

Banking & Finance - Bulletin 60

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In this issue:

Breaking a Fixed Rate Loan – our approach to break costs

Direct Debits on Transaction Accounts

Maladministration and Secured Lending

Dealing with Customers in Financial Difficulty

The financial markets globally have changed significantly since our last Bulletin in September 2008. This Bulletin deals with a number of issues that are the subjects of disputes lodged with this office by disputants affected by the consequences of the economic downturn.

Breaking a Fixed Rate Loan

With the recent industry-wide reduction in variable interest rates, we have received a large number of complaints by disputants who have incurred a fee to break their fixed rate loan contract. We therefore consider it timely to set out our approach to this type of dispute.

Ombudsman's Jurisdiction

Under the Ombudsman's Terms of Reference we are not empowered to review a general policy unless the policy breaches a specific duty or obligation owed by the financial services provider to its customer. We therefore will not review a financial services provider's general policy decision to charge a fee for its services or to recover its costs.

Extent of Investigation

Where a dispute involves a complaint about a particular fee charged to a customer by a financial services provider FOS will consider:

- Whether a fee has been properly disclosed to the customer;
- Whether a fee has been properly charged in accordance with the customer's contract with the financial services provider;
- Whether a fee has been correctly applied by the financial services provider, having regard to any scale of charges generally applied by that financial services provider; and
- If the loan is regulated by the Uniform Consumer Credit Code, whether the early termination fee exceeds a reasonable estimate of the credit provider's loss arising from the early termination.

Required Information

The Ombudsman often receives disputes from disputants with fixed interest rate loans who say that the financial services provider did not:

1. Inform them that an early repayment cost would be charged if they terminated their loan before the expiry of the fixed rate period; or
2. If some explanation was given, it did not adequately describe the manner in which the early repayment cost would be calculated.

To consider these types of disputes we will request specific information from both the disputant and the financial services provider regarding the circumstances in which the loan contract was taken out. We will also ask the financial services provider to provide:

1. A copy of the loan contract and associated terms and conditions;
2. The date the loan was funded or settled;

3. The original maturity date of the fixed rate;
4. The original loan amount;
5. If the loan is principal and interest what are the monthly repayments?
6. The date the loan was repaid;
7. Frequency of repayments;
8. The rate used by the bank in determining its funding cost at commencement; and
9. The rate used by the bank at termination.

This information will be used by the Ombudsman's Banking Adviser to form a view whether the break costs charged by the financial services provider were reasonable (as explained below).

Financial Services Provider's Calculation of Loss

FOS accepts that the right to recover the reasonable estimate of the loss suffered by the financial services provider, as a result of a fixed rate loan being repaid early, will be determined by the terms and conditions of the loan contract. Where there is a dispute about the quantum of the loss suffered by the financial services provider we will consider what the movement was in the financial service provider's cost of funds between when the fixed rate period began and the financial service provider's cost of funds for the remaining term of the fixed interest rate period, as at the date of termination.

Calculation for estimating an early repayment cost

The approximate amount of a loss suffered by a financial services provider can be estimated by multiplying the amount of the loan by the remaining term of the fixed interest period and the movement in the financial services provider's cost of funds. For example, the economic cost of repaying a loan of \$100,000 that had two and half year remaining with a movement in cost of funds of 1.00% would be in the vicinity of \$2,500 ($\$100,000 \times 2.5 \times 1\%$). This amount will then be discounted to reflect the present day value of receiving future projected cash flows in advance. This calculation is by its nature complex.

A financial services provider's cost of funds

The critical variable that is not transparent when an early repayment cost is payable is the movement in the financial services provider's cost of funds. The Ombudsman accepts that how a financial services provider determines its cost of funds is commercially sensitive and it is under no obligation to disclose that information to its customers. However, members of FOS do make available to this office their internal cost of funds, in confidence, for the purpose of enabling the Ombudsman to verify that the cost recovered by the financial services provider was a reasonable estimate of its loss.

Based on information obtained from the financial services industry, and for transparency, the Ombudsman has concluded that the pre-estimate of the movement in a financial services provider's cost of funds is best verified by comparing movement in interest rates in the wholesale interest rate market.

