



ASIC

Australian Securities & Investments Commission

REPORT 216

Response to submissions on CP 135 Mortgage exit fees: Unconscionable fees and unfair contract terms

November 2010

About this report

This report highlights the key issues that arose out of the submissions received to Consultation Paper 135 *Mortgage early exit fees: Unconscionable fees and unfair contract terms* (CP 135) and details our responses in relation to those issues.

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 (primarily the Corporations Act)
- 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.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the *National Consumer Credit Protection Act 2009* and the *Australian Securities and Investments Commission Act 2001* and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 220 *Early termination fees for residential loans: Unconscionable fees and unfair contract terms* (RG 220).

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A Overview/Consultation process

- 1 There are two national laws which are administered by ASIC that are relevant to early termination fees for residential property loans. These laws are the National Credit Code, which is part of the *National Consumer Credit Protection Act 2009* (National Credit Act), and the *Australian Securities and Investments Commission Act 2001* (ASIC Act), particularly the unfair contract terms provisions.
- 2 In Consultation Paper 135 *Mortgage early exit fees: Unconscionable fees and unfair contract terms* (CP 135), we consulted on 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.
- 3 CP 135 set out proposals on:
 - (a) when an early exit fee is likely to be unconscionable under s78 of the National Credit Code;
 - (b) when an early exit fee is likely to be unfair under the unfair contract terms provisions in the ASIC Act;
 - (c) when a right to vary an early exit fee may be unfair; and
 - (d) how early exit fees, including break fees, can be transparently explained.
- 4 This report highlights the key issues that arose out of the submissions received to CP 135 and our responses to those issues.
- 5 This report is not meant to be a comprehensive summary of all responses received. Nor is it meant to be a detailed report on every question from CP 135. We have limited this report to the key issues.
- 6 For a list of non-confidential respondents to CP 135, see the Appendix to this report. Copies of the non-confidential submissions are on the ASIC website at www.asic.gov.au/cp under CP 135.

Responses to consultation

- 7 We received 19 responses to CP 135 including responses from industry bodies, consumer groups and lenders, including authorised deposit taking institutions (ADIs) and non-ADI lenders. We are grateful to respondents for taking the time to send us their comments.
- 8 A number of submissions, particularly those from consumer groups, were supportive of our overall approach in providing guidance on when an early

exit fee may be unconscionable or unfair. There was also general support for our proposals on how an early exit fee can be transparently explained. However, a number of lenders and industry bodies argued that aspects of our guidance were too restrictive in how we interpreted when an early exit fee may be unconscionable or unfair. In particular, they submitted that a broader range of costs should be able to be recovered.

9 We have refined the proposed guidance in CP 135 to take into account the feedback in the submissions we received. In particular, we have made it clear that our guidance is high-level and principle-based. It is intended to apply flexibly and is generally not exhaustive. There may be factors other than those listed in our guidance that may cause an early exit fee to be unconscionable or unfair, or may mean that it is not unconscionable or unfair. Our final guidance is set out in Regulatory Guide 220 *Early termination fees for residential loans: Unconscionable fees and unfair contract terms* (RG 220).

10 In addition, a number of respondents commented on the interrelationship between:

- (a) upfront establishment fees and deferred establishment fees (we consider the latter is generally a type of early exit fee); and
- (b) early exit fees and interest rates.

11 In particular, a number of submissions suggested that if our guidance were to limit the amount that could be charged in an early exit fee, this could lead to upfront establishment fees and interest rates rising, or early exit fees being rebadged as another type of fee.

12 In preparing RG 220, we have kept in mind:

- (a) the interrelationships outlined above; and
- (b) the need to balance a consumer's interest in not having early exit fees that are unreasonably high or that pose an unnecessary barrier to switching and a lender's ability to recover reasonable costs and be flexible with charging.

Terminology

13 As a result of some of the submissions we received to CP 135, in RG 220 we refer to:

- (a) 'early termination fees' rather than 'early exit fees' to more closely align with the language in the National Credit Code (particularly s78(4)); and
- (b) 'residential loans' instead of 'mortgages' for better consistency with industry practice and also the language of the National Credit Code, which distinguishes a mortgage from a credit contract. 'Residential loan' is intended to refer to a type of credit contract.

