University of Sydney Policy Reform Project

Submission to ASIC on CP309: A response to questions C4Q1 and C4Q2

Authors: Mr Claudio Campi, Ms Elise Chidiac, Mr Joshua Copeland, Mr Nicholas Dawson, and Ms Catherine Muthoni Wanjau.

Supervisor: Dr Amanda Howard.

Contact: Mr James Hall, Coordinator, University of Sydney Policy Reform Project, <usyd.policyreformproject@gmail.com>.

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About the University of Sydney Policy Reform Project

The University of Sydney Policy Reform Project ('the Project') facilitates University of Sydney students to write submissions to government inquiries, and research papers for under-resourced policy organisations, under the supervision of University of Sydney academics. All work done as part of the Project is completed voluntarily.

In semester 1 2019, the Project was granted funding by the Student Experience Innovation Grants program, which is an initiative of the Faculty of Arts and Social Sciences Student Affairs and Engagement team and the University of Sydney Division of Alumni and Development.

The students that wrote this submission were Mr Claudio Campi, Ms Elise Chidiac, Mr Joshua Copeland, Mr Nicholas Dawson, and Ms Catherine Muthoni Wanjau. The academic supervisor for this submission was Dr Amanda Howard.

Any inquiries about the Project or about this submission should be directed to the Coordinator, Mr James Hall, at the following email address: <usyd.policyreformproject@gmail.com>.

Executive Summary

This submission responds to questions C4Q1 and C4Q2, which relate to proposal C4, in Consultation Paper 309.

Proposal C4	*We propose to update the current guidance in RG 209 on reasonable inquiries about the consumer's requirements and objectives to reflect the findings and guidance in Report 493 Review of interest-only home loans: Mortgage brokers' inquiries into consumers' requirements and objectives (REP 493).*
Question 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?*

Due to financial illiteracy, consumers will usually not be able to pick the most efficient options when faced with a choice of financing methods. This makes them vulnerable to exploitation by financial institutions and decreases the quality of the loan provided. Merely providing clients with a list of features for a given loan is not enough, as they might still not understand all the relevant implications.

Therefore, an efficient solution would be to push financial institutions to investigate into the exact needs and requirements of a client, as they have access to more information and expertise. However, it's also important not to place the entire burden on institutions, as they might still seek shortcuts to save time.

Question C4Q2	*What are the benefits, risks and costs for consumers in this approach (including any effect on access to and cost of credit for consumers)?*

Although the proposed guidelines in Report 493 are to be essentially used and be of benefit to the lenders of credit, they inadvertently produce benefits to the consumers in the process. These benefits include increased financial literacy of the consumer and well-matched credit facility to the consumer requirements and objectives.

The proposed changes present risks arising from an unreasonable expectation that consumers can equally estimate their own financial needs, which could lead to unfair dealings with lenders. There is also the risk that more stringent requirements could exclude disadvantaged groups or encourage them to falsely confirm understanding simply to gain access.

The approaches to reasonable inquiry outlined in REP493 can potentially reduce a range of credit costs for consumers by offsetting the risks associated with limited financial literacy. In addition to reducing the additional potential costs associated with undertaking a destructive loan, there is no evidence indicating that this approach impacts consumers' overall access to credit, instead increasing credit quality and access to beneficial credit.

1. Question C4Q1: Usefulness of the proposed update

This section responds to question C4Q1, which asks: 'Do you consider that the proposed clarification of guidance about understanding the consumer's requirements and objectives would be useful? Why or why not?'

Before providing judgement on the efficacy of changing the relevant section of RG 209 in accordance with the findings and recommendations of REP 493, it is imperative to understand the context of these two papers and how they relate to one another.

RG 209 operates as a guide for credit licensees and applicants which sets out the expectations ASIC has for 'meeting the responsible lending obligations in Ch 3 of the National Consumer Credit Protection Act 2009 (National Credit Act)' (ASIC 2014, p.2).

REP 493 was published in 2016 and is best thought of as a review of industry practices surrounding interest-only home loans at the time. It describes the practice of several large Australian mortgage brokers, identifying good and bad practice in an effort to promote responsible lending/consumer confidence in the credit industry.
RG 209 currently provides some guidance on what constitute reasonable inquiries about a consumer's requirements and objectives (RG 209.34 – RG 209.37). By and large these guidelines dictate that credit licensees must:

- Understand the purpose for which credit is being sought and determine if the contract being sought is appropriate for the consumer's circumstance.
- Be able to generate a description of why the consumer is pursuing credit provisions
- Gather pieces of financial information in order to verify consumer requirements and objectives

REP 493, following a review of the mortgage broker sector in 2016, proposed the following changes to brokers' code of conduct when it comes to issuing credit (ASIC 2014, pp.8-9). These recommendations all relate to processes which encourage a more rigorous and uniform code of conduct for mortgage brokers in assessing and document applications for credit provisions.

