

CONSUMER CREDIT LAW REVIEW

PART 2: APPLICATION: WHAT TRANSACTIONS SHOULD CONSUMER CREDIT LEGISLATION APPLY TO?

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EXECUTIVE SUMMARY

This is the second public consultation document to be released by the Ministry of Consumer Affairs as part of the Consumer Credit Law Review. It discusses the issue of the *application* of consumer credit law, or what transactions the legislation should apply to. In particular, it considers what *classes* of transaction should be regulated as consumer credit contracts.

The paper also raises the issue of whether some forms of transaction should be regulated separately. Specifically, it questions whether there is still the need for a separate Act to regulate hire purchase. Since the passing of the Credit Contracts Act 1981, the Consumer Guarantees Act 1993, the Credit (Repossession) Act 1997, and the Personal Property Securities Act 1999, the justification for the Hire Purchase Act 1971 is less obvious. Views are sought on whether it is necessary to retain the Act. There is also a brief discussion on long-term consumer leases and whether they should be treated as a distinct form of transaction.

The paper discusses the current test used to apply consumer credit protection. The focus is on the monetary ceiling of \$250,000 which is the primary means used to define a “controlled credit contract”. Disclosure provisions and the three day cooling-off period are mandatory only for controlled credit contracts. Because the monetary ceiling has become outdated through price inflation, leaving significant consumer credit contracts unprotected, the Ministry believes that it may no longer be the appropriate application test.

The document also discusses whether a monetary ceiling of \$250,000 might be having the effect of regulating – inappropriately – a large number of commercial credit contracts. Reasons why commercial credit is distinct from consumer credit include:

- functional differences – consumer credit underpins consumption while commercial credit is more concerned with production
- different characteristics of borrowers – consumers being more vulnerable
- different sources of credit – in particular, businesses rarely borrow from marginal lenders (“cash-loan” companies)
- a different relationship between borrowers and lenders – lenders normally take a more active interest in the affairs of their business borrowers
- better security is generally offered by business borrowers for credit.

The Ministry also argues that inappropriate regulation of commercial credit can lead to:

- legislation being less effective – because protections that are appropriate for consumers may not be appropriate for businesses
- increased compliance costs – through complying with disclosure and documentation requirements



- restrictions on flexibility and innovation – due to the need to meet regulatory requirements
- opportunistic use by borrowers – defaulting business borrowers can make “strategic” use of legislation in attempting to avoid their obligations.

Lastly, business borrowers would still have protection if not covered by consumer credit legislation. In particular, the Fair Trading Act 1986 offers protection, and remedies may be found in both the common law and the law of equity. It is also notable that the banking industry has in place well-regarded self-regulatory mechanisms.

The document finishes by outlining various alternatives to the current monetary ceiling in the Credit Contracts Act, examining their respective advantages and disadvantages. These are:

Raising the monetary ceiling – however, this would result in increased coverage of commercial credit contracts.

Lowering the monetary ceiling – this test is based on the premise that consumers most often borrow small amounts. An issue is whether home finance contracts should be excluded from a ceiling, as a ceiling that excluded most commercial credit contracts would also exclude most home finance.

A natural persons test – this test would regulate all credit contracts via natural persons (as opposed to legal persons). The test is arbitrary in its treatment of commercial borrowers. Additionally, without a monetary ceiling it would regulate many commercial credit contracts.

A test to include small business – it would be possible to define small business entities in legislation, in order to provide protection for them. However, matters of definition would be complex.

A contracting out provision – commercial borrowers could be permitted to contract out of credit legislation. Because lenders would likely seek to always contract out when lending to commercial borrowers, it would have little, if any, advantage over blanket exclusion of commercial credit.

The Ministry’s preferred option is for a **purpose test**, which would restrict regulation to credit provided to a “natural person” primarily for “personal, domestic or household” use. The test, and variations of it, are coming into more widespread use internationally. Australian evidence shows the test is workable for lenders and borrowers. Advantages include its flexibility and consistency with market practice. However, it may result in uncertainty in limited situations. On balance, it appears to offer a favourable approach.



CALL FOR SUBMISSIONS

The Ministry encourages written submissions from interested parties on the content of this document. The purpose of the submissions will be to inform the Ministry as it proceeds with the review of consumer credit law. Ultimately, the submissions will inform the government on any decisions it chooses to take with respect to the reform of consumer credit law.

Questions for submitters

- What should happen to the Hire Purchase Act? If you think it should be repealed, are there any provisions that should be re-enacted? In what legislation should they be re-enacted?
- Is there any reason to recognise long-term consumer leases as a specific form of consumer credit transaction? Are specific types of disclosure or other types of consumer protections needed for these types of leases?
- Are consumer and commercial borrowers sufficiently different to justify separate treatment in legislation?
- Should commercial borrowing be covered by consumer credit regulation? What are your reasons for and/or against?
- Should small businesses be provided with the same legislative protection as consumers?
- Is it appropriate for businesses to be covered by the reopening provisions but not the disclosure provisions?
- What general comments do you have on each of the options discussed in chapter four?
- Is a monetary ceiling still relevant? If so, at what level should it be set?
- Should all home finance contracts be covered in consumer credit law?
- Is the small business test appropriate? If so, what criteria should be used in defining a small business?
- Is the natural persons test adequate for the purposes of application?
- What general comments do you have on a purpose test for consumer credit legislation? What are the specific advantages and disadvantages?



Final date for submissions and contact details

Final date for receipt of submissions is Friday, 14 July, 2000.

Comments and submissions should be addressed to:

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OFFICIAL INFORMATION ACT 1982

In providing your submission, please advise us if you have any objections to the release of your submission. If this is the case, please advise us of the parts of your submission that you would wish withheld, and the grounds for withholding. In preparing and releasing any summary, and in considering any formal Official Information Act requests that might be received, the Ministry will carefully review any representations that you make in this regard.

PRIVACY ACT 1993

Any personal information that you supply to the Ministry in the course of making a submission will be used by the Ministry in conjunction with consideration of matters covered by this discussion paper only.

When preparing any summary of submissions for public circulation, it is the Ministry's normal practice to set out the names of parties making submissions. Your name will be included in any such summary unless you inform the Ministry that you do not wish your name to be included. In order to indicate your wishes, or to view personal information held about you in respect of the matters covered by this discussion paper, or to request correction of that information, please contact the Ministry of Consumer Affairs, ph (04) 474 2750.



1. INTRODUCTION

1.1 The review of consumer credit law

The Ministry of Consumer Affairs is reviewing consumer credit law to see whether it is appropriate for today's credit market. The Ministry's core purpose is to promote a fair and informed marketplace, so it has a strong interest in ensuring that consumer credit law meets the needs of both consumers and lenders.

Consumer credit can contribute to the welfare of consumers and the prosperity of business – but only if certain conditions are met. The current system of consumer credit law has a number of perceived inadequacies:

- unnecessary compliance costs for lenders and business borrowers
- unfairness for some consumers
- difficulties in enforcing the law
- overly complex provisions
- fragmentation across a number of Acts, resulting in unnecessary duplications and inconsistencies.

