RESPONSIBLE LENDING:
IRRESPONSIBLE REGULATION OF CONSUMER CREDIT IN NEW ZEALAND?

ELIZABETH MEADE

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“The rich ruleth over the poor,

and the borrower is servant to the lender.”

The Book of Proverbs 22:7

INTRODUCTION

There is nothing new about the abuse of borrowers by lenders. Given the age of the problem it is unlikely that there is any true solution to be found in the law. The regulation of consumer credit tends to be reactionary, responding to issues that emerge from market controls that can be judged in hind-sight to be overly liberal, or overly paternalistic.

The libertarian ideal that has dominated New Zealand's consumer credit market since the 1980s seems to have reached its use by date. Disclosure requirements do not ensure lenders compete for the business of well informed consumers in all areas of the market. The Ministry of Consumer Affairs has identified a problem sector; "unscrupulous" lenders who operate in the "third tier", and prey on vulnerable consumers. It has proposed that the best way to address this problem is through the introduction of a responsible lending framework. A responsible lender cannot be indifferent to the circumstances of the customer, or the effect of the debt they are providing. This dissertation focuses on the draft Credit Contracts and Consumer Finance Amendment Bill, in particular, on the "responsible lending principles", and the associated regulations. It questions the justifications for their implementation, and the likelihood of them meeting the policy aim of increased consumer protection. The views in this dissertation are based on the law available to me as at 1 October 2012.

Part One gives the background to, and rationale for the reform. Chapter One describes theories that underlie consumer protection law, and the fundamental shift to paternalism represented by the responsible lending obligations. Chapter Two details the nature and scale of New Zealand's loan shark problem that the reform aims to target. Chapter Three outlines consumer protection under the current Act, and the changes proposed under the draft Bill. Chapter Four examines the Australian approach to the regulation of consumer credit, and their responsible lending legislation upon which our Bill is modelled.

Part Two attacks the draft Bill on a number of interrelated points. Chapter Five argues that the paternalistic regulations are not sufficiently justified by economic theory, and that the Ministry's paternalistic focus creates difficulties in the cost-benefit analysis. It also introduces concern about use of the Australian model for responsible lending. Chapter Six critiques the ability of the regulation to ensure increased consumer protection, considering the vulnerable nature of the targeted group. Chapter Seven and Eight discuss the failure of the

Bill to address two areas of concern. Chapter Seven considers the issue of broker-arranged loans in New Zealand, and a loophole in the law that the Bill leaves open. Chapter Eight explores financial exclusion in the New Zealand context, and the lack of consideration given by the Ministry to the consequences that the reform may have on the issue.

The purpose of this dissertation is to critique the current proposals and draw attention to areas requiring further consideration by the Ministry. It does not propose revolutionary new means of consumer protection, the reasons for which are two-fold. The problems requiring regulatory intervention have not been properly defined by the Ministry, and without stronger empirical evidence it is difficult to say whether an approach taken in another jurisdiction would be suitable for New Zealand. Secondly, the regulation of consumer credit is a complex and varied area. To propose an improved penalty regime to ensure compliance, for example, does not address the issue of financial exclusion. Preventing the rollover of small amount credit contracts does not assist those consumers struggling with credit card debt. The issues cannot be looked at in isolation, as the Ministry has attempted to do. It should also be noted that what precisely may be required by a lender to fulfil each subsection of the legislation is not discussed. Rather the focus is on the effect of enacting legislation where it is so uncertain what will constitute compliance.

CHAPTER I: THE FUNDAMENTAL SHIFT IN CONSUMER PROTECTION THEORY

A Libertarian nature of current law

Credit granting ranks as one of the oldest professions over the ages, with the first evidence of legislation of credit agreements coming from Babylonian times with the Code of Hammurabi circa 1750 B.C.[1] The Code proposed maximum interest rates allowed on various loan agreements. The comprehensive nature of the code suggests that the abuse of borrowers by lenders were significant problems facing even this ancient society.

Legislation since this time has been reactionary, addressing problems resulting from the use and misuse of credit, shaped by the moral climate of the time. One of the oldest moral arguments is whether interest is an appropriate mechanism by which to earn income,[2] and at what point a charge made for credit can be considered usurious.[3] Limitations, or total bans on interest rates have existed throughout most of history. Deregulation occurred in the United States and the United Kingdom in the late 1970s and 1980s and was followed by New Zealand with the removal of controls on interest rates in 1984.[4] Such unrestricted credit markets where interest rates were controlled in only a limited set of circumstances can be considered the exception rather than the rule.[5]

The New Zealand credit market, like those in the United Kingdom, the United States and Australia until recently, has been dominated by a libertarian philosophy, premised on the notion that if consumers are given the information needed to make rational choices, then we can "sit back and let the free market do its magic."[6] The regulations in place aim to enhance the efficiency of the market and punish supplier misconduct.

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[1] Steven Finlay *Consumer Credit Fundamentals* (2nd ed, Palgrave Macmillan, Hampshire, 2009) at 33.

[2] At 61.

[3] At 63.

[4] Reserve Bank of New Zealand "Submission from the Reserve Bank of New Zealand to the Commerce Committee on the inquiry into housing affordability in New Zealand" <www.rbnz.govt.nz> at 2.

[5] Finlay, above n 1, at 52.

[6] Dee Prigden "Putting Some Teeth in TILA: From Disclosure to Substantive Regulation in the Mortgage Reform and Anti-Predatory Money Lending Act of 2010" (2012) 24(4) Loyola Consumer Law Review 615 at 615.

Disclosure requirements are a move away from the strict "caveat emptor"[7] libertarianism, to an informed consent policy, recognising that a consumer may not possess "perfect information"[8] and thus may be unable to see through the blandishments of the seller. Their aim is to address information asymmetries and accompanying failures that can exist in the market, by ensuring consumers receive quality information before entering a contract.

Such regulation is firmly rooted in neo-classical economic theory, which presupposes that fully informed consumers will make rational choices that are in line with their preferences,[9] selecting the best credit choice based on information, whilst creditors compete to gain their favour.[10] Resulting exchanges with fully-informed consumers acting voluntarily will increase the welfare of both consumer and supplier.[11] Neo-classical economics therefore provides support for the market-based approach to consumer protection in New Zealand.

B Responsible lending proposes a fundamental shift towards paternalism

The opposite assumption is behind paternalistic intervention. Paternalism recognises that there are times when consumers make choices which decrease their welfare. Paternalism lacks a universal definition, but can be viewed in this sense as law that has the goal of reshaping consumer behaviour in order to increase consumer welfare. A paternalistic intervention will either encourage or coerce a consumer into a choice that promotes a benefit or averts harm, through increasing the cost of the detrimental activity, or by limiting the consumer's liberty.[12] Responsible lending provisions restrict liberty, and are a form of hard paternalism as although they do not impose a complete ban on a certain product, they severely restrict a consumer's freedom of choice to only those credit products deemed appropriate for them by the lender according to the obligations. Anti-paternalist disapproval of government intervention on the basis that it knows better than consumers what is in their

[7] Timothy Irwin *Implications of behavioural economics for regulatory reform in New Zealand* (New Zealand Law Foundation, December 2010) at 4.
[8] Prigden, above n 6, at 617.
[9] Kate Tokeley "Consumer Law and Paternalism: a Framework for Policy Decision Making" in Susy Frankel (ed) *Learning from the Past, Adapting for the Future: Regulatory Reform in New Zealand* (LexisNexis, Wellington, 2011) 267 at 281.
[10] Prigden, above n 6, at 618.
[11] Richard Epstein "The Neoclassical Economics of Consumer Contracts" (2008) 92 Minn L Rev 803.
[12] Tokeley, above n 9, at 270.

best interests has been expressed for centuries.[13] An individual is the best judge of this, aligning anti-paternalism with classical contract theory.[14]

C Behavioural economics casts doubt on disclosure requirements

Disclosure requirements, whilst not entirely libertarian regulations, cannot be viewed as paternalistic. Their goal is to provide information to better allow consumers to make choices in line with their own preferences, rather than force them to make choices perceived by the government to be in their best interests.[15] Behavioural economics however casts doubt on the efficacy of this means of consumer protection. A large body of evidence now suggests that consumers do not always act rationally and with self-interest.[16] Behavioural biases relating to consumer credit can be identified which result in sub-optimal financial behaviour. According to the theory, consumers are overly optimistic, are inconsistent in their decision making, and make poor use of information. Over-optimism leads to errors when assessing the risk of taking on a loan, with consumers seeing possible causes of default such as loss of employment as being unlikely to happen to them.[17] Likewise, overconfidence may cause underestimation of the exponential growth of unpaid interest.[18] A consumer may intend to pay balances on time, but imperfect self control leads to unmanageable debt over time.[19] Inconsistent decisions arise because of consumers' susceptibility to framing, easily manipulated by lenders through advertising. Consumers also suffer from a bias towards the present, affecting the willingness to delay gratification.[20] Poor use can be made of the information that consumers do possess. Larger amounts of information generally do not aid in

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[13] Kant expressed anti-paternalist sentiments in the 1700s, describing such a government as the "greatest conceivable despotism". See Immanuel Kant *Political Writings* (2nd ed, Cambridge University Press, 1991) at 74. In the mid-1800s John Stuart Mill advocated the "harm principle", whereby the only way a government could legitimately restrict peoples' freedom is to prevent harm to others. A person's own good is not sufficient warrant. See John Stuart Mill *On Liberty* (JW Parker, London, 1859).

[14] Paternalistic responsible lending obligations interfere with the principle of freedom of contract by influencing the type of contract that can be entered into. They also interfere with the sanctity of contract principle by imposing obligations on lenders beyond those in the contract, and allowing borrowers to escape their contractual obligations. See Tokeley, above n 9, at 280.

[15] At 273.

[16] Irwin, above n 7, at 4.

[17] Iain Ramsay "From Truth in Lending to Responsible Lending" in G Howells, A Janssen and R Schulze (eds) *Information Rights and Obligations* (Ashgate, Dartmouth, 2005) 47 at 52.

[18] Irwin, above n 7, at 35.

[19] Tony Duggan "Consumer Credit Redux" (2010) 60 University of Toronto Law Journal 687 at 697

[20] Ramsay "From Truth in Lending to Responsible Lending", above n 17, at 53

the comprehension of a transaction. Decision making strategies will be more prone to error as the amount of information provided increases.[21]

D Asymmetric paternalism as a more palatable form

Behavioural economics findings provide support for, but do not necessitate paternalistic intervention,[22] and behavioural economists have attempted to draw a distinction between what is regarded as acceptable and unacceptable forms of paternalism.[23] There is an attraction in classifying responsible lending obligations as being asymmetrically paternalist. Under this theory paternalistic regulation is legitimate if it creates larger benefits for those who make errors while inflicting little or no harm on those who are fully rational.[24] Consumers who would normally act irrationally, exhibiting behavioural biases and taking out loans beyond their means, benefit from the regulation by no longer being eligible for such loans. They are saved from the inevitable debt that would result from a decision against their own self-interest. Minimal harm is inflicted upon rational consumers, who would already be making choices consistent with the regulation, and whose costs would increase only so much as was required to verify the loan was appropriate for them.

E The debate on whether paternalistic intervention is justified

New Zealand consumer protection law currently contains a mixture of both paternalistic and non-paternalistic measures,[25] and paternalistic regulations generally are supported by the community. Thus regulations that are paternalistic in nature need not always be criticised. The challenge is whether or not paternalistic responsible lending provisions to improve consumer welfare are justifiable, considering the problems facing New Zealand, and if so, whether they will be effective in solving such problems.

[21] Ramsay "From Truth in Lending to Responsible Lending", above n 17, at 53.
[22] In contrast to the direct support that neo-classical economics provide for anti-paternalist regulation, behavioural economics does not necessarily support paternalistic regulation. This is because an unregulated credit market can still protect irrational consumers if there are significant numbers of consumers acting rationally for the market to respond to.
[23] Irwin, above n 7, at 50.
[24] Colin Camerer and others "Regulation for Conservatives: Behavioural Economics and the Case for Asymmetric Paternalism" (2002) 151 U Pa L Rev 1211.
[25] Examples of paternalistic regulation designed to protect consumers include taxes that are imposed on tobacco sales under the Customs and Excise Act 1996, bans on inflammable nightwear under the Fair Trading Act 1986, and the prohibition on the sale of medicines not meeting safety standards under the Medicines Act 1981.

CHAPTER II: THE PROBLEMS FACING NEW ZEALAND

A The scale of the "loan shark" problem

The New Zealand credit industry consists of first, second and third tier lenders[26]. Although some lenders are market leaders in good practices, the business practices and conduct of many third tier lenders is resulting in significant consumer detriment.[27] It is these lenders that the Ministry of Consumer Affairs refers to as "loan sharks", whose irresponsible lending practices are resulting in severe financial hardship and spiralling debt.[28] Irresponsible lending is defined as lending without sufficient regard to a customer's ability to repay.[29] New Zealand has seen a rapid growth in this high-cost, unregulated fringe lender market over the past two decades.[30] There has been a notable increase in the number of third tier lenders particularly since 2006, indicating increased opportunities for such lenders in the recent difficult economic times.[31] An estimated 130,580 people used third tier lenders between 2009 and 2011,[32] and 218 companies have been registered as third tier lenders.[33] It is difficult to quantify the exact magnitude of the problem however, as it cannot be said that all third tier lenders engage in irresponsible practices. Such lending may only account for a small proportion of total consumer debt,[34] yet the damage that can be incurred by society's most vulnerable is not to be discounted.

[26] A first tier lender is defined as a registered bank, a second tier lender as a building society or credit union, and a third tier lender as a finance company (other than those offering finance exclusively to businesses), a pawn broker, and a mobile lending truck. See Colmar Brunton *Using a third tier lender: experiences of New Zealand borrowers* (Ministry of Consumer Affairs, August 2011) at 2.

[27] Ministry of Consumer Affairs *Regulatory Impact Statement*: *Responsible Lending Requirements for Consumer Credit Providers* (14 October 2011) at 4.

[28] Cabinet Business Committee *Responsible Lending Requirements for Consumer Credit Providers* (Ministry of Consumer Affairs, October 2011) at 2.

[29] Banking Ombudsman Scheme "Irresponsible lending" (20 December 2011) <www.bankomb.org.nz>

[30] MC Dale "Credit and Debt for Low-income and Vulnerable Consumers" (Backgrounder, Child Action Poverty Group, January 2008).

