FINANCIAL OMBUDSMAN SERVICE

# Banking and Finance - Bulletin 52
# December 2006

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** On 1 July 2008, the Banking & Financial Services Ombudsman (BFSO), Financial Industry Complaints Service (FICS) and Insurance Ombudsman Service (IOS) merged to form the Financial Ombudsman Service (FOS).*


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## Increase in monetary limit for the BFSO Scheme

On 21 November 2006, the Board of the BFSO resolved to increase the jurisdictional limit of the Scheme from $250,000 to $280,000. The increase is to take account of average increases in housing prices and the amount lent in respect of housing since the last increase of the jurisdictional limit, in 2004.

For the sake of simplicity, the operative date is 1 December 2004, which is the date that the previous increase, from $150,000 to $250,000, took effect. This means that the BFSO will be able to consider a dispute about an amount up to $280,000, provided that the event complained of occurred on or after 1 December 2004.

## Some common misunderstandings

A number of misunderstandings about legal rights and obligations arise regularly in the disputes we see. We thought that it would be useful to outline the more common ones and set out the legal position to assist members and disputants.

### Compensation for misleading conduct

Whether or not there has been misleading conduct is an issue which often arises in cases in investigation; the disputant may say that a statement was made which was relied on in entering into the particular financial services contract; the statement if made was not true and they claim compensation.

Misleading conduct in relation to financial services, which can include but is not confined to misrepresentations, is prohibited by s12DA of the *Australian Securities and Investments Commission Act* (Cth) 2001.[1]

One common misunderstanding we see is in relation to what compensation will be awarded for misleading conduct. For example, where the claim is that a representation has been made that a contract will offer a particular benefit, it is common for disputants to seek as compensation the amount that they would have received if the representation had been fulfilled and the benefit received. This is understandable, the representation led to an expectation: that expectation has not been met.

The remedy for misleading conduct, however, is not to make the alleged statement come true.[2] The measure of damages is not the value of the expected benefit, as it would be for breach of contract, rather it is the loss suffered by relying on the representation.

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[1] S12DB prohibits the making of false representations in relation to specified matters. Section 12DA mirrors section 52 of the *Trade Practices Act,* which no longer applies to financial services. Cases on s52 are nevertheless relevant to interpretation and application of s12DA.

[2] 'The disappointed expectations of a person induced by a misrepresentation to believe erroneously that his insurance policy entitles him to the payment of benefits on maturity or on the happening of a certain event are sometimes so great as to encourage the thought that compensation on the basis of lost expectations would be appropriate. However, neither authority nor principle offer support for adopting this approach.' *Gates v City Mutual Life Assurance Society Limited* (1986) 160 CLR 1, per Mason, Wilson and Dawson JJ.

The question to be asked is how much worse off was the disputant as a result of relying on the representation compared to the position they would have been in had the misrepresentation not been made. Assessment requires a comparison between the position the disputants are now in and the position they would have been in if there had been no misrepresentation.

Put another way, we ask a disputant what would and could they have done differently. There may have been a loss of the opportunity to gain the benefit elsewhere but if the expected benefit was not available in the market, or the disputant would not have been in a position to take up the opportunity elsewhere, there will be no loss.

Some examples from case law are:

Expected benefits from an insurance policy

*Gates v City Mutual Life Assurance Society Ltd* (1986) 160 CLR 1. The case involved a representation that an insurance policy would provide certain benefits in the event of disability – Mr Gates claimed that an insurance agent told him that the effect of a total disability clause was that benefits would be payable if he became unable to carry out his own occupation as a result of illness or injury. In fact the clause only covered him if he was unable to carry out any gainful profession, occupation or employment, which is more difficult to establish.

Relying on the representation, Mr Gates had extended an existing superannuation policy to include the clause and arranged for that cover to be included in a new life policy. As a result of an injury he became unable to carry on his occupation as a builder and claimed under the policy. When the insurer denied the claim he sued for damages – the loss of the expected benefits.

The claim failed because Mr Gates was unable to show that, but for his reliance on the representation, he could and would have entered into policies of insurance providing the expected cover. The High Court found that but for the statements, Mr Gates would have proceeded exactly as he did save that he would not have paid extra for total disability cover. In addition, he could not establish that a policy with the represented cover was available in the marketplace. The High Court held that where the disputant is not able to establish that those benefits were available in the market, there will be no compensable loss.