To deal with this range of issues, the review is concerned with:

- making credit legislation more relevant to consumer transactions
- simplifying this legislation
- strengthening compliance and enforcement
- identifying aspects of the legislation that cause detriment to consumers and lenders.

This discussion paper is the second in a series of five papers being released by the Ministry of Consumer Affairs. A paper dealing with transparency in consumer credit has been published at the same time as this one. Two further papers dealing with redress and enforcement, and other issues (such as insurance and electronic commerce) will be released on 30 June 2000. The first paper in the series, entitled *Setting the Scene* was released on 1 July 1999.

1.2 The purpose of this public consultation paper

This paper discusses the application of consumer credit legislation – that is, what transactions the legislation should apply to.

It does this principally by looking at what *classes* of transaction should be regulated. There are two fundamental classes:

- commercial transactions
- consumer transactions.

Whether both classes should be included in the same legislation is discussed in depth in section 3.3 – and outlined below, in section 1.3.



This paper also briefly comments on some *forms* of transactions – in particular, hire purchase and long-term consumer leases (see pages 9-11). The Ministry considers all forms of credit transactions between consumers and lenders¹ should be regulated – but it is possible that long-term consumer leases need to be treated separately from other credit sales. These leases are discussed at the end of section 2.

1.3 Main issues

The Credit Contracts Act 1981 regulates *all* credit transactions and in particular requires the disclosure of certain information in nearly all credit transactions involving amounts under \$250,000.

This has given rise to two major issues.

The first is that the ceiling of \$250,000 (set in 1981 when the Act was passed) is now too low to cover many consumer credit transactions. Increasing numbers of housing loans, for example, are now above the ceiling.

The second issue is whether it is appropriate to regulate commercial transactions. The Credit Contracts Act makes no distinction between consumer and commercial transactions. But there are significant differences between the two types of credit, and the Ministry believes they should be treated differently.

Failure to account for these differences in regulation may produce undesirable results. For instance, including commercial transactions in consumer credit legislation can lead – and in some cases has led – to:

- reduced consumer protection, because consumer protections may be inappropriate for businesses
- increased compliance costs for lenders
- reduced flexibility and innovation in commercial credit, because of the need to meet requirements designed for consumers
- exploitation and misuse of the legislation by business borrowers.

1.4 Options for reform

For these reasons, the Ministry considers it is time to re-examine the application of existing credit legislation. It has identified a number of alternatives to the status quo.

The Ministry's own preferred alternative is to limit the legislation to credit (of any amount) provided "primarily for personal, domestic, or household purposes". This is called a "purpose test". There would be no monetary ceiling. The Ministry's preferred option is discussed in section 5.

¹ Any other forms of credit not specifically discussed in this document – such as informal borrowing arrangements between private individuals, short term (less than two months) credit or unconditionally free credit – which are currently subject to "reopening" but not to disclosure requirements should continue to be treated as they are now.



Other alternatives identified by the Ministry are:

- changing the monetary ceiling
- limiting the legislation to borrowing by “natural persons”
- limiting the legislation to borrowing by consumers and small businesses (with “small business” being clearly defined)
- keeping the status quo, but allowing business borrowers to contract out.

These alternatives are discussed in section 4.

Issues for discussion

The Ministry welcomes your views on the ideas in this discussion paper.

There are some specific questions listed at the end of each section. The Ministry would like your responses to these – and also your views on other issues you see as being important in deciding what transactions should be protected by consumer credit law.



2. EXISTING LEGISLATION

The key Acts that regulate consumer credit are:

- the Credit Contracts Act 1981
- the Hire Purchase Act 1971
- the Credit (Repossession) Act 1997.

This section looks at these Acts. It also discusses the transactions covered by each of them, as the Acts are not uniform in how they distinguish between commercial and consumer transactions.

2.1 Credit Contracts Act 1981

The Credit Contracts Act is central to the consumer credit legal framework in New Zealand. Its two most important parts are:

- reopening provisions (in Part I)
- disclosure provisions (in Part II).

2.1.1 Reopening provisions

Reopening provisions give the Courts a wide power to examine (that is, “reopen”) any credit contract or any actions taken under that contract. The Courts have the power to grant certain remedies if a credit transaction, or any term or condition of a credit contract, or any action undertaken by a lender under a credit contract, is found to be oppressive.

These reopening provisions apply to all credit contracts, regardless of the amount involved or the status of the borrower or lender. A “credit contract” is defined broadly in section 3 of the Act, in order to give the protection of the reopening provisions to as many different classes of borrower as possible.

2.1.2 Disclosure provisions

Disclosure provisions make it compulsory for a lender to disclose certain information. The most important information is:

- the *total cost of credit*, which shows the total of all interest and non-interest charges (but excludes some fees)
- the *finance rate*, which shows the total cost of credit as an annual percentage rate. It takes into account the timing and amount of the advances and repayments for that particular loan.

The Act provides for penalties against lenders who fail to disclose the total cost of credit and the finance rate, or who fail to disclose it correctly. There is also a three day “cooling-off” period for borrowers after disclosure has been made. This allows them to cancel the credit contract within that period without penalty (and without having to give a reason).



These disclosure provisions are intended to provide consumer protection and to enhance competition. In particular, they provide a means of comparison between the price of credit offered by different lenders.

The disclosure provisions apply only to controlled credit contracts. These are defined in section 15 of the Act (see Appendix One), and twelve exceptions to them are also listed there. One of the main exceptions is where “the total amount of credit ... is or will be not less than \$250,000” [s.15(1)(f)]. This is known as the “monetary ceiling”.

2.1.3 The background to the Credit Contracts Act’s monetary ceiling

The original recommendations of the Contracts and Commercial Law Reform Committee² were for disclosure provisions that covered virtually all credit contracts. The Committee’s conception of the Credit Contracts Act was that this would be a basic contract statute (like the Contractual Remedies Act 1979, for example). Its recommendations reflected a primary desire for the Act’s principles to have a widespread and general application, with as few exceptions as possible.

When the Act was passed, however, it included a monetary ceiling that limited disclosure to credit transactions below a certain amount. The monetary ceiling was the “bright line” that made it clear to lenders and borrowers when a transaction was subject to disclosure and when it was not.

In this, the Act followed overseas legislation of the time – all of which employed monetary ceilings.

The approach in overseas Acts, however, was to set the ceiling low enough to cover small-scale transactions, such as personal loans and hire purchase – and this usually meant that home finance contracts were excluded. In the United States, the Truth in Lending Act has an exception to the ceiling to cover home finance, but in other jurisdictions home finance was largely outside the legislation. In New Zealand it was considered that home finance *should* be covered, and the monetary ceiling was set at a level that would largely achieve this.

2.2 Hire Purchase Act 1971

Hire purchase is a particular type of credit transaction, in which the sale of a good is financed by the seller or an associated financier. Title does not pass to the consumer until the good has been fully paid for.

The Act covers both business³ and consumer transactions, but its consumer coverage has been significantly eroded in the following ways:

- The Hire Purchase Act is subject to the Credit Contracts Act.

² Contracts and Commercial Law Reform Committee (February 1977) *Credit Contracts* Wellington.

³ Parties may contract out of the provisions governing early repayment and statutory rebates if the cash price of the purchased goods exceeds \$15,000.



