BUDDLE FINDLAY

CCCFA - the case for a more 'principles-based' approach to affordability requirements

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In December 2021, a sweeping range of amendments to the Credit Contracts and Consumer Finance Act 2003 (CCCFA) came into force that were designed to protect vulnerable people from predatory lending by some "mobile traders and truck shops" and solve the problem of borrowers being provided unaffordable loans that put them into unmanageable debt and financial hardship.[1]

Critics have noted that the new CCCFA regime has attempted to solve the problem of predatory lending by imposing overly prescriptive regulations on how all lenders determine affordability and that this 'one-size-fits-all' approach has resulted in unintended consequences such as borrowers being declined other types of consumer lending (such as home loans) because more 'mainstream' lenders can no longer exercise sufficient discretion.[2]

Is this criticism warranted? Would shifting New Zealand's consumer credit regulatory regime from a prescriptive and 'one-size-fits-all' approach to a more 'principles-based' approach similar to Australia improve access to credit, while still protecting borrowers?

This article seeks to answer this question by:

- Explaining the changes to the CCCFA regime and, particularly, the affordability requirement
- Exploring how a more 'principles-based' regulatory regime that gives lenders discretion could both protect vulnerable borrowers and mitigate the unintended consequences of prescriptive affordability requirements being applied to all consumer lending
- Discussing what lenders and regulators will need to do to ensure that a 'principles-based' approach to consumer credit regulation is effective and whether any lessons can be learned from Australia's approach.

The CCCFA and the affordability requirement

What is the CCCFA?

The CCCFA is the key legislation that regulates consumer credit contracts in New Zealand. The CCCFA's primary purpose is to protect the interests of consumers in connection with consumer credit contracts. A broad range of consumer lending products that provide credit to individuals (as opposed to corporate entities) for personal, domestic or household purposes are covered by the term "consumer credit contract" including housing loans such as mortgages as well as personal loans, vehicle loans, credit cards and credit for retail goods.

The CCCFA is supported by the Credit Contracts and Consumer Finance Regulations 2004 (CCCFR) and the Responsible Lending Code (RLC).

What is the CCCFA affordability requirement?

In 2015, amendments to the CCCFA came into force that introduced responsible lending obligations onto lenders via the "lender responsibility principles" (LRP). The LRPs are 'principles-based' obligations and rely upon the RLC to provide more practical guidance on how lenders could demonstrate compliance with their responsible lending obligations. A lender's compliance with the RLC does not provide an automatic safe harbour but it is treated as evidence of the lender's compliance with their lender responsibilities – the reason for this is that a principles-based regulatory regime allows for the possibility of there being other ways to demonstrate compliance beyond what is specifically prescribed in the RLC.

These LRPs introduced, amongst other things, a requirement on lenders to "make reasonable inquiries" before entering into a new agreement with borrowers or before making a "material change" to an existing agreement with a borrower that the credit provided to the borrower will "meet the borrower’s requirements and objectives" and that the borrower will be able to "make the payments under the agreement without suffering substantial hardship". These two requirements are often referred to as the 'suitability' and 'affordability' requirements respectively.

What issues were the affordability requirements designed to address?

In December 2017, the Government commenced a review to assess whether the 2015 amendments to the CCCFA had been effective at protecting vulnerable customers. This review found that there was still a "widespread problem" of consumers being provided loans that were unaffordable and "ending up in unmanageable debt".[3]

In June 2018, the Government launched a public consultation on consumer credit regulation with an accompanying discussion paper. In this discussion paper, the Minister of Commerce and Consumer Affairs, Kris Faafoi, stated that he had "seen evidence that some creditors are offering loans knowing repayments are unaffordable, meaning borrowers become trapped with unpaid debt".[4]

