

# Executive Summary

## Introduction

Consumers often pay for goods or services in advance of receiving them, either in the form of deposit or purchase price. This is very popular among different industries in Hong Kong, notably in purchase of flight tickets, beauty package, fitness club membership, mobile phones, electric appliances and home furniture. Consumers may prepay in accordance with trade usage, such as the requirement for deposit upon placing an order for home furniture; or act upon specific business models, such as online shopping. They may also make prepayment simply for convenience or attracted by special offers. But what underlying the prepayment are risks of losing money, particularly in the event of retailer insolvency where consumers, as unsecured creditors without preferential right under the insolvency law, have a very slim chance to recover their money. Apart from not being able to enjoy the purchased goods or services, they may also suffer financial loss. When a sizeable retailer goes out of business, a large group of consumers will be affected and the loss involved could be enormous. Predicaments faced by consumers will also arouse public attention and discussion.

Credit card is one of the most preferred forms of payment in Hong Kong. According to the statistics of the Hong Kong Monetary Authority (“HKMA”), the total value of retail sales spending for credit cards issued in Hong Kong in 2016 is about HK\$ 474.4 billion, where a significant part of which could be prepayment. Although consumer protection in retailer insolvency could be strengthened by changing the hierarchy of creditors’ claim in favour of prepaid consumers, this would involve very difficult issues to resolve. A more pragmatic approach would be to improve the protection of credit card prepayment in the event of retailer insolvency. Consumers who paid by credit card may apply to their card issuers to recover prepayment through the chargeback mechanism. In view of the above, the Consumer Council (“the Council”) has conducted an in-depth study on how the chargeback mechanism could be enhanced to better protect consumer prepayment in retailer insolvency.

## Scope of the study

The objectives of this study are:

- (1) To evaluate the application, operation and limitation of chargeback as a means to protect consumers in the event of retailer insolvency;
- (2) To recommend measures to strengthen the protection of chargeback in the interest of consumers; and

- (3) To explore the introduction of the concept of connected lender liability by legislation with a view to enhancing legal protection of consumers in retailer insolvency.

