The FOS Approach
Responsible Lending series

FINANCIAL OMBUDSMAN SERVICE

The Financial Ombudsman Service (FOS) provides free, fair and independent dispute resolution assistance to consumers (individuals and small business owners) who are unable to resolve complaints with businesses that provide financial services.

These businesses include banks, insurers, financial planners, mortgage brokers and others. We refer to these businesses as financial services providers (FSPs).

A glossary of relevant terms and useful links is included at the end of this document.

3 How we approach responsible lending disputes taking into consideration legal principles, industry codes and good industry practice)

When a consumer (an individual or small business owner) cannot make their loan repayments, they sometimes say that their financial services provider (FSP) should not have given them the loan because they never had the ability to repay the loan. The consumer may lodge a dispute with FOS for compensation for the loss they have suffered as a result of the FSP providing them the loan. We call this a responsible lending dispute. When we consider responsible lending disputes, we decide whether it was appropriate for the FSP to lend the money.

This document sets out the way we apply legal principles, industry codes and good industry practice when we consider responsible lending disputes.

Who should read this document?

1. Financial services providers (FSPs) that deal with credit products.
2. Consumer representatives who help consumers with financial services disputes.
3. Consumers and small business owners who have credit facilities or are looking for finance.
4. Consumers or small businesses who wish to lodge, or have already lodged, a dispute with FOS alleging that an FSP should not have lent funds to them.
5. Anyone who wants to understand how FOS applies legal principles, industry codes and good industry practice when considering disputes about responsible lending.

Summary of the FOS Approach

6. When we consider responsible lending disputes, we look at whether the FSP made any error when it agreed to provide credit to the consumer. In particular, we will ask:
   - Did the FSP meet its obligations to comply with the law, industry codes and its own lending guidelines?
   - Was the credit contract suitable for the consumer's needs?
   - Could the consumer repay the loan without substantial hardship?
   - What would a diligent and prudent lender have decided to do based on the information available?

When we consider responsible lending disputes, we look at whether the FSP has complied with all relevant legislation, industry codes and good industry practice.

We have created a series of approach documents such as this one to help consumers and financial services providers better understand how we reach decisions about key issues.

These documents explain the way we approach some common issues and dispute types that we see at FOS. However, it's important to understand that each dispute that comes to us is unique in nature, so this information is a guide only. No Determination (decision) can be seen as a precedent for future cases, and no approach document can cover everything you might want to know about key issues.

7. We will also look at what information the FSP relied on when it approved the consumer's credit application. To do this, we will ask:
   - Were there matters in the application which required further clarification or information (which we call "red flags")? In some cases, an FSP may have other information about the consumer in its possession which should make the FSP question the information the consumer has provided in their loan application.
   - Were there any third parties involved in the loan application process, for example a broker? Should the FSP have relied on the information provided by a third party?
8. If the FSP made an error, we will then consider whether the consumer has suffered any loss as a result of the FSP's error.

The FOS Approach

Different legislation and legal principles that apply to responsible lending disputes

9. FSPs and the lending decisions they make are regulated by different legislation, depending on the type of loan and customer and when the loan was provided.
10. When we consider responsible lending disputes, we look at whether the FSP has complied with all relevant legislation, industry codes and good industry practice. This helps us to decide whether FSPs have met their obligations.

National Consumer Credit Protection Act 2009 (Cth)

11. The National Consumer Credit Protection Act (NCCP) imposes responsible lending obligations on FSPs that provide loans and leases to consumers to purchase homes, cars and other personal assets, and on FSPs that provide continuing credit facilities (for example, credit cards and lines of credit).
12. The NCCP does not apply to credit contracts provided to businesses, and does not apply to some credit contracts provided to individuals. However, FOS is still able to consider disputes that are not regulated by the NCCP.
13. The NCCP applies to certain loans provided on or after 1 July 2010 by lenders that are not banks or credit unions. It also applies to certain loans provided by banks and credit unions on or after 1 January 2011.
14. The NCCP requires that before an FSP offers to enter into a credit contract with a consumer, the FSP should make reasonable enquiries and take reasonable steps to check the consumer's information in their loan application. The FSP is also required to assess whether the consumer's contract or changes to the consumer's contract will be not "unsuitable" for the consumer.

> The information the FSP needs to assess about a consumer's requirements and objectives depends on the consumer's particular circumstances and the type of credit contract they have applied for.

