

Consumer protection in the banking sector

Reviewing the Code of Banking Practice

By Nicola Howell

The Code of Banking Practice – a self-regulatory instrument originally published in 1993 – has recently been reviewed.

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This article explains the relevance of the Code and its place in the regulatory framework, discusses some of the key issues arising in the recent review (as identified by consumer advocates¹), and explains the relationship between the Code and the Financial Ombudsman Service.

CODES AND SELF-REGULATION IN THE REGULATORY FRAMEWORK

Self-regulation has been a hot topic in regulatory parlance for some years, and has been embraced by governments and industry as a mechanism for reducing compliance costs and facilitating flexibility in the face of rapidly changing markets and technologies.²

Self-regulation is also formally recognised as part of the regulatory framework for financial services, as the Australian Securities and Investments Commission (ASIC) can approve industry codes and industry dispute resolution schemes.³ However, as far as the author is aware, ASIC has not yet been asked to consider approving an industry code. This may be because there is no requirement for financial services providers to subscribe to an ASIC-approved code. In contrast, businesses that provide financial services to retail customers in Australia are required, by way of a licence condition, to belong to an ASIC-approved dispute scheme.⁴ But another reason may be the lack of confidence that having an 'ASIC-approved code' would create significant marketing advantages for the relevant industry members. The perception would appear to be different in the UK. There, a Consumer Codes Approval Scheme has been in operation since 2001, and an initial review reported that code sponsors envisaged greater business for members of approved codes, due to increasing consumer confidence in the scheme.⁵

STATUS AND RELEVANCE OF THE CODE OF BANKING PRACTICE

A review of the scope and operation of the Code of Banking Practice (the Code) in 2003-2004 resulted in major improvements, as well as a commitment to regular reviews. In late 2007, the next review of the Code was announced and, in May 2008, an Issues Paper was published by the independent Code reviewer. The final report of the review was published in December 2008.⁶

The Code is a voluntary one. Membership is open to banks with retail operations in Australia, and most banks

– including the four major banks – have adopted the 2004 Code.⁷

The Code can be enforced against subscribing banks in a number of ways.

First, clause 10.3 of the Code provides that 'Any written terms and conditions will include a statement to the effect that the relevant provisions of this Code apply to the banking service ...'. As a result, the commitments of the Code effectively become incorporated into the banker-customer contract, and non-compliance with a Code commitment by a subscribing bank could amount to a breach of contract, giving rights to the customer to claim damages for any loss suffered. Although this interpretation has not been tested in court, there is a consensus of opinion that it is correct.⁸

Second, the Banking and Finance Division of the Financial Ombudsman Service (FOS) must take into account 'any applicable industry codes or guidelines' when making a determination.⁹

Third, the independent Code Compliance Monitoring Committee can impose sanctions on a subscribing bank for non-compliance.

Finally, it is possible that a subscribing bank's failure to comply with Code commitments could amount to misleading or deceptive conduct, in contravention of s12DA of the *Australian Securities and Investments Commission Act 2001* (Cth), and equivalent provisions in state and territory fair trading legislation.

Thus, although the choice as to whether or not to subscribe to the Code is a voluntary one, the decision to subscribe makes the commitments in the Code binding on the subscribing bank.

THE SCOPE OF THE CODE OF BANKING PRACTICE

The Code of Banking Practice includes both broad commitments or principles and detailed rules.

The Code includes commitments to:

- continuously work towards improving standards of practice and service (clause 2.1(a));
- promote better-informed decisions about banking services (clause 2.1(b)); and
- act fairly and reasonably to customers in a consistent and ethical manner (clause 2.2).

