

# Why We Must Regulate Unfair Contract Terms

Why would someone sign a contract with a clause like **THIS**?

*From time to time we may change all or any terms of the contract*

Or like **THIS**?

*All goods sold have no warranty whatsoever*

Some businesses abuse the bargaining power they have over their customers, and those customers have no option but to sign on the dotted line, if they need what the business is selling. After all, the business next door probably has the same unfair terms buried in the fine print of its own standard form contracts.

In January 2004 the Standing Committee of Officials of Consumer Affairs released a Discussion Paper on unfair contract terms in consumer contracts. The Discussion Paper was welcomed as a step in the right direction by consumer advocates, who have lobbied long and hard for a better deal for all consumers.

Existing laws do not stop the rotting that exists at a fine print level in consumer contracts. Today, unfair contract terms are rife throughout Australian commerce, undermining consumers' rights and resulting in very real hardship being suffered by the people who can least afford to take action to protect their rights.

**WE MUST REFORM THE MARKETPLACE** and ensure that the contracts entered into by all consumers, and particularly those who are vulnerable and disadvantaged, are **FAIR** and **SAFE**.

## **WE NEED LAWS THAT:**

- **BAN unfair terms in consumer contracts**
- **GIVE ADEQUATE REMEDIES to consumers who have signed contracts with unfair terms, whether the trader actually uses the unfair term or not**
- **ENFORCE the ban on unfair terms, by allowing regulators to take action in respect of individual contracts and in respect of CLASSES of contracts that all contain unfair terms.**

This information pack shows why action **MUST BE TAKEN SOON** by:

- showing how **CURRENT LAWS FAIL TO PROTECT CONSUMERS** from unfair contract terms
- giving **EXAMPLES** of unfair contract terms being used everyday in the Australian marketplace
- showing that it makes **ECONOMIC SENSE** to regulate unfair contract terms
- showing how **OTHER COUNTRIES** have regulated unfair contract terms
- showing what new laws must do to **PROTECT AUSTRALIAN CONSUMERS**.

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# The current laws fail consumers

There is a significant body of consumer protection laws at both a federal and state/territory level. But these laws do not offer adequate and effective protection against unfair contract terms.

Laws that prohibit unconscionable conduct only go halfway towards protecting consumers:

- the *Trade Practices Act 1974*
- the *Australian Securities and Investments Commission Act 2001*
- *Fair Trading Acts* in most states and territories

Laws that promote disclosure and transactional transparency are not much better:

- the *Consumer Credit Code*
- the *Financial Services Reform Act*

## The problem with unconscionability laws: procedural v substantive

- Unconscionable conduct laws are focused on **procedural** not **substantive** unfairness. **Procedural** unfairness looks at the actions of the parties to the contract at the time of signing, and the circumstances in which the contract was entered into. The fact that a person may have had a disability at the time of signing a contract is a good example of **procedural** unfairness. **Substantive** unfairness looks at what is written on the contract itself – what the nature of the bargain is. Paying ten times the market value of something is a good example of **substantive** unfairness.
- Because they are **procedurally** focused, unconscionable conduct laws must consider the individual circumstances of particular cases if they are to be applied, and therefore can only deal with cases **one at a time**. This means that they are no good for fighting the **systemic** use of unfair terms in **standard form contracts**, which is how most unfair contract terms are used.
- Because they depend on **oral evidence** about “who said what”, and “what happened when”, cases based on **procedural** unfairness are difficult to fight in the courts, where well-resourced businesses can quickly outgun a battling consumer. A case based on **substantive** unfairness is easier, because the only relevant evidence is a copy of the unfair contract itself.

## **The Victorian law**

The *Fair Trading Act 1999* (Vic) is the only Australian law currently combating unfair contract terms. Part 2B of the Act:

- bans unfair contract terms
- makes any unfair contract term void
- allows the state regulator to declare whole classes of unfair contract terms void

The Victorian experience strengthens our call for a national harmonisation of laws banning unfair contract terms and shows that similar protection for consumers is needed Australia-wide.

