

BANKING AND FINANCIAL SERVICES OMBUDSMAN

SUBMISSION TO THE ECONOMICS REFERENCES COMMITTEE

PUBLIC INQUIRY INTO THE POSSIBLE LINKS BETWEEN HOUSHOLD DEBT, DEMAND FOR IMPORTED GOODS AND AUSTRALIA'S CURRENT ACCOUNT DEFICIT

1. About the Banking and Financial Services Ombudsman

The Banking and Financial Services Ombudsman ("the BFSO" or "the Scheme") is an independent dispute resolution service which considers disputes between individuals or small businesses and financial services providers ("FSPs") which are members of the Scheme.

Members of the Scheme include all Australian owned banks and their related bodies corporate, as well as some Australian subsidiaries of foreign banks, Australian branches of foreign banks, and several non-bank financial institutions.¹

The BFSO has been approved by the Australian Securities and Investments Commission ("ASIC") under Policy Statement 139 as an external disputes resolution ("EDR") scheme for holders of a financial services licence.

The Scheme is an alternative to the courts and its services are free to individuals and small business. The BFSO can, subject to the Scheme's Terms of Reference, consider a dispute which relates to any act or omission by a member of the Scheme in connection with the provision of a financial service.

The BFSO can make a recommendation or determination of up to \$250,000. A determination is binding on the member.

Further information about the role and operation of the BFSO is available at: www.bfso.org.au.

¹ A list of BFSO members is available on the BFSO website at www.bfso.org.au.

2. Scope of this Submission

The submission addresses the following Terms of Reference:

- **Term of Reference (b):** The factors, including the lending policies of banks and other financial service institutions, that contribute to household debt levels; and
- **Term of Reference (i):** Whether there is a need for any other form of regulatory intervention in relation to this issue.

This scope of this submission is limited to those Terms of Reference which come within the knowledge and experience of the BFSO. The submission is based on data and case studies collected by the BFSO and includes information contained in the BFSO's Bulletin No. 33 released in March 2002 (copy attached).

3. **Term of Reference (b): The factors, including the lending policies of banks and other financial service institutions, that contribute to household debt levels**

Introduction

The purpose of this submission is to draw upon the BFSO's experience in facilitating the resolution of disputes between disputants (individuals and small businesses) and FSPs, in order to assist the Committee in determining the factors, including the lending policies of banks and other FSPs, that contribute to household debt levels in Australia.

The BFSO considers that it is well placed to provide comments on this issue because:

- its has a broad based national membership of FSPs, including all Australian owned banks;
- the majority of disputes received by the Scheme are brought by individuals and, therefore, primarily relate to personal and household finances; and
- it has jurisdiction to consider disputes against FSPs in relation to maladministration in lending which, in our view, may be a contributing factor to household debt levels.

We note that the comments provided in response to this Term of Reference are observations and do not represent any conclusive findings about the interrelationship between the practices of FSPs and household debt levels. We hope, however, that the Committee will find our remarks informative and that they will be of assistance to the Committee in its inquiry.

Jurisdiction of the Scheme

The type of disputes the BFSO can consider are set out in its Terms of Reference.

Term of Reference ("TOR") 5.1(a) stipulates that the BFSO cannot consider disputes in relation to a FSP's commercial judgement:

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

However, 5.1(a) further provides that the BFSO can consider disputes about maladministration in lending:

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.

Approach of the BFSO - Maladministration in Lending in Granting Credit for Credit Card Facilities

Over the five year period ending 31 December 2004, the BFSO has received an increasing number of disputes in relation to maladministration in lending by FSPs. The largest increase in maladministration in lending disputes has occurred in the granting of credit for credit card facilities.

When considering maladministration in lending disputes the BFSO, in accordance with TOR 1.3, has regard to the law, applicable industry codes or guidelines, good industry practice and fairness in all the circumstances.

In the context of maladministration in lending in the granting of credit for credit card facilities, the BFSO applies the principle set out in paragraph 25.1 of the Code of Banking Practice which states that:

Before we offer or give you a credit facility (or increase an existing credit facility), we will exercise the care and skill of a diligent and prudent banker in selecting and applying our credit assessment methods and in forming our opinion about your ability to repay it.

In addition to its Guidelines and Policies and Procedures, which are publicly available on the BFSO website, the BFSO regularly releases Bulletins outlining its approach to new and emerging issues within the financial services sector (also available on our website). In Bulletin No 33, released in March 2002, we stated that:

This office takes the view that increases in credit card limits ought to be assessed in the same manner as the initial granting of credit.... The same comments apply to invitations issued by banks to customers to obtain an additional credit card based on the bank's assessment of the repayment history on an existing credit card.

