

12 June 2018

ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

Submission on Round 3 hearings – Loans to small and medium enterprises

1. Introduction

- 1.1. This written submission is provided by Consumer Action Law Centre (**Consumer Action**) following the conclusion of the Round 3 hearings on loans to small and medium enterprises.
- 1.2. Consumer Action is an independent, not-for-profit consumer organisation with specialist expertise in consumer and credit laws, policy and direct knowledge of people's experience of modern markets. We work for a just marketplace, where people have power and business plays fair. We make life easier for people experiencing vulnerability and disadvantage in Australia, through financial counselling, legal advice and representation, policy work and campaigns. Based in Melbourne, our direct services assist Victorians and our advocacy supports a just market place for all Australians. The comments provided in this submission are based on our extensive experience assisting consumers with responsible lending disputes.
- 1.3. Misconduct and conduct falling below community standards and expectations can cause harm to consumers. The evidence given in the hearings has shown that even when the conduct of financial service providers (**FSPs**) appears to comply with the relevant laws, regulatory guidelines and dispute resolution service approaches, the outcomes for consumers can fall well below the standards expected by the community.
- 1.4. We consider that changes are needed to create more fair and reasonable outcomes for consumers participating—mostly self-represented¹—in external dispute resolution service processes. The focus of this submission is the resolution of responsible lending complaints by small and medium enterprises and by consumers.
- 1.5. This submission responds to comments made by witness for Suncorp, David Carter, in his oral evidence on 28 May 2018² and to the following questions posed by Michael Hodge QC, Senior Counsel assisting the Commission, on the final day of hearings³:

¹ Phillip Field, Financial Ombudsman Service, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, Transcript, 28/05/2018, p.2541

² David Carter, Suncorp, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, Transcript, 28/05/2018, ps.2510, 2512 and 2531

At approximately 5:36:04, 5:42:38 and 6:33:16 of the court recording and at pages 2510, 2512 and 2531 of the court transcript (publicly available at <https://financialservices.royalcommission.gov.au/Pages/default.aspx>), Mr Carter gave sworn evidence about what Consumer Action would find 'acceptable' and see as 'reasonable' when a financial services provider (FSP) is complying with a determination of the Financial Ombudsman Service that the FSP has breached its responsible lending obligations.

³ Michael Hodge QC, Counsel assisting, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, Transcript, 1/06/2018, p.3043



- *First, if a business loan is determined to have been affected by maladministration, should the financial services provider be permitted to require the loan to be repaid within a timeframe shorter than the remaining term of the loan in circumstances where the borrower is willing and able to meet the repayment schedule under the loan?*
- *Secondly, could FOS improve its processes for dealing with loans that are determined to have been affected by maladministration and, if so, how? Should the incoming body, AFCA, adopt a different process?*

2. How is a responsible lending dispute resolved by the Financial Ombudsman Service?

- 2.1. Upon application, FOS can determine a responsible lending dispute between a consumer and a FSP. A FOS determination is binding on the FSP if an applicant accepts it and, conversely, is not binding on the FSP if the applicant does not accept it. If the latter occurs, a claim may be made to Court to decide the matter. FOS determinations are written decisions setting out FOS's findings and reasons and, if the applicant is successful, the details of any remedy to be provided by the FSP.
- 2.2. In our review of irresponsible lending determinations made by FOS in complaints made by business applicants over the last two years, we estimate that just under one third of disputes were determined at least partially in the applicant's favour.
- 2.3. Relevantly, under Clause 9.1 of the FOS Terms of Reference,⁴ FOS has the power to resolve a dispute in a number of ways, including (our emphasis):
 - a) the payment of a sum of money;
 - b) the forgiveness or variation of a debt;
 - c) the release of security for debt;
 - d) the repayment, waiver or variation of a fee or other amount paid to or owing to the Financial Services Provider or to its representative or agent including the variation in the applicable interest rate on a loan;
 - e) the reinstatement or rectification of a contract; and
 - f) the variation of the terms of a Credit Contract in cases of financial hardship.

3. What is the legal effect of a Financial Ombudsman Service determination?

- 3.1. The Victorian Supreme Court has distinguished a FOS determination from a decision of a Court, in that it creates new rights and obligations rather than declares existing ones.
- 3.2. In *Wealthcare Financial Planning Pty Ltd v Financial Industry Complaints Services Ltd*⁵ (cited with approval in *Financial Ombudsman Services Ltd v Pioneer Credit Acquisition Services*⁶), Cavanough J described the role of FOS's predecessor in the following terms (our emphasis):

The role of a FICS panel is not equivalent to that of a court. It is not established to hear and determine legal proceedings. For constitutional reasons it could not be so established. FICS, as its name suggests, entertains complaints, rather than causes of action. It conducts an industry based scheme for the resolution of consumer disputes.

