

Ministry of Consumer Affairs

**Independent Review of Proposals in
Respect of Charging Interest and
Calculating Balances**

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1 Introduction

The Ministry of Consumer Affairs has been conducting a Consumer Credit Law Review, part of which has addressed the issues of interest, fees and disclosures.

The Ministry has firmed up on its proposals in respect of charging interest and calculating balances and these are set out in the document “Consumer Credit Law Review: Further Consultation on Proposals in Respect of Charging Interest and Calculating Balances”, dated 26 March 2001.

The Ministry has received some submissions to that document and has commissioned PricewaterhouseCoopers to give an independent view on the proposals contained in the document.

We have been provided with electronic copies of Parts One to Five of the Consumer Credit Law Review consultative documents, the document referred to above, and copies of submissions made by various bodies and people to that document.

In carrying out our review we have addressed the following matters:

- are the proposals in respect of charging interest and calculating balances good policy?
- are there any adverse effects on lenders?
- are there any fishhooks in the proposals?
- are any modifications needed to the proposals?
- consideration of systems and information technology implications for lenders
- key transition issues.

In formulating our views we have:

- reviewed the Ministry’s consultative documents
- reviewed the submissions received on the proposals
- discussed the implications of the proposals with colleagues within PricewaterhouseCoopers who have experience and knowledge in this area.

2 The Ministry's Proposals

As part of the Consumer Credit Law Review, the Ministry has made several proposals in respect of charging interest and calculating outstanding balances.

These are set out in full in the document "Consumer Credit Law Review: Further Consultation on Proposals in Respect of Charging Interest and Calculating Balances", dated 26 March 2001.

The Ministry's proposals can be summarised as follows:

- 1 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.
- 2 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.
- 3 Lenders must credit payments as soon as practicable after receipt.
- 4 Lenders may prohibit early payments in the credit contract.

Throughout this proposal we will refer to these as Proposals 1, 2, 3 and 4 as indicated.

3 The Current Market

Section 2 of Part 3 of the Consumer Credit Law Review comments:

“The complex array of credit products now available was not anticipated by the legislators of two decades ago.”

“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.”

The proposals under consideration in this report must cope with this wide range of products whilst satisfying the competing demands of consumers and providers of credit. It is important that the price and key terms of a credit product be disclosed accurately and fairly to consumers so that they can draw clear conclusions about the cost of credit and can make meaningful choices between competing products. Lenders may be reluctant to change their systems and want to be able to run their businesses profitably and professionally.

The increasing availability and usage of computers has allowed the review to consider options, such as daily balance calculations, which would have been totally impractical a few decades ago.

In our view, the products affected by this legislation can be divided into two main groups. The first is those of a more traditional nature, with fixed interest rates and fixed repayment schedules. Examples of these are hire purchase agreements and short term loans. For the purposes of this report, we could call these “fixed instalment” products. The second group is then “variable repayment” products, such as flexible mortgage agreements and credit cards.

Typically, fixed instalment products have a fixed rate of interest for the term of the contract and variable repayment products can have either fixed or floating rates of interest.

Each main type has its attractions for various types of borrowing and lending, and degree of sophistication of borrowers and lenders.

We are pleased to see that the Ministry intends to allow for these two different product groups under its proposals. We believe that, in spite of the increasing popularity of revolving credit arrangements in New Zealand, there is a continuing place for fixed instalment loans for many types of lending.

A number of submissions appeared to be against allowing monthly, or less frequent, rests. The main reason for this seems to be a misconception that they result in a higher cost to the consumer.

There seems to be considerable confusion about the impact of rests. “Rests” refer to the length of time between the dates on which interest is compounded (ie, added to the outstanding balance for the purpose of calculating future interest). “Daily rests” mean that interest is compounded each day and added to the outstanding balance. Obviously this would be disadvantageous to the consumer.

Some submissions appear to have interpreted “rest” to mean a period over which the balance is considered constant for the purposes of calculating interest. These submissions therefore incorrectly viewed daily rests as being the ideal to be obtained.

