ASIC

Australian Securities & Investments Commission

REPORT 300

Review of early termination fees for residential loans entered into before 1 July 2011

September 2012

About this report

This report sets out the findings from our review of early termination fees charged by lenders on residential loans entered into before the commencement, on 1 July 2011, of the prohibition on early termination fees on new residential loans.

This report's specific focus is on how lenders were complying with their obligations under the *National Consumer Credit Protection Act 2009* (National Credit Act), the National Credit Code and the *Australian Securities and Investments Commission Act 2001* (ASIC Act), following the release of Regulatory Guide 220 *Early termination fees for residential loans: Unconscionable fees and unfair contract terms* (RG 220) in November 2010.

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 Credit Act, ASIC Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Contents

Executive summary

1 From 1 July 2011 early termination fees have been prohibited on new residential loans. However, many residential loans entered into before 1 July 2011 still include an early termination fee, which is payable if the borrower terminates the loan within a specified time after credit is provided (e.g. early termination fees are usually payable on termination of the loan in the first three to five years).

2 The *National Consumer Credit Protection Act 2009* (National Credit Act), including the National Credit Code, commenced on 1 July 2010 replacing the previous state and territory-based regulation of credit with a new national system, regulated by ASIC. Section 78(4) of the National Credit Code provides that an early termination fee is unconscionable if the fee exceeds a reasonable estimate of the credit provider's losses arising from the early termination.

3 Unfair contract term provisions in the *Australian Securities and Investments Commission Act 2001* (ASIC Act) also commenced on 1 July 2010, but do not apply to contracts, or early termination fee terms in contracts, that were entered into before this date. The provisions render a term of a credit contract void if it is unfair.

4 We released Regulatory Guide 220 *Early termination fees for residential loans: Unconscionable fees and unfair contract terms* (RG 220) in November 2010 with guidance on our views of these provisions, including the circumstances in which we would consider that an early termination fee may be unconscionable or unfair.

5 We subsequently undertook this review to see how lenders were complying with their obligations, following publication of RG 220 and what, if any, changes lenders had made to their early termination fees since 1 July 2010.

What we did

6 We selected 20 lenders for our review. These lenders were chosen to cover a broad cross-section of lenders and included authorised deposit-taking institutions (ADIs) (such as banks, credit unions and building societies) and non-ADI lenders. In selecting these lenders we specifically included lenders who had higher early termination fees compared to their peers, according to data from an online loan comparison site.

7 In February 2011, we asked the selected lenders to answer a number of questions about their early termination fees, including questions about:

(a) fee structures;

(b) the number of loans for each fee structure where an early termination fee had been paid since 1 July 2010;

(c) the number of loans for each fee structure where an early termination fee would be payable;

(d) the losses they sought to recover through their early termination fees;

(e) changes to early termination fees since 1 July 2010;

(f) fee disclosure; and

(g) complaints handling.

8 Our review did not cover standard discharge fees that are charged on the termination of a loan regardless of whether a loan is terminated early or break fees that are charged on the early termination of fixed rate residential loans.

What we found

9 The lenders we surveyed charged an early termination fee on approximately 75,000 occasions between 1 July 2010 and 15 February 2011 and had approximately 1.5 million loans on which an early termination fee would have been payable at 15 February 2011.

10 We found that lenders were generally aware of their obligations in relation to early termination fees, as outlined in RG 220, and had taken steps to ensure compliance. The types of losses being recovered through early termination fees were, in most cases, consistent with RG 220.39–RG 220.44.

11 Of concern were instances where lenders appeared to suggest that the provisions in the National Credit Code specifying the bases on which early termination fees are unconscionable had only commenced from 1 July 2010, although these provisions were previously in place under the Uniform Consumer Credit Code (UCCC) administered by the states and territories.

12 Larger lenders generally had more robust systems in place to regularly verify that their early termination fees did not exceed a reasonable estimate of their losses. Of concern were instances where smaller lenders suggested that it was not practical for a business of their size to devote resources to verifying the losses they sought to recover.

13 We found that, on an average or portfolio basis, lenders' early termination fees generally recovered less than their reported losses arising from early termination. However, there were circumstances where some lenders were estimating losses in a manner that increased the likelihood of recovering amounts exceeding a reasonable estimate of their losses on individual loans.

14 Early termination fee structures varied significantly, with a high degree of variability not only between lenders, but also between early termination fees charged by the same lender on different products. There were also instances where fee structures appeared to be tailored to particular distribution models (e.g. direct versus broker).

15 Some lenders noted that fees were changed over time in light of market competition. A number of lenders also noted changes to fee structures in light of the commencement of the National Credit Code on 1 July 2010 and the then foreshadowed prohibition on early termination fees.

16 Lenders employed a variety of methods to disclose early termination fees, including a variety of names for the early termination fees. Although disclosure methods varied in some instances based on the distribution model (e.g. additional disclosure for broker-originated loans), the method of disclosure was generally the same irrespective of the fee structure.

17 Less than 1% of instances where an early termination fee had been charged since 1 July 2010 resulted in a complaint to lenders, with more than half of these complaints resulting in the early termination fee being waived or reduced through internal dispute resolution (IDR) or external dispute resolution (EDR).

18 During our review we also identified a number of factors which increased the likelihood of early termination fees being declared unfair or unconscionable. Recommendations on how lenders can reduce the likelihood of early termination fees being declared unfair or unconscionable are summarised in Table 1.

