

# Credit Contracts and Consumer Finance Act

## Compliance issues you should know about

The Credit Contracts and Consumer Finance Act 2003 came fully into force on 1 April 2005. The Commerce Commission has been responsible for promoting compliance with, and enforcing the CCCF Act.

Since the introduction of the Act, the Commission has undertaken a number of enforcement actions against creditors who, in the Commission's view, have breached the Act.

In summary, the Commission has:

- Commenced criminal proceedings against two creditors;
- Entered into a settlement with one creditor;
- Issued formal warnings to thirteen creditors; and
- Issued compliance advice letters to six creditors advising they may have breached the Act.

As a result of these enforcement actions, key compliance areas have emerged. These are highlighted below.

### Disclosure

- Creditors must ensure disclosure has been made to the debtors and it must be readable
- If you haven't disclosed properly, you can't enforce the contract
- CCCF Act has different disclosure requirements from old Acts: update your documents
- Some people don't realise their activities are covered by CCCF Act

One of the primary objectives of the CCCF Act is to *“provide for the disclosure of adequate information to consumers under consumer credit contracts and consumer leases to enable consumers to distinguish between competing credit arrangements or competing lease arrangements... and become informed of the terms of consumer credit contracts or consumer leases before they become irrevocably committed to them<sup>1</sup> ...”*.

Improving compliance with the Act's disclosure requirements is a priority area for the Commission.

### *Giving proper disclosure*

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<sup>1</sup> CCCF Act s3(b) (i) and (ii)

The Commission has decided to prosecute two creditors under the CCCF Act and the Fair Trading Act 1986 for disclosure-related breaches.

It is alleged that *Company A*<sup>2</sup> did not alter its documentation to comply with the CCCF Act, and disclosed information on outdated documentation drafted under the Credit Contracts 1981 and Hire Purchase Act 1971. The Commission alleges that the creditor did not disclose key information set out in Schedule 1 of the CCCF Act and therefore the creditor failed to provide disclosure as required by section 17.

*Company B* allegedly disclosed using a photocopy of the terms and conditions faxed through by its agent. As a result the disclosure document was effectively unreadable and therefore the Commission alleges that the company failed to meet the disclosure standards.

It is the Commission's view, that if a creditor fails to meet the disclosure standards under section 32 of the CCCF Act, it has failed to make disclosure at all under the CCCFA. There is a duty upon creditors to not only disclose, but to disclose at the required standard.

Where disclosure is required under section 17 of the CCCF Act, section 99 of the Act prohibits creditors from enforcing credit contracts or security interests under those contracts until disclosure is provided. The Commission considers that when a creditor is prohibited from enforcing a consumer credit contract, the creditor may breach the Fair Trading Act if it tells debtors that it has a right to enforce the contract. For example, if a company has not disclosed or provided adequate disclosure to the required standard, it may breach the Fair Trading Act if it sends default letters, charges default penalties, or initiates the process of repossessing any security.

Creditors should be aware that disclosure to guarantors is also required before they can enforce the guarantee.

In cases where creditors rely on their agents to provide disclosure documentation to debtors, it is important that creditors monitor the quality of the documentation being provided to debtors. Creditors can and will be held responsible for their agents' non-compliance.

#### *Definition of "credit contract" extended*

The CCCF Act has made a number of changes to the law relating to the definition of credit contracts, and some organisations may not realise that their business is covered by the CCCF Act. For example, pawnbrokers are now considered creditors. The Commission has issued compliance advice letters to two pawnbrokers reminding them of the need to provide disclosure as required under the CCCF Act, and has also issued a

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<sup>2</sup> The companies in this article are not named for policy and/or legal reasons.

warning letter to a pawnbroker who issued pledge tickets to its debtors without providing adequate disclosure.

The Commission has also warned a district council for not providing initial disclosure to 27 ratepayers who entered into a loan scheme to build sewerage infrastructure. The council offered 179 rate payers four options to pay their share of the capital costs of the extension to the sewerage scheme. The council was not aware that two of these options fell under the provisions of the CCCF Act. Following the Commission investigation, the Council has undertaken to comply in future.

