

**Graham Gill: Fair Trading Manager, Auckland: Commerce Commission
Auckland District Law Society Credit Law Conference**

“Credit Contracts and Consumer Finance Act Investigations – Recent Findings and Dealings with the Commerce Commission”.

INTRODUCTION

The purpose of this paper is to discuss some of the key investigations undertaken by the Commerce Commission since the introduction of the Credit Contracts and Consumer Finance Act (“the Act”) and to address some important points for credit providers to consider during the course of a Commission investigation.

THE ACT & THE COMMISSION

The Act came into force from the 14th of October 2003 in relation to buy back transactions of land and fully into force in relation to consumer credit contracts, consumer leases and non-consumer credit contracts from the 1st of April 2005. The Act repealed the Credit Contracts Act and Hire Purchase Act.

The Act substantially revised the previous consumer credit legislation. The Act:

- deregulated credit contracts between businesses;
- introduced a new range of damages and penalties for breaches;
- introduced significant “safety nets” for consumers, including the introduction of the statutory right to repay early and establishment of a mechanism to address situations of unforeseen consumer hardship;
- imposed a “reasonableness” requirement on credit fees; and
- made changes to the disclosure requirements with the objective of ensuring consumers are fully informed of the terms of their credit contracts and establishing a set format for the presentation of that information.

While making a number of substantial changes, it also maintained the consumer protections in the previous legislation of cancellation and relief for oppressive conduct.

For the first time in New Zealand, the law governing consumer credit transactions was also to be enforced by a regulatory body, the Commerce Commission.

The Commission’s role within the credit industry is to promote compliance with the Act¹. Its functions² include:

- monitoring credit markets;

- taking prosecutions in relation to breaches under the Act;
- taking civil proceedings under the Act; and
- making available appropriate information for the guidance of consumers, creditors and other interested persons in relation to promoting compliance under the Act.

The Commission is not required to take any proceedings under the Act in relation to any particular person or to exercise any power conferred by the Act³. Effectively, the decision to initiate an investigation or to take one particular type of enforcement action over another in relation to a particular creditor and alleged breaches of the Act is at the Commission's discretion.

ENFORCEMENT OUTCOMES

The Commission's enforcement actions under the Act have resulted in court ordered fines of \$159,000 being awarded against non compliant credit providers and also voluntary and court ordered refunds in excess of \$1,500,000 being returned to over 5,300 debtors.

The Commission currently has 50 active credit investigations underway, over half of which relate to allegations of unreasonable fees and currently has its third conviction pending.

During the first six months of 2007, the Commission received 245 complaints from consumers, the majority alleging potential breaches of the Act by credit providers. The number of consumers reporting alleged breaches of the Act has increased steadily as consumers have become more aware of their rights under the Act and more contracts have been subject to the provisions of the Act.

THE COMMISSION'S INITIAL ENFORCEMENT APPROACH

During the early stages of its enforcement of the Act, the Commission took an educative approach to its compliance activities. The Commission presented at a nationwide industry-run road show about the Act and various other seminars.

It also produced two guides specifically for credit providers, one shorter concise guide taking a broad brush approach to the key issues under the Act and one very detailed guide that also contained guidance from the Commission in relation to certain issues (i.e. factors that the Commission considers would be inappropriate to consider when recovering losses in situations of full prepayment, and the Commission's position regarding "tiered" fee structures.) These publications are still available for credit providers and their advisors and can be downloaded directly from the Commission website⁴. Further guidance is from time to time also made available on the Commission's website.

These guides will be reviewed shortly.

The Commission's initial enforcement actions focused heavily on undertaking voluntary compliance inspections and giving feedback to credit providers where it identified issues indicating potential breaches of the Act. The objective of these inspections and presentations was to educate traders sufficiently to achieve voluntary compliance with the Act.

The Commission also focused on developing its monitoring and surveillance capability to increase its knowledge of credit industry processes and practices, traders within all sectors of the credit industry and practices that prima facie, suggested potential breaches of either the Act or Fair Trading Act.

It also implemented an information and education strategy to raise consumer awareness and encourage the reporting of alleged breaches of the Act. This strategy focused on strengthening relationships and information flows between the Commission and key consumer organisations, particularly those dealing with more vulnerable consumers.

During its initial stages of enforcement, the Commission primarily took lower level enforcement actions against creditors. These actions were largely educative and focused on encouraging credit providers to understand and voluntarily comply with the Act.

THE COMMISSION'S CURRENT ENFORCEMENT APPROACH

With the advent of the Commission's first prosecution under the Act, the Commission signaled quite clearly that it now expects compliance with the Act to be "the norm" and will, when appropriate, take higher level enforcement action against non compliant credit providers.

Litigation is now a priority for the Commission. With much of the Act remaining untested, the Commission intends to use civil and criminal proceedings to give creditors greater certainty about the obligations imposed under the Act and an indication of how various provisions of the Act will be interpreted by the Courts. We recognise that we need to take litigation to clarify the law, especially around reasonableness of fees. It is only through the development of a body of case law that the issues relating to reasonableness of fees will be clarified.

The Commission has indicated⁵ that its current strategic focus points for 2007/2008 under the Act are:

- taking further litigation to send the strongest message possible to creditors about the need for compliance with the disclosure provisions of the Act;

- establishing precedents with respect to provisions relating to “reasonableness” of fees;
- establishing precedents in relation to the credit related insurance provisions of the Act;
- Targeting credit providers operating at the lowest end of the credit market and dealing with the most vulnerable consumers;
- Using the full extent of our information gathering powers when necessary;
- Accessing and providing information to vulnerable consumers through their contact with consumer organisations;
- Continuing to work with a range of consumer organisations dealing with consumer credit issues to improve our knowledge of alleged breaches.

Breaches of the Act can also often lead to potential breaches under the Fair Trading Act. Conduct that misleads consumers about their rights is also a Fair Trading strategic focus point for 2007/2008 and is therefore likely to attract our attention.

The Act and Fair Trading Act are essential in establishing a framework for competition to function effectively. The objective of these laws is to ensure that consumers are informed, receiving accurate information about the products and services they purchase and being able to compare this information across products and services provided by different traders.

