**9 August 2010**

# AUSSIE SUBMISSION IN RESPONSE TO ASIC CONSULTATION PAPER 135: MORTGAGE EARLY EXIT FEES

## Introduction and Background

Aussie is pleased to have an opportunity to comment on consultation paper 135: mortgage early exit fees: unconscionable fees and unfair contract terms.

Aussie's history as a champion of Australian consumers since the company's inception in February 1992 is well-documented.

For generations, Australian banks had a monopoly on the mortgage market (and one might argue that as a result of the global financial crisis they do once again). When Aussie entered the market, Australians had little choice as to product variety, loan flexibility and there was relatively little competition on price. Aussie and John Symond, brought choice, innovation and real competition and the banks eventually responded by substantially cutting rates and improving customer service levels.

Aussie's commitment to consumers and fostering competition is still a driving force behind the ethos of the company and we continue to be a force for competitive change in the Australian banking environment. However, in respect of the proposed regulation of exit fees Aussie believes there are a number of critical issues that need to be addressed before implementation.

## Executive Summary

Before presenting issues we believe require redress, Aussie would like to state that it fully supports regulation that leads to a higher level of disclosure and transparency. We fundamentally believe that the issue with mortgage exit fees is less one of quantum or justification and more one of the understanding that customers have of the reasons why these fees exist and how they are calculated. Whilst we are confident we have taken steps in our business with our brokers to ensure a higher level of education of our customers, we believe that some regulation may be needed to assist in ensuring this practice is more widespread in the industry.

Having regard to the above, we fundamentally believe that in most cases the fees charged by the majority of lenders are based on maintaining adequate levels of return rather than profiteering. Whilst there may be some exceptions in sectors of the market such as near or sub-prime lending, we believe this to be true for most mainstream lenders.

To illustrate the issue – if a mortgage is written today it is uneconomic for most lenders over the first two years. Allowing customers to exit during the early years of a mortgage without some form of economic "true up" would be detrimental and lead to repricing of mortgages – most likely through interest rates rather than fees.

We have thought about our response to a market change such as that proposed and we believe that regulating mortgage exit fees as suggested will favour some and penalise others. If the regulation leads to higher levels of early exit amongst some consumers

(recognising that a significant portion of the population will remain relatively passive as they are today concerning their financial arrangements) then this will ultimately lead to a change in pricing structure. With limited options due to regulation, lenders will be forced to use blunt instruments such as interest rates. Therefore, the mass population of mortgage holders will end up paying higher interest rates because of the potential actions of what we believe would still be a minority of mortgage holders. Indeed, instead of protecting consumers, this regulation is likely to harm them. The present system is an appropriate user pays system – we do not believe the issue is one of regulation of the fees, but rather ensuring consumers are adequately aware of the fees and terms stipulated in their loan contract.

### *Impact on Competition*

We believe that further guidance and regulation on exit fees will have a negative effect on competition and mortgage product innovation. By restricting the ability to ensure that minimum terms of a contract are adhered to by consumers, smaller lenders - with a lower ability to carry losses on individual mortgages - will be forced to price higher to avoid the risk associated. Larger lenders will be able to run the risk of changed consumer behaviour, discounting up front and in so doing potentially drive smaller lenders out of the market. As small lenders exit the market over time it is likely that the overall cost of borrowing will rise through less regulated mechanisms such as interest rates.

Additionally, if the aim of this regulation is to foster competition by making it easier for consumers to switch between lenders, it is important to note that within the industry currently around 30% of new home loan business is comprised of refinancers.

At the moment, it seems exit or Deferred Establishment Fees ("**DEF**") are not a major impediment to switching between lenders.

### *Prudential Risk*

Additional guidance and regulation on exit fees may impose a prudential risk and lead to a less efficient banking system. The current system ensures that return on capital is maintained at minimum levels by ensuring mortgage contracts are profitable even if terminated by the consumer. Regulating the mechanism (exit fees) by which the system maintains a base level of economic return will most likely lead to the need for greater capital to be employed, adding onto the costs of lending and therefore passing the costs back to the consumer in another form.

### *Fixed Rate Break Costs*

Whilst no doubt the magnitude of break costs for fixed rate mortgages in certain circumstances can be significant, we believe this issue is poorly understood. For instance, we have seen a recent relatively unprecedented drop in interest rates brought about by the global financial crisis. It is rare to see such fast and significant swings in interest rates.

There is no simple solution to this issue – the economic cost of breaking fixed rate contracts is real and not one that lenders can cost effectively mitigate against. When a consumer breaks its contract (which in most cases is for a maximum of 5 years and more commonly 1-3 years) then the lender is forced to likewise break its contract or wear the economic cost of the customer doing so. Consumers cannot have it both ways – if interest rates rise then it is not likely these regulations will allow lenders to break their contract with the consumer and charge higher rates.

We believe the issue is not with the economic justifiability of the fees charged, but rather one of ensuring customers understand both the protection afforded and the downside risk of taking a fixed rate mortgage contract. Attempting to regulate these contracts we believe is likely to lead to either the withdrawal or compromising of an important mortgage option that many consumers find highly valuable – especially critical market segments such as First Home Buyers who want some degree of certainty over their mortgage commitments.