This discussion paper noted that "high-cost" lenders were "a disproportionate source of non-compliance with lender responsibilities" - these are lenders who, generally, provide small loans over short timeframes at high annual interest rates especially when compared to more 'mainstream' lenders such as "banks, credit unions and finance companies".[5] The paper also highlighted "mobile traders" (ie businesses who operate mobile shops, often from trucks), noting how a Commerce Commission investigation into 32 mobile traders found that 31 of them did not comply with their CCCFA obligations to varying extents.[6]

The discussion paper did note that "all types of lenders" had been "found to have granted unsuitable and unaffordable loans" and that many high-cost lenders stated that they had strict eligibility criteria and low default rates.[7] However, it also noted that high-cost lenders made up 24% of the Commerce Commission's complaint statistics in 2016-17[8] and highlighted stakeholder concern that some unscrupulous high-cost lenders could generate profits despite suffering high default rates and providing unaffordable loans, due to their high profit margins and the high proportion of their revenue generated from default charges and default interest.[9]

In setting out the extent of the problem, the Government cited a figure provided by a lender stakeholder and based on data from two credit reporting agencies that 30-35% of New Zealand adults had 'impaired' or 'sub-prime' credit scores and may rely upon high-cost lenders as they do not qualify for credit elsewhere due to their higher default risk.[10]

How have the amendments changed the CCCFA affordability requirement?

Following the 2018 discussion paper and ensuing consultation process, amendments were made to the CCCFA, CCCFR and RLC. Under the new CCCFA regime, lenders must now assess affordability by making inquiries into the borrower's income and expenses using prescribed mandatory standards that are set out in the CCCFR. The RLC has also been updated to provide clarity on the interpretation of these prescribed mandatory standards. This has added a layer of complexity to the loan application process.

Lenders still have to "make reasonable inquiries" before entering into a new agreement with borrowers or before making a "material change" to an existing agreement with a borrower, so as to be reasonably satisfied that the borrower will be able to "make the payments under the agreement without suffering substantial hardship".

However, following the amendments, lenders now have much less discretion in *how* they determine whether or not a loan is affordable and the process for making this determination has become considerably more onerous on both borrowers and lenders. Some of the most controversial changes include:

- When estimating a borrower's expenses, lenders may consider the borrower's transactions for the previous 90 day period and confirm with the borrower that the amounts reflect the borrower’s likely relevant expenses for an annual period. If "there is a significant risk that the initial estimate materially underestimates relevant expenses" or these expenses are self-reported, then these expenses must be verified by an analysis of the borrower's transaction records, copies of relevant contracts or invoices and any other reliable evidence. This has been criticised for being an impractical and laborious process for borrowers, banks and brokers that is overly reliant on a snapshot of a borrower's spending habits and doesn't account for the fact that borrower spending behaviour can change.
- When estimating a borrower's expenses, lenders must consider a range of specific "listed outgoings" including living expenses, utilities, food and groceries, personal expenses (including clothing and personal care) as well as any regular or frequently recurring outgoings (for example, savings, investments, gym memberships, entertainment costs, or tithing) that are material to the estimate of relevant expenses and that the borrower is unable or unwilling to cease after they enter into a loan. This requirement has been seen as intrusive and potentially forcing lenders into making uncomfortable judgement calls on a borrower's spending preferences.
- When verifying a borrower's expenses, lenders can now "benchmark" certain types of expenses such as household expenditure, including utilities, food and groceries, and transport expenses. These benchmarks must be based on statistical information about individual or household expenses that has been collected and analysed using a "robust statistical methodology", however, there is little guidance on what is considered "robust". While benchmarks don't have to be used, they have been criticised by more frugal loan applicants for adjusting their spending up to meet the minimum expected spending behaviour for similar loan applicants.
- After deducting a borrower's expenses from their income, lenders must ensure that there is a "reasonable surplus" or that the calculation has "reasonable buffers" to obviate the risk that the borrower's income may be overestimated or expenses may be underestimated, noting that there is no guidance within the CCCFA, CCCFR or RLC on what constitutes a "reasonable surplus" or "reasonable buffer".

