the circular
FINANCIAL OMBUDSMAN SERVICE

ISSUE 1 – SEPTEMBER 2009

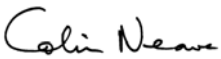
Introduction from Colin Neave

Welcome to the first edition of the Financial Ombudsman Service Circular.

The Circular is designed to facilitate dispute resolution by providing practical information and explaining our approach on substantive issues.

We welcome your feedback about how we can improve the Circular so that the information we send you is relevant, timely and succinct.

Regards



Colin Neave
Chief Ombudsman

In this issue

Operational Guidelines to the Terms of Reference

The Operational Guidelines will provide further explanation for users of our service about our approach to the application of our Terms of Reference. We are consulting with consumer representatives, our members and industry associations to obtain feedback on what the guidelines should address and how particular provisions should be framed to assist Applicants and Financial Services Providers.

We have finished member consultation and when we have completed consultation with the remaining stakeholders, we will prepare a final draft of the Operational Guidelines that takes into account feedback from stakeholders. This final draft will be submitted to our Board for approval in October 2009.

Invitation to provide feedback on changes to the Terms of Reference due to RG139 — deadline 25 September 2009

On 27 July 2009, the Australian Securities & Investments Commission (ASIC) released Consultation Paper 112 entitled "Dispute resolution requirements for consumer credit and margin lending" (CP112).

CP112 sets out ASIC's proposals on administering the new dispute resolution requirements for credit licensees and representatives, margin lenders and those who give advice on margin loans.

ASIC has sought the views of stakeholders and other interested parties on its proposals, with submissions due by 11 September 2009.

If some or all of the proposals in CP112 are adopted by ASIC, we will have to amend our Financial Ombudsman Service Terms of Reference to accommodate these proposals.

ASIC intends to consider the submissions it receives and issue an updated Regulatory Guide 139 (Approval and oversight of external dispute resolution schemes "RG139") in mid to late October 2009.

We are required to comply with RG 139 to maintain our status as an ASIC approved external dispute resolution scheme. We propose to consult with stakeholders about changes that may need to be made to the proposed Financial Ombudsman Service Terms of Reference to ensure that they comply with RG 139 when it is updated. As you will appreciate, there is little time available for this consultation.

Comments on the proposals in CP112 and/or their impact on the Terms of Reference may be made to ASIC up until 11 September 2009. You are invited to also make submissions on these matters to us. You may do this by simply providing us with a copy of your submission to ASIC.

Your submission should be provided to us by **25 September 2009** which will be the end of our consultation period. Please send your submission to Carolyn Bruns, Policy Manager – cbruns@fos.org.au or 03 9613 7389.

Actuarial confirmation of approach to break costs

Through the global financial crisis we saw retail lending rates plummet at an unprecedented rate while financiers' costs of funds increased. As a consequence, we have received in excess of 700 disputes relating to the break costs levied by financial service providers when their customers have sought to pay out or refinance their fixed interest rate loans during the fixed rate period.

Our approach to break cost disputes was recently set out in Bulletin 60, issued by our Banking & Finance group. We will consider:

- whether the break cost has been properly disclosed to the customer;
- whether the break cost has been properly charged in accordance with the customer's contract with the financial services provider; and
- if the loan is regulated by the Uniform Consumer Credit Code, whether the break cost charged in accordance with the contract exceeds a reasonable estimate of the financial services provider's loss arising from the customer's early termination of their fixed rate contract.

As explained in Bulletin 60, our policy in relation to the calculation of break or early termination costs (ETIA) was developed as a response to issues arising in the early 1990s. In the interim, our membership base has expanded from traditional banks to a variety of participants in the financial services industry, who have varying business strategies and funding sources. We therefore sought actuarial advice to assess whether our approach remained appropriate.