## **Other consumer protection mechanisms**

Consumer protection initiatives across a range of markets have in recent years focussed on laws which promote competition between businesses, and disclosure of key information in transactions between consumers and businesses. After years of relying upon these types of laws to deliver the benefits that were promised, we now know that competition and disclosure have ignored the needs of disadvantaged and vulnerable consumers, and have failed to protect Australian consumers.

### **Competition**

Unfair contract terms appear in so wide a range of contracts, and across such diverse markets, that they cannot be seen as merely symptomatic of uncompetitive markets.

The fact is that there can be no competition on unfair contract terms. Consumers do not have the time, expertise or economic incentive to compare the highly complex fine print of various suppliers' standard form contracts, so suppliers do not have any incentive to provide fairer terms than their competitors.

### **Disclosure**

Disclosure regimes are a common way of trying to protect consumers - particularly within financial services markets, and are based on the assumption that consumers will be better able to make choices, and to protect themselves from shonky deals and rip-off merchants if they are fully informed of the terms of the contracts they are going to sign.

But some people are too poor to have any choice. Or sometimes there is no choice because all the suppliers have the same unfair terms in their fine print. A disclosure regime just lets those people know they are being ripped-off, but does not help them to fight back against the supplier.

At any rate, in order to be effective against unfair contract terms, a disclosure regime would have to cover every type of consumer contract in Australia, and would be too generic to give any real protection.

Also, the compliance costs of such a disclosure regime would be sky high for both industry and government.

Competition and disclosure laws will not stop the problem of unfair contract terms.

# Everyday examples

## Mobile phones

The mobile phone market as an obvious candidate for examples of unfair contract terms. Here are some types of terms that show how telcos can exploit their customers:

- **A term allowing the supplier to charge a cancellation fee for early termination of the contract by the consumer. Regularly this amount will be higher than the contract price remaining to be paid – that is, it imposes a penalty on the consumer;**
- **A term allowing the supplier to vary the rates or charges imposed (for example call rates or SMS rates) unilaterally and at any time, and regularly without any notice to the consumer;**
- **A term that incorporates other terms and conditions into the contract, when the consumer never sees the document containing these terms and conditions - it is specified to be available "on request". Regularly, the incorporated terms and conditions will contain the bulk of the obligations imposed on the consumer;**
- **A term authorising the supplier to complete the application form for the mobile phone service on behalf of the purchaser and stating that the purchaser agrees to be bound by this completed form.**

## "Click-wrap" contracts

Fine print contracts that you have to agree to by clicking a button to enter a website are called "click-wrap" contracts. The Australian Competition and Consumer Commission discovered these "click-wrap" contract terms on Australian websites:

- **All goods sold in the clearance sale have no warranty whatsoever;**
- **Returns for refund will only be accepted within seven days of you receiving the goods;**
- **Refunds for some items will be at the current market price – not the original purchase price; and**
- **The actual products are often not the same as the images.**

## Financial services

Have a look at this clause from a major bank's loan contract:

**From time to time we may:**

- a) change the amount of or basis for calculating any fee or charge, change the interest or fee charging cycle, or both, and, except during any fixed interest rate period of the Loan, change any interest rate margin, any link to a reference interest rate and the basis for calculating interest;**
- b) impose and debit to the Loan Account any new fee or charge;**
- c) change the frequency of repayments;**
- d) change the Loan Account number ...;**
- e) change the way we describe any reference interest rate; and**
- f) change any other terms and conditions.**

When it comes to the terms and conditions of contracts,

- **lack of consumer bargaining power,**
- **an absence of competitive market pressures, and**
- **significant imbalances of information between businesses and consumers regarding the nature and effect of terms and conditions**

are all taken advantage of by business to create highly one-sided, “*take it or leave it*” contracts that regularly lead to enormous consumer detriment. Where the free operation of the market fails consumers through an absence of competitive pressure and where there is demonstrable, serious and unfair consumer detriment flowing from that failure, market intervention is warranted to protect consumers.

