CURRENT DEVELOPMENTS IN BANKING LAW

Consumer Credit — The New Laws

DAVID NIVEN

Consumer Credit Legal Service Inc, Melbourne

It is true that the legislation currently under consideration is the fourth attempt. The history of this, which is somewhat sordid, is that the current legislation which was passed in 1984 in New South Wales and Victoria, came into force in 1985. There was the infamous Kelly draft of 1989 by the Victorian Law Reform Commission; there was the more infamous Hackett-Jones South Australian Parliamentary Council draft of 1992; and finally we now have the *Credit Code*. I will not refer to it as the 'Code' because in fact, apart from being confused with the earlier speakers, it is in effect, legislation. This talk is well timed as tomorrow, Ministers meet on that Code to decide its ultimate fate and probably, because I will not be there, they will agree.

Before looking at the details of the Code, and I will try and be a little brief because we have not got a lot of time, I want to speak about the policy tensions that face the regulators, the industry and the consumer movement in trying to come up with workable, sensible, fair, consumer credit legislation. I think that those policy tensions are often overlooked, and there are three that occur to me. The first is the desire to have a level playing field in legislation (and my God, have I heard the phrase 'level playing field' used in a few meetings!) versus the fact that many of the sorts of regulations being designed are in fact designed to overcome particular problem areas in the market. The difficulty that therefore occurs is that the regulators, in trying to deal with a very difficult and possibly nasty problem, are inflicting the result on everyone and usually coming up with a result where the people who do not need the regulation are getting too much, and the people who need it get too little.

The second is the issue between whether you try and regulate through competition or prescribing rules and requirements, and again the same tension exists. Where there is competition inside the market, that is a very good factor for consumers to get fair market practices. But also in the credit field, we have areas where market competition does not exist. My Service next week will be launching a report by two economists who have done what is known as an 'Econometric Study' (and I have no idea what that means) of approximately 500 loan contracts of one used caravan dealer, that is the bottom end of the market, with a single finance company. What it in fact shows is that the interest rate increased as the risk decreased. It is not good competition.

The third factor, and possibly the most difficult issue, which shows itself up in the current proposed legislation, is whether you provide protection by lots of disclosure in a meaningful way so that consumers know what they are getting into, understand it and are therefore responsible for it (or in the words of the Victorian Supreme Court so that 'honourable men honour their contracts', a somewhat sexist expression), or whether you in fact give up at that end and counterbalance it by allowing people who have got into contracts that they do not understand and possibly were not able to understand, and overcome it by allowing that contract to be re-opened after the event, through often difficult legal proceedings. These tensions arise in all legislation of this type - be they the current Code that is being proposed, the *Credit Act* 1984, or indeed the United States *Truth in Lending Code*, or the United

Kingdom *Credit Act*. I will deal with the Code relatively briefly, because I then want to come back to some of these aspects and discuss them in more detail.

The jurisdiction of the Code in contrast to the current *Credit Act* - for starters there is no monetary ceiling at all and this is an extremely significant change. It does not matter how much is being lent, the Code will apply provided the debtor is a natural person, the credit is provided for a non-business purpose, and there is a charge for the provision of the credit. The legislation then goes on to set out what you have to do at contract entry point: there must be a written document in all cases; there must be a pre-contractual statement in the form of Clause 15 of the legislation; and, as in the case of the current legislation which has a number of lists (at least in this case there is one long list) there must be the sort of details you expect to see such as the credit provider's name, the amount of credit to be provided, the effective annual percentage rate, the effective rate as opposed to a nominal rate most people are currently aware of, the basis of calculation of the interest rate, any interest free period, the total amount of interest which is going to accrue over the anticipated length of the contract (except in the case of housing loans), the basis and method of any variation in the interest rate, instalments, details of insurances and commissions on those, and finally a category known as 'details of all permitted charges'.

Unlike the current legislation there is a much broader scope of permitted charges now allowed, and I will come back to those a little later to discuss the significance of it. Clause 27 allows now, for instance, an establishment fee to be charged which is an up front fee for writing the contract. Where the contract involves an amount over $25,000 there may be a line fee or a credit review fee. In the case of housing loans there may be a termination fee, in other cases not, and then there is a general range of associated fees, such as stamp duty, legal valuation fees, and late payment fees.