The issue of rests interacts with the issue of how the interest rate is presented – whether it is a nominal rate or an effective rate. If it is an effective rate, rests have already been taken into account. If it is a nominal rate, the frequency of rests will affect the true cost of credit. More frequent rests will lead to a higher interest cost. The Annual Finance Rate currently used is a nominal rate. However, we believe effective rates are the preferable way in which to present interest costs, as they show the true cost of credit.

This report covers each of the four proposals in turn, and addresses the following questions:

- 1 is the proposal good policy?
- 2 are there any adverse affects on lenders?
- 3 are there any fishhooks?
- 4 are there any modifications needed?

Subsequent sections then address information technology and systems implications for lenders, and transition issues.

4 Proposal 1

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.

We agree with the Ministry that the daily rate method of charging interest is the most equitable and transparent method. However, we do not believe it is suitable for all credit arrangements, and therefore also endorse Proposal 2 which permits alternative methods.

This method is best suited to flexible credit arrangements, where future receipts and debits are unknown at the time of making the arrangement. It allows for real time calculation of interest, and the consumer pays only for the credit he or she uses. It is also particularly suitable for variable or floating rate interest contracts.

In pricing this type of product, the lender takes account of the fact that it is unaware of what its actual inflows and outflows will be each day, it only knows the maximum amount which may be withdrawn. This type of lender is likely to have a treasury function well used to coping with this uncertainty. In some cases, for example bank mortgage lenders, a premium over the standard floating mortgage rate may be charged by the bank to cover the cost of this uncertainty.

Is the Proposal Good Policy?

In our opinion, this proposal is good policy in respect of variable repayment products. For fixed instalment products, we believe the lender should have the choice of complying with this Proposal or Proposal 2 overleaf.

Are There Any Adverse Effects on Lenders?

Most lenders offering variable repayment or variable interest rate products are probably already using this type of calculation. Lenders currently using flat rate or table mortgage products would need substantial changes to their systems to be able to convert to daily interest products, but will be more attracted to Proposal 2 products.

Are There Any Fishhooks in the Proposal?

We do not have any indication at this stage of how the “daily interest rate” is to be calculated, or any comments on the compounding of interest to the outstanding balance.

All lenders will want to add (or compound) interest to the balance from time to time (eg monthly). The impact of this will need to be considered in the legislation, in terms of disclosure to borrowers.

For example, a lender offers a revolving credit mortgage product, which accrues interest on a monthly basis. The nominal interest rate is 10.95% per annum. The daily interest rate is therefore

$$\frac{10.95\%}{365} = 0.03\%$$

If interest is compounded on the last day of the month (ie, monthly rests) the effective interest rate is

$$(1 + 0.0003 \times 31) \times (1 + 0.0003 \times 28) \times \dots \times (1 + 0.0003 \times 31) - 1 = 11.52\% \text{ pa}$$

This can be interpreted as follows: If a consumer borrows \$100 at the beginning of the year under this arrangement, and makes no further repayments or drawdowns, at the end of the year they will owe \$111.52.

If interest is compounded daily (ie, daily rests) the effective interest rate is

$$(1.0003)^{365} - 1 = 11.57\%$$

The effective interest rate therefore indicates the true cost of a year's credit and is to be preferred as the rate quoted to the consumer.

Are Any Modifications Needed to the Proposal?

We recommend consideration be given to requiring a lender to disclose the effective rate of interest consistent with the nominal rate used and the frequency of compounding.

5 Proposal 2

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.

This proposal will suit the many contracts which fall under our definition of fixed instalment contracts. These contracts have a fixed schedule of the extension of credit and each party to the contract knows exactly when payments are due and the amount of those payments. The lender can then plan for the reallocation of the expected funds.

We believe that contracts of this type fulfil an important role, particularly for hire purchase or borrowers and lenders who prefer the discipline of fixed repayment commitments.

Is the Proposal Good Policy?