The scope of these commitments is potentially very wide. An issue raised in the review was whether these commitments

give additional rights or causes of action to consumers with a banking dispute. For example, can a bank contravene clause 2.2 (acting fairly and reasonably), and thus be liable for sanctions, even if it has not breached any of the specific rules-based provisions in the Code?¹⁰ Consumer advocates suggested that consumers *should* have independent rights under clause 2.2.¹¹ However, UK courts have taken a different approach to a similar fairness principle in the UK Banking Code. In a 2002 case, the court took the view that the Banking Code was a regulatory code that 'guides'. This led the court to emphasise the all or nothing character of ss2.17 and 2.18 (as rules) and to discount the importance of the general promise to 'act fairly and reasonably' in all dealings with customers.¹²

As a result, in the absence of the breach of the specific rules of the UK Banking Code, the guiding principle of fairness could not ground a separate claim.¹³

The final report of the Code review did not support an expanded role for the key commitments in clause 2. Instead, it recommended that the commitments be treated as general guiding principles, to be interpreted by reference to the more detailed Code provisions.¹⁴

In addition to these guiding principles and commitments, the Code contains detailed rules on:

- disclosure and content of terms and conditions and other documents;
- timeframes for changes to terms and conditions;
- joint accounts and subsidiary cards;
- guarantees;
- code monitoring and promotion;
- internal and external dispute resolution; and
- other matters.

The full text of the Code is available from the Australian Bankers' Association (ABA) website.¹⁵

ISSUES RAISED BY CONSUMER ADVOCATES IN THE CURRENT REVIEW

Consumer advocates regard the Code of Banking Practice as one of the more effective codes in the financial services sector. It has 'provided significant benefits to consumers', and has 'aided in the resolution of disputes, both in the BFSO [now FOS] and in informal negotiations'.¹⁶

However, consumer advocates also argued that the current review provided an opportunity to improve standards, particularly given the changes that have been introduced or proposed in other self-regulatory instruments.¹⁷ These include new or proposed codes for the Mortgage and Finance Association of Australia (MFAA Code); credit unions and building societies (Abacus code), and the UK banking sector.

This development highlights the potential for the regular review process of industry codes in the same or related sectors to gradually 'ratchet up' standards over time, as each code sponsor responds (or is asked to respond) to the changes made in the codes of their competitors.¹⁸

Three important areas where consumer advocates recommended changes to the current Code, and to the interim recommendations in the Issues Paper, are discussed below.

Credit assessment and responsible lending

The 2004 Code introduced a new provision on credit assessment:

'Before we offer or give you a credit facility ... we will exercise the care and skill of a diligent and prudent banker in selecting and applying our credit assessment methods and in forming our opinion about your ability to repay it.'¹⁹

This clause was a very significant addition to the Code; however, consumer advocates remain concerned that cases of irresponsible lending are still too frequent. The impact of irresponsible lending practices is likely to worsen in the current financial crisis. While supportive of clause 25.1 at the time it was introduced, more detail is now needed.

The Review Issues Paper suggested that the Code should include a general principle of responsible lending, which is strongly supported by consumer advocates. However, for such a principle to be of practical assistance, it needs to be supplemented by more detailed guidance in the Code. In particular, consumer advocates suggested that banks should be required to take reasonable steps to ensure that (i) the product meets the needs of the customer; and (ii) the customer has the capacity to repay the loan without hardship. There is little support for expanded use of credit and behavioural scoring as a mechanism for assessing capacity to repay:

'Credit and behavioural scoring might be effective for managing the banks' risks. However, if there is no reference to an individual consumer's actual capacity to pay at the time of making the loan, or increasing the credit limit, then it is not effective in protecting the interests of that consumer.'²⁰

The development of a 'maladministration' jurisdiction in the industry dispute resolution schemes,²¹ and the outcome of recent cases under the *Contracts Review Act 1980* (NSW), such as *Perpetual Trustee Company Ltd v Khoshaba*,²² and under the *Consumer Credit Code*, such as *Permanent Mortgages Pty Ltd v Cook*,²³ also highlight the importance of lenders properly assessing borrowers' capacity to repay, without relying solely on credit and behavioural scoring.

Consumer advocates' recommendations for improved provisions on responsible lending were based on the provisions in the draft Abacus Code and draft finance brokers legislation, reinforcing the notion described above of using competitor codes to increase the standards of codes under review.

