REPORT 493

Review of interest-only home loans: Mortgage brokers' inquiries into consumers' requirements and objectives

September 2016

About this report

This report follows on from Report 445 *Review of interest-only home loans* (REP 445), which highlighted the importance of responsible lending practices for interest-only home loans.

It describes the practices of 11 large mortgage brokers and trends in the market after REP 445. It identifies good practices as well as opportunities to improve brokers' practices.

Our reviews are intended to promote responsible lending and consumer confidence in the credit industry.

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- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
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Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

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Executive summary

1 This report sets out our findings from a review of the responsible lending practices of 11 large Australian mortgage brokers when assisting consumers to apply for home loans with an interest-only period during the initial part of the loan (interest-only home loans). The report sets out actions that Australian credit licensees (credit licensees) should take to reduce the risk of being unable to demonstrate compliance with their obligations.

2 This review follows on from our previous review of lenders' responsible lending practices for interest-only home loans (lenders interest-only review), which was conducted in the first half of 2015 and published as Report 445 *Review of interest-only home loans* (REP 445).

3 Separate to this review, at the request of the Government, ASIC is currently conducting a review of mortgage broker remuneration structures, and the impact of these structures on consumer outcomes. We will complete this review by the end of 2016.

4 Since the publication of REP 445:

(a) the value of new interest-only home loans approved by Australian authorised deposit-taking institutions (ADIs) has decreased by 9%;

(b) the percentage of new home loans approved by Australian ADIs which are interest-only has decreased by 12%; and

Note: See the Australian Prudential Regulation Authority (APRA), *Quarterly ADI property exposures—June 2016*, 30 August 2016 (QPEX June 2016).

(c) the amount that can be borrowed by an individual consumer through an interest-only home loan has decreased, as a result of lenders changing how they assess consumers' ability to repay in line with our recommendation.

5 Our review of mortgage brokers found that, between the end of the June quarter 2015 and the end of the December quarter 2015:

(a) the number of new interest-only home loans fell by 16.3%, with the total value of these loans reducing by 15.6%; and

(b) the percentage of interest-only loans with a term greater than five years decreased by 54% from 11.2% to 5.1%.

6 Our review of mortgage brokers focused on how mortgage brokers inquire into and record consumers' requirements and objectives to assess whether an interest-only home loan meets their requirements. We found that:

(a) 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

(b) on just under 80% of applications reviewed, we identified a statement summarising how the interest-only feature specifically met the consumer's requirements and objectives (compared to REP 445 where in over 30% of applications reviewed, we found no evidence that the lender had considered whether the interest-only loan met the consumer's requirements).

7 We also found examples of practices that place brokers at risk of being unable to demonstrate compliance with their responsible lending obligations, and identified opportunities for brokers to improve their practices. Key compliance risks identified are as follows:

(a) *Policy and procedures*—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.

(b) *Recording of inquiries*—Record keeping was inconsistent and in some cases records were fragmented and incomplete.

(c) *Narrative statement/rationale*—Just over 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.

(d) *Consumer understanding of risks/costs*—In some cases, where the potential benefit of the interest-only loan depended on the consumer taking specific action (e.g. allocating additional funds to higher interest debt), it was unclear whether the consumer understood the potential risks/additional costs if the specific action was not taken.

Background to our review

8 For many Australians, their home is their most significant asset. For this reason, lending practices in the home finance sector are critical to the financial well-being of Australian consumers.

9 In December 2014 we announced that, in light of growth in the total value of new interest-only home loans, we would review interest-only home loans as part of a broader review by the Council of Financial Regulators into home lending standards: see Media Release (14-329MR) *ASIC to investigate interest-only loans* (9 December 2014).

10 In August 2015, we released REP 445, which summarised findings from our review of lenders' practices when providing interest-only home loans.

11 The lenders interest-only review found that:

(a) only a few lenders had procedures to consistently identify and record consumers' requirements and objectives; and

(b) even where a consumer's requirements and objectives were recorded, the stated analysis could be inadequate to explain why a loan on the terms provided was suitable for the consumer.

12 In REP 445 we also found that a greater proportion of interest-only home loans were arranged through the mortgage broker channel than direct channels (i.e. lenders). More than 50% of consumers use the services of mortgage brokers to assist in securing credit more generally: see Mortgage & Finance Association of Australia (MFAA), March 2016 quarter results.

13 Mortgage brokers are well placed to assist consumers find products that meet their requirements. For these benefits to be realised, it is important that consumers have confidence in mortgage brokers, including their compliance with obligations under the *National Consumer Credit Protection Act 2009* (National Credit Act).

14 In light of these factors and the findings in REP 445, we reviewed how 11 large mortgage brokers inquire into, and record, consumers' requirements and objectives for the purpose of assessing whether an interest-only home loan meets their requirements. For details of the methodology of this review, see Section A and Appendix 1.

15 The responsible lending provisions of the National Credit Act seek to match:

(a) the consumer's requirements and objectives; and

(b) the features of the proposed credit contract.

16 The main differences between interest-only and principal-and-interest loans are in these areas:

(a) *Cost*—If the consumer only makes contractually required payments and does not use an offset account, they will pay more interest over the full term of an interest-only home loan than for a principal-and-interest home loan.

(b) *Repayments*—Under an interest-only home loan, required repayments are lower in the initial interest-only period than required repayments for a principal-and-interest home loan. This gives the consumer additional repayment flexibility during the interest-only period. However, after the interest-only period ends, the required repayments will be higher than repayments that would have applied if a principal-and-interest loan had been obtained at the outset.

(c) *Equity*—If a consumer only makes the minimum required payments during an interest-only period, they will not build equity in the property, unless they make additional repayments to the principal (although their equity may also increase if there is a rise in the value of the property).

17 If a broker fails to conduct reasonable inquiries into a consumer's requirements and objectives, there is a risk that the broker will place the consumer in a loan that is unsuitable under the National Credit Act.

Trends in interest-only home lending

18 In our review of mortgage brokers, we tracked trends in the home lending industry since the publication of REP 445, including how changes recommended for lenders in REP 445 had flowed through to mortgage brokers and the home lending industry more generally.

19 In REP 445 we observed that most lenders were moving to reduce the maximum interest-only period available to owner-occupiers to five years. For those mortgage brokers who provided information on the length of interest-only terms on new home loans, the percentage of home loans with an interest-only period greater than five years had fallen from approximately 11% of all such loans in the first half of 2015 to just over 5% in the December 2015 quarter.

20 All lenders in the lenders interest-only review were using, or were going to change their procedures to use, the residual-term method to assess consumers' ability to meet their financial obligations for interest-only loans.

The 'residual term' method

The repayments used for the purposes of assessing the consumer's capacity are calculated on a principal-and-interest basis on the term of the loan once the interest-only period has expired. For example, if a consumer applies for a 30-year loan, with an interest-only period of 10 years, the assessment is based on principal-and-interest repayments over the residual term of 20 years.

21 Where lenders have adopted the residual-term method to assess consumers' ability to meet their financial obligations, consumers obtaining interest-only loans are now able to borrow less than they would for a principal-and-interest loan for the same amount.

22 Our review of data collected from the mortgage brokers found that, during the second half of 2015, there was a decrease in the number of new interest-only home loan application approvals, falling from a peak of almost 43% of all home loan applications in the June 2015 quarter to less than 36% in the December 2015 quarter.

23 This is in line with data from APRA, which also indicated a downward trend in the percentage of consumers entering into new interest-only home loans during the second half of 2015 and into the March 2016 quarter.

24 In the second quarter of 2016 (based on the most recent figures from APRA), the percentage of new interest-only home loans increased to a level close to that seen at the end of 2015, although the percentage is still well below the same period in 2015: see APRA, QPEX June 2016.

Key findings and recommended actions: Responsible lending

25 In just over 20% of instances there was no statement summarising how the interest-only feature specifically met the consumer's requirements and objectives. This compares with our finding in REP 445 that over 30% of applications reviewed had no evidence that the lender had considered whether the interest-only loan met the consumer's requirements.

26 It was not always evident from brokers' records why a particular loan was selected. Our review found that some brokers only recorded a broad or general comment about the consumer's requirements and objectives (e.g. 'Client is refinancing to a lower rate'). However, it was not readily evident from the records how the selected interest-only home loan met the consumer's requirements and objectives. Statements of this type on their own may not be sufficient to support the decision to recommend an interest-only loan.

27 Even when the requirement for an interest-only home loan was clearly identified or explained, there was often no record of the basis for the specific interest-only period applied for and what was intended after the interest-only period concluded. This was more common for investor home loans than owner-occupier loans.

28 The best files we observed included a logically set out and detailed narrative account of the consumers' short and longer term requirements and objectives, which drew together the consumers' responses to various questions. These accounts also described in detail the reasoning behind selecting a loan with particular features, terms and costs from a particular lender.

29 Good policy and practice for recording inquiries into consumers' requirements and objectives can mitigate the risks of being unable to demonstrate compliance with the responsible lending obligations.

30 This is particularly important for large mortgage broking firms who are responsible for ensuring compliance for a significant number of credit representatives.

31 Some key findings and recommended actions from our review are summarised in Table 1.

Table 1: Responsible lending key findings and actions

Findings	Explanation	Actions
Finding 1: Policy and procedures See paragraphs 104–116	Mortgage brokers' policy and procedures were largely general in nature, and often did not give guidance to representatives on specific loan products or loan features, including interest-only home loans. Where specific guidance was provided on interest-only loans, in all but one instance, it was quite brief and we did not identify any guidance about ensuring the interest-only period meets the consumer's requirements and objectives.	**Action 1: Provide specific guidance on loan products and features** For interest-only home loans (and other loan products or features that may impose an increased financial obligation on the consumer or restrict repayment flexibility), mortgage broking firms should ensure that specific guidance is provided to their representatives about the circumstances in which these loan products and features may be unsuitable, including the relevance of applicable timeframes (e.g. for interest-only repayments or a fixed-interest rate).
Finding 2: Inquiry tools—Records of inquiries See paragraphs 117–128	Although all mortgage broking firms provided tools (often referred to as a 'fact find' or 'needs analysis') to representatives to help them record inquiries into consumers' requirements and objectives, in some cases the mortgage broker's inquiry tool had not been fully completed. Many applications also had information about the consumer's requirements and objectives in separate file notes making it more difficult to quickly identify why the specific loan had been selected. In a few cases, the record of the consumer's requirements and objectives consisted of unstructured file notes interspersed with diagrams.	**Action 2: Ensure all questions are answered** Where mortgage brokers rely on inquiry tools to record their inquiries into consumers' requirements and objectives, they should ensure all questions are answered, including indicating if a response is 'nil' or 'N/A'. **Action 3: Keep all information in one place** Mortgage broking firms can reduce the risk of not being able to demonstrate that they have made reasonable inquiries into a consumer's requirements and objectives by capturing all records of inquiry in one location (e.g. an inquiry tool). This can be particularly relevant where an individual broker no longer represents the mortgage broking firm.
Finding 3: Inquiry tools—Underlying objectives See paragraphs 129–143	Questions on mortgage brokers' inquiry tools generally related to product features rather than seeking to record consumers' underlying objectives. Where inquiry tools allowed consumers' requirements to be prioritised through multiple choice questions, policies and procedures did not guide mortgage brokers on how to resolve a consumer's competing requirements.	**Action 4: Focus on the consumer's underlying objectives** Consumers have varying levels of financial literacy and some will be unfamiliar with various loan features. Mortgage brokers should ensure that they can demonstrate how any features selected meet the consumer's underlying objectives, particularly features with specific costs or risks. **Action 5: Have documented processes where objectives conflict** Mortgage brokers should have clearly documented processes to resolve and record the outcome of conflicting consumer objectives (e.g. specific questions in inquiry tools to identify and record a clear preference).

