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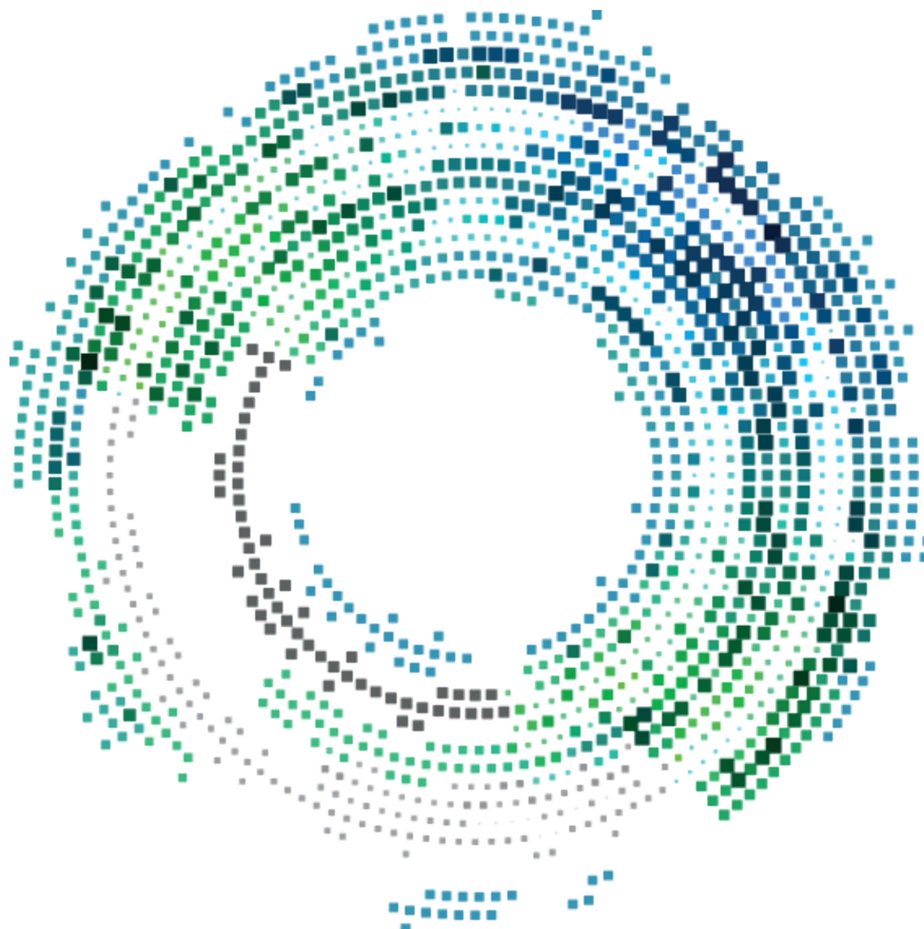

AFCA's approach to Responsible Lending

Deloitte response to consultation

11 September 2023

General Feedback

1. Inquiries and verification steps differ for individual circumstances

While the AFCA approach does acknowledge that the level of inquiries and verification steps that are reasonable can differ depending on the individual circumstances, it only provides examples where more information may be required not less. This is a departure from RG 209 Credit Licensing: Responsible Lending Conduct (**RG 209**) which provides examples of where less information may be required, such as when the consumer has previously had a credit product of a similar kind and amount[1] or when the financial firm has previously had dealings with the consumer and reasonably consider they have an appropriate level of experience or understanding in relation to financial matters[2].

The AFCA approach also refers to undertaking reasonable inquiries and verification where a "complainant knowingly provided falsified documents to verify inaccurate information in a credit application"[3]. Further guidance should be provided on what inquiries and verification would be considered reasonable in determining whether documents are falsified. We note RG 209 refers to the verification of false or altered information in situations where there is a raising of doubt or "reason to doubt".

We recommend AFCA provide more examples of when information in 'Guide 2' is required to ensure the AFCA approach is acknowledging these different circumstances, and detailed guidance on the reasonableness of inquiries and verification in line with RG 209.

