Regulation Impact Statement – *Responsible lending obligations* – *Consumer credit reforms*

Contents

Background 2

1. The problem 4

2. Case for government action/objective of reform 12

3. Policy options 14

Option 1 – Maintain the status quo 14

Option 2 – Implement a principles-based approach to ‘prudent’ lending 14

Option 3 – Implementing a prescriptive framework that provides a tiered lending approach for borrowers of varying creditworthiness 17

4. Cost benefit analysis of each option/Impact analysis 18

Option 1 – Maintain the status quo 18

Advantages 18

Disadvantages 19

Regulatory costs 19

Option 2 – Implement a principles-based approach to ‘prudent’ lending 20

Advantages 20

Disadvantages 22

Regulatory costs 23

Option 3 – Implementing a prescriptive framework that provides a tiered lending approach for borrowers of varying creditworthiness 24

Advantages 24

Disadvantages 25

Regulatory costs 25

5. Consultation 26

Lending peak bodies 27

Credit providers 28

Consumer groups 29

Intermediaries 29

6. Option selection/Conclusion 30

Background

The COVID-19 pandemic and associated containment measures are having profound impacts on the Australian economy. The recession that was induced by COVID-19 in the first half of 2020 was Australia's first in almost 30 years, with real GDP contracting by a record 7.0 per cent in the June quarter 2020. This followed a fall of 0.3 per cent in the March quarter 2020, as a result of both the devastating bushfires and early stages of the COVID-19 pandemic.

The effects on the labour market have been severe, with around 10 per cent of the labour force losing their job or being stood down on zero hours during the peak of the restrictions in April. As a result, the effective unemployment rate in Australia peaked at around 15 per cent.

The first tranches of the Australian Government's fiscal support were aimed at mitigating the most severe economic effects of the COVID-19 pandemic. The JobKeeper payment kept a large share of workers connected to their employer, while the significant support to incomes continues to support household and business balance sheets.

The economic recovery from this downturn is underway with real GDP increasing by 3.3 per cent in the September quarter, and is expected to continue to grow in 2020 and into 2021 as health restrictions continue to ease. Significant challenges remain, however, with expectations that it will be some time before the size of the economy or demand in labour markets recovers to its pre-pandemic level. With interest rates at historic lows and fiscal policy playing a significant role in supporting growth, it is important that Australia's regulatory settings also facilitate, rather than hinder, the economic recovery. Regulatory settings have a significant impact on the flow of credit, which is integral to the immediate recovery as well as the ongoing health of the Australian economy. The reforms considered in this RIS are aimed at improving the efficient and timely flow of credit by removing duplicative or excessive regulatory barriers that increase the time and cost involved in obtaining credit approval. The objective of the reform is to remove these barriers in a way that retains the requirements of prudent lending and consumer protection while also reducing the time and effort required by households and businesses to access credit, ensuring a level playing field among lenders and promoting competition in the financial services sector.

The provision of consumer credit in Australia is regulated by the *National Consumer Credit Protection Act 2009* (Credit Act). The Credit Act requires the providers of consumer credit to hold an Australian Credit Licence and comply with a range of obligations, including general conduct obligations associated with holding a licence as well as specific obligations on interactions with consumers. Specific obligations include the responsible lending obligations (RLOs) contained in Chapter 3 of the Credit Act, which are applied to each individual credit approval and require all credit providers to (1) make reasonable inquiries about the consumer's requirements and objectives; (2) make reasonable inquiries about the consumer's financial situation [and] take reasonable steps to verify the consumer's financial situation; and (3) assess whether the credit will not be unsuitable for the consumer, prior to making a loan. These obligations apply across all authorised deposit-taking institutions (ADIs) and non-ADIs when providing credit.

The providers of credit under the RLO framework have been given further guidance in the Regulatory Guide 209 (RG 209), issued by the Australian Securities and Investments Commission (ASIC) as the responsible regulator; this guidance was most recently updated in December 2019. The update was informed by consultation with stakeholders that took place throughout 2019, which was designed to understand how the guidance was operationalised, and how it could be improved. The updated guidance aimed to balance a flexible approach to RLOs with increased clarity on ambiguous regulatory concepts through the use of more case studies and examples. Feedback on RG209 has

been mixed; some stakeholders appreciate the greater clarity, but many have noted that the lengthy guidance has also increased the level of prescription attached to the regulation and reduced the flexibility of lenders to make pragmatic decisions dependent on individual circumstances.[1] ASIC's regulatory guides are not legally binding, nor do they hold any persuasive weight in judicial proceedings. However, industry generally complies with guidance set out by ASIC.

There have been a number of other changes to the overall framework for providing consumer credit since the Credit Act and RLOs were put in place 10 years ago. Unlike RLOs, which were implemented to apply universally to all types of consumers and all types of credit, other changes have been targeted and aimed at specific types of credit products or firm conduct. They include:

- providing ASIC with a product intervention power that allows ASIC to ban, or amend, a credit product where that product has resulted, or is likely to result, in significant consumer detriment;
- introducing a design and distribution obligation which will require product issuers to identify and distribute their products to appropriate consumers to reduce the risk of consumers acquiring or being mis-sold products that do not meet their needs;
- introducing a best interests duty for mortgage brokers to ensure mortgage brokers act in the best interests of consumers when providing credit assistance;
- more than doubling the maximum corporate and financial sector civil and criminal penalties under the Credit Act;
- enhancing protections for credit card customers by banning unsolicited offers of credit limit increases, simplifying how interest is calculated and requiring online options be available for consumers to cancel cards or reduce their limits; and
- establishing the Australian Financial Complaints Authority (AFCA), increasing access for borrowers to external dispute resolution.

In addition to the above, ADIs must comply with the Australian Prudential Regulation Authority's (APRA) prudential standards which impose obligations on lending, including ensuring institutions have appropriate risk management settings to manage prudential risk. These standards apply to all ADI lenders, which collectively provide more than 90 per cent of all new consumer credit generated in Australia. Specifically in the area of loan origination, APRA's standards impose obligations on lenders to ensure sound credit assessment and approval processes when assessing a borrower's capacity to repay a loan.[2] This includes expectations on lenders that they are making inquiries and

[1] Available at: https://asic.gov.au/regulatory-resources/find-a-document/consultation-papers/cp-309-update-to-rg-209-credit-licensing-responsible-lending-conduct/ (accessed 2 December 2020).

[2] Requirements on ADIs relating to lending practices are currently set out in APS 220 Credit Quality. This standard requires lenders to adopt prudent credit risk management policies and procedures, which include having a robust system for the prompt identification, monitoring and accurate and complete measurement of credit risk. This is designed to ensure creditworthiness and that lending does not occur where borrowers would only be able to repay loans with substantial hardship. APS 220 is supported by APG 223 Residential Mortgage Lending which provides guidance on prudent lending practices in residential lending, including the need to address credit risk within the ADI's credit risk management framework, sound loan origination criteria, appropriate security valuation practices, the management of hardship loans and a robust stress-testing framework. While a breach of guidance is not considered a breach of law, banks consider the guidance as setting the expectations of how to comply with the law. APRA announced a revised APS 220, now called Credit Risk Management, would take effect from 1 January 2021 (although it was delayed to 1 January 2022 as part of providing the industry with COVID-relief). The updated standard makes clearer the requirements imposed on an ADI in relation to the credit risk management framework that is appropriate to its size, business mix, and

taking reasonable steps to verify information provided by borrowers, as well as ensuring appropriate serviceability buffers when providing home loans. APRA monitors compliance and enforces conduct against the standards and guidance where there has been a systemic breach.

1. The problem

A well-functioning credit market supports the economy, including by enabling investment in productive capacity and facilitating household purchases. The cost of obtaining credit therefore flows through to every part of the economy. Treasury estimates that approximately $34 billion in new consumer credit issued each month is subject to RLOs.[3] A range of supply and demand factors impact credit growth and its associated costs, including the Government's regulatory settings. Given Government regulation can create barriers to the timely and efficient provision of credit, it is important that the regulation of credit delivers its intended outcome without unnecessarily impeding the flow of credit or raising the cost consumers pay to access credit. The objective of regulatory settings cannot be to avoid any single incident of consumer harm, but rather to set rules and expectations around the behaviour of lenders – as well as penalties for breaches and recourse for consumers should those rules be broken – but without imposing undue deadweight losses on the economy through excessive prescription in the practice of regulation.

The current RLOs are set at the level of an individual loan decision, and impose a regulatory burden that is borne by both lenders and borrowers when an individual consumer applies for credit. The guidance provided to interpret the law requires lenders as part of the application process to make detailed inquiries, and extensively verify information provided by the customer. The extent of the information requested and amount of time needed to verify the information will necessarily influence how long it takes and how much it costs for the credit assessment to be completed. RLOs were originally intended to be a risk-based principles framework that was scalable relative to the individual and product, however, over time the principles as set out in the Credit Act at the level of individual loan obligation have been further defined through increased guidance from regulators. This guidance has led to a 'one-size-fits-all' uniform and high touch approach to individual credit assessments, regardless of the specific financial circumstances of the individual borrower or nature of the credit product. If the regulatory guidance that directs the behaviour of a firm on credit assessment is beyond what may be required to establish the credit position of the consumer, this regulatory burden represents an undue cost to the consumer in obtaining that credit.

The overall objective of RLOs, that a lender should extend credit to a consumer only after ascertaining that the consumer should be able to repay their credit without substantial hardship, is sound. However, the current regulatory settings impose a greater regulatory burden on lenders and borrowers than was originally envisaged, over and above what many customers would seem to require, impacting both the timely access to, and the cost of, available credit, without substantial evidence that the increased cost of the regulatory burden is offset by a commensurate reduction in consumer harms. In recent years, the burden has increased through further regulatory guidance and prescription on what is required to verify the individual circumstances of individual borrowers. This is compounded by the fact that RLOs duplicate the intended regulatory effect of other obligations imposed on ADIs by APRA, and that APRA's requirements and other consumer protections have

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complexity. The standard now includes a requirement to have sound credit assessment and approval criteria, including for the comprehensive assessment of a borrower's repayment capacity.

[3] ABS 5601 Lending indicators.

been strengthened over time. Since the establishment of the Australian Financial Complaints Authority (AFCA) on 1 November 2018, data indicates that less than 6,000 complaints have been lodged based on a claim related to responsible lending.[4]

The RLOs as legislated were intended to be a risk-based principles framework that ensures lenders do not provide unsuitable credit to customers. The obligations involve:

- making reasonable inquiries about a consumer's financial situation, and their requirements and objectives;
- taking reasonable steps to verify a consumer's financial situation;
- making a preliminary assessment (if they are providing credit assistance) or final assessment (if they are the credit provider) about whether the credit contract is 'not unsuitable' for the consumer; and
- if a consumer requests it—being able to provide the consumer with a written copy of the preliminary assessment or final assessment (as relevant).