Findings	Explanation	Actions
Finding 4: Inquiry tools—Level of detail See paragraphs 144–161	Although all inquiry tools had provisions for mortgage brokers to record additional free-text information about consumers' requirements and objectives, the level of detail we observed in applications varied considerably. In some cases, it was not clear why the interest-only loan had been chosen.	**Action 6: Include a concise narrative summary** Good narrative accounts can 'connect the dots' between the consumer's responses to multiple questions and convey a complete picture of their requirements and objectives, including those for products, features (including any relevant timeframes) and lenders. Mortgage brokers can reduce the risk of not being able to demonstrate compliance with the responsible lending obligations by recording a concise narrative summary of the consumer's requirements and objectives and why a product and lender were chosen.
Finding 5: Confirmation of consumers' requirements and objectives See paragraphs 162–168	In most cases, it was unclear whether the consumer had been provided with an explanation of how the proposed loan had been selected. In around one third of applications, and for two particular brokers, the consumer was given a document describing how the proposed loan had been selected. In some cases, brokers asked the consumer to confirm the documents' accuracy.	**Action 7: Provide a summary statement to the consumer** The risk of mortgage brokers not being able to demonstrate compliance with the responsible lending obligations is reduced if the consumer is given a document summarising the broker's understanding of the consumer's requirements and objectives for the consumer to confirm before obtaining a loan. This document could also include a preliminary assessment, in case the consumer requests this later on (which the law allows them to do).
Finding 6: Reasons for length of interest-only period See paragraphs 188–194	In most applications we reviewed, it was not evident why the specific interest-only period was obtained and it often appeared that consumers obtained the longest interest-only period available.	**Action 8: Ensure the interest-only period reflects the consumer's intention** Where the underlying basis for a consumer seeking an interest-only loan relates to a temporary financial situation (e.g. a temporary fluctuation in income or one-off expense), the interest-only period should reflect this.
Finding 7: Specific requests and third-party advice See paragraphs 208–212	In more than 50% of applications, the consumer had sought an interest-only home loan, but the reason was not often clear. In a few cases, the loan was sought based on advice from a third party (e.g. an accountant or financial planner).	**Action 9: Ensure the consumer understands products and features** Where a consumer seeks a specific loan product or feature, mortgage brokers should confirm that the consumer understands how the product or feature operates and any potential risks to ensure the loan is not unsuitable.
Finding 8: Benefits that rely on consumer behaviour See paragraphs 232–235	In some applications, consumers were seeking an interest-only loan to free up funds to more quickly pay higher interest debt, but it was not clear that the consumer understood the potential additional costs if specific actions were not taken.	**Action 10: Ensure the consumer knows what they must do** If the potential benefits of a loan feature require the consumer to undertake specific behaviour, mortgage brokers should ensure that the consumer knows what they must do to obtain the benefit, as well as the potential costs if this action is not taken. Confirmation of this should be documented.

A Background to our review

Key points

To comply with the responsible lending obligations of the National Credit Act, credit licensees, including mortgage brokers, must make reasonable inquiries into a consumer's requirements and objectives for a loan.

We have undertaken several reviews into responsible lending practices for home loan products and published reports of our findings. In REP 445, published in August 2015, we focused on the practices of lenders for interest-only home loans and identified several compliance risks and areas for improvement.

Mortgage brokers currently arrange more than half of all new loans and play an important role in assisting consumers. This review focuses on the policy and practices of 11 large mortgage brokers when inquiring into consumers' requirements and objectives and helping them apply for interest-only home loans.

Why we undertook our review

32 The responsible lending provisions of the National Credit Act require credit licensees, including lenders and mortgage brokers, to make inquiries into consumers' requirements and objectives and their financial situation to ensure they do not obtain an unsuitable loan.

33 For many Australians, their home is their most significant asset and industry practice in the home finance sector is therefore of critical importance to the financial well-being of Australian consumers. Promoting responsible lending, including the maintenance of robust standards in the current low interest rate environment, helps ASIC promote investor and financial consumer trust and confidence, which is one of our strategic priorities.

34 In December 2014 we announced that, in light of growth in the total value of new interest-only home loans, we would review interest-only home loans as part of a broader review by the Council of Financial Regulators into home lending standards: see Media Release (14-329MR).

35 At the same time APRA flagged to ADIs that it would be paying particular attention to specific areas of prudential concern: see APRA, Media Release 14.30 *APRA outlines further steps to reinforce sound residential mortgage lending practices* (9 December 2014).

36 These areas included:

(a) *higher risk mortgage lending*—some examples are high loan-to-income loans, high loan-to-valuation (LVR) loans, interest-only owner-occupier home loans, and loans with very long terms;

(b) *strong growth in lending to property investors*—portfolio growth materially above a threshold of 10% is an important risk indicator for APRA supervisors in considering the need for further action; and

(c) *loan affordability tests for new borrowers*—in APRA's view, these tests should incorporate an interest rate buffer of at least 2% above the loan product rate, and a floor rate of at least 7%, when assessing borrowers' ability to service their loans (good practice would be to maintain a buffer and floor rate comfortably above these levels).

37 In August 2015 we released REP 445, which summarised findings from our review of lenders' practices when providing interest-only home loans.

38 In REP 445 we noted examples of practices that placed lenders at risk of breaching their responsible lending obligations, and noted that all 11 lenders reviewed agreed to change their practices for assessing consumers' ability to repay interest-only home loans. Most also agreed to reduce the interest-only periods. We are continuing to engage with lenders to ensure actions identified in that report are implemented.

39 One of the key risks identified in REP 445 was that nearly all lenders reviewed did not keep sufficient evidence of inquiries into consumers' requirements and objectives when entering into an interest-only home loan. Over 30% of applications reviewed contained no evidence that the lender had considered whether the interest-only home loan met the consumer's requirements.

40 In REP 445 we stated that applications should record inquiries into consumers' requirements and objectives, including whether specific features, benefits and costs associated with an interest-only home loan meet a consumer's objectives.

41 Mortgage brokers are well placed to assist consumers find products that meet their requirements. For these benefits to be realised, it is important that consumers have confidence in mortgage brokers, including their compliance with the National Credit Act.

42 In light of these factors and the findings in REP 445, we reviewed how 11 large mortgage brokers inquire into and record consumers' requirements and objectives for the purpose of assessing that an interest-only home loan meets their requirements.

43 This involved:

(a) collecting loan application data from the mortgage brokers for the 2015 calendar year to identify any trends since the publication of REP 445;

(b) obtaining details of the policies and tools relied on by the mortgage brokers to ensure their representatives comply with their responsible lending obligations to make reasonable inquiries into a consumer's requirements and objectives; and

(c) reviewing 20 applications for interest-only home loans from each mortgage broker (a total of 220 loan applications), with a mix of loans for investment and owner-occupation.

44 For owner-occupied properties, we sought application records from different LVR bands to ensure our review covered consumers across a range of financial positions, who may have different reasons for obtaining an interest-only home loan.

45 For more information about the methodology of this review, see Appendix 1.

Responsible lending obligations

46 The National Credit Act commenced in July 2010, introducing licensing and responsible lending obligations for credit providers and credit assistance providers, including lenders and mortgage brokers.

47 The responsible lending obligations limit the circumstances where credit can be provided to ensure the credit contract meets the consumer's requirements and objectives and that the consumer can meet their financial obligations under the contract without substantial hardship.

Our work on responsible lending obligations

48 Industry compliance with the responsible lending obligations is a key part of ASIC's strategic priority to promote confident and informed participation by investors and consumers in the financial system.

49 We have provided guidance to industry on our expectations in relation to compliance with the responsible lending obligations, in Regulatory Guide 209 *Credit licensing: Responsible lending conduct* (RG 209).

50 We have also undertaken a number of reviews of responsible lending conduct, with a focus on products and practices identified as posing a higher risk of consumer detriment.

51 In March 2008, we published Report 119 *Protecting wealth in the family home: An examination of refinancing in response to mortgage stress* (REP 119). In June 2008, before the National Credit Act was introduced, Treasury published a green paper, *Financial services and credit reform: Improving, simplifying and standardising financial services and credit regulation*.

52 In light of the risks identified in both documents, our initial responsible lending reviews in the home lending sector focused on low documentation (low doc) loans and debt consolidation. This resulted in the following reports:

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

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

(c) Report 358 *Review of credit assistance providers' responsible lending conduct relating to debt consolidation* (REP 358); and

(d) Report 410 *Review of 'low doc' home lending following the introduction of the responsible lending obligations* (REP 410).

53 More recently, as part of the Council of Financial Regulators' monitoring of and response to risks in the home lending sector, we reviewed lenders' responsible lending practices for interest-only home loans. This resulted in the publication of REP 445, which identified several responsible lending compliance risks for such loans and areas for industry improvement.

Interest-only home loans

54 An interest-only home loan is a loan where the consumer is only required to pay the interest on the principal balance for a set period at the commencement of the loan. The principal balance of the loan does not reduce during this period, unless the consumer makes additional payments.

55 At the end of the interest-only period payments will generally increase, with the increased principal-and-interest repayments calculated on repaying the debt in the remaining loan term. For example, on a 30-year loan with an interest-only payment period of five years, the principal-and-interest repayments will be calculated on the remaining 25-year term.

56 In contrast, a principal-and-interest home loan will have regular repayments over the term of a loan, with variations to the repayment amount generally limited to interest rate movements.

57 Interest-only home loans may be combined with an offset account. In these instances, the credit balance of the offset account is deducted from the debit balance on the home loan for the purposes of calculating the interest payable on the home loan.

58 Consumers may deposit funds into an offset account that may have otherwise been repaid to a principal-and-interest home loan, thereby enjoying the benefit of reduced interest charges with the ability to use the funds for other purposes, when needed, in the future.

Interest-only home loans for investors

59 Interest-only home loans have, historically, been popular with investors, largely due to the taxation treatment of negative gearing.

60 A rental property is negatively geared if it is purchased with the assistance of borrowed funds and the net rental income, after deducting other (allowable) expenses, is less than the interest on the loan.

61 The overall taxation result of a negatively geared property is that a net rental loss arises. In this case, the consumer may be able to claim a deduction for the full amount of rental loss against rental and other income (such as salary, wages or business income). Where the other income is not sufficient to absorb the loss, it is carried forward to the next tax year. For more information, see the Australian Taxation Office's webpage on negative gearing.

62 By selecting an interest-only home loan, the consumer does not have a contractual obligation to make repayments on the principal balance. The consumer may choose to direct any surplus funds towards repaying other debt—such as an owner-occupier home loan, which is not tax deductible—or any higher interest rate loan.

Interest-only home loans for owner-occupiers

63 In REP 445 we noted that in recent years there has been substantial growth in owner-occupiers taking out interest-only home loans. Interest-only home loans may be appealing to owner-occupiers for their short term cost savings which may be beneficial in relation to future investment, having more flexible repayments, redirecting cash flow and providing temporary finance: see paragraph 109 of REP 445.

64 While interest-only loans may be appropriate for owner-occupiers in the right circumstances, there are a number of risks, including whether the consumer understands the effect of not making principal-and-interest repayments and can afford such repayments after the interest-only period expires: see paragraph 114 of REP 445.

The role of mortgage brokers

65 In REP 445 we noted that a greater proportion of interest-only home loans were arranged through mortgage brokers rather than directly with lenders. We also found that nearly all lenders reviewed for that report did not keep sufficient evidence of inquiries into consumers' requirements and objectives when entering an interest-only home loan, with over 30% of applications reviewed having no evidence that the lender had considered whether the interest-only home loan met the consumer's requirements.

66 In REP 445 we also noted that, while requirements and objectives for an interest-only loan may be more apparent for investors, it was not always clear how an interest-only home loan met the requirements of an owner-occupier.

67 We previously identified concerns in REP 119 that interest-only home loans arranged through a few fringe mortgage brokers to refinance and/or consolidate consumers' existing debts were not meeting consumers' objectives to reduce their payments and save their family home.

68 In light of these factors, and given that more than 50% of consumers now use the services of mortgage brokers to identify those lenders and products that meet their needs, we considered it important to also review the responsible lending practices of mortgage brokers for interest-only home loans.

69 This report focuses on how mortgage brokers inquire into and record a consumer's requirements and objectives, in order to assess whether an interest-only home loan meets these objectives—with a focus on loans for owner-occupiers.

70 Our review of mortgage brokers also sought to identify how the changes that lenders implemented in response to the findings in REP 445 had flowed through to mortgage brokers.

B Data review findings: The interest-only home lending environment

Key points

Based on data from APRA, there were fewer new interest-only home loans funded by ADIs in the second half of 2015 and into March 2016, with numbers at the end of June 2016 significantly lower than the previous year.

A reduction in interest-only home lending more generally was reflected in the data obtained from the mortgage brokers we reviewed.

Over the same period, lenders appear to have restricted the availability of home loans with an interest-only period greater than five years to owner-occupiers and investors.

Consistent with our findings in REP 445, interest-only home loans appear to be more common with investors and those with higher incomes.

Trends in interest-only home lending

71 In REP 445 we noted that:

> over the past three years, the value of new home loans approved by banks, credit unions and building societies per quarter has increased by more than 40% in Australia—from $58.4 billion in the March 2012 quarter to $82.3 billion in the March 2015 quarter.

72 Overall the growth in home loans through ADIs has continued, with new home loan approvals in the June 2016 quarter totalling $98.3 billion: see QPEX June 2016.

73 In REP 445 we also noted the substantial growth in interest-only home lending since 2012:

> Data collected by APRA shows that the value of interest-only home loans approved by ADIs increased by about 84% from the March 2012 quarter ($18.9 billion) to the March 2015 quarter ($34.8 billion). In comparison, principal-and-interest home lending increased by about 20% over the same period.

