at the time it was made, **the Court may**, if it considers it just to do so, and for the purpose of avoiding as far as practicable an unjust consequence or result, **do any one or more of the following**:

(a) i**t may decide to refuse to enforce any or all of the provisions of the contract**,

(b) it may make an order declaring the contract void, in whole or in part,

(c) it may make an order varying, in whole or in part, any provision of the contract,

(d) it may, in relation to a land instrument, make an order for or with respect to requiring the execution of an instrument that:

i. varies, or has the effect of varying, the provisions of the land instrument, or

ii. terminates or otherwise affects, or has the effect of terminating or otherwise affecting, the operation or effect of the land instrument.

24. What the Contracts Review Act basically means is that, even if a contract is signed by a party, nevertheless a Court can still overturn, or decline to enforce, it if it finds it unjust.

25. The Court will look at the circumstances and characteristics of the party, and the circumstances of the execution of the contract, in making this assessment.

26. The central question is whether a Court regards a contract as unjust.

27. Whether a contract is unjust is a broad evaluation having regard to public interest and the totality of the circumstances.

28. Thus the Contracts Review Act is the context from which the law of asset lending arose.

29. Lending invariably involves a certain type of contract, e.g. a mortgage, a loan agreement and/or personal guarantee(s). The law of asset lending is just a particular application of the Contracts Review Act to these types of contracts.

30. Most of the law on asset lending comes from the NSW Court of Appeal.

31. The seminal case on asset lending is that of Perp*etual Trustee Company Limited v Albert and Rose Khoshaba* [2006] NSWCA 41. In that case, Basten JA gave the now well recognised definition of asset lending:

> [128] **<u>To engage in pure asset lending, namely to lend money without regard to the ability of the borrower to repay by instalments under the contract, in the knowledge that adequate security is available in the event of default, is to engage in a potentially fruitless enterprise, simply because there is no risk of loss.</u>** At least where the security is the sole residence of the borrower, **<u>there is a public interest in treating such contracts as unjust</u>**, **<u>at least in circumstances where the borrowers can be said to have demonstrated an inability reasonably to protect their own interests</u>**, for the purposes of, for example, s 9(2)(e) or (f). That does not mean that the Act will permit intervention merely where the borrower has been foolish, gullible or greedy. Something more is required: see *Esanda Finance Corp Ltd v Tong* (1997) 41 NSWLR 482 at 491 (Handley JA) cited with approval in *Elkofairi* (above) at [77] by Beazley JA.

32. Essentially, asset lending is lending money without regard to the borrower's ability to repay. It is really lending on the strength of the security, usually, real property.

33. But on top of that, 'something more' is usually required (as clarified in later cases). Usually, it is the borrower's inability to protect their own interest, or some weakness in the borrower (such as age, mental infirmity, or lack of English), or some other factor which causes 'unjustness' in the lending.

<u>Examples of Asset Lending.</u>

34. By way of illustration, this paper proposes to look at an example of where asset lending was found (*Khoshaba*), and not found (*Knezevic*).

35. In *Khoshaba*, the Khoshaba's were pensioners. They were born and educated overseas and English was their second language. They borrowed $120,000 from a lender to

enable their daughter to participate in a pyramid scheme. Both they and their daughter were financially naive.

36. In return the Khoshaba's gave the lender a first registered mortgage over their home.

37. The lender did not induce and had nothing to do with the Khoshaba's participation in the pyramid scheme. It was due to a third party. As one might expect, the pyramid scheme failed.

38. The trial judge held that the lender had not followed its loan assessment guidelines in making the loan, and had not recommended that the Khoshaba's get independent legal and financial advice. Had the assessment guidelines been followed, the loan would not have proceeded (as the lender would have discovered that the Khoshaba's were pensioners). In particular, the lender had not checked Mr Khoshaba's employment position. This is what made the loan contract unjust according to the trial judge.

39. What made the result in *Khoshaba* a bit curious was the fact that loan application(s) were submitted (twice) by a third party finance broker. Although Mr Khoshaba told the finance broker that he was a pensioner, the finance broker nevertheless stated Mr Khoshaba's income as being $43,000 per annum in the initial application. In the second application, Mrs Khoshaba was added, but her supposed signature was not actually hers. The lender was not behind these curiosities.

