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2021 Code Review
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Dear Mr Callaghan

Submission in response to the Review of the Banking Code

This submission focuses on Terms of Reference 3, 4a and 6 with attention drawn to the impact of this submission on Terms of Reference 8 and the potential requirement to amend legislation in order to implement the recommendations proposed within this submission. Throughout the submission, the Australian Banking Association Code of Conduct will be referred to as the Code.

The Issue

That financial contracts and PDS provided by financial institutions are misleading and deceptive in that the financial institutions do not fully disclose the impact of interest charges applied to borrowers during leap years. The formula applied is not adjusted to account for the additional day occurring in a leap year and this results in borrowers being overcharged during that period by an amount equivalent to one day's interest. As a result of this additional interest charge, the effective rate of interest therefore is understated.

The formula applied to calculate the annual interest payable multiplies the loan balance by the interest rate which is then divided by 365 to calculate the daily rate. In any 365 days the full amount of interest is therefore charged by the lender and recovered from the borrower.

Example: Interest calculation in a 365 day year on a loan of 400,000 at 6% pa:

$\$400,000 \times .06 = \$24,000$

Advertised/applied interest rate 6% pa, Effective interest rate 6% pa.

However, during leap years, interest rate calculations remain based on the exact same formula with the denominator set at 365 days without adjustment to account for the 366th day that occur in such years. This results in an additional day's interest being charged to the customer when, in the preceding 365 days, the full annual interest commitment has already been charged to the borrower. No adjustment is made to the annual interest rate applied to accommodate the additional day falling in a leap year over which the annual interest charge should be spread.

Example: Interest calculation in a leap year on a loan of 400,000 at 6% pa:

$\$400,000 \times .06 = \$24,000 + \$400,000 \times .06 / 365 = \$24,065.75$

Advertised/applied interest rate 6% pa, Effective interest rate 6.016% pa

As a result, customers are charged what amounts to an additional day's interest in excess of what is required by the customer's stated annual interest rate and the impact of this additional charge is then compounded over the term of the loan. The practice also results in the effective rate of interest each leap year being understated and therefore misleading. On the other hand, financial institutions

reap an additional day of interest from their customers for which the institutions have no actual entitlement.

Based on information conveyed to me by my bank, this is an industry wide practice which I believe imposes an unfair and undisclosed penalty on customers and creates a significant and undisclosed financial gain to the financial institutions who fail to make system changes to account for the additional day occurring each leap year. When assessed across the total number of loans and credit facilities current during any year taking into account the range of credit facilities such as high interest credit cards, the benefit to financial institutions is of significant magnitude.

(Please note on the basis that this is an industry wide practice, I will refer to my Bank as "ABC" so as not to single out and draw focus to any one financial institution).

Practice in contradiction to the Guiding Principles underpinning the Code

These underpinning principles are

1. Trust and confidence
2. Integrity
3. Service
4. Transparency and accountability

On 18 July 2020 I raised my concerns regarding the overcharging of interest during leap years with my bank. The Bank responded on 23 September 2020 as follows:

"ABC does not agree that you have made overpayments on your loans. This is because ABC has charged interest on your loans in accordance with the applicable terms and conditions. For example, how interest is calculated and debited for an Equity Manager facility is set out on pages 50-51 of the Consumer Lending terms and Conditions. According to those terms and conditions, interest 'will accrue on the outstanding balance..... at the applicable daily interest rate' and the applicable rate 'will be the annual percentage rate applicable to your account for that day, divided by 365'.

At the time a customer accepts a loan with the ABC, they agree to be bound by the terms and conditions which apply to that loan. In other words, the customer agrees to ABC charging interest in the way described in the terms and conditions."

Transparency and integrity must be questioned when a customer's agreement is assumed to cover not only the disclosed provisions but also those provisions not disclosed, especially when the non-disclosed elements are solely advantageous to the Bank. In signing a standard form contract with a financial institution, the borrower should be able to assume complete transparency, honesty and full disclosure. Instead, Banks hide behind the contract assuming overriding consent to terms and conditions that the full impact of which are not evident to the borrower due to the Bank's silence or absence of comprehensive detail in their documentation.

