REPORT 410

Review of 'low doc' home lending following the introduction of the responsible lending obligations

September 2014

About this report

We reviewed how lenders that provide 'low doc' home loans are complying with their responsible lending obligations.

This report presents the findings of our targeted review and identifies a number of examples of how credit licensees can reduce the risk of non-compliance.

This review follows on from the reviews in Report 262 *Review of credit assistance providers' responsible lending conduct, focusing on 'low doc' home loans* (REP 262) and Report 330 *Review of licensed credit assistance providers' monitoring and supervision of credit representatives* (REP 330).

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC’s approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

References to Regulatory Guide 209 *Credit licensing: Responsible lending conduct* (RG 209) are accurate at the time of publication.

Contents

Executive summary

1 This report examines how lenders that provide 'low doc' home loans are meeting their responsible lending obligations, following the commencement of the *National Consumer Credit Protection Act 2009* (National Credit Act).

2 The responsible lending obligations are central to the National Credit Act and limit the circumstances in which credit products can be recommended or provided to ensure consumers can meet their repayment obligations without substantial hardship.

3 ASIC, along with other regulators, has a strong interest in home lending practices and any potential increase in higher-risk lending. A focus on the responsible lending obligations in home lending assists in avoiding excessive risks in the home lending market, and in improving consumer outcomes in the consumer credit industry more broadly. Industry compliance with these obligations is therefore a key part of ASIC's strategic priority to ensure confident and informed financial consumers.

4 In considering this report, it is important to understand how 'low doc' home loans before the introduction of the National Credit Act differ from 'low doc' home loans since the introduction of this legislation.

'Low doc' loans before the national consumer credit reforms

5 'Low doc' home loans were introduced into the Australian mortgage market in the late 1990s for self-employed borrowers and others who did not have an income stream that could be readily verified by reference to standard documentation, such as payslips. Over time, these loans were made available to a wider market, including consumers that could provide standard documentation, such as payslips, to verify their income.

6 Before the commencement of the National Credit Act, 'low doc' home loans were often provided solely on the basis of a statement from a consumer regarding their ability to meet their financial obligations, with no additional verification of the consumer's financial situation. This led to concerns about loans being made to consumers who were not in a position to meet loan repayments without substantial hardship.

'Low doc' loans since the national consumer credit reforms

7 The National Credit Act commenced in 2010 and introduced licensing requirements, general conduct obligations and responsible lending obligations for both lenders and mortgage brokers. The responsible lending obligations require holders of an Australian credit licence (credit licensees) to ensure that consumers are only placed in loans that meet their

requirements and objectives and that they can repay without substantial hardship. In doing this, credit licensees must make reasonable inquiries into an individual consumer's specific circumstances and take reasonable steps to verify the consumer's financial situation before making an assessment about the consumer's capacity to repay the loan.

8 These credit reforms have increased the level of regulatory protection for borrowers and led to improvements in industry practice. 'Low doc' loans in the sense previously common in the market—where the lender does not verify the consumer's financial situation—are now prohibited and there are significant civil and criminal penalties for breaches of the responsible lending obligations.

9 The name 'low doc' loan continues to be used by some lenders to market loans aimed at self-employed consumers or those that do not have an income stream that can be readily verified by reference to standard documentation, such as payslips.

10 The majority of the lenders in our review have adopted various names other than 'low doc', such as 'alt doc', for their products targeted at self-employed consumers. These terms better reflect the obligation under the National Credit Act to verify a consumer's financial situation.

11 The level of activity in 'low doc' loans has decreased significantly since the commencement of the National Credit Act. For example, the Australian Prudential Regulation Authority's quarterly property exposure statistics demonstrate a significant decrease in the number of 'low doc' loans being approved by authorised deposit-taking institutions (ADIs). In addition, consumer groups have noted that, since the commencement of the responsible lending obligations in the National Credit Act, there has been a noticeable tightening of lending procedures in residential lending and they are not seeing the same type of problems in this sector as they previously did.[1]

Why we focused on 'low doc' loans

12 Although the level of activity in 'low doc' loans has decreased significantly since the commencement of the National Credit Act, previous concerns in relation to 'low doc' loans—including risks identified by ASIC prior to it assuming primary responsibility for consumer credit regulation from the states in 2010[2]—prompted ASIC to conduct this review.

---

[1] Senate Economics References Committee, 'Performance of the Australian Securities and Investments Commission', testimony from K Cox, Coordinator, Consumer Credit Legal Centre Inc. (NSW); and G Brody, Chief Executive Officer, Consumer Action Law Centre, Sydney, 20 February 2014, http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;db=COMMITTEES;id=committees%2Fcommsen%2Fc3c0d768-0939-45ea-8549-6bfaa4cc2cb5%2F0005;query=Id%3A%22committees%2Fcommsen%2Fc3c0d768-0939-45ea-8549-6bfaa4cc2cb5%2F0000%22.

[2] Media Release (13-289MR) *ASIC lodges second submission to Senate Inquiry*, 24 October 2013, http://www.asic.gov.au/asic/asic.nsf/byheadline/13-289MR+ASIC+lodges+second+submission+to+Senate+Inquiry?openDocument.

13 This review forms part of ASIC’s ongoing focus on responsible lending obligations, as these obligations—together with licensing and the associated general conduct obligations—are central to the National Credit Act.

What we did

14 We selected 12 credit licensees of varying sizes, representing a broad cross-section of businesses that were active in providing credit for ‘low doc’ home loans, including ADI lenders and non-ADI lenders. Some of the lenders provided credit under different branded distribution channels (e.g. wholesale funding to mortgage managers, through mortgage brokers, or directly to consumers).

15 Our review of lenders was conducted in two stages. Initially, we obtained information on the level of lenders’ credit activities in relation to ‘low doc’ home loans and the arrangements they had in place to ensure compliance with the responsible lending obligations. We subsequently obtained and reviewed 114 files for ‘low doc’ home loans in order to establish how the arrangements were working in practice. As our review focused on lenders’ responsible lending conduct, the files reviewed were for home loans regulated by the National Credit Act (i.e. home loans to individuals for owner occupation or residential property investment).

What we found

16 There have been improvements in the practices of lenders in relation to ‘low doc’ lending, including the following:

(a) All of the review participants reported significant changes to their practices since the commencement of the responsible lending obligations, with a number also citing the findings in Report 262 *Review of credit assistance providers’ responsible lending conduct, focusing on ‘low doc’ home loans* (REP 262) as a driver for such changes.

(b) The lenders we reviewed are undertaking greater inquiries into and verification of consumers’ financial situations since the commencement of the National Credit Act. This should reduce the risk of unsuitable lending against the family home, including the risk of loans being made on the basis of unverified statements about a consumer’s income and/or self-employment. For example, based on our review:

(i) ‘low doc’ loans are not being used for consumers with a regular income stream that can be readily verified by standard documentation, such as payslips. On all files reviewed, at least one consumer was self-employed, and any co-borrowers with regular employment had their income verified by standard documentation;

(ii) a consumer's self-employment income is generally verified by statements from an accountant and/or available financial information, such as business bank account statements or business activity statements (BASs). There were no instances where a lender's assessment of whether a loan would be unsuitable for a consumer was simply based on a statement from the consumer declaring their ability to meet loan repayments; and

(iii) all lenders have processes in place to ensure the reliability of information collected by third parties (e.g. mortgage brokers), including a number of lenders who would contact consumers directly to verify the information provided in the loan application—some, in all instances, and others where the information provided in the loan application was inconsistent.

17 There were, however, instances where lenders were at increased risk of not satisfying their general conduct and responsible lending obligations, and their practices had room for further improvement. This included making adequate inquiries to ascertain the relative priority of consumers' requirements and objectives, and using adequate buffers to account for changes in financial circumstances (e.g. increases in interest rates and fluctuations in consumers' incomes and expenses) when assessing consumers' ability to make repayments.

18 The lenders made a number of changes over the course of our review, including one lender that withdrew its product. We spoke directly with individual lenders regarding concerns that we identified during the review, and a number made further changes to their processes in light of risks we identified. For example, four lenders that had been relying solely on a benchmark figure for living expenses, based on the number of persons dependent on the consumer's income, undertook to make separate inquiries into consumers' actual living expenses.

19 Despite the improvement in practices identified since the introduction of the National Credit Act, and the further changes lenders have undertaken as a result of our review, ASIC will continue to monitor the home lending industry's compliance with the responsible lending obligations. This will remain a key focus of ASIC's work—given that, as noted above, such a focus assists in avoiding excessive risks in the home lending market, and in improving consumer outcomes in the consumer credit industry more broadly.

20 We have included in this report some examples of how credit licensees can reduce their risk of non-compliance. These examples are also set out in the appendix, with references to further discussion of our findings. In many

instances, these examples are relevant to credit licensees generally, not just to lenders providing ‘low doc’ home loans, and relate to:

(a) documented procedures and reliance on information from mortgage brokers;

(b) inquiries into consumers’ requirements and objectives;

(c) the use of business expense ratios, statements from accountants and income matrices to verify consumers’ income;

(d) inquiries into and verification of consumers’ living and fixed expenses, including the use of credit reports; and

(e) buffers and surplus income positions used to assess consumers’ ability to meet their financial obligations without substantial hardship.

