



# Inquiry into impairment of loans

FOS submission

September 2015



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## 1. Overview

The Financial Ombudsman Service Australia (FOS)<sup>1</sup> is an industry-based service to resolve disputes between consumers and financial services providers. FOS is approved by the Australian Securities and Investments Commission (ASIC) to operate as an external dispute resolution (EDR) scheme in the financial sector.

The inquiry into impairment of loans by the Parliamentary Joint Committee on Corporations and Financial Services (Inquiry) is examining matters that may arise in disputes considered by FOS. To assist the Inquiry, this submission<sup>2</sup> provides information on:

- our dispute resolution process
  - The submission gives a general overview of our dispute resolution process as well as explaining approaches we take to specific matters that may arise in loan disputes. Information about our jurisdiction is also included.
- the framework for resolving disputes about financial services
  - The submission explains how dispute resolution by FOS fits into the arrangements for regulating financial services in Australia.
- industry codes of practice
  - The submission explains how industry codes operate and the roles that the codes can play.
- small business loan disputes
  - The submission provides statistics on disputes about loans to small businesses handled by FOS in the last financial year.

## 2. FOS dispute resolution process

We note that the Inquiry is not investigating or seeking to resolve disputes between consumers and financial services providers. However the Inquiry may examine situations of the type that FOS considers – for example, disputes about sales of loan security property or conduct arguably amounting to loan impairment. Our dispute resolution process may therefore be relevant to the Inquiry.

This section of the submission outlines how FOS handles loan disputes by providing information about:

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<sup>1</sup> Information about FOS, and the disputes we handle, is available on our website [www.fos.org.au](http://www.fos.org.au). Overview information appears in our annual review, which is in “Publications” on the website. Appendix 1 lists key points.

<sup>2</sup> This submission has been prepared by the Office of the Chief Ombudsman 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 about financial services.

- our dispute resolution process, which applies to disputes generally and
- approaches we have developed to address specific matters that may arise in loan disputes.

## 2.1 Overview of process

Our website - [www.fos.org.au](http://www.fos.org.au) - sets out our dispute resolution process. Material under the “Resolving Disputes” tab on the website highlights key aspects of the process. This includes material that can be accessed through the following links:

- information in a simple, consumer-friendly form - [Our process and how to lodge a dispute](#) and
- a more thorough explanation – [Our dispute handling process in detail](#).

## 2.2 Approaches to specific matters

We have developed approaches to particular types of disputes and issues raised in disputes. The approach documents on our website under “Publications” explain these approaches.

The FOS approaches likely to be most relevant to matters within the Inquiry’s Terms of Reference relate to:

- mortgagee sales
- financial difficulty
- responsible lending and
- the Code of Banking Practice.

### 2.2.1 FOS approach to mortgagee sales

A financial services provider in possession of a borrower’s property must take reasonable care to sell the property for either its market value or the best possible price. If FOS believes the financial services provider in a dispute did not take reasonable care, we may award the borrower compensation for any difference between the sale price and the market value of the property.

The [document](#) setting out our approach to mortgagee sales explains:

- what the financial services provider must do if it takes possession of a borrower’s property for sale and
- what we take into account when considering a dispute about a mortgagee sale.

Case studies in our approach document provide further explanation of how we deal with disputes involving sales of security properties including:

- sales not conducted properly

- sales without adequate advertising
- sales of properties with widely varying valuations
- sales in a market described as “soft”.

### **2.2.2 FOS approach to financial difficulty**

We consider that financial difficulty occurs when a consumer is unexpectedly unable to meet their repayment obligations. This can be the result of a variety of causes including accident, separation, death of a family member, unexpected medical or funeral expense, reduction of work hours, redundancy or a downturn in business.

The documents setting out our approach to financial difficulty at present cover the topics listed below. We plan to release more documents if approaches for further topics are developed.

- [How FOS approaches financial difficulty taking into consideration legal principles, industry codes and good industry practice](#)
- [Our power to vary regulated credit contracts](#)
- [Working together to find solutions](#)
- [Dealing with common financial difficulty issues](#)

### **2.2.3 FOS approach to responsible lending**

When a consumer cannot make their loan repayments, they may claim their financial services provider should not have given them the loan because they never had the capacity to repay it. The consumer may lodge a dispute with FOS seeking compensation for a loss resulting from provision of the loan. We refer to this as a “responsible lending” dispute. When we consider responsible lending disputes, we decide whether it was appropriate for the financial services provider to enter into the loan.

