DEVELOPMENTS IN FOREIGN CURRENCY LOANS LITIGATION
FOREIGN CURRENCY BORROWING

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Thank you Mr Chairman. Probably some of you saw our Chairman on television this morning and if you did you would probably agree with me that the second version was much more attractive than the original one - the one with the blond hair and the nice teeth! Not to suggest Mr Chairman there is anything wrong with your teeth!

I will probably fulfil most of Mr Justice Rogers expectations about what I am going to say. I am very pleased to have an opportunity to talk about these foreign loan cases out of the context of the court where the discussion is necessarily limited by the questions that are asked and by the duress of the law, and in my view miss a lot of the very important implications of these cases. In fact I hope to finish up with what I think are the most important implications of the foreign currency cases which to my knowledge have not been discussed in any of the cases or by any of the learned judges who have given a decision in this area.

Firstly, looking at the foreign loan cases, there is no doubt that it is possible to misrepresent a foreign loan. At the time most of these loans were taken out that are under discussion at the moment, there were advertisements appearing in the *Australian Financial Review* which offered money at 6% per annum and no mention was made in those advertisements of the foreign currency risk involved, and I would certainly regard that as misleading. I might say that so far as I know none of the major banks were involved in that sort of advertising, but it did occur. There may have even been cases within major banks where over-zealous employees told potential borrowers that there was no risk or failed to mention the risk altogether. If I came across such a case as an expert witness, I would advise the bank very heavily, to settle that case and I could certainly tell them that anything I would have to say about them in court would do the bank no good.

It is also true that many of the bank employees involved in these loans had relatively little knowledge of foreign currency dealings in general and the implications of offshore borrowing in particular. That is a general problem that the banks have

suffered from in the deregulation. They have not reacted in terms of staff training as rapidly as perhaps they should have done. And it is to be hoped that one of the good outcomes of the present litigation will be to make sure that that does not happen again and that the banks put more effort into training their staff.

I must say however, in this context, that the legal profession, whose lack of knowledge of foreign currency matters is monumental, makes a fool of itself when it criticises bank officers for having only a moderate knowledge of foreign currency event. I have found in most of these cases that when you talk to the solicitor, he has a reasonable knowledge of foreign currency transactions. When you talk to the junior barrister, he at least knows what some of the terms mean. When you talk to the QC, he knows very little at all. And then we come to the judges!

Having said all this though, I think one of the crucial questions that has arisen in recent cases is the role which the letter of offer should play.

Now unfortunately I have to direct my remarks to the judge's draft decision in *Meta* which I received some time ago - the actual paper that you have I only received about twenty minutes ago, although I gather there is a very considerable overlap between the two, but if what I am talking about seems to be missing from the judge's paper it is because I am actually referring to the draft decision which I used to prepare this afternoon's discussion.

In general, in spite of anything the bank staff may have said in these foreign currency cases, the bank itself wrote a very simple and straightforward letter of offer to the borrower which set out in my view very clearly the risk involved in foreign currency borrowing and also drew attention to the fact that there were methods available for managing that risk. If I could just read to you from the letter which was used in *Meta*, which is in fact the standard letter that the Commonwealth Bank uses:

> "On the understanding that the exchange risks associated with borrowings in foreign currencies are fully recognised, and that any adverse exchange rate movements are for the borrower's account, the bank is prepared to allow the loan to proceed on an unhedged basis. As you are aware, exchange risks may be eliminated at any time during the life of the loan by entering into a hedge contract and the bank would be happy to provide information in this regard on request.
>
> ...
>
> We again point out the potential risk involved in borrowing in a foreign currency without covering your foreign currency exchange exposure and would like to remind you any adverse exchange rate movements are for your account."

Now the Full Court, commenting on that letter, found it quite acceptable and they mentioned that the correspondence gave warnings (incidentally, I am quoting from an article by Anne Lampe in the *Sydney Morning Herald* - I haven't seen the judgment itself - Ms Lampe is not noted for her bias towards the banks so I think that this is probably a reliable source in this context) that the correspondence gave warnings of the exchange risks associated with foreign currency loans and requirements to alter security ratios as a result of exchange movements in excess of 5%. It also pointed to the ways of avoiding such risks through, for instance, hedging. A similar warning was included in a section of the correspondence referring to payment of withholding tax.