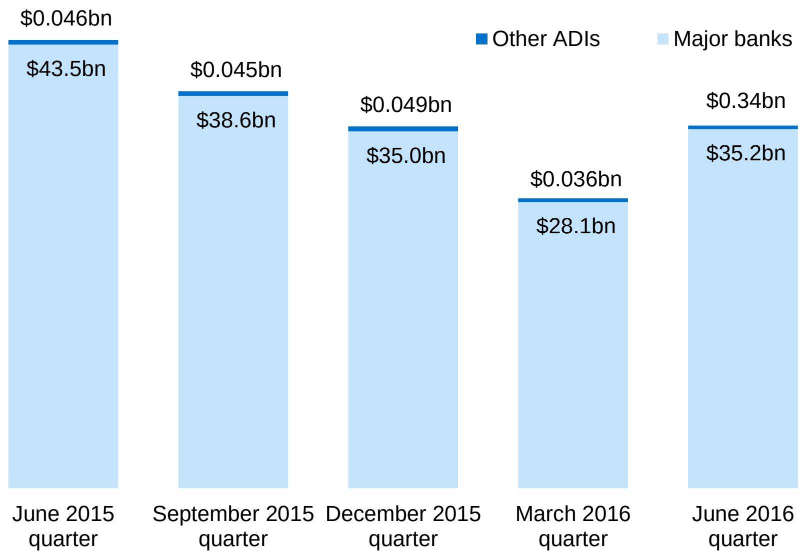
74 On the APRA data available when we compiled our findings for REP 445 (from March 2015), interest-only home lending for ADIs had increased almost 20% from the previous year, and made up around 42% of all new home loans issued in that quarter.

75 This trend reversed during the course of 2015. The APRA data showed new interest-only home lending decreasing from $44.0 billion in the June 2015 quarter to $35.6 billion in the June 2016 quarter.

76 The percentage of interest-only home loans also decreased, from almost 46% to 36% over the same period.

77 Although the second quarter of 2016 saw an increase from the first quarter in new interest-only loans to $35.6 billion, or 36% of new home loan approvals, this reflected an overall increase in home lending. However, both the value and percentage of interest-only loans remained significantly lower than that observed in June 2015: see QPEX June 2016 and Figure 1.

Figure 1: New interest-only home loan approvals (June 2015 quarter to June 2016 quarter)

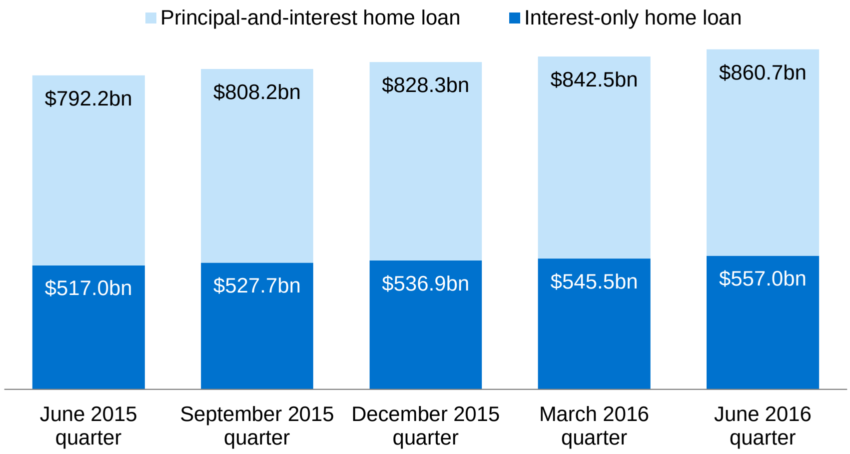


Note: See Table 3 in Appendix 2 for the complete data in this figure (accessible version).

78 Exposure to interest-only home loans by ADIs continues to increase as a percentage of their exposure to residential property, despite the reduction in new interest-only home loans being funded: see Figure 2.

79 This is due, in part, to interest-only home loans not reducing through amortisation—the principal balance of individual loans generally remain unchanged until the interest-only period comes to an end.

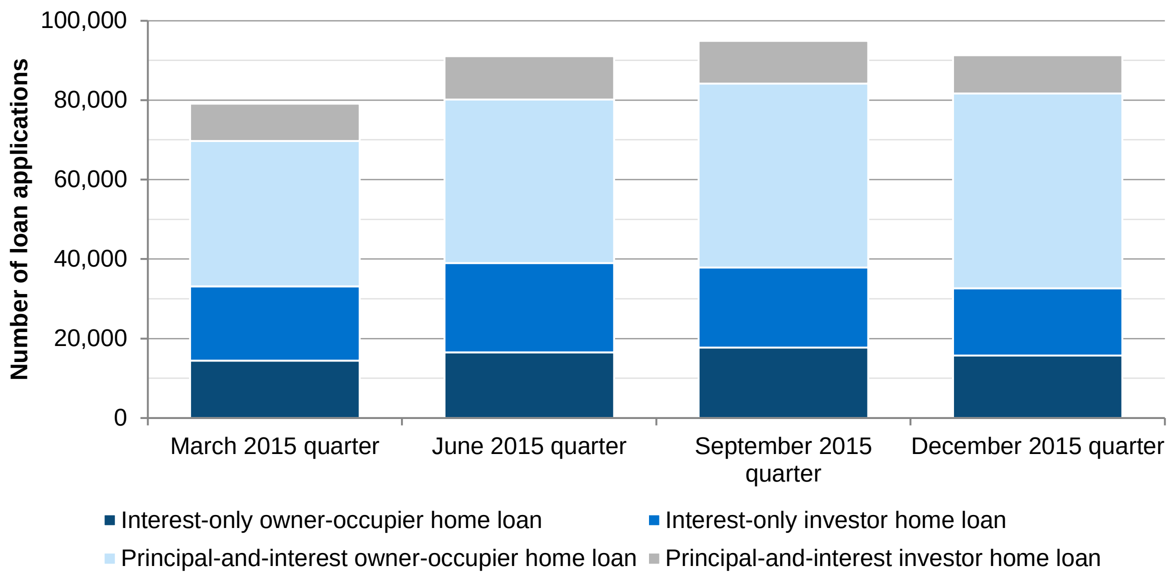
Figure 2: ADI exposure to home loans (June 2015 quarter to June 2016 quarter)



Note: See Table 4 in Appendix 2 for the complete data in this figure (accessible version).

80 This decrease in the number of new interest-only home loans was reflected in the data we obtained from the mortgage brokers as part of this review. The mortgage brokers reported 40% of all applications for home loans submitted by them during 2015 were for interest-only home loans (a total of 142,622); this peaked in the June 2015 quarter at slightly under 43% (38,980) and declined over the remaining period to represent less than 36% in the December 2015 quarter (32,644): see Figure 3.

Figure 3: Applications for interest-only and principal-and-interest home loans in 2015



Note: See Table 5 in Appendix 2 for the complete data used in this figure (accessible version).

Investor home loans

81 At their peak in the June 2015 quarter, applications for investor home loans by the mortgage brokers we reviewed represented over 36% of home loan applications. By the December 2015 quarter, the percentage had fallen to 29%. This also reflects the ADI trend, with the APRA data showing investor home lending accounting for nearly 42% of all home loans in the June 2015 quarter, falling to 36% in the June 2016 quarter: see QPEX June 2016.

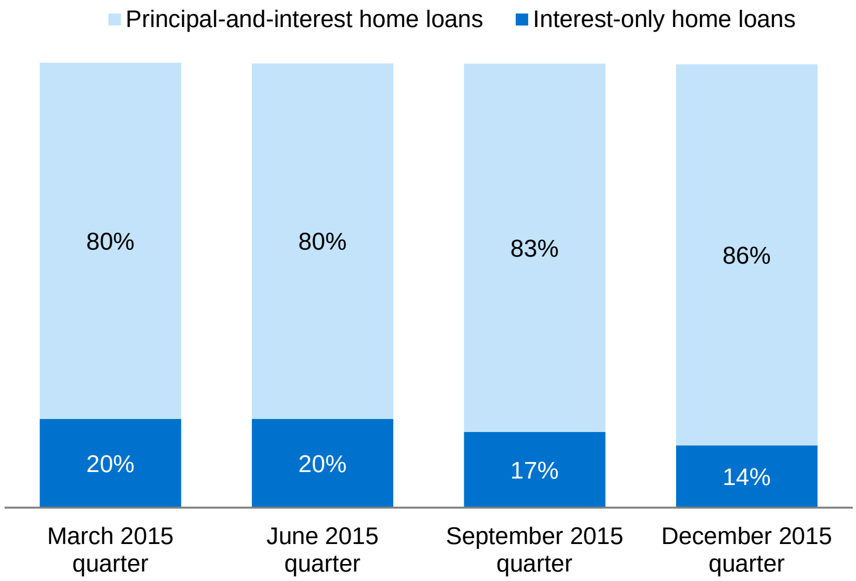
82 The percentage of the applications for interest-only investor home loans also fell, from nearly 67% of all investor loans in the March 2015 quarter to less than 64% in the December 2015 quarter.

Owner-occupier home loans

83 At their peak, in the June 2015 quarter, the number of applications submitted by the mortgage brokers we reviewed for interest-only home loans represented almost 29% of all applications for owner-occupier home loans. This declined to less than 25% in the December 2015 quarter.

84 From the information provided by the mortgage brokers, interest-only home loans were less popular with first home buyers than they were for consumers with a previous home loan. Less than 20% of first home buyers applied for an interest-only home loan in the March 2015 quarter, falling to under 15% in the December 2015 quarter: see Figure 4.

Figure 4: First home buyers by loan type (March 2015 quarter to December 2015 quarter)



Note: See Table 6 in Appendix 2 for the complete data in this figure (accessible version).

Industry and product profile

Home loan lenders

85 We sought information on each mortgage broker's six most frequently used lenders for interest-only home loans, for both owner-occupier and investor home loans, during 2015. In total, 24 lenders were represented across the 11 mortgage brokers in our review, with 15 lenders represented for both investor and owner-occupier home loans. Three lenders were represented solely for investor home loans and six solely for owner-occupier home loans.

86 In 2015, the four major banks featured in all of the mortgage brokers' top six lenders. Five mortgage brokers listed these banks in their top six lenders for both owner-occupier and investor home loan applications for each quarter.

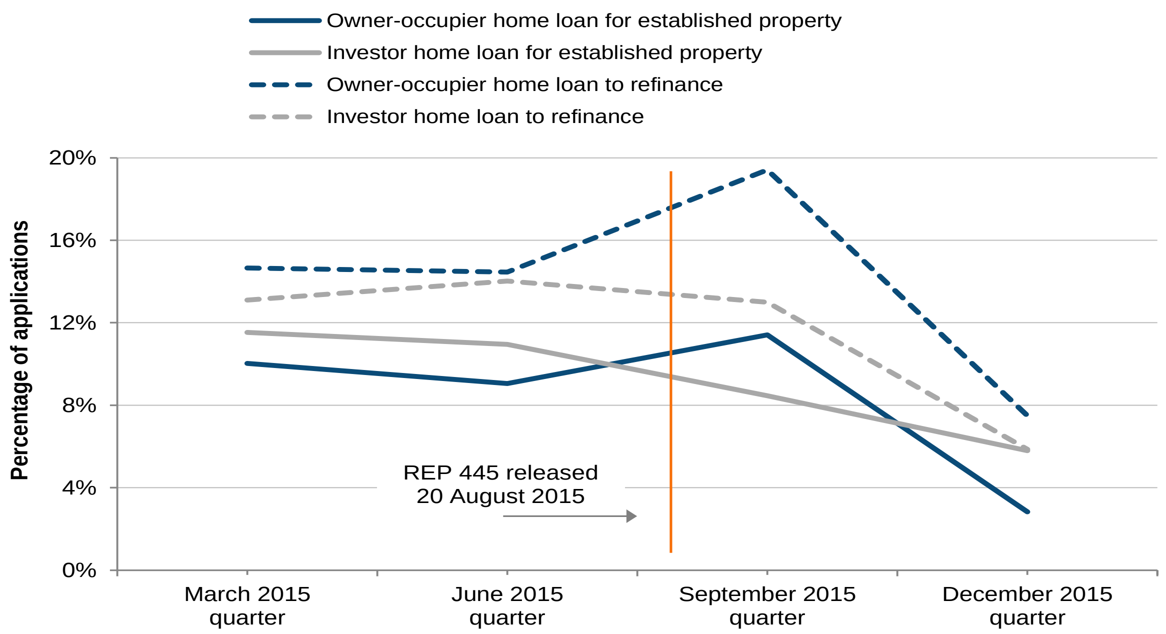
Interest-only periods

87 We also sought information on the length of the interest-only periods, categorised by the primary purpose of the loan.

88 For those mortgage brokers who provided data on interest-only periods, the interest-only periods for investor home loans were more likely to be longer than owner-occupier loans. In addition, loans with interest-only periods greater than five years reduced noticeably in the December 2015 quarter.

89 In the first two quarters of 2015, home loans with interest-only periods longer than five years made up approximately 11% of all interest-only home loans. By the December 2015 quarter, this had fallen to just over 5%.

Figure 5: Percentage of new investor and owner-occupier home loans with an interest-only period longer than five years (March 2015 quarter to December 2015 quarter)



Note: See Table 7 in Appendix 2 for the complete data in this figure (accessible version).

