ASIC

Australian Securities & Investments Commission

REPORT 445

Review of interest-only home loans

August 2015

About this report

This report is for holders of Australian credit licences (credit licensees) and highlights the importance of responsible lending practices for interest-only home loans.

It is intended to help credit licensees improve their lending practices by increasing their awareness of their obligations and identifying opportunities for them to improve their practices.

The information gathered through our review has helped inform our strategic response, which is aimed at minimising any potential detrimental impact of interest-only home lending on consumers.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

Contents

Executive summary

1 This report sets out ASIC's findings from a review of home loans with an interest-only period during the initial part of the loan (interest-only home loans). The review looked at the practices of 11 lenders who offer interest-only home loans.

2 The review found examples of practices that place lenders at risk of breaching responsible lending obligations. The report details these findings and sets out a number of actions that Australian credit licensees (credit licensees) should take.

3 All 11 lenders that were included in this review have agreed to implement the actions set out in this report.

Background

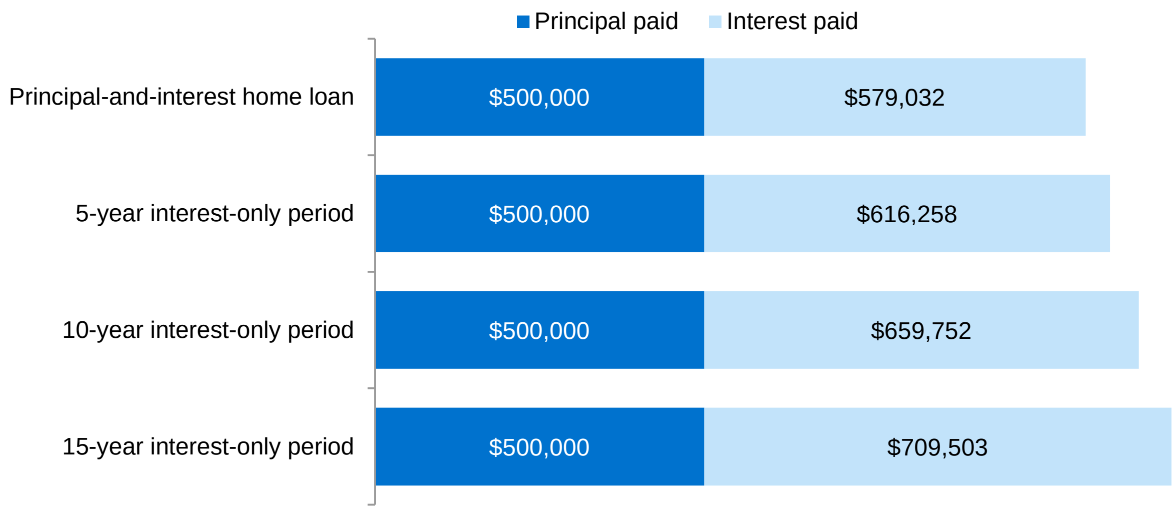
4 Home loans are a key financial product through which many Australians purchase one of the most significant assets they will own. Lending practices in relation to home loans are therefore of critical importance to the financial well-being of Australian consumers. Addressing poor lending practices helps ASIC promote investor and financial consumer trust and confidence, which is one of our strategic priorities.

5 Interest-only home loans have grown substantially since 2012. In the December 2014 quarter, the total value of new interest-only home loans issued by banks, credit unions and building societies expanded to $40.1 billion. Interest-only home loans accounted for 43% of all new home loans issued in that quarter. In the March 2015 quarter, interest-only home lending had increased almost 20% from the previous year, and made up around 42% of all new home loans issued in that quarter.

6 In the current environment of low interest rates and strong demand for housing, it is important that credit licensees make robust assessments of the capacity of consumers to make the required repayments, with appropriate buffers in place to account for higher interest rates in the future. It is also important that the length of an interest-only period of a loan is suitable for the consumer in both the short and long term.

7 A key difference between interest-only and principal-and-interest home loans is their overall cost, with interest-only home loans being more expensive in the long term: see Figure 1. The use of an interest-only home loan means that a consumer is in practice trading the benefit of lower repayments during the initial interest-only period (including the possible alternative use of money saved in this way) for a higher total cost.

Figure 1: Comparison of interest payments on principal-and-interest and interest-only home loans[1]



Source: Based on a $500,000 home loan over 30 years. Assumes constant interest rate of 6%. Monthly repayment figures determined using the MoneySmart mortgage calculator. Interest is calculated by compounding on the same frequency as the repayment (monthly).

8 In July 2010 the *National Consumer Credit Protection Act 2009* (National Credit Act) introduced responsible lending obligations for lenders and credit assistance providers. Among the responsible lending obligations is the requirement for lenders and credit assistance providers to make reasonable inquiries and verifications to assess whether a contract would be unsuitable for a consumer.

9 These obligations commenced on 1 July 2010 for credit assistance providers and credit providers that are not authorised deposit-taking institutions (ADIs) or registrable corporations, and on 1 January 2011 for all other credit providers and credit assistance providers. We have issued guidance in Regulatory Guide 209 *Credit licensing: Responsible lending conduct* (RG 209), and continue to monitor lending practices and take regulatory action where non-compliance has been observed.

Purpose of ASIC's review

10 The purpose of our review was to improve responsible lending standards, for both interest-only home loans and consumer loans more generally, by highlighting issues with current practices observed across a sample of lenders.

11 While consumers may generally be well placed to meet their repayments on an interest-only home loan in the current environment, they may find it challenging when market conditions change, which is inevitable over the full term of a home loan. The Reserve Bank of Australia (RBA) has noted that

[1] All graphs in this report are based on data collected in our survey, unless otherwise noted.

the recent decline in home loan interest rates can be expected to boost demand for housing further, and will also make it easier for existing borrowers to service their debts.[2] The RBA also found that indicators of household stress are currently at low levels, but that they could increase if labour market conditions weaken further than currently envisaged.[3]

12 Accurately assessing a consumer's ability to service and ultimately to repay a loan without hardship, including under periods of economic stress, is an inherent component of sound credit risk management, particularly for home loans.[4] The Australian Prudential Regulation Authority (APRA) announced on 9 December 2014 that it had written to all ADIs to set out plans for a heightened level of supervisory oversight on home lending for the period ahead.[5] This message was emphasised by the Chairman of APRA in a recent speech.[6]

13 We monitor lenders' compliance with the responsible lending obligations under the National Credit Act when providing home loans regulated by that Act. These obligations require lenders to offer credit products only when the consumer can meet the repayments without substantial hardship and the proposed product meets their requirements and objectives. Under the National Credit Act, credit licensees must:

(a) make reasonable inquiries about a consumer's requirements and objectives;

(b) make reasonable inquiries about a consumer's financial situation; and

(c) take reasonable steps to verify the consumer's financial situation.

When we observe non-compliance with responsible lending, we will take regulatory action.

14 Against this background, we commenced a detailed review of the interest-only home lending market to assess compliance with the responsible lending obligations. The review complements action taken by other regulators.

15 The review involved two aspects:

(a) We collected data on the market for interest-only home loans for the last three years—2012, 2013 and 2014—from 11 lenders, broken down by criteria such as consumer demographics, loan-to-valuation ratios (LVRs) and distribution channels.

(b) Concurrently, we also conducted a thorough review of over 140 individual interest-only home loan files from the same 11 lenders.

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[2] RBA, *Financial Stability Review* (PDF, 1.2M), March 2015, p. 2.
[3] RBA, *Financial Stability Review* (PDF, 1.2M), March 2015, p. 39.
[4] Prudential Practice Guide APG 223 *Residential mortgage lending*. See also Financial Stability Board, *FSB Principles for Sound Residential Mortgage Underwriting Practices* (PDF, 79.14Kb), April 2012.
[5] APRA, *APRA outlines further steps to reinforce sound residential mortgage lending practices*, Media Release No. 14.30, 9 December 2014.
[6] W Byres, 'Sound lending standards and adequate capital: preconditions for long-term success', speech to COBA CEO and Director Forum, Sydney, 13 May 2015.

16 Further information about the methodology of this review is detailed in the appendix.

17 Addressing poor responsible lending practices will reduce the risk of excessive or unnecessary defaults by consumers in the home lending market, and will result in consumers obtaining a home loan product that is more likely to meet their needs.

Data review findings

18 We conducted a review for the three-year period 2012–14 of 11 lenders. The review provided data on the market for interest-only home loans, including analysis of the types of consumers who use these loans. Differences observed in the data between interest-only and principal-and-interest home loans for an individual lender, or between different lenders, can give an indication of areas warranting further exploration or assessment.

19 Our key findings from the data review were:

(a) The majority of interest-only home loans were extended to investors; however, a substantial proportion of interest-only home loan approvals (41% in the December 2014 quarter) were for owner-occupiers.[7]

(b) A greater proportion of the total number of interest-only home loans was sold through third-party or broker channels, compared to direct channels (see Figure 6).

(c) The average value of interest-only home loans was substantially higher than principal-and-interest home loans for both owner-occupiers and investors (see Figure 7), and this was especially so for loans provided through direct channels in comparison with third-party channels.

(d) Overall, there was a smaller proportion of interest-only home loans in higher LVR categories when compared to principal-and-interest home loans (see Figure 10).

(e) A diverse group of consumers tended to take out interest-only home loans. In general, interest-only home loans were more popular with consumers who earned more money, but a substantial proportion (29%) of owner-occupiers with interest-only home loans earned less than $100,000 (see Figure 11).

(f) Consumers with interest-only home loans were, on average, further ahead in reducing the balance of their loan when including funds held in offset accounts related to the home loan, than those with principal-and-interest home loans.

[7] This is consistent with data collected by APRA from all ADIs.

Key findings—Responsible lending

20 Our review identified some practices where lenders may be at risk of not complying with their responsible lending obligations. In particular, we found that:

(a) in 40% of the files reviewed, the affordability calculations assumed the borrower had longer to repay the principal on the loan than they actually did (by using the full term of the loan to calculate principal repayments, rather than the residual term);

(b) in over 30% of files reviewed, there was no evidence that the lender had considered whether the interest-only home loan met the borrower's requirements; and

(c) in over 20% of files reviewed, lenders had not considered the borrower's actual living expenses when approving the loan, but relied instead on expense benchmarks.

21 Sections B–G of this report detail the practices we reviewed and our assessment of how they meet the responsible lending obligations under the National Credit Act, and set out our key findings in this area.

22 We identify where lenders may be at risk of not complying with their obligations and suggest various actions lenders should take, including more robust compliance processes. RG 209 sets out our expectations about the procedures lenders should have in place to ensure they are complying with the responsible lending obligations.

23 The findings in Sections B–G relate to both the data provided in response to our survey and the file reviews we conducted. The case studies are based on examples of lender conduct identified through the file reviews.

24 In relation to the obligation to make reasonable inquiries about a consumer's requirements and objectives, our key findings were that:

(a) only a few lenders had procedures to consistently identify and record the consumer's requirements and objectives; and

(b) even where the consumer's requirements and objectives were recorded, the stated analysis could be inadequate to explain why a loan on the terms provided was suitable for the consumer.

25 For example, we reviewed numerous files where the stated requirement or objective of the consumer was 'to purchase a property', with no information stating the reason an interest-only home loan had been selected. Statements of this type do not support the decision to provide an interest-only home loan rather than another type of loan, and are inadequate as they suggest that the consumer did not have any requirements or objectives for the loan itself or the features or terms on which it was offered.

26 Credit licensees also have an obligation to ensure the consumer can afford repayments under a proposed loan. The obligation requires credit licensees to understand the consumer's individual financial situation, particularly their income and expenditure. We found that lenders were using the following practices (which, in our view, makes it unlikely they were complying with their obligations):

(a) *Relying on an expenditure benchmark*—Some lenders relied on a benchmark rather than conducting inquiries into the consumer's actual expenses.

(b) *Ignoring information provided by the consumer*—Three lenders stated that they always used an expenditure benchmark when assessing the consumer's ability to service the loan, even when the consumer's declared expenses were higher than the benchmark.

(c) *Requesting information about expenses in a way that was simplistic or ambiguous*—Some lenders asked consumers to state their expenses as a lump sum, or to only state their basic expenses, without any explanation as to what was meant by 'basic'. We consider these approaches may result in lenders not obtaining accurate information.

27 In general, we consider that the obligation to make reasonable inquiries is scalable. What a credit licensee needs to do to meet these obligations for a particular consumer will vary depending on the circumstances. We would expect that credit licensees would make many, if not all, of the inquiries in RG 209.33, as entering into an unsuitable home loan can have a potentially large negative financial impact on a consumer.

28 More extensive inquiries are likely to be necessary if the potential negative impact of an unsuitable credit contact is likely to be relatively serious for the consumer. This would include situations where the consumer's income is relatively low, and they would therefore have a more limited capacity to change their spending patterns than consumers on higher incomes, or where the size of a loan is large relative to the consumer's income.

29 We also found that lenders had poor and inconsistent practices for recording inquiries into the consumer's requirements, objectives and financial situation. Where lenders do not have appropriate processes in place to capture this information, it can be difficult for them to show that they are in fact meeting their responsible lending obligations: see RG 209.38.

Recommended actions and lender responses

30 We were disappointed to observe that the practices of many lenders appeared to fall short of our expectations, which are detailed in RG 209 and previous responsible lending reports.

31 Table 1 sets out our key findings and suggests actions credit licensees should take to reduce their risk of non-compliance with the responsible lending obligations. During the course of this review, all lenders advised us that they intend to change, or have already commenced the process of changing, their practices in this area. For example:

(a) all lenders (in addition to the four who already use this method) have committed to move to assessing interest-only home loans using the ‘residual term’ method of calculating repayments;[8]

(b) all lenders (in addition to the one who introduced this practice in December 2014) have committed to moving to use an income-adjusted benchmark when considering a consumer’s expenses; and

(c) most lenders who offered longer interest-only periods have committed to reducing the maximum interest-only period offered to owner-occupiers to five years.

32 While these actions result from our review of interest-only home loans, some will have a broader application to other credit products, where they address practices that are not specific to interest-only home loans. All lenders and brokers should consider the extent to which these actions are relevant to their practices and conduct, to ensure they are compliant with RG 209.

[8] See paragraph 247(a) for an explanation of the ‘residual term’ method.

Table 1: Responsible lending key findings and actions

Section	Finding	Action
B	**Finding 1: Lack of evidence of inquiries into requirements and objectives** Nearly all lenders in our review did not keep sufficient evidence of inquiries into consumer's requirements and objectives when entering an interest-only home loan. While requirements and objectives for an interest-only home loan may be more apparent for investors, it is not always clear how an interest-only home loan meets the requirements of an owner-occupier.	**Action 1** To comply with responsible lending obligations, lenders should ensure that they make reasonable inquiries into a consumer's requirements and objectives and document the result of these inquiries. For interest-only home loans, lenders should consider whether specific features, benefits and costs associated with the loan (including, when refinancing a loan, the benefits and costs of the new loan) meet the consumer's objectives. **Action 2** To comply with responsible lending obligations, lenders should ensure that the period of interest-only repayments offered on a proposed loan is aligned with the particular consumer's requirements and objectives. We encourage lenders to review their policies regarding the maximum length of interest-only periods offered, particularly to owner-occupiers. Interest-only periods greater than five years for owner-occupiers will be at high risk of non-compliance with the responsible lending obligations unless there is clear demonstration that the length of the interest-only period is aligned with that particular consumer's requirements and objectives.
C	**Finding 2: Affordability and interest-only home loans** Lenders did not always ensure that the consumer had sufficient income (i.e. an appropriate income surplus) above their expenses and loan repayments, so that they could withstand a reasonable fluctuation in income or expenses or an interest rate rise. There was substantial variation in how lenders applied interest rate buffers. Some lenders applied a buffer to the proposed loan only and not to existing debt that may also be affected by interest rate rises.	**Action 3** To comply with their responsible lending obligations, lenders should ensure adequate policies and processes are in place to assess a consumer's ability to meet their financial obligations under the credit contract, including reasonable consideration of the effect of future interest rate rises on the proposed credit contract and existing credit contracts.

Section	Finding	Action
D	**Finding 3: Variation in treatment of volatile and irregular income** There is variation between how lenders treat volatile and irregular income sources. We found examples in the file reviews of the higher income figure being used for serviceability assessments where there was a substantial difference between previous years' incomes. Rental income is typically discounted by 20% to allow for property expenses and periods of non-occupancy. However, we saw examples in the file reviews where the property-related expenses would likely be greater than 20% of rental income.	**Action 4** Where consumers have uncertain, volatile or irregular income, lenders should: • review their policies for how they assess volatile or irregular income sources to ensure they meet the responsible lending obligations and ensure prudent credit risk management; • appropriately discount or disregard high or volatile income where there is uncertainty that the income would be likely to continue at the same level; • for rental income, ensure the level of discounting is sufficient to allow for property expenses, including maintenance, strata fees, managing agent fees and periods of non-occupancy; and • where they have a policy of using a negative gearing benefit in serviceability calculations, ensure it is consistent with the inquiry and verification obligations under the National Credit Act, taking into account that individual consumer's income, financial circumstances and objectives. To demonstrate compliance with the responsible lending obligations, lenders should record the inquiries they make and the basis on which they have adopted the relevant income figure to assess a consumer's capacity to meet their financial obligations under the credit contract.