15. The NCCP describes a loan as "unsuitable" if:
    - it does not meet the consumer's requirements and objectives, or
    - the consumer cannot repay the loan without substantial hardship
16. The NCCP also requires the FSP to specifically ask about the consumer's requirements or objectives before providing the loan or credit contract.
17. The information the FSP needs to assess about a consumer's requirements and objectives depends on the consumer's particular circumstances and the type of credit contract they have applied for. The FSP should take into account:
    - the potential impact on the consumer of entering into an unsuitable loan
    - the complexity of the loan arrangements, and
    - the ability of the consumer to understand the loan arrangements
18. For example, an FSP should enquire about:
    - how much credit the consumer needs
    - how long the consumer needs the credit for
    - how the consumer intends to use the credit
    - what benefit the consumer thinks they will receive from using the credit
    - whether the consumer wants particular product features, and whether the consumer understands the costs and any risks of these features

National Credit Code

19. The National Credit Code (NCC) is included as Schedule 1 to the NCCP Act. The NCC replaced the former Uniform Consumer Credit Code (UCCC). Loans that were entered into before the NCC commenced (and were therefore regulated by the UCCC) are usually now regulated by the NCC.
20. Facilities regulated by the NCC include most personal home loans, credit cards, personal loans and investment property loans which were entered into after 1 July 2010. (Investment property loans entered into before 1 July 2010 were not regulated under the UCCC.) Facilities that are not regulated by the NCC include facilities provided predominantly for business purposes.
21. The NCC gives the court power to "reopen" a regulated credit contract if the court considers it unjust. This means that the credit contract may be undone and the court can change the terms of the contract.
22. The NCC (at section 76(2)) sets out factors which a court may take into account when it decides whether a regulated credit contract is unjust. These factors include whether, at the time the credit contract was entered into, the FSP knew or could have learned by reasonable enquiry that the consumer could not make repayments under the credit contract, or could not make them without substantial hardship.
23. When we consider responsible lending disputes, we will look at whether the FSP has complied with the requirements of the NCC about entering into credit contracts.

> We consider that a loan offer from an FSP implies that the FSP reasonably expects the consumer will be able to repay the credit contract in accordance with its terms.

Australian Securities and Investments Commission Act 2001 (Cth)

24. The Australian Securities and Investments Commission Act (ASIC Act) prohibits an FSP from entering into a credit contract when it would be unconscionable to do so.

25. The ASIC Act also implies into most credit contracts the requirement for an FSP to exercise reasonable care and skill when it provides its financial services to a consumer. We consider that this requirement means that when an FSP is assessing a consumer's loan application, it must exercise the care and skill of a diligent and prudent lender.

26. The ASIC Act also prohibits an FSP from being misleading when it provides a financial service. We consider that a loan offer from an FSP implies that the FSP reasonably expects the consumer will be able to repay the credit contract in accordance with its terms. This is because an approved loan means the FSP has assessed the consumer's financial position and formed a view that it is willing to take that risk in getting back its money.

Skill and care of a diligent and prudent lender

27. Some courts have considered that FSPs should exercise the care and skill of a diligent and prudent lender.

28. The ability of a consumer to repay their loan is crucial to good lending practice. Legal commentators suggest that the assessment of a consumer's ability to repay the loan should be based on:
    - the information provided by the consumer
    - the FSP's own research about the consumer, the consumer's demographic (for example, their age) and the financial industry in general
    - calculations using the FSP's scoring tables, acceptable ratio limits and other methods
    - the consumer's personal factors including their business or technical ability

29. When we consider responsible lending disputes, we may also consider these matters.

Industry Codes

30. Many FSPs have developed and subscribed to industry codes of practice. Examples of these codes include the Code of Banking Practice and the Customer Owned Banking Code of Practice. Within these industry codes, FSPs commit to acting responsibly and acting diligently and prudently in their loan assessment process to form a view about the consumer's ability to repay the credit contract.

31. The industry codes of practice apply to all consumer and small business customers of an FSP that has subscribed to the industry code. In the case of a small business, it may be a micro-business or a large operation. A small business is a business with fewer than 100 full time (or equivalent) staff if the business is or includes the manufacture of goods. For all other businesses, a small business is one that has fewer than 20 full time (or equivalent) staff.

> We consider that industry codes reflect good industry practice, so we expect all FSPs to make sure their lending guidelines are in line with the codes' required standards.

Good industry practice

32. Not all FSPs subscribe to the industry codes. However, we consider that industry codes reflect good industry practice, so we expect all FSPs – even if they have not subscribed to the codes – to make sure their lending guidelines are in line with the codes' required standards.

33. When we consider a dispute involving an FSP which has not subscribed to an industry code, we review the credit assessment and the FSP's internal lending policy, and also apply the principles of industry codes and good industry practice, as well as any relevant legal principles.

What information did the FSP obtain before it granted the loan?