40. Nevertheless, the lender lost the case because it had failed to go behind the loan applications and directly check with the Khoshaba's, per its lending guidelines, about their financial status.

41. It was these circumstances which gave rise to Basten JA's now famous '*To engage in pure asset lending*…' principle. The '*something more*' that Basten JA appeared to rely upon were the personal circumstances and life history of the Khoshaba's (which meant that they were not sophisticated, had poor English and basic education) and the fact that both they and their daughter were financially naive.[15]

42. In *Knezevic*[16], Basten JA again featured. But this time, the lead judgment was given by Meagher JA.

[15] Perpetual Trustee Company Limited v Albert and Rose Khoshaba [2006] NSWCA 41 at [129] – [131].
[16] Knezevic v Perpetual Trustees Victoria Ltd and Anor [2013] NSWCA 199.

43. Ms Knezevic took out 3 loans with a lender when she was 60 years old. Again a finance broker or intermediary was involved. The purpose of the loans was stated as 'investment purposes'.

44. The 3rd loan was a refinance of the 2nd loan which was a refinance of the 1st loan. No proof of income or overall financial position was required for the 2nd and 3rd loans.

45. Unfortunately, Ms Knezevic defaulted under the 3rd loan.

46. The trial judge was not satisfied that when the 3rd loan was made, Ms Knezevic was not unable to service it.[17] Critically, the trial judge did not find anything which showed that Ms Knezevic was not able to act in her commercial interests. The 'something more' that Basten JA mentioned in *Khoshaba* was not present.

47. Unlike the Khoshaba's, Ms Knezevic's English was good, and she was able to respond to questions, and read and understand documents.[18]

48. There was also another key difference. While the lender had not enquired into Ms Knezevic's financial position, it had asked her to sign a declaration that she could service the loan.[19] This was different to Khoshaba where no such declaration was sought or signed.

49. Ms Knezevic gave the declaration that she would be able to service the 3rd loan[20], which she gave freely and with full understanding.[21] Meagher JA held that if the declaration was false she would have known it was false because she knew what she was doing.[22]

50. These examples show the importance of making detailed observations about the characteristics, circumstances and life history of a client, and the circumstances of the loan application. The idea is to check if there are were any infirmities or inabilities which might have affected the borrower's ability to protect himself/herself when he/she took out the loan, or if there were any falsities in the loan application which might have infected its validity.

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[17] Knezevic v Perpetual Trustees Victoria Ltd and Anor [2013] NSWCA 199 at [78].
[18] Ibid at [79].
[19] Ibid at [83].
[20] Ibid at [81].
[21] Ibid at [84].
[22] Ibid at [81] – [82].

The Code of Banking Practice.

51. This is the second area of law to look at. It too attempts to curb on a Bank's ability to lend without paying adequate regard to a borrower's ability to repay.

52. Whenever asset lending is pleaded by a borrower against a lender, it is common (or it would make rational sense) for the borrower to also plead breaches of the Code by the Bank if applicable.

53. The Code of Banking Practice comes from the Australian Banking Association.

54. Loan contracts these days commonly include a clause which makes the Code a part of the loan contract.

55. Over the years, there have been different versions of the Code.

56. The most recent version is the 2019 version.[23] Throughout the years there has been a 1993, 2003, 2004, 2013 and a 2018 version.[24]

57. The Code is 'voluntary' in that the Banking industry voluntarily undertakes to self-regulate by its members agreeing to abide by the Code.

58. Chapter 17 of the 2019 Code is the key chapter. It is entitled 'A responsible approach to lending'.

59. Chapter 17 states:

> 49. If we are considering providing you with a new loan, or an increase in a loan limit, **we will exercise the care and skill of a diligent and prudent banker.**
>
> 50. If you are an individual customer, that is not a business, we will do this by complying with the law.

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[23] https://www.ausbanking.org.au/campaigns/new-banking-code/

[24] https://www.ausbanking.org.au/campaigns/new-banking-code/previous-versions-of-the-code/

60. The the Code is a promise by the Banks that when they assess a borrower's ability to repay a loan, they will use the '*care and skill of a diligent and prudent banker*'.