21 Because the responsible lending obligations have been in place for some time—and in light of our guidance, reviews and published reports (including this report)—our expectations for compliance are now higher. The responsible lending obligations are a central element of the national consumer credit legislation, and ensuring industry compliance with these obligations is a key part of ASIC’s strategic priority to ensure confident and informed financial consumers. If we identify non-compliance in future, we will consider enforcement action.

A Background

Key points

Our review focused on the responsible lending conduct of lenders providing 'low doc' home loans, and follows on from REP 262 and REP 330 on mortgage brokers' responsible lending conduct.

The overall loan approval rate for 'low doc' loans in our review was slightly over 70%, with smaller lenders generally having an approval rate of less than 50%.

We reviewed documented procedures for each lender and a total of 114 files to establish to what degree their practices, including the records they kept to form the basis of an assessment of unsuitability, reflected their documented procedures and the responsible lending obligations.

Regulatory framework for home lending

22 A number of organisations are responsible for the regulation of Australia's financial system, including the home lending sector:

(a) The Reserve Bank of Australia is responsible for the financial stability of the Australian economy and sets the cash rate to meet an agreed medium-term inflation target. It regularly provides public commentary on the state of the economy and on factors affecting financial stability, including those in the home lending sector.[3]

(b) The Australian Prudential Regulation Authority is responsible for the prudential regulation of banks, credit unions, building societies, insurers and superannuation entities. It establishes and enforces prudential standards to ensure that financial promises made by institutions are met. In the home lending sector, this includes reviewing lenders' home loan approval standards, as well as developing guidelines for prudent lending practice.[4]

(c) ASIC is the primary conduct regulator for markets, financial services and consumer credit. This entails ensuring industry compliance with the consumer protection provisions of the *Australian Securities and Investments Commission Act 2001*, which prohibit misleading and unconscionable conduct; as well as the more specific licensing and responsible lending obligations for lenders and mortgage brokers under the National Credit Act.

---

[3] Luci Ellis, Head of Financial Stability Department, Reserve Bank of Australia, *Space and stability: Some reflections on the housing–finance system*, address to the CITI Residential Housing Conference, Sydney, 15 May 2014, http://www.rba.gov.au/speeches/2014/sp-so-150514.html.

[4] APRA, *APRA Insight Issue 2*, 2013, http://www.apra.gov.au/Insight/Pages/APRA-Insight-Issue-2-2013.aspx; APRA, *Consultation on draft Prudential Practice Guide APG 223 Residential Mortgage Lending*, May 2014, http://www.apra.gov.au/adi/Pages/May-2014-Consultation-PPG-residential-mortgage-lending.aspx.

23 One of the key objectives of this multi-tiered regulatory model is matching the level of regulatory intensity to the potential for loss or harm in order to ensure that stakeholders, including consumers and investors, have confidence in the financial system.

Our previous reviews

24 Following the commencement of the National Credit Act in July 2010, we undertook an assessment of industry’s responsible lending conduct in a number of areas. See:

(a) Report 262 *Review of credit assistance providers’ responsible lending conduct, focusing on ‘low doc’ home loans* (REP 262);

(b) Report 264 *Review of micro lenders’ responsible lending conduct and disclosure obligations* (REP 264);

(c) Report 330 *Review of licensed credit assistance providers’ monitoring and supervision of credit representatives* (REP 330); and

(d) Report 358 *Review of credit assistance providers’ responsible lending conduct relating to debt consolidation* (REP 358).

25 We focused on the responsible lending obligations, as these new legislative obligations—together with licensing and the associated general conduct obligations—are central to the national consumer credit reforms. Ensuring industry compliance with these obligations is a key part of ASIC’s strategic priority to ensure confident and informed financial consumers.

26 The responsible lending obligations require credit licensees, including both mortgage brokers and lenders, to ensure that consumers are only placed in credit contracts that meet their requirements and objectives and that they can meet their repayment obligations without substantial hardship. In doing this, credit licensees must make reasonable inquiries into an individual consumer’s specific circumstances and take reasonable steps to verify the consumer’s financial situation.

27 We have published specific guidance for industry regarding our expectations about compliance with the responsible lending obligations in Regulatory Guide 209 *Credit licensing: Responsible lending conduct* (RG 209).

28 One of the areas we identified for review of responsible lending conduct was the home loan sector, given that it is the largest sector of consumer credit by aggregate dollar amount.

29 We focused on ‘low doc’ home loans, given their particular compliance risks and concerns identified in Report 119 *Protecting wealth in the family home: An examination of refinancing in response to mortgage stress* (REP 119), including a heightened risk of consumers entering into a credit contract for which they would be unable to meet repayments or would only be able to repay by selling their home, due to the limited assessment of the loan application by the lender.

30 As noted in REP 262, ‘low doc’ home loans were introduced into the Australian mortgage market in the late 1990s and were initially designed for self-employed borrowers and others who did not have an income stream that could be readily verified by reference to standard documentation, such as payslips. Over time, these loans were made available to a wider market—including consumers with regular employment—and often on the basis of a statement from a consumer regarding their ability to meet their financial obligations.

31 We undertook a multi-staged review to see what effect the introduction of the responsible lending obligations has had on mortgage brokers and lenders, given the specific obligation on each of them to verify the consumer’s financial situation.

32 REP 262 and REP 330 noted, respectively, that individual mortgage brokers and aggregators were aware of the new obligations and had taken steps to comply—however, the reviews also identified a number of areas where they were at risk of non-compliance. For example, one common risk identified in our various responsible lending reviews is poor record-keeping practices; this places credit licensees at risk of not being able to demonstrate they have complied with their responsible lending obligations and their general conduct obligations, including the requirement to comply with the conditions on their credit licences: see item 15 of Pro Forma 224 *Australian credit licence conditions* (PF 224).

Our review of home loan lenders

33 For our review of home loan lenders, we selected 12 credit licensees covering a broad cross-section of ADI and non-ADI lenders.

34 The majority of the lenders in our review have adopted various terms other than ‘low doc’, such as ‘alt doc’, for loans targeted at self-employed consumers. These terms better reflect the obligation, under the National Credit Act, to verify a consumer’s financial situation.

35 Two lenders did not have a separate ‘low doc’ home loan product, but had different internal arrangements for verifying the financial situation of self-employed consumers.

36 As with our reviews of mortgage brokers, this review was conducted in two stages. Initially we obtained information on the level of lenders’ credit activities in relation to ‘low doc’ home loans and the documented procedures they had in place to ensure compliance with the responsible lending obligations. This was followed by a review of a sample of loan files to assess how documented procedures were implemented in practice.

37 Some of the lenders had separately branded retail (i.e. direct to the consumer), third-party (i.e. through a mortgage broker) and/or wholesale (i.e. wholesale or white-label funding to mortgage managers) divisions. In these instances, we obtained data from each division.

38 Although one lender withdrew its product during the course of our review, we have included our observations in relation to that lender in this report.

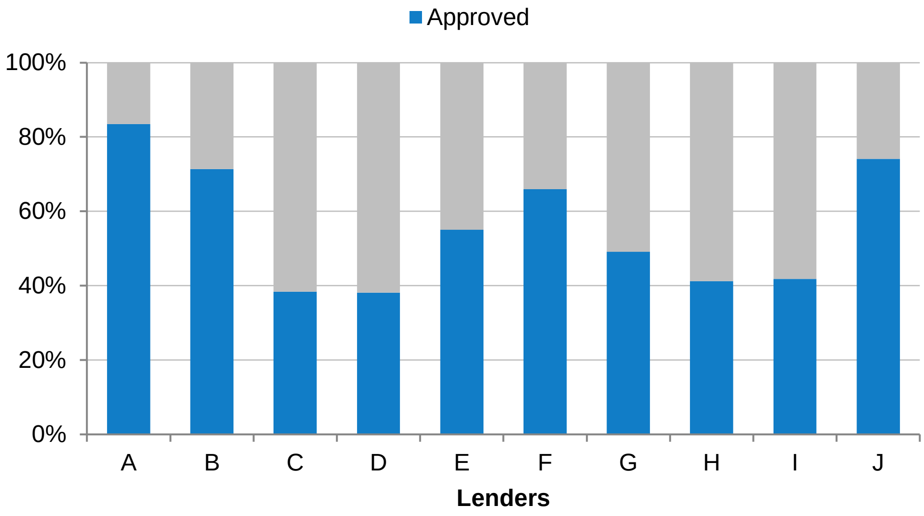
39 We also sought details on the outcomes of these applications, requesting information on the number that had been approved, declined or withdrawn. In some cases, lenders were not able to distinguish between applications that were declined and those that were withdrawn.

