GOUGH SQUARE CHAMBERS' CONSUMER CREDIT COLUMN: MAY 2016

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James Ross, Ruth Bala, Thomas Samuels and Lee Finch are all specialist consumer credit counsel at Gough Square Chambers. On a regular basis, they share their views with Practical Law Financial Services subscribers on topical developments or key issues relating to consumer credit.

In the May column, Thomas Samuels considers the annual percentage rate (APR) requirements under the Consumer Credit Act 1974 (CCA) and the Consumer Credit sourcebook (CONC).

Thomas Samuels, Gough Square Chambers

THE ANNUAL PERCENTAGE RATE: A LAWYER'S GUIDE

Introduction

Discussion of the annual percentage rate, better known as an "APR", is not necessarily a very exciting topic. It is, however, an important figure both for lenders and borrowers under the Consumer Credit Act 1974 (CCA).

Various iterations of the APR must be included in advertisements, pre-contract information, the agreement itself and post-contractual statements and notices. Although mis-calculation has never been capable of giving rise to irredeemable unenforceability (the APR has always been categorised as "prescribed information" rather than a "prescribed term"), getting it wrong can still result in the need to apply for an enforcement order pursuant to section 127(1) of the CCA, as well as a damages claim for breach of the various provisions in the Consumer Credit sourcebook (CONC) that make reference to it.

Purpose of the APR

The APR was considered by the High Court in *Sternlight v Barclays Bank plc [2010] CTLC 115*. There, a challenge was brought to a CCA-regulated agreement on the basis that, because the interest rate and APR did not match, the interest rate was therefore mis-stated, rendering the agreement irredeemably unenforceable under the then Consumer Credit (Agreements) Regulations 1983 (*SI 1983/1553*). The argument put forward by the borrowers was that, where there was a discrepancy between the two figures, the APR should be regarded as the "driver" and presumed to be the correctly calculated of the two.

In rejecting the allegation, HHJ Waksman QC commented that:

> "...there is a very clear difference between the nature and functions of the stated monthly (or annual) rate and the APR. The stated monthly or annual rate is on its face a contractual term. The APR is a statutory construct brought into existence in order to provide information to consumers, arrived at by the application of a complex formula itself based on various assumptions and designed to include not only interest rates but other charges."

Although the consumer credit regime has moved on considerably since that judgment, the APR is now governed by the FCA's CONC rules and the concept of irredeemable unenforceability has been abolished, that fundamental logic remains sound. It is not a term of the parties' agreement. Instead, it is an artificial figure created to give consumers an easy to understand basis for comparison of the cost and value of different credit products. That function is evident from the variety of contexts in which an APR is required, as discussed in *APR in financial promotions* below.

Calculation of the APR

There are two different calculations in Appendix 1 to CONC:

- App 1.1.9R sets out the calculation for certain agreements secured on land (those not covered by the Consumer Credit (Disclosure of Information) Regulations 2010 (*SI 2010/1013*) (App 1.1.2R)).
- App 1.2.6R, which gives the calculation for all other agreements.

It will therefore be CONC App 1.2 that is relevant to the vast majority of CCA-regulated agreements.

As was noted in *Sternlight*, both of these are complex mathematical formulas likely to be beyond the understanding of most lawyers. However, putting arithmetic to one side, what can be usefully understood and advised upon are the assumptions, set out in the CONC rules, to be applied when using the formulae. In particular, where an agreement provides for a variety of one-off and regular fees and charges (in addition to basic interest), it can often be difficult to know which need to be factored into the calculation and which can be disregarded.