- Its provisions for product warranties no longer apply to consumer purchases. They have been superseded by the Consumer Guarantees Act 1993. However, they still apply to business purchases (although the parties may contract out of the Act's requirements for quality, if the cash price of the goods is over \$15,000).
- Its disclosure requirements largely overlap with those in the Credit Contracts Act. There is also overlap with disclosure requirements in the Personal Property Securities Act 1999 (which require a description, in writing, of the goods concerned and certain information about the parties).
- Under the Hire Purchase Act, a financier is liable for any failure by the seller of the goods to comply with the implied warranty in the Act. This provision is replicated in the Consumer Guarantees Act.
- The provisions relating to repossession were amended and re-enacted in the Credit (Repossession) Act.
- The registration of personal goods and property as security for the hire purchase will be controlled by the Personal Property Securities Act as a "purchase money security interest".

This "erosion" raises the question of whether the Hire Purchase Act could be repealed. Very little remains in the Act that is of compelling importance. It does still contain some specific consumer protection measures relating to early repayment rights, statutory rebates, voluntary return of goods, and assignment of the hire purchase contract. These would need to be re-enacted in consumer credit legislation or other legislation. Any other relevant provisions, such as insurance, could also be re-enacted.

2.3 Credit (Repossession) Act 1997

The Credit Repossession Act applies where a lender has a right to take possession of goods under a credit agreement. It gives consumer protection in the event of repossession, and sets out a process that a lender must follow before and after repossessing.

Once the Personal Property Securities Act is passed, the Act will apply only when the goods are to be used primarily for personal, domestic, or household purposes at the time the security is given. So it will not apply to goods obtained for commercial or business purposes. These will be regulated by Part 9 of the Personal Property Securities Act.



2.4 Long-term consumer (finance) leases

A long-term consumer lease comes within the definition of credit contracts in the Credit Contracts Act, where it is effectively treated as a hire purchase. This is not necessarily appropriate for a lease, given its distinctive features.

A consumer lease is a particular type of hire contract – one in which goods are owned by one person and are “hired” to another person, who pays money for the use of the goods over a specified period. They are distinct from a hire purchase because the consumer (the lessee) has no option or obligation to purchase the good.

Long-term consumer leases are usually what is known as a *finance lease*. In this sort of lease, the lessor (the owner) expects to recover the purchase price of the leased good together with a margin for profit. Usually, the lessor is prepared to sell the good to the lessee at the end of the term. But the lease may instead be renewed, with a “new” good replacing the original leased good.

Finance leases are different from operating leases. Operating leases – also called hire agreements – are where rent is paid weekly or on some other periodic basis. The goods are usually returned at the end of the period but they can be returned earlier, if the consumer chooses.

Finance leases are relatively common in the consumer new car and computer market. These goods depreciate quickly and may be replaced regularly, which makes them suitable for lease transactions. However, largely for tax reasons, leases are usually a business transaction.

Consumer credit legislation elsewhere (including Australia) treat finance leases separately from other credit transactions. In New Zealand they are treated as a hire purchase contract for disclosure purposes, but are not covered by the Credit (Repossession) Act if they are for a term longer than one year.

It may be worthwhile to consider whether New Zealand legislation should have separate disclosure requirements, and other appropriate consumer protections (such as protection in cases of repossession) for these leases.

Issues for discussion

What should happen to the Hire Purchase Act? If you think it should be repealed, are there any provisions that should be re-enacted? In what legislation should they be re-enacted?

Is there any reason to recognise long-term consumer leases as a specific form of consumer credit transaction? Are specific types of disclosure or other types of consumer protections needed for these types of leases?



3. CRITICISMS OF THE STATUS QUO

This section describes the major problems that have become apparent with the application of the Credit Contracts Act.

3.1 The monetary ceiling

3.1.1 The ceiling has become outdated

A major problem with monetary ceilings is that they become outdated when prices change – and so they fail to capture their intended range of transactions.

The ceiling of \$250,000 specified in the Credit Contracts Act has not been adjusted since the Act was passed in 1981. In December 1982 (the Act became law in June 1982) the average house price in Auckland City⁴ was \$68,358. By December 1999 this had increased to \$316,561. Other localities where the average house sale price currently exceeds \$250,000 include Wellington City (\$266,687) and North Shore City (\$302,359).

This indicates that increasing numbers of home finance loans, which the Act was intended to cover, are falling outside of it. If the monetary ceiling had been adjusted to take account of movements in the consumer price index, it would now be about \$700,000.⁵

In practice, where a loan is above the monetary ceiling, home finance lenders will often disclose the information required by the Act.⁶ However, if disclosure is made incorrectly, a borrower cannot make use of the Act's penalties against the lender; nor can they prevent the lender from enforcing the contract. These remedies are only available when disclosure is *required* to be made. Furthermore, a borrower who takes out a loan of \$250,000 or more is not entitled to the three day cooling-off period.

Borrowers with loans of \$250,000 or more can still use the Act's reopening provisions: the ceiling affects only their rights to disclosure.

3.1.2 The ceiling is not suited to modern credit products

There are potential problems with “new generation” credit products (such as flexible mortgages) that often attach revolving credit accounts to mortgage accounts to make a single product.⁷ Such innovations did not exist in 1981 when the monetary ceiling under the Credit Contracts Act was set.

⁴ Defined by territorial authority; Source: Quotable New Zealand Ltd.

⁵ \$250,000 is nevertheless high in comparison with monetary ceilings used in overseas jurisdictions (after adjusting for exchange rates and purchasing power parities).

⁶ This commitment is made in the Banking Code of Practice para 3.10.

⁷ These products generally have the features of either overdraft or redraw facilities.



Attaching a revolving credit account to a mortgage can have the effect of pushing the total amount of credit above the \$250,000 ceiling, and excluding the entire contract from the Act's disclosure provisions. For example, a consumer purchases a family home and \$265,000 is outstanding on the mortgage account, including a \$25,000 revolving credit account and \$240,000 as a fixed sum for the house. Both accounts are part of the same contract and secured against the real estate. The revolving credit component can be used to purchase other goods and services from time to time and be repaid as circumstances dictate.

In this case, "the total amount of credit outstanding under that contract and under all other contracts is ... not less than \$250,000".⁸ So no part of the arrangement is covered by the Act's disclosure provisions. There is no requirement to disclose, no cooling-off period, and no penalties for incorrect disclosure by the lender.

When the Act was passed, revolving credit accounts were an entirely separate credit product. Now, as in the scenario above, purchases on a revolving credit account can be secured against the borrower's home – which should make a more compelling case for disclosure, rather than removing it entirely.

The absence of a monetary ceiling, or the exclusion of home finance contracts from the monetary ceiling, would avoid the problems raised in this scenario.

3.2 Inappropriate regulation of commercial transactions

3.2.1 *Consumer credit is functionally different from commercial credit*

Consumer credit is credit provided to an individual who uses it predominantly for personal, domestic, or household purposes. Examples include a television bought on hire purchase, a loan to purchase a residential home, and a secured or unsecured loan used for a holiday. Consumer credit helps to finance the satisfaction of immediate personal desires and needs out of future income. Essentially, consumer credit is concerned with consumption.

