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**IN THE HIGH COURT OF NEW ZEALAND  
AUCKLAND REGISTRY**

**CIV-2010-409-000026  
[2014] NZHC 2486**

UNDER the Credit Contracts and Consumer Finance Act 2003 and the Fair Trading Act 1986

BETWEEN COMMERCE COMMISSION  
Plaintiff

AND SPORTZONE MOTORCYCLES LIMITED (In Liquidation)  
First Defendant

AND MOTOR TRADE FINANCES LIMITED  
Second Defendant

AND MTF SECURITIES LIMITED  
Third Defendant

Hearing: 27 June 2014

Appearances: KC Francis and CSM Henley for Plaintiff  
IJ Thain and CM Moody for Defendants

Judgment: 9 October 2014

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**JUDGMENT (NO. 2) OF TOOGOOD J**

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*This judgment was delivered by me on 20 October 2014 at 2:00 pm  
Pursuant to Rule 11.5 High Court Rules*

*Registrar/Deputy Registrar*

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## Introduction

[1] In *Commerce Commission v Sportzone Motorcycles Limited (In Liquidation)* (“the liability judgment”),<sup>1</sup> I held that Sportzone Motorcycles Limited (In Liquidation) (“Sportzone”) and Motor Trade Finances Limited (“MTF”) had charged unreasonable credit and default fees to borrowers of motor vehicle finance, in breach of s 41 of the Credit Contracts and Consumer Finance Act 2003 (“CCCFA”). The fees at issue were establishment fees, account maintenance fees, and arrears fees charged in consumer credit contracts under which MTF provided finance for the purchase of motorcycles from Sportzone.

[2] I reserved for discussion by the parties and, if necessary, further consideration by the Court, the making of orders under s 94(1)(b) of the CCCFA for recovery of such portions of the fees as were determined to be unreasonable by the application of the liability judgment.

[3] The defendants have appealed against the finding in the liability judgment that the fees charged were unreasonable. The Commerce Commission has cross-appealed against the rejection of its claims that the defendants had engaged in misleading and deceptive conduct in breach of s 9 of the Fair Trading Act 1986. I held in an interlocutory Minute that it is desirable that the parties’ submissions on the appeal issues and the consideration of them by the Court of Appeal should be informed by a practical application of the liability judgment. I concluded that, after hearing from the parties, a further judgment should quantify the amounts the Commission was entitled to recover.

[4] The defendants suggested initially that they were entitled to call further evidence in support of their position on the appropriate level of recovery, but after the Commission opposed such a course they did not pursue that argument. Instead, the parties addressed quantification on the basis of the evidence given at trial, although the defendants re-cast their cost allocations and redefined the basis on which they claimed the fees imposed were reasonable. A revised approach was made

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<sup>1</sup> *Commerce Commission v Sportzone Motorcycles Limited (In Liquidation)* [2013] NZHC 2531, [2014] 3 NZLR 355.

necessary by the rejection of the full cost absorption model which the defendants had argued at trial.

[5] The parties were able to reach a measure of agreement about the effect of the liability judgment on the Commission's claims for remedies in respect of some categories of cost, but remained at odds over the full extent to which the defendants had over-charged the fees at issue. This judgment follows the hearing of further submissions on behalf of the parties. For reasons which are explained below, it deals only with the Commission's claims for recovery of fees paid to MTF.

### **Factual background**

[6] To explain the factual background to the issues addressed in this judgment, it is convenient to adopt the summary provided in the liability judgment:

[7] The first defendant, Sportzone, was in the business of new and used motorcycle sales, services and repairs. It appears to have been a victim of the Christchurch earthquakes and is now in liquidation. This case concerns fees charged by Sportzone in connection with credit contracts entered into during 2006, 2007 and 2008 with the purchasers of motorcycles who borrowed part of the purchase price.

[8] The second defendant, Motor Trade Finances Limited ("MTF"), provides financial services to associated dealers. Sportzone was one of MTF's associated dealers. The third defendant, MTF Securities Ltd, provided finance to its associated company MTF by purchasing loans from MTF which were then securitised and sold as debt securities.

[9] On 13 July 2004, MTF entered into an agreement with Sportzone which permitted Sportzone to write credit contracts to provide finance to purchasers of vehicles. Under this agreement, Sportzone was allowed to provide intending purchasers of motorcycles with finance by entering into conditional purchase agreements with purchasers for periods of one to five years, with Sportzone taking a security in the motorcycles to secure the payments under the conditional purchase agreements.

#### *The contractual arrangements*

[10] Between 26 May 2005 and 16 July 2008 the borrowers entered conditional purchase agreements for the purchase of motorcycles which named Sportzone as the lender. In order to fund the loans, Sportzone simultaneously borrowed from MTF a sum equal to the total advance made under the loans. The MTF loans were funded by MTF through short term bank facilities and by selling them to MTF Securities. As security for repayment of the MTF loans, Sportzone assigned the loans and its security interest in them to MTF. MTF then sold the loans and its security interest in

them to MTF Securities. The terms of the credit contracts required the borrowers to make the payments due on the loans to MTF Securities. Payment to MTF Securities of the amounts due under the loans discharged the obligations of Sportzone to pay equivalent amounts under the MTF loans.

...

- [12] The loans also provided for the payment of a number of default fees:
- (a) A prepossession fee of \$50 charged by MTF to the borrowers in arrears for 12 days. This fee was increased to \$80 for loans advanced after 2 February 2007.
  
  - (b) A \$70 repossession fee charged by MTF to borrowers in arrears for 34 days. This fee was increased to \$80 for loans advanced after 2 February 2007.

### **Summary of findings in the liability judgment as to applicable principles**

[7] It is desirable to restate the principal findings in the liability judgment so far as they affect the determination of the appropriate remedies claimed by the Commission.

[8] Section 41 of the CCCFA provides that fees charged by a lender under a consumer credit contract (whether credit fees or default fees) must not be unreasonable. Generally speaking, a fee will be unreasonable to the extent that it allows the lender to recover more than its reasonable costs in connection with or related to the particular activity for which the fee is charged.

[9] I held that reasonableness is to be judged from the view of an informed objective bystander considering whether it is reasonable for the particular borrower to meet the costs which the lender seeks to recover by the fees charged.<sup>2</sup> To be reasonable, the cost the creditor seeks to recover must be sufficiently close and relevant to the establishment of the particular loan, to the administration and maintenance of a particular loan, or to the actual consequences of the particular default, such that it can reasonably be said that the cost was incurred in connection with or in relation to the relevant matter.<sup>3</sup> Applied to this case, that approach does not allow the imposition of fees to recover costs which are not closely relevant to the

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<sup>2</sup> At [65].

