CHAPTER SEVENTEEN

FOREIGN CURRENCY LOANS

17.1 The issue of foreign currency loans received much publicity during the inquiry, particularly in the early stages. The Committee recognised a need to address the matter thoroughly while at the same time ensuring that foreign currency loans did not dominate other central issues in the inquiry. This chapter reports the Committee's evidence and findings on foreign currency loans.

Approach to the issue

17.2 When the inquiry was announced and submissions sought in October\November 1990, a small number were received from individuals who had been involved in foreign currency borrowing. Foreign currency loans were not addressed at all in the initial submissions received from the four major banks and the Australian Bankers' Association.

17.3 The issue came to public prominence with the publication in newspapers of extracts from the so-called 'Westpac letters', the publication by the Committee of a submission from a consultant to the Foreign Currency Borrowers' Association, John McLennan, and allegations of intimidation and gagging of Mr McLennan. These events and their outcome were described in Chapter 1.

17.4 The publicity given to the matter prompted further submissions from individual borrowers and from some people who claimed to have an expertise in foreign currency transactions. The Committee undertook to investigate the issue in detail.

17.5 A public hearing was arranged in Coffs Harbour on 20 March 1991 to take evidence from a number of individual borrowers who had made written submissions and from spokespersons of the Foreign Currency Borrowers' Association. Following this hearing, further information was received from borrowers who already had given evidence and additional submissions were received from other borrowers. As a result of this evidence, the Committee considered it had a detailed picture of foreign currency loans from the borrowers' perspective.

17.6 Evidence was also taken from some people who had made submissions and who claimed an expertise in foreign currency transactions. This evidence covered points such as foreign exchange dealings and risk and the profitability of such loans for the banks.

17.7 On the basis of the evidence taken to that point, the Committee developed a detailed questionnaire that was forwarded to the four major banks for response. A copy of the questionnaire is at Appendix 9. Other than in those areas where the banks' responses were 'commercial in confidence', they were published by the Committee. The four major banks were called to give evidence at public hearings in May 1991 to expand on responses to the questionnaire.

17.8 The responses of the banks included some internal policy documentation relating to foreign currency loans. The Committee also requested all internal policy documentation relating to foreign currency loans from the Commonwealth Bank (referred to as the 'G' documents) and from Westpac (the so-called 'core' documents). The documents were provided in late August and early September respectively and have been retained on a confidential basis. The Committee has used the documents to test the evidence taken from banks and borrowers. The contents of the documents are referred to at times in the chapter to illustrate particular points. In making such reference the Committee has not identified the particular bank involved.

17.9 Since taking evidence from the banks further submissions have been received from borrowers, including analyses of the banks' evidence. Westpac also made a further submission on the issue.

17.10 The Committee also referred all the foreign currency loan cases to the Attorney-General's Department for advice on:

- the legal basis on which the cases have been pursued;
- reasons for success or failure of cases; and
- whether there are any impediments in the law that have prevented redress in cases that could reasonably have been expected to be successful.

17.11 This advice was received on 4 October 1991 and a copy is at Appendix 10. Analyses of court cases were also provided by Mr Francis Galbally, who has acted in court cases on behalf of borrowers, and by some of the banks.

17.12 As a result of its thorough investigation of this issue a large amount of information has been compiled. In preparing this chapter, the Committee has assessed carefully all the evidence it has taken.

17.13 It is important to carefully distinguish the respective constitutional roles of the Parliament, through its committees, and the judiciary, through various State and Federal courts, in relation to the foreign currency loans issue.Where individual borrowers believe a legal case exists against a bank in respect of that institutions handling of the borrower's affairs, legal redress through the courts is the appropriate course of action. The Parliament, and its committees, can not determine the legal issues involved in such cases, and can not play the role of mediator in disputes between the borrower and the bank.

17.14 The objective in the chapter is to provide an overall assessment of foreign currency loans from the perspective of the policy framework and procedures of the banks and to reach conclusions. As indicated earlier, the Committee makes no judgement on the merits or facts in individual cases. To do so would be neither appropriate, given the responsibilities and expertise of the courts in this area, nor possible without the full documentation relating to each case. In this regard, the Committee notes that the courts have the capacity to test evidence by means of cross-examination of witnesses.

17.15 The foreign currency loans issue provides a case study of some of the effects on the relationship between bank and customer that resulted from the deregulatory changes. It is from this perspective that the foreign currency loans has been considered by the Committee.

17.16 The Committee emphasises that the bulk of the chapter is concerned with unmanaged foreign currency loans. The loans referred to in the 'Westpac letters' - those managed through Partnership Pacific Limited - are referred to at the end of the chapter.

Concept of a foreign currency loan

17.17 The State Bank of New South Wales' guidelines on foreign currency loans described a foreign currency loan simply as 'a loan denominated in a currency other than Australian dollars'.[1] The Commonwealth Bank expanded on the concept by explaining that a foreign currency loan was not a 'thing' but 'a set of legal obligations':

> The particular obligation that is relevant is the obligation to repay the amount borrowed in the currency borrowed and to make all interest payments in the currency borrowed. *The fact that both the principal and interest* payments must be made in the currency borrowed attracts the exchange risk. The exchange risk is that every time a payment has to be made it has to be sourced from Australian dollar funds and the rate of exchange

1 Evidence, p. S2753.

> may not be the same at the times of payment as it was when the funds originally borrowed. This can work in favour of the borrower or against the borrower.[2]

17.18 There are various mechanisms to limit or remove the potential exchange risk that arises from foreign currency borrowing.

17.19 One of these is to 'hedge'. This can be done through the futures market by taking out a forward exchange or hedge contract in the foreign currency to which the borrower is exposed. Essentially the borrower would buy forward (for a period such as the six month roll-over of the loan) the foreign currency of exposure. The price charged would reflect the market's view of how much the Australian dollar (AUD) would rise or fall against the particular foreign currency. The cost of buying forward reflects the rate of exchange on the day of purchase and the interest rate differential between the two currencies. Thus the consequence of hedging for the borrower is that the exchange rate exposure has been eliminated, but the loan costs at least as much as an onshore loan as any interest rate advantage has been negated.[3]

17.20 Alternative mechanisms to limit foreign exchange exposure include having a 'natural hedge' in the form of export income denominated in the same currency as the loan.

17.21 'Stop-loss' orders such that once a specified amount has been lost the borrower is 'brought onshore' by using a futures contract or by converting to Australian dollars are another mechanism. This mechanism prevents any further loss, but crystallises existing losses. The borrower is also then faced with meeting Australian interest rates.

17.22 A further mechanism is to have the loan 'managed' by switching between currencies based on expectations of whether they would rise or fall. If the fluctuations were predicted correctly, this could prove an effective means of controlling foreign exchange exposure. However, in such an uncertain area as foreign exchange movement forecasting, there would be as much potential for loss as for gain.

17.23 It was suggested to the Committee that a foreign currency loan was an inherently faulty or dangerous product.[4] This point was also made by Justice Rogers in Perciballi v. Westpac. However, the fact that there is a risk in foreign currency borrowing does not mean that the foreign currency loan product is dangerous in itself. The dangerous product analogy was dismissed in the judgment of the full Federal Court in the David Securities case. In part the judgment said:

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2 Evidence, p. S2434.

3 Evidence, pp. S2493-95.

4 Evidence, p. 1146.

> It may be accepted that there will always be a risk of an adverse movement in the rate of exchange. But it does not follow that a foreign loan transaction is something 'dangerous', let alone 'dangerous in itself'... all that can be said is that it is possible that such a transaction may result in some economic gain in certain events or in some economic loss if other contingencies occur. A foreign borrowing is not *itself* dangerous merely because opportunities for profit, or loss, may exist.[5]

17.24 While a foreign currency loan can not be considered to be an inherently dangerous product, it is a separate question as to whether it may be considered to be an inappropriate product to provide to some borrowers who do not fully understand the foreign exchange risk and who have little capacity to manage the risks. This difference was recognised by a staff member of one bank in an internal memo:

> I believe that the FCL is an excellent product, ... but I would reiterate that it must clearly only be put in the hands of borrowers with adequate financial sophistication to fully recognise the risks and be able to fully manage their own exposure.[6]

17.25 The Committee will return to this issue after its review of the evidence.

History of foreign currency loans

17.26 Foreign currency loans were not solely a phenomenon of the 1980s. They were offered earlier by the banks. Principally they were provided to large corporations, government and semi-government bodies (which presumably had the understanding and capacity to manage the foreign exchange risk) and customers involved in import\export where their receipt of foreign exchange from trade transactions provided a natural 'hedge'.[7]

17.27 The changes resulting from deregulation of the Australian financial system such as the abolition of exchange controls on foreign currency borrowing, the floating of the Australian dollar and the prospective entry of a number of new banks, especially foreign banks, seem to have provided a stimulus to the much wider offering by banks of foreign currency loans. The competitive pressure to offer the product was emphasised by all the major banks as the primary reason for the wider offering of foreign currency loans. For example, Westpac stated that:

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5 Judgement of the Full Federal Court in the David Securities Case (1990) 93 ALR 271 (at 291).

6 Banks' internal documentation held by the Committee.

7 Evidence, pp. S2492, S2693-94 and S2706-07.

> The extension of the existing FCL product into the so called retail area in the early 1980s represented a response to competitive pressures and perceived market needs. A number of foreign banks were already offering FCL facilities. Some customers were threatening to take their business elsewhere if they were not given access to FCL facilities. Consequently, Australian banks responded to demand pressures, particularly driven by solicitors and accountants acting for borrowers, to protect long standing business relationships.[8]

17.28 The Commonwealth Bank noted that another factor for it in considering the wider offering of foreign currency loans was to overcome Reserve Bank lending restrictions on Australian currency. These restrictions were removed in June 1982 and consequently were only a temporary factor.[9]

17.29 Among the major banks, a representative of Westpac stated that Westpac and the Commonwealth Bank were 'the leaders in this product' in the early stages.[10] As a result other banks' customers who were interested in the product approached these banks. Other banks sought to match the competition by also offering the product.

17.30 Borrowers and their representatives have suggested that there were tax and income advantages for banks from foreign currency loans and that these were the main reasons for banks becoming involved in offering the product. These allegations will be examined later in the chapter.

17.31 From 1982, foreign currency loans to retail customers were available from a number of banks and, according to the National Australia Bank, were 'being actively sought by both retail and non-retail customers'.[11] By the end of 1982, at least three of the major banks had developed instructional guidelines and documentation for making available foreign currency loans to retail customers at the 'smaller end of the market'.[12]

Features of the product

17.32 The features of the foreign currency loan product offered by the banks were very similar. Loans ranged from a minimum of $250,000 to $3-4m. The typical loan was for a period of five years with interest payable in arrears at each six-monthly roll-over point.

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8 Evidence, pp. S2389-90.
9 Evidence, p. S2435.
10 Evidence, p. 2112-13.
11 Evidence, p. S2694.
12 Evidence, p. S2493.

17.33 Other typical features of the product were:

- the loan could be provided in any freely available and convertible currency (Swiss francs was the most common currency);
- any foreign exchange losses or profits were for the borrower's account:
- parity adjustments could be called for if adverse exchange movements exceeded a certain amount (usually 5-10 per cent);
- the 10 per cent interest withholding tax was payable by borrowers; and
- exchange rate fluctuations could be eliminated at any time by entering a hedge contract.

17.34 Branch managers did not have the authority to approve foreign currency loans. The level of authority for approval differed between banks but was usually at a State level.

17.35 Banks usually required a greater level of security in relation to foreign currency loans than was the case for on shore loans to take account of potential exchange losses. The approach of the banks was also to ensure that borrowers had the capacity to carry the loan at on shore rates.[13] However, it appears that the banks did not always adhere to these guidelines. Professor Valentine noted that the banks had some credit evaluation deficiencies in this area, as they did in other areas in the 1980s.[14]

The perspective of the borrowers

17.36 Estimates of the total number of foreign currency borrowers vary, with most being in the range of 2000-3000 borrowers. Based on the information provided by the four major banks and two of the State banks, it is estimated that there were between 2180 and 2420 foreign currency borrowers in these particular banks up to 1986. Few loans were offered after 1986.

17.37 The Committee received evidence and documentary information from 60 borrowers from eight banks. Based on this information and the views expressed by spokespersons for the Foreign Currency Borrowers' Association, the Committee in this section outlines in general terms the perspective of borrowers to foreign currency loans.

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13 Evidence, pp. 2004-05, 2039-40, 2138 and S2408.

14 Evidence, p. S1949.

17.38 Foreign currency loan borrowers were generally small to medium business people, primary producers, professionals or property investors and developers.[15] As they were borrowing amounts of between $250,000 and $3-4 million in the early to mid-1980s, they could not be regarded as small consumers. Mostly they had significant business experience prior to taking out their foreign currency loans. The borrowers were described by a spokesperson for the Foreign Currency Borrowers' Association as being mostly 'astute businessmen ... (who were) ... at the leading edge in the commercial field'.[16]

17.39 The loans were taken out for a wide variety of purposes that included consolidating existing debt, expanding an existing business or entering a new venture. In some cases the intention of the borrowing could be described as speculative or innovative. The spokesman for the Foreign Currency Borrowers' Association said that borrowers were 'looking at new ideas, new concepts, whether it be property development, business ventures or whatever else'.[17] But in a number of cases borrowers were pursuing a natural development of their existing business.

17.40 The fact that many borrowers were experienced business people and engaged in innovative activities does not necessarily indicate that they had a detailed understanding of foreign exchange. In fact the internal documentation of the banks shows that some bankers had a view that a number of borrowers were 'unsophisticated' in foreign exchange risk and management.

17.41 The attraction of foreign currency loans for borrowers was their lower rates of interest compared with domestic loans. Table 17.1 shows comparative interest rates in Australia, Switzerland and the United States between 1980 and 1986. The lower interest rate made attractive some projects that otherwise might not have been pursued. For others it made a planned project all the more appealing. A representative of the Foreign Currency Borrowers' Association acknowledged that there was 'a greed factor' in the motivation of borrowers 'in many instances'.[18]

17.42 Many borrowers said that they were introduced to foreign currency loans by their banks. There was reference to 'seminars' or other meetings, such as service club meetings, at which the product was 'promoted' by bank staff. Some borrowers went further and claimed they were 'persuaded' to take the loans by particularank staff. It was stated that banks had a deliberate strategy to market the product and that individual bank staff had incentives or targets to sell foreign currency loans.[19]

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15 Evidence, p. S4196.
16 Evidence, p. 1124.
17 Evidence, p. 1124.
18 Evidence, p. 1124.
19 Evidence, pp. 1132, 1155, 1205.

TABLE 17.1

INTEREST RATE COMPARISONS

	AUD	CHF	USD
DECEMBER 1980	13	7	18
MARCH 1981	16	8	16
JUNE 1981	15	10	17
SEPTEMBER 1981	15	11	18
DECEMBER 1981	16	9	14
MARCH 1982	19	7	15
JUNE 1982	18	6	15
SEPTEMBER 1982	16	5	12
DECEMBER 1982	13	4	10
MARCH 1983	15	4	9
JUNE 1983	13	5	10
SEPTEMBER 1983	12	5	10
DECEMBER 1983	10	4	10
MARCH 1984	13	4	11
JUNE 1984	12	4	12
SEPTEMBER 1984	11	5	12
DECEMBER 1984	13	5	9
MARCH 1985	15	6	10
JUNE 1985	14	5	8
SEPTEMBER 1985	17	4	8
DECEMBER 1985	18	4	8
MARCH 1986	17	4	8
JUNE 1986	14	4	7
SEPTEMBER 1986	16	4	6
DECEMBER 1985	15	4	6

17.43 However, it was clear from the evidence of some borrowers that brokers and financial and other advisers played a role in introducing them to the product and acting as intermediaries with the banks. Some borrowers were very much aware of foreign currency loans and were 'shopping around' for a foreign currency loan, even changing banks to obtain it.

17.44 Individual borrowers have told the Committee that they had little or no knowledge of foreign currency movements or of the risks associated with unmanaged foreign currency loans. Almost all borrowers, whether they had sought independent advice or not, said that they relied on the expertise of their bank as their 'primary adviser on foreign currency risk'.[20]

17.45 Borrowers emphasised their relationship of trust in the 'wisdom and integrity' of their bank manager.[21] The relationship was described by one borrower in the following terms:

> I and the majority of the borrowers that I have spoken to placed the bank manager in the same category as the parish priest and the local doctor. We would not do that now, we accept that, but back in the early 1980s we did ... The fact that we did place a lot of trust in our bank managers is not being clearly understood in the commercial realities of doing business out there. You have to deal with reliable, responsible people if you are going to run a successful business in Australia, and the bank manager back in the early 1980s was one of those people.[22]

17.46 Mr McLennan similarly referred to the close relationship that existed between borrowers and banks and that this relationship changed early in the 1980s. He noted that banks became 'dealers in money' and customers did not understand that a change in the relationship had occurred.[23]

17.47 Relying on the advice of their banks, borrowers suggested that warnings given by the banks on foreign currency risk were inadequate. Many borrowers said that the advice that they received was that AUD movements against the most commonly borrowed foreign currency, the Swiss franc, were minimal (within a 10 per cent range up or down). Graphs of currency movements over only the previous five years were shown to borrowers and these did indicate that currency movement was relatively minor (see Figure 17.1 for a copy of a typical graph shown to borrowers).

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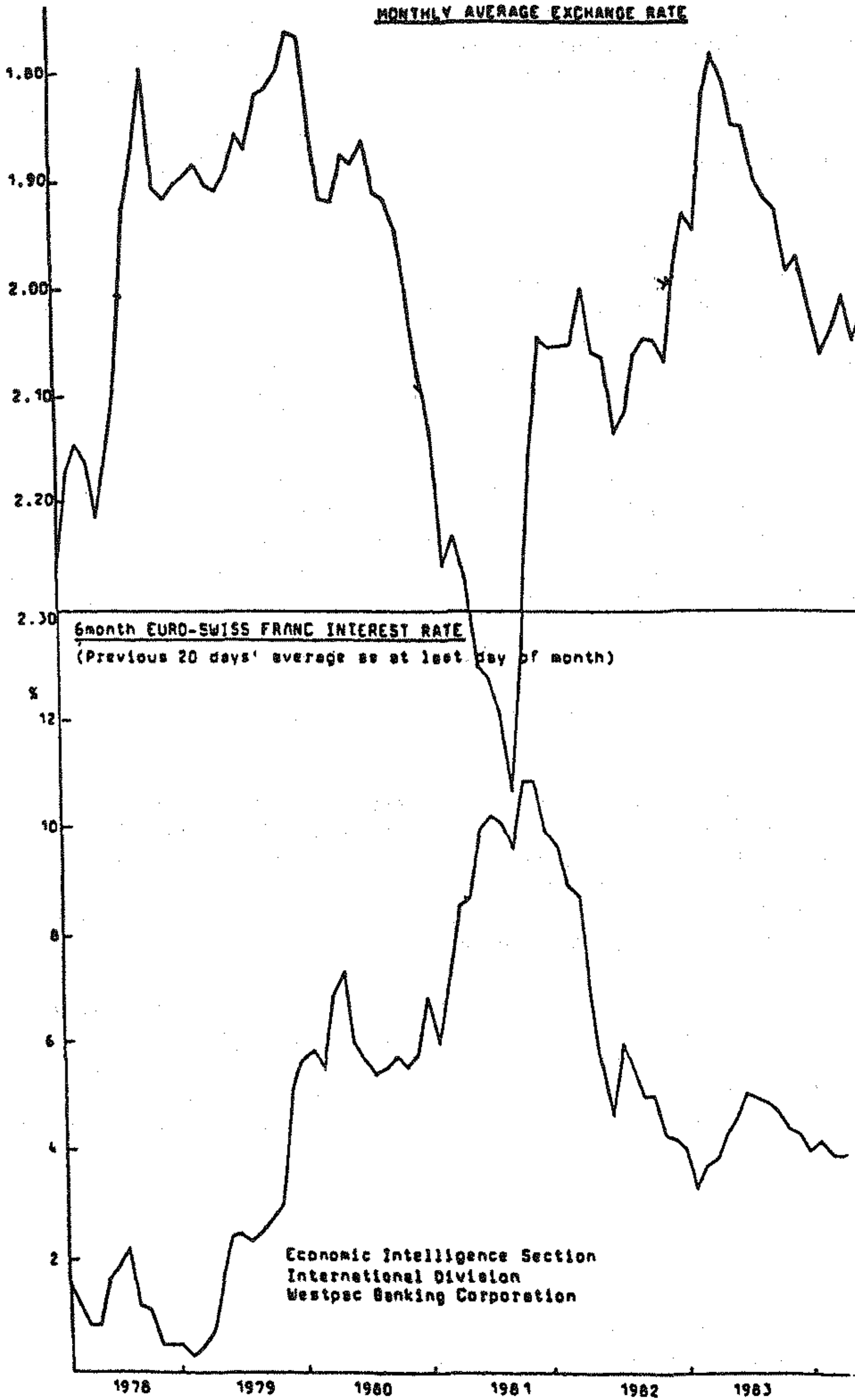
20 Evidence, p. 1162.

21 Evidence, p. S2003.

22 Evidence, p. 1151.

23 Evidence, p. 1129.

FIGURE 17.1



17.48 On the basis that such relatively minor movements were typical, borrowers claim that they were advised that any affects of exchange rate fluctuation would be compensated by savings on interest.[24] However, borrowers said that this was deceiving as graphs over a longer period revealed a steady decline of the AUD against the Swiss franc (see Figure 17.2 for such a graph). Some borrowers went further and suggested that the banks should have informed them that the risks on foreign exchange were open-ended, and that currencies could fall dramatically in a short time.

17.49 Borrowers also said that they were not advised to monitor their loans. They said that it was not emphasised to them that they were responsible for managing their foreign exchange risk. When they received advice about hedging, they were told that it would result in similar costs to onshore borrowing. Other techniques such as basket borrowing or stop-loss mechanisms do not seem to have been suggested to them by the banks. Professor Valentine claimed that such mechanisms were not widely used at the time.[25]

17.50 Some borrowers said that they were advised by the bank to seek outside advice. Where banks did advise borrowers to seek outside advice, some did not do so relying on their implicit trust in their bank. For those who did seek independent advice, their advisers generally had little knowledge of foreign exchange matters and advised the borrowers to trust their banks. However, it was noted that a number of borrowers approached the banks seeking foreign currency loans on the basis of advice from brokers and other financial advisers.

17.51 The Committee will examine the advice or information provided to borrowers by banks later in the chapter.

17.52 Foreign currency loans did not create difficulties for borrowers until the dramatic fall in the AUD in 1985 and subsequently through 1986. Some borrowers saw their liability increase by as much as 100 per cent over the term of the loan. Figure 17.3 demonstrates the fluctuation in the AUD against the Swiss franc from 1982 to 1991. Depending on the timing of their loans, other borrowers may have experienced few, if any, problems.

17.53 It is about this crucial period after the fall of the AUD that borrowers were particularly critical of the banks. Borrowers said that there were not informed by the banks of the losses they were suffering. They said they were provided with little, no or poor advice and received little support from the banks to enable them to minimise losses. Borrowers had little idea what to do to control the losses they were suffering.

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24 Evidence, pp. 1153 and 1201.

25 Evidence, p. S1950.

FIGURE 17.2

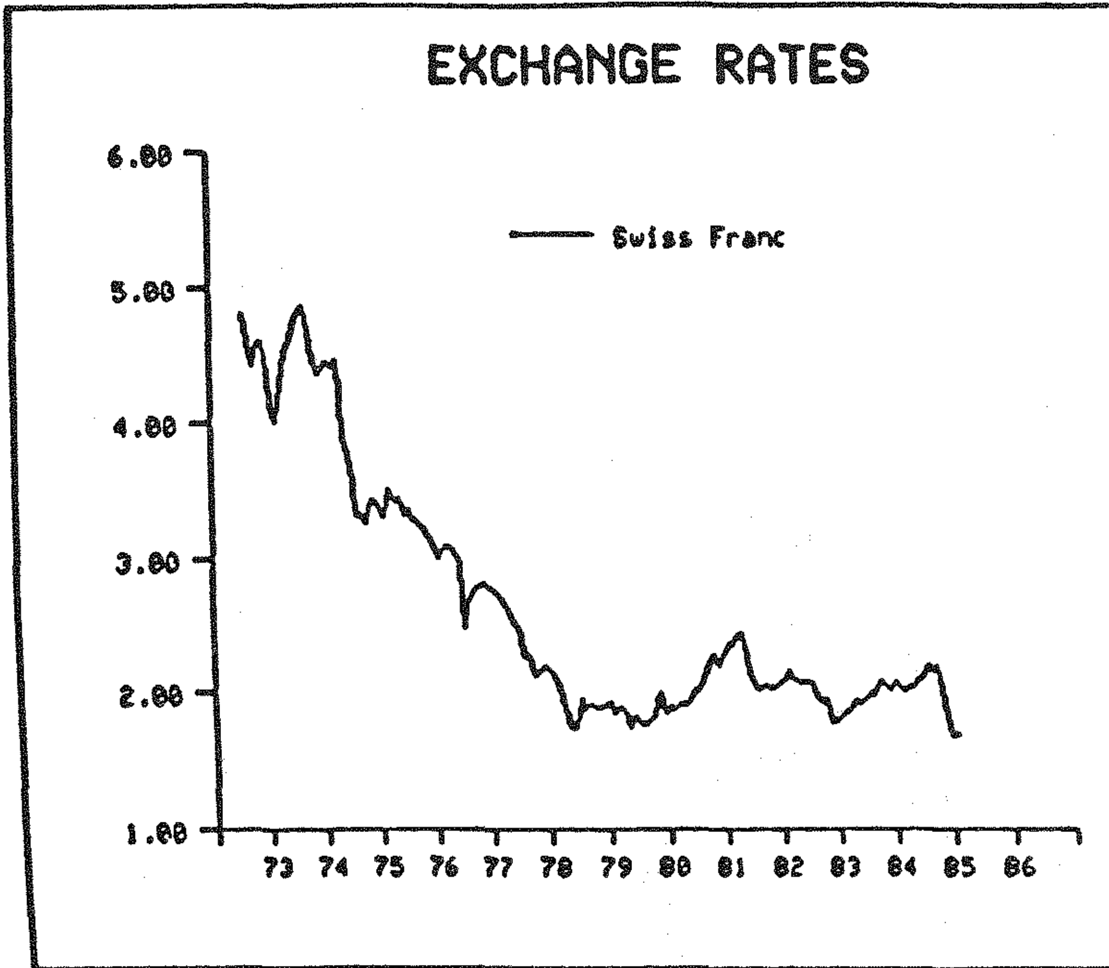
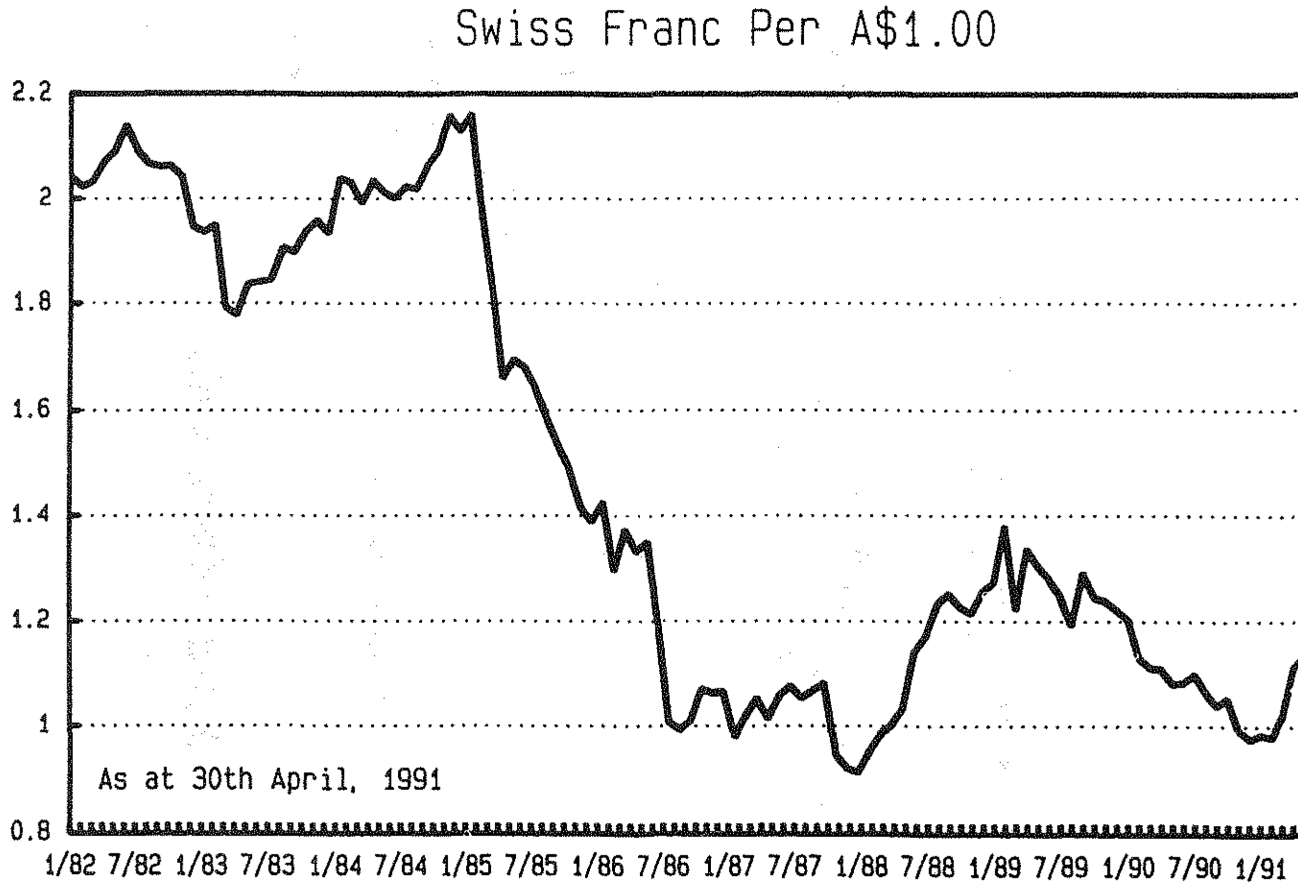


FIGURE 17.3



GRAPHICS & PUBLICATIONS - GROUP STRATEGIC DEVELOPMENT, NATIONAL AUSTRALIA BANK

17.54 The Commonwealth Bank noted that the reality for borrowers was that 'nothing could be done to recoup losses already incurred'.[26] Within this constraint borrowers' responses ranged from:

> ... those who hedged their loans and came onshore at the first opportunity, those who allowed the loan to run on over one or two rollovers before coming onshore, those who attempted to manage their loans by hedging or switching currencies while continuing to have the loan denominated in a foreign currency.[27]

17.55 As loans were typically over a five year period and losses did not have to be realised until the loan term expired, it was tempting for borrowers to remain offshore in the hope of recovering their losses with a rise in the AUD. Some borrowers claimed that they were encouraged in such a strategy by their banks which were advising them that the 'dollar would come back'.[28] Also borrowers were aware that they would have to meet much higher interest rates (on greatly increased principals) if loans were brought onshore. In many cases they would not have had the ability to meet the interest rates without some sale of security. It is important to note in this context that, under the loan documentation, banks could not force borrowers back onshore.

17.56 In cases where borrowers tried to manage their loans, they were doing so in a context where great expertise and swift movement was necessary. Though all major banks set up a service to provide information to borrowers about their foreign currency exposure, the banks emphasised that they did not have contracts to manage borrowers' foreign currency risk and that this was the responsibility of the borrower.

17.57 Borrowers and their advisers have also alleged that the banks' exploited the borrowers' captive position by taking excessive margins ('secret commissions') on any foreign currency transactions that were undertaken.[29] Further it is alleged that banks behaved improperly, and made excess profits, by taking opposite positions to those of borrowers.[30]

17.58 To assist borrowers to deal with their difficulties, the Foreign Currency Borrowers' Association was formed in December 1988 to provide a mutual support and information group to borrowers. It holds regular meetings and issues a newsletter. The Association claims a membership of around 250. Spokespersons for the Association made submissions to the Committee and gave evidence.

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26 Evidence, p. S2514.

27 Evidence, p. S2514.

28 Evidence, p. 1155.

29 Evidence, p. S2081.

30 Evidence, p. S2082.

17.59 It is not clear what has happened to the 2000-3000 borrowers who received foreign currency loans in the early to mid-1980s. It could be assumed that some did not experience the same problems as borrowers who came before the Committee. Some may have had natural hedges or had good investments that made enough to meet higher repayments. Some may have hedged early in the currency fall or brought their loans onshore at an early opportunity thereby minimising losses. It is understood that a number of borrowers have settled with their banks and, as such settlements are confidential their nature is unknown.

17.60 A number of cases have been pursued, or are being pursued, by means of litigation. While the number is significant for some of the banks involved, it represents only a small proportion of overall foreign currency borrowers. A legal firm that has acted for many borrowers, Galbally and O'Brien, estimates that more than 90 per cent of cases in respect of which proceedings are commenced are settled prior to final determination by the courts.

17.61 Borrowers have pointed to the costs of litigation and the powerful position of the banks in the process. They claim that these factors have made it difficult for them to succeed in cases. Borrowers have suggested that the banks have deliberately prolonged cases, failed to make adequate discovery and endeavoured to ruin borrowers involved in litigation with them.

17.62 The Committee has related in some detail the extensive allegations made to it by foreign currency borrowers. These allegations are serious and, if sustained in their entirety, would suggest improper, unjustified and (some borrowers would suggest) criminal behaviour on the part of major banking institutions in Australia. In the remainder of this chapter the Committee examines these allegations in detail against the evidence it has taken on the foreign currency loans issue.

Advantage to banks in foreign currency loans

17.63 The Committee referred earlier in the chapter to the motivation of the banks in becoming involved in foreign currency loans. The change to a deregulated banking environment, the anticipated entry of foreign banks and competition from merchant banks stimulated the banks to endeavour to retain and build market share. The foreign currency loan was one product that was seen by the banks as one they should be offering to customers to meet the existing and anticipated competition.

17.64 However, borrowers alleged that the banks became involved in foreign currency loans for a number of other reasons. These included:

- that offshore lending was more profitable than onshore lending;
- that there were tax advantages; and
- that 'secret commissions' could be charged to 'captive' offshore borrowers.