[31] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 3.

[32] Brunton, above n 26, at 6.

[33] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 3.

[34] Reserve Bank data indicates that non-housing household consumer debt in 2010 was at $12.6billion, with non-housing consumer loans by non-bank lending institutions with less than $100million of assets (covering third tier lenders, plus building societies and credit unions) totalling $0.517billion. See Ministry of Consumer Affairs *Third-tier Lender Desk-based Survey 2011* (July 2011) at 7.

B The nature of "loan shark" loans

Normally it is in a lender's best interest to ensure that a loan can be repaid according to its terms. It appears however that some third tier lenders have established business models on the likelihood that a customer will be unable to repay. Profit is then generated through high default fees and default interest, meaning that providing a loan to a consumer that can be comfortably repaid may actually run counter to the lender's interests.[35] Costs with such lenders can be obscenely high, with interest rates amounting to up to 550% per annum.[36] Lenders will often specialise in small cash loans with short repayment terms.[37] Tight cash flow may mean another loan may be the only option to fund day-to-day living expenses,[38] with multiple loans with different creditors or refinancing or topping up current loans common.[39] Repeat borrowing with high rates, as well as administration fees out of proportion to the size of the loan, leads many consumers to become caught in a spiral of debt, with no chance to get ahead financially.

C Characteristics of loan shark customers

Consumers who have low incomes, cash problems, existing debts, poor credit ratings, are receiving benefits or lack equity in their homes create the demand for loans from third tier lenders.[40] Indigenous and ethnic minority communities are more at risk of exploitation,[41] with Pacific people being particularly vulnerable in New Zealand.[42] Most fringe lenders are located in lower income communities, particularly South Auckland.[43]

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[35] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 8.

[36] In the case of loans from payday lenders and pawnbrokers. Other interest rates were found to be between 20 and 39% per annum. See Brunton, above n 26, at 24.

[37] Paula Cagney and Debbie Cossar *Fringe Lenders in New Zealand: Desk Research Project* (Ministry of Consumer Affairs, July 2006) at 14.

[38] Such lenders may also provide borrowers with larger amounts of credit than they asked for, offer high-interest unsolicited credit to low income households, and offer additional credit after debt has been repaid. See Brunton, above n 26, at 24.

[39] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 9.

[40] Brunton, above n 26, at 24.

[41] Elaine Kempson, Adele Atkinson and Odile Pilley *Policy level responses to financial exclusion in developed economies: lessons for developing countries* (Department for International Development, September 2004).

[42] M Anae and others *Pacific Consumers' Behaviour and Experience in the Credit Market, With Particular Reference to the 'Fringe Lending' Market* (Ministry of Consumer Affairs, August 2007) at 11.

[43] For example, of the 127 fringe lenders in Auckland, 37% have branches in South Auckland. Although this is still very high, increases in new outlets since 2006 has been focused around Auckland, not exclusively South Auckland, indicating a more general unmet demand. See Ministry of Consumer Affairs *Desk-based Survey 2011*, above n 34, at 15.

Generally these are consumers with no access to mainstream credit, possessing specific characteristics making them vulnerable to exploitation when entering into contracts. Borrowers may have English as their second language, or lack financial literacy, meaning they lack knowledge of their rights, or of the impacts of loan terms and high interest rates.[44] These borrower shortcomings can be taken advantage of by the lender by providing either long, technical contracts, or overly simplified contracts, and then simply handing over the contract for the borrower to read, or rushing them through the terms. The borrower may be so focused on getting the money immediately that little attention is paid to the details.[45] Even consumers with relatively high levels of financial literacy and awareness of associated costs still enter into loans with third tier lenders on unfavourable terms due to a perceived lack of choice about conditions under which they accept credit.[46] Lenders exploit this lack of choice and desperation arising from an urgent need for credit. The most common reported reason for using loan sharks among Pacific consumers was to meet to meet the needs of everyday household expenses, followed by the need to purchase large items. Meeting social and cultural obligations was the third.[47] Cycles of debt may mean borrowers are dependent upon such loans to meet everyday expenses, or obligations may arise for which a borrower cannot plan, increasing likelihood of accepting exploitative loan terms.

D Methods of targeting vulnerable consumers

Customers are targeted through aggressive advertising, using "hooks" to draw people into using their services. Advertisements will generally emphasise the ease and speed with which credit can be obtained,[48] and demonstrate the flexibility of loans.[49] The availability of credit to all consumers regardless of their credit history or financial situation is also commonly emphasised.[50] "No hidden costs", "attractive rates" and similar phrases express the affordability of loans, although annual percentage interest rate will not generally be stated.[51]

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[44] Brunton, above n 26, at 4.
[45] At 19.
[46] Anae, above n 42, at 13.
[47] Cagney, above n 37, at 13.
[48] Common phrasing includes "Same day approval" and "Easy, fast cash", at 23.
[49] Through phrasing such as "Loans for any reason", or by giving the upper and lower limits of credit extended, for example "Loans from $50 to $2000". Examples of when such loans may be required are given by phrases such as "Overdue bills?" or more specifically "Failed WOF but short of money?", at 23.
[50] Examples of phrasing include "Past problems? Call", "Beneficiaries OK" and "No security required." "No hidden costs", "attractive rates" and similar emphasise the affordability of loans, at 24.
[51] Ministry of Consumer Affairs *Desk-based Survey 2011*, above n 34, at 5.

Targeting of ethnic groups is explicit, with community newspaper advertisements in the Samoan, Tongan and English language. People of the same ethnicity as the target market often feature in advertisements,[52] and companies use celebrity endorsements in order to promote their services.[53] Friendly and welcoming staff have been reported as a reason for selecting a third tier lender,[54] which is played upon using first names and photographs of lenders to create a personal touch, along with phrases such as "Friendly team" and "Be part of the family".[55] Consumers may not ask all the questions that they need to of their lender because they appear to be reputable or trust worthy.[56] This is particularly so if the lender is a member of the same ethnic community.[57] The ease of access also attracts people to such lenders. Lenders operate locally, often as sole traders in low income areas,[58] or can visit a borrower's home with a mobile lending truck.[59] Increasingly, lenders advertise online, allowing consumers to apply for credit directly from their websites.[60]

E Consequences of default and debt

Generally, debt collection is assigned to a third party, who has little interest in working through the debt with the borrower.[61] It is also common for loans to be secured against personal property, with the property worth considerably more than the loan.[62] Default can therefore result in the repossession of household items.[63] The wider impacts of debt are both practical and emotional. Practical consequences include the inability to meet food, transportation and health needs, or an inability to engage in what might be considered normal

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[52] For example, the Money Shop has advertisements in both Tonga and Indian community newspapers, which are identical apart from the ethnicity of the woman featured, which matches the target audience. See Cagney, above n 37, at 21.

[53] For example, legendary rugby league player Stacey Jones was signed on to endorse third tier lender Instant Finance, controversially appearing in television advertisements, websites and brochures. Jones was chosen as an iconic figure for the target market as in Hayden Donnell "Stacey Jones fronting for 'loan shark' – MP" (6 July 2011) New Zealand Herald <www.herald.co.nz>

[54] This is particularly so if a relationship has been built up with the lender over previous loans. See Brunton, above n 26, at 13.

[55] Cagney, above n 37, at 24.

[56] Brunton, above n 26, at 13.

[57] Anae, above n 42, at 13.

[58] Ministry of Consumer Affairs *Desk-based Survey 2011*, above n 34, at 2.

[59] Brunton, above n 26, at 13.

[60] Ministry of Consumer Affairs *Desk-based Survey 2011*, above n 34, at 17.

[61] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 8.

[62] Anae, above n 42, at 10.

[63] Ministry of Consumer Affairs *Regulatory Impact Statement,* above n 27, at 5.

activities,[64] leading to social isolation. Emotionally, debt can impact negatively on mental well-being, leading to depression and straining relationships with family and extended family. The impacts of debt are not limited to the borrower, affecting entire families and their children, with children growing up in an environment where adults operate under considerable stress.[65]

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[64] Such as family outings, holidays, entertainment or participation in sport. See Families Commission *Escaping the Debt Trap: Experiences of New Zealand Families Accessing Budgeting Services* (Families Commission, Research Report 6/09, December 2009) at 13.1.3.
[65] At 13.1.3.

CHAPTER III: THE CURRENT LAW AND PROPOSED REFORM

A *Origins and aims of the Credit Contracts and Consumer Finance Act 2003*

The current Act governing consumer credit contracts, the Credit Contracts and Consumer Finance Act 2003 (the "CCCFA") came into force in 2005 repealing and amalgamating the Credit Contracts Act 1981 and the Hire Purchase Act 1971.[66] The Credit Contracts Act 1981 was unable to keep up with the changing credit environment and was rapidly outdated resulting in deficiencies in consumer protection.[67] The 2003 Act attempted to rectify these issues and bring legislation in line with credit contract concepts and procedures of the time.[68] Some provisions are almost identical to those in the predecessor Credit Contracts Act 1981, whilst other parts reflect significant change.[69] The Act now focuses on consumer protection[70] with the driving force "not being to stop consumers from acquiring debt, but rather to promote more transparency in lending."[71] Thus consumer protection is primarily achieved by requiring the disclosure of adequate information to consumers,[72] with the aim that informed consumers help in promoting healthy competition among credit providers.[73] Additionally the Act aims to provide consistent rules about how interest and fees are calculated and charged,[74] and allows consumers to seek relief from the Court to prevent oppressive conduct.[75]

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[66] Bill Bevan *Consumer Credit* (1st ed, LexisNexis, Wellington, 2005) at 1

[67] The Credit Contracts Act 1981 was drafted in the 1970s, prior to the significant financial deregulation of the 1980s which saw both the range and nature of financial institutions and credit products increase considerably. The next 20 years also saw marked technological advances which changed the way business could be done through the utilisation of computers. The law was overly complex, spread over several statutes, and imposed unnecessary compliance costs upon lenders. It was also difficult for consumers to enforce against creditors, essentially leaving it to consumers to ensure the complex requirements of the Act were met through legal action, see above n 66, at 3.

[68] Duncan Webb *Credit Contracts and Consumer Finance in New Zealand* (1st ed, Thompson Brookers, Wellington, 2004) at 2.

[69] At 3.

[70] Credit Contracts and Consumer Finance Act 2003, s3(a).

[71] Commerce Commission "New credit law enhances consumer information" (March 2003) <www.comcom.govt.nz> at 1.

[72] Credit Contracts and Consumer Finance, s3(b).

[73] Commerce Commission, above n 71, at 1.

[74] Credit Contracts and Consumer Finance Act, s3(c).

[75] Section 3(g).

B Enforcement of lender obligations

Responsibility of the Commerce Commission was extended to the administering and enforcing of the CCCFA.[76] The Commission plays a role in consumer protection by investigating lenders who may have breached the CCCFA,[77] however they are not under a duty to act for individual debtors.[78] Consumers must therefore take independent action if they suspect there has been a breach. A complaint can be made to an independent dispute resolution scheme which lenders are required to be a member of under the Financial Service Providers (Registration and Dispute Resolution) Act 2008.[79] The resolution recommended is binding on the lender,[80] but the consumer is free to accept or reject it. Alternatively, legal action can be taken by the borrower against a lender, either through the Disputes Tribunal, or the District Court.

C The "Oppression" remedy as a safety net

Section 120 permits but does not require the Court to reopen a credit contract if it considers the contract is oppressive, or a party to the contract has exercised power in an oppressive manner, or a party has been induced by oppressive means.[81] It is open to the Court, subject to guidelines, to decide in particular circumstances if oppression exists.[82] The definition of oppression remains unchanged from the Credit Contracts Act 1981 and its predecessor, the Money Lenders Act 1908. "Oppressive" is thus defined as "harsh, unjustly burdensome, unconscionable, or in breach of reasonable standards of commercial practice".[83] The provision acts as a safety net, acknowledging that even in competitive markets unacceptable practices can arise.

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[76] Section 111.
[77] Section 111(2).
[78] Section 111(3).
[79] Financial Service Providers (Registration and Dispute Resolution) Act 2008, s 48.
[80] Section 49F.
[81] Credit Contracts and Consumer Finance Act, s 120.
[82] Section 124.
[83] Section 118.

D GE Custodians v Bartle and the Supreme Court view of lender obligations

GE Custodians v Bartle[84] reaffirms the current law in New Zealand in relation to the reopening of credit contracts. The case involved an elderly retired couple of limited means and assets who had entered into an asset lending transaction.[85] Equity in their home was used as security to borrow money to invest jointly with Blue Chip in an apartment and secure a cash stream. The couple were totally reliant on Blue Chip to service the loans and purchase the apartment back after four years as they had low personal income and limited means. If Blue Chip failed to do so it was the couple who were ultimately liable to their lender and risked losing their home. The loan terms were 25 years.[86] The couple had dealt with a mortgage broker and not the lender themselves. Their lawyer, who advised a number of Blue Chip clients, was found to have breached a duty of care by providing inadequate advice about the risks. No remedy was available against him however as he was already bankrupt. The High Court dismissed the claim that the loans were oppressive.[87] On appeal, the Court of Appeal reasoned that whilst asset lending is not unconscionable per se, it has a substantial potential for injustice.[88] When making long term loans to older people such as here, the lender needs to look closely into the borrower's circumstances.[89] Responsibility under the CCCFA cannot be avoided by the use of an intermediary,[90] nor can the lender rely on borrowers having had legal advice which was neither competent nor independent.[91] The lender's own admission that the loan should not have been made was taken as powerful evidence of a departure from reasonable standards of commercial practice.[92]

This decision was considered a serious departure from established jurisprudence.[93] The Supreme Court held that oppression could not be found on the basis of matters unknown to the lender, or in respect of matters which it was not put on inquiry as a result of knowing

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[84] *GE Custodians v Bartle* [2010] NZSC 146.
[85] The issue of a lender's conduct in dealing with borrowers of advanced age has been previously considered in *Trustees Executors Limited v Turnbull & Anor [2009] NZCA 574.* Arnold J declined to grant a summary judgment as there was arguable basis that the lender had acted unconscionably by granting a $4million loan secured by mortgage to an elderly couple who had no ability to meet the interest repayments and with whom they had never dealt with directly.
[86] For further discussion of the nature of the loans refer to Chapter 7B.
[87] *Bartle v GE Custodians* HC Auckland CIV-2008-404-3460, 30 September 2009.
[88] *Bartle v GE Custodians* [2010] NZCA 174, [2010] 3 NZLR 601 at [78] per Hammond J.
[89] At [223] per Arnold J.
[90] At [88] per Hammond J.
[91] At [97] per Hammond J.
[92] At [72] per Hammond J.
[93] Brent O'Callahan "Transactions: Lenders' Duties" (2011) NZLJ 17 at 17

something.[94] The lender was entitled to assume that advice given to the borrower by the lawyer is competent and that the lawyer would not have accepted instruction if there was a conflict of interest.[95] The lender knew nothing of Blue Chip's involvement, nor did it have any duty to inquire into details of the underlying transactions.[96] The loans were therefore not in breach of reasonable standards of commercial practice, and were not oppressive.[97] It was acknowledged that the result is "hard for Bartles", but any other result would "require lenders to take responsibility for matters of which they neither knew nor should have known".[98] To hold the lender responsible for what had occurred would make "bad law".[99]

Therefore as the law currently stands, a lender is able to proceed on the basis of what is told to it, and is not required to conduct an investigation into the affairs of the borrower. A borrower cannot assume that the granting of a loan means that a transaction is fair or affordable.[100] The case reaffirms the general principle of New Zealand's lending laws that lenders do not assume the responsibility for the actions of borrowers.[101] The decision on whether or not to lend is left largely unfettered by the law.[102] The proposed reforms would essentially have the opposite effect.

