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Submission by 86 400 Ltd in response to Consultation Paper 309 – Update to RG 209 – Responsible Lending Conduct

86 400 Ltd (86 400) welcomes the opportunity to provide feedback on ASIC's consultation paper 309 (CP 309).

86 400 was founded in 2017 by Cuscal Limited (Cuscal) and is currently 100% owned by Cuscal. Cuscal in turn is largely owned by Australian challenger banks and customer-owned banks.

After conferment of a licence to operate as an authorised deposit-taking institution, 86 400 intends to offer a range of deposit and credit products. 86 400 will be a digital bank which intends to stay at the forefront of technology enabled banking services. Our intention is to distribute home loans via both brokers and direct channels. Unsecured credit products will be distributed directly.

In this submission we have focussed on those aspects of CP 309 where we think it appropriate for us to comment. We provide some preliminary context below. Responses to ASIC's specific questions on which we hold a strong view are contained in the appendix.

Principles or Prescription

Principles based regulation provides a flexibility in application that will necessarily result in different processes being adopted by different lenders. Ultimately the focus of principle-based regulation must be on achieving a reasonably consistent outcome. In the case of responsible lending regulation the outcome sought should be that borrowers are able to repay loans without hardship. The taking of reasonable steps helps to support that outcome, although the outcome cannot be guaranteed.

We agree that there is a place for additional guidance to clarify some issues, however, we are cautious of guidance which is overly prescriptive, and becomes the de-facto standard applied by the regulator or tribunal in assessing lender compliance.

We think that the "safe harbour" approach commonly used in principle-based regulation is useful in providing assurance to entities that follow those "safe harbour" procedures, while not penalising those entities that choose alternative means to achieve the same outcomes. If ASIC is inclined to provide further guidance or examples of compliant practices, we think expressing that guidance using a "safe harbour" approach would be beneficial and avoid the risk that the guidance becomes the only acceptable standard.

While we believe it appropriate for the same broad principles to apply to all forms of credit, the substantial differences in the nature of home lending from other forms of consumer credit makes it difficult to provide generic guidance. Many of the questions that ASIC poses in CP 309 require different responses depending on the credit product.

The Crystal Ball of Credit

The assessment of an individual's ability to repay a loan that extends many years into the future can never be an exact science. A typical home loan is made on the basis of a 25 to 30 year repayment term. That is an extraordinary length of time in which to predict a person's capacity to repay which will be influenced by factors both intrinsic to the borrower (e.g. future employment opportunities, relationship changes) and extrinsic (e.g. interest rate changes, economic cycles).

In the absence of a crystal ball, it has generally been accepted that current levels of income and expenditure are a reasonable proxy for determining future repayment capacity combined with historic credit reports as an indicator of behaviour and propensity. Generic buffers are usually then applied (e.g. an interest rate sensitivity) in an effort to reduce the risk of detrimental impacts. Allowances are rarely made in credit policy or in regulation for future beneficial changes (e.g. a professional in the early years of their profession could be expected to receive an increased income in future years).

We do not have a better suggestion for predicting future serviceability than these currently used proxies and behavioural indicators. We do however support the use of advances in the measurement (e.g. through comprehensive credit reporting and digital verification) which should provide a more accurate prediction of repayment ability. However, we caution against regulation or guidance making the assumption that the more detailed application of these proxies will make the determination of a particular individual's ability to service a 30 year home loan into an exact science.

Collecting and verifying customer data in a digital world

Historically lenders have relied on customer proof of income and customer self-assessment of expenses, combined with verification through available sources. While most customers are generally aware of their income they are less aware of their expenses and through no fraudulent intent, will usually underestimate those expenses. We are aware of significantly different practices by lenders in the depth of their verification of customer expenses.

Different technologies already exist which can provide lenders with an accurate assessment of income and expenses. In particular, these technologies involve "screen scraping" of customer accounts and the electronic reading ("OCR") of customer supplied hard copy or digital files, for example PDF copies of bank statements.

These technologies are in use by a significant number of lenders. As customer privacy is core to these aggregation services, each of the legitimate competitors in this industry have implemented extremely high levels of security over transmitted and stored data which far exceed the security levels that exist when customers email documents to their broker or lender.

