NEW CONSUMER CREDIT CODE AND CODES OF PRACTICE

— How are the Lenders Adapting?

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1. CONSUMER CREDIT CODE: CALCULATION OF INTEREST RATES AND CHARGES

1.1 Permitted methods of calculation of interest charges (sections 26 and 27)

With respect to closed-end contracts, the *Consumer Credit Code* requires that interest be calculated on an actuarial method - predetermined credit charge contracts are no longer permitted (but the proposed regulations dealing with transitional matters will permit predetermined credit charge contracts for a transition period of 1 year, provided interest is recalculated upon termination and any excess interest paid refunded to the customer).

For both closed-end and continuing credit contracts, the credit provider may either calculate interest daily based on the application of the daily percentage rate to the day's unpaid balances or calculate interest on a monthly, quarterly or semi-annual basis based on average unpaid daily balances. This corrects an anomaly in the *Credit Act* which provided only for the average unpaid daily balance method, requiring many credit providers to obtain exemption orders.

1.2 Limits on interest rate

There is no limit on the interest rate which the parties may contract for. This contrasts with the *Credit Act* which in certain states imposed limits (eg Victoria 30% for secured contracts; 48% for unsecured). In addition, a credit contract may provide that the credit provider can vary the contract and increase the interest rate. However an increase in the interest rate is subject to review by a court upon application of the borrower for unconscionability. The court is instructed by the Code to review:

- the reasonableness of the increase in light of any representations made by the credit provider in advertisements or otherwise, the length of time since the contract was entered into and such other factors as the court thinks relevant.

- whether the increase discriminates against the debtor compared to other debtors under similar contracts.

Section 72(2). Lenders exercising reasonable judgment (eg increasing rates for both new and existing contracts in reaction to higher cost of funds) should be able to satisfy this test. Alternatively, lenders may avoid the conscionability issue by providing in the contract for an interest rate pegged to an external index. This variable rate could be subject to a floor (minimum rate).

1.3 Establishment fee

The Code allows the parties to contract for an establishment fee. However an establishment fee is subject to review by a court upon application of the borrower for unconscionability: section 72(3). The court is instructed by the Code to review whether the fee is equal to the credit provider's reasonable costs associated with assessing the application for credit and the initial administrative costs of providing the credit. The establishment fee can be set based on the particular costs associated with a particular customer's application, or (far more likely) on the credit provider's average reasonable costs in respect to a particular class of contract. Credit providers are well advised to document their costs before settling on an establishment fee.

1.4 Early termination fee

As with the establishment fee, the Code permits contracting for an early termination fee, but then goes on to effectively limit the fee through the unconscionability provisions: section 72(4).

The early termination fee is deemed unconscionable if it exceeds a reasonable estimate of the credit provider's loss arising from the termination or prepayment, including the credit provider's average reasonable administrative costs involved in such termination. The "loss" referred to presumably is based on interest rate risk (eg potential loss in a decreasing rate environment of having to lend out the money again at a lower interest rate). A flat termination fee (eg $300) or flat percentage termination fee (eg 1%) designed to capture a credit provider's average loss on early termination would not meet this test. A formula would have to be provided in the contract which calculates the loss based on the difference between the rate at the time of termination and the current rate offered by the lender and other factors, such as the remaining amortisation period of the loan. It is submitted however that this would be a complex formula difficult to administer and difficult to properly disclose to a customer, and therefore (unless the amounts lent are substantial and the borrower is sophisticated), credit providers may be best off limiting any early termination fee to their administrative costs (preparing pay-off figures, etc).

1.5 Fees and charges payable to third parties

Credit providers may charge customers for amounts which the credit providers must pay to third parties (eg legal costs, valuation fees). However the amount charged may not exceed the actual amount payable by the credit provider to the third party: section 30(1). Any such overcharge would constitute a violation of a key requirement (see sections 15(g), 21(1) and 100)).

1.6 Other fees and charges

Except as mentioned above, there are no limits on fees and charges which may be contracted for. For example, an annual fee may be assessed. The Code provides that the regulations may specify prohibited credit fees or charges; however none are envisaged at this point: section 29.

1.7 Default charges

The Code provides that a default rate of interest may be assessed, but only on the amount in default and only during the period of the default. The Code does not allow the use of two percentages rates - one for current contracts and one for delinquent ones - as the *Credit Act* did. After acceleration of the contract and failure to pay the accelerated amounts, the default rate could apply to the entire outstanding balance. It should also be noted that the Code does not appear to permit the imposition of a flat dollar amount as at late charge: section 28.