.....

Decisions under the schemes create new rights and obligations rather than declare existing ones. There is no power to order discovery of documents or to subpoena witnesses. Enforcement of scheme decisions is "not directly sanctioned by the state. No bailiff will execute a warrant issued by an industry-based dispute resolution scheme".⁷

⁴ <http://fos.org.au/custom/files/docs/fos-terms-of-reference-as-of-1-january-2018.pdf>

⁵ [2009] VSC 7; (2009) 69 ACSR 418

⁶ [2014] VSC 172, at [31]

⁷ *Wealthcare Financial Planning Pty Ltd v Financial Industry Complaints Services Ltd* [2009] VSC 7; (2009) 69 ACSR 418 at 421 [7]



- 3.3. In one of its own published determinations,⁸ FOS confirmed this distinction and that a determination is a form of settlement agreement. In Determination 299255, FOS reasoned that (our emphasis):

.. it is important to understand that FOS is not a court and its decisions are not court orders. Its decisions are only binding as a matter of contract. In that regard they are contractual agreements to resolve disputes on certain terms, and as such are a form of settlement agreement.

4. **What is the effect of a Financial Ombudsman Service determination where the loan is found to be irresponsible?**

The loan balance is accelerated

- 4.1. In a review of responsible lending determinations in favour of the applicant, we found that FOS generally determined that interest and fees should be waived on the loan resulting in a reduced loan amount being payable by the applicant borrower.

- 4.2. However, the language used in the determinations is not consistent, making FOS's treatment of the loan contract and accordingly the rights of the applicant in the resolution of the dispute unclear.⁹

- 4.3. In some responsible lending determinations, FOS determined that the loan is reduced by the compensation amount and then states that the amount is *payable* to the FSP. For example:

"The Applicants are liable to repay the FSP a total of [the reduced amount] as at [a stated date]".¹⁰

- 4.4. Significantly, the determination does not state that the loan is varied by reducing the amount payable under the loan. This instead suggests that the loan amount has been accelerated and the entire loan balance is payable—not just any arrears.

- 4.5. It also suggests that the amount is payable as a debt under the terms of the determination, rather than as an amount payable under a varied loan contract. If so, then the applicant may have lost rights under the loan as provided by the Code of Banking Practice¹¹ and the *National Credit Code*¹² as applicable.¹³ Such rights would include the right to a subsequent hardship variation or notice of enforcement action.

- 4.6. In other responsible lending determinations, FOS determined that the loan is *reduced* by the compensation amount and that the FSP is entitled to continue charges in relation to the loan contract. For example:

"the FSP is to reduce the 2014 loan balance as at [date] to [amount] (Revised Debt). It is entitled to continue to charge interest, fees and charges at 20% of the contractual rate from [date] to the date the loan is fully repaid"¹⁴

⁸ FOS Determination 299255, 18 November 2014, p.5

⁹ It is noted that there appears in these determinations a general presumption that the security for the loan—often the family home—will be sold as part of the resolution of the dispute.

¹⁰ For example FOS Determination 289840, 10 December 2013, p3.

¹¹ Australian Banking Association, *Code of Banking Practice and Code Compliance Monitoring Committee Mandate*, 2013, available at https://www.ausbanking.org.au/images/uploads/2013_ABA_CODE.pdf

The hardship provisions of the Code of Banking Practice only apply to a "credit facility": cl.28.1. Repayment of amounts payable under a FOS determination are not a repayment under a credit facility.

¹² *National Consumer Credit Protection Act 2009*, Chapter 3

¹³ For example where the business venture was a residential property investment.

¹⁴ FOS Determination 475843, 1 December 2017, p.2



4.7. In these cases, it is more likely that the effect of the FOS determination is to vary the existing loan contract. As such it is likely, though not certain, that the applicant retains their rights under the Code of Banking Practice and *National Credit Code* as applicable. However, as explained below, the terms of repayment set out in the determination effectively accelerate the loan balance.

4.8. FOS sometimes includes in its determinations a direction about the FSP's consideration of the impact of any financial hardship being experienced by the applicant borrower then and in future. For example:

"The FSP should give genuine consideration to any proposal presented by the Applicants and try to assist them to overcome their financial difficulty."¹⁵

4.9. The use of this language again makes it unclear as to what order-making power FOS is engaging and the effect of the determination. That is, does the inclusion of a hardship direction mean that the applicant borrower has lost those rights and that the loan contract is therefore void?