The Ombudsman reviews the movement in the wholesale interest rate market by assessing the difference between:

1. The wholesale interest rate for the fixed term of the loan contract (as indicated by the appropriate Swap Rate, quarterly in arrears versus Mean Bank Bill Rate), as published in the Australian Financial Review at the time the loan was established; and
2. The wholesale interest rate for the remaining term of the fixed interest rate period (as indicated by the appropriate Swap Rate, quarterly in arrears versus Mean Bank Bill Rate) as published in the Australian Financial Review at the time the loan was terminated.

This movement in the wholesale interest rates between the two points in time is then used in the early repayment cost calculation to assess whether the loss claimed by the financial services provider represents a reasonable estimate of its loss.

The Ombudsman's Banking Adviser will perform this verification calculation by applying the wholesale fixed interest rates as published in the Australian Financial Review and adopting the principles above.

Financial institutions, however, use their own internal cost of funds for the relevant fixed rate period in their calculation of an early repayment cost. If this information is provided to us, the Banking Adviser will enter these rates along with other loan account details into his/her spreadsheet to determine whether or not the financial services provider's calculation of an early repayment cost is reasonable, according to the financial institution's cost of funds.

Ability to Dispute an Early Repayment Cost

If a customer decides to repay the loan, he/she would not be prevented from subsequently pursuing a dispute. If we conclude that the fee or any portion of the fee has been charged incorrectly we would require the financial services provider to refund to the disputant the amount incorrectly charged.

As a financial service provider's current cost of funds may vary significantly on a daily basis, if a disputant delays early repayment while a dispute is being reviewed by this office, and we do not find in their favour, there is the possibility that the cost of early termination may have significantly increased. We therefore recommend to customers that, in a falling interest rate climate, they obtain regular quotes from their lender as to the early termination cost payable and seek independent financial advice.

Direct Debits on Transaction Accounts

In June 2001, after the Direct Debits system had been in operation for some twelve months, we confirmed our approach concerning the cancellation of direct debits and claims about unauthorised debits – see BFSO Bulletin 29.

Due to a number of recent complaints by disputants about uncanceled direct debits and feedback received from financial counsellors who report that their clients still face problems in cancelling direct debits with their bank, it is appropriate to remind financial services providers about our approach. Financial services providers who are members of the Financial Ombudsman Service should in turn remind their front line staff that a customer can cancel a direct debit on their transaction account by providing an instruction to their financial services provider, without going direct to the debit user.

Our approach reflects the rules prescribed by the Australian Payment Clearing Association (“APCA”) and, for subscribing financial institutions, the Code of Banking Practice (“CBP”).

Australian Payment Clearing Association’s Rules

APCA’s rules, known as the Bulk Electronic Clearing System (“BECS”) rules, specifically set out the rights on the part of accountholders to cancel direct debits in writing or other form acceptable to their financial institution, and to claim compensation, including re-crediting of the funds.

Clause 7.12(h) of the BECS rules requires a financial institution to

“accept a written instruction, or an instruction in such other form as it determines, that it receives from a Customer to cancel a Direct Debit Request addressed by that Customer to a Debit User ... and ensuring as far as practicable (having regard to the fact that some Debit Items may already have been exchanged and/or partly processed), that no further Debit Items under the Direct Debit Request which is the subject of the Customer’s instruction to cancel are posted to the Customer’s account.”

This is reinforced by the overriding limitation stated at the end of clause 7 of the BECS rules, namely:

“But nothing in this Part 7 is to be taken to require a [financial institution] to accept and post Debit Items to a Customer’s account where to do so would be contrary to the Customer’s formal instructions to it.”

Code of Banking Practice

These requirements are mirrored in clause 19.1 of the Code of Banking Practice, which states:

“We will take and promptly process your:

- (a) instruction to cancel a direct debit request relevant to a banking service we provide to you; ...*

and will not direct or suggest that you should first raise any such request or complaint directly with the debit user (but we may suggest that you also contact the debit user)."

Our View

To the extent that a direct debit request is authority to a financial institution to debit a customer's account at the request of a third party, that authority may be cancelled by the customer either by notice to the third party and/or by notice to their financial institution.

Failure to accept or act on written or other acceptable notice of cancellation may cause compensable loss to the customer. In particular, a financial institution will not be able to recover costs such as overdrawing fees charged to an account on acceptance of a further direct debit after the customer has provided notice to the financial institution and may be obliged to re-credit the funds debited, unless the financial institution can show that the payment was made for the benefit of its customer in any event.

