

Chapter 10

Unfair contract terms

10.1 This chapter examines how competition affects unfair terms that may be included in banking contracts.

10.2 In 2009, the Senate Economics Legislation Committee inquired into the provisions of the first tranche of the Australian Consumer Law (ACL). A key provision of this bill was the banning of unfair terms in standard form business-to-consumer contracts. Standard form contracts are contracts that are not individually negotiated: they are often 'take it or leave it' contracts.

10.3 The ACL provides that a term in a consumer contract will be considered 'unfair' if:

- (a) it causes a significant imbalance in the parties' rights and responsibilities;
- (b) it is not 'reasonably necessary' to protect the 'legitimate interests' of the supplier; and
- (c) it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

10.4 A term is likely to be considered unfair if a supplier can vary any term without the consumer's consent or if a supplier can cancel a contract without a corresponding right for the consumer. If a term is found to be unfair, it is void but the rest of the contract remains in effect.¹

10.5 The ACL's unfair contract terms provisions covers banking and financial services contracts as well as utility service contracts, internet and telephone contracts and gym memberships.

10.6 The ACL's unfair contract terms provisions were introduced in July 2010 and are a schedule within the *Competition and Consumer Act 2010*. The provisions relevant to financial products and services are legislated in the *Australian Securities and Investments Commission Act 2001*.

10.7 The Senate Economics Legislation Committee's report into the unfair contract provisions noted that the banking sector criticised the bill's impact on business certainty and business costs. The Australian Bankers' Association told that committee:

1 Senate Economics Legislation Committee, *Trade Practices Amendment (Australian Consumer Law) Bill 2009 [Provisions]*, September 2009, p 1.

Central to our concerns is that the regime will create uncertainty for banks...In practice the operation of this legislation is likely to see customers agreeing on the terms and conditions for their banking services before the customer accepts a financial product, only to later seek to avoid their obligations by claiming a particular term is unfair.²

Competition and unfair contract terms

10.8 In theory, the more competitive the banking market is, the less likely that the banks will offer 'unfair' standard form banking contracts. A healthy, competitive banking market will lead to competitive and 'fair' standard form contracts. After examining the issue of unfair contract terms in 2008, the Productivity Commission noted:

If consumers value fair play by firms the question arises as to why firms would not organise themselves to exploit the market advantages that this behaviour would bestow.³

10.9 Another view was put by the Banking and Finance Consumer Support Association. It argued that an over-supply of competitors can foster unfair terms to be included in contracts and impact unfairly on the consumer, the taxpayer, the shareholder and investors. The Association noted that if left unchecked, as in low doc lending, the market becomes 'flooded with unacceptable contracts and conduct which may take years to repair the damage'.⁴

10.10 The Financial Ombudsman Service argued that competition will only have a limited impact on unfair terms in a contract. It noted that most products are sold on the basis of price and that an unfair term is not likely to be brought to the consumer's attention by the selling institution. The effect of competition on unfair contract terms was therefore only likely to occur where a competitor draws customers' attention to an institution's unfair term. Even in this event, however, it argued that this publicity was most likely to be focussed on the fee attached to the unfair term, which underlines that competition is typically based on price.⁵

10.11 Choice noted that competition alone often does not guarantee the elimination of unfair contract terms because they are routinely not adequately disclosed and

2 Mr David Bell, *Senate Economics Legislation Committee Hansard*, Trade Practices Amendment (Australian Consumer Law) Bill 2009 [Provisions], 26 August 2009, p 35.

3 Productivity Commission, *Review of Australia's Consumer Policy Framework*, April 2008, volume 2, pp 414-5. The Productivity Commission report includes a detailed discussion of issues related to unfair contract terms (pp 403-441), and gives an example of how competitive pressure from consumers against unfair contract terms in software end-user licence agreements has led to a reduction in the use of these unfair terms (p 427).

4 Banking and Finance Consumer Support Association, *Submission 112*, p 22.

5 Financial Ombudsman Service, *Submission 78*, p 3.

therefore not considered by consumers at the time of making purchase or service decisions. It argued that while the application of the unfair contract term provisions will provide significant benefits for consumers, it is not a complete solution. Specifically, Choice observed that:

- the regime only applies to consumer contracts;
- there remains some ambiguity in applying the regime as to when a term will be considered 'unfair', particularly when applying the second limb of the unfairness test—whether it is 'reasonably necessary in order to protect the legitimate interests' of the bank;
- similarly there will be some doubt about whether particular terms are part of the 'upfront price' (and therefore not covered by the regime) in the context of a banking service
- the regime does not prohibit particular unfair terms until such time as a court has determined the term is unfair.⁶

10.12 Choice argued that the issue most likely to cause the most difficulty for both consumers and the industry is the level at which terms should be considered 'unfair'. It believes that the obvious and fair rule would be that all fees should be based on the bank's cost of providing the service to which the fee relates or the loss that is incurred as a result of a default. Choice claimed that this is likely to enhance competition because it will make it more difficult for institutions to offer artificially attractive interest rates which are supplemented by fee income.⁷