Table 1: Recommendations for lenders

Topic	Our recommendations
Losses recovered See Section B	***Recommendation 1: Recoverable losses*** In two instances, lenders reported losses (e.g. servicing costs and trail commissions) that did not appear to be either unrecovered establishment costs or losses arising from early termination. Seeking to recover such losses through early termination fees increases the likelihood of the early termination fees being declared unconscionable. Lenders can reduce the likelihood of having an early termination fee declared unconscionable by ensuring their early termination fees only seek to recover unrecovered establishment costs or losses identified in RG 220. ***Recommendation 2: Verification of losses*** Fifteen out of the 20 lenders did not retain any discrete records of unrecovered establishment costs, or verification of unrecovered establishment costs, for the purposes of calculating losses from early termination. This increases the likelihood of having their early termination fees declared unconscionable or unfair. Best practice was to maintain discrete cost accounting records for unrecovered establishment costs, which are independently audited on a regular basis. ***Recommendation 3: Averaging of losses across all customers*** All lenders estimated their losses (and set their early termination fees) on a portfolio basis rather than on an individual loan basis. This included averaging establishment costs across the whole loan portfolio even where these costs appeared to differ substantively between loans (e.g. distinct differences in costs between specific products or sales channels, or for unusually large or small loans) and setting off any funds recovered in relation to individual loans (e.g. clawbacks of commissions paid to brokers or lenders' mortgage insurance premium refunds) against losses on a portfolio basis. This increases the likelihood of having individual early termination fees declared unconscionable. Lenders can reduce the likelihood of having an early termination fee declared unconscionable by ensuring any such cost differences or funds recovered are considered in the context of the individual loan being terminated early. Some lenders had additional practices in place which further reduced the likelihood of having their fees declared unconscionable, with best practice being to review fees on an individual loan by loan basis: see Recommendation 6.

Topic	Our recommendations
Early termination fee structures See Section C	***Recommendation 4: Non-reducing fees*** Thirteen lenders had early termination fees that did not reduce over the period the fee was payable. This increases the likelihood of recovering more than their losses arising out of the early termination where the early termination fee does not take into account the gradual recoupment of losses through other means (such as interest payments) over the time the loan is repaid. Lenders can reduce the likelihood of an early termination fee being declared unconscionable by ensuring the fee reduces over time to take into account other methods of loss recovery, or by ensuring that there is a sufficient buffer between the fee amount and the estimated losses. ***Recommendation 5: Fees calculated by reference to loan amount*** Fifteen lenders had early termination fees that were calculated by reference to the loan amount (i.e. proportionate), placing them at increased likelihood of having the fee declared unconscionable. This is because many of the losses that arise out of early termination are fixed and do not increase relative to the size of the loan. A proportionate early termination fee is therefore more likely to exceed the losses it is aimed at recovering, particularly for larger loans. Lenders can reduce the likelihood of having a proportionate early termination fee declared unconscionable by capping the total fee amount payable. ***Recommendation 6: Individual fee assessment*** Some lenders had specific practices which reduce the likelihood of their early termination fees being declared unconscionable. Best practice was to review each individual early termination to ensure that the early termination fee did not exceed a reasonable estimate of the lender's losses. ***Recommendation 7: Early termination fees on refinanced loans*** Most lenders waive early termination fees on loans where the consumer internally refinances into a new loan with the lender. Where existing clients refinance into a new loan, lenders will not necessarily incur the same level of establishment costs as they would for a new loan for a new client. Lenders can reduce the likelihood of having an early termination fee declared unconscionable on a loan resulting from an internal refinance by ensuring that the early termination fee takes into account any reduced establishment costs for the loan.
Fee disclosure See Section D	***Recommendation 8: Transparency of early termination fees payable*** Lenders generally did not provide any additional disclosure for more complex early termination fee structures than for simpler fee structures, increasing the likelihood of having their early termination fees declared unfair. Two lenders reduced this risk by giving consumers before loan settlement a worked example setting out in dollar terms the fee that would be payable on early termination of their specific loan.

Further work

19 We are following up specific concerns identified in our review with individual lenders. Following initial discussions, several lenders have made changes to their fee structures (e.g. reduction to fee amounts and/or period for which fees apply), and/or will be reviewing early termination fees to be charged in the

future on a loan by loan basis to ensure they do not exceed a reasonable estimate of the losses arising from early termination.

20 We encourage other lenders to review their early termination fees in light of the findings in this report.

21 Due to the prohibition on early termination fees on new loans from 1 July 2011, and the decision by some lenders to remove early termination fees on pre-existing loans, the number of loans to which an early termination fee is applicable will diminish over time as borrowers repay or refinance these loans.

A Background

Key points

The National Credit Act transferred regulatory responsibility for consumer credit to ASIC from 1 July 2010. Unfair contract terms provisions were also inserted into the ASIC Act commencing 1 July 2010.

In November 2010, we provided guidance in RG 220 on our regulation of early termination fees. We then undertook a review of how lenders were complying with their obligations following publication of RG 220 and what, if any, changes lenders had made to their early termination fees since 1 July 2010.

What is an early termination fee?

22 Early termination fees are fees payable when a loan is repaid in full before the end of the loan term. Before 1 July 2011, it was general industry practice for new residential loans to have an early termination fee, which would be payable if the loan was repaid in the first three to five years.

23 Early termination fees do not include fees that are payable regardless of when the loan is terminated, such as standard discharge fees.

24 Industry used many terms for fees that substantively sought to recover the same losses (e.g. early repayment fee, deferred establishment fee, deferred administration fees, and deferred settlement fees). However, there are some early termination fees that recover substantively different losses, such as break fees payable for the early repayment of fixed rate loans.

Our earlier report on mortgage entry and exit fees

25 In 2008, at the request of the Treasurer, we conducted an industry review of entry fees and early termination fees that applied to residential loans. The review looked at 298 residential loan products on the basis of a $250,000 loan taken out for 25 years, but refinanced after three years. The review found that early termination fees were charged on a number of different bases, including:

(a) a set fee amount (flat fee);

(b) a percentage of the original loan amount; and

(c) by reference to a number of monthly payments (e.g. an early termination fee may be equivalent to three monthly repayments).

26 Report 125 *Review of mortgage entry and exit fees* (REP 125) found that:

> … as the prevalence and level of early termination fees has grown, some do not appear to be related to the underlying costs they are purporting to recover. This is potentially so for early termination fees that are a fixed percentage of the total amount financed, or a multiple of the monthly repayment amount.

27 REP 125 noted that there had been few cases 'where entry or exit fees have been challenged on the grounds of unconscionability'. This was attributed, at least in part, to the fact that state agencies did not have standing to make applications in relation to s72 of the UCCC and, therefore, in relation to unconscionable fees, including early termination fees. REP 125 noted that the 'cost and uncertainty of litigation relative to the sums involved might mitigate against individual consumers taking action'.