While the use of a risk-based principles framework is adaptive to changing circumstances, the reality of the obligation being set at the individual loan level has led to licensees continually seeking greater certainty about how to comply with these obligations. Usually, the interpretation of principles in any legislative framework develops over time through a mixture of court decisions, regulatory guidance and industry practices. This process provides clarity to licensees on the content of their obligations and what is required to comply in any given case. In the case of RLOs, the *ASIC v Westpac* (Wagyu and Shiraz) case and the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Royal Commission) created significant uncertainty among credit providers around how to interpret and comply with RLO legislation and regulation.

In response to those developments and industry desire for greater clarity, ASIC developed further guidance on RLOs. The guidance, which runs to more than 90 pages, sets out detailed procedures on how licensees should comply with the process assessment requirements for individual loans. The implementation of this guidance has led to an approach for credit assessment by lenders that imposes additional costs on consumers. As such, in the case of RLOs, it would seem that the process of interpretation of principles has now created a regulatory burden that is beyond the scope of what was originally intended in law.

There are several aspects to ASIC's 2019 update that have added compliance costs to credit assessments without evidence of improved protections for consumers. One is fairly detailed expectations on lenders as to the manner in which consumer creditworthiness is to be assessed. This included a clarification that the onus is on lenders to verify financial information provided by borrowers, down to a fine level of detail. Under this approach, borrowers bear limited responsibility for providing incomplete or inaccurate information to lenders.[5]

In response to the ASIC guidance, many lenders have put in place detailed and lengthy credit approval processes aimed solely at meeting the requirements set out in the guidance. Through consultation, lenders have told Treasury that applications can take up to 8 weeks, and that over

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[4] Since establishment only 5,533 have been lodged relating to responsible lending complaints, of 4,425 were accepted by AFCA. Accepting a complaint does not mean that AFCA has found in favour of a complainant. Those found in favour of complainants, or resolved prior to a formal resolution are a subset of the complaints accepted. This information was obtained by Treasury in consultation with AFCA.

[5] ASIC 2019 RG 209. Available at: https://download.asic.gov.au/media/5403117/rg209-published-9-december-2019.pdf (accessed 2 December 2020)

50 per cent of the time spent on a credit application can go toward verifying information provided by borrowers. Even so, lenders still risk being held accountable if there is a piece of information they do not uncover, or if some element of process in the guidance is not followed. A number of credit providers have emphasised that these processes do not necessarily improve a lender's ability to understand if the loan is suitable for the customer. It does however have the effect of shifting the risk of an inaccurate credit assessment onto the lender, even in cases for example where a customer may unintentionally provide incorrect information.

The recent litigation between ASIC and Westpac,[6] regarding the use of expense benchmarks, did not provide lenders with further clarity on what is required to meet their legal obligations in relation to reasonable inquiries and verifications. Arguably, the case illustrates the fact that the steps lenders are required to go through to verify expenses need not be used to understand a consumer's capacity to repay as a consumer can typically choose to reduce discretionary expenses if needed. In consultation, lenders have advised Treasury that they consider a consumer's actual income and debt levels are more important indicators of repayment capacity.

Consultation undertaken by Treasury has suggested that the continued lack of clarity on treatment of areas like expense verification combined with the increased prescription in regulator guidance and heightened community awareness of specific cases following the Royal Commission has led to a more risk-averse stance among lenders. The Royal Commission was valuable at highlighting the types of misconduct that occurred within Australia's financial institutions and in bringing about a cultural shift that places a greater focus on consumer outcomes. It can be noted that a number of the cases documented by the Royal Commission occurred when the RLOs were in place, underscoring the reality that no legal or regulatory regime is able to always prevent egregious conduct by lenders or ensure consumers will always choose a product that improves their long term financial interest. At the same time, lenders have stated a greater concern of being publicly held to account for every loan written that goes bad even if the borrower was demonstrated or assessed as able to service the loan at the time it was agreed. This is directly related to the framing of the RLOs as being set in the Credit Act as an individual loan obligation.

Lenders have expressed a greater sense of caution by ensuring strict adherence to the prescriptive expectations at the individual loan level set out in ASIC's regulatory guidance rather than tailoring their approach consistent with the original intent of the law. This behaviour is further driven by the Government increasing the level of penalties for breaches of the Credit Act in the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019*.

The problem of growing risk aversion to a single event of default was emphasised by the Governor of the Reserve Bank before a Parliamentary Committee, where he noted:

> *I think the principles in the legislation are sound, but I think the way we've translated those principles into reality needs looking at again. If we can't do that properly, maybe we need to*

[6] See *Australian Securities and Investments Commission v Westpac Banking Corporation [2020]* FCAFC 111 (26 June 2020). Available at: https://download.asic.gov.au/media/5644950/asic-v-westpac-banking-corporation-2020-fcafc-111.pdf (accessed 2 December 2020). The case found that the use of statistical measures, such as the Household Expenditure Measure, when carrying out the assessment of unsuitability under the Credit Act was permitted. However, this conclusion did not override the need to make inquiries and verifications about expenses. Rather, it allowed for the information identified through the inquiries to be replaced with a statistical measure for the assessment. As a result, this did little to clarify the level of inquiries or verifications that are required to meet the process obligations in the law in any given case.

look at the legislation. We can't have a world in which, if a borrower can't repay the loan, it's always the bank's fault. On a portfolio basis, we want banks to make some loans that actually go bad, because if a bank never makes a loan that goes bad it means it's not extending enough credit. The pendulum has probably swung a bit too far to blaming the bank if a loan goes bad, because the bank didn't understand the customer; if it had done proper due diligence—this is the mindset of some—the bank would never have made the loan.[7]

A number of submissions made to ASIC's 2019 consultation on updating RG 209, including submissions from some industry bodies, were supportive of principles-based guidance, rather than further prescription, particularly on the inquiry and verification steps for the RLOs.[8] There was support for a focus on what needs to be done, rather than how it should be done. ASIC noted that a number of submissions raised concerns about greater prescription leading to significant difficulties and costs including:

- identifying relevant core standards for a broad range of credit products and consumer types, with the risk that standards would be unduly onerous in some circumstances;
- applying inflexible standards which would increase processing costs which in turn could increase costs for customers, without an improvement in the quality of assessment and decisions; and
- stifling of innovation in application processes.[9]

In commenting on the structures of financial services law generally, the Royal Commission also noted that greater prescription creates a culture of 'box-ticking', which doesn't necessarily lead to better outcomes for consumers. Compliance with obligations has to be about more than ensuring that a particular process has been complied with, and should instead be about substance and whether the intent of the law is met. To this end, the Commission considered that existing legal structures should be simplified wherever possible.[10]

RLOs were intended to protect the most vulnerable consumers from hardship. However, as discussed above, the way the RLOs are currently applied at the individual loan level across the market means the process that applies to the most vulnerable consumers is also applied to far less vulnerable borrowers whose ability to service debt is high and risk of experiencing hardship is low. Applying the same process for all consumers, irrespective of their situation or the credit product they are accessing, imposes a regulatory burden on both lenders and borrowers which is not commensurate with the policy outcome being sought. Based on broad stakeholder consultation over recent years, this uniform application of RLOs leads to delays in credit approvals and increases compliance costs, the cost of which are passed on to borrowers.

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[7] Standing Committee on Economics – Reserve Bank of Australia annual report 2019, p. 20. Available at:https://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22committees%2Fcommrep%2F868db039-2384-4ce9-a502-1354709677d2%2F0000%22 (accessed 2 December 2020)

[8] CP 309 Update to RG 209: Credit licensing: Responsible lending conduct. Available at: https://asic.gov.au/regulatory-resources/find-a-document/consultation-papers/cp-309-update-to-rg-209-credit-licensing-responsible-lending-conduct/ (accessed 2 December 2020)

[9] REP 643 Response to submissions on CP 309 Update to RG 209: Credit licensing: Responsible lending conduct. Available at:https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-643-response-to-submissions-on-cp-309-update-to-rg-209-credit-licensing-responsible-lending-conduct/

[10] See generally *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* Vol 1, pp. 495-496.

The RLOs require that all lenders must undertake an assessment. The additional cost of a detailed assessment imposed by the responsible lending framework is difficult to calculate and will vary on a case-by-case basis. However, assuming only a modest cost saving of $100 per loan for each mortgage in the absence of a prescriptive approach,[11] over the course of a year this would represent savings of around $63 million which competitive forces would over time lead lenders to pass through this cost-saving to consumers. There would also be direct benefits to consumers in the time and effort saved making applications.

Through extensive consultations, stakeholders provided the following examples of the impact of the RLO regulatory burden:

- *Where borrowers attempt to refinance to get a better deal, which helps consumers take advantage of the current low interest rate environment and supports expenditure in the economy.* Despite the borrower's income and financial position not changing from one lender to the next, Treasury heard feedback from stakeholders that lenders are applying the same full-length form and verification process for these borrowers who have evidently been able to repay their loan at a higher interest rate. Feedback provided to ASIC on RG 209 also noted that 'like for like' loans should require less extensive inquiries and verification steps, and that the regulatory burden should be commensurate with this[12].

  The Australian Competition and Consumer Commission's *Home Loan Price Inquiry 2020 Interim Report* described the consumer benefit that could be garnered from refinancing a home loan with a different lender. As at 30 September 2019, customers with new owner-occupier loans were paying, on average, 26 basis points less than customers with existing loans. This disparity is accentuated for older loans, where customers with greater than five year old loans were, on average, paying 40 basis points above what new customers were paying.[1] Price reductions for customers with existing loans are often not as large as discounts for new loans, demonstrating the importance of home loan customers shopping around to capitalise on lower rates.

- *Situations with high net-worth individuals, who generally have higher financial literacy and face a lower risk of experiencing financial hardship.* These individuals are still required to go through the same verification process as other borrowers with lower financial literacy and a higher risk of hardship when taking out a new loan, including within the same lending institution where they already have a credit history.

- *Where lending is for a mixed purpose (both small business and personal).* While small business loans are not intended to be covered by the Credit Act, Treasury has consistently heard that small businesses have struggled to get credit where there is not a clear line between home and business, such as primary producers, or storefronts that also include a residence (for example,

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[11] This would be based on reduced time needed to undertake verification of expenses.

