



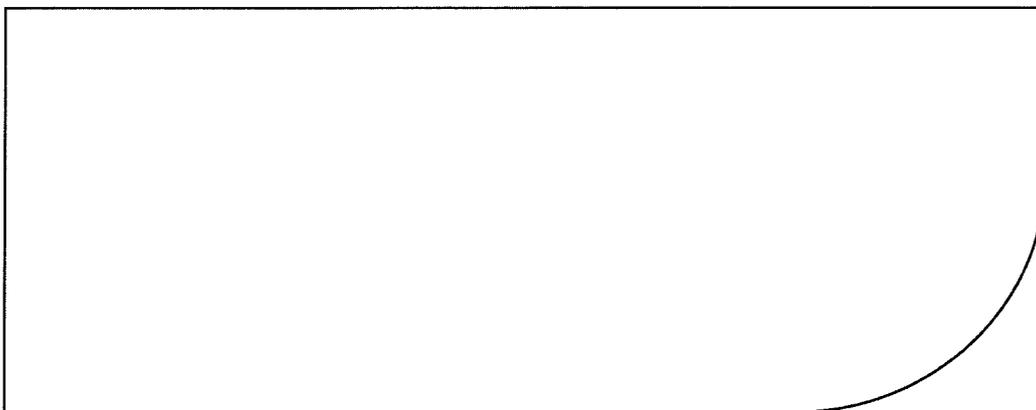
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**Credit Contracts and Consumer Finance Act 2003 -  
Some insurance issues**

22nd Annual Banking & Financial Services Law & Practice Conference  
Cairns, 7 August 2005

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## Introduction

- 1 This paper considers some of the issues relating to insurance that arise under the Credit Contracts and Consumer Finance Act 2003:
  - 1.1 The insurance and insurance-like products the Act applies to.
  - 1.2 When insurance premiums are credit fees.
  - 1.3 The Act's treatment of commissions on insurance received by a creditor.
  - 1.4 Rebating of insurance premiums under the Act.
  - 1.5 Disclosure of insurance terms.
- 2 The policy issues underlying the provisions of the Act considered in this paper are set out in one of the Ministry of Consumer Affairs' credit law review discussion papers<sup>1</sup>. Although the Ministry's review identified insurance as an important aspect of consumer finance, it is debateable whether the Act has adequately and clearly dealt with insurance, and whether consumers are as well served by these aspects of the Act as they might be. The consumer finance and insurance industries certainly both have issues under the Act which are still being worked through.

## What 'insurance' does the Act apply to?

- 3 The Act applies to a number of arrangements that the Ministry of Consumer Affairs considered to be insurance in substance:
  - 3.1 'Credit-related insurance', which comprises:
    - 3.1.1 'Insurance over secured property or leased goods'.
    - 3.1.2 Gap insurance.
    - 3.1.3 'Consumer credit insurance' (as defined).
  - 3.2 Repayment waivers.
  - 3.3 Extended warranties.
- 4 'Insurance over secured property or leased goods' clearly picks up material damage and loss covers. Presumably, if the terms of an unsecured loan require a debtor to insure its assets, that insurance would not be caught, as it would not be over 'secured' goods.
- 5 Gap insurance is:

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<sup>1</sup> *Consumer Credit Law Review Part 4: Overindebtedness, Insurance and E-Credit* (August 2000).

insurance that provides cover for the shortfall that occurs if secured property or leased goods are totally or substantially destroyed and the insurance proceeds from another insurance contract are insufficient to pay any outstanding obligations of the debtor under the credit contract or the lessee under the consumer lease.

- 6 Consumer credit insurance (otherwise known as payment protection insurance, loan protection insurance, loan repayment insurance or credit insurance) is defined in the Act as:

insurance cover in the event of the insured's disability or death or the insured contracting a sickness, sustaining an injury, or becoming unemployed, if the liability of the insurer is to be determined by reference to the liability of the insured under a credit contract or a consumer lease.

