The FOS Approach to
Responsible lending series: Low doc loans

We have created a series of FOS 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 is important to understand that each dispute that comes to us is unique, so this information is a guide only. No determination (decision) can be seen as a precedent for future cases, and no FOS Approach document can cover everything you might want to know about key issues.

1 At a glance

1.1 Scope

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 our approach to responsible lending disputes where the consumer says the FSP should not have given them a low documentation (low doc) loan.

1.2 Summary

Who should read this document?

- FSPs that offer low documentation (low doc) loans.
- Consumer representatives who help consumers with financial services disputes.
- Consumers and small business owners who have low doc loans or are looking for finance.
- Consumers who wish to lodge, or have already lodged, a dispute with FOS alleging that an FSP should not have given them a low doc loan.

Summary of the FOS Approach

When a consumer applies for a low doc loan, they do not have to provide the information an FSP usually requires to verify their income, such as payslips or tax returns. Instead, they provide a declaration that they earn a certain amount in a year, and the FSP relies on that declaration to work out whether the consumer can afford the loan. The FSP may also rely on other information such as the existence of an ABN for at least twelve months, a credit check and, in the case of a refinanced loan, a copy of existing loan statements.

Consumers who run their own business or who are self-funded retirees sometimes cannot provide the information an FSP usually requires to verify their current income (for example, payslips). In those cases, an FSP may offer the consumer a low doc loan.

We consider that low doc loans should usually not be given to PAYG employees.

Good industry practice requires an FSP who offers a low doc loan to act responsibly when assessing the low doc loan application.

In disputes that involve allegations of fraud FOS takes the view that we can still deal with the substance of the dispute, which is whether the consumer is entitled to compensation.

When we consider low doc loan disputes, we look for any “red flags” in the low doc loan application. Red flags are things in the loan application or the supporting materials which suggest that the information provided is not accurate or complete.

If there are red flags in the loan application, the FSP should make further enquiries of the consumer. If the FSP does not make further enquiries in those situations, we may consider that it was not acting as a responsible lender.

However, red flags or incomplete information in the loan application form do not necessarily mean that the consumer is not liable for the loan. We will consider who provided the information and how the FSP assessed the information. We will also consider whether, if the correct information had been provided, the FSP would still have granted the loan because the consumer could afford it.

2 In detail

2.1 What is a low doc loan?

A low doc loan is one which is approved based on the loan applicant's declaration of income, rather than being supported by payslips and other documents showing their income. In other words, the amount of documentation needed for the application is low. The FSP may also rely on other information such as the existence of an Australian Business Number (ABN) for at least twelve months, a credit check, and in the case of a refinanced loan a copy of loan statements for the existing loan.

2.2 Who should be offered a low doc loan?

Low doc loans may be suitable for consumers who are self-employed or living on their own investments and savings, and who cannot provide current information about their income.

For example, John runs his own business as an IT consultant. In September 2013, he wanted to borrow money to purchase a new home, but he did not need to lodge his tax return for the tax year ended 30 June 2013 until February 2014. He last lodged a tax return in February 2013, which was for the financial year ended June 2012. Since then, his business has obtained four new contracts and his business's income has more than doubled. Therefore, his last tax return is out of date and it does not accurately reflect his current financial position. In John's situation, an FSP may rely on a declaration by John about his current income. John could also support his declaration by providing the FSP with business activity statements (BAS) for his business for the last year.

As a general rule, our view is that low doc loans should not be offered to PAYG employees. This is because it is easy for a PAYG employee to provide current payslips and group tax certificates to the FSP, and an FSP can call the consumer's employer to verify their employment and income.

Low doc loans should also not be offered to companies, because the Corporations Act requires companies to maintain management accounts which could be produced to an FSP in support of a loan application.

2.3 What are the risks?

When an FSP relies on a consumer's declaration about their income, there is a risk that the declaration is inaccurate. There is also the risk that if the FSP had made more inquiries about the consumer, the FSP would have decided that the consumer could not afford the loan.

The FSP may be unable to show that it acted responsibly if there were "red flags" in the loan application which suggested that the income information was inaccurate or incomplete. If that is the case, the FSP may have to compensate the consumer for some or all of their loss.

For consumers, the risk of low doc loans is that they may get into financial difficulty because they cannot afford the loan.

2.4 What are some "red flags"?

Red flags can arise if the loan application contains information which appears to be inconsistent, incomplete or wrong. Red flags may also arise if the FSP has other information or knowledge about the consumer which shows that the information in their low doc application is not accurate or complete.