Profitability of offshore lending

17.65 Offshore lending was alleged to be more profitable than onshore lending because the banks charged greater interest margins on offshore. Mr Gerhard Moser cited figures based on a comparison of a A$500,000 facility taken onshore and offshore. While the interest charged on an onshore facility would have been A$37,500 over the five years of the loan (based on a margin of 1.5 per cent), the actual interest charged on the offshore facility was A$60,295 (also based on an interest margin of 1.5 per cent).

17.66 It appears that the additional interest income can be explained entirely by the application of the interest margin to the increasing loan principal that resulted from the fall in the Australian dollar. As the total of the bank's outstanding asset increased, it received a proportionately greater interest income from it. Of course, if the Australian dollar had appreciated then the bank's gross interest income would have fallen.

17.67 On the issue of the interest margins themselves, it appears from the bank's guidelines that these were charged according to the usual criteria that were applied to bill facilities. For example, between May 1982 and May 1985 Westpac charged interest margins in a range of 0.5 per cent and 3.0 per cent depending on the usual factors that would apply to onshore lending such as creditworthiness, security, value of connection etc.[31] In May 1985, Westpac guidelines changed and the interest margin charged was 'aligned to a matrix applicable to Commercial Bill facilities' but with an additional offshore loading in the range of 0.25 per cent to 0.5 per cent 'to compensate for the additional risk inherent in these loans'.[32]

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31 Evidence, pp. S2407-2415.

32 Evidence, p. S2417.

17.68 In the case of the Commonwealth Bank, the margins that were applied to a bill facility were used as a guide to charging for foreign currency loans.[33] The State Bank of New South Wales' guidelines were that a margin of 2.5 per cent was to be charged because of the 'greater degree of administrative costs involved (in a foreign currency loan) when compared to say a commercial bill facility'.[34] Westpac also noted the additional cost of providing foreign currency loans because of the financial market infrastructure and expertise required.[35]

17.69 Finally, on interest margins, the borrowers emphasised that the banks were competing keenly to attract customers to their foreign currency loan product. Given this, it could be expected that pricing of margins would have been strongly competitive, with little room for profit taking.

17.70 It also was suggested that the banks' cost of funds was lower in the case of loans arranged offshore as the banks could avoid the Reserve Bank's Statutory Reserve Deposit requirements which applied only to domestic deposits. It similarly reduced their required holdings of government securities. The reduction in cost of funds was estimated to be in the order of 1 per cent resulting in annual additional profit of about A$25 000 per facility. National Australia Bank noted that there would have been a lesser SRD with foreign currency loans, but the difference was 'marginal'.[36] However, the Bank stated that many foreign currency loans would have involved a swapping with bill finance that also did not attract SRD. The banks' internal documentation does not appear to indicate that this advantage was an important consideration in the banks making the product available.

Tax advantages

17.71 The principle tax advantage was claimed to arise by banks booking foreign currency loans through offshore centres with lower tax regimes such as Singapore (in the case of Singapore a 10 per cent tax rate). The tax effect of the use of Singapore was that profits from loans (primarily the interest income) could be sourced through the offshore centre and attract lower tax rates than would apply to income sourced to Australia.

17.72 Westpac described the allegations that foreign currency loans were a sophisticated tax avoidance scheme as the 'most serious, but at the same time outrageous' claims made by the Foreign Currency Borrowers' Association.[37] The banks indicated that there were valid commercial reasons for using their Singapore branches as a booking source for such loans.[38]

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33 Evidence, p. S2576.
34 Evidence, p. S2756.
35 Evidence, p. 2076.
36 Evidence, p. 2045.
37 Evidence, p. S2397.
38 Evidence, p. S2398 and S2531.

17.73 Further, banks said that they have discussed these issues with the Australian Taxation Office and all issues have been resolved.[39]

17.74 Banks' evidence on this issue appears to have missed the point. The charge made by borrowers was that there were apparent tax advantages to the banks at the time from writing foreign currency loans, consequently providing a motivation for banks to promote the product.

17.75 The Committee received evidence on this issue from the Australian Taxation Office. The Tax Office stated that all the major banks had been subjected to an extensive income tax audit, including the treatment of profits derived from foreign currency loans for Australian tax purposes.

17.76 In undertaking the audits the central issue for the Tax Office was whether the correct source of the profits for tax purposes was Australia or Singapore. In each case the Tax Office examined the role played by banks' Singapore branches in making the loans to determine whether the branch acted as 'an autonomous and independent decision-maker', or whether it acted merely as a 'rubber stamp' for decisions effectively made in Australia.[40]

17.77 As a result of the audit, the Tax Office found that one bank had treated all interest and fee income relating to foreign currency loans as having an Australian source and returned such income to Australia for tax. The other three major banks sourced interest and fee income from the loans, to varying degrees, through Singapore. The Tax Office was unable to obtain sufficient evidence to re-source the entire amount of these profits in Australia. However, it stated that:

> Evidence was obtained which confirmed that the practices and procedures adopted in the making of the loans had been specifically structured with the banks' Australian income tax liability in mind.[41]

17.78 As noted by both the Tax Office and the banks, these issues have now been resolved by means of settlement and no outstanding questions remain.

17.79 However, the point remains that, for at least some banks, there were perceived to be tax benefits at the time for booking foreign currency loans through their Singapore branches. As noted by the Tax office these were (legal) tax minimisation arrangements as opposed to ones involving (illegal) tax evasion.

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39 Westpac's second submission, pp. 40-41, Evidence, p. S2697 and S2531-32.

40 Evidence, p. S2955.

41 Evidence, p. S2967.

17.80 A great deal of confused evidence was taken on the issue of the interest withholding tax which borrowers were required by their agreements to pay as a cost of the loan. Interest withholding tax (at a 10 per cent rate) is payable by non-residents on interest income earned in Australia. In the case of foreign currency borrowing, the cost of the tax was passed on by the bank to the borrowers.

17.81 It was suggested by borrowers that withholding tax was unlawfully charged to them. This matter is appropriately dealt with by the courts and it is understood that it has been pursued in the David Securities vs Commonwealth Bank case (currently on appeal to the High Court). However, a representative of the Tax Office noted:

> The practice of requiring the borrowers effectively to bear the withholding tax is not new, it is a very longstanding practice that has been ... almost always included in loan agreements that I have been aware of over many years.[42]

17.82 Further, it was stated that financial institutions operate on fine margins and that the cost of the withholding tax could not be absorbed by the financial institution. A similar point was made by Westpac. It stated that, if the withholding tax had not been passed on to the borrower as part of the cost of the loan, it would have been necessary to increase the banks interest margin to preserve a commercial rate of return for the transaction.[43]

'Secret commissions'

17.83 The final area of suggested advantage for banks in foreign currency loans was the claim that 'secret commissions' were taken by the banks when trading in the foreign exchange markets on behalf of borrowers. It was stated that this occurred at original drawdown of the loan, but more particularly when some borrowers endeavoured to manage their loans by trading in foreign exchange. It was claimed that the banks were taking advantage of the captive status of borrowers to give them exchange rates incorporating excessive profit margins ('secret commissions' or point taking) unknown or unexplained to the borrowers.

17.84 The banks stated that the margins charged on foreign exchange transactions are designed to cover the cost of providing the service and to realise a profit. The transactions were described as 'the normal trading activity of a trader who buys something at on price and sells it at another'.[44] The margins varied depending on the size and nature of the transaction. While margins applied to very large currency parcels traded on a fully reciprocal basis are minimal, on small

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42 Evidence, pp. 3185-86.

43 Westpac's second submission, p. 43.

44 Evidence, p. 2050.

currency transactions such as travellers cheques, they are much larger.[45] The transactions of foreign currency borrowers fell between these two extremes. In relation to these transactions, the Commonwealth Bank stated:

> One simply cannot expect non-reciprocal, non-spot, non-normal market sized parcels to be transacted at a price applicable to the mainstream of the market.[46]

17.85 Westpac acknowledged that, as most foreign currency borrowers were not large turnover customers, they could be held to have an 'uncompetitive status'. However, Westpac said that they were not exploited.[47]

17.86 It was also stated that the margins were not 'secretive' as customers 'could readily compare their [exchange] rates with rates shown daily in the newspaper or could obtain rates from other financial institutions'.[48] It was not practice to provide a break-up of the quoted rate thereby explicitly state the margin and its components.[49] Westpac said that if a customer wished to know the basis of its charging, this would have been explained.[50]

17.87 Given that exchange rates can change significantly over a day, and even over a short time, customers were not in a position to compare their rate with the market rate. The lack of disclosure in this area gave rise to customer concerns about 'secret commissions' being taken by the banks. The Committee sees a need for greater disclosure in this area.

17.88 In a related area, borrowers claimed that the banks traded on the opposite position to them and made significant profits as a result. However, as the banks pointed out they only traded on their own foreign currency exposure that resulted from borrowers not having sufficient security to cover the outstanding debt. In doing so they were acting 'prudently to protect the shareholders and depositors' in relation to the bank's own foreign currency debt exposure'.[51] Also, as the Australian dollar appreciated during the period that such trading occurred, the banks may well have suffered losses to its own account.[52]

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45 Evidence, p. S2399.
46 Evidence, p. S2525.
47 Evidence, p. S4225.
48 Evidence, p. S2400.
49 Evidence, p. S2400.
50 Evidence, p. S4225.
51 Evidence, p. S2401.
52 Evidence, p. S2401.

Conclusion

17.89 The Committee concludes that the primary reason for banks offering foreign currency loans to a much wider market than had previously been the case was competitive pressure. This competitive pressure came initially from merchant banks and the anticipated entry into the market of other players who would offer such a product. The competitive pressure increased with the offering of the product by some of the major banks, resulting in all the major banks and some other banks becoming involved to a greater or lesser degree. The competition then fed on itself. Financial advisers and brokers also were promoting the advantages of the product and acting as intermediaries between banks and borrowers.

17.90 Much of the evidence from borrowers and their advisers on the alleged profit and other advantages to banks from the selling of foreign currency loans was either misguided or misleading. Upon examination, many of the allegations of advantages to banks could be explained in commercial terms or were incorrect.

17.91 However, the Committee has identified that, at the time, there were perceived tax advantages to some banks from the selling of foreign currency loans. It would appear that some banks deliberately structured the product to take advantage of the perceived tax benefits. The Committee notes that the question of any tax benefits resulting from foreign currency loans has been an issue between some banks and the Australian Taxation Office and that all outstanding issues have been resolved by means of settlements.

17.92 While perceived tax advantages may have stimulated the motivation for some banks to sell foreign currency loans, not all banks which sold foreign currency loans perceived that there were tax advantages in doing so. The primary reason for all banks being involved remained the competitive pressure to provide such a product to small customers to maintain or increase market share.

17.93 The Committee sees a need for greater disclosure in the area of foreign exchange so that customers, such as small foreign currency borrowers, are advised in advance of the fees and all other charges they will incur for foreign currency transactions.

Recommendation

17.94 **The Committee recommends that:**

59. banks ensure greater disclosure in the area of foreign exchange transactions by advising foreign currency loan customers in advance of all fees and charges associated with foreign currency transactions.

The 'marketing' of foreign currency loans

17.95 Foreign currency loan borrowers and their advisers suggested that foreign currency loans were actively, even 'aggressively' marketed by the banks, and in particular Westpac and the Commonwealth Banks, in the early 1980s. Among the 'marketing' methods of banks identified by borrowers were:

- the advertising of the product;
- the holding of seminars on the product and the attendance by bank staff at service clubs and other meetings to promote it; and
- the incentives and targets provided to individual bank managers and staff to sell foreign currency loans.

17.96 The banks strenuously denied that they marketed foreign currency loans.

17.97 Westpac stated that there was no centralised strategy for marketing FCLs and it was left to each State division to respond to customer demands and *competitor pressures. It did not actively nor widely market the product.*[53]

17.98 National Australia Bank maintained a policy of not marketing non-trade related foreign currency loans whether through business development calling, advertising, the holding of public seminars or otherwise.[54]

17.99 ANZ Bank acknowledged that, while it was prepared to compete with other banks in providing FCLs, no universal marketing strategy was adopted by ANZ, nor was a 'target market' selected.[55]

17.100 The Commonwealth Bank also denied marketing the product and detailed the evidence to indicate that it had not actively promoted foreign currency loans.[56]

17.101 Despite these general denials, the term 'marketing' in connection with foreign currency loans appears in the internal documentation of at least some of the banks. This includes reference to the 'marketing' activity of competitors. The following are typical:

> We are aware that at least one major Australian competitor bank has also been aggressively marketing such [foreign currency] facilities ...

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53 Evidence, p. S2393.

54 Evidence, p. S2698.

55 Evidence, p. S2708.

56 Evidence, pp. S2498-2500.

> The marketing of foreign currency loans will be paramount if they are to become an acceptable form of financing for Australian borrowers.
>
> It has come to our attention that our competitors have been increasingly active in marketing Foreign Currency Loans ...[57]

17.102 These references would appear to belie the assertions of the banks that none of them engaged in the marketing of foreign currency loans. However, the internal documentation is not clear cut as there also are references to the loans not having been marketed by the banks. The following are a few such references:

> the [foreign currency loan] facility has never been strongly marketed ...
>
> [foreign currency] loans have never been 'marketed' by the Bank and only arranged when valued business is at risk ...
>
> ... we have purposely not wanted to 'market' this facility(FCL) too heavily in the Branch Banking account sector in these relatively early days ...[58]

17.103 The Committee will now examine the specific marketing methods referred to by borrowers and the evidence taken from the banks on these.

Advertising

17.104 The banks said that foreign currency loans specifically were not advertised. Both Westpac and the Commonwealth Bank acknowledged that some of their general advertisements promoting the banks' business or foreign currency expertise referred to foreign currency loans as one element. They denied that this constituted an advertising campaign.[59] A sample Commonwealth Bank advertisement is at Figure 17.4.

17.105 ANZ Bank referred to the extensive advertising of foreign currency loans by finance brokers in the general media and professional publications in the early 1980s.[60] For a sample of such advertisements see Figure 17.5.

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57 Banks' internal documentation.

58 Banks' internal documentation.

59 Evidence, pp. S2393 and S2498-99.

60 Evidence, pp. S2709-10.

FIGURE 17.4

A discreet list of Australia's top 100 companies.

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2. ______ ✓
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______ ✓

A client of the Commonwealth Bank's Corporate Division.

If it surprises you to see so many of our clients among the top 100 companies, consider this:

The Commonwealth Bank financed the largest single loan ever negotiated in Australia.

And was the sole lead manager on a leasing operation that rated as the largest of its kind in the world.

So we're extremely well qualified to help you in areas such as multi-currency loans, leveraged leasing, sale/lease backs, currency/interest rate swaps and supplier credit facilities.

FIGURE 17.5

FINANCE

Australian Dollars from 14.25%
Foreign Currency from 6%

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Leasing, Commercial H.P.
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David R. McDonald
(09) 325 8864

Sydney:
Michael Cleary
(02) 29 1107

Seminars and other local promotion

17.106 National Australia and ANZ Banks stated that no seminars were organised by them on foreign currency loans.[61]

17.107 Westpac stated that:

> Some seminars were ... held as part of an ongoing program of bringing information on new products and innovations to the customer base, but few, if any, were focussed solely on FCLs.[62]

17.108 The Commonwealth Bank stated that it was not its 'practice to conduct seminars to the public discussing foreign currency loans'.[63] However, it referred to two seminars that it held in Wollongong in August 1984 on the mechanisms of foreign currency lending. These were for Branch Managers and Loans Officers. Some clients also were thought to have attended a seminar there at about the same time, but the Bank had no record of this. Seminars for clients covering a wide cross section (presumably including foreign currency loans) were conducted at Newcastle NSW on 14 August 1984 and at Nowra NSW early in November 1984. These seminars were organised in response to significant local demand and inquiry and not as an organised promotional campaign. In addition the Bank referred to other organised discussions and meetings, which may be called 'seminars', being held for bank staff.[64] According to the Bank, the seminars were held on an ad hoc basis to explain instructional guidelines and respond to questions arising from the guidelines.[65]

Incentives

17.109 Finally, the banks strongly denied that there were incentives for bank staff to promote foreign currency loans rather than AUD loans.

17.110 Westpac stated that 'specific performance targets were not set for branch managers to promote FCLs or to use them as a lever to new business'.[66] As the loans were booked through Singapore, all profits from the loans were sourced through Singapore rather than through branch or divisional books. Thus there may have been a disincentive for branch managers in writing this business.[67]

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61 Evidence, pp. S2698 and S2709.

62 Evidence, p. S2393.

63 Evidence, p. S2499.

64 Evidence, p. S2499.

65 Evidence, p. S2500.

66 Evidence, p. S2393.

67 Evidence, p. 2116.

17.111 However, Westpac acknowledged that the situation for State international business managers could be different to that of branch managers. A representative of Westpac was aware of one case where a State international business manager:

> ... may have had some performance target in relation to offshore borrowing. My understanding is that generally was not the case, but it appears that there is one. And who set that out, I do not know.[68]

17.112 The Committee is aware from other evidence it has taken that at least one Westpac State international business manager had such performance targets and did in fact write a significant number of foreign currency loans.

17.113 According to the Commonwealth Bank it had no incentives to bank staff to 'promote' foreign currency loans to borrowers. The bank did not pay any bonus or incentive to its staff to introduce new business including FCLs.[69]

17.114 National Australia and ANZ Banks also denied that any incentives were available to staff to promote foreign currency loans.

17.115 Apart from the banks, the role of financial advisers and brokers in marketing foreign currency loans, has been referred to. The Committee has referred to the advertising of loans by brokers. ANZ bank also stated that:

> ... accountants, solicitors and financial advisers drew down FCLs and guided their clients towards these loans. Also, the demand for FCLs was exacerbated by the rapid increase in the number of non-bank dealers and financiers who entered the Australian market.[70]

17.116 The pattern of take up of foreign currency loans is consistent with there being pockets of local demand for, or interest in, foreign currency loans.

17.117 Westpac indicated that the loans did 'cluster' in particular areas.[71] There was reference to one Westpac officer who made 19 loans in a period of about 18 months as a result of 150 requests. A representative of Westpac commented that:

> Clearly, the fact that he interviewed 150 potential borrowers means that he was part of a climate of demand for this product. Whether he generated that demand or it was generated by people who clearly he had to have

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68 Evidence, p. 2118.

69 Evidence, p. S2500.

70 Evidence, pp. S2709-10.

71 Evidence, p. 2082.

> some association with - people who came to him, so whether there were advisers or accountants, solicitors drumming up business it is not totally clear ...[72]

17.118 The Commonwealth Bank also referred to particular areas of concentration within its foreign currency loan portfolio. It noted that, of the 529 loans outstanding in June 1986, 108 originated from eight branches where 'local demand emerged'.[73] One branch, the Taree Branch, wrote 23 loans. The Bank noted that these included eight for the private companies of one client who also directed others to the Bank.[74]

17.119 ANZ Bank noted that there were 'clusters' in the lending of the foreign currency loan product and these:

> ... tended to correlate very much with the strength of particular people in particular towns, where a financial adviser, solicitor, accountant or whatever were pushing things very strongly.[75]

NAB also referred to the loans appearing in 'pockets' associated with the activity of a particular individual pushing the loans.[76] As ANZ Bank noted, there is now no sign of these individuals when things are getting difficult. The only people left are the borrower and the bank.[77]

Conclusion

17.120 The banks argued that they did not 'market' nor even 'promote' nor 'sell' foreign currency loans. They endeavoured to portray themselves as the passive victims of borrowers (often advised by brokers) determined to obtain foreign currency loans. This may be true in some instances, but it is difficult to sustain in all cases.

17.121 It was noted in the previous section that competitive pressure was the primary force driving banks to offer foreign currency loans. In such a competitive environment, it is difficult to believe that the banks did not make efforts to ensure that customers were aware that they offered a foreign currency loan product.

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72 Evidence, p. 2083.
73 Evidence, p. S2505.
74 Evidence, p. S2506.
75 Evidence, p. 2000.
76 Evidence, p. 2035.
77 Evidence, p. 2018.

17.122 The Committee has identified at least some of the promotional measures adopted by some banks:

- there was some advertising of the product as part of general advertising approaches;
- some seminars and other 'promotions' were conducted which involved a discussion of foreign currency loans; and
- there was at least one instance where a bank staff person had targets for the selling of foreign currency loans.

17.123 These do not amount to a massive market campaign or to evidence of aggressive selling and do not apply to all banks. However, they do indicate that some banks involvement in the product was not passive. The pattern of take up of loans indicates that some bank staff may have been involved, together with others outside the banks, in stimulating local demand for the product. Whether this may have led to a failure to adequately warn borrowers about the risks of foreign currency borrowing is examined in the next section.

17.124 The Committee notes the involvement of financial brokers and other advisers in the promotion of foreign currency loans. These people disappeared from the scene when borrowers experienced trouble leaving only the borrower and the bank to face the problem. They must accept the blame in some areas for the interest that was evident in foreign currency loans.

Disclosure to borrowers

17.125 The issue of information or advice provided to borrowers by banks is a crucial one in relation to foreign currency loans. The issue has two elements that need to be addressed. First there is the information actually provided by the banks to borrowers. Second there is a question of what sort of warnings should have been provided to convey adequately the degree of risk involved.

17.126 In relation to the first element, the Committee examined the general guidelines and approaches of the banks to the provision of information and advice to borrowers. As well, each borrower would have had an individual experience of advice provided by particular bank staff. While it is not possible for the Committee to go to the circumstances of individual cases, some general comments can be made.

17.127 The internal guidelines of all banks in relation to foreign currency loans emphasised that foreign currency borrowing on an unhedged basis contained significant risk and that this risk should be explained to the borrower. The following give some indication of the warnings that staff were asked to convey:

> Potential borrowers should be made well aware of the exchange risks involved and advised to seek hedging *facility available from the Bank.*[78]
>
> It is most important that customers fully understand the *potential risk involved in borrowing in a foreign currency* on an unhedged basis ...[79]

17.128 The loan approvals or agreements also invariably contained warnings about the exchange risk involved in foreign currency borrowing. For example the Commonwealth Bank's 'Application for a Foreign Currency Loan' contained warnings about foreign exchange risk, a statement that any foreign exchange losses were for the customer's account, advice about hedging and an urging for the borrower to seek outside advice.[80] Westpac noted that its loan documentation contained the following provision that borrowers specifically were required to acknowledge:

> I further acknowledge that I am aware that the letter requires the payment by me of principal and interest and other amounts in foreign currencies and that this may involve exchange losses or gains by me.[81]

17.129 The formal approval documentation of other banks also contained a warning of foreign exchange risk and that such risk was the customers responsibility.

17.130 Aside from the formal guidelines and warnings in approval documentation, the banks advised that they adopted various approaches to clients interested in foreign currency loans.

17.131 It was policy in National Australia Bank for a customer interested in applying for a foreign currency loan to have an interview with the Manager, International Banking - State Administration. At the meeting a detailed explanation would be given of the mechanics and risks of foreign currency borrowing. Amongst matters canvassed were foreign exchange risks and hedging. Charts were given to customers showing movements in the Australian dollar against other currencies for a number of years. According to National Australia Bank, approximately eight out of ten customers did not proceed further with their inquiries about foreign currency loans following these meetings. In New South Wales in one period in 1984, only 15 customers of 300 who had interviews, took out foreign currency loans.[82] Loans were approved by State Administration - Credit Area.

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78 Evidence, p. S2408.

79 Evidence, p. S2567.

80 Evidence, pp. S2535-38.

81 Westpac second submission, p. 2.

82 Evidence, pp. S2698-99.

17.132 ANZ Bank's information to borrowers differed according to the needs and requirements of the customers. In some cases lengthy discussions about the facility and exchange risk took place. In other cases, particularly where the borrower had decided to take a foreign currency loan, little information was provided. Requests for foreign currency loans were processed by Branch Managers who had access to expert staff in the Bank's International Division. Loans were approved by State Lending Administration.

17.133 In Westpac it was policy for a suitably experienced officer in international banking matters to meet with prospective borrowers to explain the mechanics and risks of foreign currency borrowing. There would be reference to available currencies, the operation of the loan, exchange rates and interest rates in various currencies and hedging transactions. Amongst information provided to borrowers was a chart showing monthly average exchange rates and interest rates in a number of currencies for the previous five years. As noted earlier, one Westpac officer received 150 expressions of interest in foreign currency loans in an 18 month period. Of these only 19 were approved.[83] Loans went to Singapore Branch for approval.

17.134 The Commonwealth Bank noted that its information about the facility was provided in writing and orally. Written information consisted chiefly of the letter of offer referred to earlier. Oral information varied according to the circumstances of the inquiry and application. All State capitals and points of approval/control for branch lending had instructional guidelines for foreign currency lending forwarded to them. Subsequently a Corporate Lending Manual, including requirements of foreign currency lending, was sent to all branches. In addition to approving officers, specialist staff at Head Office were available to answer queries from customers and staff.[84] Loans were approved by State Managers or Chief Managers.

17.135 In terms of their formal policy guidelines, documentation and approaches, the banks met their basic obligations to warn customers about the dangers of foreign currency borrowing. These invariably contained a warning that foreign currency borrowing was risky and that techniques for hedging were available to assist in managing the risk. However, the implementation of the guidelines and approaches was in the hands of bank staff dealing directly with the individual customer.

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83 Evidence, p. 2083.

84 Evidence, pp. S2503-05.

17.136 The quality and experience of staff dealing with the product and providing advice to customers was variable. The representative of one bank noted that branch managers on average would only have handled a single foreign currency loan and so it was 'No wonder that they did not have a whole lot of residual expertise on handling these.'[85] It was acknowledged by the representative of another bank that there were 'instances where the bank's delivery of the product is uneven'.[86]

17.137 The banks' internal documents confirm the uneven quality of staff and advice at the local level:

> ... it would appear that there could have been some deterioration in the quality of advice/information provided by ... staff generally regarding the risks associated with such loans ...
>
> Any advice on currency/interest rate movements that is given to either branch personnel or customer is ad hoc and unco-ordinated.
>
> At grass roots levels the quality of advice has probably never been sound!

17.138 It is possible that bank staff, in the general competitive atmosphere prevailing at the time of the writing of foreign currency loans and lacking sound knowledge of the product, may have glossed over the risk. This would have been less likely where it was the policy and practice to involve a person with extensive experience in foreign currency risk in the interviews with clients. The facts of individual cases are crucial in this area of advice to borrowers.

17.139 Borrowers seem to have a view that the banks should not only have provided general warnings about the risk of foreign currency borrowing, but also have provided specific warnings. For example, borrowers claim that the banks had expectations in 1984 of foreign currency falls and these were not passed on to borrowers. Some borrowers made a more general point that if they had been aware that the Australian dollar would fall significantly and rapidly, they would not have borrowed in a foreign currency. They consider the banks should have provided such general warnings to them.

17.140 The first point to note on specific predictions of currency movements is that they are difficult to make and there are always a range of views on them. Specifically on the value of the Australian dollar in 1984, the market was generally optimistic about the future. A book on the floating of the currency in Australia

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85 Evidence, p. 2110.

86 Evidence, p. 2160.

published in 1986, had a section on the period immediately before the fall of the AUD in 1985 entitled 'Optimism before the storm'.[87] About the fall itself the book stated:

> *Contrary to the expectations of most foreign currency* analysts, the Australian dollar plunged to record low levels during February and early April 1985.[88]

17.141 While most, if not all, market participants did not foresee the magnitude of the fall in the Australian dollar, the fact that Australian interest rates were higher than those overseas implied some concern about currency stability. Economic theory would say this expected depreciation would be (approximately) enough to offset the cost advantage of the lower interest rates. In the event, it was much more significant demonstrating that the volatility of exchange movements makes them impossible to predict. While the banks may have been better placed than borrowers generally to make assessments of foreign currency movements these were only assessments like any other available from commentators.

17.142 It must be emphasised that borrowers took the final decision to borrow in a foreign currency. Obviously many who considered taking out a foreign currency loan decided against it, presumably because of the potential risks. The product must have seemed a particularly attractive one. Some borrowers may have relied on the traditional relationship of trust with their bank in taking advice on the product, and where this advice was uneven, borrowers may have cause for grievance. But, in the end, borrowers had to make their own assessments of the risk balanced against the apparent benefits.

Conclusion

17.143 Banks had an obligation to warn borrowers that unhedged foreign currency borrowing was risky and that the risk could be managed by hedging. In the formal policy guidelines, documentation and approaches of banks relating to foreign currency loans there was provision for basic warnings to be provided to potential borrowers and for information to be given about hedging. The Committee saw no evidence that banks had a policy to deliberately mislead borrowers about the risk of the product to entice borrowers to take loans. However, the Committee notes that the banks' advice that to hedge would have negated the expected advantages of a foreign currency loan, while accurate, reveals a certain hypocrisy on their part in providing such a unmanaged product to customers on the basis that it could be advantageous to them.

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87 G Manuell, Floating Down Under: Foreign Exchange in Australia, The Law Book Company Limited, Sydney, 1986, p. 134.

88 ibid, p. 137.

17.144 However, the delivery of the banks' advice would have been variable, depending on the expertise and understanding of the product possessed by particular bank staff. There is evidence in the banks internal documentation and in admissions to the Committee that the delivery of the product was patchy, and that training of staff involved in delivery of the product was inadequate in some cases to ensure that borrowers had expert assistance available to them. This is confirmed by evidence from some borrowers about the advice they received from their bank.

17.145 While there were obligations on the banks to provide warnings, borrowers also had a responsibility to inform themselves about foreign currency risk. It was the borrower who was making the final decision on the loan and it was the borrower who had to manage the exchange risk.

Monitoring and management

17.146 It was noted earlier in the chapter that borrowers were most critical of that period after the dollar began its rapid fall and they began to suffer losses. They claim that they were provided with little information to enable them to monitor their loans and little advice on how to manage their foreign exchange risk.

17.147 The banks emphasised that their contracts with borrowers invariably provided that monitoring of foreign currency movements and management of foreign currency risk was the responsibility of the borrower. Consequently, no bank initially established a mechanism for monitoring borrowers loans or regularly informing borrowers of foreign currency movements. Banks indicated that borrowers were informed of their loan details at time of roll-over (usually six-monthly). The banks stated that borrowers could have monitored their loans themselves by referring to exchange rates in the newspapers.[89] The fall in the Australian dollar in 1985 was well reported in the media as extracts from newspapers at the time illustrates (see Figure 17.6).

17.148 Following the dramatic decline in the Australian dollar in 1985 each of the four major banks established a body to assist borrowers with information and management advice. These bodies were not established until late 1985 or early 1986 by which time many borrowers had lost large amounts that could not be recovered.

17.149 The banks stated that they had no formal responsibility for monitoring or managing the loans. This responsibility, under the loan agreements, lay with the borrowers. However, the banks can be criticised for their belated response to the problems of borrowers.

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89 Evidence, p. S2510.

FIGURE 17.6

CONSUMERS WILL
FEEL DOLLAR'S
PLUNGE

Forex dealers in bid
to calm dollar chaos

Aust dollar resumes its slide

GRIM OUTLOOK FOR
THE AUSSIE DOLLAR

17.150 The Committee considers that the banks had a moral obligation to assist borrowers. They eventually recognised this by setting up monitoring and advisory services to assist borrowers. The banks at the time realised that their customers were struggling to control their exposures, often without the technical knowledge to do so and without support from their bank. The following extracts from banks' internal documents demonstrate that the banks were aware of the difficulties of their customers and of the problems for themselves in attempting to address the borrowers' difficulties:

> ... we would point out that monitoring etc of FCL exposures can be time consuming and administratively cumbersome and under our current structure we do not have the human or physical resources in place to handle such a task ...
>
> Presently we are facilitators into the market [of FCL borrowers], and virtually abandon our customers on entry.
>
> Exposure management has not been offered because it takes resources, both manpower and technical, that we do not have.[90]

17.151 All major banks noted that their agreements with borrowers did not allow borrowers to bring loans onshore. This was a decision for the borrower. The Commonwealth Bank noted:

> There was reluctance by some borrowers who had suffered loss to bring their loans onshore or to hedge either because of lack of immediately available funds, or because they believed/hoped that the AUD would improve sufficiently to recoup their losses.[91]

17.152 Mr McLennan noted that, in the case of one bank, it would have required a massive drain on resources to have brought all borrowers back on shore and re-finance in Australian dollars.[92] At least one bank was aware that, if all foreign currency borrowers had brought their loans onshore at the same time, the bank could not have re-financed the loans in Australian dollars.[93] The banks would have had a reason to discourage at least some borrowers from coming back onshore.

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90 Banks' internal documentation.

91 Evidence, p. S2511.

92 Evidence, p.1134.

93 Banks' internal documentation.

17.153 As a result of their experience with foreign currency loans following the dramatic fall in the Australian dollar, some banks reviewed their procedures for the loans and tightened them. The Commonwealth Bank stated that its policy guidelines were revised in late 1985 to restrict the availability of foreign currency lending:

> ... because of a perception that many FCLs were proving to be for a speculative class of borrower without assured capacity to meet adverse movements in exchange rates.[94]

The Commonwealth Bank also modified its product to give it the power to hedge the borrower's loan at a pre-determined point. This was effectively a compulsory 'stop loss' mechanism and was introduced as a result of the experiences of the 1980s in which it was difficult for the Bank to encourage borrowers on shore.[95]

17.154 From May 1985, Westpac included a preamble to its guidelines on foreign currency loans that had not been included in earlier versions of the guidelines. The preamble stated:

> ... potential borrowers without a thorough knowledge of the Foreign Exchange market, should be left in no doubt as to the exchange rate and interest rate risks inherent in Offshore borrowing ...
>
> Care must be exercised in deciding whether a borrower should be offered offshore finance. Only proposals for undoubted borrowers ie. those with assured cash flow, adequate first line security and a demonstrated ability to meet top-up requirements, should be considered. In particular, those without assured cash flow (property developers etc.) and those offering specialised securities, should be treated with caution.[96]

The guidelines became even tougher in October 1986 with advice that potential borrowers without an understanding of the foreign exchange market should be 'discouraged' from borrowing.[97]

17.155 This toughening of guidelines and changing of the product indicates that some banks became aware of the problems that their earlier procedures for foreign currency loans were inadequate. There was a recognition the product was inappropriate for some of the borrowers to whom it was sold.

