REPORT 262

Review of credit assistance providers' responsible lending conduct, focusing on 'low doc' home loans

November 2011

About this report

This report sets out the findings of a review of home loan applications prepared by credit assistance providers between July and December 2010, with a specific focus on the provision of credit assistance for home loans that were promoted as low documentation (low doc).

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Executive summary

1 The *National Consumer Credit Protection Act 2009* (National Credit Act) commenced in July 2010, imposing licensing requirements, general conduct obligations and responsible lending obligations on credit providers and persons providing credit assistance.

2 The licensing requirements and associated general conduct provisions provide a framework for ensuring that all persons engaging in credit activities meet certain standards, including appropriate competencies, compliance arrangements and dispute resolution procedures. Since July 2010 we have been active in assessing Australian credit licence (credit licence) applications, precluding unsuitable persons from being licensed and undertaking compliance work to identify unlicensed credit activity.

3 The responsible lending obligations require credit providers and persons providing credit assistance to:

(a) make reasonable inquiries into a consumer's requirements and objectives;

(b) make reasonable inquiries into a consumer's financial situation;

(c) take reasonable steps to verify a consumer's financial situation;

(d) assess whether a proposed credit contract will not meet the consumer's requirements and objectives; and

(e) assess whether a consumer will be unable to meet their obligations under a proposed credit contract without substantial hardship.

4 To help industry prepare for the responsible lending obligations, in February 2010 ASIC issued Regulatory Guide 209 *Credit licensing: Responsible lending conduct* (RG 209).

5 We wanted to do an early assessment of industry's responsible lending conduct in a number of areas. One of these areas was home loans. This was because Treasury's Green Paper *Financial services and credit reform: Improving, simplifying and standardising financial services and credit regulation* (Green Paper), which proposed options for reform of credit regulation in June 2008, specifically focused on home loans as an area for regulation by the Commonwealth. Housing was identified as the largest sector of consumer credit, estimated to account for 86% of all consumer loans by aggregate dollar amount.

6 Because many home loan lenders—including all authorised deposit-taking institutions (ADIs)—did not have to comply with the responsible lending obligations until 1 January 2011, we decided to initially look at the responsible lending practices of persons providing credit assistance for home

loans from the commencement of the responsible lending obligations in July 2010 to December 2010.

7 In assessing industry's conduct, we also wanted to focus on home loans promoted as low documentation (low doc) because the Green Paper specifically identified, among the then-potential bases for law reform:

(a) lax lending practices in home lending in the United States, which was one factor in the sub-prime crisis; and

(b) equity stripping, as identified in our Report 119 *Protecting wealth in the family home: An examination of refinancing in response to mortgage stress* (REP 119), released in March 2008.

8 REP 119 had identified home loans promoted as low doc as a possible contributory factor to the loss of equity through inappropriate refinancing and debt consolidation. That report identified a number of instances where a lack of verification of a consumer's ability to meet their obligations led to the consumer entering into a credit contract in which they would be likely to default.

What we did

9 We selected 18 credit assistance providers to review, with a focus on entities with websites that publicised home loans promoted as low doc, and obtained from them a description of their approach to responsible lending compliance, and details of the consumer credit assistance they had provided between July and December 2010.

10 A total of 324 instances of credit assistance were reported for this period. Of these, 166 instances were for credit applications where the home loan was promoted as low doc. We initially reviewed the details of those credit applications to identify factors that raised a greater risk of non-compliance with the responsible lending obligations.

11 Following this risk-assessment process, we obtained and reviewed 104 files from 16 credit assistance providers for consumer credit assistance provided between July and December 2010. These 104 files comprised 78 instances where the credit assistance was for home loans promoted as low doc and 26 instances where the credit assistance was for home loans that were not promoted as low doc. We included a proportion of home loans other than those promoted as low doc to assess the selected credit assistance providers' practices and procedures for responsible lending more generally.

12 In reviewing these files we focused on credit assistance providers' responsible lending practices, including the records they kept to form the basis of an assessment of whether a credit contract would be unsuitable for a

consumer. We did not seek to determine whether any particular credit contract was unsuitable for a consumer.

What we found

Finding 1: Awareness of obligations

13 Credit assistance providers were generally aware of the new responsible lending obligations, with nearly all credit assistance providers giving us a description of their responsible lending guidelines. We note that in a number of instances the credit assistance provider was relying on guidelines prepared by a third party, such as an aggregator.

Finding 2: Changes to practices

14 The introduction of the National Credit Act has brought with it changes to practices in the credit industry. Credit assistance providers must be licensed and in becoming licensed must have met a 'fit and proper person' requirement (this includes key individuals in the businesses). All licensed credit assistance providers must now have internal dispute resolution (IDR) procedures, be a member of an approved external dispute resolution (EDR) scheme and have compliance plans. The National Credit Act has also extended regulation to cover lending for investment in residential property and amended the circumstances in which a credit contract is presumed to be for a business purpose, and therefore unregulated, thereby making avoidance of regulation more difficult. In addition, ASIC has applied resources to taking action in relation to unlicensed activity.

15 We did not observe any evidence of equity stripping, as described by REP 119, on the files reviewed. Together with the changes noted in paragraph 14, we consider this is indicative of ongoing improvement in this area of the market.

16 We note that our review was undertaken in relation to practices over the first six months of the new responsible lending regime and that practices during that period were changing as a result of our work, and actions taken by lenders, aggregators and credit assistance providers. We also understand that changes have continued to be made by credit licensees. In a number of instances, credit assistance providers' aggregators appear to have driven these initiatives, such as the introduction and/or enhancement of 'fact find' documents, apparently to assist the credit assistance providers in establishing and recording consumers' objectives.

