OCCASIONAL PAPERS: 7

EVOLVING LEGISLATION ON CONSUMER CREDIT AND TRADE PRACTICES:
STIMULUS OR DRAG ON ECONOMIC ACTIVITY?

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FOREWORD

The *Occasional Papers Series* of publications issued by APS Bank promotes the evaluation of economic and social issues. *Occasional Papers: 7* presents topics that are inspired by a common denominator: responsible and fair credit as a tool of human development, social cohesion and economic growth in an expanding regional and world market for goods and services supported by an advancing technology in telecommunications.

This is a wide area for research that is constantly changing as legislation adapts to new economic realities and political aspirations. It is a topic worth following closely. It implies reconsiderations of embedded ways of thinking in societies and, equally important, commercial and trade practices that may favour certain actors rather than others. Besides, modified rules of trade may demand a critical evaluation of existing institutions that regulate producers or traders as well as official or non-governmental organisations that mediate in the interests of fair trade behaviour.

The nine papers in this publication were initially presented at the annual seminars organised by Malta's Consumer Affairs Council held in 2006 and 2007. APS

Bank has been co-sponsoring this activity for several years and it also supported the publication of the proceedings of the Conference held in 2003 on Consumer Rights in the Travel Industry.

This time it was decided to adopt a different approach to raising awareness of certain matters related to consumer affairs, responsible credit and trade practices. The papers were organised around two ideas: i) Legal concepts and interpretations and ii) The application of such concepts in expanding legal jurisdictions with the possibility of the emergence of new arbiters on legal issues and the political connotations related to such situations.. The selected papers examine the interpretations given to such terms as 'fair pricing', 'responsible credit', and 'indebtedness'. Besides, they highlight the policy implications arising from embedded historical practices and widening legal domains. There is a continuous dialectic between regional and group interests on the one hand and the concept of fair trade and value for money applied over a widening economic space.

The underlying objective is cognisance of a basic fact: trade refers to ways in which actors benefit individually and collectively. Actors can be consumers or producers, in defined economic spaces or expanding trade areas under varying conditions. It is interesting to learn how communities respond and adapt to such developments. One can thus appreciate better the sources of potential friction or points of contention that go beyond trading rules and practices, consumers' rights and producers' legitimate aspirations for rewards. The main thrust of this objective is expanded in this writer's Introduction below, which also reviews the respective contributions to this publication.

I thank the writers for reviewing the original submissions, thereby updating their research and their

stand regarding the suggestions they made to render useful both the concepts and their application to every day practices. I thank also the Consumers' Affairs Council, in particular the Chairperson Ms. Carmen Delia, for enabling the realisation of this project, starting with the two seminars and the compilation of the texts in print. The Seminar for 2006 was organised jointly with the International Association of Consumer Law.

The views expressed by the contributors are their own. They do not necessarily reflect the opinions of the organisations to which they belong or had been attached. APS Bank presents these views to stimulate debate on the subjects examined.

E. P. Delia
Chairman, APS Bank

October 2007

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E.P. DELIA

INTRODUCTION: EVOLVING LEGISLATION, CULTURAL INFLUENCES AND ECONOMIC GROWTH

This collection of readings focuses on the ongoing search for a suitable legal framework that facilitates trade while accounting for fairness and responsible borrowing / lending in an enhanced technological environment. Drawing on experience in the European Union and the United States of America, it relates to the role of the legislator and the policy administrator in balancing measures aimed at promoting economic growth, via trade transactions in goods and services, through a mixture of market forces and regulatory interventions on prices. It proposes this ongoing process in the context of economic growth and the betterment of human welfare; legislation can either stimulate development or act as a brake by distorting initiatives of consumers, savers, investors, service providers and traders.

The readings refer primarily to the legislation and practices in the financial sector. They concentrate on identifying cultural differences in interpreting legal terms and in commercial undertakings. They depart from the consumers' view but, in the process, they reach to producers. Suggestions refer to the market structures, as there cannot be a deal without having buyers and sellers.

It is up to legislators, courts of law and pressure groups to 'read the signs of the times' and adapt the legal and commercial/trade environments to reflect them.

The transition from a system of rules and practices, in place for many years, to one that may be intended to improve ongoing exchange relations is never easy. Therefore the timing and the preparation involved in explaining the real significance of certain decisions – at times of a purely political nature – to all those concerned is critical for the success, or otherwise, of any reform. This is even more so when national practices are being superseded by wider, union/federal interests. They represent costs that communities have to bear as part of their development. The lower these costs, in terms of time and resources spent to resolve disputes, the more resources can be allocated for directly productive purposes. Legislators, courts of law, offices of intermediation and resolution of conflicts of interest have an economic role to fulfill in terms of enabling an efficient application of regions' physical and human resources.

1. The Law, Institutions and the growth of trade, production and consumption

Policy makers and econometric model-builders emphasise the role of private sector consumption in an economy. Indeed, aggregate consumption functions, the relationships between the expenditure on consumption by households at any one time and over time and several economic variables - such as household income, the prevailing rate of interest and personal wealth - have been the object of theoretical and empirical investigation for more than eighty years.

Aggregate consumption functions are basic conceptual tools on which macroeconomic models rely in attempting to understand the complex interrelationships among sets of economic parameters. Their stability is considered essential for the diagnostic and predictive qualities of econometric models. They are also the objects of policy decisions in the Western world where considerations regarding households' living standards are paramount in debates on fiscal matters. Public sector asset ownership/privatisation issues are brought into such discussions, as well as the continued role of state subsidies in cash and kind, and on the future of the capitalist system of production that had contributed to the positive trade and income growth recorded in the post-war years.

Model simulations trace the various impacts of policy decisions on outputs and prices of goods and services. By implication they attempt to evaluate future changes to human welfare as manifested in choices regarding household expenditure on consumer goods and services. Such decisions determine the configuration of several disaggregated consumption functions that, together, form the weighted, aggregate consumption function on which certain key economic policy considerations are based. But, of course, macro decisions are the sum total of the decisions made by many individuals on their expenditures on consumer goods and services.

Individual/household decisions are conditioned by two main factors. Firstly, a community's culture as this is reflected in present consumers' tastes and expectations. Secondly, consumers' present incomes and their ability to raise finance – to bridge the gap between own resources and the amount required to achieve the present consumption plans. In turn both these factors are influenced in various ways by a country's legislation regarding the rights of

producers and consumers, their obligations to one another both immediate and in the medium to long term, and the systems that determine market prices.

Factors like these also dominate people's evaluation of long-term commitment in borrowing to purchase property. Decisions on home-ownership are influenced strongly by laws ruling rent controls, one's ability to borrow funds, repayment programmes conditions, and fiscal support both in terms of tax deductions, interest rate subsidies, and, possibly, state grants to reduce the initial capital commitment.

Similar considerations refer to international trade. The significance of trade agreements, the obligations of traders pre- and post-sale regarding quality of goods, the security of payments systems that go hand-in-hand with the advancements in information technology: such conditions influence both the flow and the volume of trade between individual countries and between trading blocs. They transfer local trade habits into the global arena, subjecting such habits to international scrutiny and pressures with the aim of enhancing the international exchange of goods and services. In the process, world trade can develop on specialised lines of production and distribution thereby leading to greater country volumes, higher incomes, and, eventually, improved living standards and personal welfare.

Social and economic development is an outcome of dynamic complex phenomena. It is the result of a continuous interaction of good governance, institutional development, timely policies, as well as geographical factors reflected in natural and man-made physical endowments. People respond to the political, social and economic environment to which they are exposed in seeking self-fulfillment and self-development. In doing

so, they also influence the quality of life for others living near and far.

Research on global economic growth suggests there is a correlation between institutional quality and international income differences. The 'perceived' quality of institutions may be considered a prime factor that ***determines*** economic and social development. This observation may be extended to apply also to regional trade blocs that come together to form single markets, like the evolving trade situations in the European Union and wider-based free trade areas.

Economic literature defines 'institutions' along a wide spectrum. At one end the term stands for the formal and informal constraints on political, social and economic interactions. They are seen as setting up an incentive structure that reduces uncertainty and promotes efficiency, thereby reducing transaction costs and freeing resources to production and exchange. So, an efficient judicial system will over time induce economic efficiency by enforcing property rights and the rule of law.

Transaction costs arise as an outcome of several factors, three of which have direct legal connotations. These are:

i. The inadequacy of legal and political institutions, particularly in international issues. Unless there is a recognised competent legal authority that can evaluate a claim and decide on an issue time will be lost in searching for such authority.
ii. The inadequate specification of property rights. Social costs often arise in resources that shift from being free to being scarce as a consequence of an economic activity. Clear air is slowly polluted as industry expands. In such circumstances the right to pollute or not to pollute would not be determined as the industrial development proceeds gradually. Without an initial

delineation of property rights there cannot be market transactions of the legal entitlements and industries' output would remain socially inefficient. Sometimes an unequivocal decision on property rights may be all that is required to resolve the difficulty.

iii. Rights are not all of equal value. There exists a hierarchy of rights which represents a community's basic values that account for both efficiency (production and distribution) criteria as well as distributive justice. Conflicts could occasionally arise between expressed human rights, say, the right to produce and the right to live in a clean environment. From an economic efficiency perspective which right ranks first may be immaterial, but from an equity point of view it need not be so. Hence when duties or rights come in conflict, a moral judgement based on a conscious deliberation has to be made.

Again, a greater openness to trade and higher transparency in policy formation and corporate governance are conducive to institution strengthening and growth. Policies have a bearing on institutional quality. Thus, opening up markets may help to weaken vested interest and reduce economic rents derived from prevailing economic and institutional arrangements. A freer trade environment may lead to demand for institutions that are more suited to an increasingly varied and possibly risky range of transactions and exchange. But above all, there has to be a commitment to adapt the institutional network to enhanced competitive challenges. Key institutional reforms are asked for if improvements in sectoral and aggregate performance are to be sustained.

At the other end of the spectrum, the concept of 'institutions' refers to the degree of autonomy of certain policy decision-makers, regulatory frameworks and

procedural devices. Such institutions influence economic performance by inducing a coherent and consistent combination of policy choices. Examples include independence of regulatory institutions and key decision making bodies like central banks; the existence and structure of international trade agreements and rules governing the performance of markets for goods and services, labour services and capital movements.

Consider the role of impartial regulatory agency in contributing to the emergence of a trade environment where efficiency and fairness can co-exist. Commodities are traded under different market structures. There may be valid reasons where consumers have to face monopolistic or oligopolistic producers. In these cases it pays to think in terms of long-term contracts between those who provide a service and those who buy it. Owing to uncertainty and other issues, both parties to the contract limit future options in order to attain optimality over time. Contracts serve to provide procedural mechanisms for adjudicating future contingencies. By increasing the producers' right to serve makes the contract more attractive to producers while simultaneously making the contract less attractive to consumers. The opposite holds if the consumers' interest in the right to be served is accentuated.

A regulator can act as a proxy for such agreements. Long term contracts are difficult to define and enforce because it is difficult to delimit, ex ante, their many provisions. A regulator can monitor market behaviour and continually define the relationship between consumers and producers over time in much the same way that courts of law interpret rights and obligations of citizens vis-à-vis other citizens and the state.

Efficient regulators aim to ensure fair dealings at any one time, and anticipate changes that may be on the

legislative horizon. They contribute to the development of an economic sector in the context of international business. A world that is moving towards a relatively freer, more competitive, trade environment is bound to exert pressures that many traders accustomed to operate in sheltered business milieus may find relatively incomprehensible and be lost unless guided through timely advice. This is especially true for those economies that have relied for many years on defending domestic productive sectors, at the expense of consumers, and that join wider trade blocs, like the Single Market Model represented by the European Union.

Such a paradigm shift may be addressed in terms of moves from a 'personal to impersonal exchange' (North, 1999). 'Personal exchange' refers to a world in which people deal with one another in small-scale economic, political and social activity, where everyone knows everyone else, and where it pays to co-operate. In such a world transaction costs are low; production costs are high because it is an environment of small-scale production that excludes economies of scale.

'Impersonal exchange' is based on a global perspective in which a large number of people are involved and transactions may not be repetitive. It is a world where one's dependence rests upon people one does not know, spread over a wide geographical area. Actors in such trade environments may find it profitable to defect rather than co-operate. Institutions in such an impersonal exchange milieu render co-operation worthwhile by encouraging players not to cheat, steal or lie.

One may claim that various markets, if not entire sectors, are constantly moving away from a personal exchange set up to one where impersonal exchange conditions take over. Such specific transformations as markets expand, domestically

or/and internationally, imply continuous re-assessment of the legal and procedural context in which people exchange goods and services with the aim of selecting the optimal set of conditions where trade could grow in the interest of the community. But this evaluation induces changes in traditional practices of carrying out exchange over a wide front: from finance to after sale of goods and enhancement of services in the wake of technology advancement.

2. Themes addressed

The themes presented below are worth evaluating for the ideas they convey. The basic meaning of terms as understood in everyday life and in legal proceedings may vary according to the social and political milieus in which they have evolved. In turn these terms develop over time a series of commercial and trade practices and procedures that those involved in exchange follow and expect other to adhere to. Such 'established' customs will have to be re-addressed as a community opens up to trade and other forces coming from another group, especially if by mutual consent the two groups enter into trade agreements – the move described above from a 'personal exchange system' to an 'impersonal exchange environment'. The efficient use of resources under both scenarios will thereby become an object of analysis, an extension of the particular considerations that the subject per se demands. So, say, while the meaning, application of fairness and efficiency are interesting and socially useful per se, they have also to be followed in terms of the long-term economic and welfare connotations that they lead to.

The themes are presented under two main headings, namely, Part One: Fair Pricing, Responsible Credit and

Indebtedness; and Part Two: Consumer Credit, Technology and Adaptation to Changed Commercial Realities. The three readings in Part One examine concepts as well as cultural scenarios in which they are introduced and interpreted. The six readings in Part Two tend to focus more on the suitability or/and success of the legislation in question. Legislators' objectives may be laudable; but the timing or means of achieving them may have led systems away from rather than towards their attainment. All readings offer proposals for improvements in the context of changing realities and experience.

Arnold S. Rosenberg examines the meaning of the terms fairness/unfairness in the regimes of pricing goods and services through the underlying theoretical constructs on which notions of fairness/unfairness may be based. Rosenberg illustrates the various issues involved in the context of legislation and court cases regarding bank charges in the European Union and the United States of America. He points out that legislators can defend better consumers' interests, and as a result also improve competition in one sector, by transposing experience from one market to another. In the case in point, this would mean the lessons learnt from the insurance sector in the United States of America to the banking sector. The main thrust will be defending the consumer *ex ante* rather than ex post. By doing so, the benefits can accrue earlier to consumers, saving resources (in time and effort) that would otherwise have to be spent in attempting to redress a negative exchange. Such a move will also lead to industry efficiency because providers of services, in this case, will have to watch their revenues and costs in an attempt to safeguard their profitability. A sector's productivity will thus be boosted over time in the interest of all.

Udo Reifner evaluates the meaning of 'responsible credit' as the term is interpreted and measures implemented in the European Union and the United States of America. The variations to the term reflect existing market cultures, which are influenced by the ethics of suppliers, strength of consumer organisations, the presence of consumer protection mechanism (such as offices of the ombudsman or mediators), and the society's approach to support for the poor. Cultural differences may generate friction between national (state) law and federal/EU law. In order to resolve these clashes between country/ union approaches and application, Reifner proposes a core set of seven principles to guide policy making and implementation. These are: i) Responsible and affordable credit must be provided for all; ii) Credit relations have to be transparent and understandable; iii) Lending has at all times to be cautious, responsible and fair; iv) Adaptation should be preferred to credit cancellation and destruction; v) Protective legislation has to be effective; vi) Over-indebtedness should be a public concern; and vii) Borrowers must have adequate means to defend their rights and be free to voice their concerns.

Theresienne Bezzina explores the multiple facets of the term 'over-indebtedness', often replaced in legal texts by the term 'insolvency'. Although basically such a condition refers to availability of resources and is primarily personal in nature, yet, if permanent, indebtedness has social connotations. Legislators in the EU and the USA tend to seek preventive approaches to stall the urge to borrow and spend and complement them with individual support - for example, counselling and the offer of real tangible assistance – to the over-indebted. They aim to restore confidence in such people and render them 'productive'. States of over-indebtedness are situations

that have a moral, social and economic bearing and have to be addressed in their totality.

Geraint Howells analyses the achievement to-date of the Unfair Commercial Practices Directive of the European Union, which is described as a 'bold measure' but a 'missed opportunity'. Commercial practices cover a broad spectrum that demands harmonisation from a single market perspective. But the timing of implementing such harmonisation is seen critical as it may create more legal complications once confronted with the removal of 'national' protective practices. Desirable movements away from historic commercial scenarios may not readily follow political exigencies; they may not be as simple as one would like them to be. In the process, the evolving fair trading policy and risk across the EU market may become stalled to the detriment of establishing a sound consumer policy.

Peter Rott examines linked credit agreements in the EU. The purchase of consumer goods and services is frequently financed by a third party that is closely linked with the trader. Such a tripartite relationship replaced the bilateral situation in which the seller gives the purchaser a loan. Rott illustrates the pending issues in terms of the principles of maximum harmonisation and of mutual recognition and illustrates the case from Germany's experience. Once again it is contended that traders' culture based on years of practice and embedded expectations and practices need some time to adapt to new rules and the situations that emanate from them.

Reinhard Steennot assesses the role of enhanced means of communications for the provision of services. Using the financial sector as an example, Steennot examines the legality of online agreements and the protection offered to consumers concluding such agreements. He draws on Belgian experience to illustrate the issues that could

arise under different consumer behaviour scenarios. Technology may be advancing fast; but resolving legal matters that follow from such developments is moving at a slower pace!

Eugene Buttigieg develops the point that piecemeal adaptation over time of a set of rules, involving several laws, may end up with a corpus of legislation that is not fair to both buyers and sellers. Basing the case on Maltese legislative history, Buttigieg argues that while aiming to safeguard consumers' interest – a party to a transaction -, one can end up with a consumer policy that addresses more competitors' concerns than consumers' preoccupations. The theme examined is that existing legislation has to be assessed in terms of what it actually is achieving, starting from its declared objectives and following it through the means at hand to attain the declared aims. An occasional overhaul, or over-riding piece of legislation, may at times be an important rectifying force leading to fair trade practices in the interest of all parties to a transaction.

Achim Tiffe gives another example related to consumer protection drawn from experience of mortgage loans in Germany. There is no regulation at the EU-level for mortgage loans, while there are varieties of regulations for consumer related mortgage loans in the EU member states. Given the volume of borrowing involved in home loans and the longer time period for repayment conditions, the quality of the financial product and the correctness of advice are important for consumer related mortgage loans. The global debate on house prices, the availability of credit, and the terms on which such credit is rendered possible – including the time over which the capital is meant to be repaid: these arguments point at the sensitivity of this subject in particular in terms of informed choices and transparency.

Finally, David Fabri undertakes a critical review of price control regulation in its relation to consumer law in the Malta of post-EU membership. Supposedly temporary measures introduced to deal with emergencies can become permanent outlasting the emergencies they were meant to resolve. By adopting a single-tracked approach to consumer welfare – based on price control – policymakers may fail to introduce more meaningful measures in order to raise the quality and safety standards, safeguard contractual fairness, and ease access to the judicial process. In short, a one-minded approach could become a hindrance to the healthy development of markets, undermining the restructuring of supply facilities and economic growth in the longer term.

In sum, the subjects discussed highlight several issues. These refer to:

i) The legal and practical significance for everyday market use of such terms as fairness/unfairness in pricing, responsible credit, over-indebtedness and efficiency.

ii) Welfare considerations that policy measures are meant to maximise: the welfare of all those involved in exchange? The welfare of one particular actor/ groups of actors, say, consumers? The welfare of the groups that benefited to date? Or the welfare of a wider group of beneficiaries as trade extends over traditional borders?

iii) Moving from a 'narrow' interest group to a wider one may be desirable. But understanding the utility of such decisions, inducing a change in embedded customs and interests that could temporarily, if not definitely, lead to the erosion of privileges and related gains, is not as easy task. It could lead to a vacuum in decision making. This vacuum

contributes to unnecessary litigation, absorbing resources that could otherwise be dedicated to the creation of wealth. Situations like these contribute to the observed 'friction' in trade and pricing policies in the European Union and also in the United States of America following different interpretations of existing legislation by national/state and union/ federal institutions.

iv) Such moves demand timely intervention and basic educational preparation to minimise misunderstanding.

v) Policies that are adapted piecemeal, over relatively long stretches of time, inspired from one line of action may seem to work in a sheltered economic environment. But they automatically exclude from consideration all other possible means, which will be blocked by vested interests. In such cases a radical break with the past, pushed from above (for example, following a region's union with other states) may be the only effective way to achieving long term output and welfare gains.

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PART ONE

FAIR PRICING, RESPONSIBLE CREDIT AND INDEBTEDNESS

ARNOLD S. ROSENBERG

REGULATION OF UNFAIR BANK FEES IN THE US AND THE EU:
Current trends and a proposal for Reform

Introduction

Due to the legislative power of the banking industry, the United States (U.S.) federal government has been more reluctant to place limits on bank fees and charges than the European Union (E.U.). A trend by the courts of several American states in the 1980's and early 1990's toward striking down excessive bank fees charged to consumers, such as overdraft charges and late fees, through the application of "Little FTC[2] Acts" such as the California Unfair Business Practices Act, Cal. Bus. & Profs. Code §17200 *et seq.*, stalled due to the Supreme Court's decision in *Smiley v. Citibank (South Dakota), N.A.*,[3] the Office of the Comptroller of the Currency's ("OCC"'s) assertion of federal preemption of state laws on the subject,[4] and legislative amendments, particularly in California, narrowing the remedial provisions and standing to sue under Little FTC Acts.[5]

Meanwhile, the E.U. has been moving in the opposite direction. A casual reader of the Unfair Commercial Practices Directive adopted by the E.U. in May 2005 might think it is directed only at the sale of goods, because the

Directive frequently applies only to "products." However, due to its expansive definition of "product" as including services, the Directive covers fees for bank services. These fees are also governed by the Distance Marketing of Financial Services Directive of 1998, the Unfair Contract Terms Directive of 1993, and two sets of regulations pursuant to the 1993 Directive adopted in 1994 and 1999.

This paper will discuss these divergent trends, the factors that have contributed to them, and the rationale for and against bank fee regulation. It also will set forth a proposed solution to the problem of unfair bank fees through regulatory standardisation and review of consumer contract forms in the financial services industry.

I. Why are Unfair Bank Fees Important?

Since the mid-1990's, in the U.S., unusually low prevailing interest rates on most types of credit have reduced banks' interest income from consumer and business loans, particularly due to refinancing of home loans that has decimated banks' one- to four-family mortgage loan portfolios.[6] Bank interest income also has been diminished by the lower interest rates paid on government bonds, the primary type of investment vehicle in which American banks are permitted to invest.

Fee income and high-interest forms of credit such as credit cards, predatory lending and payday lending have replaced interest income on home mortgages and business loans as banks' most profitable lines of business. To boost fee income, American banks increasingly have imposed new fees on consumers without meaningful disclosure and often without the consumers having knowingly authorized them. For the same reason, banks fought the spread of

PIN-based debit cards, which bear lower interchange fees than credit cards and signature debit cards.

As a result, consumer complaints about bank fees have soared. In 2004, the highest percentage of all complaints to the Federal Reserve regarding state member banks[7] concerned payment card fees and penalties.[8] The same is true of complaints about banks in the United Kingdom.[9]

Recently, the Consumers Union, a non-profit consumer organization in the U.S., published an article identifying various unfair and deceptive fee practices currently in use by banks that issue credit cards.[10] Fee practices discussed in the article include the following:

- Excessive late fees, which have more than doubled in ten years, far exceeding inflation and any increase in the actual cost of late payments to card issuers.
- Practices designed to make it easier for consumers to make a late payment and incur a late fee, such as mailing statements closer to the billing date.
- Delayed processing of payments and arbitrary cut-off times, as early as noon, for processing payments; these practices can trigger late fees despite receipt of payment on or before the due date.
- Over-limit fees triggered by accrued finance charges on a balance that is otherwise within the consumer's limit.
- Honoring charges in excess of the consumer's account limit, in order to trigger over-limit fees.
- Fees of two to three percent charged for balance transfers, hidden in the fine print of offers touting low or zero interest on balance transfers.
- Fees of two to three percent charged for cash advances, again hidden in the fine print of offers of low or zero interest on cash advances.
- "Default" interest rates that bear no relation to the average cost to the financial institution of a consumer's default.

- Interest rate hikes triggered by default on obligations to other creditors, or on a downturn in a consumer's credit score, rather than on the consumer's failure to perform under the terms of his contract with the bank.
- Approval of a credit line contingent on transfer of balances due to other creditors; the effect is to trigger balance transfer fees as a condition of the extension of credit.

A.U.S.BANC Internacional, an international consumer organisation based in Spain and dedicated to consumer protection in financial services, has observed similar practices in markets other than the United States.[11]

II. When is a Bank Fee "Unfair"?

A. Theoretical Concepts of Unfairness

There are multiple theories of what constitute "unfair" contract terms, such as bank fees. Applied to bank fees, the theories include the following:

Fees imposed through informational asymmetry. There are two theories of informational asymmetry. One is an objective notion rooted in an "equal access" principle. If a bank provides fee information in a medium to which the consumer has reasonable access, then the bank has done its job of disclosure and informational inequity does not exist. The other, more exacting concept is a more subjective one, provision of fee information in a manner in which the consumer is likely to perceive it and subjectively process and use it in making decisions.

Laws addressing informational asymmetry mandate disclosure. These include the Truth-in-Lending Act[12] and Regulation Z[13] in the U.S., and the E.U. Directive on Direct Marketing of Financial Services. The E.U. Directive on Unfair Commercial Practices includes provisions

regarding informational asymmetry in ordinary consumer transactions that resemble U.S. laws on securities fraud, imposing liability not only for "misleading actions," but for "misleading omissions."[14]

The proposed E.U. Consumer Credit Directive persists in this direction. The European Credit Research Institute ("ECRI") has commented, "Consumer protection policy aims principally to correct the information imbalance between consumers and sellers by regulating the information provided. In particular, it attempts to ensure that the consumer receives information that is easy to understand and readily comparable. The underlying idea is that consumers could protect themselves against problematic transactions if they received adequate information. It appears that information is the fundamental principle of consumer protection regulation."[15]

Most disclosure laws, however, have been ineffectual in affecting consumer decision-making, because they fail to take into account psychological studies about how consumers process and use information.[16] As this author has previously argued, the timing and manner of disclosures are frequently more important than what information is disclosed in affecting consumer choices.[17] The so-called "Schumer Box" on Truth-in-Lending disclosure statements in the U.S. and the practice of "layered disclosure" are efforts to highlight high-priority information and to time disclosures according to when information is most needed.[18]

Fees imposed through inequity in bargaining power. This theory of fairness is rooted in substantive notions of distributive justice in relationships between contractual actors. Fees that consumers accept because they lack meaningful choice among banks, for example, would be unfair under this theory. The lack of meaningful choice may

arise out of collusion among banks, conscious parallelism and an absence of competition among banks, undue influence due to aggressive sales tactics, or externalities that manifest or reflect seams in the economic system.

American banks may charge depositors a fee that hovers around $30 for NSF cheques, for example, because they colluded to fix the fee, or because other banks are charging the same amount and there is no perceived competitive advantage to charging a lower or higher fee. Banks might get away with charging excessive fees because consumers feel intimidated by high pressure marketing of credit cards, or by the impact of cancelling a credit card on their credit score. They also might charge roughly the same $30 fee as an industry convention adopted in the absence of information about the actual cost of NSF cheques, or based on information developed in-house by a particular bank that might or might not be representative of costs in the industry.[19]

The E.U. Directives on Unfair Commercial Practices (2005)[20] and Unfair Contract Terms (1993),[21] in general, are rooted in this theory. However, American law, apart from a small number of cases involving unconscionable terms in contracts for the sale of goods under §2-302 of the Uniform Commercial Code, has shied away from striking down contract terms solely based on their one-sidedness and the lack of free negotiation. Rather, when they have intervened in such circumstances at all, American courts generally have required something more, such as an element of surprise, deception or unfair advantage.[22]

Some laws have focused on practices that exacerbate inequalities in bargaining power. The E.U. Directive on Unfair Commercial Practices prohibits "aggressive" commercial practices, defined as including "undue influence" as well as harassment, coercion and threats

of physical force.[23] American law has not gone as far in protecting consumers from such practices, although statutes governing debt collection[24] and foreclosure of security interests in personal property[25] do contain restrictions on harassment, coercion and threats and use of force by debt collectors and by secured creditors' repossession agents.

Fees that exceed reasonable contractual expectations. This theory of fairness is based on the principle of freedom of contract and party intentions. Consumers who open a bank account, for example, reasonably should expect to be charged a fee in case of an overdraft. They probably do not, however, reasonably expect to be charged a fee in case they have an overdraft in a different account at a different bank, or in case their credit score, dependent on their entire credit profile rather than on experience with the bank in which they opened the account, drops below a certain point. Nor do consumers reasonably expect to be charged a fee with a profit margin built into it that is wholly out of proportion to the cost to the bank caused by the overdraft. Finally, consumers do reasonably expect that in the event of a dispute regarding the fee, they will have some effective recourse, and not be denied recourse by fine print contract terms compelling arbitration of disputes at a cost out of proportion to the amount at issue, precluding class action adjudication when it is the only cost-effective means of redress, or excluding a damages remedy altogether.

Of course, what is reasonable for consumers to expect depends on the circumstances known to them. The 2005 Directive on Unfair Commercial Practices alludes to circumstances known to the "average consumer," and in its preface, defines this "notional consumer" as Directive "takes as a benchmark the average consumer, who is reasonably well-informed and reasonably observant and circumspect, taking into account social, cultural and linguistic factors,

as interpreted by the Court of Justice, but also contains provisions aimed at preventing the exploitation of consumers whose characteristics make them particularly vulnerable to unfair commercial practices. Where a commercial practice is specifically aimed at a particular group of consumers, such as children, it is desirable that the impact of the commercial practice be assessed from the perspective of the average member of that group."[26]

Fees that make the market for banking services less efficient. According to Coasian economic theory, the market for banking services would be able to solve such problems as overdrafts and late payments efficiently without regulation if the transaction costs of doing so were zero. With respect to overdrafts, efficiency might be achieved by a bank's charging the lowest overdraft fee to depositors that would have the desired effect of keeping overdraft losses to the bank at an acceptable level.

However, in the real world, there are externalities at work. First, there are inertial forces that prevent consumers from making the decision to jump to another bank, even when doing so would be their optimal choice.[27]

Second, overdraft fees are not a central term of the depositor-bank relationship, such as interest rates on savings and certificates of deposit, on which banks compete. For these reasons there is a tendency for banks to make overdraft fees into a profit center by including a margin in excess of the identifiable costs attributable to overdrafts.

Jeff Sovern has observed[28] that it becomes possible for banks and other merchants to manipulate consumers by inflating transaction costs, such as bank fees, only where consumers overlook or underestimate the cost when they enter into the transaction.[29] Behavioral mechanisms cause consumers to tend to underestimate such costs. For example, a fee that is uncertain to be charged will be accorded less

weight in consumer decision-making than a fee that is certain, and due to hyperbolic discounting, a fee that will be charged at some time in the future will be accorded less weight than a fee that is payable immediately.[30]

If there were no customer inertia and if fees were a subject of significant competition, excessive overdraft fees would cause the loss of good as well as bad customers and prompt the bank to reduce the overdraft fees to avoid the loss of further good customers. In reality, however, the transaction costs to good customers of changing banks – *e.g.*, loss of privileges earned at the existing bank, possible credit score ramifications, difficulties getting another bank to give prompt access to deposits without a long-term relationship - may cause good customers who bounce a cheques to remain with the bank despite the excessive fee, giving banks greater latitude in imposing excessive overdraft fees.

Third, transaction costs are significantly unequal. In the absence of regulation of overdraft fees, banks have the legal right to impose fees without limit by including them in their deposit agreements with customers, and can set off the fees against the balance in the account once a deposit is made at virtually no transaction cost. On the other hand, a consumer aggrieved about an excessive or unjustified overdraft fee faces significant transaction costs in obtaining redress. Half an hour with a lawyer probably would cost more than the amount of the fee. Coupled with inertia in switching to a competing bank the likelihood that a competing bank will be no more reasonable in its treatment of overdrafts, and the fact that overdrafts tend to be incurred by less desirable customers, chances are that a bank can garner significant profits on overdraft fees without losing many customers it wishes to keep.

Fourth, measuring the cost of overdrafts, and the cost savings could they be eliminated, is problematic. Banks

have to maintain accounting systems capable of identifying overdrafts, and must employ account officers and operations personnel whose duties include initiating the return of NSF cheques or, if certain customers' business is in general profitable for the bank, deciding to honor their cheques and create new loans to cover the overdrafts. The cost of accounting systems would be capitalized and depreciated, while personnel expenses are part of the bank's overhead. They are not reimbursed to the bank by the overdrawing consumer, but are absorbed by the bank. Account officers and operations personnel generally have many duties apart from working on overdrafts, and the accounting systems represent fixed costs.

B. Legal Definitions of Unfairness

U.S. Federal Trade Commission Act ("FTC Act") and UDAP Statutes. Section 5 of the FTC Act,[31] originally enacted in 1914, prohibits "unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce."[32] In 1964, the FTC issued a policy statement that articulated a three-prong test for determining whether an act or practice is unfair or deceptive. The test considers whether the act or practice (1) causes substantial injury to consumers, (2) violates established public policy, or (3) is immoral, unethical, oppressive, or unscrupulous.[33] This test was subsequently approved by the U.S. Supreme Court in *Federal Trade Commission v. Sperry & Hutchinson Co.*[34] Section 57a of the FTC Act, enacted in 1975, delegated to the Board of Governors of the Federal Reserve System the authority to issue regulations prohibiting unfair and deceptive trade practices by banks, and authorized the Office of the Comptroller of the Currency ("OCC"), which is the lead regulator of all national banks, to enforce those regulations.

However, to date the Federal Reserve has only adopted regulations pursuant to §57a with respect to credit practices, a narrowly defined set of rules contained in Regulation AA.[35] These rules ban consumer credit contracts containing confession of judgment clauses, waiver of statutory exemptions, certain assignments of wages, non-purchase money possessory security interests in household goods;[36] prohibit misrepresentation of the nature or extent of co-signer obligations and require certain disclosures to made in advance to the co-signer;[37] and prohibit delinquency charges to be assessed on non-payment of prior delinquency charges and late fees where the remaining balance of the obligation has been paid in full.[38]

Since 2001 the OCC has taken the position that it possesses independent authority to enforce the FTC Act against national banks. It brought suit against Providian, a credit card bank, and obtained a 300 million dollar settlement based on misrepresentations made to consumers regarding the terms of credit cards, not one of the practices addressed by the Federal Reserve pursuant to §57a.[39] The OCC claims this authority pursuant to a provision of the Federal Deposit Insurance Act ("FDIA") that permits the OCC to enforce any "law, rule or regulation"[40] with respect to national banks. The U.S. courts have not yet resolved whether the OCC's claim is accurate, but the OCC's position finds general support in the U.S. Supreme Court's decision in *Chevron v. National Resources Defense Council*,[41] which gave federal agencies the power to elucidate ambiguities in their governing statutes as long as the agency's view is based on a permissible interpretation of the statute, and instructs courts to give deference to the agency's interpretation.[42]

Meanwhile, at least 42 states long ago enacted "Little FTC Acts," also called "UDAP" ("unfair or deceptive act or practice") statutes, modelled on the FTC Act but which

unlike the FTC Act, grant consumers private rights of action to seek redress in state courts. Starting with the California Supreme Court's 1985 decision in *Perdue v. Crocker Bank*, a wave of state court decisions found a variety of bank fees illegal under state UDAP statutes.[43]

However, two developments have stalled efforts to rely on UDAP statutes to invalidate unfair bank fees. In 1996, the U.S. Supreme Court decided in *Smiley v. Citibank (South Dakota), N.A.*[44] that late-payment fees on credit cards were "interest" and therefore that the National Bank Act permits national banks[45] to charge fees that are lawful in the state where the bank has its principal place of business rather than being limited by consumer protection laws of the state of the consumer to whom the fee is charged.[46] Effectively, *Smiley* opened the fee floodgates, as some states, notably South Dakota, generate revenue as bank havens, luring banks to establish the headquarters of credit card subsidiaries by offering bank-friendly laws such as high interest limits and minimal restrictions on fees.

In 2004, the OCC opened the floodgates further when it issued a rule stating that most state regulatory statutes and laws, other than such mundane matters as contract and tort law, were preempted by federal law as applied to national banks.[47] One state attorney general testified before Congress, "Simply put, the OCC rules will eliminate 50 cops from the beat."[48] He further said OCC officials, in their efforts to entice federal thrifts and state banks to convert to national banks regulated by the OCC, "behave like basketball coaches trying to recruit players. As a selling point, they tout rules aimed at preempting any role for states in consumer protection."[49]

European Union ("E.U.") Directives and Regulations. While American regulators have largely deregulated bank fees, the E.U., under a mandate to provide a "high level" of

consumer protection in devising a single internal market for financial services,[50] has gone a different route.

The 1994 and 1999 Regulations pursuant to the 1993 Unfair Contract Terms Directive both contained a fairness test. A contract term that fails the fairness test is unenforceable. A contract term is unfair under the 1994 and 1999 Regulations if "contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer."[51]

Terms individually negotiated between the parties and mandatory statutory terms, required by statute to be included in the contract, are excluded from application of the fairness test under the Unfair Contract Terms Directive. Certain "core provisions," specifically the description of the "main subject" of the contract and the adequacy of the consideration, are also excluded from the fairness test, "insofar as they are in plain, intelligible language."[52] The rationale apparently was that these core provisions are sufficiently central to the contract that the consumer can be presumed to have exercised judgment in agreeing to them, whether or not they were negotiated, and consequently courts are not permitted to substitute their judgment for that of the parties with respect to core provisions.

However, the 2005 UCP Directive contains its own fairness test and does not exclude core terms from scrutiny. The UCP Directive provides that a commercial practice "shall be unfair" if "(a) it is contrary to the requirements of professional diligence, and (b) it materially distorts or is likely to materially distort the economic behaviour with regard to the product of the average consumer[53] whom it reaches or to whom it is addressed, or of the average member of the group when a commercial practice is directed to a particular group of consumers."[54] The Directive defines

"professional diligence" as "the standard of special skill and care which a trader may reasonably be expected to exercise towards consumers, commensurate with honest market practice and/or the general principle of good faith in the trader's field of activity."[55]

III. Why Do Unfair Bank Fees Exist?

In a perfect market, unfair bank fees and charges would not exist, because if fees are excessive, consumers will do business with another financial institution that does not charge excessive fees. However, in practice, consumers in the U.S. do not easily move their accounts to another branch bank. There are a number of reasons why this predicted movement of business away from financial institutions that impose excessive fees and charges may not occur.

Information Overload, Brand Loyalty, and Time. The role formerly performed by consumer protection law in the United States of facilitating comparison shopping among products increasingly is played, or made obsolete, by brand loyalty and trademark value. In shopping for products as diverse as financial services and groceries, consumers tend to rely on brand names they know. Among those factors that enable consumers to compare the quality of goods and service, American consumers weigh brand names and trademarks more heavily than other factors.

However, brand loyalty plays a more limited role in consumers' relationship with banks than in the selection of other types of products and services. A recent survey by Deloitte and the U.S. Consumer Bankers' Association revealed that only 19% of consumers can be characterized as "loyal" to their bank. What plays a greater role is the

consumer's need to save time through convenient branch location, ATM access and convenient hours:

For the majority of customers, convenience still revolves primarily around the branch, although a convenient ATM network is also very important. Here, hours of operation is one area in which customers voice strong opinions. In its report, bank opening hours received the lowest satisfaction rating out of nine elements of performance. Only 29 percent gave extended hours a 'top box' satisfaction rating, versus the 40 percent who gave it the highest rating for importance.[56]

To process the volume of information they receive or have access to, consumers can be expected to make the time-saving assumption that apart from convenience factors and a couple of key terms such as interest rates, the terms of financial products among banks of comparable reputation are essentially the same in all other material respects.[57]

Consumers assume they are best protected by relying on trademarks and the presumption of uniformity of the terms of sale of goods and services. That presumption is not always accurate. For example, take the difference in funds availability practices between Washington Mutual and Wells Fargo Bank, two of the largest banks in the western United States. Washington Mutual advertises heavily that it charges no monthly fees on deposit accounts, but its unannounced policy is to make up that loss of fee income – and, perhaps, more – by placing the maximum allowable hold on all deposits, thereby getting the benefit of the "float" on deposits for as many as nine days before permitting withdrawal. Wells Fargo, on the other hand, charges monthly fees on deposit accounts, but advertises next-day availability of deposits. In fact, even the difference in monthly fees is less than it appears, because Washington Mutual does charge monthly fees on deposits if a minimum

balance requirement is not met, and Wells Fargo has the same policy, though a somewhat higher balance threshold. Nevertheless, Washington Mutual's total deposits grew by 218% from 2000 to 2004,[58] while Wells Fargo's.grew by 168% during that time.[59]

Changes in the Perceived Value of Time. Consumers are more likely to make the time-saving assumption that contract terms are similar if they perceive their time as a scarcer and more valuable commodity. Spending the time to read the fine print of a contract – like spending the time to read a software manual or the instructions for using a camera or appliance – becomes uneconomic if the marginal perceived benefit from reading the contract is less than the marginal perceived benefit from doing other things with one's time. High-income consumers may have an educational background that equips them better to understand the fine print of a contract, yet have greater competing demands on their time and hence, less incentive to dedicate their time to understanding that contract. As commuting times to work continue to increase, as two-income families have become the norm, as increased rates of divorce have forced people to double as full-time workers and full-time parents, these competing demands on their time have skyrocketed.

Increased Concentration and Political Power in the Banking Industry. The spate of bank mergers and acquisitions during the 1990's resulted in a more highly concentrated banking industry.[60] One can argue that concentration was necessary for the players to remain competitive with each other and with foreign banks, but concentration has not resulted in a more competitive marketplace for consumer financial services.

Increased concentration has brought the banking industry increased political power. For example, the banking

industry was largely responsible[61] for the passage in early 2005 of the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA"),[62] the most profound change in U.S. bankruptcy laws since 1978, which despite its rather cynical title, severely limits consumers' access to the Bankruptcy Courts. Where the U.S. Bankruptcy Code formerly allowed modification and avoidance of some unfair interest and other loan charges in bankruptcy, consumers victimized by unfair charges must now pay those charges in full to keep their homes and cars.

Given the influence of the banking industry, it is not surprising that consumer protection in financial services has taken low priority in the policy agendas of successive administrations in Washington.

Politicized Regulators. One effect of the rise of megabanks has been the politicization of the Office of the Comptroller of the Currency ("OCC"), which regulates national banks.[63] The position of Comptroller has most recently been filled by politically connected attorneys such as John D. Hawke, Jr., a partner at the politically prominent law firm of Arnold & Porter in Washington, D.C., who as Comptroller from 1998 to 2004 was responsible for the preemption rule, and John Dugan, the current Comptroller, who stepped out of a partnership at Covington & Burling, another Washington political powerhouse, into his position as a Bush Administration appointee in 2005.[64]

However, the OCC's preemption rule has had political impact. One ripple effect of the preemption issue has been pressure to make the OCC something more of a consumer advocacy agency.[65] On September 14, 2004, the OCC issued an advisory letter for national banks on abusive practices in credit cards.[66] The advisory letter focused on three practices: issuers' automatically raising the interest rate for a cardholder who makes his card

payments on time, but pays some other bills late; the use of promotional rates to sign up new cardholders without disclosing significant restrictions about the rates and, in particular, the circumstances under which rates and fees could increase; and the marketing of cards by promoting credit limits that are seldom available. The OCC indicated that it would take "supervisory" action against national banks that engaged in these practices.

Nevertheless, the focus of the OCC has remained on disclosure, and the "compliance and reputational" problems banks could incur if they failed to disclose onerous terms in promotional materials.[67] Moreover, since Comptroller Hawkes stepped down in favor of a Bush appointee, little further action has been taken regarding unfair bank fees.

Ineffective Regulation of Credit Scoring. Loan underwriting in the U.S. has been hijacked by credit scoring and the trade secret algorithms that underlie it.[68] Credit scores are commonly called "FICO" scores, because Fair Isaacs Co. devised the algorithms used to calculate them. How credit scores are calculated remains a mystery; the National Consumer Law Center has called them a "black box."[69] Fair Isaacs' monopoly position underlies such abusive lending practices as requiring unsecured small debts to be rolled into secured home loans.

It has been argued that the latter practice constitutes a violation of the Truth-in-Lending Act[70] and Home Ownership & Equity Protection Act[71] if the small debts are not included in the finance charge.[72] However, I am skeptical that the payoffs constitute a "charge"; they are not an expense imposed on the consumer as a condition of credit, because they are an expense that already was required under the consumer's contract with a non-bank creditor. Rather, it is a change in timing of the expense designed to bring the ratio of monthly expenses to income

typically considered in the underwriting process down to a qualifying level in light of the consumer's FICO score.

Credit scoring proceeds devoid of any effective regulation; it is a black box to which even top federal regulators have no access. The Fair Credit Reporting Act, intended to protect consumers from credit abuses, has become an irrelevant joke as credit reports, which it regulates badly, have given way to credit scores, which it does not regulate at all, as a basis for credit underwriting. Interest rates, the types of credit for which a consumer qualifies, and the conditions of credit approval all are determined by scores, and as such, unfairnesses concealed in the scoring mechanism result in unfair charges of which consumers are never informed and may never know.

IV. Treatment of Adhesion Contracts in the U.S. and the E.U.

A. Heightened Scrutiny and *Contra Proferentum*

Banks already use form contracts for financial services. Every bank has a form deposit agreement between the bank and its depositors that the depositor is required to sign when opening a new account. Every consumer who obtains a credit or debit card knowingly or unwittingly enters into a contract with the issuing bank, and that contract is a form contract, not negotiated with the consumer. Banks have standard form contracts for electronic funds transfers, for home mortgages, for equity credit lines, and for many other services.