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94 Evidence, p. S 2505.

95 Evidence, p. S2462.

96 Evidence, p. S2416.

97 Evidence, p. S2421.

Conclusion

17.156 The Committee concludes banks had a moral obligation to assist foreign currency loan borrowers following the dramatic fall in the Australian dollar in early 1985. The banks belated response to the problems of borrowers was unsatisfactory.

17.157 The strengthening of guidelines and procedures on foreign currency loans by some banks indicates an awareness, in hindsight, that the product was inappropriate to some of the borrowers to whom it was sold and some banks had inadequate procedures in place to filter out inappropriate borrowers.

Settlement processes and litigation

17.158 *A major area of concern for borrowers was with the processes for final* resolution of the difficulties created by their foreign currency loans. For some borrowers these difficulties have extended over more than half a decade and undoubtedly have resulted in cases of personal hardship and trauma. In this section the Committee examines the settlement and litigation processes associated with foreign currency loans.

17.159 It is important that the extent of outstanding disputes in relation to foreign currency loans is appreciated. Of the approximately 3000 foreign currency loan customers in the early to mid-1980s, only a relatively small number remain in dispute with their bank. It is probable that at least some foreign currency loans did not give rise to complaint. Many other cases have been settled progressively by the banks.

17.160 To date a small number of cases have been pursued through the courts to completion. Borrowers have been successful in about half the cases, although there has been more success recently. As indicated earlier, the Committee sought advice from Attorney-General's Department on the legal basis for claims of borrowers, the reasons for success or failure and whether there are any impediments in the law that would prevent reasonable cases succeeding.(Copy of advice is at Appendix 10).

17.161 According to the advice, the claims of borrowers have been that banks *breached their contractual or fiduciary duties, gave negligent advice or breached the* Trade Practices Act or State consumer legislation.

17.162 The advice emphasised that outcomes of cases has depended on the facts in each case and not on general legal principles.[98] Successful cases such as Chiarabaglio and Foti have been where borrowers:

> ... were able to establish that the lender actively promoted the foreign currency loan, the borrower had no knowledge of the extent of the risks involved in borrowing in foreign currencies or of the sophisticated techniques of risk management, the borrower relied on the lender for advice and that advice was deficient, or the borrower was lulled into a false sense of security and the lender should have hedged.[99]

17.163 In cases where the borrower has failed, the advice was that they had failed because:

> ... the borrower's version of events has usually differed sharply from that of the lender and the court has preferred the version of the lender. In other words, plaintiffs have failed to persuade the courts to find in their favour on the evidence.[100]

17.164 The advice concluded that:

> There does not seem to be any technical aspect in the law of contract or tort or in the regime of the Trade Practices Act which has prevented redress in cases that could reasonably have been expected to be successful.[101]

17.165 Based on information provided to the Committee there are about 90 more foreign loan cases pending before the courts.

17.166 The approaches of particular banks in settlement and litigation have differed. National Australia Bank said that its policies in the provision of foreign currency loans meant that it did not have significant claims in respect of liability for the loans. Confidential settlements have been reached with some borrowers involving a complete release for the Bank from liability in exchange for payment of an agreed sum or forgiveness of part of the debt. Although a number of writs were issued against the bank, only one case proceeded to court. The Bank's approach has been to investigate disputes thoroughly and, based on the merits of a claim, settle it expeditiously without resort to legal process.[102]

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98 Advice from Attorney-General's Department dated 30 October 1991, p. 2.

99 ibid, p. 4.

100 ibid, p. 3.

101 ibid, p. 13.

102 Evidence, p. S2702.

17.167 ANZ Bank stated that it has endeavoured to resolve disputed claims on a commercial basis where possible and based on the merits of the claim. As a result, a number of claims have been resolved on a confidential basis, but some have been the subject of litigation. Three cases have been to the courts with the Bank being successful in all cases. A further 18 cases are still before the courts.

17.168 Of the 24 foreign currency loans written by the State Bank of South Australia between 1984 and 1986 only three are currently being litigated.[103] The State Bank of New South Wales had 30 loans with only four of these disputed. Three were settled and one is being litigated.[104]

17.169 The Commonwealth Bank stated that it has always been prepared to reach confidential commercial settlements where possible. Twenty-five claims have been settled on commercial terms, five before litigation commenced.[105] The Bank currently is litigating on 40 cases. All cases decided to date have gone in the Bank's favour with the exception of the withholding tax issue in the David Securities case and the Quade case in which a retrial has been ordered.

17.170 Westpac outlined in some detail the procedures it put in place to resolve foreign currency loan matters through an Offshore Commercial Loans Unit established in February 1986. The procedures involved a review of the cases of customers who made claims against the Bank. Westpac said that, after receiving the review report on the cases, it 'took steps in many cases to negotiate a settlement with the claimant'.[106] The Bank claimed that in a number of cases exaggerated damages claims had been made against and this had increased the cost and time of dispute resolution and litigation.[107] Westpac has 45 cases pending before the courts.[108]

17.171 Dissatisfaction was expressed by borrowers about the settlement process. They were concerned about the confidential nature of the agreements and that many settlements occurred 'on the steps of the court' when the borrower has expended significant funds.

17.172 The banks defended the confidentiality of agreements on the basis that there was a possible flow-on effect from an individual case which may differ from other cases and that the facts in such settled cases had not been determined fully. A settlement was primarily a business or commercial decision based on the circumstances of a particular case rather than a legal decision based on any assessment of liability in the particular case or generally.[109]

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103 Evidence, p. S2746.
104 Evidence, p. S2751.
105 Evidence, p. S2516.
106 Evidence, p. S4198.
107 Evidence, p. S4197.
108 Evidence, p. S4199.
109 Evidence, pp. 2106-07 and 2161-62.

17.173 Last minute settlements also were defended by the banks. The Commonwealth Bank acknowledged that it settled the majority of cases 'either during the course of the hearing or just before the hearing starts at the door of the Court'.[110] The Bank said that this timing was not 'sinister' but for the reason that:

> ... only during the hearing (or at least after all the interlocutory steps of discovery and subpoena have been completed) is the true extent of the particular borrower's knowledge of the risk of the foreign currency borrowing at the time he entered into the loan, the circumstances surrounding his entering into the facility, and the extent of his reliance (if any) upon the Bank for information and advise exposed.[111]

17.174 Borrowers were most critical of the process of litigation which they said was expensive and abused by the banks to the disadvantage of borrowers.

17.175 All parties agreed that litigation was expensive.

17.176 Francis Galbally, who has acted for borrowers in a number of cases, stated that foreign currency litigation was expensive for borrowers with costs of $50,000 - $60,000 to bring a case to trial and then $10,000 per day per participant as the cost of the trial itself.[112]

17.177 The banks acknowledged the high cost of litigation. As a result, they stated that they had no interest in unnecessarily pursuing litigation. Westpac said that the cost and commitment of scarce management time made it 'a last resort'. However, where the bank considered that the borrower did not have a valid claim it would defend the position.[113]

17.178 Borrowers also made a number of allegations about the banks' abuse of the legal processes in foreign currency cases. These included that the banks have:

- unnecessarily protracted proceedings to ruin borrowers so that they can no longer continue legal action; and

- failed to ensure adequate discovery, or had belated discovery.

17.179 For the same reasons that the banks have denied unnecessarily undertaking litigation in foreign currency loan cases, they also stated that they have no interest in prolonging litigation.

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110 Evidence, p. S2475.

111 Evidence, p. S2475.

112 Galbally submission, p. 2.

113 Evidence, p. S2402.

17.180 The banks denied that their discovery has been inadequate in foreign currency loan cases. It was explained that discovery in a complex area like foreign currency loans and in relation to a large bank took time to undertake to find all relevant documents. The Commonwealth Bank noted that documents were still being discovered. The banks also noted that discovery depended on the pleadings in a particular case and consequently different documents were discovered in each case. One bank also suggested that some borrowers were less than forthcoming with their own discovery in areas such as their prior knowledge of foreign currency loans and risk.[114]

17.181 The Committee notes that control over discovery is in the hands of the courts involved, and the courts have power to punish for contempt where there is an abuse of the court process. The Committee also notes the recent decision Quade vs Commonwealth Bank in which comment was made by the High Court in relation to discovery.

17.182 In view of the costs, delays and alleged 'abuse' they identified in litigation as a means of resolving foreign currency loan cases, borrowers and their advisers argued for the need for alternative mechanisms to resolve cases. Various mechanisms were suggested including a form of banking tribunal and an expanded and statutory independent Banking Ombudsman Scheme. The latter proposal by Mr Francis Galbally was a general one for the resolution of disputes between banks and customers, of which foreign currency borrowers would be one set of customers.[115] The general proposal for an expanded and statutory independent Banking Ombudsman is considered in Chapter 20. The specific question of the consideration of foreign currency loan cases by the Banking Ombudsman or other mediatory mechanism is considered here.

17.183 The Commonwealth Bank noted some problems with mediatory mechanisms in relation to foreign currency loan cases. In mediation, the full knowledge of the strengths and weaknesses of both sides of a case is difficult to discover without the rigorous exploration of respective claims made possible by court processes of discovery and cross-examination. The cost of commercial arbitration can be higher than litigation through the courts and can involve the courts in dealing with procedural matters prior to arbitration. As well, not all mediation will be successful and there will have to be resort to the courts.[116]

17.184 There were calls during the inquiry for a royal commission to be held into foreign currency loans.[117] The call for a royal commission at least partly related to issues raised by the 'Westpac letters' which are discussed in the next section. When the question of a royal commission was taken up with a spokesperson for the Foreign Currency Borrowers' Association he commented that:

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114 Evidence, pp. S2465-66.

115 Evidence, pp. S4748-51.

116 Evidence, pp. S2477-79.

117 Evidence, p. 708.

> Originally, I suppose that all of us in the Association thought that a royal commission was the only answer. What we are seeing is that the inquiry seems to be pursuing things with a fair degree of tenacity, which originally we were uncertain about. So, I would like to put the royal commission to one side, if you like, and say that if the basis of what the inquiry is attempting to do now - which is to ask fairly piercing questions of all the parties, both borrowers and banks - is adopted clearly by the inquiry, with sound recommendations made by this inquiry and adopted and then legislated for by Parliament where necessary, then I suppose the need for a royal commission tends to recede.[118]

Conclusion

17.185 The Committee concludes that the law is adequate in this area to provide redress for borrowers with well-founded cases. The Committee emphasises that each borrower's circumstances are different and the individual cases need to be assessed on the particular facts. The courts are well placed to make such assessments.

17.186 In Chapter 15 the Committee expressed concern about allegations made by small business of abuse of court processes by banks by means of delaying tactics and poor discovery. The issue of the cost of pursuing litigation is a further issue of concern. The Committee recommended there should be an investigation by the Australian Law Reform Commission of the powers of the courts to deal with abuse of their processes and whether there is a need for legislation in this area. The foreign currency loan cases could provide useful case studies for such an investigation. The Committee also noted that the Senate Committee is undertaking an inquiry into the cost of justice and the Committee will refer the issue of the cost of justice in cases between banks and customers to that committee for inclusion in its consideration.

17.187 However, the Committee considers that the approach adopted by some banks to settle foreign currency loan cases before court proceedings demonstrates the advantages for all of conciliation wherever possible. The court process is expensive for all parties, and can be traumatic for borrowers. The Committee favours a mediatory system being available prior to, or as an alternative to, litigation in foreign currency loan cases from the 1980s. In Chapter 20 the Committee examines broader issues of dispute resolution.

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118 Evidence, pp. 1147-48.

17.188 While favouring a mediatory approach the Committee expresses concern about settlements made between banks and foreign currency loan customers being confidential. The Committee considers this protects the banks, but does not allow adequate scrutiny of the settlements that are reached.

17.189 In regard to the unresolved problems of foreign currency loans of the 1980s, the Committee can not agree to the proposal to refer the foreign currency loan cases to the Banking Ombudsman. The Committee considers that the foreign currency loan cases have such complexity that the Ombudsman's office would become clogged with these cases at the expense of the general case work.

17.190 An alternative would be the appointment of an independent mediator to act as an intermediary between the bank and customer and, where necessary, make a non-binding determination of a settlement. The mediator would be an independent person of stature acceptable to both the borrowers and the banks.

17.191 Given that the banks have taken varying approaches to the resolution of foreign currency loan cases, it could be expected that some banks would have more matters that could be mediated than others. Therefore, like the current Banking Ombudsman scheme, it is suggested that the banks pay proportionally for their usage of the mediator. Alternatively, each bank could appoint a mediator, acceptable to borrowers, in relation to its loans.

17.192 In view of the thorough investigation undertaken by the Committee and the conclusions reached, the Committee sees no need for a royal commission into foreign currency loans. Any royal commission would be expensive and arrive at conclusions similar to those reached by the Committee. The priority now should be to resolve the outstanding disputes and the mediatory mechanism recommended by the Committee and the court processes, if necessary, allow the opportunity for this to occur.

Recommendation

17.193 **The Committee recommends that:**

60. an independent mediator (or mediators), funded by the banks, but acceptable to both banks and foreign currency borrowers be appointed to mediate in foreign currency loan cases that remain in dispute. Mediation is not compulsory, banks will pay for their own mediators or for a general mediator based on usage. The determinations of the mediator will not be binding on either party. Banks should endeavour, to the extent possible, to advise all foreign currency loan borrowers of the mediatory mechanism. The mediator should operate under the following conditions:

mediation would not be possible where cases have already proceeded through all stages of appeal so that the court processes are recognised;

- **mediation would also not be possible where out of court settlements have been reached;**
- **mediation can be sought where cases are still in court without final decision, or pending; and**
- **any determinations of the mediator will be non-binding on both parties so that both have the appropriate option of pursuing court action.**

The 'Westpac letters' and Partnership Pacific Limited

17.194 It was noted early in the chapter that the events surrounding the tabling before the Committee of the so-called 'Westpac letters' stimulated interest in the foreign currency loans issue generally. The letters themselves also attracted tremendous interest.

17.195 Before outlining the contents of the letters, it is important that they be placed in context. The letters arose from complaints from two customers who had managed foreign currency loans with Partnership Pacific Limited (PPL), the former merchant banking subsidiary of Westpac. There were fewer than 100 such customers of PPL. A preliminary investigation of those complaints by Westpac's solicitors identified 'some aspects of PPL's management of foreign currency loans which concerned them'.[119] A more detailed report was requested by Westpac.

17.196 The more detailed report provided broad details of some concerns in relation to PPL's management of their clients' foreign currency exposures, particularly during a two to three month period in the first half of 1987. The day after receiving that report, Westpac instructed its solicitors to undertake a full documentary audit of PPL's records and to report their findings. The solicitors submitted three written reports to the bank, two of which are the 'Westpac letters'.[120]

17.197 The first of the letters dated 26 November 1987 reports on the process of the audit and then draws a number of conclusions:

- that PPL told its clients it would do a professional and conservative management job and failed to do so;
- that a number of clients did *significantly* worse than either a fully-hedged or totally unmanaged position;

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119 Evidence, p. 587.

120 Evidence, p. 587.

- that PPL undoubtedly took points which exceeded its entitlements and probably engaged in switching transactions between its own account and its managed borrowers accounts;

- that managed borrowers would likely succeed in any legal action;

- but that borrowers will be slow to commence actions because of their lack of knowledge of the damaging PPL documents, the lack of success of other foreign currency loan cases, and the high costs involved; and

- that proper management should see the liability limited.

17.198 The second document dated 11 December 1987 report on some matters that were raised with the solicitors by Westpac bank at a conference on 28 November at which the contents of the first letter were discussed. The letter discusses whether criminal liability arises from the actions of PPL or its employees, whether an attempt should be made to recompense borrowers to reflect deal switching and point taking and matters relating to Westpac's foreign exchange trading activities.

17.199 On the first matter, it was concluded that there probably was no criminal liability of PPL staff in relation to point taking or deal switching.

17.200 On the second matter there was a clear recommendation that no specific recompense be provided to borrowers for point taking or deal switching but that 'PPL reflect its proper concern about this in the relative generosity with which it approaches settlement discussions'.[121]

17.201 On the third matter advice was provided, on the basis of the PPL experience, as to how Westpac should conduct its foreign exchange operations, particularly with managed borrowers.

17.202 For the Committee, the Westpac documents raise two major concerns. First is the extent to which PPL borrowers may have been properly compensated for the improper conduct and poor management of PPL that is revealed in the documents. Second is the question as to whether there has been any criminal conduct in relation to the actions of PPL staff.

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121 Letters from Mr B P Jones of Allen Allen and Hemsley to Warwick Kent, Chief General Manager, Corporate and International, Westpac Banking Corporation, dated 11 December 1987, p. 3.

17.203 In relation to the first issue, the Managing Director of Westpac, told the Committee that, the receipt by the Westpac board of the results of the PPL investigation:

> Any PPL clients who had expressed dissatisfaction with the result of management of their foreign currency exposures were contacted and the matter discussed. Where there was any suggestion that PPL's management may have contributed to the clients' concerns arrangements were negotiated. PPL's clients were given the benefit of the doubt in arriving at fair and reasonable arrangements.[122]

17.204 After the publication of the 'Westpac letters', Westpac placed an advertisement in the national media inviting former PPL customers who had managed foreign currency loans in the period 1985-87 to contact Westpac with a view to discussing any concerns. It undertook to resolve any concerns expeditiously and arranged for an independent mediator (Sir Laurence Street) to assist if necessary. (Copy of advertisement at Figure 17.7) It is understood that there have been only 16 responses to the advertisement from former PPL borrowers. Of these, only one required mediation, 13 were resolved by negotiation and two are still under negotiation, but do not appear to require negotiation.[123] The Committee notes that the low level of response to the advertisement may be explained, in part, by some former PPL borrowers not having seen it.

17.205 On the second issue of possible criminality in connection with activities revealed in the 'Westpac letters', the Committee considers that a thorough investigation is warranted. The Committee understands that the Commonwealth Attorney-General referred the 'Westpac letters' to the Australian Federal Police (AFP) to investigate whether criminal activities were involved. The AFP found no breach of Commonwealth Law. It forwarded the letters to the Victorian and New South Wales police for investigation under State law. There is no outcome yet from the State polices' investigations.

Conclusion

17.206 The Committee considers that Westpac has provided reasonable mechanisms for the resolution of the claims of former customers of PPL who had managed foreign currency loans. However, it notes that the tabling of the 'Westpac letters' before the Committee and the Committee's investigation of the issues stimulated Westpac into a belated response to the problems that existed in PPL. No additional mediatory mechanisms are considered necessary. Individual borrowers have the opportunity to pursue their cases through the courts.

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122 Evidence, pp. 587-88.

123 Letter from N J Purcell, Head of External Relations Group, Westpac Banking Corporation, dated 23 October 1991 to the Committee secretary.

FIGURE 17.7

OPEN LETTER TO PARTNERSHIP PACIFIC LIMITED (PPL) FORMER CLIENTS WITH FOREIGN CURRENCY EXPOSURE MANAGEMENT CONTRACTS IN THE PERIOD 1985–1987

The publication of the 'PPL confidential letters' and related media attention has raised questions about the impact of PPL's management of foreign currency exposures for individual clients.

Whilst Westpac believes it acted appropiately and attended to all known client concerns that arose in relation to this issue, Westpac invites former clients involved who may feel concerned to contact us with a view to discussing these matters. Westpac wishes to dispel any notion that these clients have in any way been inhibited from pursuing their conerns.

It would be our intention to resolve any concerns expeditiously and should it be necessary we will arrange for an independent mediator to assist.

Sir Laurence Street, AC, KCMG (former Chief Justice of New South Wales) has agreed to undertake this role of independent mediator.

Former clients should contact Dr Noel Purcell, Head of External Relations Group, Westpac Banking Corporation, 25th Floor, 60 Martin Place, Sydney, telephone (02) 226 3377.

S A Fowler
Managing Director
Westpac Banking Corporation

17.207 While the Committee recognises the role of the State police, it considers the issues raised by the 'Westpac letters' involve complexities of foreign exchange dealings that require examination by a body expert in investigating such issues. The Committee considers that the National Crime Authority (NCA) would be an appropriate body with the necessary expertise to undertake such an investigation. The Committee will assist the NCA by making the relevant public records from its inquiry available. The Committee will seek approval from those who provided in camera evidence that is relevant also to make that available. The Committee asks that Westpac co-operate with the investigations.

Recommendation

17.208 **The Committee recommends that:**

61. the Attorney-General refer the so-called 'Westpac letters' to the National Crime Authority for investigation as to whether any criminal wrongdoings arise from the management of foreign exchange contracts by Partnership Pacific Limited.

CHAPTER EIGHTEEN

FRAUD

18.1 In addressing the issue of fraud within the banking industry it is possible to identify a number of forms which it may take. They include misappropriation, malpractice and corruption. During the inquiry significant allegations of fraud and corruption within the banking industry were raised. While a number of individuals raised such allegations some were more vocal than others.

18.2 In particular, former Democrat Senator Paul McLean and former National Australia Bank employee Mr John Salmon alleged that there were significant instances of fraud and corruption perpetrated by the banks. Mr McLean claimed that, as a result of the 'potent evidence' he had tabled in the Senate, he was convinced that 'there is widespread malpractice and some corruption in Australian banking'.[1] Both individuals produced a number of cases as examples of bank fraud. Mr McLean and Mr Salmon were given the opportunity to substantiate their claims and to detail their cases. Mr McLean's appearance represented the longest time given to any individual before the inquiry.

Cases of fraud alleged by Mr Paul McLean

18.3 Mr McLean indicated he had received up to 400 cases alleging fraud and had tabled 70 cases in the Senate representing a cross-section ranging from small borrowers to millionaires and involving all major banks.[2] Some of these cases related to foreign currency loans which Mr McLean described as 'one of the most serious corporate frauds in Australia's history'.[3] Foreign currency loans are dealt with in Chapter 17.

18.4 In bringing the allegations of fraud to the attention of the Senate, in most cases Mr McLean tabled affidavits, correspondence and other relevant documents without attempting to explain the nature of the alleged fraud.

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1 Evidence, p. S751.
2 Evidence, p. 666.
3 Evidence, p. S750.

18.5 When questioned as to whether he had attempted to obtain the banks' opinions of the cases he had tabled, Mr McLean said:

> I learnt very quickly from documents that were put in front of me, almost from day one, that I was going to walk the same frustrating course as the complainants, if they went to the bank. I would get the same answers. I was reading the answers that these people got.[4]

When pressed further as to whether he had sought the banks' explanation before tabling the cases in Parliament he replied 'No, I have not'.[5]

18.6 Mr McLean argued that banking malpractice and corrupt practices were evident through 'targeting' businesses for asset stripping. In this process, bank staff worked in collusion with a third party where, together, they would set out to run down a company and sell it to the third party well below its actual value.

18.7 He was asked to demonstrate how businesses were targeted for asset stripping. He stated:

> A healthy business can be targeted by a branch bank manager or a regional manager and, by manipulating the cash flow against debt, they can manipulate a business into a position of vulnerability. In other words, loans are arranged that do not eventuate; cash flow is interfered with; the taps are turned on and off, not according to the needs of the business but according to the needs of the process; the business is rendered vulnerable; and a knight in shining armour may come along en route and say, 'You are in trouble up to your neck. We can save you on the right terms'; and the processes occur which are to the detriment of the targeted business and to the advantage of the knights in shining armour.[6]

18.8 Mr McLean was further requested to demonstrate the manner in which the banks were involved in this process and what benefits accrued to the banks or bank staff through their involvement. A variety of cases were used to provide examples of asset stripping. While it is not possible to refer to all the cases tabled a large number of them were examined in detail.

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4 Evidence, p. 676.

5 Evidence, p. 677.

6 Evidence, p. 665.

18.9 Reference was made to the case of Mr Bourke who had provided 75 acres of industrial land, valued by the bank at $750,000, as collateral on a loan of $250,000. When Mr Bourke could not service the loan the bank foreclosed and sold the land at auction for $48,000. The land was subsequently rezoned and placed back on the market for $1.8 million.

18.10 The Committee sought to determine what actions of the bank Mr McLean considered to be fraudulent and what the bank was able to gain from the alleged fraud in this particular case. Mr McLean indicated that the bank had acted fraudulently by foreclosing and placing the property on the market as a result of which it was sold for well under its actual value. He stated:

> Why can the banks be indifferent to the value of what they get for the asset? Because they do not pay anything for it in the first place.[7]

18.11 It was pointed out to Mr McLean that since the bank had lent the individual $250,000 and received only $48,000 from the land sale then the bank had actually lost money on the transaction. Not only was he unable to establish a motive for the bank in this case of alleged fraud, but he was also unable to determine whether the bank lost or made money. He admitted:

> On the face of it, the bank lost ... but somebody did not lose out of the process of being able to put that property back on the market at $1.8m 18 months later. I do not know the detailed answer to your question.[8]

18.12 Other cases used by Mr McLean to illustrate fraud in the banking industry were examined. In June 1985 the Commonwealth Bank provided a Bills Discount facility to Mr and Mrs Tony Rigg of Nowra, NSW. Between August 1985 and November 1987 the Bill roll-over transactions were credited and debited by the bank to the overdraft account of Mr and Mrs Rigg's trading company on 34 separate occasions. Crediting and debiting to the company's overdraft account which was authorised by officers of the bank should have been credited and debited to the private account of the Riggs. The last bill which was valued at $750,000 matured on the 22 December 1987 and was debited to the company's overdraft account on the following day as a miscellaneous debit. Mr McLean claimed that the actions of the bank officers had the effect of absorbing the profits of the company and crippling the business.

18.13 On 15 March 1988 the debit balance on the overdraft account was over $1 million. The bank wrote to the company demanding payment and also to the Riggs demanding payment as guarantors of the company's overdraft account. Since the company was unable to meet its debt the directors were obliged to freeze the

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7 Evidence, p. 670.

8 Evidence, p. 673.

account to which the bank agreed in writing. In December 1988 solicitors for the company denied liability for the sum. They also denied that Mr and Mrs Rigg were personally liable as guarantors.

18.14 In February 1989 the bank manager indicated to the Riggs that the debiting of $750,000 to the overdraft account was an error and that it would be reversed. He also wrote to the Riggs telling them they were personally liable for the $750,000 as drawers of the bill which had matured in December, 1987.

18.15 Mr McLean told the Senate:

> The bank illegally manipulated the account of the Company for the sole purpose of making a claim against Mr and Mrs Rigg personally.[9]

18.16 In a letter to Mr McLean dated 1 March 1989, the Managing Director of the Commonwealth Bank, Mr Don Sanders, responded to the claims concerning this case. He stated that the bank had made one transactional mistake which had been rectified and that there had been no impropriety on the part of the bank or its staff.

18.17 Mr Sanders provided a different view of events than Mr McLean. He pointed out that Mr and Mrs Rigg have been the only directors of the company throughout its dealings with the bank. The bank had provided $303,500 of a gross Bill Facility of $485,000 to the Riggs to construct factory units. Security involved was both a mortgage over the house owned by them and over the factory property. An extra overdraft facility of $40,000 was provided to the company with the same security given. This means that Mr and Mrs Rigg were liable to the bank for all moneys owing by them and their company but the company was liable only for those moneys which it owed to the bank as the principal debtor.

18.18 As a result of overruns in the construction of the factory units the bank, at the request of the Riggs, increased the Bill facility by $265,000. The total owing was now $792,000 with $40,000 being an overdraft to the company and the balance being to the Riggs personally. A condition of this increase in funding was the clearance of the existing bill facility of $485,000. The clearance was not carried out.

18.19 Mr Sanders pointed out that with the exception of the first draw down, the other 33 draw downs and roll overs of Bills were credited or debited respectively to the company's account. Written notice was given to Mr and Mrs Rigg. Mr Sanders clearly indicated that the Riggs were kept fully informed of the debiting and crediting of the Bill Facility. This was done in writing and details were included

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9 Senate, Hansard, 23 August 1990, p. 2131,

showing amount of the Bill, its maturity date, its duration, the amount of fees and the net amount credited or debited and specification of the account to which the debit or credit had been made.

18.20 As a result of the dispute with the bank, Mr and Mrs Rigg pursued the matter through the legal system. The bank issued proceedings against Mr and Mrs Rigg, by way of cross-claim, claiming the face value of the Bill of $750,000 plus interest. Judgement was entered against Mr and Mrs Rigg on the cross-claim. The Riggs appealed to the NSW Court of Appeal which was dismissed. The Riggs then applied to the High Court of Australia for Special Leave to Appeal against the judgement of the Court of Appeal. Mr McLean stated that the Riggs entered into a commercial settlement with the bank due to lack of funds to continue with the appeal.

18.21 On dismissing Mr and Mrs Rigg's appeal to the NSW Court of Appeal, Mr Justice Gleeson concluded:

> What is, however, of legal significance is that, at least up until the time when they first began to complain about the matter, which was after all the principal advances had been made, this method of dealing was employed with the knowledge, active participation and apparent acquiescence of appellants. There is no suggestion that the bank was concealing from the appellants the fact that the dealings were through the company account, and the funds in question only reached their ultimate destination by reason of the fact that cheques on the account were drawn by the appellants themselves. It should be added that the funds were actually being employed for the personal benefit of the appellants.[10]

18.22 The Committee considered that this and other cases were viewed from Mr McLean's mistaken belief that banks can create credit 'by mere ink on paper ' of amounts up to ten times what they attract on deposits. The credit is secured by real assets and borrowers service their loans at high interest rates. When the borrowers default the asset is sold at a fraction of the price. Since the credit created by the bank is simply 'ink on paper' the bank makes a considerable profit.[11]

18.23 Mr McLean was asked to appear again as a witness to further illustrate and substantiate his claims. He was specifically requested to select five or six cases tabled in the Senate which he considered most conveniently demonstrated his concerns about the banking industry. It was intended to provide the banks with the

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10 Evidence, p. S3616-7.

11 Evidence, p. S749.

opportunity to comment on these issues. However, despite repeated approaches, Mr McLean declined both to nominate the cases or to appear again before the Committee.

Conclusions

18.24 The Committee concluded that Mr McLean was unable to demonstrate to it's satisfaction that fraud had been perpetrated by the banks in the cases cited. He was unable to indicate what he perceived to be the advantages to banks from their involvement in actions of this nature. When questioned about the banks' motives he replied 'I do not know the answer'.[12] When questioned further whether banks made or lost money out of the alleged schemes he replied, 'I think that is a question that needs to be answered, and I cannot.'[13]

18.25 Mr McLean admitted that he had no evidence of any personal gain accruing to individual bank officers from the alleged fraudulent activity. He stated:

> No, I do not know what is in it for the bank officers. I have got no evidence of bank officers getting anything from the process but I have evidence of them participating in the process.[14]

18.26 The Committee also concluded that Mr McLean was unable to demonstrate or substantiate collusion between bank staff and others in the cases presented. As these were among his major claims the Committee could not draw the conclusion that fraud was widespread within the banking industry.

18.27 It was suggested by Mr McLean that a Royal Commission into the Australian banking industry was necessary to address, among other things, the issue of fraud. The Committee considers that a Royal Commission is inappropriate given the extensive investigation it has undertaken.

Cases of fraud alleged by Mr John Salmon

18.28 Mr Salmon had worked for the National Australia Bank for almost 37 years. He alleged that NAB had been involved in fraud and malpractice in 'a fairly extensive way since deregulation', and before that the bank was 'involved in isolated instances of fraud and malpractice if it suited them to do so'.[15] He stated:

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12 E.g. Evidence, p. 672.

13 Evidence, p. 673.

14 Evidence, p. 669.

15 Evidence, p. 2474.

> Since deregulation the quest for super profits has been the paramount aim of my former employer and as a consequence corruption and malpractice have raised ugly dimensions ... my former employer has ripped off millions of dollars from unsuspecting borrowers in Australia by increasing interest rate margins without informing the borrowers which, in my opinion, they were duty bound to do so.[16]

18.29 Reference was made by Mr Salmon to a case involving a couple who had purchased a strawberry farm. Although the couple did not bank with NAB, the vendor was a customer of the bank. A NAB officer told the couple that the strawberry farm had an excellent cash flow with monthly income of $60,000 per month and an estimated total income for the 12 month period ending 28 February 1986 of $640,000. However, actual income from 1 November 1984 to 17 December 1985 amounted to only $135,821.07.

18.30 According to Mr Salmon the deceit in this case which constituted fraud 'was that the manager made representations to them that the property - the strawberry farm they eventually purchased - had an excellent cash flow'.[17] The bank manager had manipulated the proposition and inflated the values. The couple had relied on the expert advice of the bank which proved to be 'fraudulent'.

18.31 Mr Salmon indicated that, while he was an employee of NAB, the bank had authorised him to make certain statements to a personal loan borrower which enabled the bank to convert an unsecured loan to a secured loan, an action which he considered to be highly unethical.[18]

18.32 Several other instances involving alleged fraud and malpractice prior to deregulation were detailed. It was alleged that the manipulation of excessive interest rates amounted to fraud. Instructions to carry out this practice was instigated at the executive level and senior executive level within NAB. The branch manager was made the scapegoat. The process involved NAB deceiving clients by allowing them to think they were paying one rate when in fact they were paying that rate plus an extra percentage. Mr Salmon alleged that such fraud was quite widespread.

18.33 To support his claims, Mr Salmon referred to a copy of a letter from Mr Don Argus, the then Executive Director (Banking) of NAB, to the bank's General Manager in Queensland, Mr R Kidman. In that letter Mr Argus refers to a survey of interest rates being applied to customers, carried out by the bank's Retail Centre.

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16 Evidence, p. 2474.

17 Evidence, p. 2486.

18 Evidence, p. 2482.

It indicated that up to 4.5 per cent above base rate was being charged on smaller borrowings of up to $20,000. In a number of other instances this figure amounted to 5, 6 or 7 per cent whilst isolated cases involved the charging of 10.5 per cent. However, Mr Argus also stated in the letter:

> As a matter of urgency, branches should review all pricing practices which may have resulted in inappropriate customer charging, or situations in which customers may be unaware of their current pricing status. Penalty rates should be looked at both in terms of defensible pricing, and in terms of disclosure rates and their application.[19]

18.34 Mr Salmon considered this action to be fraudulent. However, he also indicated:

> the implementation of the unauthorised increase in margins has been substantially reduced by the National Bank following the introduction of recording on the borrower's bank statement. This procedure was introduced in mid-1990, I believe.[20]

18.35 While improper charging may occur at the local level in some banks, the argument that this constitutes fraud cannot be sustained. Furthermore, in the instances cited by Mr Salmon, senior management in NAB had directed it's bank managers to remedy the inappropriate charging.

