

# **Revised exposure draft of the Credit Contracts and Consumer Finance Amendment Regulations 2020**

Submitted to

Competition and Consumer Policy team

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# Commerce Commission submission on exposure draft regulations to the Credit Contracts and Consumer Finance Amendment Regulations 2020

## Introduction

1. Thank you for the opportunity to provide comment on the proposed revised draft of the Credit Contracts and Consumer Finance Amendment Regulations 2020 (the **Revised Draft Regulations**).
2. Our objectives in making these submissions are:
  - 2.1 to assist the development of regulations that are clear for industry and enforceable by the Commission; and
  - 2.2 assist MBIE in ensuring that the regulations reflect policy.
3. These submissions should be read in conjunction with our submissions on the previous draft regulations, dated 7 February 2020.
4. As outlined in our earlier submissions, in our view regulations relating to the Lender Responsibility Principles should:
  - 4.1 describe the minimum inquiries and levels of verification lenders should make; and/or
  - 4.2 set a bright line determining when a credit agreement will be unsuitable or unaffordable.

## General Feedback

5. We recognise that some changes that have been made address some of our earlier submissions. These include changes addressing gaps identified in those submissions, and changes that go some way to ensuring that the prescribed inquiries are appropriate for a complete range of credit products (and borrowers' circumstances).
6. We continue to support prescription in relation to the affordability and suitability assessments, but consider it is important to strike a balance between providing clarity and certainty in this area and creating inflexible rules that will be difficult to apply in relation to new credit products or in particular economic circumstances (for example a global pandemic).
7. We expect that the extent and type of inquiry into affordability and suitability that is appropriate in any particular circumstances will depend to some extent on the borrower's circumstances and the type of credit product involved. There are also specific inquiries that are clearly relevant for some products, but not for others.

8. We support an approach that retains some principles-based obligations, but supplements those with prescribed minimum requirements such as minimum levels of inquiry and verification that are required.
9. It is also important, in ensuring clarity for lenders and to assist in enforcement that:
  - 9.1 Regulations are not unduly complex;
  - 9.2 The scope of any exemptions to the regulations are clear; and
  - 9.3 Where possible, thresholds are able to be easily applied.
10. Our comments reflect these high-level objectives.

#### *Flexibility*

11. As opposed to prescribing a specific process for assessing affordability which endeavours to cover all possible scenarios, we question whether the draft revised regulations need to elaborate on how affordability assessments are made at all.
12. Clauses 4AF, 4AG and 4AH all prescribe steps that are to be taken by a lender when considering whether they are satisfied on reasonable grounds that the borrower can make repayments without substantial hardship. While it is useful to include a requirement to assess income and expenses, the test for assessing that information could be broadly stated as requiring lenders to form a view on reasonable grounds that it is not likely that the borrower will suffer substantial hardship, without also mandating the consideration of matters which are inherently uncertain. For example, assessing whether there is 'a reasonable surplus to pay or save for other expenses' (clause 4AF(2)(b)) or 'a reasonable surplus to address any risk of overestimation' or estimates that are 'sufficiently conservative that there is a very low risk of underestimating the difference' (clauses 4AG(2)(b)(i) and (ii)).
13. It is appropriate for the draft revised regulations to go on to prescribe requirements for collecting information and assessing that information generally (clause 4AL and following), because these provide a minimum standard for compliance with the applicable Lender Responsibility Principles (LRPs) and a broadly stated obligation to assess the information (and any other information that the lender considers appropriate) and form a view on the likelihood of suffering substantial hardship based on reasonable grounds.
14. However, to retain flexibility in relation to the prescribed requirements for collecting information and assessing that information, we suggest that any prescribed inquiries are stated to be inclusive, rather than exclusive, as is currently the case. We are concerned that exclusive lists risk limiting the scope of the information that the lender is required to collect (or consider) when acting responsibly and in compliance with the LRPs. For example, additional information that is available to a lender, and which provides insight into affordability and suitability, should not be ignored by a lender.
15. As described in our February submissions, we remain of the view that rather than expanding the scope of the draft revised regulations to attempt to address all areas

of compliance, further guidance about compliance with the LRPs can be provided in the Responsible Lending Code. The Commission may also provide guidance about its interpretation of what is required to comply with the LRPS and the Responsible Lending Code if that is useful.

