FINANCIAL OMBUDSMAN SERVICE

National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012

Introduction

This is the submission by the Financial Ombudsman Service ("FOS") in response to the draft of the *National Consumer Credit Protection Amendment (Credit Reform Phase 2) Bill 2012* released by the Treasury for public consultation in December 2012.

This submission has been prepared by the office of FOS and does not necessarily represent the views of the Board of FOS. It draws on the experience of FOS and its predecessors in the resolution of disputes relating to financial services.

Information about FOS

FOS commenced operations on 1 July 2008. It is an independent dispute resolution scheme that was formed through the consolidation of three schemes:

- the Banking and Financial Services Ombudsman ("BFSO");
- the Financial Industry Complaints Service ("FICS"); and
- the Insurance Ombudsman Service ("IOS").

On 1 January 2009, two other schemes joined FOS, namely:

- the Credit Union Dispute Resolution Centre ("CUDRC"); and
- Insurance Brokers Disputes Ltd ("IBD").

FOS is an external dispute resolution ("EDR") scheme approved by ASIC. Membership of FOS is open to any financial services provider ("FSP") carrying on business in Australia including providers not required to join a dispute resolution scheme approved by ASIC. Replacing the schemes previously operated by BFSO, FICS, IOS, CUDRC and IBD, FOS provides free, fair and accessible dispute resolution for consumers unable to resolve disputes with FSPs that are members of FOS.

Members of BFSO, FICS, IOS, CUDRC and IBD are now members of FOS. The members of those schemes included:

- BFSO – credit providers, mortgage brokers, payment system operators, Australian banks and their related corporations, Australian subsidiaries of foreign banks and foreign banks with Australian operations;
- FICS – life insurance companies, fund managers, friendly societies, stockbrokers, financial planners, pooled superannuation trusts, timeshare operators and other Australian FSPs;
- IOS – general insurance companies, re-insurers, underwriting agents and related entities of member companies;
- CUDRC – credit unions and building societies;
- IBD – insurance brokers, underwriting agents and other insurance intermediaries.

FOS and its predecessor schemes have over 20 years experience in providing dispute resolution services in the financial services sector, and it is estimated that FOS covers up to 80% of banking, insurance and investment disputes in Australia.

FOS provides services to resolve disputes between member FSPs and consumers, including certain small businesses, about financial services such as:

- banking;
- credit;
- loans;
- general insurance;
- life insurance;
- financial planning;
- investments;
- stock broking;
- managed funds; and
- pooled superannuation trusts.

As well as its functions in relation to dispute resolution, FOS has responsibilities to identify and resolve systemic issues and obligations to make certain reports to ASIC. FOS also monitors compliance with a number of industry codes of practice.

FOS is a not for profit organisation that provides services free to consumers. FOS is funded by its members, which are FSPs. A significant proportion of our funding is from case fees, and the fees paid by an FSP reflect the number of disputes in which it is involved and the stages to which they progress.

FOS is governed by a board with an independent chair and:

- four "industry directors" appointed based on their expertise in and knowledge of the financial services industry, independence and capacity and willingness to consult with the industry; and
- four "consumer directors" appointed based on their expertise in consumer affairs, knowledge of issues pertaining to the industry, independence and capacity and willingness to consult with consumer organisations.

Submission

Schedule 2 - Small business lending

We note that the Government has decided that any reforms to small business finance will be deferred. This submission therefore does not include any comment on Schedule 2 – Small business lending. We note however that FOS's submission in August 2010 on the Green Paper *National Credit Reform - Enhancing confidence and fairness in Australia's credit law* ("NCCP Green Paper") included comments in relation to our jurisdiction to consider small business disputes and our experience with small business disputes. If a new proposal for small business lending reforms is formulated, we would welcome the opportunity to make submissions on it.

Schedule 3 – Investment lending

While membership of FOS is open to all participants in the financial services industry, the majority of credit disputes that we regularly deal with relate to lending decisions rather than credit assistance. Although our comments specifically address the proposed Division 3 – Licensees that are credit providers under protected investment credit contracts, they may apply equally to the provisions regarding credit assistance providers.

Reasonable inquiries in relation to regulated product (home-secured) investment credit contracts

In our submission on the NCCP Green Paper, we noted our concern about the number of disputes we had received to that date where lenders did not appear to have conducted any meaningful investigation into and verification of the ability of investors who borrowed for an investment purpose to service loan obligations without suffering significant hardship in the all too common event where:

- the investments did not perform in terms of income; or

- the investments failed causing partial or total loss of investment capital and total loss of investment income.