18.36 Mr Salmon was questioned about his time at the bank and whether he had witnessed fraudulent activity when he was a manager:

> CHAIRMAN - So, in 37 years of having occupied positions of branch manager and having worked as an accountant and so on within the branch structure of National Australia Bank, you had not witnessed any of that [criminal activity] yourself?
>
> Mr Salmon - No criminal activity; malpractice maybe, but not criminal activity.
>
> CHAIRMAN - What is the difference?
>
> Mr Salmon - Probably I would describe it as the aspect that I put in my report. I refer to the aspect where the bank authorised me to make certain statements to a

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19 Evidence, p. 3149.

20 Evidence, p. 2476.

> personal loan borrower, for instance, that enabled them to convert an unsecured loan to a secured loan - highly unethical. I probably did not look at it from a personal point of view as criminal. It could well be.
>
> CHAIRMAN - But what is in it for a bank employee to do that sort of thing?
>
> Mr Salmon - The bank employee is instructed to do it by his superior. He has to do it and conform.
>
> CHAIRMAN - Is there anything in it for that employee?
>
> Mr Salmon - Absolutely not, no.
>
> CHAIRMAN - So there is no suggestion of graft or corruption or anything like that for the bank employee?
>
> Mr Salmon - No, nothing at all.[21]

18.37 On further questioning about malpractice in NAB he stated:

> They were only isolated instances during my term in the bank as far as my managerial career was concerned. For example, I never saw one instance of interest rate manipulation with respect to margins, nothing like that at all. All that type of information really has come to my knowledge and it has been informed to me since my retirement. There are only pockets of malpractice.[22]

18.38 The Committee notes that Mr Salmon took early retirement and left the bank under less than amicable circumstances. This fact must be kept in mind when considering the allegations raised by Mr Salmon against his former employer.

Conclusions

18.39 The Committee concluded that the instances described by Mr Salmon as 'fraud' and 'corruption' are, at best, commercial banking practice and, at worst, improper or uncompetitive behaviour. The most significant example of improper behaviour was the charging of excessive margins by individual officers in National Australia Bank.

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21 Evidence, p. 2482.

22 Evidence, p. 2483.

18.40 The critical issues arising from Mr Salmon's allegations can be addressed by ensuring that the banking industry remains strongly competitive and adequate disclosure occurs to eliminate inappropriate charging. The Committee concluded, therefore, that Mr Salmon had failed to substantiate his allegations of fraud within the banking industry.

Banks and social security payments

18.41 Allegations of bank fraud involving the late payment of dole money were raised. An unemployed Narrabeen woman claimed that payment of dole money into her account had been delayed by up to four days. She stated that the Commonwealth Ombudsman Office had informed her that her dole payment was late because the bank 'played' the money on the short-term market. It also indicated that the Office had received other similar complaints about the Commonwealth Bank.[23]

18.42 The Commonwealth Ombudsman, Alan Cameron, said he did not endorse the comments and they did not represent the views of his office. The Australian Banking Ombudsman also stated that he had received no such allegations.[24]

18.43 The Committee investigated these allegations by requesting the bank's comments on the newspaper articles. The Managing Director of the Commonwealth Bank indicated that the complainant had recently changed the account to which payment was made and this may have caused the delay. The delay was not the fault of the bank as payment was processed on the day the bank received it. The bank's solicitors advised that the allegations were totally incorrect and defamatory and they wrote to the newspapers about the matter.

18.44 The issue also was raised with the bank when it's representatives appeared as witnesses before the inquiry. The following response was made:

> The area where they [the claims] were in correct was where they indicated that there was a delay of up to several days. The payment of these benefits varies with the type of benefit. For sickness and unemployment benefit, we give value and credit interest from the time we get the value. The issue is that it may be the next day before the customer can access the funds. The reason for that is the time it takes for us to process tapes from the Department of Social Security. It is not true that the customer does not have value, but he may take a day to get access.

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23 Manly Daily 11/7/91.

24 Sun-Herald 14/7/91.

> For other payments, particularly for pension payments, which are much more substantial, we give value and pay before we get value because of the enormous load on our system as the Department of Social Security pays pensions only on one day per fortnight. So we have elected to give value for pensions a day early and to allow the customers to get access to those funds a day early to smooth the load.[25]

18.45 Other major banks also indicated that payment of social security pensions was done on receipt. Customers accounts are credited on the same day value is received from the Department of Social Security.

The Banks' view of fraud in the banking industry

18.46 Allegations of fraud and corruption were raised with the major banks. Estimates of the extent of fraud and the processes which have been developed to deal with it were also requested.

18.47 Banks indicated that because of the sensitive nature of this issue the provision of information was on a commercial in confidence basis. Accordingly, reference to the material is of a general nature only.

18.48 The banks indicated that while it existed within their respective banks, the level of fraud by staff was very low given the volume of cash and other money transactions which constitute banking operations. Lending losses attributable to fraud are also very low. One bank estimated the amount lost to be $1.140 million for the 1990 financial year.

18.49 The Managing Director of the Commonwealth Bank indicated that fraud and corruption of the type raised in Mr McLean's evidence had not been a problem during his time with the bank.[26]

18.50 One bank provided a list of a number of cases which were attempts to involve the bank in fraudulent or suspect lending schemes or proposals. These had occurred in the current financial year and included money laundering proposals; attempted lending with non-existent securities and attempted lending with a proposal for the bank to provide security for off-shore borrowing.

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25 Evidence, pp.3666-7.

26 Evidence, p. 3663.

Methods used by banks to detect fraud

18.51 Methods set in place by the banks to detect fraud were examined. These ranged from the provision of codes of conduct to bank staff to the regular audits of bank branches.

18.52 One bank indicated that it dealt with fraud by dividing detection into preventative measures and detection measures. Preventative measures included instruction manuals setting out the bank's requirements of it's staff; the inclusion in staff training programs of fraud prevention issues; use of internal audit operations; warning indicators on accounts and liaison with government agencies and other banks. Detection measures included reporting of fraud by staff; proper recognition and follow up of customer complaints; investigation of unusual transactions passing through staff accounts and ATM camera and branch surveillance.

18.53 The Commonwealth Bank stated:

> As in any walk of life, there will be some individuals in banking who do not uphold at all times the standards one would consider proper. Bankers must get after such people because the bankers stand responsible for fraud by their staff. CBA has a clear code of conduct for its staff and there are a range of penalties applied where our standards are not met. These range from reductions in status and/or in salary to dismissal. A severe view is taken of any defalcation.
>
> There are a variety of systems and checks in place for detecting undesirable practices. In view of their confidentiality we would not wish to disclose them publicly. I would like to express my concern with the consequences of recent allegations of widespread corruption and the impact that this has on staff, customers and a group of what might be susceptible individuals. In the main, our staff deliver good service and conduct themselves ethically. It is difficult for them to put their case even when they have been named in the media and elsewhere because of our strong commitment to customer confidentiality.

18.54 The ABA has a Fraud Task Force which was formed to advise the Executive on fraud in the banking industry. It's role is to determine where major problems exist and to advise individual banks on how they can change their systems to monitor and control fraud.

18.55 Mr Salmon suggested that 'whistleblower legislation' was necessary to provide protection for bank employees who are required by their superiors to undertake fraudulent actions in the course of their duties. He indicated:

> It was also foremost in my mind that a procedure should be available to a bank employee, when he has been *instructed by a superior to act unethically or engage in* malpractice, whereby he can report the matter to the appropriate authority and at the same time be confident that there will be no recriminations from his actions.[27]

Conclusions

18.56 The Committee accepts that fraud does exist in the banking industry as it would in any other industry of its size. However, it believes fraud is of a relatively minor nature only. The central issue to determine was what banks and/or their staff gained in the cases of alleged fraud. The Committee does not accept that the generalisations presented by some witnesses justify the claim that fraud is widespread or systemic in the industry.

18.57 Furthermore, the Committee has also concluded that the banks have adequate processes and procedures to deal with fraud. However, these should be subject to continuous monitoring to ensure there is effective detection.

18.58 The Committee considers that 'whistleblower legislation' in relation to the banking industry is not necessary at this stage. However, the Committee believes that banks should develop processes that allow staff to express suspicions of instances of fraud. Staff should be able to report concerns to senior bank management without fear of retribution. Customers should also have the opportunity to report suspicions of fraud.

Recommendation

18.59 The Committee recommends that:

> **62. banks establish internal processes that allow staff to report instances of suspected fraud to senior management without fear of retribution and provide opportunity for customers to report suspicions of fraud and corruption.**

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27 Evidence, p. 2474.

SECTION V

RETAIL BANKING

This Section looks at one of the major themes of the inquiry, retail banking. Term of Reference (d) required the Committee to relate the benefits of competition to different sectors of the community including:

- access to financial services;
- product innovation;
- choice and quality of financial services; and
- information to users.

The government responded to the feeling in the community that there was widespread dissatisfaction with the activities of banks and other financial institutions by setting up the Inquiry into Banking in October 1990. There was a perception in the community that even with the deregulation of the financial sector that the benefits that had been expected had not flowed to the general population and that the corporate sector had seen more of the benefits than the average user of banking services.

The Committee investigated the changes that occurred as a result of deregulation and how these changes have affected different sectors of the community. The Committee was anxious to determine what, if any, benefits had occurred as a result of deregulation such as increased competition and who in the community was enjoying the benefits.

The terms of reference focus to a large extent on competition. The Committee has looked very carefully at the effects that deregulation has had on the competitive process. A difficulty arises in the objective measurement of competition, particularly as there are two major factors post deregulation that impact on competition in retail banking. The first is the freeing of the financial market by removing regulation such as the distinction between trading and savings banks and the interest rate ceilings on mortgages. The second is the issuing of new banking licences to foreign banks and within Australia converting some non-bank financial institutions to banks.

Another important way of assessing the competitive process is looking at access to meaningful information. Information disclosure has been considered in depth by the Committee. Consumers and banks share some common ground on this issue as it is recognised as vital to provide consumers with a choice based on as much information as is needed to make comparisons between different products and different institutions. This information should be provided in a standardised fashion so as to allow for comparing like with like.

The banker-customer relationship is central to any discussion of retail banking. This is a broad topic that in other countries is starting to be addressed by the use of codes of banking practice. Consumer organisations recommended that a code of banking practice be introduced in Australia as a way of remedying many of the unfair practices prevalent in banking. Codes of banking practice are designed to provide for a set of minimum terms and conditions in the banker customer relationship that ensure that consumers obtain financial services on a fair, equitable and informed basis. This issue is discussed in Chapter 20.

Another important issue in retail banking is that of banks' social obligations. Banks owe their existence to a licence granted by government. There are those who believe that in return for that privilege, banks have social obligations which among other things, would require them to provide free or subsidised basic banking services for those who can not afford to pay for it. They believe there is a 'right' to basic banking. This view of a social obligation of banks extends in greater measure to government owned banks. This is discussed in Chapter 22.

The view of banks in general terms about retail banking was that they were running a business and were required to make a profit. They realised that a part of this process was to provide a good service to their customers who ultimately keep the banks in business.

The banks were of the view that deregulation had delivered considerable benefits to its customers such as greater access to credit. The consumer organisations agreed that deregulation had indeed delivered benefits to some consumers but not to all. The issue of cross subsidisation was canvassed as the consumer organisations were claiming that retail banking was subsidising corporate banking which was suffering from record levels of bad debts.

The Campbell Committee in 1981 believed deregulation would benefit consumers of credit by having access to the greater volume of bank funds, thus reducing their dependence on borrowing from the non-bank sector. The problems of discrimination in access to credit would be alleviated.

CHAPTER NINETEEN

BANKING, COMPETITION AND THE CONSUMER

Definition of retail banking

19.1 Retail banking is essentially consumer banking rather than corporate/business banking. The term 'retail banking' as used in the Chapter relates to banking services for household, personal and domestic purposes. Within this definition, the participation rate in the industry is very high.

19.2 The Australian Bankers' Association (ABA) provided figures on the participation rate in the banking sector. Almost the entire Australian adult population now has a relationship with a bank. Survey results showed that 95 per cent of the population over the age of 18 had a bank account.[1] Roy Morgan Research put the figure slightly lower at 92 per cent, based on accounts held by persons aged over 14.[2]

Competition in retail banking

19.3 For the consumer, competition should mean lower prices and a broader range of better quality goods and services; for producers it provides the spur to better performance - at home and abroad.[3] To assess how competition is working in retail banking it is measured against several generally accepted criteria which are as follows:

- price competition/profitability;
- the choice between various products and institutions, innovation/technology/market research; and
- service/quality.

Price competition

19.4 Incumbent banks guard their dominant market position strenuously as clearly demonstrated in their fending off attempts by foreign owned banks to penetrate their markets. One major bank even took steps to reduce competition from

1 Evidence, p. S62.
2 Evidence, p. S1443.
3 RJ Hawke 12 March, Building a Competitive Australia.

a regional bank. State Bank of NSW (SBNSW) revealed that its competitive marketing strategies have not been welcomed by one of the major banks. The bank in question also complained to the Advertising Council of Australia about State Bank of NSW advertisements which offered lower interest rates, in an attempt to stop the advertisements. The Advertising Council did not uphold the complaint.

19.5 The ABA claimed that there was competitive market behaviour evidenced by pricing policies of banks.[4] The ABA submitted that pricing in banking, as in any business, must take into account marketing strategies and competitor activity. Different prices may be offered to attract new business or to secure a banking connection over time. This partly reflects the need to retain sufficient market share to maintain a spread of costs. The tendency of banks to develop long standing connections means that the value of a customer is evaluated over a life time. Pricing may reflect the total value of a banking relationship rather than the value of individual products.

19.6 The ABA further submitted that in competitive markets, prices were based on costs and were responsive to changes in customer demands and were able to adjust appropriately for market factors such as risk.[5]

19.7 The current situation should be contrasted with the regulated era when pricing was not a significant competitive issue. Banks were constrained in pricing by rates established by the central bank. Neither deposit nor lending rates were market determined.

19.8 However, price also depends on what the market will bear and how much the seller can get from that market.

19.9 In an oligopoly, there may be limited price competition. With products such as credit cards and passbook accounts, interest rates have been virtually constant across banks and over time. By contrast, housing and overdraft rates usually respond quickly to falls in market rates. In certain areas competition from regional banks has forced rates even lower.

19.10 However, price competition is often limited to a single product and a particular area, especially when the bank is not a major national player.

19.11 In retail banking the three primary consumer products are:

- housing finance;
- consumer credit;
  - credit cards;

4 Evidence, p. S47.

5 Evidence, p. S51.

- personal loans;

. deposits accounts;

- transaction accounts; and

- savings accounts.

19.12 The level of price competition in relation to each of these is analysed below.

Housing finance

19.13 Deregulation of housing finance has delivered to consumers many of the benefits envisaged by the Campbell Committee. Nowhere have banks gone more from being rationers of credit to marketers of credit. In the opinion of the Secretary of the Department of the Treasury, this area of banking has become very competitive.[6]

19.14 Deregulation has resulted in the removal of the ceiling on interest rates and an end to rationing of home loans. The effect has been that consumers seeking housing finance can conduct their business in a single transaction with the same institution. Prior to deregulation, consumers would, in many cases, borrow the bulk of the home purchase price from a bank at a maximum rate set by the Reserve Bank (rationed finance), and the remainder from elsewhere at a higher rate of interest secured by a second mortgage. Such arrangements were commonly known as 'cocktail' loans.

19.15 Since deregulation banks not only have responded by making more money available in a single transaction, but have also recognised marketing advantages in tailoring products to individual needs.

19.16 Banks have used the housing loan product to respond to competition and the price mechanism as a marketing tool. They have developed flexibility in tailoring products to individual incomes and to making housing finance more accessible or attractive to consumers.

19.17 Banks have offered a wide range of new products taking into account the changes in costs and incomes over an individual's life. For example, most banks offer low start loans which require lower repayments for the first few years by deferring some of the initial cost. Westpac offers a low or high start loan depending on whether the borrower wants to pay off slowly or quickly. The National Australia Bank offers loans that can be repaid in less than the standard 25 years (this facility was previously available). These are promoted on the basis of savings generated by paying out the mortgage more quickly. A welcome innovation is the linking of

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6 Evidence, p. 3580.

savings accounts with mortgage accounts which automatically converts the interest earned on savings into mortgage repayments. An example of such an account is the Commonwealth Bank's Mortgage Interest Saver Account.

19.18 The Committee is concerned that this can be done with the mortgage offset accounts and not with other accounts. The Committee believes that interest paid by a customer on one account should be able to be offset against interest received on another account for taxation purposes. However, it should be revenue neutral for government.

19.19 Information on the price of housing finance is available in the major metropolitan newspapers. A recent sample indicated there was two percentage points difference between the highest and lowest rates. This suggests that there is competition in this sector of the market.

19.20 However, where greater price competition occurs it is sometimes limited to the market for new loans rather than established loans. Some smaller banks offer a lower rate of interest for the first year, or lower establishment fees.

Consumer credit

19.21 Within the area of consumer credit, the Committee examined credit cards and personal loans.

Credit cards

19.22 The most significant area of consumer credit in terms of volume of transactions, is credit cards.

19.23 Three credit cards dominate the credit card market in Australia, Bankcard, Mastercard and Visa. Bankcard is Australian and was initially owned collectively by the major banks. Currently it is owned by nine banks - the four major banks, the State Banks of SA and NSW, R & I Bank in WA, the Bank of Qld Ltd and Trust Bank (Tas).[7] The nine banks that collectively own Bankcard are also participants in Mastercard and Visa.

19.24 Mastercard and Visa are not collectives and are not owned exclusively by Australian banks. Mastercard and Visa also are offered by building societies and credit unions and non-Bankcard banks.

19.25 At 31 July 1991 there were 4.6 million Bankcard cardholders in Australia. Approximately half the population over 14 years of age has a credit card with an average of 1.7 cards per credit card holding person. There are 284,000

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7 Bankcard Association of Australia.

participating merchants who in most cases accept not just Bankcard but all three cards. As at 31 July 1991, the nine previously mentioned banks accounted for approximately 95% of multi store credit card business.[8]

19.26 During the past twelve months interest rates on other banking products, particularly housing finance, have declined considerably. Interest rates on credit cards (other than those offering no interest free periods) have not declined at all in this period, and have remained very similar to one another. The extent of price difference is approximately 1 per cent with banks offering credit at around the 23-24 per cent per annum. As a result, there is an appearance of a lack of price competition in the credit card market. On 7 November 1991 Westpac announced a drop in interest rates on both Bankcard and Mastercard products. The major banks' credit card with interest rates and interest free periods are listed at table 19.1.

19.27 Explanation was sought as to why the range of interest rates charged by participants is so similar and why these interest rates are so high. Banks responded saying that the cost of finance dictates the rate at which money is lent, and that competition ensures interest rates are very similar.

. Profitability

19.28 Profitability is the most fundamental issue in the credit card debate. Interest free periods and merchant costs are also relevant.

19.29 It can be asked that if credit cards are not profitable, which banks have claimed until recently, why then do they continue to offer the product? The banks indicated that the product was offered as part of a total relationship with customers.[9]

19.30 The ABA provided two reports on the profitability of credit cards; the Gaudion Report entitled the Economics of Credit Cards commissioned by the Victorian Minister for Consumer Affairs and the Damania Report entitled Credit Card Pricing in Australia commissioned by the Standing Committee of Consumer Affairs Ministers (SCOCAM). The Damania report (1989) concluded that banks' credit card business was hovering around break even but qualified this conclusion by saying that banks were unable to supply much of the relevant information requested on consumer credit profiles, consumer incomes, merchant statistics and credit card costs. The conclusion was further qualified by acknowledging unresolved methodological problems associated with measuring the cost of credit card activities. Consequently, the conclusions were tentative rather than definitive.

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8 Ibid.

9 Evidence, p. 2275 & p. 2285.

TABLE 19. 1

CREDIT CARD PRODUCT DETAILS

PRODUCT	INTEREST RATE PERCENTAGE	INTEREST FREE PERIOD NUMBER OF DAYS
ANZ Bankcard	23.88	44 max
ANZ Mastercard	19.70	Nil
ANZ Visa	23.88	44 max
CBA Bankcard	23.00	55 max
CBA Mastercard	23.00	55 max
CBA Visa	23.00	55 max
NAB Bankcard	23.00	55 max
NAB Mastercard	23.00	55 max
NAB Visa	23.00	55 max
WESTPAC Bankcard	22.8	55 max
WESTPAC Mastercard	19.2	Nil
WESTPAC Visa	22.8	42 max

19.31 The Gaudion Report (1989) concluded that, in aggregate, the responding banks had not recovered the costs of operating their credit card businesses during the five years covered by the survey.

19.32 Neither report provided adequate information on the profitability of credit cards. Their data is also now out of date.

19.33 Figure 19.1 suggests that if the reports' conclusion were correct that credit cards were breaking even around 1989, subsequent falls in interest rates should have rendered them quite profitable by now.

19.34 This uncertainty was not dispelled by the banks' evidence to the Committee. ANZ Bank stated that its credit card business was just covering costs.[10] NAB indicated it was breaking even.[11] Westpac said that at the moment its credit card business was marginally profitable.[12] Information on profitability is held by the banks and credit card associations. However, without useable, up-to-date, accurate information, no conclusions can be drawn about the profitability of the product.

19.35 In contrast, data on the profitability of credit cards in some other countries is much more conclusive. In the UK and US credit cards are highly profitable. Up-front fees or transaction fees apply in many instances and interest rates are still quite high - well above the cash rates.

19.36 US credit card operations and their profitability were analysed in a prestigious economic journal.[13] Despite a large number of banks issuing credit cards and operating with little regulation, rates charged did not appear to vary with changes in the cost of funds, suggesting a lack of competition in the market. This paradox was explained by arguing that a bank which cut interest rates would attract only the less credit-worthy customers, particularly those who used the facility as a line of revolving credit. A bank which cut fees would attract the customer who intended to pay off the outstanding balance within the interest free period, but often failed to do so. It was contended there are many customers like this, which explains why the proportion of survey respondents who claim they always paid in full was greater than those reported as doing so. These customers do not shop around for low interest rates as they mistakenly believe they will not pay any interest. It was concluded for this reason there was little competition on credit card interest rates in the US, but relatively low fees and a range of gimmicks.

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10 Evidence, p. 2275.

11 Evidence, p. 2335.

12 Evidence, p. 2611.

13 Ausubel (1991).

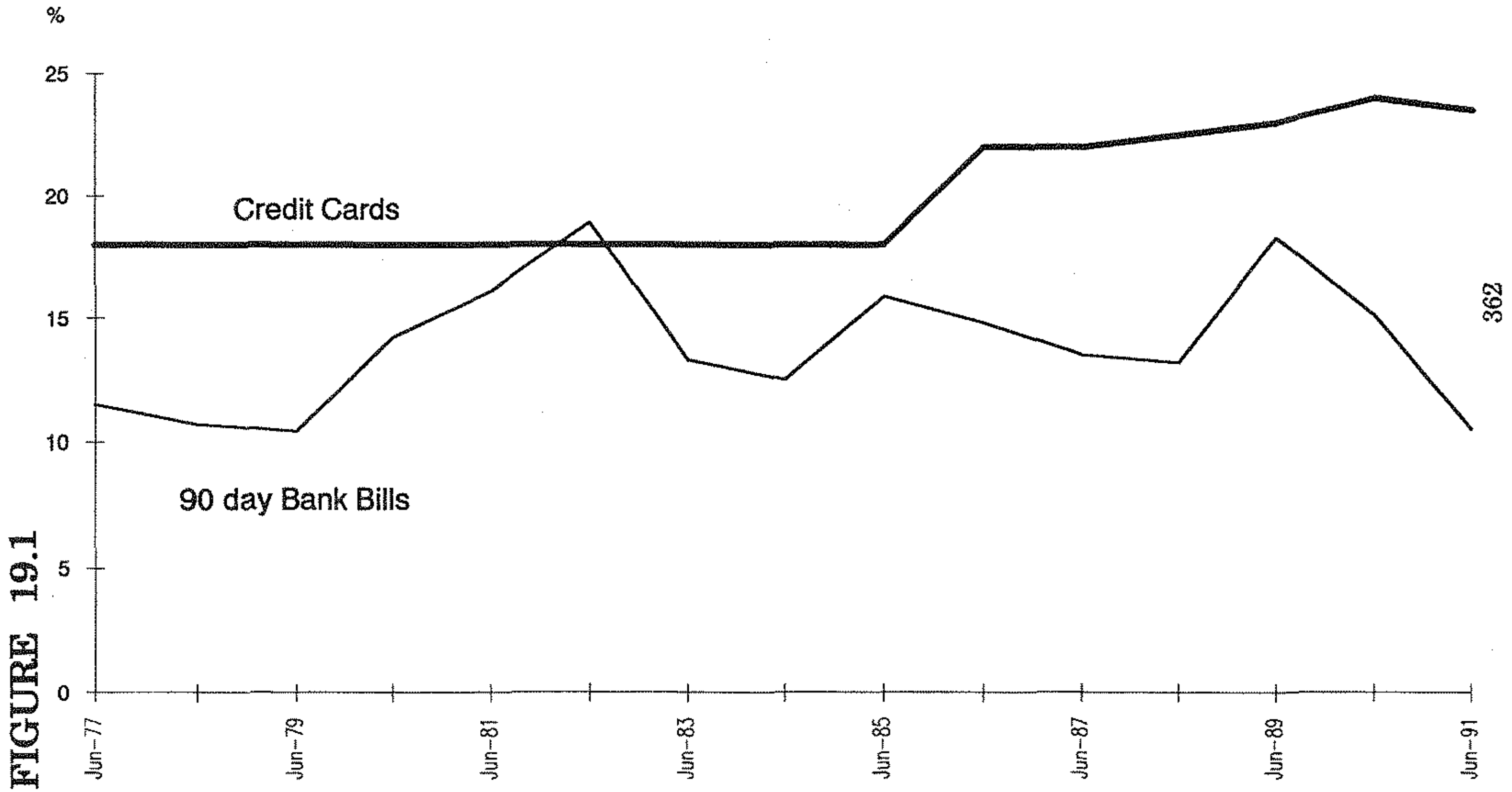

FIGURE 19.1

19.37 Data was presented showing that credit cards were far more profitable than other banking business. In 1987 banks paid 7 per cent per annum for funds, 2 per cent per annum of debts were written off and other expenses amounted to 5 per cent per annum of outstandings, a total cost of 14 per cent per annum. Banks earned 13 per cent per annum in interest,[14] 1 per cent per annum from annual fees, 1 per cent from other customer charges and 3 per cent from merchants. The profit is thus over 4 per cent of assets, representing a return on equity of over 50 per cent per annum.

19.38 *It was concluded that were credit cards to earn the same rate of return* as other bank activities in the US, the rate charged would drop to about 5 to 6 percentage points above the bill rate. In Australia fees are not permitted on credit cards, so a higher differential of 7 percentage points would be required to derive a comparable figure. This has been interpreted to mean that without the imposition of fees, banks could charge an interest rate of less than 17 per cent per annum (as at October 1991).

Product flexibility and credit card fees

19.39 Banks have been concerned about what NAB labelled 'free loaders'[15] - those customers who pay off their outstanding balance within the interest free period - and the fact that they are subsidised by those who do not. Survey evidence *from the US shows that those customers who pay within the interest free period are* wealthier than those who pay for credit.[16] The cross-subsidy is therefore regressive.

19.40 The Committee is of the view that those customers who pay off their outstanding balance by the due date are behaving rationally in optimising benefits from the product. Banks should not denigrate their customers for responding sensibly to opportunities offered by the financial market place.

19.41 For some time banks have been arguing for greater credit card flexibility. This request has usually meant the introduction of an annual fee although the introduction of a transaction fee may better reflect the costs involved. Westpac said it was considering more than one option, including a reduction in the interest free period. Westpac currently offers such a product, (Westpac Mastercard), which provides a lower interest rate of 19.2 per cent per annum and no interest free period. This contrasts with Westpac Bankcard which has an interest rate of 22.8 per cent per annum and an interest free period of up to 55 days.[17]

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14 Although they charged rates of 15 per cent to 19 per cent per annum, some accounts earned no interest as they were paid off within 25 days.

15 Evidence, p. 2335.

16 Canner & Fergus (1987).

17 Evidence, p. 2611.

19.42 The Committee considered transaction fees as a way of overcoming cross subsidisation between those who pay interest and those NAB called 'free loaders'. The Committee questioned the major banks; their responses are as follows.

19.43 NAB wanted the flexibility of having an annual fee plus transaction fees and retaining the interest. The reason was to give consumers a greater choice, depending on whether they were high or low transactors.[18]

19.44 ANZ considered credit cards as one of the best services it offered. The service the Bank provided where the outstanding balance was paid by the due date was free to the customer, however it was not free for the bank. ANZ would like to introduce either an annual fee or transaction charges.[19]

19.45 Westpac's view was similar to ANZ. It believed that there were many costs associated with credit cards one of which was for transactions which were forced into the interest rate and this was inappropriate .

19.46 The Committee is aware of variations between credit card products. Banks are adjusting their credit card products to offer a mix of options - different interest free periods and interest rates to suit different customers. Consumer groups argue that banks have considerable flexibility to vary this mix.

19.47 The specific issue of fees has been discussed for some time by the Standing Committee of Consumer Affairs Ministers (SCOCAM) as part of the broader issue of proposed uniform credit laws. The major impediment to the *introduction of up-front fees concerns State credit laws which prevent the charging* of both fees and interest. SCOCAM has not permitted the introduction of such fees because it doubts whether banks would drop interest rates sufficiently and keep them down to offset the cost of the new fees. Consumer organisations have consistently argued against such fees for the same reason.

Conclusion

19.48 Despite falls in interest rates over the past two years, the Committee notes there has been no reduction in credit card interest rates. Not only has there been no reduction but in some cases the interest free period decreased.

19.49 The Committee considers that more information is needed in order to assess the profitability of credit cards particularly in the light of overseas experience. Any further investigation would have to be undertaken by an independent authority such as the Prices Surveillance Authority (PSA).

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18 Evidence, p. 2337.

19 Evidence, p. 2275-76.

19.50 The Committee is attracted to the argument which favours more flexibility in the system to provide consumers with greater choice. Some consumers could have greater choice if the product involved an up-front fee, transaction charges and a reduced interest rate. The Committee requires that this matter which has been on the agenda of SCOCAM for some time be resolved urgently.

19.51 On the assumption that credit cards are profitable, credit card fees could be permitted on condition that banks be obliged to reduce and maintain lower interest rates. The introduction of fees would be opposed if this resulted in consumers paying more for the product.

19.52 The Committee considers that those who use transaction facilities should pay for the use of the facility through transaction fees.

Recommendation

19.53 **The Committee recommends that:**

63. a formal reference be given to the PSA to inquire into the profitability of credit cards. If the PSA finds that profits are not excessive, the Committee recommends that SCOCAM consider deregulation of fees on credit cards. If credit cards are deregulated, the PSA should continue to monitor credit card profitability.

Dual Pricing of credit cards

19.54 Another aspect of credit card business of concern relates to banks' refusal to allow discounting for consumers who choose to pay by cash. Banks do not allow for a dual pricing policy on goods and services sold by merchants who offer credit card facilities. Some merchants believe that the credit card costs already factored into their normal prices should not be passed on to non-credit card customers.

19.55 Banks have been unwilling to remove the prohibition on discounting for cash from the Merchant Agreements. In some cases they have terminated the agreements when merchants refused to discontinue discounting for cash. This is contrary to the user pays philosophy supported by banks. The cash customer should not be required to subsidise the credit card customer.

Conclusion

19.56 The Committee concludes that banks' practice of preventing merchants who operate a credit card facility from offering a discount for cash is unfair. If merchants choose not to pass on the cost of credit component built into their prices, they should exercise that discretion without suffering withdrawal of their credit card facility.

Recommendation

19.57 **The Committee recommends that:**

64. merchants who operate a credit card facility should be free to make their own decisions as to the prices they charge. Dual pricing by merchants should not be prevented by banks.

Personal loans

19.58 The main alternative to credit card finance is the personal loan where small advances of less than $1,000 are involved. Personal loans are becoming less available because credit card cash advances are dominating the market. Evidence from consumer organisations, the Brotherhood of St Laurence and banks confirmed this trend.

19.59 Low income consumers who in the past would have probably gone to a finance company will now use credit cards. The Brotherhood of St Laurence[20] expressed concern about the use of this relatively high-cost credit by people who were not as high risk as the banks suggested. In the Brotherhood's opinion, use of credit cards instead of lower cost personal loans represented a failure of the market. It concluded deregulation had failed to deliver the benefits of cheaper credit to the disadvantaged low income consumer who, in many cases, used credit cards as a revolving line of credit to sustain day-to-day living.

19.60 The cost of credit on credit cards may not be higher than a personal loan through a finance company, but the consumer is disadvantaged by the nature of the credit. If consumers opts to pay the minimum monthly balance,they may take many years to pay off a relatively small debt. Finance company loans are structured in such a way that a stipulated amount falls due at regular intervals and the loan has an agreed term. Unlike credit cards, personal loans are not open ended.

19.61 A solution offered by the Brotherhood was for consumers to use community based credit co-operatives to access funds for personal loans. It was suggested these should be structured similarly to those already operating in inner Melbourne - started with seeding grants from government but ultimately self-funding. The Brotherhood argued that such co-operative developments would be revenue neutral for governments.

Deposit accounts

19.62 In the past few years the way the average Australian has carried out daily banking has changed greatly. No longer is it usual to operate a stand-alone cheque account to pay bills and a passbook savings account for daily transactions and deposit for a particular purpose.

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20 Evidence, p. 3477.

19.63 Instead there are combinations of accounts to satisfy almost every banking need. Accounts can now be combined so that money from a cheque, saving or credit card account can be accessed by a single card through an Automatic Teller Machine 24 hours a day.

19.64 Banks have also introduced fees and charges on both deposit and loan products in the retail market. In part, this has reflected a user pays philosophy. Accounts with more than $500 do not attract fees and permit a certain number of free transactions before fees apply.