Is a 'principles-based' regime better than a 'prescriptive' regime?

In the 2018 discussion paper, the Government contemplated the merits and drawbacks of a principles-based approach over a prescriptive approach for affordability assessments by lenders.

It noted that the primary benefit of principles-based regulation is flexibility:[11]

- It can be applied to a range of current and future situations and does not need to be amended to deal with new technologies, practices and business models
- It allows parties to develop bespoke methods of compliance, improving efficiency and effectiveness
- It allows regulated parties to innovate and adapt their business and compliance plans while still achieving the aims of the regulatory regime.

However, it also noted that overreliance on principles-based regulation could lead to "a lack of clarity about legal obligations" noting that this lack of clarity "may cause particular issues when applied in isolation to smaller, less sophisticated lenders without a strong compliance culture".[12] This problem is further exacerbated by the fact that there is little New Zealand case law on responsible lending, limiting the guidance provided by regulators.[13] The lack of litigation on consumer credit is also a feature of other jurisdictions due to the relatively high cost of litigation relative to the often small amounts in dispute and use of dispute resolution services.[14]

The 2018 discussion paper argued that the benefit of a prescriptive approach for affordability assessments was that lender compliance would improve and "improved affordability assessments would lead to less irresponsible lending and resulting hardship".[15] It stated that this is due to two key reasons:

- Increased risk of detection - it would be "easier for borrowers, advisers and the regulator to detect breaches of lender responsibilities"[16]
- Clearer specifications of requirements - there would be "greater clarity" for all stakeholders on what is required to comply with the affordability requirement and have the "largest effect on lenders who genuinely intend to comply but [did not] due to an inadequate understanding of the principles-based requirements".[17]

In its initial suggestions, the 2018 discussion paper noted that prescriptive affordability requirements could be limited to "loans where there are greater concerns about non-compliance, such as motor vehicle loans and high-cost loans".[18] The legislative changes introduced did not contain any such limitations.

Can we learn any lessons from Australia's approach?

Australia has also had a similar debate about the merits of a principles-based approach over a prescriptive approach for affordability assessments as well as the drawbacks of a one-size-fits-all approach to all types of lenders and credit products and we can learn some valuable lessons from their consumer credit regulatory regime.

Overview of Australia's consumer credit regulatory regime

In Australia, consumer credit is regulated by the National Consumer Credit Protections Act 2009 (NCCPA) which fully came into effect in 2011.

The NCCPA was drafted in the aftermath of the global financial crisis in a regulatory environment with increased scrutiny on irresponsible lending practices, as these practices had led to the 2007 sub-prime mortgage crisis in the United States. At the time, regulators noted concern about certain behaviours such as the increased use of intermediaries (such as brokers) and the development of products such as 'no' and 'low' documentation loans which resulted in lenders making fewer inquiries into borrowers' financial position when deciding whether to approve a loan application.[19]

The NCCPA introduced responsible lending obligations which requires lenders and brokers to assess whether a credit contract will be unsuitable for the consumer by determining whether the consumer will be unable to comply with its financial obligations under the contract without substantial hardship[20] or if the contract will not meet the consumer's requirements or objectives.[21] These requirements are similar to the affordability and suitability requirements under the CCCFA.

In December 2019, the Australian Securities & Investments Commission (ASIC) published its updated regulatory guide on responsible lending laws known as 'RG 209' following an extensive consultation process. This was the first substantial change to the guide since 2011 and was motivated by “judicial decisions, ASIC enforcement action, thematic reviews, the Royal Commission, and changes to technology among other developments”.[22] During its consultation process, ASIC considered introducing more prescriptive steps that lenders may have to follow to meet their responsible lending obligations. While the updated guide opted to “continue the existing principles-based approach”, it introduced four new principles that ASIC would consider when determining whether a lender was compliant with its obligations, and provided more detail about these principles and more "illustrative examples" that set out how the principles should be applied in individual circumstances.