1.8 Debiting of interest charges

The Code provides that interest must be charged in arrears, ie interest cannot be charged in advance: section 27. There is an exception in the proposed regulations for the first payment of interest charges if it relates to a period that is less than normal (eg: a partial month where billing cycle is monthly). In addition, it is anticipated that the regulations dealing with transitional matters will provide that for a period of 12 months from the commencement of the Code, interest on loans in securitisations may be collected up to 14 days in advance. Interest may be debited (and compounded) daily, however each debit would then have to appear in the statement of account: section 32(E).

1.9 Penalties for overcharging interest, fees and charges

Any provision in a credit contract that provides for a fee or charge prohibited by the Code, or a fee or charge, or interest, exceeding the amount that may be charged consistently with the Code, is:

- void, and the borrower is entitled to recover such excess; and
- constitutes a breach of a "key requirement."

Sections 21(1) and 100. Section 100(1)(i) contains a curious carve-out for breaches of section 21(1) that do not occur at the time the credit contract is entered into. This appears to relate to amendments to the credit contract, ie it is not a breach of a key requirement if a prohibited obligation is imposed upon a debtor after the credit contract is entered into. The same penalties (void, and constitutes a breach of a "key requirement") would apply to the charging of a fee, charge or interest that is not provided for in the credit contract, as the disclosure required by section 15 would then not be satisfied: sections 15(D), (E) and (G), 21(4) and 100.

Given the drastic potential penalty of loss of credit charges, it is essential that credit providers exercise extreme care both in designing the interest rate, fees and charges on their products, and in drafting the credit contracts consistently with that design.

1.10 Early payments and crediting of payments

A credit provider may contractually prohibit early payments (but not paying out of the contract in full): sections 24 and 75. If a credit provider prohibits early payments, but nevertheless receives an early payment, the credit provider may accept the payment but not give the customer credit for the early payment if the credit provider informs the debtor, prior to accepting the payment, that the payment will not be credited to the debtor before it becomes payable under the contract. As a practical matter, this will require credit providers who wish to avail themselves of the right not to credit early payments before their due date to hold the payment for processing until a notice is sent to the customer and the customer is deemed to have received it under section 173.

The Code provides that a credit provider must credit each payment made under a credit contract (other than an early payment in the circumstances outlined above) as soon as practicable after receipt of the payment.

1.11 Comparison rate

The Code provides that credit providers have the option of disclosing a comparison rate as part of their pre-contractual disclosures and advertising. The comparison rate is a percentage rate intended to take into account interest, fees and charges so that consumer may compare credit plans. The comparison rate must be calculated as provided in the Code and the regulations and must be accompanied by a warning as to its use to be prescribed by the regulations: sections 14(3) and 143.

If any credit providers choose to use the comparison rate, and to argue that other credit providers are not disclosing the true cost of the credit, it may create marketing pressure for those other credit providers to follow suit. In practice we think it is unlikely that credit providers will use the comparison rate because of the complexity in undertaking its calculation. It is easier to comply with the key requirements. It should be kept in mind that a very large percentage of applications for reinstatement of credit charges under sections 85 and 86 of the *Credit Acts* were made because of inaccurate disclosures of credit charges and annual percentage rates under that legislation.

1.12 Disclosures with respect to interest, fees and charges

The precontractual disclosures and the contract itself must contain detailed disclosures regarding interest, fees and charges (sections 14 and 15). Certain precontractual disclosures must be placed in a "Schumer Box" style disclosure. All of the disclosures in section 15 regarding interest, fees and charges are "key requirements" under the Code and therefore extreme care should be used in drafting these disclosures.

Of particular note are:

- ***Credit fees and charges***

  The credit provider must disclose *all fees and charges* that are or may become payable under the contract, *when* each such fee or charge is payable, and the *amount* of any such fee or charge if ascertainable. If the amount of any such fee or charge is not ascertainable at the time the disclosure is given, the credit provider must disclose the method of calculation of the fee or charge. The credit provider must also disclose the total amount of credit fees and charges payable under the contract to the extent that it is ascertainable. For continuing credit contracts with a set contract end date, this would mean that the credit provider would need to include annual fees for the number of years in the contract: section 15(G). It should be noted that FID charges are not considered credit fees or charges and therefore do not need to be estimated or disclosed under sections 14 and 15 (although they should be included in the contract to establish the borrower's agreement to pay these charges): Schedule 1.

