

Credit Ombudsman Service

Proposal to merge the business operations of the
Banking and Finance Services Ombudsman,
Insurance Ombudsman Service and Financial
Industry Complaints Service

Australian Competition and Consumer Commission

Submission by
Credit Ombudsman Service Limited

April 2008



SUBMISSION

1. Our Organisation

COSL is an external dispute resolution (EDR) scheme approved by the Australian Securities and Investments Commission (ASIC).

As a condition of ASIC's approval, COSL is required to meet the stringent conditions prescribed by ASIC's Regulatory Guide 139.

COSL is a not-for-profit company. It is required to be impartial, accessible and independent, as well as absolutely free of charge to consumers. It provides consumers with an alternative to legal proceedings for resolving disputes with its members.

The key objects of COSL (as set out in its Constitution) are to:

- (a) act as the primary complaints resolution body for the credit industry; and
- (b) ensure the timely, efficient and effective resolution of complaints against members, having regard to the criteria of relevant legal requirements, recognised industry Codes of Practice, good practice in the credit industry, and fairness in all circumstances.

Importantly, COSL is able to award compensation in an amount of up to \$250,000 for loss. It is also able to make orders compelling a member to do or refrain from doing specified acts.

COSL's membership comprises mainly finance brokers¹, with some mortgage originators, non-bank lenders, aggregators and mortgage managers.

The overwhelming majority of finance brokers in Australia are either members of COSL or loan writers for whom COSL members have assumed responsibility.

¹ The expression 'finance broker' in this submission refers also to mortgage brokers

Importantly, about 36% of all home loans written in Australia are written by members of COSL or their loan writers.

COSL's membership now stands at more than 8,300 members, and covers about 16,000 (non-member) loan writers. COSL's strategic aim is to expand its coverage in the credit industry and so provide more consumers with further access to an EDR process.

An estimated 75% of loan writers who would not otherwise be covered by an ASIC-approved EDR scheme are covered by COSL, and this benefits consumers enormously.

About 95% of enquiries and complaints received by COSL are resolved by non-adjudicative means, that is, by conciliation, although the Credit Ombudsman does exercise his power to make Determinations, the terms of which are then published on its website.²

Like all ASIC RG139 approved schemes, Determinations made by the Credit Ombudsman bind members but not consumers. COSL's services are funded by a combination of membership fees and complaint fees paid by its members. It is free for consumers and is controlled by a Board with equal representation from industry and consumer organisations and an independent chair.

To the extent that the Banking and Financial Services Ombudsman Limited ("BFSO") has recently invited finance brokers to join its scheme, and that this is also likely to be the case for the proposed merged entity, Financial Ombudsman Service ("FOS"), then COSL can be described as a competitor of the BFSO and of FOS.

² www.creditombudsman.com.au

2. Relevant Markets

2.1 Direct competition and alternative services

Given their transactional and institutional foci, it is difficult to assert that the BFSO, Insurance Ombudsman Service (IOS) and the Finance Industry Complaints Service (FICS) are in direct competition with each other.³ As to the geographic dimensions of the relevant market, they are national in character, as is COSL's.⁴

2.1.1 Consumers

As is so often the case in matters under Part IV of the *Trade Practices Act*, it is crucial and not always easy to define the dimensions of the relevant market.⁵

For consumers, it could be argued that the relevant market is dispute resolution in consumer financial services. If so, there is no restriction as there is no requirement for consumers to access the FOS or any industry based EDR scheme as an alternative to the courts. The decisions of the schemes are not binding on consumers. It is not common practice for Australian financial services providers to include clauses in consumer contracts requiring consumers to access the industry-based EDR schemes prior to taking court action.⁶ Indeed, it is unlikely that the imposition of such provisions would withstand judicial scrutiny.

On the other hand, if the market, from the consumer's perspective, was defined as being a market for alternative dispute resolution in financial services consumer disputes, then the consumer's choice is already highly restricted prior to the proposed merger.

³ In answer to question 2(a) in Attachment A to the letter of 9 April 2008. The second 2(a) is addressed under the headings "2.1.1 Consumer and "2.1.2 Providers"

⁴ In answer to question 2(d)

⁵ E.g. *News Ltd v Australian Rugby Football League* (1996) ATPR 41-446 ("Superleague")

⁶ As opposed to the US where such compulsory arbitration clauses are common and seen as anti-consumer: Engel, K and McCoy "Turning a blind Eye: Wall Street Finance of Predatory Lending" (2007) 75 *Fordham Law Review* 2039 at p 2044

This is because it is the financial services provider that chooses the EDR scheme they wish to join. It is largely, therefore, already decided for the consumer that if they wish to obtain a general insurance service, and this gives rise to a complaint, that it must be resolved by the IOS, soon to be part of the FOS.