<sup>3</sup> At [66].

particular transaction but which are merely referable to the general business of selling motorcycles or of lending money.<sup>4</sup>

[10] In considering how the close relevance test should be applied to specific cases, I observed that, at the margins it will be a matter for judgment in the particular circumstances whether there is a sufficiently close and relevant connection or relationship between the fee matter and the cost claimed in respect of it. Context will assist to resolve marginal cases and the concept of reasonableness is sufficiently flexible to allow practical application.<sup>5</sup>

[11] I accepted a submission on behalf of the Commission that the principles of management or cost accounting provided practical guidance to lenders, the Commission in its enforcement role, and a court charged with determining whether a fee is reasonable.<sup>6</sup> The determination of whether a particular fee is unreasonable and, if so, to what extent, may be assisted by an assessment of the direct and indirect variable costs connected with or related to the activity to which the fee relates. Such costs will generally be recoverable by fees. It might be reasonable also to recover direct fixed costs, such as premises, employee remuneration, or information technology costs, having a causal connection to the activity in question or otherwise satisfying a strict application of the close relevance test.<sup>7</sup>

### **The Court's jurisdiction to order recovery of unreasonable fees**

[12] Section 48 of the CCCFA provides that if a debtor makes any payment to a creditor that, by virtue of the Act, the creditor is not entitled to receive, the creditor must refund or credit the payment to the debtor as soon as practicable. In view of the findings in the liability judgment that the fees charged by the defendants were unreasonable, s 48 requires the defendants to refund to the borrowers whose contracts are the subject of this proceeding the amounts by which the fees charged exceeded fees which were reasonable.

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<sup>4</sup> At [67].

<sup>5</sup> At [68].

<sup>6</sup> At [71].

<sup>7</sup> At [83]-[87] and [92]-[93].

[13] Section 93(a) of the CCCFA provides that the “Court may make... any of the orders referred to in section 94 if the Court finds that a person (whether or not that person is a party to any proceedings) has suffered loss... by conduct of any creditor... that constitutes... a breach of any of the provisions of sections 17 to 82”.

[14] I was told from the Bar that since Sportzone is now in liquidation, it is unlikely that there will be any distribution to unsecured creditors. For that reason, but without prejudice to its argument on appeal that the liability judgment is wrong, Sportzone does not dispute the amounts claimed by the Commission, as assessed by Mr Cregten. The Commission seeks orders under s 94(1)(b) of the CCCFA for the repayment of such amounts as will support the proof of debt filed by the Commission on behalf of the relevant borrowers and accepted by the liquidators. Formal orders will be made on that basis in due course.

[15] The Commission also seeks orders directing the payment of refunds by MTF. Without prejudice to its appeal, MTF acknowledges its susceptibility to orders in terms of the liability judgment but, although the parties have been able to agree on the extent to which MTF was entitled to recover some of its costs through the imposition of fees, the recovery of some cost items remains disputed. Counsel agreed that the parties would be best served by a quantification of the costs to be properly allocated stated as a percentage of the costs which MTF said it had incurred, leaving it to the parties to determine the effect of the quantification on the sums which the Commission is entitled to recover on behalf of borrowers.

[16] The Commission’s claims against the third defendant, MTF Securities, were pleaded as alternatives to the causes of action against MTF. Since the Commission has established that MTF is liable, it does not pursue orders against MTF Securities.

### **Quantification of the remedies sought under s 94(1)(b) of the CCCFA**

[17] The Commission’s principal witness at trial was Mr John Cregten, a forensic accountant. His evidence contained an exhaustive analysis, on a line-by-line basis, of the defendants’ expenditure in each of the 2006, 2007 and 2008 financial years by reference to the various cost centres to which MTF allocated its expenses for the

purposes of justifying the various fees charged. The cost centres represented different aspects of the company's business activity, with costs being allocated by MTF according to an assessment of the extent to which they were incurred in the conduct of each activity for which a fee was chargeable.

**Illustration of MTF's approach – finance costs claimed as part of establishment fee**

[18] It is useful to illustrate the defendant's approach by reference to MTF's allocation of costs incurred in its finance cost centre in support of the claim that it was entitled to recover finance costs by means of an establishment fee.<sup>8</sup>

[19] The MTF finance cost centre is concerned with collection, administration, reporting, and auditing processes and encompasses the finance department which, from 2005 to 2008, employed around eight to 14 full-time equivalent staff. The principal task of the department was to manage the banking system, including advancing funds to dealers, managing the collection of payments and instalments, and paying these funds to the correct parties. The department was responsible for regular reporting to MTF Securities and to other facility providers. It also reported regularly to dealers in terms of key performance criteria, enabling dealers to manage their lending processes. The finance department was involved with systems development relating to finance matters and the regular testing and checking of its systems, for example, to ensure that correct interest rates were being charged. It also handled refunds owing under contracts and early settlements. From time to time, the department dealt with finance-related customer requests (from both dealers and borrowers) which had been referred to it from the company's call centre. Inquiries through the call centre could relate to any stage of the loan process.

[20] It was accepted by Mr Cregten, on behalf of the Commission, that the finance cost centre had a direct association with the establishment of a consumer credit contract.

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<sup>8</sup> "Establishment fee" is defined in s 5 of the CCCFA as meaning "the fees or charges payable under the credit contract that relate to the costs incurred by the creditor in connection with the application for credit, processing and considering that application, documenting the contract, and advancing the credit; but does not include any fee or charge to the extent that it is a charge for an optional service".

[21] MTF argued that it was justified in allocating for recovery by establishment fees a percentage of the total annual costs incurred by MTF, within its finance cost centre, for each of the cost items of salaries and employee remuneration, training, travel, premises, communication, bank charges, directors' fees and audit costs. These allocations were made on the basis of a percentage of the total cost under that item in that cost centre, calculated according to MTF's assessment of the extent to which the finance department incurred each cost in connection with the establishment activities of applications for credit, processing and considering the applications, documenting the consumer credit contracts, and advancing the credit. For the 2006 year, for example, MTF allocated 10 per cent of the total salary costs incurred in the finance cost centre to those business activities. The defendant then claimed it was entitled to recover those costs as a component of its establishment fee for each contract by spreading the recovery over the number of contracts it reasonably estimated it would enter into in that year.

[22] Mr Cregten's evidence on behalf of the Commission contained a critical analysis of the defendant's allocations, adopting the approach under s 41 which was advocated by the Commission, and leading to his forming his opinions about whether and, if so, to what extent the defendants should be permitted to recover each of the costs incurred by way of fees.

[23] Having accepted that Mr Cregten's approach to his analysis was generally consistent with the close relevance test which I held to be appropriate, I indicated at [88] of the liability judgment that Mr Cregten's assessment of what fees would have been reasonable could form a basis for the orders sought by the Commission under s 94(1)(b). I expressed that view subject to the reservation, discussed at [89], that the Commission's expert witnesses (including Mr Cregten) had made concessions in the course of their evidence which suggested that at least some of the fixed costs or overheads which had previously been disallowed in their assessments might reasonably be included as elements of a reasonable cost recovery.

[24] On that basis, I consider the scope of the inquiry into what remedial orders are appropriate is narrowed to determining the extent to which Mr Cregten's assessments should be modified by a proper application of the correct test.

