Submission by the

Financial Rights Legal Centre

AFCA

The Approach to responsible lending: legal principles, industry codes and good industry practice.

The AFCA Approach to responsible lending: consumer credit issues

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Financial Rights Legal Centre |PO BOX 538, Surry Hills 2010 | Tel (02) 9212 4216 |Fax (02) 9212 4711 |
info@financialrights.org.au | www.financialrights.org.au | @Fin_Rights_CLC | ABN: 40 506 635 273

About the Financial Rights Legal Centre

The Financial Rights Legal Centre is a community legal centre that specialises in helping consumers understand and enforce their financial rights, especially low income and otherwise marginalised or vulnerable consumers. We provide free and independent financial counselling, legal advice and representation to individuals about a broad range of financial issues. Financial Rights operates the National Debt Helpline, which helps NSW consumers experiencing financial difficulties. We also operate the Insurance Law Service which provides advice nationally to consumers about insurance claims and debts to insurance companies, and the Mob Strong Debt Help services which assist Aboriginal and Torres Strait Islander Peoples with credit, debt and insurance matters. Financial Rights took close to 25,000 calls for advice or assistance during the 2017/2018 financial year.

Financial Rights also conducts research and collects data from our extensive contact with consumers and the legal consumer protection framework to lobby for changes to law and industry practice for the benefit of consumers. We also provide extensive web-based resources, other education resources, workshops, presentations and media comment.

This submission is an example of how CLCs utilise the expertise gained from their client work and help give voice to their clients' experiences to contribute to improving laws and legal processes and prevent some problems from arising altogether.

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Introduction and Executive Summary

Thank you for the opportunity to comment on the draft Australian Financial Complaints Authority (**AFCA**) Approach to responsible lending documents.

Financial Rights has structured our feedback on the draft AFCA Approach documents in the following way:

First we provide general comments on the structure and content of the draft Approach documents.

Second we provide feedback on the three documents themselves. We do so by commenting on the drafting in a sequential order through each document from beginning to end – not in order of priority. We work sequentially through the draft Legal Principles, Industry Codes and Good Industry Practice Approach document (**the draft Legal Principle Approach**) first, then the draft Consumer Credit Issues (**the Consumer Credit Approach**) document. We have taken this approach for ease of reading. While we have not commented directly on the draft Business Credit issues (**the Business Credit Approach**) we believe many of the comments herein are relevant to that document as well.

We do however wish to highlight our priority concerns and recommendations arising out of this submission. These priority areas are the need for AFCA to:

- emphasise the obligation on financial firms to verify expenses and for the information obtained to act upon the mind of the lender in its decision making;
- appropriately acknowledge and address the systemic problems arising from the use of benchmarks and automated calculation systems. This includes
    - warning that the exclusive reliance on a benchmark does not meet responsible lending requirements nor sound risk management standards;
    - benchmarks *should not be used as a replacement* for the obtaining of information about the consumer's actual income expenses and other circumstances that are likely to affect their ability to meet the financial obligation; and
    - if they are used at all, benchmarks *should only* be used as a tool to test the plausibility of consumer-provided information.
- include in AFCA's approach to assessment or calculation of loss and compensation explicit reference to:
    - consequential losses (for example, loss arising subsequent to and because of the irresponsible loan such as pay day loan fees, debt management firm fees etc) and
    - non-financial losses such as stress and other mental health problems, stress-related illnesses, family breakdown, homelessness, and reputational damage from credit report/insolvency listings where these are a direct consequence of an irresponsible loan.

- amend and re-draft broad, sweeping statements that are definitive, are inflexible and fail to present other common potential scenarios, in particular statements on:
    - the inevitable sale of a property or voluntary surrender of an asset
    - not considering that there may be circumstances where the appropriate remedy may be that the loan balance is not required to be repaid, either because of the non-financial or financial loss associated with the loan or the borrower not receiving a benefit
    - the assumption that any amount borrowed to refinance an existing debt is always a benefit to the borrower equivalent to the value of the loan repaid.
- introduce more situations, scenarios and examples – both in terms of common areas that need to be addressed – such as small amount credit contracts (**SACCs**) and consumer leases - but also in terms of the provision of further examples to demonstrate how the stated approach will work in a range of different circumstances.

Finally, despite AFCA's publicly stated strong commitment to fairness in all the circumstances there is no mention of how this principle comes into play in any of the scenario's discussed in the approach documents.

General comments on the draft AFCA Approach

Structure of the draft AFCA Approach to responsible lending documents

The collective and individual structure of the three draft Approaches makes little sense to an outsider and would not make sense to a consumer looking for assistance. For example, the consumer credit document begins with a substantial section examining the legal analysis of the role of the finance/mortgage broker. There is no equivalent section on the role of the lender or their obligations (it is implied but never stated explicitly). To find this you need to read both the legal principles and the consumer document together and piece it together. We submit that the legal principles document should go through all of the applicable law, including plain English statements of the roles and obligations of each player. The consumer credit document could then be used to very briefly restate the key obligations and provide a more comprehensive set of examples and remedies. Alternatively there could be a single document for consumer credit and another for business loans covering the law and examples in each case. In either case there should be cross-referencing where appropriate to alert people to where to find things if they need to refer to another document.

While consumer representatives may have some insight into the intent behind the structuring of these Approach documents borne of our legal expertise and working knowledge of FOS Approach documents, that is not the case with everyday potential complaints looking for information.

Fundamentally these documents have not been drafted taking the user perspective into account.

It is clear AFCA have relied on the structure of the FOS Approach – and for good reason. It was likely the quickest way to develop and implement an Approach during a period where an Approach document is required to deal with a current and growing backlog of responsible lending cases.

However we feel that more work is required to restructure and add to these documents to ensure that they both capture all of the substantive issues and scenarios that need to be included - many of which were not addressed in the original FOS documents. More work is required to ensure that the information is presented in a logical, accessible and understandable form.

We believe AFCA should engage a plain English expert not to necessarily re-write the Approach document content into plain English statements but to provide advice on re-structuring the documents to ensure that the information is presented in a form that has a logical progression and is more accessible to both professionals and consumers.

Missing information

One of the key problems with the draft AFCA Approach documents is that many of the statements make sweeping, grand generalisations on areas of concern that fail to provide for many common scenarios that arise. In so doing it presents an Approach that seems like a fait accompli to related scenarios where the stated Approach is clearly inappropriate.

For example, with respect to the calculation of loss, the Approach states definitively that "Where the loan funds have been used to acquire the security/asset, the asset should be sold." There are a multitude of scenarios where this is not appropriate and that it is likely that AFCA will not take this approach. Further discussion of this is example is below at "*4.2 Calculation of loss.*"

Another example is that the draft ACFA Approach takes a definitive stance against writing off a debt borne of an irresponsible loan by stating "we do not take this approach." There are many cases where it *is* appropriate to write off a debt arising out of an irresponsible loan. We provide an example below under the section where this arises: *4. Compensation for loss.*

We note too that there are many common forms of credit that should be included to constitute appropriate guidance – for example small amount credit contracts and consumer leases. The legal principles section should also cover the different/additional laws that apply to these products.

There are also a number of scenarios and case studies included in the draft AFCA Approach document that provide assistance to only one perspective where a broader range of scenarios would be more helpful.

While we accept that AFCA Approaches documents cannot be so comprehensive as to include an example scenario that covers every known situation – it however would assist if there were more than one and that at the very least additional scenarios be provided that end in different results.

It is this narrow focus on a few middle ground scenarios that leads the draft Approaches to err and use of grand sweeping statements that cannot possibly be applied to other very common scenarios. This has the potential to confuse, mislead and possibly dissuade complainants.