Consumers rarely attempt to negotiate the terms of these form contracts. They are classic adhesion contracts.[73] Adhesion contracts are not illegal either in the U.S. or the E.U. However, both jurisdictions subject adhesion contracts

to stricter scrutiny than negotiated contracts. Thus, the 1993 E.U. Directive subjects non-negotiated contract terms, but not negotiated terms, to the fairness test. Under *Restatement (2nd), Contracts,* §211(3), adhesion contracts, though enforceable, do not include a term "where the [business] has reason to believe that the party manifesting…assent would not do so if he knew that the writing contained" that term. In cases involving insurance contracts, the courts have developed the "doctrine of reasonable expectations," under which "[t]he objectively reasonable expectations of applicants and intended beneficiaries regarding insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations."[74]

Moreover, under the principle of *contra proferentem* in civilian jurisdictions and on the authority of *Restatement (2nd), Contracts*, §206 in the United States, courts construe ambiguous contract terms against the drafter. Thus, if language – negotiated or not - in a contract between Parties A and B was proposed by Party A, and if that language is capable of more than one meaning, the language will be construed in favor of Party B and against Party A.

Banks are not unique in using adhesion contracts. In fact, by one estimate, as many as 99% of all contracts entered into by consumers are adhesion contracts.[75] Few consumers take the time to read the adhesion contracts to which they bind themselves. This is true even among highly-educated consumers entering into remote contracts on the Internet.[76]

The E.U. adopted the 1993 Unfair Contract Terms Directive for the purpose of preventing abuses in adhesion contracts. That is why it only applies to non-negotiated terms. However, the transaction costs required to enforce rights under the Directive – litigation expenses, time delay

– render the Directive ineffectual in many cases. Although the Directive included a list of contract terms that are deemed unfair, the creative minds of businesspeople easily generate new unfair terms.

B. *Ex Ante* Regulatory Review of Form Contracts of Insurance

In the U.S., the insurance industry has long been exempted from most federal regulation.[77] However, state insurance regulatory agencies for many years have had the power to approve or reject standard forms of insurance policies. Before a policy form can be changed, the state insurance department or insurance commissioner must approve the change. Before a fee or other term can be added to the fine print, the addition of the fee or other term must gain regulatory approval.

Rationales advanced for requiring standardisation and prior regulatory review of insurance contract forms include the following:

(1) **Product complexity and consumers' lack of information necessary to determine their own needs**. "The typical consumer lacks the knowledge to describe or define precisely the scope of coverage needed. A well-conceived standard policy contains the typical insurance purchasers require based on the industry's previous experiences with other insureds who were similarly situated. [S]tandard policies are designed by insurers to fulfill the reasonable expectations and requirements of typical consumers."[78]

(2) **To facilitate comparison shopping**. "Where there is [sic] standardized policy provisions, the consumer can easily evaluate coverages based upon price and the insurer's reputation. Where the policies differ substantially between insurers, the consumer may often be left to compare apples and bananas."[79]

(3) **Cost reduction**. "In insurance, as in other commercial transactions, customisation costs more than standardisation. By using standard policy forms, insurers are able to avoid incurring many expenses that would inevitably result from customising millions of insurance transactions."[80]

(4) **To facilitate risk transference**. "[R]isk distribution on the scale that exists in a complex commercial society may be feasible only if insurance transactions can use standardised insurance policy terms."[81] This is true not only in underwriting, but in mergers and acquisitions of insurance carriers.

(5) **To facilitate the implementation of social policy**. For example, if a state prohibits "redlining" – a company's refusal to insure certain risks in a racially-defined geographic area, or insuring them on discriminatory terms – standardisation of policy terms facilitates enforcement of that prohibition.

States accomplish standardisation of policy language through legislation and administrative regulations and with industry cooperation. Model acts and regulations drafted by the National Association of Insurance Commissioners ("NAIC") prescribe in detail the terms that policies of each kind must contain.[82] Most states require that insurers file all policy forms for most types of insurance. Their statutes generally require regulatory "approval" of the forms submitted by insurers. Some states, such as New York and Pennsylvania, require prior approval before the insurer can use a form, while others, such as California, New Jersey and Wisconsin, permit the insurer to use a form if the regulatory agency does not object to it within a given period of time (in California, 30 days).[83] The insurance industry, through the Insurance Service Organization ("ISO"), actively participates in the development of standardised policy forms.

Moreover, under NAIC model acts, state insurance regulatory agencies have the power to roll back insurance rates, e.g., for life and health insurance, if they find that the charges to the insured are unreasonable in relation to the benefits provided.[84]

C. Shared Characteristics of Contracts of Adhesion in the Insurance and Banking Industries

Credit card agreements, bank deposit agreements and other consumer contracts for bank services share the characteristics of insurance policies usually cited as rationales for standardisation and *ex ante* review of policy terms.[85]

Consumers can compare credit card and deposit account interest rates, as they can compare insurance premiums, but they cannot readily compare other contract terms. Moreover, the most costly and dangerous contract terms in both insurance, credit cards and deposit agreements do not become relevant to consumers unless and until a future event occurs that consumers do not expect at the time of contracting – a loss, in the case of insurance contracts, or a delinquency, over-limit charge or overdraft, in the case of credit cards and deposit agreements. Because these events are not certain to occur as of the time of contracting, and if they do occur, will happen in the indefinite future, consumers tend to unduly discount the present value of their costs, due to the behavioral mechanism of hyperbolic discounting.[86]

V. A Proposed Solution: Ex Ante Regulatory Review of Form Contracts for Financial Services

The time has come to recognise that the financial services industry is no longer materially different from the insurance industry with respect to the factors that justify regulatory

standardisation of form contracts. Unfair bank fees thrive in the darkness of small print, high pressure marketing and ignorance.

As in insurance, the average consumer choosing among banks or credit card issuers lacks the time and the knowledge base to accurately evaluate his or her needs and assess the products available. Comparing financial products is not like comparing apples in a shop. Two credit cards may appear the same, for example, yet be apples and bananas due to fees and terms the consumer is unlikely to read or comprehend. Credit cards and other financial services are rarely customised for individual consumers, so regulation and standardisation of terms among banks would not result in any noticeable change in the availability of customised terms for individuals.

Financial services regulators should be granted the power, which American insurance regulators already possess, to approve or reject changes in the terms of form consumer contracts in their industry, including the power to evaluate whether new fees are unreasonable in relation to the benefit to the consumer. Rather than having to undertake supervisory action *ex post*, after consumers have been overcharged, the OCC and other bank regulatory agencies, vested with the authority to approve or reject changes in terms and to review the fairness of fees *ex ante*, could and should prevent overcharges and abuse before the abuses cause damage.

Certain scholars, notably Hillman and Rachlinski, have argued that the conventional judicial approach to the enforcement of standard contracts is generally adequate, and need not be altered for electronic contracting.[87] That may be true in some contexts, but these scholars miss the point that a consumer who has to resort to judicial action has not been protected. Because of the high transaction

costs to achieve judicial redress, that consumer has already lost her case, unless the amount in controversy is so great as to justify the transaction costs, a circumstance present in most cases only in disputes regarding home loans.

The same concept would apply to the E.U., which though more proactive than the U.S. in consumer protection in the financial services industry, continues to think in terms of redress for consumers who have been overcharged rather than prevention of abusive fees and charges. Prevention through review of standardised contracts might be more complicated in the E.U., which has not centralised the regulation of financial services companies in the same way as the U.S. However, fifty state insurance regulatory agencies in the U.S. currently review policy forms, more than the number of E.U. member states.

The laws of both the U.S. and the E.U. have long recognised the peculiar complexity of financial services products from the standpoint of consumer decision-making. As long ago as the 1967 Truth-in-Lending Act,[88] Congress recognised the need for special legislation to standardise credit terms in order to facilitate comparison shopping for consumer credit. The E.U. issued a special directive on distance marketing, containing a more complex regime than the regime for consumer protection established for distance selling in other fields. The Distance Marketing of Financial Services Directive includes a disclosure regime in addition to the cooling-off period required in distance selling of other products.

Standardisation and disclosure, however, without prior regulatory scrutiny of new terms and forms, have had limited success in the financial services industry. Consumer protection through standardisation of interest rate computations for home and car loans under the Truth-in-Lending Act in the U.S. has floundered as variable rates

and complex fee structures have rendered the annual percentage rate virtually meaningless. Disclosure has been even more of a fiasco, as anyone knows who has viewed a television commercial for such credit devices as auto leases and home mortgages. The required Truth-in-Lending and Truth-in-Leasing disclosures in advertisements for credit can be found lurking in an impenetrable thicket of fine print at the bottom of the television screen. Even the swiftest readers with the best eyesight cannot possibly read them.

Article 95(3) of the Treaty establishing the European Community ("the Treaty")[89] requires that, in its proposals for consumer protection for the single internal market, the Commission shall "take as a base a high level of protection." A consumer who has been charged an unfair bank fee is a consumer who has not been protected, let alone afforded a "high level" of protection. The transaction costs of seeking redress make effective redress the exception rather than the rule. Prevention through regulatory standardisation and *ex ante* review of consumer contract terms in the financial services industry, provided it is vigorous and not *pro forma*, could be the best way of achieving the objective set in the Treaty.

In June 2007 the government of Israel became the first to enact legislation authorising its central bank to impose price controls on bank fees and commissions charged to consumers and small businesses, and requiring banks to obtain prior permission from bank regulators before introducing price increases for their principal services.[90] This legislation arose out of concerns expressed by Israel's central bank regarding an "inadequate level of competition" in the banking sector, resulting in exorbitant fees and commissions.[91]

Conclusion

The American regulatory approach of giving financial institutions *carte blanche* to unilaterally impose new fees and contract terms, but permitting consumers to seek a remedy once they have been gouged, does not work. When the transaction costs to the consumer of obtaining a remedy are taken into account, that regulatory approach was doomed from the start. *Ex ante* regulation and review, as in the European Union's Unfair Contract Terms Directive, is the only means of protecting consumers from unfair bank fees and other unfair contract terms that might be effective in preventing abuses.

Standardisation and *ex ante* regulatory review of proposed fees and contract terms have ample precedent in state regulation of insurance policy forms in the United States, and that precedent is more relevant today than it was 15 or 20 years ago as manipulation of consumers through inflated fees has increased in bank credit card and deposit agreements. Insurance policyholders need protection in large part because they or their beneficiaries are particularly vulnerable if the events they insure against do occur, and they are unlikely to be able to predict those vulnerabilities and protect themselves at the time of contracting to purchase a policy. Credit cardholders need protection because they, too, are vulnerable in ways they cannot predict, to unilateral inflation of fees that banks know they are unlikely to spot among the slips of paper in their monthly bills, and that will not be payable unless a future event, such as a delinquency, occurs to which the behavioral tendency of hyperbolic discounting causes consumers to give little weight at the time of applying for a card.

Notes

1 © Arnold S. Rosenberg, 2007. All rights reserved.
2 "FTC" refers to the Federal Trade Commission, a federal administrative agency. The FTC Act, 15 U.S.C. §1 *et seq.*, is a federal statute that is enforceable only by the FTC and lacks any private right of action for consumers. Many states, such as California and Texas, have enacted "Little FTC Acts" that unlike their federal counterpart, include private rights of action. *See infra* at p. 13.
3 517 U.S. 735, 116 S.Ct. 1730, 135 L.Ed.2d 25 (1996).
4 *See* n. 47, *infra*.
5 On California's Proposition 64, which repealed the private attorney general provisions of California's "Little FTC Act," *see* the inaptly named *Note: California's Unfair Competition Law- Making Sure the Avenger is Not Guilty of the Greater Crime*, 41 SAN DIEGO L. REV. 1833 (2004).
6 *Industry's Fee Philosophy Becomes Less Clear-Cut; Industry Overview*, AM. BANKER (Nov. 16, 2005), at 4A ("Experts note that in the last few years many banks have put more emphasis on noninterest fee income, which provides a more predictable stream of earnings…"); *3Q Earnings: Signs of Wear at Small Banks: Will commercial slump interrupt profit run?* AM. BANKER (Oct. 29, 2002), at 1 ([F]ee-income growth…offset flat or, in some areas, declining business lending and the record level of refinancing, which continued to decimate many banks' one- to four-family mortgage portfolios…").
7 State-chartered banks ("state banks") represent over 2/3 of all banks in the U.S. and 32% of total bank assets, while the remainder of banks, which tend to be larger institutions, are national banks chartered by the Office of the Comptroller of the Currency. The majority of state banks are "members" of the Federal Reserve Bank, meaning that they have purchased an interest in it and are bound by those rules that apply to member banks.
8 *Regulation Z (Truth in Lending Act): Hearing Before the Senate Comm. On Banking, Housing, and Urban Affairs*, 109th Cong. (2005) (statement of Edward M. Gramlich, Gov., Fed. Reserve), *available at* http://www.federalreserve.gov/boarddocs/testimony/2005/20050517/default.htm.
9 *See* NAT'L CONSUMER COUNCIL, TRANSPARENCY OF CREDIT CARD CHARGES (Memorandum to the Treasury Select Comm., H.C. (U.K.)) 20 June 2003, *available at* http://www.ncc.org.uk/moneymatters/treasury20june.pdf.
10 *Credit Cards: Fees and More Fees*, CONSUMER REPORTS, November 2005, available at http://www.consumerreports.org/cro/personal-finance/credit-cards-1105/fees-and-more-fees.htm.
11 A.U.S.BANC Internacional, MERCADO DE DINERO, Jan. 2006, at 1.
12 15 U.S.C. §1601 *et seq*.
13 12 C.F.R. Part 226.
14 Directive 2005/29/EC on Unfair Commercial Practices ("UCP Directive"), Arts. 7-8.
15 ECRI Research Report No. 1, *Consumer Credit in the European Union*, 2000, at 27.
16 *See* Arnold S. Rosenberg, *Better Than Cash? Global Proliferation of Payment Cards and Consumer Protection Policy*, 44 Colum. J. Trans. Law 519, 591 (forthcoming, March 2006) ("ROSENBERG"); *Compare* Jacob Jacoby, Margaret C. Nelson &

Wayne D. Hoyer, C*orrective Advertising and Affirmative Disclosure Statements: Their Potential for Confusing and Misleading the Consumer*, 46 J. MARKETING 61, 68 (1982) ("The difficulty involved in accurately communicating meaning is often underestimated, and regulators would seem to be no exception in this regard."), *and* Jacob Jacoby, *Perspectives on Information Overload*, 10 J. CONSUMER RES. 432, 435 (1984) ("Can consumers be overloaded? Yes, they can. Will consumers be overloaded? Generally speaking, no, they will not. This is because they are highly selective in how much and just what information they access, and tend to stop well short of overloading themselves."), *and* Kevin Lane Keller & Richard Staelin, *Effects of Quality and Quantity of Information on Decision Effectiveness*, 14 J. CONSUMER RES. 200, 212 (1987) ("[B]oth the presence of too much available information and too much high quality information appears to have caused consumers to exhibit a decrease in decision effectiveness."), *with* David M. Grether, Alan Schwartz & Louis L. Wilde, *The Irrelevance of Information Overload: An Analysis of Search and Disclosure*, 59 S. CAL. L. REV. 277
(1986) (arguing that information overload is not a significant issue in consumer law), *and* Roberta Romano, *A Comment on Information Overload, Cognitive Illusions, and Their Implications for Public Policy*, 59 S. CAL. L. REV. 313 (1986) (same), *and* Robert E. Scott, *Error and Rationality in Individual Decisionmaking: An Essay on the Relationship Between Cognitive Illusions and the Management of Choices*, 59 S. CAL. L. REV. 329, 329–37, 361 (1986) (arguing that information overload and cognitive error are less relevant to legal analysis of consumer behavior than is choice management theory, in which consumers follow a rational pre-set strategy of self control; also arguing that the psychological literature on human error and decision-making leads legal analysts to the incorrect conclusion that inherently fallible behavior is correctable through legal regulation), *and* Naresh K. Malhotra, *Information Load and Consumer Decision Making*, 8 J. CONSUMER RES. 419 (1982) (arguing that consumers can handle large amounts of information without being overloaded), *and* J. Edward Russo, *supra* note 216, at 71–72 (arguing that confusion decreased with increased data, as long as subjects took enough time to process the information), *and* John O. Summers, *Less Information Is Better?*, 11 J. MARKETING RES. 467, 467–68 (1974) (questioning whether the data from Jacoby, Nelson, and Hoyer's research truly supported the conclusions they reached).

17 ROSENBERG, *supra*, at 591-592.

18 *Ibid*.

19 If determining what NSF checks actually cost a bank is not perceived as cost effective, because the expected transaction cost of making this determination exceeds the expected gain in fee income if fees were adjusted to reflect actual cost or cost plus a profit margin, the bank would tend to emulate other banks rather than spend the money to calculate its own cost per NSF check. In Perdue v. Crocker Bank, 38 Cal. 3d 913, 926 (1985), the California Supreme Court noted that the average cost per NSF check at Crocker Bank was less than one dollar, while the bank charged an overdraft fee of six dollars as of 1978.

20 UCP Directive, *supra*.

21 Directive 93/13 EEC of 5 April 1993 on Unfair Terms in Consumer Contracts ("Unfair Contract Terms Directive").

22 *See, e.g.*, A&M Produce Co. v. FMC Corp., 135 Cal.3d 473, 485-487 (1982).
23 UCP Directive, Arts. 8-9.
24 *See* Fair Debt Collection Practices Act, 15 U.S.C. §1692d & e (forbidding harassment, oppression or abuse, including violence and threats of violence, by debt collectors).
25 *See* Uniform Commercial Code §9-309 (forbidding "breach of the peace" by repossessing creditors).
26 UCP Directive, Preamble ¶18.
27 *See* further discussion *infra*, at Section III.
28 Jeff Sovern, *Toward a New Model of Consumer Protection: the Problem of Inflated Transaction Costs*, 47 WM. & MARY L. REV. 1635 (2006).
29 *Id.*, at 1663.
30 *See* Angela Littwin, *Beyond Usury: a Study of Credit Card Use and Preference Among Low-Income Consumers*, ___ TEX. L. REV. ___ (forthcoming, 2008) ("Littwin").
31 15 U.S.C. §45.
32 *Id.* The original wording of Section 5 only prohibited "unfair methods of competition"; it was intended not to protect consumers but to broaden antitrust protections beyond the "Rule of Reason," which some in Congress regarded as unduly permissive. *See* Marshall A. Leaffer and Michael H. Lipson, *Consumer Actions Against Unfair or Deceptive Acts or Practices: the Private Uses of Federal Trade Commission Jurisprudence*, 48 GEO. WASH. L. REV. 521, 525 (1980). The reference to "unfair or deceptive acts or practices" was added by the Wheeler-Lea Amendment in 1938, Pub. L. No. 447, §§1-5, 52 Stat. 111 (amending 15 U.S.C. §§41, 44, 45, 52-58), which was intended to overrule the Supreme Court's holding in FTC v. Raladam, Inc., 283 U.S. 643, 649 (1931) that the FTC's jurisdiction was limited to practices that injured competitors.
33 Statement of Basis and Purpose of Trade Regulation Rule 408, Unfair or Deceptive Advertising and Labelling of Cigarettes in Relation to the Health Hazards of Smoking, 29 Fed. Reg. 8324, 8355 (July 2, 1964) (to be codified at 16 C.F.R. pt. 408).
34 405 U.S. 233, 244 (1972).
35 12 C.F.R. §227.11 *et seq*.
36 *Id.*, §227.13.
37 *Id.*, §227.14.
38 *Id.*, §227.15.
39 For example, Providian telemarketers were instructed to tell consumers that Providian would "beat the rate" of interest they were receiving if they switched their balances from their existing cards, but consumers were given only seven days to provide proof of their current rate. Consumers who accepted the offer and transferred their balances to Providian but failed to get proof of their current interest rate to Providian within seven days wound up being charged interest by Providian at the rate of 21.5 percent.
40 12 U.S.C. §1818(b)(1).
41 467 U.S. 837, *rehearing denied*, 468 U.S. 1227 (1984).
42 For a fuller analysis, *see* McNeill Y. Wester, *OCC v. Providian National Bank: Enforcement of the FTC's Unfair and Deceptive Trade Practices Statute by the OCC*, 5 N.C. BANKING INST. 373, 382ff. (2001).

43 Perdue v. Crocker Bank, *supra* (holding that a bank customer's complaint, brought as a class action, stated a cause of action where it was alleged that a checking account overdraft fee was unconscionable due to an alleged gross disparity between the amount of the fee and the actual cost of overdrafts to the bank). For other cases applying state laws to invalidate bank charges and terms, see Best v. U.S. Nat'l Bank, 303 Or. 557 (1987) (overdraft fees); Mazaika v. Bank One, 439 Pa. Super. 95, *rev'd sub nom* Bank One v. Mazaika, 545 Pa. 115 (1994) (late payment charges and annual fees charged on credit card constitute excessive "interest"; reversed in light of Smiley v. Citibank, *infra*); Copeland v. MBNA America, 820 F. Supp. 537 (D. Colo. 1993) (late payment charges on credit card); Heastie v. Cmty. Bank of Greater Peoria, 727 F. Supp. 1133 (N.D. Ill. 1989) (violation of Illinois Consumer Fraud Act in terms of consumer loan); Ashlock v. Sunwest Bank, 753 P.2d 346 (N.M. 1988) (failure to pay interest despite representation that bank would provide "interest-bearing" account); Vogt v. Seattle-First Nat'l Bank, 117 Wash.2d 541, 817 P.2d 1364 (1991) (excessive fees for trust administration).

44 517 U.S. 735, 116 S.Ct. 1730, 135 L.Ed.2d 25 (1996).

45 Most large banks and credit card issuers in the U.S. are "national banks," meaning that they are chartered by the OCC rather than by individual states.

46 Certain states, particularly South Dakota, vie for bank operational headquarters, just as Delaware historically has competed to attract large corporate headquarters in the U.S. This competition drives bank headquarters to those states that have the most bank-friendly laws, and drives states competing for bank headquarters to enact laws that favor banks over consumers.

47 Bank Activities and Operations, 69 Fed. Reg. 1895 (Jan. 13, 2004) (to be codified at 12 C.F.R. pt. 7). *See also* Julie R. Caggiano, *2004 Update on Residential Mortgage Lending (Including Preemption, RESPA, ECOA and TILA) and Texas HELOCs*, 58 CONSUMER FIN. L.Q. REP. 308, 309 n.21 (Winter 2004); Bank of America v. San Francisco, 309 F.3d 551 (9th Cir. 2002) *cert. denied*, 598 U.S. 1069 (2003) (holding that the National Bank Act and OCC regulations together preempted conflicting state limitations on the authority of national banks to collect fees for the provision of electronic services through ATMs; municipal ordinances prohibiting such fees were invalid under the Supremacy Clause); Wells Fargo Bank of Texas v. James, 321 F.3d 488 (5th Cir. 2003) (holding that a Texas statute prohibiting certain check-cashing fees was preempted by the National Bank Act); Metrobank v. Foster, 193 F. Supp. 2d 1156 (S.D. Iowa 2002) (holding that national bank authority to charge fees for ATM use preempted the Iowa prohibition on such fees). *See also* Bank One, Utah v. Guttau, 190 F.3d 844 (8th Cir. 1999), *cert. denied sub nom.* Foster v. Bank One, Utah, 529 U.S. 1087 (2000) (holding that federal law preempted an Iowa restriction on ATM operation, location, and advertising).

48 Attorney General Roy Cooper, North Carolina, quoted in CONSUMER REPORTS, *op. cit. n. 9.*

49 *Ibid.*

50 Article 95(3) of the Treaty establishing the European Community ("the Treaty"), Consolidated version, C325/33, OJEC, 24/12/2002.

51 1994 Regulations, reg 4(1); 1999 Regulations, reg 5(1).
52 1999 Regulations, reg 6(2); *see also* 1994 Regulations, reg 3(2).
53 The UCP Directive defines "consumer" slightly more broadly than many American consumer protection statutes which define "consumer" as a natural person acting for "personal, family or household purposes." *See, e.g.,* Consumer Credit Protection ("Truth-in-Lending") Act, 15 U.S.C. §1602(h); Expedited Funds Availability Act, 12 U.S.C. §4001(10) (defining "consumer account" as "any account used primarily for personal, family or household purposes"); *but see* Electronic Funds Transfer Act ("EFTA"), 15 U.S.C. §1693a(5) (defining "consumer" as "a natural person"). Under the UCP Directive, "consumer" is defined in the negative, as a natural person acting "for purposes outside his trade, business, craft or profession." Thus, for example, a lawyer purchasing a computer to keep track of his own private investments might not be acting for "personal, family or household purposes" yet is acting for "purposes outside his trade, business, craft or profession."
54 11.6.2005 EN Official Journal of the European Union L 149/27, Art. 5, §2.
55 *Id.*, Art. 2(h).
56 BANK MARKETING INTERNATIONAL, Jan. 20, 2006, at 12, available on Lexis.com.
57 *See* fn. 46, *infra.*
58 Washington Mutual 2004 Summary Annual Report, available at http://investors.wamu.com/phoenix.zhtml?c=101159&p=irol-reports# .
59 Based on comparison of 274.8 billion deposits shown on 2004 Annual Report and 163.1 billion (total of interest-bearing and non-interest-bearing deposits) shown on 2000 Annual Report, both available on www.wellsfargo.com.
60 Cara S. Lown, Carol L. Osler, Philip E. Strahan, Amir Sufi, *The Changing Landscape of the Financial Services Industry: What Lies Ahead,* FEDERAL RESERVE BANK OF NEW YORK ECONOMIC POLICY REVIEW, Oct. 1, 2000, Sec. 4, Vol. 6, p. 39, available on www. Lexis.com.
61 *See* Hon. Keith M. Lundin, *Ten Principles of BAPCPA: Not What Was Advertised*, 24-7 ABI JOURNAL. 1 (Sept. 2005); Melissa Jacoby, *Negotiating Bankruptcy Legislation Through the News Media,* 41 HOU.S.. L. REV. 1091 (2004).
62 S. 256, the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005."
63 National banks currently represent about 68% of total bank assets in the U.S., though they comprise a minority of banks in absolute number. All other banks are chartered by individual states and are primarily regulated by state bank regulatory agencies. The Federal Deposit Insurance Corporation also regulates virtually all banks, since virtually all banks carry federal deposit insurance, which covers deposits of an individual up to $100,000 per bank.
64 *See Senate Confirms New Regulators, NATIONAL MORTGAGE NEWS, vol. 45, no. 29 (August 8, 2005), at 1; Steve Cocheo, What to Expect in the Post-Election Regulatory Shuffle, ABA BANKING JOURNAL, "Briefing," at 7 (Nov. 2004).*
65 Cocheo, *op. cit.*, at 7.

66 *See* 2004 OCC Enf. Dec. LEXIS 199; OCC NR 2004-80 (Sept. 14, 2004).
67 *Ibid.*
68 The National Consumer Law Center estimates that 75% of all home mortgage loans and 95% of credit cards in the U.S. are issued based on the consumer's credit score. National Consumer Law Center ("NCLC"), FAIR CREDIT REPORTING (5th ed. 2002), §14..
69 *Id.*, §14.5, and 2004 Suppl., §14.5.2.1.
70 15 U.S.C. §1601 *et seq.*
71 15 U.S.C. §1639 *et seq.*
72 See Steven R. Sharpe, *Empowering Subprime Borrowers: Mandatory Unsecured Credit Payoffs as Finance Charges,* 80 IND. L.J. 517 (2005).
73 For a history of adhesion contracts, *see* Andrew Burgess, *Consumer Adhesion Contracts and Unfair Terms: a Critique of Current Theory and a Suggestion,* 15 ANGLO-AM. L. REV. 255 (1986).
74 C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2nd 169, 176 (Iowa 1975), quoting Rodman v. State Farm Mut. Ins. Co., 208 N.W.2nd 903, 906 (Iowa 1973). *See* Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions,* 83 HARV. L.REV. 961, 967 (1970); Gyler v. Mission Ins. Co., 514 P.2d 1219, 1221 (Cal. 1973); Steigler v. Ins. Co. of N. Am., 384 A.2d 398, 400, 401 (Del. Super. Ct. 1987); Home Indem. Ins. V. Merchs. Distribs., Inc., 483 N.E.2d 1099, 1101 (Mass. 1985); Meier v. N.J. Life Ins. Co., 503 A.2d 862, 869-70 (N.J. 1986); Atl. Cement Co., Inc. v. Fid. & Cas. Co. of N.Y., 459 N.Y.S.2d 425, 429 (App.Div. 1983), *aff'd,* 471 N.E.2d 142 (N.Y. 1984); Collister v. Nationwide Life co., 388 A.2d 1346, 1351-54 (Pa. 1978).
75 John J. A. Burke, *Contracts as a Commodity: a Nonfiction Approach,* 24 SETON HALL LEGIS. J. 285, 290 (2000).
76 A survey reported in 2005 of Cornell University law school students shopping on the Internet revealed that few of them read the terms and conditions to which they were becoming bound. Robert Hillman, *Consumer Standard Form Contracting Practices on the Internet,* presentation given at the Shidler Center for Law, Commerce and Technology, University of Washington School of Law, March 4, 2005. *Cf.* Robert Hillman and Jeffrey Rachlinski, *Standard Form Contracting in the Electronic Age*, 77 N.Y.U. L.REV. 429 (2002).
77 McCarran-Ferguson Act (1945), 15 U.S.C. §1011 *et seq.* (exempting the "business of insurance" from coverage by federal statutes unless specifically mentioned in the statute).
78 1-2 APPLEMAN ON INSURANCE LAW & PRACTICE (2nd ed.) (Matthew Bender, 2005) §2.1.
79 *Ibid.*
80 *Ibid.*
81 *Ibid.*
82 *See, e.g.,* NAIC Group Personal Lines Property and Casualty Insurance Model Act, enacted as Alaska Admin.Code title 3 S 29.305 et seq.; Colo. Admin.Ins.Reg. 72-8; 215 Ill.Comp.Stat. 5/388a et seq.; La.Stat.Ann.-R.S. S 22:1534; Mass.Gen.Laws Ann. c. 175, S 193R; N.H.Rev.Stat.Ann. 407-B:1 et seq.; N.Y.Admin.Code tit. 11 S 153.0 et seq.; S.D.Codified Laws 58-24-45.1; Vernon's Ann.Tex.Stat.Ins.Code, art. 21.77.
83 New York--McKinney's Insurance Law S 154 (life, accident, health, annuity);

Pennsylvania Stat. tit. 40, S 751 (accident and health); Pennsylvania Stat. tit. 40, S 813 (workers' compensation); Pennsylvania Stat. tit. 40, S 477b (general section); West's Ann.California Insurance Code S 10290 (disability) (if not disapproved in 30 days); New Jersey Stat.Ann. 17:35B-4 (life); New Jersey Stat.Ann. 17:38-1 (accident and health); Ohio Rev.Code S 3915.14 (life); Wisconsin Stat.Ann. 204-31(3)(g)(2) (accident and sickness).

84 *See, e.g.,* NAIC Mass Marketed Life or Health Insurance Model Act, §1(A).

85 *See* Ronald J. Mann, *Boilerplate in Consumer Contract: "Contracting" for Credit*, 104 MICH. L. REV. 899 (2006).

86 *See* Littwin, *supra*; Ted O'Donoghue & Matthew Rabin, *Doing It Now or Later*, 89 THE AM. ECON. REV. 103 (1999); David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 THE Q. J. OF ECON. 443 (1997); Shane Frederick, George Loewenstein & Ted O'Donoghue, *Time Discounting and Time Preference: A Critical Review*, 40 J. OF ECON. LITERATURE 351 (2002).

87 Robert Hillman and Jeffrey Rachlinski, *Standard Form Contracting in the Electronic Age*, 77 N.Y.U. L.REV. 429 (2002).

88 15 U.S.C. §1601 *et seq*.

89 Consolidated version, C325/33, OJEC, 24/12/2002.

90 "This law passed at the request of the central bank, after its efforts to reach voluntary agreements with the banks had failed. It aims to reduce the number of fees and commissions that the banks charge on various services to households and small businesses from around 350 to 100…." *Israel: Competition and Price Regulations,* THE ECONOMIST Intelligence Unit, August 30, 2007, available at www.tmcnet.com. Fees that should be reduced or eliminated, according to a Bank of Israel position paper, include credit documentation fees and fees for using a credit card, which were seen as duplicative of credit card "management fees" also charged by card issuers, *The Bank of Israel's Position Regarding Banking Fees,* November 15, 2006. The Bank of Israel also favors a freeze on new fees for existing bank services, and a study of certain fees regarded as exorbitant where the consumer has no other alternative, such as fees for recovery of archived bank statements. *Ibid.*

91 *The Bank of Israel's Position Regarding Banking Fees,* November 15, 2006.

UDO REIFNER

RESPONSIBLE CREDIT IN THE EU
National Law, The New EU-Directive and Beyond

1 Introduction

At nearly the same time Europeans and Americans are caught in a contradiction between the federal and the national level on questions of consumer credit and debt prevention. While a number of states in the US have passed legislation to curtail predatory lending the American congress intends to monopolise these questions through federal legislation which would replace national regulation by form but not by contents. At the same time the European Commission has presented three nearly opposing drafts of a new consumer credit directive.

The already visible influx of new products and new providers onto the continental consumer credit market in Europe is marked by the typical ingredients of unregulated credit markets like credit card credit, payday lending, doorstep lending, lending by non-banks, credit by mouseclick, flipping, revolving credit, variable rate credit and especially cross selling of useless high price insurance products together with usurious prices disguised as risked based pricing and a multitude of lenders which escape bank supervision. Parallel to these efforts the European

Commission is pressing continental states to abolish state monitored credit extension through public banks as a form of forbidden subsidies.

Claiming that everybody should have access to credit the quality of credit products is increasingly freed from all cultural rules that historically defined consumer debts as a dangerous product. More access will lead to more competition and cut prices so that "the consumer" will profit. This is the neo-liberal message from DG Market in Brussels. But also the European Commission has to admit that the advantages of more competition will not be shared equally by all classes of society. Overindebtedness has become a major problem first in America then in the UK, Germany and France. Now countries like Greece (8% in default), Italy or Spain experience the negative effects of unregulated credit extension. The poor pay significantly more after liberalisation than before. Indebted households experience less consumer freedom and choice and have to accept products that seemingly help them to overcome their personal crisis. Caught in a trap they face the dilemma that predatory lenders may be their only help. While the market is split into lenders for risky consumers and those who get better prices the background is still the same: banks are in charge of the whole market and either refinance this credit or create own subsidiaries for this kind of business.

While credit regulation was always strongly connected with two principles: an informed decision for credit as well as the provision of products and services that will prevent overindebtedness, the new approach in Brussels not only assumes that free choice and markets are in themselves a prevention of overindebtedness but even makes this belief binding for national legislation. All drafts intend to replace national rules by European or foreign legislation introducing

a maximum harmonisation principle that limits and voids opposing national legislation and introduces the principle of mutual recognition which favours the export of such legal systems that require a minimum of compliance with product and quality regulation. The intention to open the Internet for credit and debt by abolishing the handwritten signature, the light systems favouring especially revolving credit card debt and the enormous exemptions for such forms as leasing, employer or so-called social credit as well as disclosure rules which leave up to 50% of the price disguised in linked products as well as new duties of consumers to inform the creditor threaten the national acquis of consumer and debtor protection especially in continental Europe. It is no secret that the Commission openly favours even the abolishment of rate ceilings in Germany, Italy, France, the Netherlands, Belgium and Poland claiming that they hinder competition while empirical research reveals that they efficiently curb social losses and provide access to affordable credit especially for those who most need credit to bridge gaps in earnings and expenditure.

The commission in its different policy papers still favours the home country control principle although due to the public protest the Council deleted it from the Consumer Credit Directive as well as from the Service Directive. It in fact means foreign country control for the consumer side. While unregulated markets in the UK and the US show that interest rates skyrocket and between 13 and 17% are excluded from access to bank products the EU Commission still wants to export this system which may guarantee higher rate of returns for some banks but will probably exclude local banks from competition as well as burden social budgets with additional subsidies for overindebted families. Especially on the local level debt advice has become a major factor in social welfare and while credit is

just accelerated in times of personal hardship social welfare has to provide the remedy.

Instead continental Europe has still a rich and active history of protection against usurious credit practices which are not limited to interest rates. It is mostly not part of the consumer credit legislation which followed the first EU Consumer Credit Directive but is part of the tradition of civil law with its rules on bona fide and good morals, on anatocism, default interest, early repayment, improvident credit extension and limits to usurious refinancing practices. This legislation still in force starts from the assumption that for ordinary people less debt is better than much debt and that debt which does not represent actual investments is dangerous for people and families.

This legislation has remained national while at the EU level the additional legislation on information and choice in consumer credit had been passed harmonizing the national law. This was a somehow easy task because most countries had no law on choice and information. Using an economic legal language (consumer credit instead of loan) allowed to cover all legal cultures alike regulating especially pre-contractual relations which traditional civil law had thought to be outside the contract.

While the contents of the new Draft of a consumer credit Directive as well as the Draft of the Payment Directive which will allow credit card companies which do not underlie bank supervision to extend credit under a "light regime" point to less control and more market freedom the draft introduces a new formula: responsible lending. This formula could be a principle covering the historical achievements of prevention of overindebtedness by requiring a productive investment of consumer credit into consumer households.

2 Responsible Lending in EU Law

Responsible lending would have become an EU-wide principle if Art. 5 of the 2005 Draft of the Directive had come into force. It stated:

> "The creditor and, where applicable, the credit intermediary shall adhere to the principle of responsible lending. Therefore, the creditor and, where applicable, the credit intermediary, shall comply with their obligations concerning the provision of pre-contractual information and the requirement for the creditor to assess the consumer's creditworthiness on the basis of accurate information provided by the latter, and, where appropriate, on the basis of a consultation of the relevant database."

Although the word "responsible lending" has now been omitted the obligation to assess the borrowers' creditworthiness has been kept also in the latest draft which will probably pass the council.

The principle of responsible lending comes from Belgian and Swiss law and has in the meantime been regulated into the UK consumer credit code. According to Swiss rules creditors have the obligation to deny credit if the applicant has no "credit capability" as "creditworthiness" is circumscribed in Art. 22 of the Swiss law on consumer credit from 1992. A debtor is presumed to be "incapable" if the total amount of credit divided by 36 month (irrespective of the true lifetime of the credit) would not leave him more of his earning than the part which can be garnished by law.

The Swiss law assumes that such restrictions prevent overindebtedness. Obviously this is far from what practical experience shows. Swiss law excludes bank loans especially to those who need refinancing of a debt burden which

as it is usually the case have become too high during the lifetime of the credit because earnings dropped significantly by unemployment, illness or other mishaps. It takes away remedies from the overindebted to bridge difficult times. It ignores the basic message of all credit investment that is productive if the capital borrowed produces additional income which compensates not only for the interest but help the household to increase wealth. Credit to poor people as it is assumed in Microlending schemes therefore may help to escape overindebtedness especially in cases where such people are not "creditworthy".

Without regard to the important body of empirical research on consumer debt the EU-Commission assumes that stricter rules for credit extension and less regulation for the product as well as the servicing and collection of debts would help to prevent overindebtedness. But unlike Swiss law it reduces the principle of responsible lending to an inquiry into databases where data on default as well as on the amount of credit taken by a customer are stored. Besides these databases are questionable. They tell nothing about private debts (15% according to a German survey), are often incomplete and especially retrospective without concern for the future potential of a household. The scores derived from those data bases for each household increasingly are not the basis for credit denial but more for the higher prices for poorer clients in risk based credit pricing systems. It thus achieves the opposite: the debt burden of the overindebted is higher with than without "responsible lending" which leads to a self-fulfilling prophecy: higher risk equal higher cost, equal an increased debt burden which again increases overindebtedness.

3 Responsible Credit in National Law[1]

The European Coalition on Responsible Credit, a network of especially consumer and social organisations which collaborates with the American National Coalition on Community Reinvestment and their Global Fair Finance Initiative, uses a broader approach to consumer credit than the EU-Commission does. Instead of restricting credit extension, which theoretically furthers exclusion of the most needy from equal access but practically furthers especially usurious and non-bank credit of predatory lenders of those who now legitimately are kept out of the system, it applies the notion of responsible credit. From is literal meaning responsible lending comprises both: the extension of credit as well as the development and marketing of credit products as well as the process in which credit and debt is used and paid back. The same is true for the French or Italian version. "Prêt responsible" or "prestito responsabile" is literally translated responsible credit but the German Version "verantwortliche Kreditvergabe" contradicts this broader approach and restricts lender responsibility to credit extension.

Instead the national regulations on credit and debt focus on all steps in consumer credit: starting from the development of products, its marketing, the way the contract is concluded as well as its pricing, form and time and covers also the way it is repaid or adapted in critical situations including default charges, limitations on early termination and bankruptcy schemes where in countries like France, Germany, Netherlands, Belgium and the Scandinavian countries overindebted consumers can get discharge from their debts.

Responsible credit therefore covers the whole national regulatory acquis in coping with credit and debt that may lead

to unwanted social consequences. It is not only a principle which intends to prevent unconscious borrowing (and lending) but it wants to adapt credit to the needs and social circumstances of consumers to make render it productive for them. Thus national regulations incorporate the wisdom of several thousand years in handling personal debts when they for example limit anatocism fix interest rate ceilings and regulate duties to care for the families and their living conditions if credit turns from a promising investment into mere debt. Unlike the new maximum harmonisation principle as well as the new principle of mutual recognition such historic rules on credit and debt remained untouched Art. 15 of Directive 87/102/EEC whose minimum harmonization principle left national consumer protection untouched.

There is no question that the consumer credit directive from 1987 with its amendments concerning the APR disclosure brought progress to many countries in so far as credit disclosure and early repayment was concerned. But its most important effect was that national legislation untouched by these rules were amended increasingly with the knowledge of regulations in other countries. Thus a thorough investigation in the existing regulation instead of the application of a pure market ideology could develop equal standards for responsible credit as it has been the case for transparency and information. It is not a 28th regime of a supranational "Berlemont" State developed out of own political convictions who can achieve a European Unity in diversity but only the look into the tendencies and achievement of national regulations. The following overlook gives some hints derived from a research which was originally mandated by the European Commission to study rules preventing overindebtedness which now seems to be officially ignored and hidden from the official discussion on consumer credit reform. [2]

3.1.1 Product information

Product information is an important area for credit whose services are abstract and difficult to measure with regard to the intended investment as well as the effects on the personal household especially in revolving credit schemes and overdraft which have no natural barriers to anatocism and credit for credit. ("flipping")

In France, for example, since the "*MURCEF Law*"[3] was passed, it has been compulsory to provide consumers with written terms and conditions when they open an account. Any changes must be notified three months before they come into effect. Simply displaying general terms and conditions in the respective credit institution no longer suffices.

However, the duties of life insurance providers in Great Britain go much further. They must make "Key Features" available to consumers prior to conclusion of the agreement and, where distance selling is involved, the documents must be sent to consumers within five working days. These "Key Features" were drafted by the Financial Services Authority[4]. Every insurance company must use the same format. The objective is to enhance competition by improving product comparability, but at the same time there is an explicit attempt to assist consumers to gain an improved knowledge of the product and to ensure that it is possible to compare the products of different companies. In addition to the purely factual contents of the "Key Features", they also include the necessary information about them, frequently in the form of questions and answers. For example, there is an explanation that growth rates only represent examples and that they are dependant on future growth. They explain that there is a risk that an insurance agent may highly recommend a product because it pays him/her the highest commission and they set out the effect of costs on

the investment. If these "Key Features" are indeed read by consumers, they promote their level of financial literacy because the statements they contain are simply expressed and understandable to "the man in the street", and they provide information about all significant aspects of life assurance policies. The new Consumer Credit Directive will have a similar "box" where standardised information will be presented. It resembles the Regulation Z on credit disclosure in the USA. But it will contain wrong, superfluous and misleading information. Especially the focus on the APR will be aberrant because the Directive excludes cost from insurance premiums which contain exorbitant high kick back provisions and thus hide interest in the form of premiums. In addition risk based pricing renders the advertised APR useless because what the consumer gets will only be disclosed after he or she has already invested much of its time to get the credit.

The core of standardised key information is therefore the question what information is truly and practically "key" to the consumer. Without this research key information is more dangerous than no information at all.

3.1.2 Information as to rights

Most national legislation relating to consumer credit includes already a right of withdrawal and in addition a provision for consumers to be advised of that right in the body of the agreement. In France, art. 311-15 *Code de la Consommation* also provides, in addition to information as to the existence of the right of withdrawal, for a detachable form in the credit agreement (*offre préalable*) for exercising it. This relieves consumers of the need to formulate the notice of withdrawal themselves, something which is often

difficult for non-lawyers to do and creates a default setting in which extra and even aggressive consumer activity is needed. The right of withdrawal is nearly never used in those countries like Germany or the UK because this default setting is inadequate, the necessity to repay the loans within three weeks irrational and the impossibility to be freed from the investment hinders to get the money back which they would have to return. Instead the French model of a binding offer gives a more adequate default setting with respect to consumer behaviour. In so far again the new Directive will partly deteriorate the situation for consumers as formal requirements hinder effective execution.

In Germany, § 692 I no. 5 ZPO (*Zivilprozessordnung* – Code of Civil Proceedure) contains a form for defending a writ. Existence of such forms lowers the barrier to exercising the right of withdrawal[5]. It is made easier for consumers to exercise their right. In France and Germany, use of the form to exercise the right of withdrawal is not, however, compulsory; consumers may also withdraw from the agreement by using their own letter, the only requirement being that it must make clear that they wish to withdraw[6]. The form therefore has only advantages for consumers. It makes withdrawal easier and, for less well-educated consumers in particular, it amounts to an improvement in the enforcement of their rights. Addition of a form also suggests to consumers that exercise of the right is not unusual, reducing psychological barriers.

3.1.3 Information

Current European Directives, the new Consumer Credit Directive and the Code of Conduct on pre-contractual information relating to home loans, already require or at

least mention comprehensive information about the cost of credit. However, national legislatures have still found some scope for adding to these provisions:

In Germany, under § 492, para.1 no. 1 *BGB*, the net amount of credit must be stated. Under § 491 II no. 1 *BGB* the legal definition is given as the actual amount of credit paid to the consumer[7]. This clarifies to consumers the common practice of deducting some of the costs and fees from the amount of the loan before it is paid over. The net amount of credit enables consumers to compare the amount they have to repay with the amount they actually receive. The difference between the total amount of the instalments to be paid and the net amount of credit corresponds to the total amount paid by consumers for credit[8]. However, this tells consumers nothing at all about the actual commitment they are taking on in relation to their liquidity, so it is of little significance in terms of the prevention of overindebtedness.

