CONSUMER CREDIT LAW REVIEW

PART 3: TRANSPARENCY IN CONSUMER CREDIT: INTEREST, FEES AND DISCLOSURE

April 2000

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PREFACE

The Minister of Consumer Affairs announced a Consumer Credit Law Review on 1 July 1999, on which date a public consultation document entitled *Setting the Scene* was released.

In total, five public consultation documents will be released over the course of the review. This document – which deals with transparency in consumer credit – along with the application document lead into the second stage of the review. The final two documents will deal with redress and enforcement, and other issues (including electronic commerce, insurance and overindebtedness). They are due to be released mid-year.

The transparency document covers some of the most technically complex issues likely to arise in the review. While the Ministry has attempted to make the document as readable as possible it needs to be appreciated that much of the discussion is based on intricate legal and financial concepts. Where possible, the technical detail (including financial mathematics) has been placed in appendices. We have also provided a comprehensive glossary. If you have any difficulties in working with this *Transparency* document, you are welcome to contact the Ministry's credit team.

Relationship with Application document

The application document has been released simultaneously with this document. Thus, the transparency document does not discuss which classes of transaction the various identified options would apply to – that is a central concern of the application document.

Importantly, the discussion in this document relates to *consumer* credit contracts and therefore, the proposals and options are not concerned with commercial credit. For example, the Ministry does not support a legislated right to early repayment of a credit contract for commercial debtors, although this is proposed for consumer credit contracts. The application document discusses in detail the intrinsic differences between consumer and commercial credit and the arguments for separate regulation.

Acknowledgements

The Ministry of Consumer Affairs would like to acknowledge the considerable assistance received from Rick Bowes, Counsel with the Alberta Law Reform Institute, Edmonton, Canada. As well as commenting on an earlier draft of this document, Rick provided the Ministry with policy memorandums he wrote during an extensive project on consumer credit undertaken by the Institute. Some of the analysis in this document is based on his work. The Ministry would also like to thank Warren Sloan for assisting with the financial mathematics. The responsibility for this report, however, lies solely with the Ministry.

EXECUTIVE SUMMARY

Transparency is important in consumer credit because these transactions are inherently complex. Transparency relies on disclosure by lender to consumer of the price and terms of a credit product – however, the concept goes further: it also concerns the timing of the receipt of information; the content and format of that information; and its comparability with (competing) products offered by other lenders. An effective transparency regime assists consumers to obtain information that they can use to maximise their welfare, and promotes efficient markets.

Problems in achieving transparency

An analysis of transparency in the New Zealand consumer credit market leads to the assertion that consumer protection relies on more than disclosure alone. The most important limitations on a disclosure regime are:

- The complexity of the price and terms of modern credit products. This provides a challenge for any disclosure regime. Modern credit contracts rely much less on fixed interest, fixed term products in favour of an increasingly wide range of revolving and flexible credit products. Credit card and home mortgage products have become more differentiated, and development of loyalty schemes has emphasised this trend.
- The poor literacy of a significant number of people. Many New Zealanders cannot read and understand even a relatively simple financial document, let alone a complex credit contract.

The cost of credit

In return for the use of credit, borrowers pay interest and fees. Interest was traditionally calculated using the "flat rate" method as a proportion of the principal outstanding at the commencement of the loan. Some lenders still use this method for calculating fixed interest, fixed term loans. However, most lenders now use an "accrued" interest method, whereby interest is calculated on the reducing balance of the loan – most commonly, on the outstanding daily balance. This method is advantageous to both lenders and consumers; notably it improves transparency. Interest is never calculated in advance.

Disclosure of the cost of credit in New Zealand's consumer credit law

The key statute requiring disclosure by lenders to borrowers or prospective borrowers is the Credit Contracts Act 1981. The most important disclosures for fixed credit products are the:

- *Total cost of credit* – all interest and (most) other charges must be disclosed as one figure; and the
- *Annual finance rate* – this expresses the total cost of credit as an annual percentage rate of the amount of credit outstanding on the loan.

However, these items are not required to be disclosed for revolving credit products.

The annual finance rate provides a standardised measure of the cost of credit that includes interest and other charges. It accounts for the timing and amount of all advances and repayments. Before annual finance rate disclosure was required, lenders used a variety of methods to disclose interest charges. The annual finance rate enables loans to be objectively ranked by cost on a “dollar outstanding per year” basis. It may also serve a warning function by alerting consumers when the cost of credit is unexpectedly high.

A critique of disclosure requirements

Overall, the Ministry believes the finance rate concept has significant shortcomings in practice. A number of problems can be identified:

- The statutory wording prescribing the charges that must be included in the finance rate calculation is imprecise, allowing lenders to avoid full disclosure. Judicial interpretation in respect of some fees, notably “finders” fees, is inconsistent, creating further uncertainty.
- The finance rate does not include all relevant charges with which the consumer should be aware in order to rank the cost of different credit arrangements. Notably, lenders are not required to include “official” fees or “brokerage” fees in the calculation, although there are strong arguments for doing so.
- The finance rate is inherently limited in that it cannot be used by consumers without relatively sophisticated interpretation. No precise explanation exists on how consumers should make this interpretation and, further, the finance rate cannot account for subjective considerations that will affect a credit purchasing decision – in this respect, it may actually mislead consumers.
- Disclosure of the finance rate, and the cost of credit generally, is made too late to be of use to a consumer in a “comparison shopping” process – this is known as the “timing problem”; in addition, it is impractical for lenders to disclose a finance rate in an advertisement and this rarely takes place.
- Finance rates cannot be calculated for revolving credit products, except if based on arbitrary assumptions about a hypothetical consumer’s borrowing pattern. There are further complications with variable interest rates in expressing a fully accurate measure.
- The provisions governing finance rates add to the complexity of credit law. This is because it is very difficult for legislation to cover the range of variables that might arise when a finance rate must be calculated.
- The method of calculating a finance rate is based on the “nominal” rate method, which is less accurate than the “effective” rate method. The latter takes into account the time value of money when interest is paid during the year.
- Overseas research findings point to a limited awareness and understanding by consumers of finance rates; there is no particular reason to believe that the situation is different in New Zealand.

Generally, the current legislative framework for disclosure has not prevented lenders from using obscurely drafted, standard-form contracts.

Disclosure requirements in overseas jurisdictions

The US, Canada and the UK all require the disclosure of the annual finance rate (called an annual percentage rate, "APR") by lenders to consumers, although variations exist. Canadian law was drafted most recently and provides a contemporary example. Australian law has now abandoned the finance rate approach in favour of comprehensive and full disclosure. A review by the Ministerial Council of Consumer Affairs concluded that some aspects of Australian legislation are problematic. Two notable deficiencies identified are that it does not overcome the "timing problem" and it requires disclosure of too much information, leading to "overload". Nevertheless, other provisions may provide a useful guide for reform in New Zealand.

Transparency issues with the early repayment of loans

Borrowers have only a limited right to early repayment in New Zealand. In most cases this right will depend on the contract between borrower and lender. Charges that borrowers may face include:

- An administrative charge.
- A proportion of any precalculated interest on the loan – this is most relevant to hire purchase contracts, whereby lenders may retain 10% of the precalculated interest in the event of early repayment.
- An early repayment adjustment – if a borrower makes early repayment of a loan with a fixed interest rate, the lender may seek to recover its loss if prevailing interest rates have dropped at the time of early repayment.
- An implicit, but hidden, charge resulting from the method used by the lender to calculate the rebate of precalculated interest. This is well documented with regard to the Rule of 78 method of calculating a rebate on early repayment. The Rule is recognised as being inherently unfair to consumers.

Options for reform

The Ministry believes that the shortcomings of the Credit Contracts and Hire Purchase Acts are such that options for reform should be considered.

The Ministry has identified two alternatives for reform of the initial disclosure regime.

1. Reform the finance rate in the Credit Contracts Act

Options to improve the accuracy of the current regime include:

- A prohibition on lenders from charging fees, although such a policy has some negative consequences.
- Clarify the charges to be included in the finance rate calculation ensuring that all relevant fees are included.
- Require disclosure of an effective finance rate, rather than the nominal finance rate.

2. *A synthesised approach*
The central feature of this approach is that it largely abandons the goal of facilitating “comparison shopping” based on direct creditor to borrower disclosure. Rather, it focuses on:

- regulation of interest calculations according to the “daily-rate” accrued interest method
- regulation of fees: several options are discussed
- a right of early repayment for all consumer borrowers: several options as to the extent of this right and how a lender may recover any loss in the event of early repayment are discussed
- maintenance of the three-day “cooling-off” period: however, this is proposed as a general consumer protection measure, rather than as an opportunity for comparison shopping by consumers
- reduced disclosure requirements: there are two options – whether legislation prescribes specific disclosures, or sets a performance standard for lenders to follow.

In any approach, there will be issues of timing and presentation of contractual material. Options for dealing with these issues are:

Timing:

- a “comparison rate” in advertisements: this is a proposal currently being debated in Australia
- a pre-contractual disclosure process
- a cooling-off period.

Format and presentation of contract documentation:

- a prescriptive Consumer Information Standard regulation made under the Fair Trading Act
- a less-prescriptive guideline to be added to legislation, based on Canadian law
- model forms or templates.

Finally, the concept of a “centralised” third party disclosure regime is raised. This would involve an agency collecting cost of credit information from lenders and publishing it centrally, so that consumers could compare prices. Such a model would overcome many of the problems that legislation has failed to overcome, including the timing problem. Potentially, it would allow legislation to be simplified. However, it may not work for all market segments. Furthermore, it is an untested model, and would have to be established, administered, marketed and funded.

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

The Ministry of Consumer Affairs would like to receive comment on all aspects of this document. Specific questions are asked in Chapter 9, which discusses possible options for reforms. The key issues that the Ministry is considering are:

- Should New Zealand consumer credit law continue to require disclosure centred on the annual finance rate?
- Should a new approach to disclosure be developed which abandons the goal of facilitating "comparison shopping" by consumers based on lender to consumer disclosure?
- How can disclosed information be presented to consumers in time for them to use such information?
- Are there any appropriate regulatory measures that would encourage lenders to clearly express contractual terms and conditions?
- What is the potential of a disclosure regime based on centralised third party disclosure, rather than lender to consumer disclosure?
- What right should borrowers have to repay a loan early?
- How should lenders be compensated for any loss suffered through early repayment?

Specific questions are listed in Chapter 9.

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.

PART ONE

1. TRANSPARENCY: KEY PRINCIPLES AND ISSUES

Consumer credit transactions are inherently complex. This complexity often makes it difficult to clearly inform consumers about the terms and prices of consumer credit products.

Transparency – the subject of this discussion paper – is the process of disclosing accurately and fairly to consumers the price and key terms of a credit deal. Transparency, however, is broader than disclosure alone. The timing, content, format, and presentation of information all influence how useful disclosure will be to consumers. When there are a number of competing products, consumers may be faced with significant search costs in deciding which credit deal is best for them.

1.1 Why transparency matters

Transparency provides benefits for both borrowers and lenders:
- consumers receive information they can use to choose the most suitable products or services
- consumers can decide when it is to their advantage to take certain actions under the contract – such as, repay early or refinance the credit deal
- consumers are protected against being misled about the true cost of credit and from paying arbitrary, inexplicable or unexpected charges
- efficient markets are promoted by rewarding those lenders who offer products or services that meet the needs of consumers, at a fair price.

Transparency will not eliminate all the difficulties faced by consumers in credit deals, but it will help make them better informed and more confident in their dealings.

1.2 Principles of transparency in consumer credit

The following principles are central to any discussion of transparency:

Accuracy: the information provided should allow consumers to draw clear conclusions about the cost of credit.

Comparability: information provided by different lenders should be comparable so that consumers can make meaningful choices between competing offers.

Presentational clarity: as far as possible, information should be presented clearly and in a consumer-friendly way.

Conciseness: concise documents are more likely to be read and understood – and help keep search costs down for consumers.

Timing: consumers should receive all the essential information they need before becoming irreversibly committed to a credit deal.

There is, however, a tension between these principles. To take one example, accuracy implies comprehensiveness – and this may conflict with the principles of conciseness and timing. Some of these principles have also proved extremely difficult for legislators to achieve in practice. Combining satisfactorily the goals of appropriate timing and comparability has proved to be a universal challenge for consumer credit law.

This discussion paper provides detailed discussion on these types of difficulties and the trade-offs that are involved. Depending on the principles a transparency regime may emphasise, different types of options come into play.

1.3 Transparency in practice – the key issues in this document

The key areas of consumer credit law that involve transparency are:
- what costs do consumers face in obtaining, using and ending credit deals?
- how are these costs calculated?
- how are these costs disclosed to the borrower?

The above issues are all interrelated and need to be considered as part of a unified approach to transparency that seeks to meet the five principles outlined in section 1.2.

The more specific issues that are discussed in the following chapters are:
- how interest is calculated
- expressing interest as an annual rate
- the role of other fees and non-interest charges
- how the cost of interest and other fees and charges can most effectively be disclosed to the borrower
- when disclosure should take place – timing issues
- presentational standards for disclosure of credit information
- early repayment by consumers – what right should borrowers have to early repayment and what costs might the lender charge the borrower for doing so.

1.4 Structure of the discussion paper

This discussion paper evaluates New Zealand's cost of credit and disclosure regime and compares it with other jurisdictions. It falls into three main parts.

Part one (Chapters 1 to 5) defines and discusses the basic concepts involved in transparency. An important conclusion that emerges from this discussion is that: c*onsumer protection in credit deals relies on more than direct lender to borrower disclosure alone.* The remaining parts of the discussion paper take account of this conclusion in their analysis of the regulation of interest and other charges, cooling-off periods and early repayment. It also leads the Ministry to raise the possibility of new approaches to transparency and disclosure, such as through a centralised mechanism.

Part two (Chapters 6 to 8) critically analyses New Zealand's current disclosure regime; it also looks at developments in other countries with similar systems of consumer credit law.

Part three (Chapter 9) looks at options for reform. These take two main forms: to reform the existing Credit Contracts Act in various ways; or to adopt elements of the recent Australian Consumer Credit Code and adopt a different approach to transparency.

2. PROBLEMS IN ACHIEVING TRANSPARENCY IN CONSUMER CREDIT

Consumer credit products range from hire purchase and relatively straightforward fixed-credit loans, to credit cards and sophisticated mortgage products. Because of the variety and complexity of today's credit products, credit-purchasing decisions are vastly more complicated than was foreseen by the drafters of New Zealand's current consumer credit law.[1]

As well, limited skills in literacy and numeracy result in many consumers not being able to understand even comparatively simple financial documents.

These factors present a major challenge in achieving transparency in consumer credit.

2.1 The complexity of modern credit products

The complex array of credit products now available was not anticipated by the legislators of two decades ago. The Credit Contracts Act was passed in 1981 – based on a report completed in 1977. The concepts behind the Act's "finance rate" and the "total cost of credit" were largely adapted from overseas statutes, which were themselves developed and passed in the 1960s and 1970s.

At that time the government also actively controlled the provision of credit as part of microeconomic management.[2] "Fixed" credit was the norm: loans were for fixed amounts with fixed repayment schedules. Revolving credit contracts were mainly used by commercial borrowers – and credit cards were not widely used until the early 1980s.

Today, fixed credit is in decline and revolving credit products are rapidly increasing, largely through the increased computerisation of accounting systems and automation of accounts. These modern credit products have various features – including flexible credit, variable interest rates and linkage to loyalty schemes.

[1] See also E Lanyon, "Hybrid consumer credit products in the electronic age – a challenge for regulators", Paper presented to the International Association for Consumer Law Biannual Conference, Helsinki, Finland, May 1999.

[2] For example, through the Hire Purchase (Economic Stabilisation) Regulation 1957.

2.1.1 Flexible credit

"Flexible credit" is a broad category of loans and credit arrangements without regular, fixed payments of interest and principal being set at the start of the contract. This includes overdrafts, redraw facilities, credit cards, and other similar arrangements. These are "flexible" because the borrower can choose when and how much to borrow (subject to any credit limit), and when and how much to repay (subject to any minimum required repayment). They are called "revolving credit" because the balance that is not paid off "revolves" to the next billing period.

Credit cards

Credit cards are the most common type of flexible-credit arrangement and have increased in sophistication and complexity. Although many credit cards may have similar interest rates and "grace" periods, variations in terms and conditions can affect the cost of using different cards. For example, the cost of using each card may differ because of:[3]

- the way payments are applied between the existing balance, new advances, and accrued interest and fees
- the method used by the card issuer to determine when a purchase begins accruing interest charges.

Recent innovations involve tiered interest rate structures. For instance, one mainstream credit card charges reduced interest rates as the loan's outstanding balance increases. This way, the more you borrow, the lower your overall interest rate. Other revolving credit contracts also provide tiered interest rates, but with the different interest rates applying to individual advances, not to the outstanding balance of the loan.