Legislation and guidance

National Credit Code

28 Before 1 July 2010, early termination fees were regulated under s72(4) of the state and territory-based UCCC, which provided that a fee or charge payable on early termination of a contract was unconscionable if it exceeded a reasonable estimate of the credit provider's loss arising from the early termination, including the credit provider's average reasonable administrative costs of the termination.

29 In July 2010, the National Credit Code commenced as Sch 1 to the National Credit Act, replacing the UCCC, and ASIC commenced responsibility for administering the new laws.

30 The National Credit Code applies to all consumer credit contracts entered into from 1 July 2010, including residential property loans for investment purposes. Consumer credit contracts entered into before 1 July 2010 are generally also regulated under the National Credit Code, with the exception of residential property loans for investment purposes, which were not previously regulated under the UCCC.

31 Section 78(4) of the National Credit Code replicates the wording of s72(4) of the UCCC and maintains the status quo for when a court may consider an early termination fee to be unconscionable.

32 Under s66 of the National Credit Code, a lender can unilaterally change the amount of a fee or the frequency or time of payment (except for fixed rate loans). However, in making any changes, lenders should consider whether the change, particularly if it is an increase, could be considered unjust under s76 of the National Credit Code, or the new fee considered unconscionable or unfair.

33 Under s79 of the National Credit Code, ASIC can take representative actions on behalf of consumers for the charging of unconscionable fees or unjust changes to credit contracts.

ASIC Act: Unfair contract terms

34 On 1 July 2010, unfair contract term provisions were included in the ASIC Act as Subdiv BA of Div 2, Pt 2. These provisions generally apply to standard form consumer credit contracts regulated by the ASIC Act.

35 The unfair contract term provisions render a term of a consumer credit contract void if:

(a) the term is unfair;

(b) the contract is a standard form contract; and

(c) at least one of the parties to the contract is an individual and credit is obtained wholly or predominantly for personal, domestic or household use or consumption.

36 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.

37 In determining whether a term is unfair, a court must take into account the extent to which the term is transparent as well as the contract as a whole.

38 The unfair contract term provisions in the ASIC Act have effect from 1 July 2010, and only apply to contracts entered into or renewed, or terms of a contract that are varied, from that date.

Our guidance on early termination fees

39 On 27 June 2010, we issued Consultation Paper 135 *Mortgage early exit fees: Unconscionable fees and unfair contract terms* (CP 135). We sought feedback on whether we should provide regulatory guidance on early termination fees and what form any guidance should take. Report 216 *Response to submissions on CP 135 Mortgage exit fees: Unconscionable fees and unfair contract terms* (REP 216) highlights the key issues arising out of the submissions received. The submissions can also be found on our website under CP 135 at www.asic.gov.au/cp.

40 In November 2010, we released RG 220. RG 220 provides guidance on both s78(4) of the National Credit Code and the unfair contract terms provisions of the ASIC Act. It outlines our views on the circumstances in which an early termination fee may be considered unconscionable and/or unfair.

41 During the course of this review, some lenders expressed the view that their deferred establishment fees were not early termination fees that would be subject to s78(4) of the National Credit Code, but rather were establishment fees under s78(3). This issue was considered in formulating our guidance in RG 220 and we ultimately arrived at the view expressed at RG 220.38 that we will administer the law on the basis that generally a deferred establishment fee is a fee payable on early termination to which the test in s78(4) applies.

Early termination fee prohibition

42 On 23 March 2011, reg 79A was inserted into the National Consumer Credit Protection Regulations 2010 by the National Consumer Credit Protection Amendment Regulations 2011 (No. 2). Regulation 79A prohibits a fee being charged on termination of a credit contract for contracts entered into from 1 July 2011 when the credit contract is secured over residential property. The prohibition does not apply to break fees, discharge fees or fees that are charged before the termination of a credit contract when the contract is terminated before any credit is provided.

43 The prohibition does not apply to loans that were entered into before 1 July 2011 for which a fee is payable on early termination. Therefore, an early termination fee may still be payable on these loans after 1 July 2011.

Methodology of our review

44 Following publication of RG 220, we undertook to review how lenders were complying with their obligations to see what, if any, changes lenders had made to their early termination fees since 1 July 2010.

45 We selected 20 lenders to review. These lenders were chosen to cover a broad cross-section of lenders including both ADI and non-ADI lenders. The lenders covered a range of business sizes, funding models and fee structures. We specifically included lenders who had higher early termination fees compared to their peers, according to data from an online loan comparison site.

46 In February 2011, we sought information from the selected lenders on:

(a) the losses that they sought to recover by their early termination fees, and how these losses were verified;

(b) how early termination fees were levied, including fee structures and when they are payable;

(c) the number of loans on which an early termination fee would have been payable, by fee structure, if the loan was terminated;

(d) the number of early termination fees charged, by fee structure, since 1 July 2010;

(e) the changes that lenders had made to early termination fees since the introduction of the National Credit Act and the National Credit Code, and the introduction of unfair contract terms legislation on 1 July 2010;

(f) other methods of cost recovery and how early termination fees take this into account;

(g) early termination fee disclosure; and

(h) the incidence and result of complaints about early termination fees.

47 Our review did not cover other types of fees that may be charged on the termination of a loan. It also did not cover fees that may be charged on termination of other types of loans (i.e. loans other than variable rate residential loans). Specifically, the review did not cover:

(a) break fees on fixed rate loans; and

(b) discharge fees (that are paid regardless of whether the loan is terminated early).

48 Our review did not consider the rationale for early termination fees or the impact of the prohibition on early termination fees. The review also did not seek to determine if any fee was unconscionable. The focus was to assess how lenders were seeking to comply with their obligations following publication of our guidance in RG 220.

49 We analysed the data provided to identify trends and areas where there appeared to be an increased likelihood that a lender's early termination fees might exceed a reasonable estimate of its losses. Where this was the case, we made further inquiries of the relevant lender.

50 We identified lenders who had higher costs, either in total or for particular cost items, when compared to their peers. Where this was the case, we made further inquiries of the relevant lenders to assess the reasonableness of these estimates.