Financial institutions are fully aware that in a leap year there are 366 days and that on the 366th day they will charge their customers' interest. The financial institution is also fully aware that the calculation for interest is based on a denominator of 365 which the bank does not adjust to accommodate the additional day that occurs every four years. The financial institutions must account for this supplementary payment in their budgets and financial statements. Hence failure to disclose this known anomaly in the Bank's terms and conditions is clearly purposeful and therefore

misleading and deceptive let alone inconsistent with the stated guiding principles underpinning the Australian Banking Association Code of Conduct.

As the annual interest charge has been recovered in the preceding 365 day period, the financial institution has no entitlement to the additional day of interest that is charged each leap year. From review of the information provided to me by the ABC bank, the Bank is completely silent as to the windfall gain it receives when interest is calculated in accordance with pages 50-51 in its documentation during a leap year. In fact, nowhere in the terms and conditions or the supporting PDS is there any reference to “leap year” or any variance of this term.

Term of Reference 3

This Term of Reference considers the Code’s response to the needs of customers across the broad range of people within our society. It would only be in rare circumstances that a customer could extrapolate the consequences of a particular clause on page 50-51 of the 80 page ABC terms and conditions to mean that they are agreeing to being overcharged interest every four years.

Apart from the length and complexity of the documentation, customers scan such material on the premise that the financial institution is being upfront, fair, honest and transparent. Customers do not expect Banks to take advantage of them with omissions hidden within the complexity of a mathematical formula that conceals a non-disclosed financial benefit to the Bank. Many customers would not possess the mathematical skill to apply the formula let alone look for loopholes. So, to say, these customers have agreed to the use of this formula is, simply put, wrong and unethical if not unconscionable, on par with the act of charging interest for which the financial institution has no entitlement.

Considering the contract as a whole, there is nothing to alert the prospective credit applicant to question the possibility of a material non-disclosure. I could not find any suggestive reference to attract my attention to consider how interest might be handled differently in a leap year. The exclusion of any reference to leap year or 366 days and the failure to simply adjust the formula, or interest rate applied, to avoid the overcharging of interest on the 366th day serves to protect the interests of the benefitting party by securing additional revenue for which there is no actual entitlement. In doing so, the financial institution imposes an obligation on the borrower to pay interest that exceeds the required annual amount for which the institutions have a right to demand. In addition, the institutions then impose additional penalties should this “bonus” interest not be paid.

While the banking services might be considered “inclusive, affordable and assessable for all customers” when evaluating the scope of Term of Reference 3, the service fails to earn the consumer’s trust as declared as key component of the financial services provider’s role in society under the Code. By failing to provide clear information (Chapter 8 and 15) Bank’s are failing “to do the right thing” by their customers.

Recommendation:

That the scope of Term of Reference 3 be expanded to evaluate the performance of financial institutions in meeting their commitment to their customers under Chapter 8 and 15 of the Code.

That the scope of Term of Reference 3 be expanded to assess the Banks’ commitment to the Guiding Principles underpinning the compliance with the Code as a result of their failure to declare the charging of interest on the 366th day each leap year for which there is no entitlement.

Term of Reference 4a

The ABC Bank draws attention to their Consumer Lending Terms and Conditions pages 50 – 51 in their correspondence to me (ref: COM-972855 dated 23 September 2020) as the basis on which the Bank can calculate the interest in any year, including leap years. The Bank is of the view that the borrower in agreeing to this method is bound by these terms and conditions and agrees to this method of calculation.

I would argue that the Consumer Lending Terms and Conditions form part of a standard form contract. There is undoubtedly a significant imbalance of rights and obligations between the borrower and the lending institution. The borrower has no scope to vary these terms and conditions if he wishes to secure the loan. ABC Consumer Lending Terms and Conditions comprises 80 pages and is completely silent as to windfall gain the Bank receives when interest is calculated in accordance with pages 50 – 51 during a leap year.

Given that the borrower has no scope to vary the Consumer Lending Terms and Conditions and given that the financial institution is fully aware of the bonus interest that it accrues every leap year with cumulative flow on effects, the onus must rest with the financial institution to provide full disclosure of the interest penalty incurred by the borrower by agreeing to the Consumer Lending Terms and Conditions. Failure to do so, is unfair, deceptive, dishonest and unethical.

Such practices, if consumers were aware, would fail to meet consumer and community expectations of fair, reasonable and ethical behaviour as being reviewed under Term of Reference 4a. The financial institutions cream an extra day's interest every four years and hide behind the unsuspecting borrower's agreement to the unfair and deficient contract terms in their Consumer Lending Terms and Conditions as justification for doing so.