A consumer seeking basic banking and credit services does have more choice. Whilst all banks are members of the BFSO, not all credit unions are members of the Credit Union Dispute Resolution Centre, ("CUDRC") which outsources its dispute resolution functions to the BFSO and which will be converged in the new merged entity. Some credit unions and almost all building societies in Australia are members of the Financial Co-operatives Dispute Resolution Service ("FCDRS").

As discussed above, COSL does have some non-bank credit providers as members as does the BFSO, which has also opened up its membership to finance brokers. A consumer, therefore, could be influenced in their choice of financial services provider in these sectors by choice of EDR scheme. There is no evidence, at present, that consumers do so.

The proposed merger will not affect this choice, in the first instance, should no further consolidation or convergence occur in the financial services EDR market.

2.1.2 Providers

Similar issues apply to financial services providers. There is already no effective competition for EDR for general insurance providers, financial planners, stock brokers, banks and managed investment funds.

On the other hand, credit unions, building societies and other non-bank credit providers and finance brokers can choose between the BFSO or FCDRS or COSL for EDR services. This choice will still exist after the proposed merger.

2.3 Constraints

As to competitive constraints⁷ imposed or likely to be imposed on the merger parties by their competitors, COSL can really only speak for its own competitive advantages for consumers and provider members in relation to the BFSO.

These include greater flexibility in responses to both provider members and consumers.

2.3.1 Flexibility of efficient responses to industry-specific issues

The large institutional members of the BFSO deal with more than one scheme. So for example, a bank member of the BFSO would at present also have to deal with FICS if it owns a financial planning or stockbroking firm.⁸

Given the overlap of membership, large institutional members of the BFSO would understandably find it advantageous if there was greater standardisation of systems, processes and procedures, as well as jurisdictional limits, across the three schemes. However, the rationale for such standardisation has no application to the smaller end of town. Small intermediaries would be treated in the same way as the large financial institutions who attract the vast majority of complaints and whose corporate structures and governance bear no resemblance to theirs. It is therefore not surprising that COSL's general membership does not wish to be part of a single consolidated EDR scheme geared towards large institutional members.

A merger of the BFSO, IOS and FICS is also at risk of being substantially less flexible or capable of responding quickly to changes in industry.

⁷ In answer to 2(b) of Attachment A

⁸ For example, as well as selling under its own brand, Westpac's BT Wrap is "badged" by 50 financial planning "dealer groups" (as financial advisers call their own businesses). That is, the groups put their own name on the BT Wrap as if it's their own - <http://www.smh.com.au/news/business/time-investors-beat-the-wrap/2007/02/27/1172338623012.html>

COSL's ability to quickly respond to changes in industry is perhaps best illustrated by the fact that it has changed both its Constitution and its Rule no less than three times in the last 15 months in order to respond to specific developments in the market and expand its jurisdiction and coverage of the credit sector.

Furthermore, an EDR scheme, being industry funded, should be able to decide how best to levy its members, given its particular membership characteristics. For example, COSL's membership and complaint fees are amongst the lowest of all ASIC-approved EDR schemes, primarily because of the size of its membership. At more than 8,300 members it is easily the largest EDR scheme in Australia.

This allows COSL to rely primarily on its membership fees to support its operations. Other schemes rely primarily on complaint fees or a combination of complaint fees and membership fees.

One of the key findings of the triennial Independent Review of COSL's operations made it quite clear that a 'user pays' model for complaint fees was deeply resented by COSL's membership.⁹ It found that complaint fees are often a shock to and represent a significant financial impost to small operators. 95% of COSL's membership comprises single operators, husband and wife teams and groups of no more than five operators. The Review noted that in schemes that have large numbers of small operators, user-pays complaint fees are a huge source of friction with members. This is particularly because complaint fees are payable by a member even when the complaint is eventually found to have no basis.