51 We also compared the data provided by lenders with information collected by Fujitsu Consulting as part of its quarterly *Australian Mortgage Industry* reports. There are some limitations on such a comparison, including that Fujitsu provided us with information on the range of costs for broad lender categories and did not provide us with the names of the lenders for which they collected data, nor was the data collected with a view to assessing compliance with the National Credit Act or ASIC Act. We adjusted the Fujitsu data by excluding cost items that would not appear to be lawfully recoverable by an early termination fee and third party payments (which we could verify through other means). After these adjustments, the responses from most lenders fell within the range of costs provided by Fujitsu.

52 We also tested the fee structures and cost estimates provided by lenders to identify circumstances where lenders' fees were more likely to exceed their own cost estimates.

B Losses recovered

Key points

We found that lenders generally only sought to recover the types of losses we identified in RG 220.39–RG 220.44.

We found that larger lenders generally had more robust processes in place to verify losses recovered through early termination fees, with some smaller lenders not keeping records of how they set their early termination fees or verified the losses they sought to recover through early termination fees.

We found that, on a portfolio basis, lenders' early termination fees generally recovered less than their reported losses arising from early termination. However, there were circumstances where some lenders were estimating losses in a manner that increased the likelihood of recovering amounts exceeding a reasonable estimate of their losses on individual loans.

Type of losses recovered

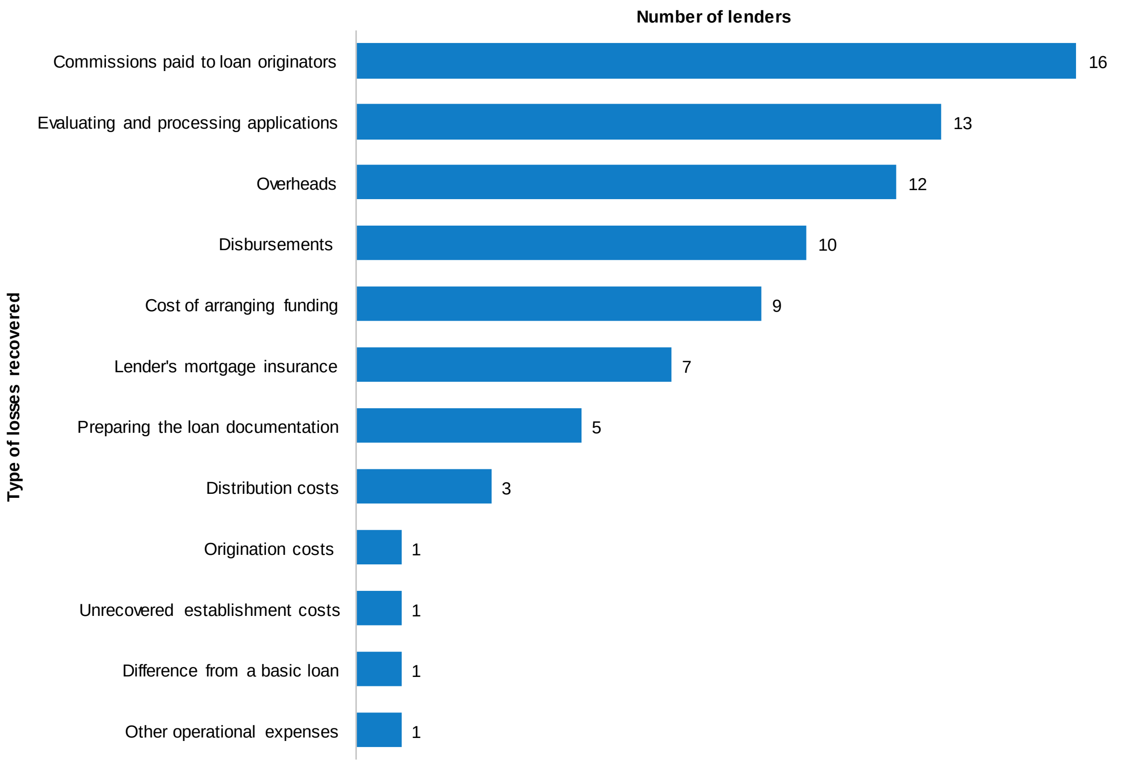
53 We asked lenders to itemise and quantify the losses they recover through early termination fees. Many lenders elected to frame their responses in terms of the losses we identified in RG 220.39–RG 220.44. Losses claimed were largely for unrecovered establishment costs, rather than for other losses from the early termination of the loan.

54 There were some inconsistencies in the way that lenders reported their losses. Some lenders appeared to have reported their total establishment costs, rather than the proportion of establishment costs that are not otherwise recovered. Furthermore, some lenders reported their establishment costs on a per-product basis, while others were able to do so only on a portfolio basis. Finally, some lenders expressed their establishment costs purely as a percentage of the credit provided, even though some costs would not be related to the amount of credit provided (i.e. fixed costs).

55 A total of 12 types of costs and losses recovered through early termination fees were identified by the 20 lenders, including commissions paid to loan originators, costs associated with evaluating and processing loan applications and overhead costs.

56 We did not provide lenders with a list of defined loss categories as part of our approach, to allow them to characterise their own cost structure. Accordingly, it is possible that the use of some of the categories was not consistent across all lenders, or that some lenders combined what others considered as several types of losses recovered under the one category. Figure 1 illustrates the frequency of losses reported by the 20 lenders that took part in our review.

Figure 1: Frequency of types of losses reported by the 20 lenders in our review



57 In general, lenders only reported recovering the types of losses that we had identified at RG 220.39–RG 220.44. However, we encountered two cost items we consider are unlikely to be recoverable under an early termination fee.

58 Initially, it appeared that one lender was seeking to recover servicing costs through its early termination fees. Servicing costs are an ongoing cost, rather than an establishment cost or cost arising from early termination, and are therefore not mentioned in RG 220 as a cost that we consider can be recovered through early termination fees. The lender later clarified that it did not recover servicing costs through early termination fees.

59 Another lender stated that it recovers trail commissions through early termination fees. Trail commissions, in contrast to upfront commissions, are not paid at establishment by lenders and are only payable for the period a loan is on foot. When the loan is terminated, lenders cease to pay trail commissions. While it is therefore unlikely that trail commissions would be a loss recoverable under an early termination fee, to the extent a lender may suffer a loss through payment of trail commissions, that loss is likely to be specific to the individual loan on which the commission was paid. Concerns relating to the averaging of losses are outlined in paragraphs 72–74 and Recommendation 3.