Credit Cards

In order to cancel a direct debit on a credit card account, the cardholder should advise the merchant, in writing, in the first instance. If debits continue, the cardholder should contact their financial services provider and ask that the transaction be reversed as unauthorised.

Maladministration and Secured Lending

In Bulletin 45, we set out our approach to disputes about maladministration in relation to credit cards. In this Bulletin, we set out our approach to dealing with maladministration in relation to secured lending.

Terms of Reference

The Ombudsman operates under Terms of Reference that describes the types of disputes he can consider. Clause 5.1(a) of the Banking and Finance division Terms of Reference says:

"The Ombudsman can consider any dispute described in 3 except:

- (a) to the extent the dispute relates solely to a financial services provider's commercial judgement in decisions about lending or security. A dispute will relate to commercial judgement if the financial services provider made an assessment of risk, or of financial or commercial criteria or of character.

The Ombudsman may consider disputes about maladministration in lending or security matters which involve an act or omission contrary to or not in accordance with a duty owed at law or pursuant to the terms (express or implied) of the contract between the financial services provider and the disputant;
...."

It is likely that financial institutions will respond differently to an application for credit from the same applicant because of their different considerations of credit risk and the profile of the applicant. The Ombudsman is not able to interfere with the lending policies of financial services providers to the extent that they reflect the lender's commercial judgement. So disputes solely about a lender's decision not to advance credit or its decision to demand repayment of a debt properly owed and exercise its legal entitlements to recover the debt are about the lender's commercial decision and, as long as no other claims arise, are matters which are outside the Ombudsman's jurisdiction.

If, however, a dispute raises a question about whether there was maladministration in a decision about lending or security, it falls within clause 5.1(a) of the Terms of Reference.

Criteria for Decision Making

The Terms of Reference also specify the criteria for decision making. Clause 1.3 states that the Ombudsman must have regard to the law, applicable industry codes or guidelines, good industry practice and fairness in all the circumstances.

Accordingly, when assessing disputes that raise issues of maladministration in the decision to lend we will also take into account:

- The provisions of the UCCC, particularly the considerations under section 70;
- The provisions under section 7 of the Contracts Review Act, where applicable;
- A financial services provider's common law contractual duty and whether the particular circumstances of the case give rise to a claim of unconscionable or misleading conduct under the *ASIC Act*;
- The provisions of clause 25 of the CBP if the financial services provider is a bank which has adopted the CBP.

How We Investigate Disputes About Maladministration

When assessing whether there has been maladministration, the disputant's ability to repay a debt is critical. Accordingly, we require information about the disputant's financial position (including sources of income, and liabilities and expenses) at the time the loan was advanced or the credit made available. We require information about how the disputant applied for the loan, what the disputant's financial circumstances were, and what the disputant told the financial services provider at the time they applied.

We will ask the financial services provider for the loan or credit application, the loan or credit file, and information about the lending guidelines it applied in its assessment of the disputant's application. We will consider the following issues:

- Was the loan advanced or the credit made available outside the financial services provider's normal guidelines for lending?
- Did the financial services provider express doubt or concerns about the loan or credit application?

- In relation to home loan lending (except for bridging finance) does the information suggest that the sale of the security property was the only real prospect for repayment of the loan from the outset?

What Happens if There is Maladministration?

If there is maladministration in lending, we encourage the parties to resolve the dispute by negotiation. If the dispute cannot be resolved by the parties, we will assess how much of the debt is repayable and, in appropriate cases, we may assist the parties to reach a mutually acceptable repayment arrangement. It is important to stress that the Ombudsman considers disputes on a case by case basis and the general approach described here may be varied depending on the circumstances of the case.

It is our view that, if there has been maladministration in lending, the customer should be returned to the position they were in, had the loan not been approved. A customer cannot retain the asset purchased with a loan and, at the same time, claim that they should not be liable to repay the loan.

Home loans

In the case of a home loan, if we consider that the loan ought not to have been granted, we assess how the disputant used the funds and what costs the disputant incurred as a result of the advance of the loan. Generally, the use of the funds comprises the value of the property purchased with the loan. In such cases, the disputant would be required to sell the property or allow the financial services provider to sell the property. The sale proceeds would be used to repay the loan and other costs incurred in acquiring and holding the asset such as:

- the disputant's costs in purchasing the property (such as the deposit or legal costs);
- any expenses incurred in maintaining the property (such as repairs and maintenance, body corporate fees and including payments made against the loan), and
- costs incurred by the disputant in selling the property.