[12] REP 643 Response to submissions on CP 309 Update to RG 209: Credit licensing: Responsible lending conduct. Available at: https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-643-response-to-submissions-on-cp-309-update-to-rg-209-credit-licensing-responsible-lending-conduct/ (accessed 2 December 2020). The Australian Competition and Consumer Commission's Home loan price inquiry 2020 Interim Report described the consumer benefit that could be garnered from refinancing their home loans with a different lender. As at 30 September 2019, customers with new owner-occupier loans were paying, on average, 26 basis points less than customers with existing loans. This disparity is accentuated for older loans, where customers with greater than five year old loans were, on average, paying 40 basis points above what new customers were paying[12]. Price reductions for customers with existing loans are often not as large as discounts for new loans, demonstrating the importance of home loan customers shopping around to capitalise on lower rates.

split use commercial zoned dwellings, such as professional service small business downstairs with residential premises upstairs).[13]

A particular example that is regularly highlighted to Treasury through its Regional Engagement Program is small scale farms where the lending may include funding the home and land for residential purposes as well as funding for plant, equipment and livestock at the property.

The regulatory burden imposed is illustrated through the *ASIC v Westpac* case. The result of that case is that lenders are still required to make detailed inquiries about the expenses of an individual loan applicant, even where a lender takes a more-risk averse approach to lending and applies a statistical benchmark in substitution for information provided by the consumer. For example, 80% of the loans in issue in that case had declared expenses from the borrower that were *lower* than the bank's own benchmark household expenditure measure.[14] This benchmark measure was based on the level of income for the loan applicants and their state of residence. For a number of reasons, which may include the possible under-reporting of expenses by applicants, Westpac instead used the household expenditure measure in substitution for the declared expenses (that is, took a more conservative approach). The decision in this case was that Westpac was not contravening the law by using statistical measures in its assessment of unsuitability, even as a substitute for declared expenses from the individual applicant. However, the decision did not remove the need for consumers to supply extensive evidence of their expenses to Westpac and for Westpac to verify that information as the RLO regulatory guidance suggests.

A consequence of this approach is that lenders must devote resources to making a standard set of inquiries for an assessment in all cases, rather than prioritising resources to more high-risk borrowers or credit products. This one-size-fits-all process approach further compounds competition issues, where large lenders have the economies of scale to more easily overcome the costs of investing in systems to meet the process requirements.

The application of a standard one-size-fits-all process is illustrated by a number of real-life examples. For example, where the circumstances of the borrower change during the application period:

> Marc put down a deposit to buy his first home after receiving pre-approval from the bank, following a suitability assessment. Prior to settlement, Marc received a promotion at work that changed his role and increased his salary (he had been with the company for a year). He notified his bank before the loan was finalised. The bank's response was that the promotion constituted a change in circumstance, and therefore the loan suitability process would need to be run again to determine how much he could borrow. However, this process was delayed because Marc no longer had a past history of income at the level to rely on. Understandably, this caused Marc concern as settlement on the house was imminent, and this was an unnecessary delay in the final approval of funds.

Another example is when a person is refinancing between lenders:

> Ashley has had a mortgage for a few years and has reduced his loan-to-value ratio below 80 per cent. Generally, loans with a low loan-to-value ratio are available to customers at lower interest rates. Because of this, Ashley applied for a refinanced loan with a new lender at a lower interest rate, which would have *reduced* his level of repayments per fortnight from current levels. Since taking out his original loan, Ashley has gotten married, so now has

13 NAB submission to RG 209, 2019.

[14] See *Australian Securities and Investments Commission v Westpac Banking Corporation* [2018] FCA 1733 (13 November 2018), (Perram J).

a dual income household. His wife lives with him and they share expenses. He has also received a promotion at work and is earning more than when he first got the mortgage. He and his wife do not update the title deed on the property, because this would involve paying a solicitor a few thousand dollars to undertake a conveyance.

Despite Ashley having made all repayments for several years, Ashley's bank is still required to undertake a verification of expenses. Because Ashley has declared he is part of a couple, he must submit expenses on behalf of himself and his wife. However, lenders cannot take into account his wife's income because she is not listed on the title. It takes Ashley's bank several weeks of emailing back and forth to verify his expenses. This causes Ashley distress and potentially inhibits his willingness and ability to change lenders and receive a more favourable rate, despite him and his wife being in a stronger financial position than when the property was purchased.

For ADIs, the current RLOs regime broadly duplicates prudential lending obligations imposed by APRA through their prudential standards, where APRA's overarching objective is to ensure institutions can fulfil their liabilities to depositors and do not take undue risks that can negatively impact the stability of the financial system. APRA has also taken a number of actions to improve the quality of lending standards, in particular following the Global Financial Crisis.[15] As a consequence of these actions and greater enforcement by ASIC of Credit Act obligations, and independent moves by the banks, the quality of new lending, in particular mortgage lending, has improved significantly over recent years.[16]

ADIs are now subject to two regulatory regimes from two different regulators that achieve broadly the same objective, increasing the regulatory burden on licensees, without any substantial benefit to consumer protection. This duplication represents an unnecessary burden, particularly when considered in the context of improvements to lending standards which have resulted in extremely low levels of non-performing loans across ADIs.[17]

Increased regulatory demand on consumers to provide information can also create disincentives to enter into transactions, including transactions that would benefit the consumer. Reports have consistently shown consumers are frequently disengaged with their financial products and often do not switch products even where superior options exist.[18] Given this, regulation – including the regulation of consumer credit – must seek to balance the need for appropriate checks and balances with efforts to minimise complexity so as to avoid discouraging consumers from switching to obtain

[15] See https://financialservices.royalcommission.gov.au/publications/Documents/Treasury-Request-for-Information-Reforms-to-Consumer-Lending-Background-paper-5.pdf. For example, APRA has continued to update its Prudential Practice Guide APG 223 Residential Mortgage Lending to outline what APRA considers to be prudent ADI practices in managing risks, including sound loan origination criteria. In addition, APRA increased its level of supervisory intensity to ensure ADIs increased their understanding and active monitoring of risks within residential mortgage lending portfolios in the lead up to its 2014 and 2017 housing lending measures, which also reinforced sound residential mortgage lending practices. Also see https://www.apra.gov.au/sites/default/files/141209-Letter-to-ADIs-reinforcing-sound-residential-mortgage-lending-practices.pdf (accessed 2 December 2020)

[16] RBA, Financial Stability Review, 2020; APRA 2018, Round 1 Hearing Submission to the Royal Commission

[17] Between 2006 and 2020, RBA data indicates that non-performing housing loans have been less than 1 per cent of all housing loans on average: https://www.rba.gov.au/publications/fsr/2020/oct/household-business-finances-in-australia.html (accessed 2 December 2020).

[18] Productivity Commission Inquiry into Competition in the Australian Financial System Final Report (2018), 151, available at https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf(accessed 2 December 2020)

a better deal. Where RLOs discourage switching due to the time taken for the credit application they impose an undue regulatory burden and additional cost to a borrower who retains a higher interest expense over the life of a loan. To this end, the Government has introduced a number of reforms aimed at improving the availability of information in the system to reduce the implicit cost for consumers to switch financial service providers. Open Banking was recently launched by the Government, which allows consumers to share their data with other banks to make it easier to compare and switch and access the best deals. Legislation is also before the Parliament to establish a mandatory comprehensive credit reporting regime, requiring Australia's largest banks to report both positive and negative information on all their accounts. However, both of these reforms will take time to be implemented across the system, and for consumers to experience their full benefit.

The proposed changes to the Credit Act can reduce the regulatory burden of individual loan level RLO compliance while retaining the need for reasonable individual credit assessment and the resulting consumer protection. It will not remove the ability of consumers to dispute transactions or obtain redress from their financial institution. Instead of an individual loan level obligation, lenders will be required to undertake reasonable credit assessments using the appropriate systems, policies and procedures in place to make reasonable inquiries and appropriately evaluate credit applications. They will be required to assess whether the consumer will be able to comply with the financial obligations under the contract without substantial hardship. Lenders will continue to be required to maintain appropriate internal dispute resolution processes. Consumers will also continue to receive free redress from AFCA in the event disputes cannot be resolved directly with the consumer's financial institution.

Individual loan level RLOs will remain in place for high cost financial products that carry a greater risk of consumer harm. Two such products are small amount credit contracts (SACCs) and consumer leases. These high-cost products are typically accessed by those without access to mainstream forms of finance. [19] The high-cost nature of these products means that repeat borrowings can quickly lead to individuals devoting significant proportions of their income to repayments.

The 2016 Independent Review of SACCs laws found that existing laws relating to SACCs and consumer leases are not sufficiently promoting financial inclusion and that additional enhancements to the regulatory regime are required to ensure sufficient consumer protections are in place.[20] The 2018-19 Senate Economics References Committee's financial hardship inquiry reinforced that SACCs and consumer leases are often used by people on lower incomes, and who may be financially vulnerable or experiencing financial hardship.[21]

In response to the Independent Review, the Government announced a suite of reforms to introduce additional protections for consumers of these products. The additional protections will enhance the existing RLO framework to limit the amount of income that individuals can devote to these products.

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[19] The current cost of SACCs is limited to a 20 per cent establishment fee and a 4 per cent monthly fee. For a $500 SACC, this would result in a 112 per cent annual percentage rate (APR) over 12 months. The cost of consumer leases is not capped under the law. ASIC's 2015 report on the cost of consumer leases reported APRs between 250 and 884 per cent.

[20] Small Amount Credit Contract Review Panel, *Review of the Small Amount Credit Contract* Laws (2016), available at: https://treasury.gov.au/sites/default/files/2019-03/C2016-016_SACC-Final-Report.pdf (accessed 2 December 2020).

[21] Senate Economics References Committee, *Credit and financial services targeted at Australians at risk of financial hardship* report (2019), available at: https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Creditfinancialservices/Report (accessed 2 December 2020).

Furthermore, the Government's reforms will limit the overall cost of the products to reduce the risk of ongoing debt cycles and systemic consumer detriment which has been associated with these products. It is for this reason that RLOs will be retained on SACCs and consumer leases.

2. Case for government action/objective of reform

The Commonwealth Government is responsible for setting Australia's national credit laws. Although Australia's financial system did not exhibit the same issues that triggered the Global Financial Crisis, the existing laws were put in place by the Government in 2010 with the aim of providing adequate protections against consumers receiving unsuitable credit. The Government did so by introducing principles-based laws intended to deliver this outcome. The principles in the law have now been further defined through regulation and guidance to a level of prescription that is impinging on the timely flow of credit. There are no viable alternatives to Government intervention as the RLOs are provided under law as individual loan level obligations on each credit assessment. Confusion as to the standard to apply in each case risks a continuation of layers of guidance from regulators and risk aversion from lenders.