60 Five out of 20 lenders reported that they recovered previously paid broker commissions through clawback arrangements in some circumstances when a loan is terminated early. To the extent that costs or losses are recovered through other means, such as commission clawback arrangements or lenders' mortgage insurance refund arrangements, they should not be recovered through early termination fees: see RG 220.41.

Recommendation 1: Recoverable losses

In two instances, lenders reported losses (e.g. servicing costs and trail commissions) that did not appear to be either unrecovered establishment costs or losses arising from early termination. Seeking to recover such losses through early termination fees increases the likelihood of the early termination fees being declared unconscionable.

Lenders can reduce the likelihood of having an early termination fee declared unconscionable by ensuring their early termination fees only seek to recover unrecovered establishment costs or losses identified in RG 220.

Verification of losses

61 RG 220.47 states that lenders should keep a record of how they calculate their early termination fees. We think that a lender that does not maintain records and verify its estimates is at greater likelihood of charging a fee that exceeds its losses from early termination and is therefore unconscionable or unfair. Accordingly, we asked lenders to provide estimates of their losses from early termination, as well as details of how and when they last verified these estimates.

62 Fifteen out of 20 lenders did not have detailed records from when the fees were set. Instead, these lenders attempted to reconstruct their establishment costs from historical records, and their understanding of how their business and the industry operated at that time. Generally, larger lenders had more detailed cost accounting records and were more likely to have had these records independently audited.

63 Some smaller lenders stated that it was not practical for a business of their size to devote resources to recording establishment costs as discrete from their other operating costs. This placed them at increased likelihood of not being able to demonstrate that their early termination fees did not exceed a reasonable estimate of their loss arising from early termination.

64 The most common way for lenders to estimate establishment costs was to rely on information recorded in financial statements and cost accounting records. Lenders generally allocated the full amount of expenses wholly associated with mortgage origination (e.g. payments to finance brokers) to establishment cost estimates.

65 Lenders generally also allocated a portion of expenses shared between mortgage origination and other business functions (e.g. staff costs) to establishment cost estimates. Where costs were split between origination and servicing costs, lenders generally estimated the split as they did not keep records of how shared expenses were divided between mortgage origination and other business functions.

66 There is a greater likelihood of a lender's early termination fee being declared unconscionable if the lender overestimates the proportion of their costs attributable to mortgage origination, for example, where the proportion of overhead costs attributed to loan origination for a specific period exceeds the proportion of loans originated in that period.

Recommendation 2: Verification of losses

Fifteen out of 20 lenders did not retain any discrete records of unrecovered establishment costs, or verification of unrecovered establishment costs, for the purposes of calculating losses from early termination, increasing the likelihood of having their early termination fees declared unconscionable or unfair.

Best practice was to maintain discrete cost accounting records for unrecovered establishment costs, which are independently audited on a regular basis.

Amount of losses

67 The amount of losses reported ranged significantly. The level of establishment costs incurred appeared to depend on a number of factors, including the lender's funding model, lending volumes and levels of commissions paid to loan originators. However, where lenders had costs that appeared to be significantly higher than those reported by what we considered to be other similar lenders, they were asked to provide further explanation.

68 ADIs tended to claim lower amounts of establishment costs than non-ADI lenders. The differences between ADIs and non-ADIs appear to be driven by the following factors:

(a) Non-ADIs reviewed generally reported higher amounts of commissions paid to third parties. Generally, the ADIs reviewed did not include an amount for commissions, with two ADIs stating that they did not pay commissions to third parties. However, the ADIs that provided wholesale funding to mortgage managers reported commissions for these products.

(b) Non-ADIs generally reported higher per loan overhead costs.

(c) Non-ADIs reported costs associated with establishing securitisation arrangements. Among ADIs, only those providing wholesale funds to mortgage managers reported securitisation costs.

(d) Some Non-ADIs were more likely to report higher costs associated with the credit assessment of loans to borrowers who did not meet standard lending criteria (e.g. self-employment, poor credit history).

69 In addition, some non-ADIs stated that fixed costs, such as overheads, had increased significantly on a per loan basis due to a decrease in lending volumes following the 2008 global financial crisis. As noted in paragraph 66, there is a greater likelihood of a lender's early termination fee being declared unconscionable if the lender overestimates the proportion of their overhead costs attributable to mortgage origination.

70 We compared the data provided by lenders with information collected by Fujitsu Consulting as part of its quarterly *Australian Mortgage Industry* reports. There are some limitations on such a comparison, including that Fujitsu provided us with information on the range of costs for broad lender categories and did not provide us with the names of the lenders for which they collected data, nor was the data collected with a view to assessing legal compliance. We adjusted the Fujitsu data by excluding cost items that would not be lawfully recoverable by an early termination fee and third party payments (which we could verify through other means). After these adjustments, the responses from most lenders fell within the range of costs provided by Fujitsu.

71 On a portfolio basis, lenders' early termination fees generally did not recover the full amount of their reported losses arising from early termination.

Use of average losses

72 Lenders estimated their unrecovered establishment costs on an average or portfolio basis, rather than on an individual loan basis. For example, some lenders took their estimated total unrecovered establishment costs and divided them by the number of loans either in their entire portfolio or for a given class of loans to arrive at an average dollar cost per loan. Other lenders divided their estimated total unrecovered establishment costs by the dollar value of loans originated to arrive at average percentage costings per loan.

73 Some individual cost items, such as overhead costs, tend to be a fixed amount per loan while other cost items, such as commissions paid to originators, tend to be proportionate to the amount of credit provided. We note that the test for unconscionability under s78(4) of the National Credit Code is based on a lender's reasonable estimate of losses arising from early termination of an individual credit contract, rather than the lender's estimate of its average losses for its portfolio of loans. While s78(4) of the National Credit Code permits the averaging of administrative costs in all cases, other averaging of losses may only be applied to the extent it is consistent with a reasonable estimate. To ensure they are not charging more than is allowable under s78(4), lenders should consider the circumstances of particular credit

contracts in some cases (e.g. where there has been a commission clawback, a refund of lenders' mortgage insurance premiums, distinct differences in costs between specific products or sales channels, or for unusually large or small loans).