Art. 14 § 3 no. 11 of the Belgian Consumer Credit Act[9] requires that the default interest rate be stated. Such information as to the consequences of breaches of the agreement gives consumers information precisely in situations of crisis. Stating of the rate of interest on arrears makes clear to consumers that their debt will continue to mount up if they fail to make payments on time.

In Belgium, where a purchase is made by instalments, the amount of any deposit due must also be stated[10]. This information is of considerable importance to consumers, because payment of this deposit is usually a condition for the loan. If the deposit cannot be paid, the loan is not made. For precisely that reason, this information is less important in the prevention of overindebtedness through information. If consumers cannot pay the deposit, the loan will not be made and cannot therefore lead to overindebtedness. If the consumer is already in a situation of overindebtedness,

and cannot therefore pay the deposit, overindebtedness has nothing to do with the loan in respect of which the deposit was to be paid.

3.1.4 Form of Bargaining

With regard to formal requirements the national legislatures have introduced a series of different formalities in terms of written form and certification, applicable to various types of transaction and in different situations, in addition to those only prescribed by European law.

3.1.4.1 Additional two weeks on delays in payments

In Germany, under § 498 para.1, sub-para.1, no.2 *BGB*, lenders must allow borrowers a two-week extension in the event of a delay in payments of a consumer loan to enable them to make up the outstanding amount. This amounts to a suspension period. Lenders may only terminate the agreement upon expiry of this period. Lenders must send a notice stating that the total amount outstanding (previously not due for payment) will be demanded if the borrower does not pay the arrears within the time limit.
This notice gives consumers the opportunity to reflect on the consequences of their default to the extent that the time allowed makes possible reflection and comparison and this could give rise to a form of self-teaching. But this represents an ideal situation which would not arise in reality. Threats to terminate loans do not in most cases lead to financial literacy.

3.1.4.2 Offer of discussion where there are arrears

Simultaneously, where there are arrears, lenders in Germany must offer borrowers the opportunity of a discussion (§ 498, para.1, sub-para.2 *BGB*). This enables borrowers to explain their circumstances and breaks down their natural tendency to shy away from discussions with lenders. The contents of these discussion are, however, as unregulated as are the penalties for failing to offer them at all. Offering a discussion does not operate to validate a notice of termination for default[11]. However, the underlying motive of bringing the parties together before termination of the agreement because of arrears, with a view to investigating potential ways of resolving the situation, makes a great deal of sense. This is further supported by the fact that information is made available to consumers at the very time when they most need it[12]. This right thus presents one of the few forms of information targeted at consumers in crisis. If such a discussion were in practice constructively carried out, it would be a perfect opportunity for educating consumers and potentially providing them with protection from overindebtedness, assuming it were not already too late.

3.1.4.3 Notarisation

Although not inside the EU, Swiss law may also be pointed to as a potential model of another national legislation, where guarantees above 2000 Swiss francs must be certified by a notary public in accordance with art. 493 II *Obligationenrecht* (the Law of Obligations). Combined with the warnings and the evidential aspects generally associated with formal requirements, the purpose of this provision is to ensure that guarantors receive advice as to their rights[13]. This is very

much to be welcomed, especially for personal guarantees which are fraught with danger and can have incalculable consequences. However, this does involve additional costs[14], usually borne by the borrower. The extent to which notarisation really ensures that the transaction is explained is also questionable. Certainly, the process should verify that the agreement accords with the actual wishes of the parties[15], but ultimately it is impossible to explore the basis of those wishes and whether in fact the parties are clear about the possible consequences of a guarantee.

3.1.4.4 Hand-written endorsement

While the Directive will even allow a mouse click although national legislators have now gained the right to apply their own rules in France, art. 313-7 of the *Code de la Consommation* requires even a handwritten declaration, whose text is prescribed by law, in order for a guarantee to take effect. Failure to observe this requirement renders the guarantee null and void[16]. It is intended that this will make guarantors aware of the significance of the transaction and the seriousness of the situation[17]. No deviation from the statutory formulation of the text is permitted[18]. Guarantors must state that they are prepared to be held liable for a specified amount, for the payments, interest, penalties for breach and interest on arrears should the principal debtor default and the text is kept short enough for it to be written out without taking an inordinate amount of time[19]. Guarantors are simultaneously given the substantive contents of the guarantee. The extent of their potential liability is made clear, as well as the fact that their entire income and assets are at risk. In addition, having to write out the declaration ensures that guarantors have really

taken notice of this information, and it is done without additional cost.

The use of hand-writing is also used in France in purchases by instalment, where the borrower waives the right of withdrawal in order to have immediate delivery of the goods purchased (art. 311-24 *Code de la Consommation*). The waiver must, in addition to the express wish to have immediate delivery, contain a declaration as to awareness of the reduction of the period for withdrawal to three days from a maximum of seven days (= the usual period for withdrawal under art. 311-15), ending upon delivery of the goods[20]. This is a formal requirement which goes beyond the formalities prescribed by European Directives, but in general terms it leads to a restriction on the period for withdrawal which has not hitherto been envisaged by the Consumer Credit Directives and which therefore remains permissible.

In Belgium, handwriting is even required to a limited extent for conclusion of a consumer credit agreement. Consumers must not only sign the credit agreement, but also write under their signature the words "read and approved for ….euros on loan[21]".

3.1.4.5 Statutory contract forms

In addition, financial service providers in a number of countries[22] are obliged to use statutory forms of contract which the maximum harmonisation principle of the new Directive will abolish. Its aims are to improve comparability of products by prescribing that certain minimum items of information can be found at the same place in the contract, thus ensuring that, if contracts are set side by side, they can be compared at a glance[23].

In the case of the "*offre préalable*", prescribed in France and Belgium in relation to consumer credit, lenders are compelled to make potential borrowers and guarantors (assuming they are a natural person) a binding offer in writing and in duplicate. The lender is bound by this offer for 15 days[24]. Unlike under current European law which the proposal intends to improve, those providing security are given the same information as the borrowers themselves. The "*offre préalable*" must contain a number of items of information. In France, this binding offer is subject only to acceptance of the borrower personally[25], which in practice is usually the case.[26]. Acceptance of the *offre préalable* otherwise gives effect to the agreement[27]. In addition to the prescribed form of the contract in France, art. R. 311-6, para.2 of the *Code de la Consommation* requires that it be clear and legible and in a minimum of font size 8. This demonstrates that even statutes are able to affect the design of contracts. A compulsory minimum font size is feasible for all contracts and would at least introduce a verifiable minimum standard in terms of clarity of presentation.

Use of standard forms of agreement can thus give consumers a fundamentally improved picture of the information with which they must be provided.

3.1.4.6 Cooling-off periods

In France, lenders must send a written offer by post, free of charge to prospective borrowers and guarantors (assuming that they are natural persons) in the case of loans secured on real estate, and that offer must contain specified information[28]. The offer cannot be accepted by the prospective borrower before the expiry of 10 days following receipt of the offer[29]. Consumers are thus compelled to

have a cooling-off period. This procedure is feasible at least in relation to larger loans. It also entails a certain amount of coercion of consumers. However, where loans are secured by a charge over land, which are in any case subject to some delay because of the various formalities involved, a compulsory cooling-off period could force consumers to consider the seriousness of their decision and encourage them to make careful product comparisons. This could prevent impulsive borrowing and thereby potential overindebtedness through making premature commitments.

3.1.4.7 Express warnings

In Belgium lenders must add to the amount written down by borrowers adjacent to their signature, in a separate line and in bold type, the following sentence: "Never sign an incomplete contract"[30].

In Great Britain, consumers must be warned in wording prescribed by the Secretary of State and contained in information handed out prior to conclusion of the agreement, that they must be sure, before entering into the agreement, that they are able to repay the sums borrowed[31].

Although both of these warnings certainly contain important statements and the Belgian one at least, because of where it is and its bold type, is more likely to be noticed by the consumer, it is still questionable whether these simple warnings will be taken seriously, or whether they will merely be dismissed as a burdensome formality. Moreover, this form of emphasis on a single warning notice creates the hidden danger that all other information will be perceived as being of lesser importance and thus hardly taken into account at all.

Art. 14 of the *"loi MURCEF"*[32] from 11 December 2001, modifying art. L.311-9 of the *Code de la Consommation* requires that all cards enabling consumers to borrow at a time of their choosing must be defined as "credit cards" (*cartes de crédit*). This provision is intended to protect consumers from taking out unintended loans in the form of the ever-increasing numbers of in-store cards and cards issued by other lenders.

3.1.5 Social Consumer Protection

All Member States have basically incorporated the regulations of the old Consumer Credit Directive. As to its effectiveness, it has to be kept in mind that very different systems of credit extension and credit supervision exist. While most countries have a bank monopoly in consumer credit, the *UK*, *Ireland* as well as most of the new accession states as well as, to some extent also, *Belgium* allow other or nearly all other persons to extend credit which seemingly needs less supervision than savings. In its recent Payment Directive the EU has extended this principles to all small credit connected to credit cards. From 2009 on all member states will be obliged to allow non-banks to sell credit linked to a credit card on the territory of the EU. This single passport legislation shares the Anglo-Saxon assumption that credit needs less supervision than savings.

This assumption is socially discriminatory because credit are only "post-savings" when the consumer has to pay the instalments. The lower 40% of the German population has a negative savings rate which means that they save after and not before they achieve goods or services. Thus costly bank supervision profits only the upper half of society. This is partly also true for instalment purchase credit in

rural areas which is by definition a by-activity of retailers and not of banks. In the other countries, the strict bank administrative bank supervision gives quite effective controls. If in these countries the Directive is not effective, it is because systematic misinterpretations or sophisticated products to circumvent its prescription (such as linked credit products with investment, insurance or payment services in particular) have been marketed. In those areas of small credit suppliers the lack of effectiveness lies more with ignorance or deviant behaviour of short term suppliers which are difficult to control.

Debtors' protection is especially important in *Belgium, France, Germany*, the *Netherlands* and *Luxembourg*. The *Southern* European countries and to some extent also *Austria* have little specialised rules concerning overindebtedness in consumer credit *Spain* and *Greece* have some old rules of debtors' protection especially in non-bank credit. Somehow in between are the *Scandinavian* countries with general clauses which are applied by a special body of consumer protection agencies. The *UK*-approach is instead focussed on information, rational choice and only recently the government claimed that social consumer protection would harm the weakest most. *Ireland* instead allows non banks to issue credit but regulates them just as Greece which fixes the limits of interest rates of such credit so low that in fact it equals an interdiction of non-bank loans. A similar system is in force for pawn brokers in Germany.

An important role play interest rate ceilings which in different ways under different forms of supervision cap interest rates according to market rates for contractual as well as default interest rates. Instead of the traditional idea of usury as exploitation they assume that high interest rates reflect market failures. The rates are fixed at a ceiling between 30% (Latin countries) and 100% (Germany) above

the average market rate for all consumer credit contracts which amounts to about 18 to 20% p.a. in 2007. Countries with interest rate caps show very low exclusion rates while countries with unrestricted interest rates discriminate more against the poor. This anachronism can be explained by the fact that consumer protection regulation creates confidence in markets on both sides so that adverse selection and moral hazard less affect lenders in countries with high confidence. In addition usurious interest rates create special markets where personal services can replace rational organisation so that even unskilled lenders have a chance to make money. In the UK door-step credit sale and debt collection although abolished 50 years ago on the continent because it was too costly has been revitalised to the detriment of the poor. The profitability of low income markets has thus increased and led to new costly forms of credit like payday loans and secured credit cards while the rate ceiling countries offer cheap and socialised overdraft credit where income and debt are consolidated, give a transparent overlook of household finance to the debtor and provide small amounts of short term credit. The obligation to provide minimum bank accounts to overindebted persons in France, Belgium and Germany helps to keep also access to credit which the new Payment Directive may threaten just by pretending to open the market to non-banks in consumer credit. Access for lenders to consumers may thus turn into less access of consumers to lenders.

The way different countries define rate ceilings and sanctions when they are ignored depends on their tradition. While most view such ceilings as a frame for the market which leads only to the avoidance of the illegal surplus interest some countries follow moral values and incriminate high interest rates as usurious exploitation using a tradition over more than 2000 years.

The Roman "laesio enormis" has been the basis for case law in Austria, Switzerland and Germany while France, Italy and Belgium as well as the Netherlands have implemented interest rate ceilings which express a less moral and a more macro-economic outlook, in which high interest rates are seen as an obstacle to the general productivity of small entities. Scandinavian countries seem to manage usury through their procedural mechanisms of a general bank moral and a tough consumer interest representation, because even without an explicit ceiling they do not have usury. On the other hand, the UK restricts the verdict of usury to a form of individual exploitation which in fact still allows interest rates in this market which would not be enforceable anywhere else. Instead the UK tries to limit these undesirable outcomes through more detailed supervision of financial services. In the USA, usury laws remain within the competence of national legislation, while truth in lending legislation is a matter for federal law. However, the national approach has weakened this legislation and let to its gradual abolition. The Calvinistic pro-credit cultures in the Anglo-Saxon countries, where there are virtually no rules on anatocism, usury and little social regulation on default, can be contrasted with the Catholic (and Islamic) tradition of extensive credit regulation to protect individuals from overindebtedness.

The new Directive does not try to harmonise these rules, although from a European perspective the difference between maximum interest rates in France for small business start-ups (less than 10% p.a.) and the UK (unlimited reaching as high as 500% p.a.) is certainly a significant obstacle to the free movement of capital and services which would need at least some harmonisation. It is interesting to note that the Commission assumes that Italian usury law[33] violates the free movement of capital [34] which questions

their willingness to save usury ceilings from liberalisation policies. But it does especially not, however, recognise that usury regulation is only a small fraction of social consumer protection rules for debtors in the member states. Besides the loopholes left in the proposed APR legislation where the amount of cost disclosed through the future APR depends on the statutory agreements and its wording are directly significant for social regulation. Many countries attach their usury ceilings to the APR so that falsified APR disclosure means in fact higher usury ceilings.

The rate ceiling countries do not limit their protection to the contract itself. They provide also strict rules for early termination and especially for rules applying to default. Germany even legislates a lower default than contractual rate and gives priority of capital amortisation for payments in default to limit the creation of interest out of unproductive failed investments which burden the livelihood of families. Restrictions on anatocism as well as restrictions to recover the cost of debt collection from the debtor are an effective way to take away any incentive for creditors to turn credit contracts into default relations.

Unlike the present proposal of a Directive which not even mentions the prevention of overindebtedness as its goal even consumer information rights in national legislation are often linked to this goal. They provide information on present and future liquidity (amortisation tables or total amount of credit) instead of mere prices for market comparison. This focus is the relation between assumed consumer income and future instalments while the other countries follow the Directive‘s approach to give price information, which make the comparison of products on the market easier. *France* has also a quite effecitve system of preliminary binding offers which give consumers a chance to seek advice while the right to withdrawl in other

countries is often compromised by the fact that the consumer already received the capital and cannot return it in order to make the withdrawl effective. As far as additional costs are concerned, the mentioned group provides restrictions on all kind of additional fees like especially broker and insurance fees and limits the way variable rate are defined and refinancing can be done.

In *Scandinavia*, there are a number of incentives to continue and adapt credit contracts with consumers in default. They top in some respect the approaches of the first group to restrict the termination of credit contracts. Instead of automatic acceleration clauses justified reasons for early termination have to be put forward and communicated i.e. a minimum of outstanding debt by size and time and the enumeration of justifications. They also oblige suppliers to mediate or at least introduce a waiting time giving debtors the chance to continue the old contract by paying the outstanding arrears even after cancellation.

All these rules have to be seen in light of the ruling market culture in these countries which is influenced by ethics of suppliers, the strength of (subsidised) consumer organisations, the existence of additional public consumer protection mechanisms like the ombudsman or mediators and a general culture of social care for the poor. There are especially differences between a more administrative approach in *France* and more judicial approaches in *Germany* and the *Scandinavian* countries.

3.1.6 Insolvency Protection

Eleven out of the old 15 EU Member States have consumer insolvency legislation. *Italy* is in the process of preparing such laws. In *France* too, where discharge of debt has been

possible only to a limited extent, this principle has been enacted recently for those consumers who have no assets. Only *Greece*, *Ireland* and *Spain* have not started a serious legal policy discussion on consumer insolvency regulation.

Thus we can conclude that consumer insolvency law has become a part of a European legal tradition. As the consumer credit market is expanding to the *Southern* Member States as well as to the new Member States that will join the European Union in 2004, it is important to emphasize that the problems of overindebted debtors must be taken seriously in all Member States and that the need for consumer insolvency legislation is acknowledged.

By consumer insolvency law we refer to such laws that provide for a partial or total discharge of debt, that are accessible to consumers and other private debtors at reasonable cost and that include debtor's assets, future income and all debts in the same arrangement.

The laws are quite different. No harmonization has taken place so far. It has to be pointed out however, that access to discharge is limited in some countries, especially in *France*, the *United Kingdom* and to some extent in *Sweden*, which gives some reason for concern in these countries.

The general principles in European laws are rehabilitation, earned start through a payment plan, access to insolvency proceedings without prohibitive costs, availability of counselling and a preference for out-of-court or pre-court procedures.

Rehabilitation of debtors as economic actors is the core of consumer insolvency law. Its basic idea is derived from the insight that consumers cannot go bankrupt. As the main capital on which they borrow money is their labour force which provides for a monthly income and as this labour force is not separable from their lives they are only bankrupt if they have died. The idea of accelerating

the outstanding instalment and require its total sum is therefore cross with the idea of consumer credit where future income is made accessible. Economically speaking all European bankruptcy schemes therefore only adapt the contractual duties of the consumer to changed income conditions. In case that within the period where income should be used for actual consumption no disposable income may occur (illness, age, no jobs, occupation with unpaid labour like child care etc) discharge only means that the credit contract has to be adapted to a zero income situation. In so far discharge is only the most extreme form of adaptation which the French code acknowledges when it give immediate discharge only the very poor while the Austrian regulation just does the opposite by excluding the very poor from the total bankruptcy scheme.

It would be wrong to conclude that discharge and adapted payment plans are the only measures for achieving rehabilitation. It is equally important to note the role of debt counselling and other social services that are available in European countries.

Essential for the European rehabilitation concept is that the discharge should be as broad as possible. To offer a real chance of rehabilitation, the discharge should cover almost all the debtor's debts. Only alimony payments are commonly excluded from discharge and some countries limit this exception to alimonies paid directly to the child. In some countries, tort claims for deliberate damage and fines are also excluded from discharge. Notwithstanding these limited exceptions, discharge in European context covers most debts. Also, some debts are given preferential treatment in consumer insolvency. Priorities have been reduced in general insolvency and bankruptcy law and in consumer insolvency law they are even fewer. It has to be noted that European laws do no accept affirmation agreements, that

is, agreements between the debtor and a creditor about payment of a debt notwithstanding discharge.

These general principles apply only to unsecured debt. Some countries protect home owning debtors (especially *Finland*, *France* and *Norway*). *Austria* and *Germany* accept contract-based wage assignments made before the insolvency proceedings. It should be noted that consumer insolvency laws do not affect the legal situation of persons who have given personal guarantees for a loan or who are co-debtors on some other grounds.

The second principle of European consumer insolvency law is earned start through a payment plan. None of the Member States allow for a quick fresh start without a mandatory payment plan. On the contrary, a payment plan is an essential requirement for achieving discharge. The duration of the payment plan is usually five years. It is generally accepted in the Member States that the payment plan should be onerous. The debtor is obliged to use all his income that is not required for living costs to pay off the debts. The living costs of the debtor and his family are calculated using the minimum level of social assistance as a starting point. Part of this rigorous, almost punitive attitude, is the regulation of what assets the debtor may keep. In many countries reference is made to the regulations forming part of debt enforcement law, which in turn enumerates domestic assets and the tools for trade in a restrictive way.

Open access to insolvency proceedings without prohibitive costs is a third principle that can be distinguished in European insolvency laws. All laws contain some restrictions for debtors who do not act in good faith. These restrictions are more numerous and restrictive in the Nordic countries than in Central European countries. The principle of no prohibitive costs is, on the contrary, generally accepted.

Most Member States have expressed a clear preference for out-of-court or pre-court procedures over formal insolvency proceedings in the courts. The only exceptions seem to be *Denmark* and the *United Kingdom* where no pre-court attempts at settlement are required.

The EU seems to assume that personal bankruptcy schemes and consumer credit regulation have nothing in common. While in its 2002 draft prevention of overindebtedness was still a goal of consumer credit regulation now the creation of a common market is the only goal that has been left. In fact the way personal bankruptcy is regulated in most countries in Europe shows that the credit contract just continues with some support by the court system who transfers unrecoverable destructive debts into a manageable debt load which gives hope to the families concerned. An especially interesting system is the Ducht system of Volkskrediet Banks run by the cities where overindebted households get competent debt advice as well as new credit for investment into their future. Thus the problem that cutting off poor people from credit cuts them off from progress and productivity in society is taken seriously and results seem to be very promising. Different from microlending schemes real banks serve the borrower and there are close connections between these banks and the commercial banking system.

4 The Threat to National Law: Maximum Harmonisation and Foreign Country Control

The national achievements are threatened by the new EU approach in regulating consumer issues. Article 21 of the draft stated:

1. Insofar as this Directive contains harmonised provisions, Member States may not maintain or

introduce provisions other than those laid down in this Directive."

2. When implementing and applying Article 5(1), (2) and (5), Article 13, Article 14(1) and (2), Articles 15, 17, 19 and 20, and without prejudice to necessary and proportionate measures which Member States may take on grounds of public policy, Member States shall not restrict the activities of creditors established in another Member State and operating within their territory in accordance with this Directive either through freedom of establishment or free provision of services.

Although No 2 has been omitted the threat of copying the American way of abolishing state consumer credit regulation in the seventies by allowing to export home state regulation to other states of the Union threatenes the cultural acquis consommataire in Europe.

Previous directives on consumer protection always used In the first preliminary draft the proposal expressly referred openly to "maximum harmonisation". This is a significant change in EU regulation. Harmonisation of consumer protection rules in the past have always been based on rules of minimum harmonisation rules like Art. 14 of the Distance Contracts Directive 97/7/EC, Art. 15 of the Consumer Credit Directive 87/104/EEC or in Art. 8 of the Standard Contract Terms Directive 93/13/EEC with words like "Member States may introduce or maintain, in the area covered by this Directive, more stringent provisions compatible with the Treaty, to ensure a higher level of consumer protection." (97/7/EC)

This new approach came along with the Internet which the Commission erroneously thought to become an own new European state which needed supranational rules. The internet today has instead evolved to a supplementary tool used within traditional face to face contacts. It is still

trust which rules consumer behaviour and trust is still closely related with where somebody lives and acts. The Amsterdam treaty acknowledged this insight when Art. 153 of the Amsterdam Treaty gave priority to national consumer protection law:

> "Member states cannot be prohibited to keep or develop stricter measures of consumer protection than provided for by paragraph 4"

The same is true for Art. 5 of the EU Rome treaty of applicable law from June 19, 1880 ("Rome I")[35] which gives the consumer a right to the application of the rules of his or her home state where he or she leaves and participates in the creation of laws and commercial customs.

Unlike the American process of unification, where the idea of a unified nation in a melting pot is prevalent and federal law increasingly replaces state law, Europe is built upon the principle of cultural diversity as a driving force for creativity and the protection of the cultural heritage. This principle is normally referred to as the **subsidiarity** principle. In the preface of the Draft for a new European Constitution "diversity in unity" is indeed the main principle governing the European Union of the future.

Consumer protection, especially in financial services, is part of this cultural heritage and art. 153 para. 5 as well as Art. 5 of the Rome I treaty are therefore a special homage to cultural diversity in consumer protection. In so far prevention of overindebtedness and exploitation through mere money services has deep cultural roots which have to be preserved and adapted according to the national pace of the development in consumer credit which today is extremely different within the EU. Problems that had long been settled in Germany now appear in Greece while those settled in the US appear in Germany. If regulation is

premature it hinders development. If it is absent at the time when the problems occur it increases discrimination and exploitation. Credit needs more than an informed choice. It needs understanding and a feeling for investment and money matters. This has to be developed in each country through financial education, public discussion and offers which adapt to the customs and believes of the people. In this respect also religious differences play an important role.

If the European Union should be more than a money society where the contact of people is easy but empty through money relations credit services have to be adapted to the existing differences. DG Market factually in charge of credit regulation shows little ability to cope with these problems. Consumers are defined as users. Instead of listening to concerned citizens in the member states the Commission nominates so-called advisors in a so-called User group. Experts for consumer issues are appointed by the Commission more on their English language skills than on their knowledge of national differences. Large conferences have been organised by DG Market during the last two years which have been solely stuffed by representatives of the supplier side and their state control agencies which all share a common belief that credit is a business and not a tool to manage family life. No efforts have been made to use existing empirical and social research. Even other departments of the commission have been kept outside like DG Social Policy or DG Enterprise. It is time that consumers and other non-profit users of financial services voice their concerns and ask for a more transparent, knowledgeable and sustainable process of credit and payment regulation in Europe. Europe is either in its member states or nowhere.

5 Towards European Principles of Responsible Credit

The present analysis has led to a formulation of a set of principles by members of the ECRC network which are designed to define at least the area in which consumer credit regulation has to be reflected and discussed.

P1: Responsible and affordable credit must be provided for all.

a. Credit is an essential for full participation in society
In the industrialized society credit has become a service essential for full participation in society. By giving people access to their own future income, credit provides the opportunity to obtain the use of advanced goods and services that require capital investments like cars, household appliances, permanent education or homeownership. Access to credit makes it possible to bridge variations in income and expenditure and thus provide the flexibility that modern labour markets require.

While credit may not currently be available in all countries, the creation of small business and self employment requires capital everywhere. While individual capital is difficult to access, credit plays the role of seed capital in self-employment. Accordingly, providing access to credit realises a human right to use one's own future resources properly. To this extent, credit has to be accessible for people in society irrespective of their social, biological, or cultural differences.

To realise this right requires the creation of banking facilities to be supported where no banking facilities are currently available, and needs people who are currently excluded from financial services to have access to banking facilities where they already exist or could be provided by

the existing banking infrastructure. Regulation should under no pretext therefore prohibit access to the best and most affordable forms of credit under competitive conditions for all. This includes facilitating forms of Microlending and alternative credit institutions. But such alternative credit institutions which have lower technical and protective standards, and operate with less cost efficiency than existing banks should be used primarily as gateways to the general system of financial services provision.

b. Banks should not discriminate and should provide real access.

Banks have been trusted to administer the savings of their depositors and thus the monetary form of our wealth of nations. The public should monitor that they use this trust properly, without any discrimination, and that they reinvest it into our communities in ways that are ethical and which meet the needs of humanity across the world. Access to credit should empower communities, not leave them disenfranchised or open them to exploitation.

Developed banking systems under competitive market structures tend to exclude vulnerable consumers from their main business by providing direct or indirect services which do not meet their own standards. This is why markets require active state supervision and regulation to stir all providers of credit to accept poor or disfavoured consumers and communities by raising public awareness (e.g. through Community Reinvestment Legislation), creating obligations for inclusion (basic bank accounts, equal credit opportunities) or engaging in subsidies or support that can remove obstacles for these customers to be accepted (rate subsidies in fair housing finance, free credit and debt counseling, state guarantees etc).

c. Credit to Consumers and Small Businesses must be supervised.

The non-commercial use of credit requires active supervision, comprehensive protective regulation and the strengthening of good morals in order to protect the borrower's position in the market and from the market.

Consumer credit, housing finance and start-up credit is directly linked to the livelihood of families and their social well-being. Its use is not only a function of profitable calculations. Its users are often unskilled and have to manage unforeseeable events out of a weak individual market position. When they have to default, the rules of the market society alone cannot offer adequate answers. This is why from the very beginning of money societies debtors have been protected and modern legislation has enlarged these regulations in line with the extension of credit. Regulation does not replace consumer awareness and individual responsibility but has to strengthen it where this is required and needs to provide social solutions where the borrower is at a disadvantage in the marketplace.

P2: Credit relations have to be transparent and understandable.

Two types of transparency should be delivered to potential borrowers to allow market forces to operate as intended. Competitive transparency gives consumers a chance to choose the cheapest and best product. But social transparency, indicating the potential impacts of credit on future household liquidity, is also necessary.

a. Competitive transparency requires a standardised mathematically correct form of "one-price" disclosure (the Annual Percentage Rate of Charge or APRC).
The APRC should include all credit-related payments that will repay the borrowed capital. The calculation of the APRC must include all cost elements that will, in practice, burden household income in the future: payments on linked cross-selling products, endowments, brokerage fees, and fees associated with acquisition, risk coverage or debt collection. Such cost elements represent services for which alternatives exist and the existence of these alternatives should be disclosed in a form which makes comparison and exit easy. The lack of transparency on insurance costs also leads to a lack of price competition in this area and runs contrary to the aims of the Directive in opening up markets to deliver better outcomes through increased price competition.

b. Social transparency requires a standardized pre-contractual payment plan.
This pre-contractual plan should disclose the likely impact of future payments on consumers' household liquidity and future purchasing power, impacts that can be predicted by statistical analysis of past experience with similar contracts. Pre-contractual plans that demonstrate an ability to repay are the cornerstone of responsible lending but they rely on full disclosure of outstanding liabilities. The extension of credit that occurs without proper attempts to discover full outstanding liabilities (for example through credit card balance transfers and the unilateral raising of credit limits without borrower agreement) is a particular problem that must be addressed.

c. Consumers should be provided with adequate time for reflection and with access to independent advice.

The right to cancel an agreement exists only once a binding offer has been made. This system provides little time for reflection by the consumer or for independent advice to be sought. Where the amounts of the agreement are large, there should be improved systems to allow for advice to be taken and there needs to be facilities to provide advice to people who are in a particularly weak bargaining position.

d. Consumers should have access to independent financial, credit and debt advice.

Consumers and small businesses have most need of advice and help when they are in difficult financial situations. This is the situation in which vulnerable consumers are most active information seekers and take the most disadvantageous decisions. In this situation they need to know about their legal rights, the economic and social consequences of their adjustments and help to cope with the effects of their problems on family, labour income and consumption. It is in this situation that the market cannot provide adequate services which require a consumer who has a free choice and adequate means to pay. Both is not available at this point. This is why credit and debt advice has to be provided at low cost by unselfish institutions monitored by society. To uphold such offers is a public task.

e. Both parties in the credit markets have to take part in a mutually productive process of financial education

Consumers need to understand and use financial services properly with respect to their potential and risks. But they also have to learn that products and services can be

changed and made more adequate if they are able to voice concern, evade credit, and engage in a collective process to develop better market conditions. Equally, the process of financial education includes learning on the part of the creditors about the needs and necessities of borrowers in order to adjust their profit driven offers to consumer requirements. Banks are not the teachers of consumers but they can provide answers to their questions.

P3: Lending has at all times to be cautious, responsible and fair

a. **Credit and its servicing must be productive for the borrower**

Not every access to credit is productive. Especially in Europe and the US, lack of access is no longer the core problem. Credit is now offered to all through damaging forms of credit that are used for unproductive investments, increase the dependency of consumers, and lead to exploitation and overindebtedness. This is why credit contracts have to be monitored and carefully regulated.

b. Responsible lending requires the provision of all necessary information and advice to consumers and liability for missing and incorrect information.

Advice links consumers' needs with their future income and purchasing power and illuminates the impact that the provided services might have on the future lives of borrowers and their families. Responsible lending requires that lenders assume liability for misrepresentation, false advice or missing information as well as for the sale of services known to be inadequate, except where there has been a deliberate and malicious intent on the part of the

borrower to defraud. Creditors must take all reasonable steps to validate information provided to them and must in particular share data on outstanding liabilities and repayment levels.

c. No lender should be allowed to exploit the weakness, need or naivety of borrowers.

If markets encourage exploitation and dependency by favouring the rich and discriminating against the poor, the law must set minimum standards for the operation of those markets. Effective rate ceilings are a starting point.

There needs to be a social guarantee that lenders will not abuse their position when the borrowers circumstances worsen through no fault of their own. In these circumstances lenders should not be able to seek higher charges on default or to worsen the position of the borrower further. There also needs to be a more sophisticated understanding of risk and a proper consideration of risk across the credit portfolio rather than an attempt to identify an individual risk based price for each and every social group. The repayment of debts should be regulated so that early repayment is possible and so that refinancing conditions are closely regulated.

d. Early repayment, without penalty, must be possible.

Consumers should always have the right to repay their debts without penalty. It is unacceptable that profit-driven systems should be able to keep consumers indebted when economic efficiency suggests that debts can and should be repaid.

e. The conditions under which consumers can refinance or reschedule their debt should be regulated.
Refinancing is not the repayment of credit. It can often represent a deterioration of credit conditions at a time when the debtor is economically weak. Regulation should guarantee that this weakness is not exploited, and in particular limit the amortization of interest and other charges. "Solutions" where future expectations are traded off for temporary relief should be controlled.

P4: Adaptation should be preferred to credit cancellation and destruction.

If debtors experience adverse circumstances, changes in credit relations by adjustments and adaptation should be preferred to acceleration, cancellation and destruction of the credit relationship.

a. There is a need for effective protection against unfair credit cancellation.
Credit relations are as important as labour and housing rent contracts in relation to individual lives. The principles of protection against unjustified or premature cancellations in these relations should be extended to credit.

b. Default charges should be adequate to cover losses only.
Default charges should be regulated in a way that prevents lenders from recovering more than the true cost of the default and lenders should aim to ensure the speedy restoration of the original contract terms.

Default interest rates should not exceed the refinancing cost of the lender plus additional administrative costs

P5: Protective legislation has to be effective.

It must cover any form of credit that is linked directly to the lives of borrowers and especially to credit provided for consumption, education, housing and the start-up of a small business. Exemptions on the basis of size of loan or type of loan only serve to confuse consumers and have adverse impacts on market behaviour.

a. Credit regulation has to cover all non-commercial users.
It should include consumers, homeowners and individuals starting up small businesses (all hereafter called "consumers").

b. Credit regulation has to cover all commercial forms of credit provision.
Definition: Credit comprises all activities which bring people into debt through the commercial offer of purchasing power, irrespective whether this is done in the form of loans, deferred payments, leasing, rent or any other legal form and irrespective whether payments are called interest or fees.

c. Credit regulation has to cover the whole process of credit extension as experienced by its users.
The economic development of suppliers has tended to divide the process of providing and servicing credit contracts into ever more distinct pieces, each undertaken by different types of firm. The impact of credit on consumer households, however, has become ever more integrated and unified. Credit was historically extended as part of one contractual relation in which a consumer bought goods and services through installment purchases.

A singe institution was creditor, broker and debt collector and that institution was accessible for consumers' concerns. This relation was later split into two separate types of contract, one for purchases/service agreements and one for loans. This has led to the creation of lenders who operate without any regard for the consumption purposes of the loan.

Cost efficiency, as expressed in the "value chain" approach, drives suppliers into horizontal co-operation and into the development of a whole bundle of separate contracts. The provision of money, the acquisition of clients, the securing of debts and the servicing of credit contracts (and adapting them to the changing living conditions of the borrowers) and, finally, debt recovery have been put into different hands. Each player is solely focused on its own profit, freed from direct concern about consumers' employment problems and consumption needs. In addition, modern global competition among the most profitable multinational financial conglomerates has led to the increased exploitation of the dependency inherent in the creditor-debtor relations. Such institutions engage in the cross-selling of linked insurance, investment and financial products at above market rates. For consumers, there is only one process —getting money for present expenditures and paying it back from future income. Nonetheless, suppliers pretend to deliver hundreds of valuable services. It is an important task of our political culture to ensure a unified vision of the demand side as a leading perspective in law and to guarantee a market whose final goal should remain the satisfaction of the needs of the people.

d. Credit regulation has to encourage efficient social and economic effects of credit extension.
Protective regulation has to adopt an economic and social language and should not use only legal language that is open to the manipulation by those who provide financial services. Providing legitimacy to usury through the device of "borrowers' consent", for example, would ignore 1,000 years of experience in which credit contracts voluntarily undertaken by needy persons have led to their exploitation and dependency. Indeed we consider that usury, by definition, is undertaken with the borrowers' consent as it is precisely the desperation of the borrowers' financial circumstances that drives them to seek out usurious loans. However, the extension of credit at usurious prices is not a solution to the problem of poverty and should not be entertained as such by credit regulation.

P6: Overindebtedness should be a public concern.

Dealing with failed credit relations and overindebtedness should be a public responsibility. The goal should be to rehabilitate and reintegrate consumers into the economic life of society.

a. Profit-driven systems cannot cope with over-indebtedness.
Refinancing, revolving credit, and predatory lending to economically over-indebted people, are not solutions to poverty. Instead, they can be a way into long-term poverty and dependence.

b. Consumers should have a right to discharge.
Consumers should have a right to a public procedure of

discharge through which their duties to repay debts are adapted to the remaining productivity of the borrowed funds.

Where credit no longer reflects a productive investment into the economic life of the borrower, a system of discharge and devaluation of debts is necessary. Firms vanish when they fail and their debts are written off in bankruptcy. Individuals, however, do not vanish and therefore their debt burden must be adapted to the value of their labour where this is the only source of income for repayment. Discharge is a fresh start for debtors and their families.

c. Bankruptcy procedures should lead to rehabilitation and not to retorsion.
Discharge requires rehabilitation and reintegration into a productive life. It must involve independent advice, shelter from creditors, and help to readapt their income to their expenditures.

P7: Borrowers must have adequate means to defend their rights and be free to voice their concerns.

a. There should be adequate individual as well as collective legal procedures to enforce borrowers' rights.
Creditors address legal matters strategically and calculate risks and cost with respect to the whole of their business. A single consumer, however, takes on an enormous risk when he or she sues a creditor. In practice, creditors dominate the selection of cases which come to the higher courts. It is therefore important to seek remedies for this strategic weakness of consumers in the process of further legal developments. In order to cover the financial risks pro deo procedures are especially important for credit

law because the vulnerable poor are least likely to defend their rights in court. In theory, class actions are adequate remedies, if the state can guarantee funding for consumer organizations which effectively care for the rights of the poor. Ombudsman schemes, and other non court based systems, whilst useful for individuals seeking redress should also be able to address broad issues within the credit industry where on the evidence of the number of individual cases being dealt with it appears that these are apparent. This may be, by example, by placing a duty on ombudsman schemes to report to state regulators on the specific concerns arising on a regular basis.

b. Critical public awareness is crucial for the development a fair and responsible distribution of credit.

Financial institutions exercise enormous influence within the media through their advertising budgets and through their investments in media firms. They can also use anti-defamation laws quite effectively to suppress critical journalism. In addition, most credit-related research in economics and law is partly financed by the supplier side. If the state does not counterbalance this enormous power, the prospects for critical responses are dim.

The provision of information on lending patterns of private sector lenders is critical to the development of public awareness and ensures that measures can be taken to address the unfair exclusion of lower income social groups from credit. The EU should therefore ensure that there is a standard obligation for lenders in the Member states to disclose information relating to lending patterns by social group and geography and that there is an affirmative obligation placed on lenders to address financial exclusion.

Notes

1 The follwoing information is taken from Reifner, U; Niemi-Kiesilainen, J.; Huls, N.; Springeneer, H. Study of the Legislation relating to Consumer Overindebtedness in all European Union Member States - Contract Reference No. B5-1000/02/000353 Hamburg 2003 257 pp, with country reports annexed (the whole report is available under www.responsible-credit.net/index..php?id=1980&viewid =32520
2 see FN 1
3 Act no. 2001-1168 of 11 December 2001.
4 http://www.fsa.gov.uk/consumer/shop_around/products_services/mn_insurance_info_get.html.
5 Kemper: Verbraucherschutzinstrumente, p. 376; Calais-Auloy: Le Crédit à la Consommation en France, p. 110.
6 Calais-Auloy: Le Crédit à la Consommation en France, p. 110; Pétel-Teyssié: Prêt à intérêt, no. 111.
7 cf. Bülow: Verbraucherkreditgesetz, § 4 margin note 64.
8 Bülow: Verbraucherkreditgesetz, § 4 margin note 68.
9 Act of 12 June 1991 relating to consumer credit.
10 Art. 41 no. 3 of the act of 12 June 1991 relating to consumer credit.
11 Palandt: Gesetz zur Modernisierung des Schuldrechts. § 498, margin note 8.
12 cf. Whitford: The Functions of Disclosure Regulation in Consumer Transactions, p. 264.
13 Hofmeister: Rechtssicherheit und Verbraucherschutz – Form im nationalen und europäischen Recht, p. 43.
14 Kemper: Verbraucherschutzinstrumente, p. 223.
15 Hofmeister: Rechtssicherheit und Verbraucherschutz – Form im nationalen und europäischen Recht, p. 45.
16 Pétel-Teyssié: Prêt à intérêt, no. 122.
17 Kemper: Verbraucherschutzinstrumente, p. 223.
18 Pétel-Teyssié: Prêt à intérêt, no. 122.
19 The wording of the original is as follows: "En me portant caution de X..., dans la limite de la somme de ... couvrant le paiement du principal, des intérêts et, le cas échéant, des pénalités ou intérêts de retard et pour la durée de ..., je m'engage à rembourser au prêteur les sommes dues sur mes revenus et mes biens si X... n'y satisfait pas lui-même."
20 Pétel-Teyssié: Prêt à intérêt, no. 109.
21 Art. 17 of the Act of 12 June 1991 in relation to consumer credit: "lu et approuvé pour ... euros à crédit" or "Gelezen en goedgekeurd voof ... euro op krediet"
22 Eg. France and Belgium.
23 Calais-Auloy: Le Crédit à la Consommation en France, in: Hörmann: Verbraucherkredit und Verbraucherinsolvenz, p. 108; Kemper: Verbrau cherschutzinstrumente, p. 207; cf. .; Bräunig: Der Konsumentenkredit im französischen Recht, p. 60.
24 France: Code de la Consommation, art. L.311-8; Belgium: Act of 12 June in relation to consumer credit, art. 14 § 1; Calais-Auloy: Le Crédit à la Consommation en France, in Hörmann: Verbraucherkredit und

Verbraucherinsolvenz, pp. 107f.; Bräunig: Der Konsumentenkredit im französischen Recht, p. 58.

25 Code de la Consommation, art. L.311-15; Calais-Auloy: Le Crédit à la Consommation en France, in Hörmann: Verbraucherkredit und Verbraucherinsolvenz, p. 111; Pétel-Teyssié: Prêt à intérêt, no. 105.

26 Calais-Auloy: Le Crédit à la Consommation en France, in Hörmann: Verbraucherkredit und Verbraucherinsolvenz, p. 112.

27 Code de la Consommation, art. L.311-15.

28 Code de la Consommation, art. L.312-7, L.312-8.

29 Kemper: Verbraucherschutzinstrumente, S. 227; Code de la Consommation Art. L.312-10.

30 Art. 14 § 4 no. 2 of the Act of 12 June 1991 in relation to consumer credit: «Ne signez jamais un contrat non rempli".

31 Consumer Credit (Quotations) Regulations 1989, Schedule 1, no. 18: "Be sure you can afford the repayments before entering into a credit agreement."

32 Act no. 2001-1168 of 11 December 2001.

33 Law N° 108 of 7. March 1996; Decree N° 394 of 29 December 2000 and Law Gesetz N° 24 of 24.February 2001

34 Press release of the European Union dated 25 July 2003

35 Extended to non contractual relations through tre Rome II proposition of July 2003

THERESIENNE BEZZINA

SAFEGUARDING CONSUMERS AGAINST OVER-INDEBTEDNESS

Over-indebtedness is attributed to a variety of factors, which is why legislation in the field encompasses different approaches in order to remedy or rather prevent the problem of overindebtedness.

The purpose of this paper is primarily aimed at determining how legislation is addressing the problem of over-indebtedness. However, in order to do this, we will have to first define over-indebtedness and then address the different methodologies used in finding a solution to the problem. This will be seen in the light of local and European legislation and what further initiatives can be undertaken in order to solve the problem of over-indebtedness in Malta.

1 Introduction

Credit is a convenience and has become common place in modern consumer society. Resort to credit is no longer viewed as a sign of failure or as a luxury granted to the selected few, but rather as a necessary means of securing consumer goods and of managing one's household. The

industry is constantly striving to make credit widely available, which is not only profitable for the industry itself, but also a socially desirable goal.[1] Credit has become an important means of balancing income and expenditure, which has led to the expansion of the credit market in western society over the years. However, inherent in the idea of credit, is the idea of risk. Borrowing money to buy goods means that that money has to be repaid sooner or later and chances are you will need to pay back more than the amount you borrowed. This is also because credit costs money and that apart from the money borrowed the consumer has to pay for the facility he obtained. Repayments will have to be made from the consumer's monthly income which can result to an unsustainable situation with more repayments than income. Insolvent consumers might not necessarily become over-indebted if they still have access to new credit or more resources. On the other hand the problem might become unsustainable if the burden brought about by debts incurred will gradually lead to deterioration in someone's living conditions.[2]

2 Over-indebtedness: A definition

There is no single definition of over-indebtedness in European legislation, and different Member States have taken different approaches in their legislation. Over-indebtedness is more often than not described as a 'social phenomenon',[3] which brings along other consequences than a mere insufficiency of funds. Over-indebtedness is signified by an overall deterioration of a person's economic situation, which will ultimately lead to social exclusion and to poverty. Overindebtedness is more than a simple financial crisis. It also badly affects the living

conditions of the families involved and their children. It is less a chosen situation than a trap in which a system, which cannot guarantee stability of income, continuously requires consumers to repay debts. However, European legislators have in very few instances legislated norms in order to address the social consequences associated with over-indebtedness. Traditionally, the term over-indebtedness was associated with insolvency and bankruptcy, which is mostly concerned with addressing the creditors' insolvency problems. More recently, more laws are enacted to address over indebtedness of consumers from the debtor's perspective, thus addressing the social concerns brought about by over-indebtedness.