Essentially, by implementing the recommended actions of REP 493, ASIC is looking to substantially increase the compliance measures faced by credit licensees when issuing credit. The proposed actions from REP 493, all represent measures to address the individuality of each consumer in their credit application. By encouraging an inquiry process which recognises applications for credit products as heterogenous ASIC is ultimately encouraging industry practice which minimises the chance of wrongdoing or oversight on the part of licensees. This ensures fair and safe protocol where all parties maximise the extent of available information.

By undertaking this process and increasing compliance measures ASIC will:

- Ensure that the richness of information input by licensees is consistent amongst all credit licensees.
- Create a more rigorous baseline of information required for compliance.
    - This means ASIC will be able to assess the compliance of licensees more easily and effectively moving forward.

Ultimately, the outcome of this process is to ensure that all credit licensees meets ASIC's expectations for meeting the responsible lending obligations as set out in Chapter 3 of the National Credit Act.

Due to the complexity of financing solutions such as loans and mortgages available to the average consumer, a widespread financial illiteracy and the issue of asymmetric information, it is unlikely that borrowers will be able to select the most efficient option for their needs. This increases risks on both sides of the market, as borrowers are more likely to default on their loans. Therefore, we believe that requiring lenders to accurately assess a customer's needs and goals is an effective strategy to implement more responsible lending behaviours, as this goes much further than simply providing clients with the terms and conditions of a financing option.

The literature on financial literacy has shown that even if we usually regard borrowers as being rational utility-maximizing consumers, in reality they often make biased decisions. For example, Ardic, Ibrahim and Mylenko (2011) show how borrowers are easily influenced by marketing schemes and confused when facing a huge amount of information, thus fail to pick the most efficient option. Moreover, Nicholson, Skelton and Tarr (2019) and Devlin (2002) have shown how individuals will try to choose shortcuts in order to simplify their decision-making process. While this indeed saves time and energy, it is clear that accuracy will inevitably be sacrificed. For example, it has been shown how a big part of consumers will choose their bank based on location, rather than on the financing options available to them.
This dynamic is crucial since, in addition to making financing decisions harder, it also implies that lenders might exploit it for their benefit. In fact, when faced with consumers that are usually not able to grasp the financial and economic nuances of each option they're provided with, institutions will likely pursue their own profit-maximizing self-interests.

From this it follows that merely increasing transparency in the details that are being provided to borrowers might not be enough. In fact, even if consumers are provided with the complete list of features of their desired loan operation, they might not fully understand it, or they might not be informed enough to compare it with other options. A responsible lending framework has to take into account the fact that consumers will more often than not lack the sufficient financial literacy to make efficient choices, whereas lenders clearly possess such expertise. It is thus safe to assume that increasing requirements on the supply side, that is, for the institutions providing loans, is an effective solution. Bank employees possess the skills and knowledge required to distinguish between different types of loans and to choose the most appropriate one based on a specific goal. Thus, giving them the responsibility of assessing whether a loan option is appropriate or not, rather than relying on uninformed consumers, is the best possible strategy.

Given a specific aim on the part of the consumer, only a small number of financing options will be viable and efficient. However, a borrower will probably not even be aware of the existence of most options. On the other hand, an officer will be knowledgeable about the whole portfolio of solutions offered by their bank, thus being able to pick the most relevant one. This is why we feel the need to stress the importance of assessing a consumer's requirements and needs, as this goes much further in informing clients than just providing them with a long list of financial jargon. Moreover, this approach forces lenders to evaluate loan requests on a case-by-case scenario, rather than just relying on simplistic categorizations. Loans can be roughly divided in broad categories, and officers might be tempted to rely on them when considering financing applications, without delving into the specific detail of each case. However, if institutions are required to assess each consumer's needs specifically, they will be pushed to review each case more accurately.

2. Question C4Q2: Benefits of the proposed update for consumers

This section responds to question C4Q2, which asks: 'What are the benefits, risks and costs for consumers in this approach (including any effect on access to and cost of credit for consumers)?' In particular, this section addresses the benefits of the proposed update for consumers.