E Introduction of the Bill

The Credit Contracts and Consumer Finance Amendment Bill Exposure Draft (the "Bill") was released in April 2012 by Consumer Affairs Minister Chris Tremain. Submissions have closed on the Bill and currently the Minister is seeking agreement from Cabinet on the content of the Amendment Bill.[103] The aim is that the final Bill is tabled in Parliament in

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[94] *GE Custodians v Bartle*, above n 84, at [47] per Blanchard J.
[95] At [48] per Blanchard J.
[96] At [61] per Blanchard J.
[97] See Chapter 7A for further discussion on how the finding of no oppression was reached.
[98] At [67] per Blanchard J.
[99] At [68] per Blanchard J.
[100] O'Callahan, above n 93, at 18.
[101] Rachel Gowing "Proposed tougher consumer credit laws target loan sharks" (2011) Bell Gully Financial Services Quarterly <www.bellgully.com>
[102] Sarah Simmers and Stuart Walker "Changes to consumer and commercial credit laws" (paper presented to the New Zealand Law Society Lending and Securities Conference, June 2012) 1 at 5.
[103] The Bill comes at the end of a time of significant reform of financial sector legislation, for example the new regulatory regime for financial service providers through the Financial Advisors Act and Financial Service Providers (Registration and Dispute Resolution) Act 2008, prudential regulation of the insurance sector under the Insurance (Prudential Supervision) Act 2008, and the establishment of a new consolidated market conduct regulator for the financial sector, the Financial Markets Authority under the Financial Markets Authority Act 2011. These reforms have all focused on the investment side of the sector. This is the second attempt made to

October.[104] The current reforms proposed were influenced by the Review of the CCCFA released in 2009[105] which analysed the effectiveness of the legislation and outlined proposed changes. Influence was also drawn from the Financial Summit hosted in 2011 by the Minister of Consumer Affairs which looked at initiatives for addressing consumer debt.[106] The Summit saw strong support for a regulatory approach which would add a responsible lending framework to the CCCFA.

F Policy objectives of the Bill

The proposed reforms have been promoted as "tougher laws for loan sharks", however the changes will apply to all creditors entering into consumer credit contracts.[107] The Policy Statement of the Amendment Bill notes that the focus of the current Act is promoting competition among credit providers and enabling them to make informed decisions. There is no requirement for lenders to behave responsibly, and the current Act provides inadequate consumer protection against "unscrupulous" lenders.[108] The Bill proposes to replace the "Purpose" section of the CCCFA, recasting it to give consumer protection the primary emphasis.[109] There is also reference to the general purposes of consumer law added by the Consumer Law Reform Bill to the Fair Trading Act 1986 and the Consumer Guarantees Act 1993. These are promoting the confident and informed participation in markets by consumers and creditors, and promoting and facilitating fair, efficient and transparent markets for credit.[110] According to the Ministry, the problem in New Zealand with third-tier lenders is best addressed through adding a responsible lending purpose and principles to the CCCFA.[111] This represents a significant departure from current general principles of lending law. The Explanatory Information released with the draft Bill outlines "responsible lending" as meaning that lenders cannot be indifferent to the circumstances of their customers or the

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address the issue of consumer protection, the first being Carol Beaumont's Credit Reforms (Responsible Lending) Bill, defeated at First Reading in 2010.

[104] Ministry of Consumer Affairs "Policy in Development: Consumer Affairs" (27 July 2012) <www.consumeraffairs.govt.nz>

[105] Ministry of Consumer Affairs "Review of the Operation of the Credit Contracts and Consumer Finance Act 2003" (September 2009) <www.consumeraffairs.govt.nz>

[106] Cabinet Business Committee, above n 28.

[107] Chris Tremain "Tougher laws for loan sharks" (2 April 2012) Ministry of Consumer Affairs <www.beehive.govt.nz >

[108] Credit Contracts and Consumer Finance Amendment Bill (Exposure Draft) (Explanatory note)

[109] Credit Contracts and Consumer Finance Amendment Bill, cl 3 at s3(1)

[110] Clause 3 at s3(2).

[111] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 4.

effect of the debt they are providing. The principle is consistent with the regulation of other services provided to potentially vulnerable consumers. Whilst the overriding purpose of the obligations is consumer protection, they will also allow lenders who already lend responsibly to compete more effectively with other lenders. The objective is to "lift the business practices of lenders towards an industry best practice standard."[112]

G Responsible lending principles and Code

The Bill sets out the "Lender responsibility principles" under a new section 9B.[113] The lender must have regard to, and comply with, all specified principles in relation to an agreement with a borrower.[114] The core of the obligations is that lenders will now be required to make reasonable enquiries as to the borrower's financial circumstances, and requirements and objectives in entering into the agreement.[115] The lender must then be satisfied, before entering into an agreement, that the borrower can be reasonably expected to make the repayments without suffering substantial hardship, and that the agreement is otherwise appropriate for the borrower, having regard to the borrower's circumstances, requirements and objectives.[116] The principles provide high level objectives but no prescriptive details. According to the Ministry, such outcomes-focused legislation is easier for businesses to comply with as they are able to determine how they will meet the objectives without having to follow "detailed or intrusive" rules.[117]

A "Responsible Lending Code" (the "Code") is to be developed which will "elaborate on the lender responsibility principles… and offer guidance on how these principles might be implemented by lenders".[118] However in keeping with the outcomes-focused approach, the Code is not intended to act as a prescriptive set of rules.[119] The Code is to be published within two years of the amendments coming into force.[120] Whether it will be developed by a code

[112] Credit Contracts and Consumer Finance Amendment Bill (Exposure Draft) (Explanatory memorandum) at 2
[113] For full principles s 9B(2)(a)-(h) see Appendix 1.
[114] Credit Contracts and Consumer Finance Amendment Bill, cl 7 at s 9B(1) and (2).
[115] Clause 7 at s 9B(2)(e)(i) and (ii).
[116] Clause 7 at s 9B(2)(f)(i) and (ii).
[117] Consumer Law Reform: A Discussion Paper (Ministry of Consumer Affairs, July 2010) at 5.
[118] Clause 7 at s 9C.
[119] Credit Contracts and Consumer Finance Amendment Bill (Exposure Draft) (Explanatory memorandum) at 2.
[120] Clause 7 at s 9E(1)(b).

committee,[121] or by the Minister in consultation with affected people has not yet been decided.[122] The precise legal standing of the Code is also not yet known. A failure to comply may amount to a breach of the principles, or compliance may be evidence of fulfilling them.[123] Therefore until the Code is published, the full nature and extent of a lender's legal obligations under the principles will not be known.[124]

H Consequences of breach

Under the current draft Bill the consequences for breaching the responsible lending requirements are significantly less severe than for breaching other obligations under the Act, such as those relating to disclosure.[125] Currently breaches of the CCCFA can give rise to statutory damages,[126] a wide range of Court orders,[127] an injunction,[128] or a conviction for an offence.[129] A breach of the responsible lending principles will not give rise to any such consequences, nor will it necessarily prohibit the enforcement of a credit contract.[130]
Under the Bill a banning order can be made if the Court considers a creditor is not a "fit and proper person" to act as a creditor, and they have breached responsible lending principles more than once.[131] The Commerce Commission can take civil proceedings against a creditor for a breach of the principles,[132] though the Commission is still under no duty to act for an individual borrower.[133] Consumer action is therefore still required in order to hold a lender to account for a breach of the principles.[134]

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[121] As is the Code of Professional Conduct for financial advisors.
[122] Credit Contracts and Consumer Finance Amendment Bill (Exposure Draft) (Explanatory memorandum) at 2.
[123] Craig Shrive and Katie Bhreatnach "Credit Contracts and Consumer Finance Amendment Bill Exposure Draft released" (4 April 2012) Russell McVeagh <www.russellmcveagh.com>
[124] See Chapter 5B for a discussion on how this uncertainty will impact on the cost of the proposed legislation.
[125] The inadequacies of the penalty regime are further discussed at Chapter 6B.
[126] Credit Contracts and Consumer Finance Act, s 88-92.
[127] Section 93.
[128] Section 96.
[129] Sections 103-105.
[130] Section 99.
[131] Credit Contracts and Consumer Finance Amendment Bill, cl 33 at s 32, Section 108 amended.
[132] Credit Contracts and Consumer Finance Act, s 111(2)(c).
[133] Section 111(3).
[134] Concerns with the effectiveness of relying on consumer initiated action to commence proceedings is discussed at Chapter 6C.

I Guidelines for finding "Oppression"

The Ministry views the oppression test applied by the Courts as setting the bar too high, and thus have included prescriptive guidelines for the Court to have regard to in an attempt to make it easier for borrowers to meet the threshold when challenging a credit contract.[135] Compliance with the responsible lending principles will now be a factor that must be considered by the Court to the extent applicable in the particular circumstances.[136] A number of the other guidelines are those that have been taken into account by the Courts in oppression cases under the past CCCFA and the Credit Contracts Act 1981.

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[135] Credit Contracts and Consumer Finance Amendment Bill (Exposure Draft) (Explanatory memorandum) at 6. See Chapter 6D for a discussion of the effect of additional guidelines on the threshold. Refer to Appendix II for marked up amendments showing changes to s 124 of the CCCFA proposed in the draft Bill.
[136] Credit Contracts and Consumer Finance Amendment Bill, cl 33 at s 33(1), Section 124 amended.

CHAPTER IV: THE AUSTRALIAN APPROACH

A A two-phase approach to reform

New Zealand is by no means isolated in the decision to make changes to consumer credit regulation through the introduction of responsible lending principles.[137] The proposed approach is consistent with regulation introduced in Australia under the National Consumer Credit Protection Act 2009 (NCCPA), which took effect for all lenders and brokers from 1 January 2011.[138] The NCCPA was implemented as Phase One of the two-phase implementation plan to transfer the responsibility of credit regulation to the Commonwealth.[139] Phase One was intended to introduce a statutory framework to the Commonwealth to regulate persons who engage in credit activities, specifically through the introduction of responsible lending principles. Whether or not additional reforms were needed, including addressing specific practices in relation to small amount credit contracts, was to be decided under Phase Two. Phase Two has resulted in the Consumer Credit Legislation Amendment (Enhancements) Bill 2012 (the "Enhancements Bill").

B Reforms under Phase One – The National Consumer Credit Protection Act 2009

1 Context of the NCCPA

Australia needed a more national uniform approach, with consistent regulation, particularly of brokers, across all states and territories.[140] Responsible lending provisions were proposed

[137] For example in the United Kingdom, the Consumer Credit Act 2006 incorporates the EC Consumer Credit Directives into national law. Under the directive a lender is required to assess a borrower's creditworthiness. In the United States the Mortgage Reform and Anti-Predatory Lending Act of 2010 is one title of the Dodd-Frank Wall Street Reform and Consumer Protection Act, under which creditors who offer residential mortgage loans must verify that the borrower has a reasonable ability to repay.

[138] Banks, other authorised deposit-taking institutions and registered financial corporations have been under responsible lending obligations since 1 January 2011. Other lenders and brokers were regulated from 1 July 2010 according to Paul Ali "Banking and Finance: New National Responsible Lending Obligations – Pt 1" (2011) 39 ABLR 464 at 464.

[139] As decided by the Council of Australian Governments, 3 July and 2 October 2008. See Consumer Credit Legislation Amendment (Enhancements) Bill 2012 (Revised Explanatory Memorandum) at 4.4.

[140] Prior to 1996 Australian territories and states regulated credit independently of one another. Under the Consumer Credit (Queensland) Act 1994 (Qld) the Consumer Credit Code was made, which became the main regulatory instrument applying across the country for the protection of consumer borrowers. Additional complementary legislation could still be enacted by states and territories. Such regulation may have covered finance brokers, but this was not so in all jurisdictions. Responsibility for poor lending decisions was able to be

in order to encourage prudent lending, sanction irresponsible lending,[141] and curtail undesirable market practices, particularly where intermediaries are involved.[142] Reform was thus already underway when the global financial crisis hit, yet it appears that these events overseas added impetus to, and influenced the shape of the responsible lending provisions.[143] Significant blame for the global financial crisis has been placed on ineffective regulation of inappropriate mortgage lending practices[144] and the resulting sub-prime mortgage crisis in the United States in 2007.[145] The Australian loan market was far more favourable, however there was recognition by legislators and regulators that there was potential for similar problems.[146] Aspects of sub-prime lending were taking place in the market through the inappropriate use of "low-doc" and "no-doc" loans, which allow borrowers to self-certify their repayment capacity.[147] The products were sold to unsuitable consumers such as social security recipients, were forced upon consumers by brokers chasing higher commission, and were used by brokers and lenders to engage in "equity stripping".[148] Brokers were also misrepresenting borrowers' financial details to gain commission on loans that would not otherwise be approved, and were "upselling" loans to earn higher commission.[149]

The new legislation thus set out to bring an end to these undesirable mortgage market practices, holding both lenders and brokers to account for irresponsible lending. The law thus applies very broadly to all classes of financial brokers and intermediaries, as well as to credit providers. It applies to all those who engage in "credit activity",[150] the definition of which is

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avoided by lenders by hiding behind actions of brokers. See Karen Cox "Hop Topics: Consumer Credit" (2010) Legal Information Access Center <www.legalanswer.sl.nsw.gov.au> at 2

[141] National Consumer Credit Protection Bill 2009 (Explanatory memorandum) at 3.16.

