Addressing uncertainty in consumer lending

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CHECK AGAINST DELIVERY

Thank you for inviting me to speak to you today. Consumer credit plays a very important role in the Australian economy, as well as in the lives of millions of Australians.

I have been asked to talk to you today about addressing uncertainty in consumer lending. To me, this phrase has two distinct meanings:

- it refers to the uncertainty in which we all operate, generated by evolving market dynamics, rapid innovation and technological change, and
- there can also be micro-level uncertainty in lending, relating to individual consumers and their loans.

Introduction

Today I will touch on both of these forms of 'uncertainty'.

I will talk about ASIC's current regulatory focus and priorities, which informs what we look for in changing markets.

I will also provide insight into some of our targeted activities and outcomes as Australia's consumer credit regulator. Responsible lending has long been a focus for us, and we see compliance with these obligations as playing an important role in addressing uncertainty in specific cases.

Finally, I will talk about innovation, including in consumer credit, and some important steps that ASIC is taking to facilitate innovation while acting consistently with the principles of the regulatory framework.

ASIC’s current regulatory focus and priorities in consumer lending

Our vision and strategic priorities

ASIC’s vision is to allow markets to fund the economy and, in turn, fund economic growth and contribute to the financial wellbeing of all Australians. We try to bring about this vision by focusing on our three strategic priorities:

- promoting investor and financial consumer trust and confidence
- ensuring fair, orderly, transparent and efficient markets, and
- providing efficient registration services.

We’ve recently released our Corporate Plan for 2016–17. The Corporate Plan is a rolling four-year document that describes how our long-term priorities and challenges are shaping our strategy and responses over this period. We see our long-term challenges as balancing a free market-based system with investor and financial consumer protection; digital disruption; structural change; financial innovation-driven complexity; and globalisation.

The Corporate Plan also identifies a number of our key areas of focus where we see particular concerns that flow from the long-term challenges we face. These are in the areas of gatekeeper conduct, cyber-resilience, misalignment of retail product design and distribution with consumer understanding, and cross-border businesses, services and transactions.

Our key projects identified for credit in 2016–17 and beyond are:

- responsible lending practices of lenders and brokers in relation to interest-only home loans
- responsible lending practices for payday loans and consumer leases
- flex commissions in the car finance market
- review of mortgage broker remuneration
- credit card marketing practices
- loan fraud
- breach reporting practices of the large financial institutions
- sale of leases and instalment contracts to Indigenous communities.

A number of these projects are well underway and I will provide more detail later in my presentation.

What ‘good’ looks like

For the first time, the Corporate Plan also attempts to set out a vision of what ‘good’ looks like for the various sectors that ASIC regulates. For the consumer banking, consumer credit, and insurance sectors, our expectation is that businesses will:

- act professionally and treat customers fairly
- provide good quality products and services that are developed, marketed and managed in a way that serves customers well, and
- ensure that consumers are fully compensated when losses result from poor conduct.

If you've been following the work of ASIC, and the various inquiries and reviews that have been taking place over the last few years, I don't think this vision will come as a surprise. In some ways, you might think this vision should be easy to achieve. After all, consumers can vote with their wallets, and those businesses that serve consumers well ought to flourish, while those that provide poor products and services shouldn't survive very long.

However, things are not that straightforward. Markets don't always serve consumers well, and it can be quite profitable – especially in the short term – for some firms to exploit vulnerable consumers with poor value products. These firms know that consumers don't always make rational decisions, and that behavioural biases result in consumers making poor choices.

Poor consumer outcomes can emerge and be maintained due to a slippery slope of poor conduct by a few firms, exacerbated by the need for better-intentioned firms to compete. The result of that can be an industry operating in a way that individual firms cannot escape from unilaterally. At ASIC, we refer to these as 'collective action' or 'first mover' problems.

If you think that this sounds a bit too academic, then don't worry, I will bring it to life with some examples that should be relevant to this audience.

Before I do that, though, I wanted to talk about culture.

Culture

ASIC has been talking a lot about the importance of culture within financial firms. It was also highlighted in the Financial System Inquiry (FSI), and by other regulators – both domestic and international. ASIC is not trying to regulate culture or micro-manage the culture of financial firms. However, we do have a strong interest in business culture.