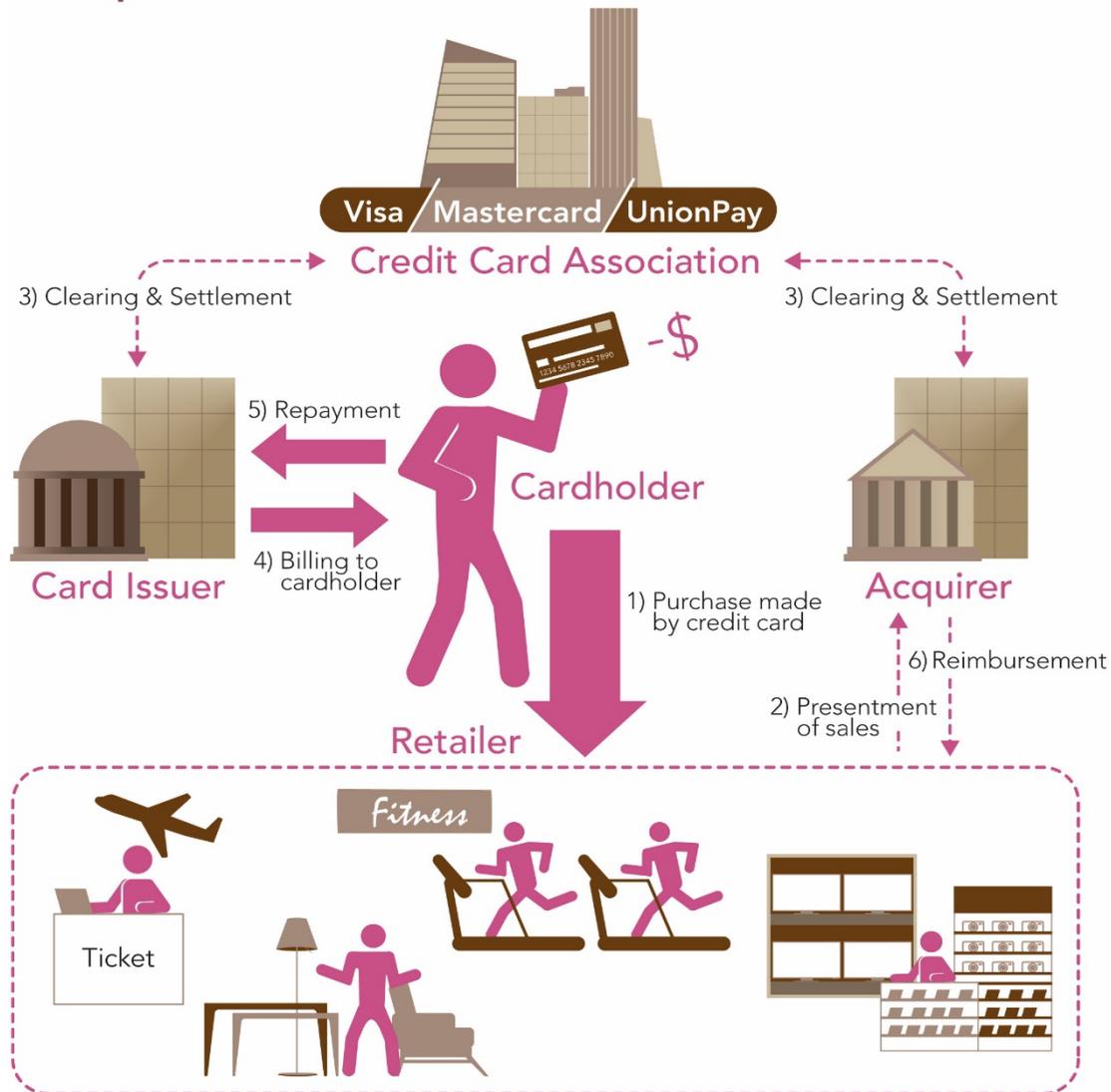
## Methodology

A questionnaire survey (“**the Survey**”) was sent to 20 major card issuers and 2 major card associations in Hong Kong in 2016. Replies from 15 card issuers and 1 card association were received. Furthermore, the Council has also reviewed the respondent card issuers’ websites and cardholder agreements, and conducted a research on credit card prepayment protection in different overseas jurisdictions. Besides, the Council also analysed 3 sizeable retailer insolvencies including California Fitness, DSC and Oasis Airlines. From the above, the Council has identified the deficiencies of the existing chargeback mechanism and made recommendations to improve consumer protection in prepayment and retailer insolvency.

## The Credit Card Cycle and the Parties involved

The first step to understand chargeback mechanism is to understand a credit card transaction cycle and the relationship of the parties involved. A typical credit card transaction usually involves five entities, namely cardholder, retailer, card issuer (e.g. banks), credit card association (e.g. Visa and Mastercard) and acquirer (e.g. banks). The card issuer enters into an agreement with and issues credit card to the consumer, who uses the credit card to pay for the goods or service. Then the acquirer processes the payment in accordance with its agreement with the retailer. The transaction will be cleared and settled by the credit card association. On the other hand, the consumer will pay the outstanding amount before the due date shown on the credit card statement. Both the acquirer and the card issuer are members of the credit card association and are contractually bound by operational rules of the respective credit card association (“**scheme rules**”). But neither the retailer nor the cardholder is a member of the credit card association or is bound by the scheme rules. The diagram below explains the relationship of parties and procedures involved in a credit card transaction.

# A 5-party Credit Card Transaction



## Chargeback

Chargeback essentially is a mechanism set out in the scheme rules of credit card associations which allows transactions to be reversed and makes refund of the transaction amount or outstanding transaction amount to the cardholder under specified circumstances, for instance, where the retailer fails to deliver goods or services after payment.

To illustrate, a consumer purchased a television from a retailer by credit card but the retailer closed down before delivery. The consumer is unable to seek either refund or delivery of the television. It is also not optimistic that the consumer can obtain any compensation through the winding-up process. In such circumstances, the consumer may contact the card issuer and request a chargeback be raised. The card issuer will ask for supporting documents and examine

the request. If the request is accepted, the card issuer will raise a chargeback claim against the acquirer pursuant to the scheme rules. Upon acceptance of the chargeback claim, the acquirer will reimburse the card issuer which will in turn refund the amount at stake to the consumer.

Under the scheme rules, the acquirer may dispute the validity of chargeback claim and the matter would be referred to arbitration for determination. The outcome of the arbitration is legally binding on both the card issuer and the acquirer.

As administrative costs and fees would inevitably be incurred in handling a chargeback claim, the card issuer may, where the transaction amount is small, make refund to the consumer at its own expense for the sake of cost efficiency without invoking chargeback. It is more so when the card issuer wishes to maintain an amicable relationship with the cardholders.

On the other hand, unless the acquirer can successfully recover the sum from the insolvent retailer, the loss will ultimately fall upon them. In order to mitigate the financial risks arising from retailer insolvency or other incidents, acquirers can defer credit card payment to retailers.

As mentioned, chargeback is enshrined in scheme rules which are contractual arrangements among the business entities. Consumers as a non-party are often unaware of the details, and can only rely on the information and assistance provided by card issuers.

