The FOS Approach to
Responsible lending series: How we work out a consumer's loss

We have created a series of FOS Approach documents, such as this one, to help consumers and financial services providers better understand how we reach decisions about key issues.

These documents explain the way we approach some common issues and dispute types that we see at FOS. However, it is important to understand that each dispute that comes to us is unique, so this information is a guide only. No determination (decision) can be seen as a precedent for future cases, and no FOS Approach document can cover everything you might want to know about key issues.

1 At a glance

1.1 Scope

When a consumer (an individual or small business owner) cannot make their loan repayments, they sometimes say that their financial services provider (FSP) should not have given them the loan because they never had the ability to repay the loan. The consumer may lodge a dispute with FOS for compensation for the loss they have suffered as a result of the FSP providing them the loan. We call this a responsible lending dispute. When we consider responsible lending disputes, we decide whether it was appropriate for the FSP to lend the money.

This document explains how we assess a consumer's loss in different responsible lending disputes and how the consumer's conduct may affect the compensation they receive.

1.2 Summary

Who should read this document?

1. Anyone who wants to understand how FOS assesses a consumer's loss.
2. Anyone who wants to understand how FOS works out how much compensation the FSP will pay if we decide that the FSP has not acted responsibly when providing a credit contract to the consumer.

Summary of the FOS Approach

If we conclude that an FSP has not lent responsibly, we will assess the consumer's loss and decide what compensation may be payable. We will consider the consumer's costs, how they used the loan funds and what they have to repay.

If the consumer used the loan funds to refinance an existing debt (for example, an existing home loan or credit card), they may not have suffered any loss. This is because the consumer was already liable to repay that amount of debt, but it was just owed to a different lender.

If the consumer purchased a property with the loan funds, we will assess the benefit they received from using it and reduce their compensation by that The FOS Approach Page 2 of 11 amount. For example, if the consumer lived in the house they purchased, we will take into account the amount of rent they would otherwise have paid. If the consumer leased the property to tenants, we will take into account the amount they received through rent and any taxation benefits.

The FSP is liable for the credit risk of its lending decision. Generally, it is not liable for the consumer's investment risk in how the consumer uses the loan funds. Therefore, if the consumer used the loan funds for investments (such as shares) or for their business, usually the consumer will have to repay at least the principal amount the

FSP lent to them (even if the value of the investment has gone down). In those cases, the consumer's loss is usually only the interest and fees they paid to the FSP.

For credit contracts which are not regulated by the National Consumer Credit Protection Act (NCCP), we may decide to reduce the amount of compensation the FSP has to pay the consumer if we consider that the consumer contributed to their loss by not acting responsibly. For credit contracts which are regulated by the NCCP, we will take into account that the NCCP requires the FSP to make an assessment about whether the loan is unsuitable. Depending on the circumstances of the case, we may be less inclined to apportion liability where the FSP has not met those requirements.

2 In detail

2.1 The FOS Approach

If we decide that an FSP has not lent responsibly, we will consider what amount of the loan the consumer is liable to repay.

Consumers who believe their FSP did not make a responsible decision to lend to them often say their debt should be written off (which means that they would not have to repay the loan). However, we do not take this approach.

When we decide how much compensation is appropriate, we take into account what the consumer used the loan funds for, and how much benefit they received from using those funds.

2.2 Refinanced debts – has the consumer suffered a loss?

If the consumer used the loan funds to repay other debts which they already owed (for example, an existing credit card or home loan), we usually consider that the consumer has not suffered any loss. This is because the consumer already owed the debt to another lender before the FSP granted its loan. If the amount of their debt is the same, the consumer now just owes that debt to the FSP, rather than the original lender.

The consumer will only have suffered a loss if the FSP's loan has a higher interest rate or fees than the previous loan. If this happens, we may award Page 3 of 11 compensation for the costs the consumer paid to refinance their debt, and for the difference between the FSP's interest rate and fees and the previous lender's interest rate and fees.

If the consumer received additional funds from the FSP when they refinanced the debt, we will consider whether the consumer is in a worse position overall. This may depend on the interest rates and fees charged by the FSP and the original lender. If the FSP's loan was at a lower interest rate, then even if the consumer borrowed more funds their total interest payments to the FSP may be less than the interest payments to the original lender. In that case, the consumer will not have suffered any loss.

2.3 Refinanced debts – should the original loan have been granted?

If we think it is clear that the consumer is not worse off with their refinanced debt, we will not form a view on whether the FSP's lending decision was appropriate or irresponsible. Instead, we will focus on how the consumer will repay the debt.

