Australian Banking Association

3 February 2021

Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Via email economics.sen@aph.gov.au

Dear Senators,

The Australian Banking Association (**ABA**) supports the Government's reforms to the National Consumer Credit Protection Act.

Timely access to credit creates opportunity. It opens doors and allows Australians to get ahead and fulfil their aspirations. Ensuring the efficient flow of credit in the wake of a global pandemic will assist families and businesses across the country at a time when they need it most. It is fundamental to the nation's economic recovery.

Against this backdrop, it is reasonable for the Government to review and reset the consumer credit laws. Australian banks expect the reforms to result in clear benefits for customers, by simplifying credit laws and boosting borrower confidence, while maintaining strong customer protections.

The reforms are well targeted and will:

- Improve the customer experience by streamlining the application process and collection of customer financial information.
- Retain customer protections, including rights of action for individual customers.
- Simplify and modernise the regulatory landscape and complement recent changes strengthening the regulation of banking. These include changes to the way bank staff are paid, introduction of the design and distribution obligations on consumer credit, tougher executive accountability and the introduction of the Australian Financial Complaints Authority (**AFCA**).

Improving the customer experience

For some customers, applying for a loan can be a trying experience. They are required to produce months of spending information across the spectrum of their lives; from the most regular fixed expenses all the way through to discretionary spending on hairdressers, travel, takeaway food and entertainment.

Banks are then required to verify this information despite uncertainty around the extent to which verification is required. This often results in over-verification, delays to the process and a less efficient approval process.

The value in verifying this information is limited, given customers may be able to reduce their expenses substantially after they have taken out a loan in order to pay it off and banks often see this occur.

Under the Government's proposed changes, the process of loan approvals will become more efficient and should result in faster approval times. Access to credit will be more efficient and easier to understand for customers.

Importantly, lenders will still need to have strong credit assessment processes to ensure that borrowers can repay their loans.

However, lenders would make this assessment by looking at information most relevant to the capacity to pay and would spend less time assessing information that has been shown to have little bearing on that capacity.

Importantly, lenders will have flexibility to use electronically derived customer information and industry external information (such as prudent application of expense benchmarks), simplifying information requests to customers. The ability for lenders to place more reliance on the information provided by the borrower will potentially reduce follow up requests to customers.

Retaining Customer Protections

The notion of 'responsible lending' is entrenched in our system. It is in the interest of both customers and banks to ensure a loan can be repaid and many customer protections and regulatory requirements will continue to ensure this is the case.

These requirements are established in the regulatory framework and will remain for ADI lenders, including:

APRA

- APRA's existing lending standards require lenders to undertake a credit assessment based on the level of risk involved. APRA requires banks to consider income, debts and expenses, the purpose for which the consumer is seeking the loan. These standards are to be further strengthened to include:
    - An updated APRA Prudential Standard: Credit Risk Management (**APS220**) which will make it clear a bank should not issue a loan that would place the borrower in substantial hardship.
    - An updated APRA Prudential Guide: Credit Risk Management (**APG 220**)
    - An updated APRA Prudential Guide: Residential Mortgage Lending (**APG 223**)
- APRA's existing far reaching supervisory and enforcement powers ensure banks comply with its standards.

Banking Code of Practice

- The duty to act as a diligent and prudent banker is set out in the enforceable Banking Code of Practice (**the Banking Code**). ABA member banks are contractually bound by the obligations under the Code, that is, the clauses of the Code have been held by the Courts to form part of the customer's contract.

Other conduct obligations

- The general conduct obligations of the NCCP Act (which are retained by the proposed reforms) which require banks to take all steps necessary to ensure that the credit activities authorised by the licence are engaged in "efficiently, honestly and fairly."
- Specific provisions of the NCCP Act regarding credit cards and reverse mortgages which are to be retained by the proposed reforms.
- ASIC Act requirements which set out specific prohibitions and penalties for unfair contracts, unconscionable conduct, and misleading and deceptive conduct in financial services.
- ASIC's powers to regulate provision of credit by banks through the general conduct obligations, strict licensing requirements and disclosure obligations.
- The design and distribution obligations on consumer credit products which require lenders and brokers to have a consumer-centric approach to the design and distribution of credit products and for lenders to review products to ensure their customers are receiving credit that is likely to be consistent with their objectives, financial situation and needs.
- The product intervention power which allows ASIC to intervene when a financial product or a credit product has resulted, will result or is likely to result in significant customer detriment. This includes the power to ban financial products and credit products.