Without Government action to amend the responsible lending regime and implement a new legislative credit framework, the regulatory burden imposed on lenders and borrowers by RLOs will continue to restrict the timely flow of credit and impose a higher cost of credit on consumers than may be required. In testimony before the House of Representatives Standing Committee on Economics on 14 August, RBA Governor Philip Lowe asserted that, "*while the principles in the current legislation are sound, the translation of RLOs into practice needs re-evaluation, as the onus on lender responsibility appears to have exceeded the guiding principles of the regime*".[22] Absent further changes in Government regulatory settings, it is possible that credit growth will be constrained in the medium term.

A timelier and improved flow of credit in the economy – particularly in personal lending – may facilitate more expenditure by consumers and in turn, stimulate business activity which has been negatively impacted by the pandemic. Economic growth has contracted by 7 per cent over the June 2020 quarter – the largest quarterly fall on record – as government and community measures to combat the spread of the virus necessitated the closure of a substantial proportion of the economy. Reducing the regulatory burden for the majority of consumers who can service debt without falling into hardship, while enhancing protections for the most vulnerable of consumers, can support the economic recovery.

Regulatory ambiguity regarding the application of RLOs where lending is in part for a small business purpose has hampered, and in some cases, prevented the flow of credit. At the commencement of the pandemic, the Government took action to ensure the continued flow of credit to small business, recognising the important role small businesses play in the economy – employing 44 per cent of Australia's workforce.[23] This included a temporary exemption from RLOs for credit licensees providing credit which includes a small business purpose – the exemption was extended for a further 6 months on 2 October.

[22] https://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id:%22committees/commrep/868db039-2384-4ce9-a502-1354709677d2/0000%22

[23] ABSFEO, 2019.

Feedback from lenders has noted that the Government's temporary changes to RLOs have clarified obligations on small business lending, and allowed for increased approvals to small business.[24] Government action to permanently address this uncertainty, particular as the economy recovers, will ensure there is not an unintended barrier to the flow of credit to small business.

The objective of the reform is to retain consumer protections while reducing the regulatory burden currently imposed by RLOs set at the individual loan level through an alternative approach. The suggested new regulatory approach builds upon a lender's incentive to write loans to customers who can demonstrate an ability to repay the loan and avoid default. A lender that provides risky credit to a borrower who appears at risk of not having the capacity to service the loan may suffer financial and reputational damage. Loans that cannot be serviced and become non-performing will become liabilities on the balance sheet, and may eventually become written-off as losses. The Productivity Commission noted in 2008 that "*in the vast majority of cases, it is in the lender's commercial interests to ensure that a loan can be repaid*".

The proposed approach to the reform is to remove individual loan level obligations as described in the Credit Act – except for high cost SACCs and consumer leases – and replace these with a system-based obligation that requires the licence holder to undertake individual credit assessments using the systems, policies and processes in place to assess whether it is likely that the customer will be able to comply with the consumer's financial obligations under the contract without substantial hardship if the credit contract is entered, or the credit limit increased. 'Substantial hardship' in the proposed legislation is defined to exist if the consumer could only comply with the obligation by selling their principle place of residence (and does not intend to at the time of the contract) or would fail to make rental payments on the principal place of residence. The proposed reform defines 'substantial hardship' in the Credit Act.

Licencees will comply with the new obligations under the Credit Act where they:

- Obtain adequate information to undertake the assessment; and
- Make reasonable inquiries, and takes reasonable steps, to verify the consumer's sources of repayment; and
- Make reasonable inquiries, and takes reasonable steps, to verify the consumer's current risk profile; and
- Rely on information provided by the consumer, unless there are reasonable grounds to believe it is unreliable; and
- Make reasonable inquiries about the consumer's expenses; and
- Take reasonable steps to verify the accuracy and completeness of information provided about a consumer by a third party.

Replacing an individual-level loan obligation with a requirement for individual assessments to take place within the lender's systems, policies and processes to result in a reasonable assessment of a credit application reduces the regulatory impost of lending obligations by allowing lenders more scope to scale and customise their systems and practices, while retaining consumer protection.

[24] The Australian Small Business and Family Enterprise Ombudsman in its submission to Treasury noted that "*Access to capital is an ongoing problem for small businesses. Easier access to capital will help some small businesses to survive this exceptionally difficult trading period. Borrowing will be made more accessible by easing responsible lending obligations…*".

A system-level approach to responsible lending will support greater competition in credit markets. This is because larger lenders are better able to absorb the current higher costs of the prescriptive responsible lending obligations when compared to smaller lenders. The per loan cost of complying with the responsible lending obligations is higher for smaller lenders because they write fewer loans, but require similar systems and checks to ensure compliance with the prescriptive obligations. The cost savings for smaller lenders of reduced regulation will therefore be greater, which will put more competitive pressure on loans offered by all lenders. It will also mean that smaller lenders are better able to compete with larger lenders, other than through innovation in technology and service provision; which has been a large source of competition provided by smaller lenders in recent years. In this sense, removing RLOs will also promoter greater competition between smaller and larger lenders.

3. Policy options

Option 1 – Maintain the status quo

Under Option 1, no changes would be made to the RLOs. ADI and non-ADI lenders would still be subject to the obligations contained in Chapter 3 of the Credit Act, and have regard to the regulatory guidance provided by ASIC in RG 209. Lenders would remain subject to the confusing legal landscape where the *ASIC v Westpac* case has indicated it is within the law for lenders to use expense benchmarks in assessments, but ASIC regulatory guidance requires an individualised and verified approach. ADIs would remain subject to APRA Prudential Standard APS 220 (Credit Risk Management) and Prudential Practice Guide APG 223 (Residential Mortgage Lending), whilst a range of new obligations – including DDOs, the mortgage brokers' best interests obligations, and small amount credit contracts (SACCs) obligations – will also govern industry participants.

Effect of option on examples provided

Under this option, the typical real-life examples of Marc and Ashley mentioned in 'the problem' section would continue to occur, and there would be no change in application times.

Option 2 – Implement a recalibrated systems-based approach to 'prudent' lending

Under Option 2, the Government would implement changes to the consumer credit framework contained in the Credit Act that would require lenders to establish appropriate systems, policies and processes for assessing borrowers' capacity to repay without substantial hardship based on the type of product and the risk profile of the consumer, while ensuring those consumers who access high-cost products are afforded the greatest protections.

This would be achieved by removing RLOs, other than for SACCs and consumer leases, and:

- for ADIs, not introducing a replacement regime reflecting that ADIs are already subject to a similar regime that is set and enforced by APRA;
- for non-ADIs, introducing a replacement system-based regime for responsible lending, informed by the equivalent capacity to repay principles applied to ADIs under APRA's prudential standards;
- for credit assistance providers, extending the best interests obligations currently applying to mortgage brokers to other credit assistance providers (CAPs), e.g. finance brokers, when providing credit assistance in relation to consumer credit contracts and consumer leases.

The new requirements on non-ADIs will incorporate the relevant provisions from APS 220[25] (credit risk management) as they relate to having a sound credit assessment and approval process. In practice, this means that non-ADI lenders will need to establish and maintain systems, policies and processes to ensure they assess that a borrower will have the capacity to repay a loan without substantial hardship. Non-ADIs will also be required to consider a range of criteria that should be applied when undertaking an assessment of a borrower's capacity to repay.

These obligations will pick up the same scalability that is provided for in APS 220, and allow for the assessment to be proportionate to the nature, type and amount of the credit. APRA will also soon commence consultation on taking the concept of "substantial hardship" which is currently found in its guidance material APG223 covering mortgage lending, and applying this in APS 220.

Non-ADIs will comply with the law where they put in place complying systems, policies and processes, undertake assessments which consider the relevant criteria in the standard, and then make decisions consistent with that assessment. These requirements represent a transition away from prescriptive obligations which are required under the RLOs, and instead support a risk-based lending model.

The new obligations on non-ADIs will rebalance responsibility through the application process, where appropriate, reducing the current onus on lenders to uncover and verify all information available about the consumer. This recognises that there is still a role for non-ADIs to verify information provided by the borrower, where it is integral to the quantum of credit extended, such as information on income and debt, but that a lender should be able to rely on the borrower's assessment of their own living expenses.[26]

The new obligations would not apply to lending which is in part for a small business purpose; in essence, this will make permanent the temporary relief that was extend following the start of the pandemic.[27] However, remaining obligations in the Credit Act, including licensing requirements and disclosure obligations, would continue to apply to all lending (by both ADI's and non-ADIs) where the lending is predominantly for a consumer purpose. In practice, this means once a lender identifies that part of the credit is for a small business purpose, it will switch off the obligations contained in the new non-ADI standard. However, a safeguard will be included to ensure that the small business purpose is not minor or incidental to the overall purpose of the credit. This will address the risk of consumers inappropriately nominating a small business purpose to avoid the lending obligations.

Under this approach, APRA would continue to independently set its prudential standards and guidance for ADIs to ensure prudent management of credit risk, including in the case of loan origination. The prudential standards operate at the whole of portfolio level, and require ADIs to

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[25] The provisions will draw on the new APS 220 which will commence from 1 January 2022. This include the need to consider the following criteria, where appropriate, when undertaking a credit assessment: reasonable inquires and reasonable verifications of income; reasonable inquiries and reasonable verification of indebtedness; and reasonable estimate of ongoing expenses.

[26] A borrower's income and debt is a fundamental determinant of a borrower's capacity repay and the quantum of debt they can service. These two components are generally not subject to variation and there is little a borrower can reasonably do to vary their income or debt after they enter into new a loan. An individual's past spending behaviour does not necessarily reflect their future spending behaviour. This information is also much more difficult for a lender to verify and doing so imposes high costs.

[27] This reform does not amend the existing 'predominant purpose test' in the Credit Act – the Credit Act applies when the credit being extended is predominantly for personal, domestic or household purposes. The 'predominant purpose' is the purpose for which more than half of the credit is intended to be used. Lending which is predominantly for a small business, or any other, purpose is not regulated by the Credit Act.

originate loans in accordance with APS 220. That standard does not mandate prescriptive processes that must be followed on origination of each loan in the same way as the RLOs do, so they are more facilitative of risk-based lending and banks making inquiries which are proportionate to the risks of any given loan. However, the standards do still require that lending to be in accordance with minimum standards, so it will continue to prevent ADIs from issuing loans that could only be repaid with substantial hardship. APRA's pending consultation on inclusion of a concept of 'substantial hardship' in APS 220 will further articulate the standard. Because ADIs will not have to ensure compliance with two different sets of lending standards simultaneously, one administered by ASIC and one by APRA, their compliance and regulatory affairs will be simplified.

