Low documentation home loans – a symptom of a greater malaise in consumer credit standards

A paper presented at a Public Forum:
The Dangers of Low Documentation Loans
Australian National University
Canberra – 12 October 2007

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Introduction

Almost a year ago I presented a paper at the Financial Counsellors' Association of Western Australia Annual Conference, entitled *Lo Doc loans – increased market access for lower income consumers, or the potential catalyst for a consumer credit meltdown?*[1] The tone of the paper was gloomy, drawing from commentary such as the following report in the Age newspaper on 3 August 2006:

> *Families struggling to pay off a mortgage are being forced to seek emergency food parcels in one of Melbourne's northern suburbs. Of the 2000 people seeking emergency relief at the Broadmeadows Uniting Care centre each year, more than 300, or 15 per cent, are trying to pay off a mortgage. About 260, or 13 per cent are public housing tenants. The centre's financial counsellor, Gary Rothman, said rising interest rates, petrol prices and inflation had forced people to choose between repaying their mortgage or putting food on the table.*[2]

In its funding report to the ACT Government for the first six months of 2007, Canberra based Care Inc Financial Counselling Service did not record quite the same level of mortgage stress amongst its clients as its colleague agency in suburban Melbourne. The trend is however similar. Of the 1005 new requests for assistance received by Care's general services January to June 2007, 16 per cent had current mortgages, 24 per cent reported household incomes over $35,000 and for only the second time, consecutively following the July to December 2006 report, problems with paying a mortgage appeared in the top ten list of reasons reported by clients for making contact at 7 per cent.[3]

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[1] The paper referred to is unpublished but can be accessed on Care's web-site www.carefcs.org.
[2] Doherty, Ben, *Howard's dream believers living on hand-outs,* The Age, Melbourne, 3 August 2006.
[3] Care Inc Financial Counselling Service, *Output and Performance Report 1 January 2007 to 30 June 2007,* Canberra, 30 July 2007.

Even in Canberra, the city that consistently records the highest per capita incomes in one of the wealthiest countries in the world, the main local financial counselling provider has been reporting a noticeable shift in its client work for some years. Very low income consumers still make up the core of Care's client intake[4]. Proportionally more people on higher incomes are however seeking assistance in relation to unsustainable debt levels. Those people are slightly more likely now than may have been the case in the past to report wages or income from self employment as their main source of income than Commonwealth benefits. Small but discernable increases can also be seen in the numbers of people trying to sustain a mortgage, rather than renting.

A consistent factor in Care's data over a number of years is that around a quarter of new clients requesting assistance report credit card debt as a key reason for seeking support. Problems keeping up with payments on home loans have however spiked dramatically. Co-located with Care, the Consumer Law Centre of the ACT noted assisting consumers at risk of or responding to mortgage foreclosure as a rapidly growing area of demand in the agency's 2004-2005 Annual Report[5]. In 2005-2006 mortgage foreclosure matters grew to represent around half of the Consumer Law Centre's case load – a situation that has been maintained since.

Considerably more commentators than consumer advocates working with lower income and vulnerable consumers are now prepared to acknowledge that debt levels in Australia are a concern than was the case this time last year[6]. A notable exception is the Reserve Bank of Australia, which whilst acknowledging personal debt is at record levels, believes the growth has a way to go and presents no macro-economic danger. I agree only with the former of those predictions – and not because there is obviously more borrowing capacity to fill, rather because it seems as a country we are destined to find the absolute saturation point in personal debt levels before governments and lenders alike question the sustainability of current market conduct.

The catalyst for greater engagement with the implications of personal debt levels in Australia has been the sub-prime lending crisis in the United States. Many economic analysts are quick to point out that to the extent there is a problem in Australia it is relatively small by comparison to the US and confined to the fringes of the credit market.

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[4] Care Inc, *Output and Performance Report 1January 2007 to 30 June 2007*, ibid. The report noted 45 per cent of clients reported incomes of less than $15,000 rising to 63 per cent for those with incomes less than $25,000.

[5] Care Inc Financial Counselling Service, *Annual Report 2004-2005*, Canberra, December 2005, page 15.