Flexible mortgages

Flexible mortgages are home loans with flexible credit features. The home loan and flexible credit facility can be combined in different ways:

- a product may simply provide a revolving credit account secured against the property and operating alongside the home loan account
- a product may be structured as a secured overdraft that is used as the principal home loan
- a product may offer a "redraw facility", in which any payments over and above the agreed periodic payments can be redrawn by the consumer as further borrowings.

Other variations include mortgage-offset arrangements where interest on a saving deposit can be offset against mortgage payments.

2.1.2 Variable interest rates and "honeymoon" periods

Variable interest rates existed when the Credit Contracts Act was passed in 1981. However, recent innovations include products that combine loans with fixed and variable rates in a single package. Sometimes the consumer can select the term for which interest is fixed; other times it is fixed by the lender.

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[3] See the study by the Consumers' Institute, (July 1992). "Balancing the cards: Best deals with credit cards". *Consumer*, *306*, 12-15.

"Honeymoon periods" are a relatively recent marketing tool in New Zealand. The lender – usually a mortgage lender – offers a discounted fixed interest rate for an initial period of the loan (usually up to one year). Once the low-start period is complete, the loan reverts to the lender's current variable interest rate.

2.1.3 Loyalty schemes

A recent development has been the partnership between credit card issuers and other institutions to offer loyalty schemes. These are referred to as co-branded and affinity credit cards. Examples are credit cards that enable the borrower to collect "Fly Buys." points or air points. The points can be redeemed for a reward provided by the loyalty company. Most credit cards now have a loyalty programme attached and the loyalty concept has been extended to home finance. One trading bank offers a special home loan, whereby air points are earned on the outstanding balance of the borrower's mortgage.

Loyalty programmes add a significant factor to be weighed up by consumers when comparison shopping, further complicating value-for-money comparisons.

2.2 Literacy requirements

The Ministry's first discussion paper *Part I: Setting the Scene* (released in June 1999) noted that a complicating factor for any disclosure regime is the limited capacity of many consumers to understand even the most simple of credit contracts.

Part I: Setting the Scene cited the 1996 International Adult Literacy Survey, which found around 45 percent of New Zealand adults were functionally illiterate: approximately 500,000 have minimal or nil reading capability, while a further 750,000 cannot comprehend an everyday document.[4] The documents on which the survey was based are likely to be less complex than a typical credit contract. The survey also found that the majority of Maori and Pacific Islands people, and those from other ethnic minority groups, are functioning below the level of literacy required to meet the demands of everyday life. There do not appear to be any studies of numeracy in New Zealand, but it is likely that similar conclusions would result.

So any disclosure regime is posed with a major challenge in providing information ordinary consumers can understand. This suggests adequate consumer protection may have to rely on more than just credit contract disclosure. The Ministry's proposals in Chapter 9 outline some ways that disclosure provisions can be designed in accordance with consumers' literacy levels.

[4] *Adult Literacy in New Zealand: Results from the International Adult Literacy Survey,* Ministry of Education (Undated – survey conducted March 1996).

3. THE COST OF CREDIT

Transparency is concerned with making the cost of credit clear to consumers – that is, what is the total cost of credit (including both interest and fees) compared with paying cash for a purchase. Before looking at how this can be achieved, what is meant by the cost of credit and how it is calculated needs to be clarified.

3.1 Distinction between interest charges and fees

Lenders charge consumers for the use of credit in two ways:
- through interest
- through fees (non-interest charges that are part of the loan).

Together, these two elements make up the cost of credit.

Interest: interest is the extra charge paid by borrowers for the use of credit. It reflects the return to the lender from offering the credit. The Credit Contracts Act defines interest (the interest rate) as any part of the total cost of credit that results from multiplying by a percentage the amount of credit provided.

Fees: these refer to any other charges a borrower is required to pay in obtaining credit.

Credit charges (which consist of interest and fees) recover the lender's costs plus any profit. There is, however, a difference in function between fees and interest in a lender's overall pricing structure for a loan (see Appendix One for more details).

The cost of administering a loan is normally heaviest at the start, when the loan is being set up and documented. Therefore, lenders commonly have an "up-front" fee, such as an application or booking fee. Other lenders may require that the first month of interest charges be paid in advance.

Credit law often affects how lenders structure their loans and recover their costs. For instance, it may allow or restrict various fees, set down a method for calculating interest, require certain fees to be included in the calculated annual finance rate and/or give consumers a right of early repayment. (See Appendix One for more detail on these issues.)

3.2 Methods of interest calculation[5]

The most common methods of charging interest on credit are the "flat-rate" (or add-on) method and the "accrued interest" method.

[5] See R Cole and L Mishler, (1998). *Consumer & Business Credit Management.* (11th Ed) Boston: Irwin McGraw-Hill, at 86.

3.2.1 The flat rate (add-on) method

Under the "flat-rate" method of calculating interest, the amount of the total interest is calculated on the original principal and is added to the loan amount (see Example 1).

Example 1

A contract has an annual flat rate of 20%. Therefore, total interest on a $1000 loan to be repaid monthly over two years comes to $400. That is:

$1000 x 20% x 2 years

The total interest is "added on" to the balance, which now comes to $1400. This is then divided by the number of payments to be made (24), to arrive at a monthly instalment of $58.33.

The *actual* interest rate is nearly twice the indicated rate of 20% because, on average, only about half of the principal is outstanding over the term of the loan. This means that the annual interest rate on the reducing balance is 34.6%. For this reason, the Credit Contracts Act requires that lenders using the flat rate method also disclose the annual finance rate – which represents the cost of credit in relation to the diminishing balance, not the original loan.

Consumer finance lenders used the flat-rate method before computerisation became widespread. It is still used by some lenders for calculating interest on fixed-credit loans, particularly by cash-loan companies – many which continue to quote the flat rate on a credit contract.

3.2.2 The accrued interest method

The "accrued-interest" method charges interest on a periodic basis (usually monthly). The interest rate is the annual rate divided by the relevant period. Each repayment is applied first to the interest, with the rest of the payment being subtracted from the principal.

Example 2

Lender X offers a $1000.00 loan at an annual interest rate of 16.95%. The monthly rate is $\frac{16.95\%}{12}$ which is 1.412%. This rate is applied to the balance each month.

The term of the loan is for 6 months and instalments are $175.00 per month. The result is a payment schedule that looks like this:

Payment Number	Interest	Payment amount	Principal reduction	Balance outstanding
0				1000.00
1	14.12	175.00	160.88	839.12
2	11.85	175.00	163.15	675.97
3	9.54	175.00	165.46	510.51
4	7.21	175.00	167.79	342.72
5	4.84	175.00	170.16	172.56
6	2.44	175.00	172.56	0.00
	0.00			

For simplicity, this example assumes each month is of equal length, as permitted by the Credit Contracts Act. In practice, many lenders allow for the exact number of days in each month.

(To see how this example has been calculated refer to Appendix Two.)

The Hire Purchase Act 1971 refers to this interest method (as “simple” interest) and assumes interest is calculated on the amount still outstanding from month to month. Accrued interest is now most commonly calculated on a daily basis – the annual interest rate divided by 365. Interest charges are usually then charged to the borrower monthly.

The accrued-interest method is preferred by most lenders as it is more flexible and can easily deal with early repayments, extra payments, missed or late payments as well as irregular payment periods and revolving credit arrangements.

From the point of view of transparency, it is also better for consumers as it:

- represents an accurate allocation between principal and interest for each repayment
- shows the balance outstanding at any time during the loan (including between payment periods)
- allows for a fair distribution of charges on early repayment
- meets the principle *that interest should not be accrued in advance, or be charged before it is earned.*

4. DISCLOSURE OF THE COST OF CREDIT IN NEW ZEALAND CONSUMER CREDIT LAW

4.1 Legal requirements

The last chapter looked at the costs – interest charges and fees – that consumers must pay in connection with a credit contract. This chapter describes how lenders are required to disclose these costs to consumers.

The Credit Contracts Act contains the most important provisions for disclosing information on the cost of credit. The focus in this discussion paper is on that Act.

The main aims of the disclosure provisions of the Credit Contracts Act were to provide information in such a form that consumers could shop around for credit.[6] Borrowers should have all the terms of the credit contract disclosed to them before they became completely committed to a loan deal. The disclosure information should be made available by lenders on a uniform basis to prevent deception and encourage competition.

To achieve these aims, the Credit Contracts Act was passed with the following disclosure requirements for *fixed* and *revolving credit*.

4.1.1 Fixed credit

Initial Disclosure

The following information must be disclosed:

- name and address of creditor
- amount of credit
- total cost of credit
- annual finance rate
- payments required
- other terms of the contract aside from those required (or implied) by law
- the cash price of any goods purchased on credit
- a statement of statutory rights.

The "total cost of credit" is defined in section 5 of the Act. It includes interest and other charges, such as booking fees and application fees: all these separate costs must be disclosed as one figure.
Each component of the total cost of credit must be disclosed. But if the credit contract is secured by a mortgage, the total interest charges over

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[6] The Contracts and Commercial Law Reform Committee stated that "the cardinal principle of our proposals regarding disclosure is that information should be provided in a form enabling the public to 'shop for credit'", (February 1977). *Credit Contracts: Report of the Contract and Commercial Law Reform Committee*, , at 101 (para 8.08).

the life of the loan do not have to be shown. This is because mortgages are often for a long duration and it is likely that the interest rate will change during the term of the loan. It is therefore not feasible to accurately calculate the total cost of interest.

The key item that must be disclosed is the "annual finance rate". The annual finance rate expresses the total cost of credit as an annual percentage rate of the amount of credit still outstanding on the loan. The rules for its calculation are in the First Schedule of the Act. The annual finance rate includes both interest charges and other fees included in the cost of credit. For contracts with variable interest rates, the finance rate is calculated according to the interest rate at the time the calculation is made.

4.1.2 Revolving credit

The requirements for initial disclosure of revolving credit are the same as for fixed credit, except that there is no requirement to disclose the annual finance rate or the total cost of credit. This is because there is no practical way of making these calculations, since the interest rate may vary over the term of the loan and there is no set schedule of advances and repayments.

4.1.3 Other disclosure provisions

There are other provisions that relate to request disclosure, guarantee disclosure, modification disclosure and continuing disclosure (the latter for revolving credit only). In this discussion paper the main emphasis is on initial disclosure – and so these other forms of disclosure are not discussed in any detailed way. The main issue in credit disclosure is providing consumers with adequate information about a loan *before* they sign up.

4.2 Timing of disclosure

The timing of *initial* disclosure must take place either before the contract is made, or within 15 days after the contract is made. (Similar provisions apply to *modification* disclosure.) Once initial disclosure has been made, the borrower is given three working days to cancel the contract if they wish.

Continuing disclosure applies to revolving credit contracts. Its timing depends on the length of the relevant "billing period" during which credit has been provided. If the billing period is 3 months or less, disclosure must be made within 20 working days after the end of the billing period. For periods over 3 months, disclosure has to be made within 45 working days.

The Credit Contracts Act requires the following information as part of continuing disclosure:

- opening and closing dates
- opening balance
- details of credit provided
- amounts paid
- charges not forming part of the cost of credit
- cost of credit
- interest rate
- closing balance.

5. ROLE OF THE ANNUAL FINANCE RATE IN DISCLOSURE

The intention of the Credit Contracts Act was to enable loans to be compared on the same basis. The major tool in the Act for doing this is the annual finance rate. This chapter describes how it attempts to promote transparency in consumer credit. (For technical details about the annual finance rate see Appendix Three.)

5.1 The annual finance rate as a standardised expression of the cost of credit

Before the Credit Contracts Act was passed, when lenders were not required to disclose the annual finance rate on credit contracts, there was a lack of uniformity in the methods used to indicate the price a borrower had to pay for credit. This made meaningful assessments of the cost of credit difficult for consumers – for instance, a loan with a flat interest rate always appears to have a lower rate than loans that use other interest methods. This problem is compounded if lenders are free to charge different fees (see Example 3).

Example 3

Which of A or B is the more expensive loan?

A. A loan of $1000 with an up front administration fee of $75 and 12 monthly repayments of $90.02; annual interest rate 14.5%.
B. A loan of $1000 with an up front administration fee of $50 and 12 monthly repayments of $94.17; annual interest rate 8%.

The finance rates of each loan are:

A. 29.7% (the interest quotation was accrued interest).
B. 33.3% (the interest quotation was at the flat rate).

The annual finance rate requires lenders to quote the cost of credit on a more uniform basis.

NB

It is important to note in this context that the annual finance rate is only a *measure*. Lenders are not required to *apply* the annual finance rate to calculate the amount of instalments or the outstanding balance on a loan. The annual finance rate assumes a distribution of interest and non-interest charges over the term of the loan, based on the formula in the Credit Contracts Act, but it does not in fact distribute those charges over the loan (such as in the event of early repayment). The finance rate can be used for this purpose, but a lender could also use the contractual interest rate, the Rule of 78 or some other method.

5.2 Annual finance rates as an aid to comparison-shopping

The annual finance rate is intended to assist consumers in comparison-shopping by giving an indication of the cost of credit that takes into account the amount and timing of all advances and payments under a loan, including interest and other charges. It has the following features:

- Provides a single measure of the cost of credit that may account for all charges that a consumer must pay in obtaining a loan. This helps the consumer to find the loan with the lowest cost, or choose between paying cash and obtaining credit.
- Systematically accounts for the timing of repayments and advances under a contract – thus indicating the cost of credit "per dollar outstanding per year". (Although to fully account for the time value of money, the finance rate would need to be calculated as an "effective rate" – see Appendix 4.)
- Provides an *objective* basis for comparing loans of different amounts and different durations.

Example 4 (following page) shows how the annual finance rate can be used as an objective means of comparison.

Example 4

A consumer is considering various finance options before purchasing a car. Information about the amount of the periodic repayments, the total amount of the repayments, and the total dollar cost of borrowing for each of two or more alternative loan options will not be a reliable indicator of their relative cost if the principal or duration of the loans is different. Suppose the consumer was given the following information about different loans offered by a lender . Each loan has an interest rate of 12%; an administration fee of $100 – added to the principal – and monthly repayments:

	LOAN 1	**LOAN 2**	**LOAN 3**	**LOAN 4**
Amount Advanced ($)	10,000.00	10,000.00	5,000.00	5,000.00
Payment Amount ($)	897.37	335.46	453.13	169.39
Term (Years)	1	3	1	3
Total Repayments ($)	10,768.47	12,076.72	5,437.55	6,098.15
Total Cost of Credit ($)	768.47	2,076.72	437.55	1,098.15
Annual finance rate	?	?	?	?

The available information about the different loans is not directly comparable because the loans are for different dollar amounts or lengths of time. The available information does not reveal the relative cost of Loan 3 (one year) versus Loan 4 (three years), taking into account the time value of money.

The total dollar cost of borrowing for each loan is known, but this does not tell the consumer how much each loan costs “per dollar outstanding per year”.

The interest rate does not tell the whole story either, because it does not account for the administration fee. Similarly, if the consumer wants to compare the cost of a loan for $5,000 with a loan for $10,000, the available information does not allow a direct comparison of Loan 1 or 2 with Loan 3 or 4.

However, with important caveats (discussed in section 6.2), the annual finance rate states the cost on a comparable basis and factors in the administration fee. When the annual finance rate for the four loans is disclosed, they can be arranged in the following order:

Loan 2 ($10,000 - 3 years)	12.7%
Loan 4 ($5,000 - 3 years)	13.4%
Loan 1 ($10,000 - 1 year)	13.9%
Loan 3 ($5,000 - 1 year)	15.8%

The annual finance rate has provided an objective measure of the cost of the different loans.

5.3 Annual finance rate as a warning

The annual finance rate may serve another useful function: it can act as a warning, or as a “red flag”, when the cost of credit is higher than the consumer is prepared to pay.[7] The annual finance rate may alert consumers to be cautious. For example, a lender may offer a contract with a low interest rate, but with high up-front fees. If consumers look at the interest rate alone, they may not fully appreciate the effect of these fees on the total cost of the loan. But when these fees are included in the total cost of credit and disclosed as part of the annual finance rate, the figure will be considerably higher than the interest rate and beyond what the consumer is prepared to pay. The annual finance rate may then signal a warning to the consumer.

[7] J Landers and R Rohner, (1979). “A functional analysis of Truth in Lending” *UCLA Law Review*, *26,* 711-752.

PART TWO

6. A CRITIQUE OF DISCLOSURE REQUIREMENTS

The previous two chapters examined some of the advantages of the Credit Contracts Act's disclosure regime – in particular, the benefits to consumers of disclosing the annual finance rate. In this chapter, a number of arguments are evaluated that question the usefulness of annual finance rates to consumers.

The main areas of concern about annual finance rates are that:
- they do not include all relevant charges
- they can be misleading in certain circumstances
- they are disclosed too late in a deal to be really useful for comparison shopping
- they do not suit modern credit products or the goal of pricing flexibility
- they make credit law over-complex
- they are not straightforward to interpret and poorly understood by consumers.

Also discussed in this chapter are some other criticisms of the current disclosure regime – in particular, the obscure drafting of credit contracts.

