Responsible Lending, Automated.

Better Outcomes for Everyone.

White Paper

May 2019

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About the Author

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Your Comments

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1. Executive Summary

Having weathered the Global Financial Crisis relatively unscathed, the Australian credit industry finds itself under pressure to get its house in order with regards to responsible lending.

Currently the NCCP Act does not define the terms 'reasonable steps', 'verify', 'substantial hardship' and 'scalable'. This has resulted in uncertainty about what is required to comply with responsible lending and has led some lenders to throw their hands up and pine for process certainty. Having more prescriptive responsible lending regulation may make it easier for lenders to implement compliant process, but more prescription runs the risk of limiting RegTech innovation and automated alternative approaches.

Our objective is to support the industry to reach a shared sense of what good responsible lending looks like to enable better policy and better, radically simple approaches to responsible lending processes.

A key point of weakness is the intersection between data governance, credit risk and responsible lending. The classic case is using transactional data, which was obtained for the purpose of verifying financial information, to build risk models without explaining that use. Does that meet community expectations around how data is used? These are questions that need to be addressed by the industry before they become problematic for the community.

Responsible lending policies must adapt and evolve and be mindful of the fact that the community expects more than just 'avoidance of harm to borrowers'. Specifically, in an application process, the goals additional to avoiding harm to borrower, include:

1. *Avoid credit loss*
2. *Automation: Fast, frictionless, appropriate effort for consumers*
3. *Respectful of privacy (not creepy), taking a Privacy by Design approach*
4. *Promote consumer education/financial literacy*
5. *Transparency:*
    a. *Consistency across credit licensees*
    b. *Processes that are practical, explainable and transparent*
6. *Unintended consequences are considered and managed or neutralised*
7. *Continuous improvement is embedded into the system with data driven feedback loops.*

Based on the workshops we conducted as a part of the Expense Verification Framework Initiative, we believe that a radical simplicity approach is worth exploring because it could enable all the goals above to be met.

In conclusion, we hope you take away four points from this paper.

- *Good automation in lending is good for Australia. This requires responsible lending compliance being automation friendly.*
- *We must tackle responsible lending from the spirit and policy aspect down and make sure that there is clarity on requirements without limiting innovation. If the NCCP legislation is not fit for that purpose, it should be fixed.*
- *We must ensure that the broader sets of community goals are taken into account in responsible lending, otherwise other critical community outcomes will be compromised.*
- *Lastly, wherever possible, a design thinking approach needs to be taken where all stakeholders co-create what good looks like. We do not believe there is a silver bullet for responsible lending compliance (e.g. the Consumer Data Right) but we do believe that creative, design thinking with all stakeholders will result in a better outcome.*

2. Introduction - Is There a Problem?

The Australian credit industry finds itself in a moment of inflexion. Having weathered the Global Financial Crisis (GFC) relatively unscathed, it finds itself having lost faith with the community, its regulators and the parliament and under pressure to get its house in order with regards to Australia's responsible lending laws.

As we write this paper, it is clear that Financial Services has lost the trust of the community. The question is, how do we fix that?

One area where the community has lost confidence is expense verification. In this specific problem area, the goal of this paper is to attempt to diagnose the problem and highlight the path to finding solutions. It is written from a place of deep respect for the Australian financial services system and Australia's system of parliamentary democracy. It you step away from the drama you can see a democracy that is 'self-cleaning' a heavily regulated industry that has not managed to protect itself from misalignment and conduct risk, and has failed to keep the consumer at the heart of what it does. It is disappointing to be in this place, given that the industry weathered systemic risk during the global financial crisis (winning it global admiration), and has a regulatory system (and regulators) that are the envy of many nations. The industry attracts talented and capable staff in all areas, and knowing many of them personally, we see a group of people who wake up every day wanting to do the right thing and yet, collectively, failed to deliver in a way that met expectations and delivered trust 'at scale'. We will leave it for the academics to argue for decades as to how all of the above came to pass. We are where we are.

Right now, it is easy to focus on the 'self-cleaning' work of Royal Commission, courts, tribunals and the remediation programs of the industry. Certainly, that is personal and emotional. It has to be worked through. But not by us.

We are focused on the possibilities beyond that – and believe that Australia will get good consumer outcomes by the entire industry co-creating to build a better system. Not only that, since digital disruption is forcing more automation of financial services, we know that good automation is the only way to achieve better outcomes for everyone. We are focused on expense verification because in that pocket of the world we are very active. We also believe that the learnings about the process and thinking to get to better outcomes in expense verification is generalisable beyond the corner of the industry we operate in.

Why Did Verifier Write This Paper?

This policy paper is the result of Verifier's work in facilitating the Expense Verification Framework Initiative, focused on the regulation of responsible lending – via the NCCP Act (and regime). The paper is written in the knowledge that policy makers and regulators are currently looking at how to regulate expense verification and lenders are looking hard at how they upgrade their responsible lending processes. Most immediately, ASIC is in a consultation phase on its Regulatory Guidance on the subject, and expense verification compliance is before the Federal Court.