Internal consistency

We are concerned that there may be a number of internal inconsistencies within and between the draft Approach documents. For example:

On page 9, of the Draft Legal Principle Approach under bullet point 2 the draft Approach states:

> *the consumer's liabilities including credit card balances;*

The words "and limits" should be included at the end of this clauses to make it consistent with page 8, bullet point 1 under heading "liabilities and expenses" of the Consumer Credit Approach which states that a common error is that:

> *The financial firm only looks at the consumer's current credit card balances, rather than the credit card limits*

Numbering

The AFCA Approach documents - just like prior FOS and Credit and Investments Ombudsman (**CIO**) documents - are regularly used by consumer representatives in providing advice and advocating. It would be helpful to not just consumer representatives but to all stakeholders including AFCA if every paragraph were to be numbered for ease of reference.

Legal principles, industry code and good industry practice

3.1 Types of information we look for

"any existing debts that the consumer is going to repay from the loan"

We note that the list of types of information that AFCA looks for does not include

> *any existing debts that the consumer is going to repay from the loan*

as currently referenced in the Financial Ombudsman Service (**FOS**) Approach[1] While it potentially may be implied in "the consumer's liabilities" we think it should be explicitly stated as it may go to the purpose of the loan and the objectives.

"consumer's liabilities including credit card balances"

With respect to "consumer's liabilities including credit card balances" this should be amended to include reference to credit card limits, since this is the amount a consumer is currently able to borrow and be held liable.

"a credit reporting agency"

We note the following paragraph:

> *the consumer's credit history, which may be demonstrated from existing loan and credit card statements but is best established by obtaining a credit report about the consumer from a credit reporting agency*

Credit reporting agencies are known as Credit Reporting Bodies (**CRB's**) in originating legislation and regulation.[2] This should be reflected in the Approach.

'Scalable'

The Legal Principles Approach defines scalability at page 9 and provides two sections on the issue providing information as to "When should a financial firm make more inquiries? And "When might a financial firm make fewer enquiries?"

We believe further guidance is required here.

Firstly we suggest AFCA make emphasise that fewer inquires are the exception, need justification, and are not the rule.

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[1] Financial Ombudsman Service, The FOS Approach Responsible Lending series. 3 How we approach responsible lending disputes taking into consideration legal principles, industry codes and good industry practice) https://www.fos.org.au/custom/files/docs/3-fos-approach-responsible-lending-industry-codes.pdf

[2] Under the current *Privacy (Credit Reporting) Code 2014* and the proposed new 2019 Code https://www.oaic.gov.au/privacy-law/privacy-act/credit-reporting

The concept of scalability has been largely interpreted as an ability to scale down what a licensee needs to do to meet their obligations. On the contrary, there should be a minimum standard set from which licensees must scale *up* their checks.

Scaling down to almost negligible levels for smaller loans can and has resulted in serious problems for consumers who pile up a series of small debts that add up to a large overall debt. If the expectation is that verification standards are lowered for these, a consumer can obtain a large sum total debt with few checks. It is critical that a minimum standard of verification is set.

Further, some small value products such as SACCs and consumer leases are high risk as a result of their comparative cost and the vulnerability of the target market. Responsible lending is extremely important to mitigate the risks of extreme hardship to many SACC borrowers and consumer lessees.

We therefore recommend that AFCA emphasise this in the Approach documents.

We also recommend that specific guidance be provided for credit cards, SACCs and consumer leases, given the specific nature of both the harms that these can cause and the systemic lack of adherence to responsible lending that has been identified in these areas by consumer representatives.

When should a financial firm make more inquiries?

The AFCA Approach should retain the FOS Approach to ensure that firms make further inquiries where:

> *the FSP has offered to provide the consumer two or more different types of credit contracts (for example, a home loan, a line of credit, and an offset account)*[3]

When might a financial firm make fewer inquiries?

We object to the inclusion of the following situation where a lesser level of inquiry or verification is justified:

> *past dealings give the financial firm a strong basis for confidence that the consumer understands the terms of the credit contract and the obligations they are taking on and that these will be met*

This is the exact justification provided for granting limit increases to customers on the basis of their repayment history rather than their current financial circumstances which resulted in large numbers of unsuitable credit card limits. While the law has now banned unsolicited credit limit increases it is imperative that these types of assumptions are not allowed to form the basis of responsible lending decisions. The law requires verification of the borrower's financial situation. There is a difference between having sufficient access to raw data about your customer to verify income and expenses with little further information required from third parties to not requiring verification at all because the customer is meeting obligations under an

[3] Section 38, FOS Approach 3.

existing contract. The former may sometimes be appropriate - the latter does not meet the requirements of the law.

We note that the Approach states that fewer inquiries and less verification might be reasonable where:

> *the consumer will not be seriously affected if the loan is unsuitable*

We suggest that this makes little sense. If a loan is unsuitable, by definition a consumer will be seriously affected. It goes without saying that a consumer will be seriously affected if it causes substantial hardship. It should also go without saying that if a loan doesn't meet the consumer's requirements and objectives then this seriously affects them since they have now incurred a debt (of any size) that is unsuitable to them.

Refinancing

Refinancing existing debt to a lower cost loan is the only situation where Financial Rights can see some sense in scaling down the rigidity of the responsible lending process, but this should not be to the point of non-compliance with the law. The law requires making appropriate enquiries and verification and this should be no exception to that rule. The difference is a more subtle one, in so far as the debtor's ability to meet their existing commitment should provide partial evidence that they could also meet a lesser monetary commitment.

Of course the lender would need to be satisfied that the borrower was in fact comfortably meeting their commitment under the existing loan (no defaults or consistently late payments); would need to ensure that their income was current (they hadn't lost their job last week, for example) and sufficient; and that their banks statements did not expose some glaring inconsistencies or ticking time bombs. We also note that the existing guidance in ASIC's RG 209 about including the costs of switching in any assessment of overall suitability and savings to the consumer would still apply.

Debt consolidation

Debt consolidation, as opposed to refinancing, is a different story. It is not uncommon for borrowers to seek, or for lenders to offer, to consolidate high costs credit, like credit cards onto a home loan in order to reduce the consumer overall repayments. We note that there are a number of downsides to this:

- the interest rate may reduce significantly but the overall cost of credit may increase due to the longer term of the loan;
- there is an increased risk the consumer will default on their (now bigger) home loan, placing their home at risk;
- the consumer may not address the underlying imbalance between their income and expenditure that led to accruing the unsecured credit in the first place and accrue further unsecured credit;

- the consolidation may mask underlying issues with the original unsecured lending (such as failures of responsible lending) that would be more appropriately addressed by reducing or waiving the debt.

It is far preferable that struggling consumers are given the opportunity to convert their high cost continuing credit debts to fixed term loans with lower interest rates, assuming there has been no failure of responsible lending. This gives the borrower the chance to pay off their debt more effectively, save money and obtain much needed breathing space, without putting their home at greater risk.

In many cases, consumers refinance to a higher interest rate home loan in order to consolidate debt. There may also be significant set up fees charged by the lender and/or third party intermediaries. This is highly risky for the consumer, as there is a strong probability they will default on the resulting more expensive loan.

Accordingly there should be a more rigid standard applied in the case of debt consolidations to ensure that the transaction has met the borrower's requirements and objectives and is not likely to place the borrower in substantial hardship.

Balance transfers

Consumers accumulating credit accounts due to accepting balance transfers and not closing the initial account is a particular problem. ASIC recently reported that that over 1 million credits cards had a balance transferred onto them at some stage or 7.6% of all open accounts.[4] Adding in cards that were cancelled, the total proportion of all cards with a transferred balance at some stage was 8.3%. Where a lender grants a balance transfer in circumstances where the borrower can afford the replacement credit but would not be able to comfortably afford the repayments on both cards then the approval should be *conditional* on the borrower providing written instructions to the original lender to close the account from which the balance is being transferred, or lower the limit accordingly. These instructions must be provided to the transferee creditor before any credit is made available, and passed on to the original creditor immediately following the transfer.