14 In this report, however, we have retained the terminology used in CP 135.

B Proposed guidance on unconscionable fees

Key points

In CP 135, we proposed that deferred establishment fees are likely to be evaluated under the test for unconscionability in s78(4) of the National Credit Code. Section 78(4) applies to fees payable on early termination. We also listed the types of loss we thought could and could not be recovered in an early exit fee that was being considered under the test in s78(4).

We received mixed responses to our proposals. While some submissions agreed with how we had characterised deferred establishment fees, others thought these fees should be considered under the test in s78(3), which applies to establishment fees. Some submissions also thought that additional types of loss than those listed in CP 135 could be recovered in an early exit fee.

Deferred establishment fees

- 15 In CP 135, we proposed that the test in s78(4) of the National Credit Code is likely to be used to evaluate whether a deferred establishment fee is unconscionable. This reflected our view that a deferred establishment fee is a ‘fee payable on early termination’, to which the test in s78(4) applies.
- 16 However, in some situations, depending on what the fee is seeking to recover, we said it may be possible that a deferred establishment fee is an establishment fee that should be evaluated under the different test in s78(3). Lenders will need to decide for themselves whether their deferred establishment fee is an early termination fee for the purposes of the test in s78(4) or an establishment fee for the purposes of the test in s78(3).
- 17 Responses were mixed on our proposed guidance. Industry bodies and some lenders argued that deferred establishment fees were establishment fees that should be considered under the test in s78(3). This was generally because the fee refers to the lender’s establishment costs. For example, one respondent stated that a deferred establishment fee is representative of the criteria referred to in s78(3). They also argued that it does not follow that an establishment fee is any less an establishment fee because it is payable at a time other than when the credit facility was established.
- 18 Another respondent argued that the test in s78(4) does not apply to deferred establishment fees because the fee is not for loss arising from early repayment. Rather, the fee is payable because of a decision by the customer to delay or waive payment of an establishment fee. This, they said, was the reason why the test in s78(3) should apply to deferred establishment fees.
- 19 A few submissions thought a deferred establishment fee could be considered under both the test in s78(3) and 78(4) given the way s78 is drafted.

- 20 Consumer groups were supportive of our proposed approach. A couple of submissions noted that a deferred establishment fee can be assessed under the tests in both s78(3) and 78(4).

ASIC's response

Consistent with our proposal in CP 135, we think that any fee payable on early termination will generally be an early termination fee to which the test in s78(4) applies. This includes any deferred establishment fee payable on early termination.

As a matter of law, we disagree with submissions that suggested that deferred establishment fees could be considered under the tests in both s78(3) and 78(4). The wording of s78(4), particularly that a fee payable on early termination is unconscionable *'if and only if'* it exceeds a reasonable estimate of the lender's loss arising from the early termination, suggests that if s78(4) applies, it applies to the exclusion of s78(3).

Reasonable estimate of the lender's loss

- 21 CP 135 listed the types of loss we thought could and could not be recovered in an early exit fee that was being considered under the test in s78(4). Such a fee is not unconscionable if it does 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.
- 22 There was broad support for our proposed approach to providing guidance. Some submissions, including those from consumer groups, were supportive of the types of loss we listed that were likely to be able to be recovered. Other submissions thought that a broader range of costs than those listed could be recovered. These submissions were from lenders and their industry bodies.
- 23 The extra costs some respondents said should be included in an early termination fee included:
- (a) loss arising from offering loans with a honeymoon rate; and
 - (b) commissions paid to loan originators.
- 24 A few submissions also argued that it would not be unconscionable to include profit or a component for marketing and business development costs in an early exit fee. In CP 135, we said we were more likely to take action if an early exit fee included components covering these types of loss.
- 25 Some respondents pointed out that costs for discharging a mortgage, including legal fees and land registry costs, were not early termination costs. They are payable regardless of whether a mortgage is terminated early or not.