They go on to say that it is difficult to see how Mr Craig, who was the bank officer in question, could reasonably be expected to do any more - the trial judges said. The judges concluded the bank could not be expected to have any special knowledge of future movements in the exchange rate and that all it could do was to indicate in a general way that there were risks and that hedging was available at a price. Learned judges. Perhaps they have more time in their positions to study foreign exchange matters.

On the other hand, in the draft decision on *Meta*, Mr Justice Rogers refers to that section that I read out as "unintelligible". I cannot see why it can be classified as unintelligible. It seems perfectly clear to me. If I get a letter from a bank which tells me that there is a risk involved in something I am doing and that much more importantly I am going to pay for any losses that occur, if I don't understand, then I make damned sure I find out quickly what is going on. I cannot believe that any further effort was necessary to draw the borrower's attention to the existence of a risk. It is not clear to me precisely what the judiciary feels should have been done in this case. Should that part of the letter have been printed in silver lettering? Should the bank manager have stood on his desk and sung about the risks involved? It has not yet been made clear what the limit is to the degree of definiteness that the warning should have included.

Mr Justice Rogers in his draft decision on *Meta* goes further than this. He also tends to call that statement in the letter an "acknowledgement" rather than a warning. Now I think the use of the word "acknowledgement" goes back to an earlier comment in the decision where he draws attention to the discovered bank material and points out that the banks were generally using the statement to cover themselves - if you would like to describe it like that - rather than to help the borrower.

I am not a lawyer, but I think frankly that is totally irrelevant. What does it matter why the banks included that statement in the letter? Just as I believe it is irrelevant that the banks wanted to get into that area of business because it was profitable. The only question surely is whether the warning was

adequate for the borrower and whether in order to obtain that profit, the bank was pushing the borrower into something that was extremely dangerous for the borrower. The motive of the bank must be irrelevant here. It is very nice for mud slinging to be able to point out that the banks like to make profits. They do have a responsibility to their shareholders, after all; but I do not believe that it should enter into this case at all. I do not believe that it is at all relevant.

In general I believe that the Full Court has made the right decision and given the correct weight to that letter of offer that the Commonwealth Bank used in the *David* case. I would happily ride down in the lift with the three judges! More so sir, since the rest of us that go into that court, some hundred of us pile into six lifts. So I would be very happy to join them. I have often wondered why the judges seem to get downstairs before the rest of us do.

In the draft judgment his Honour also seems to put a lot of weight on a statement of mine, and this is one of these things where really you wish you had never said it - after the event - that the potential loss involved in a foreign currency loan can exceed 100% of the amount that was originally borrowed. Now that is certainly an arithmetical fact, but I believe this is one of those areas where the judge has taken what suited his proposition and ignored the rest. The fact is that there is not only a question of the potential arithmetical loss to be considered, there is a question of the probability of that loss occurring which enters into whether somebody should warn a borrower about that potential. For example, if we step out of our house there is always a chance that a car will have mounted the curb, crossed our front lawn and will run into us just as we go out the front door. It has happened, consequently we cannot argue that it is impossible. You do not warn your children every time they go out the front door that this might happen, because you rate the probability as being very low. So in terms of warning about the riskiness of a given product, the question of the probability of the disastrous outcome occurring must also be taken into account.

I might say as an aside judge, that I do not disagree with the use of the term "gamble". There is certainly a gamble involved in foreign currency borrowing, just as there is a gamble involved in virtually every business decision that anybody makes. If you decide to buy a house, you are to some extent speculating and "speculation" is simply a fancy word for gambling. The fact that foreign currency borrowing did involve a gamble does not mean that it was unnecessarily risky. The question is just how good were the odds in that gamble. If they were extremely good, it may be a very wise thing to do, and I believe to this day that foreign currency borrowing is an alternative which most business should consider from time to time - although my view on it would be more conservative than it was in 1985.

The question is the probability that that 100% loss or a large loss will occur. And the fact is that if you look back into the

period when these loans were made, nobody would have expected the depreciation of the Australian dollar which actually occurred. I have yet to have brought to my notice a single forecaster who predicted the slip in the value of the Australian dollar that occurred over 1985 and 1986. Ray Block of Dominguez Barry Samuel Montague is notorious for his pessimistic forecasts. Ray was extremely pessimistic in early 1985 - he thought the Australian dollar might fall by five cents. And five cents would have left foreign currency borrowers in not too bad a position. Nobody predicted the fall that would actually occur.