Very few legal texts use the term 'over-indebtedness'[4] to address the issue, since the term 'insolvency' is usually preferred. From those who do though, the most comprehensive[5] definition of over-indebtedness is that given by the Danish legislators: debtors without assets who are caught in the deadlock of permanent indebtedness.[6] This idea of permanence distinguishes overindebtedness from a mere state of insolvency, which as serious as it can be will not necessarily imply a state of permanent inability to pay debts. Additionally, the French legislators have introduced the principle of 'good faith' in their legislation, which adds another layer to the above definition. The notion of a 'debtor in good faith' views over-indebtedness as a social phenomenon to be attributed to more factors, rather than a situation to be solely attributed to the defaulting debtor-consumer. Empirical research has shown that over-indebtedness is 'primarily not attributed to a lack of knowledge about the product but to instable income caused by unemployment, illness, divorce, sudden death and to a lesser degree – also to a false use of credit facilities'.[7] This latter point

is worth emphasising since it is a fact that some might think that the State should not protect those who have incurred excessive debts recklessly. However, as we shall see throughout this paper, the goals of regulation differ and various rules enacted to combat over-indebtedness invariably indicate the attitude a State may have towards over-indebtedness.

3 Legislation

Over-indebtedness is attributed to a variety of factors, some of which are directly attributable to the debtor, but most are extraneous to him. Legislation as a tool to combat the problem of overindebtedness can address a number of these factors by various means.

3.1 *Ex-Ante* Approach

In most cases, legislation is seen more of a preventive tool than a corrective measure. A person does not become over-indebted overnight, thus permitting a certain degree of intervention at the various stages preceding the final state of over-indebtedness. In theory this means that the law can intervene by various means and at various stages, in order to avoid someone becoming 'permanently indebted'.

Ex ante, the legislator can enact a number of rules intended to protect consumers before they run into excessive debts. Methods are varied and the effectiveness of each has to be seen in conjunction with the other methods. Most of these rules are found in consumer protection legislation, but other laws also contribute to the protection of consumer-debtors. From a consumer protection perspective, legislation is most often based on

the assumption that there is an information asymmetry between the trader and the consumer. This would mean that legislation allowing the consumer to have access to information will substantially improve the position of the consumer because the consumer will then maximize the availability of this information and arrive at perfectly rational decisions. Directive 87/102 (the current Consumer Credit Directive) and the local Consumer Credit Regulations[8] are largely based on this 'transparency principle'. The current proposal[9] for a Consumer Credit Directive builds upon this principle in that it also provides for standard information to be given in advertising, both at the pre-contractual and at the contractual phase. This technique has the added benefit of promoting negotiation and informed consumer choice without substituting public decision for private choice. Both the Directive and local Regulations oblige the creditor to disclose the APR – Annual Percentage Rate of Charge. In simple terms the APR expresses the total cost of the credit to consumers as a percentage of the credit granted. It is a pre-contractual tool which will uncover all hidden costs tied to a credit facility and therefore help consumers when choosing their credit facility.

A consumer would therefore be in a better position to assess all the conditions and costs related to the conclusion of the contract, so that he would be in a better position to make his decision. However, this is hardly ever the case, since in taking transactional decisions consumers are often irrational, blinded by brands, influenced by people and more importantly by circumstances. Besides, credit is a highly complex product, which is not easily understood by consumers. In misleading advertising cases, the European Court of Justice adopted the 'average consumer'[10] model, which might not necessarily be useful in safeguarding

consumers from over-indebtedness. As seen above, over-indebtedness is more often the result of other factors beyond the control of a consumer-debtor, which means that merely providing consumers with information about credit will not necessarily keep consumers away from over-indebtedness. Information on its own may not solve the problem, although it can certainly help. A degree of responsibility should also be placed on the creditors who should try to avoid as much as possible to offer credit to heavily indebted consumers. The principle of 'responsible lending' has been deleted from the 2003 modified proposal of the proposed Consumer Credit Directive,[11] however, this lacuna has been filled by Article 5(5) of the proposal which provides that 'creditors should provide adequate explanations to the consumer, in order to put the consumer in a position to assess whether the proposed credit agreement is adapted to his needs and to his financial situation, where appropriate by explaining the pre-contractual information to be provided, the essential characteristics of the products proposed and the specific effects they may have on the consumer, including the consequences of default in payment by the consumer'.

Strict contract law rules will somehow limit the freedom of contract for creditors and will invariably make the provision of credit more restrictive on debtors. However, contract law rules may even help consumers after the contract has been concluded. Once a debtor has signed a credit agreement, he is invariably expected to respect the terms of repayment and consequently to repay back his debt, including interest and other costs. If he does not pay his debts though, the creditor will have a right to institute legal proceedings and to enforce his rights through executive warrants of seizure, garnishee orders and repossession of goods. However the law itself

contains safeguards which would limit the hardship caused by these orders particularly when these are applied to private individuals. Besides the obvious protection which is granted to an individual in the course of legal proceedings, the law also grants exceptional protection to individuals, having regard to the debtor's living conditions. Garnishee orders cannot be issued upon any salary, wages (including bonus, allowances, overtime and other emoluments), benefit, pension, allowance or assistance mentioned in the Social Security Act or other allowance of any person pensioned by the Government.[12] The law also provides that if by way of exception, a garnishee on the above is granted by the Court, this can only be applied on the amount in excess of three hundred Malta liri monthly.[13] In the case of repossession the Consumer Credit Regulations[14] provide that if the creditor and the debtor so agree, then repossession is possible. However this shall not deny the consumer of his rights and shall only be exercised through judicial proceedings. In any case, repossession will be disallowed when the consumer has paid 70% of the total amount of credit payable.

Rules capping interest rates,[15] usury laws[16] and the banning of certain unfair practices[17] are also useful in curbing abuse and in preventing extreme cases of over-indebtedness. Distance marketing of financial services is also specifically regulated, so as to ensure that consumers are not unduly burdened when engaging in distance buying. The Right of Withdrawal as available in the Distance Marketing of Financial Services Directive[18] and as currently proposed in the draft Consumer Credit Directive[19] can also be an ulterior means for preventing over-indebtedness, although the rationale behind this proposition is not to curb over-indebtedness but rather to safeguard the interest of competition, so as to guarantee

that a consumer has made an informed decision when entering into a credit agreement.

Other means of preventing over-indebtedness include the strict supervision of money lenders, the adoption of licensing regimes and the use of express warning statements like in the UK and the utilisation of databases in ensuring that debtors are able to take on the additional burden imposed on them. Modern technology has made it possible to collect vast amounts of information of debtors, especially on defaulting debtors. This is a highly controversial issue since privacy lobbyists might argue that data sharing might go against their right to privacy. Not everyone agrees that this latter method for prevention is the best approach to prevent over-indebtedness.

The above are only some of the legislative means which can be adopted by the State in preventing over-indebtedness. Additionally, the State can promote other means to avoid extreme cases of over-indebtedness, such as financial planning courses; money advice centres; social, health and family policies; low interest loans and so on. However, it is clear that not even the best practices can completely prevent over-indebtedness. At some point or another, it is inevitable that some debtors become overcommitted and therefore unable to pay their outstanding debts.

3.2 *Ex-Post* Approach

Long gone are the days when people who were severely in debt were regarded as criminals and as sinners. The idea that a debtor should suffer the rest of his life because he becomes over-indebted is not acceptable any more in a credit society that promotes the taking up of credit and values risk-taking positively. In fact, some believe that failure is as much a part of the market process as is

success, and for the creditor, failure is a routine part of the cost when granting credit.[20]

The ensuing consequences of over-indebtedness affect not only creditors, but also society in general: because of a life-long liability for debts, people who become over-indebted lose financial incentives to participate actively in society. Insolvent people without hope become a burden to society, because the temptation to withdraw from the labour force, to hide from one's creditors, to abuse the courts, or to work on the black market is high.'[21] But whilst creditors can afford to stop granting credit and take their losses, the State cannot simply ignore the problem and abandon its citizens. From an economic perspective, it is suggested that an individual has to be constantly goaded into a continuing participation in the economy through consumption, which means that people who no longer have any motivation for working are useless to the economy.[22] This means that the State has to ensure that a citizen continues to contribute to the economy of a country, even when adversity strikes. Many European states including Malta have highly elaborate social security systems. National insurance and other social security benefits will help the person cope in cases of unemployment, illness or prolonged absence from work. When these are only temporary, the person struck with the unfortunate event can rely on the welfare system to assist him to overcome the adversity. However, when the situation is more permanent, the welfare system might not be sufficient to assist a person to repay his debts. Other means need to be resorted to, aimed at addressing the specific problem of over-indebtedness.

The Civil Code states that anyone who incurs debts is fully liable for those debts till he repays them.[23] Under Maltese legislation, a private individual cannot be

released from his obligations unless these are repaid, or unless the right to recover those debts is extinguished by prescription. This lifelong commitment is nicely explained by the saying: if you murder your wife you get six years, but if you fail to pay the milkman you get a life-sentence. Sociologically, the debtor is worse off than the criminal, who at least is innocent unless proven guilty.[24] This is particularly true of local society, which to an extent still views debt (or rather excessive debt) as a failure. However, this is not the case in all legal systems, which have chosen to tackle differently the problems associated with over-indebtedness.

In Nordic states for example, the principle of 'social force majeure' emerged, which grants a justifiable excuse in cases where a consumer cannot pay his debts because of unemployment, health problem or family problems.[25] This principle, which is present in a number of consumer-related legislative acts throughout the Nordic states, serves to mitigate the consequences usually associated with delayed payment. Usually the consequences arising from this principle are the mitigation of sanctions imposed, the prevention of the other party to terminate the contract (which can be particularly useful, especially in cases of basic utilities) and also very exceptionally give the right to a consumer hit by a 'social force majeure' to withdraw from a long term agreement.

More radically, in the United States and more recently in a number of European States,[26] consumer bankruptcy procedures and discharge of debts is becoming a common remedy to consumer insolvency. It is important to note however, that the procedure available in the US is much more radical than the one available in Europe, reason being that there is a much lower level of social-security legislation in the US than there is in Europe.

The 'Fresh Start' procedure available in the US can discharge completely a debtor from his debts. The debtor has 2 options: the Chapter 13 plan discharges the consumer from virtually all debts through a repayment plan of between three to five years, whilst the Chapter 7 plan, which was introduced more recently, provides for a liquidation of property with immediate discharge of debts. The choice between the two depends on the income and property owned by the debtor.[27] The reason behind this approach is that a consumer over-burdened with debts has no incentive to aim higher, runs a higher risk to illegal behaviour and does not contribute to the economy. In this manner, the consumer-debtor is given a 'fresh start' and a new chance to have a better economic future. In Huls's words it is a form of 'social policy put into practice through the law'.[28] As we said before, the State has to ensure that the citizen continues to participate in the economy, and in the US, the State chose to address the problem in this manner.

In Europe, similar systems have emerged, but of course, these were adapted to the realities of national welfare systems already present in European countries. In many cases, the procedure works as follows: the debtor presents himself disclosing all his income, assets and liabilities. A repayment plan is then prepared with a debt counsellor. This plan is then presented to the creditors, and in case they agree, this will have binding force. If there is disagreement, there is usually a qualified majority decision which would overrule the minority. The plan is usually to be executed within a number of stipulated years, which varies from 3 years to an unlimited number of years as allowed under French legislation. Pending the execution of the plan, interest is usually stayed, not to further aggravate the position of the over-indebted

consumer. The debtor is not allowed to conclude further credit agreements, except with the permission of the debt counsellor. Upon conclusion of the repayment plan, the law will usually stipulate if there is discharge for the outstanding debts. The Dutch model does not give a real discharge of debts for example, but keeps the debtor morally liable to pay. The French model, which we referred to before, emphasises a lot on this element of 'good faith', which has gained a highly moralistic connotation. This last point is particularly relevant, since it is highly debatable whether this procedure should be deemed as a right or as a privilege of the consumer-debtor. Should an over-indebted consumer be entitled to such a procedure on the basis of certain objective economic criteria? Or should this procedure be awarded as a privilege to the deserving debtor by the discretion of the court? Interestingly in Norway, the law tries to combine both approaches, primarily by providing that a consumer has to be permanently incapable of repaying his debts, but then stating that a discharge may not be awarded if it would be morally offensive to other debtors or society in general. The intention behind this latter clause is to exclude debtors who speculate on the possibility that they can have a discharge. In Norway, this procedure can only be granted once in a consumer's lifetime, something which acts as a further deterrent to abuse by debtors in bad faith.[29]

The above systems all provide for a system of debt counselling, which as we have mentioned have, can be particularly useful at the preventive stage. However, as an ex-post approach, debt counselling can also be useful, in that it provides 'made-to-measure' assistance to people suffering form over-indebtedness. Although not strictly embedded in any legislative act, debt counselling can still

be launched by the State as an administrative remedy to over-indebted citizens. The counsellor will liaise with the client and assist him in maximizing income, in dealing with creditors and in certain cases even in negotiating pro rate payments, in paying debts and where resources permit on assisting him in legal proceedings.[30] These centres aim to stabilise the client's finances and to make sure that the debt payment process proceeds in a well controlled manner. The services offered are free of charge, but in most cases, they are not available to the whole spectrum of society.[31]

In Malta, a similar service is offered by Caritas through its Foundation for Victims of Usury. As the name suggests, the Foundation only assists victims of usury but the services offered are similar to those offered by similar centres abroad, with the only difference that it is operated by the Church rather than the State. The Foundation offers legal, financial and even the services of other professionals if the case requires. It also asks for and expects the assistance of the Church, the Government and other institutions and associations, empowers the victim of usury to start afresh, strives to create awareness about usury through educational campaigns of information and lobbies for changes in the law so that persons who fall in the trap of usury will be protected more than it is possible in the present.[32] The Foundation is only intended for usury victims, but a member of the Foundation admitted that exceptionally they have had a few cases of non-usury victims who made use of its services.

In many cases, the services mentioned above have no legal backing, thus proving to be difficult to sustain in the long run. Furthermore, the effectiveness of these services relies to a large extent on the will on the debtor to comply with the repayment schedule. However,

in The Netherlands the State went beyond providing mere counselling services, and ventured into giving real assistance to people who are suffering form over-indebtedness. Debt counsellors in The Netherlands is provided by Municipal Credit Banks, which besides assisting consumer-debtors in debt management, also grant credit to low income groups and provide debt consolidation schemes. These banks do not operate as commercial banks, thus being to address the problem of over-indebtedness without commercial considerations.[33]

Conclusion

Although there is consensus as to the desirability to prevent and remedy the ill-effects of consumer over-indebtedness, there seems little consensus as to the right approach to be undertaken in order to do that. In this paper we have seen some approaches which might be useful in tackling the problem. However, it would be ambitious to state that these are exhaustive. Techniques vary from legislator to legislator and each approach has its advantages as well as its shortcomings in addressing over-indebtedness. Consumer information, for example, might not be the perfect solution in preventing over-indebtedness, as a consumer can never have 'the right to choose' when taking out credit, because of his low bargaining power. As argued by Kilborn, 'we ought not expect too much from passive 'debtor education' as a core part of consumer overindebtedness treatment',[34] more so when consumers are not in a position to understand the information given. Likewise, limitations on wage garnishee orders and re-possession rules will only address single debts, and unfortunately will fail to be of assistance

when multiple debts need to be settled (a collective debt-settlement procedure would be more desirable for instance).[35] This does not necessarily imply that preventive measures are futile and without any impact on the problem of over-indebtedness. Since becoming over-indebted is a process, legal provisions are of considerable importance, since they can intervene at one of the several stages of this progression (or rather regression).[36] I do not accept the argument that most ex ante efforts do little to avoid consumer over-indebtedness,[37] although I do feel that engaging in a purely ex ante approach will not do much to solve the problem. Maltese legislation is characterised by the preventive approach, largely due to our continental law tradition. However, consumer credit is on the increase and the younger generation is more and more getting used to the idea of borrowing money for all reasons imaginable. So what additional remedies could be provided by law in order to address this problem?

A proper licensing regime and proper creditor supervision would be a good start, but this needs to be teamed with the proper enforcement mechanisms backed by administrative authorities which are properly targeted at dealing with credit regulation. Creditors should be encouraged to adopt codes of conduct to regulate their own behaviour. Financial literacy and debt counselling should also be introduced by the State, working alongside organisations such as Caritas who already provide similar services, in order to provide broader assistance to the over-indebted. These counselling services can also provide financial assistance by creating 'specialised funds' and granting 'social loans' to those in need. As the last resort, we should also consider adopting a consumer bankruptcy procedure, in order to assist over-indebted people. Although this procedure might pose a moral

dilemma on the local legislator since it tries to balance the social need to alleviate over-indebtedness with the fear that a discharge of debts will have a negative effect on the moral obligation to pay one's debts, it is something worth considering. With the proper safeguards, this procedure could be particularly relevant for people on the verge of poverty or usury victims.

Notes

1 E. M. Lewis An Introduction to Credit Scoring, (2nd edn, Fair, Isaac and Co. Inc, US, 1992) 2
2 ibid
3 U. Reifner, J. Kiesilanen, N. Huls, H.Springeneer Consumer Overindebtedness and Consumer Law in the European Union Final Report presented to the Commission of the European Communities, Health and Consumer Protection DG September 2003, 18
4 Denmark, Finland, France, Sweden
5 author's opinion
6 Cf. footnote 3, 19
7 Cf. footnote 3, 52
8 LN 84 of 2005
9 Modified Proposal for a Directive of the European Parliament and of the Council on credit agreements for consumers amending Council Directive 93/13/EC COM (2005) 483
10 The consumer who is reasonably well informed, reasonably observant and circumspect
11 Cf. footnote 9
12 Code of Organisation and Civil Procedure (Cap. 12) Art 381 (1) (a) and (b)
13 Code of Organisation and Civil Procedure (Cap. 12) Art 382
14 LN 84 of 2005, Regulation 8
15 Civil Code (Cap. 16) Art. 1852 (1): The rate of interest cannot exceed eight per cent per annum. Civil Code (Cap. 16)
16 Criminal Code (Cap. 9) Art. 298C (1): Whosoever receives from another person or obtains from another person a promise to give, to himself or to others, in consideration of a loan, interests or any other gain under any form whatsoever in excess of what is allowed by law shall , on conviction, be liable to imprisonment for a term not exceeding eighteen months and to the payment of a fine (multa) from one thousand liri to fifteen thousand liri.
17 Rules regulating repossession, data collection and processing, prohibition to advertise credit to minors as found in the Consumer Credit Regulations (LN 84 of 2005). The modified proposal for a Directive on Consumer credit

has deleted the provision which banned all forms of unsolicited door-to-door selling of credit.

18 Directive 2002/65/EC

19 Cf. footnote 9, Article 13

20 N. Huls, 'Overindebtedness and Overlegalization: Consumer Bankruptcy as a field for Alternative Dispute Resolution', (1997) 20 Journal of Consumer Policy 143, 145

21 ibid

22 N. Huls, 'American Influences on European Consumer Bankruptcy Law', (1992) 15 Journal of Consumer Policy 125, 130

23 Civil Code (Cap. 16) Art. 1994: Whosoever has bound himself personally is obliged to fulfil his obligations with all his property, present and future.

24 Cf. footnote 18, 132

25 T. Wilhelmsson, 'Social Force Majeure – A new concept in Nordic Consumer Law', (1990) 13 Journal of Consumer Policy 1

26 Such as The Netherlands, Germany, France, Norway, UK

27 The Chapter 13 procedure would be more favourable to a person with high earning capacity but without property, whilst the Chapter 7 procedure would be more favourable to a person with a good deal of property but a low income.

28 Cf. footnote 18, 129

29 H. Petter Graver, 'Consumer Bankruptcy: A right or a Privilege? The Role of the Courts in establishing Moral Standards of Economic Conduct' (1997) 20 Journal of Consumer Policy 161, 170-171

30 N. Huls, 'Towards a European Approach to Overindebtednes of Consumers', (1993) 16 Journal of Consumer Policy 215, 216

31 The counselling services are usually offered to recipients of welfare assistance, homeless and criminals.

32 http://www.caritasmalta.org/

33 For more information access: http://www.responsible-credit.net/

34 J. Kilborn, 'Behavioural Economics, Overindebtedness and Comparative Consumer Bankruptcy: Searching for causes and Evaluation Solutions' (2005) 22 Emory Bankruptcy Developments Journal 13, 24

35 Cf. footnote 16, 148

36 Cf. footnote 3, 67

37 This is the view expressed by Kilborn Cf. footnote 32

PART TWO

CONSUMER CREDIT, TECHNOLOGY AND ADAPTATION TO CHANGED COMMERCIAL REALITIES

GERAINT HOWELLS

UNFAIR COMMERCIAL PRACTICES DIRECTIVE – A MISSED OPPORTUNITY

A. Introduction

The Unfair Commercial Practices Directive[1] was a bold measure. The field it covers is broad and notoriously difficult to regulate. The introduction of a European general clause was the fulfilment of a long term ambition for many in the consumer movement and was especially welcome in countries like the United Kingdom (and no doubt Malta) where there had been no previous general clause regulating fair trading. Why then do I describe it as a missed opportunity? This is because of the juxtaposition of two sets of factors. First I will make some criticism of the form of the European legislation. In and off themselves these would not be damning. This is a difficult area to legislate on even at the national level, but given the need to find a European consensus the drafters of the Directive can be considered to have made a good first effort. The problem is that these newcomers believe they have found the perfect solution and have imposed it (and allowed no more) on all Member States. It is the option of maximal harmonisation that turns the spotlight on the quality of the drafting and makes this a missed opportunity.

First some background. The prospect of a general directive on unfair commercial practices came on to the agenda with the *Green Paper on EU Consumer Protection*.[2] Despite its broad title it really focussed in on trade practices law and canvassed opinion on whether future European interventions should continue to be by punctual specific regulations (like the ideas that were developing around sales promotions) or whether a framework directive should be adopted. Even at this early stage the tone made it obvious that the Commission had ambitions for a general directive and this was confirmed in the *Follow–up Communication on EU Consumer Law*.[3] This concentrated on the form such a general framework directive should adopt and it was clear that it would be based on a general clause and limited to business-to-consumer contracts. Some Member States favoured extending it to allow businesses to challenge unfair practices of competitors, but the Commission did not want to go this far.

On the 18 June 2003 the Commission adopted a proposal for a Directive concerning unfair business-to-consumer practices in the Internal Market.[4] The structure of Directive closely resembles that of the Proposal. At the same time the Commission also proposed a Regulation on Sales Promotion,[5] which would have forced a greater liberalisation of the sales promotions allowed in Member States. It was strange for these two initiatives to have come forward at the same time from two different branches of the Commission. DG SANCO promoted the Unfair Commercial Practices Directive, whereas DG Markt is promoting the Sales Promotion Regulation as part of its services strategy. It was unfortunate in many respects that the two projects were not better co-ordinated for whilst the Green Paper on Consumer Protection tried to open a debate on the nature of European regulation, the Regulation would dictate

directly the form of regulation in a major area of European fair trading law.

The Sales Promotion Regulation has, however, proven to be very controversial and little progress has been made and now looks likely to be abandoned. By contrast, given the broad ambitions of the directive, the different national traditions in this field and the complex nature of the law and practice in this area, the proposal made relatively brisk progress through the political decision-making process. A political agreement was reached in Competitiveness Council on 18 May 2004 with a common position being agreed on 15 November 2004.[6] The Directive was adopted at the Competitiveness Council 7 March 2005 and *Directive 2005/29/EC concerning business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No 2006/2004 of the European Parliament and of the Council (Unfair Commercial Practices Directive)* was published in the Official Journal on 11 June 2005.[7]

The Unfair Commercial Practices Directive regulates unfair commercial practices harming consumers economic interest (art.1). Art. 2 provides a raft of definitions, while art. 3 delimits the scope of the directive. Art. 4 is the internal market (maximal harmonisation) clause. The meat of the Directive lies in arts 5-9. Art. 5 sets out the general unfairness test, art. 6 specifies this for misleading actions , art. 7 for misleading omissions (with Annex II listing those community provisions setting out rules for advertising and commercial communication which are regarded as material) and arts 8-9 for aggressive commercial practices. These are supplemented by a list of practices that are always considered unfair in Annex I. Codes of conduct are addressed in art. 10. Arts 11-13 deals with enforcement

issues, including rules on the substantiation of claims. Art. 15-16 deals with consequential amendments to other directives. Art. 17-20 deal with some other procedural matters considered below.

B. Some criticisms

Scholars from the continental tradition have been fairly complementary about the drafting of the Directive; admiring its structure of general clause, clauses on misleading and aggressive practices and black list of prohibited practices. However, the common lawyer in me still feels uneasy about the many unanswered questions left by the drafting and the occasional difficulty in reconciling the rules with the stated policy objectives.

The Directive's reference point for judging the fairness of a practice is the average consumer, building on the jurisprudence of the European Court of Justice; although this standard is adapted to take the interests of vulnerable consumers into account as considered appropriate. The initial proposal had contained a definition of average consumer as meaning 'the consumer who is reasonably well informed and reasonably observant and circumspect'.[8] This was removed and the Common Position simply referred to the jurisprudence of the European Court of Justice in the recitals. This was expanded on in the final version to include in the recital wording lifted from the jurisprudence - namely that the average consumer is 'reasonably well-informed and reasonably observant and circumspect, taking into account social, cultural and linguistic factors, as interpreted by the Court of Justice.'[9] There was a desire not to include a precise definition so as to allow jurisprudence to develop. Equally consumer advocates were keen to

include reference to social, cultural and linguistic factors to reflect the nuanced approach of the Court and to prevent the impression that European law uncritically assumed that everyone was always able to process information correctly and not be misled. It is therefore still a matter for debate whether European law will follow the hard nosed European Court approach or allow (perhaps at the level of national application) more consumer friendly interpretations of the average consumer.

Article 5 attempts to vary the average consumer standard to take account of the average member of a group that is particularly targeted. Moreover when a practice is aimed at the general public but it is foreseeable that it is only likely to materially distort the economic behaviour of a clearly identifiable group who are particularly vulnerable to the practice or underlying product because of the their mental or physical infirmity, age or credulity, then the practice is judged by the average member of that group. Especially the introduction of credulity risks undermining the general policy of judging practices by the average consumer standard. Moreover it is not clear whether these variations on the average consumer standard only apply to Article 5 or also the provisions on misleading and aggressive practices. This also turns on whether Article 5 should be viewed as the central provision or merely a fall back clause.

A transactional decision requirement was built into the unfairness standard to underline that the test related to economic considerations, but has lead to concerns about how much it limits the impact of the Directive. Consumer groups had concerns about the impact of this requirement on the need to establish causation between the practice and consumer detriment and also because there were difficulties in applying it to some situations where either unfair practices did not affect a transactional decision (for

instance, when consumers ignored aggressive practices) or there was no opportunity for consumers to make a transactional decision (such as post contractual removal of services by a trader). These concerns were not so much addressed as said not to be real concerns in practice. The transactional decision test is not thought to be a very high hurdle for consumers; we await to see if the courts take a similar approach.

Annex I contains a list of commercial practices which are considered unfair in all circumstances. The original proposal listed 28 practices, which in the final version was extended to 31. Whereas some of these are straightforward, others touch complex issues such as pyramid selling,[10] and one might wonder whether there is a need for more detailed rules than are found in the Annex I. Also the matters listed appear to be a rather rag bag collection of unfair practices. Although they are listed under two headings for misleading and aggressive practices it is not even clear that all the practices are listed under the appropriate heading and in some cases one might question whether they all are indeed examples of misleading and aggressive practices. Some seem to be simply objectionable practices that have simply been listed with little attention being paid to defining the underlying policy for the prohibition.

This reveals a more fundamental problem of aligning the underlying philosophy of the Directive with some of its provisions. This is especially true of aggressive practices. Aggressive practice must have two causal effects. They must impair the consumer's freedom of choice or conduct and in turn this lack of freedom must cause him to take a transactional decision that he would not otherwise have taken. The requirement that the aggressive practice must significantly impair or be likely to impair the average consumer's freedom of choice or conduct with regard to

the product encapsulates the core mischief the rules on aggressive practices are aimed at. However, this highlights a more fundamental flaw in a test based on impairment of choice. This may work with many examples concerning coercion and undue influence. Even if a particular individual is able to withstand such pressure in appropriate cases it will be possible to argue that the average consumer would have their freedom of choice or conduct significantly impaired. Impact of freedom of choice is, however, not the objection to many practices considered to be harassing that also fall within the definition of aggressive practices. Many such practices concern protection of the consumer's private sphere rather than fears that they are forcing consumers into choices or conducts they would not normally make.[11] For instance, few people actually respond to unsolicited e-mails. It does not affect transactional decision-making for most consumers, but it does irritate many and it is often considered anti-social and should fall for consideration as an aggressive practice. Likewise the making of persistent and unwanted solicitations by telephone is unlikely to impair the freedom of the average consumer.[12] One might even predict it would have a negative effect on the average consumer and put them off trading with that business. But this is a practice that is always regarded as aggressive. It is hard to see a way of resolving this conundrum. One must conclude that the article is badly drafted if the intention was, as it obviously was, to include such practices.

C. Policy Debates on Maximal Harmonisation

As was mentioned earlier these criticism of the Directive would be less damning, but for the maximal harmonisation nature of the Directive. When the Unfair Commercial

Practices Directive was being adopted one of the central debating points was the Commission's determination to make it a maximal harmonization directive. In favour of maximal harmonization, the Commission invoked the arguments about businesses needing confidence that they would not be confronted with more protective national laws in order to encourage them to truly trade on a European wide basis. Just as it has been argued that the Commission abused the notion of the confident consumer to promote consumer Directives,[13] so to it abuses the notion of the underconfident business to justify maximal harmonisation.

Moreover they argued that any objections were irrational as all unfair practices would be caught by the general clause. However at least two counter arguments can be made to this stance. First, substantively the Directive's standard may not cover all unfair practices; only those practices defined as unfair by the Directive are prohibited. Second, it underplays the value of laws providing for specific controls.

It is misleading to suggest that all unfair practices are caught by the Directive. At least, if by that one means all conceivable unfair practices. The Directive uses a very specific conception of unfairness. Practices are unfair if contrary to the requirements of professional diligence they materially distort the economic behaviour of the average consumer.[14] This is further refined to include misleading actions[15] and omissions[16] as well as aggressive practices.[17]

At least three elements risk making this a restrictive conception of unfairness. First, part of the definition of professional diligence in art. 2(h) refers to 'honest market practices.' There has been some, probably unwarranted concern, that this might allow traders to point to simple compliance with common industry practices as a defence. In any event this requirement is presumed to be satisfied for misleading and aggressive practices that will make

up the bulk of unfair commercial practices. Second, the unfairness definition builds upon European Court of Justice jurisprudence[18] and use an average consumer standard. However, the conception of the average consumer used by the directive assumes that this hypothetical person has abilities and ways of conducting themselves which seem superior to how the ordinary consumer actually is. Recital 18 echoes European Court of Justice jurisprudence by referring to the average consumer as someone who is 'reasonably well-informed and reasonably observant and circumspect.' Thankfully the other strand of European Court of Justice's jurisprudence was also eventually included to allow courts when making the assessment to take 'into account social, cultural and linguistic factors.' Third, unfairness is limited to economic unfairness. The practice must have caused the consumer to take a transactional decision he would not have otherwise taken. This transactional decision test is an express part of the misleading and aggressive practices standard and is found in the general unfairness test as part of the definition of material distortion of the consumer's economic behavior.[19] It is unclear how strict a causal test this will be. Although one could imagine courts taking fine points on this, the working assumption is that this will be a fairly easy threshold to pass. However, it does cause problems when the unfair practice occurs post contractually and the consumer does not have to take a transactional decision, such as when a post sales advice service is withdrawn. Furthermore it is hard to apply to aggressive practices that do not affect the average consumer. For instance, most consumers simply ignore spam e-mail, but that does not mean it should not be prohibited.[20]

In most legal systems there is usually a mass of detailed rules regulating particular practices. This is a certainly the case for common law countries which have relied

on punctual specific regulation of trade practices. [21] But such detailed rules exist even in systems with general fair trading clauses. They can be valuable in targeting particular practices and providing clear guidance on what is acceptable. Ideally one senses that the drafters of the directives would like these swept away. That seems inconceivable, but they will all have to be reviewed to be brought into line with the directive's standard. Some may be repealed, but most will probably be modified and in the process a layer of complication will be added to national laws.

Therefore the maximal harmonization approach of the Unfair Commercial Practices Directive give rise to two sets of concerns. First, consumers might be left vulnerable to some unfair practices that Member States might wish to control. Second, a technical set of problems arises requiring the revision of numerous specific forms of regulation and possibly the removal of some traditional forms of protect.

D. The Internal Market Clause

Article 4 of the Directive is the internal market clause. It simply states:

> 'Member States shall neither restrict the freedom to provide services nor restrict the free movement of goods for reasons falling within the field approximated by this Directive.'

The original proposal had preceded this with a clause providing that traders shall only comply with the national provisions, falling within the field approximated by this Directive, of the Member States in which they are

established. Member States in which the trader was established were to ensure such compliance. This was even more upfront in its intentions than previous consumer directives which had invoked a country of origin principle, such as the 'Television Without Frontiers' Directive[22] and the E-Commerce Directive.[23] These had simply preceded a clause similar to the one now found in Article 4, by a clause about Member States obligations to ensure compliance by businesses established in their territory or jurisdiction. The effect was of course under all versions that traders only had to comply with the rules of the state where they are established. The Unfair Commercial Practices Directive was simply more transparent in its original wording in making it clear to traders that they only had to concern themselves with one set of national rules.

The country of origin principle found in the first paragraph in Article 4 of the proposal on Unfair Commercial Practices was removed, apparently as a concession to those with concerns about the maximal harmonization approach. However, this was a rather pyrrhic victory, for it was only removed on the understanding that it was not needed to achieve maximal harmonization. Nevertheless, it does leave the receiving state as the state responsible for control.[24] This can be very important for, due to limited resources, host states' regulatory authorities may be tempted to give low priority to protection of consumers in other states. It is unclear as to what control the receiving state can exercise. Can it only apply the rules of the Directive or, as has been suggested by at least one state, does Article 4 now permit them to continue to rely on the mandatory requirements set out in *Cassis de Dijon?*[25] It would be surprising, at least to the Commission, if Article 4 could serve as a safeguard clause in disguise. It would run counter to their whole line of argumentation and

their reluctant acceptance of the removal of the country of origin clause, but only on the basis that it was not needed to achieve maximal harmonization.

The Commission refused to debate the maximal harmonization principle during the implementation process. To do so risked being considered a wrecker who wanted to go over old ground, rather than assist in fine tuning the Commission's proposals. What is particularly surprising is the Commission's refusal to even consider introducing a safeguard clause that would allow Member States to react to practices that might develop outside the control of the Directive. Traders employ legions of lawyers and consultants and have every incentive to steal a march on their competitors by pushing legal rules to the limits.[26] It seems rash of the EC to place such faith in its general clause, especially before it has been interpreted by the courts. A parachute to safety in terms of a safeguard clause, as provided for in the General Product Safety Directive,[27] the E-Commerce Directive,[28] would have seemed a sensible precaution; at least in the early years of the Directive's existence. Even though such safeguard clauses build in close supervision of Member States' exercise of their discretion, the Commission was having none of it. It is confident its law can cover all eventualities.

The Commission's efforts to establish maximal harmonization of all aspects covered by its directives are becoming a familiar feature of legislative procedures at the European level. Although it is winning many battles, the principle still meets some resistance and this often leads to exceptions and derogations being slipped into the legislation. Even the Directive on the Distance Marketing of Consumer Financial Services[29] that strove so hard for maximal harmonization, in the end and despite the long list of information requirements included in the

Directive, reserved to Member States the right (pending further harmonization) to add additional information requirements .

The Unfair Commercial Practices Directive includes its own limitations on the maximal hamonization principle. A major limitation on the scope of the harmonized rules is that they only apply to business-to-consumer commercial practices.[30] Business-to-business and even consumer-to-consumer practices are excluded; although, it is hard to imagine these should logically be more protective than business to consumer rules. Rules concerning the certification and indication of the standard of fineness of articles of precious metal are also excluded.[31]

Financial services are within the scope of the Directive, but as is customary in EC consumer law, receive special treatment. Member States remain free to impose more restrictive or prescriptive requirements with respect to financial services.[32] The same applies to immovables. A major concession was the introduction of a six year stay of execution for rules more protective than the Directive which were introduced when implementing directives with minimal harmonization clauses.[33] This concession in itself concedes that the Commission must foresee some recently enacted consumer protection rules might need to be repealed or modified because of the maximal character of the Directive.

The Directive is said to be without prejudice to rules on contract law,[34] health and safety,[35] rules determining jurisdiction[36] and rules relating to the integrity of the regulated professions.[37] Furthermore recital 7 makes it clear that the Directive does not address legal requirements related to taste and decency and Member States can continue to ban practices for such grounds even if they do not limit consumers' freedom of choice. The exact scope of

this exception is unclear for the recital gives the example of banning commercial solicitations in the street, which suggests a broader understanding of taste and decency than usual.

E. Conclusion

Commercial practices cover a broad spectrum. Some clearly need to be harmonized or they will affect the ability to trade across borders. For example, a national rule which requires a particular warning in an advertisement might impede the ability of a company to have a pan-European advertising campaign. The difficulty of ascertaining which rules impede market access lies at the heart of the *Keck* decision,[38] and the problems in determining whether selling arrangements in practice impede imports is obvious from the subsequent case law.[39]

From an internal market perspective one can see that harmonization of some commercial practices is necessary and that for many commercial practices harmonization will be desirable. However, this needs to be weighed against the undesirability of removing traditional national protection in favour of the Directive's general clause. Although most of the non-common law Member States had general clauses prior to the enactment of the Directive, they varied in content and also there were many specific legal controls in all Member States.[40] The United Kingdom and Ireland of course did not have a general clause. Moreover, the substance of trade practices controls still seems very bound to national cultures. Germany (because of the controls by competitors) and the Nordic states (because of the supervision of the Ombudsmen) have traditionally been very protective of consumers. By contrast the United Kingdom has been

more liberal especially as regards advertising, especially comparative advertising,[41] and sales promotions.[42] The Directive actually adopts the form of the continental general clauses, but has the policy perspective of the United Kingdom. European jurisprudence under the Misleading Advertising Directive had already been moving in this direction.[43] But differences in culture persist as to what are acceptable commercial practices. In sum, it seems far too early for Europe to move towards a harmonized regime. The Directive would have been better advised creating a common framework so that the legal regimes evolved towards a common conceptualisation of fairness.

Again one perceives maximal harmonization is more of a political than legal necessity. This becomes even more apparent when attention is focused on the possibility of harmonization being brought about in practice. Leaving to one side the very real differences in enforcement apparatus, one can predict that the goal of simply being able to follow one set of rules and then happily marketing in all states will be illusionary. The implementation process may well give rise to some problems. States with general clauses may be tempted to keep with their own formula rather than moving over to the Directive's standard. Assuming the United Kingdom tries to retain its specific regulations alongside the new general clause, it will be a mammoth task to trawl through the mass of relevant legislation and modify it[44] and an even more difficult task for the Commission to check this has been done properly. The best that can be expected is a good effort. When it comes to applying the general standard, national traditions and social understandings or fairness are bound to come to the fore. The European Court of Justice has already in the context of unfair terms backed off imposing a European application of the general test and indicated it is for national courts to decide.[45] This

is perhaps inevitable given that on a preliminary reference the European Court of Justice can interpret European law, but cannot apply it to the facts of the case. That is the function of national courts. Of course the European Court of Justice can give fairly detailed interpretations, which can sometimes seem to leave little room for national courts' discretion. Even when detailed instructions are given it seems that on occasions national courts are willing to use their ingenuity to deviate from the sometimes pretty strong hints from the European Court of Justice.[46]

Maximal harmonization of some commercial practices law might be necessary or at least in many cases desirable, but complete harmonization of the whole field has come too soon. The introduction of a common general clause on fair trading is to be welcomed as creating a common base level of protection and being a mechanism for the creation of a European conception of fair trading. However, the field is too broad and complex for all problems to be resolved by a simple general clause. Complete uniformity does appear to be an obtainable objective for now. The future, at least in the short to medium term, is likely to be one of increased legal complexity rather that the simplification that Brussels was trying to introduce. It is hard to find simple solutions to complex problems. In attempting to impose a common universal standard the Commission has missed an opportunity to promote the gradual evolution of a common European fair trading policy and risks making the position worse by imposing a standard that has flaws and which will in some cases be difficult to integrate with national systems. It has placed European politics and perpetuation of the myth of a common European consumer market ahead of developing a sound consumer policy.

Notes

* This paper draws upon work done for *European Fair Trading – The Unfair Commercial Practices Directive* (with Hans Micklitz and Thomas Wilhelmsson) and the section on maximal harmonization is taken from "The Rise of European Consumer Law– Whither National Consumer Law?" to be published in the *Sydney Law Review*

1 Directive 2005/29/EC concerning unfair business-to-consumer commercial practices in the internal market: OJ 2005 L 149/22.

2 COM (2001) 531.

3 COM(2002)531.

4 COM (2003) 356

5 COM (2001(546) and revised proposal at COM (2002) 585. As stated above this is likely to be abandoned.

6 OJ 2005 C38/E/1.

7 OJ 2005 L149/22.

8 Art. 2(b).

9 Recital 18.

10 Item 14.

11 Köhler and Lettl, ‚Das geltende europäische Lauterkeitsrecht, der Vorschlag für eine EG-Richtlinie über unlautere Geschäftpraktiken und die UWG-Reform' (2003) *Wettbewerb in Recht und Praxis* 1019..

12 Item 26, Annex I.

13 T. Wilhelmsson, 'The Abuse of the "Confident Consumer' as a Justification for EC Consumer Law' (2004) 27 *Journal of Consumer Policy* 317

14 Art. 5.

15 Art. 6.

16 Art. 7.

17 Arts 8-9.

18 See, *Verband Sozialer Wettbewerb eV v Clinique Laboratoires SNC et Estee Lauder Cosmetics GmbH*.C-315/1992 EC [1994] I-317 and *Gut Springenheide GmbH and RudolfTusky v Oberkreisdirekyto des Kreises Steinfurt – Amt für Lebensmittelüberwachung*, C-210/96 (1998) ECR I-4657.

19 See Art. 2(e).

20 See Annex I item 26.

21 Christian Twigg-Flenser, Deborah Parry, Geraint Howells, Annette Nordhausen, *An Analysis of the Application and Scope of the UCP Directive*, (DTI, 2005) available at http://www.dti.gov.uk/ccp/consultpdf/final_report180505.pdf.

22 Directive 89/552/EEC concerning the pursuit of television broadcasting activities : OJ 1989 L298/23 as amended by Directive 97/36/EC: OJ 1997 L202/60.

23 Directive 2000/31/EC on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market: OJ 2000 L178/1.

24 Hans Micklitz suggests that Germany views Article 4 as mirroring *Cassis de Dijon* and therefore allowing national rules to be justified on the basis of mandatory requirements: see, Geraint Howells, Hans Micklitz and Thomas Wilhelmsson, *European Fair Trading Law – The Unfair Commercial Practices Directive*, (forthcoming).

25 *European Consumer Law Group, op. cit.*
26 Jon Hanson and Douglas Kysar, 'Taking Behaviouralism Seriously: The Problem of Market Manipulation' (1999) 74 NYULR 630.
27 Directive 2001/95/EC: OJ 2002 L 11/4.
28 Directive 2000/31/EC: OJ 2000 L178/1.
29 OJ 2002 L271/16.
30 Article 3(1)
31 Article 3(10).
32 Article 3(9).
33 Article 3(5).
34 Article 3(2).
35 Article 3(3).
36 Article 3(7).
37 Article 3(8).
38 *Criminal proceedings against Bernard Keck and Daniel Mithouard* Joined cases C-267/91 and C-268/91 [1993] ECR I-6097, see Stephen Weatherill, 'After *Keck: Some Thoughts on how to Clarify the Clarification*' (1996) 33 *CMLR* 885.
39 E.g. *Vereinigte Familiapress Zeitungsverlags-und vertriebs Gmbh v Heinrich Bauer Verlag*, Case C-368/95 [1997] ECR I-3689; *Konsumentombudsmannen (KO) v De Agostini (Svenska) F□rlag AB and TV-Shop i Sverige AB* Case C-34-36/95; *Schutzverband gegen unlauteren Wettbewerb v TK-Heimdienst Sass Gmbh* Case C-254/98 [20000] ECR I-151; *Deutscher Apothekerverband e.V. v 0800 Doc Morris NV and Jacques Waterval, Case C-322/01* [2005] 1 C.M.L.R. 46.
40 See VIEW, *The Feasibility of a General Legislative Framework on Fair Trading* http://europa.eu.int/comm/consumers/cons_int/safe_shop/fair_bus_pract/green_pap_comm/studies/sur21_sum_en.pdf and Reiner Schulze and Hans Schultz-Nölke, *Analysis of National Fairness Laws Aimed at Protecting Consumers in Relation to Commercial Practices* available at http://europa.eu.int/comm/consumers/cons_int/safe_shop/fair_bus_pract/green_pap_comm/studies/unfair_practices_en.pdf. A study of the new member states was carried out by British Institute of International and Comparative Law, *Unfair Commercial Practices – An analysis of the existing national rules, including case law, on unfair commercial practices between business and consumers in the New Member States and the possible resulting internal market barrier*. See too Howells, Micklitz and Wilhelmsson, above n71.
41 Now covered by Directive 97/55/EC amending Directive 84/450/EEC concerning misleading advertising so as to include comparative advertising: OJ 1997 L 290/18.
42 As noted above, a European Regulation on Sales Promotions has been proposed but no agreement can be reached on it, underlining the different traditions in this area.
43 *Criminal proceedings against X ('Nissan')*, Case C-373/90 [1992] ECR I-13; *Toshiba Europe Gmbh v Katun Germany GmbH* Case C-112/99, [2001] ECR I-7945; and, *Pippig Augenoptik GmbH v Hartlauer Handelsgesellschaft mbH*, Case C-44/01 [2003] ECR I-3095.
44 See Twigg-Flesner, Parry, Howells and Nordhausen, above.
45 *Freiburger Kommunalbauten v Hofstetter*, C-237/02, [2004] 2 CMLR 13
46 This is hard to establish as national follow-up judgments are often less well reported outside the state concerned.

