



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 135

Mortgage early exit fees: Unconscionable fees and unfair contract terms

June 2010

About this paper

This consultation paper sets out our proposals for guidance on factors we will consider in deciding whether to take action under s78 of the National Credit Code on unconscionable fees or the unfair contract terms provisions in Subdiv BA of Div 2 of Pt 2 of the ASIC Act in relation to a mortgage early exit fee.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 27 June 2010 and is based on the *Australian Securities and Investments Commission Act 2001* (ASIC Act) and the *National Consumer Credit Protection Act 2009* (National Credit Act) as at 27 June 2010.

Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

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The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information.

We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on how the provisions regulating unconscionable fees and unfair contract terms should apply to mortgage early exit fees. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Business Cost Calculator Report and/or a Regulation Impact Statement: see [Section E Regulatory and financial impact](#).

Making a submission

We will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Comments should be sent by 9 August 2010 to:

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What will happen next?

Stage 1	27 June 2010	ASIC consultation paper released
Stage 2	9 August 2010	Comments due on the consultation paper
	August–October 2010	Drafting of regulatory guide
Stage 3	Late October 2010	Regulatory guide released

A Regulation of mortgage early exit fees

Key points

From 1 July 2010, action may be taken against lenders by ASIC or a consumer if they charge an early exit fee which is unconscionable under the National Credit Code (the Code) or is unfair under the unfair contract terms (UCT) provisions in the ASIC Act.

We propose to provide general guidance on when a mortgage early exit fee may be unconscionable under the National Credit Code or unfair under the ASIC Act. However, whether a mortgage early exit fee is unconscionable or unfair will depend on the circumstances of each case.

This section of the paper sets out some background information on our proposals.

The new regime

- 1 There are two national laws relevant to mortgage early exit fees which are administered by ASIC. These are the National Credit Code (the Code), which is part of the *National Consumer Credit Protection Act 2009* (the National Credit Act), and the *Australian Securities and Investments Commission Act 2001* (the ASIC Act), particularly the unfair contract terms (UCT) provisions. The Code and UCT provisions will commence on 1 July 2010.

Note 1: The Code is in Schedule 1 of the National Credit Act. The National Credit Act shifts credit regulation from state and territory credit laws to a national law administered by ASIC.

Note 2: Our guides to how we will regulate credit generally are available on our website at www.asic.gov.au.

Note 3: The Australian Competition and Consumer Commission (ACCC), ASIC and the state and territory consumer protection agencies have jointly developed *A guide to unfair contract terms law*, which has been created to assist businesses, legal practitioners and consumer advocates understand the new unfair contract terms laws. It is available at www.accc.gov.au/content/index.phtml/itemId/930750.

- 2 In October 2009, the Council of Australian Governments (COAG) agreed to the creation of a new consumer policy framework comprising a single national consumer law based on the *Trade Practices Act 1974* (Trade Practices Act). The new national law includes the UCT provisions in the ASIC Act for standard form contracts.
- 3 The consumer protection provisions of the ASIC Act have also been amended to include, as far as possible, equivalent consumer protection provisions to the Trade Practices Act.

- 4 The introduction of the Code and the UCT provisions has broadened our powers relating to fees charged when borrowers exit early from their residential mortgage loans. These laws will help to protect residential mortgage borrowers in a number of ways. Borrowers will be able to challenge the validity of early exit fees which they believe are unconscionable or unfair. Borrowers may also complain about these fees to ASIC.
- 5 Under the Code, a consumer or ASIC may seek court review of a fee or charge under a mortgage contract on the basis that it is unconscionable. Under the new UCT provisions in the ASIC Act, a consumer or ASIC may challenge specific terms of a contract, including those setting contingent fees or charges, on the basis that they are unfair. The general consumer protection provisions in the ASIC Act also permit a consumer to dispute their obligations under a mortgage contract on the basis that the conduct of the other party was unconscionable or misleading or deceptive.
- 6 For complaints about unconscionable fees and unfair contract terms, consumers will also be able to take claims to an external dispute resolution scheme (EDR scheme), as all lenders must be a member of an EDR scheme. EDR schemes are able to consider complaints under both the Code and the ASIC Act.
- 7 This consultation paper outlines our proposed guidance on how the unconscionable fees provisions in the Code and the UCT provisions in the ASIC Act apply to early exit fees for mortgages.
- 8 There is a lot of diversity in the mortgage industry in pricing and structuring early exit fees. In addition, whether a contractual term providing for an early exit fee is unfair is largely dependent on the circumstances of the relevant case. It is for these reasons that we propose to issue high-level, principle-based guidance on early exit fees. This approach is reflected in this consultation paper.

What are mortgage exit fees?

- 9 In the mortgage industry, consistent terminology is not used to describe mortgage early exit fees. For the purposes of this consultation paper, the term ‘early exit fee’ refers to any fee payable on early repayment of a mortgage that is not a ‘mortgage discharge fee’. An early exit fee may include:
 - (a) a ‘deferred establishment fee’, which is imposed if the full establishment fee is not charged at the start of the loan. Typically, it is charged if the consumer repays the loan in the first three to five years

- (although, in some cases it can be longer). A deferred establishment fee can be charged for both fixed rate and variable rate mortgages; and/or
- (b) a 'break fee' (sometimes called 'break costs'), which is a fee charged for early termination of a fixed rate mortgage (they are not charged for variable rate mortgages).

Note: A 'mortgage discharge fee' is a fee payable on discharge of a mortgage, whether the discharge is early or not. This consultation paper does not examine mortgage discharge fees. These will generally be regarded as part of the up-front price payable for the mortgage and are therefore unaffected by the UCT provisions in the ASIC Act.

The National Credit Code provisions

- 10 The National Credit Code (the Code) applies to credit that is provided to individual debtors or strata corporations wholly or predominantly:
- (a) for personal, domestic or household purposes; or
- (b) to purchase, renovate or improve residential property for investment purposes or to refinance such credit.

Note: For further information, see s5 of the Code.

- 11 Residential mortgage contracts entered into before the Code's commencement date of 1 July 2010 are generally also regulated under the Uniform Consumer Credit Code (UCCC) if they are wholly or predominantly for personal, domestic or household purposes. The Code largely replicates the UCCC, which has applied in states and territories since 1996.
- 12 Lending to companies or for investment other than in residential property or for small business purposes is not regulated by the Code.
- 13 The Code mandates the content of contractual and precontractual disclosure and provides relief mechanisms for consumers. We have standing to bring an action to court for a review of an unjust or unconscionable contract if we believe doing so is in the public interest. Individual borrowers or guarantors may be able to rely on a finding resulting from our action to seek individual relief, or may bring an action independently of us: s78 of the Code.

Disclosure

- 14 Under the Code, a mortgage contract must include a statement of any (ascertainable) credit fees or charges that may become payable under the contract, and when they are payable: s17 of the Code.
- 15 The contract must also contain the amount of any ascertainable credit fees and charges payable under the contract and when they are payable. If the

amount of the fee is not ascertainable, the method of calculation must be explained, if that is ascertainable.

Note: For a definition of what is 'ascertainable', see s180 of the Code.

- 16 If applicable, the contract must also include a statement about fees that may be changed and how the debtor will be told about such changes: s17 of the Code.

Unconscionable fees and charges under the Code

- 17 An establishment or early termination fee is subject to challenge by the debtor, guarantor or ASIC on the ground that it is unconscionable: s78–79 of the Code.

- 18 For establishment fees, the court must have regard to whether the amount of the fee or charge equals:

- (a) the lender's reasonable costs of determining an application for credit, and the initial administrative costs of setting up the loan; or
- (b) the lender's average reasonable costs for those things for that class of contract.

- 19 For early termination fees, the fee is unconscionable if it exceeds a reasonable estimate of the credit provider's loss (including average reasonable administrative costs) arising from the early termination.

Note: For more information on the unconscionable fees provision in the Code, see Section B.

