AUSTRALIAN
RETAIL
CREDIT
ASSOCIATION

Legal and Remediation
Australian Financial Complaints Authority

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By email

Dear

AFCA Approach to responsible lending series

Thank you for the invitation to provide feedback in response to AFCA's draft Approach to responsible lending series.

ARCA has previously provided detailed feedback to ASIC's review of RG 209, in which we noted the need for clearer and better principles-based guidance. In particular, we observed that the current guidance in respect of a financial firm's responsible lending obligations did not address the key issue of what 'substantial hardship' actually involves. As a result, stakeholders do not have a clear and consistent understanding of the 'harm' that the provisions were seeking to mitigate, which meant that the guidance as to 'what' a firm must do to comply with the inquiries and verification obligations lacks clarity. This is particularly relevant to the issue of what inquiries and verification steps are required in relation to a consumer's variable 'living expenses' – see para 63 onwards in our RG 209 submission.

We would be happy to discuss the detail of our RG 209 submission with you.

Summary of feedback to the Approach documents

We believe the Approach documents should:

i. Provide more guidance as to when an industry code will reflect 'good industry practice'
ii. Clarify the status of the guidance in the Approach documents and how it relates to ASIC's RG 209

iii. Better reflect the concept of 'scalability' and recognise the requirement to undertake 'reasonable' inquiries and verification (rather than a fixed list of steps)
iv. Recognise, and protect against, the risk of unwarranted interference with consumers' privacy
v. Address the issue of a consumer withholding relevant information or engaging in fraud
vi. Protect against the risk of making biased 'hindsight' judgments
vii. Clarify the basis upon which a broker will be the credit provider's agent

i. When should industry codes reflect 'good industry practice'

We urge caution in respect of the approach of treating industry codes as automatically reflective of 'good industry practice'. In seeking to set a higher standard for prospective signatories, an industry code may (i) address a particular issue that is relevant to the signatories to the code, which does not necessarily impact other segments of the market; and (ii) reflect and improve upon the *current* practices of those signatories. It is not appropriate to assume that those improved practices are relevant or applicable to non-signatories who may have significantly different business structures, products and processes.

Before applying the requirements of an industry code as 'good industry practice' consideration should be given to whether the expectations of the code are relevant and appropriate for all sectors of the industry, including whether there are potentially competing and inconsistent codes covering the same topic. As part of this, consideration should also be given to whether the practices provided for in the code have been adopted widely by non-signatories, as this will provide firm evidence that the provision is *actually* 'good industry practice'.

ii. Status of the guidance and relationship to RG 209

In our submission to ASIC on the review of RG 209, we noted the need to retain a principles-based approach to the responsible lending guidance (see our submission para 27 onwards). We consider that this approach is both necessary to ensure innovation and competition in the Australian credit market and is the only approach that is supported by the NCCP responsible lending provisions.

In particular, our submission noted that the legislation does not support ASIC prescribing any particular forms of inquiries or verification steps as it is up to the licensee to determine (and justify) why the approach followed was 'reasonable' in the circumstances.

For example, we have questioned ASIC's suggestion that a licensee *must* (as a matter of law) make inquiries of a consumer's income and expenses as separate matters. We have noted that (in relation to whether a consumer can afford the loan) the only requirement is to make inquiries of a consumer's capacity to service the loan and that this could, subject to all the circumstances of the loan, be assessed using alternative measures (e.g. looking at a consumer's savings history, being the difference between a consumer's income and expenses). If a licensee decided to assess a loan using such alternative measures, it would be up to that licensee to justify why that approach was 'reasonable'.

We also noted our concern that the inclusion by ASIC of lists of 'expected' or 'minimum' inquiries or verification steps in RG 209 will be treated as a mandatory and inflexible checklist by stakeholders.

If ASIC does decide to provide more 'prescriptive' guidance, we note that ASIC is able to ensure that the guidance will be informed by an open, transparent and comprehensive consultation process (e.g. ASIC has announced that it will be conducting open hearings that will be broadcast). The consultation process being undertaken by AFCA in respect of the Approach document is more limited. In addition, given AFCA's interaction with the credit industry (i.e. as the determiner of disputes), AFCA will not, through its ordinary operations, see the broad range of outcomes in the market and is, naturally, more likely to see those matters where there has been a breakdown rather than success.

