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SINGAPORE: Recent news reports highlight an alarming rise in the amount of prepayments reported lost by consumers when businesses close over the past four three years. In particular, at S$3.59 million of losses reported in 2016, that's an increase of more than three times compared to 2014.

The problems associated with prepayment have occupied public attention for the past year. This is undoubtedly due to the sudden closure of the likes of Misa Travel or California Fitness, which as a result lost large groups of consumers even larger sums of money.

Apart from the impact on consumers who may never get their money back from these companies, many are generally surprised that such reputable, long-standing companies could abruptly fold, a fate most people associate with newer, smaller and less established companies.

COMMON MECHANISM

Prepayment refers to any form of payment by consumers before receipt of goods or services. It is a very common mechanism used in consumer transactions worldwide, including deposits, stored value cards, or packaged deals for travel holidays, spas and gyms.

Sometimes prepayment is marketed as a business promotion for businesses to boost their membership base and comes with a discount off the retail price. Predominantly, though, a business's motivation for requiring prepayment is to ensure a healthy cashflow position.

Obviously, a prepaying consumer is not presumptively exposed to unmitigated risk today. There are specific laws which mandate consumer protection in certain high-risk sectors where business failures could have massive ramifications for the consumer and the economy. Banks for instance have to ensure deposits of up to S$50,000 are adequately insured.

Bank chargeback schemes also provide recourse for consumers who paid by credit card to reverse certain types of transactions. But often, these chargeback schemes have time limits of no more than 60 days.

So consumers who might have paid for that five-year gym membership with their credit card only to have their gym close down after two years will not have recourse through such chargeback schemes.

Another source of consumer protection are schemes such as those offered by the Consumer Association of Singapore (CASE), which involve accredited businesses latching on to regulated mechanisms like EZ-Link to provide prepayment protection. In such transactions, EZ-Link would hold these prepayments from the consumer in escrow, releasing them to respective businesses at points where the goods and services are delivered.

But businesses make their own decisions on whether to take up these voluntary schemes. Admittedly, these observations provide cold comfort to those who collectively have lost millions over the past years and fall into that category of consumers unprotected by statutory or voluntary schemes.

GIVE STRONGER CREDITOR STATUS TO PREPAYING CONSUMERS

Some say there is some merit to the argument that prepaying consumers should bear the risk that the anticipated goods or services may not materialise, exacerbated by the effluxion of time – not the least because they pay for such goods and services at sometimes significant discount.

But in an upbeat business environment where consumer trust is high, and where goods and services are provided by companies who have every incentive to secure business, is it fair to put the onus of assessing whether a business is likely to go bust on the consumer?

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In fact, consumers are often vulnerable and ought to be protected. They have weak bargaining positions which means prepayment is frequently presented on a take-it-or-leave it basis. Even where they have a choice, they may not be in a position to thoroughly determine a business' financial health and the risks they have to bear as consumers.

There are three ways consumers can be better protected.

A first solution is to elevate the status of prepaying consumers to that of preferred or secured creditors, and place them ahead in a queue of other creditors whose debt a business will have to satisfy first in the event of insolvency.

Some advanced countries have implemented or discussed the possibility of implementing such measures. The US has adopted this approach for prepayments of up to US$1,800. The Law Commission for England and Wales recommended in 2016 to prioritise consumers who prepaid just before the business in question becomes insolvent.

But in the long queue of employees who are owed wages, creditors who have provided collateralised loans, and the government to whom taxes are owed, prioritising the consumer before these parties may raise questions of fairness. Furthermore, for a business that can hardly afford to stay open and now has to pay a range of creditors, this solution might not go very far to satisfy the debt the consumer is owed.

In addition, given that the Insolvency Act has been recently amended in 2017, this approach, which would require legislative amendments to the Act, is unlikely to be on the legislative agenda for the near future.

A second solution is to statutorily require banks who act as the middleman in credit card transactions to reimburse consumers for outstanding prepayments in the case of default or insolvency of a businesses, as is the case under the UK's Consumer Credit Act enacted in 1974.

Yet this is far from being an adequate measure, in part since it covers only credit card transactions, and leaves aside payments through other means like cash or cheque.

More fundamentally, we may want to rethink the merits of a scheme that effectively forces banks to play the role of insurer for businesses. Doing so passes the risk of business closures and defaults onto financial institutions.

The higher costs of insuring prepayments are also ultimately likely to be passed onto businesses and consumers alike, meaning that a minority is being subsidised by society at large. Many may legitimately question the fairness and economics of this approach.

GIVE GOVERNMENT DISCRETION TO MANDATE REPAYMENT

Perhaps the way forward is to come up with a solution to avoid as far as possible this unhappy insolvent conclusion.

Consider the spa industry, which a decade ago experienced a spate of closures that left many consumers stranded without recourse to prepayments made for expensive packages. In 2008, the Government mandated that CASETrust, the accreditation arm of CASE, develop an accreditation programme for this industry to raise professional standards and improve consumer confidence.

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Accreditation required spa companies to comply with consumer-friendly practices set by CASETrust, including protection over consumer prepayments and a 5-day cooling off period where consumers may seek a full refund if they change their minds and do not wish to proceed with the services offered. Such an accreditation was made a mandatory requirement for spa companies to obtain a police license to set up shops in heartland malls – a location the scene of many closures, where consumer protection was most needed.

Spa companies became motivated to provide prepayment protection due to the government's explicit linking of accreditation to their ability to set up shop in heartlands, to their very livelihoods in some cases.

Making such volunteer schemes mandatory changed the incentive structure facing spa companies and resulted in stronger consumer protection with positive knock-on effects for the sector. Ten years on, consumer confidence in this sector is more positive than before.

Taking a leaf from the spa industry's book, we could propose that the Government mandate accreditation for all sectors, but doing so could be onerous, with significant compliance burden for businesses and regulatory burden for the Government.

Instead, there is a case to be made to changing the legal framework to empower the relevant Minister to mandate prepayment protection as the need arises, whether in specific situations when businesses close down or for specific sectors.

Such a move may incentivise businesses to proactively take consumer protection more seriously. It is well within the self-interest of businesses to voluntarily develop industry-wide best practices, including prepayment protection schemes, rather than lose control of the entire process if and when the Government intervenes.

The mere presence of the threat of intervention when a business closes down may also lead to consolidation and improvement in some sectors, allowing the Government to concentrate on those that do not positively react to this threat.

The threat of government intervention may also serve to increase both the profile and attractiveness of CASETrust by offering a readily available and reputable accreditation scheme that can be adapted to suit the needs of a specific business sector and the consumer base it serves.

In Stephen Corvey-speak, it's a win-win.

True be told, there ought to be minimal regulatory intervention for businesses should have the space and freedom to compete, and offer the best products and services at the best prices to consumers within their remit. But at the same time, minimal intervention does not mean no intervention.

So it seems the best way to achieve a high level of consumer confidence is through some measure of consumer protection as and when needed. Empowering the Government to take action against recalcitrant businesses can push businesses to decide what is the best shape and form of consumer protection for their sector.

In this case, a spoonful of sugar does make the medicine go down.

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