90 In REP 445 we encouraged lenders to review their policies on the maximum length of interest-only periods offered, particularly to owner-occupiers, to reduce the risk of non-compliance with the responsible lending obligations.

91 Most lenders in the lenders interest-only review committed to reducing the maximum interest-only period offered to owner-occupiers to five years.

92 It appears from the data provided by the mortgage brokers in this review that lenders have limited interest-only periods to five years for investor loans as well.

93 None of the mortgage brokers were readily able to provide aggregate data on what transpires once the interest-only period expires—for example, the proportion of loans that are paid out through the sale of an asset, refinanced or have the interest-only period extended. We would expect this information, and information about the performance of interest-only home loans more generally, to be available from lenders.

94 We note that where a loan is refinanced, a new responsible lending assessment would need to be undertaken. However, where the lender allows an extension of the interest-only period and the credit limit is not increased, the requirement to undertake a new assessment would not be triggered.

Consumer profile

Consumer income

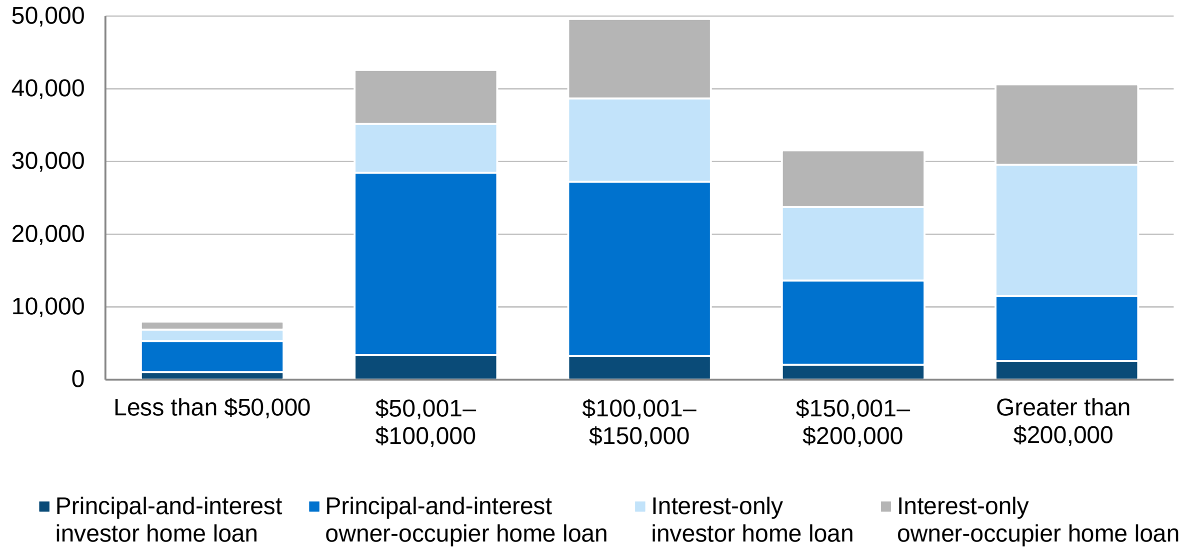
95 In REP 445 we noted that consumers who earned more than $100,000 a year made up 81% of investors with interest-only home loans and 70% of owner-occupiers with interest-only home loans. For principal-and-interest loans, consumers who earned more than $100,000 a year made up 59% of investors and 51% of owner-occupiers. This indicated that consumers who earned more than $100,000 a year were more likely to obtain an interest-only loan than consumers on lower incomes.

96 The data we received from the mortgage brokers for this review indicates a similar trend; 83% of investors and 78% of owner-occupiers who entered into interest-only home loans earned in excess of $100,000 per year, compared to 64% of investors and 60% of owner-occupiers who entered into principal-and-interest home loans: see Figure 6.

97 For consumers with an income over $200,000 per year, this difference was even more pronounced—29% of these consumers entered into interest-only owner-occupier home loans and 38% of these consumers entered into interest-only investor home loans compared to those who entered into principal-and-interest loans (12% for owner-occupier and 21% investor).

98 Two thirds of consumers earning over $200,000 per year obtained interest-only home loans compared to less than half of those on annual incomes below $200,000 and around one third of consumers earning $100,000 or less.

Figure 6: Approved loans by total household income and loan type

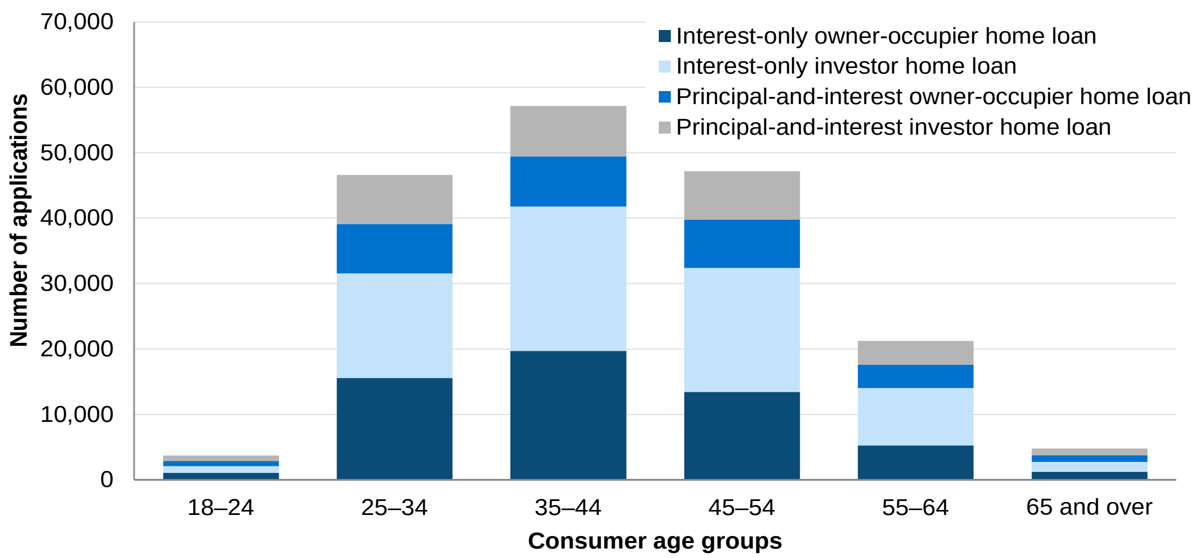


Note: See Table 8 in Appendix 2 for the complete data in this figure (accessible version).

Consumer age groups

99 In line with our findings in REP 445, the most common age group for owner-occupiers taking out an interest-only home loan was 35–44 years, accounting for 35% of these loans: see Figure 7. However, this age group was also the most represented for all other loan types and purposes.

Figure 7: Consumer age groups, by loan type



Note: See Table 9 in Appendix 2 for the complete data in this figure (accessible version).

C Responsible lending findings: Policies and tools

Key points

Mortgage brokers' procedures and policies provided only general information rather than tailored information on specific products and loan features that may impose increased financial obligations or restrict repayment flexibility for consumers.

All 11 mortgage brokers had inquiry tools (e.g. a fact find and needs analysis) that prompted questions and helped credit representatives record their inquiries into a consumer's requirements and objectives. However, these tools were of varying detail, and were not used consistently.

The risk of brokers not being able to demonstrate compliance with the responsible lending obligations is reduced if consumers are given a document summarising the broker's understanding of the consumer's requirements and objectives for the consumer to confirm before selecting a loan.

General conduct and responsible lending obligations

100 Credit licensees have a number of general conduct obligations under s47 of the National Credit Act. These obligations include taking reasonable steps to ensure that their credit representatives comply with the legislation and having adequate arrangements and systems to ensure compliance.

101 Regulatory Guide 205 *Credit licensing: General conduct obligations* (RG 205) outlines key compliance concepts, describes what we look for when assessing compliance and provides questions to help licensees test their compliance measures.

102 Regulatory Guide 209 *Credit licensing: Responsible lending conduct* (RG 209) sets out our expectations for compliance with the responsible lending obligations, including licensees' obligation to make reasonable inquiries into consumers' requirements and objectives.

103 In RG 209 we note that reasonable inquiries could include inquiries about:

(a) the amount of credit needed;

(b) the timeframe for which credit is required;

(c) the purpose for which credit is sought and the benefit to the consumer;

(d) whether the consumer seeks certain product features or flexibility, the relative importance of different features and whether they are prepared to accept any additional costs or risks associated with those features; and

(e) whether the consumer requires any additional expenses (e.g. premiums for insurance related to the credit) to be included in the amount financed and whether they are aware of the additional costs.

Policy and procedures

104 We previously reviewed mortgage brokers' monitoring and supervision of their credit representatives. Our findings from that review, including observations on good practice, are set out in REP 330.

105 In REP 445 we found that only a few lenders had procedures to consistently identify and record consumers' requirements and objectives.

106 As our focus for this review was on brokers' inquiries into consumers' requirements and objectives, we asked the 11 mortgage brokers to provide their policies and procedures and a description of how they satisfy themselves that a particular product and particular lender selected by a credit representative meet an individual consumer's requirements and objectives.

107 The mortgage brokers' guidance addressed all of these matters, generally by paraphrasing or quoting directly from our guidance in RG 209. Our guidance is, by necessity, of a general nature. Mortgage brokers' policies should be tailored to their specific business and circumstances.

108 One mortgage broker's responsible lending policy posed a number of questions for the credit representative to consider when making inquiries into a consumer's requirements and objectives:

(a) What needs and goals does the consumer have?

(b) Is this a routine owner-occupier home loan or something more complex?

(c) Is the consumer self-employed? Do they have difficulty evidencing their income?

(d) Is the consumer in financial hardship and looking to restructure an existing debt?

109 Guidance such as this can provide useful prompts for making reasonable inquiries into a consumer's requirements and objectives. However, it was not always evident from individual credit representatives' records the extent to which these questions were considered.

110 One mortgage broker's policy was an abridged version of the guidance provided in RG 209, with no further elaboration as to how this guidance should be put into practice.

111 A lack of guidance tailored specifically for the licensee's business places mortgage brokers at greater risk of not being able to demonstrate their compliance with their general conduct obligations under s47, including the obligation to take reasonable steps to ensure the compliance of their credit representatives.

112 As noted in RG 205, it is also important that mortgage brokers have initial and ongoing training, as well as regular reviews, of their representatives to ensure compliance with the responsible lending obligations.

Guidance on interest-only home loans

113 In general, guidance was not structured with specific sections on each and every loan product or feature. Rather, guidance was presented as an overall view of responsible lending and highlighted specific loan features that may impose additional costs or obligations on a consumer (such as a fixed rate or interest-only payments) and for which additional discussions with the consumer may be required to establish unsuitability.

114 Where interest-only home loans were noted in the policies, they were generally referred to as part of the obligation to make inquiries into a consumer's requirements and objectives, although one mortgage broker's guidance had a dedicated section for interest-only home loans. In two cases, we did not identify any reference specifically to interest-only home loans.

115 Only one mortgage broker's guidance referred directly to REP 445, while another broker quoted findings from REP 445 without making direct reference to the report. One further broker advised us that, as a result of the findings in REP 445, interest-only home loans had been a focus of recent training.

116 In those instances where specific guidance was provided on interest-only home loans it was, with the exception of one mortgage broker, quite brief. Further, we did not identify specific guidance about ensuring the interest-only period meets the consumer's requirements and objectives.

Action 1: Provide specific guidance on loan products and features

For interest-only home loans (and other loan products or features that may impose an increased financial obligation on the consumer or restrict repayment flexibility), mortgage broking firms should ensure that specific guidance is provided to their representatives about the circumstances in which these loan products and features may be unsuitable, including the relevance of applicable timeframes (e.g. for interest-only repayments or a fixed-interest rate).

Tools for recording inquiries into consumers' requirements and objectives

117 We also obtained details of inquiry tools (often referred to as a 'fact find' or 'needs analysis'), which may take the form of a software program or a hard copy document, and are relied on by mortgage brokers to ensure that their credit representatives comply with the responsible lending obligations to make reasonable inquiries into a consumer's requirements and objectives.

118 For some mortgage brokers, information about the consumer's requirements and objectives was one of the first pieces of information recorded in their inquiry tool, while others recorded this information after recording the details of the consumer's financial situation.

119 While the manner in which the inquiry tools are laid out may not necessarily reflect how individual credit representatives converse with their clients, recording the results of inquiries into consumers' requirements and objectives upfront can help ensure that appropriate focus is placed on this obligation.

120 All mortgage brokers' tools adopted a mix of questions inviting one or more objectives or product features to be selected from specific lists (multiple choice questions), and questions that invited a free-text response.

Full completion of the tool

121 It was apparent that not all questions in the inquiry tools were required to be answered. Where a question does not to apply to a consumer's specific circumstances, good practice is to note 'nil' or 'N/A'.

122 We noted a number of instances where the inquiry tool was not completed in full, but there were separate free-text file notes detailing the consumer's requirements and objectives. There is a risk that, by not completing all questions in the inquiry tool, the broker may overlook consumer requirements and objectives that could affect the suitability of the suggested product.