- 26 It was suggested in some submissions, particularly those from non-bank lenders and their industry bodies, that our guidance should more specifically acknowledge the business models of non-bank lenders (e.g. by specifically mentioning originator commissions as a third party cost). It was also suggested that it would be useful if our guidance set out examples of third party costs.
- 27 CP 135 proposed that an early termination fee is unlikely to be unconscionable if it recovers losses which arise as a direct result of the early termination, provided that the amount charged is reasonable. One respondent noted that this was not the test in s78(4), which refers to an early termination fee reflecting a 'reasonable estimate' of the lender's loss.

ASIC's response

We have made some refinements to our guidance in RG 220 in light of the feedback we have received. For example:

- we have removed the reference to charging a reasonable amount for a loss covered in an early termination fee as this does not reflect the language of s78(4);
- we have specified types of otherwise unrecovered third party costs which we think can be recovered in a fee payable on early termination (this includes specifying commissions paid to loan originators);
- we have broadened the range of costs we think can be recovered in an early exit fee that is compatible with the test in s78(4) to include lender's mortgage insurance, the cost of obtaining funding and costs that have not been recovered when a loan with a honeymoon or introductory interest rate is terminated early; and
- we have removed the reference to costs for discharging the mortgage as a type of loss arising from the early termination of a loan. We agree with the submissions that stated these costs are not unique to the early termination of a loan.

We disagree with submissions that loss of profits and marketing and product development costs are losses arising from the early termination of a loan. Lenders are usually able to lend the principal of a loan that is repaid early to another customer and in this situation we consider there is no loss of profits. While marketing and product development costs are costs incurred by a lender in running its business, we do not believe they are incurred because a loan is terminated early.

We also do not think that marketing and product development costs are establishment costs that can be deferred (and thus included in an early exit fee). We think such establishment costs relate more to the initial cost of providing a customer with credit, not to the cost of trying to obtain new customers or offering new loan products (which are the things that marketing and product development are directed at).

Reasonable establishment costs

28 Although CP 135 proposed that deferred establishment fees were likely to be evaluated under the test in s78(4), it also considered establishment costs that may and may not be able to be recovered in a deferred establishment fee that is considered under the test in s78(3). Some respondents sought further clarification around some of these costs.

ASIC's response

As noted above, because we will be administering the law on the basis that any fee payable on early termination will generally be a fee to which the test in s78(4) applies, our guidance will not address when a deferred establishment fee may be unconscionable under the test for establishment fees in s78(3).

However, we have taken into account the feedback we received on establishment fees and applied that to our guidance on deferred establishment costs. A deferred establishment cost may be considered a type of loss that arises from the early termination of a loan. For example, we have specified commissions to loan originators as a type of deferred establishment cost: see RG 220.33.

C Proposed guidance on unfair contract terms

Key points

CP 135 contained general guidance on when we are likely to take action because a term providing for an early exit fee may be unfair.

Responses on our proposed guidance were diverse. Some respondents agreed with our proposals. Others thought that CP 135 was too narrow in its view on when an early exit fee may be unfair. A number of respondents also sought clarification on particular aspects of our proposed guidance.

Our proposed approach

- 29 CP 135 proposed general guidance on when we are more likely to take action because a contractual term providing for an early exit fee is unfair under the unfair contract terms provisions in the ASIC Act.
- 30 Under these provisions, 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 (in this case, the lender); 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.
- 31 For the first element of the test of unfairness, we said that to determine whether a significant imbalance exists, one would have to assess the rights and obligations imposed on both parties under the contract. A significant imbalance is likely to exist if the early exit fee is unconscionable for the purposes of the National Credit Code.
- 32 For the second element, we proposed guidance on what interests we thought were or were not 'legitimate' and the types of early exit fees we thought were likely to be reasonably necessary to protect the lender's legitimate interests (e.g. a fee that is related to a lender's reasonable costs directly arising from the early termination).
- 33 For the third element, our proposed guidance provided 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.