2. Identification of harm and loss

We agree with the approach outlined on page 39, which states "*A complainant may suffer loss even if they meet repayment obligations. Consumers are considered to suffer gross loss when they enter into an unsuitable contract. In some cases, consumers may find a way to make repayments but will endure substantial hardship when doing so. This could include forgoing essentials or borrowing money from family and friends.*"

We believe this is an important inclusion and agree that a consumer falling into arrears is not required for the loan to be unsuitable. In our experience, this is particularly important when a complainant's case uncovers a systemic issue in the lending process. In such cases, it is not appropriate to identify impacted consumers solely on the basis of those who have fallen into arrears after the loan approval date. While arrears is an indicator of potential unsuitable lending, a more thorough identification process is required to identify the complete impacted consumer population.

3. Good industry practice

The AFCA approach aims to ensure consistent application and understanding of lending complaints internally and externally[4]. To achieve this, it is important that financial firms have a clear understanding of the approach. However, the current draft includes subjective measures, such as "good industry practice", which makes it difficult for firms to replicate the review process consistently and deliver timely, fair outcomes in the first instance through their IDR process.

The draft paper includes reference to the Law, to Regulatory Guides, to Industry Codes, to Bank policies, and to past AFCA decisions. These are all factual references that can be incorporated by the financial firm. "Good industry practice" cannot be incorporated into an IDR approach unless it is codified. AFCA should consider providing more detailed guidance (on how to measure good industry practice) or a separate document with a standardised approach to "good industry practice" to encourage transparency and consistency.

[1] ASIC RG209.86 (a).
[2] ASIC RG209.86 (c).
[3] AFCA approach paper, page 22.
[4] AFCA consultation paper, page 3 & 4.

4. Approach over time

Financial firms and AFCA receive complaints about loan applications that date back many years. In some cases, the review of these complaints requires the financial firm to refer to records that are decades old. This can be challenging, as the standards and practices of the financial industry have changed over time. It is essential that AFCA does not hold financial firms to a standard that was not in place when the loan was made. This is particularly important for loans made before 2011, when the National Consumer Credit Protection (NCCP) Act was introduced and when AFCA uses the term "good industry practice" to assess the financial firm's conduct.

If AFCA is aware of what "good industry practice" was for certain buffers and benchmarks over time, we suggest that this information be made available as an appendix to the approach document or a separate document. This would provide financial firms with clear guidance on how to assess their conduct when reviewing old loan applications. The appendix could be in a table format, with date ranges and references to the source (such as APRA or ASIC guidance) to improve transparency. We believe that providing further guidance on this would help to ensure that complaints are handled fairly and consistently, regardless of when the loan was made.

5. Retirement rule, discrimination and subsequent events

The AFCA approach suggests that "*If a financial firm is aware a complainant is likely to reach retirement age during the term of a loan, it should consider how the complainant will meet their repayment obligations or otherwise repay the loan in retirement and what their retirement income is likely to be*"[5]. We believe that this approach is too broad. The approach requires financial firms to consider repayment obligations that could be decades away from the consumer's actual retirement. A standard home loan term is 30 years and, for example, the AFCA approach would require retirement plans discussed with an individual who is 38 years old where the high probability for a consumer's retirement plans and circumstances to change make this rule unrealistic. Further, there is no standard retirement age used by industry. If the AFCA approach requires assumptions about the complainant's retirement age, the approach and source materials to determine this is not provided. The retirement rule within RG 209 is that if a "*consumer is approaching retirement, and will still be making repayments on the credit product after their expected retirement age, you will need to determine whether this event is likely to change their income, and information about the amount is expected to be available*"[6]. We note that "*approaching retirement*" as used by ASIC and "*likely to reach retirement age during the term of a loan*" as used by AFCA have different meanings. The approach within RG 209 is the preferred approach to describe the retirement rule.

The use of the phrase "reasonably foreseeable over the term"[7] is also subjective and limits transparency and ease of application in the IDR process. The lack of clarity is also problematic when financial firms must not reject or discriminate loan applications based on certain factors, even if they are "reasonably foreseeable".

