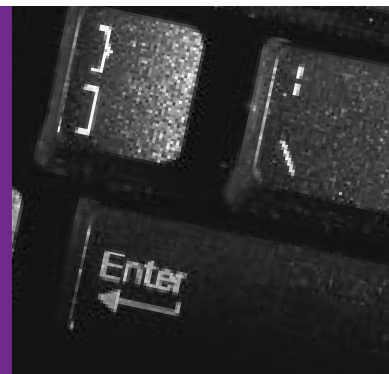


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# CREDIT CONTRACTS AND CONSUMER FINANCE ACT

DRAFT GUIDELINES FOR CONSUMER CREDIT FEES



## BACKGROUND

The Credit Contracts and Consumer Finance Act 2003 (CCCF Act) applies to credit contracts entered into from 1 April 2005. The CCCF Act governs lending within New Zealand. It focuses on lending to consumers, which is defined as meaning persons (not companies, trusts and the like) where the loan is primarily for personal, domestic or household purposes.<sup>1</sup>

## PURPOSE OF THE DRAFT GUIDELINES

These draft guidelines provide the Commerce Commission's current views on the CCCF Act's fees provisions, in relation to these aspects of the Act:

- establishment fees;
- credit fees; and
- default fees.

The draft guidelines **do not** deal with the charging by creditors of early prepayment fees or creditors passing on third-party fees to debtors.<sup>2</sup>

The guidelines are in **draft form** pending further guidance from the courts. The Commission will modify the guidelines to reflect any significant court judgments or any amendments to the CCCF Act.

The draft guidelines are intended to provide information and guidance to creditors, for the purposes of identifying areas of potential risk within their own businesses and of making informed decisions about how to manage those risks. However, these guidelines are not intended as legal advice. Each creditor's and debtor's situation is different. If you are in doubt about your rights and obligations you should obtain independent legal advice.

The CCCF Act has been in force for five years, but few cases have been heard by the courts and so the law on consumer credit fees is uncertain and requires further clarification.

The draft guidelines are not exhaustive as to the considerations the Commission may take into account when assessing whether creditor conduct has breached the CCCF Act.

The Commission will continue to exercise its discretion to screen complaints in this area, open investigations and decide to take enforcement action in appropriate cases.

## THE COMMISSION'S ENFORCEMENT APPROACH

The CCCF Act allows creditors to charge interest and fees, but constrains what fees can be charged, which creditor's costs can be recovered by way of fees and how the fees can be described.

Section 41 of the CCCF Act is a fundamental provision and prohibits a creditor from charging an "unreasonable credit or default fee". The Commission may take enforcement action if it considers a fee breaches or is likely to breach this provision. In exercising its discretion whether to take enforcement action, and what kind of action, the Commission will follow its published enforcement criteria.<sup>3</sup>

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1. The term consumer credit contract is defined in section 11 of the CCCF Act.  
2. Guidance is likely to be provided on those matters following the completion of court proceedings that the Commerce Commission has brought.  
3. Available online at [www.comcom.govt.nz/enforcement-criteria](http://www.comcom.govt.nz/enforcement-criteria)

## PURPOSES OF THE CCCF ACT

The CCCF Act's purposes are set out in Section 3 of the Act and provide important guidance as to how the Act is likely to be interpreted:

The purposes of the CCCF Act are –

- (a) to protect the interests of consumers in connection with credit contracts, consumer leases, and buy-back transactions of land; and
- (b) to provide for the disclosure of adequate information to consumers under consumer credit contracts and consumer leases –
  - (i) to enable consumers to distinguish between competing credit arrangements or competing lease arrangements; and
  - (ii) to enable consumers to become informed of the terms of consumer credit contracts or consumer leases before they become irrevocably committed to them; and
  - (iii) to enable consumers to monitor the performance of consumer credit contracts or consumer leases; and
- (c) to provide rules about interest charges, fees, and payments in relation to consumer credit contracts; and
- (d) to enable consumers to seek reasonable changes to consumer credit contracts on the grounds of unforeseen hardship; and
- (e) to provide for the disclosure of adequate information to consumers under buy-back transactions of land and for the provision of independent legal advice to those consumers –
  - (i) to inform consumers of the terms, the effects, and the implications of those transactions before they become irrevocably committed to them; and
  - (ii) to enable consumers to monitor the performance of those transactions; and
- (f) to provide rules about fees in relation to buy-back transactions of land; and
- (g) to prevent –
  - (i) oppressive credit contracts, consumer leases, and buy-back transactions of land; and
  - (ii) oppressive conduct by creditors under credit contracts, lessors under consumer leases, and transferees under buy-back transactions of land.