19.65 Such accounts offer flexibility and convenience and, if operated efficiently by the user, represent value for money even though some fees may still apply. However, there has been considerable consumer resistance to the imposition of fees and charges, as discussed in detail in Chapter 7.

19.66 Despite this opposition, the major banks are committed to fees and charges and the user pays principle. However, this same enthusiasm for user pays applies more to users of bank products than to banks themselves. Consumer organisations have queried whether the major banks should be paying market price for all money on deposit.[21]

19.67 Consumer organisations were critical of the no interest, or low interest bearing accounts, which include many passbook and cheque accounts which do not pay interest.[22] The ABA, however, defended the banks' position, on the grounds that such deposits are in fact costly to maintain.

19.68 These accounts are substantial - $12 billion that pays no interest and $6 billion in passbooks paying low interest.[23] If banks were required to pay a minimum interest rate on all deposits in a similar manner to the pensioner deeming provisions at the prevailing rate of interest of 8 per cent, profits could fall by over $1 billion a year, or depositors would receive lower interest rates or borrowers would pay higher rates.

19.69 Banks claim that many of these accounts are not low cost. They have high transaction costs with clearing house expenditure, management time required for cheque and statement savings accounts, high cost of bank processing infrastructure, staffing and data security and, for larger banks, branch networks which make widespread collection possible.

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21 Evidence, p. S1448-49.

22 Evidence, p. S1448-49.

23 RBA Bulletin, September 1991.

19.70 Information provided by banks indicated the cost of operating low-interest or no-interest accounts is greater than just the cost of interest paid. Taking into account the cost of maintaining accounts and paying interest on them, banks claim the average cost is between 8 to 10 per cent. While the cost of operating them is greater than the interest paid, it has been less than the cost of wholesale funds.

19.71 Consideration was given to whether these accounts were not only low cost but also whether there was price competition between major banks in relation to products.

19.72 Evidence relating to low interest bearing accounts indicates there is very little price competition between the major banks. The rate of interest paid is 3.75 per cent per annum for amounts under $4,000 and 6 per cent per annum for amounts above $4,000. Interest paid is similar between the majors and rates have not changed significantly, if at all, over several years.

19.73 A related pricing issue on deposit accounts, concerns the payment of interest on the minimum monthly balance (MMB). This practice is gradually becoming less prevalent. Among the established banks between 5 and 14 per cent of deposits pay interest on this basis. It is much less common among the new banks. Indeed, Citibank was so opposed to MMB that it said it would not join the ABA while that body allowed the practice.

19.74 Banks' advertising features interest rates in very large type but the Minimum Monthly Balance (MMB) basis is in very small type. Customers could easily be misled. Even when the concept is well understood it is hard for a consumer to compare interest quoted on a daily balance basis with those quoted on an MMB balance.[24]

19.75 The MMB concept has little relation to the cost of providing the account. One bank claimed before there were computers it was necessary to calculate interest in this manner. But daily interest was in use until the 1840s when banks introduced MMB to disguise a reduction in interest payments.[25] It was also suggested that it was to encourage saving by penalising withdrawals.

19.76 Some consumers may not be getting market rate return on their savings. To ensure that customers are receiving market rate, banks could change their computer programs to automatically increase all interest rates across the board to an appropriate rate.

19.77 Since the Commonwealth Government introduced deeming for pensions, there has been a 20-30 percent reduction in the amount of money held in low interest accounts. This suggests that the introduction of such a provision encourages people to move their money into accounts paying higher interest.

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24 Evidence, p. S1538-39.

25 SJ Butlin (1953) p. 336.

19.78 Consumer organisations maintain that banks are not offering market rates on all money held on deposit. Banks maintain that money held in passbook and cheque accounts not paying interest has a cost. The cost of maintaining these accounts was not insignificant. In high transaction accounts they are costing the bank more than is paid in interest.

Conclusion

19.79 It is not clear what low or no interest deposit accounts cost banks. The Committee considers that banks should pay market rates or close to market rates for all deposits.

19.80 A large number of banks are already calculating interest daily on deposit accounts. This should become standard practice for all accounts.

Recommendations

19.81 **The Committee recommends that:**

65. banks pay a reasonable rate of interest on all deposit accounts. This should take into account the costs of maintaining accounts;

66. the Australian Taxation Office investigate the possibility of changing tax laws so that taxpayers are taxed on net interest received by them, net interest being gross income received net of interest, bank fees and charges paid; and

67. banks be strongly encouraged to convert all remaining deposit accounts which pay interest on the minimum monthly balance to daily interest.

Profitability

19.82 Profitability is dealt with in Chapter 6, however, as it relates to competitive process and its impact on consumers it is hard to assess results using a single criterion. When differing points of view are argued on profitability the same argument is put forward to explain the same phenomenon. When prices are similar or when one player follows the other in time and quantum it is argued that this is either the result of strong or weak competition. To establish the answer as to whether competition is strong or weak when considering prices the issue of margins is crucial. If margins are high this suggests that competition is weak, if margins are low, it suggests that competition is strong.

Consumer choice

Alternative institutions

19.83 It has been suggested that while deregulation led to an increased number of banks, this did not necessarily result in consumer benefits or perfect competition at the retail level. The consumer retail financial services market in Australia is still dominated by the big four banks. The new Australian banks have mostly grown from building societies, and from the consumers' point of view the change is largely a change of name.[26]

19.84 Consumer organisations contend that although there are a large number of licensed banks (32), the average consumer has a limited choice. This choice is often between the four major banks, generally a State bank and one or two new banks (generally ex building societies). If consumers needed a bank within walking distance or they lived in smaller communities, the choice would be more restricted.[27]

19.85 However, six or seven banks still represents a reasonable choice. Consumers have a choice between banks for basic retail banking needs, as well as the alternatives of building societies and credit unions. The non bank financial intermediaries (NBFIs) offer similar products with some offering services more cheaply. For example, some credit unions and building societies do not charge transaction fees and offer other benefits such as free bill paying services.

19.86 The Committee also considered whether Australians were overbanked. The Committee found no evidence to support this proposition. If such a situation did arise in the future market forces would dictate whether some players should exit to correct the oversupply.

Conclusion

19.87 The Committee concludes there are adequate numbers of competing institutions within the retail banking sector to enable reasonable choice for consumers in most places. For a population of 17.5 million, availability of financial services is not restricted.

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26 Evidence, p. S1536.

27 Evidence, p. S1537.

Switching accounts/portability

19.88 A major factor impacting on consumer choice is the cost involved in changing banks or transferring accounts between institutions. Consumer organisations indicated:

> Competition will be blunted if consumers face difficulties in moving from one bank to another or from one account to another. If barriers exist, consumers will only move banks or accounts if they are at a severe disadvantage.[28]

19.89 Consumers face large cost barriers if they want to move a secured loan, such as a mortgage, from one bank to another. A number of costs were identified:

- the costs of entering a mortgage - bank charges, including application and establishment fees as well as legal and valuation fees;
- government charges including stamp duty and registration fees for the registration of mortgage documents;
- the costs of exiting a mortgage, including legal fees and in some cases an early repayment penalty; and
- government charges for executing the discharge of the mortgage.

19.90 Consumer organisations argued:

> ... entry and exit costs effectively prevent consumers from changing banks to take advantage of small differences in mortgage rates. In reality, consumers only have a choice when they take out a mortgage for a first time or when they buy a new house.[29]

19.91 Some banks have changed their pricing practices relating to early repayments of loans. Some have moved to recovering the cost associated with the transaction, not imposing a pre-determined fee or penalty as was previously the case.

Recommendations

19.92 **The Committee recommends that:**

68. all banks adopt the practice of recovering actual costs for early repayment of loans rather than imposing a penalty; and

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28 Evidence, p. S1548.

29 Evidence, p. S1550.

69. State governments reform taxes and charges they impose on mortgages so as to remove the barriers they now create to entry and exit. They should consider collecting the revenue by spreading government charges over the term of the loan.

Product innovation: technology

19.93 Banks were not the first to introduce new technology. Initially, the innovators were the credit unions. Banks chose to evaluate the effectiveness and efficiencies of ATMs and electronic banking facilities, before installing the technology themselves.

19.94 Technological developments have benefited bank customers. The introduction of electronic banking and, more recently, EFTPOS provides convenience with 24 hour banking across the country. The voluntary code on EFT provides one of the safest systems in the world. Home banking has great potential for all Australian in particular, rural Australians and the disabled. The cost/benefit associated with new technology compared to the alternative of employing counter staff makes it extremely attractive for banks and customers alike.

19.95 The ABA indicated:

> In a competitive market, banks will be forced to improve efficiency to achieve the lowest possible costs. The Australian banks have made significant productivity gains and cost savings in recent years. All banks are devoting considerable resources to achieving further gains. Initiatives include automation of back office processing, rationalisation of forms and procedures for loans and operating of accounts. This is a significant step from the situation under regulation, when Australia's system was regarded as 'among the least efficient systems of advanced countries'.[30]

19.96 RBA figures indicate that retail margins have been stable over the past 10 years. The introduction of new technology should have enabled banks to reduce staffing costs and thus reflect these savings in lower margins. Banks claim it costs significantly more to process a transaction manually than electronically.

19.97 There is no doubt that there have been gains in productivity, but whether these gains have been passed on to, or enjoyed by, consumers in the form of better service or lower interest rates on loans or higher interest paid on deposits is questioned.

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30 Evidence, p. S49.

19.98 The Committee is aware that interest rates are market/government driven but new charges have been imposed such as transaction fees and consumers can not see any efficiency gains from new technology being passed on to them. Better service to the average consumer is somewhat intangible because the use of electronic banking means that most transactions now take place outside the bank.

19.99 The level of technology in financial services is acknowledged to be high in Australia and banks should be encouraged to continue to move ahead with the adoption of new technology. ANZ indicated that it was possible to further improve service. An example of this new technology is the automatic linking of credit/debit accounts, all that is necessary is more sophisticated equipment at the merchant end.[31]

19.100 Credit cards could be further improved by streamling of different accounts. The plastic wall should be removed between credit and debit cards. EFTPOS has created a situation whereby accounts are debited almost immediately at the time of purchase, interest accruing in some cases immediately at credit card interest rates. There should be a mechanism which links different accounts operated by the same customer which allows the customer to have interest charged on purchases calculated at a rate lower than credit card interest. This could be done by linking credit card accounts with accounts which attract a lower interest rate, such as an overdraft account.

19.101 The use of such sweep technology to reduce the cost of operating different accounts is encouraged but should not be a device to avoid paying for the operating accounts. There should be a charge for this service.

Conclusion

19.102 The Committee concludes that banks should accelerate technological advances with the introduction of an interface between credit and debit card facilities.

Product innovation: market research

19.103 Market research has led banks to respond to consumer demands in several facets of retail market. Most notably this has occurred in housing finance and restructuring operating or transaction accounts. Banks should be more responsive in certain areas including product development and product choice.

19.104 Banks have devised many accounts for a multitude of purposes. Some argue this is not necessarily a good thing, as a wide array of products which often have only minor differences is confusing. Customers can be confused as to their best

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31 Evidence, p. 2272-73.

options and bank staff can sometimes be confused when advising customers. However, it does satisfy a basic consumer requirement of choice between banks and products within the same bank.

19.105 Rationalisation has taken place as some banks have recognised there are too many products on the market. Examples include the Commonwealth Bank's Streamline account, and the NAB which has advertised a reduction in the number of its accounts.

19.106 Market research has benefited consumers and there is no doubt banks will continue this process. In particular consumers have benefited from the creation of products tailored to address consumers' needs and from banks providing a wider choice of products. These factors indicate that a competitive environment has been created and that banks are not just competing on price.

Quality of service

19.107 Quality of service is much harder to measure than quality of goods. Banking is essentially about service. With the introduction and proliferation of ATMs, customers' use of bank counter staff service has declined. Ready acceptance of new technology could be related to increased convenience or, conversely, perceived slow or inefficient counter service, particularly at peak periods.

19.108 Banks are large employers of staff; one person in 50 in the workforce works for a bank. Banks also have a big turnover of staff. These factors contribute to difficulties in training staff training which affects efficiency and quality of service. Banks spend several times the training levy requirement of the Commonwealth Government, directed particularly at ensuring quality of customer service is maintained. This positive sign is a tangible measure of the effort being made by banks to improve the expertise of their staff. However, data from the Banking Industry Ombudsman indicates that consumers believe banks have a long way to go in improving their customer service.

19.109 Banks have indicated they are endeavouring to substantially improve customer service through means such as:

- appointment of senior service quality managers with area responsibilities;
- improving customer complaints procedures; and
- clearly defining service standards and assessment of staff against these standards.[32]

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32 Evidence, p. S82.

19.110 The major banks have, or are in the process of setting up, internal dispute resolution systems to deal with consumer complaints. The Commonwealth Bank has a fully functional system which it believes is the most advanced and longest established system, and one system that other banks may chose to emulate.

19.111 In its submission, the ABA gave statistics which suggested customer dissatisfaction is low with at least two areas of retail banking.[33] Statistics for two banks indicated credit card complaints average one per 6,600 transactions. In EFT, for the years to July 1990, there was an average one complaint per 13,400. This is a tangible measure of customer satisfaction.

19.112 The Chairman of the ABA indicated complaints about bank service are part of general anti-bank sentiment. Grumbling about queues, mistakes and staff training is fairly common and he questioned whether these criticisms were fair prejudices.[34]

19.113 The Chairman of the ABA further stated banks had invested heavily in staff training and were committed to service quality and customer orientation as commercially essential. He had difficulty in understanding why the public were not more comfortable with the quality of bank service, although he considered part of the answer lay in the vast size and complexity of the banking system. It was therefore inevitable some mistakes and misjudgments would be made in these circumstances, and it is surprising how low the level of mistakes and complaints actually are.

19.114 There are several reasons for complaints about service. First, the public had very high expectations in relation to bank services and were quite impatient with any failure to meet those expectations. Second, banks failed to adequately inform customers of their actions. Third, until the evolution of dispute resolution procedures and the establishment of the Australian Banking Industry Ombudsman scheme, customers were limited in their ability to quickly and cheaply resolve their complaints. Naturally, they became very frustrated.

19.115 Banks were questioned on how they allocated funds for training. The aim was to find out whether the banks were using their training resources to improve customer service. They responded that they spent a large proportion of training funds on new recruits for customer service, which included customer service training.

19.116 The Commonwealth Bank advised it had established zone training centres. These respond to shortfalls in customer training highlighted through complaint statistics. In general all banks allocated a large percentage of their training budget to risk assessment. For example, Westpac spent approximately 31 per cent of the total training budget on risk assessment. The four major banks

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33 Evidence, p. S85.

34 Evidence, p. 16.

stated they spent sizeable amounts on ongoing training programs. This type of training has assumed greater importance, as staff turnover in recent times has fallen. Over time, this should have a flow through effect, as better trained staff result in better customer service.

19.117 The issue of queues was canvassed as community concerns were expressed particularly in regard to queues on government pension days. The possibility of having two pension pay days per fortnight was raised with the Department of Social Security. The Department responded with the following:

- it was concerned at changing something as basic as the day on which pensions are paid, particularly for the aged;
- as with employees in an organisation, 'payday' can be a significant event which would be affected by staggering payments;
- there would be very significant one-off costs, or significant confusion if pro rata payments were made, during the fortnight of transactions; and
- the complexity of dealing with staggered paydays would result in a significant increase in errors in administration and consequent incorrect payments to pensioners.

Conclusion

19.118 Banking is a service industry which must maintain good customer relations by offering good customer service. Good customer service can be provided by reducing waiting time in queues and training counter staff to advise customers on new products and assist in resolving complaints.

19.119 Banks are endeavouring to improve their customer relations by staff training. They are focussing training on areas where they have identified the greatest need, utilising complaint statistics.

19.120 The Committee acknowledges banks are attempting to resolve shortcomings in their customer service. However, it believes more can be done to improve customer relationships.

Recommendations

19.121 **The Committee recommends that banks should:**

70. continue to offer training opportunities to their staff especially with regard to improvements in customer relations;

71. **speed up their implementation of effective complaint handling schemes and make known the existence of their complaint departments to their customers through brochures available in all bank branches;**

72. **make greater use of information gathered through their complaint statistics to improve their performance; and**

73. **publish customer complaints statistics in their annual reports.**

Geographic access

19.122 While not a precondition for effective competition, physical access to banking services is nonetheless an important one in a country the size of Australia. Lack of a branch network was critical in the foreign bank entrants' failure to achieve significant market share in retail banking, and the possession of a network is often cited as the reason for the strength of the incumbent banks.

19.123 Consumer organisations considered people who live in remote areas to be locationally disadvantaged. Figures indicating in 1986, 70.5 per cent of Australia's population lived in state capitals and other major cities, while only 14.5 per cent lived in rural areas.[35]

19.124 Banks suggested remoteness did not necessarily create a disadvantaged group denied basic banking facilities.

19.125 Technology has given customers many options in the way they carry out their banking needs. The vast network of Post Offices in Australia, which already act as Commonwealth Bank agencies, provides the necessary infrastructure for small remote locations. Many Post Offices not only offer EFTPOS but also Electronic Funds Transfer at Point of Banking (EFTPOB).

19.126 Technological development has also provided ATMs, and home banking. Home banking can be accessed through a modem attached to an ordinary telephone service or a facsimile machine. This technology is relatively inexpensive and easy to install. However, some limitations with home banking have been identified. A person who uses this system and does not have access to a branch or an ATM can not make cash withdrawals or deposits.

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35 Evidence, p. S1505.

Availability of finance/overcommitment

19.127 Deregulation has meant that banks are free to lend without rationing. Market forces have resulted in the quantity of money lent at market rates of interest increasing. Banks are no longer obliged to lend a set proportion of funds at subsidised rates for housing or other purposes.

19.128 Not only have banks moved from being rationers to marketers of credit but they changed from being very conservative in their lending behaviour. Attitudes in society have also undergone revolutionary change. Before World War II, debt carried a stigma that was to be avoided. Credit is now perceived as part of our way of life and often regarded as something that should be freely available.

19.129 It is claimed that the unfortunate outcome of this change is that there are now many borrowers unable to repay their debts. The level of overcommitment in Australia has risen dramatically in this deregulated era. Where the responsibility for overcommitment is open to debate. It can be argued banks should protect shareholders' and depositors' funds when assessing a borrower's ability to repay.

19.130 Banks were questioned about their credit assessment processes.

19.131 NAB responded that it used a credit scoring system which assessed a person's ability to repay. They also confirmed adopting a more cautious approach to lending to protect both the bank and customer. Delinquency rates were monitored regularly. Frequent use of credit card cash withdrawals was one indicator of a potential problem.[36]

19.132 ANZ Bank indicated the level of credit card bad debts was increasing. They were moving to widespread use of credit scoring in credit card risk assessment. This was critical when some borrowers failed to disclose other commitments when applying for additional credit or loans, and blamed the bank when they experienced difficulties.[37]

19.133 Criticisms have been levelled at these credit scoring systems, as revealed at the 1988 Credit Forum sponsored by the National Consumer Affairs Consultative Council (NCAAC).[38] NCAAC found that most credit providers considered these systems to be commercially sensitive and only one was made available for scrutiny. Although this system may not have been representative, NCAAC considered that there were some alarming attributes in the scoring system.

19.134 NCAAC considered that scoring systems did not give sufficient weight to the level of income. A pensioner could receive as many points as a private sector employee because regularity of income appeared to be more relevant than the level

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36 Evidence, p. 2340-2342.

37 Evidence, p. 2270.

38 Overcommitment of Consumer Credit, NCAAC 1988, p. 39.

of income or the means and ability of the consumer to meet repayments. The existence of a telephone was considered one of the most important factors. NCAAC considered that ability to repay should be the most important criterion, not the presence of a telephone.

19.135 Multiple banking is an aspect of banking that creates problems in credit assessment. Present privacy legislation can present problems in making assessments where a borrower has accounts and or debts at a number of different banks. It was suggested that loan assessment forms could ask the question as to commitments with other banks.

Conclusion

19.136 The Committee concludes that based on NCAAC's report, credit scoring systems do not place sufficient emphasis on ability to repay; they focus on the credit providers ability to recover debt.

19.137 The Committee further concludes that banks should make full and proper assessment of a borrower's ability to repay loans. This will benefit the bank as well as the borrower as bad debts should be reduced.

Recommendation

19.138 **The Committee recommends that:**

74. **banks should ensure that their assessment of risk and other related areas such as ability to repay are thoroughly investigated. Credit scoring systems should be amended to incorporate criteria such as income, or where it already exists, to strengthen this requirement. Bank loans officers should be adequately trained in risk assessment techniques.**

Low-income consumers

19.139 The Campbell Committee was conscious that low income-earners faced special difficulties in obtaining access to the financial system. It heard the concern expressed that the widespread deregulation of the financial system would skew the distribution of finance away from small, less sophisticated investors and borrowers. Low-income earners might have to pay more to obtain finance and simultaneously would be provided with fewer investment opportunities and services by the major financial intermediaries. The Campbell Committee considered an effect of deregulation may be to reduce the cost of finance to high risk borrowers (especially those on low incomes) who were forced to obtain finance from 'fringe' lenders at relatively high interest rates.[39]

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[39] Campbell Committee Report, p. 731.

19.140 The Committee heard that this was not the case. The Brotherhood of St Laurence and consumer organisations were strongly of the view that low-income consumers as a group, had received fewest benefits from deregulation. They had lost out in two significant ways. They had not enjoyed a reduction in the cost of consumer finance (other than for housing which they do not usually aspire to anyway), and they were finding it more expensive to participate in mainstream banking because of the introduction of 'user pays' for the operation of bank accounts.

19.141 The Committee was told low-income earners were generally considered by mainstream banks as high risk. Small personal loans were hard to obtain and such customers were usually offered credit cards instead. Credit card finance is not cheap finance.

19.142 Many low-income consumers are welfare recipients and are required by law to have an account into which their benefits are paid. Many accounts have fees and charges attached unless there is a minimum balance of around $500, an amount which many low-income consumers find hard to maintain.

19.143 As a result of the cost of maintaining a bank account, many low-income consumers have turned to credit unions and building societies which are less likely to impose fees and charges. Personal loans also are more available from these institutions.

19.144 The Brotherhood of St Laurence said that Community Based Credit Unions were a good option for low-income consumers. The credit union staff were more aware of the individual's financial situation and could take more time with their customers. Employees of some community based credit co-operatives even accompanied borrowers to buy goods for which they borrowed money. The Brotherhood also did not believe its clients were necessarily high risk and that interest rates should be set to accurately reflect risk.

Conclusion

19.145 The Committee concluded that the non bank financial intermediaries are vital to low-income consumers continued access to financial services.

CHAPTER TWENTY

BANKER-CUSTOMER LEGAL RELATIONSHIP AND FAIR BANKING

20.1 This chapter considers a number of issues involved in the relationship between banks and retail consumers. These are:

- the codification of banking law and practice;
- regulatory responsibility for consumer banking issues;
- dispute resolution mechanisms;
- banks' duty of confidentiality; and
- guarantors.

Banking law

20.2 Banking law mediates the relationship between banks and customers. Historically it has provided the parameters within which bank transactions take place and has attempted to provide a framework for fairness across those transactions. That framework has been eroded by the increasing complexity of the banking relationship, more detailed contractual agreements, and the development of new products, particularly electronic products, which do not sit comfortably within it.

20.3 The resulting mismatch between the law of banking and the practice of banks has generated much disquiet amongst bank customers, in the media and within the community at large. Some of this disquiet may be based on misperceptions and some may be transitional as both banks and consumers adjust. But clearly some of it is justified. The Committee considers it imperative in examining the quality of banking services to consider whether existing laws are adequate to community needs and if not how the deficiencies best might be addressed.

20.4 Often it is argued that the competitive market will ensure terms and conditions on contracts are fair. However, the relationship between consumer protection law and competition is a complex and dynamic one. Two distinct but related goals have prompted governments to pass laws interfering with business in general or banking in particular. First, such laws aim to ensure that competition

does not take place in a manner that subverts the goals of efficiency and equity. Second, such laws place minimum standards of fairness, honesty and equity on the banking relationship and on the competitive process.

20.5 Clearly not all elements of the complex relationship between bank and customer are subject to competition equally. For example, whilst most consumers will examine the price of a particular product in detail, few customers will consider issues such as which bank's contract most fairly distributes loss in the event of fraud by a third party where neither bank nor customer has been negligent. As such loss is not an event which the customer anticipates, it will not be a consideration for the individual customer in choosing a product. However, for the institution which enters many such transactions, it will be taken into account in the design of the product and of the drafting of the terms and conditions. It is in relation to those aspects of the banker-customer relationship to which competition does not extend that the Committee sees a need to ensure fair minimum standards are set. Similarly, the law should operate to prevent competition taking misleading forms or involving such high pressure sales techniques that consumer choice is diminished or lost.

20.6 The Committee examined two issues concerning the codification of the relationship between banks and customers. The first was the question of whether there should be a codification of the common law covering the banker-customer relationship. The second was the development of a code of banking practice to govern the day to day relationship between bank and customer. These two are closely related. As the consumer organisations noted, 'the distinction between banking law and banking practice is almost impossible to draw'.[1]

20.7 A number of submissions addressed banking law and practice. In addition there was much discussion of the possibility of industry codes, codes of conduct or codification of the law.

Need for codification

20.8 Whilst based on the law of contract, the banker-customer contract has been of a very unusual nature in that the majority of the terms have been implied ones developed by the common law. The courts have been reluctant to see those terms overturned by specific contractual agreements.

20.9 There were both advantages and disadvantages to customers in most terms being implied. The main advantage was that the courts retained power to monitor implied contractual terms. In so doing they sought to preserve a fair and balanced relationship and thus protect customers from the consequences of their relatively inferior bargaining position. For the courts, the contractual terms of the banking relationship raise issues of public policy not effectively dealt with by negotiation between substantially unequal parties. This attitude has been maintained by the courts. A recent House of Lords decision let the risks of third party fraud

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1 Evidence, p. S1598.

inherent in the system fall on the bank rather than the customer. Lord Scarman declared in justification: 'The business of banking is the business not of the customer, but of the bank.'[2]

20.10 The disadvantage to the customer was that as the contractual terms were unexpressed they remained largely unknown. Thus there was an overriding ambiguity and lack of transparency. Law shaded into established practice and there was a grey area in between where established procedure gradually became the law, either because customers did not realise they might contest it or through principles of custom and usage. This is one of the reasons why 'the bank's usual terms and conditions' is one of the most common expressions seen in bank documents.

20.11 Most of the common law remains in place today, but it has been overlain by sometimes conflicting modern developments, particularly with the wider focus of banking activities and by the increasing tendency to supplement and vary the common law with written terms and conditions. Many contracts are long, complex and extremely detailed. Terms and conditions are invariably drafted by the bank, having regard to its own interests and the benefit of its past experience. The bank can take advantage of its stronger bargaining position to ensure that the terms reflect its interests. They often exclude protection traditionally implied by the courts into the banker-customer relationship. Despite the apparent certainty of written terms, however, the traditional ambiguity remains as there is still extensive reliance on 'custom and usage' and use of clauses which are expressed to incorporate the bank's 'usual terms and conditions'. For similar reasons, the fact that the terms are written down does not mean that the transaction has become 'transparent'.

20.12 Despite these shortcomings, banking law continues to play an effective role in mediating the relationship between banker and customer. Along with associated common law and statutory provisions governing such matters as agency, cheques, consumer credit and privacy, it fulfils an important function. But the ambiguity and lack of transparency of traditional banking law, the need for an effective mechanism to replace the court's role in ensuring standards of fairness in newer products and particular areas of uncertainty are problems which the Committee has sought to address.

Codification of banking law

20.13 In a detailed analysis of banking law and practice, consumer organisations recommended that the Australian Law Reform Commission should be given a reference to investigate whether codification of banking law would assist in achieving fairness and equity in the relationship between banker and customer. It was recommended that the ALRC be requested to set minimum terms and conditions of the banker-customer relationship, with terms of reference specifying the need:

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2 Tai Hing Cotton Mill v Liw Cong Hing Bank [1985] 2 All ER 947.

- to distribute rights, responsibilities and the risk of loss in the banking relationship with fairness and equity;

- to take into account the need for a workable and efficient payments system;

- to encourage product development;

- to encourage fair market competition;

- to ensure bank customers are aware of their rights and responsibilities; and

- to ensure that banking contracts are not one-sided.[3]

20.14 It is noted that many of the areas covered in the consumer organisations' recommendation may appropriately be part of a code of banking practice.

20.15 The ABA considered it a may be timely to codify important aspects of banking law and practice. If the law were to be codified in the sense of introducing legislation, the ABA expresses the view that Commonwealth legislation administered by a Commonwealth agency would be most appropriate.[4]

Code of banking practice

- Views put to the Committee

20.16 As noted above, the ABA advised that it supported the codification of important aspects both of banking law and practice. It stated the banking industry had developed a disclosure standard in 1988 and significant progress had been made in its implementation. During the period of the inquiry the ABA also released a separate disclosure standard for lending to the rural sector.

20.17 National Australia Bank said banking practice should be codified on a national basis, that it should be a self-regulatory code and the Ombudsman 'is probably the one that first comes to mind as a possibility for ensuring adherence to a voluntary code of practice'.[5]

20.18 Westpac said that there were some aspects of the banking system which required some form of codification. It submitted its own draft of such a document.[6]

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3 Evidence, p. S1590.

4 Evidence, p. S2784.

5 Evidence, p. 2356.

6 Evidence, p. 2624.

20.19 Metway Bank also made submissions in favour of a uniform code of conduct for banks and their staff, not only to protect customers, but also to ensure that banks were prevented from acting in a manner unfairly prejudicial to each other.[7]

20.20 The Banking Ombudsman favoured the development of a code. He considered a draft code should be developed by the industry, circulated for public discussion and a negotiation process set up. He saw a threshold question in whether *the code should merely reflect existing practice or set desirable standards.*[8] The Banking Ombudsman noted that 50% of the complaints he sent back to the relevant bank for reconsideration were resolved by the bank providing an explanation to the customer. He considered this was indicative that people want to know how the system operates. [9]

20.21 Finally, regulatory authorities appeared to favour some form of codification of banking practice. Attorney-General's Department noted a good case could be made for a code but said 'they can take a long time to develop and they need to be very vigorously administered'. [10]

20.22 The then Chairman of the Trade Practices Commission stressed that the Commission had a major involvement in getting the code of conduct on EFT into an effective state and would see itself as having close involvement in any banking code of practice. [11]

. The EFT experience

20.23 Compared with the rest of the world, Australia has had a relatively extensive experience of the use of codes in banking. This experience occurred in the ten year development of the code on Electronic Funds Transfer Systems.

20.24 The development of the current EFT code involved the Treasury, the *Reserve Bank, the Commonwealth Attorney-General's Department, the Department* of Prime Minister and Cabinet, the Trade Practices Commission, State Consumer Affairs Departments, industry bodies and consumer groups.

20.25 Initially the financial institutions resisted the development of a code, saying there were few problems with the use of plastic cards and most of the small number of complaints related to misuse by customers. In the past, banks generally had a belief their systems were infallible. Their internal complaint handling systems for EFT operated on this belief. Complaints about unauthorised transactions or machine malfunction were more often than not thought to involve fraud or theft.

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7 Evidence, pp. 3101 - 3102.

8 Evidence, p. 1891.

9 Evidence, p. 1893.

10 Evidence, p. 1925.

11 Evidence, p. 3497.

20.26 Following government and community concern about the new technology, a Commonwealth working group of government agencies was established. It made four initial recommendations to industry in October 1985.

20.27 Subsequently, the working group was expanded to include state government representatives and consulted with industry bodies. It produced a Second Report setting out more detailed 'Recommended Procedures to Govern the Relationship Between Users and Providers of Electronic Funds Transfer Systems' in 1986. This was the first EFT code. It was not legally binding.

20.28 In 1988, following fairly constant consumer complaint, the Trade Practices Commission issued a paper assessing the code's effectiveness. The paper identified several weaknesses, including the ambiguous wording of the code and a failure to monitor its implementation. The TPC concluded that implementation was far from satisfactory as there were widespread instances of contractual terms not according with the code, of unclear dispute resolution procedures and a lack of appropriate penalties for non-compliance.

20.29 Subsequent reports by the Working Party and then the Treasury and Trade Practices Commission to the Standing Committee of Consumer Affairs Ministers (July 1989) reiterated the problems.

20.30 Tripartite negotiations conducted by the Trade Practices Commission involving government, industry and consumer groups led to the release of a new code in December 1989. That code remains in place.

20.31 In contrast to earlier versions the current code is:

- comprehensive, detailed and clear in its terms;
- monitored in a detailed fashion both as to implementation and the level of disputes. This is done by the Australian Payment Systems Council;
- legally enforceable in that each individual EFT contract a bank enters with a customer includes a term whereby the bank gives a contractual undertaking to comply with the Code; and
- provides in a detailed way for the handling of disputes.

20.32 The first report of the Australian Payments System Council in its monitoring role indicated a high level of compliance and the code appears to have a high degree of acceptance amongst customers and consumer groups.

20.33 Whilst the result is impressive, the process of development of the code was resource intensive. This is indicated by the number of reports issued and the number of regulatory agencies involved. It is hoped in the development of a code of good banking practice the lessons from the EFT experience can be relied upon without the need to repeat the entire process.

20.34 The following lessons can be drawn from the experience of developing the EFT Code:

- codes should be developed by a consultative process involving industry, government and consumers;
- codes should be reviewed regularly, perhaps every two years;
- codes should be monitored by a particular agency charged with that responsibility; and
- the terms and conditions of codes should be enforceable as a matter of contract law.
- Codification Overseas

20.35 Other countries have taken varying approaches to the issue of codification of banking law and practice.

20.36 In England, the Committee appointed jointly by the government and the Bank of England to review banking services law and practice (the 'Jack Committee') made two recommendations on banking law and practice. The first was the enactment of a Banking Services Act to implement 18 proposed changes or clarifications to banking law. The second was that the industry be given a limited period to develop a 'code of best banking practice' to be used by the proposed Ombudsman in determining disputes. The Committee proposed that the Government issue a formal code with statutory backing if the industry code was not satisfactory in its term, or not fully implemented or observed. The Committee made 26 specific recommendations about improved standards of bank practice that should be dealt with in the code and appended to their report a draft code.[12] However, following the subsequent UK White Paper, these recommendations were reduced to a proposal for a code of banking practice developed by the industry.[13] The draft code developed as a result has been severely criticised.