Commercial credit has a different function. It can be broadly divided into:

- merchandise credit, which is used to obtain goods, raw materials, and inventory for processing or resale
- financial capital, which is borrowed money that is needed to start, maintain and operate a business.

Commercial credit, therefore, concerns production and underpins business activity.

⁸ This is the wording used for the monetary ceiling [Credit Contracts Act s.15(1)(f)].



3.2.2 *Consumer borrowers are intrinsically different from business borrowers*

One of the main reasons for regulating consumer credit is to “even up” the imbalance of powers between *consumer borrowers* and lenders. Consumers may be inhibited by lack of information. There is typically an imbalance of knowledge between the lender and borrower. Many consumers lack the ability to obtain and process information about credit deals. One survey found that 500,000 New Zealand adults have minimal or nil reading capability and a further 750,000 cannot comprehend an everyday document.⁹ Consumers are not easily able to comprehend the detailed and complex terms and conditions of a credit contract, in comparison with lenders.

Consumers are often in a position of weak bargaining power vis-à-vis a lending institution. The consumer credit market is generally based on standard form contracts, which further lessen the scope for negotiation between borrower and lender. Also, because of their risk profile, some consumers are limited in their choice of potential lenders.

In contrast, *large and medium-sized business borrowers* are usually considered not to need consumer protection. For instance, as a business grows, it will inevitably engage accounting or financial expertise to manage its credit dealings. Furthermore, such businesses are often of similar bargaining power to financial institutions (or at least in a better position than consumers), thus negating the need for regulation. When financial institutions lend to businesses, there is less emphasis on standard form contracts and more negotiation of prices and terms.

However, *small business borrowers* may appear to be in a similar position to consumer borrowers for the following reasons:

- they face informational barriers to making the best possible decision
- some sole owners and partnerships are not protected from creditors by limited liability
- it is sometimes difficult to separate the decisions taken by small business operators from their personal affairs – for example, an individual may mortgage their personal property or personally guarantee a business loan
- small business operators may be vulnerable if faced with oppressive actions by lenders with greater economic power.

So there are arguments for and against including small business borrowing under consumer credit legislation – and, in drawing up the Credit Contracts Act, the Contracts and Commercial Law Reform Committee decided they should be regulated. Two decades later, however, there appears to be a strengthening view that the legislation should focus on protecting consumer borrowers, rather than all

⁹ Ministry of Education (undated – survey conducted March 1996) *Adult Literacy in New Zealand: Results from the International Adult Literacy Survey*.



borrowers. Protection is now commonly deemed inappropriate for businesses. What is seen as being more appropriate is:

- the development of commercial acumen, including sound judgement
- a good working relationship between lender and business
- appropriate professional advice – it is widely accepted that good business practice includes seeking advice when it is appropriate and, for example, the Bankers’ Association Statement of Principles¹⁰ emphasises the importance of professional advisers in the relationship between banks and small to medium-sized businesses.

3.2.3 Consumers and businesses have different sources of credit

While many lenders, especially large financial institutions, lend to both businesses and consumers, the credit products offered are largely based on whether the credit is offered for business or consumer purposes. In other words, consumers and businesses do not approach the same division of an institution – and often do not approach the same institution – to access credit.¹¹

Most importantly, businesses do not normally borrow from “marginal lenders” (the “lender of last resort” market), which is a major area of concern for consumer borrowers. (In fact, much consumer credit regulation is aimed at providing consumer protection for problems in the marginal lender market segment – in particular, the practices of some cash loan and hire purchase financiers.)

By contrast, businesses tend to borrow from banks and mainstream finance companies.¹² The important differences between these and marginal lenders are:

- greater competition
- more importance given to reputation and maintaining a good corporate image
- effective self-regulation (notably among the members of the Bankers’ Association).

The existence of these factors reduces the need for protection of business borrowers.

3.2.4 Business borrowers have a different relationship with their lender

One feature of the relationship between a business borrower and their lender is that the lender has a strong incentive to monitor the borrower’s business. In fact, the regular provision of financial information by the borrower is commonly a condition of commercial loan contracts. This allows the borrower to “signal” its ability and intention to repay the loan.

¹⁰New Zealand Bankers’ Association (June 1999) *Banks & Small, Medium Size, and Farming Businesses Working Together: A Statement of Principles*.

¹¹There are exceptions to this - for instance, hire purchase retailers tend not to draw a distinction between business and consumer borrowers. However, businesses are only a very small minority of hire purchasers.

¹² See for example the list contained in the Ministry of Commerce publication *Sources of Capital Available to Small and Medium Enterprises* 2000, January 2000.



“Bonding” refers to the investment made by each party towards building an ongoing business relationship and the establishment of “reputation”. These signalling and bonding processes effectively regulate the commercial relationship between borrower and lender. Consumer transactions do not give rise to these same processes¹³ – in particular, reputational checks and balances are more difficult to establish and implement.

3.2.5 Businesses can offer more attractive security for their loans

In consumer lending situations, with the exception of loans secured by real property, assets taken as security will not necessarily cover the debt if the borrower defaults.

By contrast, assets purchased for a commercial purpose usually have a much higher value on realisation, for example, livestock, machinery, and equipment. There are also a wide range of security arrangements that business borrowers can enter into, either to obtain more favourable terms or as risk management strategies to control the consequences of default. Examples are security in goods acquired after the contract has been entered into, and proceeds from the sale of goods that are secured. These arrangements are not possible for consumers (nor are they always possible for all businesses).

3.3 Implications of regulating commercial transactions

3.3.1 Legislation being ineffective

Clearly, many business borrowers are well-informed and experienced in matters of credit and are therefore unlikely to need measures designed primarily for the protection of more vulnerable consumers. Furthermore, consumer protection provisions will tend to limit business borrowers’ freedom of contract, and to restrict their flexibility in business dealings.

Conversely, credit legislation that meets the needs of business borrowers – for example, through having minimal disclosure requirements – may have adverse effects on consumers, by reducing their basic protections.

3.3.2 Increased compliance costs

When loans have complex terms and conditions, lenders will face additional compliance costs in providing disclosure information. These costs will invariably be passed on to borrowers – but if the borrower does not value or need the disclosed information, then these compliance costs are an unnecessary and inefficient imposition. This is likely to be the case when commercial credit is regulated to the same standards as consumer credit.

¹³On the role of bonding and signalling and the contrasts between consumer and commercial transactions see especially R Scott “Rethinking the Regulation of Coercive Creditor Remedies” (1989) 89 *Columbia Law Review* 730-788, at 744-45.



3.3.3 Restrictions on credit flexibility and innovation

Flexibility of terms and conditions – which can benefit both borrower and lender – are hampered by provisions designed to protect consumers.

This is particularly the case where a loan has special features – for example, a fixed-term loan in which a lender trades-off a below market rate of interest in return for a share of potential profits. The requirement to disclose an annual finance rate on such a loan may complicate and therefore discourage such innovations.