Right of customers to bring complaints to AFCA and the courts

- Critically, customers will retain recourse through several avenues:
  - The one-stop complaints authority, AFCA.
  - Both ASIC and APRA can take court action if banks fail to meet obligations.
  - Customers retain the right to apply to a court for the removal of an unfair contract term.
  - Courts can reopen unjust transactions.
  - Courts can enforce a clause of the Banking Code.

The combination of these remaining laws and regulations will continue to ensure that appropriate assessments are made of a borrower's capacity to service a loan.

A number of the changes made to strengthen consumer protections outlined above flowed from the findings of the Hayne Royal Commission. We note Commissioner Hayne also examined whether the unsuitability test should be tightened, so that lenders would assess whether a loan was suitable for a customer and recommended against making that change.[1]

Simplifying and modernising the regulatory landscape

In light of the additional protections and controls the Government has put in place since the Credit Act was enacted, there is now duplication. Lending in Australia is subject to hundreds of pages of laws, rules and guidance, two different regulators and multiple Acts of Parliament. Further expectations and interpretation on how lenders comply with this regulatory framework also come from the Code and determinations on customer complaints via AFCA.

When the times change so must our laws. The parliament is not a place of set and forget. And so much has changed since 2009 that it is only sensible for the Government to review the legislative and regulatory framework. There are now more remedies available for customers, and more penalties for banks.

In 2009, AFCA did not exist. The creation of a new dispute resolution scheme for all financial services, combining the Financial Ombudsman Service, Credit and Investments Ombudsman and the Superannuation Complaints Tribunal has created a one-stop-shop for customers to seek redress. This means there are more remedies available to customers with a complaint than existed a decade ago, including higher monetary limits and compensation caps.

The regulatory framework has also changed significantly for banks through tighter restrictions on remuneration incentives, the Banking Executive Accountability Regime, ASIC's Design and Distribution Obligations and Product Intervention Powers.

Ensuring the efficient flow of credit into the economy with strong consumer protections in place will assist Australia's recovery from the pandemic.

Yours sincerely,

Anna Bligh AC
CEO
Australian Banking Association

[1] FSRC Final Report p.59: "Consumer advocacy groups urged me to recommend that the NCCP Act be amended to require lenders to determine whether a loan contract … was 'suitable' for the consumer (as distinct from 'not unsuitable'). I do not favour that proposal."

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The Imperative for Reform

Overly complex requirements have added to time, cost, documentation and inconvenience for customers. The proposed reforms will address three key issues:

- Over-reliance on expenses in loan assessments, particularly smaller expenses which are not a reliable guide of whether a customer will face difficulties meeting repayments during the life of the loan.

- Overly complex expense *verification*. This leads to delays and costs to customers in identifying and substantiating small expenses, when that level of detail does not help the customer make a decision about the right loan for them.

- Barriers for small business owners.

Over reliance on expenses in loan assessment

The current law requires lenders to make reasonable inquiries about the customer's financial situation and take reasonable steps to verify them. While it requires banks to consider income and expenses, the specific focus on a granular expense assessment presents difficulties for customers, for the following reasons:

- Expenses are a point-in-time assessment. Many customers will change their lifestyle and reduce their discretionary expenses to repay their new loan, as outlined in ASIC vs Westpac. As Justice Perram noted in that case, "The fact that the consumer spends $100 per month on caviar throws no light on whether a given loan will put the consumer into circumstances of substantial hardship."[2]
- Income and expenses do not, and cannot, predict the significant triggers for financial difficulty such as illness, divorce, loss of employment or death.
- Other, often more robust, predictors such as debt servicing ratios and debt-to-income ratios may provide a more effective picture of loan serviceability for some customers. These are in use in many other jurisdictions around the world.

When default does occur, it's almost always due to lack of income after an unpredictable major life event such as illness, divorce or unemployment. Extensive verification of minor expenses has little bearing on the likelihood or financial impact of these major life events.

ABA member banks report the key major events include:

- Unemployment / under employment
- Marital separation / relationship breakdown
- Health issues / injury
- Additional dependents
- Natural disaster
- Death
- Family violence

The Government's reform will enable a focus on more tailored credit assessment processes undertaken before any loan is granted. And as COVID-19 has demonstrated, when faced with difficult circumstances, lenders are now more proactive in extending significant assistance programs to enable borrowers to re-establish themselves and return to repayment commitments.

The intense scrutiny of customer expenses also fails to take into account a customer's existing history with their bank servicing a particular credit product.

[2] https://www.judgments.fedcourt.gov.au/judgments/Judgments/fca/single/2019/2019fca1244

Overly complex expense verification

Banks have a responsibility to assess a customer's overall financial situation. This responsibility is regulated by both ASIC and APRA, and includes making reasonable inquiries and using benchmarks, which continue to be improved for greater accuracy and relevance.