61. A relatively recent case where a Bank was found to have breached the Code is that of *Doggett v Commonwealth Bank of Australia* [2015] VSCA 351 (noting that this case involved a former version of the Code whose 'Clause 25.1' was equivalent to the current Clause 49).

62. In *Doggett*, McLeish JA (giving the minority opinion on the issue of whether a breach of the Code caused loss and damage) described the requirements of the Code as follows:

> [163] **Clause 25.1 does not presuppose or require that a bank must form an opinion that a borrower will be able to repay the loan**. Rather, cl 25.1 **requires care in the formation of an opinion as to whether a borrower will be able to repay the loan.** The bank **may take due care in forming an opinion as to whether a borrower can repay a loan and decide that, although it is possible that the borrower may not be able to repay the loan, it will offer the loan in any event**. **That may be, for example, because additional resources can be obtained by the borrower before the loan proceeds or during its term**. Or it may be because other financial resources, not immediately available to the borrower, would in the event of default be available to the bank (in particular by way of security or guarantee arrangements). There is nothing inconsistent with cl 25.1 in a bank discharging its obligation in that way. It is inherent in the assessment process that it may reveal the need for steps to be taken to ensure that the overall proposal is acceptable to the bank before the loan proceeds.
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> [164] In other words, the failure of the Bank to exercise due care and skill, which the judge identified, **went to the manner in which it applied its credit assessment methods and formed its opinion in evaluating Dogvan's financial position, but not necessarily to the decision to advance the loan.** **Clause 25.1 is concerned with those processes and the forming of that opinion.** **It does not prescribe a precondition to the advancing of a loan, or the content of the opinion which must be formed before that is done, only the level of care and skill with which the exercise must be undertaken.**
>
> [165] It therefore does not necessarily follow that, if the Bank had complied with cl 25.1, it would not have offered Dogvan the bill facility.

63. In *Doggett*, Whelan JA (giving majority opinion on the issue of whether a breach of the Code caused loss and damage) respectfully clarified McLeigh JA's interpretation of the Code as follows:

> [8] **McLeish JA correctly observes that cl 25.1 does not presuppose or require that a bank must form an opinion that a borrower will be able to repay the loan. As he points out, what cl 25.1 requires is care in the formation of an opinion** as to whether a borrower will be able to repay the loan. Accordingly, it does not necessarily follow that, if the Bank had complied with cl 25.1, it would not have offered Dogvan the bill facility.
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> …
>
> [10] McLeish JA also points out that, as the Bank could legitimately take into account other sources of funding apart from the cash flow from the management agreement, and as there were other potential sources of funding, it is more difficult to draw the inference that the Bank would have refused to lend money for the acquisition. A further relevant factor in this connection which is referred to by McLeish JA is the level of security offered by the appellants.
>
> [11] McLeish JA concludes that, in these circumstances, the appellants had failed to satisfy the onus which was upon them to establish that if cl 25.1 had not been breached the Dogvan bill facility would not have been advanced.
>
> [12] McLeish JA's observations upon the effect of cl 25.1, and upon **other potential sources of funding and the level of security are valid considerations but, in my view, they should be tempered by the consideration that whatever recourse there might be to other sources of funds (by compulsion under guarantees or subject to the agreement of others) or to security, the capacity of a borrower to service a loan must remain a fundamental consideration. A conclusion that a loan would not have been made to a borrower who had a demonstrated incapacity to meet the required repayments by a significant margin is not one which would be ordinarily in doubt, notwithstanding potential recourse to guarantors, other parties or security.**

64. Essentially, what *Doggett* teaches us is that the Code requires a lender to exercise care in the formation of its opinion as to whether a proposed borrower can repay a loan. It

does not require that a lender actually form an opinion that a proposed borrower can repay the loan. It only requires care in the formation of that opinion.

65. How much emphasis a lender can pay to other resources of the borrower, apart from (or, perhaps, in-spite of) of the borrower's actual ability (or, inability) to directly meet the loan repayments is open for debate.