## **Two matters of principle not agreed by the parties**

[25] The parties have been able to agree on appropriate percentages of some costs incurred within certain cost centres which are properly recoverable as components of a reasonable fee under s 41 of the CCCFA, applying the close relevance approach set out in the liability judgment. I identify the agreed components below in my discussion of the item-by-item analysis for each fee.

[26] In respect of those expenses not agreed, two further issues of principle or approach are dispute:

- (a) Accepting for the purposes of this judgment that the Commission has established on a balance of probabilities that each of the fees charged in the three relevant years was unreasonable, is it incumbent upon the Commission to establish also, to the same standard, the extent to which the fees were unreasonable?
- (b) In support of its submissions about the extent of the alleged unreasonableness, is MTF permitted to rely on costs on which it did not previously rely in setting the fees or in its evidence at trial?

## ***The onus of proof***

### *MTF's argument*

[27] Accepting that the Court rejected MTF's full cost absorption model in favour of the Commission's approach which generally adopted a close relevance test, it is argued on behalf of MTF nevertheless that the onus of proof remains on the Commission throughout to establish on a balance of probabilities the extent to which the fees charged were unreasonable. In some cases Mr Cregten refused to accept the allocation of a particular cost as being recoverable by a fee, not because he considered that it did not meet the close relevance test but merely because he considered that he did not have sufficient information to determine the correct or precise amount which could reasonably be recovered. It was argued, by example,

that Mr Cregten conceded that some customer service and dealer support costs would be allowable in relation to the imposition of establishment fees. Nevertheless, he had allocated nothing for the recovery of those costs because he considered MTF had not given an adequate explanation for why it had made a 15 percent allocation as opposed to some other amount.

[28] The onus issue also arises from Mr Cregten's acceptance in a number of instances that an allocation of a particular cost could be made to justify a particular fee but he adopted a different level of allocation to that used by MTF even though he accepted that he did not have sufficient information to make an accurate allocation.

[29] Mr Thain suggested that it would be wrong to adopt Mr Cregten's estimate as if MTF had failed to provide any evidence to justify its allocation, in circumstances where MTF had provided the Commission with access to the details of its business and expenditure, and MTF's allocations of the relevant costs were explained in evidence. Mr Thain argued that there was no principled basis on which Mr Cregten's allocations should simply be taken "to 'trump' MTF's more informed allocations" in respect of costs which had been accepted in principle.

#### *The Commission's argument*

[30] For the Commission, Mr Francis argued that Mr Cregten's assessment of the costs properly recoverable by the fees charged was based, as I held in the liability judgment at [84], on a variable costs analysis predicated on his close consideration of what was actually done by the defendants in the relevant years. Since this was an approach which I held adopted the most effective accounting tool for applying the close relevance test, Mr Cregten's analysis should be accepted not only to prove that the fees charged were unreasonable but also to establish the extent to which the fees involve an unreasonable recovery of costs. The Commission's submission was that in a case such as this, where the lender's allocation of costs was based on an inappropriate methodology, resulting in a failure by the lender to establish a closely relevant connection between a fee and a particular costs centre, only those costs objectively attributable to the activity to which the fee relates should be recovered.

*Discussion and conclusion*

[31] In the liability judgment I said:<sup>9</sup>

While it is inevitably the case in enforcement proceedings that the Commission will carry the burden of proving unreasonableness on the balance of probabilities, the evidential onus of disproving unreasonableness which might be established *prima facie* is likely to fall on the lender which is in possession of all of the relevant information.

[32] I accept for the purposes of this case that Mr Cregten applied to the evidence provided by MTF an approach very similar to the close relevance test which I have held should be applied. MTF's full cost absorption model necessarily incorporated in its cost allocations some costs which meet the close relevance test but many which do not. In practice, once the Commission has established that the fees charged by a lender are unreasonable on an application of the close relevance test, indicating what it considers the proper fees should have been, the onus will shift to the lender to show that a proper application of the test allows for higher fees to be charged than those suggested by the Commission.

[33] There is force, however, in Mr Thain's submission that Mr Cregten erred in refusing to allocate any cost as part of a reasonable fee in circumstances where he acknowledged in principle that the type of cost incurred was recoverable but said the evidence did not enable him to determine the appropriate level of cost.

[34] Where costs fall into this category, a reasonable estimate of the appropriate level of recovery should be made on the basis of the available evidence. It is only where there is insufficient evidence to assist the determination that the Court would be justified in holding that no allocation should be made.

[35] Similarly, where the Commission and the lender agree that a cost item is recoverable in principle but cannot agree on the extent of a reasonable recovery, the Court will be required to reach its own view on the basis of a principled approach.

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<sup>9</sup> At [94].

[36] How these principles should be applied in practice will be demonstrated by the discussion below of the particular cost components which remain in dispute between the parties.

***Is the creditor entitled to rely on cost allocations not used in setting the fee?***

[37] The second broad question of principle which arises is whether MTF is entitled, in arguing what level of fees should properly be regarded as reasonable, to submit that the Court's assessment should take into account cost items which it did not rely upon in setting the fee or on which it did not rely in its evidence at trial.

[38] The question of whether MTF should be entitled to rely on costs which it did not attribute to a particular fee in its evidence at trial arises only because of the unique circumstances of the case. This proceeding is a test case and the expert evidence adduced by MTF in defence of the Commission's claims was predicated on the view that the full cost absorption model of recovery through fees represented a valid approach under the CCCFA. It is only because MTF's approach has been rejected in favour of the close relevance test that the defendant was obliged to recast its figures, arguably applying the close relevance test. It may be expected in future that the close relevance test will be adopted by lenders when setting their fees.

[39] In future cases, however, it is possible that a creditor faced with a claim that a fee is unreasonable will seek to justify the fee on a basis which is different from that which it applied in setting the fee. Applying the close relevance test requires the Court to have regard to a comparison between a fee and the total of the lender's actual costs closely relevant to the business activity covered by the fee. The purpose of the test is to determine whether the amount of the fee is in fact unreasonable, not whether the lender's methodology for setting the fee was flawed.

[40] Mr Francis suggested that if a lender was entitled to reallocate costs after the fee has been set and the contract entered into, the creditor has no incentive to correctly identify costs and allocate them at the time of contracting. It was suggested further that a creditor would be able to claim an allocation of certain costs to, say, an establishment fee in one case and then to reallocate the same costs to justify a

maintenance fee which was the subject of a challenge in another case. I regard these submissions as missing the point.

### *Conclusion*

[41] The question for the Court under s 41 is whether a consumer credit contract has provided for a credit fee or a default fee that is unreasonable. Sections 42 and 44 provide the basis upon which the Court is to determine, on the basis of the approach set out in the liability judgment, whether the cost is reasonably incurred in connection with or in relation to the fee charged. That requires an objective assessment based on the available evidence of what costs were actually incurred, irrespective of how they may have been assessed by the lender in setting the fee. In the event that a lender does not take certain costs into account in assessing a fee but then seeks to argue that the cost is relevant to the assessment of reasonableness, the original omission of the costs from the calculation of the fee may cast doubt on its close relevance as objectively assessed by the Court. It will not preclude consideration of the argument, however.