74 Additionally, some costs in establishing a loan, such as sales commissions, are not administrative in nature. Lenders that average non-administrative costs across a portfolio, and average the recovery of such costs (e.g. through commission clawbacks), are at increased likelihood of having early termination fees declared unconscionable for some individual loans.

Recommendation 3: Averaging of losses across all customers

All lenders estimated their losses (and set their early termination fees) on a portfolio basis rather than on an individual loan basis. This included averaging establishment costs across the whole portfolio even where these costs appeared to differ substantively between loans (e.g. distinct differences in costs between specific products or sales channels, or for unusually large or small loans) and setting off any funds recovered in relation to individual loans (e.g. commission clawbacks or lenders' mortgage insurance premium refunds) against losses on a portfolio basis. This increases the likelihood of having individual early termination fees declared unconscionable.

Lenders can reduce the likelihood of having an early termination fee declared unconscionable by ensuring any such cost differences or funds recovered are considered in the context of the individual loan being terminated early.

Some lenders had additional practices in place which further reduced the likelihood of having their fees declared unconscionable, with best practice being to review fees on an individual loan by loan basis: see Recommendation 6.

C Early termination fee structures

Key points

Early termination fee structures varied widely, with a high degree of variability not only between lenders, but also between different products by the same lender. There were instances where fee structures appeared to be tailored to particular distribution models (e.g. direct versus broker).

Fee structures are more likely to be declared unconscionable when they do not reduce over time to take into account the gradual recovery of establishment costs, do not take into account other methods of cost recovery such as commission clawbacks or lenders' mortgage insurance refunds, or are calculated on a purely proportionate basis without any capping.

A number of lenders had varied or abolished early termination fees. Most lenders indicated that this was due to compliance with the National Credit Code or a response to competition.

Number of early termination fees

75 In total, the lenders we surveyed charged an early termination fee on approximately 75,000 occasions between 1 July 2010 and 15 February 2011. The number of early termination fees charged varied across lenders, with ADI lenders accounting for just under 91% of early termination fees charged.

76 There were approximately 1.5 million loans on which an early termination fee would have been payable at 15 February 2011. Nearly 95% of these loans were provided by ADI lenders.

77 We note that proportionately, the instances of early termination fees paid and payable were roughly consistent between ADIs and non-ADIs across the two samples. We chose to use the larger sample of early termination fees payable as at 15 February 2011 as the base for our analysis of early termination fee structures.

How early termination fees are structured

78 We asked each lender to provide a description of the early termination fee structures they used across their residential loans. Seven lenders only had loans for which a single early termination fee structure was applicable. However, thirteen lenders used a number of different early termination fee structures across their product portfolios.

79 We divided the early termination fee structures we reviewed into the following categories:

(a) fixed dollar fees;

(b) proportionate fees; and

(c) combination fees.

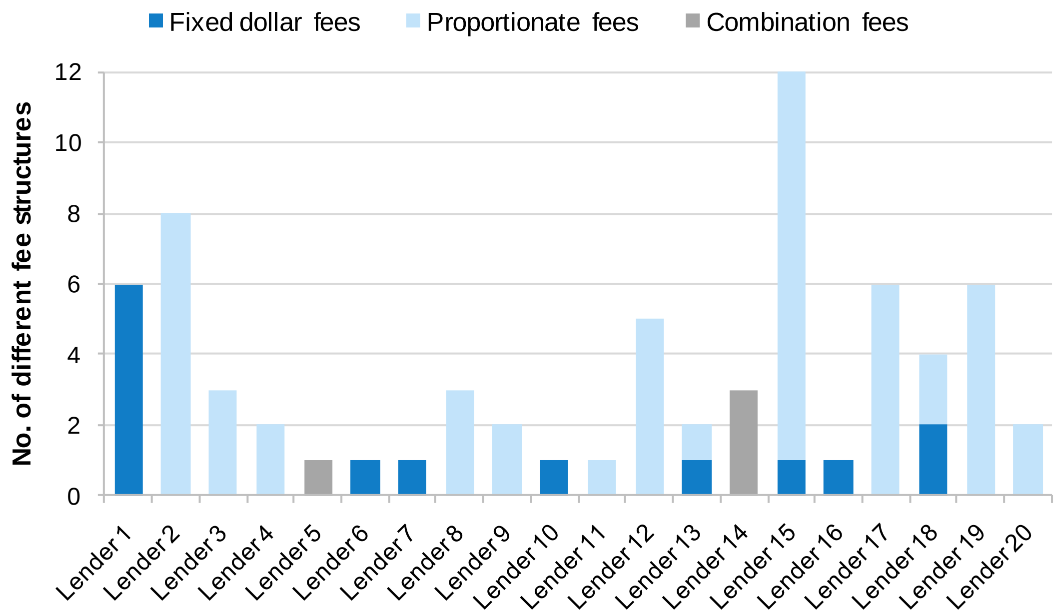
See Table 2 for an explanation of these fees.

Table 2: The three categories of early termination fee structures used by lenders reviewed

Category	Description	Examples
Fixed dollar fees	A set early termination fee charged regardless of the size of the loan. It may be a flat dollar amount or the amount may reduce over the period of the loan (usually over the first three to five years).	• One lender used an early termination fee of $1000, payable if the loan was terminated within four years of origination. • Another lender used an early termination fee that was structured at a reducing rate of $2000 in years one and two, $1000 in year three and $500 in year four.
Proportionate fees	This early termination fee is based on the size of the loan amount. It may be determined by reference to a percentage of the loan amount, or by reference to a number of monthly repayments (and, in some cases, only the interest component of those repayments). It may be a flat percentage or a set number of repayments, or the percentage or number of repayments may reduce over the time the fee is payable.	• One lender charged an early termination fee of 1.5% of the original loan amount if the loan was terminated at any time within five years of origination. • Another lender charged an early termination fee that consisted of four monthly repayments in years one to three and three monthly repayments in years four to five.
Combination fees	This early termination fee is a hybrid of the fixed dollar fee category and the proportionate fee category.	• An example of this arrangement is a lender charging an early termination fee applicable for four years from loan origination based on a reducing percentage of the original loan amount (e.g. year one: 0.8%, year two: 0.6%, year three: 0.4%, year four: 0.2%) in addition to a non-reducing fixed dollar fee. • Another example is a lender charging an early termination fee that is the greater of a fixed amount or a certain number of monthly repayments, payable for four years from loan origination.