Developing clear and succinct guidelines for lenders to adopt when assessing a borrower's needs before extending any credit facility is one of the main tenets of REP 493. Although the proposed guidelines are to be essentially used by lenders of credit, they inadvertently produce benefits to the consumers in the process. These benefits include increased financial literacy and credit facility well-matched to consumer requirements and objectives.

Financial literacy can be defined as a person's financial knowledge and how that knowledge is applied in making financial decisions or how it influences financial behaviour (Huston, 2010, p.306). One of the proposed guidelines is issuing the consumer with a summary of the lender's understanding of the consumer's requirements and objectives. This summary can increase the borrower's financial literacy through greater transparency between the lender and the consumer, clear articulation of the consumer's requirements and objectives and a baseline for financial planning. First, by ensuring that the information between the lender and the borrower is concisely acknowledged by both parties, greater transparency between them is achieved. Increased transparency results in improved financial knowledge by the consumer which in turn leads in better informed financial decisions (Cox et al. 2015). Secondly, another benefit that the consumer can gain is through the process of developing the statement when the lender is methodically asking questions to elicit information from the consumer. Through this questioning process, the consumer is being assisted to clearly articulate their requirements and objectives, if they are not already done so. Therefore, unconsciously increasing their personal financial knowledge and how they are applying it to making financial decisions (Huston, 2012, p.566). Thirdly, the statement itself can be used by the borrower as a snapshot of their financial profile, which can be used a benchmark for future financial planning. Consequently, influencing their financial behaviour for example adopting a saving scheme, reassessing their expenses or improved comparison of the different credit facilities available (Cox et al. 2015).

The proposed guidelines will work towards supporting the lenders in identifying and proposing the most suitable credit facility that matches the borrower's requirements and objectives. By ensuring that the consumers succinctly understand all the features of the credit facilities, and the consumer's obligations, lenders are better equipped to offer the appropriate credit product to the consumer (Robb & Woodyard 2011, p.76). This has a two-fold effect on the lender and the consumer. On one hand, the lender reduces their probability of being vulnerable to non-performing loans in the future because the offered loan features are aligned to the consumer's financial profile. Basically, loans are offered to those borrowers who can pay back without defaulting. On the other hand, consumers take a loan that aligns with their requirements and objectives such as owner-occupier versus investment property, which is based on their financial capability to service the loan for its entirety. This benefits the consumer by supporting them in their future financial planning because they are well-informed (financially-literate) of their current and future obligations (Huston, 2012, p.572). When the credit product is well-matched to a borrower's financial profile and financial knowledge, it protects the consumer from egregious practices by unscrupulous lenders.

3. Question C4Q2: Risks of the proposed update for consumers

This section responds to question C4Q2, which asks: 'What are the benefits, risks and costs for consumers in this approach (including any effect on access to and cost of credit for consumers)?' In particular, this section addresses the risks of the proposed update for consumers.

REP 493 emphasises the need for lenders to properly assess their client's needs, however there are inherent risks for consumers in the guidance which are related to financial literacy and financial exclusion. The use of interest-only loans was found to be indicative of lower financial literacy (Seay, Preece and Le, 2017, p.178). Furthermore, bounded rationality was found to be responsible for an over estimation of the short-term benefits and failure to take long-term risks into account. The guidance for licensees to gain a greater understanding of consumers' requirements and objectives may not be reasonable if consumers themselves do not possess the information, or if their perceptions are based on poor predictions about future scenarios.

The variation in financial literacy between households means that consumer interactions with lenders are not equal (van Ooijen & van Rooij 2016, p.1). Those with lower financial literacy tend to have a higher tendency to default on loans stemming from several factors including being unable to manage involuntary unemployment, an inability to assess affordability over the life of the loan and inaccurate predictions about the growth of wages and property values (2016, p.2).

This can be compounded by financially overconfident individuals who are more likely to make bad loan choices (Seay, Preece & Le 2017, p.169).

Greater financial literacy increases the ability to compare mortgages (Seay, Preece & Le 2017, p.170). To reduce the impact of financial literacy in financial outcomes, the Federal Government introduced Key Fact Sheets which were designed with the intention of providing clear, easily accessible and complete information about loans to consumers (Nicholson, Skelton & Tarr 2019, p.130). While this greatly increased consumers' ability to select the best value loan, it only did so in less than 40% of cases (Ibid, p.134). Further investigations revealed that instead, prospective borrowers rely heavily on third party advice from family or mortgage brokers (Ibid, p.140; Dungey, Tchatoka & Yanotti 2018, p.213).