### Credit Card Instalment Payment Plans (IPPs)

It has to be noted that not all transactions in which credit cards are used are protected by chargeback mechanism. Unlike direct debit authorization instructions arranged through credit cards, credit card instalment payment plans ("IPPs") is a loan agreement between the bank and the cardholder, under which the bank advances a one-off loan to the cardholder and pays the full amount to the retailer, while the cardholder undertakes to repay the amount to the bank by instalments through the credit card applied. This payment method is commonly used in the purchase of electrical appliances and subscription of beauty/fitness club membership.

As IPPs is by nature a loan provided by card issuers, rather than a typical credit card transaction, chargeback protection is generally not available. For example, a retailer of home appliances closed down after a consumer had purchased from it a high performance TV set by IPPs, the consumer is still bound to make the repayments to the card issuer until the loan amount is paid off even though the TV set has never been delivered.

## Key findings

### *Lack of clear and consistent application requirements and procedures*

According to the Survey, all the respondent card issuers do provide chargeback protection to their cardholders in the event of retailer insolvency. However, there is a lack of clear and consistent application requirements and procedures for raising a chargeback request. For example, some card issuers require consumers to first resolve the dispute with traders or liquidators before submitting a chargeback request, while others do not appear to have such a requirement. Discrepancies were also found in the prescribed time limit for raising a chargeback by cardholders. For example, some card issuers require cardholders to submit chargeback request within 60 days from statement, instead of 120 days from expected delivery date usually required by scheme rules.

### *Lack of transparency*

The Council finds that no clear information about chargeback is provided in the cardholder agreements and card issuers' websites. Although it is mentioned in the cardholder agreements that cardholders may submit any disputed transaction within a certain period of time, there lacks specific provision regarding chargeback protection or guideline for application. Meanwhile, there is also a lack of service pledge from card issuers in handling consumers' chargeback request. Another example is some card issuers require cardholders to submit a designated dispute form for the purpose of raising a chargeback application, but the form is not readily available on the card issuer's website which is inconvenient to consumers.

### *Uncertainty in the outcome of application*

As scheme rules are contractual arrangements among business entities, it is difficult for consumers being a non-party to know the details and latest content of the scheme rules. In the absence of any express provision in the cardholder agreement, even if the consumer has a valid ground of chargeback, the card issuer is under no contractual obligation to raise a chargeback claim for the consumer. In gist, it depends on the discretion of card issuers. As such, unless the card issuer is handling the chargeback requests in accordance with a set of guidelines which are publicly available, consumers would be uncertain about the circumstances under which the card issuer would raise the chargeback claim for them, not to mention whether they are protected by chargeback mechanism.

Some of the above problems were reflected in the insolvency of California Fitness, DSC and Oasis Airlines. Although there were successful cases to recover prepayment by making use of chargeback, some card issuers refused to handle the consumers' chargeback requests. Some complainants indicated that when they approached the card issuers for enquiries, hotline staff of card issuers failed to provide consistent and accurate information about chargeback to them. They therefore missed the opportunity to recover their prepayment through chargeback.

## Overseas experiences – chargeback and connected lender liability

The above research findings indicate that the transparency of chargeback in Hong Kong has room for improvement. Although the Code of Banking Practice, issued by the Hong Kong Association of Banks and the DTC Association and endorsed by the HKMA, has set out recommendations with respect to credit card services of card issuers, at present there is no specific legislative or regulatory provision requiring card issuers to handle cardholders' chargeback request. To ensure cardholders are aware of the risk of using IPPs, the HKMA has issued a circular setting out the regulatory measures for banks to follow if they offer IPPs which are not subject to chargeback protection. Such measures include a written confirmation by consumer with regard to the important terms of the IPPs, for example the provisions stating that consumer could not enjoy chargeback protection and he/she will not be able to cease payment to the bank even if the goods or service is not delivered by the retailer.

This Report examines the laws and regulations regarding chargeback in the USA, EU, the UK, Australia, Singapore, Mainland China and Taiwan. The Council finds that inadequate transparency of chargeback is a problem commonly encountered by many jurisdictions. The UK Law Commission recommended different measures to improve the transparency of chargeback which require the collaboration of various stakeholders. For example, it proposed card issuers to formulate an industry code of practice and issue a chargeback guide for consumers; and liquidators to provide more chargeback information to consumers. In Australia, the Code of Banking Practice and the Guidance Note on Chargeback issued by the Australian Bankers' Association and Code Compliance Monitoring Committee provide detailed guidance to the banks on how to handle chargeback requests and inform consumers of the availability of chargeback protection. For instance, banks are required to provide in their cardholder agreements general information on chargeback.