Assumptions about repayments on continuing credit

The Approach should specifically address the situation where a consumer has existing credit card accounts - any subsequent lender must assume a repayment level that would repay the fully drawn limit within three years, regardless of the minimum payment or the amounts actually being paid by the applicant. Any other approach condemns the borrower to being unable to pay down their balance within a reasonable period should they choose to do so and undermines the intent of the recent amendments in relation to credit card lending.

Where a consumer has another form of continuing contract, such as a line of credit secured over their home, the appropriate repayment level would need to be determined on a case by

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[4] Page 46, ASIC Report 580 *Credit card lending in Australia*, July 2018, https://download.asic.gov.au/media/4801724/rep580-published-4-7-2018.pdf

case basis with reference to their objectives and requirements, and other aspects of their financial situation, but it would usually be appropriate to use a repayment level that is *at least* as much as principle and interest payments would be over an appropriate term.

3.1 What is the minimum amount of information a financial firm should request?

"obtain and check"

The AFCA Approach states that as a minimum, financial firms should:

> *obtain and check copies of the consumer's PAYG payslips or bank statements*
>
> *obtain and check information to verify the consumer's information about liabilities*
>
> *obtain the consumer's estimate of their household expenses*

We note that in the current ASIC consultation on updating *RG 209: Credit licensing: Responsible lending conduct*, ASIC is proposing to clarify that it is not only the responsibility of the lender to make reasonable inquiries but for the lender to obtain the information, have regard to the information and use it to inform their assessment – that is, for the information obtained to act upon the mind of the lender.

Maintaining phrasing such as "check and obtain" continues the current ambiguity relied on by financial firms to obtain information on income and expenses but not *acting* on any discoveries that demonstrate that the declared amounts are not correct.

Case study – John's Story - C181741

John is 22 years old. He boards with his parents, and works full time to help support his family including 2 small children. He works as a carpenter and earns about $750 per week. 2 years ago he had an unsecured personal loan of about $8,000 which he was managing. He got his first small amount credit contract loan 18 months ago for $500 for the stated purpose of Valentine's Day. John had declared his monthly expenses as $600 per month, but it was clear from the 90 day bank statements that by the time his weekly pay was due he had none left over.

John would go on to obtain a further 4 small amount credit contracts from the same lender in the following 18 months, at each assessment his stated living costs remained unchanged and his 90 day statements continued to show he lived pay to pay. As the months progressed John was becoming more reliant on online lenders and obtained loans from other providers. He would occasionally default on payments and use the proceeds of a loan to pay another loan. Despite this, all the lenders assessed the loan as suitable. John now has 11 existing loans, 4 are SACCs and an additional 6 high cost online loans on top of his personal loan. In the 18 months he had 16 different loans with 5 different providers. Over 20% over his weekly income was going to pay the loans. He was struggling to make payments, and presented to Financial Rights in a state of high distress when he was forced to get an advance on his next pay to be able to afford to live.

We recommend that the Approach documents be redrafted to clearly stating that it is not sufficient to merely obtain verifying information but that the financial firm, at a minimum should have regard to it in making an assessment.

"test the reasonableness of the consumer's information"

The AFCA Approach asserts that as a minimum, the financial firm should:

> *test the reasonableness of the consumer's information about their household expenses for example by reference to a credible living expense calculator for a moderate lifestyle*

Merely testing the reasonableness is inadequate. At a minimum, financial firms must verify the information and have regard to it in making an assessment. Licensees should take all steps reasonable to obtain verifying information in all circumstances and a minimum standard should be set for doing so.

Financial Rights also remains concerned with AFCA's approach to the use of benchmarks. We detail our views on this further under "Automated calculation systems and indexes" below.

"a buffer of 2.5%"

The AFCA Approach states that a minimum, the financial firm should:

> *sensitize loan repayments based on the contract interest rate plus a buffer of 2.5%*

We support a buffer being in place. We note that there should be a cross reference to the Australian Prudential Regulatory Authority's (APRA's) *Prudential Practice Guide APG 223 Residential Mortgage Lending*[5] with respect to mortgage loans. Also given the low rates currently in place we believe 2.5% is currently too low and should be reconsidered upwards.

"notify the consumer of any price variation"

The AFCA Approach states that a minimum, the financial firm should:

> *notify the consumer of any price variation greater than 5 - 10% (?) between contract purchase price of a property and a formal sworn valuation obtain during the credit approval process. The lender in such circumstances should not proceed until the consumer instructs that they accept the discrepancy in price and they wish to proceed*

We assume AFCA is seeking guidance as to whether 5-10% is sufficient given the included question mark. We note that a conservative lender valuation may differ from a market rate and so caution should be exercised in the communication and what rate is set as to warrant notification. We are of the view that a consumer should be advised by the financial firm of the difference where they are significant (10-20%) difference.

[5] APRA, Prudential Practice Guide APG 223 Residential Mortgage Lending, https://www.apra.gov.au/sites/default/files/APG-223_0.pdf

We agree that there is a significant imbalance between the borrower and financial firm when the financial firm has information, such as a valuation, that values the asset significantly less then what a borrower may have purchased the asset for and does not share it.

However, for many borrowers, it is too late to withdraw from a purchase once a mortgage is applied for and this information is provided. In NSW, contracts may have been exchanged, with no cooling off period and the purchaser is awaiting exchange. Whilst we agree the financial firm should raise the concern, the fact a borrower who proceeds with this knowledge ought not to be precluded from responsible lending remedies completely.

In other situations, a borrower could withdraw or reconsider for example:

- refinance
- where they have obtained pre-approval and the financial firm failed to provide the valuation
- where there is a cooling off right.

We agree this information may be a factor and financial firms should be encouraged to provide the alternative valuation. The whole of the circumstances need to be examined.

"low doc loans"

The AFCA Approach states that a minimum, the financial firm should:

> *for low doc loans the borrower should be self-employed for at least 2 years, have an ABN and be registered for GST if turnover/income is greater than $75,000 pa. Declared income should be validated against recent BAS or letter from accountant.*

It is unclear whether this is intended to be in addition to the requirements for self-employed people in the earlier dot point, or instead. Preferably the dot point about low doc loans would be excluded and a note made that the list is the minimum for all loans, including low doc loans.

Further we do not believe requiring a letter from an accountant as enough. Financial Rights has been provided with letters from accountants that provide the barest of information (such as "in my opinion Mr/Ms X can afford this loan"). Letters from accountants should:

- be substantive in so far as they return to actual dollar figures for the accounts of the business and relevant time periods during which the accountant has provided services to the business etc. and
- be corroborated with at least one other form of evidence such as tax returns or BAS statements.

Case study – James' Story - C137141

James is self-employed courier. He operates the business alone, and occasionally sub contracts to people he knows if he has a lot of work on. He has a home which is secured by a mortgage of $290,000. He lives in the property with his 4 dependent children and his wife. James owed the tax department $36,000. He met with his accountant who negotiated with the tax office a lump sum of $30,000 to be paid in 3 months. James accountant referred him to a broker.

James personal taxable income for the prior year was less than $30,000.

James' accountant completed a letter from a template provided by the lender which is inserted below.

The accountant restated what James believed, that he might get a contract that was worth $120,000 for the business in the future. But, James didn't get the contract. James business income was, grossly $120,000, in the years before but James' personal income derived from the operations of the business was substantially less as seen by his personal tax returns. James had expenses, like sub-contractors to pay.

Once the new loan settled, he struggled to make any repayments and 13 months later the lender commenced legal action to repossess the home. James sold the property after receiving an urgent stay from the Supreme Court.