Section	Finding	Action
E	**Finding 4: Lack of evidence of inquiries into expenses and reliance on benchmarks** We found that, in general, lenders did not demonstrate that they had made sufficient inquiries into a consumer's expenses and relied heavily on expense benchmarks to estimate living expenses. Expense benchmarks are not a replacement for proper inquiries into a consumer's actual expenses.	**Action 5** Lenders must make reasonable inquiries into a consumer's actual expenses, including both fixed expenses (such as rent, repayment of existing debts and child support, and recurring expenses such as insurance) and living expenses (such as food and utilities). Lenders must also take reasonable steps to verify the information obtained. To demonstrate that they have met their responsible lending obligations, lenders must document the inquiries and verification undertaken. **Action 6** Where lenders rely on benchmarks to verify a consumer's living expenses, lenders can reduce their risk of non-compliance with the responsible lending obligations by using income-adjusted benchmarks (reflecting the reality that higher-income consumers generally have higher living expenses). If a consumer's actual living expenses are higher than the benchmark, lenders must not use the lower benchmark figure in the serviceability calculation unless there are reasonable (and documented) grounds for doing so. **Action 7** Lenders should take reasonable steps to verify the amount of existing debt and the repayment amounts that the consumer is committed to. **Action 8** Lenders should take steps to identify inconsistencies in information provided by consumers and make further inquiries to accurately assess the affordability of the proposed loan. The outcome of any additional steps taken should be documented.

Section	Finding	Action
F	**Finding 5: Capacity to pay after interest-only period not based on residual-term payments** A number of lenders calculated affordability using repayments that are artificially low, as they are based on principal-and-interest repayments being made over the full term of the loan, rather than the residual term remaining after the interest-only period. This practice increases the risk to borrowers with longer interest-only periods.	**Action 9** Lenders should review their methodology for assessing the affordability of interest-only home loans to ensure it complies with the responsible lending obligations. Lenders should assess a consumer's capacity to make the principal-and-interest repayments over the residual term of the loan (after the interest-only period lapses), as this will better reflect a consumer's ability to meet their financial obligations under an interest-only home loan.
G	**Finding 6: Lack of flexibility for hardship variations for interest-only home loans** We found that financial hardship policies for most lenders did not distinguish between interest-only and principal-and-interest home loans. However, a small number of lenders applied more restrictive options for borrowers seeking hardship variations under an interest-only home loan.	**Action 10** Lenders should: • review their systems, policies and processes for hardship variations for interest-only home loans; • have a variety of options available to consumers who are in financial hardship; and • assess the most appropriate outcome of a hardship application on a case-by-case basis.

Note: All lenders in this review have agreed to implement these actions.

Lessons for consumers

33 Consumers should carefully consider whether an interest-only home loan is suitable for them and assess whether they will be able to comfortably meet the higher repayments once the loan reverts to principal-and-interest repayments. When considering their requirements and objectives, consumers should take into account that, in the long term, they will pay more interest under an interest-only home loan.

34 Consumers may take out interest-only home loans to take advantage of the flexibility around repayments. However, overconfidence bias (see paragraph 111(b)) may result in consumers overestimating their own future behaviour and likelihood of making additional repayments. In light of this, consumers may wish to consider whether a principal-and-interest home loan would better suit their objectives.

35 When refinancing, consumers should specifically consider the benefits of the new loan in comparison to the old loan, such as savings in cost. If refinancing from one interest-only home loan to a new interest-only home loan, a consumer should consider the effect of the cumulative period of interest-only repayments on their level of equity in the relevant property, and the higher amount of interest that will be paid under an interest-only home loan.

Our further work

36 We identified a number of areas where the surveyed lenders may not have been complying with their statutory responsible lending obligations. We are currently undertaking further surveillance, enforcement and other regulatory action in these areas, which will be made public at a later date.

37 While all of the 11 surveyed lenders have either made or committed to making changes to their procedures, we are concerned that other lenders may have practices with similar shortcomings, and are therefore failing to meet the responsible lending obligations.

38 We expect all lenders to review their procedures in light of our findings to ensure they are meeting their obligations. RG 209 and our other work in this area has set out clear guidance and we consider that lenders have had ample opportunity to ensure their practices are compliant.

39 Where we identify breaches of the law, we will consider enforcement action or other appropriate regulatory action.

40 We have updated our consumer information on our MoneySmart website (moneysmart.gov.au) to help consumers make decisions about their home loan and highlight important things to consider when deciding between interest-only and principal-and-interest home loans.

41 We will continue to monitor and assess lending standards of licensees and compliance with the responsible lending obligations more generally (in addition to interest-only home loans). We will also continue to work with other members of the Council of Financial Regulators in the area of home lending.

A Interest-only home lending environment

Key points

This section sets out the regulatory framework that applies to interest-only home loans. It reports findings on the industry profile and trends in interest-only home lending that have been formed from analysis of our survey.[9] This survey data complements data from APRA on the growth of interest-only home loans, and provides information about this lending at a more granular level.

There has been substantial growth (by number and value) of interest-only home loans approved for both investors and owner-occupiers. The total value of new interest-only home loans approved by ADIs accounted for around 42% of all new home loans issued in the March 2015 quarter.

The majority of interest-only home loans are extended to investors; however, a substantial proportion of interest-only home loans (41% of the total number of new loans approved in the December 2014 quarter) are with owner-occupiers.

A greater proportion of the total number of interest-only home loans is sold through third-party channels, compared to direct channels.

The average value of interest-only home loan amounts is substantially higher than that for principal-and-interest home loans for both owner-occupiers and investors. The extent of the differential is greater through direct channels than third-party channels.

Overall, there were a smaller proportion of interest-only home loans in higher LVR categories when compared to principal-and-interest home loans.

The demographics of consumers taking out interest-only home loans are diverse. Consumers' motivations concentrate around flexibility of repayment and taxation treatment for investment, but may also be influenced by behavioural factors.

The regulatory framework

Regulatory bodies

42 A number of regulatory bodies are responsible for the regulation of the home lending industry. These bodies work together to maintain appropriate lending standards relating to home lending.

[9] For further information on the survey methodology, see the appendix.

RBA

43 The RBA is responsible for the stability of the Australian financial system. It is also responsible for monetary policy, which involves setting the cash rate to meet an agreed medium-term inflation target. It regularly provides public commentary on the state of the economy and on factors affecting financial stability, including those in the home lending sector.

APRA

44 APRA is responsible for the prudential regulation of banks, credit unions, building societies, insurers and superannuation entities. It establishes and enforces prudential standards to ensure that financial promises made by institutions are met. In the home lending sector, this includes reviewing lenders' home loan approval standards, as well as developing guidelines for prudent lending practice. APRA sets out its expectations on sound risk management practices for home lending in Prudential Practice Guide APG 223 *Residential mortgage lending*.

45 APRA announced on 9 December 2014 that it had written to all ADIs to set out plans for a heightened level of supervisory oversight on mortgage lending for the period ahead. This message was emphasised by the Chairman of APRA in a recent speech.[10]

ASIC

46 We are the primary conduct regulator for markets, financial services and consumer credit. This entails ensuring industry compliance with the consumer protection provisions of the *Australian Securities and Investments Commission Act 2001*, which prohibit misleading and unconscionable conduct, as well as the more specific licensing and responsible lending obligations for lenders and mortgage brokers under the National Credit Act.

National Credit Act

47 The National Credit Act commenced in 2010 and introduced licensing requirements, general conduct obligations and responsible lending obligations for both lenders and mortgage brokers. The introduction of these credit reforms led to improvements in industry practice.

48 We have published specific guidance for industry regarding our expectations about compliance with the responsible lending obligations: see RG 209.

49 The responsible lending obligations require credit licensees to ensure that consumers:

(a) do not enter loans that do not meet their requirements and objectives; or

[10] W Byres, 'Sound lending standards and adequate capital: preconditions for long-term success', speech to COBA CEO and Director Forum, Sydney, 13 May 2015.

(b) could not meet their repayment obligations, or could only meet them with substantial hardship.

50 In doing this, credit licensees must make reasonable inquiries into an individual consumer's specific circumstances and take reasonable steps to verify their financial situation before making an assessment about their capacity to repay the loan.

51 We continue to monitor responsible lending practices across the credit industry, including in relation to home loans.

Industry profile

Overview of interest-only home loans

52 Interest-only home loans are offered by many ADI lenders and non-ADI lenders to purchase property, to refinance a home loan or for investment purposes secured against property. An interest-only home loan is a loan where, for a set term, the consumer is only required to pay the interest on the principal balance, with the principal amount remaining constant. The principal will only reduce during the interest-only period of the loan term if the borrower chooses to make repayments above the required minimum.

53 An interest-only home loan will normally revert to principal-and-interest repayments at the expiry of the interest-only period. Practically this means that the borrower will either:

(a) increase their repayments to pay off the principal over the residual term;

(b) repay the loan in full; or

(c) refinance the loan (which may include entering another interest-only home loan).

54 The structure of these loans means that, for a given loan size and interest rate, repayment amounts are initially lower on an interest-only home loan than on a principal-and-interest home loan. However, after the interest-only period ends, the repayment amount will increase in order to repay the principal over the residual term.

55 In the current interest rate environment, the difference between an interest-only repayment and a principal-and-interest repayment is substantial. With low interest rates, loan repayments are minimised through the use of interest-only home loans, but if a consumer does not make additional repayments, or use an offset account, the amount paid over the long term will be greater.

56 Interest-only home loans can be combined with an offset account. Consumers may use this account to make additional repayments that may have otherwise been made to a principal-and-interest home loan. Although

many loans will offer a redraw facility, consumers may prefer to use an offset account to make those funds available for another purpose while still reducing the interest payable on the loan.

57 As described at paragraphs 106–113, there are a variety of reasons that consumers, both investors and owner-occupiers, may choose to take out interest-only home loans.

Growth in lending

58 Over the past three years, the value of new home loans approved by banks, credit unions and building societies per quarter has increased by more than 40% in Australia—from $58.4 billion in the March 2012 quarter to $82.3 billion in the March 2015 quarter.[11] In the March 2015 quarter, around 63% of new home loans (by value) were for owner-occupiers, and around 37% were for investors.

Growth of interest-only home loans

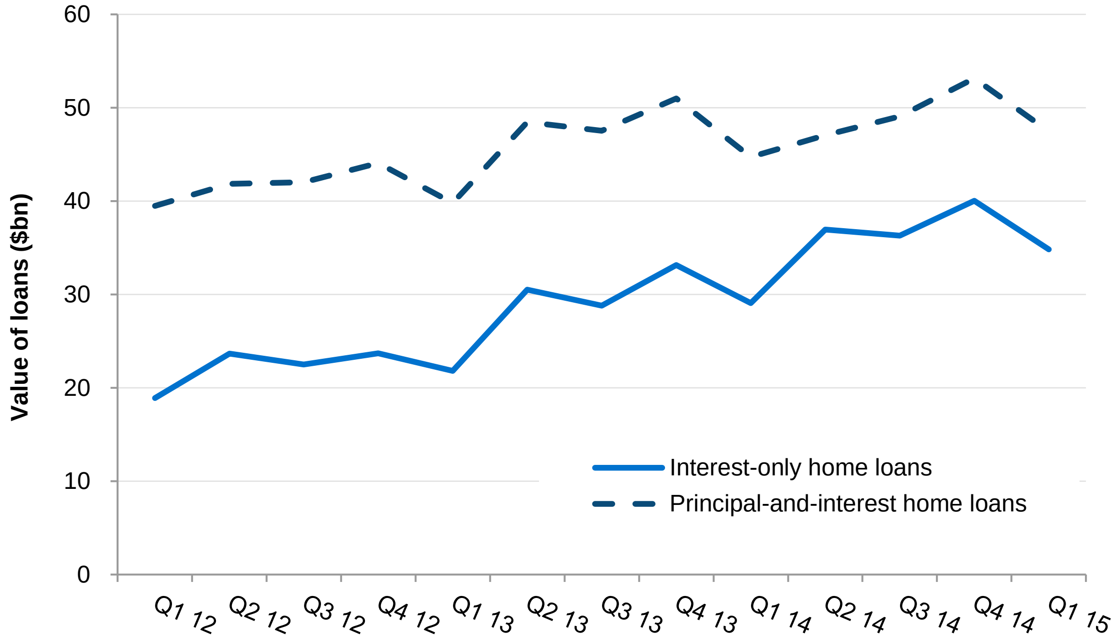
59 The value of new interest-only home loans approved by banks, credit unions and building societies expanded by about 10% from the previous quarter (to $40.1 billion) in the December 2014 quarter. Data collected by APRA shows that new interest-only home loans accounted for around 43% of all home loans issued in that quarter, which was the highest rate recorded to date.[12]

60 In the March 2015 quarter, interest-only home lending for ADIs had increased almost 20% from the equivalent quarter in 2014, and made up around 42% of all new home loans issued in that period.[13] By value, interest-only home lending forms about 37% of housing debt (as at March 2015).[14]

61 There has been substantial growth in interest-only home lending since 2012. Data collected by APRA shows that the value of interest-only home loans approved by ADIs increased by about 84% from the March 2012 quarter ($18.9 billion) to the March 2015 quarter ($34.8 billion). In comparison, principal-and-interest home lending increased by about 20% over the same period: see Figure 2.[15]

[11] APRA, *Quarterly authorised deposit-taking institution property exposures: March 2015* (Excel file, 362kb), statistics, 26 May 2015, Tab 1c.
[12] APRA, *Quarterly authorised deposit-taking institution property exposures: December 2014*, statistics, 24 February 2015.
[13] APRA, *Quarterly authorised deposit-taking institution property exposures: March 2015* (Excel file, 362kb), statistics, 26 May 2015, Tab 1c.
[14] APRA, *Quarterly authorised deposit-taking institution property exposures: March 2015* (PDF file, 695kb), statistics, 26 May 2015, p. 7.
[15] APRA, *Quarterly authorised deposit-taking institution property exposures: March 2015* (Excel file, 362kb), statistics, 26 May 2015, Tab 1c.

Figure 2: Growth in interest-only home loans amongst ADI lenders—2012–15 (new loans approved)



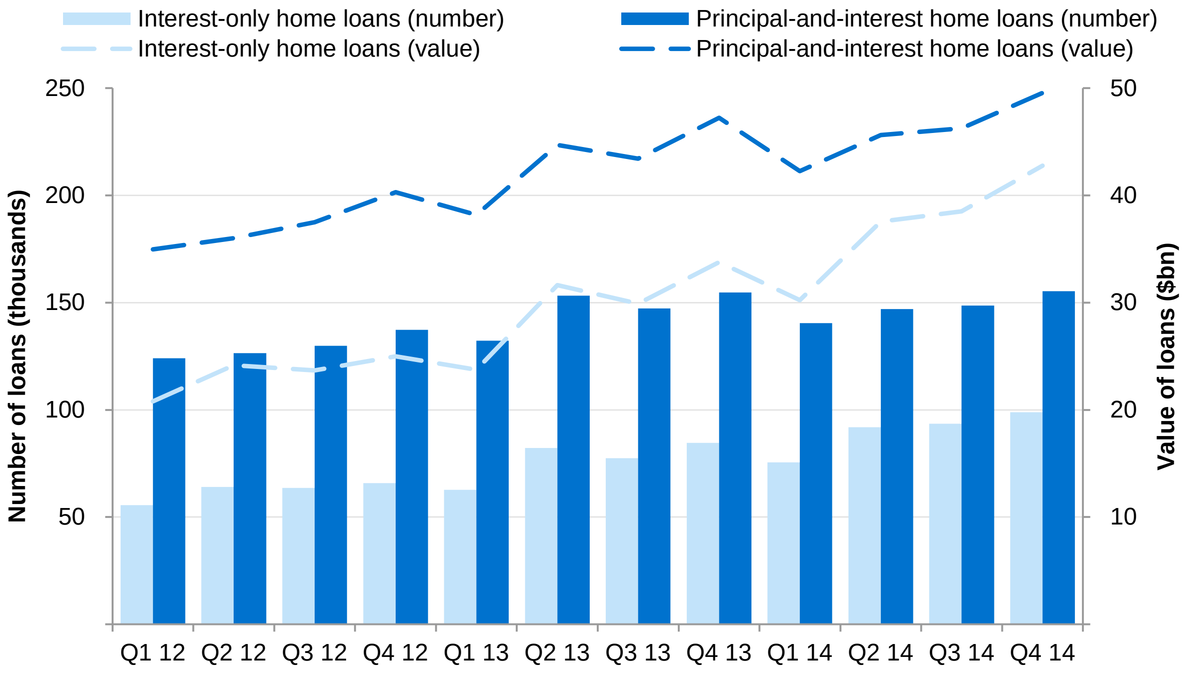
Source: APRA, *Quarterly authorised deposit-taking institution property exposures: March 2015* (Excel file, 362kb), Tab 1c.

62 In comparison, across the 11 lenders we surveyed:

(a) the number of interest-only home loans approved has increased more than 78% since 2012, while the number of principal-and-interest home loans has increased by 25% for the same period; and

(b) interest-only home loans approved in the December 2014 quarter accounted for more than 46% of the total value of new home loans, up from 37% in the March 2012 quarter.