Actuary's brief

We engaged Mercer Australia Pty Ltd ("Mercer") to:

- review our approach to estimating a reasonable ETIA and advise whether this approach continues to be reasonable for the banking sector; and
- consider whether the same approach is reasonable for the non-bank sector.

Summary of advice

Mercer:

- confirmed that our approach remains broadly reasonable for both the bank and non-bank sector;
- endorsed the formulae we use to objectively assess the reasonableness of an ETIA levied by a member as reasonable;
- recognised that some lenders (in the bank and non-bank sectors) may source their funds outside the wholesale borrowing market ("non-standard lenders"); even so, ultimately and over the longer term, the estimate for these non-standard lenders will broadly equate to that calculated according to our policy and formula;
- noted that, for any given fixed rate loan that is terminated, there may be additional considerations faced by a non-standard lender.

Our approach

Mercer described our approach as comprising two components:

- a "difference" component, being the difference between the swap rate at the time the loan was established and the swap rate at the time the loan was terminated; and
- the mechanics of our ETIA calculation which multiplies the "difference" by the remaining term and the balance of the principal outstanding adjusted to the present day value.

Mercer specifically did not consider it appropriate to incorporate a lender's margin into the calculation of the "difference" as the relative movement in a lender's margin can reflect any one of the following:

- the lender's standing (and consequential bargaining power in the purchase of funds) or the borrower's standing has deteriorated;
- the lender's fees have increased; or
- the lender's profit margin has increased.

If margins were included in the ETIA estimate, this would have the effect of capitalising changes in margins, in addition to changes in the general level of interest rates.

Non-standard lenders

Mercer considered that, while non-standard lenders may not source their funds in the same fashion as traditional lenders, differences in their costs of funds over time will move in line with differences in the swap rate. However, for any given fixed rate loan that is terminated, there may be additional considerations. For example, a non-standard lender may have a smaller book of loans or alternative source of investment and not be able to relend or reinvest for the remainder of the terminated loan period. However, a good starting point is our approach using swap rates.

Conclusion

As our approach has been verified as a reasonable basis for the estimate of a lender's loss on early repayment of a fixed interest rate loan, we will continue considering ETIA disputes in the same way we have done to date.

Should any member consider itself to be a non-standard lender, such that its particular circumstances cause its estimated loss to differ from our objective assessment, we will consider a submission regarding the appropriateness of the member's approach. However, this may well necessitate the member providing details on its business strategies and parameters of business, its actual source of funding and its reinvestment opportunities.

Advertising campaign for mortgagee sales

In the current economic climate, it is appropriate to remind financial services providers who may be exercising their rights to take possession of and sell secured assets, of guidance and comments that we have provided about a mortgagee's duty and aspects of mortgagee sales. The guidance and comments are set out in Bulletin 38 issued in June 2003.

It is well settled law and practice that a mortgagee in possession is required to advertise a mortgaged property for sale.

Bulletin 38 indicates that an advertising campaign should include print advertisements in local, regional or state-wide newspapers, specialised real estate magazines and agents' franchised publications. However, we acknowledge that internet listings have become an acceptable and widely used medium by which estate agents promote a property for sale and potential purchasers search for available properties within their buying criteria. Internet listings are also available at a price substantially less than the cost of print advertising.

Therefore, we accept that advertising on a well known and well regarded Australian real estate sales website may be an acceptable alternative to advertising in a local, regional or state-wide newspaper. However, for remotely located properties not serviced by such websites, an advertising campaign in a local, regional or state-wide newspaper may still be required for a mortgagee to discharge its obligation to advertise the property for sale.

Approach to complaints that are "frivolous, vexatious or lacking in substance"

Under clause 16 of the Investments, Life Insurance & Superannuation Terms of Reference, a dispute can be dismissed if it is frivolous, vexatious or lacking in substance.

The guidelines on when a dispute may be dismissed on this basis have been revised and updated to include recent rulings by the Investments, Life Insurance & Superannuation Panel Chair on this issue. The revisions are intended to keep the guideline up to date, and do not reflect any change to current practice.

