AUSTRALIAN
RETAIL
CREDIT
ASSOCIATION

General Manager

Policy Development

Policy and Advice Division

Australian Prudential Regulation Authority

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BY EMAIL ONLY

Dear Sir/Madam

Discussion Paper – APS 220 Credit Risk Management

Thank you for the opportunity to provide a submission in response to the draft of the revised APS 220 prudential standard.

ARCA's submission focuses on two issues:

i. **Credit assessment and approval process:** ARCA's position is that there is a need to ensure the requirements are flexible and scalable.
ii. **Restructured exposures (retail):** ARCA's position is that the current 6-month probation period is appropriate and should not be extended to 12 months.

Who is ARCA?

ARCA is the peak industry association for organisations involved in the provision of consumer credit in Australia. Our objects include promoting, through education and advocacy, responsible credit assessment and better credit management practices. Our Members include all of the 14 largest banks, large mutuals, and a diverse range of finance companies including the three largest consumer finance providers, specialist auto lenders, and a broad range of established and start-up fintechs. The four national credit reporting bodies are also ARCA Members. Together, our Membership is responsible for well over 95% of all lending to consumers in Australia. All our credit provider Members are licensed under the National Consumer Credit Protection Act, administered by ASIC.

ARCA works closely with its Members to identify issues impacting the credit industry, particularly where those issues affect credit decisions and management.

Credit assessment and approval process

The draft revised APS 220 provides for a greater focus on a borrower's ability to repay (rather than a reliance on collateral). For individuals, the draft proposals largely reflect the existing guidance in APG 223 – Residential Mortgage Lending. They are also somewhat similar to the 'inquiries and verification' steps required under the National Consumer Credit Protection Act (NCCP) (particularly as interpreted by ASIC in RG 209 and the proposed changes outlined in CP 309).

ARCA supports the move to focus on an individual's capacity to repay. This approach is consistent with an ADI's existing obligations as a licensee under the NCCP and is likely to result in better risk and consumer outcomes. However, we note that the requirements of the draft revised APS 220 may restrict innovation and competition by imposing inflexible obligations on ADIs which are not 'scalable', particularly for credit cards and other smaller loan types.

The revised APS 220 requires an ADI to include consideration of "effective verification of income or cash flows" and "the borrower's expenses, including the collection of realistic estimates". In practice, the ADI is likely to collect – and verify – an individual's income and expenses as distinct matters. However, as we noted in our submission to ASIC's CP 309 (copy attached), this is not the only way to understand a consumer's capacity to service the loan.

For example, an ADI could short-cut the inquiries and verification processes to look at the consumer's regular savings pattern, rather than income and expenses. If the regular savings were greater than the loan repayments, the consumer could afford the loan. If the regular savings were less than the loan repayments, the ADIs could make inquiries of the consumer to understand which particular pre-loan expenditure can be reduced in order to afford the loan.

While this approach is unlikely to be adopted for products such as residential mortgages, it could be appropriate for smaller loan types and allow a more efficient way to assess the loan that also delivers a better customer experience.

Accordingly, we recommend that the revised APS 220 allow for alternate methods of assessing an individual's capacity to service the loan (in addition to always considering 'income' and 'expenses' as separate matters).

Further, we note that the revised APS 220 states (at paragraph 44(d)) that, "[e]xpense benchmarks must not be used as a substitute for an ADI making reasonable enquiries of a borrower's expenses". We agree that this is the case for a consumer's material fixed expenses, including existing liabilities, as such expenses are specific to the consumer and cannot be accurately estimated by a benchmark.

However, we consider that it is possible for a benchmark to provide a more efficient and accurate way to estimate a consumer's general living expenses. We discuss this issue in detail in our submission to ASIC on CP 309 (see, in particular the section titled 'What', page 21). In summary, a consumer's ability to service the loan will depend on whether they have enough funds to pay their fixed expenses (including the proposed loan) plus their variable

expenses. Making enquiries of the consumer's historical (i.e. pre-loan) expenses does not necessarily give an appropriate estimate of the consumer's post-loan variable expenses as:

a) it is generally recognised that consumers automatically reduce their variable expenditure based on their available funds (subject to a threshold below which the consumer cannot go without experiencing substantial hardship); and
b) the consumer's financial needs may change as a result of taking out the loan (e.g. purchasing a home with a residential mortgage will materially change the consumer's financial needs, such as reducing rental expenses and introducing additional home-related expenses).

The consumer's capacity to afford the loan will be based on their needs ***post-loan*** rather than their pre-loan expenditure. Accordingly, an effective way of quantifying the available funds required to service the loan would be to understand those post-loan 'needs' (i.e. based on an understanding of the consumer's individual circumstances) and to apply a benchmark figure based on those needs (i.e. to estimate the required available funds needed to pay for those needs). As noted in our submission to CP 309, we do not believe that such a benchmark has been developed before (and in this respect the HEM model could be relevant but is not in itself the answer in its current form). Nevertheless, we recommend that the revised APS 220 does not prevent the development and use of an advanced benchmark as a means of providing a realistic estimate of a consumer's variable expenses.