In declaring a Bank's role in society, the Code states that there is an expectation of "behaviour to meet high ethical standards, backed by the right internal cultures and practices". Further, there is a commitment "to continuously improving and being accountable." Again, failure to declare that the current method of calculating interest results in the customer being overcharged a day's interest every leap year and the Bank retaining that interest for which there is no entitlement fails to demonstrate a high ethical standard, sound commercial practices or accountability.

Recommendation

That the scope of Term of Reference 4a includes a review of the current method by which interest is calculated during leap years to consider amendments to the formula by either substituting a denominator of 366 during leap years or by adjusting the rate of interest applied in the formula to compensate for the additional day interest charged during a leap year.

Term of Reference 6

Financial institutions fall under the provisions of the National Credit Code (NCC). Part 2 Division 3 Clause 27 specifies the calculation of the daily interest rate is undertaken by dividing the annual percentage rate by 365. However, Part 2 Division 2 Clause 23 does not prohibit the imposing of a charge that is calculated inconsistently with the Clause providing the resulting amount does not exceed an amount had the calculation been made in accordance with the NCC specifications.

This opens an avenue for the financial institution to vary the specified formula and substituting a denominator of 366 to arrive at an interest rate that would yield an interest payment equivalent to

what would have been applied had the year not been a leap year. Just because the NCC enables financial institutions to calculate interest payments in leap years based on Part 2 Division 3 Clause 27, it does not make it ethically right or fair to do so.

The Code is intended to provide “safeguards and protections not set out in the law. It complements the law and, in some areas, sets higher standards than the law.” The Code further states that “By promoting best practice, the Code has led to higher standards in the banking and financial services industry.” Based on these statements, rectifying the overcharging of borrowers every leap year is an appropriate means of demonstrating the commitment of the banking industry to best practice.

I am clearly of the view that the National Credit Code should be amended to account for the impact of the additional day interest occurring every four years and to close off the loophole that is used to justify, and even condone, the overcharging of customers which occurs. That all Banks follow this approach, does not make the practice right and it is certainly not the provision of a service in the best interest of their customers.

The Code states “many of the standards embedded in the Code have been included in the law”. Banks have an opportunity to demonstrate industry leadership by implementing appropriate changes to the method of calculating interest during leap years. In doing so, this would prove their commitment to the principles they claim to stand behind, then the necessary legislative changes may follow.

Recommendation

That the scope of Term of Reference 6 considers the implementation of changes to the calculation of interest rates and interest charges applied to customers by financial institutions during leap years.

Should such changes be considered valid and justified, then such amendments be proposed for review by ASIC for subsequent inclusion in the NCC.

Term of Reference 8

Under RG 185.9 to RG 185.11 of ASIC Regulatory Guide RG183, ASIC gives consideration to the interaction of a Code with the application of other regulatory regimes.

The calculation for interest as set out in the NCC based on a denominator of 365 and followed by Banks, imposes an unfair charge on customers for which the financial institution has no real entitlement. For these reasons and as stated above, I believe this draws the NCC and the financial institutions, into conflict with the consumer protections embodied in the Australian Consumer Legislation (ACL) and with legislation preceding the ACL. It is my understanding that the ACL is the ultimate compliance standard covering consumer rights and protection. Therefore, in my opinion, the NCC requires amendment to align the practical application of its provisions with the consumer protections enshrined in the ACL.

A consequence of maintaining the denominator set at 365 throughout a leap year, the interest rate, as notified to the borrower and applied in the calculation, is therefore understated. As in the example above, a 6% annual rate of interest in a non-leap year becomes an effective rate of interest of 6.016% pa in a leap year. The borrower has a fundamental right to expect that there be no variance between the stated interest rate applicable to the loan and the effective rate of interest that is charged. However, based on my calculations going back to 2007, no adjustment was made to

the interest rate applied to the interest calculations applied to my loans to accommodate the impact of a leap year.

Should the financial institutions continue to apply the formula based on a 365 denominator during leap years, then it is a simple matter of varying the interest rate used in the loan calculation to ensure the annual amount of interest charged to their customers does not exceed the financial institution's entitlement. For example, if the interest rate in a 365 day year is 5%, then in a leap year the rate used in the formula would change to a calculation rate of 4.986% to account for the additional day. The customer would then be charged the correct annual amount equivalent to 5%.