Nevertheless, we recognise that AFCA needs to have a 'starting point' with which to begin to determine whether a loan was 'unsuitable' for a consumer (i.e. the loan did not met the consumer's requirements and objectives or the consumer was unable to afford the loan). Including lists of possible inquiries and verification steps (as shown in section 3 of *The AFCA Approach to responsible lending: legal principles, industry codes and good industry practice*) provides such a starting point.

However, we consider the Approach document should clarify that:

1. The lists of things that AFCA 'expects' a financial firm to do (particularly those in section 3) is based on the products, processes and policies that AFCA has seen as part of its consideration of complaints and does not reflect a comprehensive assessment of the credit market in Australia and, as such, does not limit the flexibility provided for in the NCCP responsible lending provisions.
2. Those lists may be used as an internal 'checklist' by AFCA to undertake a retrospective assessment as to whether the loan was unsuitable when the loan was granted. That is, based on the information collected and verified by AFCA as part of the complaint using the lists in section 3, would AFCA conclude that the loan was unsuitable?
3. Simply because AFCA retrospectively concludes a loan was unsuitable does not mean the loan was irresponsible. If AFCA concludes that the loan was unsuitable based on retrospectively conducting the inquiries and verification steps set out in the lists, there will be a separate consideration as to whether the inquiries and verification steps undertaken by the financial firm at the time of the assessment were *actually* reasonable in the circumstances (notwithstanding they differ to those in the lists).
4. Further to 3, a financial firm has not engaged in irresponsible lending simply because it undertakes different inquiries and verification steps to those in the lists.

iii. Scalability and 'reasonableness'

Noting our comments above, even in respect of 'common' or 'standard' products, processes and policies, we consider that certain elements of the 'lists' in section 3 go beyond what is 'reasonable' and/or fail to recognise the permitted scalable approach to responsible lending (e.g. while the step may be appropriate for some products or in some circumstance, it should not be presented as a 'default' expectation).

More broadly, our Members believe that AFCA's interpretation of responsible lending obligations as drafted are likely to have a material affect the availability and provision of credit to consumers in the Australian lending market.

To the extent that the 'expectations' listed in section 3 will be used as a 'checklist' by AFCA complaints officers, we are concerned that they will be applied inflexibly. We consider that AFCA should provide further commentary on 'why' each of the matters are 'expected' (i.e. so as to clarify 'when' those matters will be required). For example, it is not common for financial firms to make inquiries about the 'age' of dependents. If AFCA considers that this is relevant, further explanation should be provided.

Likewise, expectations such as "test capacity to repay based on principal and interest over the remaining term after any relevant interest only period" and "sensitize loan repayments based on the contract interest rate plus a buffer of 2.5%" are typically seen as being relevant to home loan lending. It is unclear on what basis these expectations should apply to other forms of lending.

Further, the buffer of 2.5% appears to be derived from APRA's buffer for prudentially regulated entities. Such a buffer is intended to manage the prudential stability of the Australian banking industry and it is not clear why this is automatically relevant to assessing whether a particular consumer is 'likely' to be able to repay a loan (whether a home loan or otherwise) from a non-ADI lender.

We would welcome further consultation on the steps listed in section 3.

iv. Risk of interference with consumer's privacy

Our submission to the RG 209 review (see para 144 onwards) noted that the responsible lending practices of a financial firm could involve a significant invasion of an individual's privacy – both of the borrower and third parties (e.g. the ex-partner of a borrower who is paying child support).

As noted in our submission, given the harsh penalties that apply to a failure to make 'reasonable' inquiries and verification, or for providing unsuitable credit, there is a strong incentive for licensees to collect *more* information as a means of reducing compliance risk such that there may be further unnecessary inference with the individual's privacy.

We consider that it is imperative that both ASIC and AFCA ensure that any guidance that seeks to reduce poor consumer outcomes resulting from irresponsible lending does not promote equally undesirable privacy outcomes.

v. Consumer withholding information or engaging in fraud

The Approach documents do not address the problem of a consumer withholding – or doctoring – information when applying for a loan (including where that conduct would constitute fraud).