Indeed, the Draft Report into the Consumer Policy Framework in Australia by the Productivity Commission refers to the COSL Review and its discussion of complaint fees as an example of the "case for maintaining separate identities for at least some of the entities for the time being".¹⁰

⁹ Navigator Pty Ltd Independent Review of COSL 2006, p 42

¹⁰ *ibid*

The Reviewers suggested a medium term reduction in complaint fees as a strategy for improving relations with members. Following this advice, COSL introduced a new and innovative fee structure for handling complaints about its members which significantly reduced the cost burden on its members, particularly the small ones, while allowing COSL to continue to provide as much coverage of the credit market as possible.

This was an Australian first.

From 1 February 2007, members of COSL received a 'one free complaint' voucher, and complaint fees were dramatically reduced by up to 75% for the first three complaints. The 'one free complaint' voucher can be used to offset the complaint fees that would normally apply to a complaint heard by COSL, up to and including a determination by the Credit Ombudsman. The Financial Services Ombudsman in the UK adopted a similar approach for its smaller members. Industry has responded very positively to this initiative.

On the other hand, the BFSO has recently invited finance brokers to join its scheme, and ultimately the new merged entity, FOS. Its published membership fees for a broker operation comprising five loan writers is far higher than those charged by COSL (in fact 403% higher). BFSO also makes no concessions on the issue of complaint fees. These are much higher for all BFSO members than for COSL and would be crippling for COSL's small firm and sole trader members.¹¹ COSL, therefore, currently does have a competitive advantage for its members.

2.3.2 Flexibility to respond better to consumers

COSL is clearly leading the way amongst EDR schemes in its responses to consumer credit issues. These responses have been praised by leading consumer advocacy groups.¹² COSL does and is prepared to look at whether fees and charges imposed by a lender amount to a penalty at common law or are unconscionable under section 72(l) of the *Uniform Consumer Credit Code*.

¹¹ This has been a major issue for the UK FSO See commentary on the recent review of FOS by Lord Hunt at <http://www.postonline.co.uk/public/showPage.html?page=698239>

¹² E.g. The Consumer Law Centre of the ACT Submission to the Productivity Commission at http://www.pc.gov.au/_data/assets/pdf_file/0007/63862/sub074.pdf at p 7

COSL also takes the view that it is entitled to consider a complaint from a consumer that a lender has not given effect to section 66 of the *Uniform Consumer Credit Code* which deals with financial hardship. Again, this benefits consumers enormously, particularly at a time of rising interest rates and evidence of mortgage stress.

Both these positions have been eschewed, so far, by the BFSO as being either “commercial considerations” or “policy matters” for their lender members.

The flexibility and indeed alacrity with which COSL was able to assess these issues and develop considered policy responses and guidelines will be difficult, if not impossible, to achieve in a large bureaucratic organisation such as the proposed merged entity.

2.4 Switching¹³

For those financial services providers who have an option as regards which EDR scheme they join, there are some but not many impediments to switching between schemes. Several have done so, for instance, Credit Union Australia or CUA, the largest credit union in Australia, has moved from CUDRC to FCDRS and back again over the course of three years.

Firstly, membership fees are paid in advance and while some provision may be made for a pro rata adjustment, in general, a member is committed for at least twelve months of an annual membership. The detail of this varies from scheme to scheme and is found in constitutions and terms of reference.

Secondly, there are issues of training, changing procedures and documents and notice to consumers if a provider changes their EDR scheme.

As there has been no switching between the merging parties, the merger is unlikely to affect this aspect of competition.

¹³ In answer to question 2(c)

3. Barriers to Entry

It is possible for an industry group to establish their own EDR scheme. Even those holders of Australian Financial Services Licenses which are, therefore, required by the *Corporations Act* to be members of an EDR scheme, are not required to join a particular scheme but simply one which complies with section 912A(2) of the *Corporations Act*.¹⁴

It is, however, difficult, expensive and time consuming for any but the largest, best resourced, unified and maturely organised industry group to undertake this exercise. An attempt by the Australian Timeshare and Holiday Ownership Council was unsuccessful both in its application for ASIC approval and, being refused, on appeal to the Australian Administrative Appeals Tribunal.¹⁵

While the current state of the law does not require, in every State, credit providers or finance brokers to belong to an EDR scheme, this is likely to change in the very near future. The Productivity Commission has recommended in its Draft Report into the Consumer Policy Framework in Australia that EDR scheme membership be mandatory for credit providers and finance brokers¹⁶. It is also likely that the benchmark standards to be met for such schemes to satisfy these regulatory provisions will be those contained in ASIC RG139 and it will be ASIC which will determine their compliance.