## Case studies

**Ms A** signed a 12-month contract with a **fitness centre**. After 4 months, Ms A came under additional pressures at work and was no longer able to attend the gym. She had also moved house and the gym was not close to her new home. Ms A asked the gym if she could cancel the contract. Unfortunately for Ms A, she had not realised that the contract contained a term that required her to pay the full amount of fees remaining for the entire 12-month term of the contract and the fitness centre would not allow her to cancel. As Ms A still had 8 months remaining, she was forced to continue paying for her membership even though she rarely attended the gym.

\*

**Ms B**, a pensioner, flew interstate on a holiday package deal, which included car hire from a **major national car hire company**. At the end of her trip interstate, she returned the hire car to the airport. The company did not inspect the car upon it being returned but four weeks later, it claimed that there was damage to the car and debited \$370 via direct debit to Ms B’s credit card. The damage was to the driver’s door and would have been apparent at the time she returned the car, but Ms B claimed that she had not caused any damage to the car. Ms B sent a letter to the company but its reply was that the matter had been investigated and that under the terms and conditions of the contract, they had the right to automatically deduct an amount from her credit card for the repairs. They stated that there was “nothing more we can do”. Ms B paid the amount for the repairs because she could not afford to pursue the matter further.

\*

**Ms C** enrolled in a **fashion school**, agreeing to pay \$23,900 in monthly instalments over 3 years for an advanced diploma course. After attending the course for the first semester, Ms C was forced to move interstate urgently to care for her parents who were unwell. The contract included a 'declaration' as follows:

I acknowledge that by signing the [school] Enrolment Agreement I undertake to pay the prescribed fees by the specified dates as set out in the table of fees on pages 25,26 and 27 of the [school] folder, *whether I finish the course or not*.

I understand that no deferrals are possible and that no refunds will be made for any reason whatsoever.

Although the school agreed to allow Ms C to defer her course temporarily and to study by correspondence, it would not allow her to cancel the contract, despite her urgent need to move interstate. The school referred the matter to debt collectors and Ms C was pursued for the outstanding sum of \$19,594.70.

# Regulation makes economic sense

The case for legislative protection against unfair contract terms does not rest solely on equity – though equity arguments can undoubtedly strengthen the case. It also rests on hard-nosed economic considerations.

Unfair contracts impose an economy-wide cost, because they diminish trust in markets. Without trust there are two adverse economic consequences. First, some transactions will not occur at all. If buyers are suspicious of the quality of goods or services on offer, and have no means of verifying the quality, they will assume the worst – that the vendor is offering low quality, who in turn has no incentive to provide any but the lowest quality. Second, benefit of those transactions that do occur will be diluted by the addition of high transaction costs. Both buyers and sellers bear transaction costs in negotiating, drafting, interpreting and enforcing complex contracts. On the other hand, any measures that establish or build up trust in markets will have widespread benefits.

***‘Unfair contracts impose an economy-wide cost, because they diminish trust in markets.’***

In an idealised market the rule of *caveat emptor* or “buyer beware” would be a reasonable maxim to guide economic activity. Contracts would be negotiated and drawn up in bilateral exchanges. But the complex reality of contracts in most markets, particularly consumer markets, is that sellers have much more negotiating power and information than buyers. In these markets sellers almost always draw up contracts; buyers cannot hope to negotiate a unilateral change in contract terms. At most consumers may have the option of choosing between pre-set options – such as insurance waivers in car rental agreements. It is not always rational market behaviour for consumers to scrutinize all contracts.

***‘it is quite rational for a consumer not to read a standard-form contract, because it is reasonable to assume that others have undertaken this task.’***

For many important transactions the consumer is an infrequent purchaser. Just like the businessperson entering a unique or new situation they seek the assurance of a contract. If information were free, consumers could exhaustively assess all available options relating to price, quality and contract conditions for each purchase. But information is not free; comprehensive search therefore is not rational behaviour. In relation to contracts it is quite rational for a consumer not to read a standard-form contract, because it is reasonable to assume that others have undertaken this task. When there has

been scrutiny and approval of the standard-form contract by a government agency, such confidence is even better founded. Therefore the use of standard-form and officially scrutinized contracts wherever possible would be in the interest of consumers. Such measures protect not only those who rationally choose to take the risk of not reading contracts. They also reduce the transaction costs for those who are inclined to scrutinize contracts; they can afford to spend less time (and outlays on legal advice) on scrutiny.