123 In some instances, a broad comment was made about the consumer's requirements and objectives (e.g. 'Client is refinancing to a lower rate'). However, it was not readily evident from the records how the selected interest-only home loan met the consumer's requirements and objectives.

124 By ensuring that all inquiry tool questions have been responded to, mortgage brokers may be better able to demonstrate that they have made reasonable inquiry into consumers' requirements and objectives.

Action 2: Ensure all questions are answered

Where mortgage brokers rely on inquiry tools to record their inquiries into consumers' requirements and objectives, they should ensure all questions are answered, including indicating if a response is 'nil' or 'N/A'.

Maintaining complete records

125 In our review of applications, we identified a number of instances where the inquiry tool was supplemented by additional notes providing more detail about the consumer's intentions. In a small number of applications, the recording of the consumer's requirements and objectives consisted of unstructured notes interspersed with diagrams.

126 Using additional documents to record inquiries into a consumer's requirements and objectives rather than fully completing the mortgage broker's inquiry tool increases the risk of not recording information relevant to the assessment of unsuitability.

127 Data captured on the mortgage broker's inquiry tool has the additional benefit of being stored centrally and electronically. This may not be possible for manual file notes, increasing the risk of notes being misplaced or lost, or otherwise not readily available to the mortgage broking firm—particularly where the individual broker who made the notes no longer represents the firm.

128 Brokers need to be mindful that there may be instances where individual loan applications will be reviewed by third parties, whether as part of a compliance review or a dispute before an approved EDR scheme. In these instances, clear and structured records, including a coherent narrative account of the consumer's specific circumstances, can reduce the risk of mortgage brokers not being able to demonstrate compliance.

Action 3: Keep all information in one place

Mortgage broking firms can reduce the risk of not being able to demonstrate that they have made reasonable inquiries into a consumer's requirements and objectives by capturing all records of inquiry in one location (e.g. an inquiry tool). This can be particularly relevant where an individual broker no longer represents the mortgage broking firm.

Cost of the loan

129 In previous reports, we have noted the importance of mortgage brokers recording consumers' objectives for the cost of the credit contract—whether those objectives relate to the interest rate, repayment amounts or the total amount payable over the credit contract.

130 In REP 445 we noted that if one of a consumer's stated requirements and objectives is to minimise the overall cost of the loan, an interest-only loan would seem at face value to conflict with this objective, and that further inquiries would be warranted to ensure the proposed loan would be suitable.

131 In the inquiry tools we reviewed, we did not identify multiple choice questions inviting a response of 'low interest rate' or 'lowest total cost', although we did identify questions on lowering repayment amounts. We identified some applications with free text comments that recorded a lower interest rate as a consumer objective; no applications recorded an objective of lowest total cost.

132 Where consumers are placed in a potentially higher total cost product, it is important that credit representatives clearly record their discussions with consumers, including any other specific requirements and objectives, to reduce the risk of not being able to demonstrate that the loan ultimately chosen was not unsuitable.

Explaining product features

133 Multiple choice questions generally related to product features (e.g. offset account, redraw facility, interest rate and repayment type), rather than recording consumers' underlying objectives (e.g. the ability to make additional repayments and have access to these funds in future, or certainty of repayment amount).

134 Consumers have varying levels of financial literacy and experience with home loans, and some will therefore not be familiar with all the features and their costs and benefits. It is the broker's responsibility to ensure that any features selected in fact meet consumers' underlying objectives.

135 One mortgage broker's inquiry tool provided brief descriptions of an underlying objective for loan features (e.g. 'Redraw facility—It is important to have access to additional repayment funds should it be required'). There was also a separate free-text field to prompt the credit representative to disclose to the consumer any significant costs or risks (e.g. break costs).

Action 4: Focus on the consumer's underlying objectives

Consumers have varying levels of financial literacy and some will be unfamiliar with various loan features. Mortgage brokers should ensure that they can demonstrate how these features meet the consumer's underlying objectives, particularly features with specific costs or risks.

Prioritising product features

136 Multiple choice questions, used in isolation, may also present challenges in instances where a consumer identifies a number of objectives that cannot all be satisfied and/or has conflicting objectives.

137 In REP 262 we noted that by consistently recording the relative priority of consumers' requirements and objectives, licensees could reduce the risk of not being able to demonstrate they have assessed whether credit contracts meet consumers' requirements and objectives.

138 Five mortgage brokers' inquiry tools had specific fields to rank the importance of loan features. Two of the five brokers adopted a 10-point scale for each loan feature, with the questions worded in way that identified a specific risk that a loan feature may address—such as: 'On a scale of 1–10, how concerned are you about rising interest rates?'. These questions were asked separately for each consumer who was a party to the proposed loan.

139 Four mortgage brokers rated the product features based on how important the consumer deemed them to be—for example, one broker adopted a ranking of 'must have', 'don't mind' and 'not required'.

140 One of these mortgage brokers adopted both the 10-point scale and ranking of importance, with the particular method applied depending on the type of questions. The ranking applied to the desirability of product features and the 10-point scale applied to questions designed to gain an understanding of the consumer's risk sensitivity.

141 In all instances, the inquiry tools provided the ability to enter free-text comments to expand on the consumer's preferences.

142 Where inquiry tools allowed brokers to prioritise consumers' requirements, it was possible for competing requirements to be given equal weight. This factor is further complicated for joint borrowers who prioritise their objectives and requirements differently.

143 In such cases, it is important that mortgage brokers have a way to record how the conflict between competing priorities is resolved and a specific product selected.

Action 5: Have documented processes where objectives conflict

Mortgage brokers should have clearly documented processes to resolve and record the outcome of conflicting consumer objectives (e.g. specific questions in inquiry tools to identify and a record a clear preference).

Choice of lender

144 In REP 262, we noted that we did not often observe information about the choice of a specific lender. In this review we noted five mortgage brokers had specific fields to record the lenders, or the type of lender, the consumers did or did not want to use.

145 In a small number of instances the records indicated that the consumer was unhappy with their current lender. In each instance the consumer did not state a preference for a particular lender for the new loan; rather they did not want a further loan with the existing lender.

146 Where consumers stated a lender preference, it was for their current lender. We did not identify any instances where a consumer had specifically identified a particular lender that was not their current lender.

147 Our review of application records found that, where lender preference was specifically recorded, detail was often provided by way of a free-text description by the broker.

148 In some instances, the mortgage broker offered alternative lenders for the borrower's consideration. On one application the file note states:

> Customer prefers to have his loan with [specific lender] as he is existing client and he is happy with a quick turnaround time and service. Other lenders' information provided however applicant insists on this lender.

149 We also noted a number of instances where the lenders selected were based heavily on service levels. In one instance the file note stated: 'Customers have chosen [specific lender] as they need this approval quickly and [the lender] has sharp turnaround times'.

Consumers' longer term objectives

150 In REP 262 we noted that credit licensees could reduce the risk of not being able to demonstrate that they have made reasonable inquiries into consumers' requirements and objectives by recording consumers' medium-term to long-term objectives, beyond the immediate purpose of the credit.

151 Of the 11 mortgage brokers, ten had multiple choice questions to clarify details about the timeframe for which credit was required, with one broker having specific questions to identify short-term, medium-term and long-term goals.

152 However, it appeared that most mortgage brokers generally relied on free-text notes to capture information about consumers' longer term objectives, beyond the immediate purchase of property or refinancing an existing loan.

153 In REP 445 we noted a lack of records about the reasons for the length of the interest-only period required by consumers. In this review, we also observed files with a similar lack of records. Where the reason for the length of the requested interest-only period was recorded, it was through free text rather than specific prompts or questions in the brokers' materials.

154 When assisting a consumer to obtain an interest-only home loan, brokers should ensure their credit representatives inquire into and record how the specific interest-only period meets the consumer's requirements and objectives.

Narrative records of the consumer's requirements and objectives

155 All the mortgage brokers' inquiry tools had free-text fields, which allowed the credit representative to record the consumer's underlying objectives and provide a more detailed rationale on how the loan met the consumer's requirements and objectives.

156 While free text provides the flexibility to record the individual consumer's requirements and objectives, credit representatives need to ensure that they record all relevant information so they can demonstrate that the selected product meets the consumer's requirements and objectives.

157 The level of detail in the free-text notes we observed in the applications varied considerably—both in how the credit representatives recorded the consumers' requirements and objectives and explained how the specific product ultimately selected met these.

158 In one instance, there were no free-text comments recorded, with the area in the inquiry tool left blank and only some multiple choice questions about preferred product features completed. In such cases, mortgage brokers are at increased risk of not being able to demonstrate the product is not unsuitable, particularly if the individual broker is no longer a credit representative.

159 A good example of recording a consumer's requirements and objectives was this note from one mortgage broker's records:

> A little background: This application is a result of discussions with the applicants' Accountant prior to contacting me. They have 2 young children and are looking to purchase a larger home in approximately 2 years. They currently have funds exceeding the loan balance in an offset account and by converting their existing home loan to Interest only (from [a principal-and-interest home loan]) resulted in them not having to contribute any further funds toward paying down the existing Principal. This allows them to continue to save for a higher deposit on the new intended purchase. The existing property is to be retained and converted into an investment once the new owner-occupied home is purchased. Accountant had advised them to not pay anything further off the principal to maximise their tax deductibility following this transition. The applicants also indicated that they didn't want to change lenders.

160 Another good example we identified stated:

> I originally completed the assessment and recommendations around [a principal-and-interest home loan] and I also sent them a budget planner to help with their cash flow projections. They purchased in the affluent suburb of …, they're high income earners and very wealthy parents on both sides and they wanted flexible amount [interest-only] repayments so they could complete some renovations to the property and also maximise tax deductibility if it becomes an investment property.

161 This shows that comments need not always be lengthy to demonstrate inquiry into a consumer's requirements and objectives and how these are met by the loan product. Such narrative accounts can be particularly effective in connecting the dots of responses to multiple choice questions in order to convey a complete picture of the consumers' requirements and objectives and why a particular loan from a particular lender was chosen.

Action 6: Include a concise narrative summary

Good narrative accounts can 'connect the dots' between the consumer's response to multiple questions and convey a complete picture of their requirements and objectives, including those for products, features (including any relevant timeframes), and lenders.

Mortgage brokers can reduce the risk of not being able to demonstrate compliance with the responsible lending obligations by recording a concise narrative summary of the consumer's requirements and objectives and why a particular product and lender were chosen.

Confirmation of consumers' requirements and objectives

162 Under the National Credit Act mortgage brokers must undertake a responsible lending assessment of unsuitability—which takes into account the consumer's requirements and objectives, their financial situation and their ability to meet future financial obligations—before assisting or suggesting a consumer obtain a specific credit contract.

163 This assessment is known as a preliminary assessment. Where a consumer asks the mortgage broker to provide them with a copy of the preliminary assessment within two years of the brokers' quote, the broker must provide the consumer with a written copy before the end of seven business days. However, there is no obligation under the National Credit Act for mortgage brokers to provide consumers with copies of unsuitability assessments at the time of providing credit assistance.

164 In REP 330 we noted that licensees can reduce the risk of not being able to provide a preliminary assessment in the required timeframe by having direct access to the preliminary assessment and all documents that form the basis of that assessment from the date the credit assistance is provided.

165 In around one third of the applications we reviewed, it was evident that the consumer had been provided with a description of how the proposed loan had been selected. In some cases, this information was part of the broker's credit proposal disclosure document. In some cases, the consumer also confirmed the details on which the loan was selected were correct.

166 It was evident from the records of two mortgage brokers that most of the consumers received a description of how the product was selected. We found evidence that some consumers had received details of how the product was selected on all but one broker's files.

167 We see this practice as prudent, as it potentially removes doubt surrounding the understanding of the consumer's requirements and objectives when the credit assistance was provided and allows the consumer to review the document before entering into the credit contract.

168 Mortgage brokers should keep in mind that any risk of non-compliance may not be reduced where the information provided to the consumer is insufficient to demonstrate that reasonable inquiries have been undertaken.

Action 7: Provide a summary statement for the consumer

The risk of brokers not being able to demonstrate compliance with the responsible lending obligations is reduced if the consumer is given a document summarising the broker's understanding of the consumer's requirements and objectives for the consumer to confirm before obtaining a loan.

This document could also include a preliminary assessment, in case the consumer requests this later on (which the law allows them to do).

D Responsible lending findings: Record of inquiries

Key points

All applications included records of inquiry into the consumers' requirements and objectives in seeking an interest-only home loan, with flexibility, future investment and minimising payments being some of the most commonly recorded reasons. However, based on the records we reviewed, some of these inquiries were limited.

Some applications for interest-only home loans recorded consumer objectives that would require a particular course of future action (e.g. pay off the loan quicker through use of an offset account or repayment of higher interest debt). Mortgage brokers can reduce the risk of being unable to demonstrate the suitability of the loan by advising consumers of the risks if the future action is not taken, and documenting this advice accordingly.