ASIC, therefore, presents the greatest regulatory barrier to entry for any proposed new EDR scheme in the financial services sector. ASIC has already stated its policy in its submission to the Productivity Commission Inquiry saying it did not believe any new schemes should be developed.¹⁷

COSL submits that this barrier to entry into the market is almost insurmountable and that there will be no new players in the market following the proposed merger. This is not a competitive position and is not likely to accommodate new or emerging markets.

¹⁴ Further elaborated by ASIC in its RG139

¹⁵ Australian Timeshare and Holiday Ownership Council Limited and Australian Securities and Investments Commission [2008] AATA 62 (23 January 2008)

¹⁶ http://www.pc.gov.au/_data/assets/pdf_file/0006/73662/consumer2.pdf at pp 89,90 and 401

¹⁷ ASIC Submission to Productivity Commission Inquiry into Australia's Consumer Policy Framework at http://www.pc.gov.au/_data/assets/pdf_file/0007/66724/sub103.pdf at p 41 para. 3.59-3.60

4. Bargaining Power

The BFSO, FICS and IOS have admitted in their submission to the Productivity Commission that the new merged entity will have 90% of all complaints in financial services in Australia.¹⁸

This is clearly massive market power approaching the famous 97% of the Australian steel market controlled by BHP in the *Queensland Wire Industries* case.¹⁹ Although the three merging entities do not actually compete with each other, the new entity will be handling disputes about a great variety of financial services. Indeed, it will sometimes be called upon to resolve disputes with entities which play different roles in the same financial transaction.

For instance, the new entity will be handling general insurance disputes and those of insurance brokers. It will be determining complaints about finance brokers (if any take up its offer to join) and the banks and credit providers who provide the finance. The respective interests and obligations of these parties are not likely to be aligned and the situation is akin to one of vertical integration of a market. This is an acknowledged form of market power.

It is clear from decided cases that merely having market power does not amount to a breach of section 46 of the Trade Practices Act. It must be abused. The new merged entity will have massive market power in the Australian market for EDR services in financial services. The potential for abuse, even inadvertently, of such power is equally massive. The abuse may take the form of shifting liability unfairly and arbitrarily down a vertical value chain.

¹⁸ As referred to by the Commission in transcript of Public Hearings at http://www.pc.gov.au/_data/assets/pdf_file/0009/77445/sydney080218.pdf at p 813

¹⁹ *Queensland Wire Industries Pty Ltd v. BHP* (1989) 167 CLR 177

5. Vigorous and Effective Competitors

As discussed above, the merging entities do not actually compete with each other so a discussion of competition on price, quality, service and other factors serves no purpose in that context.

However, as regards its competitiveness with COSL, as also discussed above, the BFSO does not appear very competitive to provider members on price and for consumers on the quality of its responses to some consumer issues. This is likely to continue in the new merged entity.

Indeed, if after acquiring the market power referred to above, pressure is put upon COSL and its members to join a larger merged entity, then a less efficient, less competitive outcome is likely.

6. Pricing

The discussion on price comparisons above applies here. Pricing of membership and complaint fees in an EDR scheme is a complex one. The Productivity Commission has speculated in its Draft Report that any possible costs savings and efficiency in pricing of EDR services may well have already been achieved by the levels of co-operation between the merging entities and all the EDR schemes in the sector, particularly the joint call centre.²⁰

7. Other Factors

As the Commission is well aware, it should not grant authorisation for the merger unless it is satisfied in all the circumstances that it will result "in a benefit to the public."²¹

²⁰ Productivity Commission Draft Report of the Inquiry into Australia's Consumer Policy Framework Vol 2 p159

²¹ *Trade Practices Act* s90(7)

It is COSL's submission that any benefits likely from the proposed merger, in terms of efficiencies, cost savings and easy consumer accessibility via the single call centre, have already been achieved and, as discussed above, the Productivity Commission acknowledges this in relation to costs.

Thus, while there may not be a direct and immediate "lessening of competition" in the sense usually encountered by the Commission in these authorisation deliberations under section 88 of the Trade Practices Act, there will be a massive acquisition of market power and a potential for its future abuse.

The Commission may well wish to consider these issues in its deliberations on the authorisation and on any conditions it imposes or undertakings it requires as part of its authorisation.