The current legislative regime under Chapter 3 of the NCCP Act contains similar principles-based obligations. However, additional regulatory guidance has added expectations regarding how these obligations should be satisfied. The contrast of these prescriptive guidelines, against the principles-based legislative regime has created uncertainty for lenders and borrowers as to the acceptable level of inquiry and verification. Combined with the significant financial and reputational penalties for non-compliance, lenders have been cautious about how they approach this kind of activity, tending to rigidly apply the guidance even where alternative, more efficient processes would deliver the same level of confidence in the customer's capacity to service the loan.

This is particularly evident in relation to customer expense verification, where the current guidelines have generated a strong focus on often minor details of discretionary and historical expenses. This granular level of inquiry can be frustrating for customers, some of whom may regard it as scrutinising their lifestyle. It can also be costly for the lender. One major lender has indicated that it is required to check just under half a billion expense entries per annum for significant expense discrepancies. Furthermore, these historical discretionary expenses are not necessarily the most useful indicators of a customer's ability to service a loan. As mentioned, industry data confirms that major life events are the primary trigger for default.

This intense scrutiny of customer expenses also fails to take into account a customer's existing history with their bank. Long term, well known customers face the same intense scrutiny as customers new to the lender.

Under these reforms, banks will continue to be required by APRA to have in place systems and processes that lead to the right outcomes for customers, while allowing sufficient discretion and flexibility to assess whether a customer can service and repay their loan.

In line with APRA credit risk management standards, the reforms will balance a broader assessment of customer income and expenses, so the focus is on financial capacity and serviceability relevant to the type and amount of credit being applied for.

Barriers for Small Business owners

The benefits of the Government's proposed reform are not confined to household lending. They will also assist individuals who are self-employed and generate their principal income from their small business operations.

Small businesses account for 35% of Australia's gross domestic product and employ 44% of Australia's workforce. Of the 877,744 total employing businesses, 823,551 are small businesses (93.8%). The access to, and provision of, appropriate and timely credit to these small business owners supports employment and growth at scale.

There are two issues at stake:

Applying responsible lending obligations to small business loans

Many small businesses mix finances for business and personal use. For example, it is common for a small business loan to be secured by the business owner's family home. Some banks report that this arrangement accounts for as much as 80% of their SME lending book. Businesses can also have sources of income and expenses across multiple types of legal entities.

Notwithstanding the drafting of the predominant purpose test, this has led to ambiguity and inconsistency regarding the application of the 'not unsuitable' requirements of the NCCP Act where part of the loan is used for a business purpose.

While the NCCP Act may appear to be clear in not strictly applying to business lending, in practice the uncertainty has led to banks applying responsible lending laws to some business loans.

This increases time for settlement and the risk of credit either not being provided or being significantly delayed.

Difficulty for small business owners seeking a loan

Small business owners need consumer credit, such as mortgages, car loans and credit cards. Yet the current law's focus on income and expenses can make it harder to assess loans for people with lumpy or irregular income.

Business owners often have complicated financial affairs which make serviceability assessments, including inquiries and verification, more challenging.

This has meant that assessing small business owners for mortgages or credit cards often results in lower serviceability amounts or difficulty accessing standard loans. Customers are often required to spend additional resources and time to provide relevant documentation. Banks in turn can then take longer to assess the application.

The reforms will allow banks to take greater account of other factors - like strong repayment history - to assess loans to small business owners.

For the above reasons, the benefits of the Government's proposed reform are not confined to household lending. They will also assist small businesses.

Discussion and Comments for Consideration by the Committee

Consistency with recommendations of Royal Commission

The Hayne Royal Commission of 2018 was a defining moment of the past decade, with a direct impact on the regulatory landscape.

Recent commentary on the proposed legislation has suggested the Royal Commission specifically recommended against the current proposal. However, the Commissioner's recommendation was made in the context of specific submissions to change the 'not unsuitable' assessment to a 'suitability' assessment. As Commissioner Hayne noted in his report, "Consumer advocacy groups urged me to recommend that the NCCP Act be amended to require lenders to determine whether a loan contract was 'suitable' for the consumer (as distinct from 'not unsuitable'). I do not favour that proposal."[3]

The Commission did not give consideration to the question of whether the regulatory landscape facilitates or hinders the efficient supply of credit. Nor did it make any recommendations to the effect that an elected government should never review or revise the regulatory landscape when economic conditions change.

It is a mischaracterisation of the Commissioner's recommendation to say otherwise.

The Royal Commission recommendations have led to significant change across the industry, which has added stronger regulation and consumer protections to the provision of credit. These reforms, already implemented or due to commence in 2021, include:

- The updated 2020 Banking Code.
- Changes in banker remuneration, eliminating sales-based targets.
- Design and Distribution obligations to ensure customers are sold the right products, including credit products.
- Mortgage broker best interests' duty and remuneration changes.