[142] At 3.11.

[143] Ali "New National Responsible Lending Obligations – Pt 1", above n 138, at 464.

[144] In particular, brokered mortgages. See The Financial Crisis Inquiry Commission *The Financial Crisis Inquiry Report – Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (January 2011) at Ch 7.

[145] High risk mortgage debt originating from marginal borrowers was bundled and sold on the international market. The collapse of the market was contributed to by a number of features of the mortgages including a failure to properly assess the credit risk, offering initial fixed term rates of 1 to 5 years resulting in negative amortisation, weak underwriting standards permitting high loan to value ratios, high interest rates to price loans for risk, and no liability for shortfall. When anticipated gains in property prices did not occur defaults arose. Third party fraud against borrowers and lenders by brokers was also reported to be a significant factor. See Ali "New National Responsible Lending Obligations – Pt 1", above n 138, at 464.

[146] At 465.

[147] Cox, above n 140, at 8.

[148] High interest rate loans secured by a caveat over the borrower's home, often arranged for borrowers already in financial difficulty with the expectation of default and subsequent transfer of equity in the borrower's home to the broker and lender through default interest, fees and charges. See Ali "New National Responsible Lending Obligations – Pt 1", above n 138, at 464.

[149] National Consumer Credit Protection Bill 2009 (Explanatory memorandum) at 3.11.

[150] Meaning as in National Consumer Credit Protection Act 2009 (Cth), s 6.

even broader than under the New Zealand draft Bill,[151] and thus the responsible lending obligations are also imposed upon the micro-lenders our law aims to regulate.

2 Responsible Lending Obligations under the NCCPA

This legislation establishes responsible lending obligations[152] which require credit providers and credit assistance providers to take three steps; make reasonable enquiries about the consumer's requirements and objectives[153] and their financial situation[154]; take reasonable steps to verify the consumer's financial situation[155]; and make an assessment about whether the credit contract is 'not unsuitable' for the consumer.[156] A contract will be 'unsuitable' if; it does not meet the consumer's requirements and objectives[157]; or the consumer is unlikely to be able to meet their financial obligations under the credit contract or consumer lease, or can only do so with substantial hardship.[158] Substantial hardship will be presumed under the NCCPA where the consumer could only comply with its financial obligations under the contract by selling their principal place of residence.[159] Those who hold Australian credit licenses are required to keep a record of all material forming the basis of whether or not a credit contract is unsuitable for a consumer, and this material must be in a form that enables the licensee to give the customer a written copy upon request.[160]

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[151] Credit Ombudsman Service *Responsible Lending* (Position Statement Issue 5, 5 December 2011) at 3 broadly describes when the NCCPA will apply to the provision of credit (with some exceptions) as when (a) debtor is a natural person or a strata corporation; and (b) the credit is provided wholly or predominantly for (i) personal, domestic or household purposes; or (ii) to purchase, renovate, improve or refinance a residential investment property; and (c) a charge is made for credit. This is wider than the cover of the CCCFA in New Zealand as section 12 states that investment by a debtor is not a personal, domestic or household purpose. Loans thus taken out for investment purposes in New Zealand, such as the purchase of a second house to use as a rental property, are not "consumer credit contracts" for the purpose of the CCCFA, and no change is proposed to definition. The scope of Australian law to regulate the provision of mortgages over residential investment properties has only been extended under the recent reform. The implications of this difference in definition are discussed at Chapter 7.
[152] National Consumer Credit Protection Act, Ch 3.
[153] Section 117(1)(a) and section 130(1)(a).
[154] Section 117(1)(b) and section 130(1)(b).
[155] Section 117(1)(c) and section 130(1)(c).
[156] Section 131 and section 133.
[157] Section 131(2)(b) and section 133(2)(b).
[158] Section 131(2)(a) and section 133(2)(a).
[159] Section 131(3) and section 133(3).
[160] Australian Securities & Investments Commission *Review of micro lenders' responsible lending conduct and disclosure obligations: Report 264* (November 2011) at 4.

The National Credit Code forms a schedule to the NCCPA, replacing the previous Uniform Consumer Credit Code. The Australian Securities and Investments Commission (ASIC) issued a Regulatory Guide[161] to help the lending industry prepare for new obligations. The guide is detailed and prescriptive,[162] intended to give insight how the law will be enforced and how to interpret the legislation.[163]

3 Enforcement and consequences of breach of the obligations

Both ASIC and consumers are able to take action against a licensee for a breach of responsible lending obligations. ASIC is now the regulatory body for consumer credit, responsible for the enforcement of the law. Complaints can be made to ASIC who may investigate and has the power to take enforcement action against a lender whose actions are potentially affecting a number of borrowers.[164] Administrative sanctions can be administered by ASIC, with the power to ban individuals and cancel or suspend credit licenses.[165] ASIC is able to commence class action on behalf of consumers.[166] Individual consumers can have complaints resolved through the external disputes resolution scheme, or through state and federal courts. A breach of responsible lending provisions can result in significant civil and criminal penalties.[167] For contraventions that result in social, economic or moral harm such as assisting a customer to enter into an unsuitable credit contract, civil penalties of up to 2000 penalty units,[168] or criminal penalties of 100 penalty units, or two years imprisonment, or both,[169] may be imposed.

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[161] Australian Securities & Investments Commission *Credit licensing; Responsible lending conduct, Regulatory Guide 209* (March 2011).
[162] Simmers and Walker, above n 102, at 35.
[163] Cox, above n 140, at 4.
[164] National Consumer Credit Protection Act, Ch 6, s 247.
[165] Section 81(1).
[166] Under the Enhancements Bill ASIC can also act on behalf of individual consumers, with standing to apply to the Court for an order regardless of whether a civil remedy is available under another provision, under s124(a) National Consumer Credit Code.
[167] Note that Australian penalties are defined as penalty "units". Under s 4AA Crimes Act 1914, 1 penalty unit is equal to $110 AUD.
[168] National Consumer Credit Protection Act, s 123(1).
[169] Section 123(6).

C Reforms under Phase Two – the Consumer Credit Legislation Amendment (Enhancements) Bill 2012

1 Context of the Amendments

It has been recognised by the Australian Government that there are risks inherent in the use of small amount credit.[170] There has been recognition that the responsible lending obligations do not provide complete protection from such risks. They do not impact directly on the cost of credit,[171] nor necessarily prevent consumers from entering into multiple contracts, thereby increasing their overall levels of indebtedness.[172] The Enhancements Bill introduces specific changes to the NCCPA to improve the protections offered to consumers entering into small amount credit contracts.

2 Content of the Amendments

The issue of repeat borrowing and consequent spiraling debt is addressed in the Enhancements Bill by imposing new disclosure requirements, prohibiting short term lending, and introducing presumptions and obligations in relation to suitability. Substantial hardship is assumed if certain circumstances are present.[173] Lenders are prohibited from entering into contracts for small amounts where the term of the contact is 15 days or less, so that a borrower will generally have at least two income cycles to meet repayments.[174] The danger of high cost credit is also addressed through a tiered approach to a cap on costs. The cap is set at a level balancing consumer interests with the viability of the industry,[175] given the high

[170] A small amount credit contract has been defined in Australia as one where the amount of credit provided is less than $2000, and the term is less than two years. See Consumer Credit Legislation Amendment (Enhancements) Bill 2012 (Revised Explanatory Memorandum) at 4.2.

[171] Australian Treasury *Regulation Impact Statement: Regulation of Short Term, Small Amount Finance* (2 September 2011) at 38.

[172] This means that an increasing proportion of a borrower's income needs to be used to meet repayments, and the borrower's capacity to use the credit to improve their standard of living is severely diminished. See Consumer Credit Legislation Amendment (Enhancements) Bill 2012 (Revised Explanatory Memorandum) at 4.8.

[173] Consumer Credit Legislation Amendment (Enhancements) Bill 2012, Schedule 3. See Chapter 6E(1) for further explanation of the presumptions.

[174] This provision aims to address the danger to consumers posed by "pay day" lending. See Consumer Credit Legislation Amendment (Enhancements) Bill 2012 (Revised Explanatory Memorandum) at 4.3.

[175] Consumer Credit Legislation Amendment (Enhancements) Bill 2012 (Revised Explanatory Memorandum) at 5.12.

establishment costs of such loans relative to the loan amount.[176] For a small amount credit contract the maximum costs (other than in the event of default) will be the total of an establishment fee which can be a maximum of 20 percent of the amount the debtor receives in their hand, monthly fees of four percent of this amount, and any government fees, charges or duties payable in relation to the contract.[177] All other credit contracts are subject to a cap so that the annual cost rate (including credit fees and charges and interest rates) cannot exceed 48 percent.[178]

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[176] The tiered cap on costs will be discussed further at Chapter 6E(2) when assessing the likely effectiveness of New Zealand's provisions.

[177] For example, a maximum total cost of $24 on a $100 loan for a term of 16 days. See Consumer Credit Legislation Amendment (Enhancements) Bill 2012 (Revised Explanatory Memorandum) at 5.12.

[178] Formula allows for an additional $400 fee to be charged if it is a "medium amount" credit contract, defined as a contract with a credit limit between $2000 and $5000, with a maximum term of two years. See Table 5.1 of Consumer Credit Legislation Amendment (Enhancements) Bill 2012 (Revised Explanatory Memorandum)

CHAPTER V: INSUFFICIENT JUSTIFICATION FOR PATERNALISTIC INTERVENTION

A The notion of the "irrational" consumer

Neoclassical economics and the rational consumer are used to justify disclosure requirements as a means of consumer protection. Behavioural economists identify behavioural biases exhibited by consumers which contradict these assumptions about rational consumer behaviour.[179] However the use of the theory to justify paternalistic intervention is flawed.

Information based methods of consumer protection such as disclosure requirements are market-based. Paternalistic regulation through responsible lending is an individual-based model, justified by the fact that some consumers need to be protected from themselves. But this shift from market based to consumer based protection is wrongly seated in the belief that all consumers who take out high cost loans do so on the basis of irrationality. It ignores the fact that such a niche market exists, not out of consumer misinformation, but out of consumer desperation.

Acquiring a loan on unfavourable terms may not be due to a lack of "shopping around" what loans may be on offer through other lenders. For many borrowers their credit ratings, existing debts and security they can offer means such a loan is their only option for borrowing money for essentials.[180] Even if they were to "shop around" the result may be no different, as likely the only borrowers willing to lend would be charging high costs.

To assume the welfare of vulnerable consumers will increase if responsible lending obligations prevent the provision of inappropriate credit, is to wrongly equate "vulnerability" with "irrationality". "Vulnerability" can take many forms, and whilst a consumer may be vulnerable in the sense of having poor English or poor financial literacy, they may also be vulnerable in the financial sense of low income due to having recently lost employment, or suffering from sickness or injury.

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[179] Paul Ali, Cosima McRae and Ian Ramsay "Consumer Credit Reform and Behavioural Economics: Regulating Australia's Credit Card Industry" (2012) 40(2) ABLR 59 at 129.
[180] Brunton, above n 26, at 13.

Only a market-based approach ensuring the provision of affordable credit can assist such borrowers,[181] whose apparent irrational behaviour is more likely a result of circumstance, rather than a consumer's lack of knowledge relative to a high income earner.[182] The number of borrowers who will genuinely benefit from the paternalistic regulation has been overestimated if it is assumed that borrowers acting irrationally and of their own free will is what lead to the creation of the high cost third tier credit market. It ignores those who are rational but desperate.[183]

B The paternalistic bias in cost-benefit analysis

1 Difficulties with objectivity and accuracy

A cost-benefit analysis of proposed legislation is essential in the reform process. Such analysis is included in the Regulatory Impact Statement of the draft Bill. Asymmetric paternalism lends itself to such analysis, as good policy will be such that benefits to the irrational consumer exceed costs imposed on the rational consumer, lenders and the government.[184]

However an objective and accurate cost-benefit analysis of such regulation is potentially more difficult than it appears, as value judgements can shape how costs and benefits are measured. An anti-paternalist would place higher value on consumer freedom and the sanctity of contract, than on the protecting the welfare of some consumers. The paternalistic focus in the Regulatory Impact Statement on preventing over-indebtedness in vulnerable consumers means costs to lenders, consumers and the government may be understated.

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[181] The failure of the reforms to address issues of financial exclusion and ensure the provision of appropriate credit will be discussed further at Chapter 8D.

[182] Justin Malbon "Predatory Lending" (2005) 33 ABLR 224 at 237.

[183] This may stem from the fact that the principles are taken from Australian legislation where the problems being regulated are in the mortgage market. Arguably in the mortgage market, the "irrational borrower" paradigm is more apt. There is less of a sense of desperation in such consumers. The "need" for a home cannot be considered in the same sense as the "need" for credit to fund essentials such as food, medical bills, car repairs and so forth.

[184] Irwin, above n 7, at 52

2 Costs to lenders

The Regulatory Impact Statement holds that uncertainty costs for lenders will be mitigated by the Code. However the nature and extent of the obligations flowing from the principles are yet to be articulated, meaning true implementation and compliance costs cannot be assessed. The Bill allows for the Code to be implemented within two years of the responsible lending principles coming into force. Adopting the principles without the Code would create significant uncertainty throughout the lending industry. Practices would evolve in this period which may be found to be inconsistent with requirements in the Code.[185] System and process changes would be required by lenders,[186] leading to implementation costs which would be significantly larger if had to occur again once the Code was published. It is possible the Ministry may have intended for this to be a test period, allowing them to observe responses in the market and assess the success of different approaches taken to fulfilling the obligations. Implementation costs to lenders already lending responsibly are proposed to be minimal, however evidence from Australian banks has indicated costs remain significant despite current practices.[187]

Secondly, the Ministry has stated that the Code will not be prescriptive like its Australian counter-part. Flexibility can be important, however a guidance only approach creates further uncertainty for lenders, and thus greater costs. It is currently not at all clear what level of enquiry is required by a lender to satisfy each principle. Compliance costs may be as such that it would be unprofitable to provide small amount loan products, due to the high risks and high processing costs associated with such loans, resulting in lenders exiting the market. The Ministry states this would result in a more level playing field for lenders who are lending responsibly,[188] however it does not take into account the resulting undesirable decrease in

[185] Letter from Lyn McMorran (Executive Director of the Financial Services Federation) to Consumer Policy (Ministry of Consumer Affairs) regarding the Credit Contracts and Consumer Finance Bill Exposure Draft (24 May 2012) at 2.
[186] Including the development of new forms for all consumer credit products, revising contract documents to ensure that they meet obligations, and making changes to IT systems to accommodate the new information that is required to be collected from customers. See letter from Karen Scott-Howman (Regulatory Director of the New Zealand Bankers Association) to Evelyn Cole (Ministry of Consumer Affairs) regarding the proposed amendments to the Credit Contracts and Consumer Finance Act 2003 (16 September 2011) at 3.
[187] At 3.