For the majority of borrowers, these technologies currently allow the complete collection and verification of income and expenditure to be performed simultaneously to produce a complete and accurate record, with relative ease for both the customer and the financial institution.

In the longer term we would expect that these methods of verification will be replaced by Open Banking standards, but on the current timetable it is likely to be at least 2 years before Open Banking can be fully relied on for income and expense verification. We also expect that there is likely to be hesitance from some customers to the sharing of their data for at least some further years until the Open Banking process becomes ubiquitous and trusted.

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Discretionary Spending

We note that there is very little guidance in RG 209 in respect of how discretionary spending should be considered. Current and historic expenditure is an imprecise indicator of the ability of a borrower to repay a loan. This is particularly true of many first home loan borrowers who may not have geared their lifestyle around saving or investment. Many consumers formally or informally budget by maintaining discretionary expenditure (on such items as travel, luxury items and entertainment) at a level that matches their available funds. They are able to reduce that discretionary expenditure when their available funds decrease. A blanket requirement to assess all customer's serviceability on the basis of their current expenses, would therefore significantly constrain those borrowers who could reasonably adjust their discretionary expenditure to afford new loan repayments.

86 400 believes that a detailed verification of customer expenses is a reasonable requirement for a home loan (which may be achieved by manually reviewing account information, or through automated account analysis). However, reasonable judgment must be permitted by the lender to discount discretionary expenditure from serviceability calculations where the customer's circumstances indicate that this expenditure can be foregone. We think that some general guidance to this effect would be useful.

Our specific responses to ASIC's questions are provided in the appendix to this letter. We thank ASIC for the opportunity to provide comments on its proposal.

Yours sincerely,

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APPENDIX - Response to Specific Questions

Reasonable Enquiries and Verification

B1Q1: Would it be useful for licensees if ASIC were to identify the inquiries and verification steps that we consider should be taken? Why or why not?

It would be useful for ASIC to identify minimum steps in respect of different credit types (e.g. home loans, credit cards) providing it remains clear that these are "safe harbour" in nature and that lenders will not be penalised for adopting reasonable alternatives.

B1Q2: If there are particular examples of industry practice that you consider should be reflected in any guidance, please provide details of those practices.

We believe that the guidance should account for the reasonable assessment and discounting of discretionary expenditure from serviceability calculations where lenders have required complete verification of all expenditure.

B1Q3: Are there any kinds of credit products, consumers or circumstances for which you consider it may be reasonable to undertake fewer inquiries and verification steps? Please identify the kinds of products, consumers and circumstances and particular features you think are relevant.

Yes, we think there are some credit types where it would be reasonable undertake fewer enquiries or verification steps:

1) *Typical Unsecured Credit Products*

There will always be a level of uncertainty in the prediction of how well past expenses predict loan repayment ability. For instance, the prediction of ongoing expenses could be classified as $x plus or minus $y. The repayment amounts typically associated with personal loans are generally less than the quantum of this uncertainty ($y). Requiring detailed analysis and verification in these circumstances will only lead to "precise inaccuracy" which provides no greater responsible lending outcome.

We do not think that the net benefits or the risk of detriment associated with performing detailed verification on typical unsecured products always justifies the customer inconvenience of conducting that verification, particularly where lenders are reliant on manual verification processes.

However, we believe that the application of digital verification through account aggregation greatly reduces this burden and it would be reasonable for ASIC to expect that the industry will move toward this type of actual verification for unsecured credit products in the future.

2) *Same Amount Home Loan Refinance Applications*

Where a refinance application is for the same amount or a lower amount than the current home loan, we believe that a lower standard of expense verification should be reasonable in the following circumstances:

a) The borrower can demonstrate a perfect repayment history (e.g. 12 months) of all loans;
b) The lender is satisfied that there is no imminent change in the borrower' s circumstances;

c) Current income is verified; and
d) The lender meets the additional objective and requirement criteria for refinancing currently set out in RG 209.

Comprehensive credit reporting, once available, will allow an additional layer of verification over the borrower's loan repayment behaviour. In our view, the borrower's behaviour in respect to their existing loan is better evidence of their capacity to repay that loan amount than a detailed analysis of their expenses.