[3] FSRC Final Report p.59: "Consumer advocacy groups urged me to recommend that the NCCP Act be amended to require lenders to determine whether a loan contract … was 'suitable' for the consumer (as distinct from 'not unsuitable'). I do not favour that proposal."

- Strengthened breach reporting.

Enforcement and penalties for breaching lending standards

Appendix A outlines the full suite of legal obligations for ADI credit providers and the various rights of action for customers and regulators.

Regulators will retain the ability to take enforcement action for lending misconduct.

ASIC

ASIC will retain the ability to take an action where a licensee is considered to have breached the NCCP Act, Section 47 obligation to 'act efficiently, honestly and fairly'. This includes for matters involving lending misconduct, as we saw in the Royal Commission which recommended Section 47 action in such cases. Civil penalties of up to 5000 penalty units apply for individuals.

ASIC is responsible for enforcing the design and distribution obligations and can take action for breaches of these obligations. Civil penalties apply for bodies corporate up to 50,000 penalty units, 10% of turnover, or three times the benefit gained, whichever is greater. For large institutions, breaches could result in penalties of up to $525 million per offence.

ASIC can take action under certain provisions of the ASIC Act for unconscionable conduct, misleading or deceptive conduct, and breaches of implied warranties of due care and skill. Civil penalties apply for bodies corporate up to 50,000 penalty units, 10% of turnover, or three times the benefit gained, whichever is greater. The Unfair Contract Terms provisions also apply, with ASIC having the power to remove such terms from credit contracts.

APRA

APRA[4] requires banks to adopt prudent credit risk management policies. It has a proven track record of handing down penalties to banks, including Court Enforceable Undertakings, and 'add-on' capital requirements where banks fail to meet APRA requirements.

The Government's proposal continues to require lenders to comply with APRA's lending standards contained in APS 220, APG 220 and APG 223, which includes requiring them to undertake comprehensive credit assessments based on the level of risk involved. This assessment requires the ADI to undertake an assessment of the customer's income, expenses, indebtedness when applying for a residential home loan. Further, the revised APS 220 will make it clear a bank should not issue a loan that would place the borrower in substantial hardship.

APRA is also fast tracking the commencement of the revised APS 220, with new obligations relating to credit assessment and approval being brought forward from 1 January 2022, to align with the commencement of these proposed reforms.

APRA's formal legal powers range from simple information-gathering powers to more coercive and intrusive tools that enable APRA to investigate, direct entities to take action, impose license conditions, ban individuals, and refer matters for civil or criminal court action.

Non-formal approaches include supervisory methods and tools such as prudential and thematic reviews, financial analysis, heightened engagement, capital adjustment and reporting requirements.

AFCA

Customers retain a direct recourse to AFCA.

On November 1, 2018, the Government introduced AFCA as a new one-stop shop for financial complaints. This formed part of the Government's overhaul of the external dispute resolution framework for financial disputes in Australia, providing customers and small businesses with access to free, fast

[4] APRA 2019, *APRA's Enforcement Approach,* Accessed January 2021 at https://www.apra.gov.au/sites/default/files/apras_enforcement_approach_-_final.pdf

and binding dispute resolution. AFCAs rules have continued to develop over the past 2 years. The authority has engaged with banks to investigate and settle disputes.

Customers can bring a complaint to AFCA regarding maladministration of lending, for contracts as large as $5,000,000.

AFCA can take into account a wide range of factors when dealing with maladministration in lending complaints. When determining a complaint, the AFCA decision maker must do what is fair in all the circumstances, and take into account:

- legal principles
- applicable industry codes or guidance
- good industry practice
- previous relevant determinations of AFCA or predecessor schemes.

It is expected that AFCA will treat good industry practice as compliance with APS220, APG223 and the Banking Code.

Critically, customers will also retain legal recourse:

- Both ASIC and APRA can take court action if banks fail to meet obligations.
- Customers retain the right to apply to a court for the removal of an unfair contract term.
- Courts can reopen unjust transactions.
- Courts can enforce a clause of the Banking Code.

BCCC

The duty to act as a 'diligent and prudent banker' is set out in the Code and ABA member banks are contractually bound by the obligations. Compliance with the Banking Code is monitored by the independent Banking Code Compliance Committee (**BCCC**). The BCCC has the power to apply sanctions, including requiring the bank to rectify, naming a bank in the BCCC annual report or website, and reporting serious or systemic ongoing instances where a bank has been non-compliant to ASIC.

Simplifying expectations of sound lending practices.