In particular, the guide notes that lenders would now need to gather information about "how much of the consumer’s income is, and will continue to be, needed for outgoings the consumer is unable or unwilling to reduce or forego"[23] and sets out certain "essential items" such as food, clothing and communication costs as expenditure that is "essential to a person living and participating in modern Australian society" that borrowers are less likely to be able to reduce or eliminate.[24]

The guide notes that in order to meet its responsible lending obligations, a lender would likely need to engage in further discussions with the borrower to make a proper assessment of affordability and that it could not simply assume that a borrower will be able to eliminate non-essential discretionary spending without substantial hardship, citing items that are discretionary but may be essential to a particular borrower such as private schooling, health insurance, memberships and subscriptions.[25]

This guidance is very similar to the detailed inquiries New Zealand lenders must now make when assessing affordability (as discussed above) and despite claiming to remain principles-based, is significantly more prescriptive and detailed than the previous guidance.

The problem with prescriptive regulation in Australia

In September 2020, as part of its economic recovery plan, the Australian Government announced that it would seek to improve access to credit by removing regulatory barriers from its consumer credit regulatory framework. The announcement noted that "what started a decade ago as a principles-based framework to regulate the provision of consumer credit has now evolved into a regime that is overly prescriptive, complex and unnecessarily onerous on consumers".[26]

In particular, the announcement noted that the proposed amendments were intended to relax the application of the 'responsible lending obligations' which require creditors to make inquiries as to the suitability and affordability of loan products before extending credit. The announcement noted that the intent was to "simplify the system by moving away from a 'one-size-fits-all' approach" and heighten responsible lending obligations for small amount credit contracts (SACC) and consumer leases as these forms of high-cost borrowing "are more typically accessed by some of Australia’s most vulnerable consumers".

In November 2020, the Government published draft legislation along with explanatory materials for public consultation in order to make these changes to the responsible lending obligations. The explanatory materials emphasised the Government's desire to "move away from a prescriptive framework for lenders and borrowers" and towards "risk-based lending that is attuned to the needs and circumstances of the borrower and credit product" noting that a principles-based standard of conduct places responsibility on lenders to ensure their conduct meets that standard in every relevant circumstance.[27]

In December 2020, the Government introduced to the House of Representatives the National Consumer Credit Protection Amendment (Supporting Economic Recovery) Bill 2020 (Cth) (Bill) to wind back responsible lending obligations. In March 2021, the Bill passed the House of Representatives and was introduced to Senate. However, as of January 2022, the Bill has not progressed any further as the government requires cross-bench support in order to pass the Bill.

The problem with prescriptive requirements under the new CCCFA regime

In its submission during the consultations that took place prior to the new CCCFA regime, the New Zealand Bankers' Association (NZBA) noted that the changes "may lead to excessively conservative lending practices that have the unintended effect of limiting access to credit" and "may unintentionally exclude vulnerable borrowers from safer sources of credit", specifically raising concern about "low-wage workers, immigrants, and refugees" as "these communities already find it difficult to access credit from mainstream creditors, making them particularly vulnerable to predatory lending practices".

The NZBA also argued against the repeal of a provision of the CCCFA that allowed lenders to "rely on information provided by the borrower" when making its inquiries, arguing that vulnerable borrowers such as refugees "may find it difficult to provide evidence of income and expenses in the usual ways" due to, for example, limited ability to provide bank account evidence of expenses. As a middle-ground, the NZBA suggested imposing this requirement exclusively on high-cost lenders rather than on all lenders.

The NZBA also noted some practical issues with the minimum standards set out in the CCCFR, noting that verification of all expenses could prove to not only be time consuming but an exercise in futility as a three-month snapshot of expenses doesn't take into account changes in spending during a year eg electricity bills fluctuating due to the seasons or increased retail spending in the lead-up to Christmas. The new CCCFA regime also fails to sufficiently account for the fact that borrowers are often willing and able to change their spending behaviour in order to service a loan and that historic expenses are of limited value when assessing discretionary expenditure.