The documents setting out our approach to responsible lending cover the topics listed below.

- [Common issues](#)
- [How we approach responsible lending disputes taking into consideration legal principles, industry codes and good industry practice](#)
- [Low doc loans](#)
- [Assessing consumer loss](#)

### **2.2.4 FOS approach to the Code of Banking Practice**

We consider the 2013 Code of Banking Practice represents good industry practice and generally reflects the common law obligations of financial services providers. Financial services providers can subscribe to the code and, once they subscribe, are required to comply with the code.

The [document](#) setting out our approach to the code explains the way we take the code into account when we consider disputes. It also explains how we apply the code in specific situations, such as cases of financial difficulty.

### 2.3 Disputes FOS cannot consider

Sometimes FOS is unable to consider a dispute because it is outside our [Terms of Reference](#). Some of the main reasons why a dispute about loan impairment may be outside our Terms of Reference are outlined below.

- A receiver may have been appointed to a company before it lodged a dispute with FOS. At law a receiver acts as an agent of the company, not the creditor who appointed the receiver. As the receiver is in control of the company at the time of lodgement, the receiver must consent to the dispute being lodged. Similarly, if a liquidator has been appointed, then the liquidator's consent is required.
- FOS can consider disputes where legal proceedings have been issued by the financial services provider against the borrower, provided those proceedings have not gone beyond lodging a defence and counterclaim. If they have gone beyond that stage, we cannot consider the dispute.
- If a borrower is a small business and one loan exceeds \$2 million FOS cannot consider the dispute as it is more appropriately dealt with in court. This \$2 million limit was introduced on 1 January 2015. Thirteen disputes lodged with FOS since that date have exceeded the limit and we have therefore not considered those disputes.
- If legal proceedings have been issued and judgment obtained before a dispute was lodged, FOS cannot consider the dispute. Any claim the borrower had merges into the judgment. The borrower must apply to the court to set aside the judgment
- FOS can only consider a dispute where the amount of the claim (which is the amount of loss) does not exceed \$500,000. The maximum compensation we can award is \$309,000. The amount of loss is not necessarily the amount of the loan, as often the borrower repays the principal and at least some interest. However, where a guarantor owes more than \$309,000 and seeks to have the guarantee set aside, a court is a more appropriate place to consider the dispute. This is because a guarantee cannot be set aside in part. It is either valid for the amount or it is not valid at all.
- FOS cannot consider a dispute where we have already dealt with the subject matter. For example if we issued a determination which the customer did not accept, we will not look at a new dispute about the same matters.

### 3. Framework for resolving disputes about financial services

The regulatory arrangements for resolving consumer disputes about financial services have two key elements:

- financial services providers must have internal dispute resolution (IDR) procedures that meet standards set by ASIC and
- for any disputes not resolved through IDR procedures, consumers must have access to an independent EDR scheme approved by ASIC.

#### 3.1 Internal dispute resolution

IDR arrangements provide the cornerstone for effective consumer redress mechanisms in the financial sector. The vast majority of consumer issues are resolved by financial services providers directly with their customers, and research shows the way in which financial services providers deal with problems when they occur is key to gaining consumer trust and confidence.

The IDR procedures of financial services providers must meet standards set by ASIC. These standards are specified and explained in ASIC's Regulatory Guide 165.<sup>3</sup>

#### 3.2 External dispute resolution

Industry-based dispute resolution schemes emerged in Australia to provide the community with a cheaper, quicker and less formal alternative to the courts to resolve certain disputes in the financial sector. Without such schemes, the only option available to consumers would be to take action through the courts, which is not a practical option for many consumers in Australia.

While decisions made by industry-based EDR schemes (where accepted by the consumer) are binding on financial services providers, they are not binding on consumers, who are able to take their dispute to court if they do not accept the outcome.

FOS does, however, have mechanisms to engage with stakeholders on the approach we take to particular types of disputes. We encourage internal discussions at industry and consumer meetings. We have recently put in place a formal review mechanism to complement these discussions.<sup>4</sup>

In Australia, industry-based EDR schemes provide services free to consumers to resolve disputes.<sup>5</sup> FOS also:

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<sup>3</sup> See Regulatory Guide 165 *Licensing: Internal and external dispute resolution* on [www.asic.gov.au](http://www.asic.gov.au) under "Regulatory Resources".

<sup>4</sup> See section 19A of the [Operational Guidelines](#) to our Terms of Reference.