Figure 3: Growth in number and value of interest-only and principal-and-interest home loans—2012–14 (new loans approved)

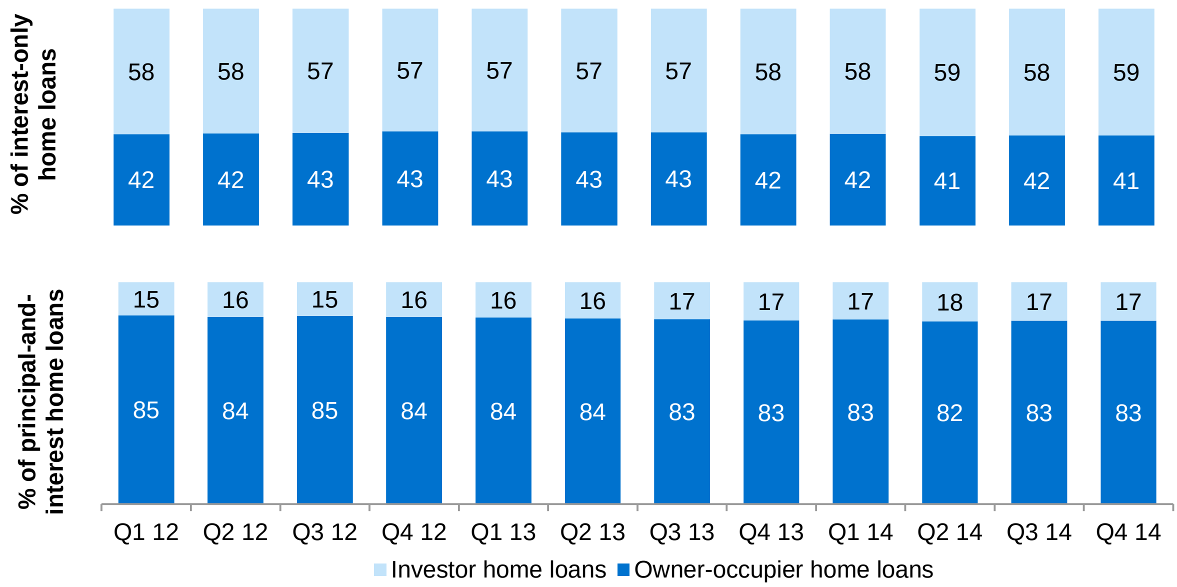


Owner-occupiers and investors

63 While the majority of interest-only home loans are extended to investors, interest-only home loans have become increasingly popular with owner-occupiers. While interest-only borrowing by investors may primarily reflect wealth-building strategies, including the tax-deductible status of interest payments for investment loans, the drivers of the strong growth for owner-occupiers are less clear.

64 Data from our survey shows, however, that the proportion (by number) of interest-only home loans approved for investors and owner-occupiers was relatively stable during 2012–14: see Figure 4. This shows that growth by number of interest-only home loans is broadly similar for both types of consumers.

Figure 4: Proportion of interest-only and principal-and-interest home loans held by owner-occupiers and investors—2012–14 (new loans approved)[16]



Lines of credit

65 A line of credit is a type of credit facility offered by some lenders. A line of credit differs from a conventional home loan in that the borrower does not draw down the whole principal amount initially, but uses the line of credit to borrow amounts up to the agreed credit limit, similar to a credit card. Interest is added to the loan each month and generally the consumer is only required to make minimum interest-only repayments on the credit used.

[16] We note that there were some data quality issues in the way that some lenders recorded owner-occupier and investor loans. However, we expect that the broad trends would not be affected substantially.

66 The borrower may at any time elect to make a repayment of any amount up to the total amount outstanding. Lines of credit can allow consumers to use a single account to combine their home loan and everyday spending.

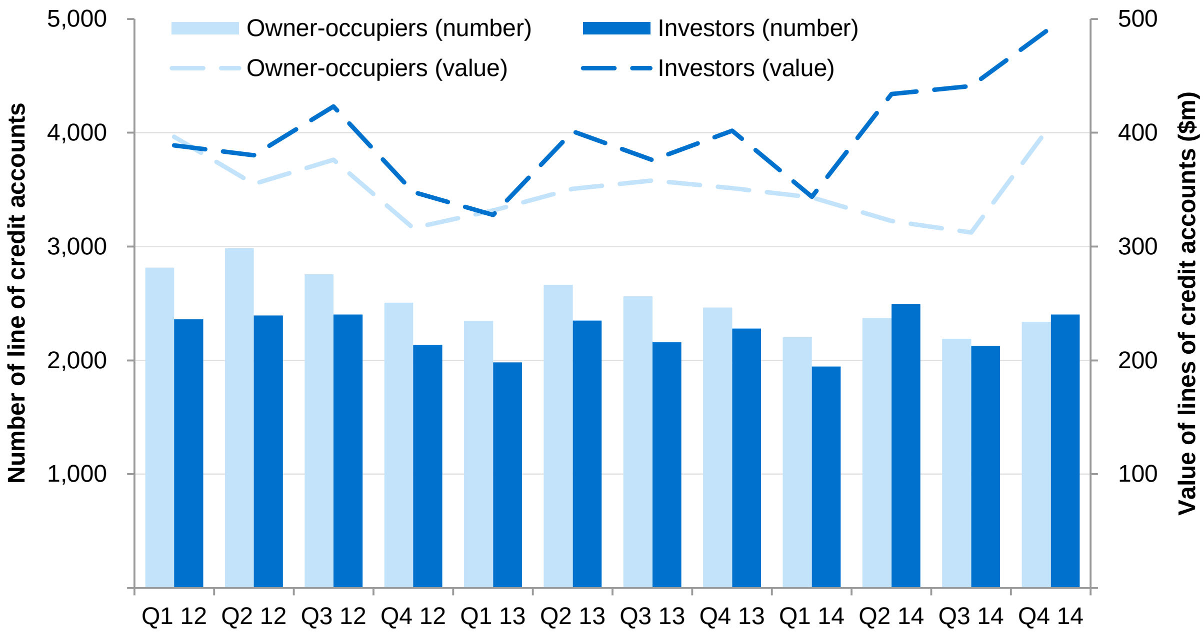
67 Some lenders reported to us anecdotally that interest-only home loans were increasing due to consumers moving from the higher cost lines of credit into the cheaper alternative of interest-only home loans. In effect, borrowers are able to manage their finances in the same way as a line of credit, by utilising an interest-only home loan combined with an offset account.

68 While there has been a reduction in the number of line of credit accounts being approved by the surveyed lenders, this has mostly occurred for owner-occupiers. Additionally, the decrease in owner-occupier line of credit accounts (as a proportion of all approved home loans) has been smaller than the increase in interest-only home loans for owner-occupiers over the same period. Lines of credit for investors have remained largely stable in account numbers, and have increased in value: see Figure 5.

69 While the number of new line of credit account approvals for both owner-occupiers and investors appear to have fluctuated somewhat each quarter during 2012–14, this may be driven somewhat by seasonality.

70 Additionally, we note that the value of new investor line of credit accounts per quarter increased over 2014 from $400 million to $490 million (an increase of more than 20%).

Figure 5: Number and value of new line of credit accounts approved for owner-occupiers and investors—2012–14



Note: This graph is based on nine of the lenders we surveyed. Two of the lenders did not appear to issue line of credit accounts.

Current state of the interest-only home loan market

Sales channels

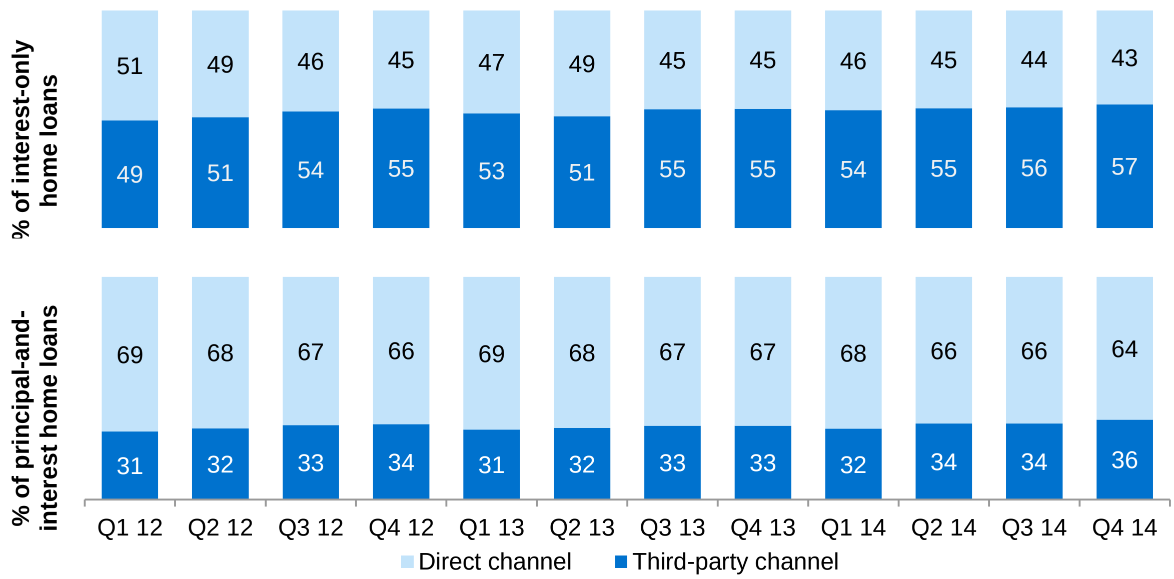
71 Across the surveyed lenders, we found that a greater proportion of interest-only home loans (by number) were sold through third-party channels, compared to direct channels. This indicates that brokers may be one driver of the increase of interest-only home loans.

72 We found that for the surveyed lenders:

(a) in the December 2014 quarter, 57% of the total number of interest-only home loans were sold through third-party channels (up from 49% in the March 2012 quarter); and

(b) approximately a third of all principal-and-interest home loans were sold through third-party channels, with the majority of loans (64%) sold through direct channels in the December 2014 quarter (see Figure 6).

Figure 6: Proportion of new interest-only and principal-and-interest home loans sold through direct and third-party channels—2012–14



Note: One lender did not offer third-party home loans. Another lender's data for third-party home loans is only available for 2014.

Remuneration and incentives

73 While a high proportion of interest-only home loans originate through broker channels, responses from the surveyed lenders showed that incentives or commissions paid to third-party mortgage brokers, or internally to employees, were consistent for both interest-only and principal-and-interest home loans.

74 Some lenders pay commissions to brokers on the balance of the outstanding loan, minus any amounts held in offset accounts; other lenders do not deduct offset balances from the loan amount when calculating commissions.

75 There may be some incentive for a broker to recommend an interest-only home loan, as the principal will not initially be paid down and the trail commission will be paid for a number of years on a higher balance.

76 On average, consumers borrow more under an interest-only home loan—possibly because of the lower initial repayment figure under this type of loan and the effect of 'present bias' (see paragraph 111(a)). This may be an incentive for brokers to recommend an interest-only home loan. Conflicts of interest could be generated because of the higher commissions paid to brokers in line with greater loan amounts.

Pricing of interest-only home loans

77 The surveyed lenders reported that there was no difference in the pricing of interest-only and principal-and-interest home loans. The only exception was certain fixed rate interest-only home loans in arrears or in advance, where the interest rate would vary from the principal-and-interest equivalent. Some lenders commented that their line of credit products were priced higher than principal-and-interest or interest-only home loans.

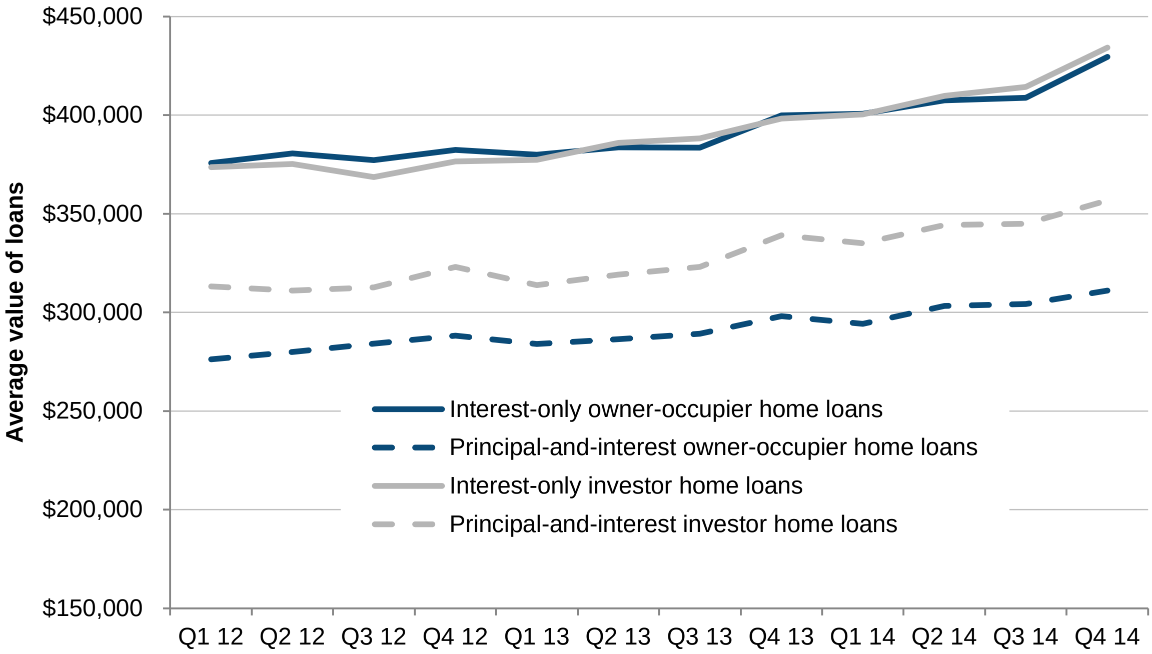
Average value of interest-only home loans

78 We found that the average value of interest-only home loans is substantially higher than that for principal-and-interest home loans, for both owner-occupiers and investors.

79 Overall, the average value of interest-only owner-occupier home loans has risen at a slightly faster rate (by 14.3% to nearly $430,000) than principal-and-interest home loans (by 12.5% to around $311,000) from the March 2012 quarter to the December 2014 quarter.

80 While the difference between the average value of interest-only and principal-and-interest home loans to investors was less than that for owner-occupiers, a substantial difference is still observed: see Figure 7.

Figure 7: Average value of interest-only and principal-and-interest home loans held by owner-occupiers and investors (at origination of loan)—2012–14



Notes: Average value calculated as the value of loans approved in the quarter for all lenders divided by the number of loans approved by all lenders in the same quarter.

81 In the December 2014 quarter, the average value of interest-only home loans approved to owner-occupiers was almost 40% higher than that of principal-and-interest home loans. For investors during the same period, the average value of interest-only home loans was over 20% higher than principal-and-interest home loans.

82 By examining sales channels, it is evident that the average value of interest-only home loans was higher than principal-and-interest home loans for both third-party and direct channels. Yet the extent of this difference was much greater for direct channel loans than for third-party channel loans.

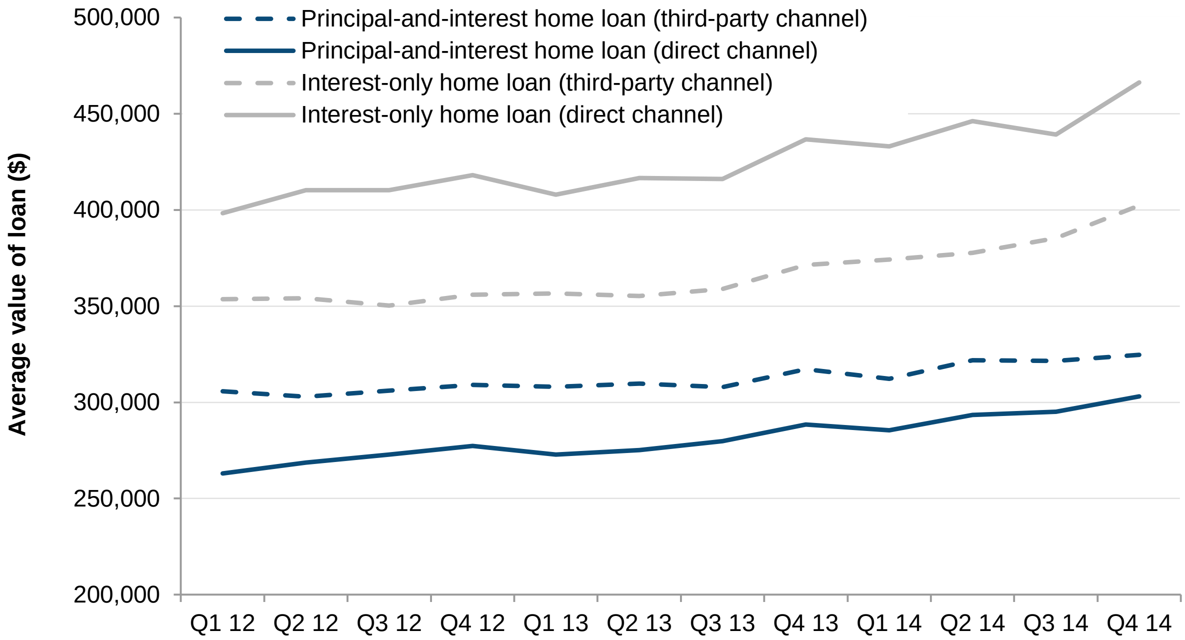
83 Among the surveyed lenders we found the following:

(a) Interest-only owner-occupier home loans from direct channels had the highest average value of all owner-occupier loan types over the survey period, with an average value of $466,000 in the December 2014 quarter (see Figure 8).

(b) While the average value of principal-and-interest owner-occupier home loans from direct channels also increased over the survey period, the increase was much smaller. This heightened the already substantial difference in average value between interest-only and principal-and-interest home loans that originated through direct channels. In the December 2014 quarter, the average value of interest-only owner-occupier home loans was over $160,000 more than the average value of principal-and-interest owner-occupier home loans for direct channels.

(c) The average value of interest-only and principal-and-interest owner-occupier home loans that originated through third-party channels also increased over the survey period, but at a slower rate than those that originated through direct channels. The difference in average value between interest-only and principal-and-interest home loans that originated through third-party channels was also less substantial, with the average value of an interest-only owner-occupier home loan approximately $75,000 more than a principal-and-interest owner-occupier home loan in the December 2014 quarter.