- 20 When we use the term 'lender' in the context of the provisions in the Code, we are referring to a 'credit provider' as defined in the Code: s5 of the National Credit Act.

Prohibited increases

- 21 For a mortgage where the interest rate is fixed for part or all of the term, a lender is prohibited from unilaterally increasing an early exit fee, including a break fee, or a fee payable for prepayment of part of the loan or the entire loan. The lender is also prohibited from changing the method used to calculate these fees, if that change has the effect of increasing the relevant fee: s70 of the Code.

The unfair contract terms (UCT) provisions of the ASIC Act

- 22 Under the ASIC Act, the unfair contract terms (UCT) provisions will apply to standard form consumer contracts that are financial products or contracts

for the supply, or possible supply, of financial services. At least one of the parties to the contract must be an individual and the financial product or service must be acquired wholly or predominantly for personal, domestic or household use or consumption: s12BF of the ASIC Act.

- 23 The UCT provisions commence on 1 July 2010 and will apply to:
- (a) new contracts entered into on or after 1 July 2010;
 - (b) contracts renewed on or after 1 July 2010; and
 - (c) terms in a consumer contract that are varied on or after 1 July 2010.
- 24 When we use the term 'lender' in the context of the UCT provisions, we are referring to the lender under the mortgage contract. For residential mortgages, this will be a credit provider under the National Credit Act.

What is an 'unfair' term?

- 25 A term is unfair if:
- (a) it would cause a significant imbalance in the parties' rights and obligations arising under the contract;
 - (b) it is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the term; and
 - (c) it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

Note: For the meaning of 'unfair' in the ASIC Act, see s12BG.

- 26 The first element of the definition of 'unfair' is that the term has caused a 'significant imbalance' in the parties' contractual rights and obligations. The claimant is required to prove the existence of such an imbalance on the balance of probabilities.
- 27 The second element of the test requires that the term is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the term. In the context of terms providing for an early exit fee, this is the lender. The law presumes that a term of a consumer contract is not reasonably necessary to protect the lender's legitimate interests. This means that the lender must establish that the use of the term is reasonably necessary to protect its legitimate interests on the balance of probabilities.
- 28 The third element of the test is that detriment *would* be caused by reliance on or application of the term. It is therefore unnecessary to prove actual detriment has been caused. The detriment is not limited to financial detriment. This allows the court to consider situations where there may be other forms of detriment that have affected or may affect consumers disadvantaged by the practical effect of a term. Other forms of detriment

may include delay or distress suffered by the consumer as a result of the unfair term.

- 29 Ultimately, we believe determining whether a term is unfair will depend on the facts of each individual case. The proposed guidance we have set out in this consultation paper is subject to this overriding consideration. Our guidance is designed to illustrate when ASIC is more likely to take action, rather than set out a definitive view of the law. We will review our approach over time in light of any judicial decisions on the provisions. For more information on unfair contract terms, see Section C.

What a court will look at in determining whether a term is unfair

- 30 In determining whether a term is unfair, a court must take into account:
- (a) the extent to which the term is transparent; and
 - (b) the contract as a whole: s12BG(2) of the ASIC Act.

Transparency

- 31 The ASIC Act defines a term as transparent if it is:
- (a) expressed in reasonably plain language;
 - (b) legible;
 - (c) presented clearly; and
 - (d) readily available to any party affected by the term: s12BG(3) of the ASIC Act.
- 32 Failure to meet the transparency requirement will not automatically mean that the term is unfair. Nor will transparency, on its own account, mean that a term is necessarily fair.

Note: For more information on the transparency requirement, see Section D.

- 33 The ASIC Act provides examples of unfair terms in s12BH. Terms may also be prescribed as unfair in regulations made under the ASIC Act.

Note: At the date of publication of this consultation paper, no unfair terms have been prescribed in regulations made under the ASIC Act.

Contract as a whole

- 34 The fairness of a particular contractual term needs to be considered in the context in which it appears in the contract. Seen in isolation, a term may appear fair or unfair, but that assessment may change when the contractual term is considered in the context of the contract as a whole.

What is the effect of a finding that a term is unfair?

- 35 If a court finds that a contractual term is unfair under the ASIC Act, then that term is void. However, the contract continues to bind the parties if it is capable of operating without the unfair term: s12BF of the ASIC Act.
- 36 In addition, if the court finds a term to be unfair in contravention of the ASIC Act, a variety of remedies set out in the ASIC Act may be sought.

Contractual terms unaffected by the UCT provisions

- 37 As mentioned in paragraph 22, only standard form contracts are subject to the UCT provisions. A contract which has been the subject of genuine negotiation is less likely to be a standard form contract, but the inclusion of trivial or token negotiated terms will be insufficient to demonstrate that it is not a standard form contract. If a party to a proceeding alleges that the contract is in a standard form, it is presumed to be a standard form contract unless another party to the contract proves otherwise: s12BK of the ASIC Act. Residential mortgage contracts will generally be standard form contracts.
- 38 Some contract terms are unaffected by the UCT provisions. These are terms which:
- (a) define the main subject matter of the contract;
 - (b) set the up-front price payable under the contract; or
 - (c) are required, or expressly permitted, by Australian law: see s12BI of the ASIC Act.
- 39 Terms imposing mortgage early exit fees, being contingent fees, are not within the categories described above. They do not describe or give effect to the subject matter of the contract. In the context of residential mortgages, the up-front price includes the amount borrowed and the interest payable, and any fees payable at the time the contract is entered into. It does not include contingent or default fees.
- 40 Certain types of contracts are also specifically excluded from the UCT provisions, but the excluded contracts do not include any form of credit contract.

Note: Excluded contracts include certain types of shipping contracts, constitutions of companies, managed investment schemes or other bodies, and most insurance contract terms.

Interaction between the Code and the UCT provisions

- 41 We consider that a contractual term providing for an early exit fee which is unconscionable under the Code is likely to also be unfair under the ASIC Act. However, it does not necessarily follow that a fee that is not unconscionable will be fair for the purposes of the ASIC Act, as the relevant tests under the Code and ASIC Act are different. Some examples of this are:
- (a) adequate disclosure under the Code is not the same as transparency of a contractual term under the ASIC Act. A term may disclose the information required by the Code, but still may not be transparent under the ASIC Act. A lack of transparency is a matter a court must take into account in determining whether a term is unfair (see also paragraphs 93–95); and
 - (b) under the Code, creditors must be told about changes to the amount or frequency of payment of a fee or charge, or the imposition of new fees or charges. However, compliance with the requirements of the Code does not necessarily mean that the variation to a fee or charge, or imposition of a new fee or charge, is fair under the ASIC Act. This is because in some circumstances a right to vary a fee may be an unfair term: see paragraphs 82–90.

Other consumer protection provisions

- 42 The ASIC Act consumer protection provisions prohibit unconscionable conduct and this operates concurrently with the UCT provisions and the Code's unconscionable fees provisions. In addition, the ASIC Act contains prohibitions on false or misleading representations and on misleading or deceptive conduct which could be applied in appropriate circumstances to mortgage early exit fees.
- 43 The prohibition on unconscionable conduct in the ASIC Act focuses on the conduct of the party alleged to have acted unconscionably, rather than on the contractual terms themselves. However, the contractual terms are a relevant factor for the court to consider in deciding if there has been unconscionable conduct.
- 44 Similarly, in considering whether there have been false or misleading representations or misleading or deceptive conduct in relation to a financial product or service, it is the conduct of a party which is the primary focus.

Our approach

- 45 We will provide guidance about our expectations for compliance with the Code and UCT provisions, including guidance about the kind of conduct we will expect from mortgage providers. As we have only recently become responsible for administering these provisions, we are consulting on our proposed guidance and seeking industry and consumer feedback.
- 46 In addition, we will administer the Code and UCT provisions in light of other obligations that apply to mortgage providers, including the general consumer protection provisions in the ASIC Act (Pt 2, Div 2) and other provisions in the National Credit Act.