[6] An increasing number of economists are now noting concerns about personal debt levels. Within the economics community Associate Professor Steve Keen from the University of Western Sydney is perhaps the most outspoken. Professor Keen produces a monthly on-line newsletter called *Debt Watch* available through the website www.debunking-economics.com. He also recently released a paper entitled *Deeper in Debt – Australia's Addiction to Borrowed Money* (Centre for Policy Development, Sydney, Occasional Paper number 3, September 2007). Of particular interest is recognition of the problems and possible repercussions from industry commentators. (See for example the estimation that as many as 70,000 Australian households are already experiencing mortgage stress, with the possibility the figure could hit 113,000 before the end of 2007 contained in the Fujistsu/JP Morgan Report *Mortgage Stress – Are Australian Households in a Pickle?* – Australian Mortgage Industry – Volume 6; Asia Pacific Equity Research, Sydney, 18 September 2007, pages 5 and 33 to 35.)

My personal experience suggests otherwise. I will seek to explain why by exploring two key propositions:

- Improvident lending in Australia, far from being confined to the fringes of the market, appears to have become mainstream; and
- In the scramble to encourage market growth governments, policy makers and to some degree regulators have forgotten the importance of a basic foundation principle in diligent, prudent and fair lending – connecting the provision of credit to the needs and capacity of borrowers.

Dangerous lending – a blurring of the distinction between fringe and mainstream credit provision

What is Low Documentation lending?

Applying for a standard consumer credit facility generally involves providing a variety of personal information. Details of income are unsurprisingly important. For some people however, for example those working casually, on contract, or particularly the self employed, providing documentation to confirm income can prove challenging. Low documentation (low doc) lending was designed to deal with borrower groups for whom supplying standard documentation like regular pay slips was hard or impossible. At a general level providing flexibility in how credit eligibility can be assessed was a positive move. It opened the credit market, especially for home loans, to groups who were otherwise excluded altogether or for whom the finance that was available was considerably more expensive.

The growth in low doc lending has been a by-product of deregulation of the home lending market. It rapidly became a key offering for new market entrants, predominantly non-traditional, non deposit taking lenders seeking to differentiate themselves in attracting market share. Invariably summaries of the effects of deregulation point to the positive impact of the competition which has followed. For example, the recent House of Representatives Inquiry into Home Loan Lending concluded:

> *2.44 There have been substantial changes to the housing lending market in Australia over the last 10 to 15 years. This has included a huge increase in the number of lenders in the market and a consequent increase in competition.*
>
> *2.45 Competition in the lending market has provided great benefits to consumers. Interest rate margins have reduced significantly and there are a range of new and innovative products available. Some of these new*

> *products are low doc loans, interest only loans and equity withdrawal loans.*[7]

This presents a very positive background to low doc lending - just the type of consumer credit activity that current Reserve Bank Deputy Governor Ric Battellino recently referred to as the *democratisation of finance.*[8] Mirroring comments made several months earlier by the head of the Australian Prudential Regulatory Authority, John Laker[9], Mr Battellino lamented the previous hurdles placed in the way of prospective home borrowers:

> *Those of us over 50 years of age can remember when, in order to qualify for a housing loan, people had first to establish a long and consistent record of savings with a bank, and even then there was a tight limit on how much the bank would lend. Many borrowers had to resort to 'cocktail' loans, at a higher cost, to meet their needs.*[10]

Where is the problem in *democratising* finance?

If low doc lending extended a welcome to people who were excluded from obtaining housing finance at all or on affordable terms, why are we attending a forum today exploring the dangers of the practice? From the perspective of an employee in a service that has responded to a considerable number of people who obtained loans through streamlined processes, there appears to be a very simple and common thread. Selling has become more important than whether the product is suitable or affordable. In the low doc space in particular, a **lot** of selling has been going on.

In an earlier speech as an Assistant Governor of the Reserve Bank Ric Battellino noted the growth of low doc lending in the Australian mortgage market over a ten year period. From a base of below 1 per cent market share in 1996, low doc loans represented about 9 per cent of new loans in 2006.[11]

The rate of growth seems to be about something more than just meeting the specific needs for which low doc loans were designed. I do not recall in the decade 1996-2006 seeing the number of small businesses in Australia increasing ten-fold, or driving past

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[7] House of Representatives Standing Committee on Economics, Finance and Public Administration, *Home loan lending – Inquiry into home loan lending practices and the processes used to deal with people in financial difficulty,* The Parliament of the Commonwealth of Australia, Canberra, September 2007, pages 12 and 13.