The disputant would be required to account for any benefit they obtained while owning the property, for example, not having to pay rent or, in the case of an investment property, any rent received from leasing the property and any claimed tax deduction.

The net amount of this calculation is the disputant's claim. If the sale proceeds are insufficient to repay the loan and the costs, then the financial services provider must waive the balance of the loan (if any) and also pay the disputant an amount of compensation equivalent to the costs incurred. If the sale proceeds are sufficient to repay the loan and the costs, then despite the maladministration, when the disputant is returned to the position they were in before the grant of the loan, they have suffered no financial loss for which the financial services provider is required to pay compensation.

If the disputant wishes to retain the property, they will be expected to honour their obligations under the loan contract.

Refinance

Where a disputant claims that a financial services provider has engaged in maladministration and the proceeds of the loan were used to refinance a pre-existing loan on similar terms, we do not consider that the disputant has suffered any loss as a result of the refinancing, since the disputant simply transferred liability for a debt from one financial services provider to another. If however, the new loan had a higher interest rate or fees, compensation may be payable to the extent of those higher costs.

If additional funds were advanced at the time of the refinance, we would apply the principles outlined above to that additional amount only.

Sale and purchase

Where in the course of the transaction the disputant has sold their existing property and acquired another, it is not possible to put the disputant back in the exact same position, because the house that was sold cannot be repurchased. The disputant could, however, purchase a property with similar features to the one sold. If maladministration were established in such a case, then, in addition to compensation for the costs incurred outlined above, the financial services provider may also have to pay compensation in relation to the cost incurred in acquiring a property similar to the one that was sold. This may, for example, include the stamp duty and legal costs for the purchase and, if property values have increased, the increase in the cost of purchasing a similar property.

Jurisdictional limitations

We cannot consider a dispute where the disputant's loss exceeds \$280,000. It is the amount of the loss that is used when assessing our jurisdiction and not the value of the loan or the property purchased with the loan proceeds. The amount of the loss, if any, may not be known until the property has been sold. We will usually proceed on the basis that we have jurisdiction to investigate the dispute (i.e., the disputant's net loss is less than \$280,000). If, however, we find that the disputant's net loss exceeds \$280,000, and the financial services provider does not consent to the dispute remaining in this office, we will be unable to continue to investigate the dispute.

Further information about our approach to maladministration appears on our website, www.fos.org.au

Dealing with Customers in Financial Difficulty

In Bulletins 46 and 53 we discussed the obligations of financial services providers under the Code of Banking Practice ("CBP") and the Uniform Consumer Credit Code ("UCCC") when dealing with customers in financial difficulty. With the economic downturn, the number of disputes including a complaint about a financial services provider's conduct when the customer is in financial difficulty has increased. We therefore would like to remind financial services providers of our approach to these disputes and explain to other readers what we expect financial services providers and customers to do when considering a financial hardship application.

Our Role in a Financial Difficulty Dispute

When we receive disputes about how a financial services provider has dealt with a customer experiencing financial difficulty, we will consider whether the financial services provider has met its obligations under the Code of Banking Practice, its own policy or in accordance with good industry practice.

In cases involving financial difficulty, we encourage the parties to negotiate a realistic solution to the customer's financial difficulty. This solution may involve a variation in the repayment arrangement. If such an arrangement will not help overcome the customer's financial difficulty, and the sale of an asset, such as a house, particularly an investment property, is the only realistic solution, then we will encourage the parties to enter into an arrangement whereby the customer is given a reasonable time to sell the property and, if a contract has not been obtained at the end of that time, to voluntarily surrender possession of the property to the financial services provider. To assist the parties reach a mutually acceptable outcome, we will in appropriate cases, convene a telephone case conference with the Ombudsman or one of our Case Managers.

If the lender has not met its obligations, we will ask the financial services provider to reassess the application for assistance and we may award compensation in some cases. The financial loss, however, may only extend to enforcement costs, default charges or fees that could have been avoided if the application for financial difficulty had been genuinely considered. We may also make an award of compensation for non-financial loss for the associated distress. However, an award for non-financial loss is conservative and would not, in any event, satisfy the customer's arrears.