The Code continues to specify in quite some detail both what is interest and how it is to be calculated. Clause 22 categorises the charges relating to a contract as falling within categories and the credit provider must stick within those categories. There must be an amount being lent (the amount financed), there can be enforcement expenses, there can be these permitted fees, which is a prescriptive list and has a boundary around it, and finally whatever else exists must be expressed as interest and charged as part of the interest rate. Clause 24 set out how that interest rate is to work and sets up a fairly standard mechanism of a period rate applying to the outstanding balance at the end of each period so the daily rate applicable to the daily balance, or the monthly rate to the monthly balance.

In the case of credit card there is an exception to allow for the standard 55 day interest free type product. There cannot be, except in the case of housing loan contracts, differential interest rates, therefore the charging regime cannot be 17% on the first $5,000 and 20% on the next $5,000 - it must be one rate only. And again the way in which credit accrues is specified in detail. The accrued credit charge at the time when the consumer pays out the loan will be calculated by the period rate to the outstanding balance. Again, there is an exception where you have got what I call a pre-determined credit charge. This is a product with fixed interest/fixed instalments. You are not applying a rate, you are saying 'I'll give you $5,000 and you pay back over 48 months a total of $10,000.' In that case the accrued credit charge is worked out on the assumption of due payment.

Statements of account in this legislation have reared their head in a big way. Because Ministers have gone down the route of a variable interest rate being allowed, we now have the situation where statements of account arise not just for credit card type contracts, contracts where there is a revolving amount of credit, but also for contracts which are of the standard loan product type. In those cases there will be a yearly statement, except where the contract is for a fixed interest/fixed term arrangement, where there is no requirement for a statement. With multiple advance contracts, overdraft arrangements and, probably more understandably, credit cards, there is standard monthly statement which is pretty much in the form of the current bankcard statement you get now.

To skirt through the other provisions, before I come back to a general analysis of the problems with the legislation - Part 3 deals with mortgages, again that is what you would expect to see with the exception that all accounts mortgages are being radically altered. You may have an all accounts mortgage but you can only apply that to a future lending product if the consumer, by way of separate acknowledgement, allows it to apply, and there must be some form of separate signed acknowledgement. Again, the current provisions relating to link credit arrangements has been picked up, these are the provisions which say that where you have got a commercial arrangement with a dealer you may be liable for the acts of that dealer if that dealer goes broke, the traditional types of examples being fitness centres that go down with people with credit cards screaming at the Consumer Affairs Minister's doors. Those provisions are pretty much like the current provisions the *Credit Act* now.

There is one interesting provision which has been snuck in and that is Clause 65, which is a fairly important provision particularly for those people who are financing through dealers. The provision states that where you have got a dealer, that dealer will be the agent of the credit provider, and to most bankers that is not a particularly unusual concept as they are used to having their staff treated as agents. It is certainly clear in Victoria that a dealer, such as a car dealer, is not the agent of the credit provider and his representations will not be those of the credit provider. Clause 65 changes that in a big way. In fact, it is very similar to the United Kingdom provision.

Insurance is also dealt with, despite the pleas of many to get rid of it in the proposed legislation. Again, the rules are pretty straightforward. Consumer credit insurance cannot be forced - and I have to say it is a big issue for people in the banking industry. My organisation has been involved in reviewing a number of procedures by a number of finance companies and banks over the last two years and there is a marked difference between the penetration rates between finance companies and banks. And you might be shocked to know that bank penetrations rates, from the material I have seen, are usually double those of finance companies. In the case of three finance companies I have dealt with over the last year, the sort of penetration rates we are seeing are between as low as 5% to 35%; in the banking industry the perception we are getting is that the penetration rate is over 50%, and often much higher. I have to say that probably there is an issue of forced insurance in those cases.

Clause 78 is particularly noteworthy as there is a 20% cap on commission charges relating to consumer credit insurance - that is a major industry change. Again, it is not unprecedented. Esanda Finance Corporation, in its recent licence agreement, has imposed a cap of 30% on its credit insurance commission.

Clause 56 is probably the provision which is going to cause people most problems. It sets out the way in which variation of credit contracts can occur and I have to say the provisions are pretty much underdone.

Clause 83 starts off with a fairly unusual concept by saying that a unilateral variation cannot occur unless prior written notice has been given. My contracts lecturer taught me that unilateral variations could not work, as you had to have an agreement. What I think the Code is getting to is what I call 'at will' variations, where in the base of the contract there is a provision saying that the bank or finance company is allowed to vary the contract at a later date without any further agreement.