Now there were a number of reasons for that. We had gone through a period of a very high of stability of the Australian dollar, particularly in the period before the float. But in 1984, the first year of the float, we had what has appeared since to be an unnatural degree of stability and people were lulled into believing that even with the floating dollar we were going to have a comparatively stable exchange rate. Certainly not one that could move by 20 or 30% in a few months.

In 1986 the Australian dollar fell and it fell largely because fundamentals worsened against the Australian dollar in that year. In particular commodity prices fell sharply. And again, I am not aware of any economist who predicted that that would occur. In hindsight moreover, it appears that the Australian dollar overshot in 1986. Those people who said that it had gone down too far were right, unfortunately at the wrong time, which is a problem most economists have. And looking back we can see that the Australian dollar probably did go too low at that point in time. Now in terms of those facts it is difficult to criticise bank officers for not being smarter than all the economists in the world. I have no information on what judicial predictions were at the time, but I tend to believe that such as they were, they were no better than the economists.

So in terms of evaluating the risk at the time, nobody understood how high it was. In hindsight we know it was considerable - the judge's 20-20 vision at the end of his paper - but at the time nobody realised it was as large as it was. And you had a tendency after the large drop in the value of the dollar for people to expect it to return, to recover rather than to continue its decline. And again, those expectations have been borne out, unfortunately the time period over which they occurred was too long to be of assistance to most of these foreign borrowers.

As a result of that I think it is very difficult to claim that the bank knew about risks which it did not tell the customer about. Banks do not push customers into excessively risky loans. As soon as a loan goes bad, the fact is a bank loses money on it. So there is no reason why a bank looking after its own interests and its shareholders' interests would put anybody into a loan which was likely to go bad deliberately. The banks themselves like all the rest of us just did not appreciate the dangers that were likely to occur in 1985-86.

I might say in that context that equating foreign currency loans to a dangerous product is nonsense. They can be handled and they can be used. There are people who have used them in recent years with a great deal of success and they are certainly not in the same category as a dangerous drug. I regard that as emotive language which is badly based in terms of the facts of the matter.

One point his Honour made was the question of managing a foreign currency loan and again the borrowers and the judges that have found in their favour have made much of this difficulty, that is nonsense. You can manage a foreign currency loan by monitoring the *Australian Financial Review* in the sense that you can avoid very bad outcomes from occurring. You may not be able to achieve the absolute optimal result, but you can avoid very bad outcomes from occurring. And as I say in my small paper, managing a foreign currency loan is actually a simpler proposition than managing a share portfolio, which many of these borrowers had done before they took the loan.

In terms of keeping track of different share prices, reading balance sheets and so on, running the share portfolio is certainly a much more onerous requirement than running a foreign currency loan where at worst you might have to look at one or two exchange rates. I think the complexity of management has been exaggerated quite deliberately and many of the people supporting borrowers talk in terms of foreign currency operations run by the banks; a $300,000 loan is not a foreign currency operation.

In terms of bank management, if I understand the judge correctly, he seems to be saying that the bank should have managed the loan for the customer - in the absence of a contract and in the absence of a payment for that management service. Seriously, I wonder what sort of legal position the bank would have been in if it had made decisions on behalf of the customer without having some contract which allowed it to do so, or some agreement with the customer that permitted it to do so. If a loan is made in my view without such a contract, the bank is wise to stay out of management altogether. And in retrospect, certainly cannot be criticised for doing so if the customer was not willing to take the bank on as a manager on a fee paying basis to run that loan.

