

RESPONSIBLE LENDING: “APPLY THE LAW AS IT STANDS!”

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Legal Briefings - By **Tony Coburn, Amy Ciolek, Julia Massarin and Nicola Greenberg**

The law is correct, now you must learn to follow it. That is the message from Commissioner Hayne regarding the consumer lending laws and responsible lending practices of Australia's banks. Despite being "urged" by consumer advocacy groups to alter the *National Consumer Credit Protection Act 2009 (NCCP Act)*, Commissioner Hayne concluded that the tests and obligations in this legislation were appropriate - it was their enactment by the banks that was lacking.

The Royal Commission's Final Report focussed not on sweeping law changes in the responsible lending sector, but instead on drawing out the particular obligations that had been present in the law, but previously overlooked or de-prioritised as part of the business of banking. The results of the Final Report set the scene for the substantial changes to come in this area, with the redrafting of RG 209 and the verdict on Westpac's use of the Household Expenditure Measure (**HEM**) to be delivered in 2019. While the Royal Commission was focussed on the behaviour of banks only, alterations to RG 209 flowing from the Final Report will have application to all providers of consumer credit in Australia.

In relation to business lending Commissioner Hayne has adopted a relatively light touch approach to recommending changes to the responsible lending laws. Broadly, small business lending will remain relatively untouched with the exception of the enhanced responsible lending provisions in the 2019 Banking Code of Practice (**Banking Code**), simplification of the 'small business' definition and ASIC being given stronger enforcement powers to enforce code provisions. Similarly guarantors will need to rely on the contractual and Banking Code provisions as well as the body of well-established case law on this topic as Commissioner Hayne seems to have left this area of law untouched.

POLICY RECOMMENDATIONS

LENDING TO CONSUMERS

The Royal Commission called for a return to the central components of the NCCP Act, the split between assessment and determination regarding the 'not unsuitability' of a credit contract. Since its introduction in 2009 the NCCP Act has contained two separate, but interlinked obligations for banks assessing consumer credit applicants:

1. conduct reasonable ***inquiries and verifications*** (as outlined in s128 of the NCCP Act); and
2. ***not*** enter into a credit contract that is ***unsuitable*** for the consumer (s133 of the NCCP Act).

These obligations test two different aspects of the lender's assessment process. The first is a question regarding the adequacy and implementation of the bank's processes and procedures. The bank must inquire (to a "reasonable" standard) about the customer's objectives and requirements, and inquire about ***and*** verify information provided about the customer's financial situation. Having carried out the process in (1) a lender must then consider whether the proposed credit contract is not unsuitable for the consumer.

While Commissioner Hayne's comments regarding this assessment process appear to consider the mortgage application process, he did not specifically differentiate this from the other kinds of consumer lending that may be provided (such as personal or vehicle loans), or attempt to address the reasonableness standard. Additionally, as RG 209 indicates that a lender's obligations are 'scalable' it would follow that changes to a credit assessment process for mortgage applicants should also be adopted (after being appropriately scaled) for the purposes of lower valued consumer credit and lease products.

WHY HAVE THESE TWO STEPS BECOME ONE?

In the Final Report, Commissioner Hayne noted that he identified through hearings that instead of two separate processes and obligations, the above steps were, in practice, conflated by the banks into a single assessment process.¹

We speculate that some clues for how this might have occurred can be found in the loan application process. Customers must provide all their information to the lender for the purposes of 'credit assessment'. In this way, the collection, verification and 'not unsuitable' assessment all become a single process. The Final Report indicates that this kind of 'credit-mash' is no longer on the menu, instead, banks must design their processes to ensure that they carry out two distinct and important processes: inquiry and verification ***and*** assessment of whether the loan is not unsuitable.

HOW MIGHT THIS WORK IN PRACTICE?

While the Final Report makes a number of observations regarding the practical steps that should (and should not) be included as part of these processes, it would be incorrect to jump straight to these issues without first considering the separation of each policy, as emphasised in the Final Report. Banks could consider the extent of separation between identification and credit assessment in their own processes by considering the following:

1. what is the bank's messaging to its staff and representatives regarding credit assessments?;
2. are staff aware of the separate primary obligation to inquire and verify data provided by the customer?;
3. are staff aware that they are **prohibited** from entering into a credit contract unless these inquiries and verifications have been made?;
4. are the loan application documents packaged in a manner that separates the inquiry and verification process, and emphasises its importance?; and
5. are there separate consequences for failures to carry out each step in the responsible lending process, or a single consequence for an incorrect or incomplete loan application?