The final report of the review recommends the inclusion of more detailed guidance on lending requirements.²⁴ However, it has not taken up some of the suggestions of consumer advocates that, for example, the Code should prescribe some circumstances in which unsolicited offers to increase credit card limits cannot be made.

Financial hardship

A new provision on financial hardship was also introduced in the 2004 Code:



'With your agreement, we will try to help you overcome your financial difficulties with any credit facility you have with us ...'²⁵

Again, this provision was warmly welcomed by consumer advocates at the time. In their response to the Review Issues Paper, they commended the implementation of this provision by the banks, noting that:

'... there are many excellent examples of banks implementing clause 25.2 in an effective manner, and improving their practices and processes to the benefit of consumers. This is particularly the case in banks that have instituted a dedicated hardship team.'²⁶

Despite positive outcomes in many cases, consumer advocates also report implementation issues, including poor communication, difficulty in getting referred to the right part of the bank, lack of timeliness, failure to confirm agreements in writing, unrealistic expectations about repayment plans, a lack of clarity about what happens at the conclusion of a short-term repayment plan, and too frequent application of a 'one size fits all' approach to consumers in hardship. Failure to advise consumers of their rights, under the Consumer Credit Code, to request a variation of their contract on the grounds of hardship, is another issue of concern.²⁷

As with the issue of responsible lending and credit assessment, consumer advocates were of the view that the time was right for the Code to include more detail on appropriate responses to financial hardship. Again, provisions in the Abacus and MFAA codes were suggested as starting points for amendments to clause 25.2. Suggested additions included obligations to provide information about hardship processes, and contact details, on default notices; to confirm arrangements in writing; and not to initiate enforcement action while a hardship application is being considered.²⁸

The final report of the review has taken on board a number of these suggestions, and has recommended expanded and more specific provisions on financial hardship.²⁹ Importantly, it has recommended that enforcement action should not be started while a bank is considering a financial hardship application.³⁰

It is interesting to observe the potential development of clauses 25.1 and 25.2 in the Code. These clauses deal with difficult issues, where it is not immediately easy to draft detailed rules. By initially couching the clauses in very broad terms, it has been possible for banks, consumers, and consumer advocates to approach individual cases in a very flexible manner, and to explore innovative ways of responding to those cases. However, now that there is some experience with the operation of these broad principles in practice, it is timely to introduce some greater specification and guidance to industry and to consumers.

Code monitoring and sanctions

Appropriate monitoring and sanctioning procedures give consumers confidence that a self-regulatory scheme will have some teeth and credibility. Monitoring arrangements

for the original Code were heavily criticised in the 2003-2004 review, and the reviewer recommended a new, more robust, approach. The ABA subsequently established the independent Code Compliance Monitoring Committee (CCMC), with powers to monitor bank compliance with the Code, and to investigate and make determinations on allegations of non-compliance (clause 34).³¹

The Review Issues Paper highlighted a range of concerns about the effectiveness of the CCMC, including the lack of clarity surrounding the relationship and respective roles of the CCMC and the then Banking and Financial Services Ombudsman (now the FOS). The Issues Paper included an interim recommendation that, if implemented, would see the FOS play a greater role in allegations of code breaches. Among other things, all alleged breaches of the Code would be referred to the FOS for determination as to whether the matter should be dealt with by the FOS, or referred to the CCMC.³²

While concerned about the relationship between the CCMC and the FOS, consumer advocates argued that the CCMC should remain independent of both the FOS and the industry. The functions of compliance monitoring and dispute resolution are very different, and merging or blurring them risk compromising the effectiveness of either or both. However, consumer advocates acknowledged the complementary nature of these functions and the critical importance of a close working relationship with the bodies responsible for compliance monitoring and dispute resolution. Information-sharing is a key part of that relationship.³³

In responding to the Issues Paper recommendation, consumer advocates strongly believed that:

- Consumers should retain the right to make a complaint directly to the CCMC, without that complaint having to be mediated through FOS;
- Consumers should be able to refer matters to the CCMC by the FOS, without having to make a separate complaint to the CCMC;
- The roles of the CCMC and the FOS should be clearly delineated;
- The CCMC and the FOS should make commitments to appropriate information-sharing, staff training, and joint promotion and publication activities.³⁴

Another issue raised in this context was the risk of differing interpretations of Code provisions. Merging the functions of compliance monitoring and dispute resolution might be one way to eliminate this risk. However, given concerns about the need for CCMC independence, consumer advocates did not favour this option, instead arguing that the risk could be managed by appropriate communication between the CCMC and FOS.³⁵

The final report of the review acknowledged the concerns raised by consumer advocates, but took the view that functional independence of the CCMC could be achieved by establishing the CCMC as a separate unit within the FOS, reporting directly to the FOS Board, and with separate terms of reference.³⁶

DISPUTE RESOLUTION – THE OTHER ARM OF SELF-REGULATION

A discussion of the Code would not be complete without reference to the dispute-resolution processes envisaged by the Code. Clause 35 requires Code subscribers to have both an internal and external (and approved by ASIC) process for handling disputes with customers. All of the banks currently subscribing to the Code have joined the FOS, which was formed in July 2008 when the Banking and Financial Services Ombudsman (BFSO) merged with the Financial Industry Complaints Service, and the Insurance Ombudsman Service.³⁷

The dispute-resolution service offered by the FOS is free to consumers; and the Banking and Finance Division can consider disputes with a monetary value of up to \$280,000. If accepted by the disputant, decisions are binding on the FOS member. On the other hand, consumers can reject a decision from the FOS, and then pursue their dispute in another forum (for example, a court). The FOS focuses on mediation and conciliation to resolve disputes, but it also has the power to make determinations. In exercising this power, the FOS must take into account:

1. the law;
2. applicable industry codes or guidelines;
3. good industry practice; and
4. fairness in all the circumstances.³⁸

In 2006/2007, the former BFSO (now the Banking and Financial Division of the FOS) received over 30,000 calls and 6,446 new cases nationally, and over half of these cases involved consumer or housing finance.³⁹ Over the same period, the Commercial Division of the Consumer, Trader and Tenancy Tribunal in NSW (dealing largely with credit matters) received 348 applications.⁴⁰ It is clear that the BFSO (and now the FOS) is the primary venue for resolving consumer banking disputes.

CONCLUSION

The Code of Banking Practice is a very significant instrument for consumer protection, with application to consumers and small businesses. Consumer advocates believe that the Code has worked very effectively over the last three to four years, but have suggested improvements to ensure that the Code regains its former place as the benchmark for consumer codes in the financial services sector. The recently finalised review of the Code paves the way for further developing the obligations taken on by subscribing banks, and the amended Code will no doubt also be a reference for future code review processes in other parts of the financial services sector. Practitioners advising on consumer and small business banking matters would do well to develop an understanding of the Code principles and application, as well as of the jurisdiction and powers of the Financial Ombudsman Service. ■

Notes: 1 In June 2008, ASIC's Consumer Advisory Panel provided funds for the author to consult consumer advocates and, based on the consultations and other research, to prepare a joint consumer submission to the Review Issues Paper. The submission