- 7 Consumer credit insurance may also provide cover in circumstances not referred to in the Act's definition. For example, it is not unusual to include cover if the insured is bankrupted by a third party. Would that extended cover still be consumer credit insurance for the purposes of the Act?

- 8 Extended warranty is defined as:

an agreement between a creditor or lessor and a debtor or lessee under which the creditor or lessor, for an additional consideration, agrees to repair or replace defective goods outside of the warranty period that would otherwise apply.

- 9 As defined in the Act, extended warranty is not a contract of insurance. However, if the extended warranty covers risks not usually covered by a manufacturer's or seller's warranty<sup>2</sup> or is provided by a third party (not the creditor or lessor), it is a contract of insurance within the category of insurance over secured property and therefore credit-related insurance for the purposes of the Act.

- 10 Finally, a repayment waiver is defined as:

an agreement between a creditor or lessor and a debtor or lessee under which the creditor or lessor, for an additional consideration, agrees to waive the creditor's or lessor's right to any amount payable under the credit contract or consumer lease in the event of the unemployment of, sickness of, injury to, or the disability or death of the debtor or lessee.

- 11 There is authority that a repayment waiver is not a contract of insurance<sup>3</sup>. However, it is in substance very similar to consumer credit insurance except that, by definition, a repayment waiver can only be provided by a creditor or lessor.

- 12 The Act does not apply to all insurances that might relate to consumer finance transactions. For example, the Act does not deal specifically with lender's mortgage

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<sup>2</sup> In *Ollendorf Watch Co v Pink* 17 NE (2d) 676 (1938), cited supra note 1 at 16, it was held that a warranty by the seller of a watch that the watch would be replaced if stolen was a contract of insurance.

<sup>3</sup> *Motorcycle Specialists Limited v AG* (1988) 2 NZBLC 103,358, a case concerning the application of the Insurance Companies Deposits Act 1953 to the giving of repayment waivers.

insurance, despite this being an insurance which the Ministry of Consumer Affairs identified as being amongst the common forms of credit related insurance<sup>4</sup>. Lender's mortgage insurance may protect a lender against risks such as a shortfall from security enforcement, a decline in the value of secured property or non-payment by the borrower. Some types of lender's mortgage insurance may be insurance over secured property and therefore credit-related insurance for the purposes of the Act, but others seem to be outside the Act.

- 13 An issue that arises with the Act's application to different types of insurance is considered is whether extended warranties, credit-related insurance and repayment waivers are mutually exclusive categories for the purposes of the Act. For example, it might be argued that extended warranty is 'insurance over secured property' and therefore credit-related insurance. In my view, the categories are mutually exclusive, as the Act defines them. This is consistent with the Act referring to all three categories in some sections (for example, sections 69 and 70).

### When are insurance premiums credit fees?

- 14 Whether insurance premiums are credit fees is significant<sup>5</sup> in terms of:
- 14.1 The application of section 41 of the Act, which prohibits unreasonable credit fees (as defined in section 44 of the Act).
- 14.2 The requirement to disclose credit fees under paragraph (n) of Schedule 1 of the Act.
- 15 Credit fees are defined as:
- fees or charges payable by the debtor under a credit contract, or payable by the debtor to, or for the benefit of, the creditor in connection with a credit contract (including any insurance premiums payable if the creditor requires the debtor to obtain insurance cover from a particular insurer); but does not include the following:
- (a) interest charges:
  - (b) a charge for an optional service:
  - (c) a default fee or a default interest charge:
  - (d) government charges, duties, taxes, or levies.

- 16 'A charge for an optional service' is defined as:

a fee or charge for a service or benefit that is offered to the debtor in connection with a credit contract if the debtor does not have to accept the service or benefit as a condition of entering into the contract.

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<sup>4</sup> Supra note 1 at 19.