National Consumer Credit Code and the recent case of ASIC v Westpac.

66. This is the third area of law to be looked at. It too attempts to curb a Bank's ability to lend without paying adequate regard to a borrower's ability to repay.

67. Once again, whenever asset lending and the Code are pleaded by a borrower against a lender, it is common (or it would make rational sense) for the borrower to also plead the National Consumer Credit Code if applicable.

68. The relevant Act of Parliament is the *National Consumer Credit Protection Act* 2009 (Cth). This is the Act which regulates the provision of credit to consumers.

69. Very recently, the much anticipated case of *Australian Securities and Investments Commission v Westpac Banking Corporation (Liability Trial)* [2019] FCA 1244 per Perram J was delivered. It interpreted a key section of the *National Consumer Credit Protection Act* 2009 (Cth), namely, Section 131(2)(a).

70. Before looking at Section 131(2)(a), it is worthwhile looking at Section 130, which requires the lender to make reasonable enquiries about the proposed borrower's 'financial situation':

> Reasonable inquiries etc. about the consumer
> Requirement to make inquiries and take steps to verify
>
> (1) For the purposes of paragraph 128(d), **the licensee must, before making the assessment**:
>
> > (a) make reasonable inquiries about the consumer's requirements and objectives in relation to the credit contract; and

(b) **make reasonable inquiries about the consumer's financial situation**; and

(c) take reasonable steps to verify the consumer's financial situation; and

71. Turning now to Section 131(2)(a), it states:

Requirement to assess the contract as unsuitable
(1) The licensee must assess that the credit contract will be unsuitable for the consumer if the contract will be unsuitable for the consumer under subsection (2).

Civil penalty: 5,000 penalty units.

Note: Even if the contract will not be unsuitable for the consumer under subsection (2), the licensee may still assess that the contract will be unsuitable for other reasons.

Particular circumstances when the contract will be unsuitable
(2) **The contract will be unsuitable for the consumer if, at the time of the assessment, it is likely that**:

(a) **the consumer will be unable to comply** with the consumer's financial obligations under the contract, **or could only comply with substantial hardship**, if the contract is entered or the credit limit is increased in the period covered by the assessment; or

(b) the contract will not meet the consumer's requirements or objectives if the contract is entered or the credit limit is increased in the period covered by the assessment; or

(c) if the regulations prescribe circumstances in which a credit contract is unsuitable--those circumstances will apply to the contract if the contract is entered or the credit limit is increased in the period covered by the assessment.

(3) For the purposes of paragraph (2)(a), it is presumed that, if the consumer could only comply with the consumer's financial obligations under the contract by selling

the consumer's principal place of residence, the consumer could only comply with those obligations with substantial hardship, unless the contrary is proved.

Information to be used to determine if contract will be unsuitable
(4) For the purposes of determining under subsection (2) whether the contract will be unsuitable, only information that satisfies both of the following paragraphs is to be taken into account:

(a) the information is about the consumer's financial situation, requirements or objectives, or any other matter prescribed by the regulations under paragraph 130(1)(d) or (e);

(b) at the time of the assessment:
(i) the licensee had reason to believe that the information was true; or
(ii) the licensee would have had reason to believe that the information was true if the licensee had made the inquiries or verification under section 130.

72. What Section 131(2)(a) does is give a Bank a legal question. The legal question is to ask whether a customer can comply with the proposed loan, or can only comply with substantial hardship. If the customer cannot so comply, or cannot comply without substantial hardship, then the loan is ‘unsuitable’ and the Bank should not give it.

73. ASIC’s central point was that Westpac had failed to take, or properly take, into account the customer’s ‘declared living expenses’ in assessing whether the customer could comply with the proposed loan, or could only comply with substantial hardship.

74. Westpac’s loan approval process was as follows:

(i) Customer fills in form disclosing income, declared living expenses, assets and liabilities →

(ii) a Westpac home finance manager puts the form onto a Generic Origination Engine →

(iii) the Generic Origination Engine is then assessed by an Automated Decision System (ADS) (i.e. a system made up of over 200 rules) →

(iv) the ADS then gives 1 of 3 results: (a) conditional approval, (b) referred for manual assessment or (c) declined.