40 One lender was unable to readily provide any data other than the number of applications received during the relevant period. An inability to readily access such information raises questions about a credit licensee's compliance with its general conduct obligations, including having adequate arrangements to ensure compliance.

41 Based on the data from lenders that provided all the details requested (10 lenders), the loan approval rate was slightly over 70%. This figure is significantly affected by results of some of the larger lenders, with one having an approval rate above 80%, while the smaller lenders generally had an approval rate in the range of 35%–50%: see Figure 1.

42 Some of the larger lenders reported having narrower lending criteria than some of the smaller specialist lenders (e.g. regarding the loan-to-valuation ratio (LVR)), as well as specific procedures to filter potential credit applications at the time of initial inquiry. Conversely, some of the smaller lenders emphasise their ability to consider non-standard scenarios and only receive applications from mortgage brokers, preventing them from directly filtering applications in the same manner. This may have had the effect of increasing the reported loan approval rate for some larger lenders as compared to some of the smaller lenders.

Figure 1: Percentage of applications approved (where a decision has been made)



43 The rate of declined applications was similar to that for withdrawn applications, both being slightly below 15%. For individual lenders, the ratio

between declined and withdrawn applications varied considerably, with one lender having twice as many applications withdrawn as declined.

44 There are a number of reasons why an application may be declined or withdrawn, including instances where a proposed security property does not meet valuation requirements. However, a large proportion of declined or withdrawn applications submitted by one mortgage broker may raise questions about whether that mortgage broker is complying with their responsible lending obligations and undertaking appropriate preliminary assessments. In such instances, lenders should ensure that compliance risks are identified and are appropriately addressed: see Section D of REP 330.

45 We also obtained copies of lenders’ documented responsible lending procedures for ‘low doc’ home loans, together with details on how these procedures had changed since the commencement of the responsible lending obligations contained in the National Credit Act.

46 Where applicable, we obtained a copy of any pro forma declaration documents intended to be signed by an accountant, or other qualified individual, on which the lenders sought to rely, either wholly or in part, to verify the consumer’s income when undertaking the assessment of unsuitability.

47 After reviewing the initial information provided, we requested 10 files for ‘low doc’ home loans from each lender. For the lenders that had multiple branded distribution channels, we requested 10 files for each business stream.

48 To gauge what impact, if any, the consumer’s equity in the security had on the assessment of the credit application, we split the selection of the 10 files on an LVR basis, requiring the lenders to provide five files where the LVR was 60% or less and five where the LVR was greater than 60%. The 60% LVR figure was chosen as this is the point that lender’s mortgage insurance is generally obtained by ADIs.

49 Not all lenders were able to provide the full number of files requested, due to insufficient loans in either an LVR band or a particular distribution channel over the relevant period.

50 In total we reviewed 114 files for home loans regulated by the National Credit Act (i.e. home loans to individuals for owner occupation or residential property investment). In reviewing these files, we sought to establish to what degree the lenders’ practices, including the records they kept to form the basis of an assessment of unsuitability, reflected their documented procedures and the responsible lending obligations. We did not seek to determine whether any particular contract was unsuitable for a consumer.

B Documented procedures

Key points

All of the lenders advised that they have made changes to their procedures since the commencement of the responsible lending obligations, with a number also citing the findings in REP 262 as a driver for change.

While documented procedures may need to be sufficiently flexible to cover a broad range of consumer circumstances, they also need to provide sufficient detail to ensure practice complies with legislative principles.

Lenders need to ensure they have robust procedures in place to support their reliance on information provided by mortgage brokers. When information provided by mortgage brokers is inconsistent, lenders should consider contacting the consumer directly to verify their actual circumstances.

Statutory obligations

51 In addition to responsible lending obligations, credit licensees also have a number of general conduct obligations under s47 of the National Credit Act. These include having:

(a) adequate arrangements and systems to ensure compliance with their obligations;

(b) a written plan that documents those arrangements and systems; and

(c) adequate risk management systems.

Procedures for assessing loan unsuitability

52 Lenders’ documented procedures generally reflected the obligations under the National Credit Act and outline, at a high level, the steps to be taken when assessing whether ‘low doc’ home loans will be unsuitable for consumers.

53 All of the lenders reported having made changes to their procedures since the commencement of the responsible lending obligations. A number of review participants cited the findings in REP 262 as a driver for reviewing their procedures.

54 While all lenders’ ‘low doc’ home loans were generally targeted at self-employed consumers, two lenders’ documented procedures noted a number of occupations for which ‘low doc’ home loans were not available.

55 None of the lenders' documented procedures prescribed in detail the method for reviewing documents obtained for verification of a consumer's financial situation, such as the business bank account statements. When we subsequently reviewed files, we often found that, even though documents were obtained in line with procedure, it was not readily apparent on file how these documents were used to verify the declared income. Lenders advised that further information on verification was included in staff training and that 'low doc' home loans are generally assessed by more experienced staff.

56 Credit licensees are at greater risk of not complying with their responsible lending obligations if their documented procedures reflect a 'tick a box' approach to achieving compliance. Credit licensees must ensure not only that a document is obtained, but that the information contained in the document is sufficient to satisfy the licensee's obligation to make reasonable inquiries and verifications and supports the assessment of unsuitability.

57 While we acknowledge that documented procedures may need to provide a degree of flexibility in order to be effective across a broad range of consumer circumstances, this flexibility should not be at the expense of ensuring compliance with legislative requirements.

Documented procedures

Credit licensees can reduce the risk of non-compliance by having clearly documented procedures to satisfy the responsible lending obligations, including:

- details of the documents to be obtained to verify a consumer's financial situation, the information to be gathered from the documents and how this information is to be used, including how any inconsistencies are identified and addressed;
- when an application should be escalated to more senior staff; and
- the circumstances, if any, in which credit may be provided outside standard lending guidelines and the need to clearly document the basis for such decisions on the loan file.

Relying on information from mortgage brokers

58 Lenders are often given information about the consumer by a mortgage broker, which may be based on information from a preliminary assessment by the mortgage broker. Mortgage brokers, who are often a consumer's first point of contact in the loan application process, play an important role in identifying the consumer's financial situation and objectives, and this is recognised in their specific licensing and responsible lending obligations.

59 RG 209.51 notes that lenders are, however, still bound by their own reasonable inquiries and verification obligations, and that we expect lenders

will have processes in place to ensure the reliability of any information collected by third parties, including information contained in a preliminary assessment. This could include a combination of approaches, such as:

(a) conducting 'spot checks' on some of the information by re-verifying it;

(b) only using information in preliminary assessments from intermediaries that have robust compliance arrangements; and

(c) having processes to actively discourage inappropriate practices (e.g. ensuring that any incentives offered to intermediaries encourage, rather than discourage, appropriate information collection practices).

60 General industry practice is for lenders to accredit each mortgage broker that accesses the lender's products. The accreditation process usually requires the mortgage broker to undertake training on the lender's products and does not cover compliance issues.

61 Relying solely on the initial accreditation, without any ongoing compliance measures to ensure the accuracy of the information received from mortgage brokers, exposes lenders to a significant risk of non-compliance.

62 All lenders in our review have additional processes in place to ensure the reliability of information collected by third parties.

63 One lender used a solicitor's certificate, confirming the consumer had been advised on the nature and effect of the loan (including the obligations and risks involved), which the consumer and the solicitor were required to sign.

64 Confirming that a consumer understands the terms of the proposed credit contract is good practice; the consumer's understanding of the proposed credit contract is a factor relevant to the level of inquiry and verification required to meet the responsible lending obligations. However, simply confirming that a consumer understands the terms of the proposed credit contract will not fulfil the responsible lending obligations regarding reasonable inquiries, verifications and assessments of unsuitability.

65 Four lenders directly contacted the consumer after receiving their application to verify the information provided. These lenders, together with a further three, also provided the consumer with details of the information relied on in making the assessment of unsuitability at the same time they made an offer of credit.

66 All of the lenders reported having a process in place to review a sample of individual applications submitted by mortgage brokers. We did not review the adequacy of lenders' review processes. However, REP 330 contains a number of findings detailing good practice for such reviews, and supervision of representatives more generally.

67 One of the lenders with a file review process reported employing a statistical analysis tool to help in a risk-based identification of any adverse trends, which reflects prudent practice identified in REP 330.

68 Lenders reported a range of practices for addressing inconsistent information, although this was not generally clearly documented. If the inconsistent information was material, seven lenders stated they would contact the consumer directly to verify the information. Three lenders generally referred the matter back to the mortgage broker. One lender declined any application where there were material inconsistencies.

69 Whether inconsistent information in an application for credit submitted by a mortgage broker is the result of carelessness or misrepresentation, it calls into question a lender's ability to rely on this information. In such circumstances, lenders are at increased risk of not meeting their responsible lending obligations if they rely exclusively on the mortgage broker to explain this inconsistency.

Reliance on information from third parties

Lenders can reduce the risk of non-compliance by ensuring that, when they rely on information provided by a third party, they have robust procedures to support this reliance: see REP 330. This may include:

- giving the consumer details of the information relied on in making the assessment of unsuitability at the same time as making an offer of credit;
- taking a risk-based approach to identifying transactions for further verification or review (see paragraphs 112–113 of REP 330); and
- following up any materially inconsistent information directly with a consumer and documenting the result.