Consumers who are financially disadvantaged generally find it more difficult to access financial products (Dungey, Tchatoka & Yanotti 2018, p.213). Access to credit is a concern for groups including women, young people, Indigenous people, people with a disability, the elderly, immigrants and rural populations who are all at higher risk of being financially excluded (Ibid). People living in a more precarious situation are more likely to be drawn to loans with low starting payments precisely because they provide them access and it is unlikely that a different product would be suitable or even accessible for them (Ibid, pp.218-219).

Decisions about mortgages are complex and require assessment of multiple factors, which can lead consumers to quickly make decisions based on internal bias and which are not necessarily the best ones (Nicholson, Skelton & Tarr 2019 p.128). This leaves consumers at risk of confirming that they understand products when they do not and confirming the accuracy of licensees understandings of their requirements and objectives in order to ensure that they can gain finance.

4. Question C4Q2: Costs of the proposed update for consumers

This section responds to question C4Q2, which asks: ‘What are the benefits, risks and costs for consumers in this approach (including any effect on access to and cost of credit for consumers)?’ In particular, this section addresses the costs of the proposed update for consumers.

To the extent that strategies for reasonable inquiries into the consumer’s requirements and objectives outlined in REP 493 are undertaken effectively, the approach proposed by C4 can potentially reduce a range of credit contract costs for consumers. Reasonable inquiries undertaken by credit licensees ensure that the consumer is able to comply with all possible costs of credit - repayments, fees, charges and transaction costs - without substantial hardship, through income rather than equity assets (NCCP Act, 2009, p.77). Logical and detailed documentation of consumers’ long and short-term objectives and requirements for the cost of credit (for example, in terms of [lower or higher] interest rates, repayments, or the total cost of the credit contract) ensure that loan features with specific costs or risks (such as interest-only loans) are undertaken only when they are adequately consistent with the consumer’s underlying objectives and requirements (REP 493, 2016, p.28).

For example, in the context of an interest-only loan, if a consumer’s documented requirements and objectives are that of reducing total costs over the life of the loan, this type of loan would be inconsistent with the consumer’s objective, justifying additional investigation to ensure the suitability of the loan (REP 493, 2016, p.28). Similarly, if it is foreseeable that a consumer would be unable to meet contractual credit payments and additional transaction fees at the conclusion of the ‘repayment free’ period, this loan would likely be considered unsuitable (NCCP Act, 2009, p.77). These practices would significantly lower the risks of undertaking a destructive loan, which in the event of default, could lead to additional costs for the consumer in the form of penalties, fees and interest charges. Impacts on a consumer’s credit score and history as a result of undertaking a destructive loan can also hinder future access to credit (NCCP Act, 2009, p.90). Moreover, *‘Finding 8: Benefits that rely on* *consumer behaviour'* in REP 493 noted that in some cases, 'consumers were seeking an interest only loan to free up funds to more quickly pay higher interest debt' without a clear understanding of the 'potential additional costs if specific actions were not taken' (REP 493, 2016, p.10). By ensuring that licensees have notified consumers of higher costs over the total length of the loan (See REP 493, Action 7), potential additional costs, and necessary actions (See REP 493, Action 10), this approach would ensure that the customer has adequate knowledge of the actions and behaviours that are needed to extract the cost advantages of a specific loan feature (REP 493, 2016, p.10). For instance, when applying for an interest-only loan, consumers should be aware that undertaking contractual payments without an offset account will lead to higher interest costs over the long-term, thus use of an offset account may be recommended to the consumer to minimise overall costs (REP 493, 2016, p.6).

The approach proposed by C4, however, could increase the cost of compliance for the industry, which could then be passed onto consumers, for example, in the form of higher mortgage rates (Fogel, 2004, p.461). In addition to possible increased consumer costs, some argue that these requirements can increase the cost of lending to the extent that lenders will flee markets as opposed to giving out loans to consumers who are marginal risks (Fogel, 2004, p.462). However, the *Financial Services Royal Commission* (2019) noted that '[t]here is little evidence to suggest that the recent tightening in credit standards, including through APRA's prudential measures or the actions taken by ASIC in respect of [responsible lending obligations], has materially affected the overall availability of credit' (Financial Services Royal Commission, 2019, p.58). As a result, to the degree that firms follow the approach outlined in C4 to offset negligent credit assessment practices, there will likely be beneficial developments in credit quality for consumers (Financial Services Royal Commission, 2019, p.58). Therefore, the proposed guidelines of C4 and REP 493 ensure that consumers are more likely to access beneficial credit which is consistent with their overall cost objectives and requirements (Fogel, 2004, p.462).

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