Verifier felt it crucial to speak up on expense verification because, post the Hayne Royal Commission, there appears to be a general reluctance in the industry to ask the tough questions about what problem we are really solving for.

Our objective in this paper, and in our work on the Expense Verification Framework Initiative, is to support the industry in reaching a shared sense of what good looks like, which enables better policy, better approaches by lenders to responsible lending, and a market for good offerings to support that – including products built by service partners and RegTechs (regulatory technology companies). With regards to the Expense Verification Framework Initiative,

all stakeholders in the industry – including regulators and policy makers – are welcome to participate. More than 50 participants (lenders, service partners, regulators, industry bodies, advisors) joined our first two workshops in Melbourne and Sydney.

The opinions in this document are Verifier's alone. However, the learnings draw on our work in preparing to run that program, including at least a hundred hours of discussion with a number of industry stakeholder groups. More on the Initiative, and an open invitation to participate, is included at the end of this paper.

The rest of this paper is specific as to expenses. However, as we said earlier, the process we went through, and the learnings are generalisable. But for now, let us get specific.

With regards to expense verification, what might good look like?

Expense Verification – Why Is It So Hard?

To answer the question as to what all the fuss is about with expense verification, ask yourself if you know what you spent last financial year? How about if you were asked to split that into 13 categories? Let us ask another question. Did you spend more last December than in February? Or, if you own your own home, do you remember the transition from renting to owning – did that change any of your spending habits?

The truth is expense verification really is difficult because:

- expenses are volatile
- expenses are a product of lifestyle choices every day
- expenses change with life stage
- expenses are seasonal
- expenses are made over a range of payment methods (cards, EFTPOS, cash…) so unless you have access to credit card statements as well as the bank statements you are missing the whole story
- expenses can be shared across households unevenly – "I will pay the gas bill if you pay for the holiday"
- expenses are very detailed – and tell you a lot more about a person's life than their payslip
- expense data is hard to categorise – feedback from the industry is that more than 30% of bank transactional data cannot be linked back to an obvious expenditure
- expenses are increasingly electronic – bank statements for a month can run into hundreds of payments including travel cards, coffees, parking etc. In the past these were handled in cash, so bank statements had far fewer line items
- getting data about expenses requires consumer permission and effort.

Expense Verification - Is There A Problem with Automation?

The automation that is at issue in expense verification is the kind of automation that supports decision making, as opposed to robotic arms on garbage trucks and contactless payments, technology that supports a transaction rather than a decision.

The answer is good decision automation is good. The trick is what does good look like and how do you get it!

Let us start with what is not good.

Firstly, let us be clear, manual processing driven decision making is not the answer:

- Manual processing increases industry costs. For Australians to get good outcomes system costs need to be as low as possible. If automation does not work then the services fees in deposit, credit and insurance sectors go up.

- Manual processing injects human bias and judgement issues, and since no two humans think identically that means decisions are inconsistent. We all have cognitive bias. We all have good days and bad days. Manual processing leaves you dependent on the mood and value set of the assessor. You can give the assessor a policy manual, but the truth is most of our biases are unconscious and most policies

leave plenty of room for bias. This type of process puts us back to the 1950s where you put your best suit on and sat down in front of the bank manager. The outcome will probably depend on whether you get the assessor on a good or bad day, whether you get a morning person in the afternoon or vice versa, or your assessor has issues with how you spend your money.

- Manual processing injects conduct risk. And let us face it, the Hayne Royal Commission has amply demonstrated how hard conduct risk is to manage. More humans, more conduct risk, more issues.
- Manual processing is hard to monitor, not just from a consistency perspective but also from a compliance perspective. The RegTech sector is developing innovative tools with natural language processing and anonymous feedback "whistle-blower" mechanisms to monitor human compliance. But, frankly, automated systems are easier to monitor - if the metrics are clear. More on that later.
- There just is not enough people to do the manual processing. As we saw in the slowing up of credit during the Royal Commission, there simply is not enough people to do the work – to run Australia's financial services requires automation. It just needs to be good automation.

Equally, what is not good is poorly deployed automation. Automation seems like the answer to the issues above - and it is. But, it can cause harm at scale if not deployed well. Here are some examples of what bad looks like:

- Automation that is tuned to the wrong outcomes is always problematic. The biggest issue with automation is its greatest strength. If any machine (a car for instance) is pointed the wrong way, it ends badly. Automated lending will consistently, with velocity, do what it is instructed to do. If the instructions are wrong, *the harm is at as great a scale as the potential benefits*.
- Automation that is poorly monitored. That means that the goals must be well defined and capable of monitoring, and that the monitoring happens. You would not drive your car without knowing what speed you are going or how much petrol you have. Good monitoring is mandatory.
- Automation that kicks out the majority of cases to manual processing obviously defeats the purpose. That will happen if clear steps cannot be articulated to make the decision (e.g. interpreting bank statements) or answers are inconclusive in the majority of cases (and go to refer queues).

