



December 2005

No. 19

## ISSUES RELATED TO INCREASES ON CREDIT CARD LIMITS

There has been a good deal of publicity in recent weeks about banks' lending practices. It has been said that banks are increasing their customers' credit card limits unnecessarily, without requiring customers to take any action to accept the increase or to submit evidence of their ability to repay the debt represented by the increased limit. Similarly, it is being said that banks are offering loan applicants more credit than they have requested, and are generally encouraging their customers to take on debt they cannot afford.

In lending to their customers, banks have obligations under the Code of Banking Practice. The Code is not as well known as it should be, and this may be a good time to remind both banks and customers of some of its provisions.

The Code begins by setting out some governing principles and objectives. Probably the most important in this context is an undertaking to "*act fairly and reasonably towards you [the customer] in a consistent and ethical way.*" The rest of the Code needs to be read in the light of this principle.

Also important is clause 3.5 (d) of the Code, which specifies

*(d) We will only provide credit to you or increase your credit limit when the information available to us leads us to believe you will be able to meet the terms of the credit facility. We have the right to decide not to provide credit to you.*

Some of the most important terms of any credit facility concern the customer's obligations to repay, and accordingly a bank is in breach of the Code if it lends to a customer when it has information that should tell it that the customer will be unlikely to be able to repay the loan as agreed.

When a customer approaches a bank and applies for credit in the form of a housing or personal loan, there is seldom a problem with clause 3.5(d) unless there has been some kind of administrative error that has led the bank to overlook or disregard relevant information. I also see the occasional case where bank staff have miscalculated loan repayments when advising customers on the affordability of a proposed loan.

More difficulties arise when a bank makes an unsolicited offer either of a new credit facility or of an increase to an existing one. If a bank intends to make a pre-approved offer, it must first consider all the relevant information it holds about the customer and assess whether the customer is likely to be able to meet the repayment obligation. It is not sufficient for a bank to consider only the customer's repayment record if it is in possession of other information with a bearing on that customer's creditworthiness. Case 1 below is an abbreviated version of a case included in my recently published casenote compendium for 2004-2005, and is a good illustration of the problems that can occur when relevant information is not considered.

Finally, some banks have a practice of making unsolicited grants of increased credit, without requiring the customer to take any positive action to accept the increase. This usually takes the form of a letter telling the customer that a credit card limit has been increased and that the customer should advise the bank if the increase is not required. I have reservations about this practice, partly because of the potential for letters to be lost or to be discarded unread if they are thought to be general marketing material from the bank, so that customers do not realise their limits have been increased.

The Code prohibits banks from issuing cards without specific instructions from the customer (clause 3.8(a)), but there is at present no such prohibition on their authorisation of increases in credit limits on existing cards. The other provisions of the Code, however, do still apply, and before increasing the limit on a credit card banks are required to take account of all information they hold in deciding whether the customer is going to be able to meet the payment commitment represented by the new limit.

The Code of Banking Practice is currently under review. In my submission to the independent reviewer I expressed the view that the “inertia selling” of credit increases is not good practice. Since I made my submission this issue has generated considerable public comment. I am hoping that the review will introduce greater clarity into this area of banking practice which touches on the lives of many bank customers.

Liz Brown  
Banking Ombudsman

The following case study illustrates both the difficulty and the importance of this issue.

***Case 1 Increasing the credit limit on the card of a customer who was unable to service that level of debt***

Mr A opened a credit card account with a limit of \$3,000 in July 2001. Later that same month, Mr A applied to the same bank for a personal loan of \$10,000 over a five-year period. The application was declined because the bank considered that Mr A would not be able to service the loan.

Between July 2001 and September 2002 Mr A contacted the bank on several occasions, gradually increasing the credit limit on his card to \$7,000. In May 2004, Mr A's credit card account was changed to a gold card, and its limit was increased to \$9,500. At the end of May, Mr J took an overdose of his medication, and was admitted to hospital and placed on a life support system.

Throughout this time, Mr A was in receipt of an invalid's benefit. His weekly net income was \$402. From this, he paid \$250 in rent, leaving \$167 per week in disposable income for living expenses. Mr A had a gambling addiction, and also suffered from bipolar disorder. In May 2004 his parents contacted the bank to explain Mr A's problem and asked that he be given no more credit.