Consumers borrowed a median amount equal to 69% of what they could have obtained, based on calculations identified on application records. Where lenders assess consumers' ability to repay a loan based on the residual-term method (as recommended in REP 445), the maximum amount a consumer can borrow through an interest-only home loan is less than what they can borrow through a principal-and-interest home loan.

Responsible lending obligations

169 Under the National Credit Act, lenders and mortgage brokers must make reasonable inquiries into consumers' requirements and objectives and ensure that consumers only obtain credit contracts that meet those requirements and objectives.

170 All credit licensees are required by conditions on their licence to keep a record of all material that forms the basis of an assessment of whether a credit contract or consumer lease will be unsuitable for a consumer. This record must be kept in a form that will enable the licensee to give the consumer a written copy of the assessment if a request is made.

171 In REP 330 we noted that licensees that rely on their credit representatives to maintain records are at an increased risk of not being able to demonstrate that they have meet their licence conditions, particularly where the authorisation of a credit representative is terminated in adverse circumstances.

172 In REP 445 we found that nearly all lenders reviewed did not keep sufficient evidence of inquiries into consumers' requirements and objectives when entering an interest-only home loan.

173 In RG 209 we note that credit providers may be provided with information about a consumer by a mortgage broker. We also state that we expect reasonable and prudent credit providers to have processes in place to ensure the reliability of information collected by third parties.

174 As noted in paragraph 103, RG 209 states that reasonable inquiries could include inquiries about:

(a) the amount of credit needed;

(b) the timeframe for which credit is required;

(c) the purpose for which credit is sought and the benefit to the consumer; and

(d) whether the consumer seeks certain product features or flexibility, the relative importance of different features and whether the consumer is prepared to accept any additional costs or risks with those features.

Records of inquiry into consumers' requirements and objectives

175 For our review of mortgage brokers, we obtained records for 20 interest-only home loan applications from each broker (a total of 220 loan applications), including 15 applications to purchase or refinance an owner-occupied property and five applications to purchase or refinance an investment property.

176 To obtain a cross section of files for interest-only home loan applications for owner-occupier properties, we obtained records across three LVR bands:

(a) less than 60% LVR (lowest LVR band);

(b) 60–80% LVR (mid-range LVR band); and

(c) 80% or greater LVR (highest LVR band).

177 We placed an additional focus on owner-occupier loans, as REP 445 had noted that while requirements and objectives for an interest-only home loan may be more apparent for investors, it was not always clear how an interest-only home loan met the requirements of an owner-occupier.

178 Our review of the mortgage broker applications found that in all instances inquiries into the consumers' requirements and objectives were recorded; however, based on the records, some of these inquiries were limited.

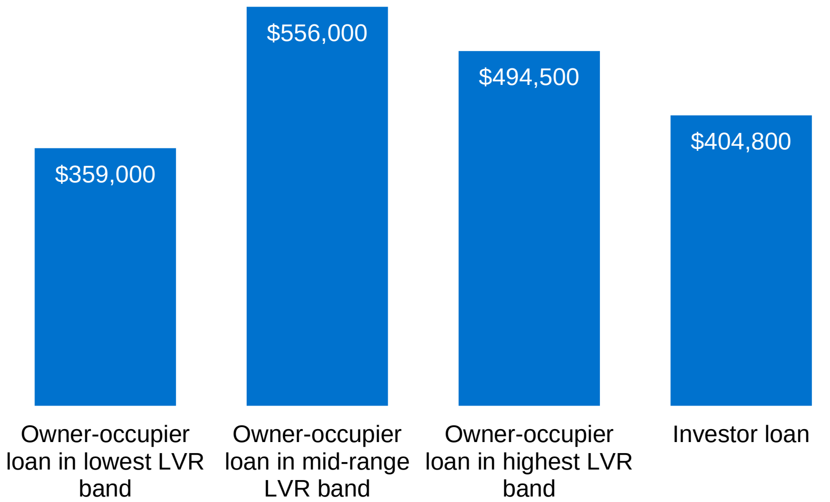
Loan amount

179 In REP 445 we noted that, on average, consumers borrow more under an interest-only home loan—possibly because of the lower initial repayment figure and the effect of 'present bias'. We also noted that this may be an incentive for mortgage brokers to recommend an interest-only home loan, because of the higher commissions paid on greater loan amounts.

180 We did not review commissions as part of this review, as ASIC is currently undertaking a separate review of broker remuneration structures and their effect on consumer outcomes.

181 The median loan amount in the applications we reviewed was highest in the mid-range LVR band (where the average age of borrowers was youngest), while the applications in the lowest LVR band (where the average age of borrowers was highest) had the lowest median loan amount: see Figure 8.

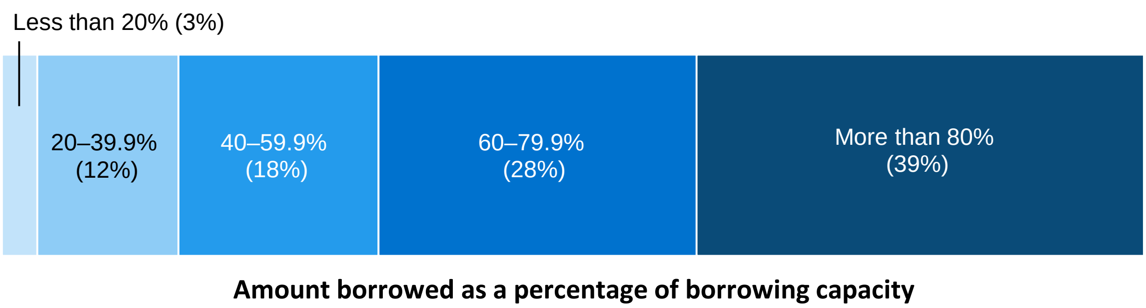
Figure 8: Median loan amount for interest-only home loans, by LVR band



Note: See Table 10 in Appendix 2 for the complete data in this figure (accessible version).

182 Nearly two-thirds of the applications included calculations of the consumer's ability to meet their financial obligations and estimated the maximum loan amount for which the consumer would qualify. Consumers applied for a median amount equal to 69% of their borrowing capacity: see Figure 9.

Figure 9: Percentage of applications by borrowing capacity



Note: See Table 11 in Appendix 2 for the complete data in this figure (accessible version).

183 More lenders are now assessing consumers' ability to meet their financial obligations using the residual-term method, where the repayments on a loan with an interest-only component are assessed over a shorter term than an equivalent term principal-and-interest home loan. For example, a 30-year loan with a five-year interest-only period would be assessed using principal-and-interest repayments over a 25-year period.

184 For a 30-year loan, the longer the interest-only term, the shorter the term over which the principal-and-interest repayments are calculated. Table 2 sets out the notional repayment amounts used for assessing a consumer's ability to meet their financial obligations for a $500,000 loan with an interest rate of 7.25% (to account for potential interest rate rises).

Table 2: Notional repayments for residual-term method on $500,000 loan with 7.25% interest rate

Term of loan	Notional repayment
30-year principal-and-interest home loan	$3,411
30 years with two-year interest-only period	$3,481
30 years with five-year interest-only period	$3,614

185 In effect, the higher notional repayments used for the residual-term method reduce a consumer's borrowing capacity for an interest-only home loan, compared to if they applied for a principal-and-interest home loan.

186 Using an online home loan calculator of one large mortgage broker, we calculated that an individual on an annual income of $90,000 could borrow the following amounts based on an interest rate of 7.5% and a 30-year term:

(a) principal-and-interest home loan—$767,000; and

(b) interest-only home loan with a five-year interest-only period—$735,000.

187 That is, the consumer could borrow $32,000 more by choosing a principal-and-interest home loan, as compared to a five-year interest-only period. More generally, where a consumer's ability to meet their financial obligations is based on notional principal-and-interest repayments once the interest-only period ends, the greater the interest-only period the less the consumer will be able to borrow.

Loan and interest-only period

188 The average full loan term (around 30 years) and interest-only period (around four years) were generally consistent across all groups. The average interest-only period for investor home loans was longer, at nearly five years.

189 In most of the applications we reviewed, it was not evident why the specific interest-only period had been obtained or what the consumer intended to do after the interest-only period expired. Where these intentions were recorded, it was more likely to be in applications for owner-occupier home loans than investor home loans.

190 In ensuring that a particular loan meets the consumer's requirements and objectives, consideration should not be limited to the interest-only period, particularly where that period is relatively short.

191 Where the consumer's financial capacity is assessed on principal-and-interest repayments over the residual period, the consumer's financial capacity should ensure that, irrespective of any intentions when the loan is entered into, that the consumer is able to meet the financial commitments.

192 However, if the consumer's ability to service the loan is calculated on principal-and-interest repayments for the full loan term—particularly where the interest-only period is relatively long and the residual term for principal-and-interest repayments is compressed—significant emphasis should be placed on the consumer's intentions after the interest-only period has expired.

193 In any event, in ASIC's view, the failure to use the residual-term method is likely to place licensees at high-risk of non-compliance with the responsible lending obligations.

194 Changes to market conditions, or lenders' credit risk appetite, may mean that the ability to refinance the home loan, either for a further interest-only period or a longer term principal-and-interest home loan, is not readily achievable.

Action 8: Ensure the interest-only period reflects the consumer's intention

Where the underlying basis for a consumer seeking an interest-only loan relates to a temporary financial situation (e.g. a temporary fluctuation in income or one-off expense), the interest-only period should reflect this.

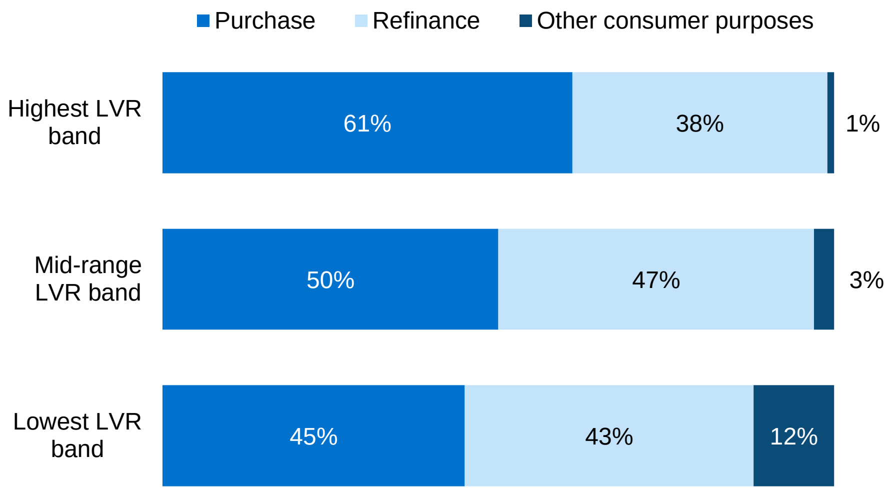
Primary loan purpose

195 Owner-occupiers seeking interest-only home loans were more likely to want the loan to buy a new property (rather than to refinance an existing loan or for some other purpose). Almost 60% of applications in the highest LVR band were for property purchase, falling to 45% in the lowest LVR band: see Figure 10.

196 Where consumers were refinancing an interest-only owner-occupier home loan, approximately one-quarter were a split loan with a principal-and-interest component. It was evident from the records in many cases that the consumer was refinancing to make equity available to buy a further property.

197 Consumers in the lowest LVR band were also more inclined to use the equity in their owner-occupied property for other purposes, such as non-recurring expenses (i.e. renovations or the purchase of a motor vehicle).

Figure 10: Primary loan purpose—Interest-only owner-occupier home loans



Note: See Table 12 in Appendix 2 for the complete data in this figure (accessible version).

Reasons for seeking an interest-only home loan

198 In REP 445 we reported on the most common reasons, as reported by lenders, for consumers seeking to take out interest-only home loans. For owner-occupiers, some of these reasons were identified as;

(a) *future investment*—where consumers wished to retain the principal balance of the loan with the intention of converting the owner-occupied property to an investment property in the future;

(b) *flexible repayments*—allowing for fluctuations in income;

(c) *redirect cash flow*—freeing up surplus funds for other purposes; and

(d) *temporary finance*—such as using interest-only repayments during the construction period of a new home, where the consumer would still be incurring other housing expenses (e.g. rent).

199 These reasons were also identified in our review of loan application files.

200 Across all LVR bands, owner-occupiers most commonly identified 'flexibility' as a requirement. Minimising payments, often associated with redirecting funds to another purpose rather than reducing the principal owing, was also a commonly cited objective. Consumers in the lowest LVR band identified minimising payments as the second-most common reason for choosing an interest-only home loan.

201 In just under 80% of instances, there was a statement summarising how the interest-only feature specifically met the consumer's requirements and objectives. This was more common for owner-occupier loans (80%) than investor loans (74%). This compares with our finding in REP 445 that in over 30% of applications reviewed, there was no evidence the lender had considered whether the interest-only loan met the consumer's requirements.