Informed consumers, who are confident of the accuracy of information they receive from traders can then drive the competitive process through their choices in selecting one service provider over another, or one product over another. Informed consumers are vital in promoting dynamic markets capable of self-regulation, providing traders with incentives to respond and adapt to market signals.

Disclosure enables debtors to “vote with their dollar” for the best and most competitive credit product, in turn putting pressure on businesses to lower prices and raise quality. Informed consumers, even those who are typically more vulnerable, have the capacity to influence the type, quality and cost of goods and services offered in competitive markets.

The primary focus for the next year is taking action on the reasonableness of credit fees. Ensuring fees are reasonable and disclosed, will reduce an area of significant detriment for consumers as well as encouraging competition as:

- Creditors will compete on the level of fees; or
- Creditors will compete on interest rates (given that fees are recovered at cost only); and
- Inefficient creditors, who are currently able to over-recover fees, will be disadvantaged.

The Commission looks for breaches of the Fair Trading Act when considering breaches under the Act. It has taken enforcement action against credit providers breaching both the CCCF Act and Fair Trading Act and will continue to do so in appropriate situations. Prosecutions under the Act have also included action in relation to Fair Trading Act breaches, with the result that creditors have been convicted under both Acts.

Creditors should be aware of the relationships between breaches under the Act and Fair Trading breaches and take steps to monitor their compliance with the Act to avoid or minimise consequential Fair Trading Act breaches.

In addition to receiving information about the credit industry from consumers, the Commission has also continued to develop and strengthened its relationships with consumer organisations in accordance with its information and education strategy. These organisations can, and do, report alleged breaches of the Act and Fair Trading Act and concerns about industry or trader specific practices to the Commission.

The Commission also undertakes its own credit industry surveillance. Clearly there is now an increased likelihood that breaches under the Act and Fair Trading Act will be detected within the credit industry. The Commission also anticipates that reforms relating to financial service providers and financial intermediaries (yet to be implemented) will also continue to increase the identification of breaches under the Act and Fair Trading Act within the credit industry as the industry becomes the subject of increased consumer and regulatory scrutiny.

CASE STUDIES – Disclosure

Senate Finance Limited

The Senate Finance Limited (“Senate”) case was the first prosecution taken by the Commission under the Act and is an early example of how breaching the Act can also result in breaches of the Fair Trading Act.

Senate was convicted of seventeen charges under the Act and a further eight charges under the Fair Trading Act. They were fined \$59,000 and ordered to pay statutory damages of \$13,700 to affected debtors.

The facts of the Senate case are relatively simple. Senate entered into consumer credit contracts with consumers purchasing vehicles. The transaction involved written documents relating to the sale and purchase of the vehicle and also written documents relating to the financing of that sale. The documents were faxed between the motor vehicle dealer and Senate, in the process the text of some parts of the consumer credit contracts was both reduced in size and became blurred. Sections of the terms and conditions were almost totally illegible although there were areas where the basic contractual details; including

the price, security for the loan, details of the item financed and contact details of the parties; remained legible.

In describing the text, the Court noted:

“It was in the small print, as they say, that the devil lay”. The terms and conditions simply could not be read. It is common in commercial standard form documents for there to be the use of what I believe the Americans call, ‘mouse print’, which are the miniature fonts that we see in the original document produced to me”.

A car salesperson at one yard involved in this case, suggested that the debtor use a magnifying glass to read the documentation.

The Commission’s position was that Senate had failed to meet the disclosure standards under section 32 of the Act. These standards require that the disclosure must “express the required information clearly, concisely and in a manner likely to bring the information to the attention of a reasonable person⁶”.

As Senate had failed to meet that standard, they had failed to provide initial disclosure as required under section 17 of the Act. Senate was convicted of the charges of failing to make disclosure under the Act.

Having failed to make disclosure Senate was then prohibited from enforcing the contracts as section 99 of the Act prohibits the enforcement of contracts, enforcement of the right to recover property relating to the contract or enforce any security interest in the contracts until disclosure has been made.

Senate subsequently breached section 13(i) of the Fair Trading Act by making representations that it had rights under the contract that were enforceable at the time the representations were made, when in fact these rights did not exist until adequate disclosure was made. The misleading representations Senate made were included in pre-possession notices and the charging of penalty interest, letter fees and monthly installment fees.

Dolbak Finance

In the Commission’s second prosecution, the partners of Auckland car finance business Dolbak Finance were convicted, fined \$100,000 and ordered to pay statutory damages of \$46,600 for not providing disclosure to approximately 100 debtors. Dolbak Finance provided finance to customers who purchased second hand cars from Fleetz Wholesale Cars Limited in Penrose between April 2005 and June 2006.

The two partners David Dolbel and Anthony Baker failed to change their contracts following the introduction of the CCCF Act. They continued to use the old Credit Contracts Act contracts for a further 14 months. This meant that

information required to be disclosed under the CCCF Act was not provided to debtors.

Dolbel and Baker were advised on at least two occasions by the Commission that their contracts were deficient, needed to comply and that they should obtain legal advice on this point. They failed to do so.

Dolbel and Baker also admitted breaching the Fair Trading Act by falsely representing to debtors they could repossess vehicles when those contracts were unenforceable under section 99 of the Act. They were also convicted of failing to provide guarantor disclosure.

South Auckland Creditors

The Commission recently warned six south Auckland creditors, and is prosecuting a seventh, for allegedly failing to provide disclosure to customers taking out personal loans. The Commission will not be commenting further on the prosecution of the seventh creditor at this stage.

The six creditors that have been warned by the Commission are Mana'ia Financial Services, Sala Multi Services Ltd, Winston's Finance, Houmatetefa Finance, Mizpah Trading Co. Ltd, and Funaki Enterprises. These credit providers predominately target Pacific Island consumers by advertising in Pacific language newspapers. They provided short term cash loans, usually of relatively small amounts. Traditional Tongan mats are being used as security for the loans.

The Commission found that the six warned credit providers allegedly failed to:

- Advise customers of their statutory right to cancel the loan within a certain period of time;
- Disclose the annual interest rate and the amount of interest payable;
- Advise customers of the costs of full prepayment;
- Adequately describe property subject to security interests.