B Proposed guidance on unconscionable fees

Key points

The National Credit Code (the Code) provides that a court can annul or reduce an early exit fee if it is unconscionable: s78. Different tests of unconscionability apply to establishment fees and early termination fees.

In general, if an early exit fee reflects the lender's reasonable costs arising from the early termination, including any reasonable deferred establishment costs, the fee is unlikely to be unconscionable under s78 of the Code, regardless of whether it is characterised as an establishment fee or early termination fee.

We propose to provide guidance on when we are more likely to take action regarding an early exit fee being unconscionable under the Code.

Unconscionable early exit fees

- 47 An establishment or early exit fee is subject to challenge by the debtor, guarantor or ASIC on the ground that it is unconscionable: s78–79 of the Code.
- 48 For establishment fees, the court must have regard to whether the amount of the fee or charge equals:
- (a) the lender's reasonable costs of determining an application for credit, and the initial administrative costs of setting up the loan; or
 - (b) the lender's average reasonable costs of determining applications for credit and setting up loans in respect of that class of contract: s78(3) of the Code.
- 49 For early termination fees, the court must determine whether the fee or charge payable on early termination or a prepayment of amounts under the contract exceeds a reasonable estimate of the credit provider's loss arising from the early termination or prepayment (including average reasonable administrative costs): s78(4) of the Code.

Deferred establishment fees

- 50 Some lenders do not charge the full amount of their establishment costs at the start of the loan. We understand that these 'deferred' costs are recovered through the interest paid if the loan remains on foot for a certain period of time (e.g. more than three or five years). If a customer exits the loan early (e.g. in the first three to five years of the loan), many lenders charge a deferred establishment fee when the loan is terminated. This fee is designed to recoup the

establishment costs which were not charged at the start of the loan and which, due to early termination, have not been recovered through repayments.

- 51 We think that any fee that is payable on early termination is likely to be an early termination fee to which the test in s78(4) applies, including any deferred establishment fee that is payable on early termination. However, in some situations, depending on what the fee is seeking to recover, it may be possible that it is the test in s78(3) which regulates the fee.
- 52 We understand from our preliminary conversations with a number of industry participants that early exit fees, including deferred establishment fees, are generally imposed only to recover the costs which arise from early termination. If this is the case and the fee is reasonable, we think the fee will generally not be unconscionable for the purposes of s78 of the Code.

Proposal

- B1** We propose to provide guidance (along the lines of paragraph 51) 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 Code.

Your feedback

- B1Q1 Do you agree with our proposed approach that any fee that is payable on early termination is likely to be an early termination fee? Please provide reasons.
- B1Q2 Are there any situations where an early exit fee is more likely to be a deferred establishment fee to which the test in s78(3) applies? Please provide details.
- B1Q3 If you are a lender, will our proposed guidance on the scope of s78 affect how you set your early exit fees, including deferred establishment fees? Please provide details of any changes and the costs involved.
- B1Q4 If you are a lender, will our proposed guidance result in:
- (a) other changes to how mortgage products are structured;
 - (b) changes to your systems for recording fees; or
 - (c) any other changes to your business?
- B1Q5 If the answer to question B1Q4 is yes, please describe the changes and the likely costs involved.
- B1Q6 Do you think our proposed guidance will affect competition for mortgage services (e.g. by causing some firms to exit the market, or preventing some lenders from offering particular products)?
- B1Q7 Do you expect that our proposed guidance will affect consumer behaviour, such as potentially increasing or decreasing the rate at which consumers switch mortgages?
- B1Q8 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.

What is a reasonable estimate of the lender's loss for the purposes of s78(4)?

- 53 Early exit fees that do not exceed a reasonable estimate of the lender's loss arising from the early termination of a mortgage, including the lender's average reasonable administrative costs for such a termination, will not be unconscionable: s78 of the Code.
- 54 There are a number of different kinds of loss that a lender may suffer when a mortgage is terminated early. We believe that recovering losses which arise as a direct result of the early termination is not likely to be unconscionable and infringe s78(4), provided that the amount charged is reasonable. As long as the relevant costs have not already been paid for by the customer, such losses can include:
- (a) break fees for fixed rate mortgages;
 - (b) administrative costs for calculating the payout figure;
 - (c) administrative costs for processing the early termination;
 - (d) third party costs that arise because of the early termination;
 - (e) deferred establishment costs arising from the lender's inability to recover establishment costs while the loan was on foot. This can include a reasonable amount for overheads; and
 - (f) costs for discharging the mortgage, including legal fees and land registry costs.
- Note: For paragraph 54(a), break fees are discussed in more detail at paragraphs 76(c) and 100–108. The Financial Ombudsman Service's (FOS), *Banking and Finance: Bulletin 60* (December 2008) sets out one method of calculating break fees: see paragraph 104.
- 55 An administrative charge, whether it is for calculating the payout figure or processing the early termination, will not be unconscionable if it does not exceed an average of the lender's administrative costs for mortgages with similar underlying costs.
- 56 We are more likely to take action if an early exit fee includes a component covering the following types of loss:
- (a) business development costs, including costs associated with marketing and obtaining new customers; and
 - (b) loss of profits.
- 57 The amount of an early termination fee should reflect a reasonable estimate of the lender's loss. We expect lenders to keep records of how they calculate early exit fees. We may use our powers under s49 of the National Credit Act to direct a licensee to provide us with information showing how an early exit fee reflects a reasonable estimate of its loss arising from early termination.

Note: Section 49 of the National Credit Act empowers ASIC to provide a licensee with a written notice directing the licensee to lodge a statement with ASIC containing the information specified in the notice about the credit activities that the licensee or its representatives are engaged in.

Proposal

- B2** We propose to provide guidance that an early exit fee which seeks to recover a reasonable amount for loss that arises as a direct result of early termination is unlikely to be unconscionable for the purposes of the test in s78(4) of the Code (along the lines of paragraphs 53–57).

Your feedback

- B2Q1 Do you agree with our proposed guidance on when an early exit fee is likely or unlikely to be unconscionable for the purposes of the test in s78(4) of the Code? Please provide reasons.
- B2Q2 Are there any other types of loss which you believe form, or do not form, part of a lender's reasonable estimate of loss arising from early termination, apart from those listed at paragraph 54? Please provide details.
- B2Q3 If you are a lender, will our proposed guidance change how you set your early exit fees? Please provide details of any changes that will be required and the likely costs involved.
- B2Q4 If you are a lender, will our proposed guidance result in:
- (a) other changes to how mortgage products are structured;
 - (b) changes to your systems for recording fees; or
 - (c) any other changes to your business?
- B2Q5 If the answer to question B2Q4 is yes, please describe the changes and the likely costs involved.
- B2Q6 Do you think our proposed guidance will affect competition for mortgage services (e.g. by causing some firms to exit the market, or preventing some lenders from offering particular products)?
- B2Q7 Do you expect that our proposed guidance will affect consumer behaviour, such as potentially increasing or decreasing the rate at which consumers switch mortgages?
- B2Q8 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.

What are reasonable establishment costs for the purposes of s78(3)?

- 58 It may be possible for a deferred establishment fee to be an establishment fee for the purposes of the test in s78(3) of the Code. Lenders will need to

decide for themselves whether it is appropriate to rely on this subsection in setting the price of their deferred establishment fee. We will scrutinise fees that are marketed as establishment fees but are in fact early termination fees for the purposes of the Code.

59 An establishment fee will not be unconscionable under s78(3) of the Code if it:

- (a) reflects the lender's reasonable cost of determining a mortgage application and the initial administrative costs of providing the mortgage; or
- (b) is equal to their average reasonable costs for doing these things for that class of mortgage.

60 We think that typical costs incurred by a lender in determining a mortgage application and setting up a mortgage are:

- (a) evaluating and processing the mortgage application;
- (b) preparing the mortgage contract and other documentation;
- (c) valuation and settlement costs;
- (d) legal and land registry costs; and
- (e) a reasonable amount for the lender's overheads for evaluating and processing the application and establishing the mortgage.

