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Wellington

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Submission on the Exposure Draft of the Updated Credit Contracts and Consumer Finance Regulations 2004 and Responsible Lending Code

CAP thanks MBIE for the opportunity to make a submission on this important topic. The regulatory changes that have been introduced are providing very important consumer protection to New Zealanders, particularly those that are vulnerable or at risk of substantial hardship.

CAP has worked with thousands of families in financial hardship over the last 14 years, and time and again has witnessed cases of loans that have both directly and indirectly led to families experiencing substantial hardship. One consistent cause for complaint to Disputes Resolutions schemes has been the inadequate effort that lenders have made to assess a borrower's ability to afford to repay a loan and to meet the needs of their family.

The regulations relating to affordability assessment introduced in December 2021 and the associated Responsible Lending Code (RLC) offer much needed clarity of what responsible lending looks like in practice, namely, guidance for responsible affordability assessment that has, in reality, been a requirement for all lenders since June 2015.

CAP's feedback on the draft exposure consultation is detailed below but could broadly be summarised as encouraging more dialogue between lenders and borrowers where discrepancies arise in affordability assessment, and of clearly leaving the onus on lenders to appropriately enact the intention of the Regulations and of the RLC as responsible lenders where the course is not clear.

CAP recommends including a definition of 'disposable income' in the RLC as it is undefined in the regulations. The current draft assumes a common understanding as it is written but it is understood quite differently between the lending and financial mentoring sectors.

CAP also recommends significant changes to the examples used in the 'obviousness' test.

1. **Do you agree with the way that the draft Regulations are phrased? If not, what changes would you make?**

   CAP is comfortable with the removal of the words "savings" and "investments" from Regulation 4AE (d) where the other examples – "gym memberships, entertainment costs. or tithing" – relate more to living expenses that are unable or unwilling to be ceased. CAP would not support further removing text from this section.

   Stopping recurring outgoing expenses may be straightforward in some cases (some entertainment costs) and may not be straightforward in other cases (tithing). Where there is evidence of recurring outgoing expenses, the onus should sit with the lender to initiate a conversation with the borrower about how these changes may occur.

CAP strongly recommends that the Responsible Lending Code guidance continues to promote dialogue between lender and borrower as the responsible and appropriate response to instances where material relevant expenses will change as a necessity of a loan.

CAP is comfortable with the proposed amendment to Regulation 4AK(2)(b) but only to the extent that it enables the policy intention of relevance only to information collected by asking the borrower. CAP's concern is that this will be misinterpreted as a back-door to rely too heavily on information provided by the borrower, as was the case before section 9C(7) of the CCCFA was repealed. The RLC should clarify that 4AM(a) places a higher requirement on lenders to satisfy and that a responsible lender would still sense-check information provided by the borrower.

2. **Do you agree with the way that the guidance relating to expenses is communicated in the Draft Code? If not, how do you suggest it is improved?**
CAP approves of the articulation that proposed section 5.4 of the Draft Code is intending to express with the language about lenders not 'closing their eyes' to information that is contained in the bank transaction records. Equal weight should be given by a responsible lender on the reliability of all transactions on a given bank statement.

It is extremely important that inconsistencies between the evidence provided by bank transactions and stated expenses is clarified. This may best be resolved by dialogue between the lender and the borrower. It is very well documented within financial capability research that people generally underestimate their expenses. Some lenders may perceive conversations about spending as invasive, but this has been the consistent framework of CAP and financial mentors that build client budgets as well as the framework used by the reputable and safe lending practices of microfinancing.

It has been CAP's experience – demonstrated through multiple formal disputes resolutions – that some lenders exercise a significantly more flexible approach to expense assessment when approving a loan than they do when approving hardship applications. As such, CAP recommends only using the "briefly" in proposed 5.4 if it is qualified that any clear inconsistencies would be the trigger for seeking further information.

CAP recommends that the RLC should clarify that the onus is on responsible lenders to resolve any initial expense differences through dialogue.