- ***To whom fees and charges are payable***

  Section 15(B) requires a statement as to the amount of credit extended and to whom the amount is to be paid. A distinction needs to be made between fees and charges attributable to a third party (eg valuation and legal fees) which are to be paid to the credit provider at closing, and any such fees and charges which are to be paid at closing directly to third parties. In the former case, the payment to the credit provider would be added to any other credit fees and charges or other amounts payable to the credit provider and shown as the amount of credit payable to the credit provider. In the latter case, the payment to the third parties at closing must be separately disclosed as payments to those persons.

- ***Total amount of interest charges***

  The credit provider must disclose the total amount of interest charges payable under the contract, if ascertainable. This section would presumably not apply to continuing credit contracts as it cannot be ascertained what amount of credit the customer will require over the course of the contract. For closed-end contracts, the credit provider may assume that payments will be made on their due dates and that there will be no changes to the interest rate. The disclosure is not required if the contract can be expected to run for a period over 7 years: section 15(E).

1.13 Variations

- ***Interest rate***

  If, pursuant to the contract, a credit provider unilaterally amends the agreement to increase the interest rate, the credit provider must either:

  (1) send the borrower a notice in writing of such change not later than the effective day; or

  (1) notify the borrower of such change by publishing notice in a newspaper circulating throughout the State.

  If a credit provider elects newspaper publication, confirmation must be sent to the borrower before or when the next statement of account is sent to the debtor. Confirmation is not required if the increase in the interest rate results from a change in the reference rate used to determine the interest rate. If however the change in the interest rate is accompanied by an increase in the required payments (other than an increase which occurs automatically under the contract where the amount and timing of the increase are ascertainable from the contract), 30 days prior written notice is required. Any change to the method of calculating interest which is disadvantageous to the customer also requires 30 days advance notice in writing: sections 59 and 60.

- ***Credit fees and charges***

  A credit provider must provide at least 30 days advance notice of an increase in the amount or acceleration of the timing of a credit fee or charge, or the imposition of a new fee or charge. Notice may be given by newspaper publication, provided confirmation is sent to the customer before or when the next statement of account is sent to the debtor after the change takes effect: section 61.

1.14 Transitional provisions

The draft regulations provide that the Code will not apply to existing closed-end contracts, but will apply to continuing credit contracts. Contractual disclosures will need to be sent to existing customers within 3 months after the Code becomes effective and statements of account for periods subsequent to the commencement of the Code will need to comply with the Code.

2. CONSUMER CREDIT CODE: PERIODIC STATEMENTS OF ACCOUNT

2.1 When required

Statements of account are required to be provided :

- *Credit Card Account.* At least every 40 days.
- *Other Continuing Credit Contracts.* At least every 3 months.
- *Closed-End Contracts that are fixed-rate and have no provision for variation of the interest rate.* Statements of account not required.

- *All other Closed-End Contracts.* At least every 6 months.

A statement of account is not required in certain situations, such as where the customer is seriously in default or there has been no activity on the account and the amount outstanding is nominal: section 31.

2.2 Content

Section 32 sets forth the information required to be included in a statement of account. The information required is substantially the same as that required under the *Credit Act* for continuing credit loans. The key requirements for statements of account with respect to continuing credit contracts are:

- The amount of the interest charge debited to the debtor's account during the statement period and when the interest was debited.

- The annual percentage rate and details of any change since the last periodic statement, if the credit provider is required to notify the customer of such change (see 1.13 above).

- The opening balance shown in each successive statement of account must not exceed the closing balance shown in the last statement of account.

There are no key requirements for statements of account with respect to closed-end contracts.

2.3 Requests for statement of amount owing

A credit provider must, at the request of the borrower or guarantor, provide a statement of all or any of the following:

- the current balance;

- any amounts credited or debited during the period specified in the request;

- any amounts overdue and when each such amount became due;

- any amount payable and the date it became due.

The statement must be given within 14 days if all the information relates to a period 1 year or less from the request date, or within 30 days if the request relates to information more than 1 year old. A credit provider is not required to give such information with respect to activity on an account which is over 7 years old, unless otherwise ordered by the court on the application of the debtor or guarantor.

In order to comply with such requests, the credit provider's systems will need to have the capability to retain and retrieve for up to 7 years complete account information as of any day (or period of time) selected by a customer. Customer requests are *not* limited to requests for copies of statements of account previously sent out: section 34.

2.4 Disputes

The Code contains provisions relating to disputed entries. While a dispute is pending, and for 30 days following a written explanation to the customer of the credit provider's position (if the credit provider does not agree with the customer), the credit provider may not begin enforcement proceedings based on default in payment of the disputed amount. In addition, if an application is made by the debtor to the court pursuant to the Code, the credit provider may not, without leave of the court, begin enforcement proceedings based on default in payment of the disputed amount: section 36.