61 Charging a reasonable amount to recover for these costs is likely to be permitted under s78(3).

62 Under s78(3), a court can take into account other considerations besides the lender's establishment costs. We think that other considerations relevant to determining if a fee is unconscionable can include:

- (a) other components included in the price of the establishment fee beyond the lender's costs; and
- (b) the conduct of the lender, including their conduct in drawing the consumer's attention to the amount or potential amount of the fee and when it is payable.

63 We are more likely to take action if establishment fees include the following components:

- (a) product development costs;
- (b) business developments costs, including costs associated with marketing and obtaining new customers; or
- (c) profit.

64 We expect lenders to keep records of how they calculate early exit fees and may use our powers under the National Credit Act to direct a licensee to

provide us with information on how they calculate their early exit fees: see paragraph 57.

Proposal

B3 We propose to provide guidance that an establishment fee that reflects the lender's reasonable cost of determining a mortgage application and the initial administrative costs of providing the mortgage, or the average reasonable costs of these things, will not be unconscionable (along the lines of paragraphs 58–61). We also propose to provide general guidance on other factors we will take into account in deciding whether to take action because an establishment fee is unconscionable (along the lines of paragraphs 62–63).

Your feedback

- B3Q1 Do you agree with our proposed guidance on when an establishment fee is likely or unlikely to be unconscionable for the purposes of the test in s78(3) of the Code? Please provide reasons.
- B3Q2 Are there any costs which you believe form or do not form part of a lender's reasonable establishment costs, apart from those listed at paragraphs 60 and 63? Please provide details.
- B3Q3 If you are a lender, will our proposed guidance change how you set your establishment fees? Please provide details of any changes that will be required and the likely costs involved.
- B3Q4 If you are a lender, will our proposed guidance result in:
- (a) other changes to how mortgage products are structured;
 - (b) changes to your systems for recording fees; or
 - (c) any other changes to your business?
- B3Q5 If the answer to question B3Q4 is yes, please describe the changes and the likely costs involved.
- B3Q6 Do you think our proposed guidance will affect competition for mortgage services (e.g. by causing some firms to exit the market, or preventing some lenders from offering particular products)?
- B3Q7 Do you expect that our proposed guidance will affect consumer behaviour, such as potentially increasing or decreasing the rate at which consumers switch mortgages?
- B3Q8 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.

C Proposed guidance on unfair contract terms

Key points

We propose to provide guidance on when we consider each of the three elements of unfairness in s12BG(1) of the ASIC Act is likely to be satisfied.

For the first element, whether there is a significant imbalance in the parties' rights and obligations will depend on the circumstances of each case.

For the second element, we propose to provide guidance on what interests we consider to be 'legitimate' and the types of early exit fees we think are likely to be reasonably necessary to protect the lender's legitimate interests.

For the third element, we believe that in most cases detriment, particularly financial detriment, will generally be suffered if a contractual term providing for an early exit fee is otherwise unfair.

65 The ASIC Act regulates unfair terms in a standard form consumer contract that is a financial product or is for the supply or possible supply of financial services: s12BF.

66 As outlined at paragraph 25, a term in a consumer contract is unfair if:

- (a) it would cause a significant imbalance in the parties' rights and obligations arising under the contract;
- (b) it is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the term; and
- (c) it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on: s12BG(1) of the ASIC Act.

67 Each of these elements must be satisfied if a court is to find a term providing for an early exit fee unfair.

68 We consider that a contractual term providing for an early exit fee which is unconscionable under the Code is likely to also be unfair under the ASIC Act. However, it may not necessarily follow that a fee that is not unconscionable will be fair for the purposes of the ASIC Act, as the relevant tests under the Code and the ASIC Act are different.

Element 1: Significant imbalance

69 The first element of the test of unfairness is whether the term would cause a significant imbalance in the parties' rights and obligations under the mortgage: s12BG(1)(a).

70 Generally, contracts provide for rights and obligations on both parties. This element of the test of unfairness would involve a factual assessment of the available evidence to determine whether a term creates a significant imbalance in those rights and obligations. This may vary depending on the context. For example, a term placing an unusually onerous obligation on a borrower may be balanced by another term which accords the borrower a countervailing increase in rights under the contract.

71 As an example of where balance is not maintained, we think that a significant imbalance is likely to exist if the mortgage contract gives the lender an unlimited unilateral right to vary a deferred establishment fee or the circumstances in which the fee applies. Such a contractual right does not place a limit on the amount of the fee that can be charged and does not give the consumer the ability to challenge the fee under the contract. (However, there may be other grounds on which the fee can be challenged: see paragraphs 5–6.) Thus, such a term greatly increases the rights of the lender (i.e. a complete discretion to increase the fee), while placing a significant responsibility on the borrower (i.e. to pay whatever amount the fee is increased to). In a situation where the justification for the fee is the need to recover costs that have already been incurred and so should have been known when the loan was taken out, such a term may be seen as creating a significant imbalance.

Note: Rights to vary early exit fees are discussed in greater detail at paragraphs 82–90.

72 We also think that a significant imbalance is likely to exist if the early exit fee is unconscionable for the purposes of the National Credit Code (the Code).

Note: Unconscionable early exit fees under the Code are discussed in greater detail in Section B.

Element 2: Protection of legitimate interests

73 There are a number of interests which a lender might seek to protect or advance in determining the price of an early exit fee. This can range from recovering costs incurred as a direct result of the early termination to a lender's interest in running a profitable business.

What is a 'legitimate interest'?

74 We consider that for early exit fees the following are less likely to represent legitimate interests:

- (a) business development (e.g. marketing, seeking new customers and recruitment);
- (b) product development;

- (c) ongoing loan administration; and
- (d) making a profit on the fee.

75 We believe interests which are likely to be legitimate include:

- (a) recovering:
 - (i) the cost of processing the early exit;
 - (ii) any deferred establishment costs;
 - (iii) break fees for fixed rate mortgages which reflect the cost incurred by the lender because the mortgage was terminated early; and
 - (iv) a reasonable component for overheads and administrative costs while the loan was on foot, provided these are not recovered through other fees and charges; and
- (b) being flexible in product design and charging (however, this does not include making a profit on the fee).

What fees are reasonably necessary to protect a legitimate interest?

76 We think that the following are examples of early exit fees that are more likely to be reasonably necessary to protect the lender's legitimate interests:

- (a) a fee that is related to a lender's reasonable costs directly arising from the early termination, including any deferred establishment costs;

Note: Direct costs which a lender is likely to incur on early termination of a mortgage are discussed at paragraph 54.

- (b) except for break fees, a fee for early termination based on an estimate of the lender's average cost for similar loans with similar underlying costs. The early exit fee does not need to be individualised for each loan; and
- (c) for break fees, a break fee that does not reflect the amount needed to recover the lender's loss from a fixed rate loan being terminated early. One way to calculate this loss is to use a method that is consistent with the Financial Ombudsman Service's (FOS's) approach to calculating break fees. An administration fee representing the reasonable costs of calculating and processing the break fee may also be charged. This may reflect an average of costs for fixed rate loans with similar underlying costs.

Note 1: The approach of FOS in calculating break fees is based on looking at the difference in the lender's cost of funding between when the loan was taken out and when it was terminated early: see paragraph 104.

Note 2: Break fees and other early exit fees should also be transparently disclosed: see paragraphs 100–108.

Element 3: Detriment

77 The third element that needs to be satisfied for a term to be considered unfair is that the term must be one that would cause detriment if it were applied or relied on. The detriment can be financial detriment or some other type of detriment. *A guide to unfair contract terms law*, developed jointly by the Australian Competition and Consumer Commission (ACCC), ASIC and the state and territory consumer protection agencies, lists delay and distress suffered as a result of the unfair term as examples of non-financial detriment that may be suffered: p. 11.

Note: The detriment requirement is also briefly discussed at paragraph 28.