Although some information was provided to debtors about their credit contracts, the Commission considered that the creditors had failed in their obligations to provide disclosure under section 17 of the Act.

Mobile Shop Trucks

The Commission has recently warned four creditors operating mobile shops throughout south Auckland, Northland, Bay of Plenty and Waikato that they risked breaching the Act by failing to disclose key information pursuant to section 17 of the Act.

The warned creditors were Lync NZ Limited, Suny Pacific International Limited, Impact Door to Door Limited and The Good Guys Limited.

In general, mobile traders offer a “door to door” shopping service, providing a range of goods including clothing, electrical goods, televisions, DVD’s, computers, nappies, furniture and clothing, and allowing consumers to use credit to pay for these goods. The cost of the goods will in most cases be substantially higher than they would if purchased in standard retail stores or supermarkets.

Consumers generally pay for the goods via direct debit or automatic payments. In some cases, multiple debit authorities are retained by creditors operating mobile shops, and can be used as “back ups” if existing authorities are cancelled by debtor’s banks (for example as a response to continued default under these authorities). While debtors are generally not charged interest they can be charged a range of fees, particularly on default and title in the goods does not pass to the debtor until the debt is paid, thus the transactions are covered under the Act.

Disclosure is a particularly important tool for debtors using these services. Mobile shops tend to target more vulnerable consumers, who may not otherwise have the opportunity to purchase these goods without using credit or without the convenience of the “door to door” service provided by mobile shops. Disclosure ensures they can be fully informed about the comparative costs charged by the mobile services and retail traders. Disclosure can give debtors the information necessary to fully understand the trade offs they make and the explicit costs and benefits involved in the decisions they make as consumers for example the decision to purchase goods or not purchase goods, purchase them from one trader rather than another, or purchase using credit or cash.

Some debtors may consider the ability to obtain essential goods on credit worth the additional cost or for example the increased cost of the goods may still be less than the transport costs and purchase price combined if the debtor purchased the same items from a standard retail outlet.

Southland District Council

An interesting example demonstrating the scope of the Act is the enforcement action the Commission took against Southland District Council. The Council was warned that it had breached the disclosure provisions of the Act in relation to the information it provided ratepayers about one particular payment option to extend a sewerage scheme.

The Council had given ratepayers four different options for funding their contributions to the sewerage scheme. These options were the payment of a lump sum, four installment payments plus interest, eight installment payments plus interest over a longer term, or a loan option. The loan option was for a term

of fifteen years and it included interest charges. If a ratepayer didn't select a particular option, the loan option was the default choice applied to the particular charges. The contribution cost per ratepayer was in excess of \$9,000.

Ratepayers received a number of information mail outs from the Council leading up to the finalization of the scheme's extension. Information that wasn't provided in accordance with the section 17 requirements included the initial unpaid balance, the total of all advances to be made, the annual interest rate, method of charging interest and details of the payments required. The liability for the payments arose from 1 June 2005 onwards, and some of the elements above were not finalised and disclosed until approximately six months later.

One ratepayer concerned at whether the interest rate was clear and whether the Council had met the disclosure requirements of the Act initially raised the matter with the Commission.

Falcon Advances Limited

In a slightly different example, Falcon Advances also admitted breaching the Fair Trading Act in relation to prohibited consumer credit contracts. Falcon Advances had failed to disclose adequately. There are several key consequences for creditors of failing to disclose adequately. Creditors can be liable for statutory damages. As mentioned, creditors are also prohibited from enforcing the contracts until they have disclosed in accordance with the Act.

Falcon Advances commenced enforcement action against a number of debtors who had not received disclosure, and in doing so, breached the Fair Trading Act. Falcon Advances took collection action against 93 debtors who had not received adequate disclosure and repossessed 26 vehicles as a result of that collection action.

In an out of Court settlement with the Commission, Falcon Advances was required to refund all of the relevant default and collection fees to affected debtors, totaling around \$12,000.

Falcon Advances also agreed not to pursue affected debtors who still owed money after their cars were repossessed and sold. Normally debtors would have been required to pay the shortfall between the loan balance and the proceeds from sale of the security.

Falcon Advances was also required to formally inform all debtors who had not received disclosure that complied with section 17 of the Act, of its failure to do so and of their right to individually pursue statutory damages under the Act.

The Motor Centre

In a further example, a Blenheim based trader, Finn Resources Limited trading as The Motor Centre admitted breaching section 32 of the Act and the Fair Trading Act by misleading customers about the identity of the credit provider. Section 32 of the Act provides that disclosure must not be likely to mislead a reasonable person with regard to any particular that is material to the transaction.

The Motor Centre used another company's loan application forms and a number of debtors understood that the contract they had was with the other company, with the Motor Centre just acting an intermediary.

During the course of this investigation, Commission staff traveled to Blenheim and executed their first search warrant in relation to investigations under the Act.

This investigation was initiated as a result of a complaint from a debtor who had fallen behind in his payments. The debtor made his payments through The Motor Centre, but with the impression that his consumer credit contract was with a large well-known finance company and The Motor Centre was just collecting the payments. He was under this impression as his consumer credit contract bore the logo and name of the well-known finance company. However this loan documentation was used prior to the Act, and was not compliant with the Act.

Upon default, the debtor contacted the finance company to discuss a repayment plan and was disturbed to find out that he did not in fact have any credit arrangement with the finance company despite the fact that he appeared to have signed loan documentation bearing the finance company's name and was, prior to the default, making regular payments towards reducing the loan balance through the Motor Centre.

General Comment

A number of the alleged breaches of the Act investigated by the Commission and enforcement actions undertaken have arisen as a result of a single debtor's complaint although the conduct itself has typically affected a much greater number of debtors.

The message to creditors is clear – one “informed consumer” reporting a breach of the Act or taking their own action to enforce their rights is all it takes for creditors both to lose any initial advantages they may have obtained by not complying with the Act and also be subject to the sanctions of the Act. Quite often the matter complained about is not pursued but another alleged breach is identified.

DISCLOSURE – RESEARCH

The Ministry of Consumer Affairs has recently released a report as part of its monitoring and evaluation of the Act. This report “Pacific Consumers’ Behaviour and Experience in Credit Markets, with particular reference to the ‘fringe lending’ market”⁷ discusses the adequacy of the consumer protection mechanisms under the Act, including the current disclosure provisions. The research suggested “that the ways in which information is provided (small print, technical language, etc.), and by whom, can prevent the consumer arriving at the understanding needed to make an informed decision⁸”.