As I mentioned earlier, one of our long-term challenges is balancing a free market-based system with investor and financial consumer protection. We are focused on ensuring that the culture and conduct of financial system participants emphasises the interests of their customers first. One key cultural observation from the FSI was the lack of alignment between the interests of financial services firms and their customers.

Earlier this year, ASIC Deputy Chairman Peter Kell spoke at the AFR Banking and Wealth Summit. He said:

> ASIC has been highlighting the importance of culture in financial firms. Our aim is to promote trust and confidence in the financial system, and poor culture clearly undermines that trust and confidence.

ASIC is concerned about culture because it is a key driver of conduct. A poor culture can generate poor conduct. Given the correlation, we consider it to be a key risk area with respect to our role as a regulator. While we don't want to minimise the importance of the role that financial services firms must play in dealing with culture internally, we are keen to examine culture and, in turn, significantly improve both compliance culture and industry standards.

As I said, one of our strategic priorities is to promote consumer trust and confidence. Addressing poor practices – particularly around important obligations like responsible lending – will help achieve this. Equally, industry needs to be confident that it is operating in a fair marketplace, where both its business partners and its competitors are operating within the rules, and held to the same account. ASIC, and the broader public, expects a firm to appropriately address any misconduct that it identifies within its organisation.

Public trust and confidence also depend on acknowledging good behaviour and industry practice, as well as there being a clear and common understanding among consumers, industry and ASIC about what is required by the law. We seek to do this through our regulatory guidance, thematic industry reviews and consumer education.

So what is ASIC looking for when we look at the culture of an organisation? We are looking for a culture that:

- seeks to put customers first, both when things are going well and when they are not
- seeks and acts on customer feedback, including dealing with complaints fairly
- ensures the right products and services are sold to the customers they were designed for, and not just to any customer who may not understand or be suited to the product
- has controls in place to support that culture – for example, how products are developed, approved, marketed, distributed, monitored and reviewed
- has a recruitment, training and reward structure that is aligned to and reinforces the culture of doing the right thing and good outcomes for customers
- provides an environment that encourages staff to challenge accepted practices and raise issues when mistakes are made or when things don't seem right.

We believe that this type of culture will leave a firm, and its customers, well placed to respond to digital disruption and change in its market.

It's also important to note that, where ASIC sees signs of a good corporate and compliance culture, we will take that into account when deciding on which regulatory tools to use when faced with a breach or problem.

Recently, we've put out several media releases highlighting breaches that have been reported to ASIC and the remediation payments being made to consumers – sometimes in the tens of millions of dollars. These media releases serve an important purpose:

- They provide transparency to the wider public about issues that have arisen and how they are being dealt with.

- They educate industry participants about the kinds of compliance issues that can arise, to assist businesses to proactively review their own conduct and controls.
- They help ensure consumers can have trust and confidence in the financial system – that, while things may go wrong, they get fixed properly.

Although we would prefer to see as few breaches as possible, when an organisation does submit breach reports to us, we do generally see this as a positive sign. It's even more positive when the breach is reported in a timely manner, and when the entity proposes a robust remediation program.

ASIC's activities and outcomes as Australia's consumer credit regulator

Responsible lending

Now I want to talk about our current responsible lending work, and some of our other key projects relating to credit. This demonstrates how our strategic priorities have effect in practice.

In respect to consumer credit, one of ASIC's key priorities is to promote responsible lending and appropriate responses to financial difficulty. Our work on responsible lending covers all sectors – including small amount loans, credit cards, and motor vehicle finance – with significant public outcomes in each of these areas over the last year.

Regulatory Guide 209 *Credit licensing: Responsible lending conduct* (RG 209) continues to be an important resource in relation to our expectations about responsible lending, including inquiries into and verification of each consumer's financial situation, requirements and objectives.

Interest-only home loans

In September, ASIC released Report 493 *Review of interest-only home loans: Mortgage brokers' inquiries into consumers' requirements and objectives* (REP 493) – the second part of our review into interest-only home loans. This review focused on mortgage brokers and their inquiries into a consumer's requirements and objectives to assess how interest-only home loans met the consumer's needs.