Representation that interest rate on loan would be fixed

*Marks v GIO Australia Holdings Ltd* (1998) 196 CLR 494. The appellants borrowed money from GIO under loan facilities which allowed GIO to vary the margin, which was added to the base rate, whereas GIO had represented to them that the margin would be fixed for the term of the loan. The appellants claimed the difference between the actual cost and the represented cost – essentially for fulfilment of the representation. The High Court held that the representation did not form part of the contract and that under misleading conduct principles no loss or damage had been suffered because no other loan available in the market at the relevant time would have given them a better rate than the actual rate provided by GIO.

Some examples from BFSO cases are:

Representation that offset account would provide 100% offset on a fixed rate loan

The disputant claimed that the brochure for an offset account was misleading because it represented that the offset account would give a 100% offset on fixed rate loans. In fact, the 100% offset was only available for variable rate loans and the offset was partial for fixed rate loans. The disputant claimed that the 100% offset should be provided with a retrospective adjustment for the lost offset benefit.

In the course of investigation by our case manager the disputant was asked what she would have done, had she known that that it was only a partial offset. She said that she would have taken a loan with other lenders who, she believed, offered a full offset on a fixed rate loan. The case manager made inquiries of the other lenders; they advised that they did not offer a full offset. In the circumstances the Finding was that the requested compensation was not payable.

Representation that funds from the sale of a property would be paid to disputants

The disputants claimed that the member told them that after they sold their house, which, with another property, was security for two home loans, all funds from the sale after the first home loan was paid out would be given to them to do as they wished. When the sale went through the bank held back part of the proceeds of sale in a term deposit account as additional security for the second loan. The disputants wanted the funds released. Because the bank, under its security documents had the right to require substitution of security on the second loan, the disputants were not entitled to enforce the representation. No loss or damage was suffered because they could not have done anything differently.

Representation about ability to make payments to loan from account with another bank

The dispute related to verbal information the disputant was given by the member about how payments to his interest only investment property loan could be made. The disputant understood from this information that he could make payments to the loan from his account with a different financial institution. In fact the terms of the contract required payments to be made from a nominated account with the member.

The disputant already had an account with the member but it had been his intention to close it due to the fees and charges. He was unable to close it because it became, by default, the nominated account for making payments. The resolution sought by the disputant was essentially to be able to make his payments from the external account. This was not possible for system reasons. The case manager found that the loss suffered by the disputant was, ultimately, the fees paid on the account which he was required to keep open: the member had already agreed to refund those fees. A small amount of compensation for non-financial loss was also awarded.

An example of compensation

Although compensation will not be on the basis of enforcement of the representation, compensation may be paid where disputants can establish that they have incurred expenses in relying on the representation. For example:

- if there has been a representation that a loan will be approved; and
- in reliance on that representation the disputants have entered into an unconditional contract to purchase a property that they cannot otherwise afford to purchase; and
- if despite reasonable efforts they were unable to obtain a loan elsewhere;

their loss will be the costs incurred in extricating themselves from the sale contract.

## Misunderstandings about the relevance of intention in misleading conduct and contract

From time to time in the responses of members of the scheme, we encounter a misunderstanding about the elements of misleading conduct. For example, in some cases the response has been about the member's intention in making the particular statement, when in fact intention is irrelevant.

Intention to mislead is not a necessary ingredient of misleading conduct.[3] This means that what a staff member intended to say or what a brochure or other advertising material was meant to express will not be relevant. If the representation is in the form of a statement of fact the question will be whether the statement in fact contains or conveys a meaning which is false.[4]

There is a similar concept in interpretation of contracts.

> 'It is not the subjective beliefs or understandings of the parties about their rights and liabilities that govern their contractual relations. '[5]

What one party intended by a particular clause is irrelevant: the test is objective in the sense that the court will look at what a reasonable person would take the clause to mean. That normally requires consideration of the text, the surrounding circumstances known to the parties, and the purpose and object of the transaction.[6]

## Misunderstandings about mistaken deposits into an account

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[3] *Hornsby Building Information Centre Pty Ltd v Sydney Building Information Centre* (1978) 18 ALR 639 at 647; 140 CLR 216 at 228, *Brown v Jam Factory Pty Ltd* (1981) 35 ALR 79 at 86;
[4] *Global Sportsman Pty Ltd v Mirror Newspapers* (1984) 55 ALR 25. See generally Miller's Annotated Trade Practices Act , 26th edition, 2005 [1.52.35]
[5] *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd* (2004) 219 CLR 165 at 179.
[6] *Toll (FGCT) Pty Ltd*, above

It is our experience that some bank customers believe that they are entitled to keep money deposited to their account as a result of an obvious error. Although the Monopoly card 'Bank error in your favour' may suggest that you get to keep the windfall, in fact the legal position is otherwise.