PETER ROTT

LINKED CREDIT AGREEMENTS IN EC CONSUMER CREDIT LAW

A. Introduction

The purchase of consumer goods or services is frequently financed by a third party that is more or less closely linked with the trader. This tripartite relationship in which the consumer is confronted with two contracting partners has replaced a bilateral relationship in which the seller has given the purchaser a loan; and it has created problems ever since.[1] What happens to the sales contract if the connected credit is invalid or withdrawn or terminated by the consumer? And what happens to the consumer credit contract if the sales contract is invalid, or if the purchased good is defective? Under what circumstances is the connection between the two contracts close enough to evoke legal consequences?

Long before the EC adopted the first Consumer Credit Directive, national courts and legislators have sought to protect the purchaser from an artificial splitting up of an economically connected situation.[2] The link between a sales contract and a credit contract is narrowest if the trader also grants a credit under a legally separate contract, or if the trader and the creditor belong to the

same group of companies, as with banks that were created in order to finance the purchase of cars of one particular producer.[3] From a purchaser's perspective, the situation is similar where the trader is in a certain, not necessarily long-standing, relationship with one or more particular creditors and acts as their intermediary. In such situations, it seems legitimate to hold the creditor liable for non-performance or bad performance because he benefits from the connection between the sales contract and the credit contract.[4] One argument of economic efficiency may be added. The creditor who is in a long-standing relationship with a trader is usually better equipped to control and sanction non-performance or bad performance by the trader than the partner of a one-off contractual relationship.[5]

This paper first analyses the respective rules of the current Consumer Credit Directive 87/102/EEC (B.) and gives an overview of the regulation of linked contracts in other consumer law Directives (C.). It then explores the rules that the EC Commission had envisaged for a new Consumer Credit Directive (D.) and their prospective relevance, in particular with a view to the principles of maximum harmonisation and of mutual recognition (E.). Taking Germany as an example to illustrate the consequences on national law on linked credit contracts (F.), it demonstrates that the new rules would severely impact on consumer protection in tri-partite relationships at least in some Member States. A postscript informs about the latest development of the legislative process at EC level (G.).

B. Linked Contracts under Directive 87/102/EEC

Directive 87/102/EEC takes into account linked contracts in its Article 11. At the time, the concept was new for a number of Member States,[6] and Directives had to be adopted unanimously. This may be the reason why the rules are rather weak. The tripartite relationship was considered in two ways: Article 11 (1) concerns the consumer-supplier relationship, and Article 11 (2) deals with the relationship between the consumer and the creditor.

I. The consumer-supplier relationship
Article 11 (1) aims at preventing that the consumer's legal position vis-à-vis the trader is not affected by the existence of a credit agreement in cases where the goods or services are not supplied or are otherwise not in conformity with the contract for their supply. This seems obvious and has never led to any debate.

II. The consumer-creditor relationship
Article 11 (2) considers to what extent the consumer can pursue remedies against the creditor of a linked contract where goods or services covered by the credit agreement are not supplied, or are supplied only in part, or are not in conformity with the contract for supply of them. This issue had been subject to controversial debate during the legislative process.[7] Consumer advocates had favoured a solution under which the trader and the creditor would have been made jointly and severally liable for any breach of the contract on the supply of goods or services.[8] This idea did not reach the consensus of the Member States. In contrast, Article 11 (2) now merely requires the subsidiary liability of the creditor under narrow conditions.[9]

Four issues must be distinguished: (1) the scope of application, i.e. the definition of a linked credit agreement, (2) the rights that a consumer can exercise in case of a linked credit agreement, (3) whether or not the consumer has to take measures against the trader first, and if so, what measures, and (4) formalities and procedural aspects.

1. The scope of application

Article 11 (2) has a very narrow scope of application, and not all the requirements are entirely clear.[10] The most important restriction is Article 11 (2) lit. b). According to this provision, the provision only relates to cases in which the creditor and the supplier of the goods or services have a pre-existing agreement under which credit is made available *exclusively* by that creditor to customers of that supplier for the acquisition of goods or services from that supplier. Thus, the consumer is not protected in cases where a trader co-operates with several creditors.[11] Obviously, this opens the door for circumvention strategies that cannot be countered by making use of Article 14 (2) of the Directive. Moreover, this criterion does not reflect the consumer's interest: From the point of view of the consumer, it is merely important that the trader and the creditor form an economic unit.[12] And finally, the criterion of exclusivity is difficult to prove for the consumer; although, in the light of ECJ case-law on the burden of proof,[13] one may require the trader to prove that he does not co-operate solely with the creditor in question. Sales contract that are paid for with a credit card are not covered by Article 11 (2).[14]

2. The rights of the consumer

The "rights" that the consumer can exercise against the creditor are not specified in Article 11 (2). Possible solutions include: the right to evoke objections from the linked contract in order to reject further payment, or the right to claim reimbursement of payments already made under the credit contract, or even the right to claim damages for breach of contract or even tort law stemming from the trader's conduct? The first proposal by the Commission had actually opted for a broad concept that had included all these types of damages[15] but met considerable resistance from a number of Member States that argued against imposing a no-fault liability on the creditor. Therefore, Article 11 (2) s. 2 now leaves it to the Member States to determine to what extent these remedies shall be exercisable.

3. Subsidiary liability

Under Article 11 (2) lit. e), the consumer must first pursue his remedies against the supplier and fail to obtain the satisfaction to which he is entitled before he can exercise his rights against the creditor. What this exactly means is subject to some controversies. Whilst some authors argue that the consumer must initiate insolvency proceedings against the trader,[16] others suggest that "simple" court proceedings or even extra-judicial measures suffice.[17] Others argue that Article 11 (2) s. 2 of Directive 87/102/EEC leaves it to the Member States to regulate on details, this being a consequence of disagreement between the Member States at the time when the Directive was adopted.[18] The ECJ has not had the opportunity yet to clarify the law.[19]

4. Formalities and procedural aspects

With a view to formalities and procedural aspects, Article 11 (2) makes no requirements. Article 11 (2) s. 2 leaves it to the Member States to determine under what conditions the consumer's rights shall be exercisable.

III. Evaluation

The responsible member of staff of the Commission, Patrick Latham, had expressed his disappointment with Article 11 as soon as in 1988, and he had hoped that the Member States would introduce more protective rules voluntarily;[20] which most Member States have not done.[21] In 2002, the Commission has given an implicit evaluation of Article 11 (2) of Directive 87/102/EEC, by stating in its first proposal for a new Consumer Credit Directive that a "number of Member States simply transposed Article 11 and created legislation that was ineffective", whereas other Member States have gone (far) beyond the requirements of that Directive.[22] In practice, Article 11 at least did not do any harm since Member States were allowed, under the minimum harmonisation clause of Article 15 of the Directive, to adopt or maintain more stringent consumer protection measures.[23] However, the provision on linked contracts, as many other parts of the Directive, has certainly not harmonised the laws of the Member States to a great extent,[24] and it does not ensure a high level of consumer protection either.[25]

C. Linked Contracts in EC Consumer Law outside the Consumer Credit Directive

EC legislation on linked contracts is relatively scarce. The Time-sharing Directive 94/47/EC, and the Distant Selling Directives 97/7/EC and 2002/65/EC consider the consequences for linked credit contracts of the withdrawal of the financed contract. Under all three Directive, a credit agreement that covers the price of goods or services fully or partly shall be cancelled, without any penalty, if the consumer exercises his right to withdrawal with regard to the distance selling or time-sharing contract.[26]

In doorstep selling law, German cases were recently decided by the European Court of Justice (ECJ).[27] In these cases, German consumers were persuaded, in their private homes, to purchase property and to take up bank loans in order to finance the purchase. Subsequently, they cancelled the doorstep credit agreement. After some clarification on the existence of a right to withdraw a secured credit agreement that is to say, credit agreements for financing the purchase of immovable property,[28] the question turned on the consequences of the consumer exercising his right to withdrawal. According to the BGH, in the event of the cancellation of a secured credit agreement, German doorstep selling law gives the lending bank a right to repayment of the net amount of credit paid with interest at the market rate. This claim is due immediately after the cancellation. In contrast, the Landgericht (District Court) Bochum and the Oberlandesgericht (Higher Regional Court) Bremen tried to persuade the ECJ that the two contracts, i.e. the credit contract and the contract on the sale of property had to be treated as linked contracts, and that the cancellation of the credit contract therefore led to the cancellation of the sales contract; a rule that the

BGH had applied in earlier cases on financed investment and that the 2nd senate of the BGH had applied recently on the financed purchase of investment funds. With such a judgment, the consumer would be released from repaying the credit, he could claim his part payment back, and he would merely have to hand over the (frequently overprices) property in return.

The ECJ declined to follow this approach. Directive 85/577/EEC does not mention linked contracts. Therefore, only the principle of effectiveness, as enshrined in Article 4 (3) of the Directive, could have been applied. Article 4 (3) requires the Member States to ensure that their national legislation lays down appropriate consumer protection measures in cases where the information referred to in this Article is not supplied. In contrast, it does not require the Member State to introduce a specific protective instrument as long as other instruments can achieve the same result.[29] Nevertheless, the ECJ has recognised that in the individual case the two contracts were linked. The ECJ makes it absolutely clear that even the conclusion of the sales contract may be a consequence of the failure to inform the consumer on his right to cancel the credit contract when it states:

> "If the bank had informed Mr and Mrs Schulte of their right of cancellation (…) at the correct time, they would have had seven days to change their minds about concluding the loan agreement. If they had chosen then to cancel it, it is common ground that, given the link between the loan agreement and the purchase contract, the latter would not have been concluded".[30]

Through this construction, the ECJ accepts the idea of linked contracts in some way: The consumer must be treated as if he had never concluded the sales contract. The sales contract as such may remain untouched because the ECJ merely considers the relationship between the consumer and the bank; however, the bank must cover all the damages that have arisen from the sales contract.

In conclusion, the EC has continued, after the initial provision of Article 11 (2) of Directive 87/102/EEC, to introduce rules that take account of the economic unit between a credit agreement and a contract for the sale of goods or the provision of services.

D. Linked Contracts in the Commission's Proposal on a New Consumer Credit Directive

With its proposal for a new Consumer Credit Directive of September 2002,[31] as amended in September 2004[32] and again in October 2005,[33] the Commission had taken up on the issue of linked contracts again. With Article 14 of its latest proposal, the Commission had partly retreated towards the old system of Directive 87/102/EEC.

1. Withdrawal of the financed contract

Article 14 (1) deals with the effect on the credit contract of the withdrawal of the financed contract. Where the consumer has exercised a right of withdrawal concerning a contract for the supply of goods or services by a trader, he shall no longer be bound by a "linked credit agreement". This new rule was first proposed by the European Parliament.[34]

Which rights of withdrawal qualify was not specified any further in that proposal. Under Directives 94/47/EC, 97/7/EC and 2002/65/EC, a linked credit agreement shares the fate of the withdrawn contract on the sale of goods or the provision of services anyway. Article 14 (1) of the proposal would however improve the consumer's situation under the Doorstep Selling Directive 85/577/EEC where no such rule exists yet.[35] Moreover, the open wording of Article 14 (1) even seemed to apply to rights of withdrawal stemming exclusively from national law as well.

The crucial issue is of course the notion of a "linked credit agreement". Under Article 3 lit. l) of the latest proposal, "linked credit agreement" meant a credit agreement where (i) the credit in question serves exclusively to finance an agreement concerning the supply of goods or the provision of a service and (ii) those two agreements form from an objective point of view a commercial unit; a commercial unit is involved where the supplier or service provider himself finances the credit for the consumer or, if it is financed by a third party, if the creditor uses the services of the supplier or service provider in connection with the conclusion, or preparation, of the credit agreement, or if the credit agreement makes reference to the specific goods or services to be financed with the credit. This definition was far broader than the one used by Article 11 (2) of Directive 87/102/EEC. In its structure, it was proposed by the European Parliament.[36] However, in contrast to the Parliament's proposal, the definition required that the credit served *exclusively* to finance the other contract, and it also specified the term "commercial unit" in an exhaustive way.

The legal consequence this would have had is not entirely clear. Under Article 14 (1), the consumer shall not

be bound by linked credit agreement. He may, however, wish to uphold the credit agreement. For example, he may have obtained a very cheap credit that was meant to promote the sale of a certain product, for example, a 0 % loan. The wording of Article 14 (1) appeared to suggest that the linked credit agreement is not necessarily void but that the creditor may remain bound to his agreement.

2. Withdrawal of the credit contract

The European Parliament has also proposed to make the financed contract dependent from the credit agreement.[37] This idea was explicitly rejected by the Commission.[38] Thus, under the new Directive a consumer who has purchased a good that was financed by a third party will be able to cancel the credit contract but retain the purchased good. This may be useful if the consumer finds a cheaper credit than the one that was linked to the purchase. In contrast, it will be impossible to avoid the whole financed contract if the latter does not include a right to withdrawal itself; which implies that the consumer will have to find another creditor in order to substitute the credit contract that was originally linked to the purchase contract.

3. Remedies against the creditor of a linked credit agreement

Article 14 (2) took up the old Article 11 (2) of Directive 87/102/EEC with identical wording. The narrow requirements that have made the old rule hardly ever relevant were maintained. Notably, the relatively broad new notion of "linked credit agreements" was not

transferred into Article 14 (2). Instead, the provision upheld the precondition of exclusivity that the Commission had proposed to drop, in an earlier document.[39] Furthermore, Article 14 (2) maintained the old uncertainty connected with its second sentence according to which the Member States shall determine to what extent and under what conditions these remedies shall be exercisable.

4. No impact on rules on joint and several liability

According to Article 14 (3), the new rules should be without prejudice to national rules under which the creditor and the supplier of a linked transaction are jointly and severally liable. This rule replaced Article 19 (2) of the first proposal with which the Commission had intended to introduce joint and several liability in cases where the supplier has acted as an intermediary for the creditor,[40] a rule that is known from English law[41] but that is far more stringent than the law of most other Member States. Article 14 (3) reflected a compromise that allows the UK to maintain its strict legislation.

E. Maximum Harmonisation, Mutual Recognition and Private International Law

I. Introduction

The Commission is convinced that the current non-existence of a European consumer credit market finds its ground in the diversity of the Member States' consumer credit laws.[42] It therefore wishes the new Consumer Credit Directive to become a maximum harmonisation Directive that disallows more stringent

national legislation;[43] an objective that has been heavily criticised by lawyers, and in particular consumer advocates, from Member States that provide for a higher level of consumer protection.[44] Since a strict maximum harmonisation approach also met the resistance of the European Parliament, the Commission proposed, in its amended proposal, a combination of maximum harmonisation and mutual recognition, whereby Article 21 (1) dealt with maximum harmonisation, and Article 21 (2) with mutual recognition.

II. The concepts of maximum harmonisation and mutual recognition

Article 21 (1) of the amended proposal expressed the aim of maximum harmonisation by prohibiting other provisions than those laid down by the Directive "insofar as this Directive contains harmonised provisions". The Commission explained that issues that are not addressed by the Directive remain in the competence of the Member States.[45] The most important example is probably usury where the policies of the Member States differ greatly. However, the scope of Article 21 (1) was still not entirely clear.[46]

The concept of mutual recognition reflected that the proposal gave leeway to national implementation, mainly due to existing heterogeneity as regards national markets or national legislation. The Commission gave the examples of national rules on early repayment or overrunning. However, it also wished to ensure that the degree of flexibility provided for national implementation within the limits of the Directive did not contribute to raise additional barriers to the single market in consumer credit.[47] The concept of mutual recognition was laid down in Article 21 (2) of the proposal:

> "When implementing and applying Article 5(1), (2) and (5), Article 13, Article 14(1) and (2), Articles 15, 17, 19 and 20, and without prejudice to necessary and proportionate measures which Member States may take on grounds of public policy, Member States shall not restrict the activities of creditors established in another Member State and operating within their territory in accordance with this Directive either through freedom of establishment or free provision of services."

What this really meant became apparent from the Commission's explanations. The principle of mutual recognition was not only meant to apply to the admission, or supervision, of creditors as service providers but predominantly impacted on consumer protection under private international law. Under the current regime of Article 5 of the Rome Convention on the Law Applicable to Contractual Obligations,[48] the choice of a law by the parties to the contract may not deprive a consumer of the protection of the mandatory provisions of the law of the country of the consumer's habitual residence, and in the absence of a choice of law, a consumer contract is governed by the law of the country of the consumer's habitual residence. Whilst the situation of isolated credit contracts is still subject to controversial debate,[49] linked credit agreements clearly come under Article 5 of the Rome Convention. Thus, the so-called "passive" consumer who was in some way approached by the creditor in his home country[50] may not lose the protection afforded to him by the mandatory consumer protection laws of his home country; and the consumer credit laws of the Member States are usually mandatory.[51]

With a view to the principle of mutual recognition, the Commission stated:

> "In the area of contract law, this could lead to another result than foreseen by Article 5 of the Rome Convention. In an Article 5 situation, which would lead to the application of the law of the country where the consumer has his habitual residence, this latter law may establish standards that, in relation to the equivalent standards applicable in an incoming creditor's home country, restrict that creditors activity, for instance by being higher (or different) than his home country standards. In that case, if areas mentioned in the mutual recognition clause are concerned, the host Member State has to ensure that the said standards would not apply to the contract. Either the law chosen by the parties, or, in the absence of such a choice, the requirements of the creditor's home country law would continue to apply."

Thus, the principle of mutual recognition would turn the rules of private international law on their head. Article 21 (2) of the Commission's amended proposal for a new Consumer Credit Directive would have deprived the consumer of the protection that private international law has offered until now.[52] And, to make bad things worse, the creditor would not even have been obliged to inform the consumer about this situation.[53] Public policy reasons that might allow Member States not to accept the rules of another Member State on linked credit agreements are difficult to see.

Remarkably, the DG Internal Market made here an isolated attempt to change the rules on private international law in the specific field of consumer credit contracts, whilst the DG Justice, Freedom and Security has tabled a proposal for a Regulation on the

law applicable to contractual obligations (Rome I)[54] that is meant to modernise the respective Rome Convention of 1980 and to harmonise and consolidate the rules on private international law within the EC and that opts, in its Article 5, for a strict application of the consumer home country principle in consumer contracts.

III. The classification of Article 14 of the Commission's proposal

The classification of Article 14 of the amended proposal is difficult. Article 21 (2) on mutual recognition explicitly mentioned Article 14 (1) and (2). However, some elements of Article 14 (1) and (2) might also have qualified for maximum harmonisation under Article 21 (1). Therefore, several elements of Article 14 might have to be distinguished.

1. Article 14 (1)

As for Article 14 (1), the consequences of the withdrawal of the linked contract for the credit agreement were regulated in a precise manner. They therefore qualified for maximum harmonisation. At the same time, Art 21 (2) on mutual recognition mentioned Article 14 (1), which implies that the Commission saw some leeway of the Member States in implementing Article 14 (1). What kind of leeway this might be is entirely unclear.

2. Article 14 (2)

With a view to Article 14 (2), one may have to distinguish the four aspects of linked credit agreements mentioned

above, i.e. the scope of application, the consumer's rights, the subsidiarity of the creditor's liability, and formalities and procedural aspects.

Article 14 (2) s. 2 of the proposal offered the Member States some discretion. It therefore came under the principle of mutual recognition, which means that the creditor would have merely been bound to the extent and the conditions under which the consumer's remedies shall be exercisable as determined by his own Member State. This concerns the consumer's rights as well as formalities and procedural aspects.

In contrast, the rules laid down in Article 14 (2) s. 1 seemed to qualify for maximum harmonisation. In this respect, it may be helpful to look at the case of *El Corte Inglés*. In his Opinion, A.G. Lenz said this:

> "As regards Article 11(2) (…) the Member States have no discretion as to whether the consumer is to be enabled to pursue remedies against the grantor of credit. Member States are intended to have a free rein only with regard to how this takes place or, in other words, with regard to the actual configuration from the technical legal point of view of the legal position (consumer claim, defence, etc). It appears from the context of the provisions of the directive that the basic grant of a legal position for the consumer is to be governed by Community law. (…) Consequently, the basic question of granting protective rights for consumers is not left to the discretion of the Member States. (…) The discretion afforded to the Member States by the second sentence of Article 11(2) with regard to what extent and under what conditions the remedies are to be exercisable is therefore limited."[55]

Although A.G. Lenz gave his Opinion in an entirely different context, namely on the issue of a potential direct effect of Article 11 (2) of Directive 87/102/EEC, Article 14 (2) s. 1 of the amended proposal would have been likely to be regarded as subject to a harmonised provision since it contained a number of clear and unequivocal rules as far as the definition, or description, of a linked credit agreement is concerned.

The fact that Article 14 (3) allowed Member States to uphold rules on joint and several liability does not affect this analysis since this provision did not necessarily allow for national provisions that are somewhere in between the proposed Article 14 (2) and the creditor's and trader's joint and several liability. This may be best demonstrated by pointing at the Product Liability Directive 85/374/EEC. The Product Liability Directive has been judged by the ECJ to be a maximum harmonisation Directive.[56] In *Commission v. France*, the ECJ had to decide, amongst others, on provisions of French law that deviated from Article 7 lit. d) and e) of the Directive.[57] Although Article 15 of the Directive explicitly made a particular exception possible, the ECJ held that Member States could only use this particular exception but was not authorised to alter the conditions under which that exemption is applied.[58] The situation of Article 14 of the amended proposal for a new Consumer Credit Directive appeared to be equivalent: Article 14 (3) allowed for national rules on joint and several liability but apart from this exception Art 14 was a harmonised provision for linked transactions that could not be derogated from in national implementation measures.

3. Article 14 (3)

Under Article 14 (3), Article 14 (1) and (2) were without prejudice to any national rules according to which a creditor shall be jointly and severally liable for any claim the consumer may have against the supplier where the purchase of goods or services from the supplier has been financed by a credit agreement.

The scope of Article 14 (3) covered two aspects. First, it allowed Member States to opt for a system of joint and several liability in contrast to a system of subsidiary liability. Thus, it allowed Member States to deviate from Article 14 (2) lit. e). Second, it related to "any claim" and therefore offered the opportunity to allow the consumer to claim damages from the creditor for any breach of the financed contract; an opportunity that is covered by Article 14 (2) s. 2 anyway.

All the other preconditions of liability, and in particular the exclusivity requirement of Article 14 (2) s. 1 lit. b), would however have remained untouched. One may at least suspect that this is the interpretation that the ECJ might have taken on this clause.

4. The consequences for the financed contract of the withdrawal of the credit contract

The question as to whether or not the withdrawal of the credit contract also renders the linked purchase contract void, as proposed by the European Parliament, appears to remain completely under national competence since Article 14 did not regulate this issue. The principle of mutual recognition did therefore not apply either.

5. Credit cards

Credit card financed contracts continue not to come under the Consumer Credit Directive either so that neither the principle of maximum harmonisation nor the principle of mutual recognition apply. Their treatment remains within the competence of the Member States.

6. Conclusion

Under Article 14 of the amended proposal for a new Consumer Credit Directive, the Member States would have been prohibited to extend the scope of application of the creditor's liability, of any kind, for non-performance or bad performance of a connected sales contract, beyond Article 14 (2) lit. b), which would have made the rule rather inefficient in itself. In contrast, they would have remained free to determine the rights the consumer can exercise against the trader, the formalities and procedural aspects, and also, through Article 14 (3), to opt for subsidiary liability or joint and several liability. In cross-border contracts, however, Member States would not have been allowed to protect their "passive" consumers against a more restrictive system of the Member State where the creditor is located since this creditor would have been protected by the principle of mutual recognition as enshrined in Article 21 (2).

F. Consequences on German Law

The potential consequences on national rules on linked contracts shall be illustrated with a view to German

consumer credit law. Germany has introduced one of the systems that the Commission has characterised, in its first proposal for a new Consumer Credit Directive, as an "independent system".[59] This means that Germany has neither simply adopted Article 11 (2) of Directive 87/102/EEC nor does Germany follow a system of joint and several liability. Instead, Germany allows a consumer, in case of a linked credit agreement, to raise all the objections that he has against the trader against the creditor. In contrast to a system of joint and several liability, however, a consumer cannot claim reimbursement from the creditor for payments he has already made or for damages the trader is liable for.

Germany has adopted a far broader definition of a linked credit agreement.[60] Under § 358 par. 3 BGB, a contract for the sale of goods or services is linked to a consumer credit contract if the credit serves wholly or in part to finance the other contract and both contracts form an economic unit. An economic unit is to be assumed, in particular, if the trader himself finances the consumer's counter-performance or, in the event of by a third person financing the sales contract, if the creditor uses the trader's services in preparing or concluding the consumer loan contract. According to the German courts, the consumer perspective is crucial: If the trader and the creditor present themselves as a unit, the two contracts are linked. The courts do not require a pre-existing agreement between the trader and the creditor but also apply § 358 par. 3 BGB to factual co-operation.[61] A long-standing relationship between the trader and the creditor is not necessary either.[62]

Furthermore, § 359 BGB does not require the consumer to take action against the trader first. Instead, he can raise objections from his relationship with the trader immediately against the creditor.

German law therefore represents a system that is not outside the scope of the Directive but that is far more stringent than Article 14 (2) of the amended proposal[63] and that does not comply fully with Article 14 (3) either. Thus, Germany would have had to reduce the level of consumer protection quite drastically by narrowing down the definition of a linked agreement for both the purposes of Article 14 (1) and (2)[64] and by making the creditor's liability merely subsidiary to the trader's liability. Alternatively, Germany would have had to introduce a UK-type system of joint and several liability that is clearly more stringent than the current system and that has always been rejected by German lawyers.[65]

G. Interim conclusion

The Commission's latest proposal on linked credit agreements was almost cynical. In Article 14 (2) of this proposal, the Commission copied out Article 11 (2) of Directive 87/102/EEC, a provision that it held itself to be dissatisfactory and insufficient right from the start and that it had evaluated to be ineffective in its 1995 report. The Commission then proposed to adopt a maximum harmonisation approach towards the preconditions of the subsidiary liability of the creditor, i.e. prohibiting the Member States to maintain or adopt legislation that is more protective than the ineffective provision of the Directive, with the exception for UK law as enshrined in Article 14 (3). The Member States should have only retained their competences with regard to the extent of the consumer's rights under these narrow preconditions, and with regard to the formalities of their exercising. And even in this respect, the principle of mutual recognition of Article 21 (2)

should have deprived consumers from a more protective Member State of their national protection measures in cases where the creditor is situated in a Member State with less protective rules. Ironically, the Commission claimed to adhere to Article 95 (3) EC, according to which the Commission, in its proposals envisaged in Article 95 (1) concerning consumer protection, is to take as a base a high level of protection. If this latter requirement is taken serious, Article 14 (2) of the proposal would have been in breach of primary EC law, and it was certainly not suited to increase consumer confidence in cross-border consumer credit contracts.

H. The result of the legislative process

Luckily, the political debates around the new Directives continued. The European Parliament commissioned a study on the impact that the new Directive would probably have on the level of consumer protection and on the increase of cross-border consumer credit contracts. The study[66] revealed that not even the banking industry believed that the share of cross-border credit would be increased through the new Directive, the main reason being that so many issues are not covered at all by its scope of application. In particular, it was thought that cross-border credit would remain difficult. The stakeholders also confirmed that the principle of mutual recognition created confusion rather than bringing about legal certainty. Finally, when the Member States reached a compromise in June 2007,[67] the principle of mutual recognition was dropped, and also the effect of the maximum harmonisation approach was slightly reduced by leaving more options to the Member States, although

some Member States will still have to reduce their current level of consumer protection at some points.

The level of consumer protection with a view to linked credit contracts was certainly increased after the amended proposal, and uncertainties were clarified.

First of all, Article 14 (1) now explicitly refers to rights of withdrawal based on Community law concerning a contract for the supply of goods or services only. When the consumer exercises such a right, he shall no longer be bound by a linked credit agreement either. As recital (25) confirms, the consequences of the exercise of a national right of withdrawal, or of the avoidance of a linked contract remain under national competence. The same applies to the consequences that the withdrawal of the credit contract has on a linked contract of sale of goods or supply of services, see recital (9).

More importantly, in Article 14 (2), the more modern definition of a linked credit agreement of Article 3 lit. l) has now replaced the old criteria of Article 11 (2) of Directive 87/102/EEC, thereby bringing the Directive more in line with German law, for example. According to recital (9a), more protective Member States can even apply the rules on linked credit agreements beyond the definition of linked credit agreements of Article 3 lit. l), for example to credit agreements that serve only partially to finance a contract for the supply of goods or provision of a service. Recital (25a) confirms that the Member States remain competent to determine the details, for example, whether the consumer has to bring an action against the supplier before being in the position to pursue remedies against the creditor. With these improvements, the new rules on linked credit agreements constitute significant increase in consumer protection at EC level, and also in those Member States that had not gone beyond Article 11

(2) of Directive 87/102/EEC until now. At the same time, it allows the more protective Member States, in particular the UK, to retain their own rules.

Still, this success should not reduce vigilance. The Commission has tabled, in April 2007, its long-announced Communication on the Review of the Consumer Acquis,[68] and the principle of mutual recognition appears again as one option for future regulation of consumer law.[69] At the same time, consumer protection in private international law has come under pressure again. Industry is trying to have the above-mentioned Article 5 of the Rome Convention abolished when the new Rome I Regulation is adopted, and it finds support by academics.[70] The fight against the reduction of consumer protection in the name of the internal market goes on.

Notes

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1 On the history of credit financed sale in Germany, see W. Dürbeck, Der Einwendungsdurchgriff nach § 9 Absatz 3 Verbraucherkreditgesetz (VVF, Munich, 1994), at 5 ff.

2 German courts first applied the good faith clause of § 242 BGB. See, for example, BGH, BGHZ 37, 94, at 99 ff.

3 See, for example, K. Reinking & M. Bexen, Der finanzierte Autokauf heute und in Zukunft, Deutsches Autorecht (DAR) 1990, 289 ff.

4 See U. Reifner, Verbraucherdarlehensvertrag, in: P. Derleder et al. (eds), Handbuch des deutschen und europäischen Bankrechts (Springer, Berlin et al., 2004), 317, at 370.

5 See COM(2002) 443 final, at 22. In the United Kingdom, banks appear to exercise thorough control on traders they have a long-standing relationship with, see A. Hüttebräuker, Die Entstehung der EG-Richtlinien über den Verbraucherkredit (Diss. Bonn, 2000), at 144.

6 See N. Reich & H.-W. Micklitz, Europäisches Verbraucherrecht, 4th ed.

(Nomos, Baden-Baden, 2003), at 747.
7 For details, see Hüttebräuker, n 5 above, at 142 ff.
8 See P. Latham, Dispositions communautaires relatives au crédit à la consommation: la directive 87/102/CEE du 22 décembre 1986, Revue du Marché Commun (RMC) 1988, 219, at 224.
9 For critical comments see G. Howells & T. Wilhelmsson, EC Consumer Law (Ashgate, Dartmouth, 1997), at 208 f.
10 See I. Klauer, Die Europäisierung des Privatrechts (Nomos, Baden-Baden, 1998), at 120.
11 See Reich & Micklitz, n 6 above, at 748.
12 See S. Grundmann, Europäisches Schuldvertragsrecht (de Gruyter, Berlin, 1999), at 676.
13 See, for example, ECJ, Case 109/88 *Handels- og Kontorfunktionærernes Forbund I Danmark v. Dansk Arbeitsgiverforening for Danfoss*, [1989] ECR 3199, at para. 13.
14 Against Howells & Wilhelmsson, n 9 above, at 209; Reich & Micklitz, n 6 above, at 749 f. Only the UK and Greece have extended the scope of their national rules to credit card financed sales, see COM(95) 117 final, at 69.
15 See Hüttebräuker, n 5 above, at 143.
16 See, for example, F. J. Scholz, Schwerpunkte der EG-Verbraucherkredi trichtlinie – unter Berücksichtigung des geltenden deutschen Rechts -, Monatsschrift des Deutschen Rechts (MDR) 1988, 730, at 734; Hüttebräuker, n 5 above, at 147.
17 See Reich & Micklitz, n 6 above, at 749.
18 See Grundmann, n 12 above, at 676.
19 The question of the Juzgado de Primera Instancia n. 10 de Seville that was answered by ECJ, judgment of 7/3/1996, Case C-192/94 *El Corte Inglés SA v. Cristina Blázquez Rivero*, [1996] ECR I-1281, merely related to the horizontal direct effect of this provision although the case also raised important questions on the prerequisites of Article 11 (2).
20 Latham, n 8 above, at 224.
21 See COM(95) 117 final, at 68.
22 COM(2002) 443 final, at 22. See also C. Ritz, Harmonisierungsprobleme bei der Umsetzung der EG-Richtlinie 87/102 über den Verbraucherkredit (Lang, Frankfurt, 1996), S. Herrmann, Der Verbraucherkreditvertrag (VVF, München, 1996), and U. Blaurock, Verbraucherkredit und Verbraucherleitbild in der Europäschen Union, Juristenzeitung (JZ) 1999, 801 ff., all of them on Germany, France and the UK; D. Henrich, Die Umsetzung der Richtlinie 87/102/EWG zur Harmonisierung des Verbraucherkredits in Deutschland und Italien, in: C.-W. Canaris & A. Zaccaria (eds), Die Umsetzung zivilrechtlicher Richtlinien der Europäischen Gemeinschaft in Italien und Deutschland (Duncker & Humblot, Berlin, 2002), 25 ff., on Germany and Italy.
23 See also Klauer, n 10 above, at 120.
24 See, for example, Blaurock, n 22 above, at 808.
25 See also M. Wolf, Störungen des Binnenmarkts durch das Verbraucherkreditgesetz, in: F. Kübler et al. (eds), Festschrift für Theodor Heinsius (de Gruyter, Berlin & New York, 1991), 967, at 970.
26 Article 7 (1) of Directive 94/47/EC; Article 6 (4) of Directive 97/7/EC;

Article 6 (7) of Directive 2002/65/EC.

27 ECJ, judgments of 25/10/2005, Case C-350/03 *Elisabeth Schulte and Wolfgang Schulte* v. *Deutsche Bausparkasse Badenia AG* and Case C-229/04 *Crailsheimer Volksbank eG* v. *Klaus Conrads, Frank Schulzke and Petra Schulzke-Lösche and Joachim Nitschke*, not yet published. See also the case notes by N. Reich & U. Rörig, Die Urteile des EuGH in den Rechtssachen C-350/03 (*Schulte*) und C-229/04 (*Crailsheimer Volksbank eG*), Verbraucher und Recht (VuR) 2005, 452 ff., and P. Rott, Risikohaftung der Banken für ‚Schrottimmobilien': Anmerkung zu EuGH, Rs. C-350/03 - *Schulte* und C-229/04 - *Crailsheimer Volksbank*", Zeitschrift für Gemeinschaftsprivatrecht (GPR) 2006, 24 ff.; id., Linked contracts and doorstep selling: Case note on ECJ, judgments of 25 October 2005, cases C-350/03 - *Schulte* and C-229/04 - *Crailsheimer Volksbank*, Yearbook of Consumer Law 2007, 403 ff.

28 ECJ, judgment of 13/12/2001, Case C-481/99 *Georg Heininger and Helga Heininger v. Bayerische Hypo- und Vereinsbank AG*, [2001] ECR I-9945.

29 See P. Rott, Gemeinschaftsrechtliche Vorgaben für die Rückabwicklung von Haustürgeschäften, Verbraucher und Recht (VuR) 2003, 409, at 414; N. Reich, Heininger und das Europäische Privatrecht, in: W. Bub et al. (eds), Zivilrecht im Sozialstaat, Festschrift für Peter Derleder (Nomos, Baden-Baden, 2005), 127, at 136. See also the deviating opinion of N. Fischer, Gemeinschaftsrechtskonforme Rückabwicklung von Haustür-"Schrottimmobilien"-Geschäften, Der Betrieb (DB) 2005, 2507, at 2509.

30 ECJ, judgment of 25/10/2005, Case C-350/03 *Elisabeth Schulte and Wolfgang Schulte v. Deutsche Bausparkasse Badenia AG*, at para 97.

31 COM(2002) 443 final, O.J. 2002, C 331 E/200.

32 COM(2004) 747 final.

33 COM(2005) 483 final.

34 See Article 16 (1) of the position of the European Parliament of 20/4/2004, Doc. P5_TC1-COD(2002)0222.

35 See supra, C.

36 See Article 2 lit. n) of the position of the European Parliament of 20/4/2004, n 34 above.

37 See Article 16 (2) of the position of the European Parliament of 20/4/2004, n 34 above: „Where the consumer has withdrawn his acceptance of a consumer credit agreement, he shall no longer be bound by his acceptance of any agreement on the supply of goods or provision of another service linked to that consumer credit agreement".

38 See COM(2004) 747 final, at 5.

39 See COM(95) 117 final, at 69.

40 See also COM(2002) 443 final, at 22.

41 Sec. 75 of the Consumer Credit Act 1974.

42 See COM(2002) 443 final, at 3 ff. For critical comments on this view that has never been proven or undermined by empirical evidence, see for example, A. Danco, Die Novellierung der Verbraucherkreditrichtlinie, Wertpapier-Mitteilungen (WM) 2003, 853, at 859; M. Hoffmann, Der Diskussionsstand zur Reform der Verbraucherkreditrichtlinie, Zeitschrift für Bank- und Kapitalmarktsrecht (BKR) 2004, 308, at 310. Doubts have already been expressed when Directive 87/102/EEC was adopted, see Scholz, n 16 above, at 731.

43 See, for example, COM(2005) 483 final, at 2 f.
44 For an account with a view to guarantees contracts under the first and second proposal, see P. Rott, Consumer Guarantees in the Future Consumer Credit Directive: Mandatory Ban on Consumer Protection?, European Review of Private Law 2005, 383 ff.
45 COM(2005) 483 final, at 7.
46 For a more detailed analysis of the distinction between issues within and without the scope of application of a Directive, see P. Rott, Minimum harmonisation for the completion of the internal market? – The example of Directive 1999/44/EC, Common Market Law Review 40 (2003), 1107, at 1115 f.; id., n 44 above, at 399 ff.
47 COM(2005) 483 final, at 7 f.
48 Consolidated version in O.J. 1998, C 27/34.
49 See, for example, K. Felke, Internationale Konsumentenkredite: Sonderanknüpfung des VerbrKrG über Article 34 EGBGB?, Recht der Internationalen Wirtschaft (RIW) 2001, 30, at 31, with further references.
50 For details, see Reich & Micklitz, n 6 above, at 457 ff.
51 For critical comments on the overprotection of the German consumer, see Ritz, n 22 above, at 141 f.
52 For critical comments on the application of the principle of mutual recognition in consumer contract law, see P. Rott, Verbraucherschutz im Internationalen Verfahrens- und Privatrecht, in: H.-W. Micklitz (ed.), Verbraucherrecht in Deutschland – Stand und Perspektiven (Nomos, Baden-Baden, 2005), 355, at 378 f.
53 On the obligation to inform about the applicable law, see Rott, n 52 above, at 379 f. A recent provision that obliges the trader to inform the consumer on the law that is applicable to the contract is Article 3 (1) no. 3 lit. e) of Directive 2002/65/EC on the Distance Marketing of Financial Services. See P. Rott, Die Umsetzung der Richtlinie über den Fernabsatz von Finanzdienstleistungen im deutschen Recht, Betriebs-Berater 2005, 53, at 57.
54 COM(2005) 650 final of 15/12/2005.
55 A.G. Lenz, Opinion of 7/12/1995, Case C-192/94 *El Corte Inglés SA v. Cristina Blázquez Rivero*, [1996] ECR I-1281, at para 11 ff.
56 See ECJ, judgments of 25/4/2002, Case C-52/00 *Commission* v. *France*, [2002] ECR I-3827, para 24, and Case C-154/00 *Commission* v. *Greece*, [2002] ECR I-3879, para 20.
57 Under Article 7 the producer is not liable under the Directive d) that the defect is due to compliance of the product with mandatory regulations issued by the public authorities; or e) if he proves that the state of scientific and technical knowledge at the time when he put the product into circulation was not such as to enable the existence of the defect to be discovered.
58 ECJ, judgment of 25/4/2000, Case C-52/00 *Commission* v. *France*, [2002] ECR I-3827, at para 47.
59 COM(2002) 443 final, at 22 fn. 23.
60 Although Germany, supported by the German banks, was one of the leading countries to block more protective legislation at EC level, see Delbrück, n 1 above, at 24 ff.; U. Franz, Der Einwendungsdurchgriff gemäß § 9 Absatz 3 Verbraucherkreditgesetz (Nomos, Baden-Baden, 1996), at 49 f.

61 See BGH, Neue Juristische Wochenschrift (NJW) 2003, 2821.
62 See BGH, Neue Juristische Wochenschrift (NJW) 1971, 2303.
63 See also Scholz, n 16 above, at 733; Grundmann, n 12 above, at 677. Wolf, n 25 above, at 974 ff., has even argued that this definition is in breach of the EC Treaty, free movement of services and free movement of capital because it deters foreign creditors from entering the German market.
64 See also Danco, n 42 above, at 860.
65 For critical comments on that option, see Danco, n 42 above, at 855 f.
66 Civic Consulting with the co-operation of H.-W. Micklitz, P. Rott, L. Tichy & A. Milne, Broad economic analysis of the impact of the proposed Directive on consumer credit, Study commissioned by the European Parliament under EP-IMCO Framework Contract Lot 4 (Consumer Protection), available at http://www.europarl.europa.eu/comparl/imco/studies/0704_consumercredit_en.pdf.
67 EC Doc. CONSOM 62, CODEC 530, JUSTCIV 142 of 16/5/2006.
68 COM(2006) 744 final.
69 See ibid., at 12.
70 See only G.-P. Calliess, Kollisionsrecht, Richtlinienrecht oder Einheitsrecht? Zur Modernisierung des Art. 5 EVÜ (Art. 29, 29a EGBGB) im System des europäischen Verbrauchervertragsrechts, Zeitschrift für Europäisches Privatrecht (ZEuP) 2006, 742 ff.

REINHARD STEENNOT

CONSUMER PROTECTION TO CREDIT AGREEMENTS CONCLUDED ONLINE

Introduction

In the information society, modern means of communication are increasingly being used for the provision of financial services. Consumers are given the possibility to open an account, to obtain credit and to buy and sell financial instruments using one or more means of distance communication, such as the Internet. The aim of this paper is to find out 1) whether it is legally and practically possible to conclude a consumer credit agreement over the Internet and 2) which protection is offered to consumers concluding a distance consumer credit agreement. Answering these questions we will take into account the European Directive on Electronic Commerce[1], the European Directive on the Distance Selling of Financial Services to Consumers[2], the Directive on the Protection of Consumers in respect of Distance Contracts[3], the modified proposal for a Directive on Consumer Credit[4] and the existing Belgian legislation.

1 The possibility to conclude a consumer credit agreement over the Internet

In most jurisdictions the conclusion of a contract solely requires the consent of the parties involved in the transaction, which implies that it is legally possible to conclude a contract over the Internet (e.g. buying a book, booking a flight, …)[5]. However in some situations, specific legislation requires that a contract is concluded in writing[6], that it is signed by the parties or even that the signature of (one of) the parties is preceded by a written statement of the person committing himself. At first sight, these requirements - that concern the contract's validity - seem to make it impossible to conclude the contract electronically.

A. The Belgian Consumer Credit Act

As far as consumer credit agreements are concerned, the Belgian Consumer Credit Act contains several formal requirements relating to the conclusion of a consumer credit agreement (art. 14). More specifically, the Act determines that the parties must sign the written document and that the consumers' signature must be preceded by a written statement concerning the amount that must be paid back. Moreover the consumer must before placing his signature write down the date and the place on which the agreement is signed. Finally, the agreement must contain certain clauses, observing stringent formal requirements (e.g. separately and in bold)[7]. Some of these clauses, such as the clause "never sign a blank contract", must appear where the consumer places his signature.

If these conditions are not met the judge can annul the agreement or reduce the obligations of the consumer to the

amount borrowed or the actual price of the good or service. In the latter situation the consumer retains the benefit of payment in instalments (art. 85).

As the Act only states that the signature of the *creditor* may be in electronic form and says nothing about the consumer's signature and the consumer's written statement, the question arises whether it is legally possible to conclude the credit agreement over the Internet. Answering this question one must take in to account the Act of 11 March 2003 on certain legal aspects of information society services. Article 16 of the Act[8] - transposing article 9 of the European Directive on Electronic Commerce obliging Member States to ensure that their legal system allows contracts to be concluded by electronic means - indicates that legal formal requirements concerning the conclusion of the contract are satisfied whenever the functional quality of the requirement is met. Article 16 also clarifies that for the application of this principle one has to take into account that:

- The requirement of a written document is fulfilled through a succession of intelligible signs that are accessible for future reference, independent of the medium or transmission methods used (e.g. an electronic document);
- The requirement of a signature is fulfilled when the parties use an electronic signature that observes certain requirements. More specifically, it is necessary to use electronic data that can be attributed to a certain person, i.e. are able to identify this person, and that preserve the integrity of the document's content (see art. 1322.2 Civil Code) or to use an advanced electronic signature[9], based on a qualified certificate and created by a secure signature creation device (see art. 4 §4 of the Act of 9 July 2001 establishing a legal framework for electronic signatures)[10];

- The requirement of a written statement of the person that obliges himself is fulfilled by every method that ensures that that person enacted the statement.

Thus, from a legal point of view it is possible today to conclude a consumer credit agreement electronically (e.g. over the Internet)[11]. All formal requirements can be met in an electronic environment using electronic documents, statements and signatures. In practice however it remains impossible in Belgium to perform all acts necessary for the conclusion of a consumer credit agreement on-line. This is due to the fact that consumers do not possess the technology required to fulfil all legal requirements. Indeed, most consumers do not have an electronic signature as required by article 16 of the Act of 11 March 2003. Moreover, most consumers do not possess technology making it possible to place an electronic signature at a certain place in a document (e.g. near the clause "never sign a blank contract"). However, this does not mean that consumers actually have to go to their financial institution to sign the credit agreement. Financial institutions enable potential clients to fill in an electronic form, to print this form and to send this printed and manually signed form by regular mail to the financial institution. The fact that the parties involved in the transaction do not meet each other is important as it leads to the application of specific legislation (infra nr. 16).