6.1 The types of charges accounted for by the annual finance rate

A fundamental question is what charges should be included in the finance rate? In answering this question, two important criticisms of the annual finance rate as drafted in the Credit Contracts Act are highlighted:
- The definition of incidental services and "benefits" in the Act is imprecise. This imprecision has received both judicial[8] and academic[9] comment – and has resulted in conflicting judicial authority on the classification of different types of fee. This increases uncertainty and provides scope for lenders to avoid full disclosure of the annual finance rate.
- Certain fees (such as brokerage fees or official fees) are not included in the annual finance rate. The more exceptions there are to being included in the annual finance rate, the less accurate and useful disclosure will be. This is because the annual finance rate will not reflect the full cost of borrowing.

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[8] *Elia v Commercial & Mortgage Nominees Ltd* (1988) 2 NZBLC 103,296 Gault J commented that the definition of incidental services was "unclear in scope".

[9] J Farrar, (1985). *Butterworths Commercial Law in New Zealand*, Wellington: Butterworths, at 253.

The position in the Credit Contracts Act

The Credit Contracts Act defines the charges that must be excluded in the finance rate on the basis that certain charges do not form part of the total cost of credit. These charges are listed in section 3 (3):

(a) Incidental services provided pursuant to the contract, and legal services relating to the contract, shall not be included as money's worth provided, or agreed to be provided, under the contract; and
(b) The following amounts shall not be included as part of the sum or sums of money promised to be paid in the future:
(i) Any reasonable amount payable for incidental services to the promisor, or for incidental services to any property sold or bailed under the contract or over which security is taken by or pursuant to the contract:
(ii) Any reasonable amount payable as a result of a default under the contract by the promisor:
(iii) Any reasonable amount payable as a result of damage to property while in the possession of the promisor:
(iv) Any reasonable amount payable for surveys, inspections, or valuations of property required for the purposes of the contract:
(v) Any reasonable amount payable for legal services relating to the contract (other than for the collection of money):
(vi) Any amount required to be paid by virtue of any enactment:
(vii) In the case of a contract of bailment where the bailee has the right to cancel the bailment, any amounts that cease to be payable under the contract upon the bailee exercising that right:
(viii) Any amount of a kind specified in regulations made under section 47(1)(a) of this Act.

The most important category of charge not included in the finance rate are “incidental services”. These are defined in section 2:

> "Incidental services", in relation to a contract, means benefits (not being benefits that consist of the provision of credit) such as, in the case of a contract providing for the security of money or money's worth by a mortgage, benefits that consist of the provision, by the mortgagee or any other person, of -
> (a) Mortgage repayment insurance paid for by the mortgagor (not being insurance under which the insurer has recourse against the mortgagor):
> (b) Life insurance:
> (c) Fire insurance:
> (d) Insurance allowed or required under section 39 of the Unit Titles Act 1972:
> (e) Services that would be undertaken for the protection, preservation, or maintenance of the property subject to the mortgage by a prudent owner of that property.

Incidental services are broadly “benefits” provided to the consumer as part of the credit contract. Insurance is given as an example only. “Benefit” means more than the ability to obtain the credit on offer (i.e. a charge does not provide a benefit just because paying the charge enables the borrower to obtain the loan).

6.1.1 Is the current annual finance rate a useful tool for consumers?

One way of assessing the usefulness of the current annual finance rate, as a tool for comparison shopping, is to see whether it includes all the charges a consumer needs to be aware so he or she can choose the least expensive credit deal.

The following 2-step test can help in making this assessment:

Step 1: would the charge have been incurred even if the consumer was paying cash?
If the answer to this first question is “no”:
Step 2: would the consumer almost certainly pay *exactly the same amount* for this service whatever type of credit they obtained?

If the first question is answered “yes”, the charge is not really a cost of obtaining credit. It is a cost of obtaining some other product, for example, freight costs. If the second question is answered yes, the charge is an unavoidable cost of credit and therefore “cancels out” across all deals.[10] Answering “*yes*” to either question suggests that the charge can be excluded from the annual finance rate without reducing its value to the consumer.

But if the answer to both questions is “*no”*, there is a strong case for accounting for the charge in the finance rate.

In the following section, the above test is used to determine whether the Credit Contract’s Act annual finance rate reflects the cost of borrowing in a way that is useful to consumers. Eight common credit charges are examined:

Interest
Interest charges are always included in the annual finance rate – and this is appropriate as these charges are always part of a credit deal and do not apply to cash purchases.

General non-interest charges: booking fees, application fees, administrative fees, service fees etc.
These types of fees are lump-sum charges that do not necessarily relate to a specific expense incurred by a lender in setting up a loan. Since these charges affect the cost of the loan to the consumer, they should be included in the annual finance rate. They meet the two steps of the “test”.

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[10] Including all the “inevitable” costs of credit may, however, assist the consumer to choose between obtaining credit to pay for a product or paying cash (or even deferring the purchase until they can afford to pay cash).

In most cases, under the Credit Contracts Act, such charges are likely to be included in the annual finance rate. (However, application or annual fees on charge cards are considered to be incidental services.[11])

Charges for setting up a loan that are paid to a third party
These types of charges relate to services provided by a third party in setting up the loan. Finder's fees are an example. It should make no difference whether the borrower pays the charge directly to the third party or is paid by the lender and then collected from the borrower. In either case, the charge affects the cost of the loan to the borrower (and will vary between loans) and so meets the criteria of the two-step "test".

Judges, however, have come to different decisions on this point in New Zealand,[12] making the position of these fees under the Credit Contracts Act unclear.

Brokerage fees
A brokerage fee affects the cost of a loan to the borrower, especially since these fees can be for sizeable amounts. A finance rate that did not account for a substantial brokerage fee would not be an accurate indication of the overall cost of the loan.

The Credit Contracts Act makes no reference to brokerage fees and market practice appears to exclude them from the finance rate, possibly because brokerage services are seen as a benefit to the borrower. However, the Ministry of Consumer Affairs would argue that the only benefit of paying a brokerage fees is that it enables the consumer to obtain credit. In this sense a brokerage fee is no more of a benefit than an application fee.

Official or statutory fees
Official fees are paid to public bodies for carrying out some service in connection with a loan – usually searching a public registry or registering a security. Under the Credit Contracts Act, official fees are excluded from the charges that must be included in the annual finance rate.

One possible reason for excluding official fees from the annual finance rate is that they are unavoidable and neutral between borrowers. For example, if a borrower will have to pay the *same* $25 charge for an official

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[11] As a result of the decision in *South Pacific Credit Card Ltd v Kay* [1986] 2 NZLR 578; the issue was whether an American Express card service was a credit contract. In his reasoning, Ellis J disagreed with the analysis of one of the authors of the Contracts and Commercial Law Reform Committee report on credit contracts. D Dugdale had submitted that the annual fee on an American Express Card was not an incidental service and therefore an American Express Card service should be regarded as a credit contract ((1981). *The Credit Contracts Act 1981*, at 22). Although the primary reason for the decision was that the annual fee on a charge card was an incidental service was because the literature provided to card holders was a *benefit*, it was also relevant to Ellis J's reasoning that the fees were flat charges and did not depend on the amount of credit provided. The effect of this decision is that charge card services are not credit contracts.

[12] In *Elia v Commercial & Mortgage Nominees Ltd supra*, Gault J held that procuration fees are a cost of credit; this case was distinguished in *Bagget v Samuel* (1990) 3 NZBLC 101, 534 [per Master Gambrill] where it was held that such fees were incidental and therefore not part of the cost of credit. The most important point of distinction appears to be that in the latter case the fees were paid separately and not deducted from the advance under the contract.

fee no matter who they get a loan from, accounting for that charge in the annual finance rate will not help in choosing between lenders. The effect of the fees is cancelled out.

Borrowers, however, may have a choice between a loan that will involve an official fee and a loan that will not. For example, a lender may make a special offer to pay the official fee. Or another lender may not require security (and so there is no registration fee), but instead charge a higher interest rate. In either case, including the official fee in the annual finance rate will make it a more accurate measure of the relative cost of loans.

Lenders also do not charge uniform amounts for actions such as registering a security. On the two-step “test”, therefore, official fees should be included in the annual finance rate.

Professional fees
Professional fees, such as legal fees, valuation fees and surveyors’ fees are more likely to be a feature of mortgage loans than of other consumer loans. These fees are excluded from the annual finance rate under the Credit Contracts Act.

The arguments here are much the same as for official fees. If payment of these charges is an inevitable expense of getting a loan, including them in the finance rate will not make the finance rate any more useful as a means of assessing the relative cost of different loans.

But, again, there could easily be situations in which the cost of the professional fees from one lender will not be the same as those from another lender. If the professional fees for the two loans are significantly different, including them in the annual finance rate gives a more accurate measure of the relative cost of the loans.

Practical considerations, however, may make it difficult to include information about professional fees in the annual finance rate. For instance, two lenders may require a property valuation. Lender A hires and pays for a valuer and then adds the cost to the amount outstanding on the loan. This lender always uses the same valuer, knows how much the valuation will cost, and can readily include that charge as part of the annual finance rate. Lender B requires the borrower to provide a valuation at the borrower’s own expense, using any qualified valuer. For this lender to include the valuation fee in the annual finance rate, they would either have to find out the valuation fee from the borrower or make an estimate.

Optional services
Consumers applying for credit are often offered a variety of optional services (or products). Insurance products are the most common optional service – but many other services or products can be offered as part of a loan agreement, including extended warranties.

There is no reason to include these services in the annual finance rate, if the charge really *does* relate to a valuable optional service provided to the borrower.[13]

Default insurance
While insurance that benefits the borrower should not be included in the annual finance rate, "default insurance" should be. This type of insurance protects the lender against the risk of default by the borrower. Borrowers only "benefit" from such insurance in that it allows them to get the loan. Default insurance meets the criteria of the two-step "test" for inclusion in the annual finance rate. The Credit Contracts Act excludes such insurance from the definition of incidental services, and so the premium is included in the annual finance rate.

In summary, a strong case can be made for including official and brokerage fees in the annual finance rate – although the Credit Contracts Act currently excludes them (a case can also be made for including professional fees). As well, some charges are ambiguous, because of judicial interpretation of the Credit Contracts Act.

6.2 Inherent limitations of the annual finance rate[14]

The annual finance rate has some inherent limitations as a concept:

(a) the best financial interests of consumers often depend on subjective considerations but the annual finance rate is an "objective" measure
(b) it does not provide a reliable guide that can be used by consumers without further interpretation
(c) no precise explanation exists of how consumers should interpret the annual finance rate
(d) many consumers probably do not have the reasoning skills to properly evaluate and interpret the annual finance rate.

Each of these points can be illustrated through examples. Example 5 (below) assumes that the annual finance rate takes account of all of the costs of a loan, and so is a perfectly reliable guide to the "objective" costs of different loans. Therefore, the most likely "rule of thumb" for interpreting the annual finance rate is: *choose the loan with the lowest annual finance rate*.

On its own, however, this rule of thumb would lead many consumers to act against their best economic interests – in particular, when deciding how much credit to obtain or the length of the loan.

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[13] It is often suggested that insurance products offered by lenders in connection with loans are overpriced, in that borrowers could get equivalent protection less expensively through an independent insurer. That may be so. But including the premium for insurance offered by the lender in the annual finance rate for a loan does not help the borrower compare the cost of the loan with the cost of other loans, nor does it help the borrower compare the cost of the insurance offered by the lender with the cost of comparable insurance from other sources.

[14] The argument in this section and examples 5 and 6 are based on R Bowes, (1997). "Annual Percentage Rate Disclosure in Canadian Cost of Credit Disclosure Laws" *Canadian Business Law Journal, 29(2), 183*-217.

Example 5

A consumer has $15,000 in uncommitted savings and wishes to buy a car for a cash price of $20,000. There is a minimum deposit of $5000. Should the consumer borrow $5000 ($15,000 deposit) or $15,000 ($5000 deposit)? The dealer offers one-year financing on the following terms:

- administration fee $150 (added to loan balance)
- annual interest rate 8.9%
- monthly payments.

The dealer discloses that the annual finance rate for the $5000 loan is 14.5%, dropping to 10.8% for the $15,000 loan. Using the annual finance rate and following the rule of thumb, the preferred deal is the loan for $15,000. The consumer could also pay back the $15,000 over three years, at the same annual interest rate and administration fee. The annual finance rate then drops to 9.6%. So, if the consumer believes he or she should choose the loan with the lowest annual finance rate, the best deal is to borrow $15,000 over three years.

In Example 5, the rule of thumb may have pointed the consumer in the wrong direction because in reality, it may well be in their best private financial interest to choose the loan for the lower amount and pay it off as quickly as possible.[15] This depends on the borrowers' subjective circumstances, thus illustrating point (a) above.

Point (b) can be illustrated by considering any loan which includes a fee: when the choice is between a short-term loan or a longer-term loan (given the same principal, interest rate and fee), the short-term loan will give a higher annual finance rate than the long-term loan. This is because the finance rate calculation will "spread" the fee over a longer period. The same effect applies with loans of different amounts: the fee will be a higher proportion of a smaller loan and will therefore result in a higher finance rate. Strictly, therefore, the annual finance rate is only a reliable guide to the cost of different loans when the loans are of the same size and duration (the amount of the repayments, the total amount of payments and the dollar cost of borrowing will serve as equally reliable guides to the cost of the loan in these circumstance).

There are further problems in comparing annual finance rates if a borrower has a "sunk cost" (such as a brokerage fee that will not be recovered) as part of the annual finance rate for a loan. Because the sunk-cost component cannot be got back, it must be disregarded when comparing the annual finance rate with that for other loans (see Example 6).

[15] As Bowes points out, "choose the smallest loan and pay it off as quickly as possible" is equally useful as a rule of thumb and would probably be recommended by most budget advisors; however, it is also not difficult to think of situations where a consumer should borrow a higher amount and pay it off slowly (perhaps to maintain a minimum savings balance).

Example 6

Two years ago, a consumer paid a $750 brokerage fee for a $25,000, five-year, second mortgage. The interest rate is 12.9%; the annual finance rate, including the brokerage fee, is 14.3%.

Another lender offers to refinance the remaining balance at an interest rate of 13.3%. This lender has no fees, so the annual finance rate is also 13.3%. As 13.3% is lower than 14.3%, should the consumer refinance?

The answer is no, because the annual finance rate on the existing loan includes the brokerage fee. The comparison should be based on the interest rate – not the annual finance rate – of the existing loan.

Therefore, the consumer must replace the rule of thumb which tells him or her to choose the loan with the lowest finance rate, with a new rule of thumb that states:

> *choose the loan with the lowest finance rate, but only if the loans are of the same amount and duration, any sunk costs have been disregarded and your private financial circumstances have been considered.*

6.3 Problems with the timing of disclosure

This section specifically looks at problems in timing the disclosure of the annual finance rate, but the analysis also applies to the disclosure by lender to borrower of cost-of-credit information generally.

If disclosure is to help consumers in comparison shopping for credit, it is essential that the information is disclosed sufficiently early for consumers to use it in making a decision.[16] Information provided to consumers who are already becoming locked into a particular deal will not help them in deciding whether to go ahead or not.

Transaction costs for consumers in obtaining information about the cost of credit need to be considered. For instance, if a consumer is looking for the best credit deal before buying a used car, they need to weigh up at a minimum:

- the duration of the loan and the repayment options
- whether to accept the insurance offered by the dealer or look elsewhere
- what deposit to make (or the amount of the trade-in)
- the security required by the lender.

It will inevitably require discussion with the lender before these details are settled. The consumer will have to undertake similar discussion with other lenders to find the most favourable credit deal. To actively comparison shop in these circumstances requires a considerable investment in time and effort[17].

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[16] See Landers and Rohner, *supra.*.

[17] Landers and Rohner argue that to comparison shop in these circumstances would be irrational, *supra,* at 717.

6.3.1 Timing of the annual finance rate under the Credit Contracts Act

By the time a consumer has signed or is about to sign a contract for a *fixed* credit contract, the lender is able to calculate accurately the annual finance rate. It is difficult to do it earlier, because the effect of a given fee on the annual finance rate cannot be worked out until all the details of the deal are known. Once all the payment terms have been settled and the annual finance rate disclosed, the borrower is likely to be psychologically committed to the contract.

The Credit Contracts Act contains a three day cooling-off period for the borrower once the annual finance rate has been disclosed. This allows the borrower to shop around for credit by comparing the annual finance rates for loans offered by other lenders and decide which one is the lowest. It seems unlikely, however, that consumers use the cooling-off period to comparison shop for loans – because of the significant transaction costs involved.

6.3.2 Disclosure of the annual finance rate in advertisements

An ideal time for disclosure of important information, such as the annual finance rate, is in advertisements. Consumers are likely to do much of their comparison shopping based on advertisements. The Credit Contracts Act[18] requires those lenders that advertise an interest rate to also advertise the annual finance rate, but only if it *can* be calculated at the time of the advertisement. Because the calculation of the annual finance rate generally depends on the particular loan being arranged, lenders rarely disclose the annual finance rate in advertisements.