We can, however, consider whether the loan should have been granted by the original lender, but only if a dispute is lodged against the original lender within the timeframes set out in FOS's Terms of Reference. If a loan is regulated by the National Consumer Credit Protection Act (NCCP) – such as a credit card, personal loan or home loan – then the dispute must be lodged within two years of the date that the first loan was refinanced with the second lender.

If the first loan is not regulated by the NCCP (such as a loan for business use) then the consumer must lodge the dispute either within six years of the date they could reasonably have known that they had suffered loss; or within two years of the first lender's final internal dispute resolution response, whichever is earlier.

For example, Sarah obtained a loan from Lender A to purchase a property. Lender A increased its interest rates, so Sarah refinanced her loan with Lender B. Sarah later said that she could not afford her loan with Lender B, and that she had also not been able to afford her loan with Lender A without substantial hardship.

We would consider Sarah's dispute against Lender A if she lodged it within the time limits in FOS's Terms of Reference.

This is because Sarah purchased the property as her home, so her loan agreement is a regulated credit contract. Therefore, she would have to lodge her dispute within two years of the date she refinanced the loan with Lender B.

If Sarah purchased a commercial investment property, she would have to lodge her dispute either within six years of the date she could reasonably have known that she had suffered loss; or within two years of Lender A's final internal dispute resolution response, whichever is earlier. If Sarah had to make loan repayments as soon as the loan was provided, it may only have been a few months after getting the loan before she would reasonably have be aware that she could not repay the loan. However, if the loan was self-funding (that is, the loan amount covered the price of her investment property and included extra funds for interest on the loan) she may not reasonably have known that she would have difficulty repaying the loan until much later – for example, when the loan limit was reached.

In exceptional circumstances, we may look at a loan taken out more than six years ago when assessing loss on a refinance.

2.4 Loans used to purchase a house or land

When a consumer says they cannot repay a loan which was used to purchase a property, and we agree that the FSP should not have granted the loan, we will decide what portion of the loan the consumer is required to repay. Generally, the consumer will be provided with 90 days to repay the adjusted loan balance.

Before we award compensation, we will consider any benefits the consumer received while they owned the property. For example, if the consumer lived in the property while trying to make loan repayments, they did not pay rent for living in the property. Therefore, they received the benefit of not paying rent. In the case of an investment property, if the consumer leased the investment property then they received rent and they may also have received tax deductions. We will deduct the value of any benefits from the amount of compensation we award.

How do we work out the amount of the consumer's loss?

We consider that the consumer's loss may include these costs:

- costs paid by the consumer related to the purchase of the property (for example, conveyancing or legal costs, building inspection reports)
- costs paid by the consumer while they owned and maintained the property (for example, council rates, payments for maintenance)
- Any repayments the consumer made to the loan account
- Costs paid by the consumer to sell the property (for example, agents' commission, advertising expenses, legal costs)

From these costs, we would take out the value of the benefits to the consumer from owning the property.

- If the loan was used to purchase a family home we would then require the FSP to write off any amount still owing on the loan, in the event the property was sold, subject to the limits defined in our Terms of Reference. If there was a surplus, it would have to be paid to the consumer. If the loan was used to purchase an investment property the consumer would generally be required to repay any shortfall after the sale of the property.
- For example, we determined that Adam could not afford the loan he used to purchase his family home. The principal amount of Adam's loan was $700,000. FOS calculated that Adam's net loss was $250,000 and his liability for the loan was reduced to $450,000. Adam sold the property for $350,000 leaving a residual debt of $100,000. At the time of the dispute FOS's compensation cap was $309,000. This meant that Adam was still liable to repay $41,000.

2.5 Loans used to purchase a car

When a consumer says that they should not have been granted a loan to buy a car or other vehicle and are seeking compensation, they cannot retain the car that has been purchased with the loan. The car will need to be sold or surrendered to the FSP so that we can work out the amount of compensation that may be payable.

How do we work out the amount of the consumer's loss?

If a consumer purchased a car with the loan funds that should not have been provided, we consider their loss includes:

- any amount the consumer personally contributed to the purchase (for example, the value of a trade-in or a deposit)
- costs paid by the consumer related to the purchase (for example, a roadworthy test)
- any repayments the consumer made to the loan account
- any costs paid by the consumer related to selling the car (for example, advertising costs and roadworthy certificate fee).

From these costs, we would take out the value of the benefit to the consumer from using the car.

We would then require the FSP to write off any amount still owing on the loan. In the case where the consumer's benefit is greater than their loss they will still be liable to repay the net benefit they received from using the car. If there was a surplus, it would need to be paid to the consumer.