We make the following additional observations:

a) APG 223 sets out APRA's expectations in respect of residential mortgage lending. This includes specific observations on how an ADI may verify and assess elements of the individual's financial situation (in particularly paragraphs 41 to 43 of APG 23). While such expectations are appropriate for residential mortgage lending – which is likely to involve a consumer's largest financial obligation by far – it would not be appropriate to automatically apply those expectations to other forms of consumer credit. If APRA is to provide further guidance on the application of the revised APS 220 to other forms of retail credit, we recommend that this guidance allow for a scalable and flexible approach. We note that the approach of applying different rules to different types of products has precedent in the NCCP (e.g. specific responsible lending rules relating to small amount credit contracts and credit cards) and likewise is applied in other jurisdictions e.g. the UK Financial Conduct Authority has a "Handbook" specifically for "mortgages and home finance", separate to the Handbook for "consumer credit" covering other forms of consumer finance.
b) We note the inconsistency in paragraph 40 of the revised APS 220 between the requirement to undertake a "comprehensive assessment" but which is also "proportionate to the nature, type and size of the exposure". We recommend that the reference to "comprehensive" be replaced by "thorough" to better reflect the concept of scalability.
c) Paragraph 41 states that an "ADI must assess credit risk primarily on the strength of a borrower's repayment capacity" [emphasis added]. We recognise that this statement appears to be making the distinction between assessing a borrower's repayment capacity and undue reliance on collateral. However, as written, we consider that this understates the importance of a lender's credit risk assessment.

d) We consider that the wording of paragraph 42 needs to be clarified. While we expect this paragraph is seeking to prevent an overreliance on corporate credit ratings provided by S&P, Moody's and Fitch, it could be seen as restricting the use of credit scores in the provision of credit to individuals.
e) The requirement, in paragraph 44(b), for ADIs to give consideration to "***all*** commitments and total indebtedness" [emphasis added] of the borrower places an overly onerous obligation on the ADI to identify potentially minor and inconsequential commitments (which should otherwise be captured by an estimate of the borrower's general living expenses). Examples would include regular minor expenses like gym memberships and 'streaming' television services. Further, this does not recognise that even exhaustive measures to identify undisclosed debts, including making inquiries of the borrower, credit checks and reviews of other verifying documents, does not guarantee "all commitments and total indebtedness" will be identified and considered within a credit assessment. We recommend that this paragraph be clarified to recognise that the need to understand a borrower's existing commitments is (i) limited to those commitments which are material to the credit assessment; and (ii) subject to a 'reasonable endeavours' consideration (where both would be subject to a consideration of the nature, type and size of the exposure).
f) Likewise, we recommend that paragraph 44(c) be clarified to recognise that the extent to which an ADI must consider a consumer's repayment history is dependent on such information being reasonably available (e.g. an ADI would not be able or expected to verify repayment history for credit providers that do not participate in comprehensive credit reporting). Also, the paragraph should be clarified to note that the examples given in subparagraphs (i) – (iv) do not establish mandatory requirements for all types of consumer credit.
g) In respect of the above comments, we note that APRA's prudential standards are typically drafted with a level of generality that allows individual ADIs to interpret and apply the standards in a way that is appropriate to the ADI's business model and circumstances. Given paragraph 40 of the revised APS 220 refers to ADIs undertaking credit assessments that are "proportionate to the nature, type and size of the exposure", we believe that this continues to be the intended approach. However, we are concerned that the Australian Financial Complaints Authority could misapply elements of the revised APS 220 by treating them as establishing inflexible and prescriptive 'rules'. To the extent that an ADI had implemented more flexible approaches that are appropriate to its business model and circumstances, the ADI would then become subject to a risk of complaints being determined against them on a systemic basis due to non-compliance with those 'rules' (regardless of whether the ADI has, in the circumstances, acted appropriately). Again, we would recommend that the 'Credit assessment and approval process' section of the revised APS 220 include a more detailed description of the ability to scale up or down based on the nature, type and size of the exposure, including an explicit recognition that this applies to the expectations described in paragraph (b) to (f) above.

Restructured exposures (retail)

ARCA does not support the proposed extension of the hardship 'probation period' from 6 months to 12 months for retail accounts.

The issue of how a loan in hardship is identified on a consumer's credit report has been the topic of significant debate for a number of years and was the subject of a review by the Attorney-General's Department (AGD) in 2018. We understand that the recommendations of that review are currently being considered by the government. ARCA strongly supports an amendment to the Privacy Act to enable a hardship indicator to be reported on a consumer's credit report in appropriate circumstances.

As part of our work on hardship reporting, we have worked extensively with Members to understand how lenders' hardship processes work and how relevant hardship arrangements are to the performance of the loan. This work fed into our submission to the AGD's review.

Over recent years, lenders have made significant effort to provide flexible solutions to customers who are experiencing financial difficulty or hardship.

A survey of our Members completed as part of our submission to the AGD's review showed that most hardship notices are received early; 35-40% when the customer is between 0-14 days in arrears, and a further 20-25% between 15-60 days. This is a positive reflection on industry's efforts to make hardship processes accessible, and shows customers are engaging proactively with their lenders.