Finding 3: Practices observed

17 Files reviewed generally recorded inquiries into a consumer's requirements and objectives, inquiries into and verification of a consumer's financial situation, and/or assessment of whether a consumer would be able to meet their obligations under the proposed credit contract without substantial hardship. Some examples of the practices we observed were:

(a) all files recorded a basic level of inquiry into the immediate purposes of the loan (e.g. to purchase a house);

(b) nearly all files recorded inquiries into the consumer's income level and source of income;

(c) all files where credit assistance was provided for loans, other than those promoted as low doc, recorded steps taken to verify the consumer's income, with multiple sources of income verification being industry best practice;

(d) nearly all files recorded inquiries into a consumer's fixed expenses, such as obligations under existing loans;

(e) nearly all files where a consumer's existing loans were to be refinanced recorded steps taken to verify those loans; and

(f) the majority of files recorded how the credit assistance provider had assessed a consumer's ability to make repayments under the proposed loan.

Finding 4: Potential compliance risks

18 We identified instances where credit assistance providers were, however, at risk of not being able to demonstrate they had met their responsible lending obligations. This is not surprising given that practices in this market were in transition.

19 There were additional risks identified where credit assistance was provided for home loans promoted as low doc. RG 209.17–RG 209.18 note that the inquiries and verifications a credit licensee must make to satisfy their responsible lending obligations are scalable, depending on the circumstances of the consumer. In some circumstances, fewer inquiries may be needed. However, RG 209 does not suggest that inquiries and verifications may be scaled down because of the label applied to a product, such as low doc.

20 We encourage credit assistance providers to review their processes and procedures in light of the findings listed in Table 1 to ensure that they are able to demonstrate that they are meeting their responsible lending obligations.

Table 1: List of findings on potential compliance risks

Finding 4.1: Compliance systems	We identified instances where credit assistance providers did not demonstrate strict adherence to their own description of their responsible lending guidelines. Credit assistance providers can lessen the risk of not satisfying their responsible lending and general conduct obligations by ensuring they have adequate processes and procedures in place to test their compliance on an ongoing basis: see paragraphs 64–68.
Finding 4.2: Consumers' longer term requirements and objectives	We reviewed files where credit assistance providers had not indicated the consumer's medium-term to long-term objectives. Credit assistance providers can lessen the risk of not being able to demonstrate that they have made reasonable inquiries about a consumer's requirements and objectives by consistently recording a consumer's requirements and objectives beyond the immediate purpose of the credit contract: see paragraphs 69–74.
Finding 4.3: Prioritisation of consumers' requirements and objectives	We reviewed files where credit assistance providers had not indicated how the consumer's identified objectives (e.g. cost of the product) were prioritised. Credit assistance providers can lessen the risk of not being able to demonstrate that they have assessed whether a proposed credit contract will not meet the consumer's requirements and objectives by consistently recording the relative priority of a consumer's requirements and objectives, including cost: see paragraphs 75–82.
Finding 4.4: Verification of consumers' income	For home loans promoted as low doc, we observed files where credit assistance providers did not record steps taken to verify the consumer's income, or appeared to rely only on statements from the consumer. Credit assistance providers can lessen the risk of not being able to demonstrate that they have taken reasonable steps to verify a consumer's financial situation by consistently recording information verifying a consumer's income, as outlined in Table 4 of RG 209, with multiple sources of verification being best practice: see paragraphs 83–95.
Finding 4.5: Verification of consumers' income from accountants' statements	We reviewed files for home loans promoted as low doc where credit assistance providers appeared to rely on statements from accountants to verify the consumer's income. These statements contained varying levels of detail, including statements that consumers could make repayments on the proposed home loan without substantial hardship. When seeking to rely on statements from a consumer's accountant for income verification purposes, best practice is to ensure the accountant's statement confirms the consumer's actual level of regular income, specifies the basis on which the statement is made, including comments on previous earnings and the underlying information supporting the statement, and identifies the relevant time period for which the accountant has been engaged by the consumer: see paragraphs 96–100.

Finding 4.6: Verification of consumers' income where self-employment is relatively recent and/or future earnings are uncertain	We observed files for home loans promoted as low doc where credit assistance providers appeared to rely solely on estimates of future earnings to verify the consumer's self-employment income. When a consumer's self-employment is relatively recent and/or the level of ongoing future earnings is uncertain, credit assistance providers can lessen the risk of not being able to demonstrate that they have taken reasonable steps to verify a consumer's financial situation by considering the consumer's previous work history, including the level of earnings and field of expertise: see paragraphs 101–103.
Finding 4.7: Inquiry into and verification of consumers' living expenses	We reviewed files where a living expense figure was only located on a printout from a calculator made available by a credit provider or mortgage insurer and, on some files, we found no recorded figure for the consumer's living expenses. Although benchmark figures can be useful for verifying living expenses, credit assistance providers can lessen the risk of not being able to demonstrate that they have made reasonable inquiries into and verifications of a consumer's financial situation by consistently recording that inquiries have been made into a consumer's actual living expenses see paragraphs 104–107.
Finding 4.8: Verification of inconsistent information about consumers' living expenses	We identified instances where credit assistance providers had not recorded any further verification of the consumer's actual living expenses when a benchmark figure for a consumer's living expenses was inconsistent with a consumer's self-reported living expenses. Where a consumer's self-reported living expense figure is significantly different from a benchmark figure for a consumer's living expenses, credit assistance providers can lessen the risk of not being able to demonstrate that they have taken reasonable steps to verify a consumer's financial situation by recording further steps taken to verify a consumer's actual living expenses: see paragraphs 108–110.
Finding 4.9: Verification of consumers' fixed expenses	We observed files where credit assistance providers had not recorded steps taken to verify the details of the consumer's expected ongoing fixed expenses, such as other existing loans that were not being refinanced. Credit assistance providers can lessen the risk of not being able to demonstrate that they have taken reasonable steps to verify a consumer's financial situation by consistently recording further inquiries into or verifications of a consumer's ongoing fixed expenses where the information initially obtained indicates other possible fixed expenses: see paragraphs 111–117.
Finding 4.10: Assessment of consumers' capacity to make repayments	We reviewed files where credit assistance providers had not recorded how they had assessed a consumer's ability to make repayments under the proposed credit contract. Credit assistance providers can lessen the risk of not being able to demonstrate that they have assessed whether a consumer would be able to meet their financial obligations under a proposed credit contract without substantial hardship by consistently recording how the consumer's ability to make repayments was assessed: see paragraphs 118–121.