[8] Battellino, Ric, *Some Observations on Financial Trends,* Address to the Finsia-Melbourne Centre for Financial Studies 12th Banking Conference, Reserve Bank of Australia, Melbourne, 25 September 2007, page 5.

[9] Laker, John, *Credit Standards in Housing Lending – some further insights,* Address to the Institute of Chartered Accountants in Australia, Melbourne 20 June 2007, page 2.

[10] Battellino, *Some Observations on Financial Trends,* ibid, page 4.

[11] Battellino, Ric, *Developments in Australian Retail Finance - Address to Retail Financial Services Forum,* Reserve Bank of Australia, Sydney, 22 August 2006, page 18.

squads of homeless small business people camped outside their local banks, credit unions and building societies holding up placards asking for a fair go in accessing home loans. So let me suggest a couple of possible reasons for the shift:

- Low doc lending has streamlined front end sales costs;
- The design of the products generally involves fewer compliance steps;
- There is less rigour in follow up; and
- Many more loans are sold through brokers rather than through branch networks.

The growth has also coincided with and undoubtedly bears some relationship to other factors – like continued increases in the cost of housing. Just maybe the democratisation of finance, read also as more loans to more people for larger sums, has actually played a role in extending and amplifying boom conditions in housing prices. The considerable activity in refinancing of home loans certainly suggests as property values have gone up, consumers have taken the opportunity to borrow more.[12]

It also seems that there is a link between the growth in low doc lending and the expansion of other types of far riskier credit provision, for example no documentation and sub-prime lending. Not all low doc loans are sub-prime, but invariably sub-prime loans have involved some form of compacting of the information that would be collected or checked in a normal, prudent assessment process[13].

It is easy to categorise the more bizarre and overtly unfair forms of credit provision as a small and isolated part of the market.[14] That belies the growth in that type of lending, the large numbers of individual consumers involved rather than what remains a relatively small percentages of aggregate activity and the fact, after all, that we are talking about the 'dress circle' of consumer lending – the home loan market.

A suggestion the financial counselling peak body AFCCRA has made across a range of markets is that much of the competition that designs and targets products and services to middle income earners and below may not deliver broad benefits. Instead competition targeting low to moderate income groups can often appear less concerned about the products and services those consumers need and can afford and more about where the providers are prepared to compete[15].

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[12] Fujitsu/JP Morgan, *Mortgage Stress – Are Australian Households in a Pickle,* Ibid, pages 13 and 14. Also see Reserve Bank of Australia, *Financial Stability Review,* Sydney, March 2007, page 33.
[13] The link is noted in a recent Law Society of NSW article, exploring issues from the US experience. Ross Foreman, *Subprime Mortgage Crisis – A legal perspective,* Law Society of NSW, Sydney, Law Society Journal vol 45 no 9 Oct 2007, page 57.
[14] For example see Martin L North, *Wizard – Fujitsu Report on Predatory Home Lending*, Fujitsu Consulting, North Sydney, September 2007. One of the conclusions reached in the Executive Summary (page 3) is:

> *Predatory lending exists in Australia and is targeted at specific customer segments, through specific channels. However, it is not widespread.*

[15] Australian Financial Counselling and Credit Reform Association, *Submission to the Productivity Commission's Review of Australia's Consumer Policy Framework- response to the Issues Paper January 2007,* Canberra, May 2007. Pages 2 to 9 of the submission in particular explore the heading *Where competition does not deliver advantages evenly or at all.*

Having found a niche and expanded quickly and successfully, new, non-mainstream home loan market entrants adopted aggressive sales and marketing approaches. The growth of such companies individually and collectively and the shift in market share away from banks and other deposit takers appears to have encouraged a loosening in the approaches of mainstream players as they have attempted to hold or retain market share[16].