How we assess the consumer's benefit from using the car

To assess the benefit a consumer has received from using the vehicle, we look at the difference between the price the consumer paid for the car and the current retail price for the car if it was sold by a second hand car dealer (adjusted for the number of kilometres the car has been driven). To assess this difference we work out the retail (not wholesale) value using either an actual valuation from a person experienced in valuing vehicles or by referencing a reputable vehicle valuation guidebook (such as Glass's Guide).

When we assess the consumer's loss we do not include:

- Petrol and other maintenance expenses. This is because we consider the consumer would have paid for fuel and maintenance for another vehicle if they did not have this particular car. Although the consumer may have used public transport or ridden a bicycle if they did not have the car, we consider that they also had that choice when they used the car. Because the consumer chose to use the car rather than public or other transport, it is fair and reasonable that they should pay for the running costs of the car.
- Payment of registration, compulsory and comprehensive car insurance. These are costs associated with the use of the car, and for the same reasons set out above, we do not include these costs in our calculation of the consumer's loss.
- Alterations and modifications made to the vehicle after it was purchased. We consider that it was the consumer's choice to make any modifications, and those expenses were not caused by the FSP's poor lending decision.

2.6 Loans used for investments

Sometimes an FSP will provide funds for a consumer to invest in any way the consumer chooses. For example, the consumer may invest in shares or other financial products, or the consumer may purchase a property without the FSP taking a mortgage over the property as security. In those cases, the FSP deposits the loan funds into the consumer's account and the consumer uses those funds for the investments they choose.

In these cases, we consider that the consumer will have to repay the loan funds to the FSP, even if the value of the investment goes down. This is because the consumer selected and purchased their investment without the FSP's involvement. The consumer bears the risk of their investment choice, which may either increase or decrease in value over time. In those cases, the consumer's loss is only the interest and fees they have paid to the FSP.

2.7 Loans used for business purposes

When the FSP provides a loan to a consumer for the consumer's business, the consumer often decides how they will use the loan funds in their business. In those cases, the consumer will have to repay the loan, and their loss is only the interest and fees they have paid to the FSP.

2.8 When does a consumer contribute to their loss?

When a consumer applies for a loan, they should consider their own financial situation and how they will be able to repay the loan.

A consumer should also take care to protect their own interests during the process of applying for a loan.

A consumer should not sign a blank or incomplete loan application form. It is reasonable to assume that an FSP will rely on the details of the consumer's financial position to assess the consumer's ability to repay a loan. These details also help the FSP to decide whether it needs any further information or to make any further inquiries.

After the loan application process has been completed and before the loan is provided, the consumer usually will also sign the actual credit contract. The consumer can usually decide not to sign the credit contract if they think the loan is not in their best interest.

If a consumer does not consider how they are going to repay the loan, or signs a blank or incomplete loan application and then signs the credit contract, we may decide that the consumer should take some responsibility for their decision to enter into the credit contract. In those circumstances, we may conclude that the consumer should be liable for some of their loss.

If we consider the consumer is responsible for some of their loss, as a starting point we will consider dividing liability for the consumer's loss equally between the consumer and the FSP. We may increase or decrease a party's share of the loss depending on the specific facts and circumstances of the dispute.

However, if the loan is covered by the NCCP, we may be less inclined to apportion loss where the FSP has not met the requirements of that legislation.

3 Context

3.1 Case studies

Case 1: Wayne's car loan and his loss

In 2010, Wayne entered into a credit contract with the FSP for $48,500. Wayne used the funds to purchase a Holden Commodore V8 car for $42,222 and to finance a consumer credit insurance policy and a shortfall insurance policy. Page 8 of 11.

In 2011, Wayne was in financial difficulty and the FSP refinanced the credit contract. The new contract included finance for a shortfall insurance policy, but not for Wayne's consumer credit insurance.

Wayne lodged a dispute at FOS. He said he could not afford his new contract and the FSP had not acted responsibly when it agreed to the new contract.

FOS considered the FSP's decision in 2010 to grant the initial credit contract (because the refinanced contract was only a variation of the old contract). We concluded that the FSP should not have approved the $48,500 loan.

We required Wayne to return the car to the FSP, and calculated Wayne's loss to be:

- the $200 deposit he personally paid for the car
- his loan repayments of $18,214
- interest on his total loss of $18,414, which we calculated to be $1,973.

According to Glass's Guide (a trade publication about used car prices), the current retail value of Wayne's car – having travelled 50,000 kilometres –was $33,225. We therefore calculated that the benefit to Wayne of using the car was $8,997 ($42,222 minus $33,225).

We determined that the FSP must pay Wayne $11,390 ($18,414 loss plus $1,973 interest less $8,997 value of use).