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12 'Banking Services: Law and Practice Report by the Review Committee,' Chairman: Professor R B Jack, CBA, Her Majesty's Stationery Office, London. February, 1989. A proportion of these related to EFT where, unlike Australia, the United Kingdom has no code.

13 Banking Services Law and Practice Cth 1026.

20.37 Similarly, many in New Zealand consider that the draft code prepared by the New Zealand Bankers Association is not adequate. National Australia Bank representatives commented that the New Zealand code did not go far enough but might provide a starting point. [14]

20.38 An alternate approach to achieving some of the objects of codes of conduct - clear and fair contract terms - has been developed in Israel and now adopted elsewhere. The approach is based on legislation which allows unfair contract terms to be dealt with in the abstract rather than in specific disputes between bank and customer. All European Community member countries now have such legislation in force or under consideration. The basic feature of such legislation is a two tiered mechanism whereby provision is made for consumer interests to be represented by a public or private body in negotiations with suppliers or their organisations to achieve agreed fair standard contractual terms. In some countries public resources are committed to providing a secretariat function in the negotiations. At the second level is a court or court-like agency with power to order a supplier to cease using particular contract terms. The existence of the second level is considered essential for the effective conduct of negotiations at the first level.

20.39 In the United States, the concept of 'truth-in-lending' underpins consumer credit legislation. The intent of the legislation is to achieve a fairer marketplace through full disclosure, so that lending transactions are carried out on a basis of 'truth.' The principle is now being extended in the US to cover borrowing.

Conclusion

20.40 The Committee accepts the view advanced in the preponderance of submissions that codification of banking law and practice is desirable.

20.41 In forming its view on these issues, the Committee has examined the need for codes in the light of the perceived deficiencies in the present position. In recommending codification the Committee's goal is to have banking services provided on terms which are fair to both parties, which are accessible and known to them, and which provide a clear basis for resolving disputes which arise.

20.42 In addition, both the contents of the EFT Code and the experience in its development have provided some indications of the essential elements for the development of an adequate system. Market forces are not of themselves sufficient to ensure that bank services are delivered on fair and equitable terms. It is not appropriate for banks to have exclusive responsibility for setting standards of banking practice. The thinking of the Committee echoes that of the Jack Committee review:

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14 Evidence, p. 2357.

> Historically the developing of standards of best banking practice has been the sole prerogative of banks. It has been argued in this Report that approach is no longer entirely appropriate: competition, while increasing, cannot be relied upon to secure, by itself, the improved standards for which we see a need. While banks must continue to have a major say in the development of standards of best practice, there is also a legitimate public interest in those standards, which should be reflected in some objective assessment of their adequacy.[15]

20.43 The Committee has determined that the consumer groups' recommendation that all of banking law be codified in statute is not appropriate. Whilst clarification of the law is desirable, the size of that task would greatly delay the necessary reforms and may result in the law becoming overly rigid at a time when the pace of technological and market change necessitates adaptability.

20.44 The Committee has determined that a better overall approach would be to proceed by way of a voluntary code incorporating the lessons set out in paragraph 21.36 of this Report. The Committee considers that codification of banking practice will provide certainty in many areas of current ambiguity. It can foster transparency in two ways: the existence of a code will provide a single source of information for a customer or his or her adviser to refer to; more significantly any code will include provisions designed to ensure that customers are adequately informed of the full details of the products they are about to use. The process of negotiating a code between the banking industry, government and consumer organisations will provide an opportunity to ensure that all its provisions are fair.

20.45 In a number of areas the Committee believes desirable industry standards should be set, rather than existing standards re-stated. Whilst standards developed in the marketplace should be given great weight in this process, one of the virtues of a code is that it can address matters not sufficiently subject to competition.

20.46 However, the Committee acknowledges that, in respect of a number of distinct issues, a voluntary code may not be sufficient to overcome impediments to change in the existing common law or statute law. Such issues include:

- the right of appropriation between accounts;
- the restrictions placed by the Privacy Act 1988 on the ability of banks to provide information to intending guarantors (a matter which is specifically discussed later in this Report); and

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15 Jack Report, p. 146.

- the banker's duty of confidentiality and any exceptions thereto.

20.47 Accordingly, the Committee proposes that, in a joint project, the Trade Practices Commission supervise the development of a code of banking practice and the Australian Law Reform Commission examine banking law. The ALRC should develop appropriate legislative proposals to deal with those areas of banking law which cannot be dealt with by a code but which require clarification or change and make recommendations as to other changes to the law necessary to facilitate the development of the voluntary code.

20.48 The Committee considers the Australian Law Reform Commission is a suitable body to undertake the task. The ALRC should examine and report on those matters which involve clarifications of, or modifications to, existing law. These include the right of appropriation between accounts and disclosure to guarantors. The ALRC should exclude from its consideration those aspects of the banker-customer relationship that would more appropriately be included in a code of banking practice. The ALRC should consult widely with industry bodies, regulatory authorities and consumer groups in developing legislation.

20.49 The Committee is of the view that a joint project would be the most appropriate way to proceed. Both the ALRC, with its experience in analysing the law, developing proposals for reform and modernisation and drafting legislation, and the TPC, with its history of developing and administering codes, have expertise which would be of immediate relevance to the task at hand.

20.50 The code should be developed through a process of negotiation between industry, consumer groups and regulatory authorities, the implementation of which is then monitored by an appropriate Commonwealth regulatory authority. That agency should preferably be the TPC. It would be renegotiated periodically to take into account technological or other changes which render it inappropriate in some way.

Recommendations

20.51 **The Committee recommends that:**

75. the Australian Law Reform Commission be requested to conduct a review of the law of banker and customer, involving consultation with industry, regulatory authorities and consumer groups. In cases where statutory change is required the ALRC should draft recommendations for appropriate legislation; and

76. **a code of banking practice, contractually enforceable by bank customers and subject to ongoing monitoring by the Trade Practices Commission, be developed as a result of a process of consultation between the banking industry, consumer organisations, Commonwealth regulatory agencies and relevant State government authorities. The consultative process should take place under the auspices of the Trade Practices Commission. *Monitoring should have regard to the degree of* compliance with the code and to the ongoing appropriateness of the provisions of the code in the light of changing circumstances.**

Regulatory authorities

20.52 No single Commonwealth regulatory agency has the full expertise in, and responsibility for, consumer banking issues. Such a role would involve:

- *complaints monitoring;*
- participation in code development and implementation;
- consumer policy;
- research;
- data collection and analysis; and
- public information.

Aspects of these roles are undertaken by differing regulatory authorities, with the TPC having the primary responsibility.

20.53 Consumer groups considered, given the desire and resources, the Reserve Bank could develop sufficient expertise to deal with consumer issues. The Reserve Bank through the Australian Payments System Council now has a role in the monitoring of the EFT Code.

20.54 As a result of discussions in the USA, the Committee is aware of the US Federal Reserve's involvement in consumer issues. The US Federal Reserve fulfils its responsibilities in the regulation and monitoring of consumer financial services through its division of Consumer and Community Affairs, which is advised by a Consumer Advisory Council. It ensures that all state chartered member banks of the Federal Reserve System comply with the Consumer Credit Protection Act and associated legislation such as the Equal Credit Opportunity Act, the Consumer Leasing Act, the Electronic Funds Transfer Act and the Fair Credit Reporting Act. It also collects and makes public, on a six-monthly basis, information from a range

of financial institutions. The Consumer Advisory Council advises the board on the exercise of its statutory authority, on the need for and development of consumer related regulations and on issues arising related to deregulation. The Council meets three times per year.

20.55 However, the Reserve Bank of Australia expressed the view that it did not wish to adopt a role similar to that of its US counterpart. It considered the extensive consumer role of the US Federal Reserve as a product of circumstances which did not prevail in Australia. These circumstances included the difficulty of achieving reasonable consistency across a large number of States and the very large number of financial institutions in the US. The Reserve Bank also argued that the addition of formal responsibility in consumer matters to its already extensive areas of activity may detract from its overall efficiency and increase the potential for conflicts to develop amongst its objectives. Further, it would result in bank transactions being regulated separately from other consumer transactions, whereas a specialist consumer affairs agency could deal with them equally. Finally, it considered its present reservoir of skill and experience would not be adequate for the task.[16]

20.56 A general difficulty in allocating responsibility to a Commonwealth agency is that none of the existing agencies has an extensive complaints handling facility. Historically, complaints have been dealt with by state bureaux of Consumer Affairs. A database of consumer complaints (The National Consumer Complaints Statistical System, NCCSS) is maintained by the state bureaux.[17] Officers of the Attorney-General's Department advised that having accurately collected, maintained and analysed complaints data is of fundamental importance.[18]

20.57 The Trade Practices Commission is in the process of resurrecting the national complaints system. The existence of the database and access to the Ombudsman's analysis of complaints made to him may overcome the lack of a separate intake point for complaints at the Commonwealth level. The Ombudsman's Office, whilst having a major complaint handling role, does not have extensive policy functions and the Ombudsman stated he did not consider it appropriate for him to have a central role in the generation of a code of practice.

20.58 The Trade Practices Commission expressed an interest in being involved in consumer issues. The TPC already has a significant role in banking consumer affairs, for example in the EFT code, guarantors, and consumer credit insurance in addition to its central role in consumer protection and the regulation of competitive activity at the Commonwealth level.

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16 Evidence, p. 649.

17 Evidence, p. S1731.

18 Evidence, p. 1919.

20.59 As well as the Trade Practices Commission, the Federal Bureau of Consumer Affairs in Attorney-General's Department has policy responsibility for the consumer protection and related provisions of the Trade Practices Act, and for consumer interests generally and has had considerable involvement in recent years in issues relating to financial services.

Conclusion

20.60 The Committee recognises the value in having one agency at the Commonwealth level with the primary responsibility in relation to consumer banking issues.

20.61 The Committee considers the Trade Practices Commission is best placed to take responsibility for consumer banking issues including the ongoing monitoring of a code of banking practice. Whilst the TPC does not have existing channels of communication with the banks to the same degree as the Reserve Bank, it has dealt with them, is experienced in code development and monitoring, has contact with the consumer movement and has relevant powers and responsibilities under the Trade Practices Act.

Recommendation

20.62 **The Committee recommends that:**

77. **The Trade Practices Commission be given formal responsibility for overseeing consumer banking issues at the Commonwealth level including the monitoring of the recommended code of banking practice.**

Dispute resolution

20.63 The area of dispute resolution is one on which many submissions placed special focus. There have been recent positive industry initiatives including the development of the Banking Ombudsman and increased focus by banks on effective complaint handling. However, many submissions expressed the difficulties customers, particularly consumers and small businesses, experience in seeking to contest a bank's action, decision or calculation.

20.64 Consumer groups submissions emphasised the significant power imbalances which exist between banks and many of their customers. These power imbalances are particularly important when a dispute arises between a customer and a bank. Some of the manifestations of these imbalances for consumers seeking redress include that:

- the banks control nearly all relevant information and documentation;

- banks have access to specialist advice and legal assistance and resources to pursue disputes to the end, whereas customers, particularly poorer customers, do not;

- banks tend to have inherent faith in their internal operating systems and bankers may be reluctant to admit failures in those systems;

- in many cases the bank's interest in resisting any claim outweighs that of an individual customer in pressing it, in that the bank is protecting its system whereas the customer is seeking redress on a one-off basis;

- because banks know they can outlast most customers, both in terms of will and resources, there is often little incentive for banks to settle a dispute, even if the bank would be likely to lose any eventual case; and

- in matters which are litigated the bank, as a repeat player, is in a position to select a particular matter to run to a hearing in order to obtain a favourable precedent.[19]

20.65 Until recently, the only recourse for aggrieved customers was the courts. In practice, however, seeking relief through the courts is not a feasible option for most consumers. Often the amount in contention will be significantly less than the likely legal costs, even where the consumer could afford to take such action. In most States and Territories, access to legal aid is tightly restricted and is not generally available for disputes involving amounts less than $1,000. Thus legal fees ensure that, for the vast majority of consumers, legal action is beyond their resources. As Sir Ninian Stephen put it: 'The Chief Justice of a State said to me just the other day that on his salary he could not possibly afford to litigate in his own court'.[20]

20.66 In addition, because of time delays involved in court proceedings, even if customers could afford legal action, they might have to wait a number of years before their matter would be heard. For those few consumers who do in fact take the banks to court, the superior resources of a bank can be used to delay the case for years and/or to place further financial strain on the consumer litigant by appealing unfavourable decisions.

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19 Evidence, p. S1639.

20 Evidence, p. 1887.

20.67 There is a need for cheap, speedy, fair and accessible alternatives to the traditional court system if customers are to receive justice in their dealings with the banks. As the Australian Law Reform Commission has stated in another context:

> It is a fundamental principle of access and equity that all individuals should be equally able to exercise their rights under the law. Cost or other barriers which unfairly
>
> disadvantage a person or group in gaining access to a particular kind of remedy should be overcome so far as is practicable.[21]

Mechanisms to avoid disputes

20.68 Many disputes can be avoided by reform of procedures and practices which give rise to them. The Banking Ombudsman noted 'the biggest problem facing the banks is their relationship with their customers in terms of communication breakdown'.[22] The Committee agrees with the Ombudsman's prescription that improving communications between banks and their customers will help to avoid potential disputes.

20.69 Many disputes arise because customers are unaware of their rights and obligations under banking contracts. This is inevitable given the opaque language used in many official banking documents, their length and the tendency to rely upon unspecified 'usual banking practice'. The Committee elsewhere recommends that all banks make a concerted effort to progressively convert all of their banking contracts into 'plain English'.

20.70 Greater disclosure of terms and conditions of contracts would do much to clarify the position of customers and banks where disputes arise and greatly assist in avoiding, or speedily resolving, many potential disputes. These matters will be dealt with in the code of banking practice. The enhanced disclosure provisions of the proposed uniform consumer credit legislation should ensure there are far fewer disputes relating to the terms and conditions of consumer loans. The Committee supports the 'truth in lending' principles contained in the draft legislation and would strongly encourage banks to apply the same 'truth in lending' principles in their credit dealings with small businesses and farmers.

20.71 One of the frustrations of those who seek to improve the transparency of consumer dealings is the realisation that even when plain English information is available consumers will often fail to read it, particularly if it is lengthy. The Australian Law Reform Commission, in the context of its reference on multiculturalism, has tentatively recommended that 'legislation should provide that the credit provider must give the consumer a short plain English summary of the

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21 ALRC Multiculturalism and dispute resolution, Discussion Paper 49, p. 46.

22 Evidence, p. 1872.

main terms of the contract'.[23] This suggestion is similar to the Banking Ombudsman's proposal that, in addition to explanation given in interviews when a loan is taken out, a simple form letter be sent from all banks to borrowers confirming and explaining basic terms of the agreement. Plain English summaries, which are available prior to entering into an agreement, should be encouraged in respect of all consumer contracts.

20.72 Thorough staff training about all of a bank's products and practices is essential if staff are to be able to provide customers with accurate and appropriate advice and service and thus avoid future disputes. All banks would appear to carry out extensive staff training, nevertheless the combination of diversification of bank products and significant numbers of part time staff mean it is inevitable there will be gaps in staff knowledge. The Committee is supportive of banks providing ongoing training and support materials for staff about all of their products and practices, including their internal dispute resolution procedures.

20.73 While there have been many important initiatives taken by banks in recent years in terms of the provision of information for consumers and staff training, the benefits of these improvements are not equally distributed. As surveys about EFT dispute resolution brochures and Ombudsman brochures have shown, their availability and staff knowledge of their existence vary dramatically from branch to branch.

Recommendation

20.74 **The Committee recommends that:**

78. all banks adopt a system of regular audits of all branches. Such audits should be designed to, amongst other things, check the availability of information to customers, the ability of staff to answer questions about products and bank practices and the courtesy of staff.

Banking Ombudsman Scheme

. The need for the Scheme

20.75 The Australian Banking Industry Ombudsman Scheme was an initiative of the banking industry, undertaken in consultation with government and consumer organisations. Its establishment in May 1989 was a recognition by major banks of the need to improve their service and public image. The Scheme was created to provide individual customers of member banks with access to an independent avenue of redress when they had a complaint about one of those banks.

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23 ALRC Discussion Paper 49, p. 13.

20.76 The reasons for developing the Scheme were the high cost of litigation, the inability of the average customer to contest matters in courts against a bank and the inadequate in-house dispute resolution mechanisms of banks.

20.77 In developing procedures to secure independence, the Ombudsman's office relied on the experiences of judicial administration for both case management and alternative dispute resolution. The Ombudsman couples investigative and determinative powers to award compensation. In resolving disputes he adopts the more innovative practices of alternative dispute resolution rather than the more formal evidentiary processes of the court system or the formal interview process of parliamentary ombudsmen. The processes of mediation, conciliation, negotiation and arbitration have been identified as working particularly well in situations where the disputing parties need to re-establish relationships. They also work well where parties can neither afford the time nor cost of a court's formal adversarial processes but need a forum to clarify information. Most importantly, they provide the opportunities for parties to reach their own solutions and settle matters amicably.

20.78 The Ombudsman considered that banker-customer complaints were ideally suited to this type of dispute resolution mechanism. Essentially, the banker-customer relationship is a relationship of trust. That trust is placed at risk when a complaint remains unresolved. The Ombudsman's office empowers the customer by placing him or her on a more equal footing to negotiate with the banks. Convenience and speed are essential. From the banker's perspective there was a recognition that some complaints developed beyond a stage where either party could resolve them.

20.79 The introduction of the Scheme represented more than just a free service offered by the banks. The basis on which disputes were to be resolved has been expanded. Importantly, the resolution of disputes is reached not only by reference to the law, but also to good banking practice and fairness in all the circumstances.

20.80 The inclusion of reference to good banking practice and fairness are significant steps in recognising the quality of service to bank users. As part of a more complete dispute resolution process banks have also moved towards establishing their own internal complaint handling divisions, the commencement of the collection of detailed data arising from consumer complaints and the feeding of that data into their long term planning.

Operation of the Scheme

20.81 The Australian Banking Industry Ombudsman Scheme commenced on 18 June 1990 to provide an independent mechanism for the resolution of banker/customer disputes. It is self-regulating, offering a free service to customers. It is the first and only such scheme operating on an industry-wide basis in Australia and is modelled on a comparable scheme operating in the United Kingdom.

20.82 The independence of the scheme provides that the Ombudsman:

- has the final power to determine whether a matter falls within his Terms of Reference;

- has determinative power to make an award up to $100,000, which if accepted by the customer, becomes binding on the bank;

- can determine the procedures of his office in considering disputes and accepting referrals;

- can, with the consent of the customer, obtain the bank file of the customer or bank-held information relating to the dispute; and

- can determine what is 'fair in all the circumstances' with reference to the law, principles of good banking practice or codes of practice.

20.83 The Scheme emerged from an agreement between 17 banks. Currently there are only two retail banks which do not take part in the Scheme; the Bank of Queensland and Trust Bank. Current membership of the Scheme is at Appendix 11.

20.84 As a company limited by guarantee, the Scheme has a Board consisting of senior bankers and a representative of the Reserve Bank. It is funded by the participating banks with each bank contributing to the maintenance of the Scheme according to the number of its disputes pursued with the Ombudsman.

20.85 Positioned between the banks and the Ombudsman Board is the Ombudsman Council which consists of three banking representatives, three consumer representatives and chaired by an independent chairperson (at present Sir Ninian Stephen. The functions of the Council are to appoint and fund the Ombudsman. The Ombudsman reports annually to the Council with the first annual report published in November 1991.

20.86 As specified in his terms of reference, the Ombudsman can not deal with matters arising out of disputes with companies associated with banks, for example the finance company arms of banks (unless nominated for inclusion by the parent bank).

20.87 The Ombudsman is an office of last resort. Consumers must first attempt to resolve their complaints at a senior level of the bank. Disputes remaining unresolved can be taken up with the Ombudsman. An upper limit of $100,000 applies for loss incurred. The relatively low limit was established initially with the banks able to review the upper threshold after the Scheme had been operating for some time.

20.88 The Ombudsman's decisions are binding on banks but not on applicants. When a matter is not resolved after reference to the bank the Ombudsman calls a conciliation conference and acts as an independent third party. Applicants may come in person or be represented.

20.89 The Ombudsman has ensured that all participating banks display his pamphlets advising of the office's existence. The pamphlets have been designed to complement the internal dispute resolution procedures developed by banks.

. Assessment of the Scheme

20.90 The Ombudsman's Office received 2626 written and approximately 26,000 telephone complaints to end of June 1991. The Scheme cost $1.37 million from 1 April 1990 until 31 March 1991.

20.91 Complaints revealed in the Ombudsman's first annual report showed that the areas of greatest cause for disputation fell under the following broad headings:

- housing finance - 22.6%;
- consumer finance - 17.4%;
- business finance - 13.4%;
- payment systems - 11.7%;
- other products - 6.9%;

20.92 These figures not surprisingly show housing and consumer finance as the two most significant areas of dispute. However, it is important to look more closely into the detail of disputes between bank customers not just the type of product.

20.93 The Ombudsman reported that consumers were dissatisfied with three main areas of banking practice: bank error (the greatest problem at 24 per cent); misinformation, incorrect information and non-disclosure (16 per cent); and unfair assessment of decision (13 per cent).

20.94 Consumer groups indicated the scheme was successful, given its limitations. They said there was a perception consumers can go to the Ombudsman and get a fair deal.[24]

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24 Evidence, p. 3006.

20.95 In the short time the Scheme has been operating, positive signs the banks are changing their attitude towards consumer disputes has been observed by the Ombudsman. There has been a change in bank culture. Previously the banks' attitude often was that consumers should resolve disputes through the courts. Since the introduction of the Scheme banks have made specific personnel appointments to deal with consumer complaints to prevent them coming to the attention of the Ombudsman's office.[25]

Jurisdiction

20.96 Three main aspects of the Ombudsman's terms of reference limit the jurisdiction of the scheme and have attracted some dissatisfaction in complaints made to the Committee. These are: the exclusion of incorporated bodies; the upper limit of $100,000; and the time restriction limiting disputes to those that have arisen since 10 May 1989. The Ombudsman's first annual report recorded levels of complaints against these three factors as being 8.3 per cent, 0.9 per cent and 6.4 per cent respectively of total cases.

20.97 Two additional categories of complaint determined to be outside the terms of reference of the Ombudsman are the non-business guarantor of business loans and the exclusion of bank subsidiaries.

20.98 Consumer groups favoured the expansion of the Scheme to cover non-business guarantors of business loans. They also favour extending the scheme to give the Ombudsman jurisdiction over products sold by banks, such as insurance.

20.99 However, consumer groups did not favour extending the terms of reference to small business and farmers, for two reasons. First, the nature of their complaints would be more complicated and the individuals involved could more readily protect themselves than could small consumers. Second, the cost of extending the scheme would be increased potentially militating against the average consumer. The Ombudsman would be hearing complaints from a greater number of people and the complaints would be more complex and require the allocation of more resources.[26]

20.100 The National Farmers' Federation said as a matter of principle it was in favour of some impartial form of appeal. However, it did not express a view on the extension of the terms of reference of the Scheme to cover farmers.[27]

20.101 Of the major banks, ANZ Bank said that it was not opposed to the extension of the scheme to cover small business and farmers but cautioned about moving away from the legal system built up over many years.[28] NAB said it was

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25 Evidence, p. 1875.

26 Evidence, p. 3007.

27 Evidence, p. 1864.

28 Evidence, p. 2303.

still a new scheme and it would like it to have more time to bed down before the terms of reference were altered to include commercial matters.[29] The Commonwealth Bank was non-committal about any changes to the scheme without seeing details of why the changes would be made.[30]

20.102 The Ombudsman recognised the value of extending the scheme to increase the upper limit and include proprietary companies. However, he noted this would make the Scheme more expensive. It also would require support from the banks who funded the Scheme.[31]

20.103 The Ombudsman also favoured extending the scheme to non-bank financial intermediaries. He said credit unions had appointed an ombudsman to look at automatic teller machine disputes. The building societies have approached him to enquire whether their automatic teller machine disputes could come under his jurisdiction.

20.104 Credit unions and building societies were asked some time ago to join the scheme but have not made a decision. The Ombudsman recognised the merit in NBFIs belonging to the existing banking scheme, rather than having several ombudsmen as is the case in the UK.[32]

20.105 Mr Francis Galbally submitted that the Scheme be extended by an Act of Parliament to increase its jurisdiction and powers. He considered the Commonwealth Government should administer and fund such a scheme to avoid any appearance of conflict of interest arising from the Scheme being funded by banks.

20.106 He proposed that:

- there be an increase in the monetary jurisdiction of the Scheme and that proprietary companies be included;
- there be no ceiling on the amount of any award;
- customers be allowed to choose whether to be legally represented, but banks not be able to be legally represented; and
- customers be able to choose the courts or the Ombudsman, but if they choose the Ombudsman they give up any remedy in the courts.

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29 Evidence, p. 2351.

30 Evidence, p. 3678.

31 Evidence, p. 1888.

32 Evidence, pp. 1889 and 1901.

Conclusion

20.107 The Committee is impressed with the effectiveness of the Scheme after such a short time of operation. However, it has some concerns about its long term viability. Banks may not wish to continue to support the Scheme in its present form.

20.108 The Scheme's terms of reference are central to its long term survival. Those terms and the question of costs are linked. If the terms of reference are extended to include commercial matters and the monetary threshold is raised the scheme will become much more expensive to operate. If it becomes more expensive to operate, banks may not be prepared to continue funding.

20.109 The Committee considers that the inclusion of commercial matters and an increase in the monetary threshold of the Banking Ombudsman Scheme should be considered by banks. This could be done by raising the threshold to $200,000 and including small proprietary companies.

20.110 The Ombudsman's figures show that the upper threshold has not restricted the use of the Scheme significantly. It would remain to be seen whether the inclusion of small commercial matters up to a maximum of $200,000 would add substantially to costs of the Scheme.

20.111 The Committee does not support the Commonwealth Government becoming involved in what has been a successful self-regulating process. The Scheme is still in its infancy and should be given more time 'to bed down' (to use NAB's words). However, the Committee would be deeply concerned if the Scheme was threatened in any way because it was seen by some banks or bank management as being too successful by focussing on banks' shortcomings.

20.112 The Committee would like the Scheme to operate for another year before a further review is made. However, if it is then clear the Scheme is not providing a real alternative to the court system and not delivering fairer banking services then other options should be considered. This could involve establishing a Scheme similar to the small claims tribunals with higher limits and devoted specifically to banking or financial services matters. This is an issue the Committee will keep under active scrutiny.

20.113 The Committee favours the establishment of an ombudsman eventually to cover the whole financial services industry and considers processes should be established now to investigate this proposal.

Recommendation

20.114 **The Committee recommends that:**

79. participating banks in the Australian Banking Ombudsman Scheme should increase the monetary threshold to $200,000 and remove the exclusions relating to small proprietary companies. The threshold should be kept under review.

80. a proposal eventually to establish an ombudsman to cover the whole financial services industry should be investigated by this Committee. In terms of development, such a scheme should give priority to ensuring access by consumers of retail or consumer products and services of all financial institutions, rather than, in the first instance, to incorporated entities.

Enhanced representative actions

20.115 Some of the problems associated with litigation have already been adverted to. Consumers will not litigate unless they have sufficient resources and a perception the amount of gain will exceed likely costs. Where the alternative dispute resolution procedures discussed in this section are not able to provide a remedy for aggrieved consumers, or are inappropriate to the nature of the dispute, there is a need to allow groups with a common legal claim better and cheaper access to the Courts.

20.116 Recently the Federal Government introduced the *Federal Court Of Australia Amendment Bill 1991*. With the passage of this Bill it will be possible for those customers with a common dispute, which falls within the jurisdiction of the Federal Court of Australia, to collectively assert their rights effectively and economically.

20.117 The Committee supports the concept of improved access to the courts through enhanced representative actions and recommends that all jurisdictions reform their Court procedure rules to allow such actions.

Internal dispute resolution

20.118 The sooner and easier disputes can be fairly resolved the better. Although access to external dispute resolution mechanisms is essential, it is always preferable for a banking dispute to be quickly, effectively and fairly resolved at branch level.

20.119 This is recognised in the procedures adopted by the Ombudsman Scheme, which require that a customer must first have taken up his or her complaint with the relevant Bank before the Banking Ombudsman will consider it. Clearly, internal dispute resolution procedures are not working properly because evidence of the Banking Ombudsman indicates most complainants come directly to

him and have not previously been dealt with internally. It would appear that internal systems are inadequate and/or there is a lack of confidence in them or knowledge about them.

20.120 The Committee has not surveyed the internal dispute resolution schemes employed by the banks. Evidence suggests, however, that while the major banks have all put an increased emphasis on internal dispute resolution procedures in recent times, standards vary considerably both between banks and between branches.

Conclusion

20.121 Banks have a vested interest in improving both their communications with customers and their internal dispute resolution procedures. Such initiatives make for better customer relations and, because the Banking Ombudsman Scheme is to be paid for by the banks on a user pays basis, provide a financial incentive to have disputes resolved internally.

20.122 To date, it has been a matter for each bank to develop its own internal dispute resolution mechanism and undoubtedly there are commercial advantages to be gained by the bank which best satisfies this important area of customer service.

20.123 However, the Committee believes that there are certain minimum standards which all bank internal dispute resolution schemes should satisfy. The matters that need attention are:

- the need for all complaints (other than those dealt with instantly over the counter at the time they arose and to the customer's satisfaction) to be recorded;
- a clear point of entry for a complainant seeking to have a dispute considered;
- clear steps which are readily accessible;
- clearly defined lines of responsibility, with each level of staff knowing the bounds of their discretion in resolving disputes;
- speedy timeliness for resolving disputes;
- the need for the customer to be given reasons for the Bank's decision;
- the need for customers to have access to all relevant documentation; and

the need for information about the Bank's internal dispute resolution procedures, the steps involved and how to access them to be readily available in brochure form and appropriately displayed at all branches of the Bank. In areas with high migrant populations, such brochures should be available in the dominant community languages. The brochure might also include information on external avenues of review, including the Australian Banking Industry Ombudsman Scheme.[33]

Recommendation

20.124 **The Committee recommends that:**

81. **the development of comprehensive procedures for resolving complaints and disputes be considered in the development of the code of banking practice. Banks should ensure that all staff are familiar with the bank's policies and procedures relating to all aspects of dispute resolution. In doing this, banks should ensure that these policies and procedures are clearly set out in staff manuals and are incorporated into both initial training programs and refresher programs. The issues identified in paragraph 20.123 above should be included in the development of internal dispute resolution procedures.**

Initiatives needed to be taken by governments

20.125 Governments also have a role to play in ensuring that consumers rights as regards banks are sufficiently protected and ensuring that have access to adequate, fair and accessible dispute resolution procedures. There are a number of initiatives which Governments should take to assist in redressing the power balance which exists between customers and their banks when a dispute arises.

20.126 The protection to be provided in the uniform Consumer Credit legislation will be of little use to consumers unless they have an easily accessible forum in which to claim it. All states except Queensland, the Northern Territory and Tasmania have established specialist tribunals/courts to oversee the enforcement of existing state credit legislation. These tribunals have the advantage of being specialised in a complex area of the law, cheap and accessible. It is essential if the proposed legislation is to truly protect consumers in their transactions then all jurisdictions must establish such tribunals.

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33 The Committee has drawn heavily on the CAFCA 1990 report, which was tendered to the Committee as 'Banking on a Problem', in preparing this list of minimum standards.

20.127 Because of the advantages tribunals have over traditional courts, governments should consider vesting them with jurisdiction wherever legislation creates rights for consumers in respect of banks and other financial institutions. The Committee recognises that where such legislation is Commonwealth legislation there may be Constitutional problems which prevent the implementation of this recommendation.

20.128 Independent financial counselling services have been established in all states and territories for many years. Financial counsellors are to be distinguished from financial planners. Financial counsellors provide low income and disadvantaged customers with free advice, assistance and advocacy in respect of their credit, debt and banking problems. This role is often beneficial to banks and other credit providers because, in helping customers to budget and renegotiate loans, they assist in reducing the liability of banks to bad debts. Funding of financial counselling services can save government expenditure in the Courts (through lower levels of debt collection litigation) and through lower levels of family breakdown caused by debt.

20.129 At present there is both State and Commonwealth funding for financial counselling. The levels of funding, however, vary significantly both between and within jurisdictions. Waiting lists are often lengthy and there are not enough financial counsellors to meet demand.

Conclusion

20.130 The Committee concludes that there are a number of measures that could be taken by banks and government to facilitate the avoidance and resolution of disputes between banks and their customers. As the Attorney-General's Department noted in its submission to the Committee, improved dispute resolution/avoidance mechanisms lead to:

- increased consumer confidence and therefore likely increased market participation;
- enhanced image of suppliers;
- more informed consumers;
- lower dispute resolution costs for consumers and suppliers;
- reduced pressure for government intervention; and
- improved communication between suppliers and consumers.[34]

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[34] Evidence, p. S1740.

The implementation of the suggestions made in this section will benefit all players in the banking system.

Recommendation

20.131 **The Committee recommends that:**

82. State and Territory governments establish credit tribunals in each jurisdiction; and

83. all governments increase funding for independent financial counselling services, as a means of enhancing early resolution of disputes.

Banks' Duty of Confidentiality

20.132 In the UK, the Jack Committee noted four main objectives to which priority should be given. One of those was to preserve and consolidate the banker's duty of confidentiality to the customer.[35]

20.133 A combination of the increasing use of electronic funds transfers and the increasing capacity for data collection and storage has given great importance to the obligation of bankers to maintain customer confidences.

The current law

20.134 The existence of a legal duty of confidentiality is well recognised. It is the extent of the limitations and exceptions placed upon the duty which give rise to confusion and controversy. The banks' duty of confidentiality was authoritatively set out in Tournier v National Provincial and Union Bank of England [1924] 1 KB 461. Although the customer enjoys a contractual duty of confidentiality on the part of his or her bank, there are four classes of case in which otherwise confidential information might be revealed to a third party.[36]

20.135 The first is by express or implied consent of the customer. 'Implied consent', or even express consent where that consent is by way of a clause buried in the small type of a document, is of doubtful validity at law. The purpose and likely import of such consent is rarely or never explained to customers. On the other hand, bank practices have grown up which are based upon the existence of an informed consent for their legitimacy.[37]

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35 Jack Report, Chapter 5: 'The Banker's Duty of Confidentiality'.