Hardship Variation Provisions of the UCCC

Section 66(1) of the UCCC sets out the general principle that a debtor with a loan for domestic, household or personal purposes, who is unable reasonably, due to illness, unemployment or other reasonable cause to meet their obligations under a credit contract, but reasonably expects to be able to repay the debt if the terms of the contract are changed in the way described in sub-section (2) of the Code, may apply for such a change.

The Courts have interpreted this general principle to apply to any reasonable cause for a debtor's financial difficulty, and not merely circumstances which were beyond the debtor's control, such as illness or employment redundancy. Therefore, the Courts have considered an application for financial hardship where a debtor has chosen to leave paid employment to try to turn around an ailing business investment, albeit unsuccessfully (*Permanent Custodians Limited v Upston* [2007] NSWSC 223).

The credit contract may be changed in the following ways:

- extending the contract and reducing payments (no change to interest rates);
- postponing during a specified period the dates on which payments are due (no change to interest rates); or
- a combination of both.

Of course, other changes to the contract can be made by agreement.

Written notice of any change longer than three months must be given by the credit provider to the debtor and any guarantor under a guarantee related to the credit contract within 30 days. It is our view that any change to the contract, even one lasting less than three months, should be confirmed in writing so that the parties are clear as to what has been agreed.

A credit provider is not obliged to agree to a hardship variation application. If the credit provider refuses to vary the credit contract, the debtor may apply to the relevant State court or tribunal for an order varying the contract.

Code of Banking Practice and Subscribing Banks

The Code of Banking Practice operates as between a subscribing bank and its individual and small business customers. It therefore has wider application than the UCCC.

Clause 25.2 of the CBP states:

“With your agreement, we will try to help you overcome your financial difficulties with any credit facility you have with us. We could, for example, work with you to develop a repayment plan. If, at the time, the hardship variations of the Uniform Consumer Credit Code could apply to your circumstances, we will inform you about them.”

For those banks which subscribe to the CBP, clause 25.2 is incorporated into every contract with its customers. Therefore, if a subscribing bank fails to meet its obligations under clause 25.2, such failure may amount to a breach of the credit contract. A list of banks which subscribe to the CBP can be found on the website of the Code Compliance Monitoring Committee at www.codecompliance.org.

Non-subscribing Financial Services Providers

We consider the CBP reflects good industry practice and we encourage non-subscribers to the CBP to consider implementing our guidelines on dealing with customers in financial difficulty under the CBP. When considering a dispute about a non-subscribing member’s conduct with a customer seeking assistance due to financial difficulty, we will review the credit contract and any internal policy the financial services provider has regarding dealing with customers in financial difficulty and will investigate whether the financial services provider has complied with the terms of the contract and the provisions of its internal policy.

Our Expectations of the Financial Services Provider

We consider that:

- the financial services provider should give genuine consideration to any repayment proposal and any reasonable alternatives that will help the customer to overcome their financial difficulty;

- where a financial services provider rejects any proposal made by its customer, it should give reasons and ensure that those reasons reflect legitimate considerations and are referable to the particular customer's circumstances;
- a financial services provider subscribing to the CBP should also inform their customer if the hardship variation provisions of the Uniform Consumer Credit Code could apply to them;
- financial services providers should comply with the ASIC/ACCC Debt Collection Guidelines;
- in their dealings with their customer, clause 2.2 of the Code of Banking Practice requires a subscribing financial services provider to act fairly and reasonably in a consistent and ethical manner taking into account the conduct of the parties and the contract.

Our Expectations of the Debtor

Under the CBP, the aim is to assist the customer to overcome their financial difficulty. Under the UCCC, the debtor must reasonably expect to be able to repay the debt if the terms of the contract are changed. Therefore, we expect the Debtor to:

- be willing to work with their financial services provider, for example respond promptly to reasonable requests for information;
- provide current and accurate details of their financial position when requested;
- propose a realistic repayment plan that will result in the eventual repayment of the debt;
- make whatever payments they can while their application is being considered and/or while we are considering any subsequent dispute.

***The Ombudsman – Banking & Finance and his staff
wish you a safe and happy New Year***



**Philip Field
Ombudsman – Banking & Finance
Financial Ombudsman Service**