### *Choice is key*

A key driver in our business is providing choice to the Australian consumer in terms of product offering. Fees and charges are no exception. Customers should be able to choose between a larger establishment fee (upfront expense) as opposed to paying a scaled version of these fees (based on when they exit the contractual loan term). This choice follows a user pays philosophy and results in those customers who do stay on book long enough for a lender to recover its administrative costs in establishing the loan (or part thereof) do not end up subsidising those customers who switch earlier.

In order for this method to be successful, it is vital to provide the consumer with appropriate disclosure and reminders of those fees and the trade-offs they are making during the sales and application process. This is where brokers pay a substantial role in the sales process as they are able to provide an independent view, and the choice to consumers based on their particular needs and the nuances of all the differing products.

### *One-size does not fit all*

We believe the legislation should not dictate how fees are calculated, rather that lenders should be able to justify their fees. Depending on their size, scale and business models, lenders have differing cost structures so a “one-size fits all” prescription is not fair and equitable to smaller players and offers larger players an unfair advantage. In simple terms, we believe that regulation of exit fees of the nature proposed is likely to reduce competition and increase the current shift of market power towards the big 4 banks. There will potentially be a further swaying away from specialist product suppliers (e.g. mortgage providers) to the broader Financial Institutions who will cross subsidise different product ranges.

### *Apples and Oranges*

Customers would benefit from a ‘standard’ use of language and better clarity on the definition of fees. It is confusing to consumers as many lenders have differing definitions and titles for the same fee. A standardised approach across the industry for fees including; deferred establishment fees, early discharge fee, discharge fee, fixed break cost fee and application fee would be beneficial for the whole industry. Additionally customers should be made aware in their loan statements that their current loan balance is not necessarily their payout amount.

## Responses to specific questions outlined in consultation paper 135

### PART B1 PROPOSED GUIDANCE ON UNCONSCIONABLE FEES

ASIC proposes that any fee which is payable when a mortgage is terminated early is likely to be an early termination fee for the purposes of the test in s78(4) of the National Credit Code.

**B1Q1** ***Do you agree with the approach?***

Aussie is supportive of the MFAA position.

**B1Q2** ***Circumstances where an exit fee is more likely to be a deferred establishment fee***

Aussie is supportive of the MFAA position.

**B1Q3** ***Changes to treatment of exit fees if DEFs are treated as early repayment fees***

Aussie is supportive of the MFAA position.

**B1Q4** ***Will there be other changes to how mortgage products are structured?***

Ultimately we believe that exit and deferred establishment fees are, in the most part, charged as a means of recovering costs incurred when a mortgage is exited prematurely. We believe the issue is not one of fairness or appropriateness of these fees, but rather ensuring there is consistent, transparent and simple disclosure of these fees so that consumers understand the terms of the contract into which they are entering.

If guidance is issued by ASIC which impacts the ability for lenders to recoup costs, Aussie is of the view that the industry will need to raise interest rates across the board – in fact, this could potentially be seen as the entire market being disadvantaged due to the actions of a relatively small percentage of the consumer market.

Under present mortgage contracts, most customers are able to exit mortgages with little more than the administrative cost of doing so once they pass the 4 or 5 year point in their mortgage. This is the point at which mortgages make a base level of return that is sustainable for the businesses writing those mortgages. If customers exit early then they are asked to pay the appropriate shortfall. However, under the new regulations, it will potentially make it easier for people to refinance their mortgages more frequently – if there is not a fee structure to resolve the uneconomic nature of this activity then the entire market is likely to wear the cost through a blunt instrument such as higher interest rates.

**B1Q5** ***Describe the product changes***

Should these fees be substantially reduced, either by regulation, or its misinterpretation, given the current environment in which net interest margins earned on mortgages have been substantially reduced and are likely to reduce further on the back of the increasing cost of holding regulatory capital. Our estimate is that larger fees will be levied upfront, discounts on mortgages removed, or products will be structured so that loyalty discounts are provided over time to customers (to the effect that the interest rates levied will be higher in earlier years of loan tenure) all of which will actually increase the comparative cost of switching and capture a broader range of customers.

**B1Q6** ***Will the proposed guidance affect competition?***

Aussie is supportive of MFAA position, however we would add that this competition initiated by Aussie resulted in a substantial savings of more than 2%, not only for Aussie's customers but for all Australian borrowers. Aussie was able to undercut the banks and force this degree of price competition due to a combination of its low cost funding model and importantly, because it charged customers based on their specific behaviour (removing cost cross-subsidisation).

While Aussie (and we believe most industry participants) have never sought to recover all of its upfront costs of establishing a loan, we believe that if fee structures like DEF's were not in place, interest rates would need to rise for all borrowers by a minimum of 0.10% *per annum* to breakeven based on today's average loan life and lenders would likely factor in a buffer to allow for uncertain switching behaviour in the future.