Finding 4.11: Interest rate buffers in assessments of consumers' ability to make repayments	We identified instances where credit assistance providers had applied interest rate buffers inconsistently to variable rate credit contracts, when undertaking an assessment of the consumer's ability to make repayments under the proposed credit contract. Credit assistance providers can lessen the risk of not being able to demonstrate that they have assessed whether a consumer would be able to meet their financial obligations under a proposed credit contract without substantial hardship by applying any interest rate buffers consistently to the consumer's other continuing variable rate credit contracts: see paragraphs 122–124.

Next steps

21 We are following up directly with the individual credit assistance providers that were reviewed about specific concerns. We are also raising the issues identified with industry bodies and will continue to work with them to assist their members in meeting these new requirements.

22 Given the significant role that credit assistance providers with a number of authorised credit representatives play in ensuring industry compliance, we are examining how these entities are ensuring compliance with the responsible lending obligations, including how they train, supervise and monitor their authorised representatives.

23 Credit assistance providers have historically been largely unregulated compared to credit providers. The amount of information credit assistance providers have obtained from consumers when assisting them to apply for a home loan has also often reflected the proposed credit provider's requirements. Any changes to the credit policies of ADIs and registrable corporations, as a result of having had to comply with responsible lending obligations in their own right from 1 January 2011, may have had a flow-on effect to credit assistance providers' practices and procedures. We therefore also intend to review how credit providers in the home lending market are meeting their responsible lending obligations.

24 We have been undertaking a number of other reviews of responsible lending conduct in various areas of the credit industry. We intend to consider the findings from these reviews and liaise with relevant stakeholders to determine what, if any, further guidance may be required in RG 209.

A Background

Key points

Credit providers originally introduced home loans promoted as low doc for consumers who were unable to provide traditional methods of income verification, such as pay slips. This enabled such consumers to obtain home loans where they otherwise would not have been able to do so.

Before the introduction of the National Credit Act, credit providers often only required consumers applying for home loans promoted as low doc to declare that they could afford to repay the home loan, with no verification undertaken by the credit provider as to the validity of that statement. As a result of this practice, some consumers who did not have sufficient income to make the required repayments on the home loans experienced financial hardship, including loss of equity.

The National Credit Act contains responsible lending obligations that, among other matters, require credit providers and credit assistance providers to make reasonable inquiries into and verifications of a consumer's financial situation to assess whether the consumer will be able to comply with their financial obligations without substantial hardship.

Home loans promoted as low doc

25 Home loans promoted as low doc were introduced into the Australian mortgage market in the late 1990s. They were initially designed for self-employed borrowers and others who did not have a regular income stream over a prolonged period of time or an income that could be readily verified by reference to standard documentation, such as pay slips. These products assisted persons with the capacity to make repayments on a loan without substantial hardship to obtain home loans where they otherwise would not have been able to do so.

26 The increase in liquidity in the home lending market during the mid-2000s, coupled with increased competition and diversification of delivery channels, saw home loans promoted as low doc being made available to a wider market, including consumers with regular employment who could provide standard documents, such as pay slips, to verify their income. In providing these products, credit providers often relied solely on a statement from the consumer to the effect that they could afford to repay the home loan. In a number of instances, these statements were relied on even when basic inquiry would have confirmed this not to be the case.

27 In *Perpetual Trustee Co Ltd v Khoshaba* [2006] NSWCA 41, the Chief Justice stated that:

> … to engage in pure asset lending, namely to lend money without regard to the ability of the borrower to repay by instalments under the contract, in the knowledge that adequate security is available in the event of default, is to engage in a potentially fruitless enterprise, simply because there is no risk of loss. At least where the security is the sole residence of the borrower, there is a public interest in treating such contracts as unjust.

28 Further, there have been instances of home loans promoted as low doc being misused for 'equity stripping', where the loans were provided with a 'buffer'—a provision of funds from which repayments were initially made, but where there was limited prospect of the consumer being able to make repayments after the buffer ran out: see *Permanent Mortgages v Cook* (2006) ASC 155–082; [2006] NSWSC 1104 (and on appeal [2007] NSWCA 219).

29 In March 2008 we released REP 119, which identified home loans promoted as low doc as a possible contributory factor to the loss of equity through inappropriate refinancing and debt consolidation. The report identified a number of instances where a lack of verification of a consumer's ability to meet their obligations led to the consumer entering into a credit contract in which they would be likely to default.

30 The Green Paper, which proposed options for reform of credit regulation in June 2008 (before the enactment of the National Credit Act and the responsible lending obligations), cited a number of specific issues as then-potential bases for law reform, including lax home lending practices in the United States, which contributed to the sub-prime crisis, and equity stripping (as identified in REP 119).

Legislation and guidance

31 In July 2010 the National Credit Act introduced a number of statutory obligations for credit providers and persons providing credit assistance. These included licensing requirements (such as a 'fit and proper person' requirement for the credit licensee and key individuals in the licensee's businesses), general conduct obligations (e.g. all licensed credit assistance providers must now have IDR procedures, be a member of an approved EDR scheme and have compliance plans) and specific responsible lending obligations.