3. MORTGAGES AND GUARANTEES

3.1 Form of a mortgage or guarantee

Writing: sections 38 and 50

A mortgage or a guarantee which secures obligations under a credit contract governed by the Code must be written and must be signed by the mortgagor or the guarantor. This requirement is satisfied:

(a) in relation to a mortgage if the mortgage is contained within a credit contract signed by the mortgagor; and

(b) in relation to a guarantee if the guarantee is contained within a mortgage or a credit contract and is signed by the guarantor.

Where the Code applies, this will be the death-knell for security interests created without mortgage instruments, eg: mortgages of land by deposit of the certificate of title and mortgages of shares by deposit of share scrip.

There is one exception to the requirement that a mortgage must be in writing. The exception is a goods mortgage where the credit provider lawfully had possession of the goods subject to the mortgage *before* the mortgage was entered into otherwise than because the credit provider supplied the goods (for example, the goods were held by way of security). Presumably this might occur in the typical situation in which a workmen's or contractors lien arises such as a lien for unpaid costs of repairs or maintenance to a motor vehicle. It is therefore virtually irrelevant to banks and financial institutions.

It is curious that the credit provider must have possession of the goods before the mortgage is entered into for the exception to apply. Why should the exception not apply to the situation where goods are handed over to the credit provider at the time the mortgage is made or under an agreement to give a mortgage of the relevant goods? Presumably most cases of this kind would be exempted from the Code by section 7(7) which applies to pawnbrokers.

Neither a mortgage nor a guarantee is enforceable if it does not comply with these requirements.

Copies of documents: sections 39, 51, 52

Prior to securing the obligations under a credit contract by a guarantee, the credit provider must provide to the prospective guarantor a copy of the credit contract and a prescribed document which explains the rights and obligations of a guarantor. A guarantee is not enforceable if these requirements are not complied with.

Within 14 days after a mortgage is made the mortgagor and any guarantor must be given a copy of the mortgage. Of course this applies only if the mortgage is required to be made in writing. It applies whether or not the mortgage is part of the credit contract.

Clear expression requirements

Under section 162 of the Code both credit contracts and guarantees are required to be easily legible and clearly expressed. On the face of it, this does not apply to mortgages.

But under the Code a mortgage may be contained within a credit contract. If this course is adopted, the mortgage must comply with all the requirements applicable to a credit contract, which includes the legibility and clear expression requirements.

It is, of course, open to credit providers to separate the mortgage and credit contract into different documents. However, credit providers cannot afford to ignore clear expression requirements completely. If a court reopens an unjust transaction under section 72, including any mortgage, one factor which it may have regard to is "the form of the contract, mortgage or guarantee and the intelligibility of the language in which it is expressed" (section 70(2)(g)).

Combining credit contract with mortgage

A number of credit providers have asked us whether we think it is a good idea to include the credit contract terms in the same document as a mortgage. Of course, this is typically what happens in home loan financing at present.

Advantages of combining the credit contract with the mortgage are as follows:

- From a marketing perspective there appears to be less paper and fewer documents for the borrower to sign.

- In those States which apply duty on conveyances of all forms of property there are stamp duty exemptions which apply to transfers of mortgage. These are designed to facilitate the growth of the securitisation market. An example is section 97AE of the *Stamp Duties Act* 1920 (NSW). If the mortgage and the credit contract are separated into two instruments, it may be argued that there are two different choses in action which have been created. One is the loan. The other is the mortgage. On that basis, the transfer of the credit contract might be separately liable to conveyance duty. Arguably it is therefore better to create the respective rights and obligations of the parties in one mortgage instrument if subsequent transfers of mortgage are contemplated.

Disadvantages of combining the mortgage and credit contract may be summarised as follows:

- It is still possible to use an "all moneys" mortgage. This means that a financial institution can create one form of mortgage for use in relation to financial accommodation provided to individuals. Credit contracts can be separately designed to reflect changing demands for different types of financial product and according to whether or not the credit is caught by the Code.

  Of course it will be necessary to "freshen up" the mortgage by getting the mortgagor to agree to "extend" the mortgage to any new obligations. It means that one mortgage instrument can be used to secure more than one credit contract. Such a mortgage would have to be carefully drawn to state that it does not secure obligations which are prohibited in relation to a credit contract (see below). Keep in mind that a mortgage which is intended to secure moneys owing under a credit contract governed by the Code may be cautiously drafted because of Code requirements such as restrictions on moneys which may be secured by such a mortgage.