An overarching purpose of the CCCF Act is therefore that creditors will provide debtors with sufficient information to enable them to make informed choices about the credit options available to them. This means that debtors should

be able to look at important aspects of a credit product or service and compare it with a competitor's product or service. This includes applicable credit fees. Unless credit fees are transparent, fee competition amongst creditors is likely to be limited and borrowers may find it difficult to find the offering that suits them best.

One of the primary principles of interpretation is that legislation is to be interpreted according to its text, and in light of the statutory purposes.<sup>4</sup> It is unlikely, in the Commission's view, that a fee will be reasonable if it is inconsistent with one or more of the stated purposes of this Act.

An important outcome of the CCCF Act is that a creditor's specific cost or loss may not be recoverable in the fee that is currently applied by the creditor. But it will not necessarily follow that the cost or loss may not be recovered under another category of credit fee, or in the creditor's interest margin. Creditors should note that while interest is defined in the CCCF Act<sup>5</sup>, the level of interest that may be charged is not limited (save to the extent that it is oppressive).

## ESTABLISHMENT FEES

An establishment fee (as defined by section 5 of the CCCF Act) is a fee or charge to a debtor that relates to costs incurred by the creditor in connection with:

- the application for credit;
- processing and considering an application;
- documenting a loan contract; and
- advancing credit to a debtor.

It expressly does not include fees or charges made for an optional service.

The body of the CCCF Act replicates this definition, and prescribes that in determining whether an establishment fee is unreasonable the court must have regard to (section 42):

- (a) whether the amount of the fee is equal to or less than the creditor's reasonable costs in connection with the application for credit, processing and considering that application, documenting the consumer credit contract, and advancing the credit; or
- (b) whether the amount of the fee is equal to or less than the creditor's average reasonable costs of the matters referred to in paragraph (a) for the appropriate class of consumer credit contract.

4. Section 5 Interpretation Act 1999

5. Section 5: interest charge means a charge that accrues over time and is determined by applying a rate to an amount owing under a credit contract.

Important components of this reasonableness assessment are therefore:

- whether the fee is “equal to or less than” the creditor’s reasonable costs arising from the specified loan-establishment activities; and
- that the costs must relate to the particular application (or to the average cost of the appropriate class of consumer credit contract).

The Commission’s interpretation is that Parliament has limited the recoverable establishment costs in this way to ensure that:

- fees are only charged as ‘establishment fees’ when they genuinely relate to the establishment (setting up) of a debtor’s loan; and
- consumers are able to meaningfully compare competing products. Establishment fees are widely thought to be one of the primary considerations for consumers when selecting loan products.

Establishment fees attract interest from day one of a contract. Accordingly, in the Commission’s view, the incorrect inclusion of costs within the establishment fee results in a higher initial cost to the debtor. Interest will also run on that cost from inception of the loan. It also acts as a barrier to the debtor repaying early and switching to an alternative creditor or product, as there is no rebate payable on an establishment fee.

Whether or not an establishment fee is reasonable is, in the Commission’s view, primarily determined by an analysis of the underlying costs recovered within the fee.

Where costs do not fall within the four identified classes of establishment costs, or costs of a similar nature, they should not be recovered as part of an establishment fee.

In considering the legality of an included cost, the Commission does not assess the ‘directness’ or ‘indirectness’ of the cost, except to focus on establishing the degree of close connection between the cost and the establishment of the loan. This will in all cases depend on the facts of the particular case.

A creditor whose establishment fee is challenged by the Commission will not be able to assert that what is charged as an establishment fee accords with “reasonable standards of commercial practice”, and that it is therefore legitimate. That provision (section 44(1) (b)) expressly does not apply when determining the reasonableness of an establishment fee (section 44(2)(a)). So the question is at all times about the ‘connection’ between the costs charged and the setting up of the loan.

In summary, the Commission therefore expects that an establishment fee should only include costs closely connected with the steps taken to establish a loan and that those costs should be reasonable. The table below expands on the Commission’s current view of the recoverability of specific costs often charged within establishment fees. It should not be taken to be exhaustive, nor as representing the Commission’s final position (which will depend on the facts of the particular case under consideration).