The findings of this research raise issues about the adequacy of the current disclosure regime as a means of protecting the specific consumers represented in the research. The Ministry released a response report in August 2007⁹ detailing the government response to that research and a number of initiatives to address the concerns raised in the report and has specifically noted “when the Ministry reports back on the operation of the CCCF Act in March 2008 it will be recommending changes to the disclosure provisions¹⁰”. The details of those changes are not yet publicly available.

The Ministry also identified the following key work priorities¹¹ in relation to the issues arising from the research:

- The continued enforcement of the Act where creditors are not complying with the law;
- Providing a means by which consumers can work their way out of debt;
- Developing an information and capability building programme to address consumer’s lack of access to information about their rights in a transaction or how to get redress;
- Addressing overly aggressive marketing practices;
- Completing the review of the Act; and
- Engaging at the government, community and business level to develop potential solutions to the problems outlined in the research.

The Ministry of Consumer Affairs also noted that one of the issues apparent from the research was non-compliance with the Credit (Repossession) Act. The Ministry has signaled that one option they are currently considering is whether matters currently covered by the Credit (Repossession) Act should be included in the Act. The Ministry notes that “under this scenario, the Commerce Commission would have a role to monitor and enforce compliance with credit repossession requirements alongside other CCCFA matters”.¹²

Case Studies – Interest

Primus Financial Services (trading as Ford Credit)

Primus Financial Services refunded \$49,000 to debtors who had been overcharged interest payments as a result of a warning from the Commission.

When debtors fully prepaid their loans, Primus charged customers for the entire month's interest in which the loan was repaid. Only debtors repaying their loans at the end of the month were charged accurately, the earlier in the month the loan was paid off the more the debtor was overcharged. The Act is quite clear; interest can only be charged until the date the full prepayment is made, it cannot continue to "run".

Geneva Finance Limited

The Commission's most recently publicised settlement is with Geneva Finance Limited. This investigation focused on Geneva's post repossession interest charges and is one of several examples illustrating Commission enforcement action taken against credit providers under the Fair Trading Act.

In the Geneva case, when debtors defaulted in meeting their loan repayment obligations, Geneva Finance repossessed and sold secured goods and applied the proceeds of the sale to repay the outstanding loan balances. However, as often occurs, the proceeds were insufficient to fully repay the outstanding loan balance.

Section 35 of the Credit (Repossession) Act 1987 imposes a limit on the creditor's right to recover from debtors in situations after possession of secured goods are taken by creditors. This section prohibits the creditor from recovering more than the difference left after deducting repossession sale proceeds from the outstanding loan balance.

Geneva continued to charge interest and fees on the unpaid outstanding loan balance after the sale of the repossessed goods secured under the consumer credit contracts.

It advised the affected debtors of their continuing (and increasing) obligations under the credit transaction in statements or reminder letters. These letters included written representations regarding the continuing interest and fees accruing on the outstanding loan balance and made demand for payment of those monies.

The Commission's view in this case was when section 35 of the Credit (Repossession) Act 1987 applied, representations by traders requesting payment of further interest and fees in addition to the amount allowable under the Credit (Repossession) Act are likely to be misleading representations and breach the Fair Trading Act. Geneva Finance agreed that this conduct had breached the Fair Trading Act.

Geneva Finance identified 946 transactions affected by these breaches and identified a further 62 affected debtors who had subsequently entered refinance agreements with Geneva Finance in order to pay off the prohibited ongoing interest and fees.

In response to the Commission's investigation, Geneva Finance reversed or refunded in excess of \$589,000. In 38 cases, where Geneva Finance recovered more than the allowable amount under the Credit (Repossessions) Act, it provided debtors with a refund of the overcharged fees and interest. It also reversed all of the interest and charges accrued under the 62 refinanced agreements.

The Commission has noted the increasing trend among creditors providing consumer lending to take security over all present and after acquired property instead of, or in addition to taking security over items that can be specifically identified at the time the loan transaction is undertaken. It is aware of an argument suggesting that this type of security effectively "holds off" the application of section 35 of the Credit (Repossessions) Act indefinitely, as the goods subject to the security will continue to become available until the entire loan shortfall and associated costs are recovered.

In the context of a current investigation, the Commission is considering what, if any, impact this form of security has on the continuing interest prohibition under section 35 of the Credit (Repossession) Act 1987. The Commission does not intend commenting further on this argument at this stage.

As noted previously, the Commission has indicated a willingness to take enforcement action or issue guidance to clarify provisions under the laws it enforces, and these issues may provide examples where clarification could be useful. The Commission has also contributed to the Ministry of Consumer Affairs' ongoing review of the Act, and will continue to raise these types of issues with the Ministry.

Galistair Enterprises Limited

The Commission's most recent prosecution is of Galistair Enterprises Limited, a West Auckland based pawnbroker trading as xtraCASH Finance ("Galistair").

Galistair pleaded guilty to charges under sections 17, 39, and 41 of the Act and one representative charge under the Fair Trading Act. Again, this case provides yet another example of how failure to disclose adequately can potentially result in breaches both under the Act and the Fair Trading Act.

Galistair calculated interest on the total amount of the initial loan, as opposed to charging interest on the decreasing unpaid balance under the loan, in doing so

the Commission considers that Galistair overcharged debtors an amount in excess of \$25,000.

The provisions in the Act regarding interest are quite clear, creditors can no longer:

- Charge flat-rate or “add on” interest where interest is calculated as a proportion of the loan principal outstanding at the commencement of the loan and is then added to the loan amount. This amount is then divided by the term of the loan to arrive at the regular installment amount. Using this method the actual interest rate is significantly higher than the “flat rate” disclosed, because less of the principal is actually outstanding over the term of the loan than is actually taken into account in the initial calculation. Flat rate interest will meet the definition of a credit fee under the Act and will therefore be subject to the rules regarding credit fees.
- Charge interest in advance. This effectively involves the creditor collecting the interest before it is earned. There are two exceptions provided in the Act to this prohibition.
- Apportion interest under the rule of 78 when dealing with fully prepaid credit contracts, using the rule of 78 means that more of the cost of credit is applied to the beginning of the contract than the end. This reduces the benefit to the debtor in paying the loan off early.