Good automated decision making is pretty much the opposite of manual decision making. It is scalable, measurable and consistent. It takes time and cost out of the process, is easier to monitor.

In financial services, an example of good automation is the move from the 1960s to adopt credit scoring. There are plenty of academic papers to attest to the benefits of credit scoring. Scoring delivered lower costs, lower loss rates (good for lenders and borrowers), and more consistent outcomes. Likewise, AML (anti-money laundering) sanction screening checks can only be done at the velocity required with automation. Sure, in both credit risk and AML, models have created problems – sometimes big ones. But the truth is that overall, automation is worth it. Just like cars cause accidents, as a community, we believe they are useful, and so we use them (with appropriate controls).

Is There A Problem with the NCCP Regime Itself?

NCCP effectiveness is continuously being examined – one thing the NCCP regime does not lack is review mechanisms. We note that ASIC is currently running a consultation process on the NCCP and specifically on RG209 (CP309). We also note that there is a continuous feedback loop between Federal Court activity and the RG209, and that part of that process are Regulatory Impact Statements for material changes to the NCCP regime. Our paper will be submitted as part of that review process and will be shared with other stakeholders in the overall regulatory environment.

NCCP effectiveness in a systems sense is largely unexamined except when it is slated for policy

review. That happens less frequently. That is the level we wish to tackle. Firstly – according to the goals of NCCP – and secondly against the broader systems goals.

Performance Against NCCP Objectives

The public policy goal of the National Consumer Credit Protection Act 2009 (NCCP) regime is to avoid causing harm to borrowers[1]. In the NCCP, this policy goal is reflected in the prohibition on lending to a borrower if complying with repayment obligations would result in 'substantial hardship' for the borrower. But what is that exactly?

It is possible that the NCCP regime does not meet the test of 'good regulation' - that is, it is legislation that sits in a 'no man's land' between an intention of doing no harm to borrowers (noting that the term 'substantial hardship' is not clearly defined) and process requirements that are not defined and are acknowledged to be 'scalable' - a term that is not defined. This leaves a vacuum for lenders to fill. This vacuum can then be filled only when a specific case is reviewed by a court or by the Australian Financial Complaints Authority Limited (AFCA), where the overall functioning of the system is not part of their remit.

At the time the NCCP laws were put in place, and many times thereafter, the point has been made that the NCCP regime may itself have a problem. There are clear principles for what good looks like in terms of regulation[2].

These are worth consideration:

1. Establish a case for action before addressing a problem;
2. A range of feasible policy options must be considered, including self-regulatory, co-regulatory and non-regulatory approaches, and their benefits and costs assessed;
3. Adopt the option that generates the greatest net benefit for the community;
4. Legislation should not restrict competition unless it can be demonstrated that:
    a) the benefits of the restrictions to the community as a whole outweigh the costs, and
    b) the objectives of the regulation can only be achieved by restricting competition;
5. Provide effective guidance to relevant regulators and regulated parties in order to ensure that the policy intent and expected compliance requirements of the regulation are clear;
6. Ensure that regulation remains relevant and effective over time;
7. Consult effectively with affected key stakeholders at all stages of the regulatory cycle; and
8. Government action should be effective and proportional to the issue being addressed.

Aside from assessing NCCP on general principles, four key weakness of the NCCP are currently in the spotlight post the Hayne Royal Commission:

Definitions: NCCP Offers Limited Clarity

ASIC v Westpac [3] highlighted the fact that key concepts in responsible lending obligations, such as 'reasonable steps', 'verify', 'substantial hardship' and 'scalable', are not defined.

Noting those court proceedings - Commissioner Hayne wrote in the Final Report that:

'If the court processes were to reveal some deficiency in the law's requirements to make reasonable inquiries about, and verify, the

[1] This policy goal was noted by Commissioner Hayne in the Final Report: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry February 2019, at page 59.

[2] Council of Australian Governments – Best Practice Regulation 2007 https://www.pmc.gov.au/sites/.../COAG_best_practice_guide_2007.rtf.

[3] *ASIC v Westpac Banking Corporation* [2018] FCA 1733

consumer's financial situation, amending legislation to fill in that gap should be enacted as soon as reasonably practicable.[4]'

The vagueness of the definition of what is responsible lending has led some lenders to throw their hands up in the air and pine for process certainty. "Just tell us what to do". While that is an understandable, visceral response to uncertainty and the fragmentation of approaches to meeting the obligations, it pretty much guarantees that the tap of innovation will be turned off. Is it not better to work out what the outcome test of NCCP is? We would argue that if a measurable outcome cannot be defined that is separate to other system goals, then it is worth revisiting the tests of good legislation.