202 Even where there was no statement from the mortgage broker summarising how the owner-occupier interest-only loan met the consumer's requirements, some records provided an indication that the broker had discussed the consumer's requirements and objectives, including:

(a) one instance where the mortgage broker provided the consumer with four lending options, including one with interest-only payments that the consumer selected; and

(b) one instance where the consumer was on maternity leave and would be returning to work in three months (while this instance shared some similarities with Example 19 in RG 209, there were no records on file as to how the 24 month interest-only period met the consumer's requirements and objectives).

203 In one further file, the mortgage broker's notes stated 'refer on-line notes'. However, we did not identify any notes in the application records provided for review.

204 In half of instances where there was no statement summarising how an investor interest-only loan met the consumer's requirements and objective, it was evident that the consumer had directly requested interest-only payments or had lengthy discussions with the mortgage broker about the loan structure.

205 In one instance there were records of the mortgage broker running a number of different loan scenarios to assist the consumer in restructuring the consumer's current home loans following a relationship breakdown.

206 While it was evident the mortgage broker and the consumer had actively considered the loan structure, there was no statement on how the interest-only feature specifically met the consumer's needs. This may expose the mortgage broker to a greater risk of being unable to demonstrate the loan was not unsuitable should a dispute arise at a later date.

207 In another application there were a number of diagrams showing different loan structures; however, it was not evident on what basis the final product was recommended.

Consumers specifically requesting an interest-only loan

208 In more than half of all applications, it was apparent from the file notes or the email correspondence between the credit representative and the consumer that the consumer had specifically sought an interest-only home loan.

209 As noted at paragraph 134, consumers have varying levels of financial literacy and experience with home loans, and may not always be familiar with specific features and any risks.

210 In instances where a consumer seeks a specific product type, the credit representative should confirm the consumer's underlying requirements and objectives (e.g. flexibility or certainty of repayment amount) to ensure a specific product would not be unsuitable. Such inquiries may also be relevant to consideration of the specific lender.

Advice from third parties

211 In a small number of these instances, it was evident that the interest-only home loan was sought based on advice from a third party, such as an accountant or financial planner.

212 Where a consumer seeks an interest-only home loan to implement a broader financial plan, a broker may not be qualified to provide advice on the plan. However, in such circumstances mortgage brokers should confirm that the consumer understands how the interest-only home loan operates and its potential risks, to ensure that the loan itself is not unsuitable.

Action 9: Ensure the consumer understands products and features

Where a consumer seeks a specific loan product or feature, mortgage brokers should confirm that the consumer understands how the product or feature operates and any potential risks to ensure that the loan is not unsuitable.

Flexibility

213 Flexibility is a broad concept, covering a variety of specific circumstances and objectives. Where such a broad objective is identified through a multiple choice question on an inquiry tool, recording additional free-text detail about a consumer's circumstances and objectives can reduce the risk of being unable to demonstrate compliance with the responsible lending obligations.

214 Our review identified one instance where application records stated:

> Customer requested [an interest-only period] for 2 years just for some breathing space whilst [the consumer] finishes studies and attains employment equivalent to [the consumer's]profession and skills.

215 This description highlights the overlap between flexibility and the reduced payments required during the interest-only period.

216 There is also an example in RG 209 of an interest-only home loan being obtained where one borrower is on maternity leave, experiencing a temporary reduction in income, with the expectation of returning to the workforce in the future. As noted earlier, we identified one instance where a loan with interest-only payments was sought by a consumer on maternity leave.

Self-employed consumers

217 The flexibility offered by interest-only home loans may also be sought by self-employed consumers whose income fluctuates.

218 Self-employed owner-occupiers obtaining interest-only home loans were more evident in the mid-range LVR band, representing 16% of all consumers in that group, compared with approximately 7% of consumers in each of the other two LVR bands.

219 In one instance, a self-employed applicant was relocating interstate and sought a low LVR loan to assist with the purchase of a new owner-occupied property, after the sale of the previous residence. The applicant requested an interest-only home loan to minimise the monthly repayments and better manage their cash flow while they re-established themselves.

Future investment

220 The intention to convert an owner-occupied property into an investment property in the future was the second-most common reason given by consumers—it was the second-most common reason in the mid-range LVR band and equal second in the highest LVR band. For examples of the information recorded on files, see paragraphs 159–160.

221 Consumers may also seek to access loan funds for other investment purposes (e.g. shares), including through interest-only home loans. While we identified instances where consumers had indicated they were accessing funds for future investment, it was unclear what specific type of investment was contemplated.

222 A small number of consumers purchased a second property, but stated they had not decided if the purchased property would be used for owner-occupation or for investment. In all of these instances, the application was processed as an owner-occupier home loan, which generally has a lower interest rate. This meant that the assessment of the consumer's ability to meet their financial obligations did not take into account potential rental income from the property, which reduced the risk of over-estimating the consumer's income.

Temporary and one-off expenses

223 We also identified applications where mortgage brokers had recorded consumers' desire for an interest-only home loan to enable them to fund a non-recurrent expenditure, after which they intended to revert to principal-and-interest repayments.

224 For example, a number of applications from first home buyers noted that the consumer required interest-only payments for a period to allow them to undertake property improvements and establish themselves in the new property.

225 One-off expenses were also recorded for a number of other consumers—in particular, for those in the lowest LVR band: see paragraph 197.

Bridging finance

226 We also identified a small number of interest-only home loans where the consumer was unsure if they would retain their existing property as an investment or if they would sell the property.

227 These consumers appeared to be entering into interest-only home loans to reduce the immediate financial commitment, rather than as a structured bridging loan. From file comments, it appeared consumers pursued this option for more flexibility and control over the timing of the sale process.

228 In each of the above instances, the consumer's financial capacity was assessed on the total debt and on the residual-term after the expiration of the interest-only period. This is a higher hurdle than a traditional bridging loan, where serviceability is assessed on the estimated residual debt after the sale of the property, but provides the consumer more flexibility by extending or removing the period in which to sell the current property.

229 In one instance, a consumer was relocating interstate and wished to buy a new property for owner-occupation. The consumer owned three encumbered properties, which they intended to sell; however, only one of the properties was under offer at the time of the application. The consumer asked for the new loan to be structured with an initial interest-only period of two years 'to keep repayments down until the other properties sell'.

230 In this instance, while all loan commitments were included in the serviceability assessment, rental income from the properties to be sold was not.

Redirecting cash flow

231 We identified some applications where it was noted that the consumer wished to access funds that would otherwise be used to reduce the principal owing.

Paying off higher interest rate loans

232 In 12 instances, we noted that consumers obtained interest-only home loans to reduce the repayment amount on a relatively low-interest rate home loan and free up funds so they could more quickly pay down higher interest rate loans. This was with a view to converting the interest-only home loan to a principal-and-interest home loan after the higher interest rate loans had been repaid. Using an interest-only period to create surplus funds to repay higher interest rate loans (e.g. car loans) was the equal highest reason given in the highest LVR band, but identified only once in the lower LVR bands.

233 Of the first home buyers, almost 30% entered into interest-only home loans with the intention of using the savings in the monthly payments to make larger payments towards higher interest rate debts, such as car loans, credit card debt and loans taken out by parents to help consumers buy the property.

234 An example of good practice was where credit representatives recorded having instructed the consumers to advise them when higher interest rate debts had been finalised, with a view to converting the interest-only home loan to principal-and-interest repayments. On one application, the credit representative's notes stated:

> Your dad has recently referred you to our office as he has been a client for many years. You are ready to buy your first home together … [Your] dad has confirmed that he will gift you some funds. You have advised me that you would like interest only for up to the first 5 years, as your goal is to pay down your credit cards etc. first as these are at a higher rate and you then let me know when you're ready to commence principal-and-interest repayments.

235 Because the effectiveness of this strategy depends on the subsequent actions of the consumer, mortgage brokers should ensure consumers are aware of the potential risks.

Action 10: Ensure the consumer knows what they must do

If the potential benefits of a loan feature require the consumer to undertake specific behaviour, mortgage brokers should ensure that the consumer knows what they must do to obtain the benefit, as well as the potential costs if this action is not taken. Confirmation of this should be documented.

Debt consolidation

236 In July 2013 we released REP 358, which states:

> Where a consumer is advised to take out an interest-only loan, the credit assistance provider should consider how the principal will be repaid in the future, ensure the consumer is aware of the higher costs over the life of the loan and advise the consumer to review their circumstances regularly. This should be documented in the client file.

237 We noted five applications where the consumer was consolidating a number of non-housing loans into an interest-only home loan. If the requirement is to simply reduce monthly repayments, an interest-only home loan would meet this immediate objective; however, this could also be achieved by consolidating higher interest rate short-term debt into a longer period principal-and-interest home loan.

238 As an example, in one instance the credit representative stated:

> Interest only for maximum term to free up cash flow. Interest only has been requested by [the consumer] and [the consumer]intends to pay the [principal-and-interest repayment] figure but would like to have access to the extra funds should they be required. Currently the consumer is paying in excess of $3,200 per month on the combined loans and credit cards.

239 In another instance, the recording of the consumer's requirements and objectives consisted solely of the loan's purpose being described as 'refinance' and two tick boxes selected for 'variable rate' and 'interest only'. The application was for the purpose of refinancing a principal-and-interest home loan secured over the owner-occupier's property, with an additional advance of approximately $95,000.

240 There was no explanation about why the consumer was switching from a principal-and-interest home loan to an interest-only home loan, or the purpose of the additional funds

241 The consumer had confirmed their recorded requirements and objectives and the proposed loan amount and structure by signing the preliminary assessment summary, which suggests that a level of discussion had occurred. Regardless, in the absence of additional information on the consumer's underlying requirements and objectives, the mortgage broker is at an increased risk of not being able to demonstrate that they met their responsible lending obligations.

242 In another instance, the consumer had consolidated higher interest rate debt into a fixed-rate interest-only owner-occupier home loan. The reason provided in the records was simply to 'reduce the repayments', with no additional objectives recorded.

243 Fixed-rate products generally have a restriction on the amount of additional repayments that can be made (in this instance, a maximum of $5,000) meaning the consumer is unable to take advantage of the flexibility that variable-rate interest-only home loans can offer. It may well be that the consumer placed greater importance on the certainty of payment amount. However, the absence of notes indicating this places the mortgage broker at greater risk of not being able to demonstrate that the fixed-rate product was not unsuitable for the consumer.

244 Fixed-rate loans, and the relevant period for which rates are fixed, present some specific responsible lending compliance risks. When selecting a fixed rate, consumers should be aware of any product restrictions that have the potential to restrict their options over the term of the loan, such as the lack of an offset facility, restrictions in principal reduction, or the triggering of break costs should the maximum principal reduction be exceeded.

245 Credit representatives should ensure that the consumer understands how specific loan features operate and how they affect their stated requirements and objectives. Where a consumer requests conflicting features, such as flexibility and a feature that restricts this flexibility (e.g. a fixed interest rate), the broker should ensure that the conflicting requests are explained and that the consumer decides which requirements and objectives take precedence. It is important for records of this to be maintained.

Cost of the loan and offset accounts

246 In REP 445 we noted that if one of a consumer's stated requirements or objectives is to minimise the overall cost of the loan, an interest-only home loan would seem at face value to conflict with this objective. However, we also noted in REP 445 that when funds held in offset accounts were taken into account, consumers with interest-only home loans were, on average, further ahead in reducing the balance of their loan, compared to those with principal-and-interest home loans.

247 Our review of mortgage brokers did not identify any applications that recorded minimising overall cost as the consumer's overriding objective. However, notes on 10 applications stated that the consumer's purpose was to pay off the loan quicker through the use of an offset account.

248 In eight of the above 10 instances, it was apparent that the consumer had specifically requested an interest-only home loan, with five of these being on the recommendation of a financial planner. However, in two instances it was not evident the consumer had requested or understood how the offset account operated.

249 While a low-interest rate product may appear best suited to meet a consumer's requirements on cost, if there is no flexibility due to a restriction or inability to make principal reductions (e.g. a fixed-rate loan), such a product may over the term of the loan be more expensive than a marginally higher rate loan with more flexibility (e.g. a loan with an offset account).

250 If achieving a consumer's objectives depends on the consumer undertaking specific behaviour (e.g. placing money in an offset account), mortgage brokers can reduce the risk of being unable to demonstrate compliance with the responsible lending obligations by advising consumers of the risk if the required action is not taken and documenting the results of these discussions: see Action 10.

Assessment of consumers' ability to meet their financial obligations

251 The primary focus of our review was on how mortgage brokers assess and record consumers' requirements and objectives. We also took the opportunity to review how brokers record consumers' financial situation and assess their ability to meet financial obligations without substantial hardship, in light of changes lenders indicated they intended to make after REP 445.

252 There are statutory presumptions that, in specified circumstances, the consumer will only be able to meet their payment obligations with substantial hardship (e.g. where the consumer could only comply with their financial obligations by selling their principal place of residence).

253 Credit licensees generally assess a consumer's ability to meet financial obligations under the proposed loan by calculating whether, and to what extent, their income is sufficient to meet the proposed repayments, other fixed payments (e.g. other loan contracts), and variable and living expenses.