The AFCA approach states that "*Subsequent events (e.g. illness or unemployment) that later cause the consumer to be unable to meet their repayments will not be relevant to the assessment unless the financial firm was on notice of these events or would have been on notice if it had made reasonable inquiries, or taken reasonable steps to verify the complainant's financial situation*"[8]. This would indicate that the financial firm is required to delve into a consumer's personal or private health situation and undertake reasonable inquiries if they were to notice something amiss. We suggest further clarification and guidance should be provided around what reasonable inquiries would look like in the instance where a subsequent event has taken place in a consumer's life that affects their ability to attend to repayments that they are yet to disclose.

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[5] AFCA approach paper, page 20.
[6] ASIC RG 209.64 (a)
[7] AFCA approach paper, page 19.
[8] AFCA approach paper, page 26.

We suggest AFCA revisit the approach to be more specific on these items to ensure the approach is fair and consistent.

6. Determination of loss

The approach to loss determination should be clear, transparent, and based on principles. This will help to ensure that complaints are handled fairly and consistently, and that they are less likely to be escalated. The following is general feedback on Part 2 of the approach:

a. Outline the compensation principle(s)

We recommend that the approach set out compensation principles. These high-level statements will enable complainants and financial firms to assess whether the approach applied has achieved the principle. For example, a general principle for remedy when a consumer has experienced loss or disadvantage is to *restore the consumer to at least the position they would have been in had the issue not occurred*. With lending products, this can be a difficult principle to achieve, particularly when the residential home has been purchased with an unsuitable loan and a prior home has been sold. Further principles, similar to those expressed by AFCA in the past[9], would then be provided to provide clarity, for example:

- Principle 1: the credit provider should not benefit from an unsuitable loan.
  This will often mean that even after a borrower was compensated for their loss, when there remains an outstanding unsuitable debt, no further interest and fees should be charged on the unsuitable portion of the loan.

- Principle 2: The borrower should be required to repay the principal funds loaned to them.

- Principle 3: The costs and benefits incurred by the borrower as a result of the lend will be included to determine an appropriate compensation amount. The nature of the costs and benefits to be considered varies depending on the type of credit provided to the borrower.

- Principle 4: If the borrower is unable to meet repayments after the compensation has been provided, the borrower has the right to seek financial hardship assistance.
  This can occur when the AFCA compensation cap leaves the borrower with a remaining liability. The right to seek hardship arrangement exists independently of responsible lending issues.

b. Remove uncertain language

We believe that the approach to loss calculations can be stated with certainty. Clarity in the approach to loss will improve efficiency and consistency. The AFCA approach uses the phrase "we may" in many instances. We believe this language is unnecessary and will limit the ability to standardise and apply consistency to loss calculations. Further, the phrase "we may" is often used when discussing benefits received and not when discussing the costs incurred by the borrower. This subjectivity and lack of transparency on one side of the ledger is an unnecessary inclusion for what could be a prescriptive section. We recommend that the AFCA approach revisit the uncertainty in the loss section. This will help ensure loss calculations are applied consistently and fairly.

c. Remaining liability

We recommend further guidance be included regarding the adjusted debt amount. In our view, whether further remedies are required once compensation has been paid, would depend on whether the consumer continues to benefit from the asset purchased with the unsuitable loan. For example, if after being

[9] AFCA response to Royal Commission's Interim Report 26 October 2018 (page 4).

compensated the consumer remains liable for some of the principal borrowed (i.e. the compensation amount is less than the outstanding loan balance) further considerations should occur:

- The financial firm must determine if the adjusted debt is suitable for the consumer's current circumstances.
  - If it is suitable, the financial firm may charge market interest rates on the adjusted debt.
  - If it is not suitable, then referring to the suggested compensation principles above, the financial firm must not benefit from this loan. This would require a 0% interest rate on the adjusted debt and the consumer should be referred to a financial assistance channel to offer any other hardship relief for the principal repayment terms.

- If this was a secured loan and;
  - The consumer has already sold the security and the sale proceeds were applied to the debt (and the adjusted debt does not include further drawdowns on the loan for other or personal use), then this would require a 0% interest rate on the adjusted debt (as this is a debt the consumer would otherwise not have incurred but for the unsuitable lend).
  - The consumer has retained security, the consumer should be given a reasonable amount of time to either sell or refinance the loan. No further interest should be charged on the adjusted debt during this period.
  - In exceptional circumstances when AFCA recommends the consumer may retain the security (and the adjusted debt is suitable) the financial firm may charge market interest rates on the adjusted debt.