<u>5.6 - Discretionary Expenses</u>
CAP is supportive of the intention to introduce a section, 5.6 on Discretionary expenses, as the wording pertains to the policy intention that lenders can ask borrowers about likely expenses after the loan is taken out, but this must be further clarified for the benefit of lenders and consumer advocates alike.

The term 'discretionary expenses' is frequently used within the consumer finance and budgeting sectors but is certainly not consistently defined between the two sectors. It is not a defined term within the Act and does not appear to be defined in the proposed RLC.

As advocates for borrowers within the formal disputes resolution process, CAP has often encountered the term 'discretionary expenses' being used by lenders as a cover-all term for any expense that is not absolutely necessary in the strictest sense. This often leads to a significant underestimate of a client's living costs.

A good example would be owning a dog. A person choosing to become a dog owner may be a discretionary choice, but once a person is a dog owner, there are now clear legal obligations to feed it, pay for registration, house it, etc. These costs are certainly no longer discretionary.

CAP posits that, for the majority of categories of expense, discretionary expenses are not a category in their own right but that they are extension over and above a benchmark or reasonable amount for standard budgeting categories. For example – if a family is spending $700 per week on food but could reasonably (not minimally) live on $400 per week, the $300 difference is the discretionary component.
'Entertainment costs' are largely considered discretionary by lenders, but even low-income families live much healthier, fulfilling lives if they have an allowance that enables them to have flexibility to enjoy their income. Even the budgets that CAP builds for families in financial hardship will include a small allowance for parents to enjoy a swim at the pools with their children. While cutting back on Netflix and a gym membership may be reasonable changes to future spending, it would be unreasonable to think that this category would be $0 for any type of borrower.

CAP recommends that the definition of discretionary expenses is clarified in section 5.6 to provide more accurate guidance as it relates to the regulations.

3. **Should the guidance be limited to certain types of expenses e.g., food?**
   CAP believes that the onus should sit with the lender to have dialogue with the borrower about any type of expenses that may appear discretionary.

4. **Are there other practices for estimating expenses that the Code should endorse?**
   CAP is generally supportive of the Code's description of expense estimation, in consideration of the comments made above.

   With regards to proposed section 5.8, care must be taken around using 'verified' as a way of choosing over benchmarked expenses, because people can always already be spending less than a reasonable minimum cost. It is CAP's experience that one common response to hardship is to stop spending on a particular type of expense altogether. Some lenders have historically been all too willing to choose 'verified' from bank statements over benchmarked expenses.

   CAP recognises that expenses are assessed against 4AM(3) in the regulations but this begs the question of how lenders define a reasonable minimum cost for someone living in similar circumstances (a benchmark) if they are choosing 'verified' underspend over a benchmark? Some lenders do not have a good track-record of understanding what a reasonable minimum cost is, and this remains undefined in the regulations.

   CAP recommends the inclusion of the words "or underestimate" after "would overestimate" in 5.8(b) to provide additional protection for vulnerable borrowers against the risk described above.

5. **Is the new wording in the Draft Code on how lenders may apply a reasonable surplus to comply with regulation 4AF(2)(b)(i) relating to changes to expenses clear? If not, how do you suggest it is improved?**
   CAP broadly accepts the intention here of the Draft Code in section 5.19 as it pertains to the stated policy intention but notes that the wording of 5.19(c) to 4AM(2)(b) here for is far too narrow to be used within the context of a surplus not being required at all. Benchmarkable expenses (as defined in 4AN) are far too narrow a category and only capture a small set of relevant expenses, especially as it is proposed to clarify that benchmarking can be declined in favour of a lower verified relevant expense (5.8(a).

   CAP recommends that the wording of (c) is replaced with "relevant expenses have had adjustments or buffers already applied" as more generic to all types of expenses.

6. **Do you have any other proposals for additional guidance on surpluses?**
   None.