[188] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 11.

consumer choice and the possible financial exclusion of consumers unable to meet requirements of first, second, and responsible third tier lenders.[189]

3 Costs to borrowers

The paternalistic focus on benefits to the vulnerable seen in the cost-benefit analysis does not take into account the cost of loss of privacy for borrowers not requiring the protection outlined in the principles, who are still required to have their financial circumstances, and requirements and objectives in entering into the loan investigated. The Ministry does note the monetary costs associated with such enquiries will likely be passed onto consumers.[190] It does not take into account that costs may increase to the point where a loan becomes irresponsible to provide. Uncertainty in what exactly is required for a borrower to fulfill the obligations may also impact on borrowers, through either increased charges to cover the risk of breach, or refusal to issue loans at all. The paternalistic assumption that the government knows best means the Ministry's analysis fails to take into account the loss of freedom to the borrower. Holding a lender responsible for ensuring a loan is appropriate firstly means a borrower is prevented the freedom of taking risks. For example, a borrower who has adequate security, but is unwilling or unable to prove their income would likely not be granted a mortgage.

Secondly, a borrower loses the freedom to make a choice between conflicting preferences which differ over time. Paternalistic policies tend to give more weight to a borrower's long term interest, in this case, the interest of not becoming over-indebted, assuming that this would be the "true" preference of the borrower if they were fully informed and rational. The short term interest of receiving the credit now is judged as harmful, though it may be the borrower's "true" preference. Thus paternalistic regulation is based on the assumption that the government knows best, forcing the consumer to make the choice the government perceives as "right", regardless of what may be the "true" preference.

[189] The consequences of further exclusion from the credit market for some consumers is discussed at Chapter 8C.
[190] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 10.

4 Costs to Government

The Ministry has noted the similarities of the proposals to the Australian model, meaning New Zealand can take advantage of their experience and guidelines, although acknowledging that there will be implementation costs associated with the development of the Code, and with the enforcement of the new provisions.[191]

It is common in New Zealand for regulatory regimes to be imported in their entirety, or with suitable adaptations, from overseas. Whilst New Zealand's small population means that specifically designed regulation can have a direct and immediate impact, [192] our correspondingly small economy means the design, implementation and maintenance of such systems can be costly. Using the responsible lending principles from the Australian NCCPA as a model for our own will have reduced these costs. However it is important that legislation is not imported directly without proper consideration of the different objectives, legislative framework and social context of New Zealand.

Although the New Zealand Bill mirrors closely the NCCPA without the amendments in the Enhancements Bill, the issues which faced the Australian consumer credit industry, and the objectives of their legislation differ significantly. Australia's reform set out to unify consumer credit law across the states, and bring an end to undesirable practices of both mortgage lenders and brokers. The broad application of the NCCPA means it applies to the third tier lenders that the New Zealand reform aims to target, but is not focused on addressing issues in this area. Australia has specifically recognised that responsible lending obligations do not directly address the risks of using the small amount credit products offered by such lenders, and thus has considered these separately. The responsible lending obligations on which we have modeled our own were enacted by Australia on the basis of what is essentially a separate issue. New Zealand may well face similar problems in the mortgage market as Australia, however our reform does not propose to address these.[193]

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[191] Ministry of Consumer Affairs *Regulatory Impact Statement,* above n 27, at 11.
[192] Susy Frankel and John Yeabsely "Introduction" in Susy Frankel (ed) *Learning from the Past, Adapting for the Future: Regulatory Reform in New Zealand* (LexisNexis, Wellington, 2011) at 4.
[193] See Chapter 7 for a discussion on the failure of the legislation to consider possible irresponsible lending practices in the New Zealand mortgage market.

The timing of New Zealand's implementation of the Australian model of responsible lending is premature. The responsible lending obligations have not yet been in force for two years. The impacts of the legislation on all lenders, not just third tier, are not yet clear. The further protections for consumers under the Enhancements Bill are at very early stages. As of 20 August 2012, the Bill has been passed by both Houses,[194] and is awaiting Royal Assent. Submissions have recently closed on regulations supporting the operations of the Bill.[195] The additional obligations and the operation of the cap do not commence until 1 July 2013.[196]

Whether or not these measures would be appropriate to address New Zealand's consumer credit issues would require a more comprehensive investigation into how our problems with irresponsible third tier lenders compared to those in Australia. It is typical that New Zealand regulators face severe information restrictions, due to large economies of scale in data gathering which work against small markets. This becomes clear when analyzing the Regulatory Impact Statement. In New Zealand a desk-based survey was carried out by the Ministry in 2011 to gauge the size and nature of the third-tier lending industry.[197] Three other main reports have been used to compile the Regulatory Impact Statement, two commissioned by the Ministry, and the third a report by the Families Commission. These reports are focused on consumer behaviour and experience in using the third-tier credit market, based upon interviews with only 133 consumers in total. The report on Pacific consumers' experiences dates back to 2007, and considering the change in the world credit market since that time, it can be considered dated. The Regulatory Impact Statement uses an estimation of the number of people who used a third tier lender in the 24 months before it was published from a report commissioned by the Ministry in 2011 which projected a sample of 28 borrowers onto the 2006 census population.[198] Unlike in Australia, there is minimal data collected from lenders themselves. There is insufficient empirical evidence to allow for an accurate comparison of the scope and nature of the problem between New Zealand and that observed in Australia. On the basis of the information known, it cannot be said that New Zealand is justified in essentially adopting a regime modeled for the Australian economy. Further research is

[194] Parliament of Australia "Bills of the current Parliament: Consumer Credit Legislation Amendment (Enhancements) Bill 2012" <www.parlinfo.aph.gov.au>

[195] The Treasury "Regulations to support provisions in the Consumer Credit Legislation Amendment (Enhancements) Bill 2012" Australian Government <www.treasury.gov.au>

[196] Consumer Credit Legislation Amendment (Enhancements) Bill 2012 (Revised Explanatory Memorandum) at 5.16.

[197] Ministry of Consumer Affairs *Desk-based Survey*, above n 34.

[198] Phone surveys are also inherently biased, as they exclude consumers who do not own a phone, and consumers who do not have a sufficient level of English to complete the survey. See Brunton, above n 26, at 6.

required to provide support for the dramatic law changes, which result in fundamentally shifting the responsibility for the question of whether or not a loan is appropriate from borrower to lender.

CHAPTER VI: REGULATIONS INEFFECTIVE IN ENSURING CONSUMER PROTECTION

A Negative registration requirements insufficient to ensure safety

It is currently estimated that around 35% of third-tier lenders are not registered[199] as they are required to be under the Financial Service Providers (Registration and Dispute Resolution) Act 2008.[200] A significant number of unregistered lenders are therefore operating in the market, with borrowers having limited recourse against such lenders as they will not be members of a dispute resolution scheme.[201] Under the draft Bill, the lender will not be able to enforce any rights in relation to the costs of borrowing, and the borrower will not be liable for any costs of borrowing during any period in which the lender is unregistered.[202] However as it is already an offence to provide a financial service unregistered[203] it is doubtful this new provision will effectively protect consumers from unregistered lenders.

Preventing the recouping of interest or fees seems unlikely to offer a stronger incentive to register than the criminal penalties already in place. Since unregistered creditors are operating outside the law, any credit contract entered into with a consumer should theoretically be unenforceable. The Ministry has claimed that voiding the whole contract would be a disproportionate response to non-registration but if consumers are required to hold lenders to account for wrong-doing,[204] chances of facing penalties are slimmer, and thus need to be more severe to ensure sufficient incentive to comply.

[199] Cabinet Business Committee, above n 28, at 3.
[200] Financial Service Providers (Registration and Dispute Resolution) Act, s 11.
[201] Section 48.
[202] Credit Contracts and Consumer Finance Amendment Bill, cl 30 at s 30.
[203] An unregistered financial service provider is liable upon conviction to imprisonment for a term not exceeding 12 months or a fine not exceeding $100,000 or to both, in the case of an individual. In the case of a person who is not an individual, a provider is liable to a fine not exceeding $300,000 under the Financial Service Providers (Registration and Dispute Resolution) Act, s 11(2)
[204] Refer to Chapter 6C for further discussion on consumer initiated action.

Registration under the Financial Service Providers (Registration and Dispute Resolution) Act 2008 offers basic negative assurances only about the creditor.[205] Unlike in Australia, there is no requirement that a person be a "fit and proper person" to engage in credit activities.

Under the Australian Credit License scheme, competency and conduct requirements are attached to a negative registration scheme,[206] with persons having to prove not only that they are not disqualified from performing such a role, but also that they are competent to operate a credit business, have the attributes of good character, diligence, honesty and integrity, and have no conflict of interest that will create a material risk that their role will not be properly performed.[207] The Ministry considers that compliance costs to businesses from having to be licensed under an additional regime would outweigh likely benefits.[208] Problems in Australia providing the need for such a scheme[209] are not at issue in New Zealand, thus an entirely separate regime may not be required. The positive entry requirements however would improve industry conduct, with any increase costs being necessary to prove consumer protection is a priority. Currently the only added protection to a borrower in using a registered lender is the availability of a dispute resolution service.

B Penalties are insufficient to ensure compliance

Penalties for breaching responsible lending obligations must be more severe in order to ensure compliance, rather than relying on consumers to call irresponsible lenders to account. As mentioned, failure to comply with the principles will not give rise to statutory damages,[210] a Court orders,[211] an injunction,[212]a conviction for an offence,[213] or necessarily prohibit the

[205] The following persons are disqualified from registering as financial service providers under s 14, Financial Service Providers (Registration and Dispute Resolution) Act 2008. A person who is an undischarged bankrupt, prohibited from being a director, or promoter or concerned in the management of a body under the Companies Act 1993, the Securities Act 1978, the Securities Markets Act 1988 or the Takeovers Act 1978, subject to a banning order under , the Securities Act 1978, the Securities Markets Act 1988 or the Takeovers Act 1978, or an order under s 108 of the CCCFA, has been convicted of particular Crimes Act 1961 offences or money laundering offences.

[206] National Consumer Credit Protection Act, s 35.

[207] Australian Securities & Investments Commission *Applying for and Varying a Credit Licence, Regulatory Guide 204* (March 2012) at RG 204.174.

[208] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 11.

[209] National Consumer Credit Protection Bill 2009 (Explanatory memorandum) at 2.4, 2.9.

[210] Credit Contracts and Consumer Finance Act, s 88-92.

[211] Section 93.

[212] Section 96.

[213] Sections 103-105

enforcement of a credit contract.[214] The Bill amends the Act so that a banning order can be made if the Court considers a creditor is not a "fit and proper person" to act as a creditor, and they have breached responsible lending principles more than once.[215] Allowing the principles to be breached once with no repercussions sends the wrong message to lenders about the severity of the breach, and possibly denies recourse to the first borrower. Contrastingly, breaching responsible lending provisions in Australia can result in significant civil and criminal remedies from fines to imprisonment. The difference in imposable sanctions between New Zealand and Australia undermines the strength of our provisions, as it is likely lenders will continue to operate illegally if a consumer complaint is required to hold them to account, and even then, punishment is minimal. The Ministry has stated that the provisions will result in a more level playing field among lenders,[216] although this can only occur if there is sufficient incentive to lend responsibly, rather than to continue to run a profitable business by flouting regulation.

C Consumer initiated action undermines paternalistic nature of laws

The paternalistic nature of the regulations is undermined by the premise that compliance with the obligations is better policed by consumer borrowers than by authorities. The Commerce Commission, as the authority responsible for the enforcement of the CCCFA[217] plays a limited role in the protection of individual borrowers, with no duty to act for an individual debtor.[218] It is essentially up to a borrower who suspects a breach to take independent action, either to a dispute resolution service, the Disputes Tribunal, or the District Court. Whilst consumer initiated action is in keeping with the current law and its focus on consumer responsibility and decision making,[219] it is inconsistent with the shift to paternalistic protection.

For a lender to be held to account for irresponsible lending, a consumer must be aware of his rights and options, and have the financial and personal resources to initiate and maintain proceedings. Studies have shown such knowledge of rights is often lacking in low income

[214] Section 99
[215] Credit Contracts and Consumer Finance Amendment Bill, cl 33 at s 32, Section 108 amended.
[216] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 11.
[217] Credit Contracts and Consumer Finance Act, s 111.
[218] Section 111(3).
[219] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 18.

and vulnerable consumers.[220] Changing the obligations of lenders to increase protection of borrowers will only be effective if the Government and Ministry have an associated focus on informing the public of the reform. [221] Even if there was sufficient resourcing to conduct a public campaign, uncertainty will remain for consumers about whether or not they are entitled to redress due to the principles-based law. A non-prescriptive code not only makes it difficult for lenders to know if they are complying, but also creates a barrier for consumers to knowing if their rights have been breached and if remedy should be sought.

A limited understanding of rights and remedies may be due to poor English or low financial literacy. Other personal qualities may limit the likelihood of a consumer challenging a credit contract such as feelings of powerlessness and fear. Many consumers are aware of the power imbalance between lenders and borrowers[222] and are reluctant to complain about loans for fear of restricting their borrowing options.[223] Assertiveness is required to initiate action, and a degree of persistence is needed to continue with the process. Vulnerable and disadvantaged consumers likely lack experience with the bureaucracy and hostile opponents that may be faced during a dispute.

The cost of legal action is likely to be a barrier for low income consumers. Out of a range of legal problems, credit problems have been shown to be the least likely to result in legal action by vulnerable consumers,[224] and in many cases, the cost of litigating would outweigh any potential benefit.[225] Compulsory membership of lenders to dispute resolution schemes should assist with access to justice, although the impact of such services on the way consumers seek to solve their problems has been questioned.[226] This service is also not available if a lender is unregistered.