Treasury will work closely with APRA in the future to ensure changes to APS 220 relevant to the provisions that have been adopted for the non-ADI framework will be reflected, as appropriate, in the non-ADI framework to ensure a level playing field across the industry going forward. Containing the new non-ADI obligations in a Ministerial Instrument will allow for flexible and timely updating to the requirements to minimise the risk of implementation delays, and ensure the framework remains fit for purpose over time.[28]

Consumers will continue to be able to access AFCA in relation to their loan. Significantly, AFCA can award damages for any 'direct financial loss' which consumers suffer as a result of lender conduct, which would continue to act as a deterrent to lenders, similar to how it does now.[29] This would ensure that any consumer harm which is caused by lenders continues to have a remedy. As all credit licensees consent to be bound by decisions of AFCA it has wide powers to make awards, which can include damages, or other relief that it thinks appropriate, such as unwinding or varying loans which were issued.[30]The best interests obligations for mortgage brokers (and their credit representatives) were legislated in 2019 as one of the commitments made by the Government in response to the Royal Commission. The best interests obligations for mortgage brokers will commence from 1 January 2021. The best interests obligations comprise two components: the best interests duty; and the conflict priority rule. Failure to comply with either of the components will be subject to civil penalties.

The duty to act in the best interests of consumers in relation to credit assistance is a principle-based standard of conduct. This means that the conduct that satisfies the duty will depend on the individual circumstances in which credit assistance is provided to a consumer. The second component of the best interests obligations is the conflict priority rule, which requires mortgage brokers to resolve conflicts of interests in consumers' favour. This means if a mortgage broker knows or reasonably ought to know that there is a conflict between the interests of a consumer and the interests of the mortgage broker or a related party, the mortgage broker must give priority to the consumer's interests.

The proposal is for both components of the best interests obligations that apply to mortgage brokers to be extended to other licensed credit assistance providers, such as finance brokers, and their credit representatives when providing credit assistance in relation to consumer credit contracts and consumer leases.

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[28] Ministerial Instruments are still subject to Parliamentary scrutiny and can be disallowed by the Parliament.
[29] See generally Australian Financial Complaints Authority, Complaint Resolution Scheme Rules (published 25 April 2020), rule D.2.1
[30] See generally Australian Financial Complaints Authority, Complaint Resolution Scheme Rules (published 25 April 2020), rule D.2.1.

While extending the best interest obligations imposes some regulatory costs for those credit assistance providers not already subject to these obligations, these providers will no longer be required to comply with RLOs, except when providing assistance in relation to a SACC or consumer lease.

The combination of system-level regulation of credit assessment and the retention a requirement to ensure loans will not place consumers into substantial harm will reduce the regulatory burden and cost of providing credit to consumers while retaining consumer protections. Meanwhile, the retention of RLOs for SACCs and consumer leases, retention of reverse mortgage provisions and extension of best interests obligations to all credit assistance providers will allow for the removal of a generic individual loan level RLO from the Credit Act while maintaining consumer protection, the ability to penalise contravention of the law and access for consumers to dispute contracts and receive redress.

Effect of option on examples provided

Under this option, the typical real-life examples of Marc and Ashley mentioned in 'the problem' section may be treated differently by their lenders. Instead, the lenders would apply sound assessment and approval processes that they consider necessary based on the information the borrower has provided, which would include the borrower's income, debt and ongoing expenses. This would reduce the time required to undertake an assessment. If the lender was to extend credit without undertaking a sound assessment, Marc and Ashley could access free dispute resolution from AFCA.

Option 3 – Implementing a prescriptive framework that provides a tiered lending approach for borrowers of varying creditworthiness

Under Option 3, the Government would implement changes to the consumer credit framework contained in the Credit Act which would prescribe a tiered approach to RLOs, based on the risk profile of both the credit product and the borrower. Broadly speaking, there would be at least three tiers of obligations:

- Tier 1: RLOs will continue to apply to high-cost products – SACCs and consumer leases.
- Tier 2: A lighter-touch regime would be established for the majority of credit, requiring less inquiries and verifications. Credit providers would be enabled to assess or streamline certain inputs as they see fit, for instance, they could forego repeated verification for minor contract changes.
- Tier 3: RLOs will be removed on specified borrowers, such as high-net worth individuals, and low-risk products, such as specified mortgages; for example, refinancing on similar terms, or mortgages with low debt-to-income ratios and low loan-to-value ratios.

For tier 2, the existing RLO framework would be amended to introduce concepts of scalability into the Credit Act, where the level of inquiries and verifications are based on the scale and complexity of the credit being extended. The RLO framework would also allow lenders to rely on information provided by the borrower when under taking their verification processes.

For tier 3, RLOs will be removed when borrowers are considered low-risk or are accessing a low-risk product. For example, a loan would be exempt from RLOs if it fell into one of the following categories:

- High-net income/asset borrowers – annual income of $250,000 for the last two years and $2.5 million in net assets.[31]
- Refinancing on similar terms – where a borrower is up-to-date on their mortgage (and has not missed a payment in the last year); they would be making smaller payments following the refinancing (due to a lower interest rate on the loan); and there have been no adverse changes to the consumer's circumstances.

The framework would include a new regulation-making power that could allow products to be allocated into one of the tiers in the future should there be evidence of a change in the risk-profile of consumers accessing a particular product.

Similar to Option 2, the temporary exemption from RLOs which currently applies to lending which is in part for a small business purpose would be made permanent.

In this scenario, APRA would continue to independently set its prudential standards and guidance for ADIs to ensure prudent management of credit risk, including in the case of loan origination.

Consumers will continue to have access to AFCA.

Effect of option on examples provided

Under this option, the typical real-life examples of Marc and Ashley mentioned in 'the problem' section would be treated differently by their lenders. Ashley's lender would have to make fewer inquiries, as he is refinancing on more favourable terms and has no history of hardship under his mortgage (Tier 3), so the outcome for Ashley is likely similar to under option 2. Marc's example may still occur (Tier 2), as lenders would be required to follow processes in assessment based on the risk of the borrower if the change in circumstances is more than a minor change. As the change in circumstance goes to Marc's source of income, it will likely not be considered a minor change (even though Marc now earns more income) and some level of reassessment will still be required. Marc's settlement is still at risk of delay as a result.

However, establishing the appropriate tier and therefore the credit assessment approach in these examples would be more complex and therefore represents a higher regulatory burden than Option 2.

4. Cost benefit analysis of each option/Impact analysis

Option 1 – Maintain the status quo

No changes would be made to the RLOs. ADI and non-ADI lenders would still be subject to the obligations contained in Chapter 3 of the Credit Act, in line with regulatory guidance provided by ASIC in RG 209.

Advantages

- **Maintains existing universal individual loan obligations:** This option would ensure that it would continue to be against the law to provide consumers with 'unsuitable' credit and preserve the uniformity in the current regulation of all parts of the credit chain, including ADI and non-ADI lenders as well as brokers. Retaining the current RLO provisions would require lenders to continue to gather a wide range of information relating to a consumer's financial

[31] This aligns with the definition of 'sophisticated investor' under the Corporations Act (s708).

situation and loan serviceability and conduct an extensive assessment, and that this would be used to make individual assessments irrespective of the risk.

- **Minimises changes:** This option would mean lenders would not have to change their systems or processes in order to continue to provide credit in a compliant manner.

Disadvantages

- **Higher compliance costs:** Maintains the existing 'one-size-fits-all' regime, where the burden of obligations are high because they are aligned with vulnerable, high-risk consumers who represent a small proportion of the overall consumers seeking to access credit. Lenders would still undertake extensive inquiry and verification processes to satisfy the current RLOs, irrespective of whether they consider this information is necessary to inform the lending application before them. This provides a competitive advantage for larger lenders that are more able to absorb the costs of regulation on a per loan basis. Negative effects on competition are demonstrated to result in poor outcomes for consumers with respect to the quality and cost of products and services.

  These processes may also translate into higher compliance costs for consumers in extra time spent on applications. Anecdotal evidence from lenders suggests that some consumers do not proceed with finalising applications due to the time required to meet the information requests. This is the case particularly for smaller scale credit, particularly credit cards, where there has been a significant shift in consumers to unregulated credit products which can be obtained in a more timely manner. In turn, this can lead to poorer outcomes for some consumers that turn to these unregulated products.

- **Continued delays in credit assessments:** Slow credit processes are expected to continue as lenders seek to satisfy themselves that they have taken all steps necessary to inquire and verify information provided by the consumer. Anecdotal evidence from lenders and intermediaries suggests that some lenders' are taking up to 8 weeks to process loan applications[32], with the majority of the application process made up of the inquiry and verification steps, particularly on expenses.

- **Difficulty in accessing credit:** Some consumers, particularly those with non-standard applications, such as irregular income or expenses, could potentially face further difficulty in accessing credit as lenders apply a 'one-size-fits-all' application and credit approval process.

  This is also the case for mixed-use borrowers, those that seek credit for both a consumer and a small business purpose, where ambiguity in the application of the law is preventing the provision of credit. This has been particularly evident for primary producers where it is difficult to distinguish between home and business. This ambiguity will continue at a time where the economy, including small business, is recovering following the pandemic.

- **Constrained credit supply and economic recovery:** Obligations would continue to have an impact on credit supply and its timing. The contribution of credit supply to Australia's economic recovery will continue along its current path.

Regulatory costs

As this option would maintain the status quo, and therefore require no regulatory or legislative changes; there are no new regulatory costs associated with this option.

[32] While some of the larger lenders have been able to make significant technological upgrades to automate some of the process and therefore reduce the overall time of processing applications, this is not evidenced across the majority of lenders. In particular, smaller lenders, where there isn't the scale for systems upgrades, face longer processing times.

Option 2 – Implement a recalibrated system-based approach to 'prudent' lending

The Government would retain RLOs for high-cost products, SACCs and consumer leases, which would be subject to heightened consumer protections due to complementary Government reforms (implementing the Government's response to the Independent Review of these products). For all other products, the Government will remove RLOs from ADIs as these lenders are already subject to the existing APRA prudential regime that sets out to achieve a similar regulatory outcome; non-ADIs would be subject to a new principles-based regime, informed by the equivalent obligations for ADIs under APRA's prudential standards. This change keeps the overall objective the same, to assess a borrower's capacity to repay credit without substantial hardship, but removes the prescriptive process that lenders are required to follow under the RLOs. This provides more flexibility on how lenders meet their existing obligations as well as removing a layer of duplicative regulation (in the case of ADIs) or new obligations (in the case of non-ADIs).

The Government would also extend the best interests obligations that apply to mortgage brokers to other credit assistance providers, e.g. finance brokers, to ensure licensees act in a consumer's best interests when providing credit assistance in relation to credit contracts and consumer leases.

Advantages

- **Reduced compliance costs:** Under option 2, there will be a greater ability to scale the credit assessment process, requiring less time required to meet compliance requirements and therefore reduced costs for lenders and the majority of borrowers.

