

Westpac's \$35million fine – has the first domino fallen for responsible lending penalties?

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Westpac has admitted to making historical breaches of responsible lending obligations of the *National Consumer Credit Protection Act 2009* (Cth) (**NCCP Act**). The breaches are historical as they occurred between 2011 and 2015, in the early days of the operation of the NCCP Act. Westpac states it changed its responsible lending process to rectify these admitted breaches in 2015.¹

Westpac and ASIC have agreed to a settlement figure of \$35 million plus ASIC's litigation and investigation costs. The key significance of the facts and agreed settlement described below is emerging as to whether the Federal Court will approve the settlement or order the amount be reduced. The outcome is being watched with interest as it will establish a benchmark for future ASIC prosecutions against other NCCP Act regulated credit providers.

This article will outline the key information regarding the responsible lending provisions, media reports on the financial impact of the penalty for Westpac and the precedent it sets for future responsible lending penalties under the NCCP Act.

Federal Court role

In September, Westpac and ASIC jointly approached the Federal Court to approve the settlement of pending proceedings concerning breaches of the NCCP Act for \$35 million (**Westpac proceedings**). The breaches, which occurred from December 2011 to March 2015 (**relevant period**), concern 10,877 home loans conditionally approved through Westpac's automated decision system.

The \$35 million civil penalty is required to be approved by the Federal Court to give legal effect to the settlement. If approved by the Federal Court, the penalty will be the largest penalty awarded to date under the NCCP Act.

Without doubt ASIC will continue to prosecute credit providers for breaches of the NCCP Act and future settlement negotiations or court proceedings will be shaped by the outcome of the Westpac proceedings.

Federal Court initial comments

On 10 September, Justice Nye Perram of the Federal Court reviewed the joint decision for approval of the Court. Surprisingly, Justice Perram questioned how the parties arrived at such a large penalty, being nearly double the largest fine previously awarded under the NCCP Act.²

His Honour compared the penalty to the \$2 million penalty awarded in *Australian Securities & Investments Commission v Thorn Australia Pty Ltd* [2018] FCA 704, which concerned 275,000

¹ David Lording, 'Westpac and ASIC settle responsible lending proceedings' *Westpac* (4 September 2018) <https://www.westpac.com.au/about-westpac/media/media-releases/2018/4-september/>.

² Luke Costin, 'Justice baulks at record \$35m Westpac fine' *Sydney Morning Herald* (10 September 2018) <https://www.smh.com.au/business/banking-and-finance/Justice-baulks-at-record-35m-westpac-fine-20180910-p502x2.html>.

customers, given that Westpac's breach was a "good faith breach that hasn't caused any loss or damage".³

ASIC argued that the penalty was appropriate given the relative size of home loans compared to other consumer loans, the sector's importance to Westpac's bottom line and the overall size of Westpac and its main competitors.⁴

Justice Perram has unexpectedly appointed Justice Gleeson, SC as amicus curiae to test whether the settlement figure, as well as its legal basis, is justified.⁵ In questioning, whether these was a legal basis for the decision, his honour asked Westpac barrister, Kristina Stern, SC, "So I'm asked here to impose a penalty for failing to comply with the procedures required by the statute about unsuitable loans... But the fundamental prohibition is... there's no fact before me that any unsuitable loans were made."⁶

When told by Kristina Stern, SC that he should proceed on the basis that no unsuitable loans have been put forward, his Honour questioned, "so then the purpose of the penalty is to deter, so what do I deter? What conduct am I deterring here?"⁷ Justice Perram has reserved his decision until a later date.⁸

Westpac's automated decision system

Westpac's automated decision system during the relevant period involved a series of 'rules' to assess whether a loan was conditionally approved. During the relevant period, the number of rules in the system increased from 208 to 217.⁹

The automated decision system had three outputs, which had the potential to be manually assessed and changed by Westpac staff. A home loan application would be:

1. declined if an application triggered any decline automated rule. In these instances, the application would be sent to lending staff who could request manual assessment or return the application to the customer
2. referred if the application triggered any refer automated rule but did not also trigger a decline automated rule, or

³ Ibid.