### **Recovery of particular costs**

[42] Against the background of the liability judgment, the facts of the case, and the issues of principle discussed above, I turn to address the particular costs which MTF relied upon to justify the establishment, account maintenance and arrears fees which it charged in the relevant years and which are the subject of the proceeding. An indication of the extent to which the parties were divided on these issues may be obtained from a comparison between the fees actually charged and the fees which the Commission says were reasonable. The competing arguments over establishment fees, which were the most significant fees charged, provide the best illustration. In 2006, 2007 and 2008, MTF charged establishment fees of \$190 for each consumer credit contract. The Commission's position at the beginning of the quantification hearing was that reasonable fees assessed on the basis of the close relevance test would not have exceeded \$23.60, \$38.00 and \$36.05 in each of the three years respectively.

### **Some cost items fail to meet the close relevance test in connection with any fee**

[43] Before quantifying the extent to which each of the fees was unreasonable, it is convenient to address those cost items relied upon by MTF which I have concluded cannot be held to be connected with or related to any of the fees charged. They are cost items which MTF has allocated for recovery across various cost centres and in respect of all fees.

#### *Training*

[44] MTF argued that training its staff to carry out the activities required to make loans was a necessary precondition to making or managing any particular loan and that the costs of training come within the close relevance test. But the test requires that a cost be closely relevant to a *particular* transaction; training costs are incurred in supporting the activity rather than carrying out the activity itself. Training costs are likely to vary widely between lenders, as is demonstrated by the sub-categories of training costs claimed by MTF – namely, airfares, accommodation, rental car expenses, taxis, meals, and tuition. Adopting the view of a reasonable objective bystander, I do not consider a borrower could be expected to meet such costs through contract fees. Training costs are overheads incurred in the business of lending which are not sufficiently closely related to any particular credit contract to justify recovery by way of fees.

#### *Travel*

[45] In arguing that it should be entitled to recover travel costs through fees, MTF submitted that its staff costs comprised more than merely salaries and included all costs necessarily incurred in engaging staff to carry out loan-related activities. The defendant did not explain, however, how staff travel costs might be closely related to any particular credit contract. Adopting the close relevance test, I consider it was appropriate for the Commission to take the view that travel costs would not usually meet this test and that in such circumstances it was incumbent upon MTF to establish why recovery of that component through fees was reasonable in connection

with or related to a particular transaction. On the evidence, I do not consider staff travel costs to be reasonably connected to any particular credit contract.

*Directors' fees and travel costs*

[46] MTF also sought to justify allocations for directors' fees and travel costs across various cost centres. In rejecting this argument, Mr Cregten considered that MTF had provided no evidence as to why costs of this kind were closely relevant to the making of any particular loan when they appeared to concern the general governance and stewardship of the entire organisation. It was submitted by MTF that the directors reviewed and approved credit policy; approved specific loan exceptions; approved facility limits; reviewed the performance of specific loans as well as the overall loan book; reviewed originator performance and management performance; and had statutory obligations to ensure that MTF operated within the law when making each loan.

[47] It is difficult to see, however, how this description of the directors' duties can be held to be sufficiently closely relevant to particular credit transactions which totalled over 30,000 each year. It is conceivable that in a smaller business company directors might have a more direct role in the approval of particular transactions, acting, in effect, as staff authorised to approve and otherwise process particular loans. In the absence of such evidence, however, I regard the cost of directors' fees and travel as a company overhead or indirect fixed cost which the reasonable objective bystander would not consider to be reasonably recoverable in the fees paid for a particular loan.

*Professional/accounting fees*

[48] MTF argued that accounting (or "professional") fees incurred in the various cost centres related to compliance with the company's obligations under the funding documents and that these were critical and, therefore, closely relevant to particular transactions. I consider this cost to be in a category of costs which would prima facie not be reasonably recoverable unless some evidence properly adduced showed them to be sufficiently closely relevant to particular transactions to justify recovery

by the imposition of a fee. In the present case there is no evidence to justify the recovery of such costs in respect of any fee charged.

#### *Legal fees*

[49] A similar view may be taken of the claim for an allocation of legal fees in various cost centres for different fees. I accept that it may be possible for a lender to demonstrate a direct link between legal or professional fees and, say, the establishment of a particular loan. For example, evidence from a lender that established that particular legal or professional fees were necessary for drawing up a loan purchase deed might be sufficient, but simply to allocate a proportion of total legal fees, without particular justification, is not sufficient. The use of boilerplate loan purchase deeds drawn up by the lender's legal services provider at some point does not suggest that the likely costs of engaging legal assistance in any year should reasonably be related to the establishment of particular credit contracts.

#### *Audit fees*

[50] Similarly, MTF allocated the cost of its annual financial audits to various cost centres and sought to recover them in connection with all fees. I regard this cost as being associated with the business of lending rather than with particular credit transactions; it is one which is a head office expense or overhead which can be recovered through interest payments but not by way of fees. A similar approach should be taken with regard to internal audit costs which are a general compliance overhead.

[51] I disallow the costs of training, travel, directors' fees and directors' travel, professional/accounting fees, legal fees and audit costs as costs which may be recovered as components of a reasonable establishment, account maintenance or arrears fee.

[52] In general, I have also disallowed what can be referred to as MTF's "cost of funds" – namely, securitisation costs, bank costs and the cost of capital – but it is

more useful to deal with these in the context of each cost centre under which they are claimed.

[53] Next, I address each fee by discussing MTF's claims and the Commission's responses in respect of each of the cost items claimed within each cost centre, including those on which they agree. It is convenient to look at the establishment fees, account maintenance fees, and arrears fees separately, examining the fees charged in each of the 2006, 2007 and 2008 financial years by reference to the various cost centres to which MTF allocated its expenses.

### **Establishment fees**

[54] The Act permits the recovery by the imposition of establishment fees of a creditor's "reasonable costs in connection with the application for credit, processing and considering that application, documenting the consumer credit contract, and advancing the credit". The costs can be determined either with reference to an individual credit contract or by averaging across the class of credit contracts.<sup>10</sup> It is likely that in most cases the fee will be struck in advance of the transaction, most probably at the beginning of the lender's financial year, based upon a reasonable estimate of the total closely relevant costs likely to be incurred in connection with the four administrative steps identified, divided by the total number of contracts which the lender estimates it will enter into. In the present case, the Commission did not dispute the defendant's estimates of the number of contracts which should be the divisor.

### ***Finance cost centre***

[55] I have already described the activities encompassed by the finance cost centre.<sup>11</sup>

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<sup>10</sup> CCCFA, s 42.

<sup>11</sup> At [18]-[20].