**TABLE 1: ESTABLISHMENT FEES**

COST	CAN THIS COST BE RECOVERED WITHIN ESTABLISHMENT FEES?
Staff costs	An appropriate apportionment of the wages, salaries and ancillary costs of staff involved in establishing the loan <sup>6</sup> may be recovered.
Depreciation	Depreciation on assets used in connection with establishing the loan may be recovered.
Costs related to debt recovery	Costs related to debt recovery (credit control functions) should not be recovered as these are not costs in connection with establishing the loan.
Administration costs	Only administration costs in connection with establishing the loan may be recovered.
Premises costs	A properly allocated portion of premises costs – being an apportionment of costs connected with the establishment of the loan – may be recovered.
IT costs	An apportionment of IT costs in connection with establishing the loan may be recovered.
Marketing and advertising costs	General marketing and advertising costs should not be recovered. This is consistent with the need to recover only costs in connection with establishment of the specific loan.
Bad debt write-off <sup>7</sup>	Bad debt write-off should not be recovered through fees; it is not a cost connected with establishment of a loan.
Provision for doubtful debts	Provision for bad debt should not be recovered through fees; it is not a cost connected with establishment of a loan.
Head office functions	An apportionment of head office costs in connection with the establishment of a loan may be recovered.
Return on capital/ cost of capital	A reasonable return on capital/cost of capital in relation to the assets and working capital connected with establishing the loan may be recovered. Section 42 requires strict cost recovery (“equal to or less than”) therefore the return is likely to be only a small percentage of the overall fee.
Profit	The Commission does not consider a profit margin in addition to the cost of capital component is allowed, due to the wording “equal to or less than the creditor’s reasonable costs”.
Declined loan applications	The Commission successfully prosecuted a creditor that included the cost of declines in its establishment fee. <sup>8</sup> The Court held that this was improper and resulted in a fee that exceeded reasonable costs or average reasonable costs.  Further, it was noted that establishment fees must relate to costs in connection with “that” consumer credit contract ie, must be particularised to an individual contract or appropriate class of consumer credit contract. A declined application does not result in a credit contract, and its costs cannot therefore be attributed to any consumer credit contract.
Entertainment costs	Entertainment costs should not be recovered, as these are not costs in connection with establishing the loan or to any particular consumer credit contract or class of consumer credit contract.
Costs relating to creditors’ funding arrangements and operating structure	In order to be accepted as legitimate costs within establishment fees a creditor must be able to establish the costs were incurred in connection with establishing the loan. The costs must also have been reasonably contemplated by the parties, and be proximate with the loan.

6. In the table, “establishing the loan” refers to the processes described in section 42 of the CCCF Act ie, applying for the credit, processing the application, considering the application, documenting the credit and advancing the credit.  
 7. Bad debt write-off in this context refers to the practice of bundling bad debts and attempting to recover the costs incurred across a class of consumer credit contract, rather than any costs arising from pursuing recovery from an individual defaulting debtor.  
 8. *CC v Galistair Enterprises Ltd* 6/12/07, Judge Aitken, DC Auckland CRI-2007-004-4009.

## CREDIT FEES

Creditors sometimes charge fees for other matters arising out of the provision of credit, for example monthly account fees and statement fees.

How is the reasonableness of such other fees to be assessed?

A credit fee is defined in section 5 of the CCCF Act as a fee or charge payable by a debtor under or in connection with a credit contract, but not including interest charges, default fees and certain other charges.

Section 44 is the general catch-all provision for fees other than establishment, third party and prepayment fees:

In determining whether a credit fee or a default fee is unreasonable, the Court must have regard to,—

- (a) in relation to the matter giving rise to the fee, whether the fee reasonably compensates the creditor for the following:
  - (i) any cost incurred by the creditor (including the cost of providing a service to the debtor if the fee relates to the provision of a service);
  - (ii) a reasonable estimate of any loss incurred by the creditor as a result of the debtor’s acts or omissions; and
- (b) reasonable standards of commercial practice.

The Commission considers that the primary considerations when assessing a credit fee – as opposed to a default fee (see below) – are:

- permitting reasonable compensation for the creditor’s costs in connection with the fee; and
- whether the fee accords with reasonable standards of commercial practice.

The Commission recognises that, as it is drafted, the ‘loss’ limb of reasonable compensation (s 44 (a)(ii)) is a matter going to the reasonableness of a credit fee. But in the Commission’s view, a “reasonable estimate of any loss... as a result of the debtor’s acts or omissions” is typically likely to be relevant only where the debtor is in default, rather than where a credit fee is being charged.

Compared with section 42 (establishment fees), a creditor charging a fee that is covered by section 44 will have greater flexibility. The ‘cost incurred’ is not prescribed as to type of cost. Further, a creditor will be able to assert to the Commission or the Court that its fee complies with reasonable standards of commercial practice.

While the phrase in section 44 “must have regard to” is mandatory, the list of considerations may not be exhaustive. However, the Commission’s current view is that any

additional relevant considerations would have to be of the same kind as the general criteria identified in the section.