Finance leases provide another example. These are predominantly a business transaction, and are regulated as a credit contract under the Credit Contracts Act on the basis that they are “deferred payment dispositions” equivalent to hire purchase. However, leases often have features that make them different from standard hire purchase (such as balloon payments and “agreed residual values”). They fit awkwardly under the Credit Contracts Act, particularly when it comes to calculating the annual finance rate and total cost of credit. They may, as a result, be less used as a financing option for businesses than they would otherwise be.

A final example where the Credit Contracts Act restricts flexibility in commercial transactions is the three day cooling-off period in which a borrower can cancel a loan. This increases uncertainty for lenders. Cancellation can involve considerable transaction costs for them – for example, if they have registered debentures as a security for a loan (and it can be important to register such securities quickly), then they must deregister them if the loan is subsequently cancelled. So one result of allowing business borrowers a cooling-off period can be that lenders delay the provision of finance, to minimise their costs if the loan is cancelled. This in turn inconveniences the borrower, because they get their financing later than they otherwise would have.

3.3.4 Opportunistic use of the Act by defaulting borrowers

Defaulting borrowers can use the provisions of the Act to avoid contractual obligations, at great expense to the lender and other third parties.

Many reported judgements on the Credit Contracts Act involve non-consumer transactions. Borrowers often are experienced traders who received professional advice before entering into the transaction. Not uncommonly, they later invoke the reopening or the disclosure provisions of the Credit Contracts Act to avoid performance of obligations which were apparent to them at the time of agreement.¹⁴

¹⁴For instance, see R. Burt “The Credit Contracts Act and the Reluctant Judge” (1990) *New Zealand Law Journal*, 240-242 and the cases cited therein, which are concerned with strategic use of disclosure provisions.



3.4 Adequate protection may already exist for commercial transactions

If commercial credit transactions were to be excluded from credit regulation, it is necessary to consider whether other laws would be adequate.

The *Fair Trading Act 1986* prohibits misleading conduct in trade generally. It covers the presentation of the terms of a credit contract, and any statements or representations made by the lender. The Act provides a strong incentive for lenders not to disguise fees or charges, or to make misleading interest rate quotations. Beyond its broad protection against misleading conduct, the Act is non-prescriptive and therefore allows considerable contractual flexibility. However, a borrower taking action under the Act cannot invoke specific penalties; they can only seek more general damages or criminal penalties.

Business borrowers alleging unfair or unconscionable conduct would, in the absence of provisions under the Credit Contracts Act, have to rely on the *common law* doctrine of duress, and on the doctrines of undue influence and unconscionable bargain in the *law of equity*.¹⁵ However, these doctrines may not give the Court the same discretion to intervene in contracts that the Credit Contracts Act does – and so there may be some argument for including business borrowing in the reopening provisions of consumer credit legislation.

There are some additional protections for businesses that borrow from banks, through the *banking industry's self-regulation*. The Code of Banking Practice and the Bankers' Association Statement of Principles for working with small and medium-sized businesses has procedures to resolve disputes. Businesses can obtain redress from the Office of the Banking Ombudsman, which can hear complaints about the conduct of banks that belong to the Banking Ombudsman scheme. The Banking Ombudsman's jurisdiction limit is \$100,000.

3.5 Conclusion

The Ministry believes that the differences between consumer credit and business credit are sufficient to consider separating consumer credit law from credit law generally. This will mean that it is easier to introduce specific consumer protections where these are required. Compliance costs to business lenders – and also ultimately to business borrowers – are likely to be reduced if lenders do not have to observe inappropriate disclosure provisions.

Businesses have other forms of protection through the Fair Trading Act, the law of contract and other common law, signalling and bonding processes, and the self-regulation of the banking industry. Removing

¹⁵See J. Burrows, J. Finn and S. Todd, (1997) *Law of Contract* Wellington: Butterworths.



businesses from credit legislation and making that legislation consumer specific will allow it to respond more effectively to modern consumer credit products. It will ensure that the most vulnerable groups of consumers can be protected without imposing unnecessary costs on the whole credit system.

Issues for discussion

Are consumer and commercial borrowers sufficiently different to justify separate treatment in legislation?

Should commercial borrowing be covered by consumer credit regulation? What are your reasons for and/or against?

Should small businesses be provided with the same legislative protection as consumers?

Is it appropriate for businesses to be covered by the reopening provisions but not the disclosure provisions?



4. ALTERNATIVES TO THE STATUS QUO

This section considers a range of alternatives to the status quo under the Credit Contracts Act. It briefly describes each alternative, along with its advantages and disadvantages. The Ministry of Consumer Affairs' preferred option – a “purpose test” – is discussed in section 5. A chart summarising all the alternatives can be found at the end of this section.

The alternatives are not mutually exclusive – for example, a monetary ceiling can be combined with other tests. The monetary ceilings currently used in consumer credit legislation in the United Kingdom and the United States are combined with a “natural persons test” and a purpose test respectively.

4.1 A revised monetary ceiling

A monetary ceiling has the advantage of clarity for all parties to a credit contract. It would eliminate most disputes¹⁶ about whether a transaction was protected.

If the current shape of the legislation was retained, this would mean that all transactions below the ceiling would be subject to disclosure. But all transactions of any amount would be subject to reopening.

There are two alternatives within a revised monetary ceiling:

- to raise the ceiling to a higher level
- to lower it.

4.1.1 Revise monetary ceiling to a higher level

The monetary ceiling could be raised so that it would cover the range of transactions initially contemplated by Parliament when the current limit was set. This would mean a ceiling of about \$700,000.

The advantage of raising the ceiling is that the vast majority of consumer credit transactions would be subject to disclosure requirements, including most mortgage contracts and flexible mortgage products.

The disadvantage is that this would capture a large number of commercial transactions for which disclosure is not currently required.

While raising the monetary limit might be justifiable in terms of increased protection for consumer contracts, it would be much less plausible in the case of commercial credit.

¹⁶However, at least in one judgement the monetary ceiling has been in issue: *Buckland v Landbase Securities (in liq)* 11/4/91, Anderson J, HC Auckland CP 2604/89.



4.1.2 Revise monetary ceiling to a lower level

When the Ministry of Consumer Affairs undertook the 1988 review of consumer credit, it suggested a monetary ceiling of \$50,000 for consumer credit contracts.

This limit would have covered borrowing from marginal lenders, excluded many commercial transactions, and been simple to apply. It would also have been consistent with consumer credit legislation in the United States, the United Kingdom, and Australia.

If the monetary ceiling is lowered, then it raises the question of what to do about home finance.

Home finance could be exempted from the ceiling. This is what the Ministry of Consumer Affairs recommended in 1988, on the basis that home finance is often the most significant financial transaction that consumers engage in, justifying additional (disclosure) protections. United States consumer credit legislation also exempts home finance from its monetary ceiling.

The alternative is to leave most home finance contracts (that is, for amounts above the ceiling) unprotected by disclosure provisions.¹⁷

The main argument here is that consumers who borrow to purchase real estate almost invariably use a solicitor to do so – and so the solicitor can advise them on the credit aspects of the transaction. However, much conveyancing work is of a paralegal nature – that is, it is provided by persons who are not qualified solicitors and who do not advise on financial aspects of the arrangement. As well, solicitors who are experienced in conveyancing do not necessarily have expertise in finance.