10.13 The Committee received some evidence expressing concern that the recent diminution of competition in the Australian banking sector will not protect consumers from unfair contract terms and fees. Associate Professor Frank Zumbo wrote in his submission to the Committee that:

...consumers are currently, and will continue to, face higher interest rates and unfair contract terms and fees as a direct result of the substantial reduction in the independent competition previously provided by St George, BankWest, RAMS, Aussie Home Loans and Wizard.⁸

10.14 As a corollary of this argument, Associate Professor Zumbo claimed that the threshold for enforcing the unfair contract terms provisions is too high. He noted that while the threshold was not as high as 'unconscionable conduct', it will nonetheless be difficult to prove and hard to enforce.⁹

6 Choice, *Submission 70*, pp 7-8.

7 Choice, *Submission 70*, p 8.

8 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 55.

9 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 55.

Mortgage early exit fees and unfair contract terms

10.15 ASIC published a review of entry and exit fees applying to home mortgages in April 2008, prepared at the request of the Treasurer. Following from this, the *National Consumer Credit Protection Act 2009* came into force in July 2010. The National Credit Code, which is contained in Schedule 1 of that Act, contains provisions, administered by ASIC, to the effect that the courts may review and annul unconscionable interest and other charges such as exit fees.¹⁰

10.16 ASIC explained:

Under this legislation borrowers can challenge the validity of early termination fees they think are unconscionable or unfair. Borrowers may also complain to ASIC or to an external dispute resolution scheme. The borrower or ASIC can seek review of fees by a court.¹¹

10.17 While it might be unlikely that an individual consumer would undertake the expense and risk of taking a bank to court to try to vary an exit fee, the Code also allows for ASIC to bring such a case in the public interest.¹²

10.18 ASIC also noted that after a period of consultation, in November 2010 they published guidance for lenders about how ASIC proposed to administer the unfair contract terms provisions in relation to exit fees:

The guidance spells out ASIC's view on such matters as what types of costs and losses might be included in an exit fee, the types of losses that might not be recovered through exit fees and the limited circumstances under which a lender might vary exit fees during the life of a mortgage.¹³

10.19 This document noted that ASIC no longer viewed ongoing loan administration as a legitimate interest. It argued that ongoing loan administration costs were recovered through other fees and charges, such as account keeping fees, and do not

10 Section 78(1) of the National Credit Code provides that 'The court may, if satisfied on the application of a debtor or guarantor that:... a fee or charge payable on early termination of a credit contract... is unconscionable, annul or reduce the charge or fee or charge and may make ancillary or consequential orders.' Section 78(4) expands on this, saying 'For the purposes of this section, a fee or charge payable on early termination of the contract or a prepayment of an amount under the credit contract is unconscionable if and only if it appears to the court that it exceeds a reasonable estimate of the credit provider's loss arising from the early termination or prepayment, including the credit provider's average reasonable administrative costs in respect of such a termination or prepayment'.

11 Dr Peter Boxall, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 21 January 2011, p 3.

12 Section 79(2) of the National Credit Code provides that 'ASIC may make an application under this Division and has standing to represent the public interest' and Section 79(3) adds 'The application...may apply to all or any class of credit contracts entered into by a credit provider during a specified period...'

13 Dr Peter Boxall, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 21 January 2011, p 3.

need to be recovered through early exit fees. ASIC also noted that it does not agree that it is legitimate for lenders to seek to recover product and business development costs in an early exit fee. It argued that it is more appropriate to recover these through other fees and charges (such as ongoing fees or in a lender's margin on lending).¹⁴

10.20 There are doubts that the ASIC approach will prove effective:

While we do have laws dealing with unfair fees, I have to say that ASIC has been very slow to enforce those laws, and suggestions that individual consumers can go to ASIC and that that will lead to an investigation are, I believe, once again naive. The reality is that agencies like APRA and the ACCC have limited resources. If a single consumer were to raise an issue, they would be likely to get back a form letter saying that it is not a priority area, it is just an isolated instance and the consumer has the ability to pursue private actions.¹⁵

10.21 The Consumer Action Law Centre noted in its submission that ASIC's formal guidance on the issue of exit fees and 'deferred establishment fees':

...makes it clear that ASIC does consider that these fees could fall foul of the new laws in certain circumstances and that ASIC could potentially take action to enforce the new laws in the future if it considered doing so was in the public interest.¹⁶

10.22 The Centre observed that given a policy goal of preventing the negative effect of exit fees on competition in financial services markets, the need for regulatory intervention was 'inevitable'.¹⁷ Nonetheless, it argued that the regulatory framework could be extended to 'clamp down' on these fees.