32 The previous state-based Uniform Consumer Credit Code (UCCC) contained a provision enabling individual consumers to apply to a court to have an individual credit contract reopened if the credit provider knew, or could have ascertained by reasonable inquiry at the time the contract was entered into, that the consumer could not pay without substantial hardship. While this

may have provided a general incentive for credit providers to ensure consumers were not financially over-committed, the National Credit Act's responsible lending provisions impose much more specific obligations on both credit providers and credit assistance providers to ensure a credit contract is not unsuitable for the consumer.

33 Among the responsible lending obligations is the requirement for credit providers and credit assistance providers to make reasonable inquiries and verifications in order to assess whether a contract will be unsuitable for a consumer. Under the *National Consumer Credit Protection (Transitional and Consequential Provisions) Act 2009* (Transitional Act), these obligations were introduced in two stages.

34 From 1 July 2010 these obligations commenced for credit assistance providers (e.g. mortgage brokers) and credit providers other than ADIs (such as banks and credit unions) and registrable corporations (generally comprising large non-bank credit providers). These obligations subsequently commenced for ADIs and registrable corporations on 1 January 2011.

35 Generally speaking, the responsible lending obligations that commenced on 1 July 2010 applied to a population that comprised credit assistance providers, such as mortgage brokers, and smaller non-bank credit providers. Approximately two-thirds of credit licensees have identified themselves as being involved in providing credit assistance through mortgage broking.

36 Under the National Credit Act, a person provides credit assistance if, among other matters, they suggest that a consumer apply for a particular credit contract with a particular credit provider or assist a consumer to do the same.

37 Before providing credit assistance, the credit assistance provider must make a preliminary assessment of whether the proposed credit contract will be unsuitable. The contract will be unsuitable for the consumer if, at the time of the preliminary assessment, it is likely that:

(a) the consumer will be unable to comply with their financial obligations under the contract, or could only comply with substantial hardship; or

(b) the contract will not meet the consumer's requirements or objectives.

38 To demonstrate that a preliminary assessment has been made, a credit assistance provider must:

(a) make reasonable inquiries about the consumer's requirements and objectives for the credit contract;

(b) make reasonable inquiries about the consumer's financial situation; and

(c) take reasonable steps to verify the consumer's financial situation.

39 It is presumed that if a consumer will only be able to comply with their financial obligations under the credit contract by selling their principal place

of residence, then the consumer could only comply with those obligations with substantial hardship, unless the contrary is established. The onus is on the credit assistance provider to establish that the proposed credit contract is not unsuitable.

40 There are significant civil and criminal penalties that apply to contraventions of these responsible lending obligations.

41 Credit assistance providers who do not satisfy their responsible lending obligations place themselves at increased risk of civil action by consumers seeking compensation for any loss or damage they may have suffered as a result, regardless of any actions that we may take.

42 Credit licensees must keep a record of all material that forms the basis of an assessment of whether a credit contract will be unsuitable for a consumer. The material must be in a form that will enable the credit licensee to give the consumer a written copy of the assessment if requested: see Pro Forma 224 *Australian credit licence conditions* (PF 224), condition 17.

43 ASIC released RG 209 in February 2010, which sets out our expectations about compliance with the responsible lending obligations of the National Credit Act and provides examples to help credit licensees understand their obligations.

44 The inquiries and verifications a credit licensee must make to satisfy their responsible lending obligations are scalable—that is, what a licensee needs to do to meet their obligations will vary depending on the circumstances of the consumer: see RG 209.17–RG 209.18. For example, we expect more extensive inquiries and verifications for a home loan, given the significant money generally owed by consumers under home loans relative to their income and the significant impact that any default and enforcement action on the home loan may have, including the potential additional loss of equity arising from sunk transaction costs (e.g. stamp duty and mortgage insurance).

45 In some instances, depending on the circumstances of the consumer, fewer inquiries may be needed. However, RG 209 does not suggest that inquiries and verifications may be scaled down because of the label applied to a product, such as low doc.

46 We have also provided guidance on a number of the other obligations under the National Credit Act, including Regulatory Guide 203 *Do I need a credit licence?* (RG 203) and Regulatory Guide 205 *Credit licensing: General conduct obligations* (RG 205). These guides and other guidance are available on our website at www.asic.gov.au/rg.

Methodology

47 We wanted to do an early assessment of industry's responsible lending conduct in a number of areas, including home loans. We decided to look at home loans because the Green Paper, which proposed options for reform of credit regulation in June 2008, specifically focused on home loans as an area for regulation by the Commonwealth, given housing was identified as the largest sector of consumer credit, estimated to account for 86% of all consumer loans by aggregate dollar amount.

48 Because many home loan lenders (including all ADIs) did not have to comply with the responsible lending obligations until 1 January 2011, we decided to initially look at the responsible lending practices of persons providing credit assistance for home loans from the commencement of the responsible lending obligations in July 2010 to December 2010.

49 We adopted a risk-based methodology in selecting credit assistance providers to review. As we considered home loans promoted as low doc to pose greater risks for non-compliance with the responsible lending obligations, we included credit assistance providers with websites promoting such loans for consumer purposes.

50 We selected 18 credit assistance providers for review and contacted each one to explain the review that we were undertaking. We requested a description of their responsible lending guidelines and details of the consumer credit assistance they had provided from July 2010 until December 2010.

51 A total of 324 instances of credit assistance were reported. Of these, 166 instances were for credit applications where the proposed home loan was promoted as low doc.

52 The volume of consumer credit assistance provided by each targeted entity varied significantly, ranging from nil to 66 consumers being assisted in the relevant period.

53 The proportion of credit assistance for home loans promoted as low doc also varied significantly between credit assistance providers who had been active during the review period. Some entities provided no credit assistance for this type of loan during the review period, whereas other entities provided credit assistance only for home loans promoted as low doc.

54 We initially reviewed the application details for those home loans that were promoted as low doc to identify factors that raised a greater risk of non-compliance with the responsible lending obligations. These factors included loan purpose, with debt consolidation and equity release being viewed as a possible indication that the borrower might not be in a financial situation to repay the proposed home loan without substantial hardship.