A good example of this shift, that I found personally horrifying, was a large scale television advertising campaign by St George Bank talking up the benefits of being able to lend to first home buyers who had no savings history or deposit[17]. The St George approach appeared to be a direct response to RAMS, a non-bank home lender that had committed considerable marketing attention to the dubious benefits of lending up to 100 per cent and beyond to new home buyers. It is interesting to note the more recent public discussion of the ongoing viability of the RAMS.

Whether the fringes have tried to re-badge themselves as the mainstream, or the mainstream has tried to become *fashionably fringe funky*, the lines have blurred. Through its significant growth spurt, low doc lending has inevitably played a role in that blurring. The race to write more business appears to have diverted low doc lending away from its initial purposes and to have undermined appropriate investment in establishing and maintaining sustainable customer relationships.

Policy and Regulation – the need to reconnect credit provision to the needs and means of the customer base:

An easy issue first…regulating the activities of mortgage and finance brokers

There is at least one response to the growth of unsafe lending activity that been agreed for a long time, namely the urgent need for a national system delivering licensing and regulatory oversight to mortgage and finance brokers. My presentation on low doc lending in Perth in October 2006 made reference to the inordinate delays in the national process overseen by the Ministerial Council on Consumer Affairs responsible for delivering the promised broker legislation[18]. Another year on – and we are still waiting.

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[16] Laker, *Credit Standards in Housing Lending,* ibid, pages 2 and 10.

[17] I have not recently seen the St George Bank television advertisements regarding no deposit home loans, although this option remains prominent in the Bank's on-line marketing www.stgeorge.com.au/mortgage/home_loans. In the preparation of this paper I have not had time to look through the web-sites of other banks and mainstream lenders but would be surprised if a significant number were not providing similar options.

[18] As noted earlier the paper is available on Care's web-site www.carefcs.org. The paper relays that the Ministerial Council commenced its review of the regulatory options for mortgage and finance brokers in 2003, circulated a Regulatory Impact Statement in 2004 and had earlier made an online commitment to a completion date for the project of March 2006.

There has been considerable time and effort expended by many people across government, industry and consumer stakeholder groups to developing a quality package for broker regulation. Some of the stakeholders in those endeavours are here today. Their efforts have been and continue to be let down by political leadership that has simply not accorded the problems the priority they have so obviously demanded. Four years since the MCCA commenced its investigation into a self-evident problem, with industry itself being one of the loudest voices for reform, we still have no draft legislation[19]. One can only guess at the numbers of unsuspecting consumers impacted by a market that has produced some extraordinary 'cowboy' conduct in the intervening years.

Notwithstanding the delays in producing broker regulation, I would like to acknowledge the efforts of both the Mortgage Finance Association of Australia[20] and the Credit Ombudsman Service Limited[21] in significantly ramping up efforts to isolate and ultimately exclude those disinterested in proper conduct from the industry. In addition, the Australian Security and Investments Commission's very recent success in civil proceedings in the Federal Court exposing the conduct of an ACT mortgage broker and arising from referral from my colleague Amy Kilpatrick at the Consumer Law Centre, is also important confirmation of regulatory intent[22]. As encouraging and welcome as these additional activities are, they do not detract from the need for or the urgency of appropriate regulation.

Other broader options for reform and response

It is difficult to have a meaningful interaction regarding the range of options available when the central figures in any such discussion are yet to acknowledge the extent of the dangers. Governments in Australia, at all levels, are yet to fully appreciate or at least to openly acknowledge the potential calamity that runaway personal debt levels may be exposing Australia to. The home loan market is a sigificant contributor to those debt levels, which is not of itself as much of a concern as the relative proportion of household income now required to service the average mortgage.

The collective Departments of Treasury who have been the architects and chief promoters of dominant competition policy obviously have a stake in keeping markets roaring along. What is missing are a range of options, beyond simply the blunt instrument of monetary policy to ensure competition is producing safe, fair and sustainable outcomes. The mechanisms that might produce some sober self reflection on the part of the broader

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[19] The latest Joint Communique produced after the Ministerial Council on Consumer Affairs Meeting in Melbourne on 18 May 2007 reported:

> *Ministers today noted progress in the national regulation of finance and mortgage brokers. A consultation Bill will be publicly released later this year.*

[20] For example the MFAA has been a strong supporter of a cross-sectoral group fighting against predatory lending. Under its Constitution and Disciplinary processes the Association also has the power to suspend or expel members and has exercised those options on a number of occasions.