6.4 Finance rates are not suitable for flexible credit products

The Credit Contracts Act does not require lenders to calculate the annual finance rate for revolving credit when those contracts include fees. (If there are no fees, the annual finance rate is equivalent to the annual interest rate.) Instead, the annual interest rate must be stated with a separate listing of the fees that the consumer may have to pay. The annual finance rate therefore cannot be used to compare fixed credit with flexible-credit products.

To calculate an annual finance rate for flexible-credit products, the lender would have to make assumptions about the amount of the advance(s) and the amount and timing of repayments.[19] Any calculations based on a particular set of assumptions will be of little relevance to a borrower whose borrowing patterns are different. In these circumstances, an annual finance rate is likely to be misleading. Yet, as noted earlier, flexible credit is becoming the norm in lending. The annual finance rate is therefore of limited usefulness for the most common form of consumer lending.

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[18] CCA, s. 36.

[19] Some jurisdictions require the calculation of an “annual percentage rate” in these circumstances – for example, Canada and the countries of the European Union.

6.5 The annual finance rate is inconsistent with pricing flexibility

The Ministry's first discussion paper, *Part1: Setting the Scene,* proposed a number of goals for consumer credit law. Two of those goals were effective disclosure and not restraining pricing flexibility for lenders. There is a tension between these two goals – and this tension affects the usefulness of the annual finance rate.

Annual finance rates are difficult to apply to products with variable interest rates because the exact cost of the loan cannot be known during its lifetime. For credit products with variable interest rates, the total cost of credit and the annual finance rate must be calculated as if the initial rate applied throughout the term of the loan. Where there is no initial rate, the lender must estimate the rate that is likely to be applied. Thus the annual finance rate is unlikely to be a fully accurate measure of the cost of the loan.

Loans with "honeymoon" periods are equally difficult to fit into annual finance rates. This is where the lender discounts its *fixed* interest rate for an initial period, before the rate switches to its prevailing *variable* rate at the time of the switch. It is impossible to accurately represent the cost of the loan as an annual finance rate, as the lender is obliged to make assumptions about the future.

These factors have meant that the annual finance rate has been criticised for only representing a "snap shot" of the cost of credit at the time a consumer enters into a loan.

6.6 Finance rates add complexity to New Zealand credit law

Credit law is inherently complex.[20] Requiring lenders to disclose an annual finance rate adds further to this complexity, while making it more difficult to draft, interpret, apply and enforce credit law. Adding to the complexity of the Credit Contracts Act is its First Schedule and the sections that deal with the annual finance rate.

Lying at the heart of this problem is that the real-life circumstances lenders must calculate and disclose an annual finance rate for are highly variable.

If the law tries to deal with every possible situation, the more complex it becomes. The provision in section 5 of the Credit Contracts Act that attempts to deal with contracts where the amount to be advanced is unknown is extremely complex.

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[20] The complexity of the Credit Contracts Act has long been acknowledged. When the Bill was debated this was a key focus, and Sir Geoffrey Palmer has been often quoted to the effect that one needed to wear a wet towel around one's head to read it. Professor McLauchlan describes the Act as "difficult and highly technical" but considers calls for brief and simple regulation to be "highly unreal" ((1984). "Contract and Commercial Law in New Zealand" *New Zealand Universities Law Review, 11,* 36-65). For equally complex consumer credit regulation, see the UK Consumer Credit Act 1974 and its associated regulations or the US Regulation Z.

On the other hand, if the procedure set out in the Act for calculating the annual finance rate does not address most variables, lenders will frequently encounter situations where the procedure is unclear. For example, the First Schedule of the Credit Contracts Act assumes all contracts have equal payment periods. The position of credit contracts with unequal payment periods (such as "no payments required for one year") is unclear.

6.7 The annual finance rate does not accurately reflect the "opportunity cost" of interest paid during the year

The Credit Contracts Act has been criticised[21] for requiring its annual finance rates to be expressed as a *nominal* annual rate rather than an *effective* annual rate. (See appendix 4 for a technical explanation of the difference between nominal and effective rates.)

The nominal rate represents interest as if it were paid in total at the end of the year. The effective rate method is a more accurate measure of the annual cost of credit to the borrower. This is because it takes into account that interest is paid during a year, thus recognising its "opportunity cost". For the lender, receiving interest at the end of each month is worth more than the receipt of twelve times that amount at the end of the year. The borrower, however, is worse off when interest is paid monthly, because the opportunity to use (or invest) the monthly interest is lost.

If the finance rate is to give the most accurate information possible to consumers, then it is argued that it should be expressed as an effective rate.

6.8 Limited consumer understanding of finance rates

There are no New Zealand empirical studies that measure consumer understanding of annual finance rates. Research elsewhere, however, suggests that there is little consumer awareness and understanding of the concept and that it has little effect on the behaviour of consumers.

American studies have attempted to measure consumer understanding of Average Percentage Rates ("APRs"). These rates are the equivalent of the annual finance rate – and the consensus of researchers is that consumers do not understand APRs.[22] Factors that influence consumers' understanding include education, the extent of the consumer's information search, seller-provided information, age and region. Some studies also suggested a positive correlation between levels of income and understanding of the APR.

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[21] E.g. Van Zijl (May 1983). "Defining the finance rate in the Credit Contracts Act", *The Accountants Journal*, cited in Consumers' Institute *The Reform of Consumer Credit in New Zealand,* August 1998 pp 42-44, which endorsed this criticism. See also Ministry of Consumer Affairs, (1988). *Consumers and Credit*; and S Baird (1999). "Consumer Credit Reform" *New Zealand Law Journal,* at 95-96.

[22] See J Lee and J Hogarth (1999). "The price of money: Consumers' understanding of APRs and contractual interest rates." *Journal of Public Policy and Marketing*. *18*(1), 66-76, and the references cited therein; for earlier studies see Landers and Rohner, *supra*.

American research is consistent with survey findings of the UK Office of Fair Trading, which tested consumers on their understanding of the APR[23] in a 1994 survey.

There seems no particular reason to believe that consumer awareness of the annual finance rate is any greater in New Zealand. One reason is that it is uncommon for advertisements here to refer to the annual finance rate on a credit contract. In the UK and the US it is mandatory for advertisements to refer to the APR, which is likely to raise consumer awareness of it.

Research has also shown that awareness of the APR/finance rate does not translate into understanding or alter transactional behaviour. This is not surprising. Interpreting the annual finance rate requires a sophisticated response by consumers.

6.9 Obscurely drafted contracts

Consumer groups have frequently criticised the consumer credit market for the obscure drafting of contracts. This was emphasised by the Consumers' Institute in a report that also surveyed the opinions of a number of community-based consumer advocates.[24] Such criticisms have led to calls for standardising the presentation of terms and conditions of credit contracts.

The Ministry of Consumer Affairs in its 1988 report on consumer credit highlighted the issue of overly complex contracts.[25] Since then, many contracts have improved in terms of plain English and readability. For instance, members of the Bankers' Association are committed to contracts that use "plain language to the extent that it is consistent with legal certainty".[26] Further improvements are likely, even in the cash-loan market, once the Personal Property Securities Act 1999 becomes law. This is because lenders will no longer be able to use standard-form contracts for secured loans based on the Chattels Transfer Act 1924. This Act is noted for its arcane language.

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[23] When asked which of four statements best explained the APR, only 11% of respondents chose the most appropriate answer: "you can use it to compare credit deals". 53% chose "it tells you how much interest will be charged", 25% did not know and the remainder chose incorrect answers. This indicated a low level of consumer awareness of the function of an APR. (Office of Fair Trading, *Consumers' Appreciation of 'Annual Percentage Rates'*, Research Paper 4, June 1994.)

[24] Consumers' Institute *supra* n. 21,at 42-44.

[25] Ministry of Consumer Affairs, *supra* n. 21, at 32-33, 39.

[26] *Code of Banking Practice*, Second Edition November 1996, clause 3.2.

In Chapter 9 a number of proposals are put forward for making the key disclosure information about a credit contract easier to understand by consumers.

7. DISCLOSURE REQUIREMENTS IN OVERSEAS JURISDICTIONS

This chapter discusses the disclosure requirements found in other countries. The American Truth in Lending Act is briefly looked at, as this Act is the model for the annual finance rate concept found in most consumer credit law. The Canadian Cost of Credit Disclosure Act is also discussed, as it was only recently recommended for adoption by all Canadian provinces.[27] A short discussion is provided of the UK Consumer Credit Act and the EU directive on consumer credit (which is based on the UK Act).

Most of the focus of this chapter is on the recent Australian Uniform Consumer Credit Code, as it was only recently adopted – and recently reviewed – and many lenders operate in New Zealand and Australia. The Ministry believes some elements of the Australian Code provide a way forward in developing a disclosure regime for modern consumer credit products.

7.1 United States

The most influential consumer credit statute is the US Truth in Lending Act. The Act, based on a bill first introduced to the US Senate in 1960, was passed in 1969. The concept of the "finance charge" (equivalent to the total cost of credit in the Credit Contracts Act) and the "annual percentage rate" (equivalent to the annual finance rate) were first developed in this Act.

When the Truth in Lending Act was passed certain fees (generally relating to insurance) were excluded from the annual percentage rate (APR). These exceptions were fairly limited and certain preconditions had to be met. Since then the Act has been amended a number of times – initially to simplify the disclosure regime and more recently to take account of more complex credit products. The Federal Reserve Board reported on the Act in September 1998[28] and recommended that the finance charge and APR should be retained, but that it should be redefined to include "all the costs the consumer is required to pay to get the credit". This recommendation, if implemented, would more or less return the APR to its original form.

[27] The Act is available on the Uniform Law Conference of Canada website at www.law.ualberta.ca/alri/ulc/acts/eccda.htm; it is accompanied by commentary at www.law.ualberta.ca/alri/ulc/acts/eccdcom.htm.

[28] This report can be downloaded at www.federalreserve.gov/boarddocs/RptCongress/tila.pdf.

7.2 Canada

Canadian provinces are all expected to adopt the Uniform Law Conference's Cost of Credit Disclosure Act, which was drafted in 1998. The Act maintains an approach to disclosure based around the APR. Lenders are required to disclose an APR for "open credit" (ie revolving credit) agreements (although not for credit cards) and for consumer leases. They are also required to disclose an APR (based on "representative transactions") in advertisements in certain circumstances.

In developing the policy behind the Act, the Canadian Consumer Measures Committee rejected the advice of the Alberta Law Reform Institute. The Institute had argued for abandoning the APR model[29] and had produced a Draft Act of its proposals for an alternative approach.

7.3 United Kingdom and Europe

The United Kingdom passed its Consumer Credit Act in 1974.[30] The Act and its regulations are detailed and complex. It follows the APR model, requiring lenders to calculate a hypothetical APR for certain "open credit" agreements and for advertising purposes.

The European Union requires all member countries to harmonise their consumer credit legislation with Directive 87/102/EEC. This directive is largely based on the UK Consumer Credit Act. APR calculations are required for credit card accounts.

7.4 Australia[31]

Australia has recently passed new consumer credit law that departs from the APR model found around the rest of the world. Australian legislation is of interest to New Zealand for several reasons. Both governments wish to harmonise trans-Tasman business regulation, and, as well, a number of lenders operate on both sides of the Tasman.

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[29] See Bowes, *supra*, and the commentary that accompanies the Act for background, *supra*. There is no evidence that the Consumer Measures Committee seriously considered adopting the Alberta Law Reform Institute draft Act. The policy proposals that underpin the Cost of Credit Disclosure Act are contained in an *Agreement for Harmonization of Cost of Credit Disclosure Laws in Canada*, Drafting Template, June 1998. This document is sparse on discussion and is perhaps a summary of existing consumer-credit policy in Canada, as reflected by the different provincial Acts, rather than an attempt at a new approach to disclosure requirements in consumer-credit legislation.

[30] The Act was reviewed in 1994: Office of Fair Trading, *Consumer Credit Deregulation: A review by the Director General of Fair Trading of the scope and operation of the Consumer Credit Act 1974*, June 1994.

[31] Much of this section is based on A Duggan and E Lanyon, (1999). *Consumer Credit Law*. Sydney: Butterworths.

7.4.1 The Uniform Consumer Credit Code

The Uniform Consumer Credit Code came into force in all Australian States by 1 November 1996. It has two goals:

- to facilitate truth in lending
- to promote product flexibility.

The basic approach is to combine maximum pricing flexibility with maximum disclosure. The overall aim is to encourage competition and comparison shopping – additional consumer protection is provided through reopening provisions.

7.4.2 Limited distinction between different forms of credit

The Code aims for a generic concept of a credit contract, avoiding distinctions – such as hire purchase, credit cards and so on – between forms of credit. As much as possible, forms of credit are treated in the same way. The distinctions that do remain are relatively insignificant:

- for disclosure purposes there is a distinction between sale and loan credit to the extent that land or goods financed by the credit contract must be described in the contract
- a "continuing credit" contract is defined, mainly for specifying how frequently statements of account must be provided
- consumer leases are regulated separately.

7.4.3 Regulating interest

The Code abandons the requirement for an annual finance rate. The "APR", as stated in the credit contract, is the annual interest rate and does not incorporate fees. The Code effectively prohibits flat-rate interest. It does this by limiting the amount of interest that can be charged on the outstanding balance of the loan to no more than what would be calculated on a daily-rate basis (see 9.2.2 for further discussion).

7.4.4 Regulating fees

The only restriction on the fees that can be charged for a loan is the requirement that establishment fees, early repayment fees and termination fees must not be "unconscionable". Reopening provisions allow the Courts to review whether these fees are unconscionable.

In deciding whether an establishment fee is unconscionable, section 72 requires the Court to consider:

> whether the amount of the fee or charge is equal to the lender's reasonable costs of determining an application for credit and the initial administrative costs of providing the credit or is equal to the lender's average reasonable costs of those things in respect of that class of contract.

A similar test applies to the reasonableness of early repayment and termination fees: the charges must not exceed a reasonable estimate of the lender's loss and/or administrative costs resulting from the early repayment.

The Code does not require any standard descriptions of credit fees and charges, nor does it define interest or fees. It facilitates maximum pricing flexibility for the lender – and has been criticised for overemphasising this at the expense of the Code's other goal of truth in lending.

Regulations may be made to prohibit fees or set maximum levels for them. As yet, no regulations have been made and none are proposed.

7.4.5 How disclosure works

Pre-contractual disclosure
The lender must give prospective borrowers a standard form before signing them up for the loan. The form is headed "Things You Must Know About Your Proposed Contract". The borrower also receives a pre-contractual statement containing relevant details about the contract – some of which are set out in a separate financial table.

The relevant details in the pre-contractual statement are:
- the lender's name
- the amount of credit
- the annual interest rate or rates
- how interest will be calculated
- the total amount of interest payable
- the amount of repayments
- credit fees and charges.

Contractual disclosure
The contract document sets out the information in the pre-contractual statement *plus* the following items:
- changes affecting interest, credit fees and charges
- frequency of statements of account
- default rate
- enforcement expenses
- whether security is taken
- payable commission
- insurance financed as part of the contract
- any prescribed information detailing the borrower's rights and obligations.

The contractual disclosure may be in the same format as the pre-contractual disclosure document. In practice, the consumer is likely to receive two copies of the contract.

Optional comparison rate instead of a calculated finance rate
While there is no requirement for lenders to disclose a calculated finance rate, the lender has the option of disclosing a "comparison rate" in its pre-contractual statements or advertising. The formula for this comparison rate is similar to the standard formula for the calculation of a finance rate.

Few lenders choose to disclose the comparison rate. This is because it makes their charges appear higher than those competitors who do not disclose the rate. If a lender chooses to disclose a comparison rate, it must be accompanied by a warning to consumers that the rate may be misleading.

7.4.6 Review of the Code

In August 1999, the Ministerial Council on Consumer Affairs completed a post-implementation review of the Code. Among the conclusions of the review were:

- In the interests of clarity, the pre-contractual disclosure requirements should be confined to essential financial and contractual information and presented in a standard table format. This table should alert the consumer to information contained in the contract, rather than attempt to disclose the current level of detail.
- The present large amount of information may confuse and intimidate a large number of consumers and ultimately obscure important financial information.
- It is unlikely that the pre-contractual disclosure document could be used for comparison shopping because of timing problems. The most positive current function of the pre-contractual information is to make the consumer aware of the costs and major terms of the contract they are about to enter.
- While many loan documents could be more user friendly, given the complexity and variety of credit products in the market, it is unlikely that standardisation of contracts would be possible or desirable. Some complexity is inherent in credit arrangements.
- Consumers should still receive accurate information about the credit deal that they are considering and the law should facilitate this as far as possible.

7.4.7 Lessons for New Zealand: an assessment of the Australian model

Strengths

The Code has been successful in allowing a greater degree of innovation by lenders (compared with the previous Australian regime) leading to more diverse products. This greater flexibility is largely attributable to the removal of the former prohibition on charging fees.