We note that Treasury's intention is that the current responsible lending obligations would not apply to investment credit contracts, but modified responsible lending obligations would apply to loans for investment in:

- regulated investment products, where the debt is secured by a mortgage over the consumer's principal residence; and
- unregulated products.

We understand that, in relation to financial products regulated under the *Corporations Act 2001*, the proposed reforms will only apply if the investment loan is secured by a mortgage over the consumer's principal residence. If this is the case, the credit provider need only:

- make reasonable inquiries about the consumer's requirements and objectives in relation to the investment loan; and
- inquire whether the consumer is prepared to lose ownership of their residence if they are unable to meet their obligations under the investment loan.

In relation to unregulated financial products, requirements for inquiries will be similar to the requirements under the current responsible lending obligations. We can see no reason why a credit provider should not also make the same inquiries about a consumer's financial situation and verify the information about their financial situation for a regulated product (home-secured) investment credit contract.

The distinction may have been made on the presumption that the consumer has obtained a statement of advice from a financial planner. However, we do not consider any such presumption can be justified as consumers can access regulated products without consulting a financial planner. Further, we do not consider that an assessment by a financial planner as to the consumer's capacity to service leveraged debt is an adequate substitute for the reasonable inquiries and verification a credit provider should make about a consumer's financial situation in order that it can make its own assessment that the consumer will be able to service the loan it intends to offer without substantial hardship. A financial planner's role is to provide advice on a geared investment strategy having regard to the consumer's current financial position and wealth creation objectives. While the credit provider may have regard to the consumer's financial information provided by the financial planner, it is incumbent upon the credit provider to make inquiries to verify the information and to consider the consumer's financial position in light of the particular loan product it proposes to offer.

Our approach to disputes about investment lending

Since our submission on the NCCP Green Paper, we have continued to receive and investigate disputes regarding an FSP's assessment of an investment loan application.

As explained in FOS Circular 5, when considering any dispute regarding responsible lending, we have regard to clause 25.1 of the Code of Banking Practice (CBP) and clause 6 of the Mutual Banking Code of Practice (MBCP), which commonly set a standard of care and prudence in the assessment of a customer's ability to repay the proposed loan.

While a FOS member against whom a dispute has been lodged may not be a subscriber to the CBP or the MBCP, we consider these codes reflect good industry practice. Therefore we have regard to the practices of subscribing banks and mutuals when considering if the FOS member has, in the circumstances of the dispute, acted appropriately. In determining good industry practice, we refer to the views of FOS's Banking Specialist and Banking Adviser regarding banking and mutuals' practice, given their extensive experience in the banking industry.

When considering disputes regarding lending for investment purposes, we investigate whether the FSP, acting in accordance with good industry practice as set out above, made reasonable inquiries about, and obtained information to verify, the borrower's capacity to service the debt without substantial hardship, taking into consideration:

- existing income source and expenditure;
- return from investment; and
- the consumer's financial wealth.

Our views on the standard required of a lender acting in accordance with good industry practice, as set out in clause 25.1 of the CBP and clause 6 of the MBCP, which commonly set a standard of care and prudence in the assessment of a customer's ability to repay the proposed loan, in relation to each of these criteria is set out below.

1. *Existing income and source*

As with currently regulated contracts, we consider it is good industry practice for a lender assessing an application for an investment loan to make reasonable inquiries about the consumer's existing income and expenses.

In reviewing an FSP's lending decision, we look at whether the borrower derived income from stable employment with a reasonable expectation of continuity, or conversely, whether the borrower was, or would imminently be, retired and reliant upon existing investment returns, superannuation or social benefits. We expect the FSP to have made reasonable inquiries about the consistency of the income earned as disclosed in light of historical information (i.e., past tax returns for self-employed applicants, group certificates for PAYG employees, investment returns for self-funded retirees).

We also look at the inquiries made about the borrower's expenses. Good industry practice would require the FSP to have taken into account the borrower's actual cost of living, rather than industry norms, where possible.

2. *Anticipated return from investment*

We review the FSP's reliance on the anticipated return from the proposed investment, having regard to the FSP's own credit policy and good industry practice.