75. Within the Automatic Decision System, there were 2 prominent mathematical equations or rules which applied:

    (a) **<u>70% Ratio Rule:</u>** Essentially, if declared living expenses exceeded 70% of the customer's verified monthly income, then the file had to be referred for manual assessment.

    The Bank used this 70% Ratio Rule because in its experience, whenever it was triggered, the risk of default increased.

    (b) **<u>Serviceability Rule:</u>** Essentially, the equation,

    Net Monthly Surplus / Shortfall = Discounted Monthly Income – (Assessed Monthly Repayments + Outgo + **<u>HEM benchmark</u>** + 'buffer').

    The item 'Outgo' was made up of rent, child maintenance, credit card repayments, other loans, other liabilities like tax, HECs and guarantees.

    But 'Outgo' did not include living expenses like groceries, transport, petrol, utilities, rent, clothing, education, insurance (car, CTP, home and contents, etc), mobile phone, internet, Pay TV, holidays, gym membership, cleaning and gardening expenses.

    If there was a Net Monthly Shortfall, and if mortgage insurance was needed (because other assets were insufficient to provide security), then it went to manual assessment.

    If no mortgage insurance was needed (because other assets were sufficient), but there was a Net Monthly Shortfall of $400 or more, it went to manual assessment.

76. The first point of interest is that the Serviceability Rule does not use 'declared living expenses'. One would have expected it to. After all, this is meant to be an equation that assesses whether a customer can sustain a loan, or can sustain a loan without going

through hardship. Nevertheless, instead of ‘declared living expenses’, something else was used, something called a ‘HEM benchmark’.

77. The second point of interest is that although the Serviceability Rule does not use ‘declared living expenses’, nevertheless ‘declared living expenses’ are used in the 70% Ratio Rule. In that sense, Westpac did pay attention to ‘declared living expenses’. The problem with this is that the 70% Ratio Rule only compares 2 things: the ‘declared living expenses’ against the verified monthly income. The actual loan repayments required by the proposed loan do not feature in the 70% Ratio Rule.

78. Essentially, the Bank appears to be, on the one hand, looking at the customer’s ability to meet loan repayments by reference to a ‘HEM Benchmark’ and not actual ‘declared living expenses’. Yet, on the other hand, the Bank is looking at ‘declared living expenses’ but only as compared to 1 other thing, namely, verified monthly income.

79. Before going on, one might ask, what is the ‘HEM Benchmark’?

80. The story behind the HEM Benchmark begins before 2010. Before 2010, the Banking industry used what is called the ‘Henderson Poverty Index’ (HPI) to assess household expenses in its serviceability calculations. The problem was that the HPI was based on United States data gathered in the 1960’s and then indexed for inflation. In 2009-2010, the major creditor providers got together and commissioned a body called the ‘Melbourne Institute of Applied Economic and Social Research’ to make an Australian equivalent of the HPI using Australian data. Thus in 2011, the ‘Household Expenditure Measure’ (HEM) was born.

81. The HEM is based on data from the Australian Bureau of Statistics’ Household Expenditure Survey (HES). The HES covers 98% of the Australian population and is made up of 600 or so goods and services.

82. The 600 or so goods and services in the HES are divided into 3 categories:

    a. <u>Absolute basic expenditure</u>: all food apart from restaurant meals and certain confectionaries, utilities, house repairs, toiletries, and household cleaning products.

    b. <u>Discretionary basic expenditure</u>: restaurant meals and alcohol, sports lessons and domestic holidays.

c. Non-basic expenditures: jewellery and overseas travel.

83. The HEM Benchmark is essentially the median level of absolute basic expenditure plus the 25% percentile of discretionary basic expenditures. In plain English, it is a theoretical household which spends $X on absolute basic expenses (where 50% of households spend more than $X and 50% of households spend less than $X) and $Y on discretionary basic expenses (where 25% of households spend less than $Y and 75% of households spend more than $Y).