The Code requires lenders to adopt the most transparent method of calculating interest and effectively prohibits the flat-rate method, still used in New Zealand. There is consequently no need for either inaccurate and unfair statutory formulas (the Rule of 78) or relatively complex statutory formulas (the actuarial method) when calculating the outstanding balance of a loan if it is repaid early.

Problems

The lack of standardisation or definition of fees and charges makes it more difficult for a consumer to work out the effect of a particular fee when making a credit-purchasing decision. Further, some fees cannot be known at the outset of the contract; yet these must be disclosed “as far as ascertainable”. This can lead to uncertainty, and so lenders have responded with extremely detailed disclosures of mandatory and contingent fees.

Consumer advocacy groups in Australia have argued that there is a lack of transparency in consumer lending because of the sheer variety of fees that are now charged. They claim that most advertising focuses on initial interest rates – and this misrepresents the true cost of a loan, particularly when the advertised rate is a low-start rate.

Their suggested solution is a “comparison rate” to be disclosed in advertising.[32] This is similar to an annual finance rate. The final methodology is yet to be finalised for the comparison rate. Some disadvantages of this concept are discussed in Chapter 9 (section 9.3.1).

[32] See for example G Lekakis, “Breakthrough in fight for ‘real home rates’”. *The Australian Financial Review*. 4 October, 1999, p 5; H van Leeuwen, “NSW leads way in home loan consumer protection”. *The Australian Financial Review*. 21 October, 1999, p 10.

8. TRANSPARENCY ISSUES WITH EARLY REPAYMENT OF LOANS

Chapter 6 discussed the transparency issues that occur when a consumer enters into a credit contract. This chapter considers the transparency issues that arise when a borrower decides to repay a loan early. These two issues are related – and there is a specific focus on the information (or the lack of it) that borrowers receive from lenders about the financial effects of repaying a loan early.

8.1 The borrower's right to early repayment

The borrower has a right to early repayment of a *hire purchase* contract through section 22 of the Hire Purchase Act.

This right does not exist for any other forms of credit except for *mortgages* of land,[33] where a borrower may repay a mortgage early but becomes liable for the full amount of interest as if the mortgage had run its full term. In practice, mortgage lenders rarely exercise this right.

Whether the borrower has a right of early repayment in contracts other than hire purchase and mortgages, depends on the individual credit contract.

8.2 Charges for early repayment

In its annual report[34] for 1998/99 the Office of the Banking Ombudsman reported an increase in complaints about the cost of early repayment of fixed interest housing loans. Notably, a drop in interest rates during 1998 meant that some borrowers were keen to take advantage of lower rates by refinancing, but the cost of repaying existing loans made this exercise uneconomic.

The Banking Ombudsman concluded that in principle it is neither unlawful nor unreasonable for a bank to recover the cost of early repayment from its customers.

The Ministry of Consumer Affairs agrees with this – but asserts that, in the interests of transparency, borrowers should receive meaningful information on the financial effects of early repayment at the time they enter into the loan as well as when contemplating early repayment.

The Credit Contracts Act, however, does not require any specific disclosure by lenders about the cost of early repayment of a loan.

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[33] Under section 81(2) Property Law Act 1952.

[34] Office of the Banking Ombudsman, *Annual Report* 1998-1999, at 5.

8.3 Factors to consider in the early repayment of loans

When early repayment involves a cost to borrowers, this needs to be part of their decision-making process. These costs can take a number of forms:

- Administrative charges to cover ending the contract – for example, calculating the final balance and processing statements.

- An “early repayment adjustment”. These charges often relate to early repayment of loans with a fixed rate of interest. If a borrower repays early, the lender may have to relend its funds at a lower rate than the rate charged on the contract. The charge compensates the lender for any loss. There are a variety of methods that can be used to calculate an early repayment adjustment.

- Any statutory limitation on the amount of the rebate payable to the consumer. Under section 23 of the Hire Purchase Act, the borrower is only entitled to a 90% rebate on the amount of precalculated but unearned interest, thus, effectively pays the lender for 10% of this amount.

- The method used to calculate the amount of rebate to the consumer on the lender’s unearned interest when a loan is repaid early. This can be a hidden cost to the consumer. It occurs only when interest is calculated according to the flat-rate method. Interest is calculated in advance with this method, and so the lender must have a system in place to calculate the amount of the unearned interest (the “rebate”) to refund to the consumer. Some methods, such as the widely used “Rule of 78”, are inherently unfair, because the inaccuracy of this rule always benefits the lender.

These last two points are discussed in more detail in the sections that follow.

8.4 The 90% rebate rule under the Hire Purchase Act 1971

The Hire Purchase Act anticipated that most hire purchase contracts would calculate interest on a flat-rate basis. In the event of early repayment, the lender was given the right to retain 10% of the precalculated but unearned interest on the loan. The consumer’s rebate was limited to 90% of the precalculated interest still to be paid on the loan, plus the remaining principal instalments.

At the time of passing the Hire Purchase Act, Parliament accepted arguments from the finance industry that there were considerable documentation and administration costs in setting up hire purchase agreements. If these costs could not be recovered from those borrowers who repay early, they would be borne by all borrowers generally.

These setting up costs, however, could be recovered through a specific fee at the start of the contract – and this is, in fact, normal practice. Lenders could also be allowed to charge a fee for the specific costs of processing an early repayment. This would be more transparent and equitable because the size of this fee could be related to the lender's actual costs – in accordance with the principle of "user-pays". Like the Rule of 78, the 90% rebate rule can operate particularly unfairly for loans with long terms or high finance charges – in these circumstances, the amount charged by the lender will vastly exceed the reasonable costs of processing an early repayment (see Example 8).

8.5 The Rule of 78

When a lender uses the Rule of 78 to calculate the rebate for early repayment, this results in further costs for consumers. The rule is inherently inaccurate because it provides an *approximation* only of the interest owing at any particular point during the term of the contract. (The Rule of 78 is fully described in Appendix Five.)

As mentioned in section 8.3, any inaccuracy benefits the lender; the effects of this are more marked when contracts have high charges or long terms and if the loan is paid off quite early in its term. In some cases, despite payments having been made, the cost of paying off the loan early can be greater that the original amount borrowed (see Examples 7 and 8 on the next page).

The difference between the cost of early repayment calculated according to a daily rate or actuarial basis, and the amount calculated according to the Rule of 78 becomes, effectively, a hidden charge paid by the borrower to the lender. This charge does not relate to any particular administrative cost, and so it can be regarded as the lender's unearned interest. The consumer may not even notice the charge because it is buried away as part of the overall rebate calculation.

The same lack of transparency means that the borrower cannot weigh up at the *start* of the loan the effect of any charges for early repayment. Standard-form hire purchase contracts are not required to disclose early repayment charges, and most contracts do not draw to the borrower's attention the consequences of early repayment. Instead, they simply include a clause stating that early-repayment rebates will be calculated according to sections 22 and 23 of the Hire Purchase Act.

Use of the Rule of 78 can be abused and lead to further consumer detriment. If a loan is frequently refinanced, and the outstanding balance calculated using the rule, the lender is continually recovering unearned interest. This is a systematic practice in the US "marginal lender" market, where it is called "flipping", and has lead to restrictions on the use of the Rule of 78. The Ministry has not investigated whether similar levels of abuse take place in New Zealand.

The application of the Rule of 78 can have startling consequences, as the following two examples demonstrate:

Example 7

Amount advanced:	$8,000.00
Term:	1 year, 12 monthly instalments.
Monthly instalment:	$800.00
Interest rate:	20% flat rate (35.1% finance rate)
Cost of credit	$1,600.00

The borrower decides to pay off the balance of the loan during the 8th month of the contract, i.e. after 7 monthly repayments have been made, thus:

Total of payments made to date:	$5,600.00
Remaining 5 instalments:	$4,000.00
Rebate under Rule of 78:	$205.13
Balance required to repay loan:	$3794.87

Example 8

This example considers a longer loan at a very high interest rate. $8,000 is borrowed, repayable by 60 monthly instalments. Interest is required at the flat-rate of 40%

Amount advanced:	$8,000.00
Term:	5 years, 60 monthly instalments.
Monthly instalment:	$400.00
Interest rate:	40% flat rate (56.1% finance rate)
Cost of credit	$16,000.00

If the borrower wishes to pay off the balance of the loan during the 8th month of the contract, i.e. after 7 monthly repayments have been made, the result is as follows:

Total of payments made to date:	$2,800.00
Remaining 53 instalments:	$21,200.00
Rebate under Rule of 78:	$12,048.09
Balance required to repay loan:	$9,151.91

Although seven monthly repayments totalling $2,800.00 have been made, the cost of paying off the loan is greater than the amount of the original loan.

If, in this example, the lender claims 10% of the precalculated interest as a settlement charge, as entitled to under the Hire Purchase Act, the consumer loses a further $1,204.81!

8.6 Rule of 78 in overseas legislation

Most countries with similar consumer credit law to New Zealand have abolished or restricted the Rule of 78, or at least considered doing so. Lenders in Canada[35] or Australia[36] can no longer use the rule to calculate the outstanding balance on a loan. As was mentioned in the previous section, the US has also limited the extent to which it can be used by lenders.[37] In the United Kingdom, the Rule of 78 has been heavily criticised by the Director General of Fair Trading;[38] and the Office of Fair Trading and Department of Trade and Industry are currently formulating alternatives.

[35] The rules for calculating the outstanding balance are in the First Schedule of the Cost of Credit Disclosure Act.

[36] Use of the rule is inconsistent with section 26 of the Consumer Credit Code, which limits interest charges recovered by lenders.

[37] Truth in Lending Act §1615 (US).

[38] Office of Fair Trading, *supra*.

PART THREE

9. OPTIONS FOR REFORM

The previous chapters have identified serious limitations in New Zealand's current consumer credit law in terms of initial disclosure and the early repayment of credit. Reforms are necessary to fully promote transparency of disclosure for consumers in these two key areas.

The first chapter of this discussion paper stated five principles that any transparency regime should attempt to meet. These were:
- accuracy
- comparability
- presentational clarity
- conciseness
- timing.

This chapter now looks at various options for *initial disclosure* and *early repayment* of credit so that the transparency regime for consumer credit law can better meet these principles. No single approach can satisfy all five principles equally well, and so various options are presented on a number of issues. This helps clarify the trade-offs involved in developing a more effective transparency regime.

There are two main options for *initial disclosure*: reforming aspects of the Credit Contracts Act; or introducing some aspects of the Australian Consumer Credit Code, thereby moving away from both the annual finance rate approach and the goal of facilitating comparison shopping through lender to borrower disclosure. (Sections 9.1 and 9.2 discuss these options – and the modified Australian approach is developed in some detail.)

Timing of disclosure is an important issue. Various options are presented to make the time at which consumers receive initial disclosure more useful to them (section 9.3).

Documentation and presentation of disclosure information can be approached from either a flexible or a more prescriptive viewpoint. Both types of option are discussed – and a proposal for an innovative centralised disclosure regime is briefly investigated (sections 9.4 and 9.5).

The final section looks at how to standardise consumers' rights to repay credit early – and to make sure that both borrowers and lenders are not disadvantaged by early repayment.

9.1 Options for improving initial disclosure – reforming the Credit Contracts Act

9.1.1 Prevent lenders from imposing fees

Advantages

One option would be to prevent lenders from imposing fees. From a consumer perspective, transparency would be improved if lenders only charged interest:[39]

- the cost of credit could be compared solely on the interest rate
- credit law and contracts could be simplified, as there would be less need for statutory formulas and conventions.

Disadvantages

The advantages of this to consumers are more illusory than real. If a creditor had a single interest rate for all loans, with no ability to recover costs through fees, it would lead to market distortions. Borrowers of large amounts would effectively subsidise borrowers of smaller amounts, and long-term borrowers would subsidise short-term borrowers. This effect was noted by the Prices Surveillance Authority[40] in Australia in 1992 when it recommended lifting the prohibition on charging fees for credit card facilities.

Lenders might respond to a regime in which they could not charge fees with graduated interest-rate pricing – that is, different rates for different proportions of the balance of the loan, with the initial proportion attracting a higher rate. Another possibility is customised-rate pricing – lenders would charge different interest rates for loans of different amounts or terms, or a different interest rate for every credit contract. These practices would not improve consumers' ability to compare the cost of loans.

Most importantly, restrictions on fees would limit product development and inhibit the ability of lenders to develop differentiated products. This is because lenders could no longer match specific costs to specific services for meeting borrowers' needs.

9.1.2 Clarify the charges to be included in the finance rate

It was shown in section 6.1 that the total cost of credit and the annual finance rate are not necessarily accurate indications of the cost of credit: some charges that are definitely a cost of credit to the consumer are not included in the calculation of the annual finance rate. This limits the usefulness of the annual finance rate for consumers when comparison shopping.

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[39] This was the position in Australia under the Credit Act 1984 (NSW), which has been repealed by the Uniform Consumer Credit Code.

[40] Prices Surveillance Authority, *Report No. 45,* October, 1992, cited in E Lanyon, (1997). "Cassandra's Curse: Disclosure Under the Australian Consumer Credit Code", *Consumer Law Journal, 5*(6), 178-191.

The Credit Contracts Act could be redrafted to give greater clarity about what must be included in the annual finance rate.[41] Certain types of fee, such as brokerage, application and official fees, could be required to be included. Alternatively, all fees that *must* be paid by the borrower to obtain the credit could be a mandatory part of the annual finance rate.

Advantages
This reform would make the annual finance rate a more precise reflection of the cost of credit. Borrowers who compared finance rates when choosing between credit deals would have a better indication of the relative cost of different credit options.

There would also be greater clarity for lenders and less uncertainty over whether certain types of fees should be included in the annual finance rate. Current inconsistent judicial authority could be replaced by clearer statutory prescription.

There is no real disadvantage to lenders. There would be if lenders were required to apply the finance rate to calculate the outstanding balance on a loan: in the event of early repayment, lenders would have to give proportionate refund of the fees paid by the borrowers. However, as discussed in section 5.1, the finance rate is a measure only and does not affect the distribution of charges over the entire loan.

Disadvantages
Such a reform would not deal with the criticisms of annual finance rates concerning the timing of disclosure. Nor would it deal with the inherent limitations of finance rates: that they are not always effective when comparing loans of different amounts or time periods, or when comparing revolving credit with fixed credit; and they cannot take account of the subjective circumstances of the borrower. These points have been detailed in Chapter 6.

9.1.3 Disclose effective rates rather than nominal rates

Advantages[42]
From a technical perspective, the effective rate is more accurate to consumers than the nominal rate in stating annual finance or annual interest rates. It may therefore be more useful. The argument in favour of the effective rate method was outlined in section 6.7. In summary, it pointed out that the effective rate measures the time value of money – specifically the "opportunity cost" to the borrower of paying interest regularly throughout the year, rather than as one payment at the end of the year.

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[41] For a modern example, see the Canadian Cost of Credit Disclosure Act s. 2.

[42] See also the Report of the Contracts and Commercial Law Reform Committee, at 151-155.

The use of the effective rate allows for more accurate comparison of contracts that have different payment periods, although this is only really notable for comparisons between contracts where payments are made annually or half-yearly with contracts where payments are made monthly or for a shorter period.

Disadvantages
The most common argument against effective rates and in favour of adopting a nominal rate of interest has been that the latter is considered to be simpler to calculate. In fact, the effective rate method is no more complex than the nominal rate method – and in some cases it is simpler and more flexible, such as where there is not a uniform period between instalments, as with contracts that have “payment holidays”.

An argument in support of nominal rates is that they have been in use since before the passing of the Credit Contracts Act in 1981, and so there would be a significant cost in changing systems. In addition, Australian credit law does not require the disclosure of the effective rate. (Only the UK and Europe use effective rather than nominal rates.)

(See Appendix Four for a definition of nominal and effective interest rates.)

9.2 Options for improving initial disclosure – a synthesised approach

New Zealand could adapt the disclosure provisions of the Australian Uniform Consumer Credit Code. This removes the requirement for a calculated annual finance rate, but requires comprehensive pre-contractual and contractual disclosure of all fees and charges.

The Code was discussed in Chapter 7. It was clear from the commentary that significant improvements would be required if this approach to consumer credit were to be adopted in New Zealand without considerable cost. However, the Ministry of Consumer Affairs believes that some aspects of the Australian Code are worth considering in New Zealand to create a “synthesised” approach.

Features of a synthesised approach could include:
- no calculated annual finance rate
- a prescribed method for calculating interest charges
- a definition of interest
- regulated fees and charges
- reduced disclosure requirements.

9.2.1 No calculated annual finance rate

The experience, both in New Zealand and internationally, with calculated annual finance rates or annual percentage rates has been one of limited success. Inherent problems with the concept have also been identified.

There appears to be a reasonably strong case for abandoning the finance rate in New Zealand consumer credit law as it has major drawbacks in promoting transparency.