  All lenders will be subject to a system-based approach to 'prudent' lending, which provides the lender with greater flexibility to determine the appropriate credit assessment and approval process to undertake that will be commensurate with the credit being sought and the risk profile of the borrower. ADIs will continue to be subject to APRA's prudential standards, whereas non-ADIs will need to have the sound systems, policies and processes, but can chose to implement them in a scalable manner. This removes the existing 'one-size-fits-all' framework and reduces the compliance cost on lenders. For ADIs, it will also reduce regulatory duplication in this area by removing the oversight of a regulator.

  For consumers, there will be reduced compliance costs as lenders streamline their processes and better target them to the financial situation of the borrower and type of product being sought.

  For small businesses, this option will remove the current ambiguity that exists for mixed-use loans, by clarifying that where lending is in part for a small business purpose it will not be subject to the new obligations. This will mean that fewer inquiries will have to be made as to loan purpose, speeding up the application process. This will in turn help ensure that small businesses can get access to credit faster as part of the economic recovery.

- **Credit can be supplied more efficiently and flexibly:** As lenders are afforded more flexibility in adhering to principles of 'prudent' lending, lenders could adapt and target their processes more according to the type of borrower and their requirements. This may lead to a reduction in the time and costs associated with extending credit.

- **Consumer protection is retained**: Banks regulated by APRA will be subject to APS220; a failure to comply with a prudential standard is a breach of the Banking Act. Non-ADI lenders will be subject to a similar regulatory structure under the Credit Act. High cost credit products will retain individual-loan assessments under RLOs and the best interests obligations will be extended to all credit assistance providers ensure a uniform approach across all consumer

credit products facilitated by credit assistance providers. Consumers will retain access to AFCA for disputes and redress.

- **Boosts competition:** Where consumers remain in products over time, it can often lead to higher costs compared to those consumers accessing new credit. This was highlighted in the Australian Competition and Consumer Commission's mortgage pricing inquiry which found that there was a 26 basis point difference between new and existing customers.[33] As this option may reduce the administrative burden faced by consumers, it may reduce barriers to switching between credit providers, encouraging consumers to seek out better terms or a lower interest rate. This would facilitate greater competition, ultimately lowering the cost of credit for consumers.

  It also boosts competition by removing regulation, which disproportionately impacts smaller lenders who face a higher per loan cost of complying with responsible lending obligations than larger lenders. This is because of the high costs of building and maintaining systems to ensure compliance.

- **Strong consumer protections retained for high risk borrowers:** The most at-risk consumers accessing SACCs and consumer leases will continue to be afforded the highest level of protections by the existing RLOs. These high-cost products are demonstrated to lead to poor outcomes for some consumers, particularly with vulnerable consumers devoting increasing amounts of their income to paying off these products[34]. Maintaining RLOs, combined with complementary Government reforms to these products, will ensure lower instances of consumer harm in these areas. The role of AFCA will also be retained for the event of lender misconduct in all cases, which will ensure that any consumer harm caused by lender conduct can be remedied.

- **Maintains prudential standards**: Adopting key tenets of APRA's prudential standards and guidance will ensure that banks are still compelled to consider systemic risk and lend sensibly across their portfolios. As part of considering systemic risk, APRA's prudential framework ensures that ADIs do not take excessive risks by lending inappropriately. This measure will retain the most essential aspect of the current framework.

- **Greater emphasis on market discipline:** Removing unnecessary regulation will mean that market mechanisms will have a greater role in determining whether credit should be extended than under option 1. This will likely lead to more credit overall being extended, as prescriptive regulation may prevent some loans from being made which are in the interests of the lender and consumer. Additionally, a recalibrated principles-based system will facilitate the efficient flow of capital in the economy contributing to an increase in the economy's productive capacity. However, because it is not in the lenders' commercial interests to write loans that cannot be serviced or are likely to become non-performing, it is unlikely that a greater reliance on market mechanisms will lead to an increase in consumer harm; and lenders will continue to undertake assessment processes in line with those commercial interests.

- **Maintains consumer protections for credit assistance provided by CAPs:** Once the RLOs are removed for credit assistance providers, consumers may be exposed to potential harms caused by CAPs' misconduct as they would no longer need to undertake a preliminary assessment of the credit's 'suitability' for potential borrowers. The extension of the best interests obligations

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[33] ACCC, *Home Loan Price Inquiry Interim Report* (2020).https://www.accc.gov.au/system/files/ACCC%20Home%20Loan%20Price%20Inquiry%20-%20Interim%20report%20-%2030%20March%202020.pdf

[34] Australian Government, *Government response to the final report of the review of the small amount credit contract laws* https://ministers.treasury.gov.au/ministers/kelly-odwyer-2016/media-releases/government-response-final-report-review-small-amount

would mitigate the risk by requiring CAPs, e.g. finance brokers, to act in the best interests of their customers when providing credit assistance in relation to credit contracts and consumer leases. While the best interests obligations are principle-based, CAPs are expected to have systems, procedures and documentation in place to facilitate compliance and prevent contravention of the requirements and to prove that they acted in the best interests of their clients when provided broking services to them. In addition, licensees are expected to take reasonable steps to ensure that their credit representatives comply with the best interests obligations.

- **Creates a level playing field among CAPs:** The majority of CAPs are mortgage brokers with the remaining small proportion of CAPs largely being finance brokers. The difference between mortgage brokers and finance brokers is that they provide credit assistance in relation to different credit products: mortgage brokers specialise in home loans; and finance brokers offer personal loans, car loans and other loan products. While customers of both types of brokers are exposed to similar misconduct risks and potential harms, mortgage brokers will need to comply with the best interests obligations from 1 January 2021 in order to mitigate those risks and harms. The extension of the best interests obligations to other credit assistance providers would create a level playing field for all brokers who provide credit assistance in relation to credit contracts and consumer leases.

Disadvantages

- **Increased flexibility may increase the risk of consumer harm:** Compared to option 1, lenders will have the flexibility to put in place appropriate credit assessment and approval processes. For the average borrower, this is unlikely to impact on the credit they receive or lead to an increase in consumer harm. However, without every application subjected to the current intense inquiry and verification process, there is the potential for some consumers to get extended credit they previously would not have received. However, all lenders are still required to carry out an assessment of a borrower's capacity to repay without financial hardship. Additionally, consumers will continue to have access to remediation and redress through the Australian Financial Complaints Authority (AFCA).
- **Increased onus on borrowers:** This option will shift accountability for information that is used by lenders to inform their decisions on applications from the lenders towards borrowers. Currently lenders have been held responsible when consumers have not identified information relating to their financial circumstances. Under this option, consumers will need to take greater responsibility, in particular noting the potential risk they could face through receiving unsuitable credit, if they provide incorrect or incomplete information to a lender.

  Consumers may underestimate or misunderstand their repayment capacity, leading to them obtaining credit they may otherwise not have obtained.
- **Lenders approaching lending at the portfolio level rather than the loan level:** This option will require lenders to have the appropriate systems, policies and processes in place to make sound credit assessments and approvals, as opposed to the current operation of RLOs which imposes obligations on each individual transaction. The imposition of obligations at the portfolio-level may lead to lenders taking on more risks (at the margin) in lending, which can lead to more instances of consumer harm. However, it is anticipated that current industry codes such as those by the Australian Banking Association and the Customer-Owned Banking Association, along with AFCA's ongoing role, will continue to inform best practices and prudent lending in the sector.
- **Some CAPS may be unsure how to comply with the best interests obligations:** In general, the mortgage broking sector is larger than the finance broking sector. Mortgage brokers, for example, normally have a panel of mortgage products to consider and compare to assist

potential borrowers, which are provided by mortgage aggregators. Finance brokers, however, vary considerably in their size and sophistication, and fewer finance brokers make use of aggregators. There may be fewer loan products available for finance brokers to consider for a customer than a mortgage broker, and finance brokers may be concerned that this would affect their ability to comply with the best interests obligations.

However, as noted previously, the best interests obligations are principle-based and do not prescribe steps that CAPs must follow in order to comply. Extending the best interests obligations to all CAPs also removes exceptions from the law, and ensures that there is a more consistent regulatory structure, one of the general recommendations of the Royal Commission.[35] Removing these exceptions helps to make the law's application clearer.

Regulatory costs

Should the Government implement option 2, regulatory costs would be permanently reduced for lenders, consumers and small businesses. The savings arise from:

- lenders being subject to a system-based approach to credit evaluation that enables greater scale and speed to be achieved for the majority of credit applications;
- ADIs only being subject to one regulatory framework with respect to loan origination requirements, removing the existing regulatory duplication and prescriptive processes;
- non-ADIs being subject to a new principles-based regime which allows the lender to set and apply appropriate credit assessment and approval processes commensurate with the credit product and the risk profile of the borrower;
- all lenders applying more streamlined application processes, which requires them to make fewer inquiries and verifications of information provided by borrowers, particularly around borrower expenses;
- borrowers facing streamlined application processes and timelier approvals; and
- small businesses not inadvertently being subject to consumer credit laws due to clarification about when the law is to apply.

There will be a reduction in administrative burden on lenders compared to the status quo, because the APRA standards require less prescriptive processes to be followed, and the new non-ADI lending standards will similarly require a less prescriptive process. The reduction would be due to reduced time taken to assess loans as a result of removing information gathering and verification obligations on new loans – even a one hour time saving on every loan written in a year would reduce regulatory costs by $62.9 million.[36]

There may be an increase in consumers experiencing financial hardship as a result of banks' inaccurate assessment of their capacity to repay at the time of entering the loan compared to the status quo.[37] Any increase would be difficult to estimate and is dependent on the behaviour of credit providers. If consumers are inappropriately extended a loan they are unable to repay they will

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[35] *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* Vol 1, 496.

[36] Based on average number of loans written per year of 1,257,000 (ABS 5601 Lending indicators) and an average hourly earnings for the finance industry of $50 (ABS 6302 Average Weekly Earnings).

[37] Over the life of a loan consumers may enter in and out of hardship as a result of changes in their circumstances e.g. job loss or illness. However, as demonstrated by the recent COVID-19 pandemic, consumers entering hardship may not indicate poor lending practices on the part of a lender where that hardship arises as a result of unforeseen circumstances.

continue to have access to free dispute resolution through AFCA in the event they experience financial loss.

Other credit assistance providers, e.g. finance brokers, would likely incur compliance costs from the extension of the best interests obligations. While some mortgage brokers that also offer non-mortgage credit products could tailor their systems, procedures and practices for the best interests obligations from mortgages to the other credit products, finance brokers (i.e. those that offer only non-mortgage credit products) would likely need to set up systems and procedures, as well as train their brokers and credit representatives, in order to comply with the new obligations. However, the reduction in regulatory burden from the removal of RLOs on CAPs is expected to outweigh this increase in regulatory burden.