### *Complexity*

16. The overview described in clause 4AD introduces a level of complexity in distinguishing between loans – High-Cost Consumer Credit Contracts, loans where the borrower will significantly rely on income to make repayments, and loans where it will not. The clauses that follow (4AF, 4AG, and 4AH) prescribe different requirements for the assessment of affordability in relation to each category of loan. This level of complexity may impact on the ability of lenders to understand what is required of them, particularly where they are providing different credit products.
17. We question whether three entirely different approaches are required or whether a clearer set of requirements may be derived from:
  - 17.1 a single default or standard approach for all loans;
  - 17.2 additional requirements for High-Cost Consumer Credit Contracts; and
  - 17.3 an alternative approach for products where income will not fund the repayments.
18. This approach would be premised upon the assumption that income will fund repayments in most cases, with exemptions or alternative approaches to apply where this is not the case.
19. We acknowledge that there are additional requirements that will be appropriate for High-Cost Consumer Credit Contracts. However, we think it would be simpler if there were a single process to follow, with prescribed additional requirements for High-cost Consumer Credit Contracts.
20. We also consider that the verification requirement may potentially introduce a degree of unnecessary complexity. The draft revised regulations provide for different levels of verification of different types of information at clauses 4AK(2), 4AJ and 4AM. We question whether verification requirements could be simplified into one set of verification rules. For example:
  - 20.1 Information obtained directly from the borrower must be verified, based on reliable evidence which can include bank statements, contracts or invoices.
  - 20.2 Lenders must undertake a credit check.
  - 20.3 Lenders considering high cost loans must obtain 90 days bank transaction records and use these records to verify the borrowers' income and expenses.

## *Exemptions*

21. We do not support either exemption from the draft revised regulations provided in Options 1 and 2 for clause 4AG(3). We acknowledge that they appear to have the objective of providing some flexibility to lenders. However, as we have set out above we suggest that flexibility is preserved through less prescriptive requirements for the conduct of affordability and suitability assessments once the prescribed information has been collected.
22. Both exemption options set out in the draft revised regulations import a test that may be difficult to apply in this regime - whether it is “obvious” that a borrower can make payments. This threshold may enable lenders to do less than they currently do pursuant to the Code and the Principles because there is no requirement to comply with the obligation to make reasonable enquiries or to be satisfied on reasonable grounds as prescribed in clause 4AG(2). Lenders may be able to claim that it was “obvious” that a borrower could have afforded payments having made very few inquiries. If, in fact, whether affordability is obvious is an objective test, a reasonable lender would need to have a certain amount of information in order to meet the threshold. In that case the exemptions do not actually exempt lenders from making reasonable inquiries.
23. In our view, some level of inquiry into income and expenses will always be necessary, so we suggest that Option 2 is particularly impractical. In addition, it is not clear from the current drafting of Option 2 what the correct measure of proportionality would be.
24. The purpose and application clause of the draft revised regulations at 4AC state that regulations 4AD to 4AO set out what reasonable inquiries must be made so as to be satisfied by the Act. If the intention is that the compliance with the regulations is required as part of, but not in satisfaction of the requirements at s9C(a)(ii), then s4AC is not correct.
25. If it is the intention that compliance with the regulations is only partial compliance with the LRPs, the exemption from making the inquiries at (2)(a) suggest that lenders may be required to make “other” reasonable inquiries which do not involve an estimation of income and expenses. It is not clear what those other inquiries would be.

## **Specific comments**

26. Where a borrower provides information or where a lender is able to use benchmark expenses we suggest, that where a lender holds relevant borrower information (such as transactional data), there should be an express obligation to consider and assess that information when conducting the affordability assessment. This information is likely to give a more complete picture about income and outgoings than relying solely on making inquiries directly with the borrower or using benchmarking information.