A secondary argument in favour of leaving home finance unprotected – that consumers who borrow high amounts are likely to be more financially sophisticated – is weak in this particular context. With a ceiling as low as \$50,000, home finance of relatively modest amounts borrowed by financially unsophisticated consumers would be unprotected. Also, even sophisticated consumers stand to benefit from the standardisation of certain terms (such as the calculation of interest) that disclosure would require.

4.1.3 Difficulties in revising the monetary ceiling

A major disadvantage with having a monetary ceiling – regardless of whether it is set high or low – is the difficulty in ensuring the ceiling is kept up-to-date. As mentioned earlier, the current ceiling has not been updated since 1981.

¹⁷In England and most of Europe, mortgage and home finance credit is largely unregulated.



Any new consumer credit legislation that used a monetary ceiling would have to include a mechanism for regularly reviewing the ceiling. For example, there could be some method of annual indexation, or the administering government department could be required to adjust the monetary limit, at regular intervals, through regulations.

4.2 A “natural persons” test

A “natural person” is an individual. It includes people in business partnerships, but does not include “legal persons” (such as companies and incorporated societies).

A natural persons test¹⁸ would treat all lending to natural persons as consumer credit. It would, therefore, exclude many commercial loans – those taken out by companies and other incorporated bodies. At the same time, sole traders and other unincorporated businesses (who are often regarded as vulnerable) would be protected.

However, the dividing line between incorporated and unincorporated businesses, while straightforward in legal terms, makes little sense in economic terms and may result in anomalies. Many incorporated small businesses operate in similar environments and face similar problems to those of unincorporated businesses of the same size. As well, some unincorporated bodies are businesses of considerable size and stature – for example, law firms and accounting firms are organised as partnerships or sole traders. Such businesses do not need consumer protection.

A natural persons test would need to be combined with a monetary ceiling, to exclude very large commercial loans that were being undertaken by unincorporated businesses.

4.3 A test to include small businesses

In effect, this is already used under the Credit Contracts Act – business borrowers with a paid-up capital of more than \$1m are excluded from disclosure provisions. However, legislation could go further and define “small business” for the purpose of including these businesses in the legislation.

A test that includes small business would need to:

- be unambiguous
- identify at what point in time the test applies (for example, only at the time the loan is taken out, or throughout the life of the loan)

¹⁸The natural persons test is used in the United Kingdom’s Consumer Credit Act 1974 [section 8(1)]. The Act regulates credit provided to “individuals”, and individuals are defined as “persons acting in their private capacity or as sole traders, a partnership or other unincorporated body of persons not consisting entirely of bodies corporate”. This test is used in conjunction with a monetary ceiling of £25,000.



- be easily verifiable by both parties at any stage when the legislation's application may be called into question.

The test would also need to define a small business. The definition could include limits on:

- financial size (for example, annual turnover of less than \$1m, or paid-up capital of less than \$1m)
- the number of employees.

The main justification for this test is that it would extend protection to smaller businesses.

Its main disadvantage is that it would make complying with the legislation more complex and less certain. It would be difficult for a lender to establish the status of a business borrower. But it would be important to do so. Any error in applying the test is likely to result in an agreement that the lender could not enforce. One way around this type of uncertainty is to require small businesses to make a "good faith" declaration of their status to the lender, much like insurance contracts require from people taking out insurance. (A similar difficulty occurs in the purpose test – see section 5.4.1.)

Another disadvantage is that defining a small business in terms of monetary values has the same problem as a monetary ceiling – that is, ensuring that the values are kept up-to-date.

Like the natural persons test, a test to include small businesses would need to be combined with a monetary ceiling to exclude very large commercial loans.

4.4 Contracting out

Credit legislation could apply to *all* transactions, but for commercial credit transactions the parties could be permitted to contract out.

This is similar to what happens in the Consumer Guarantees Act. Some commercial transactions are included under the Consumer Guarantees Act – but not if the "person who acquires ... the goods or services for the purpose of a business" agrees in writing that the transaction will be excluded from the Act.

Without restrictions, the capacity to contract out is likely to mean that lenders will seek to contract out of all transactions. Situations similar to this have arisen in Queensland, under the Australian purpose test – see section 5.4.2. To be workable, the contracting out provisions would need to safeguard against consumers being pressured to describe their credit contract as being for business purposes.

It is also unclear whether contracting out has any advantages over a test that would exclude commercial transactions altogether.



4.5 Summary chart

The chart on page 25 summarises the alternatives discussed in this section. It also includes the purpose test, which is discussed in section 5.

Some of the alternatives are combined in various ways – so it is possible to mix and match different monetary ceilings with different tests.

Issues for discussion

What general comments do you have on each of the options discussed in this chapter?

Is a monetary ceiling still relevant? If so, at what level should it be set?

Should *all* home finance contracts be covered in consumer credit law?

Is the small business test appropriate? If so, what criteria should be used in defining a small business?

Is the natural persons test adequate for the purposes of application?

<i>Test</i>	<i>Key features</i>	<i>Consumer transactions</i>	<i>Commercial transactions</i>	<i>Advantages</i>	<i>Disadvantages</i>
Status quo	Monetary ceiling of \$250,000.	Some mortgages excluded.	Significant coverage.	Easy to apply.	Now out-of-date. Unnecessary commercial coverage.
Higher monetary ceiling	\$700,000 (for example).	Comprehensive coverage.	More coverage than now.	Easy to apply. Comprehensive coverage of consumer transactions.	Reduced flexibility in commercial credit. Ceiling needs regular revision.
Lower monetary ceiling (no exception for home finance)	\$50,000 (for example).	Comprehensive coverage <i>except for</i> home finance, flexi-mortgages, and loans for very expensive consumer items.	Coverage of smaller loans only.	Easy to apply. Reduced regulation of commercial credit.	Would reduce consumer protection overall. Ceiling may need regular revision.
Lower monetary ceiling (with exception for home finance)	\$50,000 (for example) <i>except for</i> home finance credit.	Comprehensive coverage <i>except for</i> loans for very expensive consumer items.	Coverage of smaller loans only.	Easy to apply. Reduced regulation of commercial credit. Maintains comprehensive consumer protection.	Ceiling may need regular revision. No clear justification for regulating small commercial transactions.
Natural persons test	All lending to natural persons regulated. Test used in combination with monetary ceiling.	Comprehensive coverage.	All lending to corporations excluded. Only sole traders and partnerships covered.	Easy to apply. Limits coverage of commercial transactions.	Distinction between incorporated and unincorporated is artificial for many businesses.
Test to include small business	Small business would be defined in legislation. Test used in combination with monetary ceiling.	Comprehensive coverage.	Only loans to small business covered.	Would protect small and vulnerable traders.	Very difficult to define “small business”.
Contracting out	Businesses can contract out of legislation.	Comprehensive coverage.	Covered unless borrower contracts out (lender likely to want this).	No real advantage over totally excluding commercial transactions.	Some lenders likely to pressure consumers into contracting out.
Purpose test (covers entire Act)	Lending regulated if it is provided primarily for personal, domestic or household purposes.	Comprehensive coverage.	Excluded where purpose is more than 50% commercial.	Consistent with market practice in New Zealand, and with overseas legislation. Gives flexibility in commercial lending.	Possible uncertainty in some scenarios. Scope for abuse by some lenders.
Purpose test (covers disclosure provisions only)	Reopening provisions apply to all lending.	Comprehensive coverage.	Commercial borrowers can apply to Court to reopen contracts.	Has all the advantages of the purpose test, while providing redress for commercial borrowers.	Possible uncertainty in some scenarios. Scope for abuse by some lenders and misuse by some business borrowers.