Figure 8: Average value of interest-only and principal-and-interest owner-occupier home loans, by channel type (at origination of loan)—2012–14

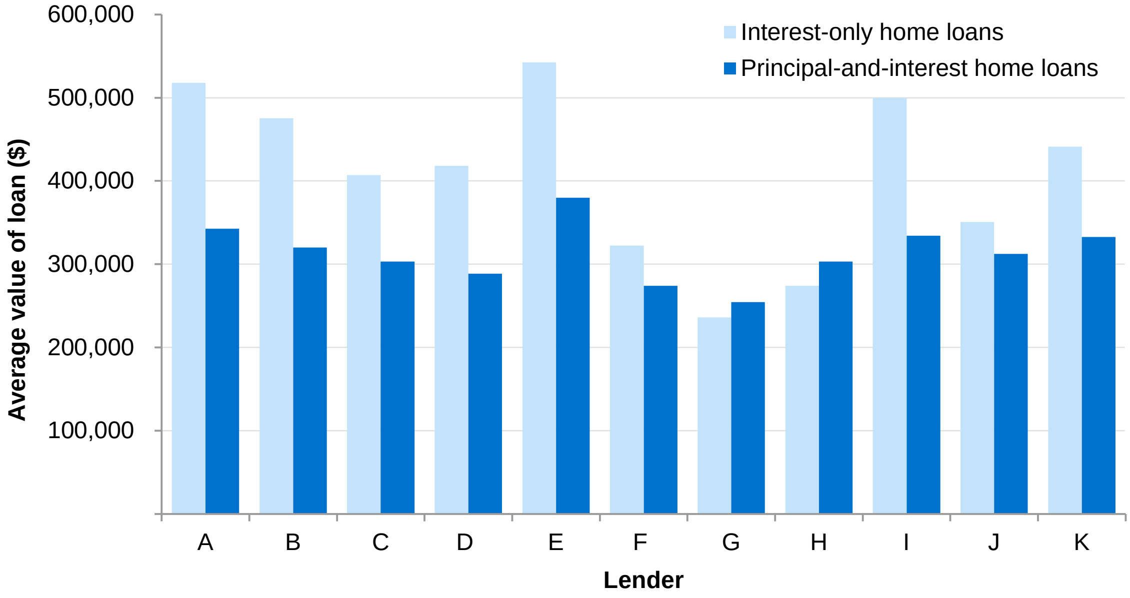


Notes: Average value calculated as the value of loans approved in the quarter for all lenders divided by the number of loans approved by all lenders in the same quarter.

Average value of interest-only home loans by lender

84 On average, the larger lenders had higher average values for interest-only owner-occupier home loans compared to principal-and-interest owner-occupier home loans in 2014. With a few exceptions, the difference in average value between interest-only and principal-and-interest home loans was much lower for small- and medium-sized lenders.

Figure 9: Average value of new interest-only and principal-and-interest owner-occupier home loans approved in the December 2014 quarter, by lender



Notes: Average value calculated as the value of loans approved divided by the number of loans approved.

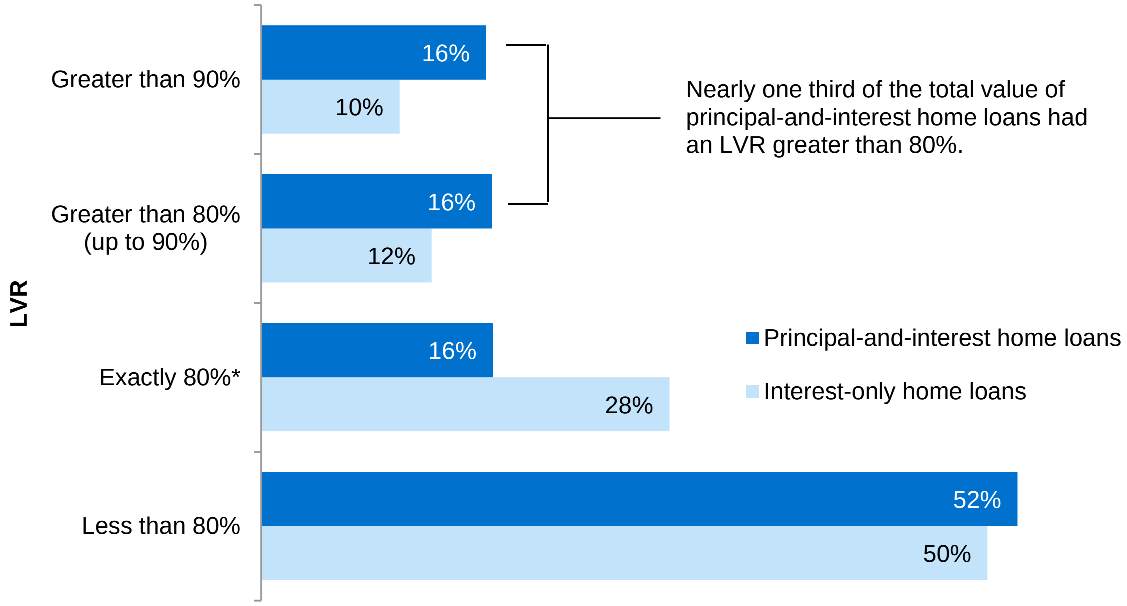
Loan-to-valuation ratios

85 Overall, the surveyed lenders reported a smaller proportion of interest-only owner-occupier home loans in higher LVR categories when compared to principal-and-interest home loans. We found that, for owner-occupiers:

(a) compared to principal-and-interest home loans, a smaller proportion of new interest-only home loans approved had an LVR above 90%—approximately 16% of the total value of new principal-and-interest home loans approved had an LVR of greater than 90%, in comparison to interest-only home loans (10%); and

(b) 78% of the total value of new interest-only home loans approved had an LVR equal to or less than 80% (see Figure 10).

Figure 10: Proportion of new interest-only and principal-and-interest owner-occupier home loans approved in the December 2014 quarter, by LVR



* Many consumers enter loans with an LVR of exactly 80% in order to borrow the maximum amount without incurring lender's mortgage insurance.

86 This pattern may reflect lender risk appetite, or the demographics and behaviour of consumers taking out interest-only home loans, or a combination of both.

Delinquency and default rates

87 We asked the surveyed lenders to provide data on delinquency rates of all outstanding interest-only and principal-and-interest home loans, for both direct and third-party channels. We found that delinquency rates were typically lower for interest-only home loans.[17]

88 Interest-only home loans that originated through third-party channels consistently had lower delinquency rates than principal-and-interest home loans from third-party channels.

89 For direct channels, delinquency rate patterns were not as consistent across the surveyed lenders. Three of the surveyed lenders had notably higher delinquency rates for interest-only owner-occupier home loans that originated through direct channels, while the remaining lenders had lower delinquency rates for interest-only home loans across the board.

90 While current delinquency rates for interest-only home loans are generally lower than principal-and-interest home loans, various factors need to be considered when assessing these results.

[17] One of the surveyed lenders was unable to extract delinquency data at this level of granularity; therefore, the data used is based on 10 lenders.

91 The increasing popularity of interest-only home loans since 2012 means that, for many consumers, their ability to meet repayments over the longer term for this type of loan is untested. For these consumers, the interest-only period (commonly the first 5–10 years) only requires repayments of the interest accruing on the loan. Once the interest-only period ends the repayment amount will increase substantially to ensure that the principal component of the loan can be repaid in the remaining loan term. At this time, there will be a greater risk of consumers having difficulty meeting their principal-and-interest repayments. This risk will be exacerbated where serviceability calculations have not included robust assessment of income and expenses and included appropriate buffers.

92 In addition, the current low-interest rate environment means that interest-only repayments are at record low rates. It is important that these consumers are able to accommodate interest rate rises and continue to service their loans in the longer term.

93 On this basis, the current delinquency rates for interest-only home loans may not accurately reflect the ability of consumers to meet repayments on an ongoing basis, and the likelihood of delinquency in the future.

94 While RBA research also found that interest-only home loans are less likely to enter arrears, they noted the fact that these loans are repaid more slowly, meaning an increase in this type of lending can represent an increase in risk to lenders.[18]

Consumer profile

95 Through this review, we sought to better understand the types of consumers who took out interest-only home loans, as well as their motivations for doing so. International research has found that financial literacy levels and levels of risk aversion can affect a consumer's choice of home loan type. Research conducted in the Netherlands found that:

(a) consumers with higher risk aversion were 97% less likely to choose interest-only home loans;

(b) consumers with higher financial literacy were 55% more likely to choose interest-only home loans;

(c) interest-only home loans were generally more likely to be chosen by wealthier and older consumers; and

(d) interest-only home loans were associated with more expensive homes and higher levels of debt.[19]

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[18] M Read, C Stewart & G La Cava, *Mortgage-related financial difficulties: Evidence from Australian micro-level data* (RDP 2014-13), research discussion paper, RBA, November 2014, p. 15.

[19] R Cox, D Brounen & P Neuteboom, 'Financial literacy, risk aversion and choice of mortgage type by households', *Journal of Real Estate Finance and Economics*, vol. 42, issue 4, May 2011.

96 Through our survey, we asked questions to build a picture of consumers who were taking out interest-only home loans. Compared to the Netherlands' research, similar findings in relation to wealthier consumers and higher levels of debt were made.

Demographics of consumers taking out interest-only home loans

97 We found that a diverse group of consumers tended to take interest-only home loans, reflecting the varying reasons consumers may take out these loans.

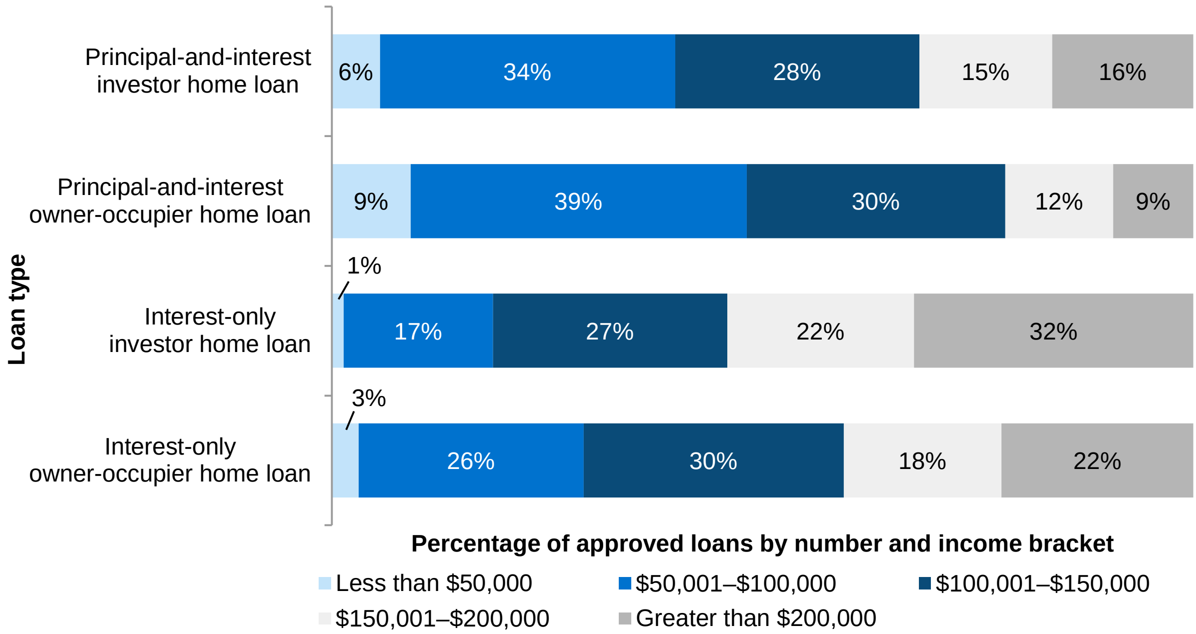
98 Among the surveyed lenders, the most common age group for owner-occupiers taking out interest-only home loans was 35–44, accounting for 34% of these loans. However, there were substantial proportions of owner-occupiers under 35 and over 44 who took out interest-only home loans.

99 In general, interest-only home loans appear to be more popular with people who earn more money.

100 Consumers who earned more than $100,000 per year made up 81% of investors with interest-only home loans and 70% of owner-occupiers with interest-only home loans. Put in context, 51% of owner-occupiers and 59% of investors with principal-and-interest home loans earned over $100,000 per year: see Figure 11.

101 A substantial proportion (32%) of investors in interest-only home loans earned more than $200,000 per year.

Figure 11: Proportion of approved loans for each loan type in 2014, by borrowers' income[20]



Note: Based on 10 lenders. One lender did not provide data for this question. Totals do not always add up to 100% due to rounding.

[20] In our survey 'borrower's income' was defined as the 'total gross annual income of the borrower(s), as recorded during the application process'.

First home buyers

102 We requested data from the surveyed lenders in relation to first home buyers, in order to understand how the trends of first home buyers compared to the overall home owner population, specifically in relation to interest-only home loans.

103 We note that the quality of first home buyer data is restricted by the way in which lenders capture this information.[21] Among the surveyed lenders we found that:

(a) only three of the lenders record data on all first home buyers;

(b) seven lenders only capture first home buyer data in relation to consumers who applied or were approved for the first home owner grant (automatically excluding investor data, as only owner-occupiers are eligible for the first home owner grant); and

(c) one lender did not keep data on first home buyers and was therefore unable to provide data in response to this part of the survey.

104 Due to the inherent limitations in the available data, it is difficult to draw firm conclusions on first home buyers. While our survey data indicated that the percentage of first home buyers taking out principal-and-interest home loans decreased substantially during 2012–14, this may not be representative of the pattern for all first home buyers. Changes in the first home owner grant eligibility criteria may have contributed at least in part to the decline.[22] However, based on the data available, the proportion of new interest-only home loans stayed relatively stable, compared to the proportion of new principal-and-interest loans: see Figure 12.

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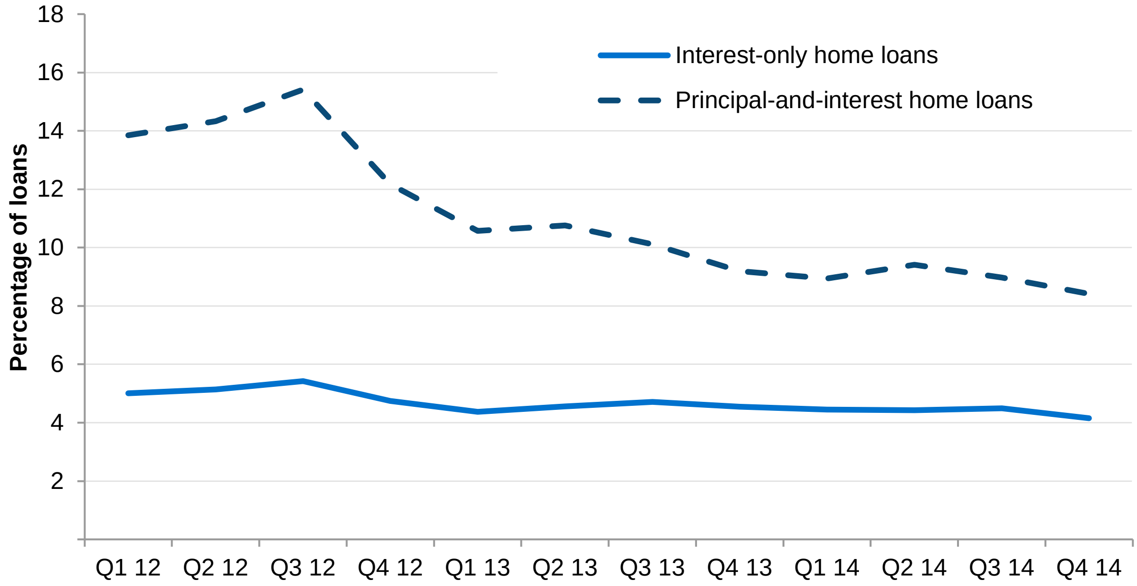
[21] Australian Bureau of Statistics, *ABS to adjust first home buyer loan estimates up 20 per cent after investigation*, Media Release No. 12/2015, 4 February 2015.

[22] First home buyer grants are administered state by state. In New South Wales, for example, the First Home Owner Grant scheme ceased on 30 September 2012 and was replaced by the First Home Owner Grant (New Homes) scheme. The new scheme restricts eligibility to new home purchases (excluding the purchase of established dwellings). This scheme restriction was likely a contributing factor to the sharp drop in first home buyers among our surveyed lenders following the October 2012 quarter. It is noted that, throughout 2013 and 2014, the decrease in first home buyers continued while the current grant scheme has remained in place.