### **Unreasonable Fees**

- Credit fees must be reasonable
- Company warned for “double dipping” when calculating fees

*What is reasonable?*

The CCCF Act prohibits the charging of “unreasonable” fees including establishment, prepayment and other credit fees and default fees.

While there is some scope for the court’s interpretation of when a fee will be unreasonable, the Commission is using creditors’ accounting cost analyses to formulate its opinion as to whether certain fees charged may be unreasonable. The Commission expects that creditors have undertaken a cost analysis process in order to set their fees and therefore will be able to justify the basis for them.

Section 42 of the CCCF Act places limitations on what costs a creditor should include when calculating an establishment fee. The Commission’s view is that, it restricts the establishment fee to only include those costs which are directly attributable to establishing the loan, such as the cost of processing the application and documenting the credit contract. The Commission expects that creditors should be able to provide relevant cost accountings when requested, and also be prepared to explain how various elements of their costs relate to such specific allowable costs.

*No “Double Dipping” on fees*

The Commission has warned *Company C* as it charged a debtor an additional fee that included the cost of time incurred by the managing director and lending manager in processing a specific credit application. However the creditor also included the salaries of those staff in its cost accounting analysis to justify its main establishment fee, which the debtor was also charged. The Commission was of the view that this was ‘double dipping’, and that the additional fee on top of the main establishment fee was likely to be unreasonable.

The Commission provided compliance advice on *Company C's* practice of including bad and doubtful debts in its monthly administration fee. The Commission's view is that including bad and doubtful debts or provisions for such costs may not be reasonable when calculating credit fees.

The Commission is also of the view that no provision for bad or doubtful debts should be made as part of a default fee, and that the averaging of bad and doubtful debts over all defaulting debtors is unreasonable and likely to be a breach of the CCCF Act as these fall outside of section 44. It is a matter of the quality of debt management and lending policy that determines the level of default, and therefore it could be considered unreasonable to on-charge bad debts to all debtors, whether defaulting or not.

The Commission has recently entered into a settlement with *Company D* which was charging a \$500 administration fee in addition to its full prepayment fee. *Company D* described the charge as an administrative fee but could not substantiate the charge.

During July 2005, the Commission undertook a number of voluntary compliance visits to creditors and issued voluntary compliance reports to the industry. *Company D* ceased charging the administration fee upon receiving the report. As part of the settlement, *Company D* admitted that its practice of charging such fee was likely a breach the Act and it has undertaken to refund 33 debtors who were charged the fee, a total of \$13,693. The fact that the creditor ceased charging the \$500 administration fee once it was advised this could breach the CCCF Act, was a factor considered by the Commission in determining the appropriate enforcement action in this case.

Factors the Commission may consider are detailed in its enforcement criteria. Details of the enforcement criteria are available in Commission publications or at [www.comcom.govt.nz](http://www.comcom.govt.nz)

### **Third Party Fees**

- Third party fees must not exceed what the third party actually charged
- Commissions for credit related insurance should be no more than 20% of the gross premium

Under section 45 of the CCCF Act, third party fees charged to debtors must not exceed the actual amount charged by the third party. The Commission warned *Company C* about its practice of charging the cost of staff time in carrying out PPSR checks under the heading of "PPSR fee" in consumer credit contracts. As a result of the investigation *Company C* has now altered its practice.

In November 2005, the Commission issued guidelines regarding its position in considering enforcement actions relating to "reasonable commission" allowed to be retained by creditors under section 45 of the CCCF Act. The Commission's position is that:

*“In the absence of any statutory guidance or court decision determining the appropriate interpretation relating to what a ‘reasonable’ commission on credit related insurance might be, the Commission intends to apply a threshold based on the approach taken in the Australian Uniform Consumer Credit Code. Accordingly any commission on credit-related insurance that is 20% or less of the gross premium paid by the debtor will be unlikely to meet the Commission’s enforcement criteria.”*

A copy of this guideline is available on the Commission’s website at [www.comcom.govt.nz](http://www.comcom.govt.nz)

## **Full Prepayment**

- If you want to include the time taken to re-lend money in your repayment formula, be prepared to justify it
- Charging extra interest on full prepayment can be seen as charging interest in advance, which the CCCF Act prohibits

The Commission has issued warning letters to a number of creditors in relation to their use of an alternative full prepayment formula, other than the “safe harbour” formula contained in the CCCF Regulations. The alternative full prepayment formulae used included extra interest for an arbitrary period ranging from one month to three months. Creditors claimed this period was the time required for re-lending funds.