⁴ Ibid.

⁵ Kylar Loussikian, 'Ex-solicitor-general Justin Gleeson SC gets a new gig' *Sydney Morning Herald* (24 September 2018) <https://www.smh.com.au/national/ex-solicitor-general-gets-new-gig-after-quitting-over-nasty-spat-with-boss-20180923-p505jc.html>.

⁶ James Evers, 'Court questions Westpac's \$35m ASIC deal' *Australian Financial Review* (21 September 2018) <https://www.afr.com/business/banking-and-finance/financial-services/court-questions-westpacs-35m-asic-deal-20180921-h15one>.

⁷ Ibid

⁸ Ibid.

⁹ *Australian Securities and Investments Commission v Westpac Banking Corporation* Statement of Agreed Facts (File No NSD293/2017) (**Statement of Agreed Facts**) <https://download.asic.gov.au/media/4860173/westpac-statement-of-agreed-facts-4-september-2018.pdf> [20].

3. conditionally approved if the application did not trigger any decline or refer automated rules.¹⁰

The responsible lending breaches related to the Serviceability Calculation Rule, which was used to calculate the financial position and servicing capacity of a prospective consumer at origination.¹¹ The Serviceability Calculation Rule was calculated using the following formula:

$$\text{Final Net Monthly Surplus or Final Net Monthly Shortfall} = \text{Net Monthly Income} - (\text{Assessed Monthly Repayments} + \text{Outgoings}) - (\text{HEM Benchmark} + \text{"buffer"})^{12}$$

In its calculations, Westpac used figures derived from the Household Expenditure Measure (**HEM**) Benchmark to calculate the Required Minimum Monthly Surplus figure (HEM Benchmark + "buffer"), instead of the consumer's Declared Living Expenses.¹³ The only rule in the automated decision system that utilised the customers' Declared Living Expenses was the 70% Ratio Rule, which determined whether a consumers' Declared Living Expenses exceeded 70% of their verified monthly income.¹⁴

Further, Westpac did not calculate Assessed Monthly Repayments based on the minimum monthly repayment that would be required at the end of a customer's Interest Only Period to repay the loan in full over the remaining term of the loan during the relevant period.¹⁵ Instead, Westpac used the Full-Term Method, which used an amortisation calculation which assumed that equal repayments of principal, interest and fees would occur over the term of the loan.¹⁶

In 2015, Westpac changed its automated decision system to address these issues.¹⁷

Responsible lending breaches

Westpac's breaches related to the measures used in the Serviceability Calculation Rule in its automated decision system. The deficiencies relate to the obligations of credit providers to make assessments and inquiries regarding unsuitability under the NCCP Act.¹⁸

Westpac accepted that it should have used a consumers' Declared Living Expenses as opposed to the Household Expenditure Measure (**HEM**) Benchmark in assessing the consumers' capacity to repay the loan.¹⁹ Of the 50,050 loans conditionally approved in the relevant period that had higher Declared Living Expenses than the HEM Benchmark, approximately 5,041 of these would not have passed the Serviceability Calculation Rule, and therefore be conditionally approved, had Westpac used the higher Declared Living Expenses figure.²⁰

¹⁰ Ibid [19].

¹¹ Ibid [21].

¹² Ibid [24].

¹³ Ibid [26].

¹⁴ Ibid [35].

¹⁵ Ibid [25(c)].

¹⁶ Ibid [25(b)].

¹⁷ Lording, above n 1.

¹⁸ *National Consumer Credit Protection Act 2009* (Cth) s 128; Statement of Agreed Facts, above n 9, [52].

¹⁹ Ibid [51(a)].

²⁰ Ibid [52(a)].