78 We do not think that *how much* detriment would be suffered is relevant.

79 We expect that in most cases where a contractual term providing for an early exit fee is otherwise unfair because of the amount of the fee, financial detriment will be or is likely to be suffered.

80 The detriment a consumer may suffer can take a number of forms. For example:

- (a) if a consumer refinances, it will take longer for them to ‘break even’ on switching mortgages;
- (b) the consumer may need to enter into further debt to pay the early exit fee and discharge the mortgage;
- (c) the consumer might be prevented from switching to a mortgage that is more suitable for them. This loss of opportunity could be considered a type of detriment; or
- (d) if a lender changes the terms governing when the early exit fee is charged, it may be unfavourable to the consumer (e.g. if the length of time in which an early exit fee can be charged is increased).

81 A unilateral right to vary early exit fees by the lender may also cause detriment.

Note: Rights to vary early exit fees are discussed in more detail at paragraphs 82–90.

Proposal

C1 We propose to provide general guidance on when we are more likely to take action because a contractual term providing for an early exit fee is unfair (along the lines of paragraphs 68–81). Our proposed guidance will focus on our views of what interests are legitimate and what fees are likely not to be reasonably necessary to protect the lender’s legitimate interests for the purposes of s12BG(1)(b).

Your feedback

C1Q1 Do you agree with our proposed guidance? Please give reasons.

- C1Q2 Do you think that other interests, apart from those listed at paragraph 75, could be considered legitimate for the purposes of s12BG(1)(b)? Please provide details.
- C1Q3 Do you think that any of the interests listed at paragraph 75 are not 'legitimate' for the purposes of s12BG(1)(b)? Please give reasons.
- C1Q4 Do you think that other fees, apart from those listed at paragraph 76, could be reasonably necessary to protect the lender's legitimate interests for the purposes of s12BG(1)(b)? Please provide details.
- C1Q5 Do you think that any of the fees listed at paragraph 76 are not reasonably necessary to protect the lender's legitimate interest for the purposes of s12BG(1)(b)? Please provide details.
- C1Q6 Are there any other specific terms in mortgage contracts relating to early exit fees which you think cause consumers detriment and could potentially be unfair?
- C1Q7 Are there any other types of detriment you think should be listed in our guidance (see paragraph 80)? In answering this question, please consider any types of detriment which are likely to be suffered by some types of consumers more than others (e.g. low-income earners, the elderly).
- C1Q8 If you are a lender, will our proposed guidance change how you set your break fees? If so, please describe the changes and the likely costs involved.
- C1Q9 If you are a lender, will our proposed guidance result in:
- (a) other changes to how mortgage products are structured;
 - (b) changes to your systems for recording fees; or
 - (c) any other changes to your business?
- C1Q10 If the answer to question C1Q9 is yes, please describe the changes and the likely costs involved.
- C1Q11 Do you think our proposed guidance will affect competition for mortgage services (e.g. by causing some firms to exit the market, or preventing some lenders from offering particular products)?
- C1Q12 Do you expect that our proposed guidance will affect consumer behaviour, such as potentially increasing or decreasing the rate at which consumers switch mortgages?
- C1Q13 Are there any other fees or charges in mortgage contracts on which you think ASIC should provide guidance regarding how we think the UCT provisions apply to that fee or charge? Please provide reasons.
- C1Q14 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.

D Proposed guidance on other considerations relating to unfair terms

Key points

This section sets out our proposed guidance on:

- when a contractual right to vary an early exit fee may be unfair; and
- transparently explaining early exit fees.

We believe that a term in a mortgage contract that gives a lender an unlimited unilateral right to vary early exit fees is likely to be unfair. We propose to provide guidance on how the fairness of a right to vary early exit fees can be improved.

We believe that early exit fees should be explained as transparently as possible. How transparently an early exit fee is explained must be considered by a court in determining whether the term providing for the fee is unfair: see s12BG(2) of the ASIC Act.

Proposed guidance on unfair rights to vary early exit fees

- 82 The unfair contract terms (UCT) provisions include a non-exhaustive list of examples of the types of terms in a consumer contract that a court may regard as unfair. An example that is relevant to early exit fees is ‘a term that permits, or has the effect of permitting, one party (but not another party) to vary the terms of the contract’: see s12BH(1)(d) of the ASIC Act.
- 83 We think that a term in a mortgage contract that permits the lender to vary an early exit fee is more likely to be unfair if:
- (a) it is an unlimited unilateral right to vary early exit fees;
 - (b) the fee is a deferred establishment fee or includes a component which is a deferred establishment fee, and there is an increase to this fee. This is because a lender should know what the costs of establishment are at the start of the loan; or
 - (c) the fee is increased and this increase is not proportional to the lender’s increase in costs related to the early exit.
- 84 If there is a term relating to an early exit fee which gives the lender discretion over a matter, the fairness of this term can be improved by not making the discretion absolute and clearly specifying when the discretion may be exercised.
- 85 For a term providing for a unilateral right to vary an early exit fee, it is possible that this term is more likely to be fair if the contract transparently

explains the right and specifies the circumstances when a lender may increase fees, including the way the increase will be calculated, if relevant. These circumstances should be reasonably necessary for the lender to protect their legitimate interests.

Note: For more information on transparency of explanations about early exit fees, see paragraphs 91–108.

Relationship with the National Credit Code

86 The National Credit Code (the Code) permits a lender to unilaterally change the amount of a fee or the frequency or time for payment. However, this does not apply to fees for fixed rate mortgages if the change has the effect of increasing the fee: s70 of the Code.

87 Changes can only be made by giving the consumer at least 20 days notice before the change takes effect. The notice must set out particulars of the change. The notice can be given by publishing it in a newspaper circulating throughout each state and territory. If this is done, the lender must also give information about the change to the consumer before or in their next account statement.

Note: The Code also requires the notice to set out any information required by the National Consumer Credit Protection Regulations 2010: s66(1). Currently, there is no information prescribed in these regulations.

88 The above notice requirements do not apply to a change that reduces the obligations of the debtor or extends the time for payment. If such a change is made, the debtor must be informed of it before or in their next account statement: s66(3) of the Code.

89 We believe that complying with s66 of the Code on changes to credit fees and charges does not necessarily mean a term is ‘fair’ for the purposes of s12BG of the ASIC Act. This is because s66 of the Code only deals with providing notice about a change in fees and does not contain any restrictions on how the fee may be increased. In this respect, s78 of the Code is relevant, as unconscionable early exit fees (e.g. those that exceed a reasonable estimate of the lender’s loss arising from the early termination) can be annulled or reduced by a court: see Section B. Section 70 of the Code, discussed at paragraph 86, also contains a restriction on increasing fees for fixed rate mortgages.

90 The transparency of a term on changes to early exit fees must be considered by a court in deciding whether the term is unfair: see paragraphs 91–108.

Proposal

- D1** We propose to provide guidance on contractual rights to vary early exit fees which are more likely to be unfair (along the lines of paragraphs 82–85), such as an unlimited unilateral right to vary an early exit fee.

Your feedback

- D1Q1 Do you agree with our proposed guidance about a lender's right to vary early exit fees? Please give reasons.
- D1Q2 If you are a lender, what, if any, changes will you need to make to ensure that your rights to vary early exit fees are 'fair' in line with our guidance at paragraphs 83–85? Please provide details of what changes will be required and the likely costs involved.
- D1Q3 If you are a lender, will our proposed guidance require other changes to contracts or other documents which deal with varying early exit fees? Please provide details of any changes that will be required and the likely costs involved.
- D1Q4 Do you think our proposed guidance will affect competition for mortgage services (e.g. by causing some firms to exit the market, or preventing some lenders from offering particular products)?
- D1Q5 Do you expect that our proposed guidance will affect consumer behaviour, such as potentially increasing or decreasing the rate at which consumers switch mortgages?
- D1Q6 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.