B. Modified proposal for a Directive on Consumer Credit

Article 9.1 of the modified proposal for a Directive on Consumer Credit determines that credit agreements must be drawn up on paper *or on another durable medium*. Also, all the contracting parties must receive a copy of the credit

agreement. The term "durable medium" is defined as any instrument which enables the consumer to store information addressed personally to him in a way which makes it accessible for future reference for a period of time adequate for the purposes of the information and which allows the unchanged reproduction of the information stored. There is no doubt that the requirement of a durable medium is fulfilled when the consumer has the possibility to store the electronic agreement (e.g. pdf-file) on the hard disk of his computer. So legally, the modified proposal recognizes the possibility to conclude a credit agreement electronically.

The modified proposal - contrary to the Belgian Consumer Credit Act - does not require that the contract is signed and that the consumer's signature is preceded by a written statement, neither that certain clauses appear near the consumers' signature. Does this mean that it will become possible in practice to conclude the contract on-line? Still, all depends on the technology consumers will possess in the future, as the use of an advanced electronic signature, based on a qualified certificate, remains necessary in many jurisdictions (e.g. Belgium) in order to prove the electronic contract and / or to fulfil the requirements laid down in money laundering legislation.

As far as the proof of electronic contracts is concerned one has to take in to account that the financial institution can only be absolutely certain that the electronic signature has the same evidential value as a written signature – and therefore that the electronic document has the same evidential value as a written document signed by the parties[12] - when an advanced electronic signature based on a qualified certificate and created by a secure signature creation device has been used (art. 4 §4 of the Belgian Act of 9 July 2001 establishing a legal framework for electronic signatures; see also art. 5.1 of the Directive on Electronic

Signatures[13]). Indeed, in case an electronic signature, not meeting these requirements is used, the judge remains free to determine the evidential value of the electronic signature[14]. Therefore Belgian financial institutions will only be prepared to conclude a credit agreement on-line when consumers use such advanced electronic signature[15].

Further it is interesting to have a closer look at the money laundering legislation. Article 4 of the Belgian Money Laundering Act determines that clients must be identified when entering into a business relation (such as the opening of an account or the conclusion of a consumer credit agreement). The Belgian Banking, Finance and Insurance Commission has elaborated detailed rules[16] determining how identification must take place when a contract is concluded at distance (e.g. over the Internet). More specifically, identification can take place on the basis of:

- An electronic identity card[17];
- A qualified certificate issued following a face to face identification of the client by a certification authority that meets certain requirements[18];
- A copy of the (electronic) identity card[19],[20].

Thus, according to existing money laundering legislation, distance identification can only take place electronically when the consumer possesses either an electronic identity card (and a smart card reader, in which he can insert his electronic identity card), or a qualified certificate that meets certain legal requirements. As for now, most consumers who already have obtained an electronic identity card do not have a smart card reader enabling them to identify themselves over the Internet using their electronic identity card. As most consumers also do not possess qualified certificates identification will have to take place by sending

a copy of the identity card by regular mail to the financial institution.

2 Information to be provided to consumers concluding a consumer credit agreement at a distance

To determine the information a consumer must be provided when consumer credits are offered online, one has to take into account: the legislation concerning consumer credits, the rules on the distance selling of financial services to consumers and the legislation concerning information society services.

A. Consumer credit legislation

The fact that a consumer credit agreement is concluded on-line or at distance does not prevent information requirements laid down in consumer credit legislation to apply. Article 4.1 of the Directive on the Distance selling of Financial Services to Consumers explicitly acknowledges this by stating: "where there are provisions in the Community legislation governing financial services which contain prior information requirements additional to those listed in this Directive these requirements continue to apply".

Article 5 of the modified proposal for a Directive on Consumer Credit obliges the creditor and, where applicable, the credit intermediary to adhere to the principle of responsible lending. Responsible lending includes the requirement for the creditor and, where applicable the credit intermediary, to comply with their obligations as regarding the provision of pre-contractual information and the requirement for the creditor to assess the consumer's

creditworthiness on the basis of the information provided by the latter, and, where appropriate on the basis of the consultation of the relevant database.

First, the creditor must provide the necessary and essential information needed for the conclusion of the credit agreement under consideration (art. 5.2). The information, which is enumerated in the proposal, must be provided in good time before the consumer is tied by a credit agreement or any offer, on paper or on another durable medium. A website, in most cases, cannot be seen as a durable medium[21], implying that it is not sufficient to post the information on the website. More specifically, the creditor will be able to fulfil his information obligation by sending an e-mail, a DVD or a written document, containing the information listed in the proposal[22], to the consumer. The information must be provided in good time before the consumer is bound by a credit agreement or any offer, implying that the consumer must have the possibility to take notice before consenting. This rule, which is also incorporated in the Directive on the Distance Selling of Financial Services to Consumers (infra nr. 17) must ensure that the consumer's consent is an informed consent.

Secondly, the creditor must assess the consumer's creditworthiness on the basis of the information provided by the consumer, and, where appropriate on the basis of the consultation of the relevant database (art. 5.1). There is no doubt that this rule also applies when a contract is concluded over the Internet or at distance. Therefore the creditor must ensure that the mechanisms used enable him to obtain all relevant information. More specifically the creditor can ask the consumer to fill in a standardised electronic questioning list[23]. For example creditors, offering consumer credits on the Internet in Belgium, require the consumer to give information about other credit agreements, net income

and other possible burdens, such as rent instalments and alimony. On the basis of these data - which are verified later on by asking the consumer to send proof by regular mail and consulting a central database containing information on all consumer and mortgage credit agreements - the creditor decides whether the consumer is able to obtain the credit.

Finally, creditors and, where applicable, credit intermediaries must provide adequate explanations to the consumer, in order to put the consumer in a position to assess whether the proposed credit agreement is adapted to his needs and to his financial situation, where appropriate by explaining the pre-contractual information which must be provided as well as the advantages and the disadvantages associated with the products proposed (art. 5.5). The question arises whether it is possible to provide such explanation on a website (e.g. using a list of frequently asked questions). Answering this question one has to take into account consideration 20 of the proposal which determines that, *where appropriate*, the relevant pre-contractual information, as well as the advantages and the disadvantages associated with the products proposed, must be explained to the consumer *in a personalised manner*. There's no doubt that additional assistance can be provided by e-mail. Interactive websites, i.e. websites that enable consumers to fill in multiple choice questions which relate to the purpose of the credit and the specific needs of the consumer (e.g. questions relating to the need for a revolving credit, the duration of the agreement, the risk entailed and the existence or not of a fixed timetable) and in that way make it possible to inform consumers electronically and automatically whether the product proposed meets his needs, may also enable the creditor to fulfil its obligation to provide additional assistance in a personalised manner.

Finally it is interesting to mention that, according to the proposal Member States may adapt the manner by and extent to which this assistance is given, as well as by whom it is given, to the particular circumstances of the situation in which the credit agreement is offered.

B. Rules on the distance selling of financial services to consumers

1. Scope of application

When a contract concerning financial services is concluded at a distance one also has to take into account the rules incorporated in the European Directive on the Distance Selling of Financial Services to Consumers. The rules are only applicable if the contract is concluded with a consumer and is concluded under an organised distance sales or service-provision scheme run by the supplier, who, for the purpose of that contract, makes exclusive use of one or more means of distance communication (e.g. e-mail, fax, phone, the Internet) up to and including the time at which the contract is concluded. The definition illustrates that the Directive only applies if the parties do not meet each other before and at the time of conclusion of the contract. Whether the parties meet each other after the conclusion of the contract is irrelevant.

Further, not every contract that is concluded electronically or at a distance falls under the scope of application of the Directive. For example, if a financial institution only exceptionally concludes a contract by e-mail with a consumer, at the consumer's request, the contract cannot be regarded as a distance contract as it was not concluded under an organised distance service-provision scheme run by the financial institution.

The consumer therefore will not enjoy the protection incorporated in the Directive.

2. Information to be provided

If the Directive on the Distance Selling of Financial Services to Consumers applies, the consumer must, in good time before he is bound by any distance contract or offer, be provided with the information, mentioned in the Directive. The information required by the Directive relates to the supplier (for example identity, geographical address, trade register number), the financial service (for example characteristics, total price, arrangements for payment and for performance), the distance contract (for example the existence or absence of a right of withdrawal, information concerning the right to terminate the contract, applicable law, competent court) and the means of redress. Comparing the information required by the Directive on the Distance Selling of Financial Services to Consumers to the information required by the modified proposal for a Directive on Consumer Credit, one will find out that the first Directive contains some additional information requirements, which must of course only be met in case the contract is concluded at a distance (e.g. information on trade register in which the creditor was entered, his trade register number, information on contractual clauses determining the competent courts, data relating to the relevant supervisory authority).

According to article 3 of the Directive the information must be provided in a clear and comprehensible manner, in any way appropriate to the means of distance communication used. More specifically, when consumer credits are offered over the Internet the financial institution can fulfil its obligation by posting the information on its website, in such way that a normal consumer acting with reasonable care can find the information immediately (e.g. using a

clear hyperlink that refers to the information). Indeed, the website can be seen as an appropriate means of distance communication[24].

However this does not mean that the information required by article 3 must not be provided on paper or on a durable medium. Article 5 of the Directive determines that the supplier must communicate to the consumer all the contractual terms and conditions and the information referred to in articles 3(1) and 4 of the Directive (information concerning the supplier of the financial service, information concerning the distance contract, concerning the financial service) *on paper or on another durable medium* available and accessible to the consumer. Once again the information must be provided in good time before the consumer is bound by any distance contract or offer. Only if the contract has been concluded at the consumer's request using a means of distance communication which does not enable providing the contractual terms and conditions and the information on paper or on another durable medium available and accessible to the consumer (e.g. if the contract is concluded over the phone), the supplier can fulfil his obligation immediately after the conclusion of the contract.

3. Sanction

The Directive doesn't oblige Member States to apply a specific sanction in case the supplier doesn't fulfil its obligations. It only determines that Member States *may provide* that the consumer can cancel the contract at any time, free of charge and without penalty when the supplier did not meet its obligations. This means that this sanction will not apply in all Member States.

More specifically, according to the Belgian Act on Trade Practices the consumer will have the right to cancel the contract 1) when the supplier did not provide the

consumer in any way appropriate to the means of distance communication used, with the information relating to the financial service and the distance contract (information required by art. 83 ter § 2 and § 3 of the Act on Trade Practices / art. 3, 2° and 3° of the Directive) and 2) when the supplier did not communicate the information which must be provided in writing or on a durable medium. According to the Belgian Act on Trade Practices cancellation has to take place within a reasonable time after learning that the financial institution did not fulfil its information requirements.

C. The Directive on Electronic Commerce

The Directive on Electronic Commerce applies to information society services, i.e. services that are normally provided for remuneration, at a distance, by electronic means and at the individual request of the consumer[25]. There is no doubt that the on-line provision of consumer credit agreements must be regarded as an information society service. According to the Directive on Electronic Commerce one needs to make a distinction between on the one hand the general information that a service provider must render easily, directly and permanently accessible to the recipients of the service and competent authorities and on the other hand the information that only has to be provided when a contract is concluded on-line (which is not likely for consumer credit agreements).

Once again additional information requirements may be imposed on the creditor. For example, article 7 of the Belgian Act of 11 March 2003 obliges the creditor to render accessible the codes of conduct the creditor has accepted (if any), and information about the possibility to consult these

codes electronically. If it is actually possible to conclude the agreement over the Internet the creditor must clearly, comprehensibly and unambiguously and prior to the order being placed provide the following information: the different technical steps to follow to conclude the contract, whether or not the concluded contract will be filed by the creditor and whether it will be accessible, the technical means for identifying and correcting input errors prior to the placing of the order and the languages offered for the conclusion of the contract[26]. Contract terms and general conditions provided to the recipient must be made available in a way that allows him to store and reproduce them.

The Directive on Electronic Commerce does not determine the sanction in case of non-fulfilment of this obligation. So, common law principles apply, unless national law transposing the Directive contains specific sanctions.

3 Right of withdrawal

In many cases the consumer will have the possibility to withdraw from the credit agreement. Before discussing the rules laid down in the modified proposal for a Directive on Consumer Credit, it is interesting to have a look at the Belgian legislation, more specifically the Belgian Consumer Credit Act and the Belgian Act on Trade Practices.

A. Belgian Consumer Credit Act and Act on Trade Practices

According to the Belgian Consumer Credit Act one has to make a distinction between several situations:

- The consumer has the right to withdraw from the contract within seven working days starting from the first working day following the signing of the agreement when the credit agreement was entered into *in the presence of both parties outside the premises of the creditor* or the person arranging the credit (art. 18 §2);
- When the parties did not conclude the credit agreement outside *the premises of the creditor* or the person arranging the credit, all depends on the *type of the credit agreement*. More specifically, the consumer has the possibility to withdraw from the contract within seven working days starting from the first working day following the signing of the agreement (art. 18 §1):
  – for every credit agreement that can not be qualified as credit sale, finance lease or loan and
  – for every credit sale, finance lease or loan with regard to 1250 euro or more.
- Finally, a specific rule applies for certain distance credit agreements, i.e. credit agreements concluded under an organised distance selling scheme run by the creditor and making exclusive use of one or more means of distance communication up to and including the moment at which the contract was concluded. The specific rule for distance contracts only applies when the agreement names the financed good bought on distance or when the credit amount was wired by the creditor directly to the distance seller (art. 20 bis). In such situation the consumer has the right to withdraw from the contract during the reflection period, applicable to the agreement concluded to buy the good at a distance (in principle seven working days). Before the lapsing of the reflection period the seller may not demand an advance. The advance is

only due within seven working days, starting from the lapsing of the reflection period.

In all these situations the consumer has the right to withdraw from the contract without giving any reason and without penalty. However the consumer withdrawing from the contract must return the amount or the goods received. Also he must pay interest for the period during which he has obtained credit. The interest due must be calculated on the agreed annual percentage rate.

When the credit agreement or the agreement financed by the credit agreement is concluded at distance, one also has to take in to account the Belgian Act on Trade Practices which contains two relevant provisions:

- Article 83 of the Act on Trade Practices, which is applicable to distance contracts concerning financial services (including credit agreements), determines that the consumer has a period of fourteen calendar days to withdraw from the contract without penalty and without giving any reason. The period for withdrawal normally begins from the day of the conclusion of the distance contract. If the contractual terms or the abovementioned information have only been provided after the conclusion of the contract - which is only allowed if the contract has been concluded using a means of distance communication that does not enable providing the contractual terms and conditions on paper or another durable medium - the period of withdrawal shall begin from the day the consumer receives the contractual terms and conditions and the abovementioned information.
- Article 81 §4 of the Act on Trade Practices concerns the situation in which the consumer has concluded a credit agreement in order to finance an underlying distance agreement concerning the sale of a good or

the provision of a service. Article 81 §4 only applies when the credit agreement was concluded with the seller or service provider or with a third person who has concluded a pre-existing agreement with the seller aiming at financing sales of the seller. In such situation the consumer who withdraws from the underlying agreement has the possibility to withdraw from the credit agreement within the reflection period applicable to the underlying agreement.

There are some important differences between the rule incorporated in article 20 bis of the Consumer Credit Act and article 81 §4 of the Act on Trade Practices:

- Contrary to article 20 bis of the Consumer Credit Act, article 81 §4 of the Act on Trade Practices also applies when the *credit* agreement is not concluded at distance;
- Article 20 bis only concerns the sale of goods and cannot be applied in case the underlying agreement concerns the provision of services;
- In order to apply, article 20 bis does not ask of the consumer to withdraw from the underlying, i.e. financed agreement;
- In order to apply article 20 bis, it is not necessary that the credit is supplied by the seller or a third person who has concluded a pre-existing agreement with the seller. It is sufficient that the good sold is mentioned in the agreement or the credit amount is wired directly by the creditor to the seller.

As the period to withdraw from the contract is different on the one hand in article 83 sexies of the Act on Trade Practices (14 calendar days) and on the other hand in article 20 bis of the Consumer Credit Act and article 81 §4 of the Act on Trade Practices (7 working days), the question arises which rule prevails. First, it is clear that article 81 §4 of the

Act on Trade Practices prevails article 83 sexies of the Act on Trade Practices, as article 6.7 of the Directive on the Distance Selling of Financial Services to Consumers states that the right of withdrawal included in this Directive - and transposed in article 83 sexies of the Act on Trade Practices - does not apply to credit agreements cancelled under the conditions of Article 6(4) of the Directive on the Protection of Consumers in respect of Distance Contracts, which has been transposed in Belgian law by article 81 §4 of the Act on Trade Practices.

Some authors believe that the same argument leads to the conclusion that article 20 bis of the Consumer Credit Act prevails article 83 sexies of the Act on Trade Practices. We doubt this as the conditions required to apply article 20 bis are different from those incorporated in Directive 97/7/EC. So, taking in to account the principle of maximum harmonisation on which the Directive on the Distance Selling of Financial Services to Consumers is based, we believe that article 83 sexies prevails.

As already indicated article 83 of the Act on Trade Practices determines – as article 6.1 of the Directive on the Distance Selling of Financial Services to Consumers - that the 14 calendar day period to withdraw from the contract only begins from the day on which the consumer receives the contractual terms and conditions and the information required, if that date is later than the date on which the distance agreement is concluded. Does this imply that the consumer always retains the possibility to withdraw from the contract when the contractual terms and all information required on paper or on a durable medium are not communicated? In the Heininger-case[27] the Court of Justice has decided that in case a Directive allows the reflection period to begin in function of the communication of certain information, the national

legislator cannot determine a maximum reflection period for the situation in which not all information required was communicated. So, it seems that the consumer who did not receive all information in writing or on a durable medium always keeps the possibility to withdraw from the contract[28]. However, if one accepts that the rule established in the Heininger-case applies, the sanction of cancellation doesn't offer much added value in the situation where the consumer has never received all information required on paper or on a durable medium. Therefore, as far as Belgium is concerned, the use of the sanction enabling the consumer to cancel the contract (supra nr. 19) in practice seems limited to the situations where the consumer is not or no longer entitled to withdraw from the contract. In any case, it is unfortunate that the Directive does not explain the relationship between these two sanctions.

B. The modified proposal for a Directive on Consumer Credit

According to article 13 of the modified proposal for a Directive on Consumer Credit consumers are granted a 14-days right to withdraw from the credit agreement without penalty and without giving any reason. This period for withdrawal shall begin:

- either from the day of the conclusion of the credit agreement, or
- from the day on which the consumer receives the contractual terms and conditions and the information to be incorporated in the agreement, if that is later than the date referred to in the first indent.

It is clear that the Belgian legislator will have to adapt its legislation transposing the future Directive on Consumer

Credit, as the duration of the reflection period for consumer credit agreements that are not concluded at distance is limited to seven working days. Moreover, the Belgian legislator does not recognise the possibility to withdraw from all credit agreements, which fall under the scope of application of article 11 of the modified proposal.

If the consumer exercises his right of withdrawal[29] he must, before the expiry of the relevant deadline, notify this to the creditor following the practical instructions given to him in the credit agreement. The deadline is deemed to have been observed if the notification, if it is on paper or on another durable medium available and accessible to the recipient, is dispatched before the deadline expires. So it is not necessary that the creditor actually has received the notification before the lapsing of the reflection period. The Belgian legislator, transposing the future Directive on Consumer Credit will have to incorporate this rule into the Belgian Consumer Credit Act. As for now, the Belgian Consumer Credit Act does not determine explicitly whether it is sufficient that the notification has been dispatched before the reflection period has been expired. In literature divergent opinions exist. Some authors believe that the creditor has to receive the notification before the reflection period has expired[30]. Others argue that it is sufficient to dispatch the notification within the reflection period[31].

Following the exercise of the right of withdrawal the creditor must notify the consumer, in writing or on another durable medium, of the sums of money to be repaid including the interest due during the period for which the credit was used. The interest due must be calculated on the agreed borrowing rate. No other indemnity may be claimed in connection with exercising the right of withdrawal. The consumer must pay to the creditor those sums of money

notified to him. The Belgian Consumer Credit Act already contains a similar provision.

The right of withdrawal incorporated in the modified proposal does not apply to credit agreements concluded through services of an official, provided that the official confirms that the consumer is guaranteed the rights under article 5 (2) and 9 (2), neither to credit agreements cancelled under:

- Article 6 of the Directive on the distance marketing of financial services to consumers;
- Article 6 (4) of the Directive on the Protection of Consumers in respect of Distance Contracts;
- Article 7 of the Directive on the protection of purchasers in respect of certain aspects of contracts relating to the purchase of the right to use immovable properties on a timeshare basis.

So, the rules concerning the right of withdrawal laid down in the modified proposal will not apply to credit agreements which are concluded at a distance. The regime incorporated in the Directive on the Distance Selling of Financial Services, which is similar, applies.

Once transposed into Belgian law, article 83 sexies of the Act on Trade Practices will apply to consumers wishing to withdraw from credit agreements concluded at a distance. The Act on Consumer Credit will no longer be applicable. The Belgian legislator will have to abandon article 20 bis of the Consumer Credit Act. Article 81 §4 of the Act on Trade Practices can be maintained as it transposes article 6 (4) of the Directive on the Protection of Consumers in respect of Distance Contracts.

Finally it is interesting to mention that the proposal contains a specific rule applying to linked credit agreements. A linked credit agreement means a credit agreement where:

- the credit in question serves exclusively to finance an agreement concerning the supply of goods or the provision of a service and
- those two agreements form from an objective point of view a commercial unit; a commercial unit is involved where the supplier or service provider himself finances the credit for the consumer or, if it is financed by a third party, if the creditor uses the services of the supplier or service provider in connection with the conclusion, or preparation, of the credit agreement, or if the credit agreement makes reference to the specific goods or services to be financed with the credit.

More specifically, article 14 determines that, in case the consumer has exercised a right of withdrawal concerning a contract for the supply of goods or services by a trader, he shall no longer be bound by a linked credit agreement[32]. The Belgian Consumer Credit Act does not contain a general provision enabling a consumer to withdraw from a linked credit agreement.

4 Cross-border credit agreements

The use of the Internet and other means of distance communication enables creditors to provide credit agreements to consumers from other states. In such situation the question arises whether the consumer can invoke the protection incorporated in his own legal system.

First, it is important to emphasize that, as far as the pre-contractual information requirements and the right to withdraw from the contract is concerned, the country of origin principle, laid down in the European Directive on Electronic Commerce and applying to information society services, is not applicable. Indeed, the country of

origin principle, implying that a creditor established in a Member State in principle only must obey to the rules incorporated in its own legislation[33], is not applicable to the contractual obligations of consumer contracts. The term "contractual obligations" must be interpreted very broadly and includes information on the essential elements of the content of the contract, including consumer rights, which *have a determining influence on the decision* to contract. One can accept that the pre-contractual information required by the consumer credit legislation is essential and therefore falls within the scope of the contractual obligations[34]. This implies that traditional principles of private international law must be applied. It is interesting to have a closer look at the Belgian legislation.

The Belgian Consumer Credit Act is applicable to:

- credit agreements concluded between a consumer having his habitual residence in Belgium and a creditor established in Belgium and
- credit agreements concluded between a consumer having his habitual residence in Belgium and a creditor established in a foreign country if
  - the creditor or his representative has received the consumer's request in Belgium or
  - the agreement was preceded by advertising or a specific invitation in Belgium

The aim of the latter rule is to protect the so-called passive consumer, i.e. the consumer who hasn't taken the initiative to contact a creditor, established in another country. When credit agreements are offered over the Internet it is not always easy to determine when the conclusion of the contract was preceded by a specific invitation or advertising in the consumer's country. We believe that this is the case when the consumer received an unsolicited e-mail from the creditor, inviting him to

conclude a contract[35], also when the creditor employed the services of a marketing firm in order to display a banner, referring to the creditor's website, whenever a certain word is typed in on the website of a search engine[36]. Finally, we believe that it is possible to apply the Belgian Consumer Credit Act when a hyperlink to the website of the foreign creditor is displayed on the website of a seller or service provider, established in the consumer's country. In all other cases – it concerns more specifically the situation in which the consumer has surfed directly to the website of the foreign creditor or the situation in which the consumer has typed in the name of the foreign creditor on the website of a search engine – it seems not possible to apply the Belgian Consumer Credit Act[37].

Article 21 of the modified proposal for a Directive on Consumer Credit determines that Member States cannot maintain or introduce provisions other than those laid down in the Directive. So, the Directive is based on the principle of maximum harmonisation. If this principle is maintained questions of private international law will no longer arise within the European Union for the subjects that are harmonised by the Directive.

Conclusion

In Belgium, legal statutes make it possible for creditors and consumers to enter into consumer credit agreements electronically, as formal requirements concerning the conclusion of credit agreements are deemed to be fulfilled whenever the functional quality of such requirement is met. However, in practice it remains impossible to conclude consumer credit agreements completely electronically, due to the fact that most consumers do not possess the

technology required to produce an electronic signature which meets the requirements set by law. The modified proposal for a Directive on Consumer Credit also recognises the possibility to conclude consumer credit agreements electronically, as credit agreements can be drawn up on a durable medium. However, as long as consumers do not possess advanced electronic signatures, based on qualified certificates, creditors will probably remain reluctant to conclude credit agreements online, taking into account rules relating to the proof of electronic contracts and money laundering legislation.

Although it is impossible to conclude credit agreements completely electronically, Belgian consumers have the possibility to enter in to credit agreements without having to meet the creditor or its representative. In case of the distance selling of credit agreements, creditors must not only meet the information requirements laid down in the Belgian Consumer Credit Act, but also the additional requirements, imposed by the Act on Trade Practices, transposing the Directive on the Distance Selling of Financial Services to Consumers. So, lots of information must be provided. In fact the amount of information to be provided in writing or on a durable medium is too high. Consumers will not read all the information including essential information.

Finally, consumers concluding a consumer credit agreement often have the possibility to withdraw from the contract. According to Belgian law, one must distinguish between several situations. If the regime proposed by the modified proposal for a Directive on Consumer Credit is to be accepted, the Belgian legislator will have to adapt its legislation, making a distinction between distance credit agreements, falling under the scope of application of the Directive on the Distance Selling of Financial Services to Consumers, credit agreements falling under the scope of

article 6(4) of the Directive on the Protection of Consumers in respect of Distance Contracts and other credit agreements. The first will fall under the scope of article 83 sexies of the Act on Trade Practices, the second under article 81 §4 of the Act on Trade Practices and the latter on the future revised Consumer Credit Act.

Notes

1,2 Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market, *OJ L* 178, 17 July 2000, 1.

3 Directive 2002/65/EC of the European Parliament and of the Council **of** 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC, *OJ L* 271 of 9 October 2002, 16.

4 Directive 97/7/EC of the European Parliament and the Council of 20 May 1997 on the protection of consumers in respect of distance contracts, *OJ L* 144 of 4 June 1997, 19.

5 Modified proposal for a Directive of the European Parliament and of the Council on credit agreements for consumers amending Council Directive 93/13/EC, COM(2005) 483 final. No other (more recent) version of the proposal has been made public at 25 July 2007, the date on which this article was sent in for publication.

6 See: O. Hance en S. Dionne Balz, *The new virtual money: law and practice*, Kluwer International, 1999, 85; A. Murray, "Entering into contracts electronically: the Real W.W.W.", in *Law & Internet. A framework for electronic commerce*, Oxford, Hart, 2000, 19; Simmons & Simmons, *E-Commerce Law. Doing Business Online*, Bembridge, 2001, 26.

7 For example, according to the Council Directive 87/102/EEC of 22 December 1986 for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit the credit agreement must be made in writing (art. 4).

8 These are interpreted very strictly by the courts. See for example: Vred. St.-Niklaas 28 maart 2001, *D.C.C.R.* 2001, 170; Vred. St.-Niklaas 4 december 2001, *R.W.* 1999-2000, 373. Zie ook: F. de Patoul, "La loi sur le crédit à la consommation et le traitement du surendettement. Tendances et perspectives dégagées par la jurisprudence", *T. Vred.* 2002, 40.

9 See: T. Verbiest, *Commerce électronique: le nouveau cadre juridique*, Brussel, Larcier, 2004, 112-113.

10 An advanced electronic signature means an electronic signature which meets the following requirements: (a) it is uniquely linked to the signatory; (b) it is capable of identifying the signatory; (c) it is created using means that the signatory can maintain under his sole control and (d) it is linked to

the data to which it relates in such a manner that any subsequent change of the data is detectable.

11 See for example : E. MONTERO, "Définitions et effets juridiques de la signature électronique en droit belge : appréciation critique", *DAOR* 2002, 13-27; P. LECOCQ and B. VANBRABANT, "La preuve du contrat conclu par voie électronique", *Actualités du droit* 2002, 295-316. As for now, only the Public Key Technology (asymmetric encryption) allows to create advanced electronic signatures. About PKI see for example : S. BAKER en P. HURST, *The limits of Trust. Cryptography, Governments and Electronic Commerce*, Den Haag-Londen-Boston, Kluwer Law International, 1998, 1-5.

12 See also: C. BIQUET-MATHIEU, "Aperċu de la loi relative au credit à la consummation après le réforme du 24 mars 2003", in *Chronique à l'usage des Juges de Paix et de Police*, 2004, Cahier 42, nr. 101; J. DUMORTIER en H. DEKEYSER, "Ruimen van juridische obstakels bij contracten langs elektronische weg", in *Elektronische handel. Commentaar bij de wetten van 11 maart 2003*, Brugge, Die Keure, 2003, 181.

13 P. LECOCQ and B. VANBRABANT, *o.c.*, 291.

14 Directive 1999/93/EC of the European Parliament and of the Council of 13 December 1999 on a Community framework for electronic signatures**,** *OJ L* **13,** 19 January 2000, 12.

15 M. ANTOINE and D. GOBERT, "La directive européenne sur la signature électronique. Vers la sécurisation des transactions sur l'internet", *J.T. dr. eur.* 2000, 74-75.

16 However, if the agreement is concluded with an existing client, it is possible that a master agreement which has been concluded previously between the client and the financial institution, determines that the proof of electronic contracts can be delivered by other means.

17 Arrêté royal portant approbation du règlement de la Commission bancaire, financière et des Assurances relatif à la prévention du blanchiment des capitaux et du financement du terrorisme, *Moniteur* 22 November 2004.

18 Today, not all Belgian residents possess an electronic identity card.

19 When the certification authority is not established in a Member State of the European Economic Region or is not accredited according to the Directive on Electronic Signatures, it is necessary that the financial institution accepting the certificate previously has decided to accept certificates issued by this certification authority. This decision must be preceded by a thorough research of the reputation and certification procedures used by the certification authority.

20 The identification on the basis of a copy of the identity card must be followed by a face to face identification or identification on the basis of an electronic identity card or a qualified certificate when the nature of the risk demands for such identification. Thus, in certain cases the identification on the basis of the copy of the identity card is provisional.

21 Article 17 of the Belgian Consumer Credit Act also determines that the creditor must identify the consumer on the basis of his identity card, but it can be argued that identification also can take place by the other means indicated by the Belgian Banking, Finance and Insurance Commission.

22 See consideration nr. 20 of the Directive on the distance selling of financial services to consumers, that determines: "Durable mediums include in

particular floppy discs, CDROM's, DVD's and the hard drive of the consumer's computer on which the electronic mail is stored, but they do not include Internet websites unless they fulfil the criteria contained in the definition of a durable medium".

23 The duty to provide information can also be discharged by supplying a draft agreement (in writing or on a durable medium) including the information that must be incorporated in the credit agreement.

24 M. Tison, "Virtuele financiële dienstverlening (e-banking en e-trading): een transactionale benadering", *Privaatrecht in de reële en virtuele wereld*, Kluwer, 2002, 305.

25 See also: Simmons & Simmons, *o.c.*, 19.

26 See: C. Biquet-Mathieu and J. Decharneux, "Contrats par voie électronique et protection des consommateurs", in *Contrats à distance et protection des consommateurs,* Luik, 2003, 17-18.

27 These rules do not apply to contracts concluded exclusively by exchange of electronic mail or by equivalent individual communications.

28 C.J. 13 december 2001, *Heininger*, C-481/99, *Jur*,2001, I-9945.

29 L.Bernardeau, "Le droit de rétractation du consommateur: un pas de plus vers une doctrine d'ensemble", *JCP* 2002, n° 40, 1723.

30 Before the consumer exercises his right of withdrawal, he may inform the creditor of his intention to withdraw from the credit agreement. This information must be given within a period of seven calendar days after the beginning of the period of withdrawal.

31 P. Lettany, *Het consumentenkrediet. De wet van 12 juni 1991*, Deurne, Kluwer, 1993, 107.

32 J. Van Den Bergh en A. Decaluwe, *Afbetalingsovereenkomsten*, in *A.P.R.*, Gent, Story-Scientia, 1975, 392.

33 See P. Rott, "Linked Credit Agreements in EC Consumer Credit Law", http://www.mcmp.gov.mt/pdfs/consumers/Mar05Seminar/ProfDrPeterRott.pdf.

34 Simmons & Simmons, *o.c.*, 64.

35 B.J. Drijber, "De Richtlijn elektronische handel op de snijtafel", *S.E.W.* 2001, 134.

36 R. Shu, "The applicable law to consumer contracts made over the internet: Consumer protection through private international law", *Int. Journ. Law Inf. Tech.*, Vol. 5, 210-211.

37 Zie ook: L. Rolin Jacquemins en T. Verbiest, "L'offre de services et produits financiers sur internet", *R.D.A.I.* 2000, 5; F. Sweerts, "Internet - Les sites bancaires veulent s'ouvrir au consommateur européen", *Bank Fin.* 2000, 262 ; T. Verbiest, *o.c.*, 179-181.

38 Support for this view can be found in a Notice of the European Commission, containing guidelines on vertical restraints, in which the Commission explains under which circumstances a supplier acts actively in the virtual world. Although the difference between active and passive is defined from the supplier's point of view and is explained in the context of a block exemption, it gives a certain insight in the way one must distinct between active and passive consumers: Commission Notice, *Guidelines on Vertical Restraints*, 11-12.

EUGENE BUTTIGIEG

CONSUMER PROTECTION AGAINST UNFAIR COMMERCIAL PRACTICES IN MALTA:
The Impact of the Unfair Commercial Practices Directive

1. Introduction

Under Maltese law there is no single piece of legislation that regulates all forms of unfair commercial practices and that prohibits unfairness through a general clause. However, various specific laws are found that directly or indirectly protect consumers, competitors and the public at large against various forms of unfair commercial practices, though by no means does this legislation target all possible unfair commercial practices. Although these laws built up layers of protection throughout the years, since the laws were enacted at different periods of the Maltese legislative history, with different objectives that usually addressed competitors' rather than consumers' concerns, from a consumer protection perspective they fail to provide a coherent and comprehensive shield against unfair practices that harm consumer interests.

This paper will first examine the main existing legislation and draw out some lacunae from a consumer protection perspective in terms of substantive rights and enforcement. Then, in the second part, it will analyse the impact that the Unfair Commercial Practices Directive,[1] that must be

transposed by June 2007 and applied by December of that year, is likely to have on Maltese legislation, the extent to which the present shortcomings and deficiencies in the law and its enforcement might be adequately addressed with transposition and the difficulties that certain provisions of the Directive might present to the Maltese legislator and courts. The paper will conclude that generally the Directive will represent significant improvement in consumer protection in Malta.

2. Legislation governing Unfair Commercial Practices in Malta[2]

Consumer protection in Malta is largely guaranteed through the fairly recent Consumer Affairs Act[3] and the secondary legislation issued under it. Enacted in 1994, it was amended in 2000[4] mainly in order to transpose the different Community consumer law directives that Malta was committed to implement in its bid to join the European Union. Moreover, the Door-to-Door Salesmen Act of 1987[5] regulating doorstep contracts, which pre-dated the Consumer Affairs Act, was also amended by the same Act of 2000 in order to be more fully aligned to the Doorstep Selling Directive[6] and was renamed the Doorstep Contracts Act.[7] In subsequent years, these amendments were supplemented by various regulations that were adopted under the Consumer Affairs Act concerning distance selling, price indication and consumer credit,[8] transposing the relative directives.[9] Consequently, this body of law incorporates faithfully the provisions of most of the directives that regulate unfair commercial practices though some give greater protection when the directives are of a minimum harmonisation type. To this must

be added the protection afforded to consumers against unfair commercial practices by legislation that though not enacted under the umbrella of the Consumer Affairs Act and that may not even be driven by purely consumer related considerations indirectly shields consumers against such practices.

2.1. Misleading and Comparative Advertising and Other Forms of Unfair Advertising

The Consumer Affairs Act,[10] in Part VI under the heading of 'unfair practices', prohibits *inter alia* all forms of misleading advertising and regulates the content of comparative advertising. It does not contain any provisions dealing with other forms of unfair advertising. There is sectoral legislation such as the Broadcasting Act[11] that deals with several other forms of unfair advertising in particular sectors but there are no broad horizontal provisions that protect consumers against all forms of unfairness in advertising. This remains a lacuna in Maltese law.

Articles 48-50 faithfully implement the Misleading Advertising Directive[12] and the Comparative Advertising Directive,[13] and so likewise, though these provisions are to be found in a consumer protection statute, they grant protection not only to consumers against deception but also to competitors against injury. The Department of Consumer Affairs, a public office set up by the Consumer Affairs Act, through its Director, is empowered to issue a compliance order in the public interest, of its own initiative or on a written application by a registered consumer association, requiring any person to discontinue or refrain from illegal advertising.[14] He may even order the trader to publish the compliance order or a corrective statement in order to eliminate or reduce the continuing effects of any infringement of these provisions.[15]

The issue of a compliance order is totally within the discretion of the Director and a registered consumer association may only request such an order. However, the association has standing before a court to seek an order for the issue of a compliance order should the Director decide not to issue a compliance order following the request of the association. For the issue of a compliance order, there need not be proof of either actual loss or damage or of actual recklessness, negligence or fault on the part of the trader.

The Director is also obliged to seek voluntary compliance, whenever it is possible and reasonable to do so, before proceeding to the issue of a compliance order. Thus, although few have been the instances when a compliance order has been issued, this may be due to the Director having often resorted successfully to voluntary compliance under the threat of compliance orders.[16] Compliance orders against trade associations or groups of traders are not envisaged in the legislation as it empowers the issue of orders only against individual traders.

The Act also empowers the Director of Consumer Affairs to issue public statements identifying and giving warnings or information about any trading practices detrimental to the interests of consumers and about the persons who engage in such practices.[17]

The law does not establish any contractual consequences resulting from such illegal advertising. The aggrieved consumer would have to resort to the general provisions of contract or tort law, as shown below. Indeed there are no private law sanctions. However, there is a criminal sanction in addition to the possibility of a compliance order as any person engaging in misleading advertising or in comparative advertising that is not compliant with the provisions of this Act would be guilty of an offence punishable with a criminal fine. Moreover, under the

Criminal Code[18] the use of misleading advertising and false trade descriptions or false weights and measures are criminal offences leading to custodial sentences.

The Consumer Affairs Act (Price Indication) Regulations[19] adopted under the Consumer Affairs Act deal with a particular type of advertising – that of price indication. These regulations, that implement the Product Price Indication Directive,[20] ensure that consumers receive correct and adequate information in the price of the goods and once again there is a criminal sanction attached to the failure to comply with these information requirements apart from the Director's right to issue a compliance order. These regulations are complemented by other regulations relating to price indication in respect of specific services such as the Theatres (Prices of Admission) Regulations[21] that require proper display of seating accommodation and admission prices and prohibit charging above the displayed price.

The Consumer Credit Regulations, 2005,[22] also issued under the Consumer Affairs Act with a view to transposing the Consumer Credit Directive as subsequently amended,[23] likewise impose information requirements on creditors in the consumer credit agreements including home loan agreements and in related advertisements and offers, for the benefit of consumers. Supervision and enforcement through compliance orders is in the hands of the Director of Consumer Affairs and non-compliance with these requirements amounts to a criminal offence.

This protection against misleading advertising and improper comparative advertising is supplemented by other non-consumer related legislation. Thus, the Commercial Code,[24] dating back to 1927, prohibits various forms of unfair competition between traders such as the use of names, marks or distinctive devices that might create confusion with the names, marks and devices used by

others in the market; or the use of firm names or fictitious names to mislead others as to the real importance of the firm; or the use of false indications of origin of goods; or the spreading of news that is prejudicial to other traders; or the subornation of other traders' employees. But clearly the rationale is to protect competitors and the functioning of the market and so only indirectly may the consumer be a beneficiary. Indeed, although such practices carry a private law sanction, this is available only to traders. Thus, under this Code it is only the injured trader that may resort either to an action for damages and interest or request the court to impose a penalty on the offending trader that would be paid to the injured trader in settlement of his claims for damages and interest (up to a maximum limit set by law). Moreover, the injured trader may also seek a court injunction to restrain such practices and order the destruction of the infringing material.[25] The consumer stands to gain indirectly because all these remedies either deter or stop deceptive advertising.

Another law that also indirectly affords protection to the consumer is the Trademarks Act.[26] Various provisions complement the aforementioned provisions of the Commercial Code by prohibiting the registration or use of trademarks that being identical or similar to earlier trademarks would enable the holder to take unfair advantage of or to damage the distinctive character or the reputation of the earlier trademark.[27] Not only would use of such trademarks in such circumstances amount to a criminal offence but infringement of a registered trademark entitles the proprietor of the trademark to seek relief before the court for breach of a property right and to claim damages.[28]

Yet another law that, though having a wider scope, benefits consumers and is now administered by the

Director of Consumer Affairs, is the Trade Descriptions Act.[29] This Act like the Criminal Code makes the application of false trade descriptions and the provision of false or misleading price indications and the making of false or misleading representations and statements a criminal offence punishable even by a custodial sentence. Moreover, the importation of goods carrying such indications or representations when they include a false indication of origin is prohibited. The Act also empowers the Minister responsible for Consumer Affairs to impose requirements relating to the information that should appear on or accompany goods and in advertisements and to the markings that should feature on goods being offered for sale for the better information of consumers.

Various sectoral legislation regulate in a more detailed manner advertising and labelling in the sector concerned. For instance, in the broadcasting sector the wide-ranging Broadcasting Act,[30] by implementing the TV Without Frontiers Directive,[31] contains various provisions prohibiting numerous forms of unfair advertising on broadcasting services such as surreptitious advertising or use of subliminal techniques in advertising. It carries a detailed code for advertisements, teleshopping and sponsorships recently revised by the Broadcasting Act (Substitution of Third Schedule) (Code for Advertisements, Teleshopping and Sponsorships) Regulations, 2001.[32] Moreover, the Broadcasting Authority has also published a Broadcasting Code for the Protection of Minors, 2000,[33] that protects minors against advertising that may cause moral or physical detriment to them and against misleading advertising specifically targeting minors and advertising that exploits minors in any way. Thus, it requires that all references to 'free gifts' for minors in advertisements should include all qualifying conditions, such as any

time limits and how many products must be purchased, and any other relevant information. Observance of these obligations is secured by the Broadcasting Authority that is empowered to give directions imposing prohibitions on persons providing broadcasting services and may impose administrative fines for non-observance.

Likewise, consumers are protected against misleading, false or incomplete information in the package travel industry through the Package Travel, Package Holidays and Package Tours Regulations 2000[34] issued under the Malta Travel and Tourism Services Act[35] that implement the Package Travel Directive.[36] These regulations impose information requirements and ensure against false or misleading information, regulate the content of the contract, protect customers against price and programme changes after conclusion of the contract and provide adequate remedies in such an eventuality. Non-compliance is a criminal offence and the Malta Tourism Authority is empowered to suspend the licence of travel agents in cases of repeated contraventions. Moreover, an organiser or retailer who supplies a customer with false or misleading information would be liable to compensate the customer for any loss that the customer suffers as a result.

Again, in relation to foodstuffs, the Food Safety Act[37] and the Labelling, Presentation and Advertising of Foodstuffs Regulations, 2004,[38] issued under the Act, prohibit misleading claims on labels attached to foodstuffs, advertising and other forms of presentation regarding the characteristics of the foodstuff or attributing to it effects and properties that it does not possess, while the Nutrition Labelling of Foodstuffs Regulations[39] contain detailed information requirements. Non-compliance is a criminal offence.

2.2. Gift Schemes, Pyramid Schemes and Similar Practices

The Consumer Affairs Act under the heading of 'unfair practices' also makes the promotional offer of gifts, prizes and other free items a criminal offence in circumstances where the trader fails to provide them or fails to disclose all the terms and conditions for obtaining them or fails to give a clear and full description of the gifts, prizes or items being offered.[40] Likewise, it prohibits all forms of pyramid selling schemes and makes the operation or promotion of such schemes a criminal offence.[41] Moreover, participants in the scheme are entitled to demand a full refund of the monies paid by them into the scheme. The scope of the prohibition of selling schemes is very wide, covering all forms of pyramid selling schemes, however described, and includes schemes or activities in which a significant or material element consists of a pyramid selling activity.

Another unfair commercial practice that is considered a criminal offence by the Consumer Affairs Act is the making of misleading representations about the profitability or degree of risk involved in work from home schemes and similar schemes or activities.[42]

Such schemes are also prohibited by the Trading Stamps Schemes (Restriction) Act[43] that attaches a criminal sanction to the promotion (through advertising or otherwise) or operation of a trading stamp scheme as well as the assistance in or participation in any such scheme.[44] This law, though, appears to have been hardly ever enforced.

2.3. Doorstep Selling

Doorstep selling is regulated by the Doorstep Contracts Act by providing for a cooling off period and the related right of cancellation.[45] Following the 2000 amendments, the Act not only fully implements the Doorstep Selling

Directive[46] but in several respects goes much beyond the provisions of the Directive, in particular by extending its provisions to all sales outside the trader's business premises and by providing for a fifteen-day instead of the minimum seven-day cooling off period. This law even makes it a criminal offence for a door-to-door salesman to refuse to leave the home or place of work of the consumer when requested to do so.[47] This is a rare instance where Maltese law specifically addresses aggressive selling techniques, something that is then conspicuously absent in the timeshare legislation. The Act gives greater consumer protection than the directive also because it provides that a consumer may not be required to pay for the goods prior to their delivery except for a 10% deposit payable only after the expiry of the cooling off period.[48] Moreover, it also regulates the content itself of the doorstep contract by imposing information requirements and prohibiting certain clauses.[49] The sanction for a breach of the provisions of this Act (or indeed of any of the provisions of the Consumer Affairs Act or any regulations made under it) is that in respect of the person infringing the provisions the Director of Consumer Affairs may withdraw or suspend or refuse to renew the licence to act as a door-to-door seller.