A more detailed discussion about the practice of FSPs in granting credit limit increases for credit card facilities is set out below. However, it is first necessary to examine the BFSO's statistical data in relation to maladministration in lending.

Statistical Data – Maladministration in Lending

For the purpose of preparing this submission, we have collated data over the period 1 January 2000 – 31 December 2004 in relation to maladministration in lending.

Disputes Included in Data

This data is presented on the basis of the total number of disputes received over the relevant period. It includes cases which were discontinued and/or determined to be outside the Scheme's Terms of Reference and, therefore, were not referred to the member for consideration.

Manner in which Data is Collected

The BFSO classifies all disputes it receives according to:

- the product or service obtained by the disputant; and
- the problem with the product or service, as reported by the disputant.

In order to limit our comments to products or services which may contribute to household debt levels, we have focussed our inquiry on 'consumer finance'² and 'housing finance'³ with the problem type of 'maladministration in lending'.

Classification of Disputes as 'Maladministration'

Where a case has been categorised as 'maladministration' this does not mean that a determination of maladministration was made by the BFSO. Rather, this category was deemed to be the most appropriate on the basis of the description of the dispute provided by the disputant.

Maladministration in Lending Disputes

The statistical information we have gathered, reveals that a growing number of disputes are being received each year in relation to maladministration in lending in the granting of consumer finance (see Table A, below). In contrast, disputes about maladministration in lending in the granting of housing finance have remained relatively static over the same period (this difference may be due to prevailing economic conditions in the housing market including low-interest rates and a widespread increase in the value of residential property).

	Maladministration in Lending Disputes	Consumer Finance	Housing Finance	Business Finance & Other⁴
2000	148	57	58	33
2001	209	129	48	32
2002	192	130	44	18
2003	205	150	39	16
2004	269	213	41	15

Table A

Maladministration in Lending Disputes – Consumer Finance

Table B, below, sets out the total number of maladministration in lending disputes received in the granting of consumer finance and the particular category each of those disputes related to.

² 'Consumer finance' includes: Hire purchase/lease – consumer; credit cards; equity finance – secured; margin lending; personal loan; line of credit/personal overdraft and interest free finance.

³ 'Housing finance' includes: home loan fixed interest; home loan variable rate and investment property loan.

⁴ 'Other' includes: deposit accounts; financial planning; payment systems; and other products.

	Maladministration in Lending Disputes - Consumer Finance	Credit Card	Equity Finance	Personal Loan	Personal Overdraft
2000	57	36	1	19	1
2001	129	108	3	18	0
2002	130	101	3	23	3
2003	150	118	0	31	1
2004	213	175	4	32	2

Table B

Maladministration in Lending Disputes – Housing Finance

Table C, below, sets out the number of maladministration in lending disputes received in the granting of housing finance and the particular product each of those disputes related to.

	Maladministration in Lending Disputes - Housing Finance	Home Loan Fixed Interest	Home Loan Variable Rate	Investment Property Loan
2000	58	6	34	18
2001	48	0	27	21
2002	44	1	26	17
2003	39	0	25	14
2004	41	2	31	8

Table C

Maladministration in Lending Disputes – Credit Cards

As set out in Table B, there has been an increase in the number of maladministration complaints received annually in relation to the granting of credit for credit cards facilities. In 2000, 24.32% of maladministration in lending disputes related to the granting of credit for credit card facilities. By 2004, this figure has increased to 65.05%.

One factor which may have contributed to this increase in disputes is the practice of FSPs of offering existing customers an increase in the limit on their credit card without undertaking a re-assessment of the customer's capacity to service the increase in credit. In some cases, the increase in the limit results in a debt that the customer cannot afford to repay.

The following case study illustrates this practice:

Case Study A

A is a pensioner living in public housing with her son. A applied to the bank for, and received, a credit card with a limit of \$1000. Over 10 years later, A requested an increase to \$2000, which the bank granted. In subsequent years the bank wrote to A and offered to increase her limit further. A accepted each offer to increase her limit. Initially the limit was increased to \$4000, then \$9000 and then to \$22,500. After the initial credit card application, the bank did not ask A to provide any information to assist the bank to undertake a reassessment of her ability to service the credit limit increases. After receiving the final credit increase, A gradually withdrew the full credit limit of \$22,500 from her credit card account. A was able to borrow money from family members to meet her credit card minimum repayments for a time. Eventually, A fell into arrears on her credit card repayments. The dispute was referred to the Scheme after A made a complaint of maladministration against the bank. This dispute is currently in the process of being resolved.

In our experience, FSP's are likely to offer credit increases to existing customers on the basis of internal "behavioural scoring" undertaken by the FSP.