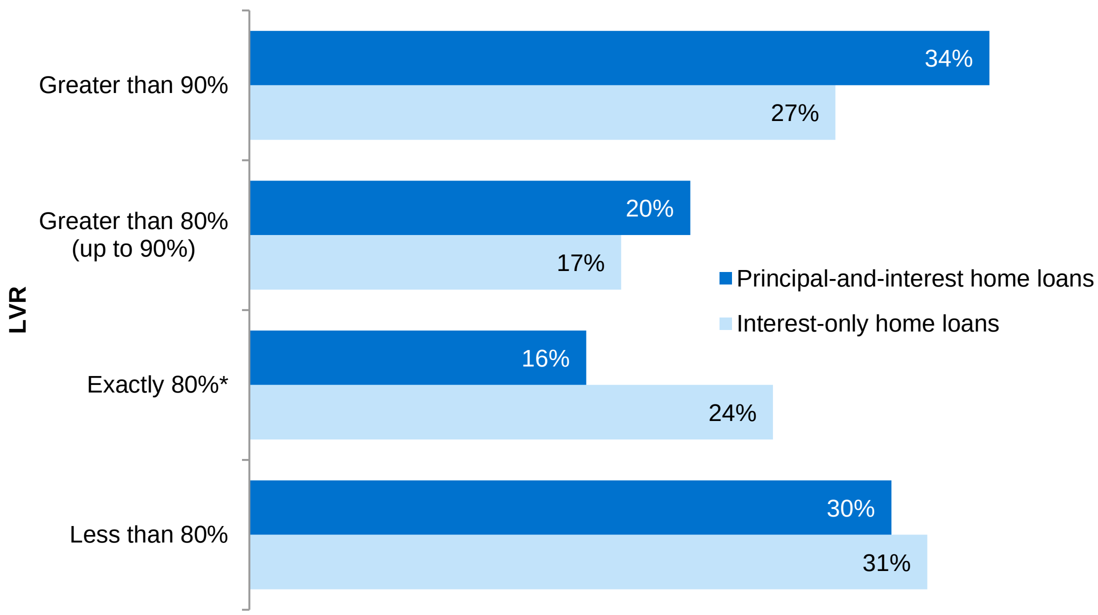
Figure 12: First home buyers as a percentage of all new loans approved from the March 2012 quarter to the December 2014 quarter



Note: Based on 10 lenders. One lender did not provide data for this question.

105 First home buyers who obtained principal-and-interest home loans as owner-occupiers in the December 2014 quarter were more leveraged than first home buyers obtaining interest-only home loans. Of the first home buyers entering interest-only home loans as owner-occupiers, 44% had an LVR greater than 80%, compared to 54% of those entering principal-and-interest home loans: see Figure 13.

Figure 13: Proportion of owner-occupier first home buyer loans in the December 2014 quarter, by LVR



* Many consumers enter loans with an LVR of exactly 80% in order to borrow the maximum amount without incurring lender's mortgage insurance.

Note: Based on 10 lenders. One lender did not provide information for this question.

Why consumers choose interest-only home loans

106 An interest-only home loan may appeal to consumers for a number of reasons. The motivations for interest-only home loans may differ between investors and owner-occupiers.

107 Through the ASIC survey, lenders reported on reasons why consumers may want to take out interest-only home loans. Some of the lender responses were based on anecdotal evidence.

Owner-occupiers

108 As discussed at paragraph 63, in recent years there has been substantial growth in owner-occupiers taking out interest-only home loans. For owner-occupiers, interest-only home loans may be appealing for the short-term cost savings. Immediate cost savings may be substantial; however, there may be longer term disadvantages for some consumers.

109 The key reasons identified in the survey for owner-occupiers taking out interest-only home loans are as follows:

(a) *Future investment*—Consumers may have a future plan to use their place of residence as an investment. The purpose of the loan may be to finance a property for owner-occupation in the short-term, but if it will be converted to an investment property, an interest-only home loan will allow maximisation of future taxation benefits.

(b) *Flexible repayments*—Consumers may require or desire flexibility with their repayments, and some may wish to make periodic lump sum payments on the home loan due to:

  (i) variable or unpredictable income arrangements, including casual work, self-employment, overtime arrangements, commissions and bonus payments;

  (ii) a temporary reduction in income or cash flow; or

  (iii) moving, furnishing or establishment costs in the early stages of their house purchase.

(c) *Redirect cash flow*—Consumers may desire to use surplus funds for other purposes, including:

  (i) non-recurring expenses;

  (ii) discretionary expenditure, such as a holiday or new car; and

  (iii) other investments.

(d) *Temporary finance*—Consumers may use an interest-only home loan as bridging finance or a construction loan while their property is built. The loan may be used as a bridging loan with the intention of selling another property and then paying down the loan. With a construction loan, the intention is usually to convert to making principal-and-interest repayments once the construction is completed.

In some cases, consumers may prefer to hold surplus funds in an offset account, which reduces the interest payable but remains accessible and can be applied to other purposes.

Investors

110 Interest-only home loans may be particularly appealing to investors, allowing them to minimise repayments in the short term, while the property value hopefully grows in the longer term. In addition to the benefits in relation to flexibility, cash flow and temporary finance, investors will also have the benefit of tax deductibility of the interest paid on an investment loan. They may have a strategy to minimise non-deductible debt and maximise deductible debt.

Behavioural insights

111 Behavioural economics, which describes the mental shortcuts or ‘behavioural biases’ that people are subject to when considering options or making financial decisions, may provide some insight into why interest-only home loans appeal to some consumers. For example, the decision to take out an interest-only home loan may be influenced by:

(a) present bias, which causes people to value and focus on immediate or ‘present’ features and costs over less immediate features and costs. This means that a consumer may prefer to make a lower repayment now, even though it will cost them more in the long run; and

(b) optimism and overconfidence bias, which can cause people to underestimate the likelihood of future negative events and overestimate their own abilities. For example, consumers may:

  (i) fail to properly account for income shocks that may affect repayment ability;

  (ii) feel they could achieve a better return on their money by investing it themselves than by making principal repayments on a home loan;[23] and

  (iii) overestimate their future behaviour and self-control. They may believe they will make additional repayments, or save in an offset account.

Offset accounts

112 Consumers with interest-only home loans were, on average, further ahead in reducing the balance of their loan when including funds held in offset accounts related to the home loan, compared to those with principal-and-interest home loans.

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[23] K Scanlon, J Lunde & CME Whitehead, ‘Mortgage product innovation in advanced economies: more choice, more risk’, *European Journal of Housing Policy*, vol. 8, 2008, pp. 109–131.

113 Among large- and medium-sized lenders, the proportion of loan amount outstanding, when funds held in an offset are included, appears to be lower for interest-only home loans compared to principal-and-interest home loans. This is particularly the case for interest-only owner-occupier home loans. The results are more varied among small lenders.

Risks with interest-only home loans

114 The increase in uptake of interest-only home loans by owner-occupiers may be driven partly by the inherent flexibility of such loans. Although interest-only home loans can be appropriate in the right circumstances, they can raise a number of risks, including:

(a) whether the consumer can only afford a home loan because it is interest-only;

(b) whether a consumer can afford and can transition to making the principal-and-interest payments when the interest-only period expires;

(c) whether the consumer understands the effect on the loan of not making principal-and-interest repayments;

(d) the risk of a consumer going into negative equity if there is a significant downturn in the property market; and

(e) whether the consumer understands that an interest-only home loan means that they will pay more interest over the term of the loan.

115 Table 2 sets out the different amounts of interest paid on different types of loan.

Table 2: Comparison of total interest paid over loan term, by length of interest-only period

Length of interest-only period	Amount borrowed	Interest payable over term of loan	Total amount repaid on loan	Additional interest paid compared to principal-and-interest home loan
0 years (principal-and-interest home loan)	$500,000	$579,032	$1,086,232	N/A
5 years	$500,000	$616,258	$1,123,458	$37,226
10 years	$500,000	$659,752	$1,166,952	$80,720
15 years	$500,000	$709,503	$1,216,703	$130,471

Source: Based on a $500,000 home loan over 30 years. Assumes constant interest rate of 6% and monthly fees of $20. Monthly repayment figures determined using the MoneySmart mortgage calculator. Interest is calculated by compounding on the same frequency as the repayment (monthly).

116 With a principal-and-interest home loan, a borrower making scheduled repayments would typically pay off about 10% of the loan's principal over the first five years, establishing a buffer against a fall in house prices. With an interest-only home loan, a consumer is not reducing the amount outstanding on their home loan (unless they make additional repayments).

117 Consumers with interest-only home loans are solely reliant on rising house prices to increase equity in their property during the interest-only period of the loan. They will not build up any buffer to protect against a decline in house prices. The longer the interest-only period is, the greater the effect will be.

118 There is some indication that borrowers are more likely to fall into arrears if they have negative equity in their property. This is likely to be particularly the case if the borrower experiences an 'ability-to-pay shock', such as a substantial reduction in income. This is because a borrower with positive equity can sell the mortgaged property to repay the loan, or can refinance. However, these options are unlikely to be available where a borrower has negative equity.[24]

119 In the absence of an ability-to-pay shock, however, the borrower might not default as they could expect house prices to recover and the borrower may consider it preferable to continue to pay the loan.[25]

120 Partly mitigating the risk of negative equity is the fact that initial LVRs tend to be lower on interest-only home loans than on principal-and-interest home loans. Our survey also showed that consumers with interest-only home loans were on average further ahead in reducing the balance of their loan, compared to consumers with principal-and-interest home loans, when including funds held in offset accounts related to the home loan.

[24] M Read, C Stewart & G La Cava, *Mortgage-related financial difficulties: Evidence from Australian micro-level data* (RDP 2014-13), research discussion paper, RBA, November 2014, pp. 3, 26–27.
[25] M Read, C Stewart & G La Cava, *Mortgage-related financial difficulties: Evidence from Australian micro-level data* (RDP 2014-13), research discussion paper, RBA, November 2014, pp. 3, 26–27.

B Responsible lending finding 1: Lack of evidence of inquiries into requirements and objectives

Key points

Nearly all lenders in our review did not keep sufficient evidence of inquiries into consumer's requirements and objectives when entering an interest-only home loan.

In over 30% of files reviewed, there was no evidence that the lender had considered whether the interest-only home loan met the borrower's requirements.

While requirements and objectives for an interest-only home loan may be more apparent for investors, it is not always clear how an interest-only home loan meets the requirements of an owner-occupier.

Lenders must make sufficient inquiries to show that the loan meets the consumer's requirements and objectives.

Regulatory obligations

121 The National Credit Act introduced general obligations for lenders, including an obligation to make reasonable inquiries about the consumer's requirements and objectives for the loan. This obligation applies to all lenders.

122 The Explanatory Memorandum to the National Consumer Credit Protection Bill 2009 states at para 3.68 that:

> the minimum requirement for satisfying reasonable inquiries about the consumer's requirements and objectives will be to understand the purpose for which the credit is sought and determine if the type, length, rate, terms, special conditions, charges and other aspects of the proposed contract meet this purpose or put forward credit contracts that do match the consumer's purpose.

123 RG 209.36 sets out a number of potential inquiries into a consumer's requirements and objectives, depending on the circumstances, which include:

(a) the amount of credit needed or the maximum amount of credit sought;

(b) the timeframe for which the credit is required;

(c) the purpose for which the credit is sought and the benefit to the consumer;

(d) whether the consumer seeks particular product features or flexibility, the relative importance of different features to the consumer, and whether the consumer is prepared to accept any additional costs or risks associated with these features; and

(e) whether the consumer requires any additional expenses and whether the consumer is aware of the additional cost of these expenses being financed.

124 The obligation to make reasonable inquiries about a consumer's requirements and objectives requires finding out sufficient details about why the consumer requires the loan, so that the lender can understand whether the loan offered will meet that purpose.

125 The requirement for lenders to make reasonable inquiries about the consumer's requirements and objectives should result in a consumer being provided with an interest-only home loan because the features of that type of loan meet the consumer's objectives.

Ensuring interest-only home loans meet consumers' requirements and objectives

126 Through our file reviews we found that:

(a) only a few lenders had procedures to consistently identify and record the consumer's requirements and objectives; and

(b) even where the consumer's requirements and objectives were recorded, the stated analysis could be inadequate to explain why a loan on the terms provided was suitable for the consumer.

127 We have made recommendations for how these practices need to change: see Action 1–Action 2. All lenders in the review have agreed to implement these actions.

Requirements and objectives in relation to cost

128 Consistent with RG 209.36, it is expected that lenders would make inquiries into the consumer's requirements and objectives, and why the consumer seeks an interest-only period. If one of a consumer's stated requirements and objectives is to minimise the overall cost of the loan, an interest-only loan would seem at face value to conflict with this objective. Further inquiries are warranted in this circumstance to ensure the proposed loan would be suitable.

129 Interest-only home loans are more expensive than principal-and-interest home loans in the long term. The total interest charged under an interest-only home loan is more than that charged under a principal-and-interest home loan on the same terms (assuming all repayments are made on time, additional repayments are not made on the loan or to an offset account, and the interest rate is the same). The amount the consumer pays under an interest-only home loan will be even greater if the interest rate charged by

the lender for that product is higher than under a principal-and-interest home loan.

130 For example (assuming the same interest rate), on a 30-year loan of $500,000 the consumer will pay approximately:

(a) $37,000 more under a loan with a five-year interest-only period; and

(b) $80,000 more under a loan with a 10-year interest-only period.[26]

131 As described in detail at paragraphs 108–110, lenders suggested that some of the reasons consumers use interest-only home loans are:

(a) if the use of the property will change from owner-occupier to investment, an interest-only home loan may allow maximisation of future taxation benefits, without incurring refinancing costs;

(b) the capacity to make periodic lump sum payments;

(c) a need for lower repayments during the interest-only period, as the surplus funds are being used to build or renovate the home; or

(d) other uses of income from lower repayments during the interest-only period.

132 By electing to pay less during the interest-only period, a borrower will end up paying more over the entire term of the contract. This difference in the amount of interest payable is not transparent to the consumer, as there is no legal obligation on the lender to inform the consumer of the higher cost under an interest-only home loan relative to a principal-and-interest home loan.

133 Further, the motivations for selecting an interest-only home loan (set out in paragraphs 131(c) and 131(d)) depend on the consumer having a reasonable surplus that can be allocated to other uses and available when the loan reverts to principal-and-interest repayments. Where the consumer has only a low surplus in dollar terms it is not readily apparent that they would obtain a significant financial benefit or that there would be a compelling reason for choosing an interest-only home loan.

134 Our survey found that consumers with interest-only home loans are, on average, further ahead in repayments than those with principal-and-interest home loans. This suggests that individual consumers may have different needs; for example, some may use the flexibility provided by lower repayments, while others may not make use of this product feature and instead treat the product as effectively similar to a principal-and-interest home loan.

[26] The comparison assumes that the interest-only and principal-and-interest home loans have the same interest rate and term, and that the borrower makes all repayments when due under the contract. Repayment amounts calculated using the MoneySmart calculator assuming a 6% constant interest rate. It does not take into account the effect of any funds that may be held in an offset account.

135 This analysis shows the need for lenders to carefully consider the consumer's requirements and objectives, to ensure that an interest-only home loan would be suitable for that consumer. Special consideration should also be given to ensure that interest-only home loans with longer terms are consistent with a consumer's requirements and objectives.

Interest-only repayments do not build equity

136 Another feature of interest-only home loans that differentiates them from principal-and-interest home loans is that by not making principal repayments during the interest-only period, a consumer is not building equity in the property through paying down the principal. There is a consequent risk for lenders that a drop in property prices will mean they face a loss in the event of default and sale of the property.

Recording of inquiries into requirements and objectives

137 Most lenders advised that they conduct inquiries into a consumer's requirements and objectives, or that they require brokers to make this inquiry where the application comes through that channel. However, we found that lenders do not have consistent or clear methods of documenting their inquiries into the consumers' requirements and objectives when providing an interest-only home loan. Many files did not have any record of these inquiries.

138 While it may seem reasonable to assume that investors will often seek interest-only home loans, it cannot be assumed that this will always be the case. We found that the percentage of principal-and-interest home loans taken out by investors was between 15% and 18% during 2012–14: see Figure 4. This demonstrates that investors will sometimes choose to pay down the principal of their loan; therefore, it cannot be assumed that an interest-only home loan will meet the needs of an investor without considering their individual requirements and objectives.

139 Through our file reviews we found that:

(a) three lenders used a 'tick box' method to capture consumers' requirements and objectives, in which the consumer's requirements were selected from a menu of options;

(b) one of these three lenders also had an open text field to capture more information about the requirements and objectives, but filling it out was not mandatory and it was only used on one of the 15 reviewed files; and

(c) the remaining lenders had inconsistent practices for how information about the consumer's requirements and objectives was recorded (such as file notes or emails).

140 We consider the absence of a structured process for documenting inquiries into requirements and objectives increases the risk that it will be deemed that those inquiries were not made, given that some files did not include any statement of the consumer's needs in relation to the proposed loan. A simplistic 'tick box' method will not provide evidence that proper inquiries have been made.

141 While we note that some lenders relied on brokers to determine the consumers' requirements and objectives, we found no observable difference between the quality of the record of requirements and objectives according to the distribution channel.

142 Where loans were introduced through brokers, there was little evidence that the lender had obtained information about the broker's inquiries because these inquiries were not documented on the file. Only in a small number of loans was there evidence that the lender had sufficient information on a consumer's requirements and objectives to assess that the loan was suitable.

143 This is a significant issue, given the increase in the percentage of loans arranged through broker channels (see Figure 5), as lenders are not ensuring that brokers take a consistent approach to recording this information.

144 Under s132 of the National Credit Act, lenders must provide the consumer with a copy of the assessment of why the proposed contract is not unsuitable on request. This request can be made well after the credit contract was entered into.

145 If lenders record details on the consumer file about the specific purpose for which the consumer requires the loan, they will be able to demonstrate that they have made reasonable inquiries into a consumer's requirements and objectives, consistent with their statutory obligations.

Adequacy of inquiries into requirements and objectives

146 Where the lender did document their inquiries into the consumer's requirements and objectives, it could be expected that this would demonstrate why a particular loan was chosen. We found that in some files the recorded inquiries did not provide an adequate or clear explanation as to why an interest-only home loan was selected.

147 Our regulatory guidance and recent case law on this point clearly articulates the requirements in this area. RG 209.122 sets out a number of factors a lender or third-party broker could take into account in considering whether a proposed loan meets a consumer's requirements and objectives. In *Australian Securities and Investments Commission v The Cash Store (in liquidation)* [2014] FCA 926 (*ASIC v TCS*), Davies J noted at para [36] that if the recorded 'purpose' for which the consumer sought the loan was too

general, it would not enable the lender to understand the consumer's requirements and objectives.