The revised guidelines ("Guideline 1") explain how we approach the question of whether a dispute is "frivolous, vexatious or lacking in substance" and the procedure for dismissing a dispute on this basis. They also include summaries of cases that have been dismissed, to help explain how this issue has been considered in practice.

Change of approach due to increase in Investments, Life Insurance & Superannuation disputes numbers

In the twelve months to 30 June 2009, the Investments, Life Insurance & Superannuation group received a 77% increase in disputes. A significant number of these are likely to require Panel or Adjudicator determination. This level of disputes is continuing in the second half of 2009. We anticipate a further 50% increase in the referral of matters for a decision by a Panel or Adjudicator in the 12 months from 1 July 2009. To date, the bulk of the increased dispute numbers has been in financial planning disputes.

Disputes that we receive after 1 January 2010 will be handled in accordance with the new Financial Ombudsman Service Terms of Reference which is currently with ASIC for approval.

In the interim, while recruiting and training additional case workers, the Investments, Life Insurance & Superannuation group has been reviewing its dispute-handling processes and procedures to identify more efficient ways of bringing disputes to an earlier resolution, without compromising the integrity of our processes, particularly our obligation to provide procedural fairness to the parties.

Some of the strategies adopted to manage the very significant increase in workload are:

- before disputes are investigated, members are provided an additional opportunity to resolve matters directly with consumers;
- the review of our processes for identifying disputes that are potentially frivolous, vexatious or lacking in substance (see below for more information on this);
- case meetings with members with significant dispute numbers to identify matters suitable for early resolution or to identify missing documentation to avoid delay in determination;
- the fast-tracking of appropriate disputes to the Panel or Adjudicator;
- a truncated information exchange process during Panel investigation;
- the early identification of the date when the Panel or Adjudicator will determine the dispute, with parties being held to the timelines established to meet that date; and
- the publication of articles on a range of typical financial planning disputes, to assist members in this sector to understand the approach that we are likely to take in investigating and determining such disputes, and therefore to assist members to respond appropriately to these disputes. (The first such article, on margin loans, is included in this Circular.)

Practice Note 2 has been revised to reflect the change of approach to disputes handling (see further explanation below).

Revised Practice Note 2: Dispute Handling Processes and Information Exchange

Investments, Life Insurance & Superannuation Practice Note 2 PN2 has been revised to reflect the intended approach to handling the very significant increase in dispute numbers. (Please note that Practice Note 2 was previously entitled Practice Note 2 PN2 Information Exchange and Case Summaries.)

View/download revised Practice Note 2.

Disputes handling

Disputes received before 1 January 2010

The revised procedures discussed in Practice Note 2 apply to all disputes received by the Investments, Life Insurance & Superannuation group before 1 January 2010. We will continue to handle those disputes in accordance with the current Investments, Life Insurance & Superannuation Terms of Reference and Practice Note 2 until those disputes are concluded, by either settlement or determination, even after 1 January 2010.

Disputes received after 1 January 2010

All disputes received after 1 January 2010 will be handled in accordance with the Financial Ombudsman Service Terms of Reference, as approved by ASIC.

At present, we are consulting with stakeholders regarding Operational Guidelines for the Terms of Reference. The processes and procedures that will be used to handle all disputes lodged after 1 January 2010 will be in accordance with the Financial Ombudsman Service Terms of Reference and its Operational Guidelines.

So for a period, the Investments, Life Insurance & Superannuation group will be handling disputes under two different Terms of References and processes, with pre-1 January disputes handled under the current Investments, Life Insurance & Superannuation Terms of Reference and Practice Note 2, and all new disputes handled under the processes and procedures which are to be developed in accordance with the Financial Ombudsman Service Terms of Reference and its Operational Guidelines.