Even if this is so, the effectiveness of alternative regimes still needs to be properly assessed. It might also be feasible to continue to require disclosure of the annual finance rate on *fixed-credit* products. If this approach was taken, it would be necessary to assess whether the finance rate should be calculated using an effective or nominal rate and the range of charges that should be included.

9.2.2 A prescribed method for calculating interest charges

One important function carried out by the annual finance rate – standardised disclosure of interest charges – could be achieved if a provision similar to section 26 of the Australian Code was adopted here. This section[43] limits the interest that a lender can charge by specifying that it cannot be more than what would be calculated by applying a daily interest rate[44] to the outstanding daily balance of the loan; or by applying a monthly, quarterly or half-yearly interest rate to the average of all daily balances during the month, quarter or half-year.

There are a number of advantages to be gained from adopting the daily accrued-interest method:

- All lenders will be effectively required to use an accrued-interest method – making the flat rate of interest redundant.

- Accrued-interest methods are acknowledged by the finance industry[45] to be more accurate and flexible than flat-rate methods, particularly when payments are not made regularly or on time, or the loan is repaid early.

- The daily accrued-interest method is the standard method used by banks and finance companies for their consumer credit products. For the majority of lenders, then, there would be little or no transition cost in moving to this regime. For those lenders that still use the flat-rate method, computer programmes for these types of calculations are widely available at modest cost.

- Interest is never calculated in advance. Therefore, there is no need for formulas to calculate rebates when loans are repaid early. This simplifies credit legislation, and avoids the consumer detriment caused by the use of the Rule of 78.

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[43] This section is supplemented by clause 17 of the accompanying Consumer Credit Regulations.

[44] That is, the annual interest rate divided by 365.

[45] R. Cole and L. Mishler, *supra,* at 47, 86.

- It promotes transparency at the point of initial disclosure and throughout the life of the loan. At any time during the term of the loan the borrower can establish their position, and it allows a precise demarcation between the interest component and principal for each payment.

- It reduces the distinction between forms credit, because the same method of interest calculation would be used for both flexible and fixed credit (as flat-rate interest cannot be used for fixed-credit loans).

The main disadvantage of this option is that there would be a transition cost for lenders currently using flat-rate methods to calculate interest. These lenders would be required to change their computer programmes and documentation, involving some one-off expenditure. As already indicated, such expenditure is unlikely to outweigh the advantages to be gained from adopting the new approach.

9.2.3 A definition of interest

The Australian Code has been criticised for not defining interest.[46] Thus, for certain types of fee there may be confusion as to whether it is actually a fee or an interest charge, providing uncertainty for lenders and borrowers.

One way to reduce this uncertainty is to adopt a definition of interest, such as that used in the Canadian Cost of Credit Disclosure Act:

> "interest" means charges that accrue over time and are determined by applying a rate to an amount owing from time to time under a credit agreement.

This definition clearly distinguishes interest from other fees. It is also compatible with a requirement for lenders to calculate interest by the accrued-interest method.

9.2.4 Regulated fees

One criticism of the Australian Code is that the lack of restriction on fees, when combined with the abandonment of a calculated annual finance rate, means that consumers have no simple basis for comparing different credit contracts. This is made worse by the fact that there is no standardisation of terminology, so fees can be called by whatever the lender chooses.[47]

The four main options for regulating fees are set out below.

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[46] E Lanyon, *supra,* note 40, at 188-189.

[47] This has important implications for early repayment of a credit contract if lenders disguise their interest charges as fees. Lenders that load fees onto the front-end of a credit contract, by deducting the value of the fee from the amount of the advance, will receive immediate benefit for the fee. If a borrower repays the loan early, the lender retains the full fee. If the fee was a disguised interest charge – that is, not related to an actual cost – the lender is effectively receiving unearned interest from the early repayment. Such a practice would violate the principle that interest should not be generated in advance and could nullify any early repayment right the borrower has.

Option 1: a standardised description for all the fees that may be charged
This approach is followed in the US, which names the different types of fee for the purpose of calculating the APR (annual finance rate). It has proved difficult for regulators to keep up with market practice as new fees are introduced – which raises the issue of whether the substance or purpose of the fee should be regulated, rather than how it is to be described.

Option 2: name and describe the types of fees that the lender can retain in the event of early repayment
The Hire Purchase Act requires lenders to refund all “terms charges” paid in advance. “Terms charges” refers to the total cost of credit as defined by the Credit Contracts Act.

Option 3: allow the Courts (or Disputes Tribunal) to review fees against certain criteria
The Australian Code allows the Court to review establishment fees, early repayment fees and termination fees to decide if they are “unconscionable”. This has the effect of restricting the type of establishment, early repayment and termination fees that may be charged. For example, an establishment fee must relate to the cost of approving and setting up a loan.

Option 4: allow lenders to charge only certain types of fee
The Alberta Law Reform Institute and the Uniform Law Conference of Canada in a project on consumer credit recommended abandoning a calculated APR and instead setting some restrictions on the fees lenders can charge. Lenders could impose:
- permitted disbursement charges (such as a credit check, or registering a security)
- permitted flat charges not dependent on the exact amount borrowed (such as application fees, booking fees, account fees)
- permitted early repayment charges
- permitted default charges
- optional service charges (such as life insurance, or extended warranties)
- charges paid directly by a borrower to a third party.

The Institute’s recommendations were that all fees had to relate to one of these categories. Any fee that did not fall under any of the above headings was effectively prohibited. The Institute did not propose regulating the terminology describing the fees, but rather the substance of their purpose.

The most significant fee would be the flat charge. Lenders would only be able to charge one flat charge for fixed credit at the start of the loan. This was to compensate the lender for internal costs in administering the loan. The charge has no relation to the size or duration of the loan. Interest is used to charge the lender’s price for the use of their money over the term of the loan. Emphasis was given to disclosing the flat charge as early as possible, including in advertisements.

The disadvantage of this scheme is that it might be incompatible with current market practice (such as charging *ad valorem* fees) and could inhibit the development of new products.

9.2.5 Reduced disclosure requirements

Disclosure of too much information (information overload) has been identified as a problem with the Australian Code and the Ministerial Council recommended that simplified requirements be developed. The Council also concluded that disclosure did not result in consumers “shopping for credit”. These are significant problems, since disclosure has to be meaningful if it is to help consumers to assess a credit deal and choose the best loan for their individual circumstances.

The Ministry considers there are two practical options for disclosure regimes.

Option 1: require disclosure of specific information
Under this option, decisions are made about what information the consumer really needs to know in order to make an informed choice when faced with a particular set of terms and prices – the emphasis of disclosure is therefore not necessarily on comparability but on bringing key terms to the borrowers attention. There is a strong argument for not requiring the disclosure of fees that are purely contingent – for example, card-replacement fees and assignment fees. Such fees must be disclosed under the Australian Code.

The requirements of the Credit Contracts Act provide a basis for what might be disclosed. These specific requirements could include:

- the amount of credit
- the annual interest rate(s) and whether it is variable or fixed
- the amount and description of any fees that have to be paid to obtain the credit, as well as any fees that *will* become payable by the borrower over the course of the loan
- a description of any good financed by the lender and taken as security
- insurance and optional service charges financed as part of the contract
- any other security interest
- the particulars of any period during which interest is waived, or any interest-free period
- the type of charge the consumer is liable for if the loan is repaid early.

Other requirements may be of a lower priority:

- how interest will be calculated (this type of disclosure is inevitably complex, and so the value of requiring it is questionable)
- the total amount of interest charges payable (this may be practical for traditional fixed-interest and hire purchase loans, but more difficult for variable-rate credit products and impossible for flexible credit)
- the amount and timing of repayments (this suits fixed-interest credit and hire purchase but, again, is impractical for variable-rate and flexible credit products).

Another consideration is whether the same disclosure requirements should cover all credit contracts, or whether disclosure requirements should be tailored to special features of the credit transaction. That is, should credit sales, mortgage loans, cash loans and revolving credit be treated separately? It is likely that certain differences – such as the existence of security – should result in specific disclosure requirements for different types of credit. But, in general, a set of rules should apply to all forms of credit.

Option 2: a performance standard rather than specific requirements
This option assumes that:

- information disclosed by lenders to consumers does not result in comparison shopping – timing problems mean that the information is often received too late
- many consumers are not capable of evaluating disclosed information because of poor literacy
- regulating interest and fees, and the existence of a statutory cooling-off period, makes disclosure less important for consumer protection.

A performance standard would be developed for the drafting and presentation of contracts, while leaving the exact format and content of disclosure to the lender. The performance standard might include:

- that information must be in plain language
- that the information must not be likely to mislead or deceive the borrower
- that information about the cost of credit and any security taken must be displayed prominently
- that statutory warnings and rights (such as the right to repay early and the right to seek one's own insurance) are displayed prominently.

Performance standards give lenders considerable flexibility. They can also lead to uncertainty because the detail is less specific. Some lenders may over-compensate by disclosing too much information. From the borrower's point of view, it provides no guarantee that information from different lenders will contain the same content and format. It is therefore an abandonment of the goal of comparability as far as documentation is concerned.

Even if comparison shopping on the basis of comparability of documentation is an unrealistic goal for a disclosure regime, prescribed disclosures may be useful in bringing the key financial details to the attention of the borrower without imposing too much cost on the lender.

QUESTIONS FOR SUBMITTERS ON SECTION 9.1 AND 9.2

(a) Which is your preferred approach to disclosure:
- i) an approach based on the finance rate? Or
- ii) an approach which abandons the finance rate?

(b) If the requirement on lenders to disclose a finance rate is to be maintained:
- i) For what forms of credit (e.g. credit cards, fixed credit) should lenders be required to make the finance rate calculation?
- ii) On what basis should certain charges be included or excluded from the finance rate calculation?
- iii) Are there any charges which are currently not required to be included in the finance rate calculation that should be? (for example, brokerage fees)
- iv) Should the finance rate be calculated as a nominal or an effective rate?

If a requirement to disclose the finance rate is to be abandoned:

(c) Should a restriction be placed on the methods that lenders use to calculate their interest charges (as described in 9.2.2)?

(d) Should "interest" be defined, and if so, how?

(e) Which option do you support for the regulation of fees:
- i) A description in legislation of the fees that may be charged?
- ii) A description in legislation of the fees that may be charged, but only for the purposes of clarifying early repayment rebates?
- iii) A provision similar to Australian law, allowing the Courts to review fees for "unconscionability"?
- iv) Explicit restrictions on the fees that may be charged by lenders?

(f) Would you prefer prescribed disclosure requirements or a performance standard to regulate what is disclosed?

9.3 Options for timing

Timing of information is a notoriously difficult area in consumer credit. This section briefly considers various options for the timing of information to consumers about possible credit deals.

9.3.1 A comparison rate in advertisements

Advertising is perhaps the most obvious means for providing early disclosure of information, because information can be given to a consumer well in advance of a credit-purchasing decision. Some overseas jurisdictions oblige lenders that advertise to include an APR for a "representative transaction" or a range of representative transactions.

This is similar to the proposal currently being debated in Australia to require a "comparison rate".[48]

Although the proposal has not been fully developed, it appears the comparison rate might be based on the average cost for the average-sized loan of the particular lender and would be limited to fixed-term products.

Comparison rates, however, are likely to be misleading. For instance, the comparison rate will make longer-term loans appear less expensive than the average loan used in the comparison rate. This is because the effect of a fee on the comparison rate will be inversely related to the size and duration of the loan. The opposite effect will apply to loans that are of shorter terms than the average loan – they will appear more expensive.

Some borrowers may be better off borrowing a larger amount over a long period of time, while others may benefit from borrowing as little as possible and paying it off quickly. It is impossible for a comparison rate to capture such subjective considerations.

Advertising is de-emphasised as a disclosure medium under the Credit Contracts Act. The most important restriction is that the advertisement must not be misleading or deceptive in terms of the Fair Trading Act.

There might be a case for more restrictions on New Zealand credit advertisements. For example:

- the amount of any known fee could be more prominently displayed alongside the advertised interest rate
- where an amount is given for periodic instalments on a loan, the advertisement could also be required to refer to the annual interest rate or annual finance rate of the loan
- the use of fine print could be limited, particularly for television advertisements.

Interactive advertisements on the Internet could significantly reduce search and transaction costs for consumers when looking for the least expensive form of finance. It is likely that mainstream lenders will increasingly use the Internet for credit advertising, particularly as Internet banking develops.

9.3.2 Pre-contractual disclosure

Australia requires the lender to produce a pre-contractual disclosure statement that contains key information about the cost of the loan *before* any signing up can begin. The key financial information must be set out in the form of a table.

Pre-contractual disclosure is aimed at giving the borrower information to consider and, preferably, take away to compare with information provided by other lenders. Whether this happens in practice depends on the transaction costs involved in getting the information. It appears

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[48] See note 32.

unlikely that the lender would prepare a pre-contractual statement until the consumer appears to be committed to the transaction. In Australia, lenders have complained about the compliance costs in producing pre-contractual disclosure statements.

9.3.3 Cooling-off periods

The Credit Contracts Act has a three day cooling-off period, although it is doubtful that it is used for extensive credit shopping by consumers. Obtaining the relevant information from a range of lenders involves consumers in too high a level of transaction costs.

The cooling-off period, however, may perform a useful function by giving the borrower time to properly read and evaluate the contract, question its terms, seek advice, or reconsider the entire deal. Occasionally, it may prompt the borrower to explore other sources of finance. It is therefore consistent with the "warning function" of disclosure (see section 5.3).

If borrowers are given an unrestricted right to early repayment of a loan, then cooling-off periods may be less important. Consumers will have the ability to refinance at any point during the duration of the loan without penalty. The policy issues relating to early repayment are discussed fully in section 9.6.

QUESTIONS FOR SUBMITTERS ON OPTIONS IN 9.3

(a) Is a "comparison rate" for advertisements for credit, on balance, desirable?
(b) How might such a measure work and what do you see as its advantages and disadvantages?
(c) Are there any other restrictions that should be placed on the advertising of credit? Is the Fair Trading Act adequate for this purpose?
(d) Do you support a pre-contractual disclosure process? Why?
(e) Do you support a cooling-off period for credit contracts? Why?

9.4 Options for documenting and presenting disclosure information

This section briefly notes some options for improving the documentation and presentation requirements of credit contracts. Many products have complex terms and conditions – while stylistic devices can help make these more understandable, their impact on assisting consumers in choosing credit products may be relatively small.

9.4.1 Regulating for presentational standards

In the past, the Ministry of Consumer Affairs has put forward proposals for a Consumer Information Standard under the Fair Trading Act.[49] A standard could regulate such presentational details as font size, placement of financial particulars and other matters of presentation.

The Ministry no longer considers that a Consumer Information Standard is appropriate for consumer credit disclosure. This is because disclosure is inherently tied up with regulating substantive issues, such as the calculation of interest. The regulatory framework for specific disclosures should be contained in one Act and not shared with the Fair Trading Act.

The Australian Code requires the presentation of a "financial table", setting out key disclosure requirements. No guidance is provided on the format of the table. In its review of the Code, the Ministerial Council recommended adopting the prescribed table in the US Truth in Lending Act as means of informing the consumer of key terms and statutory rights. This table presents essential information in a concise form. It is a possible option for New Zealand – and an example is given in Appendix Six.

9.4.2 Model forms or templates

Legislation can contain model forms to encourage lenders to adopt a particular standard or disclosure format as an alternative to prescribed forms. The Hire Purchase Act has a model form in its First Schedule – although lenders must detail the particulars contained on the form, they only have to "substantially comply" with the format. As many consumer credit transactions fall within well-defined categories, model forms can be developed without major difficulty. The advantage for lenders is that if they comply with model forms they have met their statutory requirements.

9.4.3 Broad presentation guideline

The same goal may be achievable under a more flexible option. That is, to provide a broad presentational guideline. For instance, section 6(1)(b) of the Canadian Cost of Credit Disclosure Act states:

> Where a disclosure is required … to be made in a disclosure statement, the disclosure statement … must express the required information clearly, concisely, in a logical order and in a manner that is likely to bring the information to the borrower's attention.

[49] Ministry of Consumer Affairs, *supra,* n 21.

This type of approach sets a legislative objective without prescription, leaving presentation details ultimately to the lender.

QUESTIONS FOR SUBMITTERS ON 9.4

Which option, if any, do you believe will encourage lenders to write clearly formatted, plain language contracts:
(a) A consumer information standard made under the Fair Trading Act?
(b) A performance standard?
(c) Model forms or templates? How might this option work and what should they cover?

Are there any other options which might achieve this result?

9.5 A new approach to issues of format, content and timing of information: centralised disclosure

Section 9.2.5 considered setting a performance standard for the disclosure of contract terms. This was based on the assumption that direct disclosure of information by lenders to consumers does not result in comparison shopping – largely because of transaction costs and timing problems.

The approach to centralised disclosure discussed in this section also assumes that comparability is unlikely to be achieved through direct lender-to-borrower disclosure. It would be compatible with a model that emphasises less prescription in the presentation of contracts.