Unless there is a duty on the Commerce Commission to initiate proceedings on behalf of individual borrowers, then enhanced consumer protection provisions may be of little practical

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[220] Therese Wilson, Nicola Howell and Genevieve Sheehan "Protecting the Most Vulnerable in Consumer Credit Transactions" (2009) 32 J Consum Policy 117 at 130.
[221]Letter from Andrew Hubbard (National Research and Policy Advisor at the Citizens Advice Bureau) to Consumer Policy (Ministry of Consumer Affairs) regarding the Submission on Draft Credit Contracts and Consumer Finance Bill (25 May 2012) at 57.
[222] Wilson, Howell and Sheehan, above n 220, at 132.
[223] Anae, above n 42, at 106.
[224] Christine Coumarelos, Zhigang Wei and Albert Zhou *Justice made to measure: NSW legal needs survey in disadvantaged areas* (Law and Justice Foundation, Volume 3, March 2006) at 99.
[225] Wilson, Howell and Sheehan, above n 220, at 129.
[226] Hazel Genn *Paths to Justice: What People Do and Think About Going to Law* (Hart Publishing, Portland, 1999) at 261.

assistance to vulnerable consumers, who face considerable practical and personal barriers to doing so themselves.

D New guidelines for finding oppression don't ensure increased protection

Despite the fact the scope of the oppression remedy appears very broad, there is little evidence that it has been providing effective protection. Most cases have been heard in a commercial or investment context, as the remedy applies to both commercial and consumer contracts. Such cases have reinforced that the remedy does not exist to save consumers from impecunious transactions. Success for consumer credit contracts with high interest rates or fees are very rarely successful, despite seeming harsh, unjustly burdensome, or unfair from a consumer protection point of view.[227]

The reading the Courts take from the definition of "oppressive" undermines the consumer protection policy. "Oppressive" is defined as "harsh, unjustly burdensome, unconscionable, or in breach of reasonable standards of commercial practice".[228] The Supreme Court decision in *Bartle*[229] approves Tipping J's dictum in *Greenbank New Zealand Ltd v Haas*,[230] relating to this definition, whereby he holds that the various words that form the definition of "oppressive" all contain the underlying idea that the transaction or some term of it is in contravention of reasonable standards of commercial practice.[231] This creates a gloss on the statutory definition,[232] with the potential to distort the Court's enquiry under an Act which seeks to address the imbalance of power between lenders and borrowers. If the focus is on reasonable standards of commercial practice, then naturally Courts have given little weight to whether or not the lending was responsible, as such practice is not required under current law. In theory, the introduction of responsible lending principles into the law should lead to a change in the market, with the Courts coming to regard adherence to them as being the reasonable standard of commercial practice. The Ministry has noted the risk to consumers in

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[227] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 20.
[228] Credit Contracts and Consumer Finance Act, s 118.
[229] *GE Custodians v Bartle*, above n 84, at [174].
[230] *Greenback New Zealand Ltd v Haas* [2003] 3 NZLR (CA).
[231] At [24].
[232] EW Thomas "A Critique of the Reasoning of the Supreme Court in GE Custodians v Bartle" (2011) 17 New Zealand Business Law Quarterly 97 at 107.

relying on the Courts in this way,[233] given their preference for adhering to the doctrine of *caveat emptor*.[234]

To avoid this risk, the reform proposes to add prescriptive guidelines to the CCCFA for the Court to have regard to when deciding whether or not there was oppression, in order to make it easier for a borrower to reach the threshold when challenging a credit contract.[235] Compliance with the responsible lending principles will now be a factor that must be considered by the Court to the extent applicable in the particular circumstances,[236] A number of the other guidelines are those that have been taken into account by the Courts in oppression cases under the past CCCFA and the Credit Contracts Act 1981. However without a change in the definition of "oppressive", nothing is materially added to the scope of section 124 that would not already be taken into consideration by the Courts under the current section 124(a) with "all of the circumstances related to the making of the contract" or section 124(c) with "any other matters that the Court thinks fit". The Ministry has stated that a breach of the principles will be an "indication" of oppression,[237] however such a finding is still a matter for the discretion of the Court.[238] The making of a larger list of guidelines will not ensure a lower threshold.

Additionally, the remedy still essentially relies upon self-enforcement by a consumer, so while a lower threshold theoretically encourages more litigation, it is unlikely.[239] A lowering of the threshold may increase the incentive for the Commerce Commission to commence reopening proceedings, as it has the power to do,[240] but has not yet done so.

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[233] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 21.
[234] Thomas, above n 232, at 104.
[235] Credit Contracts and Consumer Finance Amendment Bill (Exposure Draft) (Explanatory memorandum) at 6. Also note that the responsible lending principles only apply to credit contracts that constitute consumer credit contracts under s 11(1) CCCFA. The definition has not changed, the effect of which is discussed further at Chapter 7.
[236] Credit Contracts and Consumer Finance Amendment Bill, cl 33 at s 33(1), Section 124 amended.
[237] Credit Contracts and Consumer Finance Amendment Bill (Exposure Draft) (Explanatory memorandum) at 2.
[238] Credit Contracts and Consumer Finance Act, s 120.
[239] Refer back to Chapter 6C for further discussion.
[240] Section 125.

E Failure to address specific characteristics of fringe lending

1 Spiralling debt

Australia has recognised that consumers using short term loans from unscrupulous lenders are at particular risk of falling into a pattern of "repeat borrowing",[241] not adequately addressed by the responsible lending obligations alone. This behaviour has been identified as a feature of the New Zealand third-tier loan market, with reports of many consumers being multi-borrowers with several concurrent and/or consecutive small loans.[242] Such loans may offer short term financial relief, but can rapidly lead to a spiralling debt situation,[243] where an increasing percent of income must be used to meet repayments.

Under the NCCPA, an assessment must be made about whether the credit contract is "not unsuitable" for the consumer based on information gained from inquiries into the consumer's financial situation, requirements and objectives. A credit contract will be unsuitable if it does not meet requirements or objectives, or the consumer could not comply with the obligations either at all, or without substantial hardship.[244] Under the Enhancements Bill there is a presumption that a credit contract is unsuitable where the borrower is already in default under another small credit contract, or if in the three months prior to the assessment the consumer had been a debtor under two or more small amount credit contracts.[245] The effect of the presumptions is that unless the contrary is proven, the consumer would be considered to be in substantial hardship. The onus is now on the lender to establish the credit contract is "suitable".[246] This is where the difference in the wording between the NCCPA and the New Zealand draft Bill is important. Under the Bill the onus is essentially already on the lender to establish that the contract is "suitable", as it must be satisfied that it is "appropriate" with regard to requirements and objectives, and that it won't result in substantial hardship.[247] Thus

[241] "Repeat borrowing" is used to describe rollover loans where the term of an existing loan is extended with additional fees and interest, or a new loan being advanced to pay an existing loan, a new loan with the same lender taken out immediately after the previous is repaid, multiple loans at the same time for different lenders, and the regular taking out of short term loans. Such ongoing borrowing may be a necessity when an initial loan cannot be repaid, or has only managed to be repaid because other expenses, which now must be covered, have been deferred. The result is an ongoing cycle of disadvantage, reducing potential for the social and financial inclusion of this kind of consumer. See Australian Treasury, above n 171, at 20.
[242] Anae, above n 42, at 46.
[243] At 48.
[244] National Consumer Credit Protection Act, s 131 and s 133
[245] Consumer Credit Legislation Amendment (Enhancements) Bill, Schedule 3.
[246] Consumer Credit Legislation Amendment (Enhancements) Bill (Revised Explanatory Memorandum) at 4.3.
[247] Credit Contracts and Consumer Finance Amendment Bill, cl 7 at s 9B(2)(f)(i) and (ii).

under the Bill, lenders in New Zealand would be required to meet a higher standard before entering into a consumer credit contract than those in Australia.

Such presumptions may not be ineffectual here however. Even with the onus on the lender, without the implementation of the Code, what constitutes substantial hardship will be at the discretion of the lender. ASIC carried out a review of micro lenders' responsible lending conduct and disclosure obligations, after the NCCPA had been in force for six months, to gain an understanding of how the obligations were being met.[248] The review found that while micro lenders were making assessments as to the unsuitability of a loan for a customer, there was often limited information recorded about how this had been assessed. There was evidence of credit being provided to refinance another small loan, or where there have been defaults for the first and second loan repayments for a previous loan.

So there is conformation that in the market lenders are not considering the extent of the hardship suffered from the continual diversion of income to meet repayments. Even if a loan was affordable in the sense that a borrower may not end up defaulting, the presumptions would recognise the risk the borrower faces entering into concurrent or successive credit contracts, thereby enhancing consumer protection.

2 High cost of credit

As mentioned, in Australian there has been recognition that the obligations do not directly impact on the cost of credit. Australia is legislating to address this problem via a tiered interest rate cap, to place a maximum limit on the cost of credit, to specially address concerns with the short term lending industry and acknowledge the difference between this and other forms of credit. The tiered approach aims to recognise the high establishment costs for small amount contracts relative to the amount of the loan. Short term credit contracts are prohibited. Different costs are then permitted depending upon the size and terms of the loan.[249]

A comprehensive consideration of whether an interest rate cap is necessary in the New Zealand market goes beyond the scope of this paper. The merits of this means of regulation

[248] Australian Securities and Investments Commission *Review of micro lenders' responsible lending conduct and disclosure obligations* (Report 264, November 2011) at 7.
[249] For a more detailed explanation of the operation of the caps, refer back to Chapter 4C(2).

have been forever contested.[250] The Ministry has noted that it is monitoring the progress of the Australian cost of finance legislation, but currently considers that if the initiatives proposed in the draft Bill are successful then such caps will not be necessary in New Zealand.[251] However given the context in which Australia recently decided to introduce the nationwide cap, it may pay for New Zealand to further consider the issue. Whilst responsible lending was only a recent introduction into Australia law, interest rate caps have existed in some Australian states for many years.[252] This means that between Phase One and Two of the reform there was a period of parallel operation of the responsible lending obligations and interest rate caps. This allows for a direct assessment of the efficacy of the responsible lending obligations as the sole measure of consumer protection, and in conjunction with an interest rate cap. Given the similarities between responsible lending obligations between the two jurisdictions, the Australia decision to implement further protection requires due consideration in New Zealand.

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[250] Proponents argue that such controls ensure that vulnerable consumers are protected from usury and exploitation, addressing directly the problem in the fringe credit market whereby price does not reflect supply and demand. It is argued it is a targeted solution as will not impact on mainstream lenders with rates already well below the cap. In contrast opponents argue that caps are ineffective as they are easily avoided and difficult to enforce, lead to financial exclusion and the establishment of an illegal credit market, and may either become a price point for collusion are set too low, failing to recognise the true cost of providing small loans. See Ministry of Consumer Affairs *Access to Affordable Credit/Social and Community Lending Breakout Group* (Financial Summit 2011) at 4.

[251] Credit Contracts and Consumer Finance Amendment Bill (Exposure Draft) (Explanatory memorandum) at 11.

[252] A cap of 48%, inclusive of fees and charges, applied to credit contracts regulated by the Uniform Consumer Credit Code in New South Wales, Queensland, and the ACT. A 48% cap was imposed on unsecured credit, and a 30% cap on secured credit regulated by the Uniform Consumer Credit Code was imposed in Victoria. These caps applied to interest alone, with no regulation of fees and charges. Remaining jurisdictions had no cap on the cost of credit. See Nicola Howell "National consumer credit laws, financial exclusion and interest rate caps: the case for diversity within a centralised framework" (2009) 17(2) Competition and Consumer Law Journal 212 at 229.

CHAPTER VIII: FAILURE TO IDENTIFY TARGET FOR PATERNALISTIC INTERVENTION

A The loophole in the current law

The CCCFA applies to all creditors entering into consumer credit contracts, and thus whether by accident or design, could also rein in predatory lending practices of more than just "loan sharks". The Ministry has stated that the wide application is to provide certainty and consistency; create a level playing field for lenders, and mean borrowers are not disadvantaged in the quality of loan if they must use a third tier lender.[253]

However the ambit of the Bill remains narrow due to the restricted definition of consumer credit contract. The Bill proposes no change to this definition, retaining the distinction between consumer finance and business finance transactions by classifying a consumer credit contract as one that is "primarily for personal, domestic, or household purposes".[254] Section 12 provides that investment by a debtor is not for this purpose, so if a borrower enters into a contract for business or investment purposes they will not be caught by the definition.[255]

Bartle[256] cements a loophole in the current New Zealand law which leaves a number of borrowers whose credit contracts are not classified as "consumer" open to exploitation. The focus of the Supreme Court was mainly on whether the lender knew of matters alleged to be oppressive, largely neglecting to examine the loan contracts and accompanying mortgages to determine if they were substantively oppressive. The Court noted that this was the first case under the CCCFA or its predecessor of which they were aware whereby it is contended that the lender was unaware of a circumstance material to the existence of oppression.[257] The claim is that the oppressive elements arise from a combination of the Bartles' "personal situation" and the arrangements they entered into with Blue Chip over the purchase of the apartment.[258] GE had limited knowledge of the former and none of the latter. Section 124, which provides that the Court "must" have regard to "all circumstances relating to the making

[253] Ministry of Consumer Affairs *Regulatory Impact Statement,* above n 27, at 4.
[254] Credit Contracts and Consumer Finance Act, s 11(1)(b).
[255] The practical result of this is that a mortgage loan to buy a house that will be occupied by those entering the contract will be a consumer credit contract, but an identical loan secured by a mortgage on a second house which they do not intend to occupy, but instead use as a rental property, will not qualify as a consumer credit contract. The latter example covers the situation of the Bartles.
[256] *GE Custodians v Bartle*, above n 84.
[257] At [45].
[258] At [45].

of the contract" was then read to exclude factors giving rise to oppression which the lender was not aware of.