55 Because home loans promoted as low doc were largely designed to assist self-employed consumers, we conducted Australian Business Number (ABN) searches in an effort to establish the self-employment status of the individual borrowers.

56 Additionally, we reviewed the date that an ABN was established to identify any instances where it appeared that the ABN had been created primarily, or solely, to facilitate the transaction. We did not identify any such instances.

57 We also reviewed the goods and services tax (GST) registration status of individual borrowers, with non-registration for GST being considered, in conjunction with the proposed amount of credit, as a potential indicator that the consumer's business income might not be at a level to repay the proposed home loan without substantial hardship. We did not identify any such instances.

58 Following the above risk-assessment process, 104 transactions were identified for further review from 16 of the original 18 entities, as two of the entities had not reported any consumer credit activities during the review period.

59 The 104 files comprised 78 files where the credit assistance was provided for home loans promoted as low doc, with the balance of 26 files being for home loans other than those promoted as low doc. We requested application files for these other home loans to provide a comparison of the selected credit assistance providers' responsible lending practices and procedures among product types.

60 In reviewing these files we focused on credit assistance providers' responsible lending practices, including the records they kept to form the basis of an assessment of whether a credit contract would be unsuitable for a consumer. We did not seek to determine whether any particular credit contract was unsuitable for a consumer.

B Findings

Key points

Credit assistance providers were generally aware of the new responsible lending obligations and over the review period enhancements were made to their responsible lending practices and procedures.

Evidence of equity stripping, as described by REP 119, was not observed on the files reviewed. However, we identified instances where credit assistance providers were at risk of not being able to demonstrate they had met their responsible lending obligations, with additional risks being identified where credit assistance was provided for loans promoted as low doc.

We encourage credit assistance providers to review their processes and procedures in light of our findings to ensure that they are able to demonstrate that they are meeting their responsible lending obligations.

61 The introduction of the National Credit Act has brought with it changes to practices in the credit industry. Credit assistance providers must be licensed and in becoming licensed must have met a 'fit and proper person' requirement (this includes key individuals in the businesses). All licensed credit assistance providers must now have IDR procedures, be a member of an approved EDR scheme and have compliance plans. The National Credit Act has also extended regulation to cover lending for investment in residential property and amended the circumstances in which a credit contract is presumed to be for a business purpose, and therefore unregulated, thereby making avoidance of regulation more difficult. In addition, ASIC has applied resources to taking action in relation to unlicensed activity.

62 We did not observe any evidence of equity stripping, as described by REP 119, on the files reviewed. Together with the changes noted above, we consider this is indicative of ongoing improvement in this area of the market.

63 We note that our review was undertaken in relation to practices over the first six months of the new responsible lending regime and that practices during that period were changing as a result of our work, and actions taken by lenders, aggregators and credit assistance providers. We also understand that further changes have continued to be made. We encourage credit assistance providers to review their processes and procedures in light of the findings below to ensure that they are able to demonstrate that they are meeting their responsible lending obligations.

Credit assistance provider's responsible lending guidelines

64 Section 47 of the National Credit Act imposes a number of general conduct obligations on credit licensees, including the requirement to comply with the credit legislation, have adequate arrangements and systems to ensure compliance with its obligations, and have a written plan that documents those arrangements and systems. RG 205 provides guidance to licensees on meeting these obligations.

65 All credit assistance providers we contacted were aware of the responsible lending obligations and nearly all credit assistance providers gave us a description of their documented responsible lending guidelines. We note that, in a number of instances, the credit assistance provider was relying on guidelines prepared by a third party, such as an aggregator.

66 We identified instances where credit assistance providers did not demonstrate strict adherence to their own description of their responsible lending guidelines. For example, where the credit assistance provider's responsible lending guidelines for the verification of income reflected the examples in RG 209, we observed instances where the credit assistance provider appeared to rely solely on a self-certification from the consumer to verify their income, even though such self-certifications are not identified in Table 4 of RG 209 as a type of information that can be used for this purpose.

67 Credit assistance providers can lessen the risk of not satisfying their responsible lending and general conduct obligations by ensuring they have adequate processes and procedures in place to test their compliance on an ongoing basis.

68 We also found that, over the review period, enhancements were made to credit assistance providers' practices. In a number of instances these initiatives appeared to be driven by the credit assistance providers' aggregators, such as the introduction and/or enhancement of 'fact find' documents, apparently to assist the credit assistance providers in establishing and recording the consumer's objectives.

Consumers' requirements and objectives

69 The Explanatory Memorandum to the National Credit Act (Explanatory Memorandum) 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.

70 Reasonable inquiries could include inquiries about the timeframe for which credit is required, whether the consumer seeks particular product features or flexibility, and whether the consumer understands the costs of these features and any additional risks: see RG 209.28. This may be particularly important where the consumer expects to retire before repayment of the credit contract: see Example 6 in RG 209.

71 All files reviewed displayed a basic level of inquiry into the immediate purpose of the loan (e.g. to purchase a house).

Timeframe for which credit is required

72 We saw files where credit assistance providers did not appear to have inquired into the consumer's longer term objectives.

73 When assessing whether a loan will be unsuitable for a consumer, timeframes are a relevant factor. For example, a 25-year loan with a five-year fixed rate and associated break fees may be unsuitable for a consumer who expects to sell the property and discharge the loan in two to three years.

74 Credit assistance providers can lessen the risk of not being able to demonstrate that they have made reasonable inquiries about a consumer's requirements and objectives by consistently recording a consumer's requirements and objectives beyond the immediate purpose of the loan contract.

Relative priority of consumer objectives

75 We found that file notes and/or free-text comments were the most common record of inquiries into a consumer's requirements and objectives. However, it was not always clear from the file notes and/or free-text comments how the consumer's objectives, as identified, were prioritised.