Interest rates can be varied under the arrangement and that is a major difference to the current credit legislation. They may occur in the main without any effective prior notice. The contract must set out what notice occurs, prior notice can be as little as the morning of the variation, and it does not need to be individually provided, it can be provided by way of newspaper advertisement. The exception to that is where the variation will have the effect that interest will be greater than the payments then there must be a 14-day written notice. Also where there will be an increase in the payments there must be a 14-day written notice, and I think that can cause industry a lot of problems to comply with. It could be very confusing.

I said earlier that a lot of these provisions have in fact, to some degree, deregulated the current arrangements relating to limitations on fees and charges. The safeguards to this come at the end of the legislation. Clause 99 allows all contracts subject to this legislation (and that is an awful lot of contracts) to be re-opened on the basis of unjustness. There are some broad bases for doing that, but there are also some specific provisions. Clause 100 allows it to occur where there is no capacity to pay the debt by the debtor and the credit provider should have known about that. Clause 102 allows unconscionable interest rates to be re-opened and it also allows interest rate variations to be challenged and re-opened and establishment fees to be challenged and re-opened.

The enforcement provisions are again fairly standard with the exception of Clause 109. It provides for what I call a 'section 107 notice' - one month's notice to be provided before enforcement action occurs. The provision again illustrates the problem of the lack of monetary ceiling in this legislation. I think there would be few people in the room who would disagree that for a standard $5,000 used car transaction one month notice is a pretty fair and an unarguable requirement to have in consumer protection legislation. For a one million dollar yacht transaction, it is a different story. And I think the legislation in this provision illustrates that it has a problem with its failure to have a monetary ceiling. It is trying to have it both ways.

The final provisions I want to deal with are the civil penalty provisions which are included in part A. Civil penalties are basically a requirement where public enforcement can occur where a key disclosure is incorrect and the credit provider loses his right to credit charges, subject, as Barbara will know, to the right to go to a tribunal or court to have them re-instated. The current regime has been retained, although the disclosure requirement has been narrowed, in particular the ones that have gone from the current position are the requirement to show commissions - that is no longer a civil penalty, and interestingly enough the requirement to disclose payment does not also attract a civil penalty.

Next, let us go to the drafting instructions briefly to try and assess whether those provisions in fact meet the requirements of the Code. The drafting instructions were set down by the Standing Committee of Consumer Affairs Ministers who meet, supposedly annually, but it seems to be a little bit more often these days. In April 1992 they set out the basic policy objectives at the start of the drafting instructions and they were:

1. To promote competitive neutrality.

2. To encourage fair trading practices.

3. To adopt consumer protection measures.

I think most people would agree that those objectives are commendable. The consumer movement sees the Bill as a worthwhile attempt at that, but falls short in a number of important areas. In particular, I would have to say that I do not believe the draft legislation will promote competition in an open market and in some cases it will actually inhibit competition. On the issue of promoting competitive neutrality, the legislation does apply equally to all credit providers, so it applies to banks, building societies, credit unions, finance companies. But I must say I express some alarm at Clause 6 sub-clause 10 which allows an extremely broad exclusion provision which could have the effect of allowing Government, be it uniformly or not uniformly, to exclude a particular category of lender from the proposed legislation. Secondly, the legislation, although it goes some way to try and even up the rules relating to lending products, still has some weaknesses and there are two that jump straight out of the legislation. First, consumer leases are treated quite differently to all other lending products. For instance, they do not have to show any form of interest rate disclosure whatsoever. Now from a consumer perspective, whether you are obtaining a car on finance by way of a loan, hire purchase transaction or lease, the rules should remain the same - it is all the finance product to obtain the car, and that is a major weakness in the Code.

The second is that where insurance premiums are paid by way of instalments but with a credit charge, there has been a total exemption from legislation. There seems to be no justification for special treatment of insurance in this regard.

The second objective was encouraging fair trading practices and we as an organisation would agree that the appropriate method of encouraging fair trading is to promote open competition in the market. Competition occurs at two points - at the point of entering the contract where you make the choice and you do your deal, and secondly, later on when you decide you do not think the deal is too good and you want to switch to another lender who is going to give you a better deal. The problem the legislation has is that in splitting fees and charges which relate to the cost of credit from interest the ability of the consumer to choose is very much reduced. They are going to be left in a situation of having to choose between a product with a $500 establishment fee, a $7/month account charge, 15% interest, with another product which has a $100 establishment fee, a different monthly account charge and a different interest rate, and most consumers simply will be confused between which is the better product. That is not only bad for consumers, it is bad for industry. It means that those people who are providing competitive products do not have the transparency of price to sell that product.