The Royal Commission – Expenses - Do as I Say Not as I Do

The recommendations of the Hayne Royal Commission set out in the Final Report (at the time of writing this in early May - both the Government and Opposition have expressed support for unspecified levels of implementation) do not speak directly to the expenses aspect of responsible lending. Instead, if implemented, the recommendations will shape the expenses aspect as a consequence of:

- On the one hand - abolishing a range of existing exemptions to the NCCP Act (notably, the Point of Sale exemption) and a corresponding shift of focus to meeting the intent of the law rather than its 'black letter' terms; while
- On the other hand – in suggesting that present benchmarks are insufficient (such as the HEM [5]) the Royal Commission exhibited a bias towards reviewing bank statements, which contradicts its stated preference to focus on intention of the law rather than prescribed process.

It is clear from the work of the Expense Verification Framework Initiative that bank transactional data is not a silver bullet.

So, we would love to see law makers and regulators focus on the "intent" of expense verification rather than prescribe a process.

The reason is that when processes are prescribed, risk is injected into the system. Regulators and law makers are several degrees removed from the data and the process complexity. The risk is they pick and prescribe the wrong process and thereby create system wide risk. Additionally, they would stifle innovation and prevent the possibility of better approaches in the future. Similarly, prescribing a specific process (or tool) limits competition amongst service partners. None of these outcomes are desirable.

On the other hand, if policy makers can be clearer on the goals that actually reflect the spirit of the legislation, then the industry can get more innovative in how to address those goals at the scale required.

AFCA as the Policy Maker of Last Resort

Absent legislative clarity on what responsible lending entails, lenders are left in a relative vacuum that is filled by precedents set by AFCA in response to individual complaints brought before it.

If the ultimate test of how a lender should comply with responsible lending obligations is driven by a tribunal that does not have a policy mandate, the risk is that the problems of the few drive adverse outcomes for the community at large. The reality is that some borrowers will not be able to repay their loans as planned. This is often driven by life events (job loss, divorce or other life changes, medical issues). Just because a borrower cannot repay her or his loan as planned does not, of itself, indicate that irresponsible lending occurred. Having a tribunal as the de facto setting of policy does not make for good policy outcomes. This point says nothing about AFCA, its mandate or its process and performance. It just points to the fact that AFCA's mandate is not setting policy. How did it get to be the NCCP policy maker of last resort?

[4] Final Report, at page 57

[5] Household Expenditure Measure (HEM)

What data is "readily available, and that it would be reasonable to obtain" – Consultation Paper 309 (Appendix 1)

What data is available to lenders is a hot topic. ASIC in its Consultation Paper 309[6] is suggesting that it provide direct guidance on data availability and the reasonableness of using it. We do not agree with ASIC's views on availability as tabled in that Appendix – and we furthermore think that defining this needs sensitivity to supporting automation and to the broader issues that accessing data brings up. The rest of this paper attempts to define those broader goals and highlight some of the issues in obtaining (and using) data in those broader contexts. We think that reasonable itself needs defining, and a distinction needs to be made between reasonable in a philosophical, practical and competitively neutral sense. In other words, testing this concept against the criteria of good regulation referred to earlier:

Reasonable – in a philosophical sense: ASIC in its consultation paper acknowledges that some might argue that it is not reasonable to ask people to compromise their banking portal user names and passwords in order to pass bank transactional data to lenders to evaluate for responsible lending. This we totally agree with, since this practice is prohibited in the European Union [7] , the practice violates consumers' obligation to keep passwords secret, leads to problematic liability issues and injects systemic cyber-security threats into the system. When put that way "screen-scraping" as it is commonly referred to does not sound reasonable, does it? However, CP309 suggests that it is reasonable to obtain expense data by using the Consumer Data Right to access bank statements. Will ASIC expect that lenders might compel people to share that data, knowing that the Consumer Data Right is actually intended to be a right not an obligation?

Reasonable – in a practical sense: Just as important in these discussions is the issue of accessibility 'at scale'. Just because I can get the PDFs from my bank statements and submit them to a lender in connection with a significant loan application does not mean that is fair to me as a consumer (or to the lender) when I am taking out a low value loan in a conveniently digital process. This ties into the meaning of 'scalability', arguably the most important test in the NCCP regime, second only to the meaning of 'harm'

Reasonable – in a competitive sense: Since retailers can now offer store finance or digital layby, is it reasonable to request bank statements for retail finance when digital layby does not require this? This is just one example. The irony of this whole process of 'self-cleaning' of financial services is that it is happening at a time of digital transformation. For the FinTechs, automation is not optional. Likewise, for incumbents who wish to survive, automation is not optional. Hence the need for good automation.