Responses

- 34 Responses to our proposed guidance on unfair early exit fees were diverse. A number of respondents agreed with our proposed guidance that whether a term providing for an early exit fee to be paid is unfair will depend on the circumstances of each case.
- 35 Some respondents provided similar feedback as for Section B of CP 135 on unconscionable early exit fees (e.g. that product and business development costs and a component for profit should be able to be included in an early exit fee). Some respondents also said that establishment costs such as commissions paid to loan originators and lender's mortgage insurance should also be included.
- 36 A couple of respondents disagreed that ongoing loan administration and recovering a reasonable component for overheads and administrative costs while the loan was on foot was a legitimate interest of the lender in the context of early exit fees.
- 37 One respondent requested clarification on what we meant by being flexible with product design and charging (as a legitimate interest).
- 38 CP 135 also noted the interaction between the National Credit Code and the unfair contract terms provisions. Among other things, we stated that a fee that is not unconscionable under the National Credit Code will not necessarily be fair for the purposes of the ASIC Act: see paragraph 68 of CP 135. Some respondents disagreed or found this aspect of our proposed guidance confusing and/or unhelpful.
- 39 CP 135 also stated that we thought a contractual term providing for an early exit fee which is unconscionable under the National Credit Code is likely to also be unfair under the ASIC Act. Respondents did not disagree with this proposition.
- 40 A few respondents questioned or disagreed with our view that deferred establishment fees were reviewable under the unfair contract terms provisions, which was assumed in CP 135. The unfair contract terms provisions do not apply to terms that define the main subject matter of the contract or set the upfront price. They argued that deferred establishment fees were part of the upfront price.
- 41 The upfront price under a contract is the consideration that:
- (a) is provided, or is to be provided, for the supply under the contract; and
 - (b) is disclosed at or before the time the contract is entered into,
- but does not include any other consideration that is contingent on the occurrence or non-occurrence of a particular event: s12BI(2).

ASIC's response

We have modified our guidance in light of the feedback we received:

- We have removed the reference to ongoing loan administration as a legitimate interest. We agree with the respondents who noted that ongoing loan administration costs were recovered through other fees and charges (e.g. account keeping fees). They do not need to be recovered through early exit fees.
- Based on the feedback outlined at paragraph 35, we have broadened what establishment costs we think can be recovered by referring to the deferred establishment costs we have listed in our guidance on unconscionable fees (see RG 220.70).
- We have clarified what we mean by being flexible with product design and charging, which we listed as a legitimate interest, and product development, which we thought was unlikely to be a legitimate interest (see RG 220.68 and RG 220.70).

We do not agree that it is legitimate for lenders to seek to recover product and business development costs in an early exit fee. We believe it is more appropriate to recover these through other fees and charges (e.g. ongoing fees or in a lender's margin on lending).

In light of the feedback we received, our guidance does not refer to the fact that an early exit fee that is not unconscionable under the National Credit Code is not necessarily 'fair' under the unfair contract terms provisions. While this may be the case in extreme circumstances, on reflection, we believe it would be premature to provide guidance on this particular point until the unfair contract terms provisions in the ASIC Act have been interpreted by the courts.

We have retained the salient point in paragraph 68 of CP 135, which was that a term providing for an early exit fee which is unconscionable under the National Credit Code is likely to also be unfair under the ASIC Act: see RG 220.56. We believe a correlation can be drawn between fees that exceed a lender's loss arising from the early termination of a loan for the purposes of s78(4) and a fee which is not reasonably necessary to protect the lender's legitimate interest (which is one of the elements of the test of unfairness).

We also think that if a fee does exceed a lender's loss arising from the early termination of a loan, the other elements of the test of unfairness—namely, that there is a significant imbalance in the parties' rights and obligations and that the term causes detriment if it were to be applied or relied on—are likely to also be satisfied.

As a matter of law, we disagree with submissions that the unfair contract terms provisions do not apply to deferred establishment fees. We think that s12BI(2) of the ASIC Act is directed to consideration which *will be* provided under a contract rather than *might be* provided. Deferred establishment fees are a type of consideration that might be provided. They are payable only *if* a customer terminates the loan within the time that the fee is payable.