### *Requirements and objectives*

27. As we have suggested above in order to retain some flexibility about inquiries we suggest that the existing inquiries into income and expenses are drafted in a way that is non-exclusive so that they may be required in appropriate cases to make other inquiries; for example by making clear that while lenders **must** make certain inquiries, they may need to make other inquiries to comply with the LRP. We think this is especially relevant for non-standard credit products that require specific consideration.
28. If, however, the list remains comprehensive, we suggest that, in addition to the inquiries set out at clause 4AA,
  - 28.1 Lenders should inquire as to whether the borrower requires particular product features or flexibility. For example, this will be a relevant consideration if a borrower reasonably anticipates that they may repay their loan early, which would mean that a fixed rate product may not be appropriate.
  - 28.2 Where the agreement is a credit sale, in addition to the specific inquiries included at clause 4AA(2)(g), the lender should in our view consider the term of the credit relative to the likely useful life of the asset.
29. The inquiries described at clause 4AA(h) relating to the case where a borrower is seeking to switch or refinance existing products could go further to address the issues raised in our submissions in February. Rather than highlighting the costs involved in refinancing and seeking confirmation that the borrower accepts those costs, we submit that the lender should also draw to the attention of the borrower the impact the change will have in the long run. That is, to highlight the difference between any potential savings (for example, interest rate variances between the old and new loan, resulting different amounts paid over the life of the loan) and the overall cost of refinancing. If the break costs exceed the savings, the product change may not meet the borrower's needs and objectives.
30. Similarly, we support more specific inquiries where a reverse mortgage is sought (as reflected in our February submissions), including highlighting the impact on the value of the property and the changing loan to value ratio across the term of the product, due to the number of unknown factors which contribute to the property value and overall equity, we think it will be more helpful to focus on how lenders can help borrowers to reach informed decisions before entering into the agreement so as to be reasonably aware of the full implications of that agreement.

### *Draw down facilities*

31. In our February submissions we suggested that specific inquiries for draw down facilities may be appropriate. Specifically, that creditors should be required to reassess whether a revolving credit contract continues to meet the borrower's requirements and objectives on a regular basis throughout the term of the loan where a change in those requirements and objectives is reasonably foreseeable.

## Affordability

### *Inquiries Generally*

32. As with the assessments relating to the suitability of products, we suggest that the existing inquiries are drafted in a way that is non-exclusive so that they may be required in appropriate cases; for example by making clear that while lenders **must** make certain inquiries, they may need to make other inquiries to comply with the LRPs depending on the circumstances.
33. Clause 4AH does not provide for a requirement to assess whether the borrower will be able to afford the general house outgoings. In our view, the fact that the borrower does not make regular payments under the loan does not negate the requirement to assess whether the borrower can afford the product. An assessment of reverse mortgages should include whether borrowers can afford the costs of ownership such as upkeep, rates and insurance. We suggest that this is addressed in the draft revised regulations.

### *Listed outgoings expenses*

34. We support the definition of “listed outgoing” as non-exhaustive. However, we think it is appropriate to reference “insurances” as a living expense given it will frequently be a common expense type.
35. We agree that it is important for lenders to identify any regular or frequently recurring expenses. We support the flexible approach that has been adopted in allowing borrowers to indicate an intention to reduce these expenses so as to be able to make payments on the loan without substantial hardship.<sup>1</sup> This may assist borrowers to obtain access to credit. However, we suggest that lenders should be required to have reasonable grounds to believe that the borrower is able to reduce the discretionary expenses in question, and that lenders should be required to keep records of what reduction needs to be made and documents confirmation that the borrower is willing to make the reduction in order to obtain the loan.<sup>2</sup>

### *General rule for High-Cost Consumer Credit Contracts*

36. The drafting of clause 4AF(2)(b) should be revisited as it is not clear to us what this is intended to provide for. If the lender can accurately estimate borrower’s relevant expenses (including post-loan expenses) it may not be necessary for a lender to allow for a “reasonable surplus”.
37. From a drafting perspective, we suggest that the word “not” at clause 4AF(2)(b) be moved to after “will”, so that it reads “be satisfied on reasonable grounds that it is likely that the borrower will not suffer substantial hardship”.

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<sup>1</sup> As discussed in *Australian Securities and Investments Commission v Westpac Banking Corporation* (Liability Trial) [2019] FCA.

<sup>2</sup> This will likely be relevant to an assessment of whether the agreement meets the borrowers requirements and objectives.

