



Bulletin No 6

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Responsible lending

Distribution:

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Press

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1. Introduction

This bulletin will be supplemented and in some cases be amended, by the provisions of the National Credit Act 34 of 2005 which becomes fully operational in July 2007.

The subject of responsible lending has received a fair amount of attention recently and in light thereof, the Office believes it will be prudent to issue a bulletin informing its stakeholders of the Office's views on the subject.

We have started to receive complaints relating to the assessment of loan applications by the banks and the effect it has on the complainant. The complaint is usually based on the following set of facts:

The complainant applies for a loan from the bank. The bank assesses his ability to repay and grants the loan. Later the complainant finds himself in financial difficulties and is unable to afford the repayments on the loan. The bank starts legal proceedings against the complainant to try and recover the debt. The complainant then approaches our Office for assistance in resolving the matter.

In assessing complaints of this nature we sometimes notice that the complainant was granted a loan amount that exceeded his ability to repay at that time. We then deem it necessary to investigate the circumstances surrounding the assessment of the loan application and the application of the bank's lending policy in assessing the complainant's ability to afford the repayments on the loan.

It must be stressed that the Office is only concerned with any maladministration that may have occurred in the process and not with the commercial decisions of the banks.

The term “maladministration” is defined in the Banking Adjudicator’s Terms of Reference as “an act or omission in breach of any obligations or duty owed by the bank to the complainant for banking services between a bank and its customer.”

The Australian Banking Industry Ombudsman’s (ABIO) Terms of Reference defines maladministration as “an act (or omission) contrary to or not in accordance with a duty of care owed at law or pursuant to the terms (express or implied) the contract between the bank and the disputant.”

A duty of care is in turn defined as a “duty, recognised by law, requiring conformity to a certain standard of conduct for the protection of others against unreasonable risk.”

2. The Code

The Code of Banking Practice contains the following provisions applicable to lending principles applied by the banks:

2.8.3 Responsible credit:

We will market and approve loans responsibly in an attempt to ensure that you are not extended financially beyond your means. However you have an obligation to inform us and keep us informed of all your loans, other financial commitments, income and changes to these and continuously to act responsibly in all your financial affairs.

3.2 Lending

3.2.1 Financial assessment:

All lending will be subject to our assessment of your ability to afford and willingness to repay.

This assessment may include:

- taking into account your income and expenses, including the dependability of your income,
- how you have handled your financial affairs in the past;
- information obtained from credit reference agencies and, with your consent, from other appropriate parties, for example employers, other lenders and landlords;
- information supplied by you, including verification of your identity and the purpose of the borrowing;
- credit assessment techniques, for example, credit scoring;
- your age;
- any security or collateral provided;
- taking into account your statement of assets and liabilities.

3. The Australian Code of Banking Practice

The Australian Code contains the following provisions relating to the granting of credit:

25. Provision of credit

- 25.1 Before we offer or give you a credit facility (or increase an existing credit facility), we will exercise the care and skill of a diligent and prudent banker in selecting and applying our credit assessment methods and informing our opinion about your ability to repay it

- 25.2 With your agreement, we will try to help you overcome your financial difficulties with any credit facility you have with us. We could, for example, work with you to develop a repayment plan. If, at the time, the hardship variation provisions of the Uniform Consumer Credit Code could apply to your circumstances, we will inform you about them.

4. The ABIO's Approach

The ABIO issued a bulletin on the subject of Maladministration in the Decision to Lend in June 1998. The bulletin is included in its entirety as an annexure to this notice as it very neatly sets out how they investigate matters on the subject.

5. The Proposed Policy of the Office

In making a recommendation, the Office must have regard to the Code of Banking Practice (Rule 3.1 of the Office's rules of procedure), however, in making a recommendation, the Adjudicator may, where appropriate, be guided by good banking practice in other jurisdictions in order to assess whether a bank has acted fairly and reasonably (Rule 2.8)

In light of the above, the Office will, where appropriate, be guided by the guidelines as set out in the Australian Ombudsman's Bulletin in so far as they are applicable. The proposed policy is set out below:

When assessing whether or not to lend to the customer, a bank must act as a prudent banker and in accordance with relevant standard of care. If it does not do so, then it is clear that the customer may suffer financially (as may the bank).

How do we assess what a prudent banker would have done and what the relevant standards of care are?

1. Bank's Lending Guidelines

Was the loan made outside the bank's normal guidelines for lending?

This is a relevant and appropriate standard by which to assess the bank's actions because we know that considerable thought and care has gone into the development of a bank's lending guidelines to enable the bank, by its officers, to properly analyse the risks associated with lending and so assess when it is prudent to lend.

If the loan has not been approved in accordance with the bank's own lending guidelines then this raises a serious question, to be answered by the bank, as to why the loan may nevertheless have been properly made in accordance with the standards of care expected in the banking industry.