The law in relation to mistaken payments, as between the person who makes the payment and the person who receives it, is clear. The person who receives it is obliged to return the payment *unless*, in good faith, they have changed their position to their detriment. The requirement of good faith means that a recipient who knows that there has been a mistake must return the funds, whether or not they have spent it, and will not have a defence to legal action for recovery of the funds by the person who made the payment.

Good faith may be established if there was no reason to suspect that an error had been made, for example, if the payment corresponds with a genuine payment expected by the recipient. We have seen cases where the person had some doubts and contacted the bank but was assured that the payment was correct or given a reasonable explanation. Most cases, however, are ones where there is no reasonable explanation for the payment, the sender was unknown to the recipient and the fact that an error was made is obvious to the recipient.

Even where good faith is established, the recipient must have changed their position to their detriment to resist repayment. Using the funds to pay bills or on general living expenses is not sufficient to amount to a change of position. And any money still in their possession must in any event be repaid.

This misunderstanding about whether mistaken payments can be kept is a recurrent problem in internet banking cases, where a customer has made an error in the account details for a payee and the funds have been sent to the wrong person. Following our suggestions in Bulletins 35 and Supplementary Bulletin 39, it is now common practice for banks, when alerted that funds have mistakenly been sent to the wrong account, to notify the recipient of the error and request return of the funds.

In the cases that reach our office, it appears that despite being notified that the money was intended for someone else, some recipients still refuse to return the funds.

We will be discussing in a future Bulletin the position as between banks and the sender of the payment where the money is not able to be recovered from the recipient. The purpose of raising the position of the recipient in this Bulletin is to underline the responsibility of recipients of mistaken payments so that disputes may be avoided.

## Misunderstandings about compensation for errors in setting loan repayments

From time to time we receive disputes about financial services providers making an error in calculating the required repayment to repay a loan within its term. If the required repayment is set too low, the result is that the loan balance will be more than it would have been if the correct repayments had been made and the customer is charged more interest than would have been the case. Depending on the length of time the error goes undetected a significant lump sum payment may be required to bring the balance to where it ought to be to repay the loan within the required term.

Disputants often claim that they should not have to make additional payments and that the loan balance should be reduced to where it would have been had the correct, higher repayments been made. The appropriate compensation, however, is an amount equal to the capitalised interest attributable to the missed payments, not the missed payments themselves.

These cases rarely settle and usually require our office to investigate the dispute, make the calculation in accordance with our policy or review the member's calculation.

Ombudsman's policy

The key elements of a loan contract are the amount borrowed, the loan term and the interest rate applicable to the loan. From these figures the repayment amount is calculated so that the loan will be repaid within the term specified in the contract. We take the view that despite a financial services provider's error in relation to the repayment amount, the customer remains liable to repay the loan amount within the term of the loan at the applicable interest rate – these are monies the customer was always required to pay. For that reason the customer is liable to repay any missed or lower repayments and in compensation terms, account must be taken of the benefit of having the use of the funds which otherwise would have been paid to the loan. The financial loss is the additional interest incurred.

Assessing financial loss

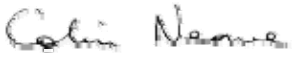
When the repayment amount is less than that required to repay the loan within the contracted term, the loan balance increases and the customer is charged more interest than would have been incurred had the loan been repaid at the appropriate periodic amount. Our policy is that the customer in these circumstances is entitled to claim compensation for an amount equal to the capitalised interest attributable to the lower payments until the date of adjustment.

There may be an additional financial loss in the future if a customer is not in a position to make up the missed repayments at the time the error is discovered. In these circumstances the loan balance is at risk of not being repaid within the stated term. Under our policy an adjustment is made for the future cost of additional interest charges.

A detailed explanation of our approach is set out in our Policies and Procedures Manual under 'Repayment Errors', available at www.bfso.org.au.

As is always the case, we welcome feedback on this Bulletin.

***The Banking and Financial Services Ombudsman and his staff wish you a safe and happy festive season***



**Colin Neave**
**Banking and Financial Services Ombudsman**