- If the two contracts are separated, it may be easier to understand the requirements of the Code which relate to variations, notices and enforcement especially if the mortgage secures more than one set of financial obligations. It is certainly less convenient to change fees, charges and similar terms under a credit contract if you have to register a variation of a mortgage to do so.

- A mortgage is not subject to clear expression requirements unless the credit contract is contained within it, although it can be reopened as an unjust transaction. It is therefore necessary to undertake a substantial re-design of mortgage instruments and their somewhat technical drafting to comply with clear expression requirements if the credit contract is contained within it. Some financial institutions have already embarked on this exercise (eg: St George Bank). It may become a significant marketing advantage for financial institutions to design mortgages and documentation which are accessible to a reasonably intelligent reader of English rather than to lawyers only.

ANZ Bank have produced an interesting reaction to the plain language drafting emphasis by developing their "plain*er* language" documentation. These documents are certainly better than those which were used previously by the ANZ Bank. If credit contract terms are combined within one mortgage instrument by the ANZ, they will no doubt decide to revisit and to test whether or not the clear expression requirements of section 162 of the Code are satisfied by the plainer language approach.

3.2 What property may be mortgaged

Specified property: section 40

A mortgage must describe or identify the property which is affected by the mortgage or it will be void.

Where the Code applies it will no longer be possible for credit providers to include within personal loan contracts a statement that the debtor mortgages any real property owned by him or her now or in the future to secure the obligations under the contract. This has been a customary practice for some finance companies (eg: Avco Financial Services) which then seek to protect the equitable mortgage so created by lodging caveats against titles to land owned by the mortgagor. This practice has been especially successful for credit providers in the past in those States which maintain a "nominal register" at the Land Titles Office which enables the credit provider to search the names of individuals to find out if any real property is registered in their names.

In addition, a provision in a mortgage that charges *all* the property of the mortgagor is void. A mortgage should therefore always specify the property to which the mortgage will attach. In practice this section is unlikely to create any problems for most banks or financial institutions because charges affecting all property are customarily used only for customers which are companies, ie: the conventional debenture charge.

Future property: section 41

In general a mortgage may not be given over future property. For this purpose "future property" is property that may be acquired by the mortgagor after the mortgage is entered into.

There are, however, exceptions which include:

(a) property that is to be acquired wholly or partly with the credit provided;

(b) property or a class of property (whether or not ascertained) which is described or identified in the mortgage; or

(c) goods acquired in replacement for or as additions or accessories to other goods subject to the mortgage.

Any provision in the mortgage instrument which creates a mortgage of future property is void. If you are going to take security over existing property and future property (relying on one of the exceptions described above) it would be prudent to structure the mortgage documents so that there are separate clauses relating to the existing property and the future property. In this way, if it is subsequently found that the relevant exception is not available for the specified future property, only the provision which purports to mortgage the future property will be void. It should not affect other parts of the document. It is always prudent in drafting of this kind to include a clause which says that if one of the provisions of the contract is void it will not affect the other provisions (a "severance" clause).

A provision in a mortgage to the effect that goods supplied from time to time under a continuing credit contract are to be subject to the mortgage is void. However, this does not prevent a mortgage being created over *specified* goods acquired under a continuing credit contract.

Wages, superannuation, cheques etc: section 46

A mortgage cannot be created over wages or salary or benefits under a superannuation scheme unless permitted by the regulations. Nor may it be created over a cheque or other bill of exchange or promissory note endorsed or issued by the debtor or guarantor. Any such mortgage is void.

3.3 What moneys may be secured by a mortgage or guarantee

Third party mortgages: section 44

A mortgage may secure only the obligations of a debtor under a credit contract or the obligations of a guarantor under a guarantee.

A "third party mortgage" is drafted so that the mortgagor is primarily responsible and liable for the debts of another person. Such a mortgage cannot be used to secure credit regulated by the Code. A third party mortgage is unenforceable and a credit provider can be compelled by a court to discharge the mortgage. Under the Code it will always be necessary to characterise the third party obligor as a guarantor under a guarantee.

All moneys mortgages and future credit: sections 43 and 54

It is possible for a mortgage to secure credit provided under a future credit contract or future related guarantee. If an existing mortgage is to be extended to cover such obligations, then the credit provider must give the mortgagor a copy of the contract or guarantee and obtain the mortgagor's written consent to any extension. Without fulfilment of these terms the credit provider cannot enforce the extension.