is available at <http://www.reviewbankcode2.com.au/default.aspx?FolderID=213> (accessed 10 November 2008). 2 See, for example, 'Taskforce on Industry Self-regulation' in *Industry Self-Regulation in Consumer Markets*, Commonwealth of Australia, Parkes ACT, 2001, p21. 3 *Corporations Act 2001* (Cth), s1101A. 4 *Corporations Act*, s912A(g). 5 Office of Fair Trading (UK), *Review of the impact on business of the Consumer Codes Approval Scheme*, OFT870, 2006, p4; available at http://www.of.gov.uk/shared_of/Approvedcodesofpractice/of870.pdf (accessed 16 November 2008). 6 J McLelland and Associates Pty Limited, *Review of Code of Banking Practice: Final Report*, Sydney, 2008, available at <http://www.reviewbankcode2.com.au/> (accessed 28 January 2009). 7 A full list of subscribing banks is available at <http://www.bankers.asn.au/Default.aspx?ArticleID=446> (accessed 16 November 2008). 8 For example, P O'Shea, P Pennington, 'The new Code of Banking Practice : Guarantees Guaranteed?', *Proctor*, Vol. 24(5), 2004, pp19-21 at 19; W S Weerasorria, *Banking Law and the Financial System in Australia*, 5th edn, Butterworths, Australia, 2000, p201 (referring to a similar provision in the 1993 version of the Code); R Viney, *Review of the Code of Banking Practice: Issues Paper*, Melbourne, 2001, p103, available at <http://www.reviewbankcode.com/pdfs/issues.pdf> (accessed 17 November 2008). 9 Financial Ombudsman Service, *Banking and Finance Terms of Reference*, 1 July 2008, 7.1(b). 10 For example, J McLelland and Associates Pty Limited, *Review of Code of Banking Practice: Issues Paper*, Sydney, 2008, p72, available at <http://www.reviewbankcode2.com.au> (accessed 17 November 2008). 11 N Howell, *Joint consumer submission to the review of the Code of Banking Practice and the Review Issues Paper*, Queensland University of Technology, 2008, p45, available at <http://www.reviewbankcode2.com.au> (accessed 17 November 2008). 12 R Nobles, 'Rules, Principles and Ombudsmen: *Norwich and Peterborough Building Society v The Financial Ombudsman Service*', *The Modern Law Review*, Vol. 66(5), 2003, pp781-91, at p785. 13 'Rules, Principles and Ombudsmen', p786. 14 *Review of the Code of Banking Practice: Final Report*, p84 (recommendations 44 and 45). 15 <http://www.bankers.asn.au/Default.aspx?ArticleID=446> (accessed 15 November 2008). 16 *Joint consumer submission*, p8. 17 *Ibid*, p9. 18 For example, a submission by the Consumers Federation of Australia to the revised draft General Insurance Code of Practice 'made an unfavourable comparison between the draft Code and the Code of Banking Practice': P O'Shea and D McGrath, 'Style and substance – the consumer view of the new look General Insurance Code of Practice', *Insurance Law Journal*, Vol. 16(3), 2005, pp297, at 297. 19 Code of Banking Practice, Cl 25.1. 20 *Joint consumer submission*, p12. 21 Credit Union Dispute Resolution Centre, *Draft Code of Practice – Mutual building societies and credit unions, Submission by the Credit Union Dispute Resolution Centre*, undated, pp6-7, available at http://www.abacus.org.au/media_centre/code_of_practice/docs/cudrc_submission.pdf (accessed 18 November 2008). 22 (2006) NSWCA 41. 23 [2006] NSWSC 1104. 24 *Review of the Code of Banking Practice: Final Report*, pp41-42 (recs 1 and 2). 25 Code of Banking Practice, cl 25.2. 26 *Joint consumer submission*, p19. 27 *Ibid*, p19-20. 28 *Ibid*, pp20-1. 29 *Review of the Code of Banking Practice: Final Report*, pp46-7 (rec 3). 30 *Ibid*, p46. 31 Details of the CCMC's operations can be found on its website: www.bankcodecompliance.org. 32 *Review of Code of Banking Practice: Issues Paper*, p59. 33 *Joint consumer submission*, pp29-30. 34 *Ibid*, pp29-30; 35-6. 35 *Ibid*, p34. 36 *Review of the Code of Banking Practice: Final Report*, pp66-8 (recs 9-18). 37 A list of FOS members is available at http://www.fos.org.au/centric/home_page/members/list_of_financial_ombudsman_service_members.jsp (accessed 28 January 2009). 38 *Banking and Finance Terms of Reference*, cl 7.1. 39 Banking and Financial Services Ombudsman, *2006-2007 Annual Report*, pp11-12; 18. 40 Consumer Trader and Tenancy Tribunal, *Annual Report 2006-2007*, p32.

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