80 Figure 2 represents the incidence of each of the three categories of early termination fees across the 20 lenders reviewed. We have treated each early termination fee structure used by lenders as a separate incidence. If a lender used exactly the same early termination fee structure over a number of products, this has been recorded as one early termination fee. Across the 20 lenders, we identified 70 unique early termination fee structures.

Figure 2: Number of early termination fee structures used by each lender

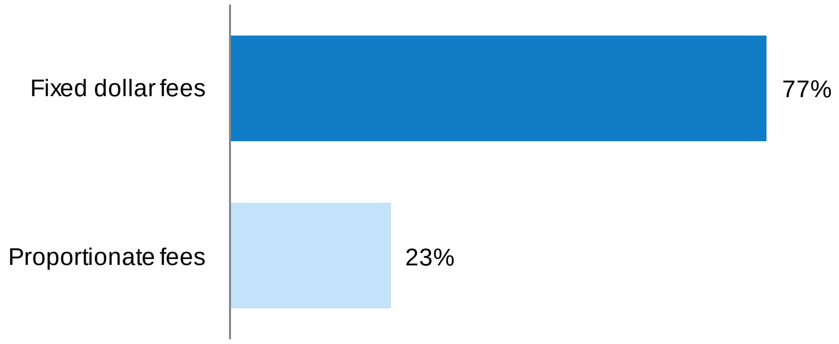


81 Three lenders used early termination fee structures that fell within more than one category, although many lenders used a range of early termination fee structures that varied within a particular category. However, a higher incidence of early termination fee structures did not necessarily indicate that the particular lender funded more loans than other lenders, with non-ADI lenders generally having a higher incidence of early termination fee structures.

82 In some instances where loans appeared to be funded through securitisation arrangements, there appeared to be a greater tailoring of early termination fees to particular distribution methods, and the particular costs and losses that flow from each method. Some lenders also suggested that early termination fee structures were set or changed to accommodate specific consumer preferences, such as an inability to pay an establishment fee upfront.

83 Figure 3 represents the percentage of loans, by early termination fee category, for which an early termination fee would have been payable if the loan was terminated on 15 February 2011 (loans subject to a combination early termination fee are not included due to the low number of loans).

Figure 3: Percentage of total loans on which an early termination fee would have been payable if the loan was terminated on 15 February 2011 (by fee structure category)

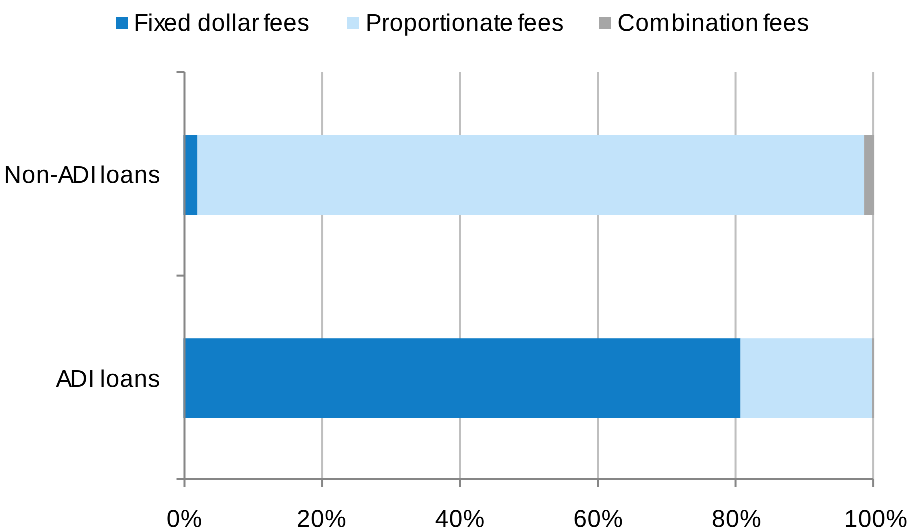


84 Although proportionate fees represented the highest number of unique early termination fee structures used by lenders, this category of fees was only applicable to approximately 23% of loans. Most loans on which an early termination fee would have been payable if terminated on 15 February 2011 would have incurred a fixed dollar early termination fee.

85 We note that a small number of ADI lenders provided the vast majority of the loans we reviewed for which an early termination fee was payable, which supports the higher incidence of loans in the fixed dollar fee category—the category predominantly used by ADI lenders in our review.

86 Figure 4 depicts the proportion of loans for each early termination fee category for the total loans provided by ADI and non-ADI lenders. Non-ADI loans represent 5% of total loans and ADI loans represent nearly 95% of total loans.

Figure 4: Proportion of loans by early termination fee category for ADI and non-ADI lenders



87 Among the loans provided by ADI lenders, approximately 81% fell within the fixed dollar fee category. Of the total loans subject to a fixed dollar early termination fee, more than 99% were based on fixed dollar fees that did not reduce over the period during which the early termination fee was payable.

88 Non-ADI lenders were more likely to use a proportionate early termination fee structure (over 96% of non-ADI loans where an early termination fee was payable) where the amount of the early termination fee is derived by reference to the loan amount.

89 Generally, we found that the early termination fee structures of ADI lenders were less complex than non-ADI lenders. We also found that early termination fees for ADI lenders were generally lower than for non-ADI lenders, and some of the larger fixed dollar and proportionate early termination fees were used by non-ADI lenders. These general findings are discussed in more detail below.

Fixed dollar fees

90 Eight lenders (six ADI and two non-ADI) charged early termination fees that fell within the fixed dollar fee category. One of these lenders had ceased to charge its fixed dollar early termination fee on all loans for which the fee applied (new and existing) by the time of our review, although the lender was still charging other types of early termination fees on other loans.

91 Early termination fees in the fixed dollar fee category accounted for approximately 77% of loans on which an early termination fee would have been payable if the loan was terminated on 15 February 2011. The fixed dollar fee category can be further sub-divided into loans where the early termination fee was a non-reducing fixed dollar amount and loans where the early termination fee was a reducing dollar amount. As stated above, more than 99% of loans subject to a fixed dollar early termination fee had an early termination fee that did not reduce over the period during which the fee was payable.