In our view section 43 should not be interpreted as applying to a mortgage securing an overdraft facility, to the extent that advances are made, repaid and remade under the facility by virtue of the drawing of cheques and the making of deposits. To find otherwise would be unworkable. It is a key requirement of disclosures in a continuing credit contract that the debtor be told of the credit limit. So long as there is no increase to the credit limit there should be no need to obtain the mortgagor's written consent to any extension of credit which might arguably occur in the day to day use of an overdraft facility.

At present most banks review overdraft facilities annually. By their nature overdrafts are repayable upon demand. There is a general understanding that the overdraft will not be demanded before the next review date unless there is a material change to the relationship between the bank and its customer. If banks retain an annual review mechanism, it may be necessary to re-document the creation of the overdraft facility agreement on an annual basis. At the least, this may involve a "variation" of the contract to provide for an extension of the period to the next review date. To be prudent, consent of the mortgagor to the extension of credit should be obtained. Similar principles apply to guarantees (see below).

It is also possible for a guarantee to apply to a future credit contract, but only if there is a provision to that effect in the guarantee. Before any such extension can be enforceable, the credit provider must provide the guarantor with a copy of the proposed credit contract and obtain the guarantor's written acceptance of any extension.

In practice this should not create too much difficulty for financial institutions. Although most "all moneys" guarantees provide that the credit provider may make new accommodation available to the debtor without obtaining the approval of the guarantor, in practice financial institutions almost always obtain consent. The Code merely adds a requirement that a copy of the proposed credit contract be provided to the guarantor in addition to complying with the existing practice of obtaining written consent to the extension of additional credit.

Maximum amount which may be secured under a mortgage: section 45

The maximum amount which may be secured under a mortgage *in relation to a credit contract that it secures* is the amount of the liabilities of the debtor under the credit contract (or the guarantor under a guarantee) plus reasonable enforcement expenses (section 45(1)).

Enforcement expenses are defined in Schedule 1 to include expenses incurred by the mortgagee in preserving or maintaining property subject to the mortgage including insurance, rates and taxes payable for the property, but only if the expenses are incurred after a breach occurs and are authorised by the mortgage. Since enforcement expenses include expenses "incurred by the mortgagee" we think that expenses such as insurance, rates and taxes payable in relation to the property for the period *before* default can be secured even if they are paid *after* default by the mortgagee.

We think that most items that are claimed under the existing law should be recoverable under this inclusive definition of "enforcement expenses". For example, a mortgagee's reasonable costs associated with a sale of the mortgaged property will be allowable. Unfortunately, there are several items which are currently secured as a matter of course in mortgages which may not fall within the definition.

In particular, it is difficult to be certain about the scope of the credit provider's right to place the property in a state of "reasonable repair" prior to sale. It is also difficult to say whether solicitor-client or indemnity costs reasonably incurred by a mortgagee in litigation to enforce a security come within the definition. Reasonable costs may be party-party costs only. Similarly, "reasonable" costs of enforcement of rights under a mortgage without litigation may be taxed costs only.

Note that the limitation in section 45 is on the amount which may be secured under a mortgage. What is meant by "secured" in this context? It might be argued that the prohibition relates to the taking of security against the property the subject of the mortgage. This would leave a credit provider free to create unsecured obligations of the mortgagor to pay certain moneys by specifically excluding those unsecured obligations from the definition of "secured moneys" under the mortgage. We think that such an approach would be an aggressive interpretation of section 45. This is because we often talk of moneys which are "secured" by a deed of covenant which may nevertheless be an obligation that is not secured against any property of the covenantor.

We think that section 55(1) supplies the probable answer to the approach which a court is likely to take to this argument about the meaning of the word "secures" in the context of section 45(1). Section 55(1) states that a guarantee is void:

> "to the extent that it secures an amount ... that exceeds the sum of the amount of the liabilities of the debtor under the credit contract and the reasonable expenses of enforcing the guarantee ...."

Clearly, the liability of the guarantor need not be secured against property yet the word "secures" is used to describe the (possibly unsecured) obligation of the guarantor under the guarantee. Given this use of the expression "secures" in another division of Part 3 of the Code, we think that a court or tribunal would be likely to strike out as void any attempt to create unsecured obligations of a mortgagor which are additional to those obligations permitted under section 45(1) if the unsecured obligations are "in relation to a credit contract" that is secured by the mortgage.

It is a little difficult to decide exactly what is meant by the expression "in relation to a credit contract" where it is used in section 45(1). If a mortgage is designed to secure obligations which are both governed by the Code and obligations of the debtor which are not governed by the Code, what happens if the mortgage secures amounts which are not permitted under the Code (eg: in relation to enforcement or repair as discussed above) in the situation where the only financial obligations outstanding at the relevant time are in relation to the credit contract? Does this mean that the impermissible obligations in the mortgage are obligations which are "in relation to" the relevant credit contract? The answer to this question is not obvious.