Instead, the Act requires creditors to specify an annual interest rate or rates and prescribes the methods that can be used for calculating interest on consumer credit transactions.

It is not acceptable for creditors to make these kinds of mistakes, they are in a position of trust and relatively small amounts of overcharging of interest can be difficult for debtors to detect. The Commission will consider whether consumers are likely to struggle to identify a breach (and therefore are unable to take their own action to remedy the breach) and also whether the offending conduct targets more vulnerable consumers when deciding what type of enforcement action is appropriate to take. The Commission expects creditors to ensure that their compliance systems will detect this type of error.

THE COMMISSION’S POSITION ON UNREASONABLE CREDIT FEES

The Commission has released some information to credit providers detailing how it is considering costs recovered in credit fees in a media release “*Compliance issues you should know about*”¹. As noted previously, one of the Commission’s current strategic priorities in relation to the Act is to establish precedents in relation to reasonableness of fees. The Commission has already taken a number of lower level enforcement actions, such as issuing compliance advice and warnings to creditors and entering into settlements in relation to fees but now intends establishing those precedents through taking litigation.

¹ Available on the Commission’s website www.comcom.govt.nz under Consumer Credit/Media releases

Anecdotally the Commission is aware that under the Act some creditors have increased fees charged, some have matched their competitors, and some appear to have just have selected a dollar value for their fees, without reference to their cost structures.

Credit fees must be based on cost. Creditors should consider the relevant provisions under the Act when setting or reviewing fees and assess whether the fees are likely to be allowable in light of the provisions of the Act, and the specific rules set for different types of fees.

While the Commission recognises that justifying fees under the Act can be a complex process, involving consideration of accounting, economic and commercial issues, it still expects this process to be undertaken adequately if creditors elect to charge fees (rather than recovering their costs through interest rates). The consumer detriment in unreasonable fees cases can be considerable, impacting adversely on the debtor's ability to repay the loan and their subsequent credit opportunities.

Further, as current experience is showing the quality of a finance company's loan book can in turn, ultimately impact on finance companies survival, the interests of its investors and the retention or distribution of investment monies within the credit industry.

Given the ability of the Court to order refunds or reductions of unreasonable fees, the potential impacts of breaching the Act in this area can be significant. While the competitive process presumes that those businesses responding to market signals will thrive and others will fail, the reality is failure can have significant personal impacts on employees, debtors, and investors alike. The Commission strongly encourages creditors to carefully consider how they would justify their fees before they are required to do so and to establish effective compliance systems for reviewing fees, in order to decrease their likelihood of breaching these provisions.

Double Dipping

Practices of "double dipping" have been identified as an area of concern for the Commission, where credit providers attempt to recover costs for one specific aspect of their operation across different fees and effectively recovered the costs several times over. For example, the Commission warned a creditor for charging 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.

Recovery of specific costs in fees – An example

The Commission has also signaled it is concerned about specific cost components being recovered, for example the recovery of provisions for bad or doubtful debts in establishment, default or administration fees have also been raised. The Commission has provided compliance advice to creditors who have included the recovery of bad and doubtful debts in their fees. 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.

Information requested by the Commission – Credit fees investigations

While there is some scope for interpreting the fees provisions under the Act, when considering whether a fee is reasonable and in applying the relevant provisions under the Act the Commission has required creditors to provide detailed costs analyses, showing the specific costs recovered under the fee. The Commission has been considering the type of costs recovered, proportion of cost allocated to each type of fee (and the related processes) and also the actual cost of each specific component.

Creditors may be asked to justify particular cost components as the Commission expects creditors to have undertaken a cost analysis exercise in relation to each class of credit fee charged. The Commission settlement with Pacific Loans also focused on a \$500 administration fee that was being charged upon full prepayment. Pacific Loans admitted that it could not justify the administration fee in accordance with the Act, and was unable to provide cost accounting information to the Commission when requested to justify this fee.

It should be noted that the Commission is asking creditors to justify their fees not just through providing cost accounting material, but by explaining how this cost accounting material falls within specific provisions under the Act and by being able to verify the cost accounting by reference to other documentation. During its investigations into fees, the Commission also asks creditors to be able to justify each individual cost component it recovers through fees, not merely the final amount recovered. When necessary, the Commission expects creditors to be able to verify cost accounting analysis by reference back to business records including financial statements, profit and loss statements and if required, by providing evidence such as invoices, contracts or other documentation in relation to particular cost components.

The Commission may request some or all of the following types of documents when considering the reasonableness of fees:

- Financial statements;
- Profit and loss statements or statements of financial performance;
- Asset registers;
- Depreciation schedules;
- Schedules of debtors affected by particular fees and copies of consumer credit contracts for affected debtors;
- Details of staff salaries, overheads and any other costs recovered under fees;
- Details of the specific tasks each staff member undertakes (if staff salaries are recovered) and the apportionment of staff salary to the processes relating to the credit fees;
- Justification for the relative apportionment of costs recovered through fees (for example time-costing studies or analyses) ;
- Explanations of fee structures, in particular tiered fee structures;
- Fee schedules outlining the cost of all fees charged by a particular creditor; and
- Information relating to the process for reviewing fees.

Other information may be requested on a case by case basis, depending on the nature of the fee investigated and the information or responses provided by creditors.

Case Studies – Unreasonable fees

Galistair Enterprises Limited

The Galistair case also provides examples relating to one of the Commission's current CCCF enforcement priorities, unreasonable credit fees. Galistair charged an establishment fee of between \$300-500 on each loan. During the course of the Commission's investigation, it became clear that Galistair had recovered the cost of processing unsuccessful applications and this cost had been incorporated into the establishment fees.

Section 42 of the Act places limits on the recovery of costs in the establishment fee to those "in connection with the application for credit, processing and considering that application, documenting the consumer credit contracts and advancing the credit". The costs are therefore limited in that they can only be those applying to the specific consumer credit contract in question (or the average reasonable costs in relation to the appropriate class of consumer credit contract section 42(b)) and they must also be costs falling within one of the four limbs – application for credit, processing/considering the application,

documenting the application and advancing the credit. The Commission's view is that any costs that do not fall within one of these four limbs should not be recovered through the charging of establishment fees.

