

---

## LITIGATION

JUNE 2008

---

---

## CONSUMER CREDIT TEST CASE PROVIDES GUIDANCE ON FEES

---



**Jenny Cooper**  
SENIOR ASSOCIATE



**Nick Christiansen**  
SOLICITOR

The dismissal of charges against a finance company in a test case over loan fees should bring greater clarity for an industry that is increasingly under the watch of New Zealand regulators.

The Commerce Commission's prosecution of Avanti Finance Limited, a large New Zealand lender to low-income borrowers, was the first case of its type under the Credit Contracts and Consumer Finance Act 2003 – and as such had many eyes on the outcome.

The Auckland District Court this month dismissed charges that Avanti breached the Act by charging excessive fees to borrowers who repaid loans early.

While the Commission has yet to announce whether it will appeal, the decision provides helpful guidance that lenders are not obliged to use the regulatory formula to calculate their early repayment fees and may use an alternative approach if that is more appropriate to the structure of their business. However, the decision also reinforces the need for lenders to justify that their fees are calculated on actual estimated costs and losses, and are not simply arbitrary.

### **Avanti and the CCCFA**

The Commerce Commission's prosecution of Avanti related to its prepayment fees.

Avanti was charged with offences over the fees it charged on 50 fixed-rate fixed-term loans that were fully repaid before their contractual end date.

### **CCCFA's provisions**

The CCCFA specifies that a fee charged by creditors on early repayment of a consumer loan must not exceed a reasonable estimate of creditor's loss from early payment. The loss may be calculated using either the "safe harbour" formula set out in the regulations, or "an appropriate procedure set out in the consumer credit contract for calculating that loss". Prepayment fees calculated using the "safe harbour" formula are deemed to be reasonable.

The safe harbour formula calculates the loss as the present value of the difference between the interest payments the creditor was expecting under the original contract and those which they can obtain by re-lending the repaid funds at prevailing interest rates. The formula assumes that the creditor can mitigate its loss by re-lending the repaid funds. If interest rates have not fallen since the original loan was made, then the creditor is considered to have suffered no loss.

To receive your updates faster, please subscribe to our electronic newsletter service on:  
[info@bellgully.com](mailto:info@bellgully.com)

To view all our publications or update your details please visit our website: [www.bellgully.com](http://www.bellgully.com)

For further information, please contact your usual Bell Gully adviser or:

#### AUCKLAND

**Murray King**  
64 9 916 8971  
[murray.king@bellgully.com](mailto:murray.king@bellgully.com)

**Murray Tingey**  
64 9 916 8903  
[murray.tingey@bellgully.com](mailto:murray.tingey@bellgully.com)

**Jenny Cooper**  
64 9 916 8608  
[jenny.cooper@bellgully.com](mailto:jenny.cooper@bellgully.com)

**Nick Christiansen**  
64 9 916 8631  
[nick.christiansen@bellgully.com](mailto:nick.christiansen@bellgully.com)

#### WELLINGTON

**Mike Colson**  
64 4 915 6857  
[mike.colson@bellgully.com](mailto:mike.colson@bellgully.com)

**Hugh Kettle**  
64 4 915 6929  
[hugh.kettle@bellgully.com](mailto:hugh.kettle@bellgully.com)

**Mark O'Brien**  
64 4 915 6972  
[mark.obrien@bellgully.com](mailto:mark.obrien@bellgully.com)

Disclaimer: This publication is necessarily brief and general in nature. You should seek professional advice before taking any further action in relation to the matters dealt with in this publication.

All rights reserved © Bell Gully 2008

Many lenders have chosen not to use the safe harbour formula because it does not capture their actual losses on a prepayment, such as marketing and broker commission costs. Nor does it reflect the fact that in many cases re-lending is unrelated to prepayment. Until now the Commission has taken the narrow view that any formula that results in a higher calculation of loss than the safe harbour formula is likely to be “unreasonable” and breach the Act.

### The Commission’s case

Avanti’s prepayment fee was calculated on the basis of the difference between the rate charged on the loan and the 90 day bill rate, plus a margin of 1.9%, for a 90 day period. The Commission alleged that this resulted in an unreasonable estimate of its loss because:

- The formula imposed an arbitrary 90 day interest period which did not relate to the time taken to re-lend funds;
- The formula had no regard to changes in prevailing interest rates and therefore no regard to a variation in the rate at which funds would be re-lent; and
- The formula did not take into account mitigation of loss by re-lending prepaid funds.

The Commission argued that the formula captured three months of future profit in a situation where the creditor had use of the prepaid funds, no risk associated with those funds, and offered no service to the prepaying debtor. The safe harbour formula would not have allowed Avanti to claim a prepayment fee as interest rates had increased over the relevant period.

### Avanti’s defence

Avanti argued that its loss was the unearned interest on the loan over the remainder of the loan term less the amount saved by repaying the prepaid funds into its bank,

plus the administrative costs incurred on early termination (which Avanti did not charge a separate fee for). Avanti’s formula was intended to estimate that loss of margin. In fact, according to Avanti’s expert witness, the company’s actual loss was greater than the amount of its prepayment fee on all but one of the 50 loans.

Avanti said that the safe harbour formula was inappropriate for its business because subsequent lending would occur regardless of any prepayment. Avanti had maintained a significant unused bank facility during the relevant period, meaning that it had excess lending capacity. This capacity, meant prepayment created no further opportunity to re-lend the prepaid funds.

### What the judge said

The judge found that a creditor’s loss is the gain the creditor would have made if the contract was not prepaid and had run its course, subject to the creditor’s obligation to mitigate its loss. In Avanti’s case, the judge said that prepayment did not create new lending opportunities for the company, but merely reduced its borrowings. The Court agreed with Avanti that the safe harbour formula did not reflect its actual loss because there was no link in Avanti’s business between prepayment and subsequent re-lending. The judge commented that the legislation does not stipulate how Avanti should run its company or source its funds. The Court was satisfied that Avanti’s formula was a reasonable estimate of its loss, and dismissed the charges.

This decision is welcome recognition that the safe harbour formula is not always the right way for creditors to calculate loss from prepayments and that they have the freedom to adopt a formula that reflects their business model.