We do not believe that this proposal should be of any concern to consumers. Indeed, for some it may be easier to understand and reproduce the calculations than for the daily balance method, or methods currently used for flat rate contracts.

The proposal will allow lenders to calculate interest on the basis that all months, quarters and half-years are of the same length. The effect of this is quite small, and will be almost negligible over each year of the contract.

This proposal will significantly ease concerns from the industry about the demise of instalment credit.

Are There Any Adverse Effects on Lenders?

Proposals 1 and 2 between them effectively prohibit some forms of consumer credit, such as flat rate. Lenders currently using this system will need to amend their systems. Preliminary discussions with some people familiar with flat rate lending indicate that systems costs could be significant for them. Most flat rate lending is for relatively short durations and so a reasonable transition period may be desirable to minimise the costs to flat rate lenders and their customers.

Some lenders may wish to use other rest frequencies, such as weekly, fortnightly or half-monthly to match their customer's repayment frequency preference. There is no good reason to prohibit these if effective interest rates are used to show the true cost of credit.

Are There Any Fishhooks in the Proposal?

Legislation should recognise that lenders using fixed instalment products will want the periods for calculating average daily balances coinciding with repayment frequencies. Proposals 3 and 4 also impact on fixed instalment products.

Are Any Modifications Needed to the Proposal?

For fixed instalment contracts it is desirable that the frequency of repayment coincides with the period for averaging unpaid balances. Thus, if instalments are made monthly it is desirable to apply monthly rates to the average unpaid daily balance for the month.

We therefore recommend that the proposal be amended to allow for other reasonable frequencies so that the frequency can coincide with the frequency of repayment. In that regard we note that there is nothing inherently wrong in charging for weekly or fortnightly periods by applying weekly or fortnightly rates to the average unpaid daily balance for that period.

We recommend consideration be given to requiring a lender to disclose the effective rate of interest consistent with the nominal rate used and the frequency of compounding.

6 Proposal 3

Lenders must credit payments as soon as practicable after receipt.

This proposal should be read in conjunction with Proposal 4 (early repayments). Critical to this proposal are the words “as soon as practicable”.

Is the Proposal Good Policy?

It is certainly reasonable for borrowers to receive credit as soon as payments are made in terms of the lending contract. However, there needs to be an opportunity for the lender to invest funds on which it is no longer receiving interest from the borrower.

Are There Any Adverse Effects on Lenders?

We do not believe there would be any adverse effects on lenders provided the time of crediting a payment is the same time as the lender would, under normal business conditions, have the proceeds available for re-investment.

For example, if a lender were to receive a cheque for a payment after the close of banking hours on a Friday, it would be unreasonable for the amount to be credited until the lender has, under normal business conditions, had a chance to bank the cheque and receive credit for it in the lender’s account.

Thus, in this context, we would define “as soon as practicable” to mean the earliest time under normal business conditions applying to the lender, that the lender would have the payment available for re-investing.

The New Zealand Bankers’ Association was very concerned about the impact of this particular proposal. Its submission mentioned instances where payment and loan systems are not automatically interfaced and manual reconciliations occur over a period of days. The above definition would, we believe, ameliorate their concerns.

Are There Any Fishhooks in the Proposal?

In some cases it may be impossible for lenders to know the actual date of the transaction. This might occur, for example, in circumstances where there is no electronic record of the transaction occurring, such as a cheque deposit to a drop off box at 11:00pm which is not collected until the next day. The definition of “as soon as practicable” overcomes this problem.

Are Any Modifications Needed to the Proposal?

For normal repayments made under a fixed instalment contract it is in order for the payment to be credited on the date that the payment is due (even if that date is not a normal business day).

For unscheduled payments made in accordance with the terms of a contract, the payments should be credited as soon as practicable (as defined above) after receipt, provided that the terms of the contract do not provide otherwise.

Reversals should, of course, be permitted in the event of dishonours or payment reversals.

7 Proposal 4

Lenders may prohibit early payments in the credit contract.

This proposal will permit lenders under fixed instalment contracts to credit a scheduled payment on the date it becomes due if the payment has been received prior to that date, as long as this is provided for in the contract.