2. Expressions of doubt by bank officers

Did the bank's own officers express doubt and concerns about the wisdom exercised in approving the loan?

The use of this standard recognises the hierarchy of loan approval within banks, the expertise of bank officers and the subjective knowledge about customers of bank officers which are relevant to an assessment of the risks associated with lending and when it is prudent to lend.

If doubts were expressed, then this raises a serious question, to be answered by the bank, as to whether the loan may nevertheless have been made in accordance with the standards of care expected in the banking industry. It should be noted, however, that in situations where a process is followed and some officers in a bank express doubt, yet because of a majority decision, the lending is approved, this will not prejudice a bank.

3. Realisation of security property

Does the balance of information suggest that realisation of the security property provided was the only real prospect for repayment of the loan from the outset?

The issue here is that put very simply it should be fundamental to a loan contract that loan repayments can be made by the borrower with the intention that when the loan is repaid the bank releases the security provided for the loan.

There may, of course, be borrowing arrangements which specifically envisage the realisation of security for repayment of all or part of the loan.

However, questions about the prudence of the lending decision necessarily arise if the customer cannot meet the loan repayments and cannot realistically hope to have the security released by the bank.

4. Further explanation

Each of the three standards of care applied by the Office and identified above is an alternative which, if it cannot be satisfied by the bank, raises a real question as to whether the bank fulfilled its duty of care.

However, the loan circumstances must be looked at as a whole. An apparent failure to meet one of the standards may not establish a breach of the duty of care when all the circumstances relevant to the decision to lend are examined.

A simple example of this would be a loan for subdivision and sale of a property when the borrower's income would not support the loan on a principal and interest basis but the aim of the parties is to complete the subdivision, sell part of the land and either extinguish the debt or repay only the balance of the debt.

Clearly here realisation of the security property was the only way the debt could be wholly or partially repaid, but the granting of the loan would not amount to a breach of a duty of care for this reason.

Review of Complaint by the OBA

Frequently, a complaint that there has been maladministration in the decision to lend will need to be investigated because of the need to obtain the bank's lending file to fully assess the complaint.

The starting point in assessing a complaint is the bank's lending guidelines.

Housing & Investment Loans

For housing and investment loans, the usual criteria identified by a bank in its lending guidelines are:

- the debt servicing ratio;
- uncommitted monthly income; and
- the loan to valuation ratio.

To review whether these tests were properly applied, questions which may need to be asked by the OBA include:

- What was the valuation of the security property?
- What did the bank do to verify the borrower's level of income?
- Was the estimate for living expenses reasonable?
- Were all commitments taken into account?
- Did the bank assess the borrower's uncommitted monthly income against relevant standards?
- Did the bank apply an average interest rate over the expected life of the loan for loans which offered honeymoon rates?
- What information is there to confirm that the bank did the calculations required by its own lending guidelines?

Small Business Loans

For small business borrowing, additional matters which may need to be reviewed include:

- Was the loan purpose consistent with and appropriate for the business of the borrower?
- What was the relevant experience of the owner operators of the business?
- Was the nature and locale of the business verified and assessed by the bank?
- Were reasonable cash flow forecasts for the business provided by the borrower and reviewed by the bank?
- Was a reasonable business plan for the business provided by the borrower and reviewed by the bank?

It should be noted that a bank will not be prejudiced merely because the projections, properly reviewed, do not materialise.

Other Information

If the financial analysis indicates that the borrower did not meet the lending guidelines of the bank, then the investigator will need to determine what the bank did to satisfy itself that, although the lending was outside the lending guidelines, the loan may nevertheless have been properly made in accordance with the standards of care expected in the banking industry.

In this context, an investigator may look at:

- The borrower's borrowing history;
- The borrower's relationship with the bank;
- Whether the loans officer had authority to approve a loan outside the bank's lending guidelines;
- Whether there were any doubts expressed about the ability of the borrowers to service the loan;
- Whether the bank relied on information provided by the borrower's accountant or financial counsellor;

- Whether the borrower gave full disclosure of relevant financial information;
- Whether the borrower had a real prospect of repaying the loan without undue hardship; and
- If income consisted of government payments, whether these were likely to be on-going.

Role of the Investigator

It is the investigator's role to be inquisitorial in his/her approach and obtain all of the information he/she considers relevant to the assessment of whether there has been any maladministration. It is the duty of the investigator to ensure that the complainant acted with bone fides at all times in its dealings with the bank and that they freely, openly and honestly appraised the bank of all pertinent financial and circumstantial facts surrounding their application for facilities, to facilitate correct lending decisions. It goes without saying that a “both sides of the story” approach must be followed

Once all of this information has been obtained, the investigator will make an assessment as to whether or not the duty of care has been complied with or breached.

**Adv NJ Melville
Ombudsman**