[6] Consultation Paper 309 – p.34

[7] Revised *Payment Services Directive* (PSD2)

3. A Choice – Radical Simplicity or Rabbit Hole

It is seductive to layer more requirements on top of existing laws, and yet the Royal Commission indicates that it is not a lack of law that was the problem, but the complexity of it. We see this complexity mirrored, in a microcosm, with expense verification. Verifier and the workshop participants identified many radical simplicity options for expense verification. It is time for the industry, policy makers and regulators to choose the path forward on what must be done to meet expense verification obligations. The choice is:

- *go further down the rabbit hole by deciding that the NCCP Act policy goal of avoiding harm can only be achieved by making more extensive and privacy-invasive enquiries about an applicant's expenses – and taking more extensive steps to verify those expenses,*

  or

- *as an industry focus on exploring, in tandem with policy makers and regulators, the concept of 'radical simplicity'. By this we mean, prove that there is a better, non-invasive way to meet the policy goal of the NCCP Act and the broader range of goals set by the numerous stakeholder groups in the community and then work with them to legislate for this far happier outcome.*

Performance of NCCP Against Broader Community Goals

The community expects more than just the 'avoidance of harm'. As all stakeholders consider how the industry is to respond to the demands on it, it is important to be clear on the overall goals, lest one objective create problems elsewhere. To date, the work of the Expense Verification Framework Initiative has identified the following requirements from lenders as they look to update their approaches to application processing. Specifically, the following objectives, in addition to avoiding harm to borrowers, are:

1. Avoid credit loss
2. Automation: Fast, frictionless, appropriate effort for consumers
3. Respectful of privacy (not creepy), taking a Privacy by Design approach
4. Promote consumer education/financial literacy
5. Transparency:
   a. Consistency across credit licensees
   b. Processes that are practical, explainable, transparent to consumers, distribution channels and staff
6. Unintended consequences are considered and managed or neutralised
7. Continuous improvement is embedded into the system with data driven feedback loops.

For the sake of clarity we will elaborate a little on each of these, for while they are somewhat self-evident when written down, it is worth reflecting on which stakeholders care about which of these – for in part we think the breakdown in policy development with respect to expense verification is caused by stakeholders thinking in their own silos.

We make apologies in advance for the relatively simplistic analysis below regarding who cares about what. Our aim is to paint a broad-brush picture and highlight the gaps – ultimately all credit industry stakeholders could and should care about the outcomes for the community overall.

Avoiding Loss – Lending Business as Usual

Credit risk is standard fare for lenders. It is what their credit risk engines and systems are tailored to. The Australian Prudential Regulation Authority (APRA) cares about credit risk. Lenders and their financiers care about credit risk. The Reserve Bank of Australia (RBA) cares about the systemic impacts of credit risk. No government

wants another global financial crisis. No one wants a recession. And at least those who are home owners do not want a negative equity cycle.

Automation is a Goal That Matters

Consumer credit is a fact of modern life; it enables cashflows to be balanced and supports the modern Australian economy. The RBA is the first to state the goal of keeping credit flowing in the economy. In turn, at the scale consumer credit operates, it requires automation of the majority of applications for the majority of products. Absent a good data point, think of this as the 80:20 rule in action - 80% automation for cases that are standard, leaving time to focus on the 20% that are non-standard.

Without scale, lending does not add the value the community requires. If there is any problem with lending at the current time, the most evident problem is the slowing of credit as a result (to some degree at least) of the increase in manual processing post the release of the report of the Hayne Royal Commission. Default rates are not the problem.

We look forward to academic analysis of this in due course – but our strong sense is that the key driver of the credit squeeze observed in 2019 is a switch from automated processes using benchmarks to manual processes using humans to assess bank statements. In time, once NCCP obligations are clarified, we will end up with good automation and the credit squeeze will be seen to be a failure of policy and industry oversight rather than a squeeze we 'had to have to be responsible'.

Yes, there has been misconduct in the industry. Yes, there is a need to create trust and transparency. But no, there is no need to return to 1950s' manual processing. That is an unnecessary step backward.

Respectful of Privacy and Community Standards

It is a pity that the Hayne Royal Commission did not look beyond misconduct cases regarding breaches of financial services regulations to privacy breaches and general creepiness caused by privacy invasive practices. The anecdotes from the credit squeeze of 2019 are a litany of problems related to bank statement analysis.

The Office of the Australian Information Commissioner (OAIC) is focused on privacy. We would like to see more consumers and consumer groups focused on this issue – and if they do, it is likely to lead to outrage. At the moment, the whistle-blowers in this regard are the risk industry professionals who point to consent asymmetry, and the fact that data used to assess serviceability under responsible lending can be used for secondary purposes, including risk analysis and marketing analysis. Should people who enjoy alcohol, gambling or brothels not get access to credit? Should access to credit be denied to people who visit cancer specialists?