B1Q4: In your view, what aspects of the consumer's financial situation would a licensee need to inquire about in all circumstances? If you think some aspects of the consumer's financial situation do not need to be inquired about, please explain why

B1Q5: In your view, what aspects of the consumer's financial situation would a licensee need to verify in all circumstances? If you think some aspects of the consumer's financial situation do not need to be verified, please explain why.

Q4 and Q5 above assume that enquiry and verification will be carried out in two distinct stages. Current and future technology solutions allow enquiry and verification of income and expenses to be conducted simultaneously, i.e. once the customer allows a lender direct access to their accounts held with other institutions (via screen scraping or Open Banking protocols) the inquiry is performed by the automatic collection of their financial information from verified sources. It would be useful for the guidance to recognise the acceptability of simultaneous inquiry and verification.

We believe that the depth of inquiry/verification should depend on the type of credit. In all cases we think it appropriate to know that the customer has an income from which to service the loan. We think the stability of that funding source is more significant for home loans and therefore a longer history of verification is appropriate than for unsecured credit.

We think expense verification is a useful exercise in home lending but must be capable of adjustment for discretionary spending. We consider that detailed expense verification for unsecured credit is best practice but it should not be mandated for unsecured credit which represents a small proportion of borrower income.

We note the current guidance in 209.51 which refers to further enquiries where a consumer provides inconsistent information to information held by the lender. In the circumstance where an applicant provides information to a broker and the lender subsequently conducts their own verification, we think the lender should be able to rely on their own verified information in preference to the collected information without making further inquiry to resolve the discrepancy. This may already be the intent but we think the guidance could be clarified.

B1Q6: What would be the effect on consumers of ASIC identifying particular inquiries and verification steps? For example, what would be the effect on access to and cost of credit for consumers?

We think that some guidance is appropriate provided that it is not prescriptive and recognises alternative options for inquiry and verification. In respect to home loans, we think customers recognise the need for lenders to carefully assess an application for credit.

Provided that allowance is made for discretionary income we do not think that guidance on verification steps should add significantly to the cost of credit, except for lenders who are currently making inadequate enquiry.

In respect of unsecured credit, prescription of detailed verification will likely create an unwanted administrative burden on consumers and lenders which would increase the cost of credit and discourage switching, thereby lessening competition. There is also a risk of financial exclusion if pockets of the population are unable to readily satisfy a combination of prescriptive rules.

Verification of consumer's financial situation

C1Q2 Do you consider that the examples included in Appendix 1 are appropriate? Why or why not?

We consider the examples in the table are reasonable but suggest further commentary to the effect that in some cases one form of evidence may verify multiple sources. E.g. If a history of bank statements verifies an income source, additional verification through, for example, payslips or an accountant's statement should not be necessary.

C1Q3 Are there particular issues with using data aggregation services that you consider should be raised in our guidance? Please provide details of those issues, and information that you consider should be included in our guidance. For example, would it be useful to include specific guidance on matters the licensee could, or should, raise with the consumer before obtaining the consumer's consent to use this kind of service?

86 400 intends to use account aggregation services to support inquiry and verification. The results generated by aggregation services can either be reviewed manually, or the review can be fully automated. We have worked closely with our aggregation partners to ensure the quality of information that is retrieved.

Provided that account aggregation is appropriately implemented and tested, we consider that it can significantly reduce customer burden in supplying information and support more accurate verification than traditional / manual methods.

Account aggregation (whether through existing screen scraping methods or future open banking protocols) allows the inquiry and verification stages of responsible lending to effectively occur within the one process.

We believe that at present, the implementation of account aggregation through screen scaping technology provides the most accurate view available of borrower income sources and expenditure. When combined with comprehensive credit reporting checks it is very difficult for a customer to misrepresent their financial position.

This form of aggregation captures all expenditure and outward transfers including non-recurring payments and discretionary expenditure. In order to reasonably adjust those expenses to account for discretionary or non-recurring items it is important to use reasonable look back period (e.g. 12 months) to determine which payments may be excluded when assessing likely post loan expenditure.

We think it may be difficult to give specific guidance in relation to the use of aggregation services as they may be implemented in different ways and will continue to develop, however, as high level guiding principles we would suggest the following could be appropriate:

- Acknowledgment of aggregation services as a reasonable approach to fulfilling both enquiry and verification requirements;
- The need for informed customer consent;
- The testing of automated solutions to ensure quality of outputs is at least equivalent to manual review; and
- The ability to adjust for non-recurring and discretionary expenditure.