Non third-party sourced applications

70 Of the 114 files we reviewed, only 10 were not originated by third-party mortgage brokers. Six of those 10 applications were identifiable as existing or previous clients of the lender.

71 There was no significant difference in the information held on file by the lenders for loans originated directly, with information similar to that provided by mortgage brokers being obtained directly by the lender.

72 Lenders often rely on mortgage brokers to assist consumers in identifying their requirements and objectives and choosing a product that is not unsuitable. Where a lender deals directly with a consumer, it must ensure not only that a consumer will be able to meet their financial obligations without substantial hardship, but also that the credit contract meets the consumer's requirements and objectives: see the 'Requirements and objectives' compliance example below paragraph 87.

C Inquiries about a consumer's requirements and objectives

Key points

On all the files we reviewed, lenders had confirmed at least one consumer was self-employed and any co-borrowers with regular employment had their income verified by standard documentation. Lenders confirmed consumers' self-employment by checking:

- their Australian Business Number (ABN) had been registered for at least six months; and
- their goods and services tax (GST) registration, where applicable.

Self-employed consumers may qualify for loans other than 'low doc' home loans, but it was often not clear from the files reviewed why the consumer was placed into a 'low doc' home loan.

Credit licensees need to ensure they understand consumers' requirements and objectives (using the inquiries outlined in RG 209.33), including the relative importance of product features and cost, as well as the consumer's medium- to long-term objectives, particularly in instances where it may be difficult or costly for a consumer to move into another product at a later date.

Statutory obligations

73 Section 130(1)(a) of the National Credit Act provides that, before entering into a credit contract with a consumer, a lender must make reasonable inquiries about the consumer's requirements and objectives.

Requirements and objectives

74 The Explanatory Memorandum to the National Consumer Credit Protection Bill 2009 states at paragraph 3.68 that:

> the minimum requirement for satisfying reasonable inquiries about the consumer's requirements and objectives will be to understand the purpose for which the credit is sought and determine if the type, length, rate, terms, special conditions, charges and other aspects of the proposed contract meet this purpose or put forward credit contracts that do match the consumer's purpose.

75 RG 209.33 sets out a number of potential inquiries into a consumer's requirements and objectives, depending on the circumstances. Given the potentially large negative impact of a consumer entering into an unsuitable home loan, due to the significant level of costs in such transactions, the amount of money typically borrowed over an extended period and the fact

that such loans are secured against a consumer’s residence, it is expected that credit licensees would make many, if not all, of the inquiries in RG 209.33.

76 On all files reviewed lenders had confirmed at least one consumer was self-employed by checking:

(a) their ABN had been registered for at least six months; and

(b) their GST registration, where applicable.

77 Although self-employed consumers may qualify for other loans, it was often not clear, from the files reviewed, how the ‘low doc’ loan met the consumer’s medium- to long-term objectives.

78 Two of the lenders made no distinction between pricing, features or product name for ‘low doc’ home loans. For these lenders the only distinguishing factor for the ‘low doc’ home loan was the internal procedures for verifying a self-employed consumer’s income.

79 For other lenders, the cost of a ‘low doc’ home loan was higher than a similar product that the consumer would qualify for with the same lender, if the consumer were able to provide a recent tax return or audited financial statements for their business.

80 RG 209.33(d) specifies whether the consumer seeks particular product features, and whether the consumer is prepared to accept any additional costs associated with these features, as a relevant inquiry. RG 209.117(b) notes that a factor to be taken into account in making an assessment of unsuitability includes whether the cost of the credit or flexibility to make later changes is more important to the consumer.

81 Lenders are at significant risk of non-compliance with their responsible lending obligations if:

(a) a consumer is placed into a home loan with a higher cost and/or less features than another loan with the same lender for which the consumer would qualify; and

(b) they do not ensure that the consumer is made aware of their options, to clarify the relative importance of the consumer’s objectives, and document this accordingly.

82 To reduce the risk of non-compliance, inquiries could include asking whether a consumer would prefer to defer entering into a home loan until such time as they had sufficient documentation to enable them to enter into a loan other than a ‘low doc’ home loan, on the basis that it may be less costly and/or have additional product features.

83 Consideration could also be given to the consumer’s ability to switch from a ‘low doc’ home loan to another product when they are in a position to provide additional financial information.

84 In home loans, more generally, a consumer's ability to switch home loans may also be affected by the cost of obtaining new lender's mortgage insurance in the absence of any increase to the value of the property (as may be the case with a high LVR home loan). In such instances, credit licensees can reduce the risk of non-compliance with their responsible lending obligations by confirming the relative importance to a consumer of being able to readily switch to another home loan in the future.

85 In the majority of files we reviewed, the lenders were given information about the consumer's requirements and objectives by a mortgage broker.

86 The lender may rely on the mortgage broker to assist the consumer in identifying the consumer's requirements and objectives and choosing a product that is not unsuitable. However, the lender must also satisfy itself that the credit contract is not unsuitable, either through its own inquiry and assessment process or by having a robust compliance process in place on which to base its reliance on the mortgage broker: see RG 209.51.

87 The lenders reviewed had in place a number of processes to reduce the risk of a consumer being placed in a 'low doc' home loan that did not meet their requirements and objectives. These included lenders:

(a) making no distinction, in pricing or product features, between 'low doc' home loans and other home loans offered by the lender;

(b) advising consumers that lower interest rate loans may be available if they are able to provide the required financial information;

(c) placing consumers in lower interest rate loans if they provide sufficient financial information, irrespective of whether they have applied for a more expensive loan; and

(d) allowing consumers to switch directly from a 'low doc' home loan to a non-'low doc' home loan at no additional cost, once the consumer is able to provide sufficient financial information.

Requirements and objectives

Lenders can reduce the risk of non-compliance by ensuring records to support their assessment of unsuitability demonstrate an understanding of the consumer's requirements and objectives, using all the inquiries set out at RG 209.33.

In the context of a 'low doc' home loan, this would include on what basis, other than self-employment, a consumer was placed in the loan, particularly if the loan has less features or a higher cost than other loans from the same lender, and the consumer cannot readily switch to another loan with the same lender.

D Inquiries into and verification of a consumer's financial situation

Key points

None of the lenders purported to rely on a consumer's declaration for verification of the consumer's income. Lenders adopted a number of approaches to verify a consumer's income, with self-employment generally verified by statements from a third party (such as an accountant) or available financial information (such as business bank account statements or BASs).

Lenders reported using BASs and business bank account statements to derive a figure for consumers' gross income from self-employment for the purposes of verifying the consumers' income. However, in many instances, it was not evident from the documents on file how the lender arrived at the derived figure or whether the figure was reasonable.

When we made our initial inquiries, some lenders made no inquiry into a consumer's actual living expenses, instead seeking to rely on a benchmark figure based on the number of persons dependent on the consumer's income. While benchmarks may be useful in assessing the reasonableness of declared living expenses, credit licensees need to be mindful of the discrete responsible lending obligations to make inquiries into and verify a consumer's financial situation.

Statutory obligations

88 Lenders are required by the National Credit Act to make reasonable inquiries about the consumer's financial situation (s130(1)(b)) and take reasonable steps to verify the consumer's financial situation (s130(1)(c)). We expect this verification to include both the verification of the consumer's income and the consumer's fixed and variable expenses: see RG 209.32(a)–RG 209.32(c).

Income

89 As we noted in REP 262, lenders must verify a consumer's income regardless of whether the loan being provided is referred to as 'low doc'.

90 While lenders obtained a declaration of income from the consumer as part of their inquiries into the consumer's financial situation, none of the lenders purported to rely on the consumer's declaration for verification of the consumer's income.

91 On all files reviewed at least one consumer was self-employed, with the self-employment being confirmed by an ABN search. In addition to confirming

that the consumers held a current ABN, all of the lenders confirmed that the consumer was registered for GST, where applicable.

92 The minimum requirements for the period of time a consumer had been self-employed varied between lenders—generally from six months to 24 months—with one lender considering applications for a shorter period based on merit, such as if the consumer had recently purchased an established business.

93 Lenders' procedures for verifying self-employment indicated that these loans were not being used for consumers who only had a regular income stream that could be readily verified by standard documentation, such as payslips. Any co-borrowers with regular employment had their income verified by standard documentation.

94 Four lenders offered 'low doc' home loans with different LVRs, based on the length of time the consumer had been self-employed. However, lenders need to consider their responsible lending obligations when implementing policies directly linked to a consumer's equity in the security property. RG 209.102 states 'generally, consumers should be able to meet their payment obligations under a credit contract or consumer lease from income rather than equity in an asset'.

95 The lenders reviewed adopted a number of approaches to verify a consumer's income, with self-employment income generally verified by:

(a) statements from a third party, such as an accountant; and/or

(b) available financial information, such as business bank account statements or BASs.