Mr A's parents complained to me, on his behalf, that the bank made an irresponsible lending decision. Staff at Mr A's local branch had been aware of his condition for some time. The parents submitted that the stress of the debt he was being asked to service contributed to his unstable condition, eventually resulting in hospitalisation for almost two months. They considered the bank should write off Mr A's credit card debt, which by September 2004 amounted to approximately \$4,350.

The bank advised that Mr A met its credit card application criteria when he initially applied for the card. When Mr A requested increases to the limit, either at a branch or by telephone, the bank's credit card automated approval system criteria were met or exceeded.

Mr A's bank records showed that his only source of income was a benefit. Also on record was an unsuccessful personal loan application in July 2001. By early May 2004, if not before, the bank was aware of Mr A's disability and his parents' request that he not be provided with further credit.

The bank stated that its credit card division was autonomous, and would have no knowledge of what was on the branch records in relation to Mr A. However, the lack of communication between different divisions of the bank was neither the fault nor the concern of the customer, and could not justify non-compliance with obligations imposed by the Code.

Having established that the bank had acted wrongly in relation to the credit limit, I had to determine whether Mr A had suffered a direct loss as a result of the bank's actions. I had to take into account that Mr A had the use and benefit of the credit advanced to him for purchases and cash advances. I formed the view that a credit limit of, say, \$2,000 would have been prudent for a person in Mr A's position. I therefore recommended that the bank refund all the interest charged on the account since February 2004 (by which time it should have been well aware of his circumstances) on a balance of more than \$2,000. I also recommended that it cease charging interest on the outstanding credit card debt and allow Mr A to enter into an affordable repayment programme for the remainder of the debt.

I also found that the circumstances of the case warranted an award of compensation for inconvenience amounting to \$1,200.

The complaint was settled on the basis that I had suggested.

## WHERE DOES RESPONSIBILITY LIE WHEN YOU HAVE A PROBLEM WITH THE ATM OF A BANK OTHER THAN YOUR OWN?

ATMs usually function efficiently and well, and when they do not, the systems in place can usually be relied on to minimise any inconvenience to the customer. However, because it is possible (and often very convenient) to use a card issued by one bank in an ATM owned by another bank, it is not generally appreciated that it can be difficult for the customer to find out who is responsible when a problem actually occurs. In case 2 the customer was convinced that the ATM-owning bank was at fault when it seemed most likely that any problem lay with the bank with which he had his account.

### *Case 2 The ATM that swallowed a customer's money*

Mr N was a customer of bank A, which issued him a card to use for Eftpos and ATM machines. He used an ATM machine belonging to bank B to withdraw \$200 in cash. The machine read his card, the transaction was accepted and the funds were dispensed by the machine. However he failed to remove the notes within the usual 30-second time limit, and they were retracted by the machine. His account was debited with the amount of the transaction.

Mr N asked bank B for his money back. Over two weeks elapsed, without any sign of a refund credit to his account. He then complained again to bank B, which contacted bank A in order to trace the funds. Meanwhile Mr N complained to the Banking Ombudsman, saying that he considered that bank B was under an obligation to credit his account with that amount as soon as it was established that he had not received the funds.

My investigator established that bank B had forwarded the funds, together with the customer's card number details, to bank A on the business day after the transaction. Bank A did not action the refund until Mr N complained, two weeks after making his initial enquiry.

Mr N was adamant that his complaint was against bank B, which owned the ATM, even though it was not the bank which had issued his debit card.

In order to determine what obligations bank B might have, I surveyed eight banks about good banking practice in the circumstances. The survey showed that:

1. Because banks are unable to access information about customers of other banks, the general practice is for a bank detecting a surplus resulting from an ATM transaction to forward the funds, together with the cardholder information, to a holding account at the card issuing bank. In some instances the ATM owning bank also sends a fax detailing the surplus transaction.
2. Only one bank would, when detecting a surplus transaction, contact the card issuing bank and request the account number details, so that it can credit the cardholder directly.
3. Only one bank had information in its terms and conditions of use brochure for the card about the bank's liability for loss experienced through a malfunctioning ATM. This also outlined the process for error notification. (In this particular case there was no malfunction, as it is normal practice for ATM machines to withdraw the cash if the cardholder does not take the notes within a short time).