Under section 120 two circumstances under which a contract may be reopened are if the contract itself is oppressive, or if the party has exercised a right or power in an oppressive manner. The focus on whether the contract was oppressive if GE lacked knowledge of the oppressive factors lead to a combining of the question of whether the contract was oppressive with whether GE's conduct was oppressive.[259] The Court views the definition of oppressive to carry the underlying idea that the transaction or some term contravenes reasonable standards of commercial practice. [260] With this view, the Court held there was nothing out of the ordinary about the terms of the loans or the accompanying mortgages.[261]

The result is essentially if a borrower is obtaining finance for a rental property, then a lender can avoid responsibility by "outsourcing" parts of their function as a lender to a mortgage broker, and not be held accountable for their knowledge.[262] Consumer protection is undermined, with lenders being insulated from the operation of the Act, leaving vulnerable borrowers with no recourse. The anomaly of not protecting such vulnerable consumers has been recognised, and correctly addressed in Australia.[263]

B The nature of the problem

There is evidence in New Zealand to justify, or at the very least give cause for consideration, that there is a problem of magnitude worthy of paternalistic intervention. The no-doc loan offered to the Bartles shares all the common characteristics of those at the centre of the United States subprime mortgage crisis.[264] Such a loan was entirely unsuitable for them, given their age and income. GE bore little or no risk, since the value of the secured assets far exceeded the loan value. The only way the Bartles would be able to pay back the loan would

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[259] Thomas, above n 231, at 108.
[260] *Greenback New Zealand Ltd v Haas,* above n 230, at [24].
[261] *GE Custodians v Bartle*, above n 84, at [45].
[262] Thomas, above n 231, at 123.
[263] The National Credit Code under the NCCPA now covers credit that is provided or intended to be provided wholly or predominantly for personal, domestic or household purposes, or to purchase, renovate or improve residential property for investment purposes, or to refinance credit that has been provided wholly or predominantly to purchase, renovate or improve residential property for investment purposes under National Consumer Credit Protection Act, Schedule 1, National Credit Code, s 5.
[264] See Chapter 4B(1) for a description of the features of mortgages in the United States that lead to the collapse of the market.

be buy selling the apartment during the interest only loan period, which was reliant on property prices continuing to rise. The Court of Appeal held that an unaffordable loan secured on an asset was not merely asset lending, but rather an "asset sale".[265] The affordability of the loan was based purely on the assumption that property prices would rise.

Most concerning is the actions of the brokers, who misrepresented the Bartles' details to ensure the unsuitable loan was approved.[266] The behaviour is precisely that which the NCCPA is intended to target. The Supreme Court took the view that such a loan product was not out of the ordinary, and the trial Judge made little of the alterations, other than saying they were made to ensure loan criteria was met.[267] The Court does not recognise the position of conflict of interest that such brokers are in, when their profit is generated on the commission of brokering loans. The incentive to grant loans regardless of affordability is therefore high, particularly as they are not the actual source of credit. It is surely significant that the Bartles were given a loan that they did not qualify for, and which GE themselves admitted they would never have advanced had they been aware of the true circumstances. That it is the Bartles who end up ultimately responsible shows a clear deficiency in consumer protection law.[268]

C The scale of the problem

There has been much media attention in New Zealand on the collapse of finance companies such as Blue Chip,[269] however the subprime lending that fuelled the schemes has gone

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[265] *Bartle v GE Custodians,* above n 88, at [78] per Hammond J.
[266] The Bartles described themselves as "retired" in their initial application, but were subsequently described in later documentation as "self employed" or "self employed investor". They had never asserted this themselves. The value of their cash assets at the time was also erroneously stated to be twice its actual value. See *Bartle v GE Custodians*, above n 88, at [16].
[267] *Bartle v GE Custodians*, above n 87, at [238].
[268] The Serious Fraud Office during its investigation of Blue Chip said that while it knew that companies were tampering with application forms, there was not the evidence to pin criminal charges. Clearly there is an issue with responsible lending, but that it is a civil matter and not really fraud as "if you go and apply for the loan and someone changes your documentation, it is not a fraud on you because you actually applied for that loan, you wanted the loan, you signed the agreement". See Susan Edmonds "Demand up for no-hassle 'liar loans'" The New Zealand Herald (online ed, Auckland, 19 August 2012).
[269] The plight of the Blue Chip borrowers has been revisited recently in the Courts. In *Hickman and Ors v Turner and Waverley Limited & Ors* [2012] NZSC 72, the Supreme Court reversed previous thinking on the Blue Chip property investment scheme. The decision overturned the previous High Court and Court of Appeal judgements which allowed the developers of the apartments to force investors to purchase the apartments The Supreme Court held that Blue Chip's products constituted "securities", and that offering them without a prospectus was a breach of the Securities Act. They did not fall within the exemption of the Act for agreements of sale and purchase of land. All sale and purchase agreements executed at the same time as, or after, the

relatively un-investigated. The precise scale of the problem is not yet known. There are no statistics in New Zealand recording the types of mortgages taken out each year. A testifying expert witness at the Bartle trial stated such loans probably made up less than five percent of the total housing loan market.[270] However the Bartles are representative of a whole raft of such investors who secured mortgages using no-doc or low-doc loans. It has recently been alleged that the problem was on a greater scale than first thought, with claims that banks have been profiting from such faulty loans.[271]

D Failure of reform to address the problem

The Bill has used the Australian model for its responsible lending obligations, aimed at ending undesirable mortgage market practices.[272] It would be a logical assumption that if the same issues existed in our market, then the proposed reform would also target these. However the Bill fails twice to offer adequate protection to vulnerable borrowers. The failure to amend the definition of "consumer credit contract"[273] to include credit that is to be provided to purchase, renovate or improve residential property for investment purposes, as in Australia,[274] leaves borrowers such as the Bartles open to exploitation. Whilst such borrowers still have the oppression remedy open to them, adherence to the lender responsibility principles would not be taken into account when deciding if the contract should be reopened.[275] To assume that exploitation of borrowers by lenders is solely a feature of the third tier market, or that predatory lending must involve high interest, small amount loans, is to fail to correctly identify areas of the credit market requiring paternalistic intervention. Since there is no discussion of the issue by the Ministry, or indeed no mention of the *Bartle* decision in documents released pertaining to the reform, such borrowers may have been excluded through an oversight. Alternatively, there may be a wish to maintain a distinction between the

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corresponding Blue Chip investment product agreements are unenforceable under s 37 of the Securities Act, relieving investors from ongoing financial commitments and allowing them to seek redress for losses suffered as a result of the enforcement of the SPAs. Interestingly, the majority judgement is given by William Young J, who sat on the Court of Appeal when it found for the Bartles. Unfortunately, this ruling comes too late for the Bartles who have already lost their home.

[270] *Bartle v GE Custodians*, above n 87, at [298].

[271] As alleged by Australian consumer rights activist Denise Brailey. See Richard Meadows "Lending loopholes about to be tied up" The Press (online ed, Christchurch, 1 September 2012).

[272] Context of the NCCPA and details of the practices that the Act seeks to bring an end to are discussed at Chapter 4B(1).

[273] Credit Contracts and Consumer Finance Act, s 11(1)

[274] National Consumer Credit Protection Act, Schedule 1, National Credit Code, s 5.

[275]Simmers and Walker, above n 102, at 206.

rights and capabilities of a borrower who borrow for "investment" and one who borrows for "personal, domestic and household" purposes. When considering the Bartles as an example, such a distinction seems arbitrary. Described as a couple of "normal intelligence, but lacking sophistication in business matters",[276] the "investment" was for the purpose of securing an income additional to superannuation, and had they intended to occupy the apartment they purchased, the credit contract would be considered "consumer".[277]

Secondly, while the use of mortgage brokers has decreased since 2007, brokers still process around 20 percent of home lending.[278] Of course not all loans arranged through a mortgage broker will be inappropriate, or marred by a broker's conflict of interest. However considering the opportunity that a broker provides a lender with to insulate itself from the operation of the CCCFA, that the reform has not also addressed the obligations of brokers, as the NCCPA does, requires explanation.

[276] *Bartle v GE Custodians*, above n 87, at [18].

[277] This sort of reasoning raises the concern about where the line should be drawn. If borrowing to invest for retirement can be called "personal", then all investments can be considered "personal" in a sense. However arguably the Australia exception to "investment" under the NCCPA is very narrow, and requires consideration.

[278] The percentage of broker-processed loans increased greatly between 1991 and 2007, when they were responsible for about 40 percent of lending. See Susan Edmonds "Mortgage brokers in the cold" The New Zealand Herald (online ed, Auckland, 7 October 2012).

CHAPTER VIII: THE REFORM AND FINANCIAL EXCLUSION

A Defining financial exclusion in the New Zealand context

The definition of financial exclusion[279] can be taken in broad sense to mean processes that prevent poor or disadvantaged social groups from gaining access to the financial system, or can be looked at in a more narrow sense as the absence of ownership of a particular type of financial product.[280] Financial exclusion has been defined in Australia as "the lack of access by certain consumers to appropriate low cost, fair and safe financial products and services from mainstream providers".[281]

A similar definition seems fitting for New Zealand, as indeed it is the ease of access to credit generally that leads to consumer detriment. It is customers who cannot access the mainstream market who are driven towards the fringe sector where high cost and exploitative credit products are granted. There is no shortage of credit, but a clear lack of access to credit that can be considered affordable for consumers who are vulnerable. In the New Zealand context the definition can be further narrowed to be more product ownership-based than that in Australia. Particularly concerning in New Zealand is the lack of access for vulnerable consumers to affordable small loans. Credit is sometimes not perceived as being central to financial exclusion debates, compared to savings or money transmission for example. This is because borrowing is often seen as exacerbating the problems of those on low incomes as repayments reduce already limited income.[282] Provision of small amounts of credit however enables consumers to meet emergency needs, or smooth consumption when there is a variation in income or expenditure.[283] It may therefore not be desirable, but may be unavoidable, and can thus be regarded as "essential".[284]

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[279] The term originated in the UK in the 1990s, however financial exclusion in the UK is focussed upon exclusion from access to basic banking, a problem not prevalent in New Zealand, likely reflected by the fact that welfare payments from Work and Income New Zealand require a New Zealand bank account. See Work and Income New Zealand "What to bring when you apply for financial assistance" New Zealand Government <www.workandincome.govt.nz>

[280] Chant Link and Associates *A Report on Financial Exclusion in Australia* (ANZ, Final Report, November 2004) at 1.

[281] At 58.

[282] Elaine Kempson, Claire Whyley, Sharon Collard, John Caskey *In or out? Financial exclusion: a literature and research review* (Financial Services Authority, Consumer Research 3, July 2000) at 3.116.

[283] Chant Link and Associates, above n 280, at 35.

[284] Kempson, Whyley, Collard and Caskey, above n 282, at 3.116.

The extent of financial exclusion in New Zealand is dependent on the definition as being exclusion from access to appropriate low cost, fair and safe small amount loans. It is difficult to quantify, as there is little data available on the ownership of fringe credit products, and exclusion is inherently hard to measure since not everybody without credit wants or needs it.[285] Regardless, it can be assumed that the fringe credit market exists because of demand created by the exclusion of vulnerable customers from the mainstream market.

B Reasons consumers are financially excluded

The competition based approach through disclosure requirements that has dominated consumer protection theory does not address the issue of financial exclusion. Financially excluded consumers are not seen as desirable for mainstream lenders, and competition will not be sufficient to induce such lenders to meet their needs.[286] There is a reluctance within mainstream providers to provide credit to low-income and vulnerable consumers, or to those with poor credit records.[287] There is little New Zealand research on the attitudes of mainstream lenders, but it can be assumed that the reluctance stems from similar concerns to those quoted in Australia and the UK. These include concerns that such consumers are of high risk[288] and the need not to exacerbate the over-indebtedness of such consumers.[289] Additionally large volumes of small value loans do not fit easily into the business of banks.[290] Mainstream providers have largely withdrawn from the small loans market, possibly due to lack of profitability in this market. High costs relative to principal of providing small loans mean higher relative charges are necessary to make a profit, as administrative costs and loss provision can often be equal to large, long-term loans.[291]

This failure by mainstream lenders to provide such a product means that excluded consumers must use third tier lenders, where there is a distinct lack of competition in the market to

[285] At 3.118.
[286] Nicola Howell and Therese Wilson "Access to Consumer Credit: the Problem of Financial Exclusion in Australia and the Current Regulatory Framework" (2005) 5 Macquarie LJ 127 at 136.
[287] At 132.
[288] At 132.
[289] Therese Wilson "Responsible Lending or Restrictive Lending Practices? Balancing Concerns Regarding Over-Indebtedness with Addressing Financial Exclusion" in Michelle Kelly-Louw, James Nehf and Peter Rott (eds) *The Future of Consumer Credit Regulation: Creative Approaches to Emerging Problems* (Ashgate Publishing, Hampshire, 2008) 91 at 98.
[290] At 99.
[291] Australian Treasury, above n 171, at 58.

ensure safe prices. As discussed, consumers using fringe lenders are often under pressure to obtain finance, feel they have a lack of options in securing finance, have little appreciation of the true cost of the credit, and as a result fail to shop around to find the lowest possible price.[292] Such consumers are generally not price sensitive, leading to minimal price competition between lenders. It has been noted that competition does not affect the fees charged in the small loan market in the way that "one normally thinks competition will affect loan market interest rates".[293] Thus financial exclusion in New Zealand can be partly attributed to mainstream lenders not offering the right products to certain consumers, with the result being that such consumers turn to third tier lenders who have developed business models allowing them to take on higher risk consumers and still make profits.

C Effect of reform on financially excluded customers

Financially excluded consumers are forced to enter into high cost, unaffordable loans. The obligations therefore in one sense positively affect financially excluded consumers, operating in a preventative sense to limit the extent to which such loans can be entered into,[294] and thereby minimising the harm caused by them.

However the reform will likely have greater negative consequences for financially excluded consumers, by reducing their access to credit, either through having loan applications refused, or through lenders exiting the market. There is no mention in the Regulatory Impact Statement of "financial exclusion".[295] Rather than addressing the possibility that the obligations create a real risk of complete exclusion from the credit market for some consumers, the Ministry proposes that the responsible lending obligations will lead to an overall reduction in the cost of credit for more vulnerable consumers.[296] There appears to be an assumption that the reforms will address the exclusion of consumers from the provision of affordable credit by reducing the cost of credit from third tier lenders. However as Australia has recognised, offering more affordable credit is not the necessary response to prohibiting lenders from setting repayments at unaffordable levels. Denial of applications because the

[292] Refer to Chapter 2C for full discussion on the characteristics of loan shark customers.
[293] Mark Flannery and Katherine Samolyk *Payday Lending: Do the Costs Justify the Price?* (Federal Deposit Insurance Corporation, Working Paper 2005/09, 2005) at 10.
[294] Nicola Howell "National consumer credit laws, financial exclusion and interest rate caps: the case for diversity within a centralised framework" (2009) 17(2) Competition and Consumer Law Journal 212 at 216.
[295] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27.
[296] At 10.

proposed contracts cannot be complied with, thereby limiting access to credit,[297]is a real possibility.

