18 October 2018

The Honourable Kenneth Madison Hayne AC QC

Re: Interim Report Submission Regarding the use of HEM when assessing Household Expenses

Your Honour,

In response to the Commission's request for public submissions on the Interim Report into Misconduct in the Banking, Superannuation and Financial Services Industry, I wish to draw your attention to an article published in the Australian Financial Review on the 21st September 2018 at 11:20 AM.

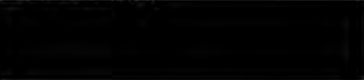
A link to online version can be found here:
https://www.afr.com/personal-finance/westpac-not-an-irresponsible-lender-20180920-h15o6z

In my view this article provides a frank and balanced opinion on the challenges associated with assessing Household expenses as part of responsible lending obligations, especially with regard to the role played by the Household Expenditure Measure (HEM).

A copy of the text follows.

Kind regards,

Charles Higby



Westpac 'not an irresponsible lender'
by Christopher Joye

It appears Westpac did not engage in irresponsible lending, at least based on Federal Court justice Nye Perram's reading of the responsible lending laws. This case has also provided the first comprehensive empirical evidence revealing that droves of Aussies are indeed defrauding banks by lying on their home loan applications, which likely eviscerates any ability to leverage (excuse the pun) off these laws.

This is important in the context of the royal commission which has spent considerable time dwelling on these laws – introduced by Labor in 2009 to shift liability for repaying home loans (among the simplest financial products) away from borrowers to banks. The casualties will be depositors who are the underlying funders of these loans and borrowers who are now finding it harder to get approved and, when they do get a loan, are being slugged with higher interest rates as lenders scramble to cover escalating compliance costs.

In what is an embarrassing blow for the regulator, Perram has thus far refused to approve ASIC's request to fine Westpac $35 million for allegedly breaching its responsible lending obligations. This is all the more surprising because ASIC and Westpac agreed in a joint statement that "Westpac contravened the requirements of...the National Consumer Credit Protection", which mandates the steps lenders must take to ensure borrowers are not entering into "unsuitable" loans.

In September Perram pointedly told ASIC's lawyers that "it's not really a case in which I'm being asked to penalise irresponsible lending...because there is no agreed fact about irresponsible lending in front of me". For the avoidance of doubt, he added that the laws' "fundamental prohibition is on the making of unsuitable loans, and...there's no fact before me that any unsuitable loans were made".

ASIC contends Westpac breached the responsible lending laws because it conditionally approved the 19 per cent of applicants who disclosed living expenses that were higher than the HEM. Erin Jonasson
To resolve whether Westpac acquiesced to a $35 million penalty it should not have to pay, Perram has appointed an "amicus" or "friend of the court" to parse the laws, which have not been subject to proper judicial clarification.

Between 2011 and 2015 Westpac's automated loan assessment system, which contains over 200 rules, conditionally approved 261,987 mortgages. In these applications borrowers warrant that they have provided accurate data on their assets, liabilities, incomes, expenses and other personal information (such as their age, address, marital status, dependents, employment history and so on) to enable Westpac to make an informed judgement about whether they can service the debt.

Cheating banks
Yet as Westpac's lawyer explained to Perram, the evidence suggests "human beings are not very good of keeping track of and declaring their expenses". That's weasel words from a bank that has been bashed to within an inch of its life. The truth is that Australians are systematically cheating banks by misrepresenting living costs to maximise the amount they can borrow. You know I'm right, because most of you have done it.

This is no longer a matter of opinion. In ASIC and Westpac's statement of facts, they reveal that of the 261,987 applications Westpac conditionally approved (subject to a valuation of the collateral asset and verification of the application data), 81 per cent "declared living expenses that were below the applicable Household Expenditure Measure (HEM) benchmark".

The truth is that Australians are systematically cheating banks by misrepresenting living costs to maximise the amount they can borrow.
How could that be? This is, after all, the same HEM benchmark that analysts and pundits have pilloried banks for relying on as a poor substitute for borrowers' real-world living costs. Yet according to Westpac's clients the opposite is true, at least on the applications they signed.

