Consumer Credit Law Review: Further Consultation on Proposals in Respect of Charging Interest and Calculating Balances

Purpose of this paper

1. The purpose of this paper is to seek further feedback concerning proposals by the Ministry, as part of the Consumer Credit Law Review (CCLR), in respect of charging interest and the calculation of balances. In particular, the Ministry is keen to hear from submitters who might be affected by the proposals (were they to be implemented) because their software and billing systems would need to be changed.

What is interest?

2. Interest is of central and obvious importance to consumer credit, as interest is usually by far the greatest cost paid by consumers in return for the use of credit. In considering what interest is, it is helpful to begin with common law definitions:

- "Interest is the return or compensation for the use or retention by one person of a sum of money belonging to or owed to another. *Interest accrues from day to day even if payable only at intervals*, and is, therefore, apportionable in respect of time between persons on succession entitled to the principal" (emphasis added). Halsbury, *Laws of England* (4th Ed), Vol 32, "Money", par 106.

- "[T]he essence of interest is that it is a payment which becomes due because the creditor has not had his money at the due date. It may be regarded as either representing the profit he might have made if he had had the use of the money, or conversely the loss he has suffered because he had not had that use. The general idea is that he is entitled to compensation for that deprivation." Per Lord Wright in *Riches v Westminster Bank* [1947] AC 390, at 400.

- "[I]nterest is compensation for delay in payment". Per Fowler J in *Bond v Barrow Haemitite Steel Co* [1902] 1 Ch 353, at 363.

Methods used to charge interest and calculate balances by New Zealand lenders

3. There are a variety of methods for determining the interest payable on a credit contract and of distributing it over the term of the loan. By examining a wide range of consumer credit contracts the Ministry has found that the methods described below are commonly used.[1] We have not surveyed the extent of usage of the different methods.

[1] The Ministry has viewed a large number of consumer credit contracts and it has talked to those in the industry. It has noted that, with the exception of banks and mainstream finance companies, lenders generally do not disclose the method of charging interest in the contract. There may be other methods used by lenders (e.g. discount interest), but these are clearly

Accrued interest methods

Daily rate methods

3.1. The daily method involves applying a daily interest rate to the unpaid daily balance. The combined daily charges over a payment period are then deducted from the payment which is made at the end of the period. If the payment is late or not made the charges may be added to the balance (i.e. "capitalised" or "compounded"). Generally, lenders in New Zealand do not compound the interest between payment periods (e.g. daily compounding).

3.2. A variation on the daily rate method which achieves the same result is the average daily balance method whereby at the end of each payment period the interest charge is calculated by applying a periodic rate (usually monthly) to the average of all the daily balances for the period.

3.3. The daily rate method is used by lenders offering revolving credit contracts.[2] It is used for fixed credit contracts (of all varieties) offered by banks and the larger, mainstream finance companies and other mortgage lenders.

3.4. This is the most flexible and accurate method of charging interest and has considerable advantages for lenders and consumers.[3] For instance, if a borrower makes a late payment, the balance continues to accrue interest charges. If a borrower makes an early payment, the balance is automatically adjusted and the borrower will save on interest. If the borrower repays the loan early, he or she will only be liable for interest accrued to the date of payment.

Actuarial method

3.5. Other lenders use a slightly less sophisticated accrued method of charging interest. Interest is calculated over the course of the loan by applying a periodic interest rate to the reducing balance. This produces an interest charge for each period which is deducted first from the periodic payment. Standard amortisation tables and the functions in widely used spreadsheet software calculate interest in this way.

not common. Theoretically, there are numerous other ways in which lenders might charge interest.

[2] The Ministry has not seen any contracts which use alternative methods for charging interest on revolving credit accounts known as the "previous balance" method and the "adjusted balance" method.

[3] See *Transparency* at page 16, 52-53.

3.6. The difference between this method and the daily rate method is that no adjustments are made for the exact number of days in a period – all periods are presumed to be of the same length – or for the timing of payments. A borrower will not receive the benefit of an early payment. A late payment will not result in the borrower paying additional interest charges at the contract rate, but the contract is likely to provide for default charges to compensate the lender for the loss due to late payment. If the borrower repays the loan early, interest will be accrued to the end of the complete payment period during which the balance is repaid.

3.7. This method is used by smaller finance companies, including some cash loan lenders, and by some mainstream hire purchase lenders for fixed credit products.

Flat rate (or add-on) method

3.8. This method has traditionally been used by small finance companies and cash loan companies and hire purchase sellers offering fixed credit. Interest is calculated as a proportion of the initial balance. In the event of early repayment or refinancing, lenders usually use the Rule of 78 as a means of distributing the interest charge over the term of the loan.