96 Two of the 12 lenders accepted either third-party statements or available financial information. One of these required different documents for different 'low doc' home loans, depending on the consumer's length of self-employment, with a BAS required if the consumer had a longer period of self-employment.

97 Two lenders accepted a statement from an accountant in support of lodged BASs. Three relied solely on statements from accountants to verify consumers' self-employment income. Five lenders required BASs and/or business bank account statements to verify self-employment income.

98 There was no discernible difference between the types of verification processes adopted between the types of lenders. For example, ADIs were just as likely to accept statements from accountants as non-ADI lenders.

99 In the majority of files that we reviewed, it was apparent that the consumer's business had been in operation for a number of years. As business circumstances can quickly change, it may be that home loans for which self-employment

income is verified by reference to current accountant statements, BASs or business bank account statements pose a lesser risk of non-compliance with the responsible lending obligations than home loans that rely solely on aged financial statements or tax returns for income verification purposes.

Statements from accountants

100 The three lenders who relied solely on statements from accountants for income verification purposes had their own pro forma documents that they required the accountant to complete and sign.

101 We did find, in a small number of instances, non pro forma statements from accountants that the lenders accepted for income verification purposes. Generally the non pro forma statements contained more information than the pro forma ones and, in some instances, gave a brief history of the consumer's self-employment, together with the reason why current financial statements were not available.

102 The reviewed accountant statements had generally been signed after the application form for the proposed credit contract had been signed, and commonly after the application for credit had been submitted to the lender. This was the case even when the mortgage broker was involved in the transaction and would have been obligated to verify the consumer's financial situation before undertaking a preliminary assessment of unsuitability and assisting the consumer to apply for a particular credit contract with a particular lender.

103 Mortgage brokers are at a significant risk of being unable to demonstrate that they have complied with their obligation to verify a consumer's financial situation prior to making the preliminary assessment if the only recorded method of income verification is an accountant's statement completed after suggesting or assisting a consumer to apply for particular credit contract from a particular lender.

104 Finding 4.5 of REP 262 notes that, when seeking to rely on an accountant's statement to verify a consumer's income, best practice is to ensure the statement provides:

(a) the consumer's actual level of income;

(b) the basis on which the statement is made, including comments on the consumer's previous earnings and underlying information supporting the statement; and

(c) the relevant time period for which the accountant has been engaged.

105 Many of the pro forma accountant statements reviewed did not meet all of the above criteria and a number of lenders updated their statements over the course of the review.

Consumers' income

106 Six of the seven lenders who accepted accountant statements, either solely or in conjunction with BAS, or business bank account statements, had the accountant confirm awareness of the income amount that the consumer had declared. Such statements, by themselves, do not verify that the amount stated is accurate. Five of the lenders also stated the amount of income declared by the consumer and, of these, four confirmed that this amount was accurate and/or a reasonable estimate.

107 The remaining pro forma statement, which was used in conjunction with BASs, stated 'in my opinion … the loan will not create undue hardship'. As noted in paragraph 97 of REP 262:

> relying only on a statement from any party (including an accountant) that simply states the consumer would be able to meet their obligations under a proposed credit contract would place a credit licensee at significant risk of being unable to demonstrate that it had taken reasonable steps to verify the consumer's financial situation.

108 Paragraph 99 of REP 262 also notes that:

> where an accountant makes a statement regarding the consumer's capacity to meet the proposed credit contract's obligations, depending on the specific circumstances the accountant may be at risk of engaging in credit activities and require a credit licence or appointment as an authorised representative.

109 Guidance on when a credit licence is required, including the potential licensing requirements for persons providing information to verify a consumer's financial situation, is contained in Regulatory Guide 203 *Do I need a credit licence?* (RG 203).

Basis for statements

110 Three lenders' pro forma accountant statements identified the basis on which the statements were made using declarations along the lines of 'I know the applicant's income and their expenditure and, based on this knowledge and my understanding of their financial position, believe …'. One of these statements also confirmed that it was based on knowledge of the consumer's ownership share of the business, and another provided some information on the consumer's previous earnings (e.g. 'We have reviewed the previous business earnings and advise that these are consistent with the above').

111 Two lenders' pro forma accountant statements confirmed that the consumer had lodged their most recent BAS or tax return with the Australian Taxation Office, but did not confirm whether the accountant had been responsible for preparing these documents. One lender's pro forma accountant statement confirmed that the accountant had prepared the consumer's tax return.

Relationship

112 Four of the seven lenders’ pro forma statements required the accountant to disclose the period of time the person making the declaration had been engaged as the consumer’s accountant. While the period of time does not itself determine the level of knowledge the accountant has of the consumer’s financial situation, lenders need to satisfy themselves as to the reasonableness of any statement on which they seek to rely.

113 It was not evident from any of the lenders’ documented procedures if further inquiries and/or verification were required when the consumer’s relationship with the accountant was relatively short.

114 There were instances where the accountant who signed the statement was also the mortgage broker or where the mortgage broker appeared to work for the same, or a related, company as the accountant.

115 One lender’s pro forma statement required the accountant to confirm that they did not have a conflict of interest and did not stand to gain financially from the lender advancing the loan.

116 Another lender’s pro forma statement required the accountant to confirm whether they would receive a referral fee for placement of the loan. However, it was not clear from the lender’s documented procedures what steps would be taken if a referral fee was received.

117 It did not appear that the other lenders had any specific procedures for such circumstances.

Identification of accountant and verification of statement

118 All but one of the pro forma accountant statements clearly identified the accountant and the accounting practice. These statements also required the accountant to note their membership of the applicable professional industry body.

119 The one pro forma statement that did not clearly identify the accountant simply required a signature in the ‘signature of accountant’ box. Although the accountant was also required to state if they were a certified practising accountant (CPA) or a chartered accountant (CA), no membership number was required. Unless the signature was legible and consisted of the accountant’s full name, there were no means to independently confirm the identity and qualifications of the person making the statement. This lender is no longer offering this product.

120 Three lenders also independently contacted accountants after receiving the consumer’s application, to confirm the information contained in the statement, while one lender contacted the accountant on all applications where the LVR was over 70%.

121 While contacting the accountant may reduce the risk of false or fraudulent declarations being accepted, it is unlikely to compensate for any deficiencies in the declaration itself, particularly if the contact seeks only to confirm that the accountant has completed the pro forma statement.

122 Where a lender makes contact with a consumer's accountant to verify the statement made, the lender can reduce the risk of non-compliance by confirming the information contained in the statement, obtaining any additional factual information to clarify any gaps or inconsistencies in the information provided, and documenting this accordingly.

Disclaimers

123 Five of the seven lenders' pro forma accountant statements contained disclaimers that sought to limit the accountant's liability (e.g. 'The accountant makes no representations or warranties about the accuracy or completeness of the information in this declaration'). Lenders face a significant risk of not meeting their responsible lending obligations if they rely solely on a statement that does not provide a reasonable verification of the consumer's financial situation due to disclaimers made about the accuracy of the information provided in the statement.

Statements from accountants—Content

When seeking to rely on a statement from an accountant to verify a consumer's income from self-employment, credit licensees can reduce the risk of non-compliance by ensuring the accountant statement not only contains the information detailed in Finding 4.5 of REP 262, but that it also:

- allows for tailoring of information specific to the individual consumer;
- identifies the accountant and their professional qualification; and
- is free from disclaimers about the accuracy or reliability of information contained in the statement that are so strong as to make it unreasonable to rely solely on the information for verification.

Statements from accountants—Procedures

Credit licensees can further reduce the risk of non-compliance when seeking to rely on a statement from an accountant to verify a consumer's income from self-employment by ensuring they have clearly documented procedures regarding:

- how to identify and manage any potential risk if the accountant providing the statement has only been engaged by the consumer for a short period and/or is related to the consumer or the mortgage broker; and
- when and how additional verification of the information contained in the statement is undertaken.

Statements from other third parties

124 Lenders also accepted statements from other third parties to support the consumer's ability to meet the financial obligations of the proposed credit contract. These statements included statements from property managers regarding prospective rental income from investment properties.

125 Lenders that rely on statements from third parties are at greater risk of non-compliance with the responsible lending obligations if they do not ensure the person making the statement is qualified to make that statement or take appropriate steps to identify and manage any potential risk if the person making the statement has a conflict of interest.

Business bank account statements and BASs

126 Nine lenders' documented procedures indicated they accepted business bank account statements and/or BASs as part of their income verification process, with two of these lenders also accepting statements from accountants as sole verification in some instances.

127 The period of time for which BASs or business bank account statements are required varied between lenders from six months to 12 months. Five of the lenders who accepted such statements required business bank account statements covering six months, or 12 months of lodged BASs.

128 One lender would only accept BASs (and not business bank account statements) for loans where the LVR exceeds 60%. The documentation required by another lender varied depending on the period of the consumer's self-employment, with BASs required if the consumer had been self-employed for a longer period.