1. I am a practising accountant and a member of the Institute of Chartered Accountants in Australia.
2. I am the accountant to [redacted] and have acted for the Borrower in that capacity for the last two years, and still act as their current accountant.
3. I understand that the Borrower has applied for a loan of $380,000, through [redacted] repayable by monthly instalments of $2,278.29 over 30 years at an interest rate of 6% per annum.
4. I am aware the borrower has stated a current gross income of $120,000
5. I know the Borrower's income and expenditure and based on that knowledge and my understanding of the Borrower's financial position believe this stated income is accurate.
6. We have reviewed the previous business earnings and advise these are consistent with the above.
7. I am not aware of any factors which may affect the Borrower's ability to make the repayments or which may cause substantial hardship to the Borrower to make repayments.
8. I confirm that the Borrower is a registered tax payer with the Australian Taxation Office ('ATO') and have lodged their most recent tax return for ATO assessment of income tax.
9. I understand that you are relying on this letter in agreeing to make the loan to the Borrower.
10. I do not have a conflict of interest in providing this certification and do not stand to gain financially from the making of the loan should it be granted.

[redacted]

WARNING

The Borrower is applying for finance and [redacted] is relying on your certifications in making its credit decision. Please make sure that your certifications are correct to the best of your knowledge. Obtaining finance by deception, fraud or dishonesty (which includes knowingly making false statements as to income) are crimes and offenders prosecuted.

3.1 Credit provider reliance on finance broker information and verification

Spot checks are not enough to identify basic inconsistencies or contradictions in the information provided. An important basic expectation of credit providers in assessing and verifying finance broker information should be the establishment of a process in all cases to identify and act upon prima facie inconsistencies of the information provided. In other words, it should be no defence to have good processes in place if the credit provider has failed to identify a clear problem evident on the face of the particular loan application being assessed.

This must be included in the list of processes expected to be in place.

3.1 Automated calculation systems and indexes

Financial Rights cannot support the AFCA Approach as drafted for automated calculation systems and indexes.

The draft suggests that financial firms may continue to use a benchmark to test the reliability of information (although not as a substitute for making Inquiries).

This minimal statement is no longer appropriate. Key expense information must be verified, whether by reviewing a bank statement or otherwise.

A lack of an informed assessment is becoming more common with the increased use of automated systems.[6] The Banking Code Compliance and Monitoring Committee (**CCMC**) noted in 2017 that:

> *the majority of applications for unsecured credit are processed using automated systems. Banks also indicated that the use of technology in the credit assessment process is likely to continue to grow over the next 12 months and beyond.*[7]

Automated systems are used to process approximately 97% of applications for unsecured credit.[8] Lenders have increasingly been using systems and adopting policies that preference automation to improve administrative efficiencies (and presumably cost savings associated) over meeting the obligations of responsible lending laws.

The CCMC found that:

> *At this point in time banks have not demonstrated, to the CCMC's satisfaction, that the use of an automated system or statistical credit scoring model alone is sufficient to comply with the Code obligations*[9]*, unless up-to-date information regarding a customer's financial position is*

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[6] Code Compliance Monitoring Committee Own Motion Inquiry Provision of Credit Examining banks' compliance with the provision of credit obligations under clause 27 of the Code of Banking Practice, January 2017

[7] Page 5, CCMC 2017

[8] As above

[9] Clause 27 of the Code of Banking Practice requires a bank to exercise the care and skill of a diligent and prudent banker in: • selecting the credit assessment method it will apply to a credit facility or credit increase • applying the selected credit assessment method to the customer, and • forming its opinion on the customer's ability to repay the credit facility.

> *incorporated into the credit assessment. The CCMC considers that having a full and current picture of a customer's financial circumstances is fundamental to complying with the Code obligations.*

A reliance on automated processes increases the probability that a lender merely obtains the verifying information, but does not have regard to it.

Benchmarks should not be solely relied on to test information

The AFCA Approach should be clearer and more direct. It should state that:

- Benchmarks should not be solely relied on to test information – information should always be positively verified.
- Exclusive reliance on a benchmark does not meet responsible lending requirements nor sound risk management standards.
- Benchmarks *should not be used as a replacement* for the obtaining of information about the consumer's actual income expenses and other circumstances that are likely to affect their ability to meet the financial obligations.
- If they are used at all, benchmarks *should only* be used as a tool to test the plausibility of consumer-provided information. Benchmarks do not confirm a consumer's income and expenses. Benchmarks provide a guide as to whether the expenses and income provided are realistic. Even if they appear realistic, some other corroboration should be sought, such as checking they are largely consistent with expenditure on a bank statement.
- Benchmarks should never be relied upon for housing expenses
- Housing is too big an expense to get wrong. Licensees should always use actuals for housing expenses. To do otherwise would not meet the standard of a prudent and diligent banker.

"Recent practice"

Financial Rights notes that the section includes the following paragraph:

> *Recent practice by many financial firms has been to use an industry index, for example, the Household Expenditure Measure, to test a consumer's estimate of their regular expenditure and living expenses. Where the index figure is higher than the consumer's estimate, financial firms often do not query the consumer about their expense estimate. Instead financial firms often utilise the index figure rather than the consumer's estimate in the financial firm's loan affordability calculation.*

There is no accompanying contextual statement suggesting that this "recent practice" is unacceptable. In a document all about "good industry practice" placing this paragraph here without any clear qualifying statement suggests that this recent practice may in fact be good industry practice. The AFCA Approach on this point must be clearer in its meaning and intent.

Use the higher of the benchmark or the declared expenses figure

In the situation where a benchmark[10] is used to test expense information and the reported expense estimate is lower than the benchmark then the first step should be to seek further verification of the expense information to determine whether it has been underestimated. AFCA should make this explicit in its approach. We also propose that AFCA Approach support the following steps being taken:

1. The lender should make inquiries about whether the expenses reported are genuine and plausible. There are rare cases where somebody may have low expenses – such as a young person who has inherited a home and is not paying rent or high housing costs.
2. The lender should make an assessment as to whether the borrower's situation is reasonably likely to change resulting in a likely increase in expenditure. For example, we regularly advise young adults who were living at home rent free when they obtained a loan but now cannot meet their repayments because they have left home and need to meet the cost of renting/boarding.
3. If the lender cannot verify the expenses, rejecting the loan should be explicitly acknowledged as an option.
4. If the lender is of the view the lower expenditure estimate is correct, they should apply the correct verified expenditure figure for major costs such as housing and apply ***at least the benchmark*** figure for general living expenses. In cases where the verified expenses are only a little below the benchmark, a larger buffer may be required.

"the appropriateness of the index for the use of it by the financial firm"

According to the Banking Royal Commissioner, referring to the HEM:

> *much more often than not it will mask the fact that no sufficient inquiry has been made about the borrower's financial position. And that will be the case much more often than not because three out of four households spend more on discretionary basics than is allowed in HEM and there will be some households that spend some amounts on 'non-basics'. Using HEM as the default measure of household expenditure assumes, often wrongly, that the household does not spend more on discretionary basics than allowed in HEM and does not spend anything on 'non-basics'.*[11]

The AFCA Approach should state that benchmarks should be sufficiently robust and regularly reviewed, evaluated and recalibrated for evidence of:

- their effectiveness compared to conscious human decision-making based on all the relevant information and the objectives of responsible lending;
- their impact on financial exclusion and vulnerable customers.

Further, there are serious limitations to genuinely engaging with consumer requirements and objectives in an automated environment without much more sophisticated processes than a tick a box or drop down menu.

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[10] That is a solid benchmark rather than the low income HEM benchmark, which we do not support

[11] Interim report p 28 Royal Commission

AFCA should emphasise that lenders who do rely on fully or largely automated systems do so at their peril and will be responsible to remediate customers where their systems get it wrong, and will be at risk of systemic non-compliance if they do not correct weaknesses in the system that are so identified.

3.2 Business loans

The AFCA Approach states that

> *we expect the financial firm to have obtained and considered:*
>
> - *financial statements and other information to assess the ability of the business to meet loan obligations which might include a business plan, information about the market in which the business operates, information about management experience, an accountant's report*

We reiterate the point made above that the AFCA Legal Principles Approach should explicitly note that an accountants report must be substantial, specific and detailed rather than perfunctory, vague and non-specific, as Financial Rights has seen with James' case study above.