For this reason, RG 220.53–RG 220.55 states that we will administer the law on the basis that a deferred establishment fee is not part of the upfront price of a loan.

D Other considerations relating to unfair contract terms

Key points

In CP 135, we proposed that early exit fees, including break fees, should be explained as transparently as possible.

Most submissions were supportive of our proposed guidance, although some questioned whether warnings should be included at the front of a contract.

Transparently explaining early exit fees

- 42 In CP 135, we proposed that early exit fees, including break fees, should be explained as transparently as possible and proposed guidance on how this could be done. We suggested that meaningful worked examples could be used to explain break fees, as long as it would not be misleading to do this.
- 43 Submissions were generally supportive of our proposed guidance. A couple of submissions did not support mandatory or prescriptive disclosure requirements. However, such requirements were not proposed in CP 135. One respondent was of the view that the requirement to pay early exit fees should be disclosed at every opportunity, and there would be greater utility in disclosing early exit fees at the loan application stage rather than in the contract.
- 44 A few respondents believed that including warnings about early exit fees would be useful. However, it was pointed out that practically it is not possible to disclose everything of importance in a contract.
- 45 More detailed guidance about what information on early exit fees could be included in account statements was also requested by a few respondents. On the other hand, there were a couple of submissions that did not agree that information about early exit fees should be included in account statements.
- 46 A couple of respondents commented that guidance on providing explanations at the front of the contract could conflict with the requirement in the National Consumer Credit Protection Regulations 2009 (National Credit Regulations) that certain information needs to be included in a pre-contractual statement and only that information should be set out at the beginning of the proposed contract, where the pre-contractual statement is not in a separate document: see reg 72.

ASIC's response

Although a court must take into account the extent to which a term is transparent in determining whether a term is unfair, we agree that transparent explanations are not a requirement of the law.

Accordingly, our guidance simply suggests things lenders can consider trying in transparently explaining their early exit fees.

Respondents to CP 135 were generally supportive of this approach and we have retained it in RG 220. We do not propose to impose prescriptive, mandatory disclosure requirements in RG 220.

We have removed references to giving prominence to fees by disclosing them at the front of the contract and including warnings at the front of the contract. This was because of concerns that it will be difficult to comply with our guidance and the requirements of the National Credit Regulations. Our guidance now states that warnings should be prominent.

We have also provided:

- more detail about what information should be included in account statements about early exit fees (see RG 220.110);

Note: We have not removed our guidance on this point, even though a couple of submissions did not support it. Our guidance simply suggests that including information about early exit fees in account statements is one thing lenders can consider doing. Lenders do not have to do this if they do not think it is necessary in order to transparently explain early exit fees.

- guidance that it is good practice for lenders and mortgage intermediaries (e.g. brokers) to discuss with consumers the fact that an early exit fee is payable (see RG 220.112).

Transparently explaining break fees

47 Most respondents who commented on our proposals on explaining break fees were supportive of our suggested approach. While there were some mixed responses on whether it is helpful for lenders to provide worked examples, most respondents supported providing generic examples. However, a few argued that this should be avoided because it could be misleading.

48 One respondent suggested that warnings about break fees could include more detail about the uncertainty and risks associated with break fees.

ASIC's response

CP 135 mentioned that worked examples should not be used if it would be misleading to include them. In light of concerns expressed by some respondents about whether it is possible to explain break fees in a way that is not misleading, we have reiterated throughout RG 220 that worked examples should not be used if it would be misleading to do this, or if the examples do not provide a realistic picture of the break fees that could be payable. We have also provided more detailed guidance on the information lenders can consider providing in a warning about break fees: see RG 220.115.

Appendix: List of non-confidential respondents

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- Abacus – Australian Mutuals
 - Aussie
 - Australian Bankers' Association
 - Australian Finance Conference
 - Care Inc and Consumer Law Centre of the ACT
 - Challenger Financial Services Group
 - Consumer Action Law Centre
 - Consumer Credit Legal Centre of NSW
 - Financial Ombudsman Service
 - HWL Ebsworth
 - Liberty Financial
 - Mortgage Finance Association of Australia
-