As a contract grows in length and complexity, the more costly it becomes for the consumer to study it. As the time taken to wade through a contract rises, the logic of not reading the contract and taking a risk becomes more appealing. But the risk of there being unfair or detrimental clauses in the contract has also risen. The consumer may give up the transaction altogether, even if the contract is not unfair. Or they may find an alternative supplier with a simpler, possibly less fair contract or whose goods and services are less satisfactory.

Legal protection against unfair terms goes a long way to avoid economic losses caused by complexity and obscure unfair terms, while preserving consumer benefits from standard form contracts. Either

assurance that the contract contains no terms a reasonable person would consider to be unfair terms or assurance that unfair terms, if invoked, would be rendered inoperative will serve the purpose. This is not to absolve the consumer from responsibility to understand what is being negotiated, but it is to give the consumer more confidence in situations where they may lack experience or where contracts are necessarily complex. It will diminish the incentive for unscrupulous suppliers to make contracts deliberately long or complex.

While standard-form contracts with legal protection against unfair terms are beneficial in smoothing out transactions in all markets, their greatest benefit is likely to be found in relation to purchases of intermediate value. For very expensive outlays, particularly real estate, it is quite rational for the consumer to take great care in scrutinising the contract, with the help of a lawyer. Markets for low-cost repeat purchases, with low risk of consequential damages, can work with minimal contract protection reasonably well for all but the most vulnerable consumers. However in intermediate range markets the goods and services which are reasonably expensive themselves (such as cars), or for which the consequences of poor performance can be very high in relation to the purchase price (such as house repairs) there is need for legal protection – not only for gullible consumers, but also for “rational” consumers who deliberately limit their search efforts.

In the absence of contract protection in such markets the most likely consequence is for unfair contracts to prevail. It is difficult for a purchaser, untrained in contract law, to judge the quality of a contract. The rational choice for consumers is to assume that all contracts in particular markets (e.g. phone services or investment services) are unfair. Faced with such logic, the ethical business enjoys no reward for offering a fair contract. Bad contracts drive out good contracts.

***‘In the absence of contract protection ... the most likely consequence is for unfair contracts to prevail.’***

Individual firms can overcome this loss of faith by building on their brand reputation for honest dealing (reputational capital). This may seem to provide a market solution. But it comes with the economic cost of restricted competition, for it is very hard for new firms to establish reputational capital and trusted outlets will be more expensive to deal with.

At times sellers deliberately use techniques that diminish people’s capacity for rational consideration. There is also evidence that people systematically underestimate risk in certain situations. They are subject to the bias of overconfidence, and may place undue faith in their ability to scrutinize a contract on a quick read, to calculate and choose the best options, or to judge the honesty of the salesperson on the doorstep. Such optimism can underestimate the risk of our own behaviour leading to exercise of harsh and oppressive unfair terms in a contract.

Lock-in contracts that limit a consumer’s capacity to switch suppliers impede the market mechanism of demand to moving to lower-cost, more efficient suppliers, and reduce incentive for high-cost suppliers to reduce their costs.

Bundling, while sometimes a consumer benefit, offers no assurance that the combination will be the lowest priced or lowest cost if all the elements of the bundles are considered separately. Like lock-in contracts bundles can result in higher than necessary consumer prices and impede the efficient operation of markets in re-allocating resources to their most efficient use.

***‘Adequate and effect protection against unfair contract terms is necessary not only for consumers, but also for businesses, and for the economy at large.’***

Adequate and effect protection against unfair contract terms is necessary not only for consumers, but also for businesses, and for the economy at large. Governments and regulators must make sure that this message is spelt out clearly and strongly to all sectors of the Australian marketplace.