Case study –Renee's story - S226244

Renee and her husband resided in a non-metropolitan area and they owned their home with a manageable $180,000 mortgage on their incomes from loc*al work. Renee and her husband* decided to purchase a business for her husband to work in metropolitan Sydney. She saw the local bank branch with the business speci*fications*.

Renee admits she and her husband were amateurs and had never bought a business before. She provided the material to the bank and they approved an increase to purchase the proposed b*usiness based on the materials* Renee provided.

It's been a few years now, and it is clear that the business is a turkey.

Renee has seen an accountant now, who advised her *that* the bank's business banking section have been completely negligent in valuing the business. It was clear from the documents she provided the bank that the business had not turned a profit in the 3 years prior to purchase, and would not be sustainable enough to re-pay the loan. Renee was distraught, she had gone to the bank to get help with working out to buy the business and now they will lose everything.

3.3 Red flags

Again the AFCA Legal Principles Approach needs to be more direct and explicit in putting forward their expectation that credit providers should have verified the expenses and accessed all information that they hold on the consumer including transaction accounts.

4. Compensation for loss

The draft AFCA Approach states that:

> *We only provide compensation if the complainant has suffered loss as a result of a financial firm failing to meet responsible lending obligations (legal, code and good practice). Borrowers who believe their financial firm did not comply with responsible lending obligations often say their debt should be written off (which means that they would not have to repay the loan). However, we do not take this approach.*

While Financial Rights expects the AFCA Approach to include direct and definitive statements as to the approach AFCA will take to cases, this is one key area that some flexibility is necessary.

There may be cases where it is appropriate to write off part or all of a debt.

Case study –Tracey's story - C118047

Tracey entered into a contract with a finance company that is owned and operated by a car dealership. Tracey was subsequently sold a car by a related dealership that is a linked credit provider for $9,990 and entered into a loan at 48% per annum. She is also required to take out multiple in house warranties and CCI policies. Tracey made repayments, but struggled. Default fees were added to the loan, the car was repossessed a few times and returned after Tracey borrowed money from her daughter to pay the costs and clear the arrears. Tracey is desperate to keep the car and is going without food some weeks to pay. Tracey has paid $8,000 by the time they come to get help. The car has always been a bit of a lemon and breaks down continuously. Tracey has paid over $1,000 out of pocket for repairs which the in-house warranty did not cover. A Red Book valuation values the car at $3,200 at the time of purchase. Tracey is disputing the loan.

Is it fair in all the circumstances that Tracey loses the car and must surrender it? If she does not, is Tracey obliged to pay the difference between $8,000 and $9,900? Is the remedy of the AFCA approach to secured cars sufficient?

In our view it is not, and there will be factual circumstances that demand that part of a loan balance be written off or offset due to the conduct of the financial firm.

Case study –Douglas's story C156985

Douglas entered into a credit contract to purchase "holiday points" about 8 years ago. He never could really afford it and never used any of the points to go on a holiday. 3 years ago he was really struggling to repay and so contacted them and they convinced him to sign a refinance of the contract with another related lender. This occurred again a year ago. The loan is growing, as exit fees were accrued at each refinance. Douglas couldn't afford the first, second or third loan none of them were responsible. The limitations under the NCCP have expired for some of the earlier loans. Doug has made repayments, but hasn't repaid the principal amount borrowed on the last refinance when he seeks advice about lodging in AFCA

Is it fair that Douglas has repaid over $40,000 for a product he has never received any value from? Is it fair, that the lender gets the benefit of Douglas being convinced to refinance each time he struggled to repay?

In our view, it is not and Douglas ought to be a candidate for a refund of money paid and for the principal to be written off given the sharp practices of the entities in encouraging him to refinance where each loan ought to have been unsuitable. Had a hardship variation been entered rather than a new advancement Douglas would have paid substantially less and would have his time limits on foot for some potential remedies. He may also have sought advice before the responsible lending time limit expired.

Another example: a large number of Aboriginal consumers in Central Australia that Financial Rights assisted. The clients live in remote Aboriginal communities and would travel to the regional centre for shopping and other reasons. The clients were typically speaking English as a 3rd or 4th language, reliant on Centrelink or had income supporting many dependents. While browsing the department store, some with no intention to purchase goods or seeking particular goods an employee of the store would approach and encourage them to buy more goods, including on one occasion selling a blue ray player to client who, having no idea what a blue ray was, threw it in the bin shortly after receipt. The clients would either be offered a lease or an interest free credit with a credit card arrangement. Many of them had the direct debit for a few months before the loans would default, and a debt collector would start collection. All of the application forms were worked by the employee without the client's knowledge so that the loans would be approved without scrutiny from the lender, monthly income was set as fortnightly and dependents or rental ignored. All of these matters were resolved in internal dispute resolution by the financial firms involved.

Is it fair in all the circumstances to hold clients taken advantage of by the point of sale exemption, where the lender has taken no steps to verify?

In our view, the financial firm's response in these circumstances was fair and reasonable in the circumstances. They agreed to buy back the debts, refund payments, transfer ownership of the goods and waive the balances. If AFCA does not have this as a tool in their tool belt, financial firms may not take this approach in future.

We recommend that AFCA should soften the language here and *at the very least* replace "However, we do not take this approach" with "However this is not our starting point and it will depend on the circumstances". It may be appropriate to refer specifically to some of the factors including, defining the benefit, remedies under unjustness and offsetting for non-financial or financial loss scenarios.

4.1 Suitability of credit

The AFCA Approach states that:

To test whether the credit was in fact suitable on the basis of affordability at the time of application, we ask the complainant for details of their financial position at the time of their loan application, including their income, liabilities and expenses. We also ask for supporting information such as the complainant's tax returns, account statements from other lenders and Centrelink statements.

Financial Rights is concerned with AFCA's recent approach to information requests such that the upfront requests have been excessive, burdensome and place a significant impediment or hurdle for consumers to engage with external dispute resolution.

Case study –Drago's story - S182790

Drago contacted Financial Rights with a FOS determination that he had to provide certain documents requested by the insurer; otherwise his claim for a stolen vehicle wouldn't proceed due to non-cooperation. As Drago is an elderly person whose first language is not English with low if any computer skills, Drago was not able to understand the requests and to obtain and provide the documents in required format.

Case study –Jono's story C149177

Jono was assisted by a caseworker at Financial Rights when he was being debt collected for a car shortfall of $20,000 from a few years ago. The worker raised a possible responsible lending dispute with his lender and requested a copy of the application form, assessment as to suitability and documents relied on as from the workers experience it did not seem affordable that Jono with 2 dependent children and dependent wife could afford the loan. Jono instructed the worker that he remembered he went to a dealership and bought a car. A broker helped him with the application, and he provided his payslips. The worker lodged in AFCA as months had past and he never got any of the documents he requested from the lender or the debt collector. The dispute outlined his financial circumstances at the time of the loan.

AFCA gave the worker 7 days, to collect:

a. A statement o f financial position reflecting the time when Jono got the loan;

b. a current statement of financial position;

c. payslips for the whole 12 months prior to getting the loan;

d. a full copy of Jono's *full* tax returns for 2 years prior to the loan and the first year of the loan.

Jono's representative was a bit shocked. The financial firm had not provided anything about what they had done in assessing the loan as suitable and our client was being asked to provide more then what the lender had asked for at the outset!

It is our view that AFCA must investigate whether a potential breach has occurred including engaging with the credit provider first. Once this has occurred this information should be exchanged and further inquiries made of the borrower. If AFCA proceeds with wanting to gather this information AFCA should provide more warning, and in addition provide more time for a consumer to supply the information. An explanation as to why the information is necessary would also assist.

Jono is lucky he has a representative who could limit the request and negotiate alternatives. For many consumers they will see this as too hard and potentially disengage in the process. Completing a retrospective statement of financial position can be very challenging and often requires the assistance of a financial counsellor to help. Financial counselling resources are already limited and scarce.