3.9. This method is currently used by small finance/cash loan companies, but is no longer common.

Rule of 78

3.10. The Rule of 78 refers to a method of distributing interest over the term of a loan i.e. of calculating the interest component of each payment made by the borrower.[4] It is often used by lenders who pre-calculate interest using a flat rate to calculate the outstanding balance on early repayment by the borrower.

3.11. Many hire purchase lenders (including mainstream lenders) use this method. Many finance companies and cash loan companies also use it for personal loans. The lender's software is programmed to amortise the loan using the Rule of 78 and calculate the finance rate for disclosure purposes.

3.12. If the consumer pays according to the payment schedule, it will not make any difference whether the interest is distributed by the Rule of 78 or actuarially, however, it can have a considerable impact on early repayment or when a loan is refinanced.

[4] The Rule is discussed in *Transparency* at 45-47; a technical explanation of the Rule is at 80-81.

3.13. Some lenders also calculate the interest actuarially for the purposes of disclosure and calculating repayments, but in the event that the loan is repaid early or refinanced, use the Rule of 78. Lenders adopting this practice are likely to lend at high rates and refinancing using the Rule, rather than an actuarial calculation, will result in an additional return.

Problems in the consumer credit market relating to the manner in which interest is calculated

Non-standardised quotation of rates

4. One of the most important grounds for intervening in the consumer credit market is because of information difficulties faced by consumer. A key manifestation of these difficulties is the multitude of both the ways by which interest can be charged in respect of contracts, and the way those charges can be disclosed. A flat rate, for instance, appears to be lower than an accrued rate – this has the potential to be misleading as well as raise information costs for consumers.

5. This problem has to some extent been resolved by the requirement on lenders to disclose the finance rate.[5] If the finance rate were no longer required to be disclosed, the proposed measures in this paper would also deal with the problem of non-standardised quotation of rates.

Unfair rules on early payment

6. Another widely known problem with some methods of balance calculation is that they have an unfair impact on early repayment. This refers in particular to the Rule of 78. The Ministry discussed the impact of this rule in detail in its *Transparency* document. In summary, the rule apportions the interest and the principal component of each instalment payment in such a way as to disproportionately load the interest on to the early stages of the contract. Lenders who accept early repayment of loans with long terms or high rates can gain significant unearned interest in a manner that is not transparent to the consumer.

No credit for extra payments ("prepayments")

7. The Hire Purchase Act gives consumers a right to pay off in full the loan at any time. In this case, the consumer is entitled to a rebate of the "terms charges". However, if the consumer makes an extra payment, over and above the scheduled instalments (a "prepayment"), they are not entitled to receive any credit for that payment. In practice, many lenders do not give credit for prepayments. This is contrary to the basic principles of interest discussed in paragraph 2, which imply that consumers should only be liable to pay interest on the actual balance outstanding: if the balance has

[5] Only to some extent: lenders sometimes quote a flat rate and the finance rate. There are also issues concerning the finance rate generally.

been reduced by a prepayment, it follows that the consumer should pay less interest. As interest is “compensation” to the lender for being denied the use of the funds outstanding, it logically follows that if the funds have been “recovered" via a prepayment, the lender is not entitled to compensation.

8. An extreme example of this problem appeared on television’s Fair Go programme. A consumer borrowed $2,500; with finance charges, the amount to be repaid was $3,500 over three years. They decided to settle early and the settlement figure was $2,581.75. Two years later, the consumers received a bill for $888, calculated as 24% on $2,581.75 – the problem was the consumer forgot to pay the 75 cents but interest was charged on the $2,581.75. Clearly, a result like this is unfair.

The Ministry’s proposals

9. The following section outlines the Ministry’s proposals.

An interest charge cannot exceed the amount arrived at by applying a daily interest rate(s) to the unpaid daily balance(s) owed by the debtor.

10. The Ministry considers that the daily rate method is the most transparent and equitable method of charging interest. It accords with the common law treatment of interest. It is the required method in Australian law and used by many mainstream lenders in New Zealand.

11. The advantages to consumers and lenders who use this method have been discussed. The advantages from a policy perspective in adapting Australian provisions are:

    a) It provides for standardisation in the quotation of interest rates.

    b) It results in the fairest method of calculating the outstanding balance during the loan.

    c) It is substantially more simple than the alternatives: such as requiring lenders to disclose a finance rate to meet the concern in (a); or to include formulas in legislation to meet the concern in (b).

Views of submitters

12. The daily rate method proposal was canvassed in *Transparency* and received a divided response from submitters. Pointedly, there was no unanimity within the finance industry on this point. In its submission the New Zealand Bankers’ Association stated:

    “The additional costs imposed on those lenders that do not use [an accrued interest method] will not outweigh the advantages to be gained generally.”

