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Code of Banking Practice
PO Box 2045
Parkdale, Victoria, 3195

Dear Sirs,

I have pleasure in enclosing the Institute's submission for your attention, prepared by the Commercial Law Section's Financial Services Committee.

I look forward to hearing from you in due course.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'John Corcoran'.

JOHN CORCORAN
President

LAW INSTITUTE OF VICTORIA

SUBMISSION ON THE REVIEW OF THE CODE OF BANKING PRACTICE ISSUES PAPER

Fairness

The incorporation of a principle of “fairness” is not disputed. However, the proposed substitute section 1.7.3(i) is considered ambiguous. Unconscionability along the lines of section 51AA of the Trade Practices Act is more certain but would arguably add little to the Code. If fairness is going to be included some examples or guidance might be helpful.

Definition of Small Business

The concept of applying the code in total to small business may need to be considered in further detail. It is not apparent that all the provisions of the code are directly applicable to small business customers. For example, the application of the proposed provisions relating to guarantees is not considered appropriate [p89 of the Viney proposals].

Nor is it considered that the definition of small business as contained in the FSR is necessarily appropriate without further consideration. The definition of “retail client” in the FSR encompasses small business, defined as a manufacturing business employing fewer than 100 people or other business employing fewer than 20 people. However, the application of the substantive provisions of the FSR is subject to other exclusions and it is not apparent whether these should not also be incorporated into the Code. If the number of employees is to be the sole criteria, this will create anomalies between the FSR and the code.

It is also not considered appropriate that the code apply to some corporations or other entities that will nevertheless satisfy the definition of a “retail client” for the purposes of the FSR. The application of the FSR to such an entity will merely result in various disclosures being made but will not impact on the substantive rights. The application of the Code will impact on substantive rights, such as the ability to take unlimited directors guarantees secured by mortgages of properties or other assets.

For example, subsidiaries of public companies, property developers, subsidiaries of overseas entities, venture capital enterprises and high risk start up enterprises may all amount to a “retail client” for the purposes of the FSR. However, it is considered inappropriate for these to be subject to the Code.

• Statements of Account

The recommendation that the code apply the substance of UCCC requirements in section 31 to 34 (inclusive) to small business statements of account and related information is considered to be too prescriptive. It is recommended that the current Code provisions relating to provision of statements of account should be extended to small business but not the provisions of the UCCC. Small business accounts take many forms and applying prescriptive statements is considered inappropriate. For instance, small businesses may use some or all of the following types of facilities:

- Bill discounting facilities;
- Trade credit facilities;
- Foreign currency accounts;
- “Come and go” facilities;
- Overdrafts;
- Fixed term loans;
- Fully drawn advances;
- Short term cash facilities.

Whilst some of the provisions of the UCCC (such as section 32) are unremarkable, others will be inappropriate to certain of the above facilities. For instance, the information required by section 31 would be inappropriate in regard to a bill discount facility or a bill discount and acceptance facility. It will also be inappropriate to trade finance or foreign currency accounts

Shadow Ledgers

It is not apparent what the concern is that has led to this recommendation. The maintenance of “shadow ledgers” is necessary for operational and accounting purposes. If a bank writes-off an account that is in default, it will lead to remove it from its ledger of performing loans and from ledgers recording interest accruals. It will, as a matter of accounting, be classified as a bad debt and no interest accruals will be recorded in the general ledger account. To do otherwise would be to breach accounting standards. If a customer requests a statement of the amount owing, the bank should be obliged to provide it with such a statement. If the bank provides a statement which does not include a manual calculation of interest, the customer only need tender the amount stated to be outstanding. If that amount is tendered, the bank risks having to accept that amount in full satisfaction of the debt.

It is suggested that, if banks have quoted amounts showing only the amount written off and not accruals of interest, this is merely a result of an administrative error, not some form of disreputable practice. The answer should simply be to provide in the Code that, if a bank provides a written quotation of the amount outstanding, it should accept that amount in discharge of the loan. This would merely reflect what is likely to be the result at common law anyhow. There is no need to automatically provide customers in default with statements of account as if the account were not in default. This implies that banks will be required to continue to provide statements of accounts in circumstances where it is clear that the borrower has defaulted and disappeared

Code clauses 9.1 and 9.3

Even if technically speaking a bank could avoid a notice period because there was no change to a fee but rather a change in the circumstances in which a fee might be charged the proposal introduces an unnecessary level of complexity.

