RESPONSIBLE LENDING LAWS REGARDED AS 'UNSUITABLE'

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In a year of epic events, it is difficult to see how any financial services reforms could be seen as truly significant. The removal of consumer responsible lending laws, though is significant, at least in relative terms.

Regulation - of anything - is about shifting responsibility. In financial services, this means shifting responsibility for the quality of products. Without regulation, it is the responsibility of the buyer to buy the right product - buyer beware. The trend of the last almost two decades has been to shift that responsibility to financial services professionals (such as financial planners and mortgage brokers) and product providers (such as lenders and fund managers). Reforms in that direction are continuing, including ASIC's newly introduced product intervention power, which allows it to block from sale financial products which - though compliant - are likely to cause consumer detriment. From next year also, financial product issuers will bear responsibility for ensuring their products are suitable for their target market and are only sold to that target market, through reforms known as the design and distribution obligations (or DDO).

Speaking before releasing the recent Federal Budget, the Federal Treasurer, Josh Frydenberg, was correct when he said the responsible lending reforms are the most significant in a decade, because they reverse this trend. They represent a major departure even from the recommendations which the Treasurer gladly received - and pledged to implement - from Commissioner Ken Hayne in his Final Report. The Treasurer has described these changes as introducing a 'borrower responsibility principle', which represents a return to a buyer beware approach.

Under the changes being proposed (to take effect from 1 March 2021):

- Responsible lending laws are to be scrapped for bank and non-bank lenders. Responsible lending laws currently require lenders to ensure loans they make to consumers are not 'unsuitable', by collecting and verifying a range of data about the would-be borrower's financial situation.
- Banks will continue to be subject to prudential lending standards administered by APRA. These standards operate as guiding principles, similar to prudential standards APRA issues on other matters.
- The prudential lending standards will be expanded to apply to non-bank lenders. For these lenders, ASIC rather than APRA will administer these prudential requirements.

SO, WHAT DOES IT ALL MEAN FOR BANKS, FINTECHS AND OTHER LENDERS? AND WHAT ABOUT THE BORROWERS?

Markets appeared to have judged the reforms positively for the banks. It is telling that the markets think it is beneficial for banks to be able to make 'unsuitable' loans. Perhaps this just shows how dimly these laws had come to be regarded within the industry. ASIC's guidance on these laws – a defacto legal standard – is highly prescriptive. It was the fringes of this prescription that led to the recent Federal Court battle between ASIC and Westpac, in which the court ultimately found in favour of Westpac. This loss by ASIC should not however reflect negatively on the laws themselves – on the contrary, this is how the system is supposed to work. Parliament makes laws and regulators attempt to enforce them. The courts decide and, in so doing, provide clarity and certainty about the meaning of parliament's laws.

The responsible lending laws are to be replaced with APRA's prudential lending requirements. These too impose principles which fetter the ability of banks – and, once the proposed changes take effect, non-bank lenders too – to lend. However, their focus is on the risk to the lender, not the borrower. ASIC describes them as separate sides of the same coin - APRA's standards to lower the risk of default for the bank and ASIC's guidance to lower the risk of the borrower being saddled with unsuitable amounts of debt. Given the different focus of the APRA standards, the lender is given much greater latitude about how it quantifies and manages those risks. This will allow lenders to make their own assessments about the quantity and quality of data they need to make a credit decision. Significantly, the new rules will do away with the need to verify information from a borrower, unless there is reason to suspect it is unreliable. For a loan with a low loan-to-valuation-ratio and security over quality residential property in a capital city, detailed information (and independent verification of that information) about the borrower's finances may not be required.

Fintech was largely born out of a desire – perhaps a competitive opportunity – to do financial services better, often by providing a better user experience. These changes will undoubtedly free up fintechs to design simple, streamlined loan applications which do away with voluminous document requests. Leveraging advances in the sharing of bank transaction data facilitated by the open banking regime, a borrower could simply provide their prospective lender with access to a data feed of their recent transactions (which would, after all, include salary and expense information). The lender may not need much more to make its decision.

Borrowers also stand to benefit from freer flowing credit, in a time when we are told that this is what we need. During the Royal Commission, Commissioner Hayne concluded that extending responsible lending laws to small businesses would have an unwanted cooling effect on the availability of credit and he recommended that they not be extended. Little did he know, nor could anyone have then foreseen, that those laws would go completely. Free flow of credit, coupled with interest rates which are for now at historic lows, is not without its risks however. And, only time will tell, whether those risks will be adequately managed by the expanded prudential lending principles. Borrowers who access credit via a mortgage broker will also have some protection by the newly imposed duty of mortgage brokers to act in the borrower's best interests.

One sleeper here is the role of Australian Financial Complaints Authority (AFCA), the dispute resolution body available to any disgruntled borrowers. With the responsible lending laws in place, many AFCA complaints alleged that the lender did not fulfil these obligations. However, AFCA regards its role more broadly than this and sees one of its functions as ensuring fairness – a key tenet of ASIC's enforcement ethos and also mentioned by Treasury as one of the residual protections of borrowers. What AFCA will make of these changes, and how they interact with issues of fairness, may well impact just how significant these reforms will turn out to be. It could be, for example, that AFCA considers fairness requires more than just complying with the less onerous prudential standards and that some aspects of the current responsible lending framework operate as informal guides to fairness.

Responsible lending laws have been a prominent feature of the consumer lending landscape for a decade and their removal would, in any other year, be significant.

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