148 In our file reviews we found instances where:

(a) none of the files reviewed contained any information relating to the reason an interest-only home loan had been selected (three lenders); and

(b) only a few of the files reviewed in each sample included the reason an interest-only home loan had been selected (eight lenders).

149 For example, we reviewed numerous files where the requirement or objective of the consumer was recorded as 'to purchase a property'. This statement does not address whether the consumer had any requirements or objectives in relation to the features of the loan beyond enabling them to purchase the property.

150 A statement that the consumer's objective was only to purchase a property suggests the consumer could be provided with a much wider range of loans than were suitable for their specific needs. For example, it can be inferred from this approach that the consumer was indifferent to the overall price they paid. It is very unlikely that this would be the case in practice.

151 One of the lenders who used the 'tick box' method had several files where this document was completed in a way that was contradictory. The consumer selected competing objectives, as they ticked the box for both 'I want to reduce my home loan quickly' and 'I want to minimise my repayments'. We would expect that a lender provided with such an ambiguous response would follow this up with the consumer to resolve this conflict.

152 Table 3 in RG 209 specifically states that:

> More inquiries about the consumer's requirements and objectives are likely to be necessary where it is evident to you [a credit licensee] that … the consumer has conflicting objectives or the consumer is confused about their objectives (or has difficulty articulating them).

153 The process of establishing the consumer's requirements and objectives should include a determination of, first, what the consumer's objectives are, and then whether those requirements and objectives are met by an interest-only home loan.

Inquiries into requirements and objectives—specific types of loan

154 In the course of our review, we identified two types of loan where lenders may need to make additional inquiries:

(a) interest-only home loans used for refinancing; and

(b) loans with lengthy interest-only periods.

Refinancing with an interest-only home loan

155 Additional inquiries would be warranted where the bulk of the credit being provided under the interest-only home loan is to refinance an existing debt held by the consumer (whether this is an existing principal-and-interest or interest-only home loan). In these transactions it can be presumed that the consumer is seeking some benefit or financial advantage through the subsequent loan that is not available under their existing loan.

156 We found that one lender included a specific question in its application form to inquire about the consumer's requirements and objectives where the consumer was refinancing. It required the benefits from refinancing to be specifically identified (such as savings in costs).

157 We note that consumers may incur significant costs when refinancing, such as:

(a) exit costs from the old loan;

(b) entry costs for the new loan; and

(c) in some cases, a new lender's mortgage insurance premium, where the consumer has to pay the cost of a new premium without receiving a rebate on the premium paid for the old loan.

158 We found that inquiries where the consumer was refinancing were quite limited. For example, some loans proceeded without any identification of the interest rate the consumer was paying under their current loan, and therefore without addressing the consumer's objectives and requirements for the interest rate under the new loan—for example, whether they wanted a lower interest rate or, if they were prepared to accept a higher rate under the new loan, the benefits that justified or explained this decision.

159 Our concerns about the level of inquiries into the consumer's requirements and objectives are compounded where the existing loan being refinanced already has an interest-only period. In these circumstances the effect of the refinance is to extend the interest-only period and further defer the point in time at which the consumer begins accruing equity by reducing the principal. The risks associated with such a transaction may warrant additional inquiries to ensure the terms of the refinance meet the consumer's requirements and objectives.

Loans with lengthy interest-only periods

160 Loans where the interest-only period extends to 10 or 15 years for owner-occupiers also warrant additional inquiries about the consumer's objectives and requirements for the loan.

161 We found substantial differences between lenders on the maximum length of interest-only period that they will offer, ranging from five years to 15 years, and in the level of use of these products between lenders.

162 Among those lenders offering lengthy interest-only periods, there were two lenders who offered interest-only periods for owner-occupiers of up to 15 years and three lenders who offered interest-only periods for investors of up to 15 years.

163 For the two lenders who offered interest-only periods of up to 15 years to owner-occupiers, the following interest-only periods applied to loans approved, as an average over the period 2012–14:

(a) of the first lender's interest-only home loans:

 (i) 16% of owner-occupiers had interest-only periods of 11–15 years and 15% had interest-only periods of 6–10 years; and

 (ii) 23% of investors had interest-only periods of 11–15 years and 20% had interest-only periods of 6–10 years; and

(b) of the second lender's interest-only home loans:

 (i) less than 1% of owner-occupiers had interest-only periods of 11–15 years and 69% had interest-only periods of 6–10 years; and

 (ii) less than 1% of investors had interest-only periods of 11–15 years and 55% had interest-only periods of 6–10.

164 These results can be contrasted with the consumer outcomes from other lenders (again for loans approved, as an average over the period 2012–14). We found:

(a) five lenders did not have any owner-occupier or investor home loans with an interest-only period longer than five years; and

(b) 97% of one lender's interest-only owner-occupier home loans had an interest-only period of five years or less (despite offering longer terms).

165 The two lenders at paragraph 163 also reported high percentages of home loans for first home buyers with interest-only periods of 6–15 years:

(a) the first lender reported 10% of first home buyer interest-only home loans had an interest-only period of 6–10 years, and 15% had an interest-only period of 11–15 years; and

(b) the second lender reported 53% of first home buyer interest-only home loans had an interest-only period of 6–10 years, although none had a longer period than 10 years.

166 It could be expected that, as a class, first home buyers would be more likely to be interested in accruing equity as quickly as possible, which would be inconsistent with such a lengthy interest-only period.

167 The extent of the disparity in consumer outcomes between lenders is substantial: with one lender over 97% of owner-occupiers had a home loan with an interest-only period of less than five years, and with another lender the percentage of interest-only home loans for owner-occupiers with interest-only periods of up to five years was 31%.

168 We consider it is unlikely that consumers would have such different preferences between lenders. This raises the question of whether longer term interest-only periods are being promoted by lenders and brokers for other reasons.

169 The files for the loans with a 10–15 year interest-only period did not specify a reason why such a long term had been selected. We note that one of the reasons lenders gave for consumers using interest-only home loans, as set out in paragraph 131(a), may justify this length of term (i.e. where the use of the property is expected to switch from owner-occupier to investment). However, the other reasons given for providing an interest-only period of any length would ordinarily not apply.

170 From a lender's perspective, research shows that the probability of entering arrears is higher the more slowly a loan is repaid.[27]

Lender changes

171 Following completion of the survey, most lenders have committed to reduce the maximum interest-only period for owner-occupiers to five years. Lenders that will continue to provide owner-occupiers with interest-only periods greater than five years will take steps to ensure these loans are suitable.

Actions

Action 1

To comply with responsible lending obligations, lenders should ensure that they make reasonable inquiries into a consumer's requirements and objectives and document the results of these inquiries. For interest-only home loans, lenders should consider whether specific features, benefits and costs associated with the loan (including, when refinancing a loan, the benefits and costs of the new loan) meet the consumer's objectives.

Action 2

To comply with responsible lending obligations, lenders should ensure that the period of interest-only repayments offered on a proposed home loan is aligned with the particular consumer's requirements and objectives.

We encourage lenders to review their policies regarding the maximum length of interest-only periods offered, particularly to owner-occupiers. Interest-only periods greater than five years for owner-occupiers will be at high risk of non-compliance with the responsible lending obligations unless there is clear demonstration that the length of the interest-only period is aligned with that particular consumer's requirements and objectives.

[27] M Read, C Stewart & G La Cava, *Mortgage-related financial difficulties: Evidence from Australian micro-level data* (RDP 2014-13), research discussion paper, Reserve Bank of Australia, November 2014, p. 15.

C Responsible lending finding 2: Affordability and interest-only home loans

Key points

Lenders did not always ensure that the consumer had sufficient income (i.e. an appropriate income surplus) above their expenses and loan repayments, so that they could withstand a reasonable fluctuation in income or expenses or an interest rate rise.

There is substantial variation in how lenders apply interest rate buffers. Some lenders apply a buffer to the proposed loan only and not to existing debt that may also be affected by interest rate rises.

Regulatory obligations

172 Before entering into a credit contract with a consumer, lenders must make an assessment that the loan meets the consumer's requirements and objectives and that the consumer can comply with their financial obligations without significant hardship, based on reasonable inquiries and verification.

Assessing ability to pay (serviceability)

173 We found that lenders generally used three kinds of serviceability models to assess a consumer's ability to repay a home loan. The models are:

(a) net income surplus model;

(b) debt service ratio model; and

(c) surplus / uncommitted monthly income model.

174 While the methodology varies between these methods, they all assess a consumer's income, living expenses, existing debt commitments and the proposed loan repayments.

175 In order to be approved for a loan, the consumer must also have a positive surplus after further adjustments have been applied to account for possible increases in repayments due to interest rate rises over the term of the home loan.

176 Two main tools are used for this purpose:

(a) *Buffer*—This is a percentage amount added to the current interest rate offered to that consumer to allow for increases in interest rates. The lenders surveyed used a buffer of between 1.5% and 2.3%. APRA has advised lenders that they should have a minimum interest rate buffer of at least 2%.[28]

[28] APRA, *APRA outlines further steps to reinforce sound residential mortgage lending practices*, Media Release No. 14.30, 9 December 2014. As a result of this, many lenders are likely to have increased their buffers since the time of our survey.

(b) *Floor rate*—This is the minimum interest rate at which serviceability will be assessed, and is higher than the interest rate applied under the contract. There was substantial variation in the floor rates used by the lenders surveyed, with the rate ranging from 6.8% to 8%. The floor rate of lenders has historically been higher at different points in the interest rate cycle. APRA has advised lenders that they should have a minimum floor rate of at least 7%.[29]

177 For example, if a lender has a buffer of 1.5% and a floor of 8%, and the interest rate offered to a consumer is 5%, the applicable interest rate for the serviceability would be the floor rate of 8%, because it is higher than the actual interest rate plus the buffer. Alternatively, if a lender had a buffer of 2.3% and a floor rate of 6.8%, at an interest rate of 5% to the consumer, the loan would be assessed at 7.3% (the actual interest rate plus the buffer).

178 The use of a buffer or floor rate interacts with the inquiries into the consumer's income and expenditure to determine the level of risk in the transaction. The more robust the serviceability assessment, the greater the extent to which a surplus is available to meet increases in interest rates.

179 The smaller the surplus calculated for a particular borrower's financial situation (especially if a benchmark figure has been used as the basis for assessing the consumer's expenses, and that figure is lower than the consumer's actual expenses), the more important the level of buffer or floor rate applied. In these situations, the buffer or floor rate may in practice be covering the risk of both an increase interest rates and that the consumer's expenditure is greater than that relied on through the use of a benchmark. This analysis highlights the fact that, in addition to using appropriate buffers and floor rates, robust processes for assessing the consumer's ability to repay the loan are also essential for sound responsible lending practices.

Lack of an absolute floor on interest rates

180 One lender surveyed did not have a floor rate and relied on the interest rate buffer, meaning that in the current environment, the interest rate used to assess capacity to pay (i.e. current interest rate plus a buffer) would be substantially less than the floor rate of all other lenders. Better practice would be for lenders to adopt an appropriate floor on interest rates.

Applying a buffer to existing debt

181 There is substantial variation in policies regarding how lenders apply the interest-rate buffer. Some lenders apply an interest-rate buffer to both the consumer's existing debts (such as loans outstanding on existing owner-occupied or investment properties), as well as to the proposed new loan.

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[29] APRA, *APRA outlines further steps to reinforce sound residential mortgage lending practices*, Media Release No. 14.30, 9 December 2014. As a result of this, some lenders are likely to have increased their floor rate since the time of our survey.

However, some lenders apply an interest rate buffer to the proposed loan only and do not apply the buffer to existing debt.

182 A consistent application of a buffer would mean that the effect of interest rate rises is considered in relation to all variable rate debts of a consumer (i.e. where the repayment amount may vary with interest rate rises). Failing to apply a buffer to a consumer's existing debts with variable interest rates may affect serviceability substantially.

183 For example, Table 3 demonstrates a hypothetical scenario where a consumer with two investment properties applies for a loan to purchase a home to reside in.

184 In the hypothetical example, the consumer's new loan is $1.2 million over 30 years, with a five-year interest-only period. She has two investment properties, with outstanding debts of $350,000 and $480,000. The current interest rate on both of her existing home loans and her current application is 5.5%. The consumer earns $150,000 net salary per year, and also receives $70,200 per year in gross rental income. For the purposes of serviceability, the lender reduces her rental income by 20%, resulting in net monthly income (from salary and rent) of $17,180.

185 If the interest rate buffer was only applied to the new loan, the consumer would be considered to have a monthly surplus of $526. However, if the interest rate buffer was applied across existing debts, she would *fail* serviceability by $485 per month.

Table 3: Effect of applying a buffer to existing debts (based on a monthly income of $17,180)

Monthly expense type	Cost (buffer of 2% applied only to new debt)	Cost (2% buffer applied to all variable interest rate debts)
Living expenses	$2,400	$2,400
Investment property A	$2,418	$2,830
Investment property B	$2,958	$3,557
New home loan (this application)	$8,878	$8,878
Total monthly expenses	*$16,654*	*$17,665*
Surplus (monthly income of $17,180 minus total monthly expenses)	**$526**	**−$485**

Notes: This is a hypothetical scenario and is not based on any loan file we reviewed. Repayment amounts have been calculated using ASIC's MoneySmart mortgage calculator. Assumes that investment property A has 20 years of repayments remaining and investment property B has 25 years of repayments remaining. Each home loan has a monthly fee of $10. Does not take into account negative gearing.

Action

Action 3

To comply with their responsible lending obligations, lenders should ensure adequate policies and processes are in place to assess a consumer's ability to meet their financial obligations under the credit contract, including reasonable consideration of the effect of future interest rate rises on the proposed credit contract and existing credit contracts.

D Responsible lending finding 3: Variation in treatment of volatile and irregular income

Key points

There is variation between how lenders treat volatile and irregular income sources.

We found examples in the file reviews of the higher income figure being used for serviceability assessments where there was a substantial difference between previous years' incomes.

Rental income is typically discounted by 20% to allow for property expenses and periods of non-occupancy. However, we saw examples in the file reviews where the property-related expenses would likely be greater than 20% of rental income. Discounting of 20% may not be adequate to cover property expenses in all cases.

Regulatory obligations

186 Lenders must ensure that consumers do not enter credit contracts where they cannot meet their repayment obligations, or could only meet them with substantial hardship.

187 Credit providers must therefore assess an individual consumer's specific financial circumstances, including by making reasonable inquiries about their income, and by taking reasonable steps to verify that income.

Employment income

188 We found that:

(a) lenders generally made appropriate inquiries into a consumer's income and took steps to verify their income; and

(b) there were inconsistencies in the treatment of irregular or volatile income sources.

189 Through the file reviews, we generally found that lenders undertook inquiries into and verification of both employer-paid and self-employed income. To verify income they typically obtained:

(a) recent payslips detailing regular salary or wage income;

(b) a written statement from the consumer's employer or accountant confirming income;

(c) tax returns;

(d) bank statements to confirm regular salary or wage income credits; and/or

(e) other documents relating to income, such as trust statements and business activity statements.

190 It was standard practice for some lenders to verify the consumer's employment by contacting their employer by phone, using publicly available contact details and therefore confirming their employment, tenure, status, and salary. We note that failure to confirm employment by contacting the employer directly increases the risk of fraud, through the use of manufactured payslips.

191 There was only one lender who did not consistently keep evidence of income on file. We will be working further with this lender to ensure their record-keeping has improved and that they can demonstrate compliance with their responsible lending obligations.

Rental income

192 Where the consumer was an investor, the surveyed lenders all stated that they would include the rent from the investment property in the consumer's income when carrying out the serviceability assessment.

Verification of rental income

193 Our file reviews found that rental income from an existing property (with a documented rental history) is normally verified by one or more of the following documents:

(a) a current lease agreement;

(b) bank statements confirming rental deposits;

(c) taxation returns showing rental income; and

(d) rental statements from a managing agent.

194 Where a new investment property was being purchased, lenders assessed future rental income through:

(a) an assessment of likely rental amount contained in the valuation report; or

(b) a rental appraisal from a third party, such as a real estate agent.

195 Lenders that rely on statements about future rental income may need to consider the qualifications and financial interests of the person making the statement. For example, there is a risk that a real estate agent may overstate the possible rent in order to encourage the consumer to use their services rather than those of a competitor.

196 We found an application where the lender had obtained two different rent assessments, and used the higher assessment for the purposes of assessing the consumer's capacity. While this approach may have been justified, there was no analysis in the file to support this decision. Given that, in this particular example, if the lower rental assessment had been used the consumer would have failed serviceability, we consider the reason for choosing the higher assessment is important.

Discounting rental income

197 While projected rental income is included as part of a consumer's income, all surveyed lenders stated that they discount the figure by 20% to allow for costs associated with the property. These costs typically include maintenance, strata fees, managing agent fees, taxes, and periods of non-occupancy.

198 The use of a 20% rule may not always accurately reflect an individual's circumstances. For example, in one file we reviewed, the annual rental income was approximately $22,000. Strata fees were over $2,700 per year. The use of a 20% figure only left a balance of $1,700, which would likely be insufficient in many cases to meet costs, such as agent fees and insurance for the property, and cover the risk of gaps between tenants.

Volatile or irregular income sources

199 We found substantial variation among lender practices in how they treat volatile or irregular income sources, such as self-employment, trust income and distributions, bonuses, commission, overtime, and investment earnings. Some lenders took an average of the income over the last two years from the irregular source, even where the most recent year's income was lower. Other lenders calculated capacity on the basis of the consumer's most recent income in the year before the loan application.