The suggestion that customers be given 30 days advance notice in writing of a change in the minimum balance to which an account keeping fee exemption applies or a change in the interest rate tiers applying to a deposit account, introduces unnecessary complexity into the code.

At present, the code requires 20 days notice of the introduction of new fees and charges or changes to the calculation of interest. The FSR will require 30 days notice of changes to fees and charges for deposit products. It is likely that the FSR will apply to circumstances set out in the interim recommendation anyhow. If not, it is questioned why these particular changes are singled out for specific treatment compared to any other change. If the principle is that customers should be given notice in advance (which is a principle that the Institute supports) consistent notification requirements should apply. Either the general provisions are adequate or they are not. If not, the general provisions should be changed. There is no need to make specific provisions in relation to two specific matters that have come to the attention of the reviewer.

- **Guarantees and indemnities**

In general, the recommendations relating to guarantees and indemnities and the extension of the Code to individuals guaranteeing small business lending is supported.

However, a number of members of the Committee consider that the application of these provisions to guarantees or indemnities given by directors or officers of corporations is inappropriate. This is so whether the director is an executive director or non-executive director. The principles that have been developed by courts of equity have applied generally to "volunteers". It is inappropriate to apply the concepts to parties that have a direct or indirect financial interest in the transaction. To require a director (perhaps the sole director) of a company to be given independent legal advice and a recommendation that they receive financial advice, when the director is guaranteeing the affairs of a company that they manage, is a waste of resources. This would require a small business operator to engage, in effect, two law firms, one to advise the company and one to advise the director.

In practice, it will simply result in pressure being applied upon independent legal practitioners to provide certificates in favour of lenders for a charge that is inappropriate for the level of complexity of the advice required and the risk assumed by the solicitor. We have already reached a point where solicitors in at least one State have been advised not to provide certificates and there have been concerns expressed in a number of other jurisdictions that the level of risk undertaken by solicitors in providing certificates to lenders is inappropriate.

If the recommendations are implemented, it will be necessary for the Institute to reconsider its position on solicitors issuing such certificates.

On the other hand, there is a view amongst other members of the Committee that the guarantee provisions should apply to directors of proprietary companies on the ground that it might lessen the number of guarantee cases that proceed to litigation where the guarantor invokes equitable principles to set aside the guarantee. The arguments listed above why the provisions should not apply to directors - cost, inconvenience and so on- do not apply if one bears in mind that the directors can always opt out of these provisions.

The recommendation that a bank not accept an all monies mortgage or guarantee unless the mortgage or guarantee contains a provision that it does not extend to any future contract or facility unless the mortgagor signs an extension of the mortgage, is also questioned by some members of the committee. Presumably, if the mortgagor is to sign an extension of the mortgage, after being provided with the new contract or facility, the mortgagor will also need to receive further independent legal advice and be advised to seek financial advice. Again, this will add to costs and complexities and will ultimately limit the provision of finance to small business.

The Institute notes that the recommendation refers to an all monies mortgage extending to any future contract or facility. It does not refer to, for instance, an annual review of a facility that results in an increase in the overdraft limit or an extension of the credit limits. If it is proposed that it apply to such annual review, it will severely restrict the provision of finance to small business, at least through the types of facilities that are commonly available to small businesses.

- **Right to cap liability with guarantees.**

The second paragraph of the recommendation is adequate to safeguard the guarantor from further advances to the borrower whether by way of a new loan or an increase in the limit to the existing loan.

By referring to a "right to vary the guarantee by reducing the cap on liability", this infers that there is a "new" legal right when in fact it is really referring to the existing position that a guarantor should not be liable for further advances (whether by way of a new loan or an increase in the limit) unless he or she has consented to same.

- **Right to withdraw from guarantee before credit extended - whether the UCCC approach is appropriate to adopt in the code**

Lenders may insert appropriate clauses to protect themselves not to fund the small business borrowers if, prior to funding the lender receives notice that the guarantee has been withdrawn. However, from the perspective of the small business borrower, where reliance has been made that the guarantee is in place prior to entry of contract with a third party in the belief that funding has been approved, and then the guarantor withdraws, not only the contract with the third party may not only be able to proceed, but damages claims and heavy consequential losses may arise. Therefore, the UCCC approach on the right to withdraw from guarantee may not be appropriate in regard to small business

- **Appropriate wording in relation to further advances in regard to joint and several borrowers**
Views are sought on the "appropriate wording" in relation to further advances where one of the joint and several borrowers is able to terminate the liability in respect of further advances unilaterally.