4.10. In circumstances where FOS appears to presume that the sale of the security—often the family home—is required to resolve the dispute, we submit that at the very least:

- a) the FOS determination should not accelerate the loan balance, and so make the loan balance due and payable; and
- b) applicants *should* retain their rights under the loan contract to apply for financial hardship assistance and the FSP *should* be required to comply with enforcement procedures under the Banking Code of Practice or *National Credit Code* as applicable.¹⁶

Term of repayment of the loan

4.11. Having determined compensation, some FOS determinations then require the applicant borrower to propose a repayment plan for the Revised Debt within a set period of time. If the repayment proposal is not acceptable to the FSP, the FSP is entitled to commence recovery action for the Revised Debt. For example:

"If the parties are unable to reach an agreement for repayment of the Revised Debt within 14 days of the Applicant's proposal, or if no proposal is required, the FSP is entitled to commence recovery action with respect to the Revised Debt in accordance with the terms and conditions of the facility, once the FOS dispute is closed. This may include taking possession of and selling the security property."¹⁷

4.12. Again, the effect of such determination is to accelerate the amount payable under the loan contract.

4.13. In determinations where FOS set a fixed time (usually 14–30 days) for negotiation of a "reasonable" repayment plan,¹⁸ no guidance is provided as to what a "reasonable" period might be¹⁹. Where the repayment period is not limited to a period equal to or greater than the remaining period under the loan, there is the potential to cause significant financial hardship to the applicant borrower.

4.14. The manifest unfairness in FOS determining that the adjusted loan balance is repayable, subject to a repayment proposal being accepted by the FSP, was evident in the Jennifer Low dispute.²⁰ In some cases, the award by FOS of waiving interest and fees on the loan will mean that the applicant borrower

¹⁵ For example, FOS Determination 368086, 12 August 2015, p.2 (in this determination, FOS also determined to which loan or part of the loan the repayments are to be directed such as the (higher) interest bearing (parts of the) loan)

¹⁶ This issue is of even greater significance with consumer lending.

¹⁷ FOS Determination 475843, 1 December 2017, p.2

¹⁸ For example FOS Determination 475843, 1 December 2017, p.2

¹⁹ The only guidance is the Financial Ombudsman Service, *The FOS Approach to Responsible lending series: How we work out a consumer's loss*, at p.5 with respect to loans used to purchase property, which provides that "Generally, the consumer will be provided with 90 days to repay the adjusted balance."

²⁰ See evidence of Phillip Field, Financial Ombudsman Service, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, Transcript, 28/05/2018, p.2549

is no longer in arrears under the loan. As a result, the FSP is not entitled to 'call up' the loan balance and make it due and payable. In these circumstances, the applicant borrower, as a matter of law, is entitled to continue to make payments over the full term of the loan.

4.15. Given the uncertainty over the repayment term, we submit that:

- a) FOS should remain involved in the negotiations, at least to assist in the calculation of the loan following its determination; and
- b) FOS should not order a debt be recoverable if, after consideration of the reduced repayment amount, the applicant borrower is not in arrears under the original loan contract.

5. What reason is there for financial service providers to lend responsibly?

5.1. Responsible lending obligations under chapter 3 of the *National Consumer Credit Protection Act 2009* (Cth) (**NCCP Act**) only apply to consumer loans. However, the Code of Banking Practice, to which all major lenders are signatories, also imposes obligations on FSPs. Moreover, FOS's approach is that remedies for irresponsible lending to consumers and businesses are interchangeable.

5.2. The current approach to irresponsible lending remedies adopted by FOS²¹ falls below community standards and expectations for two reasons. First, consumers who are successful in their claims of irresponsible lending are required to repay any "unwarranted benefit"²² as a precondition to setting aside the loan.²³ And second, FSPs who have lent irresponsibly are usually permitted to recoup the principal amount owing while being in control of any repayment plan.

5.3. When assessing loss in cases of irresponsible lending, FOS's approach is that the FSP should not profit from the transaction²⁴ and the consumer should be returned to the position they were in before the loan was approved^{25,26}. The perception is that if the borrower does not account for the "benefit" they received from an irresponsible loan, this will cause an injustice to the FSP.²⁷ This approach suffers three flaws:

- a) it does not appreciate the significant harm caused to borrowers who experience financial hardship as a result of an irresponsible loan;
- b) it undermines the objective of responsible lending, which is to ensure strong consumer protection through truth in lending principles²⁸; and
- c) it assumes that the amount lent was always to the borrower's "benefit".