200 Simplistic approaches to assessing irregular income may result in unreliable assumptions being made about the consumer's capacity to pay. It may be preferable for lenders to further investigate the reasons the consumer's income has fluctuated in order to better assess likely future income and make a more robust assessment of their capacity to pay. APRA considers that ADI lenders should 'haircut' (i.e. apply a discount to) any volatile income sources.[30]

[30] W Byres, 'Sound lending standards and adequate capital: preconditions for long-term success', speech to COBA CEO and Director Forum, Sydney, 13 May 2015.

Case study 1: Assessment of self-employed income

A self-employed consumer applied for a $650,000 loan, with a two-year interest-only period, to refinance the home he resides in. He also borrowed an additional amount to undertake some renovations. The consumer supplied his most recent income tax statement for one year, and the lender determined that his net monthly income for that year was $5,500.

The lender did not obtain any verification of the consumer's income from other years to determine the consistency of that income. The lender used $5,500 per month as the consumer's estimated income for the purposes of assessing affordability, without considering how self-employed income might be prone to fluctuations.

The lender determined that the consumer could afford the loan repayments, with a surplus of $34 per month. The assessment did not take into account the likelihood that a sole trader will have different income each year, and if the consumer's income is reduced, he may not be able to afford the loan repayments.

Negative gearing

201 Through the survey, we found that eight lenders took into account anticipated future tax benefits from negative gearing in assessing capacity to pay. One lender did not use negative gearing benefits in their automated assessment, but was able to take it into account for manual assessments or reviews, meaning that it was likely to be used where an application initially failed serviceability and was referred for manual assessment. Two lenders did not use negative gearing benefit at all in their serviceability calculations.

Lender changes

202 Some lenders are changing their policy during 2015 so that the negative gearing benefit is no longer taken into account in assessing capacity to pay. This means that the financial benefits from assumed negative gearing tax flows have been removed from calculations, reducing the consumer's surplus for the purpose of assessing the amount they can borrow.

Action

Action 4

Where consumers have uncertain, volatile or irregular income, lenders should:

- review their policies for how they assess volatile or irregular income sources to ensure they meet the responsible lending obligations and ensure prudent credit risk management;

- appropriately discount or disregard high or volatile income where there is uncertainty that the income would be likely to continue at the same level;
- for rental income, ensure the level of discounting is sufficient to allow for property expenses, including maintenance, strata fees, managing agent fees and periods of non-occupancy; and
- where they have a policy of using a negative gearing benefit in serviceability calculations, ensure it is consistent with the inquiry and verification obligations under the National Credit Act, taking into account that individual consumer's income, financial circumstances and objectives.

To demonstrate compliance with the responsible lending obligations, lenders should record the inquiries they make and the basis on which they have adopted the relevant income figure to assess a consumer's capacity to meet their financial obligations under the credit contract.

E Responsible lending finding 4: Lack of evidence of inquiries into expenses and reliance on benchmarks

Key points

We found that, in general, lenders did not demonstrate that they had made sufficient inquiries into a consumer's expenses and relied heavily on expense benchmarks to estimate living expenses.

In over 20% of files, lenders had not considered the borrowers' actual living expenses when approving the loan, but instead relied on expense benchmarks.

Expense benchmarks are not a replacement for proper inquiries into a consumer's actual expenses.

We found that:

- three lenders relied on a benchmark figure of typical household living expenses for the purposes of assessing capacity;
- some lenders made inquiries into the consumer's expenses, but relied on the benchmark figure even when the consumer's declared living expenses were higher than this amount;
- some files for these lenders did not have any evidence to show that the lender had made any inquiries at all into the consumer's living expenses; and
- some lenders used a benchmark figure even when it was unreasonably low and unlikely to reflect the consumer's actual expenditure.

Regulatory obligations

203 Lenders must ensure that consumers do not enter credit contracts where they cannot meet their repayment obligations, or could only meet them with substantial hardship. In doing this, lenders must make reasonable inquiries into an individual consumer's specific circumstances, including the nature and level of their expenses.

204 The obligation to make reasonable inquiries about the consumer's financial situation has been the subject of judicial consideration in *ASIC v TCS*. Davies J observed at [42] that:

> Assessing whether there is a real chance of a person being able to comply with his or her financial obligations under the contract requires, at the very least, a sufficient understanding of the person's income and expenditure. It is axiomatic that 'reasonable inquiries' about a customer's financial situation must include inquiries about the customer's current income and living expenses. The extent to which further information and additional inquiries may be needed in order to assess the consumer's financial

> capacity to service and repay the proposed loan and determine loan suitability will be a matter of degree in each particular case.

205 While this case addressed conduct in relation to the provision of small amount credit contracts to consumers, the court's observations are equally applicable to other forms of credit. In particular, there is no reason why the responsible lending obligations should be interpreted by lenders in a way that means they do not have to inquire into the consumer's income and expenses.

206 Given the requirement for lenders to inquire into the consumer's expenditure, it follows that sole reliance on a benchmark figure, such as the Household Expenditure Measure (HEM) benchmark or Henderson Poverty Index, to estimate a consumer's financial circumstances will not be sufficient for a lender to meet their responsible lending obligations. Lenders may use appropriate benchmarks as a verification tool to complement robust inquiries.

207 The Explanatory Memorandum to the National Consumer Credit Protection Bill 2009 states at para 3.141:

> Reasonable inquiries about the consumer's financial situation could ordinarily include inquiries about the amount and source of the consumer's income, determining the extent of fixed expenses (such as rent or contracted expenses such as insurance, other credit contracts and associated information) and other variable expenses of the consumer (and drivers of variable expenses such as the number of dependents and the number of vehicles to run, particular or unusual circumstances). The extent of inquiries will however depend on the circumstances.

208 RG 209 sets out the expectation that lenders cannot solely rely on benchmark-derived living expense figures, and must also make inquiries about the consumer's actual living expenses. It states at RG 209.105:

> Use of benchmarks is not a replacement for making inquiries about a particular consumer's current income and expenses, nor a replacement for an assessment based on that consumer's verified income and expenses.

209 We note that this approach is broadly consistent with that of APRA (in relation to ADIs). APG 223 states at paragraph 38:

> ADIs typically use the Household Expenditure Measure (HEM) or the Henderson Poverty Index (HPI) in loan calculators to estimate a borrower's living expenses. Although these indices are extensively used, they might not always be an appropriate proxy of a borrower's actual living expenses, which are likely to be considerably higher. APRA therefore expects ADIs to use a borrower's declared living expenses as a more representative measure of their actual living expenses than the HEM or HPI indices, which may nonetheless contribute to the serviceability assessment.

210 In general, we consider that the obligation to make reasonable inquiries is scalable. What a lender needs to do to meet these obligations in relation to a particular consumer will vary depending on the circumstances. We would expect that credit lenders would make many, if not all, of the inquiries in

RG 209.33, as entering into an unsuitable home loan can have a potentially large negative financial impact on a consumer.

211 More extensive inquiries are likely to be necessary where the potential negative impact on the consumer is likely to be relatively serious if the credit contract or consumer lease is unsuitable. This would include situations where the consumer's income is relatively low, and they would therefore have a more limited capacity to change their spending patterns than consumers on higher incomes. We note, as set out in Figure 11, that 29% of interest-only owner-occupier home loans were provided to consumers with an income of $100,000 or less. Another situation is where the size of a loan is large relative to the consumer's income.

Evidence of inquiries into living expenses

212 We found that nearly all lenders failed to demonstrate that they had made inquiries into the consumer's regular living expenses. They generally relied on a benchmark as a surrogate for the consumer's actual expenses. Lenders most frequently used the HEM benchmark.

213 We also found that there was inconsistent reliance on bank statements to establish the consumer's spending and savings patterns. Some loan files had no bank statements at all, even though this would generally be the most direct way of verifying the consumer's financial circumstances.

214 Three lenders advised that they use a benchmark figure for living expenses in all cases—that is, regardless of the consumer's actual expenditure. Of these lenders:

(a) one relied on the HEM benchmark with no indication that actual living expenses were accounted for;

(b) one stated that they identify consumers with unusually high expenses and refer them for manual assessment; and

(c) one stated they allow for discretionary expenses to be added to the serviceability calculator.

215 We have made recommendations for how these practices need to change: see Action 5–Action 8. All lenders in the review have agreed to implement these actions.

216 We have previously resolved concerns with Bank of Queensland about the use of benchmarks.[31] In our view, the Bank's reliance on a benchmark and lack of inquiry into actual expenses was not consistent with their responsible lending obligations. In November 2014, we updated RG 209 to clarify that

[31] Media Release (15-125MR) *ASIC concerns prompt Bank of Queensland to improve lending practices* (25 May 2015).

credit licensees cannot rely solely on benchmark living expense figures, and must make inquiries about a consumer's actual living expenses.

217 At the other end of the spectrum, the file reviews found that some lenders used an application form that required the consumer to state their expenses for each item on a comprehensive list that covered basic expenses (such as housing, food and clothing) and other expenses (including education, childcare, medical expenses, insurance premiums, car costs, and internet, mobile and phone costs). We consider that this approach would be more likely to prompt the consumer to consider the amount they spend in relation to each item on the list, which is supported by recent research into peoples' ability to predict their own future spending and the impact of 'unpacking' costs.[32] We also consider that unpacking a consumer's expenses may enable lenders to better identify possible anomalies in spending patterns than if there is no breakdown in expenses. The more comprehensive the list of expenditure items, the less likely it is that a consumer will unintentionally underestimate particular individual items.

218 A third group of lenders used a form that asked for expenditure without any detailed breakdown. They used different approaches, including asking the consumer to:

(a) state their expenses as a single amount;

(b) only state their basic expenses; or

(c) provide a breakdown between basic and discretionary expenses.

219 We consider this approach increases the risk of an amount being used that underestimates the consumer's actual expenses. This risk may arise because consumers may:

(a) have different understandings of what constitutes 'basic' or 'minimum' expenses for the purposes of the application;

(b) state a lower amount if they consider this will assist the loan being approved; or

(c) underestimate their expenses when asked to provide a figure as a total sum.[33]

220 As set out in RG 209, the lender may decide to rely on the benchmark if, after reasonable inquiries, the consumer's declared expenses are lower than the relevant benchmark (to address the risk the consumer has understated their expenses or that they may increase).

221 In each case, the assessment relies on a lender making proper inquiries into a consumer's expenses. Lenders should not simply discount the consumer's

[32] J Peetz, R Buehler, D Koehler & E Moher, 'Bigger not better: Unpacking future expenses inflates spending predictions', *Basic and Applied Social Psychology*, vol. 37, 2015, pp. 19–30.
[33] J Peetz, R Buehler, D Koehler & E Moher, 'Bigger not better: Unpacking future expenses inflates spending predictions', *Basic and Applied Social Psychology*, vol. 37, 2015, pp. 19–30.

actual (higher) expenses in preference for a benchmark figure. To do so may create a risk that the consumer will be unable to meet the repayments under the home loan.

Lender use of benchmarks as a substitute for inquiries

222 Eight lenders advised that they use the consumer's declared expenses where they are higher than the benchmark the lender uses. However, the consumer outcomes in the file reviews suggest there was an inconsistency between the stated policy and actual practice.

223 Through the file reviews we found that:

(a) there was only one lender where a benchmark was rarely relied on;

(b) two of the eight lenders used the benchmark every time, and did so even where the consumer's declared expenses were higher than the benchmark; and

(c) one lender used a benchmark in almost all of the loan assessments.

224 It could be expected that, if these lenders had made reasonable inquiries, they would identify differences in the spending patterns of their consumers, and that therefore a benchmark would be used only rarely.

225 We consider that these results raise an important question about whether those lenders with substantial levels of apparent consistency between the benchmark and the consumer's stated expenses are making reasonable inquiries into the consumer's expenses, or in fact defaulting to the benchmark as a substitute for making such inquiries. If lenders are simply relying on a benchmark it is likely that some consumers would have higher expenses than the benchmark figure, and therefore may have been provided with a loan with repayments that they cannot afford without making substantial adjustments to their expenses.

226 Even where the application form requested a figure for living expenses, we found cases in our file reviews where there were no documents to indicate that the lender had made reasonable inquiries into these expenses. In some files the loan was approved even though the question on the application form about living expenses was left blank by the consumer—including, in one instance, on a form that specifically stated that the consumer must answer this question.

227 As set out in RG 209, the use of benchmarks is not a replacement for making inquiries about a particular consumer's income and expenses.

Use of an income-adjusted HEM benchmark

228 The HEM benchmark was developed in 2011 by the Melbourne Institute of Applied Economic and Social Research at the University of Melbourne. It represents a low-end estimate of the spending habits of Australian families. It uses median expenditure on goods and services with variations according to whether they are characterised as 'absolute basics' or 'discretionary basics'.

229 The HEM benchmark takes the median expenditure on absolute basic goods and services and combines this with the 25th percentile of expenditure on discretionary basic goods and services.[34] As an example, food purchased from the supermarket and children's clothes are absolute basics, while a meal at a restaurant or adult clothes are considered discretionary basics.

230 The use of these figures for the HEM benchmark means that it is unlikely to be a reliable proxy for an individual consumer's actual expenses. In simple terms, the use of these percentile figure means that:

(a) 50% of consumers can be expected to have expenditure on 'absolute basic' goods and services that is higher than the HEM benchmark; and

(b) 75% of consumers can be expected to have expenditure on 'discretionary basic' goods and services that is higher than the HEM benchmark.

231 Most lenders use a single HEM benchmark figure, which varies depending on the number of adults and children the consumer supports, and is also expressed as a figure that does not vary according to income.

232 However, the Melbourne Institute found that the higher the consumer's income, the more money they would spend on both 'absolute basic' and 'discretionary basic' goods and services. It found that, in comparison with a household income of $20,000 a year, 'Households on about $75,000 a year would double the spending on absolute basics … but increase spending on discretionary basics more than fivefold.'[35]

233 For consumers with an income above $75,000 per year, expenditure would still increase but at a slower rate. Household expenditures 'increase rather rapidly initially when moving from the bottom of the household income distribution, but the growth rate then tapers off.'[36]

234 The Melbourne Institute publishes an income-adjusted HEM benchmark, which is scaled by income bands and reflects different spending habits in

[34] Melbourne Institute of Applied Economic and Social Research, *The development of a Household Expenditure Measure*, final report, The University of Melbourne, May 2011, p. 11.
[35] Melbourne Institute of Applied Economic and Social Research, *The development of a Household Expenditure Measure*, final report, The University of Melbourne, May 2011, p. 33.
[36] Melbourne Institute of Applied Economic and Social Research, *The development of a Household Expenditure Measure*, final report, The University of Melbourne, May 2011, p. 33.

each band. The income-adjusted HEM benchmark has been available to lenders since 2011.

235 We found that the use of the single HEM benchmark figure, rather than the income-adjusted HEM benchmark, was likely to result in a figure for living expenses that was substantially lower. The outcome can be shown by comparing the figures allocated for living expenses in some of the files we reviewed with the income-adjusted HEM benchmark, as set out in Table 4.

Table 4: Living expenses used in loan assessments compared to income-adjusted HEM benchmark

Family unit	Location	Age(s)	Gross annual income band	Figure used for living expenses	Income-adjusted HEM benchmark
Single with no dependants	Perth	35	$80,000 to $90,000	$14,004 per annum $1,167 per month	$21,476 per annum $1,790 per month
Single with no dependants	Brisbane	46	$50,000 to $60,000	$14,088 per annum $1,174 per month	$17,004 per annum $1,417 per month
Single with one dependant	Sydney	51	$70,000 to $80,000	$18,872 per annum $1,573 per month	$23,244 per annum $1,937 per month
Couple with no dependants	Melbourne	34 and 36	$100,000 and over	$25,620 per annum $2,135 per month	$35,412 per month $2,951 per month
Couple with two dependants	NSW (other than Sydney)	31 and 33	$100,000 and over	$34,296 per annum $2,858 per month	$42,484 per annum $3,540 per month
Couple with three dependants	Melbourne	35 and 41	$100,000 and over	$41,580 per annum $3,465 per month	$45,500 per annum $3,792 per month

236 Case study 2 illustrates the difference between using the single HEM benchmark figure compared to the income-adjusted HEM benchmark.

Case study 2: Income-adjusted HEM benchmark

A consumer applied for a $1.6 million home loan to be repaid over 30 years with a five-year interest-only period, in order to refinance her Melbourne-based home. The consumer is single, and has one dependent child. The lender did not keep a record to show any type of inquiries into the consumer’s living expenses, but instead used the default benchmark living expenses for one adult and one dependant of $1,450 per month.

The consumer’s gross annual salary is over $200,000. If the lender used the income-adjusted benchmark the consumer’s living expenses would be estimated at $2,375 per month. If the income-adjusted benchmark had been adopted the consumer would have had failed serviceability by over $700 per month.

237 Currently the income-adjusted HEM benchmark has a maximum income band of ‘$100,000+’ and will not differentiate in the spending patterns of persons regardless of how much they are earning in excess of $100,000.

While the differential is likely to be less for income bands over $100,000, due to the tapering off of increased spending,[37] it is worth noting this limitation. This is particularly critical for couple borrowers, many of whom will tend to have high household incomes if both are employed.

Lender changes

238 Using an income-adjusted benchmark for assessing minimum consumer expenses was adopted by one lender in our review. Following our review, all other lenders involved have now committed to introducing an income-adjusted benchmark.