The current situation places the burden of proof solely on the complainant to prove that the credit provider has been irresponsible rather than the credit provider to demonstrate that they have been responsible. Whilst it may be appropriate for AFCA to obtain this information at this stage, and to flag with the consumer that these may be necessary, to provide requests without context may cause consumers to feel they are being investigated and disengage from the process.

4.2 Calculation of loss

The AFCA Approach includes an example in the first paragraph on calculation of loss. The example here is one where no loss has occurred. More instructive to consumers, their representatives, and the industry would be to provide a multiplicity of examples where significant loss has occurred, and some losses have occurred. The draft Approach is significantly limited by the lack of useful, instructive examples.

We recommend that where an example is used at any point in an AFCA Approach document that a number of examples are used to elucidate the array of potential situations rather than the one.

Consequential loss, non –financial loss and refunds

The draft AFCA Legal Principles Approach (as well as the draft AFCA Consumer Credit Issues Approach) fails to address two important aspects of losses arising out of an irresponsible lending case.

Consequential losses

The first is consequential losses. In many of the cases we deal with consumers who have been subject to an unsuitable loan suffer significant financial losses due directly but consequently from the original unsuitable or irresponsible loan. Borrowers may turn to other high cost lenders (such as SACC providers) to meet their day to day expenses, or consult debt management firms in a bid to resolve their situation solely or primarily as a result of one or more irresponsible loans. Where people opt for insolvency solutions such as debt agreements under the *Bankruptcy Act*, there are considerable fees paid, in addition to reputational damage in the form of both their credit file and the national personal insolvency index. Where someone has gone bankrupt, the costs can be even higher, yet arguably the original lender should foot the cost of annulling the bankruptcy (if it is clear the bankruptcy was only necessary as a result of that debt).

Case study –Mary's story - C186535

Mary entered into a Debt Agreement (**DA**) 3 years ago. She had gone to the Debt Management Firm (**DMF**) to help her clean up her credit file, she had defaults relating to a consumer lease for a TV and laptop she had entered when she was 18. The DMF told her only option was a DA. The DA covered a consumer lease of $4,000, and two other debts totalling $11,000. The DA was for a 5 year term. She maintained her payments on the debt agreement. Three years after entry into the DA she received a letter from the consumer lease provider, stating that they had reviewed their file and advised her they should never have lent to her. They were going to refund the money she had paid. The Consumer Lease provider told her that they will remove the waived amounts from the DA. Mary was distressed. She would never have entered the DA in the first place, but for the debt to them. Her credit report is still affected by the original default and now the DA on top of it.

This is not an uncommon experience. Recently released research in the 2018 Journal of Consumer Policy[12] has outlined the findings of Australia's first large-scale study on the experiences of people in financial hardship. Many participants in this study took steps that exacerbate their financial difficulties such as:

- seeking a limit increase on their credit card (13.2%)
- pawning their personal belongings (15.4%)
- consolidating their debts[13] (10.2%)
- entering a debt agreement (9%)
- refinancing their home (6.5%)
- borrowing from a pay day lender (6.3%)
- using for profit credit repair or budgeting services (2.5%).

[12] Evgenia Bourova, Ian Ramsay and Paul Ali, "The Experience of Financial Hardship in Australia: Causes, Impacts and Coping Strategies", *Journal of Consumer Policy* (2018).

[13] Consolidation can be a good strategy but it can also be very detrimental, particularly if the new loan is on worse terms than some of the original debts.

Non-financial losses

The second set of losses unaccounted for in the AFCA Approach document is non-financial losses. Struggling to pay an unsuitable loan is a stressful and incapacitating experience. The links between debt or financial difficulties and mental health problems[14], family breakdown[15] and poor decision making[16] are well established. The research mentioned above found that many respondents took steps including:

- cutting down on food (57.8%);
- cutting down on electricity, gas or water usage in their home (55.5%);
- forgoing medical care (32.5%); and
- borrowing more money, predominantly from friends or family (33.6%).

Some also moved into temporary accommodation (such as staying with family or friends) or postponed separation from their partner in order to make ends meet. These findings are consistent with our experience providing debt advice and assistance.

All of these consequences lead to significant costs for people. These are again a direct consequence of misbehaviour on the part of the credit provider and too should be able to be considered by AFCA in compensating loss.

These impacts should be recognised and suitably compensated within the applicable limits for non-financial loss.

In both cases – but for the unsuitable or irresponsible loan, such losses would never have occurred.

Refunds

The Approach documents do not appear to contemplate consumers receiving refunds. There are many scenarios when after calculating the amount that would be owing after deducting interest, fees and any other applicable compensation, and then deducting the amounts already repaid by the borrower, the credit provider has been overpaid. This is particularly the case with unsecured loans like credit cards, where the consumer may have been making payments

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[14] For example: Australian Government, Department of Health, Head to Health "Mental health and financial safety are strongly linked. Experiencing a mental illness can add to financial stresses, and financial stresses can add to a mental illness." https://headtohealth.gov.au/meaningful-life/feeling-safe-stable-and-secure/finances

[15] For example: Anna Darnell Bradley and David Marjoribanks, *In too deep An investigation into debt and relationships*, UK 2017 "Financial hardship is a key factor leading to relationship problems, predicting lower relationship satisfaction and quality, higher psychological distress, and increased risk of relationship breakdown."
https://www.relate.org.uk/sites/default/files/relate_problem_debt_report_web.pdf

[16] For example, Sunanda Creagh, Study links poverty and poor decision-making, *The Conversation*, November 2012 https://theconversation.com/study-links-poverty-and-poor-decision-making-10500

for many, many years. Car loans can also result in refunds, particularly where there have been exacerbating factors such as thousands of dollars in useless add on insurance.

We refer you to the Central Australian examples above, as well as John's story. John had seven of his payday loans with the one provider, with each new SACC refinancing the previous one or providing the capital he needed to meet the repayments on the 5 other existing loans he had. In assessing John's loss, and his spiralling debt situation Financial Rights believes that the SACC provider should refund the interest fees and charges he paid over the principal but also to consider the consequential impact on him needing to borrow funds to make payments.

Business loans

While Financial Rights agrees with the general principle that the credit provider in a business loan is not responsible for investment losses per se, for the key reason that they are not responsible for deciding how to invest the loan amount, this cannot be set in stone as it currently is in the draft AFCA Approach document.

This is because there are numerous situations where it is reasonable for a bank to be responsible for losses on a business loan. For example, if a credit provider has made a manifestly bad decision in providing credit for a business loan that on the face of it should never taken place, then the credit provider should not be able to simply wash their hands of the decision. In many situations *but for* the decision of the credit provider to provide a loan on a manifestly bad business loan or investment decision a loan a risk or investment would never have been taken.

We direct your attention to the case of Robert Regan presented at the Banking Royal Commission:

Case study –Robert's story

Consumer Action Legal Centre's client Robert Regan was the first bank customer witness took the stand at the Banking Royal Commission.

Robert Regan, a 72 year old widower from Victoria, took out a home loan with the ANZ through a broker in 2017 following the death of his wife.

Mr Regan, who lives with an acquired brain injury, borrowed the money after being targeted by an online romance scam. Mr Regan fell into severe financial hardship shortly after being signed up to the loan by ANZ, having to seek assistance from charities for food and groceries.

Mr Regan gave evidence to the Commission about:

- incorrect information provided by the broker to ANZ about his financial situation, particularly his expenses
- ANZ's failure to respond to clear anomalies in his bank accounts indicating large

overseas transactions

- an ANZ bank manager assisting him to transfer over $30,000 to the scammer's bank account in the UK
- ANZ's failure to provide appropriate hardship assistance to him after he told them his financial struggles
- the impact of the scam and the behaviour of ANZ and the broker on his life and family. ANZ's offer to Robert's lawyers resolve the dispute which stated that Mr Regan would remain liable for the loan but that fees and interest would be reversed, future fees and interest would be stopped, the monthly payments would be reduced and ANZ would apply a goodwill credit of $1,500 (among other term).