[21] See for example Credit Ombudsman Service Limited Media Release, *Credit Ombudsman Service means business,* Sydney, 28 February 2007.

[22] Australian Securities and Investments Commission v Skeers [2007] FCA 1551 (9 October 2007)

credit industry may not be overly complicated in design. Neither do they need to be seen as an end to commerce as we know it. To follow are two such examples:

- **A positive requirement to test needs and capacity**

One would imagine it is in the interests of borrowers and lenders alike for the provision of a credit facility to be informed by an assessment of the borrowers' needs and means. When credit is extended without regard to either, but particularly without making proper enquiry as to capacity to pay, really stupid things can occur. Some of highest profile examples of silly outcomes can be found in the credit card market and include offers of credit being made to deceased people, to children, even to pets. Financial counselling agencies, working predominantly with low income consumers, report a steady stream of cases in which even the most rudimentary consideration of the consumer's capacity would have shown paying back the amount being extended on cards would not have been possible or not without causing considerable hardship.

In November 2002 the ACT became the first jurisdiction in Australia to impose a positive requirement on credit providers to assess a consumer's financial capacity before extending new credit or increasing limits on existing credit card facilities[23]. This additional obligation has drawn considerable criticism from credit providers, in particular from the banking industry. At a level of principle however what the ACT reform sought to achieve should, in my view, be extended to all forms of consumer credit. Central to industry criticisms of the ACT initiative is the claim that consumers routinely misrepresent their financial circumstances, or selectively exclude important information that would produce an accurate picture of their income and expenses. It has always seemed an odd proposition that you would discourage the establishment of an effective and communicative relationship on the assumption that good communication is unlikely anyway.

Leaving aside the emotion of the debate that has ensued in credit card regulation, the net result of not checking a consumer's capacity to repay a homeloan facility invites a conclusion the credit provider's main focus is that the secured asset is sufficient to cover indebtedness should the borrower fail to meet repayment commitments. In other words, if low doc lending has become code for 'not making an active assessment of a consumer's capacity to pay', then it is in fact asset lending by another name.

It should be possible to design assessment steps for low doc loans differently to suit the different needs of the consumers this type of product is meant to assist. Collecting alternative documentation and tailoring assessments to individual circumstances is what low doc lending should encourage, rather than doing no real assessment at all or passing over the responsibility to self-assess to the borrowers themselves.

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[23] The change was made by amendment to the *ACT Fair Trading Act (1992)*, inserting a new provision – section 28A

A process exists under the Consumer Credit Code[24] to challenge lending on the basis of unconscionability. There are a number of criteria that the court may have regard to when considering whether the conduct has been unconscionable. Included in that list is a reference to the consumer's capacity to repay.

> *Uniform Consumer Credit Code s70(2)(l)*
> *"whether at the time the contract, mortgage or guarantee was entered into or changed, the credit provider knew, or could have ascertained by reasonable inquiry of the debtor at the time, that the debtor could not pay in accordance with its terms or not without substantial hardship"*

There are two immediate problems with the Credit Code approach:

a) The obligation to check capacity is not a positive one. There may be an implicit expectation that a diligent and prudent credit provider will have some sort of assessment process but nothing requiring such a process, or indicating what it should entail; and
b) It puts onus on the consumer to take action in reverse of the problem being delivered

In general terms, more progressive forms of consumer regulation globally, are imposing additional obligations on product and service providers to trade fairly and to design products and services that are inherently safe and fair. For example, in jurisdictions that have developed unfair contract terms legislation, offending terms can be removed or rewritten by Courts, usually on application by a Government Consumer Agency[25].

Imposing a requirement to assess repayment capacity should be central in a modern, safe and fair consumer credit market. That does not mean that the assessment processes would have to be exactly the same in all circumstances. But doing nothing at all and relying on borrowers themselves to self-assess, is an abrogation rather the fulfilment of a credit provider's responsibilities.