WHAT KIND OF VERIFICATION WILL BE REQUIRED?

Commissioner Hayne devoted a significant amount of the Final Report's consideration of the NCCP Act to discussion of the kinds of verification that are, and are not acceptable.

What's in	What's out?
<p>More detailed application forms. The Final Report notes that CBA has introduced mandatory expense breakdowns, ANZ has introduced a detailed breakdown of living expenses, and Westpac has expanded its expense categories and made some categories mandatory.²</p>	<p>Sole reliance on the Household Expenditure Measure (HEM) as a substitute for inquiries. Despite noting that it would not be appropriate for the Final Report to comment on the proceedings between ASIC and Westpac regarding use of HEM in loan assessments, the Final Report makes a number of comments that indicate that in the Commissioner's opinion, reliance on HEM only does not constitute appropriate verification of a borrower's expenditure.</p>
<p>Digital tools and use of technology The Final Report notes that both ANZ and CBA are updating systems to better capture and characterise data about customers' expenditure and obligations, including commitments from other financial institutions. We discuss below how this may have implications for the use of data obtained through the Open Banking regime.</p>	<p>Brokers as bankers The Final Report makes it clear that the brokers must act in the best interests of the client, not as proxy-bank-representative. This may change the extent to which a bank relies on aspects of assessments performed by the broker. We discuss this further in our review of the 'intermediaries' section of the Final Report.</p>

IS 'UNSUITABILITY' STILL SUITABLE?

There was discussion of the term 'unsuitability' and whether the test should, in fact, be the 'suitability' of the product for the consumer. Commissioner Hayne noted this, and that the double-negative associated with the 'not unsuitable' test created some confusion, but ultimately concluded that 'not unsuitable' was the appropriate test.

This decision is likely to come as a relief to the banks, as it reinforces the bank's role to test the consumer's ability to service the product, not whether the product itself is going to benefit the consumer. While consumer groups may be disappointed, the consumer-centric changes throughout other sections of the Final Report (such as the 'best interest' test for brokers, and implementation of Sedgwick's consumer benefit requirements for remuneration) ensure that consumers have increased personal attention, without requiring such a substantial re-definition of the responsible lending obligations.

LENDING TO SMALL AND MEDIUM ENTERPRISES

No extension of regulated lending to SMEs

On the face of it, small and medium enterprise (**SME**) lenders have been spared by Commissioner Hayne as he recommended that the consumer credit laws in the NCCP Act **not** be amended to extend to SME lending (**Recommendation 1.9**).

Banking Code

Despite this, Commissioner Hayne made his views known that the existing standard in the Banking Code of exercising “the care and skill of a diligent and prudent banker” seemed appropriate when deciding whether to provide a new SME loan or increase an SME's loan limit.

Similarly, Commissioner Hayne expressed satisfaction with the banks’ responses to the way in which they assess SMEs' credit under the responsible lending obligations in Chapter 17 of the Banking Code. This requires banks to make an assessment of whether the customer can repay the loan based on the circumstances reasonably known to the bank about the customer’s financial position or account conduct. Certain banks suggested that extending responsible lending regulations to SMEs may impact credit availability to SMEs.

Nevertheless, in his other recommendations, Commissioner Hayne proposed that the provisions of the Banking Code be made into “enforceable code provisions” (**Recommendations 1.15 and 1.16**) with the result that contravening those provisions would constitute a breach of the law. [See our discussion in our general banking and credit article for further information.](#)

THE BIG PICTURE

LENDING TO CONSUMERS

No change to the NCCP Act

Consumer lending was destined to be a big-ticket item for the Royal Commission, with stories of consumer hardship dominating media reporting before the hearings even began. It may therefore surprise some that Commissioner Hayne did not recommend alterations to the legislative framework for consumer lending in the NCCP Act.

Imminent changes to Regulatory Guide 209

This statement should not, however, be viewed as inaction regarding consumer lending. Instead, it is a reflection of the fact that banking practice has morphed and changed the effects and interpretation of key provisions of the NCCP Act. Additionally, while Commissioner Hayne did not make any recommendations for alterations of the law, his statements will be particularly relevant to ASIC as it prepares its draft update to RG 209 in the coming weeks, and prepares for the outcome of its matter against Westpac on the use of automated systems and benchmarks.