### *Salaries and performance scheme*

[56] In 2006, MTF allocated 10 percent of the salaries of finance staff to activities covered by the establishment fees. The Commission accepted that this allocation was reasonable in 2006 but adopted Mr Cregten's assessment that only eight percent of salary costs should be recoverable in 2007 and 2008, principally because of a substantial increase in the dollar amount allocated for salaries in those years without any evidence of an increase in staff levels. Notwithstanding what may have been an unexplained increase in salary levels, MTF's allocation of 10 percent across the three years is consistent and I am not persuaded that there was any proper basis upon which that approach should be rejected. I consider that 10 percent of finance costs centre salaries is reasonably recoverable in each of the three years through the payment of establishment fees.

[57] MTF made a similar claim to recover 10 percent of remuneration paid to finance costs centre staff under its performance incentive scheme. Mr Cregten considered that performance scheme payments were not likely to be related to the establishment of credit contracts and noted that there was no specific evidence from MTF explaining which employees benefited under the scheme. However, MTF's allocation of 10 percent across the board was consistent with its approach to recovery of salary costs and there is no evidence to justify Mr Cregten's assumption that the performance scheme related only to senior employees not involved in activities closely relevant to the establishment of contracts. Allocating payments made under the performance scheme in the same proportion as salaries ensures that it is allocated only in respect of those staff members doing closely relevant activities and I would allow MTF's allocation over the three years.

### *Premises*

[58] In the written submissions filed in support of their respective positions on the quantification of remedies, the Commission accepted MTF's proposition that some proportion of premises costs could properly be attributed to establishment activities. Mr Cregten conceded that premises costs could be taken into account in assessing a reasonable establishment fee if the space used by staff for establishment activities

could be identified. MTF endeavoured to recover more than 50 percent of its premises costs but the Commission argued that the appropriate percentage should reflect the allocation of finance costs centre staff salaries to establishment fees. While indicating that MTF did not agree with the Commission's method of calculation, Mr Thain said MTF would accept the Commission's figure on the basis that whatever allocation was made for staff costs in each cost centre, a similar allocation would be made for premises. I endorse that approach as being reasonable.

[59] The premises costs recoverable in this manner include storage rental, office rental, rates, energy costs, buildings' insurance, security and cleaning, premises maintenance and depreciation of fixtures and fittings.

#### *Bank*

[60] The Commission accepts that bank activity fees can appropriately be allocated to costs reasonably recoverable through an establishment fee in relation to the activity of "advancing the credit". MTF's proposed allocation of 10 percent is accepted by the Commission and I agree that that is a reasonable level of recovery.

#### *Payment waiver insurance*

[61] This cost, for which MTF claimed a 100 percent allocation in 2007 under the finance costs centre heading, relates to the development of an optional insurance product not taken up by all borrowers. In Mr Cregten's view the cost of the product could be passed on as a contract-specific extra charge to borrowers who took up the option, allocated on the basis of expected contract adoption. MTF argued that although the option may not have been taken up by every customer it was included in every application for credit and was integrated into requirements under the loan purchase deed which related to each specific individual loan contract.

[62] The short answer to this claim lies in the definition of establishment fees in s 5 of the CCCFA which excludes any fee or charge to the extent that it is a charge for an optional service. In any event, as a matter of principle, an optional product producing a separate revenue stream, which may have the effect of lowering costs

which a lender might seek to recover as part of its interest rate, is not the type of cost which is recoverable as being connected with a particular transaction. Given that an establishment fee is added to the amount of the loan and attracts interest accordingly, there is no justification for allowing the cost of establishing the payment waiver insurance option to be added to the contracts for consumers who do not take up the option. I agree with Mr Cregten's view that this cost is not recoverable through the establishment fees.

### *Communication*

[63] This cost covers telephone and cell phone charges. MTF sought to allocate five percent of the communications costs in the finance costs centre to establishment fees in 2006, 5.4 percent in 2007 and 10 percent in 2008. Mr Cregten regarded these as indirect or infrastructural costs on the basis that there was no evidence establishing a link between cell phone and other telephone usage and establishment activities.

[64] I consider the cost of communication generally to be as integral to the activities covered by an establishment fee as salaries and premises costs. Normally, in the absence of other evidence, I would take staff salaries as the benchmark and allocate this cost at the same proportions as salaries and premises on the basis that, if a lender requires a certain number of staff to process loan applications, it will incur a proportionate cost in premises and communications. However, in this instance MTF has allocated its communication costs at a lower rate and I accept those allocations as reasonable.

### *Treasury cost centre*

[65] The treasury cost centre encompasses MTF's treasury department which, between 2005 and 2008, employed three to four full-time equivalent staff. The treasury department was involved primarily in managing MTF's funding facilities so that MTF had funds available to make consumer loans. The funding facilities included the securitisation programme through MTF Securities for which treasury was responsible, from the initiating of contracts into the programme, monitoring the

programme, and setting interest and buy-rates. Treasury was also responsible for other sources of funding including the issue and management of perpetual preference shares on the New Zealand debt market, the issue and management of ordinary shares, and the arrangement and maintenance of short term banking facilities. Overall, MTF's evidence established that the sole focus of treasury was on establishing sufficient funding for MTF to be able to make loans.

*PC banking and direct credit and debit facilities*

[66] The parties were agreed that Mr Cregten had accepted allocations of 10 percent in 2008 for costs related to PC banking and direct credit and debit facilities. It appeared also that the parties were agreed that bank activity fees incurred in this cost centre could reasonably be allocated as costs recoverable by establishment fees. I leave it to the parties to determine whether other bank charges which MTF sought to allocate, such as replacement cheque charges, were also accepted in line with Mr Cregten's reasoning.

*Other treasury costs*

[67] In all other respects, however, the Commission rejected MTF's claim that treasury costs could be recovered by fees. It is appropriate, in my view, to make a distinction between MTF's cost of funds and its operating costs (that is, the cost of acquiring the money it lends to borrowers and the money it uses to run its business). Treasury costs, securitisation costs and the cost of capital are all, to a greater or lesser extent, components of the cost of funds. MTF is a money-lending business and the cost of sourcing funds from the money markets is a company overhead referable to the general business of lending money.<sup>12</sup>

[68] Although s 42 requires reasonableness to be assessed with reference to "the creditor's reasonable costs in connection with ... advancing the credit", that expression is intended to cover costs incurred by MTF in transferring the credit to its dealers in respect of particular transactions, not the cost of sourcing those funds. The focus of s 42 is on particular transactions and not the overall business of arranging

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<sup>12</sup> See the liability judgment at [67].

funding. As the Commission submitted, it was envisaged in the Consumer Credit Law Review that costs directly associated with the acquisition or use of finance, including the servicing of a lender's borrowed funds, would likely be recovered by lenders through the interest rate.<sup>13</sup>

[69] Except as is agreed in relation to bank charges, I would not allow any of the costs incurred in the treasury cost centre to be recovered through establishment fees.