The Commission’s position is that:

*“In the absence of any statutory guidance or court decision providing indications of what factors will be relevant in determining whether an alternative formula accurately represents a reasonable estimate of loss, the Commission considers, as a general principle, a credit provider may not include an allowance for the time taken to re-lend funds. Any estimate of loss should be calculated on the basis that a creditor will take reasonable steps to mitigate their loss and to re-lend any money prepaid as soon as possible. Any creditor who, in calculating their reasonable estimate of loss, claims an allowance for the time to re-lend, should be prepared to demonstrate based on an analysis of its operations that a delay in re-lending the money is unavoidable and that the extent of the delay has been accurately calculated.*

*The adopting of an arbitrary time allowance will certainly not be an appropriate procedure under section 54(1)(b) CCCF Act.”*

If creditors want to reflect the time taken to re-lend funds in their full prepayment formulae, they must be able to demonstrate the reasonable steps they have taken to mitigate their losses from prepaid contracts, and provide supporting evidence to show that funds cannot be re-lent immediately.

In addition, charging extra interest on full prepayment of the contracts may be seen to be charging interest in advance contrary to section 38 of the CCCF Act.

### **Credit-related Insurance**

- Credit related insurance should only be required if it is appropriate
- Arrangements such as guarantees/indemnities that are insurance in substance will be covered by the CCCFA
- Disclosure of insurance must be provided by creditors

Section 69 of the CCCF Act prohibits creditors from making unreasonable requirements that a debtor to take out credit-related insurance, a repayment waiver or an extended warranty.

A number of creditors appear to require their debtors to purchase credit-related insurance without considering whether the insurance cover is applicable to the debtors' circumstances. For example, *Company F* was warned for requiring an unemployed debtor to obtain credit-related insurance that covered redundancy, a benefit the debtor could not claim.

*Company G* was warned by the Commission for charging a guarantee fee for a 'guarantee' which was in effect an insurance contract by a different name. Creditors who arrange credit-related insurance for debtors are required to provide a proportionate rebate of the insurance premium to debtors when full prepayment is made. Disguising an insurance product in order to avoid this requirement is likely a breach of the Act.

On the other hand, if such a 'guarantee' is required, and the creditor says it is not credit-related insurance, under section 45 of the Act the creditor is not allowed to retain any commission from the fee payable to a third party, as the third party fee must be passed on at cost. *Company G* has undertaken to review its practice and stopped charging a commission when advised.

The Commission is also of the view that creditors may be breaching the Fair Trading Act if they mislead customers about the existence or effect of any guarantee, or about the nature of the service they are paying for.

Creditors should be aware of the requirement to disclose a copy of any credit-related insurance, repayment waivers or extended warranties involved in consumer credit contracts. A motor vehicle trader *Company H* which provided finance as well as arranging credit-related insurance, failed to ensure that debtors received a copy of the terms of the insurance and was warned by the Commission for a potential breach of section 70 of the CCCF Act.

The Commission is aware that some creditors providing credit-related insurance may not be complying with legislation governing insurance providers. Further information about

this is available on the Ministry of Economic Development's website at [www.med.govt.nz](http://www.med.govt.nz) . The consequences of failing to comply can be costly for insurance providers.

### **What you can do to comply with the CCCF Act**

- Establish a compliance programme
- Conduct regular employee training and reinforcement of the need for compliance with the CCCF Act and Fair Trading Act
- Periodically review your processes to make sure you comply
- Keep your compliance programme up to date and maintained, particularly with a view to staff turnover

The Commission expects that creditors using agents or brokers will also take reasonable steps to ensure their agents or brokers also have adequate compliance programs.

For further information you should visit [www.comcom.govt.nz](http://www.comcom.govt.nz). The Commission's publications on the CCCF Act and the Fair Trading Act, media releases and relevant guidelines are available through the website.

Enquiries can also be made through the Commerce Commission Contact Centre on 0800 94 3600