For example, as part of the low doc loan assessment process, the FSP may receive a copy of the consumer's transaction account statements which show regular repayments on an existing loan which was not disclosed in the low doc loan application form.

As another example, if the consumer is already a customer of the FSP, the FSP may have information about the consumer's financial position which is not declared in the income declaration in the low doc loan application form.

Some other examples of red flags are:

- The consumer's transaction account statements show fortnightly family tax benefits. These benefits are not available where the primary income earner earns more than the family tax benefit threshold, which in 2013-14 was approximately $150,000. If the consumer has declared income above the threshold, their receipt of the family tax benefit should prompt the FSP to make further enquiries about the consumer's actual income.
- The consumer's transaction account statements show regular deposits for the same or similar amounts, suggesting the consumer may be employed. If the consumer has declared they are self-employed, the FSP should make further enquiries about the deposits.
- The consumer's loan application discloses that they have been self-employed for five years, but an ABN search shows they have only been registered for 12 months. The FSP should make further enquiries to determine whether the business name has changed or if there is another explanation. Where a business is less than two years old and relatively unproven, an FSP lending responsibly may not place much reliance on the consumer's income declaration.
- The consumer's business or company is also a customer of the FSP. The consumer applies for a low doc loan for investment purposes and declares their personal income to be $200,000, but the FSP knows that their business has been overdrawing its accounts. Acting responsibly, the FSP should enquire about the consumer's proposed investments. If the consumer actually intends to "invest" the funds in their business, the FSP should assess the request as a business loan.

- The consumer declares income which bears no relationship to their asset position. For example, if a consumer declares annual income of $200,000 but has no savings or assets, the FSP should enquire why they have no savings or investments.

You can read more about "red flags" and errors we commonly see in responsible lending disputes in the FOS Approach to responsible lending – common issues at www.fos.org.au/approach.

What happens if the low doc loan application contains inaccurate information?

When we consider a low doc responsible lending dispute, we look at who provided the information to the FSP and how the FSP assessed that information.

Generally, the income declaration in the application form includes a statement that the information the consumer has provided is true. However, we consider that these declarations do not mean that the FSP does not have to make proper enquiries when it is deciding whether the consumer can afford the loan. If there were "red flags" in the application and the FSP failed to make adequate enquiries, we may conclude that it did not lend responsibly.

We will consider whether the consumer made a false declaration, either deliberately or mistakenly. If a consumer has failed to protect themselves by providing exaggerated figures, or has signed a blank form and trusted someone else to accurately complete it (for example their representative or broker), we may decide that the consumer has to be responsible for some of their loss. In those cases, we may reduce the amount of compensation the FSP has to pay.

Even if some information in a loan application is incorrect, this does not necessarily mean that the FSP should not have provided the loan to the consumer. Some information on a loan application is not important to the decision about whether the consumer can afford the loan.

For example, if a consumer declared that they have $40,000 superannuation, but they in fact only have $20,000, this would not necessarily affect the FSP's assessment. This is because the FSP will usually rely on the consumer's current income to assess their ability to make their repayments, and not on their ability to access superannuation or to sell other assets.

Also, even if information in a loan application is incorrect, sometimes a diligent and prudent lender would still have provided the loan to the consumer if they had known their actual financial position.

For example, John applied for a low doc loan for $350,000 to purchase a new home. He declared his income to be $200,000, but he actually earned $150,000 that year. However, even though he earned $50,000 less than the amount the FSP relied on when assessing his loan application, we may decide that he did not suffer any loss. This is because we may calculate that even after taking into account his living expenses, he could still afford the repayments on his loan.

3 Context

3.1 Case studies

Case 1: Inadequate inquiries

Bruce and Barbara had loans with another lender that totalled approximately $263,400. In December 2006, they accepted the FSP's home loan offer for $284,000 to refinance their existing loans. This amount included additional funds of approximately $20,600.

In November 2007, Bruce and Barbara found a block of land they wished to purchase. They made a low doc loan application to the FSP for $240,000 to assist in their purchase. In their application, Bruce declared that he earned $200,000 per annum from his crash repair business.

Bruce and Barbara had planned to build a new family home on the block of land. However, there were delays for over five years in getting their plans drafted and approved by the local council. They had difficulty making repayments on their total debt of $524,000. In 2012, Bruce and Barbara lodged a dispute at FOS, claiming that the FSP should not have provided them with the $240,000 because they were not able to service their total debt. In 2013, while we were considering their dispute, Bruce and Barbara refinanced the two loans with another lender. After 2013, the land dropped in value.