Option 3 – Implement a prescriptive framework that provides a tiered lending approach for borrowers of varying creditworthiness

This option is designed to introduce a tiered, tailored framework that matches the creditworthiness of a borrower with the bespoke tier of regulatory obligations at the individual loan level. A tier system that assesses the capacity of consumers to service debt – without falling into financial hardship – would be designed, and then paired with corresponding lending obligations.

The Government would design parameters, based on a number of metrics, which characterise products and borrowers into tranches of risk and loan serviceability. Products which are high-cost and represent high risk to consumers, such as SACCs, would still require adherence to RLOs, whilst low risk products, such as a low-limit credit card, would not be subject to the RLO framework. Borrower indicators that convey creditworthiness, such as loan to valuation ratio, income and asset thresholds, and existing debt, could be utilised to model appropriate groupings of risk.

Advantages

- **Reduced compliance costs:** Under option 3 there would be reduced compliance costs compared to the status quo (option 1), although less than that of option 2.

  All lenders would be subject to a tiered approach to lending obligations – the tiered approach will reduce the regulatory obligations applied to the majority of credit.

  For consumers, there will also be reduced compliance costs as lenders streamline their processes for some products and better target them to the requirements and financial situation of the borrower.

  For small businesses, this option will remove the current ambiguity that exists for mixed-use loans, by clarifying that where lending is in part for a small business purpose it will not be subject to the new obligations.
- **Improves efficiency of credit supply for low-risk borrowers:** Individuals with a high capacity to service debt, such as high net worth individuals, will have more streamlined and timely access to credit.
- **Retains protection for vulnerable borrowers:** Similar to option 2, the most at-risk consumers accessing SACCs and consumer leases will continue to be afforded the highest level of protections by the existing RLOs. These high-cost products are demonstrated to lead to poor outcomes for some consumers, particularly with vulnerable consumers devoting increasing

amounts of their income to paying off these products[38]. Maintaining RLOs, combined with complementary Government reforms to these products, will ensure lower instances of consumer harm in these areas. The role of AFCA will also be retained for the event of lender misconduct in all cases, which will ensure that any consumer harm caused by lender conduct can be remedied.

Disadvantages

- **Reduced scrutiny on some credit applications increasing the risk of consumer harm:** Compared to option 1, lenders would have the flexibility to put in place bespoke credit assessment and approval processes for borrowers of varying creditworthiness. For borrowers deemed to be of higher creditworthiness, this is unlikely to impact on the credit they receive, whilst borrowers of lower creditworthiness will still be subject to RLOs. In a tiered system, there may be borrowers that fall between the tiers and are incorrectly assessed to be worthy of credit, which may actually be inappropriate and not serviceable.
- **Retains regulatory burden:** Maintaining some degree of RLOs – even if only for a smaller proportion of borrowers (those in tiers 1 & 2) – retains the regulatory burden that may dampen credit growth and economic recovery. Lenders would first need to make an assessment of which tier the consumer fell into to determine the relevant regulatory settings – in some instances there may be ambiguity leading lenders to make a conservative classification so as to not breach the law. The lenders would also still be subject to prescriptive obligations, although more relaxed compared to the status quo, meaning the lenders cannot apply flexible practices to determine appropriate credit assessment and approval process compared to option 2.
- **Increases complexity and uncertainty:** A requirement to apply RLOs differently across varying cohorts is likely to increase complexity and confusion to an already ambiguous system. The arbitrary cut offs and qualifications that are inherent in a tiered system may cause lenders to encourage borrowers to self-identify in a different cohort to reduce regulatory burden. The tiered system may also dissuade innovation in products where regulatory ambiguity does not provide the lender sufficient clarity regarding their legal obligations.
- **May restrict credit supply to higher risk borrowers:** There is also a risk that lenders are dissuaded by ongoing compliance costs, and will therefore reduce credit supply to marginal borrowers in the RLO-applicable tiers. Such a result would be a poor outcome for individuals who require credit and would still be able to service debts once their more deeply scrutinised loans are granted.

Regulatory costs

Should the Government introduce option 3, lenders will incur upfront regulatory costs as they adjust their practices to comply with the new regime. However, regulatory costs would be expected to be permanently reduced for lenders and consumers, at the cohort-level, and small businesses, albeit significantly less compared to option 2. This is because lenders will be required to undertake a new initial assessment of the borrower's credit worthiness to assess which tier they fall into before they can make the decision to extend a credit product. Therefore, the total regulatory burden is only moderately offset by not having to apply RLOs across all cohorts.

Similarly to Option 2, the impact of removing RLOs for consumers – even after an initial assessment and placing into a creditworthiness tier – is difficult to estimate. If consumers are inappropriately

[38] Australian Government, *Government response to the final report of the review of the small amount credit contract laws*, https://ministers.treasury.gov.au/ministers/kelly-odwyer-2016/media-releases/government-response-final-report-review-small-amount

extended a loan they are unable to repay, they will continue to have access to free dispute resolution through AFCA in the event they experience financial loss.

5. Consultation

Treasury engages continuously with stakeholders on the state of the economy, the flow of credit to business and consumers, and the Government's regulatory settings. In respect of RLOs and lending standards, in-depth insights into regulatory settings and their implications have been provided in recent years as a consequence of:

- discussions in the Council of Financial Regulators since 2015 on bank lending standards and macro-prudential policy settings;
- the first round of hearings in the Royal Commission on consumer lending issues in early 2018, and related documents, subsequent submissions to the Commission, and its Interim and Final Reports;
- updating of RG 209, public hearings and submissions processes; and
- the Westpac case, including the initial judgment and subsequent Court of Appeal judgment.

The consistent feedback from industry stakeholders is that RLOs are imposing a level of regulatory burden not commensurate with the policy outcomes. This feedback increased as part of the industry response to the Royal Commission hearings, consistent with widespread media reporting at the time regarding the flow of credit, and subsequently strengthened further following the issuing of ASIC's updated regulatory guidance. The Royal Commission and feedback also highlighted the material strengthening of APRA's lending standards in recent years.

In late 2019 and early 2020 Treasury undertook targeted consultation with a range of stakeholders to canvas views on Australia's responsible lending laws and possible changes to the regime.

Following the start of the pandemic, Treasury commenced targeted consultation with stakeholders to consider options to provide relief to small business, given the particular concerns they were facing in accessing credit at the time. That, along with the earlier consultations, helped inform the temporary exemption from RLOs that was put in place in March 2020.

Building on insights already obtained and previous consultations noted above, additional targeted consultations were undertaken on specific issues as part of consideration of policy options for the 2020-21 Budget in October. Further targeted consultations with stakeholders were then undertaken.

In the lead up to the Government's 25 September announcement, an interim RIS was developed which informed a decision to include the measure in the 2020-21 Budget.

Following the Government's announcement of 25 September, Treasury undertook public consultations to inform the development of draft legislative materials that were then subject to public consultation from 4 November to 20 November 2020 – 58 formal submissions were received.

At a high-level, industry stakeholders were strongly supportive of recalibrating the approach to responsible lending and replacing the current RLO framework with a flexible, principles-based regime. In doing so, industry noted the importance of maintaining a level playing field between different lenders. Conversely, consumer advocacy groups and academics strongly opposed changes to the existing regime.

The views of stakeholders were informative in considering which option to pursue, how to calibrate the reform, and identifying gaps that needed to be addressed. In particular, Treasury has consulted

closely with ASIC and APRA, and with AFCA who will continue to provide dispute resolution. The views of stakeholders are broadly summarised below.

The consultation following the 25 September announcement was used in the development of the RIS in its final form, before final decision.

Lending peak bodies

Based on feedback across the consultations, banking associations and other peak bodies associated with credit providers support the reforms, as they will provide support for the economy at a critical time if they strike the right balance between boosting credit supply and maintaining strong consumer protections. In particular, banking associations were supportive of simplifying the regulatory landscape and removing duplication and moving to a more risk-based framework, but stressed the importance of delivering a consistent credit regime for all credit providers. Banking associations noted support for maintaining heightened protections for high-risk products including SACCs, consumer leases, reverse mortgages, and credit cards. It was noted that any changes made to the regulatory framework for credit assistance providers should seek to maintain consistent regulatory obligations for when customers seek a loan through a broker or directly through a bank.

Peak bodies flagged that moving away from a 'one-size-fits-all' approach would deliver better consumer outcomes. Reasonable inquiry and verification requirements that are dependent on the circumstances and risks faced by each individual borrower would enable application streamlining when appropriate, without diluting protections for vulnerable borrowers. For instance, a lower level of inquiries and verification would be suitable for borrowers with a financial position showing positive repayment history, or those that are not 'on the margins' in regard to their ability to service new debt.

Peak bodies also indicated that there would be competition benefits from moving away from having a 'one-size-fits-all' approach, and that smaller lenders would be able to better compete with larger lenders on price.

Banking associations stressed the importance of consumers continuing to have available consumer protections, and that their industry codes provide a commitment to customers of their members.[39] It was noted that AFCA will play a critical role, where their determinations, precedent, and approach documents may influence member conduct, and a continuation of current decisions may cause lenders to remain apprehensive in extending credit despite the legislative changes.

Banking associations also emphasised the benefits of having a single regulator to ensure that there is no duplication of regulatory efforts, and possible inconsistencies between standards applied under a multi-regulator model.

Non-ADIs also welcomed the reforms and noted that removing onerous obligations would support timely credit provision, but cautioned that proper implementation is imperative to achieving the Government's policy goals. It was noted that the existing regime, in particular the regulatory guidance, had resulted in a risk averse culture for all lenders and had contributed to constrained credit growth. An alternate framework underpinned by the application of APS 220 was endorsed,

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[39] Among ADIs, there is the Banking Code of Practice issued by both the Australian Banking Association and the Customer Owned Banking Association. The Codes of Practice bind members to obligations contained in the code. Breaches of the Code are enforceable by AFCA.

but a high-level approach based on outcomes and has a portfolio-based view would be preferred, where AFCA's role is also retained to address individual cases of misconduct.

Credit providers

Treasury consulted with a range of banks covering the majors and mid-tiers, who welcomed the intention to remove redundant barriers to credit and enable the economic recovery, whilst maintaining integral consumer protections for individuals who are most vulnerable. This feedback has also come through in their submissions to the consultation on draft legislation.

The banks have noted a range of other consequences of adhering to the RLOs. The current expense verification process is time consuming, imprecise and ambiguous, and inefficient given that borrowers have a level of expenses which is similar to the Household Expenditure Measure (HEM).[40] The use of 'greater of declared expenses or HEM' can also be counterproductive. When considering two customers with identical financial circumstances, the customer with a lesser understanding of their finances who underestimates their expenses would be viewed more favourably than the customer with a thorough understanding that accurately declares all expenses, even though they are likely to be lower risk.