C2Q1 Do you consider that the proposed clarification of guidance on reasonable verification steps would be useful? Are there any other aspects of our guidance on verification that you consider would be useful?

While we think it self-evident that information obtained and verified would be used in a responsible lending assessment, that clarification may assist those that take an alternative view. We agree in principle that where inconsistent information is uncovered during verification, further investigation may be warranted, but we do not think a forensic approach to that investigation is necessary.

If there are elements that clearly stand out as being inconsistent with inquiry (e.g. large transfers out of an account for no apparent purpose) then it seems reasonable to make further enquiry but we think that depends very much on the circumstances. For example, where the inconsistent information would not impact the lending decision there should no requirement to investigate further.

C2Q2 Would an 'if not, why not' approach encourage improvements to current verification practices? Why or why not?

We think that such an approach is unnecessary. The legislation and guidance already provides an objective test of reasonableness of verification steps and acknowledges that lenders may take a scaled approach. The introduction of a "why not" test would require a lender to not only demonstrate that the approach taken was reasonable for the circumstances of the loan but also to prove that other approaches were not reasonable.

In an objective test of what is reasonable, one factor that *may* be relevant is whether other verification steps could have been effectively and efficiently implemented. However, to prescribe a requirement to demonstrate in all cases why another alternative was not chosen goes beyond the legislative intent and, in our view, provides little or no benefit to the consumer.

C2Q4 What additional business costs would be involved in this approach?

We can foresee increased compliance costs in monitoring credit decisions against more prescriptive guidelines to satisfy a "why not" test. Such costs would inevitably be passed on to consumers.

C2Q5 In your view, what would be the effect (either positive or negative) on competition between licensees? Please provide details

We think some broad guidance (e.g. that details obtained in enquiry should actually be used in a credit decision) may help rein in outliers whose practices might be producing outcomes inconsistent with the intent of responsible lending. However, we think there is the potential for overly prescriptive guidance to stifle innovation between lenders and amongst intermediaries who will develop new verification methods. This, in turn, has the potential to entrench existing barriers to entry, for example by eliminating lower cost alternatives which could have increased competition.

Use of Benchmarks

C3Q1 Do you consider that the proposed clarification of guidance about use of benchmarks would be useful? Why or why not?

Potentially, although we do not find that the commentary on HEM in this consultation paper provides enough certainty. We read the consultation paper as indicating an openness by ASIC to the use of scaled HEM in particular circumstances, but there is little to help assess what those circumstances might be.

We think that this commentary would benefit by differentiating between the credit products for which the use of a scaled HEM might be more acceptable. For example, would ASIC believe that reliance on a scaled HEM alone will ever be an acceptable alternative to expense verification for a home loan?

In our view HEM is an inherently unreliable measure with which to assess a particular individual's non-discretionary expenses. We acknowledge ASIC's proposed guidance that where HEM is used, a lender should monitor loan portfolios to see if average disclosed expenses are close to HEM. This recognises the ease with which borrowers (often assisted by brokers experienced in HEM measures) can manipulate their applications but it is only a detective control over loans that have already been made.

For this reason we do not think HEM alone is a reasonable alternative for expense verification in respect of home loans.

We note that it is APRA's current expectation for residential mortgage lending that a scaled benchmark be used as a backstop to declared expenditure. In our view there should be no requirement for the application of a benchmark as a hard backstop where expenses have been thoroughly verified such that a borrower can prove that their actual living expenses are below the relevant scaled benchmark. Lenders should be allowed to lend to those consumers who have chosen a deliberately frugal lifestyle in order to attain home ownership or other asset.
Where a lender has chosen to implement the aggregated verification of expenses from actual banking records, there should be no need for the further application of any benchmark.

We think there is a better case for the application of a benchmark where loan repayments would constitute a small proportion of the borrower's income, which will generally be the case with unsecured credit. In that circumstance we think that a scaled HEM is a reasonable substitute for expense verification for those lenders who are unable to implement an aggregation service to verify actual expenses.

C3Q3 What are the benefits, risks and costs for consumers in this approach (including any effect on access to and cost of credit for consumers)?