36 Evidence, p. 1646.

37 See Law Reform Commission Report No 22, *Privacy*, Vol 1, para 871.

20.136 The second is where it is 'in the interests of the bank' to do so. The 'interests of the bank' constitutes a particularly vague concept. Such interests may include, on the one hand, revelation of confidential information in proceedings against the customer for enforcement of obligations under the contract. On the other hand, the information may be used for direct marketing techniques which, the consumer groups suggested, may include unduly intrusive or oppressive conduct.

20.137 The third case is where there is a 'duty to the public' to disclose the information. This exception appears to be limited to matters of public emergency and the like, for example in times of war.

20.138 The fourth and final case is where disclosure is required under compulsion of law. This would include in response to a Court order or in compliance with a statute.

20.139 It is important to note that further protection for customers has resulted from the introduction of the *Privacy Amendment Act 1990.*

20.140 The 1990 Act regulates information relating to consumer credit which may be kept by a credit reporting agency, access to that information by financial and non-financial institutions and external use of that information. Banks are bound by the requirements of the code of conduct issued by the Privacy Commissioner in September 1991. Paragraph 2.16 of that code expressly provides as follows:

> A credit provider which is a bank may not disclose to another bank a 'banker's opinion' relating to an individual's consumer creditworthiness, unless that individual's specific agreement to the disclosure of such information for the particular purpose has been obtained.[38]

20.141 There are other detailed provisions regulating such disclosures between credit providers, including banks.

Threats to consumers' privacy

20.142 A number of areas of concern have been identified by the Inquiry:

- the uncertainty of the current law as expressed in the Tournier case;
- credit reporting information;
- access by banks to confidential information held by other agencies for use in debt collection;

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[38] 'Credit Reporting- Code of Conduct', paragraph 2.16.

- use of confidential information for marketing purposes; and

- the need to ensure the accuracy of information held

20.143 Consumer groups suggested that these concerns were heightened by an absence of sensitivity on the part of bank staff to appropriate restrictions on the use of confidential customer information and as to the fact that banks were capable of building up huge data bases not restricted to credit or financial information.

20.144 In response to the particular recommendations of the consumer groups, the ABA submitted that:

> A code of banking practice should be explicit about the banker's duty of confidentiality.[39]

20.145 Both the consumer groups and the ABA made submissions in relation to provision of information to potential guarantors, which have been dealt with specifically later in this chapter.

Uncertainty of the current law

20.146 It is generally accepted that the operation of the current law of confidentiality is somewhat vague, in particular that in the case of bankers' opinions, the law will usually imply the customer's consent from the mere fact that they have opened an account, regardless of any understanding on the part of the customer. Most customers would be surprised to be told that, in opening an account, they have given an implied authority to their bank to supply a reference to another bank at the request of a third party. They will not be told when any such inquiry is made nor the nature of their bank's response.

20.147 The Committee agrees with the UK Banking Ombudsman's conclusion that this situation is unacceptable.[40] Customers need to be informed that bank practice is to give and request bankers' opinions. Banks should not be able to give a reference without the customer's express and informed consent.

Credit reporting

20.148 The area of potential invasion of privacy that has received most attention in recent times is that of credit reporting. As noted by the Hon Senator Richardson, in his Second Reading Speech for the Privacy Amendment Bill 1991:

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39 Evidence, p. 2788.

40 L Shurman (UK Banking Ombudsman) 'A Fair Banking Code', Ernest Sykes Memorial Lecture 1991.

> The Australian Law Reform Commission's privacy report, which was tabled in this Parliament in late 1983, found that many members of the Australian community saw credit reporting agencies as posing a threat to privacy. A detailed public opinion poll carried out by the ALRC on attitudes to privacy ranked credit reporting agencies at the head of the list of potentially intrusive organisations.[41]

20.149 Banks themselves are involved in substantial data collection and credit reporting activities.

20.150 Questions of privacy in relation to credit information have been the subject of important innovations in Australia, including the development of a code of conduct promulgated by the Privacy Commissioner in September 1991 under the Privacy Act 1988. The Australian Bankers' Association, amongst many other groups, was involved in the consultation which led to that code of conduct.

Access by banks to confidential information held by other agencies for use in debt collection.

20.151 Evidence has been given recently in another inquiry of private inquiry agents engaged to collect debts on behalf banks obtaining confidential information from government departments by bribing public servants.[42] The Federal Privacy Commissioner has argued that:

> The ultimate responsibility for wiping out the practice of bribing public servants lies with those who engage the private investigators - banks, finance companies, insurance companies and the like. While they may see their needs - to locate defaulting debtors, for example_as justifying whatever steps are being taken to obtain relevant information, they should reconsider that attitude. By turning a blind eye to private investigators's activities, and paying well for the service rendered, they are creating an environment of disregard for the confidentiality of information held by government agencies.[43]

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41 Senate Hansard, 16 June 1989, p. 4216.

42 The NSW Independent Commission Against Corruption, Inquiry into Unauthorised Dissemination of Government Iformation.

43 Human Rights Australia, Privacy Commissioner, *Second Annual report on the Operation of the Privacy Act for the period 1 July 1989 to 30 June 1990,* p. 9.

Sharing of information with related companies

20.152 The UK Jack Committee drew attention to the 'public disquiet' at the increasing use of confidential customer information for marketing and other purposes. The UK Banking Ombudsman has expressed the view that it should not be permissible to pass on any personal information whatsoever even within the same group without the express consent of the customer. Given the increasing ties between banks and non-bank financial institutions, such as life offices, this could present significant problems in the future for consumers. Consent should be obtained in such a way that the customer's attitude is drawn to the consent that is being given and feels no pressure to give it.

20.153 Consumer groups submitted that banks should be forbidden from using customer information 'for marketing of non-banking services without the express and informed consent of customers'.[44] In response, the ABA argued that it was perfectly acceptable business practice to advise customers of other goods and services available.[45] It did not, in its submission in reply, specifically address the use of confidential information for such marketing purposes.

20.154 In the course of its overseas inquiries, the Committee became aware of the progress being made in Canada in relation to the establishment of a 'privacy code' which has involved both the Privacy Commissioner in that country and the Parliamentary Banking Committees. The Committee was informed that the question of sharing of information between subsidiary companies had not been addressed in the code, but was likely to be addressed by individual banks in their own codes of conduct, which were expected by the end of 1991.

Accuracy of information

20.155 Apart from misuse, there is a general and legitimate concern to maintain the accuracy of personal information in data bases. That concern can only be met by ensuring adequate access to the information on the part of the individual, and knowledge of the right to such access.

20.156 The Committee notes concerns regarding the accuracy of information held by credit reference bureaux were being expressed in the USA. The Committee was advised that errors were occurring simply from the pressure of keeping up with the volume of information available. Access by consumers to ensure accuracy was widely considered essential. In Australia consumers have ready access to information held by the major credit bureau. It is not clear that they are sufficiently aware of their right to such access.

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44 Evidence, p. S1648.

45 Evidence, p. S2788.

20.157 Apart from information held by credit bureaux, there is no general right of access to information held by private corporations on an individual. The Federal Privacy Act applies mainly to the Commonwealth public sector, to use of the tax file number and to credit reporting. The Committee notes that a number of countries including Ireland and the UK grant consumer's access to information held in computer records by private corporations.[46] The Committee believes that banks ought to be obliged to make information available to the subject of that information in the same way as a government department.

Conclusion

20.158 There is a demonstrated need for modernisation and clarification of the law relating to the banker's duty of confidentiality. Although banks now possess major data bases, they are not fully subject to the regulation relating to them.

Recommendations

20.159 **The Committee recommends that:**

84. the obligation of banks to maintain customer confidences should be expressly recognised by law and should be subject to express exceptions. The exceptions to the duty of confidentiality should include the following circumstances:

- **disclosure of information where subpoenaed for the *purposes of litigation*;**
- **disclosure under due process of law;**
- **disclosure pursuant to express consent in writing obtained by the customer and for a particular purpose, and**
- **disclosure to other credit providers and agencies subject to the restrictions imposed by the Privacy Act 1988 (as amended) and the Credit Reporting Code of Conduct;**

85. the duty of confidentiality should extend to all information obtained by the bank in relation to its customer, other than information readily available to the public;

86. customers should have access to all personal information concerning them contained in the records of the bank;

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46 Privacy Committee of NSW, Privacy and Data Protection in NSW: A Proposal for Legislation, June 1991.

87. **customers should be advised upon opening an account or commencing a relationship with a bank and at intervals thereafter of their right of access to personal information about them held by the bank; and**

88. **the obligation imposed upon credit reporting agencies by the Privacy Act 1988, to take reasonable steps to ensure that accurate files are maintained, should apply to personal information held by banks in relation to customers.**

Guarantors

20.160 A guarantee is a contract in which one party (the guarantor) agrees to meet the debt obligation of another (the borrower) should the borrower fail to do so. Generally the guarantor obtains no direct financial benefit from the transaction.

20.161 Guarantees are used in a number of ways:

- to provide security or additional security to support lending which is normally done only on a secured basis. The typical example is a friend, relative or business associate offering real estate as security for credit granted to a business;

- to provide security in return for the lender continuing to make available credit to a business which the lender is no longer prepared to remain unsecured; and

- to support consumer lending where the bank does not assess the prospective borrower as credit-worthy in his or her own right. This may be because the borrower is a minor, because the bank does not have sufficient information to assess the borrower or because the bank assesses the borrower as not credit-worthy or marginally credit-worthy.

- guarantees given by directors of private companies are an exception. Often directors of a company will be required to execute guarantees to support credit made available to the company. In the case of companies owned by the directors, the financial interest of the company and the directors are largely indistinguishable and credit advanced to the company benefits the directors.

20.162 It is common for guarantees of consumer lending to be given without the bank taking security over any asset.

The Issues

20.163 A number of individual submissions to the inquiry detailed experiences with guarantees that have gone wrong. They are of particular concern because, in many cases, people have lost, or stand to lose, their only asset, their home, as a consequence of a decision to go guarantor. This most commonly results from a guarantor agreeing to put up security on an otherwise unsecured business loan, usually for a family member.

20.164 It is disturbingly common for banks to obtain guarantees from relatives or friends of business proprietors in relation to business borrowing in circumstances where the potential guarantor has no knowledge of the financial position of the business, no ability to obtain that knowledge and thus no capacity to assess the risk that the guarantee will be called upon.

20.165 The concerns regarding the use of guarantees raised in the inquiry reflect developments elsewhere. Over the past ten years there has been a steady stream of matters litigated in the courts mainly involving third party security given to support relatively small commercial loans. In response there has been an ongoing process of revision of legal advice to banks advising them to adopt more stringent procedures when taking guarantees.

20.166 In their submission consumer groups argued that a risk of unfairness was inherent in the nature of guarantees. In particular they pointed out that:

- guarantees are required only where there is doubt about the principal's capacity to pay;
- guarantors do not have access to details of the borrowers financial situation or other aspects of the transaction;
- guarantors are often under emotional pressure to enter the contract;
- guarantees are not well understood in the community; and
- guarantors are not taking on an immediate liability and so are less likely to scrutinise the details of the transaction.[47]

20.167 They recommended that guarantors be provided with sufficient information to understand both the nature of the transaction and the level of risk that they were undertaking. The ABA, in response, advised that it is considering developments to inform more clearly guarantors of their responsibility in entering a guarantee.[48]

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47 Evidence, S 1624-1625.

48 Evidence, S 2783.

20.168 The most recent publicised case concerning the use of a guarantee by a bank was in 1991. In this case the TPC took action against the National Australia Bank. The facts of the case are summarised as follows.

20.169 The Bank procured guarantees from a couple as security for a loan of $28 000 to their son to establish a hairdressing business. The son had no business experience, no hairdressing background and no equity in the project. One of the two had a long history of illness and the other had poor comprehension of English. Both were pensioners. They depended on their bank manager for financial guidance.

20.170 The prospects for success of the business were to be based on the opinion of the bank manager who deemed it worthy of bank backing. The business was unsuccessful from the start. The loan was refinanced in September 1988, when the bank was aware of numerous dishonoured cheques and loan defaults. At this time the bank procured from the son a letter of disclosure authorising it to inform the parents of the son's financial dealings. This was not acted upon, despite the accounts rarely being in order from that time. In July 1989, the Bank called in a total of $47,000 against the parents, being money secured by a guarantee and registered first mortgage on their sole asset, the family house. By this time the debt had increased by virtue of interest calculated at 21.5 per cent per annum, to $65,000.

20.171 Following the Bank's refusal to answer specific questions relating to the alleged conduct, the TPC served notices on two bank managers to give oral evidence before it. These hearings were completed in June 1990. Proceedings were commenced against the Bank in October 1990 and, on 29 October 1990, the court issued an injunction restraining the Bank from exercising its power of sale over the property, pending the outcome of the principal proceedings. An agreement was reached by both parties that the Bank would discharge the mortgage in consideration for $12,000 payable by the couple, contingent on some accommodation being reached with the TPC.

20.172 The kind of conduct found to be unacceptable by the TPC was:

- undue influence exercised by the borrower over the guarantor;
- the guarantor having a 'special disability';
- the guarantor having a poor general understanding of the concept of a guarantee;
- the guarantor becoming involved in the transaction at a late stage; and
- the complex nature of guarantee documents.

20.173 The Commission proposed the following terms to the Bank which were accepted:

- amendments suggested by the TPC were to be made to the Bank's lending manual;
- in relation to the Bank's form of guarantee, the following were to be introduced;
  - marginal notes broadly defining each clause;
  - bold type emphasis in certain clauses; and
  - a bold type warning on the front of the guarantee document along the lines of 'THIS IS AN IMPORTANT DOCUMENT. If you, as an intending guarantor, are not confident you understand it, seek independent advice from someone you trust, such as your solicitor or accountant ...';
- the Bank's training program to include a module on unconscionability; and
- the Bank to suitably publicise these undertakings in the press.

20.174 The significance of this case was that banks were put on notice that certain conduct in relation to guarantees was not acceptable. The Bank in question has changed its practice and the outcome of the case has been publicised. All other banks are now in a position to know what is expected of them when using such guarantees in the future. All banks could risk prosecution by the TPC if this out of court settlement is ignored.

20.175 One reform which might be considered would be to amend the law such that a contract of guarantee will only be enforceable if the guarantor's signature has been witnessed by a solicitor. In such circumstances, a cautious solicitor would take the time to fully advise the guarantor of the extent of his or her liability and of the wisdom of signing the guarantee at all. However, the overall costs to the customer would be likely to increase if this were made a requirement.

Conclusion

20.176 The Committee questions the appropriateness of guarantees as commonly used financial instruments.

20.177 The Committee believes that measures such as those obtained by the TPC in relation to the case involving the National Australia Bank should be adopted by all banks. The Committee also suggests that guarantors receive a clear statement of their maximum liability.

20.178 The principles laid down in the undertakings from the NAB to the TPC *should be included in a code of banking practice as it relates to guarantees.* This would ensure that guarantors are aware of the nature of the transaction and their potential liability.

Recommendations

20.179 **The Committee recommends that:**

89. the use of unlimited guarantees no longer be permitted.

90. the details of the relationship between a bank and a guarantor be clearly laid down in a code of banking practice and include the specific undertakings that were part of the TPC's agreement with the National Australia Bank. In addition, banks should be obliged to inform guarantors as to the reasons for requiring a guarantee.

Disclosure of information about the borrower

20.180 A rational person unconstrained by circumstantial or emotional pressure would consider it necessary to have full information on the borrowers financial situation before deciding whether or not to enter into a contract of guarantee. This is particularly so given that a guarantee is required only when the lender is not satisfied with the borrowers ability to meet their obligations.

20.181 The guarantor is usually the most vulnerable of the parties to the transaction. The Committee believes that every effort should be made to appraise guarantors of all relevant information about the borrower as well as about the proposed contract.

20.182 The law as it stands does not ensure that the guarantor obtains all relevant information even if he or she does request it. A lender is under a legal obligation to disclose to the proposed guarantor any 'unusual facts' about the borrower or the transaction. In most cases it has been held that a fact must be quite unusual to require disclosure. The fact that the borrower's account is consistently overdrawn or even that the borrower is suspected of fraud have been held by the courts not to require disclosure under current law. It is difficult, however, to see consistency in the courts decisions. In another case the fact that the security was a commercial truck, and so subject to very rapid depreciation in value, was sufficient to require that the guarantors attention be drawn to the risk of being called upon.

20.183 On the other hand a bank is under a duty of confidentiality to its customer, the borrower. In general it may not disclose any information to another party without the customers' consent except in a number of strictly defined

situations. One of those exceptions is where the disclosure is required by law, this would include those 'unusual facts' which a lender has a duty to disclose. It is very difficult for a bank to judge when a fact falls into this category. If it makes a mistake it will necessarily be in breach of either its duty to disclose to the guarantor, or its duty to the customer not to disclose!

20.184 In 1990 the Privacy Amendment Act was passed. It is now due to come into effect on 25 February 1992. On 20 August 1991 the Attorney General indicated that further amendments were proposed to the Act prior to it coming into effect. So far as relevant the amended Act will have the effect of preventing a bank or other lender providing information to the guarantor.

20.185 Consumer groups recommended that:

> Banks should be required to disclose to intending guarantors all financial information in their possession relevant to the guarantor's assessment of the risk that the principal debtor will default and the guarantee be called upon.[49]

20.186 In response the ABA submitted:

> Under the Privacy Act, even with the consent of the debtor, banks would not be able to provide all the financial information in their possession relating to the borrower. The Courts have had regard to banker and customer confidentiality circumstances. We do not consider that this would be an appropriate part of a package to enhance the position of guarantors. Debtors themselves are in a position to advise the guarantors of their financial situation.[50]

20.187 The ABA advances no commercial or policy reason why information about the borrower should not be disclosed. Rather their objection is legal. There is no reason why those legal impediments could not be overcome by suitable amendments to relevant legislation.

Conclusion

20.188 The Committee regards an intrusion on the borrower's privacy as justified in circumstances where the borrower wants the guarantor to undertake a significant financial responsibility. The information as to the borrower's financial position is not merely relevant but crucial to the prospective guarantors decision. A requirement that banks disclose to intending guarantors relevant information about

49 Evidence, p. S1627.

50 Evidence, p. S2784.

the borrower would alleviate present uncertainty about what must be disclosed and what may not be disclosed. It may be that as a result fewer intending guarantors agree to go through with the transaction and that some loans are not made. The Committee regards that result as far preferable to guarantors entering improvident transactions unaware of the risk involved.

20.189 In order to implement the proposal that guarantors be provided with relevant information about the borrower, two steps will be required. First, amendments will be required to the Privacy Act to allow banks to disclose the required information where the borrowers consent has been given. Second banks should be required to insist on that consent being given as a condition of negotiating the loan and then to disclose the relevant information to the borrower. The appropriate place for such a requirement is the Code of Banking Practice.

Recommendations

20.190 **The Committee recommends that:**

91. the code of banking practice require a bank to disclose to prospective guarantors all material facts known to it relating to the borrower and the proposed transaction. Failure to so disclose should render the guarantee voidable unless the bank can show that the failure was inadvertent and the guarantor knew of or was in a position to know of the relevant fact or would have entered the transaction if the fact had been disclosed; and

92. the code of banking practice also require the bank to advise the guarantor of the state of the borrower's account on inquiry or as soon as the account becomes overdue.

93. the Privacy Act be amended to permit banks, with the consent of borrowers, to disclose information about the borrower or prospective borrower to a prospective guarantor.

CHAPTER TWENTY ONE

DISCLOSURE OF INFORMATION

Introduction

21.1 A major issue identified by consumer organisations was the lack of adequate disclosure of information about banking products - information such as the terms and conditions applied to banking services that consumers use every day. Consumer organisations wanted greater and more meaningful disclosure.

21.2 This view was shared by the Reserve Bank. In its 1990 Annual Report the Bank said the potential benefits for consumers from deregulation in financial markets will not be realised unless intermediaries disclose fully the terms and conditions on which services are offered.

Reasons for disclosure

21.3 The need for adequate disclosure in banking stems from the nature of the relationship between bank and customer. In a court judgment in 1921 it was stated that:

> The central relationship between customer and banker is one of creditor and debtor ... Even though the relationship is contractual it is a contract of a very unusual kind in that ordinarily all or nearly all of the terms are implied terms.[1]

21.4 The courts have gone a long way towards developing a code of implied terms in relation to the elements of the traditional banker customer relationship. However, there are elements of the relationship which remain unclear. The problem is not one of the substance of the law, but the opacity of the law from the point of view of the consumer. The relationship retains the legal fiction of being a contract but nowhere are the terms of that contract conveyed to the consumer either orally or in writing.[2]

21.5 The principle on which the need for written disclosure is based is 'truth in lending' which includes the following:

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1 Joachimson v Swiss Bank Corporation (1921) 3 KB 110, at 127 Lord Aitkin.

2 Evidence, p. S1604.

- a permanent record of information;
- proof of what was disclosed;
- a link between the legally binding contractual terms and the signature of the customer;
- disclosure of all terms in one document rather than a series of documents;
- disclosure of all terms before consumers are bound by them as well as during and at the termination of a contract; and
- disclosure in other areas such as advertising.

21.6 The need for written disclosure is important because there is a community expectation that important legal information be provided in writing.

21.7 Deregulation of the financial markets has meant that financial institutions must provide understandable information to consumers of financial services as an urgent priority. It has been suggested that a deregulated market can work effectively only if customers are informed and can compare products and prices so as to make choices best suited to themselves.[3]

21.8 One view put to the Committee was that there was an imbalance of information between financial institutions and individual customers. It was considered that the mismatch of information was so great that one of the necessary conditions for effective competitive markets was not being met.[4]

21.9 There has been a fundamental change in the risk structure of the market, leaving customers ill-informed of the risks and costs involved. For instance, the number of financial institutions has increased; institutions have increased the services they offer; products have become more diverse and complex; charges have been levied where there were none before; and the price of a loan is presented in different ways because of differing fee structures.[5]

Adequacy of disclosure

21.10 One submission referred to a sampling of some bank products that has been undertaken to find out how much information was readily available at bank counters in Sydney's CBD. Examples of the types of products were as follows:

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3 Evidence, p. S1461.

4 Evidence, p. S1461.

5 Evidence, p. S1461.

- new account applications;
- cheque accounts;
- loan agreements; and
- savings accounts.[6]

21.11 In general, it was found the terms and conditions attached to such products were either inadequate or simply not available. Whilst this was not a large sample, it is an indication that such information can be lacking and banks in some cases are not providing the customer with adequate information on bank products.

21.12 A survey was carried out by the TPC and Treasury on the Electronic Funds Transfer area of banking for which there is a code of practice which requires reviews to be undertaken every two years. The most recent review was carried out in 1990 and, among other things, assessed disclosure of terms and conditions and other aspects of the code such as availability of brochures provided by banks on dispute resolution schemes.

21.13 The TPC and Treasury found there was generally good compliance with the code as it related to disclosure. This was not the case with the previous review which revealed problems.

Current situation on disclosure

21.14 There are two areas relating to bank products where rules on disclosure are laid down. They are the State and Territory credit acts and the voluntary code on Electronic Funds Transfer (EFT). The main issues covered by these two areas are discussed below.

State and Territory credit acts

21.15 The main area in which banks provide informative contract documentation is in their lending which is regulated by the State and Territory credit acts.

21.16 The requirements imposed by these Acts are based on the principle that customers are entitled to know the terms of the contract, including relevant pricing information, before they are bound by the contract and to have a record of the terms of the contract.

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6 Evidence, p. S1632-1635.

21.17 A number of requirements are mandatory in all regulated loan contracts and credit sale contracts. Breach of the requirements may result in loss of the credit charge. The requirements include:

- description or identification of goods or services;
- statements of amount financed, the credit charge, the total of the credit charge and amount financed, the annual percentage rate, instalments, any commission charges and the existence of any mortgage;
- an explanation of terms used;
- prescription statements to debtors about their rights and liabilities under the contract; and
- the provision for any variations to the contract to be in writing with prescribed details.

21.18 In relation to continuing credit contracts there are less stringent requirements. These are that:

- before a debtor incurs a debt a statement must be provided as to rights and obligations; and
- there must be a schedule setting out, among other things, the amount of the agreed maximum of the debt, the method of charging, terms and conditions for a billing cycle, when payment is due, the annual percentage rate, the amount of any stamp duty payable, the particulars of any mortgage, how contracts may be varied, and details of other terms and conditions.

21.19 As to guarantees, these must be documented or they are not enforceable. The guarantee must be in writing and the contract must be given to the guarantor as well as the debtor.

21.20 State and Territory credit law is still under review through the Standing Committee on Consumer Affairs Ministers (SCOCAM) mechanism. Additional information requirements are proposed under a Uniform Draft Credit Bill. These include:

- the disclosure of pre-contractual charges and all relevant conditions associated therewith;
- the disclosure of contract documents pre-contractually;
- the signing of a contract in a prescribed form by both parties and the provision of it to debtor at time of contract;

- ensuring that all documents are legible and expressed in language that is comprehensible; and

- providing all relevant documents free of charge to the debtor.

21.21 There is also a requirement that a uniform measure - a 'comparative rate' - will be used for disclosure of interest rate and fees and charges.

Electronic Funds Transfer systems

21.22 The only facet of banking to have been examined in detail on a national scale to ensure the adequate definition of the banker-customer relationship in the context of changing technology is the Electronic Funds Transfer systems area. Despite initial reservations by banks, the implementation by them of a voluntary code of practice and a ten year process of complaint and investigation has developed a thorough, rigorous, fair and enforceable code. As a result, customers can be confident that contract terms are fair and will be disclosed in plain English, that they will not carry the burden of losses caused by factors beyond their control and that they will effectively be able to pursue disputes.

21.23 The Code was released in December 1989. It is now reviewed jointly by the Trade Practices Commission and Treasury who report their findings to the Australian Payments System Council. The Council stated in its last report in 1990 that institutions have now taken the monitoring exercise seriously and that the overall level of compliance is high.

21.24 Forces outside the market place were required to impose a degree of fairness on the EFT relationship. The process of achieving the code had been long and arduous. With hindsight it might have been done more quickly and effectively. Initially, far too much faith had been placed in the willingness of the banks to implement the code voluntarily. But without a process for monitoring its implementation, the code was not enforceable by customers.

Achieving better disclosure

21.25 Banks need to provide more adequate useable information to customers in three broad areas which are not governed by State credit Acts or the EFT voluntary code of conduct. These are:

- the banker-customer relationship which includes bank legal documents;

- general information in the market place which provides consumers with the relevant information on which to make informed decisions including ongoing information such as interest rates and fees and charges; and

- comparative information provided (in a standardised form) in an ongoing manner so that customers are informed better of their options.

21.26 In general, the major banks and the ABA agreed that there should be greater disclosure of information. However, there was some disagreement about how this should be achieved. The three levels for disclosure are now addressed more fully below.

The banker-customer relationship

21.27 The fundamental legal relationship between banks and their customers is an implied contract, the terms of which are seldom set out. Bankers are well aware of the terms but most of their customers remain ignorant of them although they involve important rights and obligations. This sometimes continues even after bank documents are signed.

21.28 Although the terms of the banker-customer contract remain unspecified, there is little possibility that competition in the market place will improve the situation. Customers will continue in ignorance of their position or be able to assert or enforce their rights. To all intents and purposes bank practice and tradition are the law.

21.29 Consumer organisations stated that the terms and conditions which currently form part of the banker-customer relationship should be codified in a code of banking law. They believe that a formal reference should be given to the Australian Law Reform Commission (ALRC) to incorporate disclosure principles relating to the banker-customer relationship.[7]

21.30 The major banks were questioned about the concept of a code of banking practice which included industry disclosure principles. The banks were not opposed to such a code but preferred that it be self-regulatory.

21.31 Westpac has released a code of banking practice which includes disclosure principles. The code is in-house, self-regulatory rather than enforceable by consumers.[8] It is a good first step and other banks should follow.

21.32 Given the legal nature of the basic banker-customer relationship there is good argument for this code. There is also good argument for general disclosure requirements to be incorporated into a code of banking conduct.

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7 Evidence, p. S1591.

8 Evidence, p. 2624.

Conclusion

21.33 The Committee concludes that there should be adequate disclosure by banks. The principle of disclosure should be written into an industry code of banking practice.

Recommendation

21.34 **The Committee recommends that:**

94. the principle of disclosure be incorporated into a code of banking practice.

Plain English documentation

21.35 The following comment made by a NSW Supreme Court Judge in 1971 regarding a bank mortgage is equally applicable today:

> It is surely a sad commentary on the operation of our legal system that a borrower should be expected to execute a document which only a person of extraordinary application and persistence would read, which if read, is virtually incomprehensible and which in any event has a legal effect not disclosed in its language.[9]

21.36 Despite continuous adverse comment from the courts, customers and consumer groups, many bank contractual documents remain lengthy and incomprehensible to all but trained experts. For example, the first sentence in the current Westpac Home Mortgage document is more than 1000 words in length.

21.37 While it is generally accepted as desirable to have documents in plain English, it should be acknowledged that existing case law may provide some legal impediments. Further, it is argued that complexity in documentation has resulted from the process of accretion as terms are added which seek to avoid the effect of court decisions protecting customers.[10]

21.38 The Law Reform Commission of Victoria has been working with the major banks to produce mortgage and guarantee documents in plain English.[11] Initially all four major banks were supportive of the process but recently support for the process has waned. It would appear that the reason for this is that some banks are concerned that changes to the language of documents could affect the substance of the documents.

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9 Fox J in Richards v Commercial Bank of Australia (1971) 18 FLR 95.

10 Evidence, p. 2993.

11 Evidence, p. 1894.

21.39 If the legal complexities justify the involvement of the Law Reform Commission of Victoria in order to clarify the law - something the banks have sought - it should not be left to the banks individually to develop the documents, but to be given help in drafting and clarifying documents.

21.40 The ABA and the Commonwealth Bank have argued against having legal documents written in plain English.[12] They considered that plain English documents could be misleading because changes in the wording of documents could create conflict over legal interpretation. However, in recent times similar documents have been successfully put into plain English - documents such as insurance contracts, the EFT code and credit Acts. If documents are in plain English it does away with the need to have them interpreted by the court. They mean what they say.

21.41 The Commonwealth Bank's opposition to the introduction of plain English documents is inconsistent with its support for the concept in its code of conduct.

21.42 Professor David Kelly of the Victorian Law Reform Commission said of the concept of plain English documents being misleading:

> The suggestion that plain English is misleading is based on the understanding of what is meant by 'plain English' in this context. If 'plain English' means simplified or 'popularised' English the suggestion would of course be correct. It is obviously not possible to substitute commonly used word for technical legal words without changing the effect of the language used.[13]

21.43 In this context, 'plain English' simply means English that is properly structured and is free of the repetition and circumlocution that abound in legal documents. All technical legal words are retained. Only the overlay of obscure language and incoherent structure is removed. The document's meaning is unchanged.

21.44 One of the many benefits of rewriting a document in plain English is the re-examination, not only of the documents as a whole, but also of each of the document's provisions. This process often reveals that the meaning and nature of the document are different from what they were thought to be.

21.45 Two documents stand out for special consideration for rewriting in plain English. They are the mortgage and guarantee documents.

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12 Evidence, pp. S2785 and 3636.

13 Evidence, p. S4773.

The Mortgage document

21.46 The mortgage document is one of the most important legal documents that customers will be required to sign and understand. The Committee has heard evidence from the major banks on the need for a mortgage document to be clear and understandable. Three of the major banks agreed that the mortgage document should be written in plain English and have already taken steps to develop such a document in conjunction with the Law Reform Commission of Victoria.[14] There has also been discussion on a uniform mortgage document that in the future could allow a mortgage to be transferred from one bank to another thus reducing the cost of changing banks.

21.47 Consumer organisations suggested that a regulatory agency be resourced to develop a model plain English home mortgage. This document would be produced as a result of negotiation between consumer representative groups and industry groups.[15]

Guarantee document

21.48 In a recent out of court settlement against the National Australia Bank, the bank agreed to several undertakings one of which was to describe in bold print on the document the significance of what the guarantor was signing.[16]

21.49 The ANZ Bank in its evidence said of guarantors that the bank would like to see the guarantee documentation made clear, plain, absolutely unambiguous, and that the bank was working on redrafting the guarantee agreement.[17]

Conclusion

21.50 The Committee concludes that there is a need for banks' documents to be produced in plain English. Such documents could be produced either by the banks themselves or an appropriate external legal organisation. The Committee supports the latter approach because uniformity of language and clarity of meaning would be introduced throughout the industry.

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14 Evidence, p. 2290.

15 Evidence, p. 2992.

16 Trade Practices Commission Annual Report, 1990-91 p. 99.

17 Evidence, p. 2990.

Recommendation

21.51 **The Committee recommends that:**

95. a requirement for plain English documents be incorporated in the code of banking practice. Plain English documents should be produced urgently by the Australian Law Reform Commission working wherever possible in conjunction with State law reform commissions and in consultation with the banking industry, consumers and users. Priority should be given to producing important consumer documents such as the mortgage and guarantee documents.

Market place information

21.52 The banker-customer relationship is subject to two kinds of terms and conditions. Some terms and conditions are set out in writing in documents such as mortgage documents. Others are not specified and vary from time-to-time. The difference between the written contractual relationship and what is implied from time to time, is that one is static while the other is dynamic.

21.53 Examples of the practices that occur in the marketplace are as follows:

- a failure to provide with a document the associated terms and *conditions which, once signed, constitute the agreement;*
- the use of pamphlets only to provide information on terms and conditions (these are not seen as legal by customers);
- the use of a brief application with terms and conditions provided later; and
- the use of pamphlets which mix marketing material with legal terms.

21.54 Pamphlets giving details on internal complaint handling procedures and external review through the Banking Ombudsman Scheme are an important example of information that should be provided by banks at their counters.

21.55 There are two specific areas since deregulation that have been prone to fluctuation; these are interest rates and fees and charges. Customers are particularly sensitive to the movement of both.

21.56 Disclosure aspects of these two important pricing factors are discussed below.

Interest rates

21.57 Evidence from the major banks on the issue of disclosure of interest rates showed that there were significant differences in the ways in which they represented interest rates. However, there was general agreement among them that interest rates should be disclosed clearly.