5.4. In some cases, the business loan will be for a flawed business venture which resulted in either all, or some of the principal amount being lost. FOS takes the approach that the applicant borrower is liable for this investment risk. That approach does not discriminate between different circumstances. For example, it may be that the FSP's enquiries when approving the loan revealed that the business investment was imprudent, but nonetheless granted the loan. If a "but for" causation approach is taken, then the applicant borrower would not have lost the principal sum if the irresponsible loan had not been granted.

²¹ Financial Ombudsman Service, *The FOS Approach to Responsible Lending Series: how we work out a consumer's loss*, available at <https://www.fos.org.au/custom/files/docs/fos-approach-to-responsible-lending-assessing-consumer-loss.pdf>

²² *Vadasz v Pioneer Concrete (SA) Pty Ltd* (1995) 184 CLR 102; *Maguire v Makaronis* (1996) 188 CLR 449

²³ Clause 2.4, Financial Ombudsman Service, *The FOS Approach to Responsible lending series: How we work out a consumer's loss*, p.5

²⁴ Assuming what FOS calls the "credit risk"

²⁵ Assuming what FOS calls the "investment risk"

²⁶ Clause 1.2, Financial Ombudsman Service, *The FOS Approach to Responsible lending series: How we work out a consumer's loss*, p.2

²⁷ *Esanda Finance Corporation Ltd v Tong* (1997) 41 NSWLR 482; *First Mortgage Managed Investments Pty Limited v Pittman* [2014] NSWCA

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²⁸ Revised Explanatory Memorandum, *National Consumer Credit Protection Bill 2009* (Cth), p.6



- 5.5. The Commission will recall similar concerns raised in the Round 1 hearings on consumer lending. For example, the case of Robert Regan where the FSP approved a 30 year loan in the amount of \$50,000 to a single 72 year old pensioner for home renovations, and then immediately transferred more than \$30,000 directly to an international Western Union account.²⁹ And in the case of Nalini Thiruvangadam, the FOS approach did not take into account the substantial hardship she experienced, including missing rent and utility bill payments to pay her car loan repayments, as a result of the irresponsible loan.³⁰
- 5.6. The effect of the “penalty” is that the FSP is unable to charge fees and interest for the life of the loan. There is, however, little financial incentive to enter into a reasonable payment arrangement following a determination. The result is that the loan is generally accelerated at the end of the negotiation period set by FOS. And even if a payment arrangement is reached, it is in the FSP’s commercial interests to make it for as shorter term as possible.
- 5.7. Put simply, if a loan is determined to be irresponsible, the loan is effectively accelerated and made payable over a significantly reduced term thus reducing the loss occasioned by the FOS determination to the FSPs ability to charge fees and interest.
- 5.8. Conversely, while the FSP is arguably returned to its original position by being able to recover the principal amount lent in a shortened period, the applicant borrower may have to sell their family home or car to repay a loan they should never have received. This can cause serious financial and personal hardship. In many cases, the hardship imposed has serious long-term consequences that mean the applicant borrower may never recover financially.
- 5.9. It is clear that in spite of responsible lending obligations existing to protect applicant borrowers, the approach taken by FOS to remedies in cases of irresponsible lending provides little incentive for FSPs to lend responsibly.

6. Benchmarks in business lending

- 6.1. As with consumer lending, FSP’s rely upon benchmarks for some business lending.³¹ Most appear to use the Household Expenditure Measure (HEM). This raises the same concerns as were canvassed in the Round 1 Hearings on consumer lending.³² We note that the FOS determinations dealing with irresponsible business loans use the HEM or the Henderson Poverty Index to assess general living expenses,³³ which we consider an inadequate method of verifying actual expenses.

7. What is fair and reasonable in all the circumstances?

- 7.1. FOS can forgive a debt in resolution of a responsible lending dispute; however, debt waivers are quite rare.³⁴ Though there is legal precedent for irresponsibly lent contracts to be set aside ab initio as unjust transactions, borrowers are generally still required to repay the principal amount owed, and thus account for any “benefit” obtained under the loan.³⁵ It is difficult to understand how this represents what the community would expect to be fair and reasonable in all the circumstances.
- 7.2. Applicant borrowers should be provided with a clear right to debt waivers when a bank lends irresponsibly, including refunds of amounts already paid where appropriate. Where the loan is secured, the FSP should also release the security (for example, over a family home or car) where appropriate.