34. When we consider whether an FSP should have provided a credit contract to a consumer, we pay particular attention to the consumer's ability to repay the debt.

35. The FSP must make reasonable enquiries about the consumer's financial position and their ability to repay the loan. Therefore, we will look at the information the FSP requested and obtained, and how it assessed that information.

Types of information we look for

36. In most cases, we expect the FSP to have considered:
    - the amount and source of the consumer's income, including the length of their employment and the type of employment (for example, part time/casual)
    - the consumer's main expenses, such as rent, repayments to other loans/debts, child support, insurance
    - the consumer's variable or discretionary expenses, such as school fees, pay TV
    - any existing debts that the consumer is going to repay from the loan
    - the consumer's credit history, which may be shown from loan statements from their existing lender, credit card statements and the consumer's credit file
    - the age and number of dependants the consumer is supporting
    - the consumer's assets (for example, property or cars they own)
    - reasonably foreseeable or predictable changes, such as the end of a short-term introductory interest rate on a loan, planned retirement, or the end of short-term employment, and
    - geographical factors, such as the distance the consumer lives from any cities or large towns (which may increase their expenses)

37. In Regulatory Guide 209, ASIC says that an FSP's obligations are "scaleable". This means that what the FSP is required to do when assessing a consumer's loan application will depend on the circumstances.

When should an FSP make more enquiries?

38. In our view, the FSP should make more enquiries where:
    - the consumer's lifestyle and wellbeing would be seriously affected if the loan was unsuitable (for example, where the loan is large compared with their income and assets)

We will look at the information the FSP requested and obtained, and how it assessed that information. As a minimum, the FSP should obtain documents to check the consumer's ability to repay the loan.

- 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), and
- the consumer may not understand the terms of the credit contract or the obligations they are taking on (for example, if the consumer has not had that type of loan before, or the credit contract is unusual or complicated).

When might an FSP make fewer inquiries?

39. In our view, the FSP may need to make fewer enquiries where:
    - the consumer will not be seriously affected if the loan is unsuitable
    - the credit contract is a simple or common product (such as a credit card), and
    - the consumer easily understands the terms of the credit contract and the obligations they are taking on.

What is the minimum amount of information an FSP should request?

40. Regardless of circumstances, there are minimum enquiries we expect an FSP to make in all cases before providing a credit contract to a consumer.
41. As a minimum, the FSP should obtain documents to check the consumer's ability to repay the loan – for example:
    - checking the consumer's PAYG income by obtaining copies of their payslips
    - checking the consumer's self-employed income by obtaining copies of their tax returns and bank statements
42. When an FSP provides a low documentation (low doc) loan to the consumer, the FSP usually receives less information about the consumer. The FSP usually relies on what the consumer says their income is, and the consumer may not give the FSP payslips, tax returns or financial statements.

Using automated calculation systems and indexes

43. In Regulatory Guide 209 ASIC acknowledges that FSPs may use an automated system to test whether they can rely on a consumer's declared income, without asking for copies of the consumer's payslips or other documents to confirm the declared income.
44. We consider that if an FSP relies only on an automated system, the FSP bears the risk that its modelling is not correct or does not accurately reflect the consumer's actual financial position. The FSP may not be able to satisfy the NCCP requirements if it relies on an automated system.
45. To estimate a consumer's regular expenditure and living expenses, FSPs often use published data – for example, the Henderson Poverty Index. In our view, this data often does not include some types of expenses, such as:

> If the FSP does not assess a consumer's individual circumstances, it might offer the consumer a credit contract which the consumer cannot afford.

- expenses for the particular needs of the consumer, for example additional medical and pharmaceutical expenses
- voluntary commitments such as school fees
- extra transport costs due to remote location

46. We may consider that an FSP can prudently rely on a published index to assess a consumer's expenses, particularly if the FSP considered that the consumer had under-estimated their expenses. However, we expect an FSP to add a buffer to the expenses estimated by the published index (that is, they should estimate higher expenses). This is because most published data records an individual's minimum expenses. If a consumer has income lower than those minimum expenses, the consumer would be living in poverty, and FSPs should expect consumers to live comfortably above this level.

47. If the FSP does not assess a consumer's individual circumstances, it might offer the consumer a credit contract which the consumer cannot afford.

What else will we consider?

48. An important question we consider is whether the FSP properly applied its own lending guidelines when it assessed whether the consumer could afford to meet the loan repayments without substantial hardship.

49. We will also look at whether the FSP's staff expressed any concerns during the application process about the consumer's ability to repay, or any concerns about the information the consumer had provided. If the FSP's staff had any concerns, we will look at whether the FSP took reasonable steps to address those concerns.