13. Other lenders supported the proposal, as did consumer groups. However, two major hire purchase lenders disagreed, arguing that such a

requirement would make instalment hire purchase credit more complex and expensive to administer and would lead to its demise in favour of revolving credit products. This, it was said, would be to the disadvantage of low income consumers who utilise straightforward instalment credit as a means of financing consumer goods.

14. The Ministry therefore recommends modifying the general principle that interest must be calculated daily to take account of these concerns by allowing interest to be calculated on monthly, quarterly or half-yearly rests and by allowing lenders the right to "hold" early payments until payable.

Lenders are permitted to charge for monthly, quarterly and half-yearly periods by applying monthly, quarterly or half-yearly rates to the average unpaid daily balance for that period.

15. The majority of fixed consumer credit contracts require monthly payments to be made by the consumer. As explained earlier, lenders do not always make adjustments to take account of the timing of the payment or the exact number of days in a period, which they would be required to if calculating interest on a daily basis. For these lenders, it is more straightforward to accept the payments when they are made, and treat them as if they had been made on the day they were due (subject to the lender's treatment of overdue payments). This appears to be the standard practice in relation to hire purchase.

16. To accommodate this practice, lenders should be permitted to calculate interest on monthly, as well as quarterly and half-yearly rests. In these cases the annual interest rate is divided by 12, 4 or 2 and is applied to the average unpaid daily balance for the period. The effect of this is that interest charges for months, quarters and half-years can be calculated on the basis that all months, quarters and half-years are of the same length. However, the average unpaid daily balance of a period must be calculated on the actual number of days in the period.

17. Some examples demonstrate this method:

(a) Whole period – payment made on time (or contract prohibits early payments, see paragraphs 21-24).

- interest charges cover the month of January i.e. 31 days
- unpaid daily balance $1,000 on each of days 1 to 31
- average unpaid daily balance:

  $1,000 x 31 = $31,000 ÷ 31[days] = $1,000

- interest charges for January:

  (annual interest rate ÷ 12) x $1000

(b) Part period – prepayment made during period

- interest charges cover the month of January i.e. 31 days
- extra-payment of $250 made during period on January 16
- unpaid daily balance $1,000 on each of days 1 to 15
- unpaid daily balance of $750 on each of days 16 to 31
- average daily unpaid balance:

($1,000 x 15) + ($750 x 16) = $27,000 ÷ 31 [days] = $870.97

- interest charges for January:

(annual interest rate ÷ 12) x $870.97

(c) Part period – balance repaid in full during period

- interest charges cover the first 15 days of January – the loan is repaid in full on 16 January
- the unpaid daily balance on each of days 1 to 15 is $1,000
- average unpaid daily balance:

$1,000 x 15 = $15,000 ÷ 31 [days] = $483.87

- Interest charges for January :

(annual interest rate ÷ 12) x $483.87

Lenders must credit payments as soon as practicable after receipt.

18. Once a borrower has made a payment, they should receive the immediate benefit of it. Thus, the lender must credit the payment as soon as practicable after receipt i.e. adjust the borrower's unpaid balance. This accords with the general principle that debtors should only pay for the credit that they use and that lenders should not benefit from unearned interest.

19. Some lenders credit a payment on the day it is processed, while others credit it on the day it is received, despite it being processed at a later date. This latter practice is known as "effective dating". For example, a withdrawal made by a customer on a non-business day (e.g. by drawing on a line of credit through an automatic teller machine on a non-business day) may not be processed by the lender until the next business day. For the purpose of calculating the balance and interest charges, the lender may treat the withdrawal as having been made on the date it was actually made, that is the lender gives the transaction an "effective" date of the non-business day. A similar example might involve a borrower making a

payment on a non-business day, e.g. through an ATM. Effective dating also occurs where a lender corrects an error in previous processing.

20. Legislation should explicitly contemplate the practice of effective dating as failure to do so may make contracts difficult to administer under a daily interest rate regime.

Lenders may prohibit early payments in the credit contract.

21. Strict application of the rule that payments must be credited as soon as practicable after receipt may be inconvenient for lenders offering instalment credit, such as hire purchase. Many of these loans are structured so that consumers pay a fixed amount of interest each payment and a fixed amount of total interest. If a scheduled payment is made early, the lender has to make adjustments to the entire amortisation schedule as a result of crediting the payment immediately.

22. To avoid instalment credit becoming more complex to administer, lenders should be permitted to "hold" scheduled payments until they become payable (in practice, this means the payment is likely to be assigned an effective date of when it became payable). However, lenders will need to provide for this in their contracts. Lenders that do not make provision will have to comply with the rules outlined above.