# The overseas story

Many countries around the world already have well-established unfair contract terms laws. The experiences of these countries – and particularly European countries - prove that unfair contract terms regulation can protect consumers effectively, as well as working towards a healthy marketplace for businesses as well.

## European Community

In April 1993, the Council of the European Communities adopted a Directive on *Unfair Terms in Consumer Contracts*. This required the Member States to pass laws to ensure that unfair terms in consumer contracts will not bind consumers. Members must also establish measures to prevent the continued use of unfair terms.

***‘By 2007, nearly half a billion consumers will have protection against unfair contract terms.’***

A contract term that has not been individually negotiated is regarded as unfair 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. However, the question of whether the *price* is fair cannot be reviewed under the Directive. The Directive includes an indicative and non-exhaustive list of the terms that may be regarded as unfair (see box below), and requires written contracts to be in plain, intelligible language. It also allows states to provide greater consumer protections – for example, in some countries, the issue of price is *not* excluded from the relevant regulations.

The indicative and non-exclusive list of terms that **may be considered to be unfair** includes terms which have the object or effect of:

- Excluding or limiting the legal liability of a seller or supplier in the event of the death of a consumer or personal injury to the latter resulting from an act or omission of that seller or supplier.
- Permitting the seller or supplier to retain sums paid by the consumer whether the latter decides not to conclude or perform the contract, without providing for the consumer to receive compensation.
- Requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation.
- Enabling the seller or supplier to alter the terms of the contract unilaterally without a valid reason, which is specified in the contract.

The European Community has recently expanded, and now has 25 member countries. By 2007, when two more countries join, nearly half a billion consumers will have protection against unfair contract terms.

## United Kingdom

To give effect to the EC Directive, the United Kingdom has implemented the *Unfair Terms in Consumer Contracts Regulation 1999*. This mirrors the terminology and the list of unfair terms that is found in the Directive.

The Director of the Office of Fair Trading (OFT) is obliged to examine complaints that a contract term drawn up for general use is unfair. If the Director agrees, he or she can take legal action to stop the use of the term in consumer contracts. However, cases are normally resolved informally, when the OFT accepts an undertaking in lieu of court proceedings.

During the 2002-2003 financial year, the OFT received more than 1,000 complaints about unfair contract terms, and 1,477 contract terms were abandoned or amended as a result of OFT enforcement action. Sectors that featured high in consumer complaints included financial services, tenancy contracts, package holidays, and fitness clubs. Details of key cases are included in the OFT's quarterly *Unfair Contract Terms Bulletin*. The OFT's jurisdiction to take action is shared with "qualifying bodies", including other regulators (eg, the Director General of Gas Supply) and the Consumers' Association.

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The UK also has an *Unfair Contract Terms Act 1977*, which applies to both consumer and business contracts, and to both standard form terms and individually negotiated terms. The Act relies on aggrieved individuals to take action, and does not contain any process for dealing with unfair terms in a systemic manner.

Law reform agencies in the UK are considering whether a single unified regime could replace both pieces of legislation.

## **Canada**

In Canada, many provincial governments prohibit unfair practices in consumer transactions.

For example, in Saskatchewan, the *Consumer Protection Act 1996* prohibits a supplier from committing an unfair practice. An unfair practice includes "taking advantage of a consumer by including in a consumer agreement terms or conditions that are harsh, oppressive or excessively one-sided."

A consumer who has suffered loss because of an unfair practice can commence action against the supplier. Alternatively, the Director of Fair Trading can take action on behalf of an affected consumer if it is in the public interest.

If a court finds that the supplier has engaged in unfair practices, it can order the supplier to pay damages (including punitive or exemplary damages), to restrain the supplier from continuing the unfair practice, or make other orders.

Similarly, the *Alberta Fair Trading Act* prohibits unfair practices, and provides that "It is an unfair practice for a supplier .... to include in a consumer transaction terms or conditions that are harsh, oppressive or excessively one-sided".