Westpac also accepted that for interest-only period loans, it failed to use the higher repayments at the end of this interest-only period when assessing a consumers' capacity to repay the loans.²¹ Of the 49,839 interest-only loans conditionally approved by the automated system during the relevant period, approximately 5,395 of these loans would not have been conditionally approved had Westpac used the Residual Term Method when determining serviceability.²²

Of the loans that went through the automated system during the relevant period, 4% should have been referred for manual assessment. Despite this, Westpac has stated that the affected home loans have to date had a lower rate of hardship applications and a similar rate of 60+ days delinquency than manually approved loans processed during the relevant period.²³ Affected loans also had a higher rate of additional repayments or funds held in linked offset accounts than manually approved loans processed during the relevant period.²⁴ Westpac's consumer bank CEO, George Frazis, has questioned why, if the credit quality of the affected loans are performing equal to or better than the bank's entire portfolio, the assessment process can be deemed irresponsible.²⁵

Financial impact on Westpac

Westpac have agreed to pay, in addition to the \$35 million civil penalty, ASIC's litigation and investigation costs, which will likely bring the total to \$40 – 50 million.

The average loan size in Australia is \$397,300²⁶ however, given that the affected loans originated between 2011 – 2015, it is likely the loans are larger than average, as borrowers will not have made significant contributions to pay down their loans. With banks generally making an 80-basis-point clear profit on home loans each year,²⁷ the 10,500 loans in question could have provided Westpac with \$33 million profit per year assuming the average loan size applies. Westpac has stated that 5,400 of these loans are still active,²⁸ which would generate around \$17 million in annual profit, easily covering the \$35 million penalty in just two years.

A single breach of the responsible lending obligations under the NCCP can incur penalties of up to 2000 penalty units,²⁹ with corporation contraventions multiplying this by five.³⁰ At \$210 a penalty unit³¹ and 100,000 potential breaches, this would attract a maximum civil penalty of \$210 billion.

²¹ Ibid [51(c)].

²² Ibid [52(b)].

²³ Ibid [56].

²⁴ Ibid [61].

²⁵ Stephen Bartholomeusz, 'The paradox within Westpac's 'irresponsible' lending breach' *Sydney Morning Herald* (11 September 2018) <https://www.smh.com.au/business/banking-and-finance/the-paradox-within-westpac-s-irresponsible-lending-breach-20180911-p50310.html?crpt=homepage>.

²⁶ Australian Bureau of Statistics, *Summary of Findings* (Report 5609.0 – Housing Finance, Australia, July 2018) <http://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/5609.0Main%20Features2July%202018?opendocument&tabname=Summary&prodno=5609.0&issue=July%202018&num=&view=>.

²⁷ Michael Janda, 'Westpac comes out ahead on dodgy loans despite ASIC's \$35 million fine' *ABC News* (6 September 2018) <http://www.abc.net.au/news/2018-09-05/westpac-comes-out-ahead-on-dodgy-loans/10202638>.

²⁸ Lording, above n 1.

²⁹ *National Consumer Credit Protection Act 2009* (Cth) s 128.

³⁰ *National Consumer Credit Protection Act 2009* (Cth) s 167(3)(b).

³¹ *Crimes Act 1914* (Cth) s 4AA.

Comparatively, Westpac's \$35 million is a drop in the bucket for what could be awarded for future breaches.

Will we see a domino effect of responsible lending penalties?

In light of the misconduct revealed in the Financial Services Royal Commission, it is likely that we will see ASIC continue to prosecute financial institutions for violations of the NCCP Act and its responsible lending provisions.

It is unclear at this point in time if the Westpac and ASIC agreed settlement is the benchmark for future cases on responsible lending breaches. This is particularly so in view of the initial comments of Justice Perram referred to above that suggest evidence of deliberate breaches may be required before significant penalties are awarded.

Summary

ASIC and Westpac have reached a \$35 million settlement on responsible lending proceedings brought by ASIC against Westpac. If approved by the Federal Court, this will be the largest settlement agreed to date under the *National Consumer Credit Protection Act 2009* (Cth). As stated in this article, the Federal Court has questioned the extraordinary size of the penalty. It remains to be seen whether or not the settlement is approved by the Federal Court or if a lower settlement is ordered. It is reasonable to anticipate that this Westpac case will be a significant benchmark in the settling of future ASIC prosecutions against financial service providers.



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