Apart from chargeback protection, this Report also looks into a legal concept having an important bearing on consumer protection, namely the connected lender liability. Essentially, it means that a credit provider will be held jointly liable to the consumers for the retailer's breach of contract and/or misrepresentation. In the context of credit card transactions, card issuers, as

credit providers, use attractive offers to invite consumers to apply for credit card, and encourage credit card consumption by launching promotion campaigns with traders. Under this concept, card issuers shall be jointly liable with the retailers.

Connected lender liability has been applied to different types of consumer credit consumption under the consumer protection legislation in the USA, EU, the UK and Australia. Among these jurisdictions, the Consumer Credit Act in UK applicable to credit card spending with no geographical constraint, offers the most comprehensive protection to consumers allowing them to recover loss from the card issuer direct in the event of retailer insolvency. Early in 1965, a committee was established in the UK to study the consumer credit law. The committee recommended that connected lender should be jointly liable for consumers' loss in the event of retailer insolvency. Subsequently, the UK Government implemented the recommendation and introduced connected lender liability by the Consumer Credit Act in 1974.

The Council is of the view that the UK and Australia's experiences provide very useful reference to Hong Kong in formulating measures to improve the transparency and operation of the chargeback mechanism. Furthermore, in order to strengthen the protection to consumers using IPPs, it is advisable for the Government to consider introducing connected lender liability by legislation with reference to the practices of the UK.

## Recommendations

The study concluded that there is an imminent need to improve the chargeback mechanism in Hong Kong to better protect prepayment by consumers. Besides, existing legal protection for consumers who make purchase by IPPs is clearly not adequate. Looking forward, the Council proposes the following recommendations to the relevant stakeholders:

### (1) Card Issuers

1. Supply cardholders with clear and easy-to-understand chargeback information in the cardholder agreements and card issuer's website;
2. Provide a chargeback guide to assist consumers in raising a chargeback claim;
3. Provide training to ensure that frontline staff are knowledgeable enough to explain the chargeback mechanism and its procedures to cardholders; and
4. Upon receiving a consumer's request for chargeback, exercise the right of chargeback against the acquirer under the scheme rules as soon as practicable.

## (2) The HKMA

Since most of the card issuers in Hong Kong are banks and subject to the supervision of the HKMA, it is recommended that the HKMA should issue regulatory guidance to card-issuing banks to ensure that they consistently implement the above improvement measures to enhance the transparency of chargeback and its service pledge.

## (3) Liquidators

The Official Receiver's Office and Hong Kong Institute of Certified Public Accountants shall provide guidance to insolvency practitioners, encouraging them to provide consumer creditors with more information about chargeback in the course of liquidation, including:

1. Remind consumers who have made prepayment by credit cards to request their card issuers to submit a chargeback claim;
2. Remind consumers that further information on chargeback can be found in the chargeback guide provided by the card issuers;
3. Posting a notice on the retailer's website that the retailer is in liquidation together with hyperlinks to the card issuers' chargeback website; and
4. Making available to consumers other evidence or information which may be required for chargeback application.

## (4) The Government

Even if the above recommendations are in place, consumers who made purchase by IPPs are still unprotected. To further enhance the interest of consumers, the Council urges the Government to follow the practices of the UK and introduce connected lender liability by legislation, allowing consumers (including those who use IPPs) to recover credit card prepayment from card issuers in the event of retailer insolvency. Without resorting to the winding-up process, consumers may claim their credit card issuers for retailer's breach of contract and recover their credit card prepayments. However, to strike a balance between consumer protection and maintaining business competitiveness, it is proposed that the extent of liability may be limited to the amount of the credit provided to the consumers.

Although connected lender liability would require card issuers to bear the loss of consumers in the event of retailer insolvency, card issuers could recover its loss from the acquirer through chargeback under the scheme rules to mitigate their exposure. This may also encourage card issuers to utilize chargeback protection for consumers in appropriate circumstances.

## Conclusion

Retailer insolvency is a common hidden hazard of consumer prepayment. Consumers may suffer “double loss” - being not able to enjoy the goods or services purchased and failing to recover the payment. Under the current insolvency law, Hong Kong consumers do not enjoy any special protection as unsecured creditors. Very often, it is extremely difficult for them to obtain redress from the winding-up process.

Chargeback is a long-established mechanism intending to provide effective and practical protection to consumer credit card prepayment. By virtue of this Report, the Council wishes to generate public discussion and call for the concerted efforts of card issuers, the HKMA, liquidators and the Government to improve protection for consumer prepayment by credit card.

Having said that, chargeback is generally not applicable to IPPs. The introduction of connected lender liability can establish consumer rights in retailer insolvency. It is a direction worth exploring. Given the use of credit card plays a predominate role in the local consumption activities, improving credit card prepayment protection will definitely be beneficial to both consumers and the economy as a whole.

In case of any inconsistency between the English and Chinese versions, the English version shall prevail.