## **United States**

The *Uniform Commercial Code* – adopted in the majority of states – enables a court to make various orders (including refusing to enforce the contract) if it finds a contract, or any clause of a contract, to be unconscionable at the time it was made. Case law suggests that unconscionability under the *Uniform Commercial Code* has both procedural and substantive components, and decisions will depend on the individual circumstances of each case.

# What must be done

Australian law should reflect the following statement of principle:

*Consumers are entitled to enter into contracts that are fair and safe*

This is self-evident.

The variety of consumer protection laws that we have focus either wholly or predominantly on *procedural* unfairness, and operate poorly or not at all in the context of **substantive** unfairness.

As a result, a wide range of markets regularly employ contracts that contain unfair contract terms, against which consumers are given no adequate or accessible remedies.

If consumer safety remains the goal of government, regulators, and indeed industry, then such regulation must be implemented.

**ADEQUATE and EFFECTIVE consumer protection must:**

- **BAN unfair terms in consumer contracts**
- **GIVE ADEQUATE REMEDIES to consumers who have signed contracts with unfair terms, whether the trader actually uses the unfair term or not**
- **ENFORCE the ban on unfair terms, by allowing regulators to take action in respect of individual contracts and in respect of CLASSES of contracts that all contain unfair terms.**

In order to provide the greatest possible benefit to consumers with the least cost to traders, industry and government, such regulation should be structured in the following way:

## **Nationally consistent laws**

The proper home for the proposed regulation is the *Trade Practices Act 1974* and the *Australian Securities and Investments Commission Act 2001*, with mirror provisions in the fair trading legislation of each State and Territory.

We acknowledge, however, that consideration of reform is being driven by the States and territories, and not the Commonwealth. If regulation is to occur first at this level, then we support a national uniform scheme (similar to that already in place for consumer credit).

## **Protection across all consumer contracts**

The fundamental right of all consumers to enter into contracts that are fair and safe is not conditional upon the type of products or services that they are purchasing.

We support regulation that applies to all contracts entered into by consumers: regulation that applies equally and without distinction to all traders and across all industries that offer goods and services to consumers.

### **Focus on both substantive and procedural unfairness**

While procedural unfairness is already regulated, that regulation is neither uniform nor consistent. There is likely to be great benefit to all market participants in codifying what matters are likely to constitute unfair conduct, and clarifying what remedies are available to consumers who are induced to enter into unfair or unconscionable transactions. We support uniform regulation of consumer contracts in their entirety.

### **Minimal compliance cost for industry**

We are aware that regulatory reform in certain industries, including the financial services industry, has created significant compliance costs. It is likely that the great majority of this cost arises out of the disclosure-based nature of those reforms.

Unlike burdensome disclosure regimes, the proposed regulation does not require additional inputs by industry, but simply cuts unfair terms out of contracts. This form of regulation will have entirely different cost implications for industry, resulting in a significantly lighter burden than might have been experienced in other contexts.

***‘Unlike burdensome disclosure regimes, the proposed regulation does not require additional inputs by industry’***

By allowing government to determine whether terms are fair or unfair, the proposed regulation would benefit industry by increasing certainty in the integrity of contracts.

### **Efficient targeting of the problem**

Consumer protection mechanisms that rely on consumer awareness and education are inherently reliant on the effectiveness with which the message is communicated to and absorbed by consumers. More importantly, such mechanisms inevitably fail vulnerable and disadvantaged consumers.

The proposed regulation does not seek to inform consumers about existing dangers, but rather to remove those dangers. In this way, all consumers will be protected, regardless of their individual characteristics, vulnerabilities or circumstances.

### **Proper and effective enforcement**

***‘Governments must provide sufficient resources to regulators to ensure compliance with the proposed regulation.’***

No mechanism for consumer protection can be effective if it is not enforced. Governments must provide sufficient resources to regulators to ensure compliance with the proposed regulation. This would include education for both industry and consumers, monitoring and enforcement.

Non-government agencies should also be empowered to seek appropriate remedies – including injunctions – in respect of an identified class of unfair contract terms. Such a power would complement the current activities of a number of existing agencies.