Proposed guidance on transparently explaining early exit fees

- 91 The unfair contract terms (UCT) provisions of the ASIC Act provide that in determining whether a term of a consumer contract is unfair, a court must take into account the extent to which a term is transparent and the contract as a whole: s12BG(2). Section 12BG(3) provides that a term is transparent if it is:
- (a) expressed in reasonably plain language;
 - (b) legible;
 - (c) presented clearly; and
 - (d) readily available to any party affected by the term.
- 92 In considering the contract as a whole, it is possible that there are terms in the contract which could counterbalance any potential unfairness in an early exit fee. For example, while a contract may provide that any term may be unilaterally varied by the lender, there may be an overriding term which

provides that the price of the early exit fee will not be changed. A court might take such a term into account in deciding that a general term allowing fees to be varied is not unfair.

93 While the UCT provisions only apply to consumer contracts, we believe the transparency requirement is relevant to information given to a consumer before the contract is entered into (e.g. disclosures about early exit fees in the precontractual statement required by s16 of the Code). A court can take into account any matter it thinks is relevant in deciding whether a term is unfair. We believe explanations of early exit fees and the transparency of such explanations in precontractual documents are likely to be a relevant consideration for a court in deciding if a term is unfair.

94 As with unfairness of a contractual term, it is for a court to determine whether a term is transparent. Transparency, on its own account, will not necessarily overcome underlying unfairness in a contract term. In addition, while the transparency of a term must be considered when deciding if a term is unfair, a court may find that a term is 'fair' even if it is not transparent. For example, the term may still be reasonably necessary to protect the lender's legitimate interests. However, we believe early exit fees should be explained as transparently as possible.

95 Sections 16 and 17 of the Code require the mortgage contract and a precontractual statement to contain information about the fees and charges that are or may become payable under the mortgage. This includes setting out when the fee is payable and the amount of the fee or, if that is not ascertainable, the method of calculation. Explaining this information transparently is likely to improve the fairness of the fee. However, as mentioned above, transparent explanations will not overcome unfairness.

Factors to consider when explaining early exit fees

- 96 In transparently explaining early exit fees, lenders should consider:
- (a) giving prominence to the fee by disclosing it at the front of a document and using bold text or other style features to highlight the fee;
 - (b) explaining in a meaningful and clear way when the fee will be charged. A clear explanation is one that is in plain English with no industry or legal jargon;
 - (c) clearly stating the amount in dollars of the fee or, if that is not possible, the method of calculation. If all the variables that determine how a fee is calculated are known at the time the fee disclosure is made, then the fee should be stated as an amount. If this is not possible, the method of calculation should be disclosed. Meaningful worked examples that give an idea of the range of fees that could be payable should generally be included in the document, unless it would be misleading to do this; and

- (d) clearly disclosing the circumstances when a fee may be changed.
- 97 The above considerations may also be relevant when disclosing other contingent fees and charges (e.g. those payable when a mortgage is terminated because a customer is in default).
- 98 Lenders may also consider using other textual features to transparently explain early exit fees. This can include, but is not limited to:
- (a) a warning at the front of the contract that:
- (i) if an early exit fee is charged, the mortgage may not be suitable for the consumer if they plan on exiting the loan within the time that the early exit fee is charged; and
- (ii) for fixed rate mortgages and reverse mortgages, if a consumer seeks to terminate the contract early they could be required to pay break fees, the amount of which can be substantial (in some circumstances tens of thousands of dollars). A reference should also be made to where further information about how break fees are calculated can be located; and
- (b) information in account statements at least annually about the early exit fee that may apply if the consumer were to terminate the loan as at the date of the statement. This will help keep consumers aware of the fact that an early exit fee is payable.
- 99 Lenders should decide whether such features are an appropriate way of transparently explaining early exit fees for their particular mortgage products.

Proposal

- D2 We propose to provide guidance that the fairness of an early exit fee can be improved by explaining it transparently (along the lines of paragraphs 91–95). We also propose to provide general guidance on some of the ways in which an early exit fee can be transparently explained (along the lines of paragraphs 96–99).

Your feedback

- D2Q1 Do you agree with our proposed guidance about transparently explaining early exit fees?
- D2Q2 If early exit fees are payable, do you think it is useful for a warning to be included at the front of a contract:
- (a) that the contract may not be suitable for a consumer who plans on terminating the loan within the time that the early exit fee is payable; and
- (b) if break fees apply, that these fees can be substantial (in some circumstances tens of thousands of dollars)?

- D2Q3 Do you think it is useful for account statements to include information about the early exit fees that may apply if the consumer were to terminate the loan as at the date of the statement?
- D2Q4 Apart from the mortgage contract, in what other documents typically received by a borrower do you think early exit fees should be explained?
- D2Q5 What steps will your business need to undertake to implement the measures described at paragraphs 96 and 98? Please provide details of these steps and the likely costs involved.
- D2Q6 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.

Factors to consider when explaining break fees

- 100 We believe that transparency is particularly important when a contractual term imposes a liability on a consumer that is substantial and will be an important part of the consumer's decision-making process when entering into the contract. Break fees for fixed rate mortgages and reverse mortgages can be substantial. For example, in some circumstances these fees can be tens of thousands of dollars.
- 101 As mentioned at paragraph 94, we believe that early exit fees, including break fees, should be explained as transparently as possible. For break fees for fixed rate mortgages, we think that a transparent explanation should clearly describe in plain English the amount of the fee, or if that is not ascertainable, the method of calculation, and give this appropriate prominence so that consumers are alerted to the consequences of terminating a fixed rate mortgage or reverse mortgage early. Any schedule of fees in the mortgage contract should also:
- (a) make clear when this fee is payable; and
 - (b) note with appropriate prominence that the amount of the fee can be substantial and indicate a likely potential range, if the amount of the fee is not ascertainable.

Worked examples of break fees

- 102 Meaningful worked examples that give consumers an idea of the range of fees they may be liable for can be a useful tool in transparently explaining break fees.

Break fees for fixed rate mortgages

- 103 The Financial Ombudsman Service (FOS) in *Banking and Finance: Bulletin 60* has published information about how they consider complaints about unconscionable break fees under the Uniform Consumer Credit Code (UCCC). In considering complaints, FOS generally evaluates the loss suffered by the lender as a result of a customer breaking a fixed rate loan.
- 104 While the purpose of *Bulletin 60* is to set out FOS's approach to complaints about break fees, it does provide one illustration of how a break fee calculation can be explained (reproduced below). A lender may find that there are other examples and explanations which provide a more meaningful illustration of the break fees that apply to their fixed rate mortgages.

Note: FOS's statements in *Bulletin 60* relate to whether the break fee is unconscionable under s72 of the UCCC. Section 72 of the UCCC is drafted on the same terms as s78 of the National Credit Code, which is discussed in Section B.

FOS's approach to break fees

FOS accepts that the right to recover the reasonable estimate of the loss suffered by the financial services provider, as a result of a fixed rate loan being repaid early, will be determined by the terms and conditions of the loan contract. Where there is a dispute about the quantum of the loss suffered by the financial services provider we will consider what the movement was in the financial service provider's cost of funds between when the fixed rate period began and the financial service provider's cost of funds for the remaining term of the fixed interest rate period, as at the date of termination.

Calculation for estimating an early repayment cost

The approximate amount of a loss suffered by a financial services provider can be estimated by multiplying the amount of the loan by the remaining term of the fixed interest period and the movement in the financial services provider's cost of funds. For example, the economic cost of repaying a loan of \$100,000 that had two and half years remaining with a movement in cost of funds of 1% would be in the vicinity of \$2,500 ($\$100,000 \times 2.5 \times 1\%$). This amount will then be discounted to reflect the present day value of receiving future projected cash flows in advance. This calculation is by its nature complex.

A financial services provider's cost of funds

The critical variable that is not transparent when an early repayment cost is payable is the movement in the financial services provider's cost of funds ... the Ombudsman has concluded that the pre-estimate of the movement in a financial services provider's cost of funds is best verified by comparing movement in interest rates in the wholesale interest rate market.