The core feature is a centralised, independent agency to collect data from different lenders about the cost of their individual credit products. Consumers shopping for the best credit deal could then access the agency, probably over the Internet, to receive comparative data about the credit available from many different sources. The information could be structured, including any calculations, so that is maximises comparability and accuracy (for example, it could disclose effective interest rates).

A similar model exists for the retail electricity market with the “Powerswitch” facility operated by the Consumers’ Institute over the Internet.

If necessary, the agency could be established by legislation. Lenders that participated could then be given reduced disclosure requirements, as disclosing directly to borrowers for comparative purposes is no longer necessary. This may provide an incentive for lenders to participate. Those lenders that did not participate may still be required to meet more detailed disclosure requirements.

Advantages
The main benefit of this system is that it would significantly reduce the search costs and timing problems faced by consumers in shopping for credit. It would simplify many of the current disclosure requirements for lenders. Practical problems about the inclusion of different types of fees in annual finance rates would be solved, if the agency disclosed them rather than the lenders directly. In an interactive system, consumers would be able to customise the information they receive by keying in their own preferences about the amount of credit, the frequency and amount of repayments and other details.

Disadvantages
The main disadvantage is that the agency would have to be established, administered, marketed, and funded. It is unlikely that a system would operate successfully if funded entirely by user charges.[50]

A system would have to be established for collecting data from a sufficient number of lenders. Some lenders, notably cash-loan companies, could be reluctant to provide information. Similarly, some groups of borrowers (those who access marginal lenders) might not have ready access to a centralised disclosure system based on the Internet. A centralised disclosure system will not create competitive pressure in this part of the market unless a significant number of "shoppers" use and access the system to search out the lowest prices and most favourable terms.

In summary, a centralised disclosure model offers many attractions for achieving transparency and the goal of comparability in consumer credit. It is an untested model, but the Ministry has raised it here in order to gauge the level of interest.

QUESTIONS FOR SUBMITTERS ON 9.5

(a) What are your views on a centralised disclosure mechanism for consumer credit?
(b) Is such a model realistic and what do you see as its advantages and disadvantages?
(c) How might such a proposal be established and funded?
(d) Do you foresee any problems in gathering data from lenders for centralised disclosure?
(e) If such a proposal was to be acted upon, what relationship should it have to the overall regulatory framework for consumer credit?
(f) Would participation in a centralised disclosure process justify reduced disclosure requirements for individual credit contracts?

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[50] This is because it is difficult for the seller to gain the full benefit of the information due to consumers free-riding on those who pay for the information. See A Schwartz and L Wilde, (1979). "Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis" *University of Pennsylvania Law Review, 127*, 630-682.

9.6 Options for the early repayment of credit

9.6.1 The consumer's right to early repayment

The right to repay credit early allows consumers to deal with a change in their personal circumstances and to protect their overall financial interests. Borrowers commonly make use of it when they decide to sell an asset purchased with credit, or if credit becomes available on better terms (such as after a drop in interest rates). A right of early repayment also promotes competition in the credit market, as consumers will have an incentive to search for lower prices during the term of a loan.

There is no reason why borrowers should be given a right of early repayment for hire purchase contracts but not for other forms of fixed credit. For example, there is no difference in substance between a borrower who obtains a fixed, secured loan from a bank to buy a good, and another borrower who buys the same type of good on hire purchase.

Currently, one of these forms of credit includes a statutory right to early repayment and the other does not. The Ministry of Consumer Affairs' view is that consumers should have a general right to early repayment for all forms of credit, including mortgages.

9.6.2 Methods for calculating rebates of flat-rate interest

The issue of devising a fair formula for rebate calculations is redundant if a limitation is put on interest charges by using daily-rate interest calculations. This is the method used in the Australian Consumer Credit Code – and it effectively eliminates the need for rebates on loans where interest was calculated by a flat-rate method (section 9.2.2 has discussed this point in some detail).

If such a proposal is not adopted, however, there are two choices:

- the current rule of 78
- the actuarial-formula method.

Rule of 78

Chapter 8 analysed the serious disadvantages for consumers resulting from the use of the Rule of 78 by lenders. For these reasons, the Ministry of Consumer Affairs believes that New Zealand should follow the example of similar countries and prevent lenders from using the Rule of 78 in calculating early-repayment rebates.

Actuarial formula

An actuarial formula provides a more accurate and equitable calculation of the rebate on the balance outstanding than the Rule of 78. The principle of the actuarial method is that the borrower's payment on ending the loan early should result in them paying finance charges at the same rate over the shortened term as they would have done over the full term of the loan. (See Appendix Five for more detail on the actuarial method.)

Provision could be made for lenders to recover any unpaid portion of the costs in setting up the loan. Some of the possibilities for doing this are discussed in the next section.

9.6.3 The borrower's liability for early repayment

The issue here is what extra charges (if any) should the borrower have to pay for early repayment – apart from the credit charges still to be paid at the date of repayment. There are three main approaches.

A full refund of all costs
One option is to allow the consumer the right to a proportional refund of all credit charges – including establishment fees – paid up to the time of repayment. This policy is followed in Canada for non-mortgage credit.

This policy could be expected to result in lenders being reluctant to offer long-term, fixed-rate loans. In such circumstances as these, it would mean that the cost of early repayment will not be borne by the borrower repaying the loan, but instead will be borne by all borrowers through higher interest charges. This type of policy will therefore have undesirable costs.

An administrative charge
Lenders may want to charge an administrative fee to cover the cost of processing the early termination of the loan. This seems unobjectionable in principle, and is certainly more transparent than the current rule in the Hire Purchase Act that allows the lender to retain 10% of the unearned interest. Such a charge is likely to be for a small amount, but there may have to be similar provisions to the Australian Consumer Credit Code to the effect that any administrative costs of this kind must be reasonable.

Compensation for the lender's loss
Compensating the lender for loss comes about when a borrower makes an early repayment of a loan with a fixed-interest rate. If interest rates at the time of repaying the loan are lower than the interest being paid on the loan, then the lender suffers a loss.

The Ministry believes the lender should be able to recover this loss from the borrower. Otherwise, long-term fixed-interest loans could become problematic if borrowers can end a loan at will (when interest rates change) and refinance it elsewhere.

The two most equitable approaches appear to be:

- prescribe lenders a formula with which to calculate their lost future interest
- allow the Courts to review the fees charged by lenders for early repayment.

These rule out the current provisions in section 23 of the Hire Purchase Act and section 81(2) of the Property Law Act.

Option 1: Prescribing a formula for calculating lost future interest

Three common methods used by lenders to calculate their lost interest are:

- a flat charge in dollar terms, or a number of months' interest at the contract rate for the loan
- a charge calculated as the 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 relent for the remaining term at current interest rates
- an actuarial calculation based on the rate at which the lender can borrow money in the money market – this method is likely to be used by banks.

Not all lenders will use the same method, and so a standardised formula may not suit the different circumstances of different lenders.

Option 2: Courts (or Disputes Tribunal) to review fees charged for early repayment

This would be an equivalent system to what happens under the Australian Code. It allows a Court or Disputes Tribunal to review a fee to make sure it does not exceed a reasonable estimate of the lender's loss resulting from the early repayment. This approach accepts that it is reasonable for lenders to recover lost "future interest" on the contract, but remains flexible about how the lender makes the calculation.

QUESTIONS FOR SUBMITTERS ON 9.6

(a) What right, if any, should the consumer have to early repayment of a credit contract?

(b) If lenders are to be permitted to calculate interest by the flat-rate method:
   - i) Should lenders be permitted to calculate rebates with the Rule of 78?
   - ii) Or should lenders be required to use an actuarial formula?

(c) What should be the borrowers liability on early repayment?
   - i) No liability (i.e. a full refund of charges)?
   - ii) For an administrative charge only?
   - iii) To compensation for the lenders loss?

(d) If consumers are liable to compensate a lender for its loss on early repayment, what protections, if any, should be put in place to ensure any charge is reasonable?

GLOSSARY

Key terms are marked in bold, with synonymous terms included below.

Accrued interest method Simple interest in North America	Calculates interest charges by applying an interest rate for a specific period (usually daily or monthly) to the balance outstanding on a loan during that period. The interest charge is then added to the outstanding balance.
Actuarial Rule	In relation to the early repayment of a loan, a method of calculating a rebate of precalculated interest. It calculates the present value of future instalments under a loan contract.
Advance	A transfer of value from lender to borrower – that is, the amount of a loan (or loan instalment) extended to a borrower or the cash price of a good sold in a credit sale/hire purchase deal.
Annual effective rate of interest True rate of interest	The expression of an interest rate for a period of less than a year as an annual interest rate – the annual "effective" interest rate is an exponential function of the period interest rate taking into account the timing of loan repayments during the year.
Annual finance rate Annual Percentage Rate – APR	A standardised calculation that incorporates interest and other charges to show the total cost of the loan over the entire loan term. It does this by relating the amount and timing of payments to the amount and timing of advances. Also used to express the *total cost of credit* as an annual percentage rate.
Annual nominal rate of interest	The expression of an interest rate for a period of less than a year as an annual interest rate – the annual nominal interest rate is found by multiplying the period rate by the number of periods in a year.
Borrower Debtor	The person who is liable for the debt arising from a loan.
Consumer Credit Code	Australian consumer credit legislation. The Code became law in all states in November 1996.

Term	Definition
Continuing disclosure	Disclosure made pursuant to a revolving credit contract, at the end of each billing period. It discloses the credit provided and the charges incurred by the borrower during the billing period.
Cost of Credit Disclosure Act (CCDA)	Consumer credit statute drafted by Uniform Law Conference of Canada in 1998 and expected to be adopted by all provinces.
Credit	The right granted by a lender to a borrower to defer payment of debt, incur debt and defer its payment or purchase property and services and defer payment.
Credit Contracts Act 1981	Key statute that regulates the provision of credit in New Zealand
Daily-rate interest method	Calculates interest applying a daily interest rate, usually 1/365th of the annual interest rate, to the daily outstanding balance.
Early repayment	Payment of a loan in full before its agreed term has run its course.
Fee	A specific charge made for the use of credit, which is not an interest charge.
Fixed credit Instalment credit	Credit of a “fixed” known amount, with the amount and timing of all payments agreed at the start of the loan.
Flat-rate method Add-on interest	The amount of interest is calculated on the original amount of the loan for the whole term of the loan, rather than on the outstanding balance from time to time.
Grace period	A period under a credit contract during which interest on the outstanding balance, or a purchase, is waived so long as the balance or purchase price is repaid during that period. Cf. interest free period.
Guarantee disclosure	Disclosure under the Credit Contracts Act which is required to be made to guarantors of a credit contract.

Hire purchase	An agreement under which possession of goods is given either on the basis of a hiring with an option to buy, or as an agreement to purchase by instalments. Ownership in the goods does not pass to the purchaser until payment has been made in full.
Honeymoon interest rate Low-start rate or initial interest rate	A discounted interest rate applied for the first few periods of a loan, which may be a marketing device to attract borrowers.
Initial disclosure	Disclosure at the time that the credit contract is first entered into (or no later than 15 days after).
Interest charges	Charges for the use of credit; usually computed as a rate applied to the outstanding balance from time to time, or as a proportion of the original amount of the loan.
Interest free period	A period during a credit contract during which the outstanding balance does not accrue interest. Cf. grace period.
Lender financier credit provider	The party which extends credit to a borrower; or to which, under an agreement, credit is owed.
Modification disclosure	Disclosure required after the terms of the credit contract have been modified by the lender (although this does not refer to the lender exercising a power under the contract).
Outstanding balance	The total amount owing at a particular time during a credit contract.
Period	A period of time between instalments, such as monthly, daily, semi-annually, annually etc.
Period rate of interest	A rate of interest that is applied to the outstanding balance of a loan during a specific *period*.
Present value	The current "money's worth" of an amount due in the future. The present value is determined by discounting the amount due by a rate (eg the interest rate). If a sum equal to the present value was invested now at the given rate, it would accrue to the specified future amount at the future time.

Principal	The amount of credit that has been extended, but not including interest or other charges.
Rebate for early repayment	The return of a portion of the total *flat-rate interest* included in a *fixed loan* when it is repaid early.
Repayment Instalment Payment	The amount of a payment under a loan. It is applied to interest, other charges and the balance of the loan.
Request disclosure	Disclosure of finance information on the contract, made pursuant to the written request of the debtor.
Revolving credit Open credit Continuing credit	A credit agreement that anticipates multiple advances and repayments – these are made at the request of the borrower and not according to a fixed schedule. There will usually be a credit limit and a required minimum monthly payment.
Rule of 78	An method used to calculate the amount of the rebate of flat-rate i*nterest* when a fixed-term loan is repaid early.
Search cost	The time and effort spent in discovering the terms on which goods or services are available in the market. A type of transaction cost.
Total cost of credit	The total amount that a borrower must pay for credit over the course of a loan. It includes all interest and fees, but does not include incidental services or the amount borrowed.
Variable interest rate	An interest rate on a loan that may be adjusted (raised or lowered) periodically by the lender.

APPENDIX ONE

The lender's costs and how they are recovered

Lenders incur costs in respect of any credit contract. These relate broadly to the following:

(a) Costs directly associated with the acquisition or use of finance, including the servicing of a lender's borrowed funds.

(b) Setting up costs directly associated with a particular credit contract, which arise before or at the outset of the agreement. Such costs may include the following:
- legal costs
- brokers fee and commission
- documentation costs
- credit reference agency and public record searches
- registration of a security.

In effect, when advancing a $10,000 loan, the lender commences the agreement with an outlay of more than $10,000. Some setting up costs may be recovered by consequent charges to the borrower to be paid at the outset of the agreement or added to the principal and the borrower charged interest until the costs have been fully recovered. Others may be incorporated in the lender's interest rate and recovered over the life of the agreement.

(c) Other general costs arising before or at the outset of the agreement. These costs might include:
- business set up costs
- advertising and other marketing costs
- ongoing administration costs including staff costs, accommodation costs and overheads etc.

(d) Costs associated with the ongoing maintenance of a lender's records, including the application of repayments and interest charges.

(e) Default costs. These are the costs that a lender incurs on default of a borrower and include:
- administrative costs
- repossession and enforcement costs
- the amount that is unrecovered after repossession and enforcement.

Costs on settlement can be further distinguished according to whether the contract was settled early:

(f) Administration costs which would have been charged whenever the account was closed, such as:
- processing the termination of the account
- notifications to public records or credit reference agencies.

(g) Administration costs arising on early settlement which would not arise if the loan were to run its course. For example:
- processing of settlement statements
- other administrative costs of closing the account early.

However, these costs may be offset by future costs avoided, eg the administration costs of issuing further statements and maintaining accounts and the removal of the risk of default.

(h) Costs involved in relending loaned money repaid early.

(i) Lost future interest. If interest rates fall, borrowers may wish to repay early, even if they need to refinance. Potentially, however, if rates have risen, lenders can re-lend at a higher rate and gain future interest, but note that borrowers may be less likely to settle under these conditions.

These costs can be recovered from the borrower through interest or fees, depending on the pricing structure used by the lender. If lenders are free to structure their loans in anyway they please they are likely to do so as follows:

- The costs referred to in (a) are directly related to the cost of funds and will be included in the interest rate.

- Costs falling under (b) above are specific to the loan in question: it is likely that any sums which are not recovered by requiring the borrower to pay them at the outset of the agreement will be added to the balance of the loan granted. The lender will then recoup these costs as part of the borrower’s repayments, receiving interest for the delay in their recovery and, on early settlement, any unrecovered element as part of the outstanding balance.

- Costs falling within (c) above are not specifically related to an individual loan and likely to be treated s as overheads on the generality of the lender’s business—or the cost of funds—and recovered through the interest rate charged on the loan.

- Costs relating to (d) are most likely to be recovered in the interest charge, but could also be recovered through fees.

- Costs that fall within (e) are recovered from the individual defaulting debtor to the extent possible. This is attempted through the realisation of security, late payment fees, wage garnishments and Court enforcement. That proportion of default costs not recovered from the individual debtor may be recovered as part of the interest rate on all loans, again reflecting the lender's cost of funds.

- Costs that fall within (g) are related to an individual loan. It may therefore be appropriate to recover them by a fee levied on early settlement or by the deduction of such costs from any rebate, as also for costs under (f).

- Costs falling within (h) and (i) are related to the circumstances surrounding a loan at the time of settlement. Common practice in the New Zealand consumer credit market is for a lender to levy a prepayment fee, sometimes called an "Early Repayment Adjustment", when consumers seek to prepay loans on fixed rates of interest.

APPENDIX TWO

"Accrued" interest

Example one: a fixed schedule loan with interest calculated simple basis

This example is further to Example 2 on page 18 and describes how it is calculated. We recall that Lender X offers a $1000.00 loan at an annual interest rate of 16.95%. The monthly rate is $\frac{16.95\%}{12}$ which is 1.412%. This rate is applied to the outstanding balance each month.