LENDING TO SMALL AND MEDIUM ENTERPRISES

Small business lending responsible lending provisions

Although less prescriptive, banks have to be careful in applying the responsible lending obligations outlined in the Banking Code as a misapplication is likely to result in a breach of law attracting enforcement action.

Small business definition in the Banking Code

Banks should consider whether they undertake their review and re-write of their product terms and conditions in preparation for implementation of the Banking Code from 1 July 2019 based on:

- the definition of 'small business' in the Banking Code; or
- the broader definition recommended by Commissioner Hayne which is likely to be implemented as a change by the ABA with the support of both the Labor party and the Coalition.

INSIGHTS AND TRENDS

LENDING TO CONSUMERS

The Final Report expresses Commissioner Hayne's view that there exists a new expectation that banks undertake a more sophisticated data collection and verification process that does not rely on automated minimum expense tools. In our experience, the processes that seem to best fit within this criteria draw on the bank's existing knowledge and experience with consumer lending and customer data. While some (particularly the larger) banks have rich data holdings, many do not, and many store their data in legacy systems which do not interoperate without significant development cost and time. With initiatives such as the Open Banking regime, access to data may improve over time, but again, not without cost. As reliable data becomes more freely accessible, we expect that lenders will incorporate it into their assessment process.

Commissioner Hayne's view raises questions about whether banks are 'on notice' of information they hold and information asymmetry throughout the lending industry, including between lenders of different sizes. It would lead to a disappointing consumer outcome if only the large can afford to comply, and competition reduces over time as smaller lenders cannot afford to comply and compete.

Commissioner Hayne displayed restraint in his discussion about income and expense inquiries and verification. He considers that relying on the borrower's declared expenses, and defaulting to HEM are both inadequate. Digital information may be helpful to verify declared expenses. His choice to avoid discussion or making recommendations about the correct method of verification is intentional to avoid influencing the Westpac case. The informal recommendation made is to amend legislation if Justice Perram's findings reveal a deficiency in the law's requirements to make reasonable inquiries about, and verify the consumer's financial situation.²

We understand that ASIC proposes to release a revised draft RG 209 this year. This will be the first time the regulatory guide has been substantially changed in eight years other than minor edits made in 2014 to clarify ASIC's expectations about making inquiries into expenses. This will give ASIC an opportunity to revise its guidance about the use and role of technology in responsible lending.

LENDING TO SMALL AND MEDIUM ENTERPRISES

It seems that the banks will preserve their lender flexibility by continuing to apply their evaluation processes to SME loan applications, despite some wanting more transparency in the process.

Commissioner Hayne said, having reviewed the banks' submissions, that it would not be useful to "prescribe any particular approach to be applied by all banks" in the way they evaluate loan applications.

However, the banks are on notice that any short cuts taken in performing these assessments are likely to attract consequences similar to those imposed on regulated credit providers.

SO WHAT DOES THIS MEAN FOR THE INDUSTRY?

The recommendations set out in the Final Report relating to responsible lending will undoubtedly lead to significant regulatory, policy, procedure and system changes. While it appears that there is a clear role for technology and enriched data, and potentially a regulatory or "[community expectation](#)" that all lenders will use rich and accurate digital data to verify expenses, many challenges exist. For example:

- the *Treasury Laws Amendment (Consumer Data Right) Bill 2018*, which is the law that enacts the proposed Open Banking regime has not yet been presented to parliament;
- there is mixed industry concern that bank account scraping and aggregation systems that are used by some lenders may place borrowers in breach of their account terms, or may impact borrowers' rights under the ePayments Code (a known issue since at least 2011); and
- data and system integration is expensive, and many smaller banks, mutuals and lenders simply cannot afford the cost, or are using legacy technology which is not compatible with modern data services.

It is likely that the specific expectations regarding expense collection and verification will be further drawn out by the outcome of the case between ASIC and Westpac. If, as Commissioner Hayne suggests, any deficiency in the law's requirements is identified as a result of this case, this may give rise to a further obligation to amend the law to remedy this issue.

The reach of RG 209 is broad, and goes beyond the banks to all providers of consumer credit. We suggest it is likely that all such businesses must scale-up their assessment and verification mechanisms. However, given the significant data holdings and IT capability at large banks, ASIC's expectations regarding bespoke inquiry and verification of borrower information may be higher for these industry players.

[Return to main page](#)

ENDNOTES

1. Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report* (1 February 2019), Volume 1 (**Final Report**), Page 54.

2. Final Report, page 55.

3. Final Report, page 57.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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