2.4. Timeshare Selling

Timeshare selling is regulated by the Protection of Buyers in Contracts for Time Sharing of Immovable Property Regulations 2000,[50] issued under the Malta Travel and Tourism Services Act.[51] These regulations implement the Timeshare Directive[52] by imposing information and transparency requirements and repair and maintenance obligations on the seller, providing for a ten day cooling off period, regulating the content of the timeshare contract and prohibiting advance payment before expiry of the

cooling off period. Failure to comply with these regulations constitutes a criminal offence. Moreover, the Director of the Enforcement Directorate of the Malta Tourism Authority is entrusted with the monitoring of practices covered by these regulations and is empowered to stop any practices that are done in contravention of the obligations imposed by these regulations. However, as stated above, there is a lacuna in the protection of consumers in these regulations as they do not regulate the conduct of timeshare sellers nor protect consumers against aggressive selling techniques. Nevertheless, the latter might constitute a contravention under the Criminal Code[53] and moreover, the Civil Code makes any contract where the consent of one of the parties has been given by error, or extorted by violence or procured by fraud null and void.[54]

2.5. Distance Selling

Distance selling other than distance selling of financial services is regulated by the Distance Selling Regulations,[55] adopted under the Consumer Affairs Act.[56] These regulations implement the Distance Selling Directive[57] by imposing information and transparency requirements and providing for a fifteen day cooling off period. They also regulate inertia selling and unsolicited communication, two types of aggressive selling techniques, and lay down obligations concerning delivery and performance of distance contracts and protect consumers against fraudulent use of credit cards through provisions that follow very closely the provisions of the Directive. A criminal sanction is attached to the failure to comply with these requirements and obligations, apart from the Director of Consumer Affairs' right to issue a compliance order. Moreover, the aggrieved consumer may also request the court, finding the trader guilty of an offence, to make a compensation

order condemning the trader to pay the consumer in full or partial compensation for the damages suffered by the consumer as a result of the offence.[58]

On the other hand, other regulations govern the distance selling of financial services. The Distance Selling (Retail Financial Services) Regulations 2005,[59] issued under the Malta Financial Services Authority Act,[60] establish a cooling-off period and consumer rights against unsolicited services and communications and impose information requirements in respect of the distance selling of financial services in line with the Distance Marketing of Consumer Financial Services Directive.[61]

Here the Authority responsible for the protection of the consumer is the Malta Financial Services Authority set up by the Malta Financial Services Authority Act.[62] Indeed, under this Act this Authority has a general duty to guard consumers against unfair commercial practices in the financial services sector as it has the function to 'investigate allegations of practices and activities detrimental to consumers of financial services, and generally to keep under review trading practices relating to the provision of financial services and to identify, and take measures to suppress and prevent, any practices which may be unfair, harmful or otherwise detrimental to consumers of financial services'.[63] The complaint would be initially handled by the Consumer Complaints Manager whose role is specifically that of looking after the interests of private investors and in serious cases he may refer the case to the Supervisory Council of the Authority. The Authority is empowered to issue specific directives to the holder of the licence to do or refrain from doing any act and in case of non-compliance it may impose an administrative penalty.

In respect of distance selling of financial services, the Authority, apart from the power to impose administrative

penalties, also has the power to issue compliance orders, of its own initiative or on the request of a local registered consumer association or any qualified association or organisation or public body from another EU Member State or EEA State, after first seeking voluntary compliance.[64] In this compliance order the Authority may order the deletion or alteration of certain clauses in the distance consumer contract considered as unfair to consumers or the incorporation of certain terms for the better information or protection of consumers or the taking of certain measures or the cessation or desistance from the commission of a breach of the regulations. Although the issue of a compliance order is at the discretion of the Authority, a registered consumer association, as other qualified entities, has standing before the Financial Services Tribunal to seek the issue of an order requiring the Authority to issue a compliance order in instances where it refuses to do so. For the issue of a compliance order, there need not be proof of either actual loss or damage or of actual recklessness, negligence or fault on the part of the supplier.[65]

2.6. Remedies under Tort and Contract Law

A damages claim for any unfair commercial practice may be filed by any person, be he another trader or a consumer, if it can be shown, under the general provisions on tort of the Civil Code,[66] that there was fault on the part of the trader and damages were suffered as a result of such practices. Under these provisions, a person is deemed to be in fault if in his acts he does not use the prudence, diligence or attention of a bonus paterfamilias. Moreover, any person who, with or without intent to injure, voluntarily or through negligence, imprudence or want of attention, is guilty of any act or omission constituting a breach of the duty imposed by law is liable for any resulting damage. Although the

Commercial Code,[67] as stated above, specifically states that this right to a remedy under tort law is available to the injured trader in instances concerning unfair competition, there is no reason to doubt that the same remedy does not also exist in all other instances of unfairness to any aggrieved person if the criteria under the tort law provisions of the Civil Code are satisfied.

Likewise, the contract law provisions of the Civil Code[68] provide that the seller is bound to warrant the thing sold against any latent defects which render it unfit for the use for which it is intended or which diminish its value to such an extent that the buyer would not have bought it or would have tendered a smaller price, if he had been aware of them. If the defects of the thing sold were known to the seller, he is not only bound to repay the price received by him but he is also liable in damages towards the buyer. If the defective thing perishes in consequence of its defects, the loss is borne by the seller who still has to repay and indemnify the buyer. These provisions are applicable to any purchaser, irrespective of whether or not he is a 'consumer', as the Civil Code does not distinguish between household purchasers and other purchasers.

A civil claim may be brought by the consumer against a trader either before the ordinary civil courts or in the case of small claims (not exceeding Lm 1500 equivalent to 3400 Euro) before a Small Claims Tribunal[69] or a Consumer Claims Tribunal[70] with a right of appeal to the Court of Appeal. A Consumer Claims Tribunal may also award a very limited amount of moral damages to the aggrieved consumer.

2.7. Conclusion

Thus, in the absence of a general horizontal legislative instrument regulating unfairness in commercial practices,

consumer protection against unfair commercial practices in Malta is currently afforded through a range of specific laws with different scopes and objectives. The result is that while certain forms of unfairness such as aggressive selling and suggestive advertising are largely unregulated, other forms of unfairness are regulated concurrently in different ways by various laws.[71] The main sanction is a criminal one, accompanied by the power of different administrative bodies, depending on the sector concerned, to issue compliance orders to stop or prevent such practices and in some instances even to impose administrative fines. Thus, apart from the criminal courts, various administrative authorities are involved in the interpretation, application and enforcement of these provisions. The possibility for compensation awards and orders for repayment of sums paid by the Small Claims Tribunals or Consumer Affairs Tribunals or Courts exists only through the general civil law provisions while traders may seek prohibitory injunctions under the general civil law procedure in order to restrain unfair competition. So there is a combination of public and private enforcement.

3. Impact of the Unfair Commercial Practices Directive

Although the Unfair Commercial Practices Directive[72] was adopted in 2005 and currently the Maltese authorities, as those in the other Member States, have been considering the implications and the best approach to implementation and participating in the discussions within the working group of national experts regularly meeting in Brussels, there has neither been any public consultation and debate on the directive in Malta nor any official announcement on the measures that the government intends to adopt in

order to implement the directive or on the issues on which it will seek public consultation, if at all, in the coming months. Nor has the local consumer association or the business community of its own initiative publicly voiced any opinions or concerns. It seems as if the debate will be ignited only when the government eventually publishes the proposed legislation that will transpose this directive, presumably towards the end of the year.

This part of the paper will attempt to identify the possible difficulties that the Maltese authorities might encounter in implementing the directive by looking at the main elements of this directive and will highlight the impact that these might have in the light of the current legislation discussed above and any relevant jurisprudence.

It seems that the legislator has two options for implementing this directive. It could either enact a new piece of legislation that would regulate horizontally all unfair commercial practices in business-to-consumer transactions in full harmonisation with the directive and retain the existing legislation only where relevant after making any necessary amendments or it could try to transpose the directive by amending the existing legislation without enacting any new law.

In the past, the latter option seemed to be the legislator's preferred option as one directive after another was transposed simply by amending and adding new provisions to the Consumer Affairs Act. This technique, however, has resulted in a cumbersome piece of legislation that lumps together provisions with a purely consumer protection rationale with provisions whose scope of protection is wider as they extend their protection to competitors and the public in general in respect of business-to-business transactions as well. Thus, in the same Act one finds provisions protecting consumers, in the narrow sense of the

word,[73] against unfair contract terms in consumer contracts and at the same time provisions protecting the public at large and competitors against misleading advertising or providing compensation for defective products, be they consumer or industrial products, under product liability rules for anyone who may be aggrieved – and all this in an Act of Parliament entitled 'Consumer Affairs Act'. This may have led to the misconception that these provisions on misleading and comparative advertising or on product liability may only be resorted to by 'consumers' in relation to business-to-consumer transactions.

Therefore, it is submitted that the best option would be the first one – the enactment of an ad hoc law that regulates all unfair business-to-consumer commercial practices transposing all the provisions of the directive. This would also entail a major overhaul of the Consumer Affairs Act. Ideally, the only provisions that would be retained in the Consumer Affairs Act would be those establishing the office of the Director of Consumer Affairs, the Consumer Affairs Council and the Consumer Claims Tribunals and regulating their functions and powers and enforcement procedures.

The provisions dealing with misleading and comparative advertising and various selling schemes that are currently applicable to both business-to-consumer as well as business-to-business transactions would be incorporated in new legislation dealing with business-to-business practices that would replace the Trade Descriptions Act and the unfair competition provisions of the Commercial Code while in relation to business-to-consumer transactions they would be subsumed under the new consumer statute on unfair commercial practices. The provisions on product liability would also be incorporated in a separate ad hoc law regulating product liability to clarify its wider scope

and although the provisions on unfair contract terms in consumer contracts and on sale of consumer goods are clearly limited to consumer transactions, for the sake of legislative tidiness these may also be put in separate ad hoc laws.

Concurrently, the provisions on price indication and distance, doorstep and timeshare selling could be incorporated in the new consumer statute on unfair commercial practices. However, where such provisions give greater protection to consumers than the respective directives as in the case of the Doorstep Contracts Act which imposes additional information requirements, such provisions may be retained for the duration of the transitional period allowed by the Unfair Commercial Practices Directive, provided the European Commission is notified about them.[74]

The other sectoral laws applicable to both business-to-consumer and business-to-business (or at least to 'consumer' in the wider sense) transactions would have to be reviewed to ensure compliance with the Directive. This would be an opportunity to rationalise local consumer laws and repeal long-standing legislation that has fallen into disuse such as the Trading Stamps Schemes (Restriction) Act.

3.1 More Protection for Consumers

Transposition of this Directive will bring more protection for consumers in Malta as the blanket prohibition on unfairness in Article 5 and the wide definition given to misleading actions and omissions and aggressive commercial practices in Articles 6 to 9 and Annex 1 will mean that a much wider range of business-to-consumer commercial practices will be caught so that it will fill in the gaps left by the present fragmented set of specific laws while the level of detail required in the information requirements will be greater.

While under the Civil Code, contracts would be unenforceable if the consent of any party is extorted by violence or fraud, under the Directive not only is the notion of 'aggressive commercial practices' wider as it incorporates also use of 'harassment', 'coercion' (that is not restricted to use of physical force) and 'undue influence' but it also requires the Member States to provide for injunction orders or compliance orders by courts or administrative authorities to stop or prevent such aggressive practices. Thus, transposition will bring greater protection for consumers against aggressive commercial practices, though the aforementioned provision in the Civil Code will not itself require amendment as Article 3(2) stipulates that 'the directive is without prejudice to contract law and, in particular, to the rules on the validity, formation or effect of a contract'.

However, the concept of 'invitation to purchase' attached to the information requirements in the Directive, that is quite novel to the Maltese legal system, is apt to raise interpretation difficulties for administrative authorities and courts. If a wide interpretation is given to the concept, it is feared that the additional information requirements might impose a disproportionate burden on industry and present practical difficulties for modern forms of advertising such as advertising via billboards or short text messages on mobile phones. The correct interpretation of this concept is currently a matter of debate among commentators and national experts involved in the drafting of the national implementing legislation.

So while this higher protection to consumers is welcomed, it is likely to raise business concerns that the new information requirements might create crippling financial and practical burdens on local traders, particularly the small and family run businesses that constitute a good part of the local business community.

3.2 General Clause of Unfairness and General Notions

One particular feature of this directive is the use of such general notions as 'the general principle of good faith', 'honest market practice' and 'requirements of professional diligence' in the determination of what amounts to an 'unfair commercial practice'. As stated above, there is no general provision in Maltese law prohibiting unfair commercial practices. Though the Consumer Affairs Act proclaims the right of protection against unlawful or unfair trading practices as one of the basic consumer rights that it sets out in a 'Declaration of Principles', this part of the law is not directly enforceable in any court or tribunal.[75] So neither the courts and tribunals nor the administrative authorities have experience in interpreting and applying a general prohibition of unfairness.

Nevertheless, courts and, to a much lesser degree, administrative agencies have experience in applying general clauses of 'fairness' and 'good faith' in relation to contracts. Thus, the Consumer Affairs Act prohibits unfair terms in consumer contracts and declares them null and unenforceable against the consumer, be they individually negotiated or not.[76] According to the criteria set in this law, what amounts to an unfair term may also depend on whether the requirements of 'good faith' have been observed.[77] However, the law does not provide any definition or guidance on the good faith requirement. The Director of Consumer Affairs is empowered to examine consumer contract terms for fairness and to issue compliance orders requiring any person to delete or alter a term in a consumer contract that he deems to be unfair to consumers and/or requiring the trader to incorporate in a consumer contract such terms as he considers necessary for the better information of consumers or for preventing a significant imbalance between the rights and obligations

of the parties in order to benefit consumers. Civil courts, on the other hand, may be faced with individual lawsuits where a consumer might claim that a particular term is unenforceable because of its unfair nature. Thus both the administrative agencies and the courts are required to interpret 'fairness' and 'good faith' in the application of these provisions.

Likewise, under the regulations on distance selling described above and in line with the relative directives, the information that the supplier must provide must be provided 'with due regard to the principles of good faith in commercial transactions'. These regulations are enforced by the Director of Consumer Affairs and the Malta Financial Services Authority.

Thus, the public enforcement of these consumer statutes has for the first time made local administrative bodies, such as the Director of Consumer Affairs and the Malta Financial Services Authority, familiar with the application of such general notions as 'fairness' and 'good faith'. However, since all these statutes are relatively very recent, having been enacted over the past six years, these authorities are still in the process of learning how to apply these concepts. On the other hand, courts have long been familiar with the notion of 'good faith' as the Civil Code contains various provisions invoking the consideration of good faith as a relevant factor, though 'honest market practice' would be a test that is totally new also for the courts, unless it is synonymous with good faith.

Likewise, to a certain extent, courts are already familiar with the use of standards such as 'professional diligence' as under the law of tort and in relation to other aspects of civil law the standard used is that of 'the diligence of a bonus paterfamilias' and the diligence of persons with the 'necessary skill'. Under tort law a person who 'without

the necessary skill' undertakes any work or service would be liable for any damage caused to others through his unskillfulness and the courts regularly deliver judgments awarding damages for defective work or services using a test based on the standard skill that is expected of persons in a given trade or profession.[78] A similar test based on 'unskilfulness in the exercise of one's art or profession' for assessing various forms of wrongdoing applies under the Criminal Code.[79] One will have to see whether under Community case law the professional diligence requirement will develop into a more specific standard.[80]

Thus, it may be concluded that, it is more likely that it will be the administrative authorities that will find it particularly hard to apply these general concepts until there develops a well-established body of local and Community case law in relation to fairness of business-to-consumer commercial practices to guide them.

3.3 Consumer Benchmark and Transactional Decision Test

For the purposes of assessing the fairness of commercial practices, the Directive requires the adjudicating body to apply two tests:[81] to consider whether the practice is contrary to 'the requirements of professional diligence', a test that, as shown above, is not totally unfamiliar to our courts, and secondly to determine whether the practice materially distorts or is likely to materially distort the economic behaviour of the average consumer with regard to the product concerned (the so called 'transactional decision' test). For the purposes of this transactional decision test, the Directive defines the consumer benchmark as the 'average consumer' while reiterating the narrow definition of consumer as 'any natural person who … is acting for purposes which are outside his trade, business,

craft or profession'. However, it also recognises that in certain circumstances the interests of clearly identifiable groups of 'vulnerable' consumers should also be taken into account: vulnerability resulting from their mental or physical infirmity, age or credulity.

Currently, the law governing unfair commercial practices does not direct Maltese administrative authorities and courts to use any particular consumer benchmark though the provisions regulating distance selling and broadcasting do require the adjudicator to take the interests of minors and other vulnerable persons into account.[82]

It is very difficult to ascertain what standard, whether the 'average consumer' or the 'vulnerable consumer' standard, is followed by the administrative bodies when enforcing the consumer law provisions through compliance orders but in view of its Broadcasting Code for the Protection of Minors, the Broadcasting Authority is more familiar than other administrative authorities with the use of a 'vulnerable consumer' test in the assessment of the fairness of advertising.[83]

On the other hand, some court judgments, albeit not in the field of consumer law but in the field of intellectual property, indicate that Maltese courts tend to apply the average consumer yardstick in the context of a transactional decision test. Thus, in *Dr Maurice Agius Vadala noe v Albert Mizzi et noe*[84] the Commercial Court stated that for unfair competition to subsist it must be shown that the average consumer, one who is neither too circumspect nor too distracted and of average intelligence, would be deceived into buying a product that he did not intend to buy, mistaking it for the competing product that he intended to purchase. Likewise, in *Prof JA Micallef et noe v Silvio Camilleri et noe*[85] and *Gino sive John Cutajar noe v Kevin Caruana*[86] the standard that was used as yardstick to

gauge the deceptiveness of the trademark was that of the average, ordinary consumer.[87] Moreover, in *Valletta Dr Pio M noe v Busuttil Joseph et noe*, the Court of Appeal, not only applied the average consumer standard but actually cited case law of the European Court of Justice applying the average consumer test in relation to trademarks, although it was not obliged to do so as at the time Malta was still not a member of the European Union.[88]

Furthermore, courts apply a test similar to the average consumer test in the context of contract law under the Civil Code. While, as shown above, the provisions of the Civil Code only partly afford protection against aggressive selling in comparison to the Directive because they vitiate the contract only when consent is extorted by violence, they do attach a standard that is akin to the average consumer standard. This is because Article 978 considers consent to be distorted by violence only when 'the violence is such as to produce an impression on a reasonable person' though it does require consideration to be given to the age, sex and condition of the person concerned and in this respect it might be going beyond the standard set by the directive for aggressive commercial practices in Article 8.[89]

So, it could be concluded that, while the obligation to apply a transactional decision test using the average consumer standard is unlikely to create any difficulties for the courts, when this obligation is displaced by the obligation to apply the vulnerable consumer standard because the practice concerned is directed at particular groups or likely to affect them only, courts would be faced with a standard that they are largely unfamiliar with, as in the past they have not been particularly sensitive to the economic behaviour of the more vulnerable members of society. Following transposition of this directive, both national administrative agencies and courts would have to

become more sensitive to the perceived economic behaviour of vulnerable consumers when assessing the fairness of commercial practices.

3.4 Enforcement

The Directive will not mean more enforcement powers for the Director of Consumer Affairs and courts in relation to unfair commercial practices as virtually all the enforcement powers and sanctions envisaged are already available with the possibility of criminal sanctions and the Director's power to issue compliance orders and the duty to do so as expeditiously as possible and without the need to prove actual loss or damage or fault. However, currently, although the Consumer Affairs Act[90] provides the Director with wide-ranging fact finding powers, it falls short of stating expressly, in line with the Misleading Advertising Directive,[91] that the Director is empowered to consider factual claims as inaccurate if the evidence demanded is not furnished or is deemed insufficient. Since the Unfair Commercial Practices Directive[92] repeats this provision this power would have to be expressly stated in the new statute.

Currently, most public enforcement provisions prescribe a criminal sanction. This is possible because the laws concerned prohibit specific forms of unfairness and define them with enough specificity to allow a criminal sanction to be attached to the prohibition. But in a law that prohibits 'unfairness' using general concepts, as would be the law transposing this directive, it is unlikely that maintaining criminal sanctions for breach of the law would be compatible with the general principle of legal certainty in criminal law. So, it is submitted that while the criminal sanctions for specific forms of unfairness that are specifically defined in the law may be retained, for the general prohibition on

unfairness the only sanction would have to be compliance orders and private enforcement through individual civil law actions.[93]

In Malta self-regulation by traders is rare but regulated professions do have codes of ethics and codes of conduct and rules drawn up by their associations regulating their practice as in the financial services sector. However, even where such codes exist, monitoring for compliance and disciplinary action have always been conspicuously absent. So, while the formulation of such codes by professional and trade associations in other sectors should be encouraged, as it would reduce the need for recourse to administrative or judicial action while if recourse to such remedies is necessary it would also assist courts and administrative bodies in the determination of what is 'honest market practice' in any given sector, the law should also provide that code owners have a duty to devise proper monitoring and disciplinary systems for compliance.

4. Conclusion

Clearly, this directive will mean an improvement in consumer protection, as the implementing legislation will cover more forms of unfairness and more types of commercial practices than the current regime. It will also provide an opportunity to the legislator to tidy up the law that was developed piecemeal to remove overlaps and apparent or real conflicts. At the same time, however, the new legislation will provide new challenges for the adjudicating bodies and especially for the administrative enforcement authorities, as they will have to tackle new general concepts and consider the interests of the more vulnerable consumers where necessary. If the improvement

is not to remain purely theoretical, the administrative authorities would have to be adequately resourced and motivated to take on these new challenges and to be vigilant and act as expeditiously as possible.

It has been shown that a number of concepts will be novel to both courts and administrative bodies. The legislator would have to decide whether to simply reproduce the provisions of the directive and leave the interpretation and application of these concepts to be clarified by decisional practice and case law throughout the years or else to attempt to clarify through more detailed provisions in the legislation transposing the directive, possibly even with the aid of accompanying guidelines.

Both approaches have their pros and cons. Leaving elucidation of the general concepts to the interpretation of the administrative bodies and courts might lead to a period of legal uncertainty. This in turn might result on the one hand in uncertainty among the business community as to what is permissible and what is not and on the other hand to reluctance on the part of consumers to enforce their rights. However, by attempting to define more precisely such concepts the legislator might run the risk of misimplementing the directive as some of the concepts have not yet been interpreted by the Community courts in the field of consumer protection. It would require careful drafting.

Another dilemma facing the legislator is that some parts of the directive have been shown by some commentators to be ambiguous and capable of differing interpretations.[94] Yet it would not be advisable for the legislator to attempt to clarify this ambiguity by opting for any particular interpretation in the absence of clear guidance by the European Commission in its Explanatory Memorandum, given that this is a maximum harmonisation directive. Rather, elucidation

should be left to the European Court of Justice that would, undoubtedly not long after implementation, be requested by the national courts of the Member States, through the preliminary reference procedure, to clarify the interpretation of these nebulous parts of the directive.

For successful implementation it is essential that a public consultation process be launched within the coming months with the business community and the consumer association and other stakeholders so that any contentious issues would be ironed out and solutions found well before the deadline for implementation. Moreover, once this consultation period is over and the law has been formulated and enacted by Parliament, a proper information campaign should be conducted before its entry into force to educate consumers about their new rights and traders about their new obligations so that consumers and consumer associations would be able to take full advantage of these enhanced rights against unfairness.

Notes

1 Directive 2005/29 of the European Parliament and Council concerning Unfair Business-to-Consumer Commercial Practices OJ [2005] L149/22.
2 This part is partly based on a national report on unfair commercial practices in Malta that the author co-authored with Professor Peter G Xuereb for the British Institute of International and Comparative Law, London, UK in 2005 that was commissioned by the European Commission and currently appears on the website of DG SANCO.
3 Chapter 378 of the Laws of Malta.
4 Act XXVI of 2000.
5 Act VII of 1987.
6 Council Directive 85/577 to protect the consumer in respect of contracts negotiated away from business premises OJ [1985] L372/31.
7 Chapter 317 of the Laws of Malta.
8 Distance Selling Regulations LN 186 of 2001, Consumer Affairs Act (Price Indication) Regulations LN 283 of 2002 and Consumer Credit Regulations, 2005 LN 84 of 2005.
9 Directive 97/7 of the European Parliament and Council on the Protection of Consumers in respect of Distance Contracts OJ [1997] L144/19, Directive

98/6 of the European Parliament and Council on Consumer Protection in the Indication of the Prices of Products offered to Consumers OJ [1998] L80/27 and Council Directive 87/102 concerning Consumer Credit OJ [1987] L42/48.

10 Chapter 378 of the Laws of Malta.
11 Chapter 350 of the Laws of Malta.
12 Council Directive 84/450 concerning Misleading Advertising OJ [1984] L250/17.
13 Directive 97/55 of European Parliament and Council concerning Comparative Advertising OJ [1997] L290/18.
14 Consumer Affairs Act, Article 94.
15 Ibid, Article 101.
16 The author was told by an official of the Department of Consumer Affairs that to date only nine compliance orders have been issued, eight in relation to price indication irregularities and one in relation to misleading advertising but that this was due, in some measure, to the Department's success in negotiating voluntary compliance.
17 Consumer Affairs Act, Article 8.
18 Chapter 9 of the Laws of Malta, Articles 298 and 307.
19 LN 283 of 2002.
20 Directive 98/6 of the European Parliament and Council on Consumer Protection in the Indication of the Prices of Products offered to Consumers OJ [1998] L80/27.
21 LN 20 of 1960 as subsequently amended.
22 LN 84 of 2005.
23 Council Directive 87/102 concerning Consumer Credit OJ [1987] L42/48 as amended by Council Directive 90/88 OJ [1990] L61/14 and Directive 98/7 of the European Parliament and Council OJ [1998] L101/17.
24 Chapter 13 of the Laws of Malta, Articles 32-37.
25 In conjunction with Article 873 of the Code of Organization and Civil Procedure, Chapter 12 of the Laws of Malta.
26 Chapter 416 of the Laws of Malta.
27 Articles 6 and 10.
28 Articles 14 and 85.
29 Chapter 313 of the Laws of Malta.
30 Chapter 350 of the Laws of Malta.
31 Council Directive 89/552 concerning the Pursuit of Television Broadcasting Activities OJ [1989] L298/23 as amended by Directive 97/36 of the European Parliament and Council [1997] L202/60.
32 LN 245 of 2001, as subsequently amended.
33 LN 160 of 2000.
34 LN 157 of 2000 as amended by LN 258 of 2001.
35 Chapter 409 of the Laws of Malta.
36 Council Directive 90/314 on package travel, package holidays and package tours OJ [1990] L158/59.
37 Chapter 449 of the Laws of Malta.
38 LN 483 of 2004.
39 LN 247 of 1998.
40 Chap ter 378 of the Laws of Malta, Article 51.

41 Ibid, Article 52.
42 Ibid, Article 53.
43 Chapter 182 of the Laws of Malta.
44 The Act defines a trading stamp scheme as 'any scheme, plan, promise, offer, obligation or similar arrangement or undertaking by which the purchasers of specified goods or from specified sellers would be entitled to receive gifts as an inducement for the purchase of such specified goods or from such specified sellers against the delivery of and in exchange for trading stamps'. Trading stamps are defined as 'any stamp, coupon, voucher, token, label, wrapper or similar device which is or is intended to be delivered to any person upon or in connection with the purchase by that person of any goods and is or is intended to be redeemable in specified quantities by that or some other person against the receipt of a gift'.
45 Chapter 317 of the Laws of Malta.
46 Council Directive 85/577 to protect the consumer in respect of contracts negotiated away from business premises OJ [1985] L372/31.
47 Article 5A.
48 Article 9.
49 Articles 6, 7 and 11.
50 LN 269 of 2000, as amended by LN 151 of 2001 and LN 80 of 2002.
51 Chapter 409 of the Laws of Malta.
52 Directive 94/47 of the European Parliament and the Council on the protection of purchasers in respect of certain aspects of contracts relating to the purchase of the right to use immovable properties on a timeshare basis [1994] L280/83.
53 Chapter 9 of the Laws of Malta. Article 251 prescribes that any person who uses violence to compel another person to do, suffer or omit anything would be guilty of a criminal offence liable to a custodial sentence.
54 Chapter 16 of the Laws of Malta, Article 974.
55 LN 186 of 2001.
56 Chapter 378 of the Laws of Malta.
57 Directive 97/7 of the European Parliament and Council on the Protection of Consumers in respect of Distance Contracts OJ [1997] L144/19.
58 Consumer Affairs Act, Chapter 378 of the Laws of Malta, Article 14.
59 LN 36 of 2005.
60 Chapter 330 of the Laws of Malta, Article 20A.
61 Directive 2002/65 of the European Parliament and Council concerning the Distance Marketing of Consumer Financial Services OJ [2002] L271/16.
62 Chapter 330 of the Laws of Malta.
63 Ibid Article 4.
64 Distance Selling (Retail Financial Services) Regulations 2005, LN 36 of 2005, Regulations 13-14.
65 Ibid Regulation 19.
66 Chapter 16 of the Laws of Malta, Articles 1031-1033.
67 Chapter 13 of the Laws of Malta, Article 37.
68 Chapter 16 of the Laws of Malta, Articles 1424-1432.
69 Set up by the Small Claims Tribunal Act, Chapter 380 of the Laws of Malta.
70 Set up by the Consumer Affairs Act, Chapter 378 of the Laws of Malta.

71 One case where a conflict between laws was mooted but rejected by the Civil Court First Hall was *World Marketing Services Limited v Crosscrafts Company Limited*, judgment of 11 April 2001, where the defendant argued that there was a conflict between the provisions on comparative advertising in the Consumer Affairs Act implementing the Comparative Advertising Directive and the provisions on unfair competition in the Commercial Code on the grounds that the latter was stricter in its approach to such advertising. The judge ruled, however, that there existed no conflict, as both laws required that comparative advertising, even when based on true facts, should refrain from passing unfair and denigrating comments on competitors.

72 Directive 2005/29 of the European Parliament and Council concerning Unfair Business-to-Consumer Commercial Practices OJ [2005] L149/22.

73 'Consumer' defined as the person who in commercial transactions is acting for purposes that are outside his trade, business, craft or profession.

74 Article 3 grants a transitional period till 2013 with the possibility of a further limited period being proposed by the Commission in its review report of 2011.

75 Consumer Affairs Act, Chapter 378 of the Laws of Malta, Article 43. It does state, though, that in the interpretation and implementation of the provisions of the Act and regulations made under it these principles must be adhered to.

76 Ibid. Articles 44-47 implement the provisions of Council Directive 93/13 on Unfair Terms in Consumer Contracts OJ [1993] L95/29 but go beyond by providing a wider scope and stricter protection for consumers, this directive being a minimum harmonisation directive.

77 Ibid. Article 45 provides that a contract term is deemed unfair if it satisfies *any one of the following four criteria*:

(a) it creates a significant imbalance between the rights and obligations of the contracting parties to the detriment of the consumer; or

(b) it causes the performance of the contract to be unduly detrimental to the consumer; or

(c) it causes the performance of the contract to be significantly different from what the consumer could reasonably expect; or

(d) it is incompatible with the requirements of good faith.

This unfairness test is easier to satisfy and thereby more favourable to the consumer than the one in Article 3(1) of Council Directive 93/13 on Unfair Terms in Consumer Contracts OJ [1993] L95/29. Clearly, the legislator's intention was to give the maximum protection to consumers and so it opted for an unfairness test that was more akin to the test that the European Commission had originally proposed in its initial proposal for the Directive (OJ [1990] C243/2) that would have caught more contractual terms that might be detrimental to consumer interests than to the current narrower test that was adopted in the finalized directive with its requirement that the contractual term be both contrary to good faith and cause an insignificant imbalance in the parties' rights and obligations to the detriment of consumers in order for it to be deemed unfair. The legislator might also have been inspired by the original proposal when it opted to extend the protection to individually negotiated contractual terms

as the proposed directive likewise had a similar broad scope before it was narrowed down following the European Parliament's amendments prior to Council approval.

78 Civil Code, Chapter 16 of the Laws of Malta, Articles 1038-1039.

79 Chapter 9 of the Laws of Malta, eg Articles 52, 225, 243A, 328.

80 There is some debate over the definition of 'professional diligence' in Article 2 that speaks of a standard of *special* skill. See 'An Analysis of the Application and Scope of the Unfair Commercial Practices Directive' a report for UK's Department of Trade and Industry by C Twigg-Flesner, D Parry, G Howells and A Nordhaussen, May 2005 available on DTI's website.

81 It is debateable whether these are two alternative tests or two cumulative tests – see 'An Analysis of the Application and Scope of the Unfair Commercial Practices Directive' a report for UK's Department of Trade and Industry by C Twigg-Flesner, D Parry, G Howells and A Nordhaussen, May 2005 available on DTI's website.

82 Distance Selling Regulations LN 186 of 2001, Regulations 4 and 10, the Broadcasting Act (Substitution of Third Schedule) (Code for Advertisements, Teleshopping and Sponsorships) Regulations, 2001, LN 245 of 2001 as subsequently amended and Broadcasting Code for the Protection of Minors, LN 160 of 2000.

83 Ibid.

84 Commercial Court judgment of 9 August 1990.

85 Case 778/90 DS, Civil Court judgment of 23 February 2001.

86 Court of Appeal judgment of 23 January 1998.

87 The average consumer standard was also used by the Court of Appeal in Case 1431/96 GV *Hyzler Dr George Noe v Borg & Aquilina et*, judgment of 13 July 2001.

88 Case 268/91 FGC *Valletta Dr Pio M noe v Busuttil Joseph et noe*, judgment of 19 November 2001 where the Court of Appeal cited European Court of Justice Case C-342/97 *Lloyd Schuhfabrik Meyer & Co GmbH v Klijsen Handel BV* [1998] ECR I-3819.

89 There is debate as to whether the specific prohibitions in Articles 6-8 of the Directive, that is those concerning misleading actions and omissions and aggressive commercial practices, require the application of an average consumer standard only or also a combination of the average consumer standard and vulnerable consumer standard as in the case of the general probation of unfair commercial practices in Article 5. See 'An Analysis of the Application and Scope of the Unfair Commercial Practices Directive' a report for UK's Department of Trade and Industry by C Twigg-Flesner, D Parry, G Howells and A Nordhaussen, May 2005 available on DTI's website.

90 Chapter 378 of the Laws of Malta, Article 104.

91 Council Directive 84/450 concerning Misleading Advertising OJ [1984] L250/17, Article 6 as amended by Directive 97/55 of European Parliament and Council concerning Comparative Advertising OJ [1997] L290/18.

92 Directive 2005/29 of the European Parliament and Council concerning Unfair Business-to-Consumer Commercial Practices OJ [2005] L149/22, Article 12.

93 Though criminal sanctions may be retained for subsequent breach of the injunction or compliance order as what would have constituted unfairness in the specific case would have been clearly identified in the order itself.

94 'An Analysis of the Application and Scope of the Unfair Commercial Practices Directive' a report for UK's Department of Trade and Industry by C Twigg-Flesner, D Parry, G Howells and A Nordhaussen, May 2005 available on DTI's website.

ACHIM TIFFE[1]

WHAT DOES "RESPONSIBLE CREDIT" MEAN FOR MORTGAGE LOANS IN EUROPE?[2]

The Principles of the European Coalition for Responsible Credit

The European Coalition for Responsible Credit (ECRC) was founded in the year 2006 in Brussels to ensure a Responsible Credit Market in Europe in face of predatory lending, increasing use of combined products, the rise of revolving credit cards in Europe and the bad reputation this new phenomenon has developed judging from its effect on over-indebtedness in the USA over the past decades, and an increasing lack of transparency of financial services. The principles of the ECRC are:

P1: Responsible and affordable credit must be provided for all.

- No exclusion, no discrimination, bank accountability

P2: Credit relations have to be transparent and understandable

- Transparency (competitive & social – APRC & payment plans), reflection time, access to independent advice, mutual process of financial education

P3: Lending has at all times to be cautious, responsible and fair.

- Productivity, information provision, no abuse of borrower naivety, no penalty for early repayment, regulation of debt refinancing

P4: Adaptation should be preferred to credit cancellation and destruction.

- No unfair credit cancellation, no disproportional default charges

P5: Protective legislation has to be effective.

- Cover for non-commercial users, all commercial forms of credit provision, throughout the whole credit process, and for efficient social & economic outcomes

P6: Over-indebtedness should be a public concern.

- Right to discharge, bankruptcy procedures that lead to rehabilitation

P7: Borrowers must have adequate means to defend their rights and be free to voice their concerns.

- Adequate individual & collective legal procedures to enforce rights, public awareness

Mortgage loans are part of the financial sector and therefore responsible lending is also important in this sector. The following examples show what kind of problems consumers have in Germany in relation to mortgage loans and what "responsibility" means for the mortgage sector.

Existing Regulation for Mortgage Loans

At the moment mortgage loans are not yet regulated by the European Union. The consumer credit directive from 1987

excluded mortgage loans in general. The decision was made not to regulate the mortgage sector on the supranational level through an EU-Directive. Fourteen years later a seeming compromise was found with the Voluntary Code of Conduct for home loans, signed by the European Organisations of Consumers and Providers. The Code of Conduct is based on pre-contractual information for consumers starting with general information and ending with a European Standardised Information Sheet for mortgage loans (ESIS). The Institute for Financial Services made a survey in twelve EU-countries to verify the implementation and effectiveness of the Code of Conduct in the year 2003.[3] The publication of the study provoked a new discussion about the effectiveness of voluntary codes and the right moment to hand out pre-contractual information to consumers. At this point the European Commission started to reconsider the position not to regulate the mortgage sector at all. With the Green Paper on mortgage credit in the year 2005 the European Commission started a debate about a regulation of the mortgage sector on the European level which is not finished yet. A report of the Mortgage Funding Expert Group followed in December 2006 and different experts are working on a concept for an EU-regulation.

Today, we still have no regulation at the EU-level for mortgage loans, while there exists in the EU-countries a variety of different regulations for consumer related mortgage loans. In relation to consumer credits it is not acceptable to have no regulation for the mortgage sector which has a high risk for consumers to end up in over-indebtedness and where the transparency of prices is even more important. Because of significant higher amounts of home loans compared to consumer credits and the longer time period for repayment conditions, the quality of the financial product and the correctness of advice are even

more important in the case of consumer related mortgage loans than for consumer credits. Therefore a lot of European States implemented civil law with the focus on consumer protection for mortgage loans while other countries have almost no specific regulation for consumer related mortgage loans.

The **German** history of consumer protection with a focus on consumer credits started with the "Abzahlungsgesetz" where the APR was established for consumer products paid in instalments long time before the European directive for consumer credits was created for consumer credits in general. With the implementation of the first consumer credit directive, Germany integrated mortgage loans in the regulation for consumer credits with a lot of exemptions. But the technical integration helped in the following years to bring, step by step, the law for consumer credits and mortgage loans closer together. Today the specific law for consumer credits and mortgage loans is integrated in the German Civil Code (§§ 491 ff. BGB) without any exemptions and the consumer has the right to withdraw a mortgage loan just like it was established 20 years ago for consumer credits only.

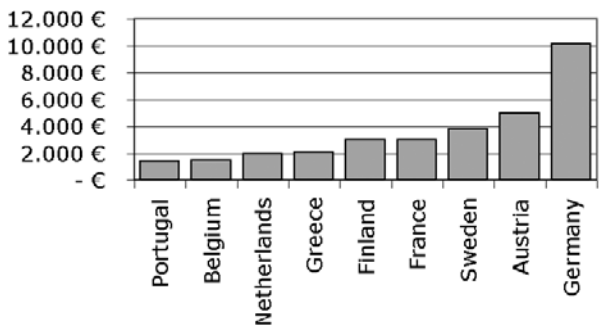
France has also a specific and very consumer orientated regulation for consumer related mortgage loans. The law is combined in a specific "Code de la Consommation". The lender of a mortgage loan for example must make a binding offer for 30 days (offre préalable) so that the consumer has time for shopping around and to reconsider the decision. France also has a nationwide office structure for consumers providing help with mortgage loans (ANIL). Another example of French trend-setting regulation is the case of early repayment fees which have been reduced to 6 monthly instalments and to a maximum level of 3% of the outstanding amount by law for consumers.

Meanwhile other countries like **Bulgaria** have not implemented any specific regulation for mortgage loans for consumers whatsoever. When Bulgaria adopted the consumer credit directives in 2006, the only article which has any relevance for mortgage loans is Art. 15, which regulates advertisement.[4]

Specific Problems with the Financing

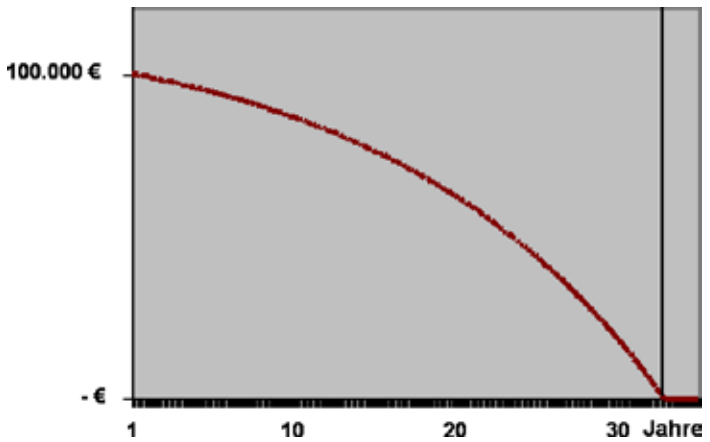
In Germany we have a lot of problems with mortgage loans. One higher-ranked problem is the increase of **individual pricing** which is directly connected to a **lack of transparency**. Banks started to offer customers individual prices for mortgage loans, thereby rendering shopping around for credit more and more difficult.

Another problem is the "110%-Financing offers", which mean a higher risk of over-indebtedness for consumers in the event of unexpected problems. This is because the monthly instalments are higher and in the event of an immediate selling the consumer could easily end up in a debt trap. The **lack of independent advice** on how to finance an own house or apartment and the high level of **early repayment fees** in Germany are other existing problems.[5]



Another huge problem in Germany is the so-called "Schrottimmobilien". **"Junk apartments"** have been sold in Germany since the nineties, in a strategy that approached consumers with sales arguments to reduce their taxes and to help them do something for their own old age pension. The most of such apartments were sold without the consumers ever having seen them. The intermediaries increased the price to double the real value of the property, and in several cases worked in close collaboration with certain banks. The consumer just signed several contracts and a plenary power. After a while, the consumer would find out that nobody else actually wants to live in the apartments and that the price they paid was usurious, or that in any case the price paid had no relation to a realistic market price. The Federation of German Consumer Association (VZBV) estimates that 300,000 consumers are affected by these junk apartments in Germany.

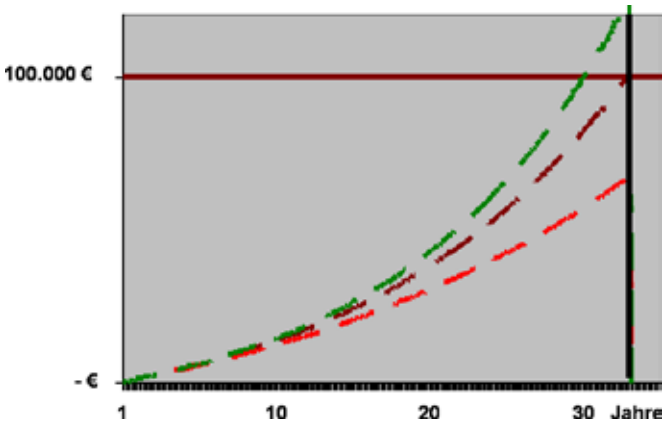
There are different ways to help consumers. Court decisions show that some banks have violated their duty of disclosure about the real market price and that they have to pay compensation to the consumers or have to reverse the contracts. Lawyers try to get court decisions where the



banks have to take the junk apartments and have to return all payments the consumer made to the banks to pay their instalments. In cases of door-to-door-sales for example, invalid issues of plenary powers and the right of withdrawal help to re-process the whole contract. Although some court decisions from the highest German civil court and the European Court of Justice still exist, the legal debate in Germany about compensation and re-processing in cases of selling junk apartments is not finished.

In Germany you can also find an aggressive sale of **combined products**. Combined Products of mortgage loans are regularly more expensive for the consumer than normal mortgage loans with a steady amortisation. Transparency is also missing and they have more risks for the consumer. Whereas a normal mortgage loan is paid continuously and the outstanding amount goes down every year a little bit faster, with a combined product, there is no amortisation of the mortgage loan until the end. The consumer just pays the instalments for the interest rate and saves additional money with another product, normally a life insurance with an integrated saving product. After 25 or 30 years the life insurance is calculated to reach and equal the amount of the outstanding loan. But low interest rates for bonds in recent years reduced the expectations for the saving product. This break between the mortgage loan and the savings is paid by the consumer, who is now likely to be on the way to retirement and must live the life of a pensioner with a reduced income as a result of having to suddenly pay back the outstanding amount. The credit institutions promote combined products with a lower interest rate more than the other products with either fixed or variable interest rates but a steady amortisation schedule. For the consumer, to buy a combined product seems to be the most attractive way to finance his/her own house or flat. The

annual percentage rate of charge looks quite attractive in relation to normal products but the saving product is not included, which makes the combined products actually very expensive. Furthermore, the risks are often not explained to the consumer at the beginning.



The correct **adjustment of variable interests** is another irritating problem. In the last fifteen years a lot of consumers and small enterprises started interest repayments with an interest rate of about 9% p.a., which was a good offer at the beginning of the nineties. During the past decade, though general interest rates fell down continuously, the variable interest rate of most of the customers did not. In the following graph, you see the red line for the interest rate paid by a consumer and the development of the reference interest rate (black line). German court decisions show that the consumer has the right for a continuous adjustment if variable interest rates were agreed.[6] The interest rate must follow the reference interest rate at each point in time (blue line).

The meaning of advice for consumers in relation to home loans

To buy a house or apartment is one of the most complex financial services that a consumer has to face, and in general the largest indebtedness in a consumer's life. But normally there is no legal obligation for advice. Independent advice for consumers is not very common in Germany. Most of the consumers use only the information from their credit institution when they make the step of buying real estate for their own living.