The Motor Centre

The Motor Centre settlement, discussed earlier also provided some clarification around unreasonable fees. The Motor Centre charged between \$3-5 for checks of the Personal Properties Securities Register but chose not to do the checks. It did not refund the amount undertaken for the checks. The Act is quite clear, creditors cannot charge debtors for services they do not undertake, costs recovered must relate to actual costs incurred and/or reasonable estimates of loss – in this case, the Motor Centre did not experience any loss and did not expend any costs doing the searches.

Pacific Loans

The Commission has settled with Pacific Loans, a West Auckland creditor in relation to overcharging of third party fees. Pacific Loans charged a security repossession fee of \$300 and a daily storage fee of \$10. The repossession fee incorporated both the actual cost of repossession and Pacific Loans' own administrative costs. The fee that was charged was in excess of the third party costs, and breached section 45(1) of the Act.

THE COMMISSION'S POSITION ON FULL PREPAYMENT FEES

Current Prosecution – Avanti Finance

The Commission currently has a case before the Courts in relation to full prepayment fees. This case is set down for February 2008. The case relates to full prepayment charges.

Discussion – Full prepayment fees

The Act provides debtors with the statutory right to prepay their loans, paying the loan balance off before the end of the loan term. The Act contains specific rules to assess the amount that can be charged in these situations. It also provides a "safe harbour" formula credit providers can use. If this formula is used correctly, creditors are deemed to have produced a reasonable estimate of their loss, as required by the Act. Credit providers are not however, required to use the safe harbour formula and can use an appropriate procedure set out in the contract to calculate their loss.

The charging of unreasonable full prepayment fees can make impact negatively on debtors' ability to "switch" between credit products or creditors, increasing the costs associated with switching, making it less likely those debtors will switch and

at best distorting (at worst eliminating) the signals debtors can send to the market and individual creditors through the act of switching. In these sense, issues surrounding full prepayment are conceptually similar to those experienced by consumers facing prohibitive switching costs in energy or telecommunications markets. The ability to switch and “vote with their dollar” is a strong tool in driving competition.

The Commission has previously publicised its position in relation to arguments with regard to including a “time to re-lend funds” (or similar concepts) in full prepayment formula. The Commission has also taken enforcement action against creditors including the “time to re-lend” in these formulae.

The Commission’s position is that as a general principle, a creditor may not include an allowance for the time taken to re-lend funds. Any estimate of loss should be calculated on the basis that credit providers take reasonable steps to mitigate their loss and re-lend money prepaid as soon as possible. Creditors choosing not to do so (i.e. including a time to re-lend in their formulae) should be able to demonstrate that any delay in re-lending monies is unavoidable and be able to justify the extent of the delay.

Case Studies – Full prepayment

Falcon Advances

In a settlement with the Commerce Commission, Falcon Advances admitted it breached the Act by not calculating interest properly, and over-charging those who wished to repay their loans early.

Falcon Advances had used "the rule of 78" to calculate the interest owing by debtors upon the full prepayment. This method of calculation, which is no longer allowed under the Act, unfairly disadvantages debtors and results in a greater repayment figure. Falcon Advances refunded in excess of \$12,000 to 143 as a result of the Commission’s investigation.

Gilrose Finance

The Commission settled with Gilrose Finance in relation to inaccurate rebating of credit related insurance when debtors prepaid their loans. Gilrose Finance used computer software that it understood would correctly calculate the appropriate rebate. However, in the case of 2414 debtors it failed to do so. Gilrose Finance had overcharged some customers and undercharged others. Gilrose Finance refunded in excess of \$50,000 to affected debtors, once the matter was drawn to their attention as a result of the Commission’s investigation. Gilrose’s co-operative stance, prompt action to remedy these breaches, and action to ensure breaches weren’t ongoing were all significant factors the Commission took into account when deciding whether to prosecute or settle with Gilrose.

WIDER APPLICATION OF THE ACT

Pawnbroking

The Commission has made it clear to the pawnbroking industry; through communications with the industry body, the New Zealand Licensed Traders Association; that pawnbroking transactions are subject to the requirements of both the Act and the Secondhand Dealers and Pawnbrokers Act 2004. Some pawnbrokers initially chose only to comply with the latter Act and did not consider they could comply with both Acts. In doing so, they failed to disclose the specified key information required by the Act. It is clear that pawnbrokers must comply with the Act and are not exempt from complying with the same standards that must be met by the wider consumer credit industry.

Ancillary Service Providers

For those traders undertaking support functions for creditors, such as debt collection services, the Commission encourages the regular review of compliance systems to ensure such systems are able to promptly and effectively identify potential risk areas and contraventions of the Fair Trading Act. The objective in establishing and maintaining such compliance systems should be to mitigate harm resulting from any inadvertent contravention of the Fair Trading Act to both the trader and affected consumers.

There is a flow-on from a creditor's disclosure breaches to debt collectors in particular. It might be prudent for debt collectors to adopt a "best practice" model to ensure that the creditor has complied with the disclosure provisions of the CCCF Act. This may ensure debt collectors do not inadvertently breach the Fair Trading Act by collecting debts under prohibited contracts. The message to debt collectors is clear - establish compliance systems in order to take reasonable precautions and exercise due diligence and avoid contravening the Fair Trading Act.

It is important to note that "late" disclosure by a creditor will not mitigate an earlier breach of the Act; it will merely put a stop to ongoing breaches of the Act.

Insurance

The Commission has released guidelines detailing its position on section 45 of the Act. The guidelines particularly relate to commissions on credit related insurance. Section 45 of the Act relates to third party fees or charges passed on to a debtor by a credit provider. The Commission has made it clear that any commission on credit related insurance that is 20% or less than the gross premium paid by the debtor will be unlikely to meet the Commission's enforcement criteria. The Commission will however assess each case in accordance with its enforcement criteria.