76 Checklists were also used to inquire into and record a consumer's requirements and objectives in some of the files reviewed. In these instances a number of items were selected, indicating the consumer's requirements and objectives, including desired product features. However, there were checklists that did not appear to indicate the priority of the consumer's objectives and requirements.

77 Further, in some cases, it was not clear how the features identified in the checklists related to the consumer's specific circumstances, the relative priority of the features of the loan to the consumer, and the costs and benefits of those features.

Example

An offset account is an account linked to a loan where the credit provider does not pay any interest on the account to the consumer, but instead the account balance is deducted from (or offset against) the balance owing on the loan when calculating the accrual of interest on the loan. The net effect of this is to reduce the interest paid by the consumer on the loan.

Generally, the credit provider charges fees or a higher interest rate for this feature. Consequently, whether such a feature financially benefits a consumer depends on whether the additional cost for this feature is exceeded by the interest savings, determined by the amount of money the consumer holds in the offset account.

Where this feature was specifically noted as important to a consumer, it was not always clear from the file what benefit the consumer would derive from this feature based on the consumer's stated financial situation.

78 We reviewed files where the reason recorded by the credit assistance provider for placing a consumer in a home loan promoted as low doc was not articulated other than the consumer being self-employed. Placing a consumer into a home loan promoted as low doc solely on the basis of self-employment places a credit assistance provider at greater risk of not being able to demonstrate that the credit contract would not be unsuitable.

79 We saw files where consumers noted a low interest rate as an objective, but it was not apparent from the file what priority the consumer attached to this low rate. It was also not apparent whether the consumer had given consideration to the 'lowest' interest rate available, although there is a reasonable expectation that the cost of the loan would be one of the primary considerations for consumers. By not documenting such considerations, credit assistance providers put themselves at greater risk of not meeting their responsible lending obligations.

80 Even the use of checklists that do prioritise a certain number of common objectives and standard product features may not provide sufficient flexibility to identify each consumer's particular objectives and requirements. A more robust approach might combine the use of priority checklists and file notes, including, where appropriate, explicit comparisons drawing consumers' attention to the differences between lower cost basic credit contracts and more expensive credit contracts with additional features and/or flexibility.

81 Other considerations around the selection of products, such as loan approval time and service levels from credit providers or a consumer preference for a specific credit provider, were not often observed on the credit assistance providers' files. By not documenting such considerations, credit assistance

providers put themselves at greater risk of not meeting their responsible lending obligations.

82 Credit assistance providers can lessen the risk of not being able to demonstrate that they have assessed whether a proposed credit contract will not meet a consumer's requirements and objectives by consistently recording the relative priority of a consumer's requirements and objectives, including cost.

Inquiry into and verification of consumers' financial situation

83 The National Credit Act requires the credit assistance provider to make reasonable inquiries about and take reasonable steps to verify the consumer's financial situation to ensure the consumer can meet their obligations under the credit contract without undue hardship.

84 The Explanatory Memorandum states at paragraph 3.70 that:

> … reasonable inquiries about the consumer's financial situation could include: determining the amount and source of the consumer's income; determining the extent of fixed expenses (such as rent or contracted expenses such as insurance, other credit contracts and associated information); and other variable expenses of the consumer (and drivers of variable expenses such as number of dependents and number of vehicles to run, and any particular or unusual circumstances).

85 These obligations are scalable—that is, how a credit licensee complies with the obligations depends on the circumstances: see RG 209.17. However, this does not mean that in certain circumstances, or with certain products, licensees would be altogether exempt from these obligations.

Inquiry into and verification of income

86 Inquiries into the consumer's income level and source of income were generally recorded on the loan application form for home loans promoted as low doc and home loans that were not promoted as such. However, there was a significant difference between the income verification for home loans promoted as low doc and those that were not promoted as such.

87 We found that in the majority of application files for home loans not promoted as low doc, consumers were employees and their income was confirmed by pay slips and/or an employer's letter. Other forms of verification included bank statements and tax returns.

88 Using multiple sources to confirm a consumer's income increases the likelihood of a credit licensee complying with their responsible lending obligations and appears to be industry best practice.

89 We noted in some instances that documents obtained as part of the income verification were 'assessments of earnings' (group certificates) in excess of 12-months old at the time the credit assistance was provided. Credit assistance providers would be at higher risk of not being able to demonstrate they had taken reasonable steps to verify a consumer's financial situation by relying solely on such old documents. However, it is noted that in these instances the 'assessment of earnings' documents were not the primary source of income verification.

90 Credit assistance providers are also at a higher risk of non-compliance should they choose to solely rely on the use of assessment notices issued by the Australian Taxation Office (ATO). While these documents display an income figure, they do not disclose the source or expected continuation of the income at the level shown.

91 Our review found less evidence of income verification on applications for home loans promoted as low doc.

92 Files for home loans promoted as low doc generally contained evidence that the credit assistance provider had confirmed that the consumer had a registered ABN. Although ABN registration may substantiate a consumer's claim of self-employment, it is not a means of verifying a consumer's actual income.

Self-certification of income

93 We observed files for home loans promoted as low doc where there was no evidence of any steps taken by the credit assistance provider to verify the consumer's income, or the evidence on file was limited to a statement or certification from the consumer confirming their ability to meet loan repayments. Such statements on their own do not verify the consumer's financial situation and are not identified in Table 4 of RG 209 as a type of information that could be used for this purpose.

94 Relying solely on a statement from a consumer to verify their income places credit assistance providers at significant risk of not being able to demonstrate that they have taken reasonable steps to verify a consumer's financial situation.

95 Credit assistance providers can lessen the risk of not being able to demonstrate that they have taken reasonable steps to verify a consumer's financial situation by consistently recording information verifying a consumer's income as outlined in Table 4 of RG 209, with multiple sources of verification being best practice.