10.23 The Centre noted the United Kingdom's lead of imposing disclosure obligations on lenders in relation to these fees. This requires lenders to disclose early exit fees upfront using easy to understand cash amounts. All lenders are required to call this type of fee by the same name, so that consumers do not have to compare the costs of early termination fees as opposed to deferred establishment fees.

10.24 The Centre argued that the unfair contract terms provisions are important to protect consumers once they have entered into a contract. Disclosure is not protection against unfair or excessively high fee levels. Accordingly, the Centre recommended that the unfair contract and consumer credit law provisions be amended to clarify that that only costs directly related to early termination can be recovered in an early exit

14 Australian Securities and Investments Commission, *Response to submissions on CP 135 Mortgage exit fees: unconscionable fees and unfair contract terms*, November 2010, p 12.

15 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 55.

16 Consumer Action Law Centre, *Submission 87*, p 14.

17 Consumer Action Law Centre, *Submission 87*, p 14.

fee. It noted that in Victoria, there is already a model for regulating early termination fees in this way.¹⁸

Unfair fees

10.25 An unfair fee might broadly be described as one where the fee payable materially exceeds the reasonable cost to the financial institution of undertaking the activity to which the fee relates.¹⁹ The ability of a bank to charge an 'unfair' fee reflects, in part, a lack of competitive tension in the market. As Choice noted in its submission:

...unfair fees and charges are a symptom of an uncompetitive market in Australia. CHOICE has welcomed the Government's recent moves against excessive mortgage exit fees and unfair credit card terms. But it is notable that consumers have been driven to taking collective legal action to recover unfair fees.²⁰

10.26 The Committee received some comment on the need for a tougher legislative stance on banks' unfair fees. In his submission, Associate Professor Zumbo recommended amending the definition of unfair term under the ACL to expressly deal with unfair fees. He suggested amending the meaning of 'unfair' in section 24(2) of the ACL²¹ to state that:

(2) In determining whether a term of a consumer contract is unfair under subsection (1), a court may take into account such matters as it thinks relevant, but must take into account the following:

...in relation to a fee payable in connection with a financial product, whether the fee materially exceeds the reasonable cost to the financial institution of undertaking the activity to which the fee relates.²²

10.27 The Consumer Action Law Centre argued that as the national unfair contract terms laws have only recently been introduced and are specifically designed to target unfair contractual terms, 'they should now be given a chance to work' and 'regulators should be given an opportunity to monitor the market and enforce the law'.²³

18 Consumer Action Law Centre, *Submission 87*, pp 16–17.

19 Associate Professor Frank Zumbo, *Submission 56*, p 7.

20 Choice, *Submission 70*, p 4.

21 A corresponding amendment to section 12BG of the *Australian Securities and Investments Act 2001* is also likely to be required.

22 Associate Professor Frank Zumbo, *Submission 56*, p 7.

23 Consumer Action Law Centre, *Submission 87*, p 20.

Bank selling practices

10.28 The trade union covering bank workers is critical of some selling practices:

It is common practice throughout the banking industry for significant numbers of employees to have their wages and conditions outcomes and in some cases their employment predicated on employer imposed sales targets associated with the sale of products, very much including credit products...this encourages a culture of product pushing onto consumers, with little regard for whether it is the right product for consumers or their ability to afford it.²⁴

10.29 A recent opinion poll showed that 59 per cent of customers were 'unaware of bank workers' salaries being tied to the selling of debt products' and 79 per cent 'want sales targets of credit products delinked from wages for bank workers'.²⁵

10.30 Among the bank workers themselves, 43 per cent reported 'being placed under pressure to sell credit/debit products to customers regardless of their ability to afford them' and 81 per cent say such targets were not adjusted during periods of economic difficulty.²⁶

Committee view

10.31 The Committee believes that more intense competition will lead to fewer rather than more instances of contracts with unfair terms. There is still a role for some regulation to supplement the benefits of improving competition. Regulations governing clear, simple and comparable disclosure would certainly assist consumers in determining whether or not to sign a contract. As discussed in Chapter 7, the Committee believes that bank exit fees should be allowed but they should be related to the costs incurred by the lender, not set at a prohibitive level where they act as a barrier to competition. As the unfair contract term provisions have been in operation for less than a year, the Committee believes it is prudent to wait to reserve judgment on their effectiveness.

10.32 As the Committee has noted in Chapter 7, public education to improve financial literacy is an important component of ensuring that the full benefits of a competitive financial system are available to all consumers.

Recommendation 17

10.33 The Committee recommends that the Government introduce regulation of mortgage early exit fees (including deferred establishment fees), requiring disclosure of these fees upfront in a simplified and comparable format.

24 Finance Sector Union, *Submission 80*, p 10.

25 Cited in Finance Sector Union, *Submission 80*, p 7.

26 Cited in Finance Sector Union, *Submission 80*, p 8.

