

CREDIT CONTRACTS AND CONSUMER FINANCE ACT 2003

PROPOSED REGULATIONS

This discussion document outlines the content of regulations that are proposed to be made under the Credit Contracts and Consumer Finance Act 2003 (CCCF Act). The regulations relate to:

- The formula which creditors may use to calculate the charge payable by the debtor on full prepayment (early repayment).
- The formula that must be used by creditors in calculating a proportionate rebate of a consumer credit insurance contract (payable in the event of full prepayment where there is a consumer credit insurance contract financed under the credit contract).
- Allowable assumptions that may be relied on by creditors when making disclosure.

The document is divided into three sections as follows:

- (1) Safe harbour formula for calculating a creditor's loss resulting from a full prepayment
- (2) Rebate of consumer-credit insurance premium in the event of early repayment
- (3) Allowable assumptions.
- (4) Other regulations

Each section of the document explains the proposals. Regulations are also proposed for "model forms" that may be used by creditors when making disclosure under the Act. These regulations are still being developed and proposals will be ready for consultation at a later date in 2004.

*Submitters comments are welcome on all aspects of the proposed regulations by **Friday 6 February 2004**. The intention is to have the regulations drafted and in place as soon as possible following this consultation.*

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1. Safe harbour formula for calculating a creditor's loss resulting from a full prepayment

Introduction

The CCCF Act introduces new rules for the early repayment of a credit contract by debtors. It also introduces new terminology:

- “full prepayment” refers to payment of the entire unpaid balance before it becomes payable;
- “part prepayment” refers to payment of an amount less than the unpaid balance before it is payable.

The concepts of prepayment are applicable to instalment credit contracts, ie credit contracts where the amount to be advanced and the amount and timing of payments under the contract is known at the outset.

The term “prepayment” is not applicable to revolving credit contracts, which are credit contracts that anticipate multiple advances with the amount and timing of advances and payments not being known.

The Act's rules relating to full prepayment

The rules relating to prepayment in the Act are:

1. Debtors have the right to full prepayment under a contract at any time (s 50(1)).
2. The amount that a creditor may require a debtor to pay for full prepayment must not exceed the sum of the following:
 - The unpaid balance (being the amount outstanding of preceding advances, and fees or interest charges debited to the balance, less payments made by the debtor).
 - Interest charges and fees that have accrued up to the date of the repayment.
 - Fees to cover the administrative costs relating to the repayment (provided such fees are authorised by the contract).
 - A rebate of any consumer credit insurance product financed under the contract.

And, importantly for the purposes of this paper:

- A charge that does not exceed a reasonable estimate of the creditor's loss arising from the prepayment.

The Act does not define “loss” but the Courts are expected to draw an analogy with the doctrine of penalties relating to damages for breach of contract.

Thus, “loss” includes the gains the creditor would have made if the contract had run its course and there had not been full prepayment. Applying contract damages principles, the “loss” is mitigated as follows:

- As a damages award involves early payment of amounts due in the future, the award will be discounted to its present value.
- Secondly, the creditor must mitigate its loss by reinvesting the amount paid on full prepayment. This occurs when the creditor re-lends the money under a subsequent credit contract at its prevailing interest rate. The profit from this second contract is set off against the foregone gain of the first. If the prevailing interest rate is lower than the original rate, the creditor would have suffered a loss.

Section 54(1) provides that the loss is to be calculated according to an appropriate procedure specified in the credit contract. (“Appropriate” means effective at providing a reasonable estimate of the creditor’s loss, as required by s 54(2)). Alternatively, the creditor may use the procedure provided in regulations made under the Act.

Use of the procedure in regulations provides a safe harbour for the creditor. Provided the creditor has applied the formula correctly, the creditor is assured that the charge does not exceed a reasonable estimate of its loss and is free from any challenge.

The Ministry of Consumer Affairs recommends the formula laid out on the following pages. The formula is based on the positive difference between the present value of the remaining payments due on the loan and the present value of the payments that would be received if the amount paid early is re-lent for the remaining term at the creditor’s prevailing interest rate.