After considering the survey and the other information obtained during my investigation, I concluded:

- Since the complainant did not have a contract for banking services with bank B, there was no failure to meet any contractual terms.
- The evidence showed that bank B had complied with good banking practice in following its usual practices and policies.
- It had returned the money to bank A promptly (on the following business day).
- Bank B had not consequently failed in any obligation it owed to the complainant.

Mr N remained firmly of the view that bank B should have taken immediate steps to credit the funds directly to his account, but after hearing his further submissions I was not convinced that I should alter my initial view. I accordingly discontinued my investigation.

## PARENTS WHO GUARANTEE HOUSING LOANS FOR THEIR CHILDREN BEWARE!

In today's economic climate, characterised by sharp increases in house prices and interest rates, many young people need more money than they can personally afford to borrow and turn to mum and dad for financial guarantees, for housing finance in particular. Although banks advise persons seeking to offer financial guarantees to obtain legal advice, such persons frequently neglect to do so, and often do not appreciate that they may be letting themselves in for more than they had imagined possible.

Here is a cautionary tale for all parents who follow their hearts into financial arrangements to benefit their children. Most parents are more than willing to help their children, but this willingness should not blind them to the possibly unforeseeable consequences of entering into such financial commitments.

### *Case 3      Guaranteed trouble?*

Mr and Mrs C agreed to help their son and daughter-in-law financially by guaranteeing a loan of about \$175,000. Their liability would be limited to \$63,000, with their own home as security. Although they took legal advice before signing the bank guarantee, it subsequently became clear that they lacked an understanding of the full legal and financial implications of what they had done.

About a year later the son and daughter-in-law separated, and their home was sold. After all costs of the house sale had been deducted, less than \$150,000 was available to meet their debts.

At this point Mr and Mrs C found that the son and daughter-in-law, and in some cases the daughter-in-law alone, had taken out other loans from the bank. They had an overdraft of about \$7,500, in addition to credit card debts amounting to about \$4,500. The bank wanted to use the proceeds from the house sale to settle these additional debts as a first priority, and to use any remaining money to pay off the housing loan. This left a debt of about \$55,000, which their son undertook to pay. Mr and Mrs C were surprised and disturbed to discover that, if their son defaulted, they were legally liable for debts unrelated to the housing loan.

Mr and Mrs C erroneously believed that their guarantee related only to the housing loan, and that they would consequently be liable only for any difference between the amount realised by the sale of the house and the amount outstanding on the loan, in this case about \$27,000. They also felt that the bank had been remiss in not telling them about either the loans already in existence when they gave their guarantee or about the loans taken out later.

As the law states that a bank does not have to disclose to an intending guarantor any information relating to the financial position of a loan applicant, Mr and Mrs C were labouring under a misapprehension when they assumed that the bank was legally obliged to disclose information about other loans or debts accruing to the applicants – in this case their son and daughter-in-law.

Although the bank guarantee was in this case limited to an amount of \$63,000 (plus some costs and interest), it did not impose any other restrictions on their liability. In particular, there was nothing in the guarantee that would require the bank to use funds realised from the sale of the house or any other source to pay off the guaranteed housing loan before it paid other debts. I had no option other than to find that the bank was legally empowered to require Mr and Mrs C to pay the full outstanding amount of \$55,000. I might add that Mr and Mrs C can count themselves lucky that, unusually, the amount which they had guaranteed was limited.

I am concerned that parents who guarantee housing loans for their children often do not appreciate that they could be accepting legal liability for other debts incurred by the children, irrespective of whether those debts were incurred before or after they provided the guarantee. It never occurred to Mr and Mrs C that they could subsequently be liable for any credit card debt incurred with the bank by their son and daughter-in-law.

The bank noted that this was not currently an issue, as the son was repaying the debt, and there was no need to call on Mr and Mrs C under the guarantee for the time being. The bank undertook to reassess the position if it should need to call upon Mr and Mrs C in this way. On this basis I concluded my investigation.