- **A national focus for credit regulation and policy**

The earlier discussion regarding failures on the part of the Ministerial Council to deliver reform for mortgage and finance brokers is an excellent example of apparent dysfunction in current power sharing relationships. The states and territories will always be important partners in ensuring local compliance with consumer protection legislation. Whether they are able to carry and give timely effect to policy and law reform functions seems less clear.

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[24] *Uniform Consumer Credit Code (1996)* sections 70-72
[25] In Australia, only Victoria has adopted unfair contract terms legislation. This legislation was enacted in 2003 by way of the addition of Part 2B to the *Fair Trading Act 1999 (VIC).* The Victorian legislation excludes credit contracts.

There is considerable dicussion emerging about the potential benefits in having a uniform national system for regulating credit. The House of Representatives Committee into Home Loan Lending observed:

> *Credit regulation has failed to keep pace with the rapidly evolving and growing credit market. The current regulatory framework is ineffective in dealing with the new practices that have emerged*[26]

In what was a low key and surprisingly cautious report, the Committee was very straightforward in its view of where ultimate responsibility for steering credit regulation should sit:

> *The Committee recommends that the Commonwealth Government regulate credit products and advice. This includes the regulation of mortgage brokers and non-bank lenders*[27].

Shortly after the Committee's report was released, NSW Fair Trading Minister Linda Burney expressed concern about an unjustified grab for power on the part of the Commonwealth[28]. Minister Burney noted:

> *Some time ago the States and Commonwealth agreed that action was needed to crack down on predatory lending. Now after the work has been done by the States, despite the bureaucratic obstacles imposed by the Commonwealth Government, they want to take it over – this is hypocrisy of the highest level...*[29]

Obviously there are considerable tensions that dominate state, territory and commonwealth relationships. For whatever reason however, the current system for response is too convoluted and slow. One would hope therefore full and proper consideration can be given to the potential benefits in developing a system better able to move with changing market dynamics and consumer needs. For its part the Australian Securities and Investments Commission appears to be indicating if it were asked it would be ready willing and able to add credit to its supervision of financial services and products[30].

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[26] House of Representatives Standing Committee on Economics, Finance and Public Administration, *Home loan lending,* ibid, paragrapg 5.71, page 47.
[27] House of Representatives, *Home loan lending,* ibid, paragraph 5.85, page 49.
[28] NSW Office of Fair Trading, *Media Release – Commonwealth seeks credit where it's not deserved,* Sydney, 17 September 2007.
[29] NSW Office of Fair Trading, *Media Release,* 17 September 2007, ibid.
[30] Australian Securities and Investments Commission, *Submission to the Productivity Commission Review of Australia's Consumer Policy Framework,* Melbourne, 10 August 2007. See in particular page 2 of the cover letter from ASIC Deputy Chairman Jeremy Cooper:

> *ASIC's financial services consumer protection experience highlights that consumers' credit experiences contribute significantly to their view of, and confidence in, the financial services sector as a whole. This suggests the need to see credit within the broader framework of financial services regulation, rather than as something apart from it.*

Conclusion

Low doc loans were originally developed to meet specific needs and to overcome exclusion within niche consumer markets. Small business people in particular required more flexibility from financial institutions in deciding what and how information would be gathered to determine suitability for ordinary credit facilities like home loans. To the extent low doc loans provide an opportunity to access affordable credit on safe, fair and appropriate terms, like any lateral response to exclusion they can be beneficial.

Taking a broader view of the home lending landscape in the last two to three years, there is considerable evidence that low doc loans have become the lending vehicle of choice for credit providers seeking to establish, maintain or win back market share and minimise costs. With the growth in low doc lending initially boosted by non-bank, non-deposit taking credit providers, mainstream institutions have developed their own extensive range of product options. As low doc lending has increased as a proportion of overall market activity, so have other ‘riskier’ forms of credit provision in the form of no documentation and sub-prime offerings.

Coupled with record levels of personal debt and the increasing incidence of financial stress amongst ordinary Australian households in the mortgage belt, the boom conditions in the home lending market cannot be assumed to be self-sustaining. Many consumers already experiencing hardship as a result of loans that take them to the limit of payment capacity and beyond may be the unwitting victims of credit provision that has forgotten, or not been required to do the basics properly.