In terms of equity, as I point out in my paper, what is being required of the banks now is to provide the borrowers with what is now known as a "cap". There wasn't such a thing available at that time. A cap is a guarantee that a foreign currency borrower's costs will not exceed a certain amount. The foreign currency borrower takes any benefits that occur - and it might surprise you but I have never yet had to appear in a case where a foreign currency borrower was suing a bank to force it to accept part of his profits - so the foreign currency borrower reserves the right to take his profits, but the bank is expected to cover him for any losses that he might have suffered. Now that sort of instrument is well known nowadays, it is called a cap, you can buy them in the market, and if you buy them there is usually a

fee involved in return. In retrospect what the banks were asked to do, are being told to do now, is to provide a cap to these foreign currency borrowers, ask no fee and just pay out the loss that they suffered. Now had the banks been in the business over the 80's of providing a cap, obviously they would have done badly in 1985-86, because they would have been paying out heavily, much more than any premium they would have charged for the cap. But at the same time they would have done well in the early 80's and they would have done well since 1987 because they would not have had to pay out, they would have received a premium. And over the 80's as a whole they might have made a profit out of that arrangement. Unfortunately they did not realise that Mr Justice Rogers was up ahead of them and they did not charge for the cap that he is now having them provide, or would like to have them provide, and in terms of fairness I do not believe that that is fair. I believe that the banks are being asked to do something which goes beyond reasonable behaviour.

The banks are actually, under the current situation, being asked to provide a one-way bet for borrowers. Borrowers can take what appears to be a cheap loan. If it turns out to be cheap, great. If it turns out not be cheap, the bank will pay the cost. Now it is not clear to me why the bank, their shareholders, or the bank depositors should have to pay that one way bet. I also think that, as a number of people have said in common sense, we should ask the borrowers why they believe they were getting a low interest loan when nobody else in the economy had access to that sort of low interest rate. Didn't they suspect there was some problem with the loan? They claim now that they didn't, but frankly I find that very hard to believe given that quite a few of them had substantial financial experience, had been involved in property development and things of that nature.

Finally, Mr Chairman, the major problem I have with these cases is the broader implications of them which have not been discussed in the courts at all. If the sort of principles that have been espoused by Mr Justice Rogers in his paper today are accepted, what stops them from being extended to a whole lot of other areas of banking activity? Where is the end to the situation if you accept those ideas? Are banks going to be responsible for every loss ever suffered by their clients? If I borrow money to buy a house from a bank and then the price of that house drops because the property market turns down and I have to sell out at a loss, is the bank responsible for that? If so, please tell me, because I'll buy a house as soon as I can. And that is one of the major problems with this type of extension. You are creating a moral hazard. If you tell people that they do not have to repay the bank, they will take loans and they will take risks because they know that in the end the bank will be responsible for any losses whereas they can walk away with the gains.

Now quite apart from the fairness aspect, and you may not particularly want to be fair to banks, but quite apart from that aspect, that is going to do a lot of harm to the Australian financial system.

In speaking about this topic on earlier occasions I have made the joke that I hope to find some lawyers who would help me sue a couple of the banks because I have dealt with both those banks for upwards of twenty years and in 1987 neither of them called me and told me what a good thing offshore borrowing was. And had they done that, and I borrowed offshore in 1987, I would have done extremely well out of that. Now I thought that was a good joke.

Two weeks ago one of the banks told me a claim had been made against them on just that basis. And I say again, where, once we start on this process of moving responsibility for management of borrowers' affairs from the borrower to the bank, where will we end? And what are the implications of that situation? One of the major problems here is that the banks, if they are faced with that, will simply stop lending on anything that looks at all dangerous and the implications of that for the Australian economy are horrifying.

Banks have an obligation to take care of their shareholders and depositors, and the sort of burdens that are being laid on them now will cause them to go into very safe forms of lending and to stay out of the sort of economic development that we would largely see.

Finally, Mr Chairman, I can only express discontent about the trend that is represented by these cases. I spent many years arguing against regulation and was involved in the Campbell effort to get deregulation in the financial system. It appalls me to see now that we are seeing regulation brought back through the back door - regulation by judicial prejudice. And I do not believe that judicial prejudice is a sound basis for applying regulations in the economy anywhere and in the financial system in particular.

I would like to leave you with the thought that if we are going to look into the question of making people responsible for advice, I would like to see some move to make lawyers responsible for the advice that they give their clients. I would like to see action taken against lawyers who advise clients to take on cases in which there is very little hope of success. And I would like to see action against judges who bring down decisions which are later reversed by higher courts. And most importantly, without mentioning the name of a well known Melbourne law firm, I would like to see something done about ambulance chasing. Thank you.