Further information

If you have any queries regarding the revision to our current processes, please contact the case manager who is currently handling your file, or:

- Michael Ridgway, Conciliation Manager – for queries regarding the revised case management and the conciliation process on (03) 8623 2007
- Fran Bolger, Manager Panel Case Team – for queries regarding Panel Case Management or Panel and Adjudicator processes on (03) 8623 2038.

Appropriateness of gearing and margin lending strategies

The economic downturn in Australia has shown financial planning and banking practices that have called into question whether gearing and margin lending strategies were appropriate for investors in certain instances.

Gearing and margin lending have often featured in disputes that we have considered. Below is an overview of the general approach followed when considering the merits of disputes involving these types of strategies.

This information is provided as an indication of our general approach. We will continue to consider each dispute about gearing or margin lending on its own merits.

What approach do we follow?

The Investments, Life Insurance & Superannuation Terms of Reference set out a requirement to have regard to amongst other things, the law and good industry practice. Our primary duty, however, is to be fair in all the circumstances.

In addition, we consider the obligation on all Australian Financial Services Licensees to operate their businesses in an efficient, honest and fair manner, as required by s.912A of the Corporations Act.

Further, for AFS licensees that provide personal financial advice, we take into account the more stringent obligations of s.945A of the Act. Given the nature of gearing, this consideration is based on the principle that a financial planner must not recommend a financial product or strategy to a person, who may reasonably be expected to rely on it, if the adviser does not have a reasonable basis for making the recommendation.

This means that an adviser must research the recommended products and then ascertain that the recommendation is appropriate for the investment objectives, financial situation and particular needs of the particular investor. As a general principle, an adviser must match the risk exposure and return potential of the strategy being recommended with the investor's objectives and tolerance to risk.

Who should be using a gearing strategy?

Whilst exceptions can be made in a variety of circumstances, gearing is usually a strategy for high-income earners who have a reasonable period of their working life remaining and have a suitable tolerance for risk. We will assess the suitability of a recommended gearing strategy with these general circumstances in mind.

Important factors in gearing disputes

Important factors in gearing disputes considered by the Panel have included the following:

- What type of investor was involved? Was he/she an aggressive/growth-oriented investor or conservative investor?
- Did the investor have any prior experience with a gearing strategy or margin lending?

- What was the extent of the investor's existing debt liabilities prior to adopting the gearing strategy?
- Was there double gearing? Had geared securities been provided by the investor as collateral for further lending?
- Did the strategy rely upon dividends to service the borrowing costs?
- Had the adviser discussed the history of dividend payments and stability of company earnings with the investor?
- In the case of margin loans, had the adviser explained to the investor the nature of the loan to valuation ratio (LVR) and its potential impact on the investor if the value of the investor's portfolio reduced in value?
- Had the adviser explained any clause of the finance contract relating to the effects of a suspension of trading in a stock?

Our view on gearing

Whilst each case is determined on its own particular merits, some broad points can be made based on disputes regarding gearing strategies that have come before the Panel to date:

- if the investor had little or no ability to resource the loan facility, aside from investment proceeds, it would be difficult to establish that the recommendation was suitable;
- if the adviser's recommendations could only be achieved through the use of gearing and were in conflict with the investor's investment objectives and risk profile, it would be difficult to establish that the recommendation was reasonable;
- if the loan was secured over an investor's primary residence with few other liquid assets in the investor's portfolio, it would be difficult to establish that the recommendation was reasonable;
- if the recommendation to enter into a gearing strategy was based on general or limited advice, it would be difficult to establish that the facility was appropriately entered into.

Other criteria may also make a particular recommendation to adopt a gearing strategy or enter into a margin loan unsuitable for a particular client, and therefore in breach of an obligation under the Corporations Act 2001.

We recommend that financial services providers consider all of the above issues when considering the suitability, or otherwise, of a gearing or margin loan strategy for a particular investor, as well as when assessing its responses in the event of a dispute before the Financial Ombudsman Service.

Contact us

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