In respect of unscheduled payments (often called prepayments) the lender may refuse to accept them if such refusal is provided for in the contract. However, if such a repayment is accepted it must be credited as soon as practicable (as defined). The lender will have to determine how it treats such a payment. Options are:

- the term of the loan may be shortened
- the size of instalments could be reduced over the remaining term of the loan
- future instalments, equating the value of the prepayment, could be deferred.

Is the Proposal Good Policy?

We believe that this proposal is practical and suitable for fixed instalment products. It protects the interest of borrowers by making them aware that there will not be any reduction in the interest charges for early payments.

It will preserve the concept of fixed instalment products, which we believe is desirable for reasons mentioned earlier in the report.

Are There Any Adverse Effects on Lenders?

Lenders wanted this proposal.

The proposal also, by inference, allows for the imposition of penalties on early repayment if contemplated in the contract or if early repayment is not allowed (and therefore subjected to negotiation by mutual agreement).

Are There Any Fishhooks in the Proposal?

The proposal makes no mention of any basis on which early repayment fees can be applied, and this was a point of concern in a number of the submissions. In particular, submitters were concerned that Proposal 1 would apply, preventing them from charging early repayment fees altogether. No submission was in favour of allowing the Rule of 78 to be allowed.

Similarly, the issue of late payments and consequential penalty fees has not been covered explicitly.

Are Any Modifications Needed to the Proposal?

Clarification of the meaning of “early repayments” is required.

An “early repayment” could be defined to mean a scheduled payment under a contract where the payment is received by the lender prior to the scheduled date. In that case, the lender may, if provided in the contract, credit the payment on the scheduled date.

A “prepayment” could be defined to mean an unscheduled payment under a contract. If provided in the contract, the lender may refuse to accept such a payment. If the payment is accepted it must be credited as soon as practicable (as defined).

We suggest that the proposal be modified to allow lenders to credit prepayments on a basis specified in the contract, and not necessarily as soon as possible.

We further suggest that lenders be permitted to charge reasonable fees on early repayment. These fees should be of a level which reflects the loss to the lender and the basis of their calculation should be specified in the contract.

Clarification of the lender’s ability to charge late penalty fees would also be advisable.

8 Systems and Information Technology Implications for Lenders

With any change in law such as this, there will be a need for some companies to change or upgrade its systems.

In our opinion, Proposals 2 and 4 go some way towards minimising the level of system re-specification and product design that will be required.

However, we understand flat rate lenders will face significant systems costs and possible contract re-negotiation costs unless there is a reasonable transition period. Not only are systems affected which track customers' accounts, but also accounting and tax treatment of interest accruals.

There may also be some implication for the crystallization of tax liabilities on transition from flat rate products to products satisfying Proposal 2.

The area which is of the most concern in terms of system respecification is crediting payments on the date on which they are received for revolving credit products. We understand from the New Zealand Bankers' Association that there may be issues where one system does not interface with another. However, it is difficult to understand why, if the Bank has the money and it is therefore available to reinvest, the customer should not have the benefit of that interest. We believe our suggested definition of "as soon as practicable" would overcome that Association's concerns.

9 Key Transition Issues

A number of submissions expressed concerns about the transition. The suggestions made were:

- that sufficient time be allowed after the legislation is enacted for systems changes to be made. We support this, especially for flat rate products
- that existing contracts be exempt from the legislation
- that changes be allowed to existing contracts to enable them to comply with the legislation to remove duplication in lenders' systems.

It is reasonable to allow for a lead in time after enactment to ensure the final system modifications are understood and able to be completed. We suggest that existing flat rate contracts be allowed to run-off under existing conditions, for a maximum of, say, three years.

Allowing the option of moving existing products to the new basis or leaving them on the old basis will satisfy many submitters. In the first case the effective rate of interest on the new basis should not be greater than the effective rate of interest on the original product, and there should be no material changes to the terms of the contract (such as frequency of payments).

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