5. THE MINISTRY'S PREFERRED ALTERNATIVE: THE PURPOSE TEST

This section describes the operation of the purpose test. It also sets out the advantages and disadvantages of this test and describes how some of the disadvantages could be overcome. The increasing use of this test in other countries is briefly summarised in a box at the end of this section.

The purpose test could be used in conjunction with a monetary ceiling, as it is currently in the United States. The Ministry, however, envisages the test as standing alone in defining which transactions are subject to the legislation (or in defining which transactions are subject to particular provisions within the legislation).

5.1 Definition of “purpose test”

The purpose test aims to restrict credit regulation to consumer transactions by covering only those transactions where the credit is to be used by *a natural person wholly or primarily for personal, domestic or household purposes*.

This test is based on the positive wording used in Australian, Canadian and United States consumer credit legislation. But it could instead be framed in negative terms – that is, by excluding loans that are wholly or primarily for a business purpose.

Some further clarification of the purpose test is likely to be needed to limit uncertainty:

- “Primarily” may need to be defined as being more than half of the intended purpose.¹⁹ (Often the assessment of “more than half” will be based on an estimate by the borrower.)
- “Investment” may need to be conclusively defined as a business purpose. Thus, credit obtained primarily for an investment purpose (such as a rental property) would not be consumer credit.

5.2 How the test would work

The purpose test is applied at the time that the contract is entered into. So it usually requires the lender to actively inquire about the purpose for which the borrower intends to use the credit.

In most cases, this is not likely to be an onerous task. It is already usual for banks and finance companies to find out the borrower's purpose – and most of these lenders have separate lending arrangements which

¹⁹This is the definition used in Australia's Consumer Credit Code [s.6(5)].



depend on the loan's purpose (for example, "home lending", "personal lending", "commercial lending").

Other lenders – such as those in the hire purchase market – will find it impractical to distinguish between purposes because virtually all their lending is for consumer purposes. Lenders in these markets could adopt standard credit contracts that meet the legislation's requirements, and use these for all loans regardless of purpose. However, the legislation would still apply only to contracts entered into for consumer purposes. The contracts could also be worded to include a disclaimer stating that the legislation does not apply to contracts entered into for a business purpose.

5.3 Advantages

The purpose test has a number of advantages:

- It fits well with market practice (as discussed in section 5.2). It coincides with the practices of banks and finance companies, and can be easily adapted for hire purchase and cash loan lending.
- It is consistent with other recent New Zealand consumer protection legislation, such as the Consumer Guarantees Act, which gives business parties the opportunity to contract out, and the Credit (Repossession) Act, which will apply only to consumer transactions once the Personal Property Securities Act comes into force.
- It is consistent with Australian credit law. So a purpose test would result in greater harmonisation of trans-Tasman regulatory requirements for credit contracts, creating efficiencies for those lenders who operate in both Australia and New Zealand.
- The test cannot become outdated or need regular updating (as happens with a monetary ceiling). So it is simple and inexpensive to administer.
- In the vast majority of cases, the test is both clear and easy to apply. Most credit is either for a straightforward business or consumer purpose – although there are some grey areas (which are discussed in section 5.4.1).
- It allows more flexibility in business lending and borrowing arrangements. It should also reduce compliance costs for lenders by relieving them of mandatory disclosure and documentation requirements – and these savings could then be passed on to business borrowers by lowering the cost of their credit.
- It largely eliminates the problems of exploitation of the legislation by business borrowers who default on their loans.
- It continues to provide protection to consumer borrowers – whose weaker bargaining position (relative to that of lenders) is sufficient justification for the continuing regulation of consumer credit contracts.



5.4 Disadvantages

The purpose test has two potential disadvantages:

- uncertainty
- scope for abuse.

5.4.1 *Uncertainty*

The most common objection to a purpose test is that it may create uncertainty for lenders. This is because the lender may not know the precise purposes of the borrower.²⁰

Sometimes a borrower takes out a loan for “mixed” purposes and deciding which is the primary purpose may be difficult. For example:²¹

- A person borrows money for a tractor to use on their hobby farm. It is unclear whether the hobby farm is for business/investment purposes or for personal/domestic purposes.
- A person borrows money to buy a painting. The motivation may be investment, personal enjoyment, or both.
- A business executive applies for a credit card and uses it from time to time to purchase airline tickets for business travel. At the outset of the contract, however, it is impossible to estimate the extent to which it will be used for this.
- A farmer enters into a “terms sale” contract²² for the purchase of a farm. There is a farmhouse on the property that the farmer intends to live in, but the contract does not apportion the purchase price between the house and the rest of the property.

Modern flexible mortgage products may also cause problems in clearly identifying a primary purpose. For instance²³ an individual borrower seeks a loan of \$100,000. Of this, \$60,000 is to be used to purchase a house and \$40,000 is to be used in the borrower’s business as working capital. One-sixth of the house is to be used as an office for the business – which means that 50 percent of the loan is for business purposes.

These examples demonstrate that for certain transactions there will be a grey area. This uncertainty is a potential cost for lenders, and it may occasionally result in litigation.

There are, however, two possible ways for lenders to minimise this uncertainty.

²⁰This is the basis on which both the United Kingdom’s Crowther Committee (1971) and New Zealand’s Contracts and Commercial Law Reform Committee (1977) rejected a purpose test.

²¹These examples are taken from A. Duggan and E. Lanyon (1999) *Consumer Credit Law* Sydney: Butterworths.

²²A contract under which the buyer pays the seller back in instalments.

²³This example is taken directly from the *Australian Consumer Credit Law Reporter* (Volume One), CCH Australia, at 8,502.



The first is *to seek a formal declaration from the borrower as to the purpose of the loan*. This could require the borrower to estimate the expected use of the credit, or the goods purchased on credit. The lender can then rely on the declaration in good faith to determine whether or not the loan is regulated.²⁴ (For some possible problems with declarations, see section 5.4.2 below.)

The second is *to document the credit contract as if it were regulated*. This has already been mentioned in section 5.2 as a practical strategy for lenders in the hire purchase market, where a requirement to differentiate between consumer and business purpose is unrealistic. It is also an obvious risk management strategy for any lender faced with a situation of uncertainty. If it turns out that the contract *is* regulated, this approach will avoid problems. As well, incorporating a notice in the contract to the effect that credit for business purposes is unregulated should avoid problems if it turns out that the contract was indeed unregulated.

5.4.2 Possible scope for abuse

The Queensland Office of Fair Trading has reported that “fringe” lenders sometimes obtain false declarations from consumers.²⁵ The consumer is pressured into declaring that the credit they have applied for is to be used for business purposes, and this allows the lender to (try to) avoid the provisions of the Uniform Consumer Credit Code. Other states in Australia have not reported such findings.