The HEM was developed by the Melbourne Institute after a request from lenders, and is based on over 600 items in the ABS's Household Expenditure Survey. It tracks the median, or 50th percentile, household spending on staples like food, utilities, transport, communications and clothing, and the 25th percentile costs on discretionary items like alcohol, restaurants and childcare. In its loan-decision system, Westpac scales the HEM for the borrower's marital status, dependents, the location of their intended residence and quarterly inflation.

Contrary to what critics claim, it is more conservative for banks to rely on the HEM in aggregate than the misleading information many borrowers submit. One might counter that lenders could more carefully verify expenses with reference to bank statements and credit cards. While this is undoubtedly prudent, borrowers can also game this approach by cutting back on costs prior to applying for a loan and/or not disclose all their credit limits.

As an objective, non-gameable baseline of relatively thrifty living requirements, the HEM is an entirely credible input for banks to rely on, among other variables, in what is a complex decision-making matrix. Or, in Perram's words, lenders might reasonably take the view that "people applying for loans [can't] be trusted to fill the answers out honestly" and it may be "better compliance with the statute to use a statistical approach such as the HEM".

It is more conservative for banks to rely on the HEM in aggregate than the misleading information many borrowers submit.

ASIC contends Westpac breached the responsible lending laws because it conditionally approved the 19 per cent of applicants who disclosed living expenses that were higher than the HEM. While ASIC is right that lenders should rely on whatever is greater – HEM or declared expenses – there are nonetheless flaws in its logic apropos the laws.

The HEM benchmark is only one input variable in Westpac's loan serviceability algorithm. This calculates the borrower's net monthly surplus or shortfall by deducting from their post-tax monthly income a number of expenses – including the repayments on the proposed loan, the relevant HEM benchmark and a "buffer" factor. This buffer is a very conservative stress test of the borrower's repayments on both the new loan and existing debts. In Westpac's case, it assumed that interest rates increased by more than two percentage points (or by eight normal RBA rate hikes) above prevailing levels. So if the loan rate was 5 per cent, Westpac assumed the borrower had to service 7 per cent.

While ASIC might submit that Westpac underestimated 19 per cent of its applicants' living expenses, it has at the same time massively overestimated their interest repayments. This is important because the responsible lending laws are silent on what specific information lenders have to use when assessing a loan's suitability (defined as the ability to repay it). As Perram put it, the law "doesn't say what information you must take into account...and hence it can't mandate [a] requirement to take into account monthly expenses". "It just does not say that [banks have to use a borrower's expenses when assessing a loan]."

The laws also state that "it is presumed that, if the consumer could only comply with [its] financial obligations...by selling [its] principal place of residence, [it] could only comply with those obligations with substantial hardship, unless the contrary is proved".

In this drafting Labor has tried to compel lenders to assess secured loans backed by residential properties as if they are actually unsecured "cash-flow" lends with no asset backing, like a personal loan or credit card. There is a very good reason why interest rates on credit cards and personal loans are so high – because lenders face much greater risks of loss with no collateral protecting these products.

Under case law precedents, the definition of "substantial hardship" is taken to mean something that is severe and hard to endure (eg, an inability to meet the necessities of life, including food, medicine and shelter). Selling a house to repay a loan is not remotely tantamount to substantial hardship, and many Australians do this every day, particularly those downsizing into retirement.

It is, therefore, open to lenders to argue that they have accounted for the value of the asset backing the loan as one component of their repayment analysis, which they all do. Insisting on a minimum equity

buffer is a condition precedent for all loans, as is requiring a valuation of the property to verify the collateral before making an unconditional offer.

According to the RBA, only about 47,200 of the 5.9 million home loans outstanding today are more than three months in arrears. Aussie banks have maintained among the lowest mortgage default rates in the world over the last three decades spanning the 1991 recession and the global financial crisis, despite imposing internationally high mortgage rates.

This track record indicates that our banks are very good at ensuring borrowers can meet their obligations. And contrary to popular myth, they have zero financial incentive in seeing borrowers get into trouble.

The risk with the royal commission and the new responsible lending laws is that to protect a tiny minority, politicians and regulators end up punishing the overwhelming majority. One legacy will likely be that it is much harder to get approved for a loan, which will come with higher interest rates to cover the exponential increase in compliance costs.

The author is a portfolio manager with Coolabah Capital Investments, which invests in fixed-income securities including those discussed by this column.