    Note that if the security is retained (such as the residential house), the consumer receives an ongoing benefit of the use and potential capital gain from the security. We suggest AFCA detail the steps of the method, the rationale and reference the outcome to the compensation principles. The example AFCA provides on page 37 fails to recognise the benefits of retaining the security as there is no detailed method on this point. Similarly, the example on page 47 extends beyond the remedy for the unsuitable lending when AFCA suggests an alternative interest rate on the adjust debt. The adjusted debt with benefit of ownership of the security is essentially an appropriate debt on which the financial firm will determine an appropriate interest rate. The past issue of an unsuitable loan has been resolved, and if the consumer is in financial difficulty going forward, they should apply for hardship assistance with the financial firm.

7. Loss on unsuitable home loans

We recommend AFCA provide further examples and method details. In our view, it is appropriate to state that when a home loan is found unsuitable, the costs and benefits considered in the calculation will be driven by the loan purpose. This is because depending on what was the primary purpose of the loan, the consumer would be in a different situation had the unsuitable loan not occurred. Loan purposes can be broken into two categories:

- Loans for the purchase or construction of a property
  It is appropriate to include all the costs and benefits that the consumer would otherwise not have incurred or obtained in the loss calculation.

- Loans for the purchase other than the purchase or construction of a property
  These include:
  - Refinancing an existing home loan.
  - Renovation, maintenance or top-up for a property already owned by the consumer.
  - Other investment (non-real estate) or personal expenditure (for instance a reverse mortgage used to finance living expenses).

  For these loans, the assumption is that the costs and benefits from owning the property, securing the loan would have been incurred and earned regardless of the loan being granted by the financial firm. That is, the

consumer's loss is not related to the ownership of the property, but to the existence of the loan. As such, only the costs and benefits relating to the financing of the loan should be considered.

We recommend for accuracy, consistency and transparency in the approach to loss, the table on page 45 of the AFCA approach should be expanded to include the different purposes of home loans along the lines suggested above.

Further, the AFCA approach is currently silent on how loss will be determined in instances where:

- The home loan involves more than one borrower and how the costs and benefits should be apportioned.
- The consumer used drawings from the home loan for personal purposes other than the stated purpose of the loan, and how the costs and benefits of those funds should be dealt with in the loss calculation.
- The complainant is a guarantor of the unsuitable home loans and should have never been a guarantor.

In our view the approach to loss and remedy of these instances should be part of the AFCA approach document and open to feedback and consultation.

8. Loss on unsuitable investment home loans

Investment loans will often include a tax benefit to the borrower. This is in the form of negative gearing and should be included in a loss calculation. AFCA has not mentioned this in the approach.

9. Loss on unsuitable car loans

The examples have not included the benefit of using the car and it is not clear if this is example specific or a method oversight. We recommend the examples include how the calculations will be performed, set out in a clear table.

10. Loss on unsuitable unsecured loans: personal loans

The paper does not discuss the scenarios where a portion of the personal loan was suitable lending. For example, a $20,000 personal loan to renovate a kitchen was unsuitable however a $17,000 personal loan was suitable. In this scenario, the consumer would likely proceed with the kitchen renovation with a reduced budget and the compensation method would focus on the costs and benefits of the unsuitable portion of the loan. We recommend more detailed examples, including a refinanced loan.

11. Loss on unsuitable unsecured loans: credit cards

The example on page 54 is unclear regarding which increased limit was unsuitable and how 25% of drawn down funds as a benefit was determined. We recommend more detailed examples to improve clarity on the calculations proposed.

We also recommend synergy between the approach to compensation for credit cards and personal loans. These are both unsecured lending products where it is reasonable to state that the consumer has had the benefit of these funds (often perishable goods, lifestyle choices and holidays) and will therefore always remain liable for the principal amount (principle 2 above) while the financial firm may not benefit (charge interest) on the unsuitable portion of the lend. Statement like these will make the approach clear for the many different scenarios related to these products.

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