Much is said about AI – the truth is, risk models can probably predict the chance of you getting divorced better than you can. Do we want to live in a world where a lender says "Sorry Mr X, we cannot lend to you because you have 75% chance of divorce in the next two years based on your transactional data and the fact that you are applying for a renovation loan which, of itself, statistically increases the likelihood of divorce by x times." As an aside - anyone who is either in a relationship or has renovated, will appreciate why that might be!

Verifier welcomes the advent of the open banking reforms, which will (when enacted) implement the 'Consumer Data Right'. But, to all those who think that will fix the expense verification problem – think again. The Consumer Data Right is exactly that – a right and not an obligation. The Australian Competition and Consumer Commission (ACCC) cares about the Consumer Data Right, and the fact is that its policy goal is to promote competition. The ACCC cares that consumers give their consent expressly, voluntarily and for the purpose stated. That is fair enough. Are we going to force people to use that right (to address lenders' responsible lending compliance challenges) when sharing might be detrimental to them?

Let us not forget the creepy/community standards issue. A process might feel invasive even if it is compliant with privacy law. This leads us back to the earlier discussions around what an assessor might think about your spending habit

expenses and the large number of articles written about consumers being impacted by lifestyle choices in loan applications.

Consumer Education/Financial Literacy

ASIC, the broader community, the industry and financial counsellors/consumer welfare groups are all united in wanting a more financially literate community. This is a no regret outcome. And yet, in all the conversations about responsible lending, we see very little about responsible borrowing. The paternalism inherent in our current system means that a lot about responsible lending happens behind people's backs, rather than drawing them in to the assessment and helping them learn about and improve their financial situation.

By re-imagining the entire credit application process the opportunity exists to really tackle this at scale at the moment of truth – when someone is entering into a loan contract. That will only happen with smart automation – and a lot less trawling through transactional data.

Transparency

There are two issues around transparency.

Internal to the lender:

Financial literacy and automation are both aided by clarity around how responsible lending assessments happen.

One of the challenges presently is that there is a large variety of approaches to lenders' internal responsible lending policies and processes. As a result of the Expense Verification Framework Initiative, we see a deep need for a smarter way to think about these internal policies and processes. So often, internal policies start at the data level, miss the overall 'common sense' logic, and are written with little regard for the automation challenge. When rules are overly complex, they become impossible to communicate, to reality check, and to automate. Part of the work of the Expense Verification Framework Initiative is the development of 'Good Practice Guides' for internal policy development on shared, significant topics. Our participants are finding this really helpful support to accelerate smarter, internal policy development.

We note a key point of weakness is the intersection between data governance (around privacy), credit risk and responsible lending. These three policies tend to be conflated, confused, and factors get missed. The classic case of that is using transactional data obtained for serviceability assessment to build risk models without explaining that use, and then thinking that credit risk outcomes satisfy responsible lending requirements. That is unsatisfactory.

Across lenders:

Better yet, if at a systems level there is some degree of consistency, but not necessarily homogeneity, then it is much easier for brokers and other intermediaries to operate.

Because of the uncertainty around what responsible lending requires, each lender riffs on the matter and develops their own unique approach to meeting their compliance obligations. What this means for borrowers and brokers is that no two loan applications assess people the same way – when presented with the same facts.

While credit risk policies, models (built on historical data) and processes are a core source of competitive advantage for lenders, we strongly believe that the same is not true of approaches to responsible lending. In other words, if all lenders took a consistent approach to expense verification, it would leave each of them free to focus on risk assessment to achieve competitive advantage.

Is the answer a prescriptive black letter law style NCCP process that must be followed? We say no for two reasons. Firstly, the last thing the RBA or APRA would want is systemic risk caused by reliance on one system or model (arguably that was what HEM added to the mix). But likewise, extreme variation makes no sense at all. We think letting the industry create emergent pockets of consensus around good practice makes sense and enables dynamism and competition. What we think is missing is some kind of safe harbour support for emergent practices.

This is a matter for policy makers to reflect on.

Solving for Unintended Consequences Risk

In a way, all of the broader goals outlined are areas where fine tuning the NCCP Act the wrong way might lead to adverse outcomes. However, more broadly, the point is that if there is not clarity on all the goals, then it is so easy to short change the community without intending to. How are policy makers, regulators and the industry going to fix that? We are convinced that acting in silos is not how to do it.

Continuous Improvement as A Necessity

Similarly, a competitive industry on the cusp of digital transformation should not be limited by overly prescriptive black letter law. It needs to adapt and evolve. So too, responsible lending policies must adapt and evolve. This is why, despite the allure of ASIC setting out in even more detail what lenders should do to lend responsibly, we believe this will set the industry back and create systemic risk. This loops back to the criteria for good regulation. Let us get this right. And make it robust for changing circumstances.