Because section 45(1) makes the mortgage void only to the extent that it secures a prohibited amount, a credit provider might choose to include unsecured obligations of the mortgagor to pay moneys which are additional to the liabilities of the debtor under the credit contract (or the guarantor's liability under the guarantee) and the reasonable enforcement expenses of enforcing the mortgage. It will be important to ensure that any such unsecured obligations are contained in separate provisions so that if they were found to be void it should not affect other provisions of the mortgage.

One final and important qualification to the right of the parties to contractually allocate risk is contained in section 169 of the Code, which provides that a provision of a contract or other instrument by a person seeks to have the debtor or guarantor indemnify the credit provider for any loss or liability arising under this Code is void.

Maximum amount which may be secured under a guarantee: section 55

I suppose that upon one view credit providers should be relieved that it will still be possible to take guarantees at all in the future. Only two years ago the consumer lobby was arguing for the abolition of guarantees in respect of loans to consumers. This was in the context of "sexually transmitted debt" and similar problems which arose as Australia plunged into recession in the early 1990s. It was argued that it is always difficult to fully explain the effects of a guarantee to a guarantor. It was also argued that credit providers should only lend to people who can afford to service loan obligations. Abolition of guarantees would therefore force credit providers to pay more attention to analysing the capacity of a debtor to repay from his or her own resources.

Now, of course, section 70(2)(l) of the Code places some pressure on credit providers to carefully consider the capacity of the debtor to meet obligations. It adds, as one of the tests of an unjust transaction, the question of whether at the time the contract, mortgage or guarantee was entered into or changed, the credit provider knew, or could have ascertained by reasonable enquiry of the debtor at the time, that the debtor could not pay in accordance with its terms or not without substantial hardship. The upshot of all this is that the right to take guarantees has been retained. It is also important to remember that the scope of application of the Code is considerably wider than applied to previous understandings of "consumer" lending. Guarantees are important if loans are for significant amounts, eg: in excess of $100,000. Guarantees may have been retained, but as we shall see, there are some important restrictions on their use.

Under section 55(1) a guarantee is void to the extent that it secures an amount in relation to a credit contract that exceeds the amount of the liabilities of the debtor under the credit contract plus the reasonable expenses of enforcing the guarantee (or any lesser amount agreed between the credit provider and the guarantor).

There are two significant effects of this:

(a) First, currently it is commonplace to include an indemnity in a guarantee by which the guarantor indemnifies the credit provider against any loss suffered in relation to the non-payment or non-recovery of the guaranteed moneys for *any* reason. This is no longer permitted.

(b) Secondly, at present guarantees usually contain detailed terms which are designed to keep the guarantee alive for the full amount of the relevant financial accommodation even if other events or circumstances have modified the obligations of the debtor. At common law by definition a guarantee (as opposed to an indemnity) is never enforceable for an amount which exceeds the debtor's liability anyway. Now, if the principal obligation cannot be enforced against the debtor, the guarantor is not liable because of the operation of section 55(1). The only exception (in section 55(2)) is where the principal liability is unenforceable solely because of the debtor's death, insolvency, incapacity, or any other act or omission by, or circumstance affecting, the debtor.

It is clear that under the Code a guarantee in relation to a credit contract will not be enforceable, for example, in the following cases:

- an obligation under a credit contract is void, for example for illegality;
- a credit contract in whole or part is set aside, revised or altered by a court under the unjust transactions sections of the Code;
- an action by the credit provider on the credit contract is statute barred under a limitation Act in circumstances where an action on the guarantee is not statute barred;
- an obligation under a credit contract is unenforceable because it has been waived by the credit provider;

Credit providers should remember that the Code does not apply to *all* guarantees of loans subject to the Code. For example, it is possible for a company to guarantee and to give security for loans to individuals. Although the loans themselves are regulated by the Code, the corporate guarantee would not be. It will be possible to include within a corporate guarantee a form of indemnity which would be effective to make the company liable for the full amount of the financial accommodation, even if the liability of the debtor is rendered unenforceable. This may be especially helpful to banks and financial institutions if a debtor has few assets in his or her own name because a discretionary trust (with a corporate trustee) hold assets which are to be the subject of relevant security interests in favour of the credit provider. Check, of course, that the trust deed permits the giving of guarantees/indemnities and the supporting security that is proposed.

As a practical matter, credit providers will need to employ distinct sets of documentation to achieve this.