129 None of the lenders' documented procedures detailed how BASs and business bank account statements were intended to be used to verify the consumer's income from self-employment, or business income. Lenders advised that additional information on verification was included in staff training.

130 The lenders who obtain BASs and/or business bank account statements generally reported having loan applications assessed by more experienced staff, either based on internal delegated approval limits or as part of a specialist team.

131 From the review of files, it appeared that lenders were seeking to use BASs and business bank account statements to derive a figure for a consumer's gross income from self-employment, for the purposes of verifying the consumer's declared income.

132 Five lenders generally applied a predetermined expense ratio to the business's gross revenue to establish the reasonableness of the consumer's

declared income from self-employment. As an example, if the gross revenue was calculated at $100,000 and the lender adopted a 40% expense ratio, the income amount used to assess the reasonableness of the consumer's declared income from self-employment would be $60,000.

133 Three lenders established the reasonableness of the consumer's declared income from self-employment by comparing it to an income figure derived from identifying income and expense components from the consumer's BASs and business bank account statements.

134 One lender calculated the consumer's gross revenue and used this amount, without any specific reference to expenses, to test the reasonableness of the consumer's declared income from self-employment against an income matrix. Assessment of a consumer's business income without consideration of related business expenses places credit licensees at greater risk of non-compliance.

135 All but one of the lenders used the lower of their derived income figure and the income declared by the consumer (or an accountant) to undertake their assessment of whether the consumer would be able to meet their obligations under the proposed credit contract without substantial hardship.

136 Adopting the lower of a declared income figure and an income figure derived from the review of financial records will only be adequate if the derived income figure itself is credible. In a number of instances it was not apparent from the documents on file that the income figure derived by lenders was a reasonable estimate for verification purposes.

BASs

137 On all files reviewed where a lender was seeking to rely on BASs to verify a consumer's declared income from self-employment, practice appeared to be limited to totalling the gross sales amounts for a given period and annualising the result to derive a figure for self-employment or business income.

138 Non-capital expenses listed on the BAS were often not considered. In one instance the non-capital expenses were significantly greater than gross sales over a 12-month period, and no further inquiry was evident.

139 RG 209.46 states that:

> In some circumstances, taking reasonable steps to verify information should involve making additional inquiries about the consumer where:
>
> (a) the information that a consumer provides is inconsistent with other information that you hold about the consumer (e.g. in a credit report or account information for existing customers); and/or
>
> (b) the information that a consumer provides is outside the standard range for the consumer (e.g. the income stated is far greater than would be expected for the type of work the consumer undertakes, or their expenses are far lower than would be expected, as indicated by relevant benchmarks).

140 Lenders are at an increased risk of non-compliance if they do not have adequate procedures to address inconsistencies between the income or expense figures derived and other information provided by the consumer.

Business bank account statements

141 Lenders’ practices for deriving a consumer’s gross self-employment income from business bank account statements generally consisted of reviewing listed credits to identify any possible revenue over a certain period, annualising the result and, with the exception of one lender, subtracting identified expense items or applying a predetermined expense ratio.

142 It was not generally apparent from the files reviewed what the lenders included as revenue and what they excluded, with the transaction descriptions on the business bank account statements often providing limited insight. It appeared that the most common course of action was for lenders to simply total all credits in the account and adopt that figure. However, in a majority of instances we were unable, based on the documents on file, to arrive at the income figure that the lender had adopted.

143 Often there was no evidence on file that the lender, or the mortgage broker, made any further inquiry into or verification of whether the credits on the business bank account statements represented actual income.

144 It was also often not evident from the information on file that debits had been reviewed or considered as part of the process of verifying self-employment or business income. In one instance there was a considerable history of loan repayments evident on the business bank account statements, which had not been disclosed by the consumer. It did not appear that the lender made any further inquiries or verifications regarding these repayments.

145 A number of business bank account statements showed transfers to and from other accounts, including accounts held by the consumer, with the inward transfers treated as income, without any explanation of the original source, and no deduction made for outward transfers.

146 Lenders are at significant risk of non-compliance if they are unable to demonstrate how they have derived the income figure they seek to rely on for verification purposes and that this figure is reasonable.

Business expense ratios and income matrices

147 RG 209.45 states:

> The use of sophisticated automated systems and tools for testing the reliability of information about income provided by an intending borrower may play a role in satisfying the requirements to take reasonable steps to verify such information. It is the responsibility of credit providers to satisfy themselves that the use of any such system is adequate and appropriate for verifying information provided by a consumer about their financial situation, in relation to the credit being applied for.

148 Five lenders adopted predetermined expense ratios, which they applied to the income figure derived from either BASs or business bank account statements, to check the reasonableness of the self-employment income declared by the consumer. Four lenders adopted set expense ratios that were the same for all consumers, irrespective of any differences in business type or size. It was unclear on what basis these ratios had been adopted and whether they were reasonable, with the expense ratios varying by up to 50%.

149 One lender's expense ratios varied depending on the type of industry in which the business was operating, with ratios based on historical financial data obtained from the lender's business loan portfolio.

150 One lender had adopted an expense ratio lower than its standard expense ratio on two files that we reviewed. While this may have reflected the individual consumers' actual financial situations, there was no evidence on the files to indicate this was the case. It was not apparent from the files on what basis the lower ratios had been adopted, placing the lender at increased risk of not being able to demonstrate it had satisfied its responsible lending obligations.

151 One lender did not consider costs incurred by the business in generating the income. Instead, it relied on an income matrix, based on the period of time the business had been in existence and the broad industry in which it operated, to check the reasonableness of the income declared by the consumer in conjunction with BASs and business bank account statements.

152 The responsible lending obligations contained in the National Credit Act require lenders to make reasonable inquiries into and verification of the individual consumer's financial situation. There is an increased risk of non-compliance when a lender relies on set expense ratios or income matrices irrespective of the nature of the consumer's business or particular circumstances. This is because the profitability of an individual business depends on a number of factors, including industry, size, management competence and operational efficiency.

153 In the majority of files that we reviewed, it was apparent that the consumer's business had been in operation for a number of years. In such instances, it may be appropriate to also assess an individual business's financial situation using financial statements from previous years.

Business expense ratios and income matrices

Credit licensees are at greater risk of non-compliance when they seek to rely on business expense ratios or income matrices that do not take into account the business's specific circumstances to verify a consumer's income from self-employment.

In such instances, credit licensees can reduce the risk of not meeting their responsible lending obligations by considering other information regarding the consumer's financial situation, including previous years' financial statements.

Income from other sources

154 Twenty-four of the 114 loans reviewed had a co-borrower whose income was not derived from self-employment.

155 When the income was of a pay-as-you-go (PAYG) nature, lenders, as a minimum, obtained multiple pay slips. In addition, lenders also obtained bank trading statements, taxation assessment notices and/or tax returns. This reflects our findings in REP 262.

Rental income

156 When rental income was reported, lenders relied on a number of different documents for verification purposes, including rental statements, letters from real estate agents and assessments of fair market rental contained in valuation reports (if a rental property was used as security for the loan).

157 In some instances the rental income was detailed separately in an accountant's statement, when the lender relied on such a document for income verification.

Expenses

158 Consistent with RG 209, we segmented consumers' personal expenses into variable expenses (where the consumer has no contractual obligation to make payments—i.e. living expenses) and fixed expenses (where there is a contractual obligation to make payments, including credit facilities and service contracts).

Variable expenses

159 At the time of our initial inquiries, seven of the lenders reviewed made inquiries into consumers' actual living expenses and one lender made inquiries into 'other' expenses.

160 We initially found that six of the seven lenders that made inquiries into consumers' actual living expenses did so by having a 'living expense' item on the loan application form, while one lender adopted an itemised approach.

161 The other four lenders made no inquiry into consumers' actual living expenses and instead sought to rely solely on a benchmark figure based on the number of persons dependent on the consumer's income. As a result of our review, these four lenders have committed to making separate inquiries into consumers' actual living expenses.

162 Some lenders indicated that consumers may have difficulty estimating their living expenses. If this is the case, credit licensees may also consider making inquiries into how much consumers regularly save—that is, if consumers are

not saving money they would be expected to have expenses equalling their income.

163 Credit licensees have discrete responsible lending obligations to make reasonable inquiries about and take reasonable steps to verify a consumer's financial situation. Relying on a benchmark living expense figure, which does not verify an expense figure reported by the consumer or which is not verified by other information from the consumer, places licensees at significant risk of not meeting their responsible lending obligations to make reasonable inquiries into and verification of a consumer's financial situation.

Inquiry into and verification of variable expenses

Credit licensees can reduce the risk of non-compliance by ensuring that they have discrete processes to make reasonable inquiries about, and take reasonable steps to verify, consumers' variable expenses.

164 Lenders who made inquiries into the consumer's actual living expenses checked the reasonableness of this figure by comparing it to a benchmark based on the number of persons dependent on the consumer's income. These lenders adopted the higher of the amount declared by the consumer or the benchmark figure.