This minor adjustment to the interest rate applied in the formula would result in no customer being overcharged due to the occurrence of the 366th day and the advertised interest rate would be accounted for and stated accurately. Banks vary interest rates applied to accounts frequently so there is no complicated system rework required to vary the effective rate of interest applied to loans during leap. But failure to do so could potentially constitute misleading and deceptive behaviour under the ACL.

Contracts covering the establishment of loans or credit arrangements fall under the standard form contract provisions whereby the borrower has no bargaining strength against the financial institution. The contract is prepared by the lending body and offered to potential borrowers on a 'take it or leave it' basis. The customer can rarely fully comprehend the detail in the documents put before them and face to face interviews generally covers only the key aspects of the agreement such as applicable interest rate, payment due date, amount of loan and interest charges.

As stated above, few customers could read and understand such lengthy and complex documentation that forms the basis of the agreement let alone have the skill to examine the contents in search of undisclosed information. Moreover, as the financial services lenders follow similar practises, potential borrowers would encounter similar experiences when confronted with contracts from alternative lenders. Therefore, there is little option but to accept the non-negotiable terms and conditions because competitors would have similar clauses in their terms and conditions.

So, for a financial institution to say "*At the time a customer accepts a loan with the ABC, they agree to be bound by the terms and conditions which apply to that loan. In other words, the customer agrees to ABC charging interest in the way described in the terms and conditions.*" I believe this is unconscionable. No ethical financial institution conducting business in good faith would make such a claim. This same institution has the capacity to make system changes such that customers are charged an annual amount that the customer believes was agreed to based on their understanding of the terms and conditions. No customer would knowingly agree to being overcharged interest for which the only beneficiary was the financial institution.

Chapter 6 of the Code sets out how the Code interacts with legislation. "If the Code imposes an obligation on us that is in addition to our obligations applying under a relevant law, then we will comply with the Code unless in doing so would lead us to breach the law." I would argue there are already breaches of the law as outlined above. However, I would also argue that in order to observe the Guiding Principles behind the Code, changing the calculations of interest payments during a leap year should be a fundamental and necessary amendment.

Recommendation

That the scope of Term of Reference 8 further considers the implementation of changes to the calculation of interest rates and interest charges applied to customers by financial institutions during

leap years on the basis that the current practice results in borrowers being overcharged a day's interest and financial institutions charging and receiving that interest payment for which there is no entitlement. Such practice resulting in the unfair treatment of customers is counter to the principles of the ACL.

That such practice results in interest rates being falsely advertised at a rate that is less than the effective rate of interest applied to customers during leap years. This is misleading and deceptive advertising and counter to the principles of the ACL.

That should no changes be adopted to the current method of charging interest during leap years, then in the spirit of transparency and accountability, a requirement that documentation clearly describe the process and the resulting impact whereby Banks overcharge customers by one day each leap year, the effect of which is compounded over the term of the debt facility.

Conclusion

While I understand all Banks follow the same practices, I can only base my argument on the ABC Bank while not intending to specifically single out the ABC Bank. This failure to disclose all relevant information further taints the image of Banks. They knowingly accept this bonus revenue under the guise of borrowers accepting their Terms and Conditions which in themselves are deficient in openness, transparency and full disclosure and where borrowers basically have no other option but to accept the terms and conditions if they need a loan.

I believe the behaviour of the financial institutions is misleading and deceptive. I believe the terms of their contract to be unfair in so much as the Bank relies on the terms to secure a benefit to itself at the detriment of the borrower. I believe that the failure to reflect the correct interest rate that results from the additional day of interest charged constitutes false advertising. The resulting outcome whereby Banks cream an additional day of interest every four years and do not act to change their systems or the legislation under which they operate is unconscionable.

Separately to what I present as violations of the consumer protection laws, I dispute that the NCC enables this unearned financial advantage to the financial institutions. The formula is concise in its description but there is provision to adjust the interest factor that is also a component of the equation. The NCC also requires that the interest rate be correctly represented but this requirement is completely overlooked in the application of the formula. To avoid future misinterpretations and to close of the apparent loophole, the NCC should be amended to clarify the calculation of interest during leap years. However aside from legislative amendment, financial institutions should uphold the Guiding Principles of the Code they claim to observe and implement the system changes necessary to calculate interest during leap years in a fair and ethical manner.

Chris Baulch