Case 2: Sally and Richard should have taken more care

Sally and Richard had an existing home loan of approximately $330,000 with another lender. In 2008, they asked the FSP to refinance that loan and to lend them an additional $80,000. They offered to provide a mortgage over their home, which they estimated was worth $640,000. The FSP approved a loan for $410,000.

Sally and Richard failed to make their repayments, and they surrendered their home to the FSP in February 2011. The FSP sold their home in November 2011 for $410,000. Because of the interest which had been charged to the loan since 2008, there was still $189,989 outstanding on the loan after the sale proceeds were used to repay the loan.

Sally and Richard lodged a dispute at FOS. They said that the FSP should have known that they were in financial difficulty with their existing home loan. They also said that if the FSP had not granted the loan, they would have sold their home in 2008 and received proceeds of approximately $310,000 (after repaying their earlier home loan). They could not pay the shortfall in the loan and they believe they should not be responsible for it.

We reviewed the FSP's credit assessment. The FSP had received copies of statements for Sally and Richard's existing home loan, even though its policy did not require it to receive those documents. As it received the statements, the FSP should have considered the information in the statements. If it had done this, it would have realised that sometimes Sally and Richard were late in making repayments. Further, their existing loan was at a fixed rate of 7.36%pa, but they had applied for a variable rate loan at the FSP's advertised rate of 8.98%pa.This information should have alerted the FSP that it needed to make further inquiries about why Sally and Richard wanted to refinance their loan. Therefore the FSP had not acted responsibly in providing the $410,000 loan to Sally and Richard.

We considered Sally and Richard should not be compensated for the drop in the value of their home since 2008, because they chose to refinance their existing home loan in 2008 rather than sell it. Any amount that Sally and Richard lost because of the drop in the house value was not caused by the FSP's lending decision; it was caused by their decision to refinance.

Sally and Richard's loss on their refinanced home loan was the costs they paid to refinance the loan, and the difference between the interest and fees they paid the FSP and the interest and fees they would have paid their existing lender. They were still required to repay the $80,000 which they still owed on the loan. However, their loss included the interest and fees charged on that amount of the loan. In total, we calculated their loss to be $40,220.

We considered that Sally and Richard should have taken more care to protect their own best interests. They knew they were having difficulties making their existing home loan repayments, but they decided to refinance with the FSP for a larger loan and at a higher interest rate. They did this because they did not want to sell their home. Therefore, it was fair and reasonable that they accept some responsibility for their decision. We determined that the FSP was required to compensate them for 50% of their loss, which was $20,110. This amount was to be deducted from the remaining debt. Sally and Richard were still liable for the rest of the outstanding loan.

Case 3: The FSP should have made further enquiry about Stephen's financial position

Stephen obtained a loan of $376,000 to assist with the purchase of an investment property. The FSP calculated Stephen's ability to service the loan based on a declaration of income he provided. There were inconsistencies with the information contained in the application for finance and FOS determined that a prudent lender would have made further enquiries before providing the loan. Had it done so it would have established that the Applicant could not afford to repay the loan. We decided that it was appropriate to apportion 50% of the loss to Stephen on the basis of the inaccurate information he provided to the FSP.

FOS determined that Stephen was liable to the FSP for the principal loan amount or $376,000 plus 50% of his loss. Stephen was entitled to the benefit of payments that he had already made to the loan of $91,030.05.

Description	Amount
Principal borrowed	$376,000
Plus: Interest & Fees (Apportioned 50%)	$140,909.83
Plus: Net Benefit (Apportioned 50%)	$62,974.18
Less: Repayments made	$(91,030.05)
Total	**$488,853.96**

The FSP was required to reduce the loan amount to $488,853.96 and Stephen was provided with three months to repay the loan.

3.2 References

Definitions

Term	Definition
Consumer	An individual or small business owner who uses the services of a financial services provider
Credit contract	A credit facility provided to an individual or small business which may include a\ regulated credit contract
FSP	financial services provider, a business that has chosen FOS as its external dispute resolution scheme and provides a financial service
NCC	National Credit Code
NCCP	National Consumer Credit Protection Act
Regulated credit contract	A contract regulated by the NCCP and NCC or by the UCCC
UCCC	Uniform Consumer Credit Code

Useful links

This document is one of a series we have produced about responsible lending. We have also created documents which cover:

- How FOS approaches responsible lending disputes taking into consideration legal principles, industry codes and good industry practice
- Common issues in responsible lending disputes
- FOS's approach to low doc loans

All four documents in this series can be found on the FOS website at:

- www.fos.org.au/approach

We have published other documents that outline the FOS Approach, including our approach to disputes lodged by guarantors. You can see them all at:

- www.fos.org.au/approach

The FOS website contains more information about what we do, the types of disputes we can consider, and our dispute resolution processes.

- www.fos.org.au