### *Credit cost centre*

[70] The credit cost centre encompasses the credit department which, between 2006 and 2008, included around four to seven full-time equivalent employees. The department was responsible for assessing the desirability of a potential borrower and determining the appropriate lending rate for that borrower. The principal focus of the department was on ensuring that loans were properly made at the outset, to minimise the risk of default. The credit department monitors the performance of dealers' ledgers which are taken into account in determining the level to which a dealer is permitted to lend. A dealer's lending levels may be adjusted upwards or downwards depending on the performance of the loans that they made. The credit department is also responsible for evaluating new dealers who wished to join MTF. In respect of settlements, the department might be involved in hardship applications and also in recovering unpaid loans directly from dealers where the dealer has become liable to pay.

### *Salaries, performance scheme costs and communications costs*

[71] Mr Cregten accepted that some level of salary costs incurred in the credit department should be allocated to establishment fees as staff were involved in the consideration and allocation process. He said, however, that he did not have enough detail to be precise as to the level and considered that because many of the credit department's tasks were associated with monitoring the performance of contracts and the arrears process the maximum that should be attributed to establishment fees was 50 percent. In 2006, MTF allocated 80 percent of its credit department's costs to

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<sup>13</sup> Consumer Credit Law Review (Part 3, April 2000) at 70-72.

establishment fees and 70 percent in 2007 and 2008. MTF argued that because Mr Cregten was not familiar with the activities of MTF's credit department he was not in a position to dispute the allocations made.

[72] Since MTF's allocations were based on an erroneous view of what it was entitled to recover, applying the full cost absorption model, I am not persuaded that Mr Cregten's approach is wrong; it accords more closely, in my view, with an assessment of the costs likely to be incurred in close association with establishment activities. I would, therefore, allocate 50 percent of the salaries of credit department staff to establishment fees.

[73] It follows that the same allocations should be made, consistently with the approach I have proved for the finance costs centre, in respect of performance scheme costs and communications expenses in this cost centre. In the case of those cost items, therefore, I would approve an allocation of 50 percent.

[74] The parties are agreed on the allocations for processing (credit reference) costs proposed by MTF; namely, 100 percent in 2006, 65 percent in 2007 and 65 percent in 2008. In 2007 and 2008, some of these costs were relevant to arrears activities.

***Customer service/dealer support cost centre***

[75] This cost centre encompasses the help-desk system which, during 2006 to 2008, employed around 12 to 13 full-time equivalent staff. The help-desk responds to queries from both dealers and customers at all stages of the lending process from establishment through to settlement and arrears. At the establishment phase, if dealers are having an issue with the initiating of a contract, they could contact the dealer support team. A significant part of the dealer support team's work concerns maintenance issues with existing dealers and with the settlement of contracts. Designated members of the help-desk team are also responsible for the induction process for new dealers and their training.

*Salaries, performance scheme costs and communications costs*

[76] Mr Cregten acknowledged that part of the help-desk costs might be sufficiently connected with establishment fee activities but was unable on the evidence to see justification for MTF's allocation of 15 percent across the salaries, training, travel and communications costs items. In circumstances where the nature of the activity suggests that some allocation should be made but the evidence falls short of establishing a particular percentage, the Court should make such reasonable estimate as it can on the evidence. I would allow an allocation of 10 percent of salaries and the cost of the performance scheme and communications costs, consistently with allowances made for those items in respect of other cost centres. I decline to make any allowance for training and travel for the reasons already given.

*Motochek fees*

[77] A claim for 60 percent of Motochek fees is claimed by MTF on the basis that part of the establishment of each loan may require a manual check on the registered owner of the vehicle. This allocation appears to be reasonable and I understand it is now accepted by the Commission.

*System development cost centre*

[78] Systems development included general marketing to generate new business, such as point-of-sale marketing, promotions, signage and brochures. The cost centre was also involved in IT systems, with a focus on the MTF website which incorporates the dealer website and public website, the Rapid Contract Origination System, and the financial systems. MTF sought to allocate 90 percent of salaries, performance scheme and training costs for this cost centre, travel at 40 percent and communication costs at 50 percent. However, the allocation was made in the context of the full cost absorption approach and on the basis of a general argument that developing the loan origination system and compliance systems for financial reporting was necessary for MTF to comply with its obligations under the loan purchase deed. The evidence suggests that this cost centre has a strong marketing bias with a focus on developing infrastructure rather than operating costs closely

relevant to particular transactions. On the basis that Mr Smith acknowledged in his evidence on behalf of the Commission that some parts of the cost centre's activity would meet the test but that most would be ascribed generally to the business of lending, I allow an allocation of 10 percent of salaries, the costs of the performance scheme and communications costs only.

***Product development cost centre***

[79] The product development cost centre is concerned with the development of products offered by MTF as part of MTF's goal of generating new business and remaining competitive. The training, travel and communications costs were said to be primarily associated with the ongoing development of MTF's new online loan origination system and the training of staff to use it. That system allowed dealers to enter borrower details and receive, for example, credit check results quickly. It was not designed to allow MTF to expand into any new areas of business but to enable MTF to consider and process loan applications more efficiently. Legal fees claimed in respect of this cost centre were apparently incurred as part of developing the contractual terms and conditions for MTF's new payment waiver financial product and incorporating those terms and conditions into MTF standard loan contracts. Dealers then had the ability to offer payment waivers to all borrowers.

[80] Since I have rejected the payment waiver costs as being related to an optional product when considering finance costs centre allocations, I can see no basis for allowing this cost in respect of the development of the product. Nor can I see a basis for allowing MTF to recover, via establishment fees, the cost of development of any other product which allows it to generate new business and remain competitive. The costs in this cost centre appear to be related to the general business of lending rather than to specific transactions. The evidence does not establish that any allowance should be made for costs incurred by product development activities.

***IT production cost centre***

[81] MTF argues that its strong information technology infrastructure is a key point of difference enabling it to produce a quick turnaround on loan applications.

The major IT systems operated by MTF include Rapid, the front-end loan application and credit assessment software that enables immediate lending approvals within pre-determined parameters, and Sovereign, MTF's banking and finance receivable management software which interfaces with Rapid and other banking applications and maintains all transactional and customer-related information over the life of the loan. The IT production cost centre covers the cost of all IT systems in place governing all aspects of MTF's financing business and includes the costs of hardware, backup systems, software testing, security and networks.

[82] During the 2006 and 2008 financial periods, the emphasis of the IT production cost centre was on technology involved with the origination of loans as MTF had moved to electronic origination for all contracts. There was ongoing development and refinement of this aspect of the IT system after its initial rollout. Mr Cregten accepted this cost centre as having a direct association with establishing a contract but said that it principally supported the entire infrastructure of the business. Both Mr Smith and Mr Cregten accepted that MTF might be able to justify some allocation of its IT costs to specific fees but the evidence did not support the 100 percent allocation contended for by MTF. The IT systems created by MTF appeared to support not only the business of establishing and maintaining particular loans but also non-recoverable overhead functions such as marketing and general administration.