4. Big Issues to Solve

Leaving the policy level issues aside, participants in our workshops identified the following big issues to solve:

- *Benchmarks/models are needed that are fit for purpose and current.*
- *Bank data (statements) are hard to interpret and reviewing the data can feel very invasive to consumers.*
- *Credit licensees cannot assume that consumers will be willing to share transaction data under the open banking reforms. It is an opt-in regime, so credit licensees must plan for consumers who do not opt in to share their transactional data.*

The Big Ideas Are Already There

To date, there have been two workshops for the Expense Verification Framework Initiative, one in Sydney (in February) and one in Melbourne (in April). Even in two days of workshop, participants generated a number of really big ideas, which will continue to be developed as part of the Initiative.

All the big ideas have in common that they start from the consumer's world view and work backwards to what the industry can do about it, recognising that if the person is really at the heart of the process, one size does not fit all. When we say big ideas, we are being a little flippant, because these ideas are pretty obvious when you think about it. But, in contrast to the messy complexity that lenders are wading through, these ideas really are radically simple!

One radically simple idea is to tackle the issue by first distinguishing between at-risk consumers and those who are not at-risk. At the heart of this idea is a discussion that surfaced early in the first workshop of the Initiative around the risk of paternalism creeping in to the process – if I can prove that I have a track record of paying loans back (good credit score) and I have a buffer over some benchmark threshold for expenses given my outstanding liabilities (CCR), isn't it my business what I spend my money on? It would be interesting to test with the community their expectations about personal agency around their money. This is where the idea of distinguishing between "at risk" consumers, who need more active help, and those who don't could play a critical goal in meeting community expectations.

Likewise, when you think about meeting the needs of Australians, another radially simple idea is to bypass the distinction between discretionary and non-discretionary expenses in the light of the fact that one person's discretionary can be another's basic. By categorising expenses, we are making, as an industry, judgments about how people live. Certainly, there are lots of anecdotes about grumpy consumers who feel that their lifestyle choices are being judged. We have a list of media articles on the subject - available on request.

Is there a better way?

It is possible to come up with new, better approaches that truly put people at the heart of what we do. It just takes investment in thinking time and a bit less reaction. This needs the support of regulators and policy makers.

Scalability as the Pivot

The most powerful concept in the NCCP regime, in our view, for supporting responsible lending is the concept of scalability. Getting that wrong can take us back to the 1950s. Getting that right can transform the industry to a digital-first reality.

We have some thoughts on this, but this is where we would like to see the debate centred - with consumers at the very heart of the conversation.

One of the questions on the road to automated responsible lending will be how well-defined does scalability need to be to support good automation without creating systemic risk? And who sets the scalability test?

We think that the industry is capable of setting a good practice standard for this of its own accord, if it chooses. But really, who sets the test is part of the broader scalability debate that needs to happen. Dimensions that might drive scalability include:

- Product significance – value, duration of loan
- Consumer cohort – vulnerable, sophisticated, repeat user of the product, etc
- Serviceability buffer – income less liabilities.

Another key question will be whether scalability is tested against not just responsible lending requirements but all the other goals that the industry must meet.

Automated Responsible Lending – What It Looks Like

We believe that addressing all the system goals will require a radical simplicity response that can be dialled up or down based on the dimensions identified above. This response would ensure that the NCCP Act policy goal of avoiding harm to borrowers is met – as well as meeting all other industry goals. We refer to this as '**Automated Responsible Lending**'. Let us look at what can be delivered in this way:

	Automated Responsible Lending Approach	Continuing the Existing Approach to Responsible Lending
Avoiding Harm	Harm to borrowers measured and monitored.	Harm to borrowers not identified.
Avoiding Loss	Business as Usual	Business as Usual
Automation: Fast, frictionless, appropriate effort	Automation tuned to avoid harm to borrowers but automates the majority of applications.	Manual processing becomes the norm again and/or high referral rates to check on bank statement interpretations.
Respectful of Privacy and Community Standards	'Less is more' principle applies. In general, analysis sits above the transactional data level either via benchmarks with exception-driven benchmarking or aggregated assessment of net inflows/outflows.	Default review of transactional data and lack of appropriate data governance means consumers feel privacy invaded (use in risk models, marketing, awkward questions about medical expenses and lifestyle preferences).
Consumer Education/Financial Literacy	Where issues are identified consumers are involved in the conversation in a collaborative way (for the small number of referrals and also by the way application interfaces are designed in automated cases).	Happens behind the scenes with no attempt to educate the consumer.
Transparency – Within the Process	The process is clear and communicated throughout the organisation. Use of data is not opaque and consumers are clear on what they agreed to.	Data is asked for. The process is not specified.
Transparency – Consistency Between Lenders	Ideally – each lender focuses their efforts on gaining advantage from risk assessment but makes life easier for channels and consumers by applying a set of consistent pre-	Each lender applies distinct, unique, approaches to responsible lending throughout the process.

	screening tests (if not identical). Ultimately, each will interpret the legislation in their own way, but the goal is to minimise variation at the early stages of the process.	
Solving for Risk of Unintended Consequences	By understanding the broader goals and managing change with all lenses at once, risk across all goals is identified and managed.	Currently, each system goal is handled by different regulators, policy makers and teams within lenders. There is no overarching view of the system.
Continuous Improvement as A Necessity	Lending is, and must be, a dynamic, evolving industry. Consumer behaviour varies. The metrics for each goal in the system need to be measured and monitored and each lender must be adapting its approach to present reality.	Measurement of performance on NCCP has traditionally been evaluated in terms of risk or process adherence – new system wide concepts of acceptable/unacceptable variance between stated expenses, what can be verified and what ultimately is experienced by the lender need to be developed and used to identify where work is needed.