The Ombudsman reviews the movement in the wholesale interest rate market by assessing the difference between:

- the wholesale interest rate for the fixed term of the loan contract (as indicated by the appropriate Swap Rate, quarterly in arrears versus Mean Bank Bill Rate), as published in the *Australian Financial Review* at the time the loan was established; and
- the wholesale interest rate for the remaining term of the fixed interest rate period (as indicated by the appropriate Swap Rate, quarterly in arrears versus Mean Bank Bill Rate), as published in the *Australian Financial Review* at the time the loan was terminated.

Source: FOS *Banking and Finance: Bulletin 60* (December 2008). Available at http://www.fos.org.au/centric/home_page/publications/the_circular/the_circular_1_September_2009/actuarial_confirmation_of_approach_to_break_costs.jsp.

105 As mentioned above, in addition to including worked examples, the variables which affect how break fees are calculated could also be explained.

Break fees for fixed rate reverse mortgages

106 Similar to break fees for fixed rate mortgages, we understand that break fees for fixed rate reverse mortgages are also based on the cost to the lender for ‘breaking’ the arrangements it has entered into on the wholesale market to fund the fixed rate loan.

107 Calculating the break fee for a fixed rate reverse mortgage can be more complex than that for a typical fixed rate mortgage. However, we believe that worked examples should still be used to illustrate the break fees that may be payable. Transparent explanations and meaningful illustrations are useful tools to help consumers understand break fees.

108 Worked examples of the break fees that would be payable for a typical fixed rate reverse mortgage with an expected term of 20 years if it were terminated two and ten years into the reverse mortgage could provide a meaningful illustration of the break fees that can be payable.

Proposal

D3 We propose to provide guidance (along the lines of paragraphs 100–108) that for break fees to be transparently explained, they should be clearly explained in plain English with appropriate prominence. Meaningful worked examples may also be used in explaining break fees: see paragraphs 100–108.

Your feedback

D3Q1 Do you agree with our proposed approach to providing guidance about transparently explaining break fees?

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

- D3Q3 Do you think our guidance should provide an example of a break fee that could be payable for a fixed rate reverse mortgage? If so, what variables do you think should be used and how should the break fee be calculated? Please provide reasons.
- D3Q4 If you are a lender, will our proposed guidance change how break fees for fixed rate mortgages and reverse mortgages are explained? Please provide details of what changes will be required and the likely costs involved.
- D3Q5 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.

E Regulatory and financial impact

- 109 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us we think they will strike an appropriate balance between:
- (a) consumer interest in not having early exit fees that are unreasonably high or that pose an unnecessary barrier to switching; and
 - (b) a lender's ability to recover reasonable costs and be flexible with its charging.
- 110 Before settling on a final policy, we will comply with the requirements of the Office of Best Practice Regulation (OBPR) by:
- (a) considering all feasible options;
 - (b) if regulatory options are under consideration, undertaking a preliminary assessment of the impacts of the options on business and individuals or the economy;
 - (c) if our proposed option has more than low impact on business and individuals or the economy, consulting with OBPR to determine the appropriate level of regulatory analysis; and
 - (d) conducting the appropriate level of regulatory analysis (i.e. complete a Business Cost Calculator report (BCC report) and/or a Regulation Impact Statement (RIS)).
- 111 All BCC reports and RISs are submitted to the OBPR for approval before we make any final decision. Without an approved BCC Report and/or RIS, we are unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.
- 112 To ensure that we are in a position to properly complete any required BCC report or RIS, we ask you to provide us with as much information as you can about our proposals, including:
- (a) the likely compliance costs;
 - (b) the likely effect on competition; and
 - (c) other impacts, costs and benefits.

Note: See 'The consultation process' on p. 4.

Key terms

Term	Meaning in this document
ASIC	Australian Securities and Investments Commission
ASIC Act	<i>Australian Securities and Investments Commission Act 2001</i>
break fee	A type of fee charged for early termination of a fixed rate mortgage (sometimes called 'break costs')
Code	National Credit Code at Schedule 1 of the National Credit Act
deferred establishment fee	A type of early exit fee which is imposed if the full establishment fee is not charged at the start of the loan. Typically, it is charged if the consumer repays the loan in the first three to five years (although, in some cases it can be longer)
early exit fee	A fee that is not a mortgage discharge fee payable on early repayment of a mortgage. Full repayment is generally considered to be early if the mortgage is terminated in the first three to five years. The early exit fee includes any 'deferred establishment fee' or 'break fee'
EDR	External dispute resolution
EDR scheme (or scheme)	An external dispute resolution scheme approved by ASIC under the Corporations Act (see s912A(2)(b) and 1017G(2)(b)) and/or the National Credit Act (see s11(1)(a)) in accordance with our requirements in Regulatory Guide 139 <i>Approval of external complaints resolution schemes</i> (RG 139)
FOS	Financial Ombudsman Service—an ASIC-approved EDR scheme
lender	In relation to provisions in the Code, means a 'credit provider' as defined in the Code. In relation to the UCT provisions, means a lender under the mortgage contract
mortgage discharge fee	A type of fee payable on discharge of a mortgage, whether the discharge is early or not
National Credit Act	<i>National Consumer Credit Protection Act 2009</i>
National Credit Code (or the Code)	National Credit Code at Schedule 1 of the National Credit Act
National Credit Regulations	National Consumer Credit Protection Regulations 2010
s78 (for example)	A section of an Act or Code as specified (in this example numbered 78)

Term	Meaning in this document
Trade Practices Act	<i>Trade Practices Act 1974</i>
UCCC	Uniform Consumer Credit Code
UCT provisions	The unfair contract terms provisions in Subdiv BA of Div 2 of Pt 2 of the ASIC Act

List of proposals and questions

Proposal	Your feedback
<p>B1 We propose to provide guidance (along the lines of paragraph 51) 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 Code.</p>	<p>B1Q1 Do you agree with our proposed approach that any fee that is payable on early termination is likely to be an early termination fee? Please provide reasons.</p> <p>B1Q2 Are there any situations where an early exit fee is more likely to be a deferred establishment fee to which the test in s78(3) applies? Please provide details.</p> <p>B1Q3 If you are a lender, will our proposed guidance on the scope of s78 affect how you set your early exit fees, including deferred establishment fees? Please provide details of any changes and the costs involved.</p> <p>B1Q4 If you are a lender, will our proposed guidance result in:</p> <ul style="list-style-type: none"> (a) other changes to how mortgage products are structured; (b) changes to your systems for recording fees; or (c) any other changes to your business? <p>B1Q5 If the answer to question B1Q4 is yes, please describe the changes and the likely costs involved.</p> <p>B1Q6 Do you think our proposed guidance will affect competition for mortgage services (e.g. by causing some firms to exit the market, or preventing some lenders from offering particular products)?</p> <p>B1Q7 Do you expect that our proposed guidance will affect consumer behaviour, such as potentially increasing or decreasing the rate at which consumers switch mortgages?</p> <p>B1Q8 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.</p>

Proposal	Your feedback
<p>B2 We propose to provide guidance that an early exit fee which seeks to recover a reasonable amount for loss that arises as a direct result of early termination is unlikely to be unconscionable for the purposes of the test in s78(4) (along the lines of paragraphs 53–57).</p>	<p>B2Q1 Do you agree with our proposed guidance on when an early exit fee is likely or unlikely to be unconscionable for the purposes of the test in s78(4) of the Code? Please provide reasons.</p> <p>B2Q2 Are there any other types of loss which you believe form, or do not form, part of a lender's reasonable estimate of loss arising from early termination, apart from those listed at paragraph 54? Please provide details.</p> <p>B2Q3 If you are a lender, will our proposed guidance change how you set your early exit fees? Please provide details of any changes that will be required and the likely costs involved.</p> <p>B2Q4 If you are a lender, will our proposed guidance result in:</p> <ul style="list-style-type: none"> (a) other changes to how mortgage products are structured; (b) changes to your systems for recording fees; or (c) any other changes to your business? <p>B2Q5 If the answer to question B2Q4 is yes, please describe the changes and the likely costs involved.</p> <p>B2Q6 Do you think our proposed guidance will affect competition for mortgage services (e.g. by causing some firms to exit the market, or preventing some lenders from offering particular products)?</p> <p>B2Q7 Do you expect that our proposed guidance will affect consumer behaviour, such as potentially increasing or decreasing the rate at which consumers switch mortgages?</p> <p>B2Q8 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.</p>