In our view, good industry practice requires a conservative view to be taken on the anticipated return from the proposed investment, to determine if that income or part thereof should be relied upon in assessing the borrower's ability to service the loan. A lender may prudently take into account dividends (or part thereof in accordance with its lending policy) from a share portfolio, having regard to historical averaged returns over preferably two to three years. A prudent lender would not have regard to anticipated capital appreciation, as this would be part of the consumer's wealth appreciation strategy rather than a reliable source for debt servicing. In relation to investments with no established income stream, a lender exercising good industry practice would assess the consumer's capacity to service the debt without regard to the projected income return from the investment.

3. *Consumer's financial wealth*

In reviewing an FSP's investment lending decision, we also have regard to the borrower's investment portfolio and other assets.

In our view, a lender may have regard to the liquidity of the proposed investment or other investments/assets held by the consumer in assessing the consumer's capacity to repay via a secondary exit strategy. The lender exercising good industry practice would make adequate inquiries to be satisfied that equity exists in other assets and the gearing level would permit realisation of the investment and/or other assets to meet the debt in full without exposing the borrower's principal place of residence.

If it would assist Treasury, we would be pleased to provide a de-identified example of an Ombudsman's Determination about a dispute concerning an FSP's assessment of an application for a regulated product (home-secured) investment loan.

Adoption of linked credit provider model and unregulated financial products

We also have some concern about the possible adoption of the linked credit transactions in Part 7 of the *National Credit Code* as a model for defining the relationship between the credit provider or credit assistance provider and the provider of the investment product, particularly if the consumer's right of redress is mirrored in the proposed reforms.
Pursuant to section 130(2) of the *National Credit Code*, a consumer/debtor must bring proceedings jointly against the linked credit provider and the supplier. Section 130(3) provides that joint proceedings are not required where:

- (a) the supplier is insolvent, cannot be located or no longer exists; or
- (b) in the court's opinion, it is not reasonably likely that a judgment against the supplier would be satisfied.

Suppliers of regulated financial products are required to hold an Australian financial services (AFS) licence, a prerequisite for which is membership of an external dispute resolution (EDR) scheme. Therefore, in the event that there is a dispute in relation to a regulated financial product, both the supplier and the credit provider would have EDR membership. If both the supplier and the credit provider were FOS members, we would be able to consider disputes against them jointly. Conversely, if one was a FOS member and another was a member of the Credit Ombudsman Service Limited (COSL), we would work co-operatively with COSL to ensure the disputes were considered in tandem.

In contrast, suppliers of unregulated financial products are not required to hold an AFS licence, and therefore have no compulsion to be members of an EDR scheme. If a dispute arose in relation to an unregulated product investment credit contract, unless the supplier was insolvent, unable to be located, no longer in existence, or proven to be impecunious, the current approved EDR schemes would not be able to consider the dispute as the supplier could not be compelled to participate in an investigation or be bound by a scheme's decision and the dispute jointly against the credit provider and the supplier would need to be brought in a court of competent jurisdiction.

We have experienced such difficulties in relation to disputes against linked credit providers and have, in circumstances where a claim could viably be made against the supplier as well, had to close our file on the basis that the court is a more appropriate forum.

If Treasury is envisaging a consumer's primary right of redress to be through a credit provider's EDR scheme, in our view the reforms must specifically allow the dispute to be brought against the credit provider alone.

Schedule 4 – Private lending

We note Treasury's proposal that a credit activity investor engaging in credit activities as a credit provider or a lessor in accordance with a servicing agreement with an intermediary who holds a credit licence will not themselves need to be licensed, although they will be required to have EDR membership.

In granting or renewing a credit licence, the Australian Securities and Investments Commission (ASIC) must be satisfied a licensee has adequate professional training and business policies and systems in order to meet its obligations as a credit provider or credit assistance provider. Our effectiveness as an EDR scheme is enhanced by the professional standards ASIC requires of a licensee, such as the professional training of responsible managers, an adequate internal dispute resolution process and membership of an EDR scheme. Having met ASIC's requirements, we can reasonably expect a FOS member to engage constructively with us and their customer in a dispute. If they do not do so, we may feel justified in reporting them for serious misconduct. Absent such a requirement (and consequences for its breach) there is no incentive to meet the necessary standard to competently deal with complaints. This in turn may impact on our ability to obtain the co-operation of non-compliant financial services providers in dealing with disputes.

Schedule 5 – Consumer leases

We have no comments.

Schedule 6 – Anti-avoidance

We have no comments.

Yours sincerely

Shane Tregillis

Shane Tregillis
Chief Ombudsman