Under the current regime, credit decisions by ADIs are regulated by ASIC through the NCCP Act and by APRA.

The Government's proposal seeks to simplify the regulation so that for most credit activity, banks will need to comply with APRA's standards for credit risk management including expectations of sound lending practices.

This will ensure a single set of regulator expectations and prevent discrepancy between the approaches taken by two regulators.

Technical comments on the Bill

Best interest duty for credit assistance providers

The Bill extends the mortgage broker best interest duty to other credit assistance providers and will require those providers to comply with the duty in relation to credit contracts. This duty will not apply if the licensee (or its credit representative) provides credit assistance where it is the credit provider, where the credit representative or licensee performs the obligations or exercises the rights of a credit provider in relation to the majority of the credit contracts, or where the credit assistance provider is offering credit contracts from one credit provider.

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While the Explanatory Memorandum provides some guidance on the application of the duty, further clarity is required to ensure that the best interest duty will not apply to an individual entity where they are providing credit assistance in relation to the products of multiple credit providers under the same corporate group. In addition, where a related body corporate of an entity holds a separate ACL as a credit provider, guidance is required to ensure that where one of the entities provides credit assistance in connection with its related body corporate credit contracts (but not in connection with the contracts of any credit provider outside of the corporate group), they remain excluded from best interest duty. This will remove any ambiguity that currently exists in the application of the duty.

Recommendation – *the ABA recommends that the Explanatory Memorandum provide greater clarity on the application of the best interest duty by clearly outlining that the duty will not apply to credit assistance providers within the same corporate group and between related bodies corporate.*

Low limit credit contracts

The proposed changes in the Bill create the concept of a 'low limit credit contract' for when an ADI provides an unsecured loan of under $2000 that is not a continuing credit contract, and with a term of between 16 days and one year. As currently drafted, an ADI that provides such a loan will be subject to the responsible lending obligations in the NCCP Act.

The current NCCP Act settings for small loans differ between ADIs and non-ADIs, with Small Amount Credit Contracts being defined to exclude credit provided by ADIs. This appropriately reflects the need for governance around short-term, small amount credit products provided by non-ADIs such as payday lenders.

The proposed changes in the Bill mean ADIs that provide these credit contracts would be subject to both the responsible lending obligations under the NCCP Act and APRA's standards contained in its guidance for these types of loans. Supervision and enforcement of these loans will also remain the responsibility of ASIC as well as APRA.

This duplication in regulation is unnecessary as APRA's framework provides sufficient consumer protection, and will complicate the consumer lending framework, rather than simplifying it. Under APRA's credit risk management standards, ADIs could appropriately tailor their credit assessment processes to extend these loans to customers according to their serviceability capability.

The increased complexity and cost of having to manage two different sets of standards may act as a disincentive for some ADIs to provide such loans and will disadvantage a category of customers that already struggle to access safe and affordable credit. ADIs providing such credit generally offer small loans at competitive interest rates, backed by robust hardship policies and processes.[5]

Recommendation – *the ABA recommends the removal of the responsible lending obligations for all consumer loans offered by ADIs to avoid the duplication of regulation. This can be achieved through the removal of the concept of 'low limit credit contract' from the Bill for ADIs so that these loans are only subject to APRA's lending framework.*

Reverse mortgages protections

The ABA supports the Bill's retention of the special conduct provisions as they relate to reverse mortgages as the risk associated with these mortgages can be significant.

We note that the Bill has maintained the requirement to give equity projections, but from 1 March 2021, this obligation is required prior to the licensee providing credit assistance, entering the credit contract, increasing the credit limit or making an unconditional representation about the consumer's eligibility.

In addition, we note and support the introduction of a prohibition on licensees from entering into reverse mortgages, where the loan to value ratio exceeds a calculation dependent on the borrower's age. This prohibition provides an essential consumer protection and will operate as follows:

[5] For example, an ABA member offers unsecured loans over $1000 at a comparison rate of 12.49%.

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- A licensee must not enter into a reverse mortgage with a borrower who is under 56 years of age where the loan to value ratio of the mortgage exceeds 15%.
- A licensee must not enter into a reverse mortgage with a borrower who is at least 56 years of age where the loan to value ratio of the mortgage exceeds the sum of 16% and 1% for each year the borrower is more than 56 years of age.

Regulation of ADIs and non-ADIs

The ABA understands that the Government will develop a Non-ADI Credit Standard that will govern the provision of credit by non-ADIs and will be administered by ASIC. It will be essential that this credit standard for non-ADIs is aligned and consistent with the obligations of ADIs under the APRA framework. This will ensure adequate protections for customers and will maintain a level playing field between ADIs and non-ADIs.