This report follows on from our review of lenders and ASIC Report 445 *Review of interest-only home loans* (REP 445), which was released in August last year. This earlier report highlighted a number of compliance risks for industry, and we are still working with individual lenders to ensure that key findings are understood and appropriate actions are taken.

The report found some lenders were falling short of their obligations by failing to consider, or at least record, whether an interest-only home loan would meet the consumer's requirements and objectives.

Since the release of REP 445 in August last year:

- the value of new interest-only home loans approved by authorised deposit-taking institutions (ADIs) has decreased by 9%
- the percentage of new interest-only home loans approved by ADIs has decreased by 12%, and
- the amount that can be borrowed by an individual consumer through an interest-only home loan has decreased, where lenders have changed their processes in line with our recommendations.

In light of our findings about mortgage lenders, and considering that more than half of consumers are using the services of mortgage brokers to assist them in obtaining a home loan, we then undertook a review of large mortgage brokers' responsible lending practices in relation to interest-only home loans.

Our review of information provided by 11 large mortgage brokers found that, between the end of the June quarter 2015 and the end of the December quarter 2015:

- the number of new interest-only home loans fell by 16.3%, with total value of these reducing by 15.6%, and
- the percentage of interest-only home loans with a term greater than five years reduced by 54% from 11.2% to 5.1%.

ASIC reviewed more than 200 home loan application files of representatives of 11 large mortgage brokers, including owner-occupier loans and investment loans. ASIC also reviewed the policies and guidance that these mortgage brokers provided to their representatives to ensure they complied with the responsible lending obligations.

We found that:

- all mortgage brokers provided their representatives with inquiry tools (e.g. a 'fact find' or 'needs analysis') to assist them in inquiring into and recording consumers' requirements and objectives, and
- for about 80% of applications reviewed, we identified a statement summarising how the 'interest-only' feature specifically met the consumer's requirements and objectives. This compares well with our finding in REP 445 that over 30% of applications reviewed had no evidence the lender had considered whether the interest-only loan met the consumer's requirements.

However, we also identified a number of instances where mortgage brokers were at increased risk of not being able to demonstrate (whether to ASIC, an EDR scheme or the Court) compliance with their responsible lending obligations. We found that:

- mortgage broker policies and procedures provided only general information rather than tailored information on specific products and loan features that may impose increased financial obligations or restrict repayment flexibility
- record keeping for recording inquiries was inconsistent and, in some cases, records were fragmented and incomplete

- more than 20% of applications reviewed did not include a statement explaining how the 'interest-only' feature of the loan specifically met the consumer's underlying requirements and objectives. The level of detail in these statements varied considerably and, in some cases, where an interest-only loan was specifically sought by a consumer (including where this option was recommended by a third party, such as an accountant), the reason for this was not clear, and
- in some cases, where the potential benefit of the interest-only loan depended on the consumer taking specific action (such as allocating additional funds to higher interest debt), it was unclear whether the consumer understood the potential risks or additional costs if the specific action was not taken.

Our report sets out the actions that mortgage brokers can take to reduce their risk of being unable to demonstrate compliance with their responsible lending obligations. These actions include:

- ensuring they understand the consumer's underlying objectives for requesting specific loan products and features
- recording concise narrative summaries of consumers' requirements and objectives, and why a particular product, features and lender were chosen
- providing a statement summarising the broker's understanding of the consumer's requirements and objectives – which could also include the reason a particular loan is suggested – for the consumer to confirm before obtaining a loan
- where the potential benefits of a loan feature will require the consumer to undertake specific behaviour, ensuring consumers are aware of the action they must take to obtain the potential benefit, as well as the potential costs should this action not be taken.

Broker remuneration

Another industry-wide review we are doing is looking into mortgage broker remuneration. This review is being undertaken at the request of Minster Kelly O'Dwyer, as part of the Government's response to the Financial System Inquiry.

In particular, ASIC was requested to review the mortgage broking market to determine the effect of current remuneration structures on the quality of consumer outcomes. The Government has requested that the review be completed by the end of 2016, and that the results will be made public.