Statements from accountants

96 We reviewed files for home loans promoted as low doc where credit assistance providers appeared to rely on statements from accountants to verify a consumer's income. These statements took a number of forms and contained varying levels of detail, from stating that the consumer could make repayments on the proposed home loans without substantial hardship to providing the consumer's specific income details and comments on previous earnings, together with details on the period in which the accountant had been engaged by the consumer.

97 A credit assistance provider may rely on a statement from a consumer's accountant as one type of information to verify income: see Table 4 in RG 209. However, 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.

98 When seeking to rely on statements from a consumer's accountant for income verification purposes, best practice is to ensure the accountant's statement confirms the consumer's actual level of regular income, specifies the basis on which the statement is made, including comments on previous earnings and the underlying information supporting this statement, and identifies the relevant time period for which the accountant has been engaged by the consumer.

99 Additionally, 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. A number of accounting bodies have alerted their members to this issue.

100 It is therefore important to note that s31 of the National Credit Act prohibits a credit licensee from engaging in credit activities if the licensee would be conducting business with an unlicensed person who is engaged in those credit activities in contravention of the National Credit Act.

Other documents used to verify self-employment income

101 In some applications for home loans promoted as low doc, to verify the consumer's income, credit assistance providers relied primarily on Business Activity Statements (BASs) or on various other documents, including statements of estimated commission income, copies of employment contracts, bank statements and/or tax returns.

102 Relying solely on unsupported estimates of future income is not a means of verifying actual income and is not identified in Table 4 of RG 209 as a type of information credit assistance providers could use for this purpose.

103 Where a consumer's self-employment is relatively recent and/or the level of ongoing future earnings is uncertain, credit assistance providers can lessen the risk of not being able to demonstrate that they have taken reasonable steps to verify a consumer's financial situation by considering the consumer's previous work history, including the level of earnings and field of expertise.

Inquiry into and verification of expenses

Variable expenses

104 In the majority of applications for credit assistance reviewed, we found a variable or 'living' expense figure located on a calculator made available by a credit provider or mortgage insurer. It appears that these figures were automatically generated based on the number of people supported by the consumer's income, rather than inquiry into the consumer's actual living expenses. Living expense figures were also found on application forms from the credit provider and the credit assistance provider.

105 Depending on the circumstances, relying on a benchmark figure for living expenses from such a calculator may be sufficient for verifying a consumer's self-reported living expenses. However, relying on such benchmarks will only be satisfactory for verification purposes if the amounts allocated by the calculator are appropriate. Credit assistance providers are therefore responsible for ensuring they have a reasonable basis for relying on the calculator. We are not in a position to comment on the appropriateness of the calculators used.

106 However, we observed files where a variable expense figure was only located on a printout from a calculator made available by a credit provider or mortgage insurer and, on some files, we found no recorded figure for the consumer's variable expenses.

107 Although benchmark figures can be useful for verifying expenses, credit assistance providers can lessen the risk of not being able to demonstrate that they have made reasonable inquiries into and verifications of a consumer's financial situation by recording making inquiries into a consumer's actual living expenses.

108 We also observed files that contained both a consumer's self-reported living expense figure on an application form and a benchmark figure on a printout from a calculator made available by a credit provider or mortgage insurer.

109 We identified instances where these figures were inconsistent, but it was not clear from the file that further inquiries or verifications had been undertaken to confirm the consumer's actual living expenses, and it appeared that the benchmark figure had been relied on for determining whether the consumer could make repayments on the loan without substantial hardship. This conduct places a credit assistance provider at greater risk of not being able to demonstrate they have taken reasonable steps to verify a consumer's financial situation.

110 Where a consumer's self-reported living expense figure is significantly different from a benchmark figure for a consumer's living expenses, credit assistance providers can lessen the risk of not being able to demonstrate that they have taken reasonable steps to verify a consumer's financial situation by recording further steps taken to verify a consumer's actual living expenses. This might include reference to other documents such as bank statements.

Fixed expenses

111 A record of inquiry into a consumer's fixed expenses, such as obligations under existing loans, was identified on nearly all of the files reviewed. In each of these instances the information was contained on the loan application form, and in most of these instances the form readily identified those loans that were intended to be ongoing and those that were to be paid out or refinanced. Having the consumer clearly indicate which loans are intended to be ongoing and which are intended to be refinanced appears to be industry best practice.

112 In nearly all instances where existing loans were to be paid out or refinanced we found a record verifying the terminating expense, all by means of loan statements.

113 Fixed expenses that were ongoing were also identified in the majority of applications. Where we found a record that ongoing fixed expenses had been verified, in nearly every instance this was done by reference to a loan statement. A copy of the loan contract was the other means used for verification purposes.

114 However, we observed files where credit assistance providers had not recorded steps taken to verify the consumer's remaining debt(s), and the associated repayments.

115 Although RG 209.39 notes that credit assistance providers may not always have access to credit reports, we saw many files where credit assistance providers had obtained credit reports. However, it was not always evident that the credit assistance provider had taken steps to make further inquiries into or verifications of the consumers' financial situation based on the information provided in the reports. For example, where the credit report

indicated other credit applications having been made, we identified instances where the credit assistance provider had not recorded confirmation as to the outcome of those applications, whether through a discussion with the consumer or a review of other documentation, such as the consumer's pay slip or bank statements that might detail any other fixed contractual expenses.

116 Credit assistance providers may need to make additional inquiries to verify a consumer's financial situation where information provided by the consumer is inconsistent with other information held: see RG 209.42–RG 209.43. Credit assistance providers who do not take additional steps to verify such inconsistent information are at higher risk of not meeting their responsible lending obligations.

117 Credit assistance providers can lessen the risk of not being able to demonstrate that they have taken reasonable steps to verify a consumer's financial situation by consistently recording further inquiries into or verifications of a consumer's ongoing fixed expenses where the information initially obtained indicates other possible fixed expenses.