The term of the loan is 6 months and instalments are $175.00 per month. The instalments can be calculated easily on a spreadsheet[51] or financial calculator. The following is the repayment schedule:

Payment Number	Interest	Payment amount	Principal reduction	Balance outstanding
0				1000.00
1	14.12	175.00	160.88	839.12
2	11.85	175.00	163.15	675.97
3	9.54	175.00	165.46	510.51
4	7.21	175.00	167.79	342.72
5	4.84	175.00	170.16	172.56
6	2.44	175.00	172.56	0.00

The outstanding balance at the end of the first month is calculated as –
loan + finance charge $1,000 x 1.412% – instalment $175 = $839.12

At the end of the second month –
$839.12 x 1.412% – $175 = $675.97

and so on until the loan is fully repaid at the end of the contract.

[51] The formula on a Microsoft Excel spreadsheet is simply [=PMT(0.0141,6,-1000,0,0)]

APPENDIX THREE

The finance rate: general

In general terms a credit contract may be considered as a series of cash flows. The outwards cash flow (from the perspective of a lender) is the amount(s) of the advance(s), and the inwards cash flow is the specified repayments at specified future times, as stated in the contract. The finance rate is that rate which equates the present value of the amount(s) of the advance(s) to the present value of the repayments. Some people are familiar with this concept as an "internal rate of return", or "discounted cash flow".

To begin with some expressions and symbols for the purpose of generating formulae for various contracts are defined. The expressions and terms in italics are as defined.

Advance	the amount of an advance of credit
Repayment	the amount of a repayment, under the terms of a contract, regardless of whether it represents part of the advance or a charge (as defined by "total cost of credit" in section 5 of the Act)
Payment	the amount of an *advance* or *repayment*
Interval	the period between *payments*, for which an period rate is calculated, before being converted to an annual *finance rate*
t	the time of a *payment*, measured in *intervals*, time zero being the date on which the first *advance* is made
A_t	the amount of an *advance*, at time t. Any charges payable before the date on which the first *advance* is made shall be deemed to be made at time zero.
A	the amount of a single *advance* at the commencement of a contract, ie at time zero
R_t	the amount of a *repayment*, at time t
R	the amount of a level *repayment* throughout the term of a contract
fr	the finance rate, expressed as a percentage per annum
a	the period rate, expressed in relation to the *interval* between *payments*, which is used to determine the *finance rate*. The period rate is expressed as a rate per unit of the amount to which it is deemed to be applied
i	as for a above, but used for the period *interest* rate, not the period *finance* rate (references to a can be interchanged with i where interest is the only charge being considered)
m	the number of *intervals* in a year
n	the number of intervals in the term of a contract
v^t	represents the present value of an amount of 1 due at the end of t periods i.e.:

Formula (1)

$$v^t = \frac{1}{(1+a)^t}$$

Finally, a reminder regarding summation notation:

$\sum_{t=0}^{t=n} A_t$ Denotes the sum of the sequence of values A (ie t=0) to A_n (ie t=n) and is shorthand for the expression $A_0 + A_1 \ldots + A_n$.

The General Formula for a Credit Contract

The general formula for all credit contracts, expressing the equivalence of the values of advances to the values of repayments, is:

Formula (2)

$$\sum_{t=0}^{t=n} A_t \times v^t = \sum_{t=0}^{t=n} R_t \times v^t$$

This formula can be applied to any contract to determine the finance rate when the amount and timing of advances and repayments are known. For example:

Example 9

Consider a loan of $1,000.00 repayable by 6 monthly instalments of $175.00, due at the end of each month, and an establishment fee of $30.00 charged at the commencement of the contract. The equation for determining the finance rate for the contract becomes:

$1{,}000.00 \times v^0 = 30.00 \times v^0 + 175.00 \times v^1 + 175.00 \times v^2 \ldots + 175.00 \times v^6$

Given the amounts and timing of the advance(s) and the repayments, the evaluation of v in such a formula will give the discount factor applied in each period. In Example 9, v^1 is equal to 0.9774. Restating formula (1) as:

$$a = \frac{1}{v} - 1$$

we can calculate the period rate, a, as 0.02312.

However, to calculate a or v, requires knowledge of one or the other variable. If neither is known, to make the calculation you must guess a or v, calculate the present values of each repayment, check if they add up to the loan, if not, adjust your guess, and start again. This process is called *iteration* and is likely to be performed by a computer.

Example 9 continued

The operation of the finance rate for this contract can be illustrated by the following amortisation table. The finance charge is calculated by multiplying the balance outstanding by 0.02312.

Payment Number	Finance charge	Payment amount	Principal reduction	Balance outstanding
0		30.00	30.00	970.00
1	22.43	175.00	152.57	817.43
2	18.90	175.00	156.10	661.33
3	15.29	175.00	159.71	501.62
4	11.60	175.00	163.40	338.22
5	7.82	175.00	167.18	171.04
6	3.96	175.00	171.04	0.00

The finance rate for a contract is defined in section 6 and the First Schedule of the Act as a nominal rate, expressed as a percentage rate per annum. The finance rate, "*fr*", can therefore be determined by the formula:

Formula (3) $fr = a \times m \times 100$

In Example 9, the finance rate is 27.75%, which would normally be rounded to 27.7%.

The finance rate under formula (2) can be very difficult to determine, even with the aid of a computer. Under complex contracts that may be the only way of determining the finance rate. However, under certain repayment conditions, the general formula may be simplified somewhat:

Formula (4) $A = R_0 + R \times \frac{1 - v^n}{a}$

This formula applies to the situation of a contract with equal instalments (R) due at the end of equal intervals, with an up-front fee (R_o).

The operation of the finance rate

The concept of the finance rate bears no relation to the manner in which interest and fees are calculated and charged under a loan. Using the amounts of the specified advance(s) and repayments, the finance rate represents an equivalent interest rate under the contract (taking into account all elements of the cost of credit) as if the interest was the only charge.

The finance rate and the Credit Contracts Act

The forgoing discussion considered the mathematical concept behind the finance rate. Now we discuss its relationship with the Credit Contracts Act.

The finance rate is defined in section 6(1):

> (1) In this Act, the term "finance rate", in relation to a credit contract, means the rate that expresses the total cost of credit as a percentage per annum of the amount of credit and that is—
> (a) The annual finance rate, as defined in the First Schedule to this Act, for that contract (which may be rounded to the nearest quarter of one percent); or
> (b) A rate that is correctly derived or calculated from tables, or in accordance with a formula, prepared and published by the Government Actuary for the purposes of giving the annual finance rate (as so defined) for that kind of contract.

Subsections (1A) and (2) deal with contracts where some of the variables are unknown.

The Act does not specifically prescribe how the finance rate should be calculated, however, the formula in the first schedule to the Act makes it possible to confirm that the finance rate has been calculated correctly. The schedule states:

> 2. **Definition of "annual finance rate**"—
> A rate *r*% is the annual finance rate of a credit contract if—
> (a) In respect of each period between instalments, an amount is obtained by multiplying the outstanding balance during the period by a fraction a where—
>
> $$a = \frac{r}{100n}$$
>
> and—
> *n* is 365 divided by the number of days in the period—
> (which amount forms part of the outstanding balance during the next succeeding period); and
> (b) The total of the outstanding balance during the final period between instalments and the amount obtained in respect of that period pursuant to paragraph (a) of this clause equals the amount of the final instalment.

Thus, we can confirm that 27.75% is indeed the finance rate for the loan in Example 10:[52]

[52] This example is similar to that in *Gault on Commercial Law*, Brookers: Wellington, at 5-29 to 5-31.

Example 10

Following the steps specified in the first schedule:

(A) First period:
We must work out the outstanding balance (see cl 1(1) of the First Schedule which defines "outstanding balance"). This is the amount to be advanced immediately before the period commences - $1000 - $30 establishment fee = $970.00.

r = 27.75% and *n* = 12 (for one calendar month, cl 3(c) of schedule).

We then multiply the outstanding balance by a fraction *a* to calculate the finance charge of:

$$\frac{970.00 \times 27.75\%}{100 \times 12} = 22.43$$

(B) Second period
The outstanding balance is now $970 + $22.43 – $175.00 = $817.43. The outstanding balance is again multiplied by the fraction *a* to calculate the finance charge for the second period:

$$\frac{817.43 \times 27.75\%}{100 \times 12} = 18.90$$

(C) Subsequent periods
This process is repeated for the next 4 periods. For the final period we have a balance outstanding of $171.04 and a finance charge of 3.96.

If our earlier calculation that the finance rate is 27.75% is to be confirmed, then the sum of the outstanding balance during the final period between instalments - $171.04 – and the amount of the finance charge for the period (pursuant to cl 2(a)) - $3.96 – will equal the amount of the final instalment - $175.00. In our example the sum is $175.00. Our finance rate of 27.75% is therefore correct.

The process as outlined above corresponds with the process outlined in Example 9 which was based on the general formula (formula (2)) for a credit contract.

Limitation to the general formula and formula (4)

However, both formulas only apply to loans with the following features: regular payment periods and no skipped payments. Neither formula deals with irregular payment periods; for loans with this feature the result is uncertain. An example is a hire purchase contract with a payment holidays: Term = 36 months
Payment frequency = monthly
First payment due at end of 13th month (ie. a 12 month payment holiday).

The Act is difficult to interpret under this scenario. Lenders are likely to calculate the finance rate assuming 12 periods with a zero repayment.

APPENDIX FOUR

Nominal and effective interest rates

There are different models for expressing the annual interest rate under the "accrued interest" method. Generally, they fall into two categories: the nominal rate of interest and the effective rate of interest. Both models deal with the following issues:

- the mathematical relationship between the interest rate for a period less than a year and the stated annual interest rate
- the frequency at which interest is charged;

However, there are important differences which are summarised below.

The nominal annual rate of interest

This is the model upon which the Credit Contracts Act is based. It represents the relationship between the annual interest rate and the rate for a period less than a year as *linear*:

Formula (5) $r = i \times m$

> where r is the annual rate, i is the rate for a period between instalments (a "fractional period") and m is the number of such fractional periods in a year. A monthly rate of 1% translates into a nominal annual rate of 12%.

The effective annual rate of interest

The disclosed annual rate allows for the timing of payments during a year. The relationship between the rate for a period and the annual rate is *exponential*:

Formula (6) $r = ((1 + \frac{i}{100})^m) - 1 \times 100$

A monthly rate of 1% would translate into an effective annual rate of 12.68%.

APPENDIX FIVE

Early repayment: the Rule of 78 and the actuarial method

The Rule of 78

The Rule of 78 is a method of calculating the amount required when a borrower wishes to pay off a loan. It is so called because 78 is the sum of the digits from 1 to 12 (the number of months in a year). Hence its alternative name, the "sum of the digits method". Thus:[53]

$$1 + 2 + 3 + 4 + 5 + 6 + 7 + 8 + 9 + 10 + 11 + 12 = 78$$

> *Where a loan is being paid off by equal instalments, the principal is being progressively reduced over the length of the contract. Interest on the reducing balance therefore also reduces progressively.*

In a 12-month contract, the Rule of 78 allocates the cost of credit (ie combined interest and other fees) to each instalment in the following manner:

12/78 of the cost of credit is allocated to the first instalment
11/78 to the second instalment
10/78 to the third instalment
and so on to –
1/78 to the final instalment

For a contract other than for 12 months, the allocation is adjusted accordingly. For example, in a 6-month contract the cost of credit is allocated as 6/21 to the first instalment, 5/21 to the second instalment etc [1 + 2 + 3 + 4 + 5 + 6 = 21].

The formula for the rebate to be applied to the sum of the remaining instalments is:

Formula (7)

$$X = C \times \left(\frac{m(m+1)}{n(n+1)} \right)$$

[53] Note: A quick way to sum any string of digits is: $\frac{n(n+1)}{2}$ where n is the number of digits

But for explanatory purposes, we will use:

Formula (7a)

$$X = C \times \left(\frac{1+2+3+....+m}{1+2+3+....+n} \right)$$

Where X is the rebate
C is the cost of credit under the contract
n is the original number of months under the contract
m is the number of complete months remaining under the contract

A lender calculating a rebate under the Hire Purchase Act may multiply R by 90% because it is entitled to 10% of the precalculated interest.

Now we return to Example 8 on page 46

Example 11

Amount advanced:	$8,000.00
Term:	1 year, 12 monthly instalments.
Monthly instalment:	$800.00
Interest rate:	20% flat rate
Cost of credit	$1,600.00

The calculation is as follows:

$$90\% \times \$1{,}600 \times \left(\frac{1+2+3+4}{1+2...+12} \right) = \$1{,}440 \times \frac{10}{78} = \$184.62$$

Here, we assume the contract is a hire purchase contract and multiply the rebate by 90%.

Why the Rule of 78 produces anomalies

The Rule of 78 is only an approximation of the proportion of cost of credit charges that relate to each instalment. Its premise that the proportion of repayments representing interest under a loan will fall by the same amount with every instalment is overly simplistic and overestimates the interest in the early stages of a loan. The actual relationship between the proportion of interest and principle within a repayment is actually a more complex exponential relationship where the amount of interest falls relatively slowly in the early stages of the loan and then progressively more quickly.

In a case such as Example 8 (page 46), the interest charges attributed to the early stages of the loan by the Rule of 78 are larger than the repayments. Under the Rule, therefore, the borrower’s payments are not sufficient to cover the interest being added to the balance each month and the settlement figure increases rather than decreases.

THE ACTUARIAL RULE

The actuarial formula for calculating the amount to extinguish a credit contract is similar to that for the calculation of a finance rate at the commencement of the contract, except that it takes into account only the prospective repayments still outstanding under the contract.
The general actuarial formula, for the cost of extinguishing a credit contract, at the due date of the next repayment, is:

Formula (8)

$$C_z = \sum_{t=0}^{t=z-1} R_t \times v^t$$

where C_z is the cost of early repayment of a contract with z repayments outstanding
R_t includes only future repayments under the contract
t is measured from the due date of the next repayment, that date being time zero
z number of payments remaining.

Where a loan is repayable by equal instalments due at equal intervals, this formula can be simplified in a similar manner to that for determining the finance rate under a contract, ie

Formula (9)

$$C_z = R \times \frac{(1+a) - v^{z-1}}{a}$$

Formula (9) calculates the value of future repayments at the due date of the next repayment. In other words the repayments are due at the beginning of each period, rather than at the end. The present value of each repayment is effectively multiplied by (1+ a).

Formulae (8) and (9) calculate the cost at the due date of the next instalment. Therefore they might effectively allow additional interest to the lender on the outstanding debt for, on average, half of the period between instalments. For contracts repayable monthly or more frequently, this might be quite reasonable and could be considered as some compensation to the lender for the early termination of an agreed contract, at the wish of the debtor. If a borrower wished to repay a loan at the due date of the next instalment, as might frequently occur, there would be no additional interest.

If the due date of the next instalment is some time in the future, say more than a month, it could be reasonable to allow some further discount in the formula, ie:

Formula (10)

$$C_z = R \times \frac{(1+a) - v^{z-1}}{a \times (1 + a \times m \times p)}$$

where p is the fraction of a year from the settlement date to the due date of the next repayment

Formulae (8) to (10) could be evaluated directly by inserting the relevant values of the variables into either an electronic calculator or a computer application. Alternatively tables could be prepared to give the present value of the remaining repayments, to be multiplied by the amount of the instalment. These tables would be quite extensive because they would need to cover a wide range of finance rates, the range of remaining repayments, and different frequencies of repayments.

This section does not deal with any past repayments which may not have been made on their due dates, nor any penalties or penalty interest on such sums.

This section does not include any allowance for any costs which might be incurred by the lender upon early repayment of a credit contract.

Example 12

Early Repayment of a Credit Contract

Loan	$8,000	Finance rate per annum	35.074%
Flat interest rate	20%	Finance rate per period	2.923%
Number of repayments	12		
Number of repayments per annum	12		
Cost of credit	$1600		
Repayment instalment	$800		

Repayments made	Early Repayment Actuarial Method	Early Repayment Rule of 78 (100%)	Difference	Early Repayment Rule of 78 (90%)	Difference
0	8,233.83	8,246.15	(12.33)	8,381.54	(147.71)
1	7,651.11	7,671.79	(20.69)	7,784.62	(133.51)
2	7,051.36	7,076.92	(25.57)	7,169.23	(117.87)
3	6,434.07	6,461.54	(27.46)	6,535.38	101.31
4	5,798.75	5,825.64	(26.89)	5,883.08	(84.33)
5	5,144.86	5,169.23	(24.37)	5,212.31	(67.45)
6	4,471.85	4,492.31	(20.46)	4,523.08	(51.23)
7	3,779.17	3,794.87	(15.70)	3,815.38	(36.21)
8	3,066.25	3,076.92	(10.67)	3,089.23	(22.98)
9	2,332.49	2,338.46	(5.97)	2,344.62	(12.13)
10	1,577.28	1,579.49	(2.21)	1,581.54	(4.26)
11	800	800	0	800	0
12	–				

APPENDIX SIX

Disclosure form required in US law