

SUBMISSION 5

Banking and Financial Services Ombudsman Limited

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Andrew McGowan
Inquiry Secretary
Inquiry into Home Loan Lending Practices and Processes
House of Representatives Standing Committee on Economics,
Finance and Public Administration

BY EMAIL: andrew.mcgowan.reps@aph.gov.au

Dear Andrew

Home Loan Inquiry

Thank you for your letter dated 25 June 2007 inviting me to participate in the inquiry into home loan lending practices and the processes used to deal with people in financial difficulty. I am grateful for this opportunity to make a short submission to the inquiry, in accordance with your invitation.

The Banking and Financial Services Ombudsman

The Banking and Financial Services Ombudsman (**BFSO**) is an independent external dispute resolution (**EDR**) scheme that considers and seeks to resolve disputes between Australian financial services providers that are members of the scheme and their individual and small business customers. It is an alternative to litigation and free to individuals and small businesses. BFSO members include Australian banks and their related corporations, Australian subsidiaries of foreign banks, foreign banks with Australian operations and other Australian financial services providers.

The BFSO also manages the operations of the Credit Union Dispute Resolution Centre (**CUDRC**) and I am the Dispute Manager for CUDRC. CUDRC is also a free, independent EDR scheme. Its members include credit unions and building societies.

I am able to make observations about the disputes lodged at BFSO and CUDRC concerning their members as well as general



observations about the financial services industry and the operation of the relevant regulatory requirements.

I note however, that I do not have an overview of the entire lending market. Importantly, not all lenders are members of the BFSO (or CUDRC). Australian financial service licence holders are required under the *Corporations Act 2001* (Cth) (the **Corporations Act**) to become members of an EDR scheme like BFSO. However, not all credit providers are required to hold an Australian financial services licence and therefore are not compelled to become a member of an EDR scheme. Some non-conforming lenders would fit into this category. In addition, there are a number of other EDR schemes that have members who participate in the lending market. Those lenders are not members of BFSO or CUDRC.

Issues raised by the inquiry

The following addresses the issues raised in your letter.

1. *To what extent have credit standards declined in Australia in recent years? Market share of non-conforming lenders and increase in low-doc products*

Neither BFSO nor CUDRC has conducted specific research into the numbers of non-conforming lenders and/or low-doc loans in the marketplace. However, publicly available information indicates that the market share of these products has increased in recent years. For example, data recently released by Standard & Poor's reveals an upward trend in the sub-prime portion of the residential mortgage-backed securities market in the past five years.¹

My own observation is that there has been a proliferation of credit products generally in the market in recent years. New and more complex products, such as equity release loans and new loans aimed at first home buyers, are now appearing. Some of these products offer non-standard terms and conditions that are attractive to borrowers who would previously not have been able to afford a loan. Other loans, such as the so called low-doc or non-conforming loans, seem to be specifically marketed toward consumers who have a poor credit history, poor employment record or low income.

¹ Standard & Poor's, 281 *Australian Securitisation News* (18 May 2007), 3 at <http://www2.standardandpoors.com/spf/pdf/fixedincome/Issue281_SecuritisationNews.pdf>.

2. *Have declining credit standards caused an increase in the number of loans in arrears and the number of repossessions? Lack of accurate data on repossessions; 'agreed' sales hiding true rate of defaults.*

Once again, neither BFSO nor CUDRC has undertaken specific research into the number of loans in arrears and the number of repossessions taking place but there is some information publicly available on the issue.

It appears that there have been a growing number of repossessions recorded in relevant Court records. It has been reported that, over the year to April, 2720 repossession claims were lodged with the Victorian Supreme Court, up from 2374 the year before and the highest in six years² and that in 2006, similar court orders in NSW had more than doubled in the past four years.³ The Reserve Bank of Australia has observed a 50 per cent increase in such applications in 2005 in Victoria and NSW compared with the previous year but only about 10 per cent in 2006.⁴

We understand that research is currently being undertaken by the Australian Bankers Association into the number of repossessions taking place in New South Wales, which will also look at the source of the loan and the identity of the lender but results of this research are not yet available.

We are also aware of speculation that the number of repossessions has been underestimated and may be up to four times higher than the reported figures.⁵ It has been said that about three-quarters of forced sales are coordinated with the consent of home owners, and are not recorded in court repossession figures and that defaults are not always reported by some lenders.⁶ However, we note that this speculation is not universally accepted.⁷

BFSO has not observed a significant growth in disputes to our service specifically related to low-doc loans or non-conforming lenders. This may be because we have a relatively small number of non-

² Nassim Khadem, 'Mortgage Defaults on the Rise', *The Age*, 21 May 2007.