254 Lenders' calculations and assessments often incorporate different adjustments to income and expenses, based on their own historical experience and market forecasts. They will therefore often provide brokers with an assessment tool to assist them in determining whether a consumer qualifies for a loan. In approximately 85% of applications, we identified a calculation using a tool provided by the lender to which the loan application was submitted.

255 Mortgage brokers are required to undertake an assessment of unsuitability before assisting a consumer to obtain a loan, including that the consumer will be able to comply with the consumer's financial obligations under the contract without substantial hardship.

256 As noted in REP 262, while these tools play a role in the mortgage broker's assessment of the consumer's ability to meet their financial obligations, mortgage brokers are responsible for ensuring they have a reasonable basis for seeking to rely on these calculations.

257 Where records supporting the consumer's ability to repay the debt are not retained on file, the mortgage broker is at significant risk of not being able to demonstrate that they have met their responsible lending obligations.

258 Mortgage brokers used three different methods for assessing consumers' ability to meet their financial obligations:

(a) *'Residual-term' method*—Repayments are calculated on a principal-and-interest basis on the residual loan term after the interest-only period expires.

(b) *'Full-term' method*—Repayments are calculated on a principal-and-interest basis on the full term of the loan.

(c) *'Interest-only' method*—Repayments are calculated solely on an interest-only basis.

259 The frequency of each method is set out in Figure 11.

Figure 11: Method used by mortgage brokers to assess consumers' ability to meet their financial obligations

Note: See Table 13 in Appendix 2 for the complete data in this figure (accessible version).

260 In REP 445 we noted that all lenders in that review (including four who already used this method) had committed to using the residual-term method to assess consumers' ability to meet their financial obligations for interest-only home loans.

261 Where brokers assessed consumers' ability to meet their financial obligations using the interest-only method, this was generally for applications submitted to lenders before, or shortly after, the release of REP 445.

262 In a number of cases where the mortgage broker used the full-term method to assess the consumer's ability to meet their financial obligations, it was because they had completed the lender's assessment tool incorrectly by not including the relevant interest-only period.

263 In a small number of applications lodged after the release of REP 445, consumers clearly articulated that they intended to sell the property before the interest-only period expired. However, in each case, the consumer's ability to meet their financial obligations was assessed using the residual-term method.

264 This approach gives the consumer additional protection as it reduces the amount the consumer can borrow and allows the consumer a degree of flexibility if for some reason the property is not sold within the interest-only period (e.g. if real estate market conditions are not favourable).

265 Such assessments provide a useful financial buffer if the consumer's situation changes. The calculation takes into account repayments after the interest-only period has elapsed (with an additional buffer for potential interest rate increases) and factors in repayments for the consumer's current debts (e.g. personal loans), which may be repaid before the principal-and-interest repayments fall due.

266 Where mortgage brokers assessed consumers' ability to meet their financial obligations using the full-term method, it was not evident from the application records that discussions had been held with consumers about their intentions following the expiration of the interest-only period.

267 If a mortgage broker fails to account for the interest-only period, this places the mortgage broker at significant risk of being unable to demonstrate compliance with the responsible lending obligations. This may also lead to the lender declining the loan application for failing to meet its own assessment criteria, which may have a negative impact on the consumer.

Appendix 1: Methodology

268 We identified 11 large mortgage brokers, who hold their own credit licence and are responsible for nearly 14,000 credit representatives (around 40% of all credit representatives and 63% of mortgage broking credit representatives. The number of credit representatives for each broker ranged from 342 to 3,135.

Survey data on trends and practices

269 For REP 445, we obtained comprehensive data from lenders on the nature of their loan portfolios.

270 For this review, we asked for similar data from mortgage brokers for the 2015 calendar year to identify any trends after the publication of REP 445. However, given the nature of the brokers' business, we did not seek any data on the post-settlement performance of interest-only home loans.

271 We also reviewed information from APRA on interest-only lending by ADIs, as well as residential lending activity more generally, in 2015 and into 2016.

272 From each mortgage broker, we obtained and reviewed the policies and tools relied on by the broker to ensure that their credit representatives comply with the responsible lending obligations to make reasonable inquiries into a consumer's requirements and objectives.

Targeted file review

273 We reviewed the records for 20 interest-only home loan applications from each broker (a total of 220 loan applications), including:

(a) 15 applications for owner-occupied properties with a proposed LVR of:

- (i) 60% or lower (lowest LVR band);
- (ii) between 60% and 80% (mid-range LVR band); and
- (iii) 80% or greater (highest LVR band); and

(b) five applications for investment properties (irrespective of proposed LVR).

274 We obtained application records from different LVR bands to ensure our review considered consumers across a range of financial positions, who may have different reasons for obtaining an interest-only home loan.

275 We specifically did not request application records for construction loans, which are commonly only interest-only during the construction period and revert to principal-and-interest repayments on completion of the property.

276 Our review examined how individual credit representatives were collecting and recording their inquiries into consumers' requirements and objectives and the reasons for obtaining an interest-only home loan.

Appendix 2: Accessible versions of figures

277 This appendix is for people with visual or other impairments. It provides the underlying data for each figure in this report.

Table 3: New interest-only home loan approvals (June 2015 quarter to June 2016 quarter)

Lender	June 2015 quarter	September 2015 quarter	December 2016 quarter	March 2016 quarter	June 2016 quarter
Major banks	43,523,000,000	38,516,000,000	35,022,000,000	28,079,000,000	35,232,000,000
Other ADIs	459,000,000	451,000,000	485,000,000	358,000,000	343,000,000

Note: This is the data contained in Figure 1.

Table 4: ADI exposure to home loans (June 2015 quarter to June 2016 quarter)

Home loan type	June 2015 quarter	September 2015 quarter	December 2016 quarter	March 2016 quarter	June 2016 quarter
Interest-only home loans	517,002,400,000	527,690,100,000	536,882,700,000	545,452,500,000	556,991,200,000
Principal-and-interest home loans	792,218,200,000	808,198,700,000	828,252,300,000	842,456,500,000	860,658,400,000

Note: This is the data contained in Figure 2.

Table 5: Applications for interest-only and principal-and-interest home loans in 2015

Home loan type	March 2015 quarter	June 2015 quarter	September 2015 quarter	December 2015 quarter
Interest-only owner-occupier home loan	14,458	16,568	17,721	15,739
Principal-and-interest owner-occupier home loan	36,587	41,157	46,257	48,996
Interest-only investor home loan	18,677	22,412	20,142	16,905
Principal-and-interest investor home loan	9,361	10,948	10,827	9,618

Note: This is the data contained in Figure 3.

Table 6: First home buyers by loan type (March 2015 quarter to December 2015 quarter)

Home loan type	March 2015 quarter	June 2015 quarter	September 2015 quarter	December 2015 quarter
Principal-and-interest home loans	79%	78%	81%	84%
Interest-only home loans	20%	20%	17%	14%

Note: This is the data contained in Figure 4.

Table 7: Percentage of new investor and owner-occupier home loans with an interest-only period longer than five years (March 2015 quarter to December 2015 quarter)

Interest-only home loan type	March 2015 quarter	June 2015 quarter	September 2015 quarter	December 2015 quarter
Owner-occupier home loan for established property	10%	9%	11%	3%
Investor home loan for established property	12%	11%	8%	6%
Owner-occupier home loan to refinance	15%	14%	19%	8%
Investor home loan to refinance	13%	14%	13%	6%

Note: This is the data contained in Figure 5.

Table 8: Approved loans by total household income and loan type

Loan type	Less than $50,000	$50,001–$100,000	$100,001–$150,000	$150,001–$200,000	Greater than $200,000
Principal-and-interest investor home loan	1,020	3,418	3,283	2,026	2,556
Principal-and-interest owner-occupier home loan	4,264	25,021	23,956	11,612	8,953
Interest-only investor home loan	1,579	6,740	11,416	10,088	18,017
Interest-only owner-occupier home loan	1,104	7,380	10,941	7,809	11,088

Note: This is the data contained in Figure 6.

Table 9: Consumer age groups, by loan type

Age	Interest-only owner-occupier home loan	Interest-only investor home loan	Principal-and-interest owner-occupier home loan	Principal-and-interest investor home loan
18–24	1,051	1,033	3,226	819
25–34	15,590	15,945	32,064	7,535
35–44	19,724	22,041	33,638	7,691
45–54	13,427	18,980	23,592	7,383
55–64	5,520	8,786	9,820	3,598
65 and over	1,213	1,535	2,614	1,022

Note: This is the data contained in Figure 7.

Table 10: Median loan amount for interest-only home loans, by LVR band

Loan type	Median loan amount
Owner-occupier loan in the lowest LVR band	$359,000
Owner-occupier loan in the mid-range LVR band	$556,000
Owner-occupier loan in the highest LVR band	$494,500
Investor loan	$404,800

Note: This is the data contained in Figure 8.

Table 11: Percentage of applications by borrowing capacity

Amount borrowed as a percentage of borrowing capacity	Percentage of applications
Less than 20%	3%
20–39.9%	12%
40–59.9%	17%
60–79.9%	28%
Greater than 80%	39%

Note: This is the data contained in Figure 9.

Table 12: Primary loan purpose—Interest-only owner-occupier home loans

LVR band of loan	Purchase	Refinance	Other consumer purposes
Lowest LVR band	45%	43%	12%
Mid-range LVR band	50%	47%	3%
Highest LVR band	61%	38%	1%

Note: This is the data contained in Figure 10.

Table 13: Method used to assess consumers' ability to meet their financial obligations

Method	Percentage of files that used the method
Interest-only method	3%
Full-term method	27%
Residual-term method	70%

Note: This is the data contained in Figure 11.

Key terms

Term	Meaning in this document
ADI	Authorised deposit taking institution—has the meaning given in s5 of the National Credit Act
APRA	Australian Prudential Regulation Authority
credit	Credit to which the National Credit Code applies
credit assistance	Has the meaning given in s8 of the National Credit Act
credit contract	Has the meaning in s4 of the National Credit Code
credit licence	An Australian credit licence under s35 of the National Credit Act that authorises a licensee to engage in particular credit activities
credit licensee	A person who holds an Australian credit licence under s35 of the National Credit Act
credit provider	Has the meaning given in s5 of the National Credit Act
full-term method	A method of assessing the consumer's capacity to pay, based on repayments that are calculated on a principal-and-interest basis over the full term of the loan.
general conduct obligations	The obligations under s47(1) of the National Credit Act
highest LVR band	A home loan in this band has an LVR of 80% or greater
interest-only home loan	A home loan on which only interest is paid during a set period. The loan will revert to principal-and-interest repayments at the end of the interest-only period.
interest-only period	The period of time during which the consumer is only required to make payments covering the interest of their loan
investor	A consumer who has acquired a home loan for the purpose of purchasing a property that is intended to be rented to a third party
lender	A credit provider
lenders interest-only review	Our previous review of lenders' responsible lending practices for interest-only home loans conducted in the first half of 2015 and published as REP 445
lowest LVR band	A home loan in this band has an LVR of less than 60%
LVR	Loan-to-valuation ratio. The ratio of the amount of the loan outstanding to the value of the property securing the loan
MFAA	Mortgage & Finance Association of Australia

Term	Meaning in this document
mid-range LVR band	A home loan in this band has an LVR of 60–80%
mortgage broker	A credit assistance provider who assists or suggests a consumer to obtain a home loan
National Credit Act	*National Consumer Credit Protection Act 2009*
National Credit Code	National Credit Code at Sch 1 of the National Credit Act
principal-and-interest home loan	A home loan on which the consumer is required to make payments over the term of the loan that pay off interest as well as the principal of the loan
QPEX June 2016	APRA, Quarterly authorised deposit-taking institution property exposures—June 2016, 30 August 2016
REP 445 (for example)	An ASIC report (in this example numbered 445)
residual-term method	A method of assessing the consumer's capacity to pay, based on repayments that are calculated on a principal-and-interest basis on the residual-term of the loan, once the interest-only period has expired
responsible lending obligations	The legal obligations set out in Chapter 3 of the National Credit Act
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

Related information

Headnotes

affordability, credit, interest-only period, investor, home loan, mortgage brokers, owner-occupier, principal-and-interest home loan, repayments, responsible lending, requirements and objectives, serviceability

Regulatory guides

RG 205 *Credit licensing: General conduct obligations*

RG 209 *Credit licensing: Responsible lending conduct*

Legislation

National Credit Act, s47

Consultation papers and reports

REP 119 *Protecting wealth in the family home*

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

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

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

REP 445 *Review of interest-only home loans*

Media and other releases

14-329MR *ASIC to investigate interest-only loans*

Other references

APRA, Media Release 14.30 *APRA outlines further steps to reinforce sound residential mortgage lending practices*

APRA, QPEX June 2016

Australian Tax Office, Negative gearing (webpage)

MFAA, March 2016 quarter results

Treasury, *Financial services and credit reform: Improving, simplifying and standardising financial services and credit regulation*