We considered the FSP's credit assessment and concluded that the FSP had failed to make adequate enquiries. While it was appropriate to provide a low doc loan to Bruce because he was self-employed, the FSP should also have taken into account the information it already had about Bruce and Barbara from their existing $284,000 loan. Bruce and Barbara's transaction account statements showed that they received Family Tax Benefit Part A payments, which are not available to a family whose principal income earner makes $200,000 per annum. The FSP should have made more enquiries with Bruce and Barbara about the difference between Bruce's declared income and Bruce and Barbara's receipt of family tax benefits. If the FSP had made those enquiries and had asked for tax returns for Bruce's business, those tax returns would have shown a net income for the financial year of only $23,527.

As the FSP failed to make those enquiries, we concluded that it had not acted responsibly in providing the $240,000.

Bruce and Barbara's loss was the amount of money they contributed to the purchase of the land, repayments they made on the $240,000 loan, and holding costs they paid for the land (such as council rates). However, their loss did not include the costs of refinancing the loan with the new lender, or the interest they paid to their new lender. This is because it was Bruce and Barbara's choice to move to the new lender instead of selling the land. Bruce and Barbara's loss also did not include the drop in the value of the land, because the land's value had not changed between 2006, when they purchased the land, and 2012, when they refinanced their loan with another lender.

Case 2: Broker's conduct and consumers' conduct

In 2008, Mike and Felicity asked for advice from a mortgage broker about the best way to borrow $30,000 to help Felicity develop her business. At that time, they already owed the FSP $50,000 for a home loan. The broker advised them to apply to the FSP for a loan to purchase an investment portfolio and for a line of credit for the business. The broker advised them to mortgage their home to provide security for the loans.

The broker completed their loan application with incorrect details. In particular, the application stated that:

- Mike's income was $75,000 and Felicity's income was $50,000. However, Mike's true income was approximately $16,000 and Felicity's true income was $14,000.
- Felicity contracted as a child care centre provider and Mike was a locum teacher.

The FSP provided Mike and Felicity with three loans totalling $342,000 and Mike and Felicity provided a mortgage over their home as security for the loans. Mike and Felicity later lodged a dispute at FOS. They said:

- They had signed three pages of the application and had not seen any other pages of the application. They did not see the other pages of the application until the FSP provided them with a copy of the application after they lodged the dispute at FOS.
- The broker encouraged them to sign blank documents. When they signed the income declaration in the application, it did not state their incomes, it only stated the amount of the loans.
- The FSP did not check their income with their accountant.
- They had taken legal action against the broker and recovered $80,650 in compensation.
- They used one of the loans to make repayments on the other two loans. When there were no remaining funds in the first loan, Felicity used a pension from her superannuation funds to make loan repayments.

In responding to the dispute, the FSP said:

- Its low doc lending policy did not require it to verify their income.
- It had relied on information provided by Mike and Felicity's broker.
- Mike and Felicity's repayment history on their existing home loan was satisfactory and their credit reports were clear.

When we considered their dispute, we noted that Mike and Felicity's age was a "red flag" because they were both 60 years old when they applied for the loans.

The FSP had made further inquiries with the broker about Mike and Felicity's ability to repay the loans, and the broker told the FSP that Mike and Felicity had $450,000 equity in their home and $360,000 superannuation which they could use to reduce their debt when they retired. The FSP also knew that Mike and Felicity were currently working and that the loans were for investment purposes, which could be expected to create additional income and possible capital gains.

We could see that the FSP had complied with its low doc lending policy when it approved the loans. There were no "red flags" which might have alerted the FSP to the false information in the application, so it was entitled to rely on the information in the application to assess whether Mike and Felicity could afford the loans.

We analysed Mike and Felicity's ability to service the loans based on the information in the application and the FSP's knowledge of their existing home loan, and concluded that Mike and Felicity could afford the loans.

Although the broker may have done the wrong thing, the FSP did not know and had no reason to suspect that the information the broker provided was inaccurate. Also, the broker was Mike and Felicity's agent, not the FSP's agent. For those reasons, the FSP could not be held liable for the broker's conduct.

3.2 References

Definitions

Term	Definition
Consumer	individual or small business that has lodged a dispute with FOS
Credit contract	A credit facility provided to an consumer or small business which may include a regulated credit contract
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

Useful links

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

- How FOS approaches responsible lending disputes having regard to legal principles, industry codes and good industry practice
- Common issues in responsible lending disputes
- How we work out a consumer's loss

All four documents in this series can be found on the FOS 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

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

- www.fos.org.au