How to ensure the success of a principles-based regime

As the Australian experience demonstrates, the prospect of increased certainty makes a prescriptive approach very appealing. However, Australia's push to wind back to a more principles-based regime for assessing affordability is likely a response to the similar problems that New Zealand has faced when moving to a more prescriptive approach.

It is difficult for any prescriptive regime to properly account for all current and future eventualities and such a regime can lead to a myriad of unintended consequences. Such rigid systems are also unresponsive to change and can stifle innovation by lenders constrained by inflexible rules and processes. These problems are compounded by the use of a one-size-fits-all approach to different types of consumer credit contracts and lenders who have different levels of sophistication and pose different levels of risk to vulnerable borrowers.

There are clear benefits in reverting to a more principles-based regime, however, for this to be effective, lenders will need to invest time and resources in developing robust internal processes and procedures which apply those principles in practice to their businesses, and be prepared to demonstrate the effectiveness of these systems to regulators. Regulators also have a role to play in ensuring the success of a principles-based regime. Lenders require assurance from regulators that they will be provided sufficient and clear non-prescriptive guidance when it comes to interpretation of the principles and clarification of any potential grey areas.

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[1] Cabinet Paper "Review of Consumer Credit Regulation"(2018) at [4].
[2] Cabinet Paper "Review of Consumer Credit Regulation"(2018) at [48].
[3] Cabinet Paper "Review of Consumer Credit Regulation" (2018) at [12].
[4] Discussion Paper "Review of Consumer Credit Regulation" (2018) at 4.
[5] Discussion Paper "Review of Consumer Credit Regulation" (2018) at 13.
[6] Discussion Paper "Review of Consumer Credit Regulation" (2018) at 27.
[7] Background Paper "Review of Consumer Credit Regulation" (2018) at [31].
[8] Background Paper "Review of Consumer Credit Regulation" (2018) at [34].
[9] Background Paper "Review of Consumer Credit Regulation" (2018) at [35].
[10] Background Paper "Review of Consumer Credit Regulation" (2018) at [17].
[11] Background Paper "Review of Consumer Credit Regulation" (2018) at [273].
[12] Background Paper "Review of Consumer Credit Regulation" (2018) at [276].
[13] Background Paper "Review of Consumer Credit Regulation" (2018) at [277].
[14] Jeannie Paterson and Nicola Howell *Everyday Consumer Credit Overview of Australian Law Regulating Consumer Home Loans, Credit Cards and Car Loans: Background Paper 4* (The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Australia, 2018).
[15] Background Paper "Review of Consumer Credit Regulation" (2018) at [290].
[16] Background Paper "Review of Consumer Credit Regulation" (2018) at [288].
[17] Background Paper "Review of Consumer Credit Regulation" (2018) at [289] – [290].
[18] Background Paper "Review of Consumer Credit Regulation" (2018) at [281].
[19] National Consumer Credit Protection Bill 2009 (Explanatory memorandum) at 3.9.
[20] National Consumer Credit Protection Act 2009 (Cth), s131(2)(a).
[21] National Consumer Credit Protection Act 2009 (Cth), s131(2)(b).
[22] Sean Hughes, ASIC Commissioner " Keynote address" (ASF Conference, Sydney, 18 November 2019).
[23] Regulatory Guide 209 "Credit licensing: Responsible lending conduct" (9 December 2019) at RG 209.66.
[24] Regulatory Guide 209 "Credit licensing: Responsible lending conduct" (9 December 2019) at RG 209.67(b).
[25] Regulatory Guide 209 "Credit licensing: Responsible lending conduct" (9 December 2019) at RG 209.71.
[26] Josh Frydenberg MP "Simplifying access to credit for consumers and small business" (press release, 25 September 2020).
[27] National Consumer Credit Protection Amendment (Supporting Economic Recovery) Bill 2020, Exposure Draft Explanatory Material.

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