The Ministry notes only once the risk of lenders choosing to exit the market rather than modifying business practices to comply with obligations, resulting in a reduction in consumers' access to credit. Lenders exiting the market, and thus restricting access to credit is concerning, as the consumer need for credit will not correspondingly decrease. High cost credit providers meet the needs of a particular niche market, and responsible lending obligations risk reducing supply without reducing demand. Vulnerable consumers may turn to illegal providers willing to lend at high premiums. Despite severe penalties, a high proportion of lenders still operate unregistered. Proposed sanctions for failing to register seem unlikely to deter certain lenders from operating outside of the law.[298] Illegal operations have the potential to be even more exploitative, with lending taking place in a supply vacuum to desperate consumers who have no opportunity for redress.[299] The Ministry has described the business models of some third tier lenders, whereby loan affordability is counter to lenders interests as the "worst problem",[300] and has identified the ease of exit from the market. Given these factors seem to establish a high risk for lenders choosing not to comply, and instead leaving the market, and possibly operating illegally, that the Ministry has not made more of the possible effects of decreasing access to credit is concerning.

D Failure to ensure alternative credit is available

Whilst responsible lending obligations do not prevent the availability of appropriately structured credit products being offered to vulnerable consumers, they alone cannot ensure that such appropriate credit is available.[301] The proposed reform fails to directly engage with

[297] Australian Treasury, above n 171, at 10.

[298] Refer to Chapter 6A for a discussion on the registration regime.

[299] It has been noted in the UK that illegal lending arises in a supply vacuum, with such lenders being unequivocally a last resort due to having no other credit options. Illegal lending may be relatively benign, but more commonly in the UK seems to operate on the basis of fear and intimidation, with coercive practices, violence, and the taking of illegal securities being used as means for lenders to gain control of borrowers. See Personal Finance Research Centre *Illegal Lending in the UK* (UK Department for Business, Innovation and Skills, Research Report 06/1883, November 2006) at 6.

[300] Ministry of Consumer Affairs *Regulatory Impact Statement*, above n 27, at 8.

[301] Howell, above n 294, at 227.

the issue of financial exclusion, with no consideration for how regulation could be used to encourage the availability of small loans.

There are a number of different possible approaches for regulation which would serve to reduce financial exclusion. Firstly, legislation could provide direct obligations on mainstream providers to meet the needs of low income consumers, through offering incentives for providing credit to such people.[302] There could also be governmental support for microfinance programs which offer low interest loan schemes through partnerships with banks and community organisations.[303] Government recognition of the fact that credit unions and other mutual societies play a valuable role in addressing financial exclusion through minimally interventionist regulation could be of value.[304] Regulation could also ensure that lenders inform borrowers of such alternative schemes,[305] and other welfare-based options that are already in existence.[306] Such interventions in the credit market through providing incentives to private institutions or underwriting community programmes is not out of alignment with other measures to combat poverty taken by the government[307] such as welfare and state housing. More detailed descriptions of such recommendations goes beyond the scope of this dissertation, but the failure of the Ministry to consider any such regulation is reflective of the lack of research in New Zealand evaluating broader impacts of financial exclusion, and failure to ensure appropriate alternatives are available in the credit market.

[302] An example of such is the Community Reinvestment Act introduced in the United States in 1977 which provides real incentives for banks to address the credit needs of lower income communities, as they are ranked on the extent to which they do, and this ranking is then taken into account when determining applications for mergers and acquisitions, and the opening of new bank branches. The Community Reinvestment Act 1977 is focussed on residential mortgages, but it an interesting model to consider to encourage the provision of small loan products by mainstream providers. See Wilson, above n 289, at 103.

[303] Government backing is required if community organisations are going to be able to compete with predatory lenders on loan schemes. See Malbon, above n 182, at 227.

[304] Howell and Wilson, above n 286, at 144.

[305] Australian Treasury, above n 171, at 55.

[306] For example, Work and Income New Zealand has a number of means by which consumers can receive extra grants when help is needed to pay for something urgently, such as the "Recoverable assistance payment grant", "special needs grant" and "temporary additional support payment" according to Work and Income New Zealand "Don't have enough income" New Zealand Government <www.workandincome.govt.nz>

[307] Malbon, above n 182, at 228.

CONCLUSION

The Ministry has identified a problem within the consumer credit industry, and has chosen to promote the reform as "tougher laws for loan sharks". However such a label is a misleading and oversimplified account of the issues that need addressing. It is clear that the current protections offered under the CCCFA are inadequate, but to assume that the introduction of responsible lending principles into the law will provide a complete solution is ill-conceived.

New Zealand has introduced paternalistic regulation without proper consideration for the cause of the problem. Predatory lending is not the root cause for over-indebtedness. Rather it is an opportunistic practice that arises from failures within the social and economic system. The introduction of paternalistic regulation fails to see this. Responsible lending obligations preventing access to unaffordable loans is not like paternalistic regulation banning cigarettes. The nicotine craving may eventually decrease, but certain borrowers will still be searching to fund day-to-day expenses. Behavioural economics can be used to support paternalistic intervention, but in the New Zealand context wrongly assumes that borrowers enter into abusive loans on the basis of irrationality, rather than out of desperation. This misconception likely explains the failure of the Ministry to consider the issue of financial exclusion. If there are no moves by the Government to regulate for the provision of affordable credit, then this sector of the credit market would likely be pushed underground, resulting in increased consumer detriment.

The paternalistic bias towards consumer protection leads to an inaccurate cost-benefit analysis. Implementation and operation costs to lenders, particularly in complying with legislation that offers so little certainty, are underestimated. These costs flow on to consumers who also must pay the price for loss of freedom and privacy. The benefit to the Government of using the Australian reform as a model is overestimated. The NCCPA targets undesirable mortgage market practices, and the amendments made relating specifically to small amount credit contracts have not been considered in New Zealand. If the same problems in the mortgage market are of concern here, the Ministry has not recognised them. If the legislation is going to apply widely to all classes of lenders it seems futile to exclude a potentially vulnerable group of borrowers, and leave open a loophole in the law essentially allowing for irresponsible lending.

Even if the new laws were theoretically well conceived, they will fall short in meeting the policy objective of increased consumer protection. The registration system is not sufficient to ensure that only responsible lenders are operating in the market. Penalties both for failure to register and for breaches of responsible lending obligations do not represent a proper commitment by the Government to condemning predatory behaviour, and will not be sufficient to ensure compliance. Relying on vulnerable consumers to initiate action undermines the paternalistic regime, with such consumers lacking the required personal and financial resources to hold a lender to account. For this reason, even if the amended oppression remedy results in a lower threshold, it is unlikely to offer increased protection.

The Ministry's myopic view that responsible lending obligations will protect vulnerable consumers from the plight of over-indebtedness is overly optimistic and ignores the complexity of the issues at hand when regulating consumer credit. The problem with "loan sharks" proposed by the Ministry is not properly defined, and other issues in the credit market have been neglected. Undoubtedly change is needed, however if enacted in its current form, the reform not only fails to hit target, but misses other areas calling out for regulatory intervention. There is a certain sense of a need to keep up with foreign regulatory trends, however the enactment of laws that result in such a fundamental shift from established principle should not be taken lightly. It is naïve to assume that the adoption of a single strategy such as responsible lending could solve what is an age-old problem of borrower abuse by lenders.

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J OTHERS

Letter from Elizabeth Bang (President of the National Council of Women of New Zealand) to Consumer Policy (Ministry of Consumer Affairs) regarding the Submission to the Ministry of Consumer Affairs on the Credit Contracts and Consumer Finance Amendment Bill – Consultation Draft (25 May 2012)

Letter from Sue Chetwin (Chief Executive of Consumer New Zealand) to Consumer Policy (Ministry of Consumer Affairs) regarding the Submission on Draft Credit Contracts and Consumer Finance Bill (25 May 2012)

Letter from Claire Dale (Research Fellow at Child Action Poverty Group) to Consumer Policy (Ministry of Consumer Affairs) regarding the Submission on Credit Law Exposure Draft (25 May 2012)

Letter from Karen Scott-Howman (Regulatory Director of the New Zealand Bankers Association) to Evelyn Cole (Ministry of Consumer Affairs) regarding the proposed amendments to the Credit Contracts and Consumer Finance Act 2003 (16 September 2011)

Letter from Andrew Hubbard (National Research and Policy Advisor at the Citizens Advice Bureau) to Consumer Policy (Ministry of Consumer Affairs) regarding the Submission on Draft Credit Contracts and Consumer Finance Bill (25 May 2012)

Letter from Ann Martin (Chief Executive of Age Concern New Zealand) to Consumer Policy (Ministry of Consumer Affairs) regarding the Submission on Draft Credit Contracts and Consumer Finance Amendment Bill (25 May 2012)

Letter from Lyn McMorran (Executive Director of the Financial Services Federation) to Consumer Policy (Ministry of Consumer Affairs) regarding the Credit Contracts and Consumer Finance Bill Exposure Draft (24 May 2012)

APPENDIX I

Responsible Lending Principles under the Credit Contracts and Consumer Finance Amendment Bill (Exposure Draft)

9B Lender responsibility principles

1) Every lender must, at all times, have regard to, and comply with, all the principles specified in subsection (2).
2) The principles are that lenders will, in relation to an agreement with a borrower –
   a) exercise reasonable care and skill
   b) provide the borrower with sufficient information to enable the borrower to make informed decisions, both at the time of entering into an agreement and during all subsequent dealings with the lender
   c) ensure that the terms of the agreement are not unduly onerous and are expressed in a clear, concise and intelligible manner
   d) not to say, or omit to do or say, anything that is, or is likely to be, misleading, deceptive, or confusing to the borrower
   e) make reasonable enquiries as to the borrower's –
      i. financial circumstances
      ii. requirements and objectives in entering into the agreement
   f) be satisfied, before entering into an agreement, that –
      i. the borrower can be reasonably expected to make the repayments under the agreement without suffering substantial hardship; and
      ii. the agreement is otherwise appropriate for the borrower, having regard to the borrower's circumstances, requirements and objectives
   g) not charge unreasonable credit fees
   h) not advertise, or permit to be advertised, agreements, products, or services in a manner that is, or is likely to be, misleading, deceptive, or confusing to borrowers generally or, if the advertisement is aimed at a particular class of borrowers, to that class.

APPENDIX II

Marked up amendments to show changes to CCCFA oppression provisions under the draft Bill

120 Reopening of credit contracts, consumer leases, and buy-back transactions

The court may reopen a credit contract, a consumer lease, or a buy-back transaction if, in any proceedings (whether or not brought under this Act), it considers that—

a) the contract, lease, or transaction is oppressive; or
b) a party has exercised, or intends to exercise, a right or power conferred by the contract, lease, or transaction in an oppressive manner; or
c) a party has induced another party to enter into the contract, lease, or transaction by oppressive means.

124 Guidelines for reopening credit contracts, consumer leases, and buy-back transactions

In deciding whether section 120 applies and whether to reopen a credit contract, consumer lease, or buy-back transaction, the court, to the extent that they are applicable in the particular circumstances, must have regard to—

(a) all of the circumstances relating to the making of the contract, lease, or transaction, or the exercise of any right or power conferred by the contract, lease, or transaction, or the inducement to enter the contract, lease, or transaction (as the case may be); and

~~(b) the following matters if they are applicable:~~

~~i. whether the amount payable by the debtor under the contract, lessee under the lease, or occupier under the transaction is oppressive (whether or not on default by the debtor, lessee, or occupier):~~

~~ii. if a debtor, lessee, or occupier is in default under the contract, lease, or transaction, whether the time given to the debtor, the lessee, or the occupier to remedy the default is oppressive, having regard to the likelihood of loss to the creditor, lessor, or transferee:~~

~~iii. if the creditor has required, as a condition of the full prepayment of a credit contract, that the debtor pay a certain amount, whether the amount is oppressive having regard to the expenses of the creditor and the likelihood that the amount repaid can be reinvested on similar terms:~~

~~iv. if the creditor, lessor, or transferee has refused to release part of any security interest relating to the contract, lease, or transaction, or has agreed to the release subject to conditions, whether the refusal is, or the conditions are, oppressive, having regard to the obligations secured by the security~~

~~interest and the extent of the security that would remain after the release; and~~

(b) whether the creditor has, in relation to any aspect of the agreement (including the creditor's conduct in entering into the agreement), complied with the lender responsibility principles (see section 9B(2)); and

(c) the relative bargaining power of the parties; and

(d) whether, taking account of the particular indebted person's characteristics (for example, his or her age or physical or mental condition), that person or (if represented by another person) the person's representative was reasonably able to protect the indebted person's interests; and

(e) whether, before entering into the agreement, the borrower obtained legal advice or other professional advice in relation to that agreement; and

(f) whether the credit provider, or any person acting in the interest of that provider, subjected the indebted person to unfair pressure or tactics or otherwise unfairly influenced the indebted person to enter into the arrangement and, if so, the nature and extent of that unfair conduct; and

(g) the terms of comparable agreements offered by other creditors, including –

(i) the costs of borrowing under those agreements; and

(ii) whether the agreement under consideration imposes significantly more onerous terms on the debtor than would be imposed under those comparable agreements; and

(h) the amount payable by the indebted persons; and

(i) the amount of any payment required as a condition of the full repayment under the arrangement, including the credit provider's expenses and the likelihood that the amount repaid could be reinvested on similar terms; and

(j) the form of the arrangement, including whether it is expressed in plain language, is legible, is clearly presented; and

(k) whether the terms of the arrangement –

(i) allow the indebted person to be reasonably able to comply with his or her obligations under the arrangement; and

(ii) are reasonably necessary to protect the interests of the credit provider; and

(l) the length of time the indebted person has to remedy any default; and

(m) if the credit provider has refused to release, or has agreed to release subject to conditions, a security interest relating to an arrangement, the obligations secured by the security interest and the extent of security that remains after the release or conditional release; and

(n) whether action by the credit provider was relation to the enforcement of, or recovery under, the arrangement was reasonable in the circumstances; and

(~~e~~ o) or any other matters that the Court thinks fit.