Source: Consumer Action Legal Centre

It is clear in the situation where a loan is provided to a day trader to invest in the stock market that the risk is borne by the day trader. It is far less clear where the business investment is, say the proverbial Nigerian scam, where such documentation should be clear to all involved including the credit provider that such a loan should not go ahead as there is no investment.

In extreme cases, where it is clear the loan was not responsible and that the consumer received no benefit AFCA ought to have the ability to reduce the principal amount and should not constrain itself from that power. Otherwise the result may be manifestly unfair for the consumer. From a causation position, were it but for the conduct of the lender in breaching their responsible lending obligation the loan would not have been granted. Another important factor in assessing suitability of the loan is where the loan will be paid from the fruits of an investment, and not by the consumer's current available assets.

Further, where the loan provided is to invest in a related investment of the credit assistance provider, or financial firm then we consider AFCA ought to be able to determine the loan is to be reduced or written off to the extent that is fair in all the circumstances.

Credit providers should not be provided a licence to be wilfully blind when it comes to business and investment loans.

"the asset should be sold"

The draft AFCA Approach states that:

> *Where the loan funds have been used to acquire the security/asset, the asset should be sold. This should occur within a reasonable time. Generally, that would be within 6 months of a finding of irresponsible lending*

This is another area where the draft AFCA Approach is too definitive, and more flexibility is required due to the varied cases that exist.

Assets can be more than houses. They can include household goods, cars and other items that may have been over priced or depreciated in value.

There are circumstances where the sale of an asset may not be appropriate to remedy the harm. Example:

Case study –Kerry's story - C177970

Kerry owned her home unencumbered, having inherited it from her parents. She is on a disability support pension and has been for years. She accrued a credit card debt of over $30,000 over a few years whilst on the DSP which she was struggling with and paying interest on. She contacted the bank and was granted a home loan secured over the property for $30,000 paying out the credit card.

A few years later she sought and was granted an increase of $15,000. The payments are $180 per fortnight which Kerry cannot meet. Kerry had previously negotiated hardship, but the bank has knocked her back as she will unlikely ever be able to make $180 per fortnight with the growing cost of living. A financial counsellor rang the bank with Kerry and raised Kerry's concerns about her current financial hardship and queried the loan and the increase given Kerry's financial situation. The bank agreed that the loan was not responsible and reduced the debt to $13,000 and Kerry will repay at a rate she can afford. Kerry is able to make repayments on the remainder over the next 5-10years.

Under the currently drafted AFCA approach, Kerry may be expected to sell within the next 6 months. Kerry was lucky she had some capacity to repay. Other, particularly aged consumers are at risk of losing their only asset. In some circumstances, it may be appropriate for the debt to be secured as a debt on the property to be paid at sale or on death of the owner to redress the harm.

We consider that there may be more nuanced options rather than AFCA's current Approach that AFCA would have the power to implement to redress the wrong that would be fairer in all the circumstances. These should include:

- debt reduction or forgiveness[17]
- release of the security[18]
- variation of the applicable interest rate[19]

Some responsible lending breaches may also be accompanied by remedies under unjustness or offsetting for other loses.

[17] D.2.1(b) AFCA Rules

[18] D.2.1(c) AFCA Rules.

[19] D.2.1(d) AFCA Rules

Consumer credit issues

Guarantors

The previous FOS Approach on Common Issues included a small section on guarantors. While inclusion of Guarantors may not necessarily fit the structure of the current draft AFCA Approaches, it would be good to include a cross reference to AFCA's Approach to claims by guarantors.

1.3 Summary of the AFCA Approach

The summary states in part

> *If the consumer used the loan funds to repay other debts which they already owed (for example, an existing credit card or home loan), we usually consider that the consumer has not suffered any loss. This is because the transfer of credit from one credit provider to another does not change the consumer's overall debt situation.*

Financial Rights does not agree with this position. A full explanation of this is provided below under 4.1 Refinanced debts, where it arises in the document. See also Douglas' story above.

2.2 And if the broker wasn't an agent of the credit provider?

"Some liability"

The draft AFCA Approach states that:

> *If we decide that the broker was not the credit provider's agent, the credit provider may nevertheless have some liability for the consumer's loss caused by irresponsible lending*

We believe that the previous FOS Approach is much clearer and more direct as to the credit provider's concurrent and separate responsibility. It states:

> *If we decide that the broker was not the FSP's agent, we will still consider whether the FSP met its own responsible lending obligations.*

Suggesting that they have "some liability" as opposed to "meeting their own obligations" devalues the separate responsibilities that the financial firm holds. This needs to be emphasised and clarified.

Other broker scenarios

The draft AFCA Approach again does not take into account other common scenarios that arise in this space that may lead to different Approaches needing to be taken. In the case of brokers, it is likely that AFCA will need to deal with situations where a Broker is acting neither the agent of the credit provider nor the agent of the consumer but acting in their own interest or on behalf of a related non-AFCA entity.

For example, credit assistance provider A works with a property spruiker B. Consumers attend B's seminars and are encouraged on false information to invest in their strategies. They are referred to see A and invest. A has fiduciary duties owed to their client, but instead preferring their own interest and wanting the client to invest in B arranges an unsuitable loan by misleading the credit provider.

Whilst this falls into category 2.2 it may need to be expressly referred that brokers duties extend to those of a fiduciary.

Scenario 1 and Discussion

The scenario presented is one where Sam the mortgage broker is fully liable. It would be helpful to provide an example where the credit provider is fully liable and one where there is an apportionment between the credit provider and the broker. This would better illustrate the intent of the Approach being put forward.

Further depth is required to better fill out what occurs in terms of compensation as in the current scenario, John is entitled to the fees paid to Sam and the amount the credit provider would have been liable to compensate John. It would be helpful for consumers to understand what these may include. For example, the credit assistance provider is liable to put John in the position he would have been in, if not for their conduct potentially including:

a. the legal fees charged by the lender to repossess the property;
b. interest fees and charges incurred on the loan;
c. if the property was sold as mortgagee in possession, the difference in value in the purchase and sale price; and
d. the loss of deposit.

All these losses may not be awarded in all the circumstances depending on how the property sells and what loss crystallises, it is important that the scenario AFCA presents be detailed and fulsome enough to enable readers to understand what potential loss they should claim when at AFCA.

3 Common errors in loan assessments

Financial Rights notes that there are no examples provided relating to common errors in pay day loan or consumer lease assessments. This is an area where we see a significant amount of poor practice and clear wrong-doing. It is critical that the draft AFCA Approach document include this to guide and drive improved industry practice and decrease potential numbers of complaints in this area.

For example, pay day lenders are overly reliant on third party providers providing analysis of the 90 days bank statements in assessing expenses. In John's case study above, all assessments were performed by third party provider software and they did not pick up that he had dependents. John was often in deficit due to payments coming out and recorded loans as income. Such an approach can lead to manifestly inappropriate loans.

Given AFCA now has a number of SACC provider members it would be valuable to industry and consumers to outline expectations clearly.

We also believe a statement needs to be included in this section that asserts that the most common error in loan assessments is the failure to verify information provided and that there is an obligation on the financial firm to verify information provided and that this act upon their decision. This information has been included (in part) in the Legal Principles Approach however we believe it should also be included here too.

3.1 Income

Financial Rights notes that most of the list included in the draft AFCA Approach to common income errors is drawn from the previous FOS Approach. However one common error that was previously included is no longer there. That is:

- *The FSP relies on a source of income which has restrictions on how it can be used, such as child maintenance payments (which should be used only for children's expenses). For example, an FSP may not consider those restrictions, even though its own lending policy says it should*

We see no reason why this should not be retained as it is a common error. For example, Financial Rights assisted a consumer whose National Disability Insurance Support payment was used as income, when it ought not to be.