The flexibility of solutions provided by lenders also means that many customers who engage with the lender early won't ever go significantly into arrears; either because the customer's circumstances resolve within a short period, or because the customer makes part payments on the loan during the period of financial difficulty. We believe that it is unnecessary to require ADIs to treat such accounts as non-performing for the proposed 12 months (assuming the consumer recommences minimum payments after the period of difficulty but is not able to pay out the missed payments in full). The existing period of 6 months is sufficient to provide comfort that the customer is once again able to meet their required minimum payments.

We understand that some of our Members may provide feedback directly to APRA in response to the proposals in the revised APS 220. However, one Member – a large regional bank – has advised that their data shows that only a very small number (<5%) of hardship customers fall back into arrears between 6 and 12 months. On this basis, that Members consider the current 6-month period is seen as being an appropriate reflection of risk.

We note that the current 6-month period is a minimum period only and an ADI is still required to consider whether the customer has demonstrated that they are likely to be able to pay the required minimum payments. If a customer does not meet their minimum payments during that period, the 6-month 'probation period' will recommence. Hence, the existing requirement already has the capacity for an extended probationary period.

Likewise, given many restructures for retail accounts are done by way of a redocumentation, this would require the ADI to make a responsible lending assessment under the NCCP (i.e. to assess whether the consumer is likely to be able to repay the redocumented account without substantial hardship). Additionally, an ADI would, under the National Credit Code's unjust transaction provisions (see section 76(2)(l)), need to assess whether the customer was able

to pay in accordance with the restructured terms regardless of whether it is done by variation or a redocumentation. Hence, any “exit” following the 6-month probationary period already requires a decision by the ADI that involves them being satisfied that the loan going forward is sound.

The proposal could also result in poorer customer outcomes. For example, a credit card customer who has been a good customer but then experiences temporary financial difficulty (e.g. loses their job) may ask for hardship assistance before they are overdue. It is common for lenders to not approve a hardship ‘variation’ at this point as it is not clear if, and when, the customer will be able to recommence payments. Instead, the lender may offer a period of ‘indulgence’ under which it does not take action in respect to the missed. During this time, arrears will continue to accrue.

If, in the above example, the customer recommences employment after three months (i.e. 90 days overdue) the ADI will attempt to negotiate the payment of the arrears to return the account to current. However, it is not uncommon for a customer to be able to recommence minimum monthly payments, without being able to immediately repay the arrears in full. In this case, the customer may not be able to be returned to a performing status for a further 12 months; during which time the customer would not be able to use their card. This is a poor consumer outcome and is likely to reflect – in the eyes of the consumer – poorly on the ADI.

Further, based on the likely form of the likely hardship indicator coming out of the AGD hardship review, the proposal to extend the probation period from 6 months to 12 months would mean that a hardship indicator could, based on the ADIs processes, be shown on the above customer’s credit report for 15 months (i.e. 3 months for the indulgence and 12 months during the probation period); which would remain visible to other credit providers for an additional 24 months (i.e. the likely retention period for the hardship indicator). Given the feedback of consumer advocates to the AGD hardship review, this is likely to cause significant concern to those stakeholders.

In summary, we consider that the current 6-month probation period is adequate for retail accounts, particularly as it is already a requirement for the ADI to comfort itself that the customer is likely to be able to make their minimum payments before returning the account to a performing status.

Arrangements not subject to formal terms

We note that paragraph 97 requires an ADI to treat a restructured exposure that is not subject to a formal agreement as non-performing (where a ‘restructured’ exposure under paragraph 12 of the revised APS 220 would include an exposure where a “concession” has been granted, including “deferring recovery/collections actions for extended periods of time”). This contrasts to the current position that where an exposure is not treated as “restructured” *unless* the contractual terms have been modified. Exposures that have been granted “relief” without being formally restructured would “continue to accrue arrears for purposes of APRA reporting according to the original schedule of payments and would be reported as past due (if well secured) once unpaid amounts reach 90 days worth of payments as described in AGN 220.1” (see APRA letter to all ADIs re hardship reporting, signed 8 August 2012).

As noted above, an ADI may offer a period of indulgence in under which it does not take action in respect of missed payments. To the extent that such an indulgence involves a

concession of “deferring recovery/collections actions”, we recommend that prior to finalising the revised APS220 APRA provides guidance as to the meaning of “extended period” under subparagraph (l) of the definition of a restructured exposure (i.e. to clarify the circumstances in which an indulgence – which does not modify the contractual terms – could be considered a restructure and which would require the exposure to be immediately treated as non-performing) . We recommend that for retail exposures this period be at least 90 days. In support of this, we note that the period of 90 days is consistent with the concept of a ‘simple arrangement’ under ASIC’s Class Order CO 14/41 (as extended by Credit (Amendment) Instrument 2018/114).

If you have any questions about this submission, please feel free to contact me or Michael Blyth.

Yours sincerely,

Mike Laing

Chief Executive Officer, ARCA