The Government and regulators have previously considered remuneration in other contexts, such as financial advice and insurance. There are significant differences between the commission structures of financial planners and those of mortgage brokers. Nonetheless, it is important in any sector to understand the remuneration practices and structures, because these are key drivers of behaviour and culture.

Our main objective is therefore to produce a clear picture of mortgage broker remuneration structures and trends.

Having consulted widely and issued a final scoping paper in May 2016, we have now requested information from the major banks, other banks, mutuals and non-bank lenders. We have also sent requests to aggregators, broker businesses and certain other industry participants, such as the providers of rate comparison websites.

The information requests we have issued, particularly to the lenders, are substantial. We are asking for information about a significant quantity of individual loans, as well as detailed information about the remuneration structures themselves. This is necessary to ensure that ASIC can make observations based on robust data and sampling.

There is a lot of interest in the review, and there has been commentary in both the traditional and industry media. We have tried to be very transparent in conducting this review. We are doing this work at the Minister's request, and we have no preconceived view about the results. Our report will be delivered to the Government at the end of this year. We may do follow-up work in 2017–18 with the additional ASIC funding the Government announced earlier this year.

Flex commissions

We are also looking at commission structures in the motor vehicle finance sector and, in particular, the role of flex commissions. We have been concerned about flex commissions because of the poor consumer outcomes created by this type of remuneration structure, and the disproportionate impact on vulnerable and less sophisticated consumers.

Importantly, flex commissions do not facilitate risk-based interest rate pricing. This is not about ASIC preventing lenders from charging higher interest rates to consumers who are riskier from a credit perspective. Instead, flex commissions enable car dealers to charge higher interest rates because they can, and to receive higher commissions for higher rates. We have seen examples of loan contracts with interest rates more than 800 basis points above the base rate.

Some people might argue that car dealers should be allowed to structure their pricing freely. If a consumer is willing to pay more for car finance, especially if they got a good deal on the car, why should ASIC intervene? At the risk of oversimplifying things, this is a bit like the convenience store argument. Everyone knows that you can get a litre of milk at Coles for $1, but nobody is stopping convenience stores from selling the same milk for $3.

Importantly, however, financial services are different from other parts of the economy. Financial services require consumers to have trust and confidence; and we need to make sure that that trust and confidence are not misplaced.

Historically, disclosure was seen as the solution to ensuring consumers made properly informed decisions. However, as the FSI pointed out – as well as bitter experience in different financial scandals, disclosure has significant limitations. It's one thing for a consumer to pay $3 for a litre of milk – they know what product they are buying and they know they're paying more than they could, but they have decided to pay the price for convenience. They also probably don't buy their milk for $3 every week.

In contrast, buying a car on finance is a big financial decision – second only for many consumers to getting a mortgage. Flex commissions do not operate in a way that is sufficiently transparent to consumers – if the pricing structure was transparent, you could imagine that consumers would not pay higher interest rates. Most consumers spend a lot of time deciding what car to buy, and then negotiating a good deal on the price of the car or trade-in. By the time they get to the financing, or add-on insurance products, consumers have done little to no research, and are highly susceptible to agreeing to whatever is put to them.

It is for these reasons that ASIC has been concerned about flex commissions. From a legal perspective, we are concerned that conduct associated with flex commissions is unfair under the *National Consumer Credit Protection Act 2009* (National Credit Act). But rather than take enforcement action, we have decided a whole-of-industry response is required.

We realise that, as a first mover problem, no individual lender can move away from flex commissions unilaterally. If an individual lender decided to abandon flex commissions, it is highly likely that car dealers would simply divert business to those lenders that continued to pay flex commissions.

Reflecting these concerns, some of the themes that emerged from our consultation with stakeholders were that:

- there was general support that any changes be introduced in a way that ensures competitive neutrality
- similarly, there was broad support for any changes applying to all transactions regulated by the National Credit Act, although stakeholders did not identify any other market niches where flex commissions were operating, and
- finally, there was no enthusiasm for a two-stage process, as lenders and car dealers would incur two sets of implementation costs.

Given the complexities of this issue and its implications for industry, it is important that the decision is a considered one, based on a review of the best available evidence. We expect to finalise our position on this issue shortly.