It is inevitable that the information collected by a financial firm from a consumer will not be a 'perfect' reflection of the consumer's actual financial situation. Most of the time, this will be done innocently (e.g. the consumer was not fully aware of their own financial situation or simply misunderstood the questions on the application form) and the required 'reasonable'

verification steps should be directed towards identifying these types of errors (to the extent that they are material to the assessment of suitability).

However, some consumers will seek to deliberately seek to withhold or doctor information that is material to the loan assessment. As we noted in our submission to the RG 209 review (see para 155 onwards), there are numerous matters that are relevant to a consumer's ability to afford the loan that a financial firm is simply unable to verify or cannot verify without significantly interfering with the privacy of *all* their customers (i.e. both those customers telling the truth and those seeking to mislead the financial firm).

As an example, a consumer's statement as to their relationship status must be taken on face-value. It would either not be possible to verify that information or, if possible, would involve a significant invasion of the consumer's privacy (e.g. looking through account statements for indications of relationship breakdown or contacting the consumer's family or friends to inquire about the status of the relationship). Importantly, this would have to be done for *all* customers, not just those who have given incorrect information.

We recognise that section 154 of the *National Credit Code* will operate to relieve the financial firm of liability in some circumstances where a consumer has provided false or misleading information in relation to the loan application. However, there should not be an expectation that the 'reasonable' steps will identify all cases of a consumer deliberately lying or withholding information – this is not fair to the financial firm or to innocent consumers who will bear the additional costs, inconvenience and interference with their privacy.

vi. Protecting against "hindsight bias" in judgments

As an overarching comment – which is of significant concern to our Members – we consider that the Approach documents need to explicitly address the risk of 'hindsight' bias; this is the widely recognised phenomenon in which we revise probabilities after the fact or over-estimate the extent to which past events could have been predicted beforehand.

A consumer who is complaining to AFCA of irresponsible lending will almost certainly be *currently* unable to repay the loan. The cause of the consumer's inability to repay the loan may even have been an identifiable 'possibility' when they took out the loan.

In our submission to the RG 209 review we discuss the ambiguous meaning of 'likely' as it is used in the NCCP responsible lending provisions (see para 162 onwards) and some specific examples of matters that could impact a consumer's future ability to repay a loan (see "'Lifestyle-choice' expenditure: gambling, smoking, drinking etc" at para 194 onwards and "Predicting future changes to a consumer's financial situation" at para 207 onwards).

As examples, it is deceptively easy *in hindsight* to say that a consumer who was previously gambling money at the horse races was 'likely' to become a gambling addict and therefore would be unable to repay the loan. But clearly, all people who gamble do not develop problems with gambling addiction.

Likewise, it is easy *in hindsight* to suggest that a woman in her early thirties was 'likely' to become pregnant during the term of a home loan and therefore would have difficulty affording that loan. However, the same could be said for a range of possibilities – that same woman could lose her job, become sick with cancer and/or have a relationship breakdown.

An overly keen sense of 'hindsight vision' will lead to the conclusion, because the 'possibility' eventuated, it 'should' have been clear that the consumer should not have been provided the loan. Taken to its conclusion, hindsight vision would result in a significant reduction in credit being granted. We recommend that AFCA explicitly recognise this risk in the Approach documents and, ideally, provide training to its staff in respect of this form of cognitive bias.

vii. Clarify the basis upon which a broker will be the credit provider's agent

We welcome AFCA's recognition in section 2.1 of *The AFCA Approach to responsible lending: consumer credit issues* that "[m]ost commonly, we find that a broker is the consumer's agent rather than the credit provider's agent". However, we are concerned about the list of factors that AFCA will look at when deciding whether the broker was the credit provider's agent.

On its face, the list of factors appears to describe an ordinary relationship between a broker/aggregator and the lender. In fact, some of the factors appear to reflect a good relationship, including compliance with a credit provider's internal policies and practices and the provision of training by the credit provider. It is concerning that these activities could be discouraged by AFCA's Approach document. Further, we are concerned that some of the factors, including whether the consumer was directed to the broker to answer questions, would act against smaller lenders who do not have the same business structure (e.g. branch network, call centres etc) as other lenders and are more reliant on broker channels to distribute their products.

We would be happy to meet with you in person to discuss this feedback and our submission to ASIC's RG 209 review further. Please feel free to contact me or Michael Blyth.

Yours sincerely,

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Chief Executive Officer
Australian Retail Credit Association