<sup>5</sup> The issue may also be relevant to determining whether a credit contract is a consumer credit contract (section 11(1)(c)(ii)), whether continuing disclosure is required (section 21(1)(c)) and the amount of statutory damages (section 89).

- 17 There are some uncertainties around the words in brackets in the credit fees definition:
- 17.1 Are insurance premiums only credit fees if they fall within the words in brackets? Or can premiums be caught by the general opening words of the definition, unless they are a charge for an optional service? (This would require a premium to be a fee or charge).
- 17.2 What does 'for the benefit of the creditor' mean? Must the fee or charge be directly for the benefit of the creditor, or would the payment of a premium for an insurance that the creditor benefits from indirectly be sufficient?
- 17.3 What does 'requires' apply to? If taking out an insurance is optional, but the creditor requires it to be obtained from a particular insurer if the debtor elects to have it, is the premium caught? Or are the words in brackets only intended to catch either compulsory insurance? Given the exception for optional services, the likely answer is that only compulsory insurance is caught.
- 17.4 What is 'a *particular insurer*'? If the creditor offers debtors a range of insurers, would the premium be caught? If the requirement is that insurance be provided by an insurer acceptable to the creditor, would the premium be caught? Reading this phrase very widely so that it applies to insurers the creditor has no relationship with may result in it being impossible for creditors to comply with the Act's disclosure requirements, which cannot have been the intention.

## Commissions on insurance

- 18 The policy of the Act is to prohibit a creditor from charging the debtor fees that are unreasonable<sup>6</sup> or, in the case of the reimbursement by the debtor of costs incurred by the creditor, marked-up costs. Section 45 of the Act provides, so far as is relevant, that:

### **Fees or charges passed on by creditor**

(1) A fee or charge payable by a debtor for an amount payable or to reimburse an amount paid by the creditor to another person, body, or agency must not exceed the actual amount payable by the creditor if that amount is ascertainable when the fee or charge is paid by the debtor.

(2) The actual amount payable must be determined by taking into account any discount, rebate, or allowance received or receivable by the creditor or any related company.

....

(5) For the avoidance of doubt, nothing in this section prevents a reasonable commission from being payable or paid to a creditor in connection with any credit-related insurance taken out by the debtor.

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<sup>6</sup> Section 41(1).

- 19 In the case of an insurance premium, section 45(1) would prevent a creditor who sells an insurance product from deducting a commission from the gross amount paid by the debtor before on-paying the net premium to the insurer. The creditor could, of course, pay the gross amount to the insurer and receive a separate commission payment back from the insurer. (It has been argued that this is not the effect of section 45(1), because the commission is payable by the insurer, not the debtor. In my view, the natural meaning of section 45 does not support this interpretation).
- 20 It has been argued that the commission is a 'discount, rebate or allowance' that is caught by section 45(2). In my view, it is not, as discounts, rebates and allowances reduce the cost of a service to the creditor, but a commission does not.
- 21 While section 45(5) may have been intended to avoid doubt, it has had rather the opposite effect in the insurance industry. The principal problem is what a 'reasonable' commission is. As the Ministry of Consumer Affairs noted<sup>7</sup>, Australian studies have found that consumer credit insurance is priced uncompetitively, and there is anecdotal evidence that this is also the case in New Zealand. In Australia, the response has been to cap commissions on consumer credit insurance at 20%<sup>8</sup> and to require commissions to be disclosed<sup>9</sup>. This is an issue which I understand the insurance industry is still coming to terms with.
- 22 There is also the difficulty that section 45(5) only refers to credit-related insurance. What is the position of insurance that is not credit-related insurance as defined? One view is that because section 45(5) is 'for the avoidance of doubt' (suggesting that the earlier parts of section 45 do not, even without section 45(5), apply to reasonable commissions) the same principle applies to these other insurances. Another view is that nothing in section 45 requires commissions to be reasonable, only that section 45(1) be complied with, which can be done by paying premiums to the insurer on a gross basis.
- 23 And what is the position in the case of extended warranties and repayment waivers? As defined, they cannot be caught by section 45 because no third party is involved in providing them. If the fees paid for them are credit fees, the 'reasonableness' of the fees would be determined under section 44(1) by reference to the (presumably actuarial) cost to the creditor of providing them and 'reasonable standards of commercial practice'. If they are not credit fees, it appears that the Act does not apply to them at all.