The second issue is portability. Here the consumer movement has made a major concession in saying that variable interest rates are a good thing and have a number of benefits to consumers. One of the major safeguards from a consumer point of view is the ability of people where the interest rate has been varied to go to a better dealer and one of the concerns I have is a practice called 'rate baiting' where you are told at the point of entry that this rate is 12% and you move on and find out two months later its 21% or 31%. The notice requirements in that area are inadequate and the problem with the establishment fee will mean that people will have not enough information in trying again to look at the cost of credit and to understand the cost of moving, and again I think that will be a major problem in creating open competition.

The final aspect of the Minister's policy statement was encouraging fair trading practices. The one aspect I want to pick up on is that of having an appropriate redress mechanisms, appropriate remedies where the various disclosure measures are failed and the point I want to speak about particularly is civil penalties which has been retained in the current draft. One thing I suppose you can say about civil penalties is the comment Ralph Rahner wrote in the American legislation back in 1984 which is true in Australia as well, and again Barbara will have some feeling for, he said that 'although some would say that truth in lending is a paper jungle, no one could seriously claim that it has been a paper tiger'. Civil penalties have had a major impact on the industry. They have certainly had an impact on compliance and obtaining compliance. The story I always tell is in relation to one finance company which I litigated against which had a number of systemic problems who now have a major compliance program in place which means they make one error in every 5,000 contracts, and that's a major victory for everybody.

There are a number of arguments put against civil penalties. One is that they are unfair, they should be based around the loss occasioned to the consumer. There are two answers to that I think. The first is that it misses the purpose of civil penalties. They are a civilly enforceable penalty, they are not there as a redress mechanism. Mr Justice Fullagar said in the **Encyclopaedia Britannica** case '... Forfeiture against the offender, not benefiting the debtor is the rationale.' The other aspect which the Saskatchewan Law Reform Commission put very nicely back in 1989 is that the enforcement redress mechanisms which are included in the consumer credit legislation are as important as the rules which the legislation enacts. It came to the view that at the end of the day public enforcement was an intrinsic aspect of that because firstly,sometimes enforcement by Government is one of those areas which is cut, and in Victoria the Schilling report has cut Consumer Affairs programs in a wholesale manner and I can vouch for that, being in an organisation which has been cut 50%, which will bond me with a number of bankers here today who feel the same way. And secondly, often regulators, because of their involvement with the industry and their need to obtain technical expertise in the industry, can become captured by the industry. The second problem with not having a civil penalty is the ability to actually prove loss where the interest rate is wrongly expressed is virtually impossible. In the case of **Stan Cusack Finance v The Director of Consumer Affairs** in Canberra the credit provider was charging 34% to 36% but in fact putting on the contract 18%. The Director tried to prove that if the people had seen 34% they would have gone elsewhere and got cheaper credit - on their credit card for instance at 20%. The court held, rightly, that this was speculative evidence and again to go back to Mr Rahner and the American experience it has been exactly the same, and he said:

> *'Insofar as the purpose is to provide disclosure to consumers the truth in lending violation may cause a lack of information. This of itself does not give rise to a monetary loss. Theoretically if the consumer tried to show if accurate information had been given he would have gone elsewhere but such a showing has not been reported in any case, and that still remains the case.'*

Finally, what of tomorrow? The best information I have is that there will be agreement, but the threat of Mr Dawkins coming through and overriding the area has been enough and that Ministers will agree. They will not agree on the Code in its current form, they will make two major changes to it, or so I am told, and I will find out tomorrow whether I am right. Firstly, they will further deregulate the fees and charges area. There will no longer be, as in the current legislation, a boundary around what fees may be charged. It will be open slather, there will be a capacity for Government to prescribe fees that you cannot charge. The trade-off to that will be a broad right to re-open unfair fees. The second thing which we understand will occur will be there will be no comparability rate - the contract will simply have fees and charges and the interest rate and nothing else. The comparability rate will not be on the contract nor in advertising. Also civil penalties will be retained, again on hearing from my sources, but subject to a number of caps to limit the extent of liability depending on the size of institutions.