*Salaries (including temporary staff), performance scheme costs and cell phone costs*

[83] Basing his allocations on an assessment that four of the seven staff in the IT department performed establishment activities and by reference to the job descriptions of the staff involved, Mr Cregten allocated 23.5 percent of staff salaries in 2006, 9.9 percent in 2007 and 12.1 percent in 2008. In supporting its allocation of 50 percent of staff salaries and other employment costs in 2006 and 55 percent in 2007 and 2008, MTF criticised Mr Cregten's allocation as crude, inaccurate and lacking any basis for challenging MTF's assertion that IT staff were involved in relevant loan establishment activities.

[84] Since Mr Cregten's estimates are based on an approach which I consider to be consistent with the application of the close relevance test and MTF has not provided evidence suggesting that Mr Cregten's estimates were probably incorrect, I accept his allocations. Similar allocations should be made in respect of performance scheme costs. I also accept that the claim for an allocation of 12.1 percent in 2008 for temporary staff, it being a reasonable inference that temporary staff were engaged to a similar extent in establishment fee activities as full-time staff. Allocations for cell phone use would also be allowable in the same proportions as staff salaries.

*Other communications costs – paper, printing, stationery and postage*

[85] The Commission accepts that other communications costs such as printing, stationery, paper and postage are recoverable in principle. As costs closely relevant to establishment activities, Mr Cregten made allowances for stationery and postage on the basis of a close analysis of actual costs including the average cost of a two-page letter sent with each new contract, and splitting the allocation between stationery and postage. MTF's allocations, on the other hand, ranged between 30 and 55 percent of its total communications costs for this cost centre. On the evidence I would allow the allocations estimated by Mr Cregten for stationery of 17 percent for 2006, 15 percent for 2007 and 19.8 percent for 2008, and also the allocations for postage of 14.2 percent for 2006, 12.5 percent for 2007 and 19.2 percent for 2008 on the basis that MTF's evidence does not displace Mr Cregten's analysis. There does not seem to be any principled reason not to allow similar estimates to recover printing and paper costs as for the stationery costs and I allow them on that basis.

*Hardware and software depreciation*

[86] Mr Cregten made no allowance for hardware and software depreciation, arguing that these costs were not sufficiently connected to particular transactions. The Commission now accepts, however, that recoverable indirect costs could include depreciation through being allocated across multiple fees on the basis of generally accepted accounting practice. I see no basis to disapprove the allocations now agreed to by the Commission for these items.

### *Security and storage*

[87] Similarly, it appears that the Commission now accepts adjustments for security and storage which Mr Cregten had disregarded as being a company overhead. The allocation by MTF of 65 percent of these costs to establishment fees is acceptable.

### *Securitisation and bank cost centre*

[88] Although evidence of these costs was provided at trial, MTF did not seek to rely upon recovery of these costs as being available under the full costs absorption method which it adopted. It now argues, however, that in order for MTF to be able to advance funds to borrowers it needed to have sufficient funds available which necessarily required MTF to incur securitisation and bank costs.

[89] Securitisation costs are part of the cost of funds in the same way as treasury costs are an overhead for a money-lending business and are not sufficiently closely relevant to the making of any particular loan. I do not reject an allocation for these costs simply because MTF did not initially claim it but I am satisfied that there is no basis for treating these costs as meeting the close relevance test.

### *Cost of capital*

[90] The cost of capital is the cost of funds used to finance a business. In MTF's case, it is what it considers its shareholders require as an acceptable rate of return in order to stay invested in the business. MTF submits that this rate is [withheld from publication] percent, and allocates this rate across the [withheld from publication] percent of its assets which it says are used in a closely relevant sense for fee-related activities. It says it does not seek an allocation for the percentage of its cost of capital which relates to general overheads.

[91] In making these claims, MTF refers to an observation I made at [92] of the liability judgment as if I had determined as a matter of principle that the cost of

capital was a cost which met the close relevance test of reasonableness. In that passage I said:

In assessing the reasonableness of establishment fees, the recovery of any portion of fixed cost items such as depreciation, premises costs, IT costs, head office functions, and return on capital/cost of capital, would require a strict application of the close relevance test. This is particularly important given the impact which the addition of an establishment fee has on the total cost of the transaction to the borrower, including on the liability to pay interest.

[92] I referred to the return on capital or the cost of capital as an example of fixed cost items which had been the subject of divergent expert evidence and argument at trial. The point of the observation was merely to indicate that while the strict variable cost approach advocated by the Commission's expert Professor Bowman would rule out such fixed costs altogether, the evidence in particular cases might be sufficient to satisfy a court applying the close relevance test that the costs were recoverable by one or more credit fees.

[93] The Commission opposes recovery of the cost of capital by establishment fees as a matter of fact and law. As a matter of fact, the Commission suggests that [withheld from publication] percent is an unusually high rate of return. As a matter of law, it says this cost is not the type of genuine accounting cost that is contemplated by ss 41, 42 and 44 of the Act. That is because, in the Commission's submission, the cost of capital is not an actual cost incurred; rather, it is a notional return on invested capital.

[94] It is difficult to see how any allowance could be made for an accounting item which is not an actual cost incurred in the establishment of any loan and therefore not connected with it. I place the cost of capital in the same category as treasury and securitisation costs in that they relate to the cost of funding the business of lending. They are recoverable through interest payments but are too remote from any particular transaction to justify recovery through fees.

### **Account maintenance fees**

[95] MTF charged a standard fee of \$3 for each contract in each of the three years as a recoverable cost related to the oversight and maintenance of a credit account during the lifetime of the contract.

### ***Finance cost centre***

#### *Salaries*

[96] I understand that by the time of the hearing on the quantification of remedies, the parties had agreed that Mr Cregten's allocation of salaries in the finance costs centre concerning account maintenance fees were appropriate. These figures were 40.9 percent for 2006, 28.9 percent for 2007 and 30.6 percent for 2008. I allow similar allocations for performance scheme costs, premises and communications, consistently with the approved approach for establishment fees.

#### *Bank*

[97] Bank costs were originally disallowed by Mr Cregten as not being sufficiently connected with account maintenance fees but I understand the Commission now to accept the allocations proposed by MTF, consistently with the approach taken to these costs in relation to establishment fees. In principle, that appears to be correct.

#### *Software maintenance*

[98] The Commission accepts in principle that software maintenance may be recovered to the extent justified by the evidence. It takes issue, however, with MTF's proposed allocation of 100 percent of its costs for recovery by the account maintenance fee, because it argues that some of the software costs in the finance cost centre will be related to aspects of its business, such as management, that are not closely relevant to the making or maintenance of particular loans. Mr Cregten's approach to the claim for software maintenance in relation to account maintenance fees was that there was insufficient evidence to show that there was any sufficiently

close connection between the costs and the fee, and he therefore allowed no recovery. Given that software maintenance costs are recoverable in principle, and because it seems likely that much of the cost in this cost centre will be in relation to software that facilitates the maintenance of loans, I allow an allocation of 70 percent.

