

Banking and finance update

January 2016



Responsible lending obligations – saving borrowers from themselves

Credit legislation often has a “sting in the tail” - something that was not readily apparent when the legislation was first framed but then comes back to haunt credit providers down the track.

We are reminded of what happened under the *Credit Act 1984* (Cth) where there was an automatic loss of entitlement to interest charges in circumstances where certain disclosure or other requirements in that legislation were not observed.

While the uniform Consumer Credit Code which operated from 1996 to 2010 was a generally benign piece of legislation, the same cannot now be said for the *National Consumer Credit Protection Act 2009* (Cth) (*National Credit Act*).

The issue of “responsible lending” under the National Credit Act is fast becoming a major area of concern for credit providers, lessors and credit assistants.

In a series of articles we will examine various issues associated with the responsible lending obligations imposed under the National Credit Act and the impact it is having on the business and practices of participants in the credit industry.

SAVING BORROWERS FROM THEMSELVES

The title for this article was chosen carefully – “Saving borrowers from themselves”.

Traditionally the credit assessment process for lenders was aimed at avoiding losses to lenders. Initially this was done by way of ensuring there was sufficient equity in any security so that moneys lent could be recovered in circumstances of default. Now, lenders look at the credit assessment process in terms of capacity of the borrower to repay the amount lent from their own resources rather than realisation of any security. That was always the case in relation to unsecured loans – the difference now is it applies to secured loans as well. But, it does not really matter how robust a lender's credit assessment procedures are, a lender can still fall foul of the responsible lending obligations set out in the *National Credit Act*.

WHY IS THIS SO?

This is so because **credit assessment procedures are no longer about protecting the position of the lender – instead, the responsible lending provisions under the National Credit Act are all about protecting the borrower – “saving borrowers from themselves”.**

If lenders and credit assistants do not recognise this paradigm shift they will continue to get into trouble in the area of compliance with responsible lending provisions. And that trouble will not only come from ASIC. More and more now it is the external dispute schemes that are leading the charge in this area.

If one were to take a cynical view on matters one could form the view that in order to comply with responsible lending obligations nothing a prospective borrower says on the loan application is to be accepted on face value.

IN SUMMARY (AND FOR LENDERS SPECIFICALLY):

- Assets have to be valued to make sure that the borrower is not overestimating their worth
- Income has to be verified to make sure the borrower is both employed and earning the stated sum
- Bank statements have to be examined to make sure there are no regular expenses which have not been disclosed
- Credit Checks need to be made to make sure that there are no undisclosed loans
- Borrowers' general living expenses have to be benchmarked to make sure they are not being underestimated.

So let us then look at what the responsible lending obligations contained in the *National Credit Act* are and how they apply.

WHAT IS THE OBJECTIVE OF THE RESPONSIBLE LENDING OBLIGATIONS?

The objective of the responsible lending obligations is to enable an assessment to be made in relation to a credit contract or lease that it will not be “unsuitable” for the consumer.

A loan contract/lease will be unsuitable, if at the time the assessment is made, it is likely that:

- The consumer will either be unlikely to comply with the financial obligations under the contract and could only do so with substantial hardship; or
- The contract or lease will not meet the consumer's requirements or objectives.

Certain contracts or leases are presumed to be unsuitable in certain situations. An example for a credit provider is in the case where compliance with obligations would necessitate a sale of a consumer's principal place of residence (section 131(3)). With small amount credit contracts there are a number of situations in which a contract will be presumed to be unsuitable (section 131(3A)).

The language used in relation to ensuring that a contract is “not unsuitable” is somewhat torturous. But, in terms of everyday language, the expression “not unsuitable” can be readily be understood by explaining that the credit licensee doesn't have to ensure that the contract is the “right” contract for the consumer, but instead needs to make sure that it is not a “wrong” or “bad” contract for the consumer.

WHAT MUST BE DONE BY A CREDIT LICENSEE TO FULFIL THE OBLIGATION TO ASSESS UNSUITABILITY?

In terms of the National Credit Act the credit licensee must do two things:

- Make a credit assessment (preliminary credit assessment in the case of a credit assistant); and
- Make the responsible lending enquiries and verifications.

The key sections are 131 (credit providers), sections 118 and 141 (credit assistants) and section 154 (lessors).

A credit licensee must make the enquiries and verifications before embarking on the process of making the assessment as to whether or not a contract is “not unsuitable” for the consumer.

WHAT ARE THE RESPONSIBLE LENDING ENQUIRIES AND VERIFICATIONS?

Importantly, the responsible lending enquiries and verifications are identical for credit providers (section 130), credit assistants (sections 117 and 140) and lessors (section 153).

This is so even though a credit assistant is only required to conduct a "preliminary credit assessment" while credit providers and lessors are required to conduct a "full credit assessment".

The actual enquiries and verifications required are made before the credit assessment is made are:

- (a) *Make reasonable enquiries about the consumer's requirements and objectives in relation to the credit contract; and*
- (b) *Make reasonable enquiries about the consumer's financial situation; and*
- (c) *Take reasonable steps to verify the consumer's financial situation; and*
- (d) *Make any enquiries prescribed by the regulations.....; and*
- (e) *Take any steps prescribed by the regulations to verify.....*

For small amount credit contracts there are some additional requirements, such as examination of bank statements - which we will not go into here.

WHAT ARE THE CURRENT ISSUES IN RESPONSIBLE LENDING?

If "responsible lending" under the National Credit Act is fast becoming a major area of concern for credit providers, lessors and credit assistants, then what are the current issues?

To our mind the current issues and areas of concern are:

1. Determining whether the responsible lending enquiry and verification obligations for lenders/lessors are different to those for credit assistants and if so then in what respects?
2. Scalability of enquiries.
3. The best way to determine requirements and objectives.
4. What constitutes sufficient enquiries about income and expenditure.
5. How to verify expenses, including general living expenses.
6. Use of benchmarks.

In each of the above areas there has been specific mention and consideration by ASIC and in some cases by the courts.

WHERE TO NEXT?

In further email alerts we will examine further the issues outlined above and identify the main areas of contention.

Watch this space.

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