Inquiries into the consumer’s existing debts

239 We found that lenders generally had documentation of a consumer’s existing liabilities to third parties. For example, information in relation to personal loans, other home loans and credit card debts was typically included in the loan application, with evidence of inquiries into the amount of the debt outstanding and the regular payments the consumer was making.

240 However, in the files we reviewed, lenders often failed to verify or confirm the amounts the consumer was paying—for example, by obtaining bank statements, loan account or credit card statements.

241 Verification of these liabilities would be straightforward, given that consumers can commonly access these statements online, and can therefore provide copies without any undue delay to their application. Nevertheless, lenders often failed to confirm the amounts the consumer was paying.

Accurately assessing the consumer’s financial situation

242 We found examples of applications where there was a failure to identify and resolve inconsistencies in the documents on the file, and therefore a failure to make reasonable inquiries into the consumer’s financial situation. If there are anomalies in the application it is not reasonable for the lender to rely on only one part of the information without making additional inquiries.

243 Examples of the types of inconsistencies are illustrated in the following case studies.

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[37] Melbourne Institute of Applied Economic and Social Research, *The development of a Household Expenditure Measure*, final report, The University of Melbourne, May 2011, p. 33.

Case study 3: Childcare expenses

The borrowers were a couple who were both working full-time. They had three children under 13. There was no amount allocated for childcare costs, and no record of any inquiries into the parents' arrangements for looking after the children outside school hours and whether or not they were in fact incurring childcare expenses.

Case study 4: Motor vehicle expenses

A borrower's living expenses were stated as $1,167 per month or $14,004 a year. The application form showed that the borrower owned four vehicles, and another document on the lender's files showed that the applicant incurred annual motor vehicle expenses of about $6,600 (or 47.1% of the attributed living expenses).

It meant the consumer had only $617 a month attributed for living expenses (other than in relation to the cars). The low nature of this figure warranted further inquiries.

244 We note that RG 209 specifically addressed the issue of inconsistencies, stating at RG 209.39 that the process of making inquiries and verifying the information obtained will in many cases raise additional issues (e.g. if the information received is inconsistent with other information the lender has on the consumer). RG 209.39 stipulates that lenders' processes should be flexible and allow for additional inquiries to be made as needed.

Actions

Action 5

Lenders must make reasonable inquiries into a consumer's actual expenses, including both fixed expenses (such as rent, repayment of existing debts and child support, and recurring expenses such as insurance) and living expenses (such as food and utilities). Lenders must also take reasonable steps to verify the information obtained.

To demonstrate that they have met their responsible lending obligations, lenders must document the inquiries and verification undertaken.

Action 6

Where lenders rely on benchmarks to verify a consumer's living expenses, lenders can reduce their risk of non-compliance with the responsible lending obligations by using income-adjusted benchmarks (reflecting the reality that high-income consumers generally have higher living expenses).

If a consumer's actual living expenses are higher than the benchmark, lenders must not use the lower benchmark figure in the serviceability calculation unless there are reasonable (and documented) grounds for doing so.

Action 7

Lenders should take reasonable steps to verify the amount of existing debt and the repayment amounts that the consumer is committed to.

Action 8

Lenders should take steps to identify inconsistencies in information provided by consumers and make further inquiries to accurately assess the affordability of the proposed loan. The outcome of any additional steps taken should be documented.

F Responsible lending finding 5: Capacity to pay after interest-only period not based on residual-term payments

Key points

In 40% of the files reviewed, the affordability calculations assumed the borrower had longer to repay the principal on the loan than they actually did.

A number of lenders calculate affordability using repayments that are artificially low, as they are based on principal-and-interest repayments over the full term of the loan, rather than the residual term remaining after the interest-only period. This practice increases the risk to borrowers with longer interest-only periods.

Lenders can minimise the risk of consumers not being able to afford repayments once the interest-only period expires by assessing the consumer's ability to meet the loan repayments required when the loan reverts to principal-and-interest repayments.

Regulatory obligations

245 Lenders must ensure that consumers do not enter credit contracts where they cannot meet their repayment obligations, or could only meet them with substantial hardship. In relation to interest-only home loans, the obligation therefore requires lenders to assess the consumer's capacity to meet both the initial (interest-only) repayments and the higher (principal-and-interest) repayments arising at the expiry of the interest-only period.

246 If lenders do not properly assess the consumer's capacity in relation to the different repayments during and after the interest-only period, there is a risk the consumer will be unable to meet the higher repayments.

Method for calculating repayments

247 We found that lenders have different ways of assessing a borrower's capacity to service the loan, depending on how the repayments they used for this purpose are calculated. Lenders use two different methods:

(a) *The 'residual term' method*—The repayments used for the purposes of assessing the consumer's capacity are calculated on a principal-and-interest basis on the residual term of the loan once the interest-only period has expired. For example, if a consumer applies for a 30-year loan, with an interest-only period of 10 years, the assessment is based on principal-and-interest repayments over the residual term of 20 years.

(b) *The 'full term' method*—The repayments are calculated on a principal-and-interest basis on the full term of the loan. For example, if a consumer applies for a 30-year loan with an interest-only period of 10 years, the assessment is based on principal-and-interest repayments over a 30-year period, even though the principal-and-interest period is only 20 years.

248 Calculating the repayments using the full-term method means that the repayments used for assessment are lower than those calculated using the residual-term method. In addition, the repayments are artificially low, being less than the repayments the consumer would in fact be required to make once the interest-only period has expired.

249 Table 5 demonstrates the variation in repayments between the residual-term and full-term methods. It shows how the full-term method can artificially increase the consumer's surplus. The longer the interest-only period of the loan, the greater the distortion between the repayments used by the lender in their serviceability calculation and the repayments the consumer will have to make.

Table 5: Comparison of serviceability assessment made using the full-term and residual-term method, by interest-only period

Length of interest-only period	Monthly repayments using residual-term method	Monthly repayments using full-term method	Increase in consumer's apparent surplus if full-term method is used
5 years	$3,242	$3,018	$224
10 years	$3,602	$3,018	$584
15 years	$4,239	$3,018	$1,221

Source: Figures calculated using MoneySmart mortgage calculator. Based on a $500,000 home loan over 30 years. Assumes constant interest rate of 6% and monthly fees of $20. Interest is calculated by compounding on the same frequency as the repayment (monthly).

250 We found that five lenders used the full-term method, and therefore did not test the consumer's capacity against the actual amount of the repayments the consumer would be required to make when the interest-only period expires.

251 In contrast, six lenders calculated affordability using the residual-term method. This approach is more closely aligned with a consumer's actual financial commitments under the credit contract.

252 The following case studies illustrate the outcomes in individual cases, from the files reviewed by us in the course of this review.

Case study 5: Full-term method

A couple applied for a $1 million loan to be repaid over 30 years with a 10-year interest-only period, in order to purchase a property to live in.

The lender assessed the couple's capacity to pay using the full-term method. The lender determined that they had a surplus of $446 per month.

If the couple's ability to repay the loan had been assessed using the residual-term method, the couple would have an estimated monthly serviceability shortfall of $727. Therefore, if any buffers applied were not sufficient to make up the shortfall, the couple would be unlikely to be able to meet their repayments after the interest-only period expires without making significant adjustment to their expenses.

Case study 6: Residual-term method

A consumer was assessed for his ability to repay a loan of $1.5 million over 30 years, with a 10-year interest-only period. His capacity to pay was assessed using the residual-term method.

The lender determined that the consumer would have an approximate monthly surplus of $6 and the loan was approved on this basis. For the first 10 years of the loan the consumer is estimated to have over $3400 surplus per month, which he may choose to put in an offset account in order to minimise the interest on his loan. His actual surplus may be higher if interest rates do not rise to the level of the buffer applied in the serviceability calculation.

Effect of method used on loan amount

253 The use of the residual and full-term methods affects the amount that the consumer is eligible to borrow.

254 If the full-term method is used, a consumer can borrow more under an interest-only home loan compared to what would be available to them if the residual-term method was used, but there would be no difference in the maximum amount the consumer can borrow compared to a principal-and-interest home loan from the same lender.

255 Consistent with this analysis, the five lenders who use the residual-term method reported that the maximum amount a consumer could borrow was less for an interest-only home loan, because they would be assessed at a higher repayment figure that reflected the repayments required over the remaining term.

256 One lender stated:

> It is possible for a borrower with the same income to be approved for a principal-and-interest loan for a larger amount of money than an [interest-only] loan, as the principal and interest repayments are lower than [interest-only] repayments due to the term used. [We] may also consider a higher loan amount, commensurate to a higher LVR, where the client will be paying principal and interest rather than interest-only.

257 In contrast, the lenders who assessed capacity to pay using the full-term method reported no difference in the loan amount the consumer would be

eligible for, whether they took a principal-and-interest or interest-only home loan.

258 The average value of interest-only home loans approved to owner-occupiers was almost 40% higher than that of principal-and-interest home loans among the surveyed lenders in the December 2014 quarter: see Figure 7. There are a number of drivers that may affect the average value of interest-only and principal-and-interest home loans, including demographics of consumers taking out interest-only home loans (see paragraphs 97–101) and common behavioural biases, such as present bias (see paragraph 111).

Lender changes

259 All lenders involved in this review have advised us that they will move away from using the full-term method, and implement a system to assess capacity to pay using the residual-term method.

Action

Action 9

Lenders should review their methodology for assessing the affordability of interest-only home loans to ensure it complies with the responsible lending obligations.

Lenders should assess a consumer's capacity to make the principal-and-interest repayments over the residual term of the loan (after the interest-only period lapses), as this will reflect a consumer's ability to meet their financial obligations under an interest-only home loan.

G Responsible lending finding 6: Lack of flexibility for hardship variations for interest-only home loans

Key points

We found that financial hardship policies for most lenders did not distinguish between interest-only and principal-and-interest home loans.

However, a small number of lenders applied more restrictive options for borrowers seeking hardship variations under an interest-only home loan.

Lenders should have a variety of options available to consumers who are in financial hardship, and assess the most appropriate outcome on a case by case basis.

Regulatory obligations

260 Under the National Credit Code, at Sch 1 to the National Credit Act, lenders are required to consider whether to vary the payments under a loan where the borrower is unable to meet their repayment obligations due to hardship. Depending on when the loan was entered into, a monetary threshold for hardship applications may apply.[38] Industry codes of practice also include standards for members relating to financial hardship.[39]

Hardship variations

261 The surveyed lenders were asked for information on the way applications for hardship variations are assessed for interest-only home loans, and whether there were any differences between these procedures and those for principal-and-interest home loans.

262 All 11 lenders surveyed stated that applications for hardship are assessed in the same way, regardless of whether the consumer is making interest-only or principal-and-interest repayments at the time. This is supported by the hardship policies from each lender.

263 However, we found that, in practice, two lenders offered fewer options to assist borrowers under interest-only home loans.

[38] For loans entered into before February 2013, the procedures only apply to loans where the amount borrowed was less than $500,000. However, lenders may still to agree to a hardship variation even if the loan amount exceeds the threshold.
[39] Clause 28 of the Code of Banking Practice 2013; cl 24 of the Customer Owned Banking Code 2014.

264 Most lenders reported that during the interest-only period of a loan, a consumer in hardship may be offered the option to reduce or postpone payments. The borrower would then have the option of paying the additional amounts as a result of the reduced or deferred payments through:

(a) a lump sum payment at the end of the hardship relief period;

(b) a repayment over a set period of time; or

(c) a capitalisation of the arrears:

  (i) over the remaining period of the loan; or

  (ii) combined with an extension of the loan term.

265 In relation to interest-only home loans we found that:

(a) one lender required borrowers to pay back the deferred payments as a lump sum at the end of the hardship relief period; and

(b) one lender would not extend the loan term for interest-only home loans (but would do so for principal-and-interest home loans).

266 It is likely that the cause of financial hardship that prompts the consumer to seek a change in repayments will also mean that they are not in a position to repay a lump sum at the end of the variation period. For example, consumers may have a period of temporary unemployment. A consumer in this position is unlikely to be able to afford to both repay the deferred payments as a lump sum and to make the usual payments under the contract.

267 We consider that the inflexible application of an approach to hardship variations can place a short-term focus on the assistance provided, rather than matching the terms on which a variation is provided to the consumer’s circumstances. Responding to a financial hardship request in a pre-determined manner may result in poor outcomes for both borrowers and lenders.

268 To improve outcomes available to consumers, lenders should consider the effect of any system limitations on the type of hardship variations they will provide to consumers and assess the most appropriate outcome of a hardship application on a case-by-case basis.

Action

Action 10

Lenders should:

- review their systems, policies and processes for hardship variations for interest-only home loans;
- have a variety of options available to consumers who are in financial hardship; and
- assess the most appropriate outcome of a hardship application on a case-by-case basis.

Appendix: Methodology

What we did

269 We selected 11 credit licensees of varying sizes to participate in the review, representing a broad cross-section of businesses that were active in providing interest-only home loans, including both ADI and non-ADI lenders. These licensees either provided credit through mortgage brokers, directly to consumers, or through a combination of channels.

270 Conducted between December 2014 and June 2015, our review of interest-only home loans involved two phases:

(a) a survey to industry designed to collect data on trends and practices in relation to interest-only home loans and assess responsible lending policies (Phase 1); and

(b) a targeted file review to assess compliance with the responsible lending obligations (Phase 2).

Phase 1: Survey data on trends and practices

271 In early 2015, we prepared a survey to collect data from industry on aggregated trends for interest-only home loans, as well as information on individual lenders' loan books. The survey also requested data on the arrangements lenders have in place to ensure compliance with their responsible lending obligations.

272 We note that there were some data quality issues in the way that some lenders recorded owner-occupier and investor loans. However, we expect that the broad trends would not be affected substantially.

Phase 2: Targeted file review

273 In addition to the information collected through the industry survey, we obtained and reviewed 140 actual loan files for interest-only home loans in order to review compliance with responsible lending obligations in practice. The files reviewed related to home loans for both owner-occupiers and residential property investment.

274 We conducted the file reviews in collaboration with APRA, to enable both regulators to gain an in-depth understanding of practices for interest-only home lending, and to view the issues from both a prudential and conduct regulation standpoint. A number of the file reviews were conducted at the lenders' premises.

Key terms

Term	Meaning in this document
ADI	Authorised deposit-taking institution—has the meaning given in s5 of the National Credit Act
APG 223 (for example)	An APRA prudential practice guide (in this example numbered 223)
APRA	Australian Prudential Regulation Authority
ASIC v TCS	*Australian Securities and Investments Commission v The Cash Store (in liquidation)* [2014] FCA 926
broker	Generally, a member of the sector of the credit industry that provides independent home loan credit assistance (i.e. home loan credit assistance where the credit assistance related to credit secured by real property and neither the licensee nor its representatives will be the credit provider)
capacity to pay	A consumer's ability to meet required repayments on their loan
consumer	A natural person or strata corporation Note: See s5 of the National Credit Act
credit	Credit to which the National Credit Code applies Note: See s3 and 5–6 of the National Credit Code
credit assistance	Has the meaning given in s8 of the National Credit Act
credit contract	Has the meaning in s4 of the National Credit Code
credit licence	An Australian credit licence under s35 of the National Credit Act that authorises a licensee to engage in particular credit activities
credit licensee	A person who holds an Australian credit licence under s35 of the National Credit Act
credit provider	Has the meaning given in s5 of the National Credit Act
full-term method	A method of assessing the consumer's capacity to pay, based on repayments that are calculated on a principal-and-interest basis over the full term of the loan.
general conduct obligations	The obligations under s47(1) of the National Credit Act
HEM benchmark	Household Expenditure Measure benchmark
interest-only home loan	A home loan on which only interest is paid during a set period. The loan will revert to principal-and-interest repayments at the end of the interest-only period.

Term	Meaning in this document
interest-only period	The period of time during which the consumer is only required to make payments covering the interest of their loan
investor	A consumer who has acquired a home loan for the purpose of purchasing a property that is intended to be rented to a third party
lender	A credit provider
licensee obligations	The obligations of a credit licensee as set out in s47 and 48 of the National Credit Act
loan origination	Process by which a lender determines whether and under what conditions to make a loan
LVR	Loan-to-valuation ratio. The ratio of the amount of the loan outstanding to the value of the property securing the loan.
National Credit Act	*National Consumer Credit Protection Act 2009*
National Credit Code	National Credit Code at Sch 1 of the National Credit Act
person	Has the meaning given in s5 of the National Credit Act
principal-and-interest home loan	A home loan on which the consumer is required to make payments over the term of the loan that pay off interest as well as the principal of the loan
RBA	Reserve Bank of Australia
residual-term method	A method of assessing the consumer's capacity to pay, based on repayments that are calculated on a principal-and-interest basis on the residual term of the loan, once the interest-only period has expired
responsible lending obligations	The legal obligations set out in Ch 3 of the National Credit Act
RG 209 (for example)	An ASIC regulatory guide (in this example numbered 209)
s132 (for example)	A section of the National Credit Act (in this example numbered 132), unless otherwise specified
serviceability assessment	A lender's assessment of a consumer's ability to meet the required repayments on a loan, based on an assessment of income, expenses, and buffers
surplus	The level of funds a consumer is deemed to have remaining after taking into consideration income, expenses, and buffers

Related information

Headnotes

affordability, credit, interest-only period, investor, home loan, repayments, responsible lending, requirements and objectives, serviceability, owner-occupier, principal-and-interest home loan

Regulatory guides

RG 209 *Credit licensing: Responsible lending conduct*

Legislation

Australian Securities and Investments Commission Act 2001

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National Credit Act, s132; National Credit Code

Cases

ASIC v TCS

Media releases

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Other documents

APG 223 *Residential mortgage lending*

APRA, *Quarterly authorised deposit-taking institution property exposures: March 2015*

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