Risks and Opportunities for the Consumer

The following shows the complexity of financing an own home or apartment: a consumer has different possibilities to finance it. He can use a mortgage loan with a variable interest rate or a fixed interest rate, with terms ranging from 5, 10 or 15 years, additional governmental subsidies and a combination of all of these. A consumer must also

analyse his own situation: Do I earn enough to finance the house? Is my income stable enough to pay the monthly amounts in the coming years? What could happen during the next 25 – 35 years?

The motivation for buying a house or apartment is also different. Most consumers want to change their form of living from a rented apartment towards an own residential property which they can construct and design by themselves. Others may simply want to create wealth, reduce taxes or use it as a provision for old age, because having one's own property to live in reduces the costs of living significantly once the mortgage loans have been fully repaid.

The typical German mortgage loan at the moment is a loan with a fixed interest rate over 15 years. That means no flexibility with the monthly payments and high early repayment fees in case of unexpected sale for more than the first ten years.[7] Several things can happen during the repayment period of a mortgage loan of about 25, 30 years which will have an effect on the credits: The value of given factors of security can change; One's own salary could change e.g. in the event of unemployment or reduction of work (part-time); Divorce, death of the borrower or relocation are other typical stress factors not only for the family but also for the relation with the creditor. Money could end up being lost because of distress sale or when it comes down to it in over-indebtedness.

Another risk is the fall in value of the own real estate. The influence of the demographic factor for the value of houses and apartments is part of a huge discussion in Germany and has started to affect prices of real estate already. Changes in lifestyles over the decades could influence the preferences of suburbs and preferred houses and the prices of more and more unattractive areas and apartments too.

The opportunities for consumers to buy real estate are expected to create wealth. Real estate plays an important role for retirement and inheritance. For most Germans, the own house or apartment is the possession with the single highest value among all that they own and can pass on to the next generation. Home owners are also privileged from the government with tax regulation and subsidies.

Lack of Access, Discrimination and Strategies against it

During the last ten years the *Institute for Financial Services* has found a lot of different situations of missing access and **discrimination** linked to mortgage loans. Some credit institutions offer higher interest rates to old customers for the following-up financing then for new customers who enjoy better conditions. Consumers who could not change their bank are trapped into bad credit conditions or do not even know that they pay more than others for the same period of time.

The **access** to mortgage loans and to the opportunity to create wealth depends on the amount of one's own assets, the prices for houses and apartments, the age of the consumer and the form of income he has. While employed persons are usually accepted as borrowers, low income groups, people with short-term contracts and employees in what are seen as uncertain professional branches, all have problems just getting a mortgage loan, let alone at reasonable price. Another growing group with access problems are self-employed persons. In Germany, it is not just the typical owners of a small restaurant and commercial traders that have problems getting access to mortgage loans to finance their home ownership, but members of established professions such as lawyers and doctors.[8]

The **Community Reinvestment Act** of the USA (CRA) is a good example for a legal approach to stimulate investment in "precarious" suburbs – also for mortgage loans. Enacted by Congress in 1977 the Act intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighbourhoods, consistent with safe and sound banking operations. This includes periodical evaluations through the authorities, public CRA-Ratings and consequences in case of missing reinvestment. For example, a financial institution's track record in reinvesting is taken into account when considering an institution's application for deposit facilities, including mergers and acquisitions.

A Framework for Responsible Credit

What does *responsible credit* mean in relation to mortgage loans?

First of all there should be a **general duty for credit institutions to advise** their customers in a clear and understandable way about the possibilities to finance their home, the opportunities and risks of certain products, and a legal right for compensation in case of bad, misleading or incomplete advice. Most consumers finance their own home only once in their lifetime and are thus unable to collect the necessary experience with different mortgage products throughout their lifetime. The risks for consumers of making a wrong costly decision are high. Therefore a consumer has the right to get the best advice possible when financing it. The consumer's situation and the value of the object must be analysed by the credit institution before a mortgage loan is sold. A consumer should also get

information about the calculation and the estimated value of the house or apartment, which implies that banks should share more information that they have at their disposal, and which they only currently hold for their own internal purposes.

Furthermore there must be an economical correctness in the price (annual percentage charge) which still does not exist at the European level for mortgage loans, neither for mortgage loans in general or for combined products.

There must be a sensibility for structural discrimination of regions, suburbs or specific households and a mechanism to correct discriminative mechanisms. In that context it is important to understand that most of the credit institutions today do not discriminate certain groups or neighbourhoods intentionally. While every individual decision is understandable from the point of view of the banker, the system as a whole could still end up to be discriminating.

At least exploitation of the consumer's situation should be banned. In case of economic problems and early repayment, *incomplete contracts* should not be an invitation for credit institutions to take a consumer to the cleaners. Fair rules must be established in case of unexpected situations for consumers and legal consequences in case of disregard should be developed.

The legal demands for consumer related mortgage loans are the following:

- Same level of consumer protection for consumer credits and consumer related mortgage loans
- An obligatory Annual Percentage Rate (APR) for consumer related mortgage loans – which should also include combined products
- Early extensive information (ESIS)[9] and individual price information to allow shopping around

- A right to withdraw a contract for a mortgage loan within a certain time frame
- Dismissal protection, at least in the case of two outstanding instalments
- Claim for fair follow-up financing with similar conditions as those enjoyed by new customers with similar risks
- Reduction of early repayment fees to a maximum of three instalments (e.g. Belgium Consumer law)
- Greater awareness of community reinvestment and prevention of structural discrimination

Legal and Economic Perspectives for Malta

Malta has opened the regulation applied to consumer credit to that of mortgage loans. The APR is also an obligation for mortgage loans and pre-contractual information is integrated in the Maltese law for consumer related mortgage loans. Therefore mortgage loans for consumers are not an unregulated issue in Malta.

Representatives of Maltese credit institutions described the Maltese real estate market as a constantly growing market. Risks for the Maltese market could be new financing products with a lack of transparency, an overheated real estate market and the vulnerability of a real estate market which is strongly connected to the tourism sector in Malta.

A first step for more transparency could be to establish a price index for real estate in Malta and develop further the Property Price Index published annually by Malta's National Statistics Index. That there is a need for economic transparency was highlighted in a recent article in a Maltese newspaper with the headline "Institute of Valuers

needed".[10] Therefore, the exact size of apartments, houses and the territory must be collected and analysed. One possibility for obtaining this kind of information is to do so directly from the land registry and to then publish a report every year showing the average and the spread of prices for apartments and houses for each suburb and village (Euro/square meter). Another possibility is to collect the data from newspapers over the year. This was done in Germany's second biggest city, where prices of property for Hamburg were identified by a credit institution and published every year in one major newspaper.[11] The study could then be sold to consumers who are interested in buying an apartment or house in Malta without the risk of paying too much over the estimated value of their property. It could also be a possible new extra source of steady revenue for a consumer association having established a high reputation for consumer welfare on the island. The organisation could also combine the study with additional information about how to properly finance real estate acquisition for one's own residential needs. Transparency of prices will not only help to avoid an overheating of the market, which Malta is particularly vulnerable to, but it will also help establish quality standards for homes and flats in the housing market more generally.

Notes

1 PhD, deputy director of the institute for financial services situated in Hamburg, Germany, and Attorney at Law
2 Held on 9th March 2007 during the Responsible Credit Seminar in Malta
3 Download: http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/home-loans-final-report_en.pdf
4 Art. 1 (5) "The provision of this Act with the exemption of Article 15 shall not apply to credit agreements or agreements for intermediation in credit granting: 1. secured with mortgage loans, 2. intended for the purpose of acquiring or retaining property rights in land or …"
5 Tiffe: Early Repayment Fees in Europe: Based on the following example:

100,000 – loan, 6 % interest rate fixed for 10 years, repayment after 5 years (2003); Download with executive summary: http://www.vzbv.de/mediapics/projektbericht_vfe_europa.pdf

6 OLG Celle, Urteil vom 20.12.2000, AZ 3 U 69/00, VuR 2001, 324; LG Köln, Urteil vom 14.08.2002, AZ 20 O 152/99, WM 2003, 828

7 After ten and a half years the consumer can quit the contract without paying an early repayment or other fees.

8 Article "Kein Geld für Ärzte und Anwälte: Freiberufler haben bei Kreditinstituten schlechte Karten"; Die Zeit, 23. Nov. 2006.

9 That means pre-contractual information and a European Standardised Information Sheet (ESIS) with the first individual offer of the creditor.

10 The Times (Malta) from 10the March 2007, p. 12

11 See for example: http://www.lbs.de/hamburg/immobilien/studien/immobilienmarkt-2007-01/uebersicht and http://www.engelvoelkers.com/Alstertal/de/Buero/Studie_der_LBS.pdf

DAVID FABRI

CONSUMER LAW IN POST-ACCESSION MALTA:

A critical review of price control regulation and the Supplies and Services Act 1947*

> "***The control of the cost of living should be the cornerstone of consumer protection***." (Dr C Moran, Shadow Minister for Social Welfare, 1992) [1]

> ***"…the present price control system would have to be dismantled upon Malta's entry into the European Union..."*** (Dr Joe Borg, Head of the EU Directorate at the Ministry for Foreign Affairs, 1992) [2]

The Notion of Price[3]

In the sale of goods, price is extremely important. Price is what the buyer obliges himself to pay. It constitutes his single major obligation under the law of sale.[4] And receiving the price is usually the main objective of the vendor. The price is so essential to every contract of sale that in the absence of an express clear mutual agreement on the price, a contract of sale cannot come into existence. It is therefore no surprise that the law has over the years given very keen attention to price and has made various efforts, using different techniques, to try to ensure that a buyer gets a fair deal for the price he

has paid. Different legal provisions have promoted price transparency and have created safeguards against over-pricing and misleading prices. Consumers cannot fail to be interested in legal controls over the price of goods offered for sale to them. The obligation to show the correct and final price to consumers prevents surprises.[5] Mandatory price transparency facilitates the detection and punishment of over-charging, applying misleading prices and the promotion of false sales.[6] A successful price control framework requires and relies on mandatory price indications rules. Over-pricing is of course the underlying abuse at the heart of price-fixing cartels, black-market activities and hoarding at times when supplies are scarce usually in the event of an emergency. Such acts have now been further prohibited particularly through recent competition legislation.[7]

The Supplies and Services Act 1947

Recently Price Order No. 1 of 2007[8], issued under the Sale of Commodities (Control) Regulations, 1972,[9] established the "*maximum prices of Maltese type bread*".[10]

There can be no doubt that price controls still form an integral part of our law.[11] The 1972 regulations, issued on the strength of the Supplies and Services Act 1947, constitute the most significant set of price and trade restrictive rules in Maltese law.

2007 marks the fiftieth anniversary of the Supplies and Services Act, which is still the principal source of price regulation in relation to consumer goods sold to consumers in Malta. This paper investigates and comments on the role that this unlikely law continues to play in the rapidly changing landscape of Maltese law, particularly following EU accession in 2004.

Price controls originally introduced to deal with an extraordinary emergency situation have survived in the Maltese legal system recently much reformed to fully embrace the EU *acquis communautaire* including its well known principles of trade liberalisation and free movement of goods.[12] Both the law and various trade restrictive regulations made under it have survived unscathed the accession negotiations and the reforms linked to transposition of EU law, as well as three full years of membership.

Although this paper concentrates on the Supplies and Services Act price control framework, it should be clarified at the outset that this law is just one strand in an intricate web of price restraints scattered within the Maltese legal system that affect different sectors of commercial and professional activity. Price controls have been introduced under such diverse laws as the Code of Police Laws as well as legislation regulating such matters as hotels and restaurants and public transport. Minimum wages result from employment law while interest restraints arise under the Civil Code.

From a war-time measure intended to deal with serious black market and hoarding abuses, the 1947 Act gradually began representing official trade policy applicable also to periods of normalcy. The Act refused to follow the Second World War into history, remaining the most important, extensive and complex source of trade restrictions. Regulations passed on the strength of the extensive enabling powers assigned by the Act to the Minister responsible for trade, especially the 1952 and 1972 regulations, are as important as the primary Act itself, and in some respects perhaps even more. As amended over the years, the 1972 regulations have constructed a truly impressive compendium of restrictions and barriers that did not allow

free competition and consumer choice to develop through the normal workings of a market economy.[13]

In Malta, price controls have for many years been popularly perceived as the cornerstone of consumer protection. Few viewed them as potential counter-productive trade barriers and mischief makers. Certainly, many business operators despised them. Even today, despite the adoption of much modern consumer and competition legislation since 1994, the authorities seem reluctant to abandon price controls as an anti-inflation and pro-consumer measure. As we have already seen, price orders are still being issued.

The 1947 Act permits stringent price controls in relation to sales of goods to consumers: not just essential goods, but any item whatsoever. The Act is anachronistic, and some of its legal provisions do not seem to fit too easily with the island's commitments attached to EU accession and membership. These commitments have failed to materialise, whereas the price control rules have proved more resilient. Rules that one would have reasonably expected not to last out the millennium have instead survived decades of extensive legal social, economic and political reforms, including substantial trade liberalization measures carried out since 1987. This paper traces selected official documentation which reveal how at the immediate pre-accession stage, the 1947 rules were considered archaic and ripe for repeal or total reform.

The need for effective price control seems to be ingrained in the minds of the Maltese public. Perhaps primarily because for too many years politicians themselves thought price controls were the most legitimate and effective form of consumer protection. However, today, the strict price control legislation sits very uncomfortably with the modern, complex and sophisticated consumer and competition laws

and mechanisms introduced into Maltese law since 1994. A large part of these legal reforms were imported into the island through the pre-accession transposition exercise.[14]

Price control has been a constant feature in the Maltese trading environment since even before the start of the Second World War. One can find that even some legal enactments of the Knights of Malta contained restrictions on the price of certain commodities deemed essential, including meat and fish.[15] The seventies and the eighties saw the extensive and suffocating utilization of price restraints and other clumsy trade restrictions, such as bulk-buying, import substitution, import controls and import quotas. These measures reflected misinformed and superficial notions of consumer protection.[16] Indeed, for many years[17], price controls and consumer protection appeared synonymous. For many, even today, consumer protection largely means widespread price controls, price indications and relative price monitoring and enforcement. The Maltese public seems in thrall of the unbounded benefits that strict price controls can bring. Price, it would seem, and not quality or safety, is what matters most of all.

Like several pockets of local law and administrative practice, Maltese trading and consumer law is still apparently caught in the often traumatic transition from the old to the new. Since 1994, although Maltese consumer and trading laws have been substantially reformed and brought broadly in line with the laws of other EU member states, some areas of law and practice have resisted the advent of these reforms. They may be testimony of a nostalgic hankering for the outmoded but familiar bureaucratic solutions of the past.

The Problem with the 1947 Act

It is time to investigate briefly how the Supplies and Services Act allowed such apparently unbridled use of price orders affecting every consumer product, no matter how non-essential. The two principal rules are the definition of "*essential goods*" and article 3. The definition adopts a subjective test and the Minister responsible for Trade has complete discretion to decide to which goods the Act applies. While initially the impression is that the law was intended solely for essential goods and services (regarding which there would have been little controversy), the second part of article 3(1)(a) dramatically extends the Minister's wide intervention to "*articles of any description, and, in particular, for controlling the prices at which such articles may be sold*". This slight change facilitated the widespread issue of price orders in relation to non-essential items. Many of them are still in force today.

Just to make doubly sure, the same article 3 emphasised that the Minister's powers in relation to all items could be used "*in particular, for controlling the prices at which such article may be sold*." This leaves no room for doubt or interpretation regarding the intention of the legislator. Somebody somewhere took the fateful decision to extend the draconian restrictive ministerial powers to all items without limitation. The 1947 Act is not restricted to goods, but also applies to "*essential services*" and "*essential work*".[18] In these two latter areas, the 1947 law has predictably proved a total failure.

Regrettably, the ill-advised and practically unlimited ministerial powers in the 1947 Act, relating to any aspects connected to or arising from the supply of any goods and services, provided a tool for government to use whenever political expediency suited it. This intervention may have

been provoked by industrial action or by certain sectors not being sufficiently ideologically aligned to the government's own inclinations. Thus we find regulations being adopted under the Act to control (and to an extent also punish) bakers[19], tugboats and lighters[20] as well as the maximum fees that may be charged by private schools.[21]

Once the law was extended to all commodities, whether essential or not, the temptation to then proceed to control too much could not be avoided. The consequence was a massive over-use of official mandatory price orders affecting practically all consumer items, no matter how non-essential. A few actual examples of price orders will quickly highlight the problem: orders have affected such diverse non-essential goods as "*good quality Franka stone*" slabs[22], a particular brand of scouring cream[23], a particular brand of safety razor blades[24], a particular brand of ice-creams[25], and colour televisions[26].

A 1972 Report on the new Regulations

The Supplies and Services Act spawned a number of important regulations, but none so interesting as the Sale of Commodities (Control) Regulations of 1972. These regulations constructed probably the most complete price control framework ever devised in the Maltese legal system.

The 1972 regulations are quite evidently based on the fundamental assumptions that consumer prices are there to be controlled and constantly monitored; and that prices are to be shown clearly both by marking individual items and by affixing price lists outside or inside business premises. They imposed various restrictions and requirements on traders that included stringent price indication rules, various costing, reporting and record-keeping obligations,

as well as convoluted rules how the maximum permitted profit was to be calculated. They also contained some of the earliest prohibitions against anti-competitive price-fixing agreements, hoarding of supplies and refusals to provide goods or services to consumers. Most of these regulations remain in force today. Breaches of the regulations amount to a criminal offence.[27]

Other regulations issued under the 1947 Act hampered trade by means of mandatory import and export licences. These regulations are worthy of attention and their significance should not be underestimated. But like the 1947 Act, they are emblematic of their time. The Act reflected a need to bring some order to a dramatic war situation; the regulations were typical of an unimaginative Labour government intent on controlling practically all aspects of trade. When issued in 1972, the trade organisations protested loudly.

In April 1972, a joint written report was drawn up by the island's then leading private sector organisations, included the Chamber of Commerce, the General Retailers and Traders Union and the Federation of Malta Industries.[28] This report was submitted to the Minister responsible for Trade of the then Labour government. The joint submission strongly objected to the new wide-ranging regulations that had just been issued and published in terms of the Supplies and Services Act. New and very stringent and extensive price controls and other significant trade restrictions were being introduced. It was reported that the organisations *"deplored the fact that the Government had thought fit to move backwards to, instead of away from, the 1939-46 war-time conditions which might have justified the introduction of the original price controls."*[29]

The report concluded with the claim that *"…..the quality of life and standard of living will be denuded or eroded. Businessmen*

will be subjected to unprecedented Government interference". It emphasised that "*the new regulations were only suitable in crises conditions*".

Thirty five years later, these maligned regulations remain solidly in place. Since 1972, many things have changed and consumer protection is now an integral part of Maltese law, moving far beyond traditional price controls. These past 35 years have seen the publication of two consumer-oriented White Papers, the adoption of significant new consumer legislation, the introduction of new consumer rights and remedies and the establishment of consumer-friendly administrative and judicial structures. 2004 brought Malta into the European Union involving the full transposition of the EU *acquis*. The economic and political environment in 2007 bears no comparison to the 1972 situation. Some may therefore be excused for being rather surprised and bemused that the extensive 1972 price control regulations remain in force.

The 1992 Government Activities Report

The *Report on the Working of Government Departments for the Year 1992*[30] contains one of the first ever sections specifically dedicated to Consumer Affairs in these annual official reports. This Report announces that new legislation was being drawn up and that a new Consumer Affairs Bill had, during the year under review, "*been presented to Parliament*".[31] As if in a time-warp, the section dealing with the activities of the Department of Trade continued to reflect the considerable restrictions under which trade had been labouring for so many years. The Report cheerfully records the number of import and export licences issued during the year by the Licensing Division, and elaborates on the

operations of the Price Monitoring Division, the Costings and Bulk Buying Division Sections as well as the Price Control Section. Two statistical appendices were attached to the Trade Department's account of its activities in 1992. One happily records the number of physical inspections carried out in retail premises by the Price Control Division while the second enthusiastically details the *"Outcome of Price Control Sittings"*.[32]

Nothing in these sections betrays any intention to do away with all or any of these anachronistic approaches. The 1992 Report is nevertheless evidence of a growing conceptual clash between the discredited negative control-based methods of the past with the new more positive rights-based approaches to consumer protection.

The European Commission gives its opinion

In October 1999, the European Commission organised the so-called *screening session* where the various consumer protection directives were matched against Malta's consumer laws.[33] During this session, price control was not discussed because price controls have no place and do not form part of the EU's consumer strategy.[34] Indeed EU has no specific rules regarding price control which remains a matter for the national law of the member states.[35]

Some years earlier, in June 1993, the EC published its first *Avis*[36] on Malta's EU membership application. Both the original *Avis* and its subsequent regular updates contain interesting comments relevant to our present subject. The *Avis* adjudged Maltese consumer law to be inadequate and far below EC standards. It is also very revealing of the Commission's thinking on the extensive restrictions and controls under which local business was still operating:

"The Maltese economy is covered by an administrative and regulatory framework which tends to swell production costs and hamper the business sector's ability to adapt and compete.

The restrictive measures include:

- rigorous control of prices and profits, currently considered essential by the Maltese authorities to curb the monopolistic tendencies of certain firms that are a consequence of the lack of competition in the Maltese market.....

The need for reforms

The reforms which imply Malta's adoption of the acquis communautaire *affect so many different areas (tax, finance, movement of capital, trade protection, competition law, etc) and requires so many changes in traditional patterns of behaviours that what is effectively involved is a root-and-branch overhaul of the entire regulatory and operational framework of the Maltese economy."*[37]

The Opinion also considered the state of play of competition legislation concluding that *"Maltese anti-trust law is incomplete……There is no specific legislation and no central supervisory department or agency. The authorities realise that competition will come to play more of a part in the economy and are considering ways of rectifying the situation."*[38]

Following Malta's re-activation of its membership application in September 1998, the EC was requested by Council to *"present an update of the 1993 Opinion"*.[39] This 1999 update examined in detail what progress was achieved, sector by sector, since the original 1993 Opinion. Eventually, the EC published its Regular Report on the 13 October 1999. Here it commented negatively that:

> *"Concerning free movement of goods, major institutional arrangements regarding the implementation of the acquis… are missing or not yet finalized… In general terms, Malta lacks legislation in line with the EU acquis in the area of free movement of goods and should consider adopting an internal market approximation programme…No substantial progress has been made since February and Malta should make the internal market its priority."*[40]

No doubt this was also an allusion to the negatively impressive price regulations in place.

The 2000 Regular Report was generally more upbeat about Malta's preparations for membership, but the tone changes when the existing price control framework was assessed: *"The remaining price controls distort relative prices and produce an inefficient allocation of resources. The influence of the state in the economy is still too high in some areas"*.[41]

Government Documents and Official Promises

The two consumer White Papers published in 1991 and 1993 both specifically addressed the future repeal of the existing price control framework and of price orders issued in terms of the 1972 regulations. Several other official documents and statements show the Maltese government had started committing itself in earnest to overhaul the situation which was considered (a) unsustainable in view of imminent EU membership, and (b) no longer justified in the light of significant reforms undertaken in consumer rights and fair competition legislation. This paper will now consider two important policy documents.

The National Programme for the Adoption of the Acquis (NPAA)

The first document is the hefty NPAA which described in detail the Maltese government's EU law implementation position as at January 2001.[42] It constituted Malta's detailed programme of commitments to the EC to align with EU laws by the end of 2002.[43] Chapter 3 of the 2001 NPAA deals with Malta's obligations with regard to the internal market and free movement of goods in particular.[44] This section contains an explicit straightforward and unambiguous statement on price controls:

> *"Price Control*
> *The system of price control on the sale of commodities includes the setting of maximum margins of profit as well as the regulation of prices through price orders on certain essential commodities. Amendments to the Competition Act (Cap.379) were adopted by Parliament in November 2000. These amendments provide for the application of interim measures with regard to fixing maximum prices on essential goods and services. New legislation to replace the Supplies and Services Act (Cap 117) and the Sale of Commodities (Control) Regulations 1972 (LN 21/72) is being drafted. The main scope of this legislation is to adjust the present price control system to become more in line with Community practices in the area, as well as to transpose Directive 70/50/EEC."*[45]

Later, the NPAA spells out the commitment even further:

> *"The Supplies and Services Act (Cap.117) and the Sale of Commodities (Control) Regulations (LN 21/72) will*

be amended by the third quarter of 2002 to transpose Directive 70/50/EEC (abolition of measures that have an effect equivalent to quantitative restrictions on imports). Existing price controls will be adjusted in line with Directive 70/50/EEC on accession."[46]

The November 2003 Report

In November 2003, the Ministry of Finance and Economic Affairs submitted to the EC its first "*Report on Economic Reforms: Product and Capital Markets*". This report was described as "*part of the integration of the process of the integration of the acceding countries into the Community's economic policy co-ordination process*".[47] The 25-page document specifically addressed the issue of price controls[48]. It makes interesting reading:

"Price Controls
The Maltese economy has been characterised by relatively low consumer price inflation in the past years and indeed the inflation rate has been close to the EU average in recent years. It is government's economic policy that prices should, as far as possible, be determined through market forces, whilst taking into account the specific realities of the small domestic market. The imposition of price controls is regarded as leading to misallocation of resources and economic inefficiency as economic agents base their decisions on prices that do not reflect the true market value of the commodity in question. In this regard, during 2003, substantial amendments to the Supplies and Services Act (Cap.117) were enacted, which will repeal the price orders that were issued under the previous Act. The new law envisages a system whereby temporary price

orders may be issued in response to abnormal or exceptional situations or where it is manifested that market forces are not working. This new legislation would align the Maltese legislation to the provisions of Directive 70/50/EEC on the abolition of measures which have an effect equivalent to quantitative restrictions on imports."

The clear vision and the reforming determination emanating from this document seems to have been relegated to a footnote in history. The price regulation regime which the report explicitly promised to sweep away has, instead, survived.

The new Supplies and Services Act of 2003 and the post-1994 Legislative Framework

The Labour governments that governed Malta between 1971 and 1987 continued to rely on a series of very unimaginative and restrictive trade policies comprising severe price controls, bulk-buying importation of many products, and import substitution. These measures reduced competition and led to poor consumer choice. Three unsatisfactory and patchy consumer-oriented laws were passed between 1981 and 1986.[49] These could not dislodge price control as the primary consumer protection mechanism which continued to be very extensively enforced.

In 1991, the Nationalist government elected in 1987, after long years in opposition, launched an innovative White Paper on consumer rights. This innovative document set out a long term programme intent on introducing modern and effective consumer law principles and structures to Malta. The idea was also to gradually start replacing the traditional price and other trade restrictions

still disguising themselves (badly) as *bona fide* tools of consumer protection. [50]

1993 saw Government issuing a second White Paper where consumer law reforms were considered jointly with new sweeping reforms in competition law. The Fair Trading White Paper led to the adoption of the first ever Competition Act, an extremely important law which introduced a new legal framework incorporating new rules for the issue of price orders and for the prohibition of abusive price-fixing agreements. This new framework was intended to replace the archaic and unloved 1947 Act and many of its regulations.

The Consumer Affairs Act of 1994 was a new and refreshing start in consumer legislation, introducing credible and effective rules and structures promoting consumers within a cohesive framework. The Act was a massive step forward for the legal recognition and protection of consumer rights in Malta. The fragilities and the incoherence of state measures that sought to protect consumers indirectly by severely restricting trade activities through price and other dubious administrative controls were, it seemed, about to be finally relegated to history. But that did not happen.

With a view to bringing price control within the newly reformed legal framework, a Bill to redress the 1947 anomaly was presented to Parliament and passed through all the stages in 2003, just months ahead of accession.[51] Regrettably, this new law has not been brought into force and has remained shelved, seemingly forgotten.[52]

In its issue of 10 July 2003, under the title *"19 laws being aligned to EU acquis"*, The Times reported that government had presented a Bill which *inter alia "practically repeals the Exchange Control Act and the Supplies and Services Act.."*. Paraphrasing a statement in Parliament made by Minister

John Dalli[53] who was piloting the Bill, the Times reported optimistically that:

> *"The Supplies and Services Act, which gave the government draconian powers in areas such as price orders, was being amended extensively to the point that it was practically repealed. The government, however, would be able to take drastic action in case of emergencies to protect consumers as in the case of acute shortages of particular products. The government may issue temporary price orders to stabilize the situation when problems arose.*
>
> *Mr Dalli said experience had shown that price orders did not work, with many ways being found around the system. The government would continue to guard against abuse but his view was that the best way of control was through competition."*

Act No. IX of 2003 is clearly a landmark event for the subject covered by this paper. It sought to reform the price control regime, and convert the Supplies and Services Act of 1947 into a leaner and more acceptable tool. It paved the way for the repeal or radical overhaul of the 1972 regulations.[54]

Speaking during the debate on the Bill, Parliamentary Secretary Mr. Edwin Vassallo confirmed that the objective of the Part IV amendments was to allow the issue of price orders exclusively in exceptional circumstances and to restrict them to products that were truly essential for the daily life of a society, "*such as bread and fuel*". The aim, he explained, was to shift towards a more objective basis for intervention thereby reducing the subjective discretionary powers enjoyed by the Minister and the Director of Trade. He described the current law as constituting "*a barrier to trade*", particularly in view of the burdens it imposed on

importers. The 1947 law was not in line with EC law, gave the Minister too wide discretionary powers and wrongly extended its restrictions indiscriminately to all commodities placed on the Maltese market, whether manufactured locally or imported. He declared that all these negative features were being rectified by the adoption of the new legislation.

The most important provision of the new Act is article 4 which empowers government to intervene in the market and impose maximum prices or price margins only in "*abnormal or exceptional circumstances*" or where competition "*is not functioning in a reasonably effective manner*". In these special instances, the most that the Director of Trade can do is to issue a temporary price order for a duration not exceeding six months.[55] The order may be extended for six month periods by specific order published in the Government Gazette - a far cry from the indefinite duration of price orders issued under the 1972 regulations, many of which remain technically effective until today, not having ever been specifically repealed. Article 5 then assigns authority to the Minister to make regulations to establish price control over essential goods or services deemed "*essential for the life and well-being of the community*", which he would be obliged to list in the Government Gazette.

The 2003 legislation was the promised and long overdue re-vamp of the 1947 measure. The circumstances under which the two laws were adopted could not have been more different. The 1947 Act was devised to resolve a post-war emergency involving poverty, severe shortages and black marketing. To the contrary, the backdrop to the 2003 reform was the imminent membership of the EU with its highly liberalized internal market during a stage of relative economic prosperity. The 1972 regulations were adopted at a time when consumer and competition

law had not yet been conceptualized, let alone developed. Instead, the 2003 reform was undertaken when consumer and competition law were already well developed and functioning. The new rules sought to allow market forces to act as the main factor in securing fair prices and wider consumer choice. Government's role was redefined and reduced to making sure that the market does in fact function properly, particularly through the operation of the Competition Act of 1994.[56] The 1947 Act and 1972 regulations envisaged government intervention as the norm. The 2003 Act limited official intervention to extraordinary situations where the market and competition law mechanisms have broken down and failed. In such cases, government could intervene to secure supplies, and to prevent over-charging and hoarding. Extraordinary circumstances could include a national emergency, the aftermath of a war in the region, an earthquake, a pandemic outbreak, scarcity of some particular product as a result of economic factors extraneous to the island. These circumstances warrant government intervention to protect legitimate public interests. The new Act had the necessary flexibility to permit the swift implementation of extraordinary measures to address abnormal situations. Safeguards were put in place to prevent arbitrary or grossly disproportionate action by government.

The 2003 law was predicated on three inter-related propositions:

1. The first is that it was right that government should retain residual rights to intervene in extraordinary situations which could cause serious hardships to consumers.[57] This aspect of the 1947 Act was a worthy employment of law and administrative power. It was not in the public interest for government to simply sign away its responsibility to intervene in the market to protect the public when

crisis situations warrant it or when competition fails.[58]

2. The second is that, unlike the 1947 Act, the 2003 initiative does not consider Malta to be in a permanent state of economic crisis.
3. The third observation is that in the wrong hands, the 1947 Act proved a dangerous piece of armoury which was easy to over-use or otherwise misuse. This represented a negative feature of the Act which warranted rectification. It was in the public interest that these discretionary administrative powers should be adequately curtailed and controlled.

Regrettably, the 2003 Act has not been brought into effect. The failure to bring the new Supplies and Services Act (replacing the 1947 Act) into force is a worrying development which breaches specific official NPAA and EU membership commitments.

Price Orders in 2006

Any person inclined to believe that price controls were a thing of the past may, in April 2006, have felt justifiably perplexed to find the government threatening to issue price orders in order to curb inflation which it felt may have been caused by price-fixing and cartels in certain sectors. The Parliamentary Secretary in the Ministry of Finance was quoted as warning that "*if certain prices, particularly those of imported foodstuffs and medicine, keep failing to reflect market trends, the government would be forced to introduce price orders.*"[59] Not surprisingly, the GRTU and other trade organisations strongly objected to government's threat to introduce price orders of certain imported foodstuffs and medicines. The GRTU was reported as describing

the threatened price orders as "*definitely unacceptable in a liberalised, free market economy*".[60] The same *Times* report also had an unnamed spokesman for the European Commission explaining to it that EU law does not prevent a national government from introducing '*maximum price*' legislation, adding that:

> "*However were a national government to introduce particular measures, the Commission would look carefully at any such measures to determine whether they are in all their aspects compatible with competition and single market rules, for example that they are not discriminatory.*"

The government eventually relented and withdrew the threatened publication of price orders under the 1947 Act. But the incident nevertheless proved that old habits die hard.

CONCLUSION

This paper has focused on the Supplies and Services Act of 1947 and the regulations issued thereunder, particularly the Sale of Commodities Regulations of 1972. The present enquiry has asked whether the continuation in force of the 1947 Act and the 1972 regulations make any more sense now that (i) Malta has since 1994 been introducing modern legislation and structures for the promotion of fair competitive trade practices and consumer rights, and (ii) Malta has since 2004 formed part of the European Union with its significantly liberalized internal market fuelled by the free movement of goods principle. The paper suggests that the retention in the Maltese legal system of the 1947 Act, the 1972 regulations, together with the numerous

disparate price orders issued thereunder, is incongruous: a monument perhaps to incoherence and ineptitude.

Various official documents and statements of policy, particularly during the four years immediately prior to EU accession, repeatedly reveal that government was convinced that the 1947–1972 price control framework was no longer sustainable and was incompatible with the new EU legal context. This is the position resulting from the negotiating positions agreed between the Maltese government and the EC, from the NPAA commitments and from Act IX of 2003.

Price control is important but it is also a source of controversy. Very often widespread price regulation is a simplistic and administratively very costly and burdensome mechanism. It may also be a politically convenient reaction to increasing inflation, as it shows government doing something immediate which the public will readily understand, and in a true emergency, may even appreciate. Regardless of the controversy surrounding governmental price restrictions, it is felt unwise for a government to absolutely renounce to the power to intervene and regulate prices of essential goods and services. The state should therefore retain a residual measure of power to deal effectively and urgently with emergencies and with possible artificial shortages and abuses which competition authorities may be unable to resolve quickly or effectively. Government price regulation should therefore be based on two principles:

(i) it should not extend beyond goods and services which are truly essential to the proper well-being and functioning of a modern society; and

(ii) it should come into play sparingly and only in extraordinary situations where competition between suppliers and the protective mechanisms of competition

law fail to provide the required guarantees of adequate supplies of essential goods and services at reasonable prices.

The Consumer Affairs Act of 1994 Act has expressly recognized that a consumer has a right *"to have adequate access to basic essential goods and services at reasonable prices and to be able to choose from a diverse range of goods and services."*[61] This consumer right now finds itself effectively re-stated in new article 3 introduced by the 2003 amendments which declares that:

> *"Consumers have the right to be placed in a position to purchase adequate and reasonable quantities of any goods or services that are made available on the market in order to satisfy their normal requirements."*

The history of consumer legislation in Malta is inexorably intertwined with the history of price and other trade controls. In both contexts, the 1947 Act has played a principal role. Price control and other trade restrictive measures were for too long confused with consumer protection. This had negative consequences. It meant that it took Malta far too long to realize that consumer protection is more than just keeping prices low, and that other serious consumer concerns such as product safety, unfair contract terms and consumer credit and other abuses needed to be addressed.[62]

For a long time, consumer protection was deemed sufficiently served by assigning to public authorities various discretionary powers to intervene in the market and dictate prices and practices. Extensive price controls were more easily justified when fair competition and consumer rights legislation had not yet been sufficiently developed. Whether price controls are an efficient legal-economic tool for the

protection of the public, particularly the poorer sectors, from abusive pricing by unscrupulous traders, will be left to others more expert to tackle. There seems to be evidence that where price controls are employed inefficiently, they may regrettably help fuel shortages of supplies resulting in less consumer choice. They may therefore prove counter-productive, becoming part of the problem rather than the solution. The problem is compounded by a public administration behaving as though consumer protection simply means more and more price controls. By so doing, it fails to take more useful and meaningful measures to raise the standards of quality and safety of consumer products, to safeguard contractual fairness, and to ensure consumers receive adequate remedies and easy access to the judicial process.

The 1947 law may be a useful lesson in how supposedly temporary measures introduced to deal with emergencies often become permanent outlasting the emergencies they intended to resolve. Indeed, one need not study the whole history of price control restrictions in the various stages of Maltese history to come to the conclusion that the Supplies and Services Act of 1947 and the 1972 regulations are an anomaly whose time seems to be truly up. Price control and other trade restrictions in our law remain evidence of a past that refuses to go away and make way for the new.

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2. *'Fair Trading.....the next step forward'*, November 1993, White Paper, Department of Information;
3. The National Programme for the Adoption of the Acquis (NPAA), September 2000;
4. The National Programme for the Adoption of the Acquis (NPAA), January 2001.

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2. Regular Report on Malta's Application 1999, updated in 2000.

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2. Competition Act 1994;
3. Consumer Affairs Act 1994;
4. Supplies and Services (Amendment) Act 2003 (not yet in force).

Secondary legislation (regulations)

1. Supplies and Services Act 1947:
   i. Sale of Commodities (Control) Regulations 1972;
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2. Consumer Affairs Act 1994:
   i. Display of price-lists in Bars and Kiosks Regulations 1997;
   ii. Price Indications Regulations 2002.

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2. *'A Note on Consumer Policy and Law in the context of the EU Accession and Transposition Process- 1990 to 2004 and beyond'*, published on the MESA website and still available at http://home.um.edu.mt/edrc/mesa/consumer_protection_paper.PDF;
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5. *'Lifting the Screen: Welcome to the Silent Revolution'*, The Accountant, (cover story), March 2000;
6. *'Maltese Consumer Law and Policy before and after EU membership - the good news and the bad news'*, address to a conference organized to launch the European Consumer Centre on 7 December 2005;
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Notes

* The paper reflects the position as at September 2007.

1 (Translated from Maltese), "L-Orizzont", 25 September 1992, quoted in *False Starts and Broken Promises: some mishaps in the development of Maltese consumer law*", published in *Law and Practice*, official journal of the Malta Chamber of Advocates, October 2006.

2 "*Regulation of Trading Practices in Malta*", paper published in 1992. Dr Borg is currently an EU Commissioner.

3 This applies equally to the supply of services, but this paper is only concerned with the sale of goods to consumers.

4 Civil Code, The Law of Sale, articles 1346-1439.

5 One example is Legal Notice 97 of 1997, The Display of Price-Lists in Bars and Kiosks Regulations 1997.

6 Article 13 of the Trade Descriptions Act, 1986.

7 Competition Act 1994, in particular articles 5 and 9.

8 Published in the Government Gazette on 7 September 2007.

9 Legal Notice 21 of 1972.

10 In terms of this Order, loaves weighing more or less 600 grams cannot be sold at a price higher than 20 cents.

11 This paper is based on Maltese law as published on the Ministry of Justice website www.gov.mt in September 2007.

12 See generally article published in Law and Practice, December 2000, which already probed the compatibility of price controls and the 1972 regulations with the EU *acquis*.

13 The 1947 Act was a very useful tool but it also made almost unlimited powers available to politicians and public administrators to intervene and meddle in the market, sometimes to good and sometimes to bad effect.

14 See generally paper published in Law and Practice, November 2006.

15 Phone-ins by consumers on local radio station programmes dealing with consumer complaints - often in distressingly superficial style - provide yet more contemporary testimony of how much price control continues to be ingrained in the minds and hearts of Maltese consumers.
16 These measures were devised with tremendous and at times almost hilarious meticulousness and led to bureaucracy of the most inefficient kind, and worse.
17 And for too many persons in authority who should have known better.
18 See definitions in article 2.
19 Legal Notice 134 of 1957, Requisition of Bakeries Regulations and Legal Notice 2 of 1980, Bakers' Licences Regulations.
20 Legal Notice 9 of 1975, which authorized the Minister to requisition and take control over any tugboat or lighter.
21 Legal Notice 67 of 1982, the Control of Private School Fees Regulations.
22 Price Order No. 71 of 1977.
23 Price Order No. 219 of 1979.
24 Price Order No 2 of 1980.
25 Price Order No. 68 of 1980.
26 Price Order No. 35 of 1982.
27 The 1972 regulations replaced and effectively consolidated and expanded the provisions of the earlier original regulations enacted in 1952 and which had undergone numerous amendments in the intervening years. Many price orders were issued during the sixties, including a general price freeze imposed to curb price hikes resulting from the Arab-Israeli war and the devaluation of the pound. See Legal Notices 38 and 392 of 1967.
28 This was a rather rare show of unity highlighting the importance of the issue at stake.
29 The Times of Malta on 19 April 1972 carried a page-long feature on this matter under the title "*Joint submissions on new price controls*".
30 An annual Department of Information publication which reviewed the activities carried out by all the various government departments during the previous year. See in particular the section dealing with the newly formed Department for Consumer Affairs, pages 210-211, and the section covering the performance of the Department of Trade on pages 262-263. These annual reports are a mine of information regarding the development of government policies and departmental activities over the years.
31 This must have been a reference to the so-called 'first reading' of what eventually became the Consumer Affairs Act of 1994. The actual Bill only appeared in print in November 1993, appended to the White Paper "*Fair Trading…the next step forward*".
32 "*Sittings*" here refers to judicial proceedings instituted before the Magistrates Court dealing with the criminal prosecution of traders found to have breached the price control regulations.
33 And vice-versa. See Article published in the Accountant 2000.
34 Very briefly, price controls are allowed in EU member states provided that they are non-discriminatory and do not obstacle the free movement of goods across borders. The issue of the validity of price controls introduced by member states was tackled by the European Court of Justice in various cases. Howells and Wilhelmsson have described ECJ's approach to national

price regulation measures as one which does not declare any: "*general prohibitions or restrictions on national price regulation measures. Only if the measures are practiced in a discriminatory way or lead to discriminatory effects are they to be considered to violate the Treaty: for example, if the prices are fixed at such a level that it becomes impossible or more difficult to sell imported products, the measure will be considered to have an equivalent effect to a quantitative restriction of trade*." (*EC Consumer Law*, Geraint Howells and Thomas Wilhelmsson, Dartmouth Publishing Company Limited, 1997, page 87; See also Oliver, Free Movement of Goods); See also generally Peter Oliver, *Free Movement of Goods in the European Community*, Sweet and Maxwell, 3rd edition, 1996, especially pages 161 to 171.

35 On the other hand, price indications were discussed and "screened" as they are regulated by an EU Directive (Directive 98/6/EC of 16 February 1998 on consumer protection in the indication of the prices of products offered to consumers).

36 The EU's official opinion on the qualification and preparedness of an applicant country for eventual EU membership.

37 Opinion 1993, pages 16-17.

38 Opinion 1993, page A/15. A Competition Act was adopted in the second half of 1994.

39 Report Updating the Commission Opinion on Malta's Application for Membership, EC, February 1999.

40 Pages 17-21.

41 Ibid.

42 *Malta: National Programme for the Adoption of the Acquis, as at January 2001*", Ministry of Foreign Affairs, Malta, available at www.mic.org.mt/Malta-EU. The first NPAA had been published in February 2000.

43 This was based on government's projected (or virtual) date of accession of 1 January 2003.

44 Pages 24 to 39.

45 Page 24.

46 Page 26.

47 Foreword, page iii.

48 Pages 3-4.

49 These have already been reviewed in paper published in Law and Practice, November 2006.

50 Important statements of policy on pricing of consumer goods and the future of the 1972 regulations were made in the 1991 and 1993 White Papers. See "*Rights for the Consumer*" White Paper, Chapter XIII on '*Pricing*', pages 30 - 31, Department of Information publication, August 1991; and "*Fair Trading: the next step forward*" White Paper, Department of Information publication, November 1993, Part III, pages 15 – 18.

51 Part IV of Act No. IX of 2003 published in the Government Gazette on 2 September 2003.

52 Thereby effectively thwarting Parliament's declared intentions. The adoption of the Bill was specifically highlighted in the November 2003 report on economic reforms.

53 Then Minister for Finance and Economic Services.

54 The Bill had its Third Reading before Parliament on the 16 July 2003, sitting

number 4, Parliamentary Committee for the Consideration of Bills.

55 Article 4(3) of Part IV of Act No. IX of 2003.

56 Administered by the Director for Fair Competition.

57 See entry on "Price gouging" in Wikipaedia on www.en.wikipaedia.org/wiki/Price-gouging.

58 A recent illustration of how this can come about was described in a CNN.com report dated 26 December 2001. Headlined "*Hotel fined for post-Sept 11 price gouging*", it narrated how in the days immediately after the 11 September incidents, hotels in New York over-charged stranded air passengers exorbitant rates, even up to 285% more then the normal price. The CNN.com wrote: "*New York's anti-gouging law prohibits 'unconscionably excessive' prices of essential consumer goods during a state of emergency*." The hotel in question was fined and ordered to affect refunds to its customers.

59 The Times, 26 April 2006. See also Medical Association website www.mam.org.mt/newdetail report dated 26 April 2006 on the same controversy.

60 Former Labour Trade and Finance Minister and currently a newspaper columnist, Lino Spiteri, found the threat to issue price orders "*ironic*" - probably recalling the extent to which his Ministry had been savaged for its extensive resort to price orders in the early eighties.

61 Consumer Affairs Act, article 43(2)(a).

62 Many of these problems were only properly addressed by the law thanks to the transposition of the EU consumer *acquis*.

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