23. There is a similar provision in the Australian Code, which provides that lenders must credit payments as soon as they are made, but may also hold payments until they become payable. As well as providing for this in the contract, the lender must inform the consumer that he/she will not receive credit for the payment until it is payable. This latter requirement appears to be unnecessarily cumbersome if the early payment is simply a scheduled instalment made a few days early. The Ministry therefore does not recommend it.

24. In respect of an extra payment made over and above the scheduled instalment (referred to in Australia as "prepayments"), the lender may refuse to accept it if provided for in the contract. However, if such a payment is accepted, it must be credited as soon as is practicable. The lender will have to determine how it treats such a payment. Options are:

- The lender could refuse to accept the payment. This is probably difficult in practical terms.

- The term of the loan may be shortened.

- The size of the instalments could be reduced over the remaining term of the loan.

- Future instalments, equating to the value of the prepayment, could be deferred.

Impact on lenders

25. Any changes resulting from the CCLR will lead to some transitional cost on lenders e.g. lenders will need to update their documentation and procedures, retrain staff etc. The specific impact on lenders from the proposals relating to interest rates are:

- Lenders will need to review their software to ensure that the way in which it calculates balances and debits charges is consistent with the proposals. This will impact unevenly on lenders. Some lenders currently use systems which are compatible (this would apply to lenders which offer revolving credit). Also, for many lenders, the terms of their software support contract provide that any changes to legislation are automatically included in new versions of the software which the supplier provides as part of its ongoing relationship with the lender. These lenders will not incur significant extra costs. However, others will need to install new software systems or reprogramme their systems at some cost – particularly if they have custom built programmes, older systems or no support contract with their provider.[6]

- Lenders must consider whether they will credit early payments. If they do not wish to, they must ensure that this is provided for in the contract. They will also have to consider how they deal with prepayments.

- Lenders must review the systems they use to assign dates to payments. For instance, credit card contracts differ on whether payments are credited on the day they were received or the day they were processed. The meaning of “as soon as practicable” (taken from the Australian Code) suggests that payments should be given an effective date of the day they were received.

- It has been suggested that the proposals may adversely affect participants in securitisation programmes. The only effect that the Ministry is aware of is it may make cash flows less certain for investors in securitised portfolios as lenders will be less able to guarantee the exact amount of interest to be earned. However, this situation already exists because of the consumer’s right to early repayment and the possibility of default. It is a risk that exists with securitisation of variable rate mortgages and credit card receivables (etc), so it is a familiar risk to investors in securitisation programmes and to rating agencies. The Ministry is therefore not unduly concerned by this aspect.

Conclusion

26. The proposals outlined in this paper are being seriously considered by the Ministry under the CCLR. They are not the only options for dealing with

[6] Many lenders with such systems have had to upgrade them in response to the Personal Property Securities Act 1999.

the problems concerned, but the Ministry believes they are the best – subject to the views of submitters through further consultation. The Ministry's proposals would set the daily rate method of interest charging as the basic method to be used for all credit contracts. This method is currently used by a large proportion of lenders and is the required method in Australia.

27. The modifications proposed by the Ministry – permitting interest to be calculated on monthly rests, allowing lenders to credit early payments only when they are payable, and giving lenders flexibility in the way they deal with prepayments – should reassure those submitters who considered that a daily interest rate regime would make instalment credit impossible.[7] In fact, instalment credit is entirely possible under a daily rate regime, even if lenders accept early payments (the result is that the outstanding balance is brought to zero sooner and a readjustment of the final payment will be needed).

28. These modifications will not impact on the three key advantages in paragraph 11 (standardised quotation of interest rates, equitable rules on early repayment and simplified legislation) while providing more flexibility for lenders.

29. In responding to this proposal as raised in the *Transparency* discussion document, some submitters revealed certain misunderstandings. It is important to note that the Ministry's recommendations will

- not require monthly payments to vary in amount according to the exact number of days in a month,

- not require monthly statements for fixed credit contracts; and

- not prevent lenders from taking security over goods purchased on credit.

30. Following the transition period, as lenders adjust to the new regime it is reasonable to expect that fixed credit will be no more difficult to administer than it is at present.

[7] The position is actually similar in Australia. The CCH Consumer Credit Law Reporter (para 52.600) states: "Because of a number of exceptions as to the way in which balances are calculated, credit providers, if they choose to, can introduce systems, documentation and procedures which will enable them to mimic the effect of a predetermined interest charge [a contract in which the amount of interest payable is fixed at the outset of the contract].

Submission Details

Although it has not asked specific questions, the Ministry is interested in comments on any aspects of this paper and the proposals it discusses. Please direct comments by 4:00pm, 30 April 2001 to:

Nick McBride
Consumer Credit Law Review Team
Ministry of Consumer Affairs
PO Box 1473
WELLINGTON

Ph	04 474 2818
Fax	04 473 9400
Email	nick.mcbride@mca.govt.nz

26 March 2001