Some Key Choices Need to Be Made

As part of working out what expense verification should look like, there are certainly some key choices to be made.

Does the community want to prescribe the steps involved in responsible lending or give more specific guidance on outcome tests?

Being more prescriptive makes it easier to regulate but might hold back innovation and competition.

Are there good reasons to use benchmarks in some cases? We think there are and the Australian Securities and Investments Commission (ASIC) suggests as much in CP309 [8]. If so, there is a need for the industry to invest more in benchmarks both to get clear about how benchmarks should be evaluated, and then to look at how they might be developed. We believe that there is room for multiple styles of benchmark, that are tailored for particular contexts – which would assist with scalability.

We would also make the point that benchmarks are models built with data – and that the use of historical bank transactional data to predict the future is ALSO a model. We think there is a need to recognise that fact and look at how stakeholders can collaborate to make interpretation and use of bank transactional data "models" more consistent and dependable – be it by humans or machines.

How is a lender's performance to be assessed on expense verification? Since expenses are by nature highly volatile, it is not possible to get expense verification 100% right. We think there is a strong case to think in terms of acceptable/unacceptable variances between actual and verified expenses. But if this is what good looks like, then that has to be accepted by AFCA and ASIC.

[8] CONSULTATION PAPER 309 Update to RG 209: Credit Licensing: Responsible lending conduct (**CP309**)

5. In Conclusion: Responsible Lending, Automated – The Only Way

In conclusion, we hope you take away four points from this paper.

- *Good automation in lending is good for Australia. This requires responsible lending compliance being automation friendly.*
- *We must tackle responsible lending from the spirit and policy aspect down and make sure that there is clarity on requirements without limiting innovation. If the NCCP legislation is not fit for that purpose, it should be fixed.*
- *We must ensure that the broader sets of community goals are taken into account in responsible lending, otherwise other critical community outcomes will be compromised.*
- *Lastly, wherever possible, a design thinking approach needs to be taken where all stakeholders co-create what good looks like. We do not believe there is a silver bullet for responsible lending compliance (e.g. the Consumer Data Right) but we do believe that creative, design thinking with all stakeholders will result in a better outcome.*

To illustrate the last point, we offer a quick story. Have you heard the classic story of the truck stuck in a tunnel in the Swiss Alps? The tale goes that the truck was too tall and got stuck (it could easily happen and does at the South Melbourne light rail bridge from time to time!). In response to this drama, the police are sorting out the traffic, the engineers are worrying about bridge stress fractures, the mechanics and emergency crews are looking at the feasibility of sawing the top off the truck etc. In the midst of this chaos, out of a car banked up in the queue emerges a ten-year-old who points at the truck tires and asks why they don't just let the air out? That is what we believe is possible for the lending industry – a clever solution - if we all work together.

6. Invitation to Join the Initiative

As mentioned earlier, this paper is the result of Verifier's Expense Verification Framework Initiative. The Initiative aims to work with lenders and service partners to redefine lending processes to deliver trust at the scale required of Australia's modern, digital financial services industry. The Initiative will progress on the topics and with the velocity that the industry determines.

The Initiative delivers in the following ways:

- ***Thought Leadership** – via policy papers and operational whitepapers – designed to elevate the conversation and promote better outcomes. For everyone.*
- ***Process Innovation** – the Initiative uses design thinking as a model to iteratively ideate, test (with data) and prototype (with Good Practice Guides) better responses to the set of goals that lenders face when assessing applications for credit.*
- ***Data Driven Insight** – the data phase has already begun in earnest – looking at what new styles of benchmark are possible to support creating a win/win between better compliance and better automation*
- ***Good Practice Guidelines** to support acceleration of better responsible lending policies – focused on the key pain points identified by the Initiative participants and workshopped by them. We have just released the Joint Account Guide to participants.*
- ***User Groups** – an ongoing community of interest via the user groups that meet and use the process and data resources of the Initiative to continuously improve and upgrade in respond to changing dynamics – consumer behaviour, regulatory requirements and technological developments.*
- ***Service Partner Involvement** – a cross section of service partners and industry experts are involved to support the lender participants and keep a focus on how vendors and consultants can assist in this evolution of the industry.*