Innovation

I will now talk about innovation in financial services and credit.

Technology and innovation are disrupting and reshaping the world we live in. While innovation is not a new phenomenon, the scale, breadth, speed – and potential – of change we’re currently seeing are unprecedented.

We are now surrounded by mobile devices and data, and we are seeing many new developments in areas such as robotics, self-driving cars and smart buildings.

In financial services we are seeing automated financial advice (robo-advice), new developments in payments, and the potential of distributed ledger (or blockchain) technology.

Consumers have a lot to gain from technological innovation. Technology has made possible new products and services that streamline our lives, make things more convenient and reduce costs. At the same time, changing consumer demographics, consumer engagement and behaviour are forcing businesses to change the way they design and deliver products.

We are seeing new entrants into financial services can often deliver value with greatly improved quality, speed or price. We are also seeing the development of the 'sharing' economy which is disrupting existing industry structures – and is underpinned by technology-enabled platforms.

ASIC supports innovation in financial services and credit, especially where that innovation may lead to better consumer outcomes. Financial innovation provides both opportunities and risks. Industry and regulators have a common interest in seeing innovation that fosters public trust and confidence.

Innovation Hub

As you may be aware, we also established an Innovation Hub. The intent of this hub is to help new business – particularly small, financial technology businesses – navigate the laws we are responsible for.

An important element of our Innovation Hub is offering informal assistance, or guidance, to eligible new businesses. We believe that, by giving new businesses early contact with senior ASIC staff, we can help them identify key regulatory issues that they should think about as they settle on their business models and prepare to apply for a licence from us. We expect that this will reduce the time and cost taken to enter the market.

During the last 12 months, we have provided this sort of informal assistance to over 80 eligible businesses. Some of these entities have since obtained a licence from ASIC and commenced trading.

Although our Innovation Hub initiative is focused on new businesses, we are also happy to talk to incumbents about new products or services, especially where it is unclear how the law applies to those offerings.

Formal guidance

Where we can, we have also provided more formal guidance to industry. For example, in February, we released an information sheet on marketplace lending, which sets out the main obligations that apply to platform operators, as well as our expectations about disclosure and advertising. We've also released updated guidance for digital advice businesses.

International cooperation

As part of our Innovation Hub work, we have also signed four cooperation agreements with regulators overseas. Our agreements with the UK's Financial Conduct Authority, the Monetary Authority of Singapore, the Capital Markets Authority of Kenya and the Ontario Securities Commission reflect the global nature of innovation and change in financial services and credit. We actively stay abreast of international developments, and work with like-minded regulators to share information and, where possible, refer businesses between jurisdictions where they are considering international expansion.

Proposals to facilitate innovation

In June this year, we consulted on additional measures to facilitate innovation in the sectors we regulate. This includes what has become known as a 'regulatory sandbox' – a licensing exemption under which some concept validation testing can take place without all of the normal regulatory obligations being triggered.

Concept validation testing involving retail clients could pose risks, so we proposed a number of conditions that would need to be met before someone could provide services without a licence. These include client and exposure limits, service restrictions, and preserving some of the usual consumer protections, such as compensation arrangements and dispute resolution processes.

ASIC's proposal is unique in that any business that meets the specified conditions will have a legal right to test certain services without a licence. Other regulators have established 'sandboxes' that involve individual negotiations between the firm and the regulator around conditions and parameters of testing. Our class-wide or 'whitelisting' approach will provide certainty and speed-to-market benefits by limiting the need for individual tailoring of the terms of any concept validation.

We have received many submissions on our proposals and we are currently considering the feedback industry has provided. We are working towards finalising our proposals on facilitating innovation later this year.

Conclusion

I hope that my speech today has given you some insights into ASIC's priorities and areas of focus, and what that means for the consumer credit sector.

I'd like to conclude by emphasising the importance of industry and regulators working together to harvest the opportunities from financial innovation.

We expect that all parts of industry – including those developing new and innovative offerings – will have the interests of their customers front of mind. We all have a common interest in seeing the opportunities of new technology work to the benefit of consumers. At the same time, we need to mitigate the risks so that we all enjoy the benefits of investor and consumer trust and confidence in our markets, and sustainable growth.