Third party fees should be passed on at cost and should be reasonable as should extended warranties and repayment waivers. The Commission has noted that some credit providers may be moving towards using repayment waivers as a means of not needing to provide a rebate of the premium on full prepayment. It is the Commission's position that repayment waivers and extended warranties are likely to fall outside the provisions of section 45(5) –using the definition of credit related insurance - and therefore a reasonable commission cannot be recovered on their sale.

The Commission has also provided guidance to the Insurance Council regarding the potential impact and possible liability of the Act on its members. Specifically insurers were advised that liability for aiding, abetting, counseling or procuring any other person to breach section 45 of the Act was a matter that the Commission would assess on a case by case basis.

The Commission has come across creditors who provide insurance products but are not registered with the Life Insurance Act and Insurance Companies Deposits Act. These Acts require deposits to be lodged with the Public Trustee. These creditors have been reported to the Ministry of Economic Development.

IMPORTANT POINTS FOR CREDIT PROVIDERS TO CONSIDER DURING THE COURSE OF A COMMISSION INVESTIGATION

There are a number of important points for creditors and their advisors to be aware of when dealing with the Commission. The most important point being that the Commission's objective in its enforcement activities is to ensure individual creditor and industry compliance with the Act. When determining the appropriate enforcement action to address an alleged breach of the Act, the Commission will assess the conduct in question against its enforcement criteria.

Further information detailing about the Commission's enforcement criteria is available in both current credit guides and from the Commission website.

Powers

The Commission does have powers to issue statutory notices requesting the provision of information and also powers to obtain search warrants in relation to breaches under the Act. The Commission has increasingly used its notice powers within the credit industry and has to a more limited extent also used search warrant powers.

Unlike Fair Trading Act investigations, when a breach of the Act is being investigated the Commission also has the ability under the Commerce Act to issue a notice requiring an individual to appear before it at a specified time and place to give evidence and produce any document or class of documents under the notice. The section 98c provisions of the Commerce Act have not yet been

used during an investigation under the Act however it is expected they will be at some stage. To date, the level of co-operation from the credit industry has been high, with most credit providers voluntarily providing information and working with the Commission to resolve alleged breaches under the Act.

Enforcement approach

The Commission has a range of enforcement outcomes available to use to resolve an investigation. We have five enforcement responses that may be applied to an investigation. These outcomes include deciding to:

- **Take no further action.** This response is used in cases where there is no breach or possible or likely breach of the Act. This outcome may apply where the information received is incorrect, or cannot be verified, where the conduct does not fall within the Commission’s jurisdiction or where it is more appropriate for another agency to deal with the issue.
- **Issue a compliance advice letter.** This response occurs where the Commission considers there is a possible or likely but not serious breach of the Act. The aim of this option is to inform the creditor in question and deter further illegal behaviour.
- **Issue a warning letter.** This response occurs where the Commission considers there is a likely breach of the Act. The aim of this option is to inform, stop the behaviour in question and deter the creditor from repeat or new illegal behaviour.
- **Settle with the creditor.** This response occurs where the Commission considers there is a likely and serious breach of the Act which the creditor acknowledges. The aim of this option is to modify the conduct of the creditor, inform others and seek redress for affected parties. Settlements will always require an admission by the creditor and will also require the creditor to take steps to refund debtors and institute adequate compliance programmes. The Commission has entered into settlements with creditors resulting in refunds of over \$1.2 million being returned to debtors, creditors should note that apparently small amounts of overcharged fees, unreasonable credit related insurance or the like can if they affect a large class of debtors, result in substantial refunds being made. As part of the settlements the Commission has entered into to date with creditors, unclaimed funds have been donated by the creditors to community organisations, including community law centres.
- **Prosecute the creditor (and related parties).** This response occurs where the Commission considers there is a likely and serious breach of the Act. The aim of this response is similar to the aims of a settlement but also include penalising the creditor in question.

Creditors receiving compliance advice or warnings should understand that these tools are used by the Commission to put a creditor “on notice” of issues where the Commission considers the creditor is breaching the Act. Subsequent

monitoring is generally undertaken of creditors receiving this notice and assessments made of whether the issues have been rectified to the Commission's satisfaction or require additional investigation and higher level enforcement action. The aim of these lower level enforcement responses is primarily to educate and achieve voluntary compliance with the Act.

Provision of information to promote compliance

The Act specifically gives the Commission a function to "make available appropriate information for the guidance of consumers, creditors, lessors, transferees and other interested persons¹³". Accordingly, the Commission has produced two guides for the credit industry "*Credit Contracts and Consumer Finance Act A guide for the credit industry*" and "*Credit Contracts and Consumer Finance Act What you need to know*" and an article for the industry "*Compliance Issues you should know about*". The Commission guides are also currently being updated. Further information will be made available on the Commission's website once additional fees projects are finalised or advanced.

The Commission has also made information regarding its approach to section 45 of the Act (in relation to third party charges and commissions) available on its website. From time to time, the Commission will make further information available to creditors through its website.

The website also includes all of the Commission's media releases about enforcement action taken under the Act or Fair Trading Act. These media releases have an educative function, both for consumers and credit providers. Consumers and their advocates can also access the media releases, and obtain basic information about their rights under the Act and practices which may breach those rights. Credit providers can get a useful indication of the types of conduct targeted by the Commission and also a benchmark to assist in evaluating their own compliance with the Act. The Commission does focus on providing information primarily to creditors, although does recognise that consumers and consumer groups may also access resources it provides. Information specifically directed at consumers is also available on the Ministry of Consumer Affairs website¹⁴.

The Commission's guide for the credit industry also includes a discussion of the Commission's enforcement powers and the method it uses for assessing complaints at the beginning of an investigation and determining the appropriate enforcement outcomes at the conclusion of the investigation. This method is the Commission's enforcement criteria.

The Commission's guide for the credit industry also contains material discussing the features and functions of compliance programmes.

The Commission is an observer on an Australian Exploitative Credit Working Party, has been consulted in relation to various initiatives within the finance industry, including the National Strategy for Financial Literacy and has also contributed to the Ministry of Consumer Affairs' review of the Act.

Creditor conduct during the course of investigations

Although most breaches under the Act are based on strict liability, credit providers can still take practical steps during the course of Commission investigations to mitigate any harm both to their consumers and to their own businesses. The Commission actively encourages credit providers to quickly stop and correct illegal behaviour and take steps to compensate affected consumers where possible. This is taken into consideration when a decision as to enforcement action is made.