The Commission offers some guidance on these components of the analysis below, but notes that in the absence of any judgments from the Courts these interpretations are preliminary.

### MEANING OF “THE MATTER GIVING RISE TO THE FEE”

The phrase “the matter giving rise to the fee” seems to indicate that any credit fee must relate to a specific matter or step taken in connection with a credit contract. The concept of ‘compensation’ dovetails with this interpretation – the step or matter giving rise to the fee is identified, and the Commission or Court then assesses the extent to which the fee compensates for the costs involved in the matter.

This makes it clear that the type of fee must be accurately described so as to comply with disclosure requirements and to avoid misleading debtors.

### MEANING OF “REASONABLY COMPENSATES”

The Court will consider, in assessing reasonableness, whether the credit fee “reasonably compensates” for “any cost incurred by the creditor (including the cost of providing a service ...).”

A creditor seeking to support its fee to the Commission or the Court will likely need to provide costing information and analysis. This would link the matter giving rise to the fee with costs incurred and, in turn, with the fee charged.

The Commission accepts that some averaging or estimation may come into this costing analysis, and that a fee will seldom exactly match related costs. But the Commission emphasises that if a creditor supports a fee on the basis that it reasonably compensates for costs incurred, the costs must actually be “incurred”, rather than notional.

A key question that arises will be the meaning of the word “any” in the phrase “any cost incurred”, and whether that is to be construed as embracing any cost actually incurred, no matter how remote from the loan. The Commission’s current view is that the fee must be causally connected to the cost incurred, and satisfy common law standards of remoteness – it must be a cost proximate to the provision of the credit. The Commission would be unlikely to regard a cost as reasonable if it were not a cost within the reasonable contemplation of the parties to the loan.

## MEANING OF “REASONABLE STANDARDS OF COMMERCIAL PRACTICE”

The phrase “reasonable standards of commercial practice” is not defined in the CCCF Act and will be a matter for the Courts to determine.

The Commission anticipates making a two-stage enquiry when this limb of section 44 is put into issue:

- First, ascertaining actual standards of commercial practice as they bear upon the credit fee.
- Secondly, assessing the reasonableness of the commercial practice. It is well accepted that just because something is common commercial practice it does not necessarily follow that it is reasonable.

The precise relationship between the compensation limb (section 44(1) (a)) and the commercial practice limb (section 44 (1)(b)) remains to be tested. Both are mandatory considerations and there is nothing to suggest that they do not carry equal weight. But if this is the case, it is possible that a fee that over-compensates may nonetheless satisfy a Court if it reflects reasonable commercial practice. Or perhaps a fee that is a reasonable compensation for a cost, but which is unique in commercial practice, might nonetheless be legitimate. A third outcome could be that a Court might reduce a fee that compensates for a cost incurred because it does not comply with reasonable commercial practice.

The Commission, for its part, would expect creditors to have a sound basis for supporting a credit fee under either the compensation limb or the commercial practice limb. A creditor who is able to justify a credit fee under both limbs will be more likely to satisfy the Commission or the Court as to the reasonableness of the fee.

The Commission has a number of fees investigations underway that may assist in providing further clarity on these issues. In the interim, the Commission provides the following indications as to its current views on credit fee-related costs.

**TABLE 2: CREDIT FEES**

COST	CAN THIS COST BE RECOVERED WITHIN OTHER CREDIT FEES? (EXCLUDING DEFAULT FEES)
Costs related to debt recovery	Costs related to debt recovery (credit control functions) should not be recovered because these arise only on default and must be described as a default fee.
Marketing and advertising costs	An apportionment of these costs may be recovered providing they are not too remote from the matter giving rise to the fee or an unreasonable standard of commercial practice.
Bad debt write-off <sup>9</sup> or an increase in provision for doubtful debts	Bad debt cannot be recovered through credit fees; such fees are not connected with the credit contract to which they are being applied.
Head office functions	An apportionment of these costs may be recovered providing they are not remote from the matter giving rise to the fee or an unreasonable commercial practice.
Return on capital/ cost of capital	A reasonable return on capital/cost of capital in relation to the assets and working capital attributable to the matter giving rise to the fee may be recovered.
Profit	The Commission does not consider that a profit margin in addition to the cost of capital component is allowed under section 44(1) (a)(i) given that profit is not compensatory.
Declined loan applications	The Commission considers that declines cannot be recovered by way of fees charged to loans that proceed. Unsuccessful applications do not become consumer credit contracts and the CCCF Act limits recovery of costs to those incurred in connection with consumer credit contracts.
Entertainment costs	These costs may be recovered providing they are not remote from the matter giving rise to the fee or an unreasonable standard of commercial practice.