7. **Is the updated guidance and examples on 'obvious' affordability helpful? Do the examples represent situations where affordability is obvious? If not, how could they be improved?**
   It is unfortunate to see the reference in the original code about the intention of the general rule being a "high test" removed as CAP believes this set the tone for the general principle of 4AG.

   CAP is pleased to see the specific guidance as drafted in section 5.27. This is very important because repayment history and credit scores have all too commonly been relied on in the past as evidence of affordability, without considering that people will repay a loan while falling into further hardship (a frequent example would be the repayment of a vehicle loan to avoid repossession, even though it puts the borrower into other types of hardship).

   In relation to the drafted examples of 'obvious', it appears that Example 1, 2 and 3 may all be referring to the same Borrower K. There seems to be the clear link at the start of Example 3, "One year later," but there is no clear link between Examples 1 and 2. Even though the lender and borrowers are the same, there is no practical way that the lender could rely on information collected in previous examples after such a large period of time.

   CAP recommends that distinct, unrelated examples are provided.

   Examples 2 and 3 seem to relate to borrowers with much higher income and net worth (not established in the first example) which seem more in line with the original intention of having a high bar.

   <u>Example 1</u>
   CAP is concerned about the inclusion of the Example 1. This seems a very long way from a high-bar test and could be highly problematic. There seems to be a presumed 'safety' about this particular loan - is it the 'low' interest rate, the low repayment route, the 'low' loan value?

   How could the specific 'obviousness' of this particular case be determined without already having assessed 4AJ income, 4AK expenses (how does the lender verify that spending is indeed taking place on discretionary spending?) A definition of discretionary spending is sorely needed for this to be a viable example. CAP is concerned that this would be a new low-bar target for lenders to aim for. CAP recommends the removal of Example 1.

   <u>Example 2</u>

   Example 2 seems like a reasonable example to include. The extension of this example in the second paragraph seems reasonable but the facts presented do beg the question about whether a home loan top up is suitable for a loan that can be paid off entirely in less than two months with $200,000 disposable income per annum. CAP recommends that the second paragraph is removed or at least separated and presented as a different example.

   <u>Example 3</u>
   CAP is concerned about the inclusion of the Example 3. This may have been included as suitable because of the connection with the facts presented in Example 2, but a financial mentor would recognise significant red flags that should warrant further clarification. In Example 2, K and their partner have $5,000 disposable income every 9 days. In one month, they will have a quarterly bonus payment of $6,000 and also disposable income of over $16,000. A responsible lender would just point out that K has $200,000 disposable income every year.

   CAP suggests that the facts of Example 3 by themselves would not pass an 'obviousness test' – many people rely on bonuses, however guaranteed. If the assessment of Example 3 as obvious relies on facts from Example 2, then it cannot stand on its own right. CAP therefore suggests Example 3 be replaced by an alternative example.

8. **Do you have any other proposals for additional guidance and examples for 'obvious' affordability?**
   It could be helpful to have record an example of two cases that are similar where one could meet the obvious test and one doesn't – a loan from the same lender for the same amount on the same finance conditions but one borrower's circumstances that would be suitable and one that would warrant the full assessment as required by the regulations.
   CAP recommends that, in any case, the RLC specifies that the onus is on the lender to exercise this carefully and infrequently.
   CAP also recommends that the Minister instructs the Commerce Commission to regularly assess cases with a wide variety of lenders that have approved under this condition – perhaps quarterly rather than annually – to ensure that this is not being over-used or abused.

9. **Would any of these initial changes require changes to lender systems before they could come into force? If so, what are the likely timeframes for making these changes?**

   CAP defers to lenders to comment on their own requirements but note that financial mentors and debt solutions specialists like CAP appreciate support to understand and incorporate change to community and advocate training that the Commerce Commission has provided.

I welcome the opportunity for further dialogue and remain willing to discuss any aspects of this submission.

Ngā manaakitanga,

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Christians Against Poverty