Under CONC App 1.1, items included and excluded from the APR calculation are set out at CONC App 1.1.5R and 1.1.6R respectively. The equivalent rules for all other agreements are laid down at CONC App 1.2.3R. Of particular note is the specific inclusion for the agreements within CONC App 1.1 of premiums of insurance required as a condition of the credit and to protect the borrower against the risk of being unable to pay through death, invalidity, illness or unemployment (that is, mandatory payment protection insurance). This is a far narrower provision than that which applies for the vast majority of agreements under CONC App 1.2.3(4)R, which requires the inclusion of any "ancillary service" that is "compulsory in order to obtain the credit or to obtain it on the terms and conditions marketed." It should be noted that the latter is distinct from charges levied, whether the purchase is made on credit or not, which are specifically excluded (CONC App 1.2.3(5)(b)).

Moreover, it is to be noted that any sort of default charge is excluded from the APR calculation (CONC App 1.1.6(1)(a)-(b) and CONC App 1.2.3(5)(a)).

The assumptions for the calculation of the APR at CONC App 1.2.5R are crucial. Perhaps the key items are as follows:

- That the agreement is to remain valid for the agreed term with both parties fulfilling their contractual obligations.
- Where variable interest rates cannot be ascertained for the duration of the agreement at the outset, it must be assumed that the rate will remain at its initial level throughout.
- That where there is a fixed interest rate at the outset, then reverting to a rate referable to an agreed indicator (for example, a base rate), in the APR calculation, it should be assumed that the variable rate will be that which would have applied at the time of the calculation.
- Where the agreement gives the borrower the freedom of drawdown, it should be assumed that the full amount will be drawn down immediately (also in relation to overdraft agreements).
- If the duration of an overdraft facility is unknown at the outset, it should be assumed to last for three months.
- In the case of running account credit where the credit limit has yet to be agreed, it should be assumed for the purposes of the APR that it will be £1,200.

APR in financial promotions

By further demonstration of its informational purpose, the APR plays a key role in financial promotions under CONC 3 (Financial promotions and communications with customers). In particular, the invention of the "representative APR" for adverts for unsecured agreements (CONC 3.5) and the "typical APR" for adverts for secured agreements (CONC 3.6).

The representative APR is required wherever a "representative example" is required under CONC 3.5.5R, that is, where the financial promotion states an interest rate or mentions the cost of credit (CONC 3.5.3R). It is also required when the financial promotion indicates or implies the credit may be available to those whose access to credit is usually restricted, includes a favourable comparison with another person, product or service, or includes an incentive to apply for credit (CONC 3.5.7R).

Obviously, in the case of an advertisement where a huge range of terms might potentially be agreed as a result, it would be complex and confusing to attempt to set out the range of possible APRs that might ultimately apply. Therefore, the representative APR is that "at or below which" the firm communicating the promotion "reasonably expects, on the date on which the promotion is communicated or approved, that credit would be provided under at least 51% of the credit agreements which will be entered into as a result of the promotion".

Equally, in relation to secured agreements, the typical APR is required in similar circumstances (CONC 3.6.6R); that is, where it is particularly important for the consumer to appreciate the likely cost of their borrowing because they may be applying for the credit for other reasons. Again, therefore the information purpose of the figure is of central importance. The definition is, in effect, the same, save that it must apply to at least 66% of the credit agreements entered into as a result of the promotion.

Both definitions are somewhat conceptually difficult because it may be that, in fact, there will not be an APR which is immediately identifiable as likely to apply to at least 51% or 66% of agreements. For example, if ten agreements were entered into over different terms with different loan amounts for different credit risks, each might have a different APR. In such a case, it would seem to be necessary for the firm making the promotion to estimate the likely mode average, that is, which set of circumstances is the most likely to occur so as to give rise to the applicable APR.

Conclusion

Although APR calculations are best left to expert actuaries, there is a role for lawyers to advise on the purpose, assumptions and application of the figure.

The APR was a novel innovation of the CCA, created to provide comparative information to consumers. It remains a key figure for businesses and customers alike. For example, even if the bare repayment figures on a payday loan may seem achievable, converting them to a 2,000% representative APR, compared to perhaps 5% on the high street, certainly puts matters into perspective.