### *Full Income and Expense Assessment*

38. Clause 4AG(2)(i) may incorrectly refer to clause 4AF instead of clauses 4AJ.
39. It is not clear to us that the assessments described in each of 4AF(2)(b) and 4AG(2)(b) require different measures. Each are stated in exclusive terms, which means that the scope of what may constitute 'reasonable grounds' is narrowed from the current scope of the relevant LRP. For example, if a lender knows that the borrower may face impending unemployment, but that at the time of the assessment their income exceeds their expenses, the reasonable grounds threshold will be met under the draft revised regulations, whereas the LRP would not be met if interpreted broadly.
40. As we have outlined in these submissions, we support an approach that does not mandate the steps required to assess affordability and instead imports a 'reasonable grounds' test. However, if the decision is made to retain the prescriptive assessment process, the use of measures such as 'reasonable surplus', 'sufficiently conservative', 'sufficient detail' lack sufficient clarity and may potentially undermine the effect of prescription. Specifically, we are concerned about the uncertainty which could arise from the following:
  - 40.1 Clause 4AF(2)(b): assessment of a "reasonable surplus"
  - 40.2 Clause 4AG(2)(b)(i): assessment of a "reasonable surplus"
  - 40.3 Clause 4AG(2)(b)(ii): assessment as to whether estimates of expenses or income are "sufficiently conservative"
  - 40.4 Clause 4AM(2): assessment of whether there is a "significant risk" that the initial estimate understates relevant expenses
  - 40.5 Clause 4AN(2)(c): assessment as to whether there is a "low risk" that the benchmark will be "materially lower" than the particular borrower's relevant expenses.

### *Verification and Analysis*

41. The draft revised regulations as drafted provide a very prescriptive way of estimating and verifying likely income – it is not clear whether lenders have the option of discounting a borrower's the income for the purposes of assessing affordability. It is our understanding that some lenders discount certain sources of income in undertaking affordability assessments in order to hedge against inaccuracies or fluctuations. We suggest that there should be a catch-all that enables the lender to reduce the income used in the calculations if it considers it to be appropriate in the circumstances.

### *Assessing Expenses*

42. Clause 4AK provides for the ways in which lenders must estimate a borrower's likely expenses, including by obtaining at least 90 days' of bank transaction records. We



suggest that this is amended to make it clear that the obligation is not only to obtain the bank transaction records, but to review those records to identify actual expenses. We also suggest that it would be advisable to expand the scope so as to allow for “other” transaction records, such as credit card statements, to allow for situations where borrowers use other credit products for their everyday expenses.

43. It is not clear that the initial content from clause 4AK(2)(c) would be met over and above the initial inquiries being made of the customer. Our reading is that in most cases, lenders will be expected to obtain a credit report. If this is the intention, then it may be clearer to expressly state that this is required. We assume that the reference to “credit report” in this context relates to “positive” or “comprehensive credit” reporting, as opposed to “negative” reporting. We expect that lenders may seek to clarify this.
44. Clause 4AL(c) provides that in assessing the amount of payments due under an existing revolving home loan facility, lenders should assume that borrowers will repay the credit in 30 years. We think that there should be flexibility so that lenders can apply a lesser timeframe if it is appropriate (for example, if the home loan term is fixed for a lesser period). We also suggest that lenders have the flexibility to adjust their calculations to allow for revolving home loan facilities that have reducing credit limits, where payments will be required when the facility is fully drawn.
45. We are concerned that the test at clause 4AM(2) of assessing whether there is a “significant risk” that an original estimate of relevant expenses has been understated is difficult for lenders to determine. Rather than including an initial assessment we suggest that it might be more useful to incorporate a requirement to verify the likely accuracy of the data, whether by reference to reliable statistical information, actual documentary evidence, or other reliable evidence held by the lender.
46. We are not clear as to what is intended to be provided for by clause 4AM(3), particularly how increasing the amount of an expense may result in avoiding substantial hardship. We suggest that the drafting is reviewed.

#### *Benchmarking*

47. Our reading of clause 4AN(2) is that this is intentionally wide so as to mean that banks may use their own internally developed benchmark data, provided that the requirements in paragraphs (a), (b) and (c) are all met. We support this approach.

#### **Disclosure of agreed changes**

48. Clause 4F(1) should apply for the purposes of 22(1)(b) not 22(1) as currently drafted. We understand that these draft revised regulations are to prescribe the information that a lender must provide to borrowers in addition to the “full particulars of the change” set out at 22(1)(a).