Any such attempt to avoid the Code’s provisions will depend on the lender not being found out: the Code states that its provisions will still apply, despite a false declaration, if the lender knows that the credit is to be used for consumer purposes. However, the Australian government is now considering whether the Code needs further amendment to establish “procuring a false declaration” as an offence.

5.5 Australia’s experience with the purpose test

Ministry of Consumer Affairs officials recently investigated the impact of the purpose test in Australia, where it has been in force since 1 November 1996.

Representatives of the Australian lending industry, as well as lawyers practising in the area of consumer credit, were unanimous that the purpose test had been successful. The test has not created undesirable levels of uncertainty for lenders or borrowers, and the lender’s right to seek a declaration of purpose from borrowers has (despite the Queensland experience) resolved many potential problems.

²⁴This is provided for in Australian law [Consumer Credit Code s.11] See Appendix Two.

²⁵Office of Fair Trading (May 1999) *“Fringe” Credit Provider – A Report and Issues Paper* Queensland.



Overseas use of the purpose test

Canada and *Australia* have recently updated their consumer credit legislation. Both use a positive purpose test, with minor wording differences. Both tests are based on the wording in the United States' Truth in Lending Act and its Uniform Consumer Credit Code, which is in force in 12 states. All forms of consumer credit, including home finance, are covered, and there is no monetary ceiling.

In the post-implementation review of its Consumer Credit Code, completed in August 1999, Australia's Ministerial Council of Consumer Affairs considered whether the Code's provisions should be extended to small businesses. It decided against this. The Code establishes a regulatory regime specifically for consumer credit. Extending this to small businesses would create problems.

In the *European Union*, three Directives relate to consumer credit, the most important one being Directive 87/102/EEC. (The others are Directive 90/88/EEC and 98/7/EC, both of which are concerned with the formula used to calculate the annual percentage rate under a credit contract.)

Directive 87/102 in effect uses a purpose test, in that it limits the application of the Directive to "a natural person who ... is acting for purposes which can be regarded as outside his trade or profession". The Directive also contains a monetary ceiling of 20,000 ECU, and it does not apply to any credit that is intended to be used in buying real property.

While all member countries are obliged to bring their consumer credit legislation into line with the Directive, individual member countries can choose to apply it beyond the context of consumer credit. A number of countries have done this, in different ways. For instance, the definition in German law includes persons who enter into a credit agreement with a view to launching a business. In the Netherlands, protection is extended to all natural persons unless the credit is for goods used exclusively for professional purposes. In Belgium, the law will only apply when private purposes are primary.

Issues for discussion

What general comments do you have on a purpose test for consumer credit legislation? What are the specific advantages and disadvantages?



APPENDIX ONE

Credit Contracts Act 1981

15 Meaning of “CONTROLLED CREDIT CONTRACT” —

- (1) In this Act the term "controlled credit contract" means a credit contract—
- (a) Where the creditor, or one of the creditors, for the time being is a financier acting in the course of his business; or
 - (b) Which results from an introduction of one of the parties to the contract to another such party by a paid adviser; or
 - (c) That has been prepared by a paid adviser;—
but does not include—
 - (d) A contract where every debtor for the time being is—
 - (i) A financier by virtue of either paragraph (a) or paragraph (c) of the definition of that term; or
 - (ii) The Crown, a local authority, or a Government agency; or
 - (iii) A body corporate that has a paid up capital of not less than \$1,000,000; or a body corporate that is related to such a body; or
 - (e) A contract where every party to the contract for the time being is a body corporate that is related to every other such party to the contract; or
 - (f) A contract if the total amount of credit outstanding under that contract and under all other contracts between the same creditor and debtor is or will be not less than \$250,000; or
 - (g) A contract that results from an offer of securities to the public within the meaning of sections 2 and 3 of the Securities Act 1978; or
 - (h) A contract the only effect of which is to modify the terms of a controlled credit contract; or
 - (i) A contract entered into pursuant to a revolving credit contract; or
 - (j) A contract entered into pursuant to [a registered superannuation scheme]; or
 - (k) A contract that forms part of a transaction involving the export from New Zealand, or the import into New Zealand, of goods or services and that is entered into for the purpose of facilitating the export or import of those goods or services; or
 - (l) An agreement to which sections 5 and 7 of the Door to Door Sales Act 1967 apply; or
 - (m) A contract of a kind specified in regulations made under section 47 (1) (d) of this Act.
- (2) For the avoidance of doubt, it is hereby declared that where a person's account with a bank is debited and—



- (a) The effect of the debit is to put the account into overdraft, or to increase the amount of an overdraft beyond an agreed limit; and
 - (b) The creation of the overdraft, or the increase in the limit, has not been agreed between the bank and the person before the debit of the account,—
- neither the debiting of the account nor the creation, or increase, of the overdraft shall constitute a controlled credit contract, whether or not the bank knows at the time the account is debited that the debit would have that effect and whether or not the bank makes a charge (whether interest or otherwise) relating to the creation or increase of the overdraft.



APPENDIX TWO

Australian Uniform Consumer Credit Code

Provision of credit to which this Code applies

6 (1) [Key elements] This code applies to the provision of credit (and to the credit contract and related matters) if when the credit contract is entered into or (in the case of pre-contractual obligations) is proposed to be entered into—

- (a) the debtor is a natural person ordinarily resident in this jurisdiction or a strata corporation formed in this jurisdiction; and
- (b) the credit is provided or intended to be provided wholly or predominantly for personal, domestic or household purposes; and
- (c) a charge is or may be made for providing the credit; and
- (d) the credit provider provides the credit in the course of a business of providing credit or as part of or incidentally to any other business of the credit provider.

[...]

6 (4) [“Personal, domestic or household” purpose] For the purposes of this section, investment by the debtor is not a personal, domestic, or household purpose.

6 (5) [“Predominant purpose”] For the purposes of this section, the predominant purpose for which credit is provided is—

- (a) the purpose for which more than half of the credit is intended to be used;
- or
- (b) if the credit is intended to be used to obtain goods or services for use for different purposes, the purpose for which the goods or services are intended to be most used.

Presumptions relating to application of Code

11 (1) [Code presumed to apply] In any proceedings (whether brought under this Code or not) in which a party claims that a credit contract, mortgage or guarantee is one to which this Code applies, it is presumed to be such unless the contrary is established.

11 (2) [Debtor’s declaration as to purpose] Credit is presumed conclusively for the purposes of this Code not to be provided wholly or predominantly for personal, domestic or household purposes if the debtor declares, before entering into the credit contract, that the credit is to be applied wholly or predominantly for business or investment purposes (or for both purposes).



11 (3) [Credit provider's knowledge as to purpose] However, such a declaration is ineffective for the purposes of this section if the credit provider (or any other person who obtained the declaration from the debtor) knew, or had reason to believe, at the time the declaration was made that the credit was in fact to be applied wholly or predominantly for personal, domestic or household purposes.

11 (4) [Form of declaration] A declaration under this section is to be substantially in the form (if any) required by the regulations and is ineffective for the purposes of this section if it is not.