Whilst not offering "appropriate wording" it is noted that at law if a joint borrower refuses to agree to a further advance, or has conveyed his or her disagreement for further advances, then the mandate (ie request) for further funding would appear to have been terminated: Tyree, *Banking Law in Australia*, 3rd ed, para 5.58. In addition, Paget's *Law of Banking*, 7th ed, page 64 says:

"if one party to the account withdraws his mandate, the bank would decline to pay the other even if the mandate provided for either to sign; in the absence of provision or agreement to the contrary a mandate for a joint account can be withdrawn by one party to it".

- **Credit assessment**

Under the existing regime, when a lender is required to consider a "customer's capacity to repay", there is under clause 15.1 specific guidelines for consideration. For instance, the customer's income and expenditure, the purpose of the banking service, credit scoring and the customer's assets and liabilities.

Under the new proposals, the specific guidelines have been deleted and in its place, it is simply a reference to "the customer's capacity to repay".

This can be interpreted to mean the exclusion of consideration in regard to the customer's assets and liabilities. This may be appropriate with respect to consumer credit cards, where traditionally they were unsecured, but this is not so with respect to ordinary loans and loans to small business where it becomes necessary to consider both the corporate customer and its directors.

The reference to credit assessment on consumer credit cards can be accommodated by a separate sub-heading under clause 15 that is more amenable to a non-prescriptive approach to avoid situations of over-commitment.

- **Monitoring compliance**

The proposal that some form of independent monitoring be put in position is strongly supported. The ASIC would seem to be the better body to do this, given its role in monitoring compliance with the equivalents of s 52,53 etc of the TPA. The role of monitor and enforcer are not entirely incompatible. It would muddy the waters if the ABIO Council had the job of monitoring given the AIBO's job of dispute resolution.

Sanctions

It was felt that civil penalties for breach of the Code would be appropriate at an appropriate level to encourage compliance and have a deterrent effect. Perhaps some breaches of a minor nature should be

exempt from such a regime. Customers can, of course, bring their disputes on a civil basis to the ABIO and if dissatisfied with the decision can litigate in the normal way

- **Copies of documents**

Copies of relevant documents should be supplied to customers and guarantors at the outset free of charge. Further copies should be available on request at a reasonable fee.

- **Charge backs**

As a general point anything that detracts from certainty of payment must be regarded as negative from the payee's point of view. The promotion of a "right" of charge back might encourage misuse of the "right". Arguably this might detract from the relative certainty of payment by credit card compared with, say, payment by cheques. At least with a stopped cheque the payee can bring an action on the dishonoured instrument, an easy default procedure being available. However, if a purchase is subject to a charge back the merchant will have to sue the cardholder on the contract. Ultimately, to the extent that the losses fall upon merchants, the merchants will seek to recover those losses through higher prices for card customers or higher prices for all customers. The result is that the customers will bear the ultimate cost of fraud inherent in the proposal and not the banks.

It is, however, conceded that with credit card purchases over the phone a right of charge back is acceptable given the possibility of easy fraudulent use of the credit card number over the phone. The usual credit card requirement that the holder must sort out disputes directly with the merchant, would seem to be inappropriate for the use of credit card over the phone (no signed voucher) given the frequency of disputes and cardholder refusal to pay the bank.

- **The option of being able to place a stop on credit card accounts in certain circumstances**

Given that the bank may have a right to charge-back a disputed purchase to the merchant, the issue is whether the cardholder should have a right vis-a-vis the bank to stop payment. The right of card holders to avail themselves of the bank's right of charge back against the merchant is legally dubious and confusing, especially when credit card conditions often say that the card holder must sort out disputes directly with the merchant but must make payment to the bank. A right of the cardholder against the bank to put a stop on the account in the event of a dispute would make things somewhat clearer. However, there may be system constraints in doing this. The new EFT Code will now cover telephone use. But allowing a right of stop payment may detract from certainty of payment as noted already.

If the purchase is beyond the credit limit of the card, the bank should be allowed to pay only if the cardholder has authorised the purchase.

- **Advertising the institution's right to unilaterally change terms and conditions in regard to specific types of accounts**

It would not seem necessary to specifically include this in the Code. Such practices as described would seem to fall foul of the TPA and should be dealt with accordingly