<sup>5</sup> The principles adopted in Australia for establishing EDR schemes are consistent with the G20 High Level Principles on Financial Consumer Protection, which emphasise the need for jurisdictions to ensure that consumers have access to adequate complaints handling and EDR mechanisms that are accessible, affordable, independent, fair, accountable, timely and efficient.

- helps financial services providers resolve disputes with consumers directly
- shares and discusses information about issues that commonly give rise to disputes, with a view to preventing or reducing future disputes
- highlights and addresses systemic issues and
- contributes to policy development and law reform.

### 3.3 Decisions based on merits

FOS decides each individual dispute on its merits based on the specific facts and circumstances involved.

When deciding a dispute and determining whether a remedy should be provided, FOS will do what in its opinion is fair in all the circumstances, having regard to each of the following:

- legal principles
- applicable industry codes or guidance as to practice
- good industry practice and
- previous relevant decisions of FOS or a predecessor scheme (although FOS will not be bound by these).<sup>6</sup>

The courts in Australia, and overseas in jurisdictions such as the United Kingdom, have strongly endorsed a merits-based approach for EDR schemes.<sup>7</sup>

In an environment as dynamic as the financial sector, merits-based decision making is an important factor. It allows EDR to keep pace with industry developments and to resolve disputes on their individual merits in a collaborative manner rather than applying a more legalistic and adversarial approach.

### 3.4 Accountability of FOS

To maintain ASIC's approval to operate as an EDR scheme, FOS has to meet extensive requirements specified and explained in ASIC's Regulatory Guide 139<sup>8</sup>.

FOS must be accessible to consumers by providing a dispute resolution service (even when legal proceedings have commenced) at no cost to the consumer, and must actively promote its services so consumers are aware of its existence.

The requirements in Regulatory Guide 139 ensure that FOS:

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<sup>6</sup> See paragraph 8.2 of our [Terms of Reference](#).

<sup>7</sup> *Wealthcare Financial Planning Pty Ltd v Financial Industry Complaints Service Ltd & Ors* [2009] VSC 7; *Moor & Edgecomb Ltd v Financial Ombudsman Service Ltd* [2008] EWCA Civ 642.

<sup>8</sup> See Regulatory Guide 139 *Approval and Oversight of external dispute resolution schemes* on [www.asic.gov.au](http://www.asic.gov.au) under "Regulatory Resources".



- operates independent of industry
- acts impartially and fairly in its decision-making
- is governed by a board of directors, comprised of equal numbers of consumer and industry directors and an independent chair
- reports regularly to its stakeholders and publicly on its performance
- reports systemic issues and serious misconduct to ASIC and
- undertakes periodic independent reviews.

These measures provide a robust accountability framework for our dispute resolution and the services we provide to consumers of Australian financial services.

## **4. Industry codes of practice**

### **4.1 Operation of industry codes**

A code of practice sets standards of good industry practice for financial services providers to follow when dealing with people who are, or who may become, individual or business customers. FOS provides support arrangements for a number of codes in the financial sector, with a separate business unit supporting the work of independent code compliance committees<sup>9</sup> whose role is to monitor compliance with these standards.

The committees are comprised of an independent chair, a consumer representative and an industry representative. In our experience this composition facilitates transparency and accountability in the code monitoring and governance frameworks.

Each of the contractual arrangements with the committees is the subject of a separate funding and service level agreement with the relevant industry body or code committee.

Each code subscriber has made a commitment to:

- work to improve the standards of practice and service in their industry
- promote informed decisions about their services and
- act fairly and reasonably in delivering those services.

For the Inquiry, two banking codes are particularly relevant. They are:

- the Code of Banking Practice and
- the Customer Owned Banking Code of Practice.

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<sup>9</sup> See [FOS Annual Review 2013-2014](#) also available on our website under “Publications”.

The Code Compliance Monitoring Committee is the monitoring body established under clause 36 of the Code of Banking Practice. The committee has made a submission to the Inquiry.

## 4.2 Roles industry codes can play

Industry codes can play an important role in enhancing the relationship of trust between consumers and financial services providers. They are means by which industry bodies and their members can complement formal law and regulation in areas relating to service issues for consumers, standards of professional conduct, practice standards and ethical behaviour.

Most industry codes are “technology neutral”. Accordingly, codes can respond to changing business models within the financial sector, including the transition from face to face interaction with customers towards digitalised services.