Limits to guarantee of continuing credit contract: section 55(4)

Where there is a continuing credit contract, a guarantor is entitled by notice to the credit provider to limit his or her guarantee to the *amount* of credit previously provided (plus such other amount as the guarantor may agree to).

Since the amount of credit actually provided to the debtor before the guarantor gives notice may be less than the credit limit under the credit contract, it will be important to ensure that continuing credit contracts contain provisions which allow the credit provider to refuse credit requests by a debtor over the limit to which the guarantee then applies. It will also be important to ensure that a credit provider does not waive its rights to refuse such a request if it receives notice that a related guarantee is limited by continuing to allow credit. Systems must be implemented so that if the guarantor serves such a notice:

- the credit limit is reduced; and
- authorisation procedures for the grant of credit are promptly adjusted.

It is not at all clear how a credit provider should comply with the key requirement for disclosure of the credit limit if the credit limit is to be automatically adjusted downwards upon receipt of a notice of withdrawal of the guarantee by the guarantor. Presumably the credit limit should stipulate the amount which is initially agreed between the parties. There should also be a disclosure that the amount will be reduced to the amount then outstanding under the contract if the guarantor withdraws his or her guarantee.

3.4 Withdrawal by guarantor

Credit providers will have to allow for the possibility that a guarantor may exercise a statutory right conferred by section 53(1) to withdraw from the guarantee at any time upon written notice before credit is first provided under the credit contract. The right of withdrawal is also available to a guarantor after credit has been provided if the guarantor can demonstrate that the credit provided under the credit contract "differs in some material respect" from the proposed credit contract or pre-contractual statement (section 53(1)(b)). We expect that "material" change would be given its ordinary meaning of a change which, if known to the guarantor at the time of entering into the guarantee, would have reasonably affected the decision of the guarantor to give the guarantee.

However, if the credit provider increases the liability of a guarantor under a guarantee with written notice and acceptance (section 56(1)) then the guarantor would be unable to exercise the statutory right of withdrawal under section 53.

It will be important to ensure that credit contracts contain provisions which allow the credit provider to refuse a credit request by a debtor under the credit contract if the related guarantee is withdrawn, eg in a building finance contract where credit is drawn down in stages. It will also be important to ensure that a credit provider does not waive its rights to refuse such a request if it receives notice that a related guarantee is withdrawn, but continues to allow credit to the debtor.

3.5 Reopening unjust transactions

Under section 70(1) a mortgagor or guarantor, as well as a debtor, may apply to the court to reopen a transaction giving rise to a mortgage or guarantee or credit contract on the grounds that it is unjust. This applies only where the maximum credit is $125,000 or less: section 66(3).

"Unjust" is defined in section 70(7) to include unconscionable, harsh or oppressive. In determining whether a transaction is unjust the court must have regard to a list of factors in section 70(2), but only if they were reasonably foreseeable at the time that the transaction occurred.

I do not propose to list the factors which the court can consider, except to observe that many factors correspond almost word for word with the matters in section 147(2)(a)(i) of the *Credit Act*. The effect of the new factors which have been added is to require the credit provider to be more careful in assessing transactions. The credit provider will also need to make debtors, mortgagors and guarantors aware of potential risks.

There is a variety of orders that a court may make if it reopens a transaction, which include the rights to set aside either wholly or in part or to revise or alter any agreement (which includes a guarantee) made or mortgage given in connection with the transaction.

It appears to be possible under this section for a mortgagor or guarantor, without the involvement of the debtor, to apply to the court to reopen the terms of the credit contract in addition to the terms of the mortgage or guarantee. In the case of guarantees, this must be a factor for banks in deciding whether or not to seek one.

Under section 72 the courts on an application of a debtor or guarantor may also review unconscionable interest variations, establishment charges, and fees for pre-payment and early termination fees.

3.6 Stamp duty

In New South Wales, under section 84EB of the *Stamp Duties Act* 1920 duty is not chargeable in respect of a loan security in so far as it secures the payment or repayment of an amount payable or repayable under a regulated contract within the meaning of the *Credit Act* 1984.

I am not aware of any similar proposal relating to contracts which are to be governed by the *Consumer Credit Code*. Presumably mortgage duty on home finance is a reasonably significant revenue source for State governments. Arguably section 84EB may have been included to reduce the burden on credit providers in complying with technical disclosure requirements of the *Credit Act* if stamp duty is payable and reimbursed by the debtor. Accurate disclosure of such stamp duties is not a key requirement under section 15 of the Code. Perhaps section 84EB will simply be allowed to lapse.