Some views about "Responsible Lending"

Introduction

The term "responsible lending" has been used for some years, usually by lenders, to describe various approaches to marketing and selling credit that are regarded as ethical and appropriate.

Initially in response to claims of "irresponsible" or "reckless" lending, the term is used amid increasing concerns about consumer debt levels and mortgage stress. This paper asks "what is responsible lending?" and "to what extent to borrower and lender interests align?".

What is Responsible Lending

Is responsible lending simply providing credit in circumstances where the borrower is unlikely to default – or where the risk of default is within a range acceptable to the lender based on the interest rate (or possibly security)? Or do lenders have a greater responsibility – to offer/provide products in a way that helps their customers achieve their financial goals? By hearing many of the banks talk, you'd think it was the latter – but their conduct suggests the former.

We are not suggesting that lenders should take a paternal approach – but there's a big difference between molly-coddling customers and not drawing them into a trap. Competition has encouraged lenders to use a variety of means to sell and up-sell credit – and a significant part of retaining customers is to encourage them to borrow more or pay back slower. Industry's response to difficulties experienced by some borrowers is usually based on the need for information, and financial education! Unfortunately, the messages that come from marketing are much stronger than those that will ever come from educational material or warnings. If lenders genuinely wanted to have an impact on an individual's ability to manage credit, they may consider putting aside the educational material all together, and focus on ensuring that their marketing and selling practices don't lead borrowers into choices that are not in their best interests.

There are many examples of bad lending practices where those practices are neither in the interests of the lender or the borrower. Of course, if the lender finds these practices are unprofitable overall, it will adjust its lending processes.

For example, there may be little dispute between lenders and consumer advocates in relation to the following scenario. Financial counselors report stories of pensioners, or long-term unemployed borrowers, with no assets and credit card balances of $30,000 or more. Even if these borrowers had equity in their homes, most lenders would be somewhat reluctant to sell this person's home. The lender and the borrowers lose from lending strategies that lead to this type of situation. However, it is often strategies used to "hook in" borrowers (for example pre-approved credit limit increases) that contribute to these extreme cases. The case studies presented by financial counselors and other consumer advocates suggest that many of these clients who have accepted such offers, would not have actually sought the increased limit had it not been "pre-approved" – and anecdotally these are often borrowers with short or long term issues such as illness, depression, family breakdown etc.

However, would lenders agree with our concerns about some other borrowers?

- An aged pensioner with a $10,000 credit card balance, who is unlikely to ever pay it off in her lifetime, but can manage the payments?
- A young couple – able to maintain more than minimum payments on a credit card, but high level of card debt is a key factor in them being unable to save a deposit (or borrow) for a home.
- Any borrower who could not pay off their credit card within 3-5 years.
- A borrower with equity in their home, but where their high debt level stays fairly constant due to constant redraws for holidays, to pay off other debts, etc.
- A borrower who is financially secure (own their home outright) but are about to enter into retirement with a large credit card debt?

The above examples are likely represent situations where there is some divergence between the interests of lenders and consumers. Most of these people won't default in payments – and even those that find themselves in financial trouble, are more likely to refinance (often at higher interest rates) than default.

Unfortunately, it appears that many of that the most profitable borrowers could be those who are, to some extent, financially out of control.

When we consider higher risk and fringe lenders, there are clearer differences between lending that is clearly profitable and lending that is responsible. For example:

- High cost payday lenders and other fringe lenders may lend to those who struggle to repay at very high interest rates (which compensate for the high level of defaults); and
- Fringe mortgage lenders may approve credit based solely on the value of the mortgage property without making any assessment of capacity to pay.

However, there are concerns that even mainstream lenders may sometimes place too much reliance on the ownership of assets as opposed to ability to repay.

This view from a risk management perspective was evident in a report published by Visa International.[1] The authors argued that "Taking net worth into account, the very low-income earners have a very high capacity to repay if they spend their entire limit." In fact, "net worth" is likely to represent the equity in the family home, particularly for lower income consumers, and we would argue strongly that this does not indicate "high capacity to pay". While reverse mortgages have become generally available to retirees since publication of the Visa report, we believe it is of concern if lenders regard home equity as evidence of capacity to pay credit card, or any other, debt.

Examples of Irresponsible Credit Marketing

There are some lenders who are prepared to lend on the basis of home equity alone[2]- but these are not mainstream lenders.

Of course, the provision of credit these days is much more than an individual consumer deciding that they want to borrow funds for a purpose, and approaching a lender and making an application. A lot of credit is sold, rather than bought. Borrowers are urged to borrow more, our mailboxes are overflowing with offers. It often appears that the question is how much can they lend rather than how much does the borrower want. Credit is "pre-approved" to consumers who haven't even requested credit,[3] lenders aim to keep borrowers in debt, and relationships with borrowers are often an ongoing opportunity to market. In some cases, the initial provision of credit is just a "foot in the door" to a relationship for the marketing of more profitable credit. As far back as the 1980s, the Victorian Credit Licensing Authority found that one finance company used information from personal loan applications to market its most profitable product, a mortgage loan which consolidated debts. Lenders are not only seeking out consumers who are unlikely to default, but those who will be profitable – and in some cases this means borrowers who are high risk.

Examples of current credit marketing practices include:

- Pre-approved credit limit increases offered to current credit card customers that can, over the years, increase a $1,000 credit card to over $20,000 – in some cases over $50,000;

[1] Visa International, The Credit Card Report - Credit Card Spending in Perspective, 2002
[2] ASIC, "Protecting Wealth in the Family Home – an examination of refinancing in response to mortgage stress", March 2008, available at: http://www.fido.asic.gov.au/asic/pdflib.nsf/LookupByFileName/REP_119_Protecting_wealth_in_family_home.pdf/$file/REP_119_Protecting_wealth_in_family_home.pdf
[3] Consumer Action Law Centre, *Congratulations, You're Pre-approved*, forthcoming, August 2008

- Letters from our mortgage lenders encouraging us to re-draw from our mortgage – or suggesting we could reduce our payments and use the "savings" for other purposes;
- Deliberate targeting of borrowers who don't (including those who can't) pay off their credit cards within interest-free periods. In fact, it is likely that borrowers most attracted to "transfer balance" deals are those with high balances that they can't pay off within a short period of time;
- Targeting of borrowers who have multiple debts, for example lenders promoting debt consolidation;
- Targeting of borrowers who are currently in default;
- Promotion of "interest free" deals for purchases, which result in a high interest (approximately 28%) credit card with often a much higher limit than required, and urging the consumer to use the card, for example to "withdraw cash at any ATM"; and
- Promotion of further borrowing to "solve" over indebtedness.

Industry Responses to "Responsible Lending"

Current industry responses include:

- Calls for a general increase in financial literacy;
- Provision of information to consumers by way of booklets, or general warnings in marketing materials (often buried in the much brighter attractive marketing material);
- Attempting to remove borrowers who exhibit particular behaviours from pre-approved credit limit increases;
- Calls for more personal financial information through the credit reporting system.

While some of these responses are positive, they fail to address some of the key irresponsible conduct relating to product design and marketing.

Consumer Action Law Centre
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