165 We noted a number of instances where the amount declared by the consumer was the same as the benchmark figure, which raised concerns that either no discrete inquiry had been undertaken or that, if it had, there was no record on file as to the outcome of the inquiry and the basis on which the benchmark had been used.

166 Using a benchmark figure as a minimum living expense amount for the purposes of assessing whether a consumer will be able to meet their obligations without substantial hardship can reduce the risk of contravening the prohibition on entering into unsuitable credit contracts.

167 Credit licensees are, however, at significant risk of not meeting their responsible lending obligations if, for the purposes of their assessment of whether a consumer will be able to meet their obligations without substantial hardship, they rely on benchmark figures for living expenses that are significantly less than a consumer's self-reported living expenses, without any further inquiry or verification.

168 While consumers may be willing and able to make changes to their spending patterns, this should not be assumed, particularly where the benchmark may be based on a poverty measure.

169 RG 209.96 notes that, in the context of considering whether repayment obligations under a credit contract will cause a consumer substantial hardship, credit licensees may wish to take into account any other

conversations that they have had with a consumer about how the credit contract will affect their living standards, as a consumer may be willing to make reasonable changes to their lifestyle, such as cutting back on non-essential expenses.

170 In the absence of specifically confirming consumers' willingness to make changes to their spending patterns, and maintaining a record of this confirmation, credit licensees are at significant risk of not being able to demonstrate they have met their responsible lending obligations.

171 In addition, while consumers may express a willingness to make changes to their spending patterns, there may also be a question as to whether a consumer is reasonably able to make those changes without substantial hardship.

Consumers' ability to reduce variable expenses

If a credit licensee's assessment that a consumer will be able to meet their obligations without substantial hardship is premised on the assumption that the consumer will be willing and able to reduce their living expenses, licensees can reduce the risk of not meeting their responsible lending obligations by making further inquiries and verifications with the consumer and recording these on file. The greater the proposed reduction, the more detailed the inquiries and verifications that credit licensees may need to make.

Fixed expenses

172 All lenders obtained details of consumers' existing debts in their loan application form.

173 Files reviewed generally only contained loan repayment statements for loans to be refinanced or finalised by the proposed credit contract. It appeared that lenders obtained these statements to confirm that the loans being refinanced were being conducted in a satisfactory manner.

174 All lenders stated that they checked a consumer's fixed expenses against the consumer's credit report. A number of lenders also reported checking the reasonableness of declared repayment amounts by undertaking their own repayment calculations based on the declared debt. However, this was generally not well documented in lenders' procedures or files.

175 Those lenders who reviewed business bank account statements advised that, as part of the process, they sought to identify ongoing fixed expenses, with one also stating that it obtained statements for ongoing fixed expenses if it was unable to verify details of declared expenses from the business bank account statements.

176 It was not apparent that any of the other lenders obtained statements for consumers' existing ongoing fixed expenses to confirm details such as the amount of ongoing repayments, the contract period and any balloon

payments due at the end of the contract. Nor was it evident that the mortgage broker had provided the lender with confirmation of such verification.

177 Obtaining statements of ongoing fixed expenses may also confirm whether the consumer is meeting their current repayment obligations, noting that not all defaults are necessarily listed on credit reports.

178 Many lenders noted that the adoption of comprehensive credit reporting may help them meet their obligation to verify a consumer’s financial situation, although it was acknowledged that this would likely depend on a number of factors, including the level of other lenders’ participation. Practice should reflect the tools available to the lender at the time of undertaking the assessment.

Fixed expenses

Credit licensees can reduce the risk of not meeting their responsible lending obligations by obtaining statements for the consumer’s ongoing fixed expenses to confirm repayment amounts, the number of remaining repayments, any expected balloon payments and whether the consumer is meeting repayment obligations.

Credit reports

179 All lenders reviewed stated that they obtained both a consumer and a commercial credit report for the consumer. However, not all files reviewed contained a record of these reports being obtained. Lenders are at risk of non-compliance with the responsible lending obligations if they do not maintain records that support the assessment of unsuitability.

180 While lenders stated that they used credit reports to review consumer’s previous credit applications and check the reasonableness of the consumer’s declared fixed expenses, it appeared that the primary purpose of obtaining a credit report was to confirm the consumer had no adverse repayment history (e.g. defaults).

Credit reports

When seeking to verify the financial situation of a self-employed consumer, lenders can reduce the risk of non-compliance by obtaining both a consumer and a commercial credit report and reviewing all the information contained in the reports to ensure that it supports the stated financial position of the consumer. Any anomalies or inconsistencies in the information should be queried.

E Assessment of unsuitability

Key points

It was not evident from lenders’ documented procedures or files how they assessed whether the proposed ‘low doc’ home loan met the consumers’ requirements and objectives when undertaking their assessment of unsuitability. RG 209.117 outlines a number of factors for credit licensees to take into account when undertaking assessments of unsuitability.

The reliability of a lender’s assessment of a consumer’s ability to repay a loan without substantial hardship is only as reliable as the financial information used for that assessment. This is of particular relevance when lenders rely on figures for self-employment income that are based on various estimations or approximations.

Lenders are at lesser risk of not satisfying their responsible lending obligations the greater the buffers used to account for potential changes to financial circumstances (e.g. interest rate increases and fluctuations in income and expenses) and the greater the surplus income required to meet their lending guidelines.

Statutory obligations

181 Sections 128 and 129 of the National Credit Act provide that a lender must not enter into a credit contract with a consumer unless the lender has made an assessment of whether the credit contract will be unsuitable. Under s131, the contract is unsuitable if:

(a) the consumer will be unable to comply with their financial obligations under the credit contract;

(b) the consumer could only comply with substantial hardship; or

(c) the credit contract will not meet the consumer’s requirements or objectives.

Whether contract meets consumers’ requirements and objectives

182 It was generally not evident from the lenders’ documented procedures or the files reviewed how lenders assessed whether the proposed ‘low doc’ home loan met the consumer’s requirements and objectives when undertaking their assessment of unsuitability.

183 Although the four lenders who contacted the consumer after receiving their application advised that they discussed the suitability of the proposed loan with the consumer, this was generally not well documented on the files reviewed.

184 A number of lenders reported having updated their procedures for documenting their assessment of unsuitability process, including how they assess whether a proposed loan meets the consumer’s requirements and objectives. A number of other lenders indicated that they would review their procedures in this regard.

185 RG 209.115 notes that, having completed reasonable inquiries, credit licensees must then assess whether the credit contract is not unsuitable, which includes assessing whether the credit contract meets the consumer’s requirements and objectives.

186 RG 209.117 outlines a number of factors for credit licensees to take into account, including, if the consumer has more than one requirement or objective, the relative importance of each objective to the consumer (e.g. whether the cost of credit or flexibility to make later changes is more important).

187 The less specific the information obtained through initial inquiries into the consumer’s requirements and objectives, the greater the risk that a lender may enter into an unsuitable credit contract in contravention of its responsible lending obligations. In such instances, credit licensees are not only at risk of regulatory action, but also civil action by consumers seeking compensation for any loss or damage they may have suffered as a result.

188 Lenders are at greater risk of entering into unsuitable credit contracts with consumers if they do not obtain and consider, at a minimum, information relating to the various factors in RG 209.117.

189 Other processes observed in this review, which reduce the risk of entering into an unsuitable ‘low doc’ home loan with a consumer and which are noted in Section C, include:

(a) making no distinction in pricing or product features between ‘low doc’ home loans and other home loans offered;

(b) advising consumers that lower interest rate loans may be available if they are able to provide the required financial information;

(c) placing consumers in lower interest rate loans when they provide sufficient financial information, irrespective of whether they have applied for a more expensive loan; and

(d) allowing consumers to switch directly from a ‘low doc’ home loan to a non-‘low doc’ home loan at no additional cost, once the consumer is able to provide sufficient financial information.

Consumers' ability to comply with their financial obligations

190 All of the lenders reviewed assess the consumer's capacity to repay the credit contract without substantial hardship by using a higher interest rate than the prevailing rate for the contract at the time of application.

191 However, the interest rate loading that was applied to the new credit contract was not applied to existing loan contracts for the purpose of assessing serviceability.

192 When the interest rate loading on the new credit contract is applied to provide a buffer against increasing interest rates, lenders can reduce the risk of not meeting their responsible lending obligations by applying the loading to all ongoing variable rate credit contracts: see Finding 4.11 in REP 262.

193 Lenders reported that the interest rate loading not only provided a buffer for potential interest rate increases but also additional expenses and/or reduced income. Where an interest rate loading is used to provide a buffer against a number of events, the loading should be sufficient to cope with these events occurring simultaneously. A more robust approach would be to have a separately identifiable buffer for each event the lender is seeking to cover.

194 Lenders generally assessed whether the consumer could meet the financial obligations without substantial hardship by confirming the consumer had a surplus of income after taking into account all expenses. This was assessed as a dollar amount and/or a ratio of income to expenses. One lender required a higher surplus for its 'low doc' home loans and another lender undertook a higher stress test for larger loans.