Proposal	Your feedback
<p>B3 We propose to provide guidance that an establishment fee that reflects the lender's reasonable cost of determining a mortgage application and the initial administrative costs of providing the mortgage, or the average reasonable costs of these things, will not be unconscionable (along the lines of paragraphs 58–61). We also propose to provide general guidance on other factors we will take into account in deciding whether to take action because an establishment fee is unconscionable (along the lines of paragraphs 62–63).</p>	<p>B3Q1 Do you agree with our proposed guidance on when an establishment fee is likely or unlikely to be unconscionable for the purposes of the test in s78(3) of the Code? Please provide reasons.</p> <p>B3Q2 Are there any costs which you believe form or do not form part of a lender's reasonable establishment costs, apart from those listed at paragraphs 60 and 63? Please provide details.</p> <p>B3Q3 If you are a lender, will our proposed guidance change how you set your establishment fees? Please provide details of any changes that will be required and the likely costs involved.</p> <p>B3Q4 If you are a lender, will our proposed guidance result in:</p> <ul style="list-style-type: none"> (a) other changes to how mortgage products are structured; (b) changes to your systems for recording fees; or (c) any other changes to your business? <p>B3Q5 If the answer to question B3Q4 is yes, please describe the changes and the likely costs involved.</p> <p>B3Q6 Do you think our proposed guidance will affect competition for mortgage services (e.g. by causing some firms to exit the market, or preventing some lenders from offering particular products)?</p> <p>B3Q7 Do you expect that our proposed guidance will affect consumer behaviour, such as potentially increasing or decreasing the rate at which consumers switch mortgages?</p> <p>B3Q8 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.</p>

Proposal	Your feedback
<p>C1 We propose to provide general guidance on when we are more likely to take action because a contractual term providing for an early exit fee is unfair (along the lines of paragraphs 68–81). Our proposed guidance will focus on our views of what interests are legitimate and what fees are likely not to be reasonably necessary to protect the lender’s legitimate interests for the purposes of s12BG(1)(b).</p>	<p>C1Q1 Do you agree with our proposed guidance? Please give reasons.</p> <p>C1Q2 Do you think that other interests, apart from those listed at paragraph 75, could be considered legitimate for the purposes of s12BG(1)(b)? Please provide details.</p> <p>C1Q3 Do you think that any of the interests listed at paragraph 75 are not ‘legitimate’ for the purposes of s12BG(1)(b)? Please give reasons.</p> <p>C1Q4 Do you think that other fees, apart from those listed at paragraph 76, could be reasonably necessary to protect the lender’s legitimate interests for the purposes of s12BG(1)(b)? Please provide details.</p> <p>C1Q5 Do you think that any of the fees listed at paragraph 76 are not reasonably necessary to protect the lender’s legitimate interest for the purposes of s12BG(1)(b)? Please provide details.</p> <p>C1Q6 Are there any other specific terms in mortgage contracts relating to early exit fees which you think cause consumers detriment and could potentially be unfair?</p> <p>C1Q7 Are there any other types of detriment you think should be listed in our guidance (see paragraph 80)? In answering this question, please consider any types of detriment which are likely to be suffered by some types of consumers more than others (e.g. low-income earners, the elderly).</p> <p>C1Q8 If you are a lender, will our proposed guidance change how you set your break fees? If so, please describe the changes and the likely costs involved.</p> <p>C1Q9 If you are a lender, will our proposed guidance result in:</p> <ul style="list-style-type: none"> (a) other changes to how mortgage products are structured; (b) changes to your systems for recording fees; or (c) any other changes to your business? <p>C1Q10 If the answer to question C1Q9 is yes, please describe the changes and the likely costs involved.</p> <p>C1Q11 Do you think our proposed guidance will affect competition for mortgage services (e.g. by causing some firms to exit the market, or preventing some lenders from offering particular products)?</p>

Proposal	Your feedback
	<p>C1Q12 Do you expect that our proposed guidance will affect consumer behaviour, such as potentially increasing or decreasing the rate at which consumers switch mortgages?</p> <p>C1Q13 Are there any other fees or charges in mortgage contracts on which you think ASIC should provide guidance regarding how we think the UCT provisions apply to that fee or charge? Please provide reasons.</p> <p>C1Q14 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.</p>
<p>D1 We propose to provide guidance on contractual rights to vary early exit fees which are more likely to be unfair (along the lines of paragraphs 82–85), such as an unlimited unilateral right to vary an early exit fee.</p>	<p>D1Q1 Do you agree with our proposed guidance about a lender's right to vary early exit fees? Please give reasons.</p> <p>D1Q2 If you are a lender, what, if any, changes will you need to make to ensure that your rights to vary early exit fees are 'fair' in line with our guidance at paragraphs 83–85? Please provide details of what changes will be required and the likely costs involved.</p> <p>D1Q3 If you are a lender, will our proposed guidance require other changes to contracts or other documents which deal with varying early exit fees? Please provide details of any changes that will be required and the likely costs involved.</p> <p>D1Q4 Do you think our proposed guidance will affect competition for mortgage services (e.g. by causing some firms to exit the market, or preventing some lenders from offering particular products)?</p> <p>D1Q5 Do you expect that our proposed guidance will affect consumer behaviour, such as potentially increasing or decreasing the rate at which consumers switch mortgages?</p> <p>D1Q6 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.</p>

Proposal	Your feedback
<p>D2 We propose to provide guidance that the fairness of an early exit fee can be improved by explaining it transparently (along the lines of paragraphs 91–95). We also propose to provide general guidance on some of the ways in which an early exit fee can be transparently explained (along the lines of paragraphs 96–99).</p>	<p>D2Q1 Do you agree with our proposed guidance about transparently explaining early exit fees?</p> <p>D2Q2 If early exit fees are payable, do you think it is useful for a warning to be included at the front of a contract:</p> <ul style="list-style-type: none"> (a) that the contract may not be suitable for a consumer who plans on terminating the loan within the time that the early exit fee is payable; and (b) if break fees apply, that these fees can be substantial (in some circumstances tens of thousands of dollars)? <p>D2Q3 Do you think it is useful for account statements to include information about the early exit fees that may apply if the consumer were to terminate the loan as at the date of the statement?</p> <p>D2Q4 Apart from the mortgage contract, in what other documents typically received by a borrower do you think early exit fees should be explained?</p> <p>D2Q5 What steps will your business need to undertake to implement the measures described at paragraphs 96 and 98? Please provide details of these steps and the likely costs involved.</p> <p>D2Q6 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.</p>
<p>D3 We propose to provide guidance (along the lines of paragraphs 100–108) that for break fees to be transparently explained, they should be clearly explained in plain English with appropriate prominence. Meaningful worked examples may also be used in explaining break fees: see paragraphs 100–108.</p>	<p>D3Q1 Do you agree with our proposed approach to providing guidance about transparently explaining break fees?</p> <p>D3Q2 Do you think it is helpful to provide worked examples?</p> <p>D3Q3 Do you think our guidance should provide an example of a break fee that could be payable for a fixed rate reverse mortgage? If so, what variables do you think should be used and how should the break fee be calculated? Please provide reasons.</p> <p>D3Q4 If you are a lender, will our proposed guidance change how break fees for fixed rate mortgages and reverse mortgages are explained? Please provide details of what changes will be required and the likely costs involved.</p> <p>D3Q5 Is there any further guidance we should give? Please provide as much specific information as possible, as this will assist us to provide guidance that is of greater use to you.</p>