21.58 The National Australia Bank said that the interest rate shown on its statements to customers was not the base rate but the rate actually charged to them. The Bank's base rate was published in newspapers and customers could calculate their margin above the base rate from this. Changes to base rates are published weekly. Fees are disclosed separately.[18]

21.59 The ANZ Bank said that from 1 July 1991 all statements of its loan accounts will have the applicable interest rate shown on them, including the dates of any changes. The interest rate shown on the statement will be the nominal interest rate, that is the interest rate that is needed to check the bank's interest calculation. ANZ Bank had an open mind on the issue of whether effective interest rates also ought to be provided. It had not done so because it was not compelled and because it considered that disclosure of two rates may be a 'culture shock' to customers. ANZ Bank was in favour of a code of banking conduct and a uniform measure of disclosure of interest rates, fees and charges.[19]

21.60 Westpac was in favour of a uniform measure of disclosure on fees and charges and interest rates and an industry code of conduct.[20] The Commonwealth Bank favoured the principle of disclosure. The Bank felt that disclosure was becoming more important and that it should get on with implementing the principle.

21.61 There are a number of concepts of interest rate. The most important are:

- the 'period rate'; applied to the balance each charging period to determine the amount of interest charged to an account. This is the rate a customer needs to calculate that the interest on their account is correct;

- the 'nominal rate'; this most commonly disclosed measure for loans is equal to the period rate times the number of periods per year;

- the 'effective rate'; an annual rate that allows for compounding. It is often disclosed in advertisements for deposits; and

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18 Evidence, p. 2360.

19 Evidence, p. 2991.

20 Evidence, p. 2618-2627.

- the 'comparison rate' (also known as APR or ERIC); an effective rate which includes the charges as well as interest.

21.62 As an example, a $1000 loan where interest rate is charged monthly and there is a $50 fee payable at the end of the year might have a period rate of 1 per cent per month, a nominal rate of 12 per cent, an effective rate of 12.7 per cent, and a comparison rate of 16.8 per cent.

Fees and charges

21.63 Major banks also adopted different approaches in relation to the disclosure of fees and charges.

21.64 National Australia Bank said that there were only two fees that they charged. One was an establishment fee and the other was a regular line fee. These fees were clearly explained to the customer when they took out a loan and were declared on statements.[21]

21.65 ANZ Bank gave an example of fees and charges on an overdraft; there is an establishment fee, an interest charge, an annual service charge (a line fee) and government duties. The Bank considered that it was part of its duty to disclose all charges and terms and conditions.[22]

Conclusion

21.66 The Committee concludes that disclosure of all relevant information is of vital importance. It is important not only when a customer enters a contract, but also in relation to any changes that might be made. Customers should be kept informed of all costs in such a way that they can refer to them with the minimum of difficulty. There are several ways in which banks can make this information available and update it regularly. It can be done by direct mailing to customers or be printed on statements in such a way that the information is clear, for example by being printed in bold lettering at the bottom of the statement. It can also be done the same way that banks inform customers of movements in the exchange rates on overseas currencies, by the use of boards in bank branches displaying interest rates on a variety of consumer products.

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21 Evidence, p. 2360.

22 Evidence, p. 2297.

Recommendation

21.67 **The Committee recommends that:**

96. banks should disclose all fees and charges and interest rates relating to all products. Disclosure should be done in such a way that all fees, charges and interest rates are clearly drawn to the attention of consumers.

Comparative and public information

21.68 When the issue of information was raised in evidence before the Committee, it was primarily raised in the context of disclosure to consumers, at the *point of sale, of information relating to particular contracts.*

21.69 However, information was also raised by the consumer groups in the context of considering how to assist consumers generally to exert greater market pressure to improve the price and quality of products and services. They argued that this could be achieved through the collection and publication of information about the banking industry's performance and of comparative product information.

Public information

21.70 Consumer groups maintained that the ability to evaluate how well a market is performing was an important ingredient for ensuring the effective operation of that market. They further claimed, that in most markets, there was no single measure or indicator of performance. In the banking industry, performance indicators include such factors as the degree of market concentration and profit margins.

21.71 Consumer groups argued that, as governments stepped back from direct regulation of the banking industry particularly of such factors as pricing, the performance monitoring capability of the banking public becomes more important. Further, they claimed that the monitoring role could only be performed well if regulators ensured that sufficient, detailed information about the banking industry was collected and published regularly. The easier it was for the public to monitor the performance of an industry, the more competitive and efficient that industry was likely to be.

21.72 However, some information already existed in the public arena in Reserve Bank publications and through private firms publications on subscription. The latter provided detailed comparative information but it was expensive to buy, the former's information was not wide enough in its scope.

21.73 The types of statistical information which consumer representatives argued should be gathered and published for these purposes included information about:

- retail and corporate margins;
- personal, commercial and corporate lending, including interest rates applicable to both personal and commercial lending;
- establishment fees and servicing charges;
- patterns of consumption and distribution;
- market concentration; and
- the size and nature of both personal and corporate indebtedness.

21.74 The issue was not touched on by industry or government representatives in evidence.

Comparative information

21.75 Both the consumer groups and industry representatives agreed that the collation and publication of comparative information about banks' products and services was important.

21.76 As a consumer representative described:

> The real challenge for consumer groups, the financial industry and policy makers is not just to agree on a standard of information disclosure - and that in itself is proving hard - but to present and distribute information in a way that consumers can use that information for financial decision-making.[23]

21.77 The post-deregulation era in consumer financial services has not seen any large-scale information or education initiatives aimed at increasing the financial competence of consumers. Instead, the trend has been for information to be broken down into product type and placed in brochures. The brochures have tended to have more 'gloss' than solid information, making product comparison virtually impossible. They also have tended to offer little information about product combinations and their respective advantages and disadvantages.

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23 Evidence, p. S1461.

21.78 The difficulty of financial decision-making for consumers has been increasing as a result of product proliferation, the development of more complex credit and debit packages (such as, *mortgage interest saver accounts*) and the introduction of new personal taxation and social security rules (such as the 'deeming' provisions for pensioner accounts).

21.79 The banks have recognised some of the problems with the availability of comparative information.

21.80 ANZ Bank said it was debatable as to whether there was a lack of comparative information. It pointed out that money supplements in various newspapers did a reasonable job of providing detailed comparative information.[24] The Bank considered it to be inappropriate for competitor banks to endeavour to provide comparative information as they tended to misrepresent information in a fashion which advantaged themselves. It was the duty of banks to make their own information on products absolutely clear and then allow magazines such as Choice and newspapers to provide consumers with simple and clear comparative information.[25]

21.81 National Australia Bank referred to the development of a number of interesting product packages which applied fees and interest rates and interest rates in innovative ways. It considered that it was difficult to find a single comparative figure that would enable valid comparisons to be made between these products.[26] The evidence from NAB suggests that competition may not be working effectively if comparison between products is as difficult as described by the Bank.

21.82 Westpac said that the market should be allowed to operate effectively with institutions becoming aware that they would not be successful if they did not supply the right information. Westpac considered that the market would become aware of those who were not disclosing the true situation.[27]

21.83 If consumers had access to higher quality, more timely and comparable information about products and services, it would enable more informed choices to be made and it would promote a more transparent market place, thus encouraging keener competition and providing better value to consumers. It would also give consumers a better chance of acquiring greater levels of financial literacy and, thus, improved ability both to cope with changes in the market place and to utilise products and services which meet specific needs. The Committee recognises that some consumers will never acquire financial literacy. The banking industry would also benefit from access to comparative and analytical data on a regular basis, and from having a better-informed customer base.

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24 Evidence, p. 2997.

25 Evidence, p. 2997.

26 Evidence, p. 2363.

27 Evidence, p. 2624.

Conclusion

21.84 The Committee concludes that the collection and publication of detailed information about the banking industry, its operations, trends and consumption patterns would provide a significant stimulus to competition and efficiency, as would the regular publication of comparative product information.

Recommendation

21.85 **The Committee recommends that:**

97. the Reserve Bank should immediately begin discussions with banking industry and consumer representatives with a view to implement:

- **ways in which more information about indicators of the banking industry's performance can be collected and published; and**

- **ways in which more information about banking products can be collected and published.**

Industry standard on disclosure

21.86 The Australian Bankers' Association has acknowledged the need for more meaningful disclosure. The ABA said that banks have learned that there was commercial value in providing customers with information that enabled them to make appropriate choices. It considered that information must be relevant and the cost be within reasonable bounds. The ABA suggested that regulation should be avoided as much as possible as it ran the risk of restraining choice and misleading customers by providing superficially comparable data.

21.87 The ABA proposed a disclosure standard which should include:

- full disclosure of interest rates on loans, both before contracting and at the beginning of the life of the loan;

- the requirement to advertise any changes in variable loan interest rates in the national press; and

- individual itemisation of fees and charges, including full listing of any Government charges, prior to the loan being made.[28]

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28 Evidence, S 88.

While the ABA has not adopted the standard yet, it reported that the major banks are working towards implementing the standard.

21.88 Westpac was supportive of an industry standard on disclosure. It believed that it had been a driving a force to get an industry standard in place.[29]

21.89 The Committee recognised inadequacies in the proposed ABA standard. These are that:

- there is no requirement of disclosure in writing;
- it is not specific enough;
- it is not enforceable by customers;
- it is not monitored;
- it deals primarily with disclosure on entry to a contract and not for continuing disclosure; and
- it leaves too much to banks' discretion eg. terms 'where relevant'.

21.90 The Committee is aware that in addition to the draft industry standard on disclosure there is a proposal being considered by SCOCAM (in the proposed Uniform Credit Bill) which includes a standardised measure of disclosure for interest and fees and charges. This creates a comparable measure that will assist consumers to make choices more readily and with more accuracy.

A standardised measure or 'comparative rate'

21.91 It has been noted previously that a requirement for effective competition is consumers having sufficient information to readily compare the price of products. In banking the comparison of interest rates has been made more difficult by having a variety of methods of disclosing interest rates. For example, a nominal annual interest rate of 18 per cent compounds to an 'effective' rate of 19.6 per cent if applied monthly, but only to 18.8 per cent if applied on a six-monthly basis.

21.92 The Australian Bankers' Association told the Committee that it is the policy of the ABA that the market should move to effective rates of interest.[30] However, the ABA has not included this in its disclosure standard.

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29 Evidence, p. 2626.

30 Evidence, p. 39.

21.93 Over recent years there has been a proliferation of fees and charges on loans in addition to interest. There are sound reasons for many of these as they enable the price of a loan to reflect more accurately the cost of providing it. The costs of establishing a loan, including credit assessment and documentation, and administering it does not necessarily vary in direct proportion to the size of the loan. In many cases, forcing these costs to be recouped from the interest payments means either that larger borrowers are subsidising small borrowers or that small borrowers will have their access to credit restricted.

21.94 However, customers facing various combinations of fees and interest will find it much harder to compare the cost of credit from different banks than if they are only comparing interest rates. There is a particular concern that some banks may highlight in their advertising a relatively low interest rate while revealing little about relatively high fees.

21.95 For these reasons there has been a push to introduce for consumer loans a summary measure of the total cost of credit which incorporates both interest and fees and charges. Standards Australia released a draft standard in 1990.[31] The measure is based on the actuarial concept of an 'internal rate of return' and has variously been referred to as 'ERIC' (Effective Rate of Interest and Charges) or the 'comparability rate'.

21.96 Most of the discussion has referred to consumer loans but the approach applies equally well to deposits and other loans. The National Farmers' Federation believed there was no single, more effective assistance measure that could be offered by government to consumers in a complex financial market than to provide a standard measure for comparison of competing products.[32]

21.97 The formula and an example of its use are given in Appendix 12. The resulting figure is directly comparable with an annual interest rate. For a loan with no fees, the measure will be the same as the effective interest rate.[33] The measure is similar to that incorporated in 'Regulation Z: Truth in Lending' issued in the United States under the auspices of the Federal Reserve System and the Annual Percentage Rate required in the UK. A similar measure has been the subject of a European Community directive.

21.98 The Committee discussed the operation of the comparative rate during its visit to the USA. It was told that a comparative rate was not a difficult concept nor had there been any great difficulty in implementing it.

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31 Draft Australian Standard For Comment, Interest Rate Description - Consumer Credit, Standards Australia, 1 January 1990 (No DR89224:R).

32 Evidence, p. S1889.

33 An alternative approach, although sharing the same aims is presented by the National Farmers' Federation in Evidence, pp. 2137-77.

21.99 The Standards Australia measure has been included in Draft Uniform Credit Bill released by SCOCAM in September 1991 under the name of 'comparison rate'. The rate must be disclosed in the contract. Any advertising material containing a reference to the cost of credit must include one or more hypothetical credit transactions and the comparison rate for each transaction.

21.100 The Committee is aware that the Uniform Credit Bill has been under consideration for many years. Agreement was not been reached at the last meeting of SCOCAM in August 1991.

21.101 The 'comparative rate' measure is supported by the Reserve Bank. The bank believed a comparative rate had the advantage that it allowed flexibility in structuring charges and interest costs so that they could accurately reflect the various costs involved in providing a loan, but summarised them so that a borrower could make comparisons across a range of differently structured loans. The Bank considered the concept was fair in determining and measuring an effective rate. It was considered to be a major improvement over the unnecessarily complex formula based on nominal rates which was in currency legislation.[34]

21.102 Professor Harper was also supportive:

> There is a relatively simple financial measure that enables you to compare the cost, that is its internal rate of return. All the loans are standard contracts. You receive an amount of money and you steadily pay it back. You also may along the way pay for various fees and charges. All of them can be incorporated into a discounted cash flow analysis and one simply solves for the internal rate of return. The internal rate of return, which can be solved using any moderately sophisticated hand held calculator, will give you the true or effective cost of the loan. All things are considered, fees, charges, interest pattern. You have got a number that can be compared. It is meaningful.[35]

21.103 Banks had mixed views about the measure. The ABA referred to a national telephone survey of their customers which 'revealed a need for improved disclosure of interest rates and charges in a readily comparable form'.[36] However, the ABA was wary of 'misleading customers by providing superficially comparable

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34 Evidence, p. S2918-9.

35 Evidence, p. 3409.

36 Evidence, p. S87.

data' and asserted in its submission that 'there is no way in which a single price can be used exclusively to represent a product without creating inequities and distortions'.[37] However, in a later appearance, the ABA said 'we accept the usefulness of a summary statistic, which includes fees and charges'.[38]

21.104 While Westpac opposed the proposals, NAB 'has supported the introduction on consumer lending of the requirement to disclose the Effective Rate of Interest and Costs'.[39]

Conclusion

21.105 The Committee concludes that there was general acceptance of the need for adoption of a comparative rate which included all components of credit for loans and deposits. The Committee sees value in such a rate being available to consumers to enable them better to compare bank products. The Committee considers the Commonwealth Government should legislate in this area in relation to banks that fall under the Banking Act. SCOCAM should legislate similarly in relation to State institutions.

Recommendations

21.106 **The Committee recommends that:**

98. the use of a comparison rate (as described in Appendix 12) to facilitate the comparison of the total cost of credit for loan and deposit products be implemented immediately by the Commonwealth Government in relation to banks under the Banking Act; and

99. SCOCAM implement urgently similar legislation in relation to the financial institutions under its purview.

Confidentiality

21.107 The common law concept of banker-customer confidentiality is claimed by bankers to be fundamental to the relationship. It is an important issue when it comes to disclosure. There are certain things that the banks claim fall within that concept that enable them to deny access to information.

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37 Evidence, pp. S87 and S91.

38 Evidence, p. 2175.

39 Evidence, p. S501.

21.108 Banks often use this principle selectively, disclosing when it suits and denying access when it does not. An example that came to the Committee's attention was in regard to the rural sector. When the Committee was in Dubbo in NSW one bank was asked questions about a particular customer's dealings with that bank. That customer had spoken publicly about her own matters in Dubbo on the same day. The bank refused to discuss the case because of customer confidentiality. The next day a letter from the bank was published in a rural newspaper in the town in which the customer lived disclosing details of that customers dealings with the Bank. This appeared to demonstrate a double standard about the bank's approach to customer confidentiality. The issue of privacy was discussed further in Chapter 20.

Access to documents

21.109 Banks hold documents about their customer's financial affairs. From time to time customers will be in dispute with their bank and may need access to documents that are held by the bank. It seems fair that banks should make personal information available to customers.

21.110 This principle of access to information exists in the *Commonwealth Freedom of Information Act 1982.* The object of the Act is to extend as far as possible the right of the Australian community to access to information in the possession of the Government of the Commonwealth. This includes access to personal information as a right.

21.111 The banks have resisted this notion. They have provided information and documents when they considered it appropriate. However, they have not done so in all cases. Not only have banks provided information to third parties in the past, but they have conferred power on the Banking Industry Ombudsman, with the customer's consent to obtain files on request. There is a power under the Ombudsman's terms of reference to ask for a bank file, but there is no power for the Ombudsman to pass the file to the customer.

21.112 The Ombudsman supported the principle of providing information through documents to customers. It has been done successfully by the Commonwealth in regard to its Public Service, despite initial concerns that it would create administrative difficulties and lead to poor decision-making. The Ombudsman considered that the access of individuals to personal information under the Freedom of Information Act had improved the decision-making processes of bodies such as the Social Security Appeals Tribunal and the Administrative Appeals Tribunal.[40]

21.113 The ANZ Bank's view on providing customers with documents was that it was not a lack of willingness or a company policy against giving customers their own documents. The way in which their systems were designed meant that a

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40 Evidence, p. 1889.

customer's information would not be on a single file; there would be several, as a customer would have a separate file for each product. This will not be so in future as it will change in the next two years. The Bank is moving to a customer information file, which will mean that there will one source of information for each customer.[41]

21.114 The Committee notes the UK has a Draft Code of Banking Conduct which provides, through the *UK Data Protection Act 1984*, for personal information to be made available.

Conclusion

21.115 The Committee concludes that customers are entitled to have documents relating to their personal affairs. The definition of personal or own affairs contained in the Freedom of Information Act should be considered by the banks as the basis on which such information is provided.

Recommendation

21.116 **The Committee recommends that:**

100. personal information be provided as a 'right' to individuals. This 'right' should be written into a code of banking practice.

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41 Evidence, p. 2307.

CHAPTER TWENTY TWO

BANKS AND SOCIETY

22.1 There is no doubt banks occupy a special position in Australia's society and economy.

22.2 As the ABA observed in its submission:

> Australia could not function without a banking system. Every business and almost the entire population has a relationship with a bank. Banks supply the payments system and protect its integrity. They are the major providers of finance and related financial services. The financial system depends on public confidence, and banks have a special role here in being of undoubted safety and integrity, subject to strong prudential management and supervised by the Reserve Bank of Australia. They provide a safe haven for depositors.[1]

The Government and banks

22.3 As mentioned earlier in this Report, the banks play a crucial role for the Commonwealth Government, as the means by which it is able to:

- implement monetary policy;
- ensure an efficient, stable and broad-based payments system;
- ensure productive financial intermediation of savings and lending; and
- monitor large cash transactions.

In addition, banks collect various Government taxes and imposts.

22.4 The Commonwealth Government confers a number of privileges on the banks.

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1 Evidence, p. S11.

22.5 The most significant privilege which banks have is access to the Reserve Bank's lender of last resort facility. The Reserve Bank may, at its discretion, make funds available to the banking system as a whole or to an individual bank which, though well managed, is experiencing temporary liquidity problems.

22.6 The second and related privilege, although partly a perception, is that the Reserve Bank will guarantee a bank's deposits. Although the RBA does not guarantee any individual bank, there is nevertheless a strong community perception that the Reserve Bank would not allow a bank to fail.[2] Public perception is that the Reserve Bank stands behind the banking system in some form or other. Past Government practice when a bank gets into trouble has been to arrange a merger, thereby protecting depositors' funds. A recent example is the Commonwealth Bank's arranged buy-out of the State Bank of Victoria. This implicit guarantee of bank deposits gives the banks a significant competitive edge, in terms of public confidence. Acknowledging that there is in fact no guarantee, nevertheless very considerable public resources are allocated to ensuring the banking and payment systems are stable. As mentioned in Chapter 12, through the Reserve Bank the Government devotes considerable financial resources to bank supervision.

22.7 The third privilege is exclusive authority to issue chequing accounts, through exchange settlement accounts with the Reserve Bank.

22.8 The privileges enable the banks to maintain a huge market share, through the attractiveness to customers of their stability and safety, and have mostly protected the banks from financial instability.

Banks in society

22.9 Banks play a role in the lives of nearly all Australians. According to ABA survey data, 95 per cent of the population over the age of 18 has a bank account.[3]

22.10 New technology has resulted in people increasingly moving away from cash transactions and towards greater use of bank services and facilities. It has been estimated that, by the year 2000, only 5 per cent of wages and salaries will be paid in cash. Most will be directly deposited into employees' nominated accounts with financial institutions.[4] Since 1987, virtually all Social Security and Veterans Affairs pensions, benefits and allowances have been directly deposited into nominated accounts. In comparative terms, Australians have among the highest per capita use of EFT facilities in the world.[5]

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2 The only tangible comfort for consumers is that depositors have first claim on the assets of a bank in the event of its being wound up.

3 Evidence, p. S 26.

4 Evidence, p. S1493.

5 Evidence, p. S1493.

22.11 Australian banks provide a multiplicity of credit and transaction services to consumers through a network of 14,000 branches and agencies. However, recent studies have shown that customers participating in this wholesale use of banking services possess widely differing levels of skill.

22.12 Many bank customers are financially sophisticated and have no difficulty using banking services and exercising informed choice in a way which keeps the banks responsive to their demands. At the other end of the spectrum are those who are incapable of or have serious difficulty with using banks' services without assistance. According to the NSW Department of Family and Community Services, around 1 per cent of the NSW population (or 148,000 people) suffer from intellectual disability of varying degrees of severity.[6] Many would suffer from memory difficulties, which can easily result in particular problems with account numbers and PINs.

22.13 A study of adult literacy undertaken by the Department of Employment, Education and Training in 1989 revealed 32 per cent of those surveyed were unable to fill out a cheque correctly.[7] If that percentage is applied to the whole adult population of Australia, it indicates millions of people in Australia may be unable to carry out one of the basic bank customer actions correctly. In addition, Australia has a high proportion of migrants from non-English speaking backgrounds, with differing levels of English literacy skills.

22.14 For economically disadvantaged consumers, a transaction fee of whatever amount is a far more significant cost than it is for average customers. Over time it may deplete what small savings they are able to accumulate. For a person with an income equivalent to a social security pension who maintains a low minimum monthly balance, fees and charges on an annual basis may exceed one week's income.[8] This sector of the community benefits little from any increase in interest rates on deposits.

22.15 This snapshot of the society in which the banks operate indicates that most Australians conduct at least some of their financial affairs through banks. However, the scope for exercising choice as to whether or not to use a financial institution at all is narrowing. Also, consumers apply widely differing levels of skill to the use of financial services in Australia and widely different levels of income.

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6 Evidence, p. S1493.

7 Evidence, p. S1467.

8 Evidence, p. S1499.

Obligations of banks

22.16 As has been discussed in earlier chapters, the Commonwealth Government imposes prudential requirements on banks. Other legislation, such as the Cash Transaction Reports Act, imposes specific obligations on banks. Some very general obligations are imposed on corporations, including banks, through the Trade Practices Act, and State Fair Trading Acts. As with any corporation, banks have responsibilities to their shareholders under the Corporations Act.

22.17 Banks also incur costs as a result of the prudential standards imposed on them, including receiving a low rate of interest on their deposits with the RBA and holding more capital and liquid assets than they otherwise would.

22.18 The Government imposes no specific statutory obligations as regards services to the community on either the private or the government-owned banks.

22.19 The consumer representatives argued that banks are parties to a social contract. Since banks are the creation of governments (being required to be licensed, even in a deregulated market), it could be said they have entered into a contract with society to perform certain services. The price which society should ask the banks to pay in return for their privileges should not, consumer representatives argued, take the form of, say, a licence fee. Rather, it should be a payment 'in kind' - the provision of community access to banking, on fair and equitable terms.[9]

22.20 The ABA has argued against this interpretation, questioning whether banking products and services should be viewed as any different to other goods or services.[10] In its view, suggestions that banks should be obliged to provide certain community services on any basis other than explicit pricing are misguided:

> ... the strong suggestion is that banks should provide free or substantially subsidised services to particular groups in society and that the rest of the banking customer base should be forced to pay for this. They are, in effect, arguing for a return to regulation. The ABA cannot accept such a proposition and believes that subsidies to particular groups (if warranted by the community) should be provided explicitly through the budget, not through the banks. It would be inappropriate and inequitable for banks to provide certain services without proper regard to the costs of their provision, as such costs would invariably have to be met by other users.[11]

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9 Evidence, p. S1492.

10 Evidence, p. S2780.

11 Evidence, p. S2774.

22.21 However, it is questionable whether, overall, a bank would stand to lose or to gain from providing such services. At a Consumer Financial Services Forum held in Canberra in November 1990, the Commonwealth Bank drew attention to an assumption in the Commonwealth Government's 1987 policy guidelines for Commonwealth Statutory Authorities and Government Business Enterprises, that community service obligations only constitute a 'cost.' The guidelines require reporting of 'Performance against previously established goals, including financial and operational targets, together with assessment of the cost of meeting community service obligations ...' The Bank commented that:

> ... This requirement does not take account of our newly-found appreciation that CSOs need not just cost, they can also increase revenue, through appropriate marketing of CSO activity, so enhancing public perception of an organisation and hence increasing market share ...
>
> ... In the case of the Commonwealth Bank, ... we see a commitment to social responsibilities such as CSOs as being in the interests of good business ...[12]

22.22 The Campbell Committee looked into the question of the community service obligations of banks and made the preliminary observation that:

> It is ... clear that an economically efficient distribution of funds determined purely on economic criteria may not necessarily be the most appropriate distribution on social grounds; some individuals have greater market power than others and so will be more successful in obtaining finance or in locating attractive investments. Even a perfectly functioning market may give rise to what may be considered social inequities.[13]

Access to banking and the user pays approach

22.23 The Campbell Committee identified home borrowers, small businesses, low income earners and exporters as groups whose particular needs might justify special assistance.

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12 'New Directions in Consumer Financial Services', Canberra, 1990. Page 136.

13 Report of Campbell Committee, 1981, para 724.

22.24 However, the Campbell Committee did not reach any absolute conclusions on the matter of who should bear responsibility for protecting that access, since it regarded such considerations as outside the scope of its inquiry. It concluded that such assistance should, as far as possible, be effected directly through the budget process and not through intervention in the financial system, '... except where the source of the problem lies in the system itself'.[14]

22.25 Where a difficulty with access is caused by the combination of bank fees and charges and low incomes, it is difficult to identify precisely the source of the problem.

22.26 The consumer representatives argued that access problems should principally be addressed by requiring the banks to provide 'basic banking' services.

22.27 Although no strict definition of 'basic banking' was offered in evidence, in the US it has been described as the provision of very low cost or free transactions accounts the cashing of Government cheques.[15]

22.28 In many overseas countries, bank refusal to allow certain people to open or maintain accounts or refusal to cash cheques has become a significant problem. Some governments have responded by requiring banks to contribute to the provision of basic banking services.

22.29 In France, for example, a retail bank with a large branch network wrote to 19,000 of its customers asking them either to change their banking habits of keeping low balances and/or maintaining high transaction rates or to move to another institution. As a result of complaints to the Government, the French Central Bank was obliged to order banks to open accounts for customers in 1,600 instances in 1990.[16]

22.30 In Belgium, government stipulation has meant that fees and charges can only be imposed where social obligations are met. By law, no-one can be excluded from the banking system.

22.31 In the US, governments have imposed obligations on banks in numerous State and Federal statutes, in return for the privileges conferred.

22.32 As yet there is no statutory requirement in the US that banks offer basic banking services or cash Government cheques. In 1986, the Federal Financial Institutions Examination Council issued a statement on basic banking services which encouraged all deposit-taking financial institutions:

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14 Report of Campbell Committee, 1981, para 631.

15 J. Mitchell, 'Access to Basic Banking Services,' Rhode Island Consumer Council, 1990, p.7.

16 'Retail Banker International', 217, 8 October 1990.

... to meet certain minimum needs for all consumers, in particular:

- the need for a safe and accessible place to keep money;
- the need for a way to obtain cash (including, for example, the cashing of government cheques); and
- the need for a way to make third party payments.[17]

22.33 Unfortunately, the Statement is vague in its terms and compliance is purely voluntary; accordingly, it has been virtually impossible to measure its impact on consumers.

22.34 There is clearly a widely held belief in the US that the Statement has not been effective, as legislation to compel banks to provide basic banking is currently before Congress. This step has been taken despite the fact that the Community Reinvestment Act has tended to operate indirectly to improve the provision of these services. In broad terms, that Act requires banks to provide for the credit needs of communities within which they operate and to take affirmative steps to meet the banking needs of those individuals and businesses who tend to be excluded from full participation in the banking system.

22.35 In Canada, the House of Commons Standing Committee on Finance and Economic Affairs recommended in 1988 that banks 'be required to provide accounts that would make basic banking services available'.[18]

22.36 However, the response of the Belgian and North American governments cannot be said to be typical and it remains to be seen whether some of the proposals being considered will actually be implemented.

22.37 The ABA gave evidence that Australian banks are currently providing services which amount to basic banking services. In its supplementary submission to the Committee, the ABA surveyed the accounts offered by several of its member banks and concluded that each bank offered accounts with low charges, minimum opening balances of $1, limited or no withdrawal charges and a choice of ATM or counter access. The ABA did not identify the accounts nor make it clear whether all these features were to be found in the one account. According to the ABA, many banks also offer accounts with a certain number of free transactions, particularly to certain groups such as charities and, generally, banks offer government cheque cashing services.[19]

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17 Federal Financial Institutions Examination Council, 'Joint Policy Statement on Basic Banking Services', October 2 1986. Published in Federal Reserve Bulletin, April 1987.

18 Evidence, p. S1452.

19 Evidence, p. S2776.

22.38 The consumer representatives, however, pointed out that there is no reliable information as to why 2.6 per cent of Australians over the age of 14 do not have a relationship with any financial institution and no information is collected in Australia regarding consumer access to and use of particular banking services.[20] This is in contrast to the situation in the United States, France and Canada, described above, where regulatory authorities have monitored access and governments have legislated or directed banks to provide basic banking services.

22.39 The consumer representatives also presented evidence from surveys, undertaken by J. Taylor of the School of Economics at La Trobe University in 1989 and 1990, of deposit and chequing products offered by the banks.[21] The surveys revealed a dramatic upward trend in the imposition of charges, in addition to ATM transaction charges, passbook cheque or package accounts. Of accounts surveyed, 40 per cent had fees in 1980. By 1990 this had risen to 57 per cent.

22.40 Although problems relating to access to basic banking services in Australia may not be as severe as they are alleged to be in some European countries and the US, evidence suggests that the Australian banks are moving towards much more sophisticated and deliberate selection of customers. This trend would appear to indicate a need for monitoring consumer access, to ensure that the same problems are not created in Australia as appear to be experienced in other countries.

22.41 Consumer resistance has resulted in the pace of introduction of user-pays being slowed down. User-pays, however, is a trend which is likely to continue. As noted in Chapter 7, the application of user-pays by the banks is selective. It is logical for banks to want to retain the right to waive fees and charges where the overall or long-term business of a customer is worth more to them than the immediate recovery of costs.

22.42 Evidence points to a future in which banks will increasingly target the more profitable customers with their most attractive products and services, while fees and charges will continue to rise for those customers who are individually of less value to the banks.

22.43 Whether banks in Australia will in the future provide services which amount to basic banking is uncertain.

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20 Evidence, p. S1451-2.

21 Evidence, p. S1499.

22.44 It has been suggested to the Committee that access will not be a problem because consumers have access to non-bank financial intermediaries which provide no fee or low fee accounts with similar deposit and even chequing facilities.

22.45 However, recent collapses in the building society and credit union sectors in Victoria underline a major difference in some states between banks and many non-bank financial intermediaries - many NBFIs are not as safe for depositors as are banks. As the ABA pointed out in its Submission, '... (T)he community regards banks as financial institutions of exceptionally high integrity and stability'.[22]

22.46 If the proposed tougher prudential controls over NBFIs described earlier in this report are enacted, this difference will probably be reduced. However, it is likely public perception as to the higher risk will linger for some time and the banks will continue to benefit from that perception.

22.47 A counter-argument to the view that consumers who need access to basic banking services will be catered for by the NBFIs is that there is no guarantee that these accounts will remain fee free.

22.48 Further, the Committee has noted that non-banks do not have as direct access to the payments system as banks and cannot offer quite the same chequing services.

22.49 When considering who should take responsibility for ensuring the on-going provision of basic banking services, it is important to take into account the need *in any society for at least one 'safe haven' for consumer deposits and* savings.[23] Consumers need safety from institutional collapse. In Australia, that need is fulfilled by the banks.

22.50 The Australian society in which this primary policy goal is to be achieved is characterised by a high level of (partly compulsory) participation in the financial system by the poor. If their access to the 'safe havens' in the financial system is to be assured, it may be that one of the payments which society should demand of banks for their privileges is to ensure that all Australians can afford to deposit their savings and other funds in the safety of a bank.

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22 Evidence, p. S19.

23 Evidence, p. S11.

Conclusion

22.51 Although it is clear that some adult Australians do not have a relationship with any financial institution, there is no reliable information to explain why. There are indications, however, that a connection may exist between low levels of income and low levels of participation in consumer financial services. In the light of the current trend towards 'user pays', Australia may in future begin to experience similar access problems to those apparently being experienced in parts of Europe and North America.

22.52 The Committee notes that it may be useful in the future for more information about those who do not have a relationship with a financial institution to be obtained.

Recommendations

22.53 **The Committee recommends:**

101. that retail banks and the Department of Social Security jointly investigate the feasibility of developing a basic banking product. The product should be offered by all retail banks, should allow for a set number of free withdrawals each week and should be targeted to the needs of low-income Australians; and

102. that a structure for an on-going dialogue between the Reserve Bank, the Trade Practices Commission and consumer representatives be established, with a view to ensuring that the Bank and the Commission are and continue to be more fully aware of the experience of consumers of retail banking services and products.