Consumers' ability to make repayments without substantial hardship

118 The majority of files recorded how the credit assistance provider had assessed a consumer's ability to make repayments under the proposed loan. However, we reviewed files where credit assistance providers had not recorded how they had assessed a consumer's ability to make repayments under the proposed home loan without substantial hardship.

119 Where there was a record of how the credit assistance provider had assessed a consumer's ability to make repayments under the proposed home loan without substantial hardship, credit assistance providers generally relied on calculators supplied by the proposed credit provider or a mortgage insurer.

120 Such tools may play a role in the credit assistance provider's preliminary assessment, so long as they employ an appropriate method for indicating whether or not a consumer will only be able to meet their financial obligations under the proposed credit contract without substantial hardship. Credit assistance providers are therefore responsible for ensuring they have a reasonable basis for seeking to rely on the tool for these purposes.

121 Credit assistance providers can lessen the risk of not being able to demonstrate that they have assessed whether a consumer would be able to meet their financial obligations under a proposed credit contract without substantial hardship by consistently recording how they assessed the consumer's ability to make repayments.

122 An interest rate buffer was often applied to variable rate loan terms longer than 12 months, in apparent acknowledgment of the potential for interest rates to rise, when assessing the consumer's capacity to make repayments. However, we identified instances where credit assistance providers had applied this interest rate buffer inconsistently to the consumer's other continuing variable rate credit contracts.

123 It was not clear on what basis a interest rate buffer was applied to the proposed variable rate home loan and not other variable rate credit contracts that would be ongoing.

124 Credit assistance providers can lessen the risk of not being able to demonstrate that they have assessed whether a consumer would be able to meet their financial obligations under a proposed credit contract without substantial hardship by applying any interest rate buffers consistently to the consumer's other continuing variable rate credit contracts.

C Further work

Key points

We are following up directly with the individual credit assistance providers that were reviewed about specific concerns and with industry bodies regarding the issues we identified. We will be conducting further reviews of industry compliance with the responsible lending obligations, including a review of the supervision of authorised credit representatives by credit licensees.

125 We are following up directly with the individual credit assistance providers that were reviewed about specific concerns. We are also raising the issues identified with industry bodies and will continue to work with them to assist their members in meeting these new requirements.

126 We understand that some credit assistance providers who intended to become authorised representatives of larger licensed credit assistance providers were not able to do so until the end of December 2010, as some of the larger credit assistance providers delayed appointing their authorised representatives until that point in time. As such, a number of persons who initially registered to engage in credit activities with ASIC, and thus became responsible for compliance with the responsible lending obligations, may have expected to ultimately rely on another person for compliance.

127 Given the significant role that credit assistance providers with a number of authorised credit representatives play in ensuring industry compliance, we are examining how these entities are ensuring compliance with the responsible lending obligations, including how they train, supervise and monitor their authorised representatives.

128 Credit assistance providers have historically been largely unregulated compared to credit providers. The amount of information credit assistance providers have obtained from consumers when assisting them to apply for a home loan has also often reflected the proposed credit provider's requirements. Any changes to the credit policies of ADIs and registrable corporations as a result of having had to comply with responsible lending obligations in their own right from 1 January 2011 may have had a flow-on effect to credit assistance providers' practices and procedures. We therefore also intend to review how credit providers in the home lending market are meeting their responsible lending obligations.

129 We have been undertaking a number of other reviews of responsible lending conduct in various areas of the credit industry. We intend to consider the findings from these reviews and liaise with relevant stakeholders to determine what, if any, further guidance may be required in RG 209.

Key terms

Term	Meaning in this document
ABN	Australian Business Number
ADI	Authorised deposit-taking institution
ASIC	Australian Securities and Investments Commission
BAS	Business Activity Statement
consumer	A natural person or strata corporation Note: See s5 of the National Credit Act.
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that 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 at Sch 1 of the National Credit Act
credit legislation	Has the meaning given in s5 of the National Credit Act
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
credit provider	Has the meaning given in s5 of the National Credit Act
EDR	External dispute resolution
EDR scheme	An external dispute resolution scheme approved by ASIC under the Corporations Act (see s912A(2)(b) and 1017G(2)(b)) and/or the National Credit Act (see s11(1)(a)) in accordance with our requirements in RG 139
Explanatory Memorandum	Explanatory Memorandum to the National Credit Act
IDR	Internal dispute resolution
IDR procedures	Internal dispute resolution procedures that meet the requirements and approved standards of ASIC under RG 165
National Credit Act	*National Consumer Credit Protection Act 2009*, including regulations made for the purposes of that Act

Term	Meaning in this document
registrable corporations	A registrable corporation under s7 of *the Financial Sector (Collection of Data) Act 2001*
RG 209 (for example)	An ASIC regulatory guide (in this example numbered 209)
s47 (for example)	A section of the National Credit Act (in this example numbered 47), unless otherwise specified
Transitional Act	*National Consumer Credit Protection (Transitional and Consequential Provisions) Act 2009*
UCCC	Uniform Consumer Credit Code

Related information

Headnotes

consumer, credit assistance providers, credit licensees, financial situation, home loans promoted as low doc, 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 205 *Credit licensing: General conduct obligations*

RG 209 *Credit licensing: Responsible lending conduct*

Legislation

National Credit Act, s31, 47; Explanatory Memorandum, paragraphs 3.68 and 3.70; Transitional Act

Cases

Cook v Permanent Mortgages [2007] NSWCA 219

Permanent Mortgages v Cook [2006] NSWSC 1104; [2006] NSWSC 1104 (and on appeal [2007] NSWCA 219)

Perpetual Trustee Co Ltd v Khoshaba [2006] NSWCA 41

Reports

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

Treasury's Green Paper, *Financial services and credit reform: Improving, simplifying and standardising financial services and credit regulation* (June 2008)