84. The Court found that living on the HEM Benchmark was not poverty, but rather a modest level of expenditure that enabled a citizen to ‘participate in society’ with a ‘reasonable standard of living’:

> [43] … Westpac submitted, and if it were necessary **I would be inclined to accept, that the HEM benchmark captures expenses of a modest level that would permit individuals to participate in society**. …
>
> …
>
> [46] I reject Westpac’s faintly pressed submission that the use of the HEM benchmark did involve an assessment of the borrower’s actual expenses and **accept instead its contention** at ¶122 of its closing written submissions **that the use of the HEM benchmark is not an estimate of the borrower’s actual living expenses but ‘an estimate of the level of household expenditure that the consumer could reasonably be expected to spend to participate fully in society with a reasonable standard of living**.’

85. The Court found that it was acceptable to use the HEM Benchmark, instead of ‘declared living expenses’, in the Serviceability Rule formula because declared living expenses are not really that helpful anyway in determining a person’s ability to sustain a loan because a person can always trim back their spending. In making this point, the Court employed some colourful language:

> [71] … Questions of whether the consumer could in absolute terms afford the repayments; **so too, the fact that the consumer takes an annual first class holiday to the United States is not relevant to assessing whether the**

repayments will put the consumer into circumstances of substantial hardship.

…

…

[76] In fact, the only way that one or more declared living expenses can be shown to be necessarily relevant to the issue of whether the consumer can afford to make the repayments is by identifying some living expenses which simply cannot be foregone or reduced beyond a certain point. For example, everyone has to eat so there must be an amount for food which is the minimum which can conceivably be spent. But that minimum is an entirely different concept to the declared living expense of what the consumer actually spends on food. Indeed, knowing how much the consumer actually spends on food does not tell one anything about that conceptual minimum. **I may eat Wagyu beef everyday washed down with the finest shiraz but, if I really want my new home, I can make do on much more modest fare.** Knowing the amount I actually expend on food tells one nothing about what that conceptual minimum is. But it is that conceptual minimum which drives the question of whether I can afford to make the repayments on the loan.

86. The Court also found that, in any event, Westpac did look at declared living expenses because it was look at in the 70% Ratio Rule:

    [27] **By means of the 70% Ratio Rule Westpac did take into account the consumer's declared living expenses** from the Form PFI001 as part of a process leading to an answer to the s 131(2)(a) Questions. …

    [86] This case fails on the facts. **Westpac did not fail to take into account the consumer's declared living expenses. It took them into account in applying the 70% Ratio Rule as part of its process of assessment under the ADS**, i.e. in conjunction with the other rules such as the Serviceability Rule. …

87. With all due respect, the result in *ASIC v Westpac* is puzzling. The very equation which assesses serviceability pays no attention to the actual individual borrower's living expenses. One would have expected it to.
88. In any event, *ASIC v Westpac* now represents an interpretation of the National Consumer Credit Code that is beneficial towards more lending for the residential property market.

89. It is no wonder that ASIC has signalled that it will seek to change the relevant legislation if it loses the case (which it now has).[25]

90. Notwithstanding the result in *ASIC v Westpac*, the National Consumer Credit Code still exists and remains capable of being applied to the individual circumstances of each borrower.

Practical tips.

91. In conclusion, a legal practitioner might take the following steps when presented with a client whom a Bank is chasing for a mortgage default and/or pursuant to a personal guarantee given in connection with a mortgage over residential property:

    a. Find out the personal circumstances, education and characteristics and life history of the client. Find out how the loan application was made and get a copy of it. Such information might prove useful in launch an asset lending case.

    b. Ascertain when the loan was provided so that the correct version of the Code of Banking Practice can be obtained. Read the loan contract to see if it incorporates a clause which makes the Code a part of the loan contract.

    c. Ask the Bank for a copy of its assessment of the client's ability to repay the loan. This will have been made when the loan was given. The *National Consumer Credit Protection Act* 2009 (Cth) gives the client the right to ask for a copy of the assessment free of charge if the request is made within 7 years of provision of the loan (Section 132). This will help the legal team to assess how and whether the Bank properly assessed the borrower's ability to repay.

[25] https://www.smh.com.au/business/banking-and-finance/home-loan-hit-asic-will-seek-to-change-laws-if-it-loses-key-case-20190206-p50vys.html

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