3.2 Liability and expenses

Similarly two common errors listed in the previous FOS Approach have been removed from the draft AFCA Consumer Credit issues Approach which we believe should be retained. These are:

- *The consumer has not repaid and cancelled their credit card facility, even though they said they would do so in the loan application. …*
- *The FSP does not take into account the amount of rent that the consumer will pay while their home is being built.*

With respect to the former, the robustness of financial firms requiring cancellation should still be a consideration. For example, did the firm simply ask the consumer to close the account (and failed to follow up) or did they require the credit limits to be reduced before the credit was provided? These are still relevant considerations

3.4 Incomplete or incorrect calculations

The draft Consumer Credit Issues AFCA Approach states:

> *For a credit contract with an interest-only period, the financial firm assesses affordability without taking account of the principal repayments to be made after that period ends.*

We again note that the previous FOS Approach goes on here and states:

Prudent lending practice requires the FSP to base its assessment of the consumer's ability to repay both principal and interest over 25 or 30 years, even where the credit contract will have an interest-only period

This should be retained.

4.1 Refinanced debts

The draft AFCA Approach states that

If the consumer used the loan funds to repay other debts which they already owed (for example, an existing credit card or home loan), we usually consider that the consumer has not suffered any loss. This is because the transfer of credit from one credit provider to another does not change the consumer's overall debt situation.

While it is often true that a person obtained a benefit equivalent to the payout figure(s) on refinanced debts, this is far from universally the case. Where the original loan or loans were unjust or irresponsible in the first place, there can be serious consequences of compounding this error with further irresponsible lending. For example:

- Time limits may be lost to challenge the original loan
- The inevitable sale of an asset may be postponed, which could affect the amount of the shortfall or remaining equity
- Consequential losses and non-financial losses may be extended over a longer period.

While the set up costs, interest and fees are forfeited by the lender under the approach proposed by AFCA, these other losses need to be factored into the equation. There is also the potential scenario where one party has taken on liability for a loan via debt consolidation for which they had no liability in the first place (particularly in the case of couples refinancing individual debts).

We refer you to Douglas' story above.

We also note the scenarios of payday lenders who routinely allow for the refinancing of SACC and MACC's, which regularly contribute to a consumer entering into a debt spiral where they pay interest on interest.

There is case law that enables decision makers to look behind the earlier contract and review the fairness of the previous loan.[20]

This has previously been applied by FOS in determination number 217587[21] where it was found that

in order for the earlier transaction to be opened against the new financial services provider, there must be conduct by that financial services provider which gives rise to some culpability

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[20] *Bank of Western Australia Ltd v Tannous* [2010] NSWSC 1319 (3 December 2010) at [43]

[21] Para 37, FOS Determination Case number: 217587, 19 March 2013 https://service02.afca.org.au/CaseFiles/FOSSIC/217587.pdf

> *concerning the earlier contract, for example, a failure by the new financial services provider to ensure that, contrary to its procedures, the borrower obtained independent legal advice before entering into the new loan. Had the borrower obtained such advice, she may have been advised about possible defects in the old loan and made a claim about them, rather than refinancing that (old) loan.*

4. Assessment of loss

As described above under our comment of section "4.2 Calculation of loss" of the draft Legal Principles Approach there is no acknowledgement in this draft Consumer Credit Issues Approach of consequential loss, non-financial loss or refunds. This is a significant failing given these are clear impacts that should go to the heart of any true assessment of loss in an irresponsible lending complaint.

We recommend that the Assessment of Loss Approach document be similarly updated to address these three important forms of loss that consumers commonly suffer.

4.2 Loans used to purchase a house or land

As detailed above at "4. Calculation of Loss: 'the asset should be sold'" we do not support the definitive statement that a property should be sold. There are a significant number of other scenarios where this would not be appropriate and the draft AFCA Approach is too definitive in this case. For example:

- Where the borrower(s) can afford to repay the principle amount after the application of compensation over a reasonable period, including by a suitable refinance;
- Where the lender has extended the loan inappropriately on one or more occasions, but the borrower could afford the principle amount borrowed prior to those extensions (while the borrower may have received some benefit from the extensions, fairness in all the circumstances suggest they should not lose their home);
- Where an arrangement could be made for the credit provider to be repaid the residual amount owing upon the death of the borrower, or the eventual sale of the house, particularly where the borrower(s) is/are elderly or there are other compelling compassionate grounds (one borrower is very disabled or terminally ill).

4.2 What adjustments do we make to the principle amount owing?

While it may be implied we believe that the list of adjustments should include any repayments the consumer made to the loan account.

Scenario 3: Sale of the consumer's home to repay an irresponsible loan

Further details and clarity is required in this scenario. The discussion states that:

> *In these circumstances, AFCA would decide that the credit provider should forgive the balance of the debt. This would mean that the value of the total compensation provided to*

Adam was $350,000 ($250,000 plus the residual debt of $100,000) an amount within AFCA's monetary jurisdiction.

As outlined above, in relation to Sam's scenario, a more fulsome range of remedies or heads of losses would assist consumers in having realistic expectations of what they may receive. This may have the ancillary benefit of allowing consumer and financial firms to have appropriate settlement discussions if these matters were addressed in the Approach.

4.3 Car finance loans

The draft AFCA approach is not very clear in assessing the benefit and we think may be in error which may result in unfairness.

In our experience, consumers who are successful in making a responsible lending argument under this calculation are often required to make payments to contribute to their "benefit" by repaying a "revised loan amount". Whilst the "loan balance" is written off, the accounting for the use of the vehicle can leave consumers with a substantial debt.

Examining Tracey's story from above in more detail, she paid $9,900 and the market value was $3,200 at the time of the dispute. She had paid $8,000, inclusive of repossession and default fees. Assuming these are included in payments made, if we apply the AFCA approach:

A. Loan Repayments:	$8,000
B. Purchase price	$9,900
C. Current value:	$3,200
D. Complainant benefit:	$6,700
Revised loan amount (D-A)	$(1300)

Our understanding of the AFCA Approach would be she is required to surrender the car and would be refunded $1,300 only. We do not see that redresses the harm of the circumstances, and should be more flexible.

In other matters we have been provided the following:

A. Loan Repayments:		$12,929
B. Purchase price:		$49,990
C. Current value:		$23,400
D. Complainants benefit:	(B-C)	$26,590
Revised loan amount:	(D-A)	$13,661

The consumer is required to pay $13,661 when it is established that the loan was not responsible. We do not see that the consumer is being placed into a position he would have been in had the loan not been entered.

The approach does not fairly take into account:

a. Vehicles depreciate at different rates;

b. consumers can enter “bad bargains” and pay more than they should to purchase vehicles.

c. loan repayments can be very low as the loan is unsuitable and the consumer could not afford to pay;

d. consumers can struggle to surrender vehicles

e. the lender may take time to agree to a sale by the borrower

f. the lender may take time due to no fault of the borrower to repossess the vehicle.

FOS adopted the same approach in FOS Determination 438112:[22]

A. Loan repayments	$4,024
B. Purchase price:	$35,991
C. Current Value	$28,500
D. Complainant benefit:	$7,491.00
Revised loan amount:	$3,466.88

The applicant was successful in their responsible lending argument but still owed the financial firm money. In our view this compounded the unfairness and does not resolve the situation.

Where clients do get money back, as in Tracey’s calculation it is insufficient and in the above examples consumers who are successful are still repaying the lender money.

We do not think this is a fair measurement.

The calculation is not an accurate measure of “benefit”. The circumstances of the loan need to be addressed, and in our view where responsible lending is made out the shortfall ought to be written off as the starting point.

Benefit should be accounted for on a case by case situation.

Concluding Remarks

Thank you again for the opportunity to comment. If you have any questions or concerns regarding this submission please do not hesitate to contact Financial Rights on (02) 9212 4216.

Kind Regards,

Karen Cox
Chief Executive Officer

[22] FOS Determination, Case 438112, 23 January 2016, https://service02.afca.org.au/CaseFiles/FOSSIC/438112.pdf

Financial Rights Legal Centre
Direct: (02) 8204 1340
E-mail: Karen.Cox@financialrights.org.au