³ Stephen Long, 'ACT Lenders Move to Repossess Homes', *ABC News Online*, 14 September 2006, at <<http://www.abc.net.au/news/newsitems/20060609/s1740660.html>>

⁴ Reserve Bank of Australia, 'The Macroeconomic and Financial Environment', *Financial Stability Review* (March 2007) 17.

⁵ Anthony Klan, 'True Rate of Home Defaults Hidden', *The Australian*, 16 May 2007.

⁶ *Ibid.*

⁷ Australian Bankers' Association Inc, 'No Understatement of Housing Default Statistics' (Press release, 16 May 2007).

conforming lenders who are members of BFSO. It is possible too that those non-conforming lenders that are members of BFSO may be more willing to engage with customers who have a dispute than lenders who are not members of the scheme. Finally, not all customers who are in default of their home loan will lodge a dispute with BFSO. Indeed, if legal proceedings have commenced, the BFSO no longer has jurisdiction to consider a dispute.

Generally speaking however, there are cases that we have dealt with, where we have found that the consumer did not have the capacity to repay the loan at the time that it was extended by the lender and made a finding of maladministration in lending. In such matters, depending on the circumstances of the particular case, the lender has been required to waive interest or write off part or all of the debt.

With this in mind, it is worth noting that if a lender that is a member of BFSO extends a loan without making prudent enquiries about the borrower's credit history and capacity to repay the loan, there is a risk of a finding of maladministration in lending being made against it in the event that the borrower defaults on the loan and lodges a dispute with BFSO.

3. *Are borrowers in financial difficulty being treated appropriately by lenders? Obligations under CBP and/or UCCC; access to superannuation for repayments.*

BFSO has dealt with a number of cases that have raised the obligations of lenders under the *Code of Banking Practice (CBP)* and/or the *Uniform Consumer Credit Code (UCCC)* when dealing with a customer who is suffering from financial difficulty.

Section 66 of the UCCC

Section 66 of the UCCC provides that a debtor who is unable, reasonably, because of 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 contract is changed in the ways described, may apply to the credit provider for such a change. This can include extending the contract and reducing repayments (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.

Importantly, the hardship provisions of the UCCC are subject to a threshold. If the amount of the loan exceeds this threshold, then the

hardship provisions do not apply. The threshold is a floating threshold, equal to 110% of the average loan size for the purchase of new dwellings in New South Wales as reported by the Australian Bureau of Statistics on a monthly basis.

A credit provider is not obliged under section 66 to agree with the application and vary the contract but if it refuses, the debtor can apply to the relevant state court or tribunal for an order varying the contract.

More information about the way section 66 has been applied by the Victorian Civil and Administrative Tribunal and other state Tribunals is set out in a recent paper by Philip Field, Legal Counsel at the BFSO, which is also attached to this letter. Also attached is a case note summarising the recent case of *Permanent Custodians Ltd v Upston* [2007] NSWSC 223, which considers section 66.

If a request for a variation under section 66 is the only issue raised in a complaint to BFSO, and the member is not a subscriber to the CBP, we will not investigate the case because we cannot make an order requiring a variation. We consider it more appropriate and time efficient for the customer to apply to the relevant state court or tribunal for a variation. However, we will draw both parties attention to what we consider to be good industry practice and, in our view, good industry practice is consistent with the broader requirements in clause 25.2 of the CBP.

Clause 25.2 of the CBP

Clause 25.2 of the CBP states:

With your agreement, we will help you to overcome your financially difficulties with any credit facility that you have with us. We could, for example, work with you to develop a repayment plan. If, at the time, the hardship variation provisions of the [UCCC] could apply to your circumstances we will inform you about them.

Clause 25.2 applies only to banks that subscribe to the CBP.

Central to compliance with this requirement is that the subscribing bank responds when put on notice that the customer is in financial difficulty and gives real and genuine consideration to the relevant information their customer has provided about their financial position.

Systemic issue investigations into subscribing banks in relation to clause 25.2

In our 2005-2006 Annual Report, we reported that we had received a number of disputes relating to clause 25.2.

BFSO has the power to investigate and resolve systemic issues, that is, issues that are raised in a dispute with BFSO and appear to have either affected, or have the potential to affect, a number of customers in addition to those who have complained to BFSO.

BFSO considered the problem to be a systemic issue in each of the cases and worked with each of the banks to resolve the issue.

BFSO considered the existing procedures of the relevant members in respect of customers in financial difficulty and different measures were adopted to resolve the systemic issue in each case, including:

- Updating procedures to ensure the bank gave genuine consideration to customers in financial difficulty;
- Revising correspondence to inform customers of their rights under the UCCC;
- Providing written reasons to customers declining a hardship application; and
- Training staff to recognise when customers are experiencing financial hardship.

Further disputes

Since the 2005-2006 Annual Report, we have continued to receive disputes which point to systemic issues in this area.