### **Insurance premium rebates**

- 24 Under section 50 of the Act, a debtor always has a right to prepay a consumer credit contract in full. Section 51 sets out the maximum amount that can be required to be

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<sup>7</sup> Supra note 1 at 14.

<sup>8</sup> Consumer Credit Code, section 135.

<sup>9</sup> Ibid, section 150(N)(d).

paid on such a full prepayment. The calculation of that amount requires a deduction to be made in respect of certain insurance premiums.

25 Sections 52 and 53 of the Act provide:

**52. Rebate of insurance**

(1) The amount to be deducted under section 51 is an amount equal to a proportionate rebate of the premium paid under any consumer credit insurance contract financed under the consumer credit contract.

(2) The rebate must be calculated using the procedure prescribed for the purposes of this section by regulations if regulations have prescribed a procedure.

(3) An amount is to be deducted under subsection (1) only if the creditor has arranged the insurance.

(4) If an amount is deducted under subsection (1), the creditor may recover the amount from the insurer as a debt due.

(5) In this section, insurance is arranged by the creditor if 1 or more of the following applies:

- (a) the creditor or a related company of the creditor is the insurer;
- (b) the creditor or a related company of the creditor acts as the agent of the insurer in relation to the insurance;
- (c) the creditor or a related company of the creditor receives a commission in relation to the insurance;
- (d) the creditor requires the debtor to obtain the insurance from a particular insurer.

**53. Termination of consumer credit insurance contract**

A consumer credit insurance contract financed under a consumer credit contract is terminated on the full prepayment of the consumer credit contract unless the consumer credit insurance contract:

- (a) provides insurance cover in connection with 1 or more other credit contracts; or
- (b) otherwise provides a benefit to, or insurance cover for, the debtor.

26 Section 52(1) only refers to consumer credit insurance. Premiums for other types of credit-related insurance and repayment waivers are not rebated. The premium is also only rebated if it is financed under the consumer credit contract. Premiums that are paid up front by the debtor are not.

27 There is no express connection between sections 52 and 53. For example, section 52(1) does not have the words 'that is terminated under section 53' at its end. However it seems to be generally accepted that that is how the sections should work together. It cannot have been the intention to give debtors a premium rebate if the insurance is not terminated.

28 Section 52(4), which allows the creditor to recover the rebated premium from the insurer creates difficulties for insurers, because the rebate of the premium is calculated on a gross basis, rather than allowing for the commission on the insurance retained or received by the creditor and calculating the rebate on a net basis. The

result can be that an insurer owes a creditor more under section 52(4) than the insurer ever received in premium.

- 29 The insurance industry has come up with a number of possible solutions to this problem:
- 29.1 Not financing the premium for consumer credit insurance under the credit contract. However, this is not attractive to the creditor.
  - 29.2 Introducing commission recovery mechanisms in arrangements with the creditor so a rebate of the creditor's commission can be set off against the debt due under section 52(4). Again, this is not attractive to the creditor.
  - 29.3 Replacing consumer credit insurance with repayment waivers (which section 52 does not apply to), and then insuring the risk taken on by the creditor under the repayment waivers.
  - 29.4 Developing products that are not caught by section 52. These products generally either take advantage of section 53(b) (for example, by providing a low level of ongoing cover to the debtor) or have a payout that exceeds the liability of the debtor under the credit contract.
- 30 In the case of the second of the products described in paragraph 29.4, it is argued that as the payout does not *match* the debtor's liability, the product is not consumer credit insurance, which requires 'the liability of the insurer to be determined by reference to the liability of the [debtor] under a credit contract'. There is a counterargument that a payout that always exceeds a debtor's liability is still 'determined by reference to' that liability.
- 31 There is also a risk that the products designed to avoid the application of section 52 breach section 69 of the Act, which provides, so far as is relevant:
- Restrictions on credit-related insurance, repayment waivers, and extended warranties**
- (1) A creditor or a lessor must not, in connection with a consumer credit contract or consumer lease, make any unreasonable requirement as to the terms on which the debtor or lessee is to take out or obtain credit-related insurance, a repayment waiver, or an extended warranty.
  - (2) A requirement is unreasonable if:
    - (a) it is not reasonably necessary for the protection of the legitimate interests of the creditor or lessor; or
    - (b) it is not reasonably justifiable in light of the risks undertaken by the parties to the arrangement.
- 32 The risk is that the additional cover built into these products makes them 'unreasonable' as defined in section 69(2).