Industry codes can potentially play an important role in the initial product design stage and within the whole lifecycle of a financial product. Codes have traditionally paid less attention to industry standards for product design or ensuring the financial products are “fit for purpose”.

In a number of other jurisdictions regulators have articulated high level principles on product design. The Monetary Authority of Singapore<sup>10</sup> and the UK Financial Conduct Authority<sup>11</sup> both have principles for fair dealing with consumers that clearly set out the responsibilities of the board and senior management of the financial services provider in ensuring that trust and a culture of fair dealing is embedded at all stages of the life cycle of a financial product and service, including the initial product design stage. The Australian Financial Markets Association has also published a set of principles relating to product approval for retail structured products.<sup>12</sup>

## 5. Small business loan dispute statistics

Many of the submissions to the Inquiry published to date relate to loans to small businesses. This section provides statistics on disputes about loans to small businesses handled by FOS in the last financial year.

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<sup>10</sup> Monetary Authority of Singapore (Financial Advisers Act- CAP 110) *Guidelines on fair dealing: board and senior management responsibilities for delivering fair dealing outcomes to customers:* [http://www.mas.gov.sg/~media/resource/legislation\\_guidelines/fin\\_advisers/fin\\_advisers\\_act/guidelines/Guidelines%20on%20Fair%20Dealing.ashx](http://www.mas.gov.sg/~media/resource/legislation_guidelines/fin_advisers/fin_advisers_act/guidelines/Guidelines%20on%20Fair%20Dealing.ashx)

<sup>11</sup>UK Financial Conduct Authority: *The six TCF outcomes: Treating Customers Fairly:* <http://www.fca.org.uk/firms/being-regulated/meeting-your-obligations/fair-treatment-of-customers>

<sup>12</sup> Australian Financial Markets Association October 2012 *Principles relating to product approval: retail structured financial products:* [http://www.afma.com.au/afmawr/\\_assets/main/lib90032/product%20approval%20principles.pdf](http://www.afma.com.au/afmawr/_assets/main/lib90032/product%20approval%20principles.pdf)

Our Terms of Reference allow us to consider disputes between a financial services provider and a consumer. The consumer may be an individual or a business within this definition of “small business”:

A business that, at the time of the act or omission by the financial services provider that gave rise to the dispute:

- if the business is or includes the manufacture of goods – had less than 100 employees or
- otherwise – had less than 20 employees.<sup>13</sup>

As a preliminary point, we note that small business disputes account for a small fraction of the disputes we handle – normally about 6% of the total disputes accepted by FOS per year.

In the financial year from July 2014 to June 2015, FOS closed 7,734 disputes relating to credit (excluding credit card disputes). 496, or about 6.4%, of these disputes were lodged by small businesses.

Section 2.3 above refers to disputes outside our Terms of Reference, which specify our jurisdiction.<sup>14</sup> Two of the exclusions from our jurisdiction are based on monetary limits:

- paragraph 5.1o) of the Terms of Reference excludes a dispute if the value of the consumer’s claim exceeds \$500,000 and
- paragraph 5.1r) excludes a dispute if it concerns debt recovery against a small business where the contract provides for a credit facility of more than \$2 million.

Of the small business disputes relating to credit (excluding credit card disputes) closed in the 2014-2015 financial year, 11 were excluded because they exceeded the monetary limits noted above. In eight of these disputes, the value of the claim exceeded \$500,000 and the remaining three disputes involved debt recovery and a credit facility of over \$2 million.

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<sup>13</sup> This definition appears in paragraph 20.1 of our Terms of Reference.

<sup>14</sup> Section B of our Terms of Reference specifies our jurisdiction.

## Appendix 1 - About FOS

FOS was formed in 2008 from the merger of three predecessor schemes organised largely along industry sector lines. The original participants were:

- the Banking and Financial Services Ombudsman
- the Financial Industry Complaints Service and
- the Insurance Ombudsman Service.

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

- the Credit Union Dispute Resolution Centre and
- Insurance Brokers Disputes Ltd.

FOS is an ASIC-approved independent EDR scheme that covers disputes across the financial sector. Our service is free to consumers and is funded through a combination of levies and case fees paid by our members, which are financial services providers.

Our operations are governed by our [Terms of Reference](#), which form a contract with our members. The Terms of Reference are available on our website.

FOS and its predecessor schemes have over 20 years' experience in providing dispute resolution services in the financial services sector. FOS provides services to resolve disputes between member financial services providers 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 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.