50. We also look at the information the consumer provided to the FSP. We consider whether the consumer's information was incorrect or inaccurate, and whether it conflicted with information the FSP already had in its possession (for example, information in the consumer's previous loan applications, or information from the consumer's transaction account).

51. Where there is disagreement between the FSP and the consumer about the accuracy of the information the FSP obtained, we will ask the consumer for details of their financial position at the time of their loan application, including their income, liabilities and expenses. We will also ask for supporting information such as the consumer's tax returns, account statements from other lenders and Centrelink statements.

52. If we conclude that the FSP did not lend responsibly, we will consider what loss the consumer has suffered. To do this, we will look at the position the consumer was in before the loan was granted, and take into account how they used the funds and how much they need to repay. You can read more in the FOS Approach to responsible lending – how we work out a consumer's loss at www.fos.org.au/approach.

Case studies

NCCP obligations

Will was 20 years old, lived at home and had a job at the local supermarket. He found a car he wanted to buy at a Prestige Cars dealership and applied through the dealership's finance broker for a loan for $50,000 from the FSP. That amount covered the purchase price of $40,000 plus comprehensive insurance and consumer credit insurance. The FSP approved a seven year fixed interest loan which required Will to make monthly repayments of approximately $800.

Will struggled to make his repayments. His mother lodged a dispute at FOS on Will's behalf, in which she said that the FSP:

- failed to take into account the high operating costs of a high performance car
- failed to make any enquiries about whether Will had any upcoming significant expenses

We considered the dispute and found that the FSP had relied on the information in Will's loan application and on its own generic data to determine his living expenses. The application stated that Will was employed, he already owned a car worth $6,500, he owed $10,000 in "other loans" and he had no savings.

We concluded that the FSP had failed to meet its NCCP obligations to lend responsibly because:

- The FSP had not contacted his employer or made any enquiries about Will's requirements or objectives (except for his obvious desire for a high performance car). If the FSP had contacted Will's employer, it would have learned that he was employed on a casual basis, and he earned more from irregular incentive payments than his casual wage.
- Before the loan, Will owned a car worth $6,500 and owed $10,000 in personal loans. After Will bought the car, he increased his overall debt to $50,000 without the FSP making any enquiry about his potential employment opportunities or other ways he could repay this substantially larger debt.
- The FSP also failed to consider Will's future expenses if he moved away from home, which was a reasonable consideration given his age.
- Given that Will had no savings, it was obvious that his living expenses were greater than the FSP's estimate allowed, and there was no reasonable basis to presume Will could afford a further liability of $800 per month.

Good industry practice

Doris and Bill obtained a $200,000 line of credit from the FSP which they used in their business. Their business went into liquidation. Doris and Bill lodged a dispute with FOS, claiming that the FSP should not have provided the line of credit.

The FSP said that FOS did not have jurisdiction to consider their dispute because:

- the line of credit was not a regulated credit contract under the NCCP and the NCC
- the credit contract was not a financial product under the ASIC Act
- there was no relevant case law which applied to a lending decision which required the FSP to meet any standard of care in assessing Doris and Bill's loan application
- it was not a subscriber to any industry code which imposed responsible lending obligations

We said that we would consider Doris and Bill's dispute, because our Terms of Reference state that we can consider a small business dispute, and that we are not limited to considering only regulated lending under the NCCP or NCC. Our jurisdiction is broader than a court because we not only consider legal principles but also how the FSP should conduct itself to comply with good industry practice. Even though the FSP was not a subscriber to any industry code, we still apply the guidelines of relevant codes when we consider if an FSP has followed good industry practice.

Definitions

Word	Definition
ASIC Act	Australian Securities and Investments Commission Act
FSP	financial services provider (a business that has chosen FOS as their external dispute resolution scheme)
Low doc loan	a loan which is approved based on the loan applicant's declaration of income, rather than being supported by payslips, tax returns or other financial documents
NCC	National Credit Code
NCCP	National Consumer Credit Protection Act
Regulated credit contract	A contract regulated by the NCCP and NCC or by the UCCCt
UCCC	Uniform Consumer Credit Code

Useful links

This document is one of a series we have produced about responsible lending. We have also created documents which cover:

- Common issues in responsible lending disputes
- How we work out a consumer's loss
- Low doc loans

All four documents can be found on our website at

www.fos.org.au/approach

We have published other documents that outline the FOS Approach, including our approach to disputes lodged by guarantors. You can see them all at

www.fos.org.au/approach

Our website contains more information about what we do, the types of disputes we can consider, and our dispute resolution processes.

www.fos.org.au