The interest rate to be used for determining the present values is the rate at which the creditor would make an advance for the outstanding amount to a customer of the same risk for a period equal to the remaining term of the original contract. This is to be based on the creditor’s prevailing rates.

Where the exact remaining term is not offered for new lending, the lender may use the interest rate for the closest available term (either shorter or longer).

The second present value above, that of the re-lent payments, is equal to the unpaid balance of the loan.

The formula in detail

The value of the loss can be calculated exactly using the actuarial formula given below.

$$\begin{aligned} \text{Loss} &= 0 && \text{if interest rates have not reduced} \\ &= VFP - \text{unpaid balance} && \text{if interest rates have reduced} \end{aligned}$$

where

VFP = Value of forgone payments, ie:

$$VFP = P \times \left(\frac{1 - v^n}{\frac{i}{f}} \right) \times (1 + i)^{\frac{d}{365}}$$

f = the payment frequency of the terminating contract

$$v = \frac{1}{1 + \frac{i}{f}}$$

i = the annual interest rate currently offered on a credit contract of the same type and risk as the original contract, but with a term equal to the remaining term of the original contract.

n = the number of payments remaining on the original contract

d = the number of full days since the last payment due date*

P = the payment per period for the discontinuing contract

Example

The effect of the formula can be seen in the following example.

Creditor makes an advance to Debtor with the following relevant terms:

Amount of advance: \$5000

Annual interest rate: 12%

Duration: 2 years (24 payments)

Payments: \$235.37 per month

Six months into the term, Debtor seeks to prepay the loan in full. The unpaid balance is \$3859.62.

The number of days since the last payment is 5.

The annual interest rate for an equivalent loan of 18 months duration is 10%.

* Under the Act, interest is only payable at following the end of a full day (s x).

The lenders loss can be calculated thus:

$$v = \frac{1}{1 + \frac{0.1}{12}} = 0.9917$$

$$VFP = \$235.37 \times \left(\frac{1 - (0.9917)^{18}}{\frac{0.1}{12}} \right) \times (1 + 0.1)^{\frac{5}{365}} = \$3,924.23$$

The loss to the creditor is \$3,924.23 (VFP) – \$3,859.62 (unpaid balance) = \$64.61.

Although the formula may appear complex when laid out as an actuarial equation, it is quite straightforward and can be easily programmed into a spreadsheet. An example can be found on the Ministry's website at www.consumeraffairs.govt.nz/policyandlaw/discussionpapers/dp-credit-contracts-regs/dp-credit-contracts-regs-formula.xls

Limitation of the formula

The use of the formula applies to loans that have the features given in the examples above, ie equal-sized payments and payment periods. The formula may be difficult to apply to loans with complex or unusual features. In such cases, the creditor will have to work out an appropriate formula.

Formula is voluntary

Remember that the use of the formula is optional. This means that creditors may frame the full prepayment charge differently from the way it is provided in the formula. The charge will be valid, so long as it can be shown not to exceed a reasonable estimate of the creditor's loss.

2. Rebate of consumer-credit insurance premium in the event of early repayment

Consumer-credit insurance is insurance that protects the debtor in the event of the debtor's death or disability, or the debtor contracting a sickness, becoming injured or unemployed. The insurance provides cover for the debtor's liability under a credit contract in these circumstances.

In the event of full prepayment of a credit contract, the creditor must refund to the debtor a proportionate rebate of any consumer credit insurance contract financed under the contract.¹ The consumer credit insurance ceases to have any value after full prepayment, and it is more efficient to require the creditor to pay the rebate to the consumer and then claim reimbursement from the insurer, than it would be for the consumer to claim the rebate from the insurer directly.

In calculating the proportionate rebate, the creditor must use the formula prescribed by regulations (if such regulations have been made).

The Ministry proposes the following formula for calculating the proportionate rebate. This formula is used in Australia in respect of almost identical rules.

$$Y = \frac{PS(S + 1)}{T(T + 1)}$$

where:

Y	=	is the amount of the rebate of the premium
P	=	the amount of the premium paid
S	=	is the number of whole months in the unexpired portion of the period for which insurance was agreed to be provided
T	=	is the number of whole months for which insurance was agreed to be provided.