At present, ADIs appropriately have additional prudential regulation to protect deposits with several prudential regulatory requirements relating to serviceability such as those found in APG 223. In addition to being prudential measures, some of these requirements have a direct consumer protection effect. Those prudential measures that significantly strengthen consumer protection should also be reflected in the Non-ADI Credit Standard to ensure consistent consumer protections, serviceability assessments and regulatory compliance requirements across all lenders and lending markets. This will reduce any differences in regulation, ensure adequate consumer protections, and contribute to a more level playing field for all credit providers. A level playing field across all credit providers is necessary to maintain a competitive credit industry and deliver a range of benefits to customers including competitive pricing, improved service and ongoing innovation in products and technology.

Recommendation - *the ADI and non-ADI credit frameworks should be aligned and consistent to ensure adequate consumer protections and a level playing field across all credit providers.*

Non-ADI subsidiaries

Banks often have non-ADI subsidiaries within their corporate group that undertake relevant credit activities. The Bill and Explanatory Memorandum provide for the Non-ADI Credit Standard to make different provisions in relation to different situations, activities or classes of licensees or credit providers and notes that this power could be used to ensure that the Non-ADI Credit Standard does not apply to bodies corporate (such as non-ADI subsidiaries of ADIs) that are regulated by APRA's prudential standards.

The ABA supports the inclusion of this power to ensure that non-ADI subsidiary entities are not subject to both APRA's framework and the Non-ADI Credit Standard. The application of both frameworks would result in unnecessary duplication of regulation and is inconsistent with the Government's intention of simplifying the regulatory framework.

Electronic transactions

The ABA supports the Government's efforts to modernise electronic transactions in business communications to reflect advancements in technologies and create efficiencies for customers. Action the Government has taken during the COVID-19 pandemic to provide relief from the Corporations Act has meant essential business such as holding AGMs virtually and allowing documents to be executed electronically has been able to continue.

The ABA supports Treasury's Modernising Business Communications consultation as a vehicle to identify legislative change enabling financial institutions to utilise existing and new technologies to improve banking services for the benefit of customers.

Appendix A – Summary of the protections and penalties within the regulatory framework

Regulation	Conduct	Enforcement	Penalties
APRA Standards and Guidance	Under APRA's framework in APS 220 and APG 223, ADIs are required: a) to identify requirements and the objectives of the customer in seeking the loan b) to verify income and expenses c) to consider character, condition, capital and collateral d) to utilise benchmarks e) to undertake an assessment of the unsuitability of the credit contract **APS 220 – Credit Risk Management** Paragraph 39 – An ADI must establish sound credit assessment and approval criteria. These criteria must set out the borrowers who are eligible for credit, the extent and nature of credit the ADI is willing to provide and the terms and conditions the exposures would be subject to. Paragraph 40 – An ADI must undertake a comprehensive assessment of a borrower's credit risk which would consider and be proportionate to the nature, type and size of the exposure. An ADI must use experienced credit judgement in adopting a scalable and flexible approach to its credit risk assessment of a borrower. Paragraph 41 – An ADI must assess credit risk primarily on the strength of a borrower's repayment capacity. The ADI must not place undue reliance on collateral provided by the borrower as a substitute for a comprehensive credit assessment. Paragraph 42 - An ADI must not place undue reliance on external credit ratings. An ADI must obtain adequate information to undertake a comprehensive credit assessment of a borrower. Paragraph 43 - An ADI must give due consideration to the integrity and reputation of the borrower as well as its legal capacity to assume liability. Paragraph 44 - For exposures to individuals, an ADI's credit assessment must include consideration of the following criteria, where relevant: • the purpose and structure of the exposure and sources of repayment, including making reasonable inquiries and taking reasonable steps to verify income or cash flows; • the current risk profile of the borrower, including making reasonable inquiries and taking reasonable steps to verify commitments and total indebtedness; • the borrower's repayment history and capacity, assessed under various scenarios such as: (i) an increase in interest rates; (ii) a change from a fixed-rate to a floating interest rate (and vice versa); (iii) a decrease in income or cash flows, particularly for less stable income or cash flow sources; and (iv) for exposures with an interest-only period that subsequently converts to principal and interest payments, on a principal and interest basis of repayment;	Non-formal approaches include supervisory methods and tools such as prudential and thematic reviews, financial analysis, heightened engagement, capital adjustment and reporting requirements. Formal legal powers range from simple information gathering powers to more coercive and intrusive tools that enable APRA to investigate, direct entities to take action, impose license conditions, ban individuals, and refer matters for civil or criminal court action.	APRA can impose additional capital requirements on non-complying banks and pursue Court Enforceable Undertakings. If APRA issues a compliance direction under s11CA of the Banking Act and that is not complied with, s11CG imposes a 50 penalty unit civil penalty for each day of non-compliance.