²⁹ <https://policy.consumeraction.org.au/wp-content/uploads/sites/13/2018/04/180403-Submission-on-Consumer-Lending-FINAL-1.pdf>, at [4.1-4.14]

³⁰ <https://policy.consumeraction.org.au/wp-content/uploads/sites/13/2018/04/180403-Submission-on-Consumer-Lending-FINAL-1.pdf>, at [9.26-9.40]

³¹ FOS Determination 452282, 9 May 2017, p.7

³² <https://policy.consumeraction.org.au/wp-content/uploads/sites/13/2018/04/180403-Submission-on-Consumer-Lending-FINAL-1.pdf>

³³ For example: FOS Determination 483474, 23 March 2018, p.7; FOS Determination 369034, 24 September 2015, p.10; FOS Determination 452282, 9 May 2017, p.7

³⁴ In a case of irresponsible lending concerning a consumer lease, FOS set aside the contract and released the applicant from all past, present and future obligations under the contract in resolution of the dispute: FOS Determination 266568, 25 February 2015, p.15

³⁵ *Australian Securities and Investments Commission v Channic (No 4)* [2016] FCA 1174



This would provide fairer outcomes for victims of irresponsible lending, and incentive to FSPs to comply with responsible lending laws.

- 7.3. This would align with the approach under the NCCP Act. Under section 180, if a lender engages in “unlawful credit activity”, the borrower is not liable for future payments and is entitled to recover any amounts already paid under the loan. Currently, “unlawful credit activity” applies to limited offences under the NCCP Act: engaging in unlicensed credit activity and providing short-term credit for a term of less than 16 days. Given that irresponsible lending to consumers is also a criminal offence,³⁶ it seems appropriate that this approach be extended to unaffordable loans.
- 7.4. Where a borrower would be “unjustly enriched” from the use of a secured asset (for example, living in a house or driving a car), there should be a straightforward and fair calculation for determining the value of the benefit they derived. This should take into account any distress or hardship the borrower experienced as a result of the irresponsible loan. If the value of the benefit is more than the amount already paid under the loan, the residual amount owed should only be repaid in affordable instalments. A reasonable repayment plan ought to begin with repayments being made within the original term of the loan.

8. Gaps in legal assistance

- 8.1. We have identified a significant gap in legal assistance for small business-related matters, including those that affect quite vulnerable people. We recently released a report on this unmet legal need in the context of drought-affected areas.³⁷
- 8.2. In that report, we consider that there is merit in establishing a small business community legal centre, potentially based in a Victorian regional city. This service would have the capacity to deliver flexible, mobile services across the State, particularly in areas affected by drought and other extreme climate conditions. This service would primarily serve the needs of vulnerable small businesses facing financial and other legal challenges to their viability, and to the health and wellbeing of business owners and their families. Ideally, this new community legal service would be supplemented by a specialist small business financial counselling program, and would be able to advocate on key policy issues including responsible lending and dispute resolution.

9. Recommendations

- 9.1. FOS must be consistent and clear in its approach to resolving responsible lending disputes, and the effect of a FOS determination on the rights and obligations of the parties under the original loan contract clarified.
- 9.2. Law reform is also required to provide fairer outcomes to victims of irresponsible lending, as well as a greater incentive for FSPs to comply with responsible lending laws. This includes:
 - a) Introducing a presumption that no benefit has been obtained by a borrower who is the victim of irresponsible lending;
 - b) Providing borrowers with a clear right to debt waiver and release of security in irresponsible lending cases;
 - c) Where a borrower would be “unjustly enriched” from an irresponsible loan, developing a straightforward and fair calculation for determining the value of the benefit they derived. This should take into account any distress or hardship the borrower experienced as a result of the irresponsible loan and reducing the value of the “benefit” accordingly;
 - d) Varying the loan contract to reflect the new amount to be repaid (if any) and adjust the repayment amount. Repayments should be in affordable instalments. A reasonable repayment plan ought to begin with repayments being made within the original term of the loan; and



³⁶ *National Consumer Credit Protection Act 2009 (Cth)*, s 133(6)

³⁷ <https://policy.consumeraction.org.au/wp-content/uploads/sites/13/2018/02/180109-Drought-Legal-Assistance-Final-Report.pdf>

- e) Acknowledging that the rights of the consumer under the existing contract remain including right to apply for financial hardship arrangements and rights regarding enforcement.

9.3. This approach should also be adopted under the Terms of Reference for the Australian Financial Complaints Authority.

9.4. As noted above, we also support the establishment of a dedicated small business community legal centre, supported by a specialist financial counselling service.