In particular, we found that a number of subscribing banks had continued to undertake their collection activities with reference to the more limited hardship provisions in the UCCC and had not adequately updated or reviewed their policies and procedures to ensure that they were compliant with the broader obligations under the CBP.

For example, we found that the subscribing banks policies did not give attention to the fact that:

1. Financial difficulty can arise from circumstances other than illness, unemployment or other cause (as specified in section

66 of the UCCC). For example, over-commitment or over spending may not be considered a reasonable cause under the UCCC. However, under the CBP, if the person is experiencing financial difficulty, there is no requirement to make a moral judgment about the circumstances that led to the person being in that position; and

2. There are a broader range of responses available under clause 25.2 of the CBP than the changes specified in section 66 of the UCCC. The CBP does not limit the types of arrangements that can be made, the most obvious difference being that there can be an arrangement with a change in interest rates, even if it is a short term waiver of interest.

Some of the forms of communication or processes about which we have concerns include:

- Staff appearing not to respond when a customer indicates that he or she is in financial difficulty and so information about how to obtain assistance with their financial difficulty is not given. In some cases it seemed that the bank member did not respond at all unless and until the words “financial difficulty” or “hardship” were used by the customer and then the response was driven by the UCCC rather than the broader CBP obligations;
- Requiring customers to show that there is a “reasonable cause” for their financial difficulty which indicates a UCCC focus rather than looking at what the financial position of the customer is, separate from the cause;
- Customers being told that, if specified information was not returned within comparatively short time frames, the account would automatically be referred back to collections meaning that the application would also be automatically rejected. In our view a short time frame does not recognise the time needed to seek and receive supporting documents from bodies such as Centrelink;
- Procedures which limit available responses to short term solutions of three months duration rather than looking at longer term solutions which may be more appropriate. In some cases the use of three month moratoriums seem to be driven by an exception to the UCCC section 65 obligation to document a change. The exception arises under sub section

(2) where the change defers or reduces obligations for a period not exceeding 90 days. Again this seems to show that responses are confined to UCCC considerations;

- Requiring the customer to apply to access their superannuation before an application for assistance will be accepted; and
- Not applying clause 25.2 processes to small business or investment loans or if the loan value is over the UCCC threshold. Clause 25.2 is not subject to these restrictions.

For more information about our approach to clause 25.2, please refer to our Bulletins number 46 and 53. Bulletin 53 in particular includes a number of detailed case studies. Copies of both of the Bulletins are attached to this letter. Please refer also to the attached paper by Philip Field, which also discusses the obligations of subscribing banks under clause 25.2.

Summary and recommendation

In our view, clause 25.2 of the CBP is a very valuable step forward in this area. It provides a good framework for both subscribing banks and their customers with which to deal with financial difficulty. Following BFSO's work with subscribing banks, we have noticed that subscribing banks have paid greater attention to their obligations under clause 25.2 and have taken steps to ensure that they are compliant with the clause, and in some instances have raised the standards even higher.

As noted above, clause 25.2 of the CBP is only applicable if the lender is a subscribing bank. Although we consider that our approach to clause 25.2 (as set out in our Bulletins) generally indicates good industry practice, other lenders are not bound to comply with these obligations.

In our view, the committee could give some consideration to the value of working with the States and Territories to broaden the requirements in the UCCC to encompass the obligations currently set down in clause 25.2 of the CBP. This would ensure that all lenders are subject to the same requirements and would also provide more certainty for borrowers about the way in which they will be treated if they are in financial difficulty.

4. *Are declining credit standards likely to have any long-term implications for the Australian financial system? Lessons from the current situation in the United States.*

BFSO has not conducted any research on the sub-prime lending market in the United States and I have no other comments to make on the long-term impact on the Australian financial system of the rise in non-conforming lenders and low-doc loans.

Other comments

Current regulation of consumer credit by the States and Territories under the UCCC has led to a significant gap in coverage in relation to consumer access to EDR schemes.

As noted earlier, some credit providers are not subject to the same regulatory and licence requirements as providers of other financial services that are regulated under the Corporations Act. In particular, licensed financial services providers are required to become members of an EDR scheme but lenders who provide credit only are not subject to this requirement. This means that some consumers of credit products do not have access to any EDR scheme. This particularly affects the customers of small amount loans but may also affect the customers of some non-conforming lenders.

Ultimately, this means that borrowers who obtain loans from lenders that are members of an EDR scheme have greater ability to obtain redress in the event that they have a dispute with a lender.

The committee may wish to consider further ways to ensure that lenders that are currently not subject to licence requirements under the Corporations Act may be required to become members of EDR schemes.

Please contact me on 03 9613 7301 or cneave@bfsso.org.au if you have any questions about the above.

Yours faithfully

Colin Neave
Banking and Financial Services Ombudsman