***Treasury cost centre***

[99] Although some element of treasury costs may be regarded as being closely relevant to establishment activities, there is no evidence that the MTF treasury department was involved in account maintenance. In the absence of evidence of a sufficient connection I disallow any allowance for this cost centre in respect of maintenance fees.

***Customer service/dealer support cost centre***

[100] The parties have agreed that salaries under this cost centre can be allocated for recovery by a maintenance fee at 12 percent for 2006 and 2007 and 10 percent for 2008. Performance scheme costs and communications should be allowed at the same rates. I also consider that the allocation for Motochek costs at 30 percent is a reasonable allocation and I understand this to be accepted by the Commission.

***System development cost centre***

[101] As discussed above, the evidence suggests that this cost centre has a strong marketing bias with a focus on developing infrastructure rather than operating costs closely relevant to particular transactions. On that basis I would allow the same allocations as for establishment fees – 10 percent of salaries, the costs of the performance scheme and communications costs only.

***Information technology cost centre***

[102] Mr Cregten considered salaries in relation to the functions performed within this cost centre and allocated 18.4 percent in 2006, 7.8 percent in 2007 and 9.5 percent in 2008. There is insufficient evidence from MTF to suggest that his approach was not reasonable and I agree with Mr Cregten's allocations. A similar

allocation should be applied in each of the three years to performance scheme and temporary staff costs, consistently with the approach which I consider appropriate for establishment fees. Communications costs may be allocated on the same basis.

[103] As for hardware and software depreciation, software maintenance and security and storage, I understand that these figures are largely agreed by the Commission with the result that MTF's allocations should be allowed.

[104] For the reasons given in relation to establishment fees, I disallow any claim to recover securitisation and bank costs and the cost of capital in respect of maintenance fee activities.

#### **Arrears fees**

[105] MTF categorised borrowers who defaulted on any payment which was overdue by four days or more as being in arrears. A pre-possession fee was charged if a borrower remained in default after 12 days and a further repossession fee was charged if a borrower remained in default after 34 days.

#### ***Finance cost centre***

[106] I understand the parties have agreed on a five percent recovery in relation to arrears fees for all premises costs.

#### ***Credit cost centre***

[107] For the reasons given in relation to establishment and maintenance fees, I consider it appropriate to allow the allocations for employee remuneration including salaries, the performance scheme costs and also for communication at the rates claimed by MTF (except that, in line with salaries and premises, the allocation for communication in 2006 should be 15 percent). Credit reference costs have been allocated by MTF at a rate of 35 percent in 2007 and 2008 and I understand that this allocation is accepted by the Commission as being reasonable.

***Customer service/dealer support cost centre***

[108] Mr Cregten was prepared to accept a 25 percent allocation of employees' salaries under this cost centre for recovery by the arrears fees. MTF allocated 35 percent in 2006 and 37 percent in 2007 and 2008, but the allocations were based on the full cost absorption model which is inappropriate. There is no evidence which displaces Mr Cregten's analysis of the sufficiently close connection for this cost, but the same 25 percent allocation should be applied to performance scheme and communications costs for the reasons given in respect of the other fees.

***System development cost centre***

[109] As I have held that some system development costs can be recovered in respect of establishment fees, I accept MTF's allocation of three percent for salaries and performance scheme costs in 2006.

***IT production cost centre***

[110] MTF seeks allocations of 10 percent for staff salaries, performance scheme costs and temporary staff, the latter being for the 2008 year only. I am satisfied that this is a reasonable allocation notwithstanding that there was no clear evidence of the role of IT staff in relation to arrears. 10 percent is a relatively low figure reflecting what may be inferred to be the occasional involvement in arrears activity. Communications costs for printing and stationery should be allowed at the rates which Mr Cregten would allow for stationery and postage, and for reasons given above at [84] I would also allow recovery for paper and printing at the same allocation as stationery. However, there is insufficient evidence to justify the allocation sought by MTF for the encoding machine.

[111] Hardware and software depreciation should be allowed at the rates claimed by MTF for the reasons given in relation to other fees at [86] above.

### ***Bad debt expense cost centre***

[112] This cost centre covers circumstances in which a borrower has defaulted on his or her loan, and MTF is unable to recover any part of that loan.<sup>14</sup> MTF averaged out the cost of these “bad debts” and recouped them via arrears fees, which were levied on any borrower who went into default – even if that borrower soon remedied the default and ultimately repaid his or her loan. That is, the losses which MTF estimated it would incur because of the actions of a small group of borrowers who defaulted on their entire loan were recouped by charging fees to a wider pool of borrowers who were only temporarily in default.

[113] To justify its arrears fees, MTF has allocated 100 percent of these bad debt costs in 2006 and 2007 to this cost centre. Mr Cregten argued that MTF should not be able to recover any of these bad debts through arrears fees. The Commission submits that such an allocation is contrary to the statutory language of s 44, which effectively provides that creditors may only charge default fees if they reasonably compensate it for, in relation to the matter giving rise to the fee, “any cost incurred by the creditor (including the cost of providing a service to the debtor if the fee relates to the provision of a service)”<sup>15</sup> or “a reasonable estimate of any loss incurred by the creditor as a result of the debtor’s acts or omissions”.<sup>16</sup> The Commission submits that bad debts are not a “cost incurred by the creditor” in relation to the matter giving rise to the fee per the first limb of the test, because a bad debt cost in relation to one borrower is not an actual cost incurred in relation to another borrower. Therefore, it says, the costs could only be recoverable under the second limb of the test.

[114] However, the Commission submits that an equal allocation of bad debts across all contracts is unlikely to constitute a “reasonable estimate of loss”, because no attempt is made to distinguish between the losses that result from a loan of, say, \$2,500 and a loan of \$25,000.

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<sup>14</sup> Normally MTF would recover bad debts by recourse to the dealers who made the loan, but in a small proportion of cases it would not do so and the unpaid loan would become a bad debt on MTF’s books.

<sup>15</sup> Section 44(1)(a)(i).

<sup>16</sup> Section 44(1)(a)(ii).

[115] I accept the Commission's submission but I consider the objection to the recovery of bad debts through arrears fees can be viewed more fundamentally. The section is directed at loss arising from "the debtor's" acts or omissions, which indicates that the person who pays the fee should be the one who caused the loss. In this case, it is borrowers who are temporarily in default who shoulder MTF's losses arising because other borrowers default permanently. I see no good reason why this should be the case. The cost of bad debts is a cost of being in the business of lending; it is one of MTF's general overheads and should be recovered through the interest rate.

***Securitisation and bank costs and cost of capital cost centre***

[116] These claims should be disallowed for the reasons given in relation to other fees.

**Orders**

[117] I reserve leave to any party to apply for the making of formal orders under s 94(1)(b) directing the payment of refunds to the borrowers named in the proceeding.

[118] Costs are reserved.

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**Toogood J**