Using HEM rather than detailed verification in respect of unsecured credit can significantly reduce the application burden for consumers if the lender relies on manual collection and verification processes. While there may still be cases of borrowers who are living on the edge of their means being accepted for unsecured loans, we think that risk is small compared to the potential additional burden to the customers of those lenders.

Consumer's Requirements and Objectives

C4Q1 Do you consider that the proposed clarification of guidance about understanding the consumer's requirements and objectives would be useful? Why or why not?

We think that there needs to be differentiation in the guidelines between the reasonable actions of a mortgage broker and a direct lender. We agree that the types of enquiry suggested in paragraph 66 of CP 309 are reasonable for a mortgage broker who has a range of products which may suitable for the borrower. A future "best interest" duty for mortgage brokers would likely require those brokers to recommend the products from their affiliated lenders that are the most suitable for the borrower rather than products that are merely "not unsuitable". We think that the enquiries suggested in paragraph 66 are better aligned to a suitability test than a "not unsuitable" test.

The same test should not apply to a direct lender. It should be appropriate that a direct lender obtains enough information to be satisfied that its product (which has been selected by the potential borrower) is not inconsistent with the broad purpose of the borrower. If a lender has only one home loan product, then the broad purpose of the borrower "to purchase a house" should be sufficient objective.

A direct lender with a single product should be able to rely on the customer to determine whether their own requirements are satisfied by that product, provided that the product features are clearly disclosed.

For an on-line direct lender, enquiries of the nature suggested in paragraph 66 and 67 would likely require a questionnaire of various loan attributes followed by a summary presented to the customer indicating how well the product matched those required attributes. This could be of some use to a customer in comparing loans, but only if every lender was required to ask the same questions and present the same summary. We think that loan comparison sites already serve this purpose in a more efficient manner.

We therefore submit that a high level enquiry of the purpose for credit (which may be in the form of a drop down menu of several choices e.g. purchase a home; purchase an investment property; refinance a home; consolidate debts) together with clear disclosure of loan features are reasonable steps for a direct lender to take in satisfying s117 1(a) of the NCCP Act.

Fraud Risks

D2Q1 Would specific guidance about loan fraud and the impact on responsible lending obligations of the licensee be useful? Would guidance encourage broader improvements in processes for identifying fraud and reduce the risk of consumers entering unsuitable credit contracts as a result of fraud? Why or why not?

The aspect of credit fraud that relates to responsible lending will generally be limited to the overstatement of income, the understatement of expenses or the stability of income (employment). We think that adequate verification measures within the guidelines already adequately cover this. It would be a significant risk for a lender to outsource verification of these items to a third party, but if that were done then it would be prudent for a high degree of monitoring over that party's practices.

We think that including recommendations for detailed fraud controls within RG 209 is inconsistent with the purpose of providing guidance on the NCCP Act requirements of responsible lending. For instance, we think the inclusion of circumstances provided in paragraph 76 of CP 309 would create considerable uncertainty in what steps ASIC thinks are reasonable for the sharing of fraud related information and what might constitute reasonable suspicion.

We think some additional commentary could be given in the context of placing reasonable reliance on information collected from third parties, without having to delve into the details of appropriate fraud controls.

We note that collection and verification of financial information using account aggregation services virtually eliminates the risk of an intermediary manufacturing fraudulent financial information.

Use of Repayment History Information

D3Q1 Would guidance about use of negative repayment history information and hardship indicators reduce the risk that credit providers consider it necessary to refuse applications for further credit products that may in fact be affordable for the consumer? Why or why not?

We think it unlikely that additional guidance would have any impact on the practices of lenders. Lenders have long used negative information in credit decisions in accordance with their own risk appetites. Some lenders may accept negative histories where others would not. We do not see this approach changing as lenders come to rely on positive credit information. We believe that lenders should be able to continue to exercise their own reasonable judgment in how credit reports are used.

Content of a Written Assessment

D5Q1 Would it be useful for ASIC to provide an example of a written assessment to illustrate the level of information that we think should be included?

Why or why not? D5Q2 Please provide any comments

We think an example would be useful, although we note that most lenders would reasonably have automated the production of these assessments and that the level of information expected should lend itself to automation.

We refer to our previous comments in relation to the consumer “requirements” in which we have submitted that a direct lender should not need to collect or analyse detailed objective and requirement information.

Subject to those two comments, we think that Appendix 2 provides a reasonable example.