In the cases we have seen, the behavioural scoring methods adopted by FSPs do not include a request that the customer provide up to date information about their income and financial circumstances, including whether the customer has obtained other credit cards or financial commitments (such as a personal loan) from other FSPs since their initial application for a credit card.

Often behavioural scoring will be used for the purpose of sending unsolicited offers to existing customers to increase their credit limit. However, in some circumstances, as illustrated by the following case study, a FSP may use behavioural scoring, including factors such as previous repayment history, to grant a customer initiated request for an increase in credit:

Case Study B

B is on a disability pension and currently earns around \$200 per week. B had a credit card with a limit of \$12,000. The limit on the card had been increased from \$6,000 to \$12,000 after B had accepted a pre-approved offer from his bank. B decided to close his account, which he did, but two months later B applied for and received a new credit card with a limit of \$1,000. The next day, B requested an increase to \$12,000. The request was granted on the basis that B had previously had a credit card with a limit of \$12,000 and had maintained that account in good order. Over the following months, B withdrew all his available credit in cash advances which B states was

spent on gambling. B was unable to maintain his minimum monthly repayments and fell into arrears. B made a complaint of maladministration against the bank.

In our view, the bank's decision to increase the card limit from \$1,000 to \$12,000 amounted to maladministration because, based on B's income and living expenses, B did not have the capacity to service a \$12,000 credit limit. The fact that B previously had a credit card with a limit of \$12,000, and had maintained that account in good order, did not justify the granting of a similar limit on a new card.

It appears, from the above case study and other disputes which have been referred to us, that the behavioural scoring methods adopted by FSPs can place significant emphasis on the repayment history of a customer. However, no enquiry is made into the sources of repayment and, in a number of cases, the customer's ability to meet the minimum repayment amount by the due date does not necessarily indicate that the customer is able to service the debt. A customer may, for example:

- make the minimum repayment on the due date and then use the card to the value of that payment the next day because without those funds they cannot pay for expenses;
- withdraw a cash advance from one credit card to meet the minimum repayment on another credit card; or
- borrow money from friends or family members to meet the minimum repayments.

Conclusion

The statistical data collected by the BFSO reveals a marked increase in disputes received in relation to maladministration in lending in granting credit for credit card facilities. Although the number of cases may not be great compared to the number of credit card accounts in the population, when credit is granted without a capacity to repay substantial hardship is caused to the individuals involved. In our view, it is likely that the failure of FSP's to undertake a re-assessment of an existing customer's capacity to pay before granting or offering an increase in their credit limit has resulted, at least in part, in this increase in complaints. While the BFSO is not in a position to comment more broadly on the impact of the lending practices of FSPs on household debt levels, we can make the observation that this practice may be a contributing factor to household debt levels and, on that basis, should form part of the Committee's inquiry.

4. Term of Reference (i): Whether there is a need for any other form of regulatory intervention in relation to this issue

The BFSO is supportive of the role played by self-regulation in the financial services sector. Self-regulatory initiatives, including the establishment of the Scheme in 1990, have made a significant contribution to the development of effective dispute resolution procedures for consumers and small businesses when dealing with FSPs.

It is vital, however, that self-regulatory initiatives are underpinned and supported by a strong legislative framework which ensures that consumers and small businesses have access to independent dispute resolution procedures when dealing with a FSP.

In this regard, we note that entities who are required under the *Corporations Act 2001* (Cth) to have an Australian financial services licence and who provide financial services to retail clients must have a dispute resolution system in place to deal with consumer complaints about any of the financial products and services provided under the licence.⁵ The dispute resolution system must include membership of one or more EDR schemes to cover all products and services provided to retail clients.

However, while financial services licensees must belong to an approved EDR scheme, other businesses competing in similar markets are not required to do so. For example, finance companies and other credit providers are not subject to similar requirements. Similarly, many finance and mortgage brokers are not legally required to belong to an approved EDR scheme⁶. This is problematic for consumers where the conduct of a finance company or broker may have caused them loss, but that entity is not a member of an approved EDR scheme.

In our view, it is desirable that all credit providers, finance companies and mortgage and finance brokers offer similar access to EDR mechanisms. Requiring membership of an ASIC approved EDR scheme would provide consumers with consistent and effective remedies across the financial services sector. We support regulatory intervention, and a state and national level, to achieve this outcome.

⁵ See section 912A(1)(g) of the *Corporations Act 2001* (Cth).

⁶ We note that the Ministerial Council on Consumer Affairs in New South Wales has released a discussion paper on the proposed national regulation of finance brokers. The BFSO has provided a submission in response to the discussion paper.

5. Further information

For further information about the submission, please contact Ms Margery Clark, Policy Officer, on (03) 9613 7370.