## Disclosure of insurance

- 33 A particular issue identified by the Ministry of Consumer Affairs in its credit law review was the inadequate disclosure of the terms of insurance<sup>10</sup>. This issue is addressed by section 70 of the Act, which provides:

### **Disclosure of credit-related insurance, repayment waiver, or extended warranty**

(1) If a consumer credit contract or consumer lease involves credit-related insurance and that insurance was arranged by the creditor under the contract or by the lessor under the lease, the creditor or the lessor must ensure that every insured person is supplied with a copy of the terms of the credit-related insurance (other than terms implied by law) within 15 working days of the day on which the credit-related insurance is arranged.

(2) If a consumer credit contract or consumer lease involves a repayment waiver or an extended warranty, every creditor under the contract or lessor under the lease must ensure that every debtor under the contract or lessee under the lease is supplied with a copy of the terms of the repayment waiver or extended warranty (other than terms implied by law) within 15 working days of the day on which the repayment waiver or extended warranty is arranged.

(3) For the purposes of this section, insurance is arranged by the creditor or lessor if 1 or more of the following applies:

- (a) the creditor or lessor or a related company of the creditor or lessor is the insurer;
- (b) the creditor or lessor or a related company of the creditor or lessor acts as the agent of the insurer in relation to the insurance;
- (c) the creditor or lessor or a related company of the creditor or lessor receives a commission in relation to the insurance;
- (d) the creditor or lessor requires the debtor or lessee to obtain the insurance from a particular insurer.

- 34 The scope of section 70 is reasonably straight forward, although the meaning of 'a particular insurer' is potentially an issue<sup>11</sup>.

- 35 There are some issues for creditors however:

35.1 What does 'supply' mean? It seems to mean more than merely making available. Assuming electronic supply is permitted (see below), would making insurance terms available on a web site be sufficient?

35.2 It may not be practical for the creditor to supply copies of the terms of the insurance. If consumer credit contracts are entered into through a dealer network, there may be concerns about relying on the dealers to do so. So

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<sup>10</sup> Supra note 1 at 15.

<sup>11</sup> See paragraph 17.4 above.

can the creditor delegate supplying the terms to the insurer? The creditor 'must ensure' terms are supplied. The obligation is not 'to supply' the terms. This suggests that delegation is permitted, albeit on the basis that the creditor remains responsible.

- 35.3 If the creditor does delegate supply of the insurance terms, will an indemnity from the delegate be enforceable, or would it be contrary to public policy to allow the creditor to shift risk in this way?
- 35.4 Section 70 does not refer to the terms of insurance being 'disclosed', and there is no express connection between section 70 and sections 32 and 35 of the Act (which set out how disclosure can be made and when it is deemed to be made). How and when is supply made? Is physical delivery of the terms to the insured the only safe option?
- 35.5 Sections 32(4) and 35(1)(c) of the Act specifically permit disclosure in electronic form. Given the lack of a connection between section 70 and these sections, does that mean insurance terms cannot be supplied electronically?