In the following example, the debtor enters into a 36 month loan agreement and agrees to pay \$500 for a consumer credit insurance policy. The debtor prepays the loan after 18 months. The rebate is calculated thus:

$$\$128.38 = \frac{500 \times 18 \times (18 + 1)}{36(36 + 1)}$$

This formula is recognisable as the Rule of 78. Despite the fact that the Ministry has been critical of this formula when used to calculate rebates of interest on a credit contract, the Rule is considered to be appropriate for rebating insurance premiums. This is because the risk insured against (that the debtor will not be able to repay the credit) diminishes with time.

¹ Provided that the creditor has arranged the insurance.

3. Allowable assumptions

The Bill requires creditors to disclose certain information to debtors at specified times. The information required to be disclosed at the commencement of a credit contract is listed in Schedule 1.

Some of the information is required to be disclosed by creditors *if ascertainable*. Section 33 of the Act provides that information is treated as ascertainable if it is ascertainable on the basis of the prescribed assumptions.

The other function of assumptions is to provide certainty to creditors by clarifying when assumptions may be made. Otherwise, creditors may be left in doubt when information is uncertain.

At the time of its introduction the allowable assumptions were contained in a schedule to the Bill. It has been decided to move them to regulations. The reason for this is that the assumptions can be amended or new ones added in a much more flexible manner.

The allowable assumptions proposed are detailed below. They are identical to those formerly listed in the Third Schedule of the Consumer Credit Bill.

Interest charges

In disclosing the information referred to in paragraphs (k) and (l) of Schedule 1, the creditor may assume—

- (a) that, in the case of an annual interest rate, the rate disclosed will not vary over the term of the credit contract or any shorter period for which it applies; and
 - (b) in the case of a variable interest rate, that the variable interest rate applicable over the period for which it applies is the same as the equivalent variable interest rate as at the date that the disclosure statement is prepared;
- and
- (c) that the debtor will make payments required by the credit contract at the times required by the credit contract.

Payments

In disclosing the information referred to in paragraph (o) of Schedule 1, the creditor may assume that the debtor will make payments required by the credit contract at the times required by the credit contract.

Business day

Disclosure relating to payments, charges, or fees may be made on the assumption that every day is a business day.

Charges and fees

Disclosures relating to charges (other than interest charges) and fees may be made on the following assumptions:

- (a) that there will be no change in the charges and fees as disclosed and no new fees or charges imposed; and
- (b) that the charges and fees will be paid by the debtor at the times required by the credit contract.

Date of advance being made

If disclosure involves an advance being made under the credit contract on a certain date and that date is not ascertainable at the time the disclosure statement is prepared, disclosure may be made on the assumption that the advance is made on a date specified in the disclosure statement as being the date on which the advance is most likely to be made.

4. Other regulations

The regulations detailed above are important to the working of the Act and will be implemented, once finalised following consultation. As mentioned in the introduction, proposed model forms will be developed in the first part of 2004.

Section 138 also provides for regulations to be made in a large number of areas. At this stage no such regulations are intended. However, we are interested in whether stakeholders think any further regulations are necessary or desirable in the interests of certainty and compliance.

Regulations may relate to:

- Exempting any class of credit contract from the definition of consumer credit contract, and thus from the obligations in Part 2 of the Act (such as disclosure, restriction on fees etc).
- Prescribing additional information that must be disclosed by creditors during initial disclosure in relation to consumer credit contracts and consumer leases, or during variation disclosure to debtors or guarantors.
- Providing alternative publication measures for disclosure under s 23 or s 26 in relation to disclosing a change to the amount of an interest rate or a change to the amount of any fee or charge payable. This replaces a provision in the Bill which allowed disclosure of these matters by newspaper advertisement. We are interested in whether regulations to provide the same are appropriate.
- Prescribing a class of change to a credit contract for which disclosure is not required to debtors.
- Prescribing a formula for determining the maximum amount payable by a lessee following early termination of a lease.