While our interpretation of ASIC's consultation paper is that it is not the intention to remove these fees we strongly believe these fees, properly and transparently disclosed, are to the benefit of the consumer.

This type of activity referred to in our responses to B1Q5 and B1Q6 will:

(a) provide a further disincentive to new industry entrants;

(b) reduce innovation of mortgage products as product and development costs are specifically excluded as a component of an establishment fee;

(c) put the cost of lending further beyond the reach of first home buyers as income serviceability tests will increase, whereas ability to pay DEF's are not captured in net servicing ratios; and

(d) reduce the amount of switching further (in general moving from a lower rate to a higher new rate plus higher entrance fees).

**B1Q7** ***Change in consumer behaviour***

Referencing our responses to B1Q5 and B1Q6's, our view is that any proposed guidance with an increased focus on lender's costs would not materially change the level of switching by refinancers, but will reduce the ability of the first home buyer to enter the market.

**B1Q8** ***Further guidance***

Aussie is supportive of MFAA position and would like to add that an additional recommendation to improve disclosure of early exit fees will be to mandate meaningful worked examples if the lender discloses the method of calculation and not the monetary amount of the early exit fee in the loan contract.

## PART B2 QUANTIFYING LENDER'S LOSS FOR THE PURPOSES OF 78(4)?

**B2Q1** ***Proposed guidance***

We broadly agree with the guidance provided however we question whether these fees should be directly linked to cost at all.

Should the link to cost remain, we do believe that lenders should be able to justify those fees described as DEF's or early exit fees in an unprescribed manner.

Further prescription on what can be considered within the fees might lead to undesirable industry behaviours, reduced competition and higher borrowing costs in general.

A better test around whether a fee is unconscionable is the transparency of the fee to the borrower. Unconscionable fees and unfair contractual terms are quite well covered within the current *Australian Securities and Investments Commission Act* (2001) particularly the unfair contract terms provisions.

Should these types of fees be over-prescribed then it may lead to lenders seeking a declaration of loan tenure intent from the borrower at the time of loan application, so the lender can determine the appropriate interest rate that should be offered to the borrower based on the borrowers response (which of course the borrower can choose not to proceed with).

**B2Q2** ***Other types of loss***

Aussie is supportive of the MFAA position.

**B2Q3** ***Changes to exit fees***

Aussie is supportive of the MFAA position.

**B2Q4** ***Changes to product structuring***

Aussie is supportive of the MFAA position.

**B2Q5** ***Describe changes in cost***

See B1 responses.

**B2Q6** **E*ffect on competition***

See B1 responses.

**B2Q7** ***Impact on consumer behaviour***

Aussie is supportive of the MFAA position.

**B2Q8** ***Further guidance***

No comment.

## PART B3 WHAT ARE REASONABLE ESTABLISHMENT COSTS?

**B3Q1** ***Do you agree with the approach?***

Aussie is supportive of the MFAA position and we would like to complement that by indicating that lenders have differing business and cost structures, in particular under securitised models where besides broker commissions, mortgage manager and servicer costs another significant cost is the lender mortgage insurance ("LMI") premium for loans with a loan to value ("**LVR**") ratio of less than 80%. Under the securitisation model, mortgage managers pay the LMI premium for loans with an LVR of less than 80%. For loans with an LVR of 80% or more, the borrower pays the LMI premium.

We reinforce that the regulations or any further ASIC guidance should not be prescriptive in which costs are 'reasonable' or should be allowable components of the early exit fee, but rather require lenders to justify their fees according to their individual business models.

**B3Q2-B3Q8**

See B2Q2 – B2Q8 responses.

## PART C – PROPOSED GUIDANCE ON UNFAIR CONTRACT TERMS

**C1Q1 – Proposed guidance**

Aussie is supportive of the MFAA position.

**C1Q2 – 14**
No further comment.

## PART D –OTHER CONSIDERATIONS RELATING TO UNFAIR TERMS

***Varying early exit fees***

**D1Q1 Proposed guidance**

Aussie is supportive of the MFAA position.

**D1Q2 -6**

No further comment.

***Transparently explaining exit fees***

**D2Q1** ***Proposed guidance***

We agree with the proposed guidance.

**D2Q2** ***Is a warning at the front of the contract useful?***

Yes.

**D2Q3** ***Is it useful in account statements to show information about early exit fees?***

Yes

**D2Q4** ***What other documents should explain early exit fees?***

Nil.

**D2Q5** ***What steps do businesses need to take to implement these steps?***

Depending on the final provisions of the regulations or ASIC guidance notes, we envisage that there will be a certain amount of system and process changes, which would require a period of upfront investment and time for implementation.

**D2Q6** ***Further guidance***

No comment.

## PART D3 FACTORS TO CONSIDER WHEN EXPLAINING BREAK FEES

**D3Q1** ***Proposed approach that providing guidance about transparency explaining break fees?***

We agree with the proposed guidance.

**D3Q2** ***Do you think it is helpful to provide worked examples?***

Aussie is supportive of the MFAA position.

**D3Q3 – D3Q5**

No comments.

Yours faithfully



Stephen Porges
Chief Executive Officer