9. Bad debt write-off in this context refers to the practice of bundling bad debts and attempting to recover the costs incurred across a class of consumer credit contract, rather than any costs arising from pursuing recovery from an individual defaulting debtor.

COST	CAN THIS COST BE RECOVERED WITHIN OTHER CREDIT FEES? (EXCLUDING DEFAULT FEES)
Depreciation	Recovery of an apportionment of depreciation on the assets used in connection with the matter giving rise to the fee would be acceptable.
Costs relating to creditor’s funding arrangements and operating structures	An apportionment of these costs may be recovered providing they are not remote from the matter giving rise to the fee or an unreasonable commercial practice.

## DEFAULT FEES

The CCCF Act includes default fees within the same section dealing with the reasonableness of credit fees (section 44).

This relationship is unusual in that the two types of fees are fundamentally different: credit fees are charged in accordance with the terms of the contract, while default fees are charged as a consequence of a breach of the contract. Section 5 of the CCCF Act reinforces the difference, expressly noting that “credit fee” does not include “default fee”. “Default fee” is defined (section 5) as “fees or charges payable on a breach of a credit contract ... but does not include default interest charges”.

As indicated above, the Commission interprets section 44 as having a ‘loss’ limb that is invariably relevant when assessing default fees. So the principal considerations for assessing the reasonableness of a default fee would be:

- whether the default fee reasonably compensates the creditor, which is expressed in section 44(1)(a)(ii) as compensation for “a reasonable estimate of any loss incurred by the creditor as a result of the debtor’s acts or omissions”; and
- whether the fee accords with reasonable standards of commercial practice.

The key concept is that the default fee must not exceed a reasonable estimate of the creditor’s loss. The loss that is estimated must also result from “the debtor’s act or omission” – it is specific to loss caused by the debtor, not by some other debtor or class of debtor. The fee must also be a genuine estimation of future loss. It cannot be a penalty.

The common law will provide guidance in estimating loss, and the Courts have held that the standard principles of causation, remoteness and mitigation of loss will apply.<sup>10</sup> Based on those common law principles, the loss that is charged in this fee must be loss of a kind that is within the contemplation of the parties to the loan.

As above, the commercial practice limb will also apply in determining whether a default fee is unreasonable. The Commission is not in a position to stipulate in advance what will be a reasonable standard of commercial practice, and in every case it will depend upon the evidence available.

The Commission gives the following preliminary indications about its current views on costs typically included within default fees.

**TABLE 3: DEFAULT FEES**

COST	CAN THIS COST BE RECOVERED WITHIN DEFAULT FEES?
Costs related to debt recovery	Costs relating to credit control functions may be recovered provided they relate to the particular debtor’s acts or omissions. It may be a reasonable commercial practice to average these.
Marketing and advertising costs	These costs cannot be recovered.
Bad debt write-offs <sup>11</sup> or an increase in provision for doubtful debts	Bad debt cannot be recovered through fees. Neither can provision for bad debt which bears no connection to the actual debtor’s default.

10. *CC v Avanti Finance* 28/04/09, Judge Asher HC Auckland CIV-2008-404-210.

11. Bad debt write-off in this context refers to the practice of bundling bad debts and attempting to recover the costs incurred across a class of consumer credit contract, rather than any costs arising from pursuing recovery from an individual defaulting debtor.

COST	CAN THIS COST BE RECOVERED WITHIN DEFAULT FEES?
Head office functions or holding company management fees (for example where a group levy is charged to a creditor)	An apportionment of head office costs may be recovered where it is involved in credit control functions. This will require a case by case analysis, and the costs must not be too remote from the credit contract.
Return on capital/ cost of capital	Default fees arise only where a debtor has defaulted on its contractual obligations. In <i>Avanti</i> <sup>12</sup> Asher J affirmed that common law principles as they relate to damages are applicable. The Commission does not have a settled view on the recovery of cost of capital, and may seek clarification on this issue from the Courts.
Profit	The Commission does not consider a profit margin is allowed under section 44(1) (a) given that profit is not compensatory. Inclusion of profit would need to satisfy the reasonable standards of commercial practice limb in order to be recovered which the Commission considers unlikely in the context of default.
Declined loan applications	The Commission considers that declines cannot be recovered by way of fees charged to loans that proceed.
Entertainment costs	Not recoverable as not a consequence of specific debtor's acts or omissions.
Costs relating to creditor's initial funding arrangements and ongoing operating structures (excluding credit control)	Not recoverable as a default fee as not a consequence of breach or default.

12. *CC v Avanti Finance* 28/04/09, Judge Asher HC Auckland CIV-2008-404-210.