- the borrower's expenses, including the collection of reasonable estimates. Expense benchmarks must not be used as a substitute for an ADI making reasonable enquiries of a borrower's expenses;

- the proposed terms and conditions of the exposure, including covenants designed to limit the ADI's exposure to changes in the future risk profile of the borrower to an acceptable level to the ADI; and

- where applicable, the adequacy and enforceability of collateral, guarantees and other risk mitigants, including under various scenarios.

Paragraph 45 - For exposures other than to individuals, in addition to paragraphs 44(a), 44(b), 44(c), 44(e) and 44(f), an ADI's credit assessment must also include consideration of the following criteria, where relevant:

- the borrower's business expertise, economic or industry sector and its position within that sector;

- the borrower's historical financial and future cash flows;

- the borrower's equity capital invested in the business; and

- the availability and enforceability of risk mitigants other than collateral, such as hedging and insurance.

In addition, APRA is intending to make amendments to paragraph 41 of APS 220 to require ADIs to assess an individual borrower's repayment capacity without substantial hardship.

APG 223 – Residential Mortgage Lending

Paragraph 13 - Failure to meet responsible lending conduct obligations, such as the requirement to make reasonable inquiries about the borrower's requirements and objectives, or failure to document these enquiries, can expose an ADI to potentially significant risks. A prudent ADI would conduct a periodic assessment of compliance with responsible lending conduct obligations to ensure it does not expose itself to significant financial loss.

Paragraph 38 - As part of its serviceability assessment, an ADI would typically assess and verify a borrower's income and expenses having regard to the particular circumstances of the borrower.

Paragraph 41 - A prudent ADI would be expected to make reasonable inquiries and take reasonable steps to verify a borrower's available income. Verification of a borrower's stated income would normally be achieved through a combination of factors, for example:

a) confirming employment status, i.e. whether permanent, casual, part-time, contractor or fixed term contract

b) reviewing recent payslips detailing regular salary or wage income of the borrower, including usual shift penalties

c) seeking written advice from the borrower's employer or accountant/tax advisor confirming actual or likely income levels

d) reviewing income tax assessment notices and returns

	e) reviewing bank statements that confirm regular salary credits f) reviewing other documents pertaining to income (e.g. business activity statement) and g) making independent enquiries into the borrower's credit history (e.g. through credit reporting bodies). Paragraph 44 – A borrower's living expenses are a key component of a serviceability assessment. Such expenses materially affect the ability of a residential mortgage borrower to meet payments due on a loan. ADIs typically use the Household Expenditure Measure (HEM) or the Henderson Poverty Index (HPI) in loan calculators to estimate a borrower's living expenses. Although these indices are extensively used, they might not always be an appropriate proxy of a borrower's actual living expenses. Reliance solely on these indices generally would therefore not meet APRA's requirements for sound risk management. APRA therefore expects ADIs to use the greater of a borrower's declared living expenses or an appropriately scaled version of the HEM or HPI indices. That is, if the HEM or HPI is used, a prudent ADI would apply a margin linked to the borrower's income to the relevant index. In addition, an ADI would update these indices in loan calculators on a frequent basis, or at least in line with published updates of these indices (typically quarterly). Prudent practice is to include a reasonable estimate of housing costs even if a borrower who intends to rely on rental property income to service the loan does not currently report any personal housing expenses (for example, due to living arrangements with friends or relatives). Paragraph 45 - A prudent ADI would have effective procedures to verify a potential borrower's existing debt commitments and to take reasonable steps to identify undeclared debt commitments.		
National Consumer Credit Protection Act	The general conduct obligations of the NCCP Act, which are retained by the proposed reforms require banks to do all things necessary to ensure that the credit activities authorised by the licence are engaged in "efficiently, honestly and fairly". <u>Obligations of licensees</u> s47(1)(a) – General conduct obligation of licensees to act efficiently, honestly, and fairly. s158LA & s158LE – Mortgage brokers' duty to act in the best interest of the customer.	Customers can seek compensation orders and other remedies including injunctions under Part 4-2 of the NCCP Act. ASIC can seek a civil penalty action for breaches of the general obligation provisions.	Customers can seek damages. ASIC can seek civil penalties of up to 5000 penalty units against individuals. Against bodies corporate, the greater of 50,000 penalty units or 10% of annual turnover, up to a maximum of 2.5 million penalty units are applicable. ASIC can also apply to the court for an order for the body corporate to pay pecuniary penalties under s167.
Banking Code of Practice	The duty to act as a diligent and prudent banker is set out in the Banking Code and ABA member banks are contractually bound by the obligations under the Banking Code: Clause 49 - provides that ABA subscribing banks will exercise the "care and skill of a diligent and prudent banker" when providing credit to an individual or small business customer. Clause 50 – stipulates that this 'prudent and diligent banker' standard requires banks to comply with the law for individual customers. Clause 51 - for small business lending this 'prudent and diligent banker' standard requires banks to consider the customer's circumstances involving the financial position and account conduct	Compliance with the Banking Code is monitored by the independent BCCC. The BCCC has the power to apply sanctions, including: • requiring the bank to rectify or take corrective action on the breach identified • requiring a bank to undertake a compliance review of our remediation actions • formally warning a bank • requiring a bank to undertake a staff training program on the Code • naming a bank in the BCCC annual report or website, and	The customer can seek an action for damages of a bank's breach of contract.