195 Credit licensees are generally at greater risk of non-compliance with the responsible lending obligations, the smaller the loading or buffers applied and the smaller the surplus income they require to assess a proposed loan as not unsuitable. This risk is heightened the less certain the information used in making those assessments, including when information on a consumer's self-employment income is based on a number of estimations or approximations.

Buffers and surplus income position

When credit licensees are assessing a consumer's ability to meet their financial obligations without substantial hardship, the more uncertainties, estimations or approximations underpinning the information used in the assessment, the greater the licensees' risk of non-compliance.

In such instances, licensees can reduce the risk of non-compliance by ensuring the use of adequate buffers for changes to financial circumstances (e.g. interest rate increases and income and expense fluctuations) and requiring a greater surplus income to assess a proposed loan as not unsuitable.

196 We understand that, when assessing a consumer's ability to meet their financial obligations, general industry practice is to discount certain types of income, such as various forms of investment income.

197 For example, when using rental income to assess a consumer's ability to meet financial obligations, general industry practice is to discount rental income in recognition that the property may at times be untenanted.

198 While the discounting of rental income was evident on some of the files we reviewed, it was not evident in others. This was generally when the rental income had been verified by a statement from an accountant in which the rental income had simply been added to the income from self-employment.

199 It was not evident from lenders' documented procedures why the treatment of rental income verified by accountants' statements differed from the treatment of rental income verified by other means and for other loans.

Differing treatments of income

If credit licensees treat particular types of income, groups of consumers or products differently for the purposes of assessing a consumer's ability to meet their financial obligations without substantial hardship, they can reduce the risk of non-compliance by ensuring that they have a reasonable basis for this approach and that the different methods are clearly documented.

Appendix: Examples of how credit licensees can reduce their risk of non-compliance with the responsible lending obligations

Topic	How credit licensees can reduce their risk of non-compliance
Documented procedures See paragraphs 52–57	Credit licensees can reduce the risk of non-compliance by having clearly documented procedures to satisfy the responsible lending obligations, including: • details of the documents to be obtained to verify a consumer's financial situation, the information to be gathered from the documents and how this information is to be used, including how any inconsistencies are identified and addressed; • when an application should be escalated to more senior staff; and • the circumstances, if any, in which credit may be provided outside standard lending guidelines and the need to clearly document the basis for such decisions on the loan file.
Reliance on information from third parties See paragraphs 58–69	Lenders can reduce the risk of non-compliance by ensuring that, when they rely on information provided by a third party, they have robust procedures to support this reliance: see REP 330. This may include: • giving the consumer details of the information relied on in making the assessment of unsuitability at the same time as making an offer of credit; • taking a risk-based approach to identifying transactions for further verification or review (see paragraphs 112–113 of REP 330); and • following up any materially inconsistent information directly with a consumer and documenting the result.
Requirements and objectives See paragraphs 74–87	Lenders can reduce the risk of non-compliance by ensuring records to support their assessment of unsuitability demonstrate an understanding of the consumer's requirements and objectives, using all the inquiries set out at RG 209.33. In the context of a 'low doc' home loan, this would include on what basis, other than self-employment, a consumer was placed in the loan, particularly if the loan has less features or a higher cost than other loans from the same lender, and the consumer cannot readily switch to another loan with the same lender.
Statements from accountants—Content See paragraphs 100–123	When seeking to rely on a statement from an accountant to verify a consumer's income from self-employment, credit licensees can reduce the risk of non-compliance by ensuring the accountant statement not only contains the information detailed in Finding 4.5 of REP 262, but that it also: • allows for tailoring of information specific to the individual consumer; • identifies the accountant and their professional qualification; and • is free from disclaimers about the accuracy or reliability of information contained in the statement that are so strong as to make it unreasonable to rely solely on the information for verification.

Statements from accountants—Procedures See paragraphs 100–123	Credit licensees can further reduce the risk of non-compliance when seeking to rely on a statement from an accountant to verify a consumer's income from self-employment by ensuring they have clearly documented procedures regarding: • how to identify and manage any potential risk if the accountant providing the statement has only been engaged by the consumer for a short period and/or is related to the consumer or the mortgage broker; and • when and how additional verification of the information contained in the statement is undertaken.
Business expense ratios and income matrices See paragraphs 147–153	Credit licensees are at greater risk of non-compliance when they seek to rely on business expense ratios or income matrices that do not take into account the business's specific circumstances to verify a consumer's income from self-employment. In such instances, credit licensees can reduce the risk of not meeting their responsible lending obligations by considering other information regarding the consumer's financial situation, including previous years' financial statements.
Inquiry into and verification of variable expenses See paragraphs 159–163	Credit licensees can reduce the risk of non-compliance by ensuring that they have discrete processes to make reasonable inquiries about, and take reasonable steps to verify, consumers' variable expenses.
Consumers' ability to reduce variable expenses See paragraphs 164–171	If a credit licensee's assessment that a consumer will be able to meet their obligations without substantial hardship is premised on the assumption that the consumer will be willing and able to reduce their living expenses, licensees can reduce the risk of not meeting their responsible lending obligations by making further inquiries and verifications with the consumer and recording these on file. The greater the proposed reduction, the more detailed the inquiries and verifications that credit licensees may need to make.
Fixed expenses See paragraphs 172–178	Credit licensees can reduce the risk of not meeting their responsible lending obligations by obtaining statements for the consumer's ongoing fixed expenses to confirm repayment amounts, the number of remaining repayments, any expected balloon payments and whether the consumer is meeting repayment obligations.
Credit reports See paragraphs 179–180	When seeking to verify the financial situation of a self-employed consumer, lenders can reduce the risk of non-compliance by obtaining both a consumer and a commercial credit report and reviewing all the information contained in the reports to ensure that it supports the stated financial position of the consumer. Any anomalies or inconsistencies in the information should be queried.
Buffers and surplus income position See paragraphs 190–195	When credit licensees are assessing a consumer's ability to meet their financial obligations without substantial hardship, the more uncertainties, estimations or approximations underpinning the information used in the assessment, the greater the licensees' risk of non-compliance. In such instances, licensees can reduce the risk of non-compliance by ensuring the use of adequate buffers for changes to financial circumstances (e.g. interest rate increases and income and expense fluctuations) and requiring a greater surplus income to assess a proposed loan as not unsuitable.
Differing treatments of income See paragraphs 196–199	If credit licensees treat particular types of income, groups of consumers or products differently for the purposes of assessing a consumer's ability to meet their financial obligations without substantial hardship, they can reduce the risk of non-compliance by ensuring that they have a reasonable basis for this approach and that the different methods are clearly documented.

Key terms

Term	Meaning in this document
ABN	Australian Business Number
ADI	Authorised deposit-taking institution—has the meaning given in s5 of the National Credit Act
BAS	Business activity statement
consumer	A natural person or strata corporation Note: See s5 of the National Credit Act.
credit	Credit to which the National Credit Code applies Note: See s3 and 5–6 of the National Credit Code.
credit activity (or credit activities)	Has the meaning given in s6 of the National Credit Act
credit assistance	Has the meaning given in s8 of the National Credit Act
credit assistance provider	A person who provides credit assistance as defined by s8 of the National Credit Act
credit contract	Has the meaning in s4 of the National Credit Code
credit licence	An Australian credit licence under s35 of the National Credit Act that authorises a licensee to engage in particular credit activities
credit licensee	A person who holds an Australian credit licence under s35 of the National Credit Act
lender	A credit provider as defined by s5 of the National Credit Act
'low doc' home loans	Home loans for self-employed borrowers without recent tax returns or audited financial statements for their business, and borrowers who do not have a regular income stream over a prolonged period of time or an income that can be readily verified by standard documentation such as pay slips
LVR	Loan-to-valuation ratio
mortgage broker	A credit assistance provider as defined by s8 of the National Credit Act
National Credit Act	*National Consumer Credit Protection Act 2009*
registrable corporations	A registrable corporation under s7 of the *Financial Sector (Collection of Data) Act 2001*

Related information

Headnotes

assessment of unsuitability, consumers, credit licensees, documented procedures, financial situation, lenders, ‘low doc’ home loans, not unsuitable, responsible lending guidelines, responsible lending obligations, requirements and objectives, substantial hardship

Pro formas

PF 224 *Australian credit licence conditions*

Regulatory guides

RG 203 *Do I need a credit licence?*

RG 209 *Credit licensing: Responsible lending conduct*

Legislation

Explanatory Memorandum to the National Consumer Credit Protection Bill 2009, paragraph 3.68

National Credit Act, s47, 128, 129, 130, 131

Reports

REP 119 *Protecting wealth in the family home: An examination of refinancing in response to mortgage stress*

REP 262 *Review of credit assistance providers’ responsible lending conduct, focusing on ‘low doc’ home loans*

REP 264 *Review of micro lenders’ responsible lending conduct and disclosure obligations*

REP 330 *Review of licensed credit assistance providers’ monitoring and supervision of credit representatives*

REP 358 *Review of credit assistance providers’ responsible lending conduct relating to debt consolidation*