Another issue raised was the requirement to reassess income, expenses and other liabilities for minor changes to a credit contract. For instance, a customer who has paid down a significant portion of their mortgage but requests a $1,000 limit increase to their credit card would need to re-verify all the documentation that was provided at the initial application despite the bank seeing a clear demonstrated history of serviceability and meeting of obligations. This is because the process of assessment must be complied with each time.

One lender noted that credit card applications have dropout rates of 30 per cent, in part because a significant proportion of consumers are discouraged by the overly onerous process. It was noted that APRA's standards should allow lenders to reduce administrative friction, particularly given the standards are flexible and scalable.

Lenders expressed the importance of a high degree of certainty – particularly in an environment with numerous oversight bodies – where inadequate reforms may only cause confusion and superficial change. Moreover, ensuring certainty is closely linked with AFCA's determination approach, as lenders' adoption of the new framework will be in-part determined by AFCA's interpretation of credit assessment in the new regime.

A number of lenders suggested that the level of inquiry should be proportionate to the potential customer detriment, which could be assessed by factors such as loan size, probability of default, and customer history in repaying debts of a similar type and size. The concept of scalability is also relevant for this tailored approach, where lenders would prefer to be able to innovate and adjust their systems to achieve appropriate, customer orientated outcomes.

Lenders noted it was important to ensure a consistent regime between ADIs and non-ADIs so as not to cause anti-competitive outcomes.

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[40] The HEM is a report which examines household expenditure in Australia undertaken by the Melbourne Institute, University of Melbourne. Using local survey data linked to the Consumer Price Index, the HEM looks at what families actually spend in relation to different types of household. The HEM classifies more than 600 items in the Australian Bureau of Statistics' Household Expenditure Survey as absolute basics, discretionary basics or non-basics. These items are then used to calculate modest expenditure for eight types of household.

Consumer groups

Treasury consulted with a range of consumer groups, including Consumer Action Law Centre, Financial Counselling Australia, Financial Rights Legal Centre, iCAN and CHOICE. In addition, Treasury received written submissions from a range of consumer groups on the recent consultation on the draft legislative package. Consumer advocates have been critical of the reforms, suggesting that borrowers will have fewer rights. They note that the peddling of unsuitable loans would have the potential to most adversely impact vulnerable consumers, and that the long-term implications of wider and deeper financial hardship are of grave concern.

Consumer groups argued that the APRA prudential standards and guidance do not themselves contain consumer protections, since those standards are about credit risk. They also noted that the application of the new framework across ADIs and non-ADIs may also give rise to uneven regulatory action.

The risks associated with having limited oversight over information provided by intermediaries was noted, and the consumer groups strongly advocated for additional protections in these channels. Moreover, consumer groups noted that the removal of the unsuitability assessment negates consumer protections for credit cards and reverse mortgages, and that these deficiencies must be addressed to avoid severe cases of consumer detriment.

Ongoing access to AFCA and ability to access redress via the courts were also raised as key concerns. An overreliance on borrower responsibility and consumer understanding was cautioned against. Consumer groups noted that the borrower responsibility onus in other jurisdictions was implemented in conjunction with an education scheme to improve financial literacy, and such a scheme should be considered in Australia.

Consumer groups also flagged that any intention to remove the predominant purpose test, which triggers the operation of the Credit Act on loans that are of a mixed use, would give rise to sham lending, where the likelihood of regulatory avoidance and inappropriate credit provision would rise inordinately.

Consumer groups did not put forward specific alternative suggestions on how to improve the responsible lending obligations, reduce application times or otherwise improve regulation to improve the flow of credit. These groups advocated for the option of maintaining the status quo.

Intermediaries

Intermediaries are businesses that sit (directly or indirectly) between a credit provider (lender) and a consumer, wholly or partly for the purpose of securing the provision of credit for the consumer. Credit assistance providers (including mortgage and finance brokers) are a type of intermediary that assist consumers to apply for credit.

Intermediaries, including credit assistance providers, through consultation and written submissions have expressed support for reforming the RLOs, noting the existing regime has become overly prescriptive. Industry representatives, e.g. the Mortgage & Finance Association of Australia (MFAA) and the Finance Brokers Association of Australia (FBAA), noted that in practice the actions of mortgage brokers were unlikely to change following the extension of the best interests obligations to credit assistance providers more broadly, given the service they already provide to their customers, the commencement of the best interest obligations for mortgage brokers from 1 January 2021, and the requirements placed on them by lenders. However, they noted this could impose

further compliance costs which could detract from achieving the goal of providing better access to finance. The MFAA and FBAA were supportive of the extension of the best interests obligations to other credit assistance providers because it would provide a more level playing field across the sector and likely enhance the professionalism and the reputation of the credit broking industry. However, they requested a longer implementation period between 6 to 12 months.

Intermediaries also noted the important role AFCA will play in these reforms being effectively implemented by lenders.

6. Option selection/Conclusion

The problem to be addressed is ensuring that unnecessary barriers to the provision of credit are removed, and the regulatory burden imposed on lenders is appropriately calibrated to the objective of the regulation: reducing the risk of consumers getting credit that they will not have the capacity to repay without substantial hardship. Evidence to date has demonstrated that the regulatory regime is imposing a regulatory cost on both lenders and borrowers and is impacting the flow of credit. To improve the timely flow of credit and reduce the overall cost of credit a re-calibrated principles-based approach to 'prudent' lending (Option 2) is preferred.

This option will retain the overall objective of the existing regulation, to assess a borrower's capacity to repay without substantial hardship, while providing lenders greater flexibility to determine the sound assessment and credit approval process which is required to deliver on this objective. This option also removes the 'one-size-fits-all' process requirements associated with RLOs.

Lenders will have greater capacity to take advantage of new technology to streamline processes, where appropriate, benefiting both the lender and consumers.

For borrowers, there will be more timely access to credit, there will be more streamlined approval processes (should their risk profile allow it) and there will be potential reductions in the cost of credit – both from lenders being able to reduce the cost of their offers as a result of a lower regulatory burden, but also from taking advantage of lower barriers to switching.

Where a borrower suffers direct losses as a result of lender conduct, consumers will continue to have access to free redress through AFCA.

This option also will rebalance responsibility which has fallen heavily on the lender over recent years, to make borrowers more accountable for the credit they are seeking and the information they are providing. This will increase the willingness of lenders to lend and address the risk-aversion that has crept into the system.

While these changes combined may increase the harm experienced by a number of marginal borrowers – those seeking to borrow at their limit – they are outweighed by the overall benefits from reducing the regulatory burden on lenders and borrowers, improving the timely flow of credit, and reducing the overall cost of credit.

Table 1: Cost-Benefit Summary of Options		
Option	*Benefit*	*Cost*
1. Maintain the status quo	Maintains existing consumer protections for all types of borrowers and lenders. Minimises changes required to be implemented by credit providers in order to continue to provide consumer credit in a compliant manner.	Constrained credit supply will persist, where consumers who can service a loan without falling into hardship will continue to face delays and even denied credit. The compliance costs incurred in extensive information gathering and verification will continue to burden lenders. Dampened credit supply will slow economic recovery. Competitive advantage for larger credit providers will persist stifling competition amongst providers.
2. Implementing a New Credit Framework and a risk-based approach to lending responsibly	Supports credit supply as lenders are afforded more flexibility in adhering to reasonable lending principles, rather than prescriptive RLOs. Reduction in time delay and costs will improve credit supply efficiency. Consumer protections will be retained for high-risk borrowers. Competition will be augmented as barriers to switching between credit providers will reduced. Encouraging credit supply will assist economic recovery. Greater emphasis on market discipline will result in more efficient flow of capital in the economy. Creates a level playing field amongst credit assistance providers.	Increased flexibility may increase the risk of consumer harm. Increases onus on borrowers to take responsibility for their part in the lending process. Lenders may approach lending at the portfolio level rather than the loan level. Some credit assistance providers may be unsure how to comply with the newly imposed best interests obligations.
3. Implementing a Bespoke Credit Framework that prescribes a tiered lending approach to borrowers of varying creditworthiness	Improves efficiency of credit supply for low-risk borrowers, where compliance costs and regulatory burdens are reduced. Retains protections for the most high-risk borrowers, where lenders will still have to consider the probity of their credit extension. Encouraging credit supply will assist economic recovery.	Retains regulatory burden for a segment of the lender population, as credit providers lending to higher-risk tiers of borrowers will still be subject to RLOs. Increases complexity and certainty, as a tier system where borrower groups of varying creditworthiness are treated differently will add confusion to an already ambiguous framework. May cause lenders to withdraw credit supply to higher-risk borrowers, as retaining compliance costs for servicing these customers may be a significant deterrence.

7. How will you implement and evaluate your chosen option?

The reforms will have a commencement date of 1 March 2021. Treasury notes that credit providers, in both the ADI and non-ADI space, should already be compliant with the bulk of the obligations as they are currently subject to APRA standards or RLOs. The transitional period is expected to be used to reduce onerous compliance costs and practices that will no longer be required in the new regime. Credit assistance providers will be provided with a 6-month transition period from the later of 1 March 2021 and the day after the Royal Assent.

The new standards will be applied across an extended timeframe, so their success will need to be evaluated across a similar timeframe. Measuring their success should also be considered in the context of the broader economic recovery, where a large number of existing loans have been put under pressure because of the unforeseen significant economic shock caused by COVID. The fact that some loans have recently become distressed, or would have become distressed if not for repayment deferrals offered by banks, may not indicate poor lending practices on the part of a lender where that distress arises as a result of unforeseen circumstances. Similarly, consumers may enter in and out of hardship as a result of changes in their circumstances, such as the loss of a job or illness, and this similarly is not necessarily causally linked to lending practices.

The new standards will apply in a situation where there is an economic recovery underway, so success of the measure should be measured accordingly. Increases in the rate of non-performing loans does not necessarily indicate that lending standards have not been adhered to, or that there is fault on the part of the lender, particularly where there is significant economic volatility. Australia has historically had very low levels of non-performing or impaired loans when compared to other similar countries.[41] Any increase in these levels would therefore need to be carefully considered in light of the current economic circumstances.

Consideration of the effectiveness of the reforms in supporting the flow of credit to the economy will be informed by data collected by the Reserve Bank of Australia and APRA.

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[41] Between 2006 and 2020, RBA data indicates that non-performing housing loans have been less than 1 per cent of all housing loans on average: https://www.rba.gov.au/publications/fsr/2020/oct/household-business-finances-in-australia.html (accessed 2 December 2020).