	Clause 54 – stipulates that ABA subscribing banks will not approve a co-borrower if they will not receive a substantial benefit from the loan, unless the subscribing bank meets certain requirements including the need to take reasonable steps to ensure the customer understands the associated risk; the need to take into account the reason for the customer wanting to be a co-borrower; and the bank is satisfied that the customer is not experiencing financial abuse Clause 61 – stipulates that a customer can advise the subscribing bank of their preferred credit card limit and restricts the subscribing bank from giving the customer a limit that is more than the customer requested Clause 38 – commits subscribing banks to taking extra care with customers who are experiencing vulnerability.	• reporting serious or systemic ongoing instances where a bank has been non-compliant to ASIC.	
ASIC Act	The ASIC Act sets out specific prohibitions and penalties for unconscionable conduct and consumer protection in financial services and unfair contracts. ASIC will also continue to regulate the provision of credit by banks through the general conduct obligations, strict licensing requirements and disclosure obligations. <u>Obligation to identify requirements and objectives of the customer</u> s12ED – Warranties in relation to the supply of financial services. <u>Assessment of unsuitability of credit contract</u> s12BF- Unfair terms of consumer contracts and small business contracts. s12CB - Unconscionable conduct in connection with financial services. s12DA - Misleading or deceptive conduct. <u>Special protections for credit cards</u> s12DL – No unsolicited credit or debit cards.	Customer can apply to a court for the unfair contract term to be removed and can seek compensation orders and other remedies under s 12GD (injunctions) and s12GF (damages) of the ASIC Act. ASIC can apply for declaration of contravention and seek a civil penalty action.	The unfair term can be assessed to be not enforceable and removed from contract. ASIC can apply for a declaration of contravention and civil penalties. ASIC can seek civil penalties of up to 5000 penalty units against individuals. Against bodies corporate, the greater of 50,000 penalty units or 10% of annual turnover, up to a maximum of 2.5 million penalty units are applicable.
Design and Distribution Obligations	The DDOs on consumer credit products require lenders and brokers to have a consumer-centric approach to the design and distribution of credit products and for lenders to review products to ensure their customers are receiving credit that is likely to be consistent with their objectives, financial situation and needs.	ASIC can seek an action for civil penalties for non-compliance with these obligations. Customers can seek compensation orders and other remedies under s1317HA (damages) and s1324 (injunctions).	A successful action by ASIC for civil penalties can lead to a payment of 50,000 penalty units or 10% of annual turnover, up to a maximum of 2.5 million penalty units, and other s 1317G(4) penalties for body corporate. The customer can seek an action for damages.
BEAR – Banking Act	The Banking Executive Accountability Regime imposes heightened accountability obligations for individuals with responsibility for management or control of significant or substantial parts of an ADI group's operation. <u>Obligation of an ADI</u> s37C – the obligations of an ADI are to take reasonable steps to conduct its business with honesty and integrity, and with due skill, care and diligence. <u>Obligation of an accountable person</u> s37CA(1)(a) – obligation that an accountable person is to conduct the responsibility of their position by acting with honesty and integrity, and with due skill, care and diligence.	APRA can disqualify an accountable person for serious non-compliance with their obligations as an accountable person. APRA can seek civil pecuniary penalties for breaches of the BEAR. ADIs are required to withhold all or part of an accountable person's variable remuneration that is deferred where the accountable person has engaged in behaviours in breach of BEAR obligations.	APRA can apply for an order by the court for civil pecuniary penalties. The maximum penalty available will depend on the size of the ADI. For large ADIs the maximum civil pecuniary penalty will be 1 million penalty units, for medium ADIs the maximum penalty will be 250,000 penalty units and for small ADIs the maximum penalty available will be 50,000 penalty units. APRA can disqualify an accountable person. The ADI can withhold all or part of an individual's variable remuneration.

Australian Banking Association