Compliance Programmes

Not only does the Commission actively encourage credit providers to establish compliance programmes in order to identify and remedy potential breaches under the Act as promptly as possible but the Act provides that the Court must consider whether a credit provider has an appropriate compliance programme when assessing the reasonable mistake defence under the Act. A compliance programme is also likely to be relevant when the Court has the opportunity to consider a creditor's application to reduce statutory damages.

Agents and brokers should be aware that in some cases, the Act may also apply to their conduct, and implement appropriate compliance programmes as well.

Complaints

A number of Commission investigations under the Act have resulted from receiving a single initial complaint about a particular trader's conduct. As many consumer credit contracts are standard form documents, creditors use standardised processes and most charge standardised fees during the term of the transaction, a complaint from one debtor can be sufficient to identify an entire class of debtors affected by an alleged breach of the Act.

An additional point to note is that irrespective of whether debtors correctly identify an alleged breach of the Act, as a matter of standard practice when assessing complaints the Commission will consider all of the documents and information a complainant provides. In some cases, a complaint about one issue has led to the identification of a number of other potential breaches under the Act.

The Commission suggests that creditors take debtor complaints alleging non-compliance with the Act seriously and check to assess whether other debtors are also affected by the same potentially non-compliant conduct. The Commission takes debtor and consumer advocate complaints seriously and they provide us with a useful source of information – both in terms of potential breaches, and in terms of assessing appropriate enforcement outcomes. The Commission expects non-compliant creditors to “put right their wrongs” as soon as they identify them, without waiting for the breach to be detected by the Commission, investigations to be initiated or enforcement action to be taken. Creditors who continue to breach the Act in circumstances where the Commission or debtors have previously put the creditor on notice of instances of non-compliance may find this impacts significantly on the choice of enforcement response the Commission will use.

Co-operation Policy

The Commerce Commission does have a co-operation policy designed to provide creditors with an incentive to report and promptly address breaches of the Act. This policy does, when appropriate, apply to investigations undertaken within the credit industry – both under the Act and under the Fair Trading Act. The co-operation policy may apply in circumstances where a credit provider has been involved in conduct that contravenes the Act or Fair Trading Act and voluntarily informs the Commission of this, the Commission may exercise its discretion to apply the co-operation policy.

It is important to note that this policy does not necessarily limit the Commission to taking particular types of lower level enforcement actions, such as warnings. Although in some cases it may result in a lower level enforcement action resulting, such as a settlement being agreed between the Commission and credit provider in circumstances where otherwise the matter may have proceeded to Court action. However, a lower level enforcement action may also include a submission made by the Commission to the Court for a reduction in penalty on behalf of a trader.

There are however some important conditions in relation to this co-operation policy. These conditions include the trader taking the following steps:

- Continuing to co-operate with the Commission’s investigation;
- Making reparation to affected parties by the trader if the Commission considers this appropriate;
- Ceasing the offending conduct immediately;
- Putting in place or being willing to put in place an effective compliance programme.

This policy is discretionary and the Commission is unlikely to exercise this discretion in circumstances where a trader “forced or encouraged others to take part in an activity which contravened any of the relevant Acts²”.

Further information about this policy is available on the Commerce Commission’s website.

CONCLUSION

The Commission has taken a number of different approaches to date to develop compliance with the Act. While it will continue to use a range of tools when appropriate, the Commission has clearly signaled to creditors that while it recognises its educative function, it is also willing and able to take higher level enforcement action to drive compliance with the Act.

In doing so, the Commission’s goal is threefold. Firstly, to ensure that individual creditors and the industry as a whole respond to the guidance provided by the Commission’s enforcement actions and by the Court decisions. Secondly, to ensure that the statutory rights of consumers are upheld. Finally, to ensure that competition within the credit industry is promoted and operates on the basis of a level playing field, ensuring that creditors who fail to comply with the Act are not unfairly advantaged at the expense of compliant creditors and consumer choice.

The Commission is pro-market, believing the market is the most efficient tool for allocating scarce resources. The Act and Fair Trading Act are both consumer protection laws but the Commission views their role as crucial in the wider competitive process that occurs within markets. Consumers drive competition through their choices, and can only ensure the market functions effectively if they receive the right information on which to base their choices.

Conduct that obscures or sends false information to consumers, whether it is about fees, interest rates, the price of a particular service or the competitiveness of one traders products and services in comparison to another traders services, reduces the effectiveness of the competitive process and harms traders.

Strong enforcement of the Act works in favour of compliant credit providers and has adverse consequences for non-compliant traders, overall it encourages conduct across the industry that fosters the competitive process and is ultimately beneficial to both consumers and credit providers operating within the statutory framework of the Act.

² Co-operation Policy www.comcom.govt.nz

¹ Section 111(1) of the Act

² Section 111(2)(a)-(d) of the Act

³ Section 111(3) of the Act

⁴ The Commission's website is www.comcom.govt.nz . Information of interest to creditors can be found under the Consumer Credit/Publications tab and also under the Consumer Credit/Media releases tab. Details of the Commission's co-operation policy can also be found on the website.

⁵ Commerce Commission Statement of Intent 2007-2010 p 33-34

⁶ Section 32(1) (c) of the Act

⁷ www.consumeraffairs.govt.nz/policylawresearch/pacific-consumers/report/index.html

⁸ Research Findings Report and Government's Response Strategy Part B: Summary of Findings and Government Response Strategy

⁹ www.consumeraffairs.govt.nz/policylawresearch/research/fringe-lenders/response-report/index.html

¹⁰ Research Findings Report and Government's Response Strategy Part B: Summary of Findings and Government Response Strategy 6. Ensuring the Effectiveness of the CCCFA, Disclosure.

¹¹ Research Findings Report and Government's Response Strategy Part B: Summary of Findings and Government Response Strategy

¹² Research Findings Report and Government's Response Strategy Part B: Summary of Findings and Government Response Strategy: Government response 1. Non-compliance with Current Legislation

¹³ Section 113(d) of the Act

¹⁴ www.consumeraffairs.govt.nz