92 Non-reducing fixed dollar early termination fees ranged from $700 to $2795, and were generally charged in the first four to five years. Four ADI lenders and two non-ADI lenders charged non-reducing fixed dollar early termination fees.

93 Table 3 demonstrates the range of non-reducing fixed dollar early termination fees, split between ADI and non-ADI lenders.

Table 3: Range of non-reducing fixed dollar early termination fees for ADI and non-ADI lenders

	ADI (four lenders)	Non-ADI (two lenders)
Minimum	$700	$750
Maximum	$1000	$2795

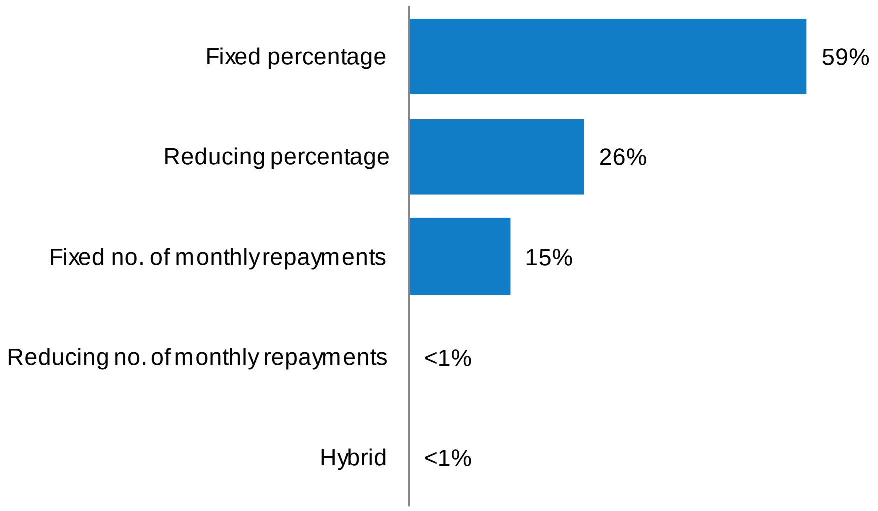
94 Although the sample sizes for Table 3 are relatively small and not intended to be indicative of ADI and non-ADI lenders generally, they do provide a useful snapshot of the ranges for non-reducing fixed dollar early termination fees that we encountered.

95 As few lenders we reviewed used a fixed dollar early termination fee that reduced over the period during which the early termination fee was payable, we have not included an analysis of this data and the applicable ranges.

Proportionate fees

96 Proportionate early termination fees had the highest number of unique structures among the lenders we reviewed, but accounted for approximately 23% of the total loans on which an early termination fee would have been payable if the loan was terminated on 15 February 2011. This category can be further broken down into sub-categories, depending on how the early termination fee is derived from the loan amount, as shown in Figure 5.

Figure 5: Proportionate early termination fees based on size of loan (or other cost) by sub-categories on a number of loans basis



Note: Data for this chart is based on information provided by 19 of the 20 lenders reviewed. We were unable to include the loan data from one lender who did not split the number of loans between its early termination fees that were based on a fixed number of monthly repayments and those based on a reducing number of monthly repayments. The loans from this lender represented less than 1% of loans with proportionate early termination fees.

97 The sub-categories we identified are:

(a) a fixed percentage of the loan amount that does not reduce over the period during which the early termination fee is payable;

(b) a percentage of the loan amount that reduces over the period during which the early termination fee is payable;

(c) the value of a set number of monthly repayments (or the interest component of the repayments);

(d) the value of a number of monthly repayments (or the interest component of the repayments), with the number of monthly repayments that determine the early termination fee reducing over the period during which the early termination fee is payable; and

(e) a hybrid of the above.

98 As indicated in Figure 5, a proportionate early termination fee was most likely to be based on a fixed percentage of the original loan amount.

99 In total, 13 lenders used proportionate early termination fees (four ADI lenders and nine non-ADI lenders).

100 Loans from ADI lenders made up nearly 78% of the loans represented in Figure 5, of which approximately 75% related to a fixed percentage, and 25% to a reducing percentage, early termination fee. Non-ADI loans made up approximately 22% of loans in Figure 5. 69% of these related to an early termination fee based on a fixed number of monthly payments and 29% on a reducing percentage. The remaining 2% of non-ADI loans were spread across the other three types (fixed percentage, reducing number of monthly repayments and hybrid).

101 Fixed percentage early termination fees ranged from 0.5% to 4% of the original loan amount (although one lender based its fixed percentage early termination fee on the loan size at termination), and were generally applicable for two to five years from loan commencement. Three ADI lenders and five non-ADI lenders charged a fixed percentage early termination fee. One of these lenders included a cap that prevented the early termination fee from exceeding a specified dollar amount.

102 Reducing percentage early termination fees ranged from a maximum of 4% of the original loan amount in year one to a minimum of 0.15% in the final year in which the early termination fee was applicable. In contrast, the lowest percentage early termination fee in year one was 0.4% and the highest in the final year was 3%, which in that case was year three, although this fee structure had been discontinued on new loans before 1 July 2010. A further breakdown of ranges for reducing percentage early termination fees can be seen in Table 4.

Table 4: Range of proportionate early termination fees for ADI and non-ADI lenders based on reducing percentage

		ADI (two lenders)	Non-ADI (five lenders)
Minimum	Year one	0.70%	0.40%
	Final year	0.15% (year four)	0.20% (year five)
Maximum	Year one	1.8%	4%
	Final year	1.5% (years four–five)	3% (year three)

103 In all cases, the percentages refer to the original loan amount. Seven lenders (two ADI and five non-ADI) used a proportionate early termination fee based on a reducing percentage of the original loan amount. As the sample is relatively small, Table 4 is not intended to be indicative of ADI and non-ADI lenders in general, but rather a snapshot of some of the lenders we reviewed.

104 Three lenders (all non-ADI) used an early termination fee structure that was based on a number of monthly repayments (fixed or reducing number). Where the number of repayments was fixed (two lenders), the early termination fee ranged from one and a one-half to four monthly repayments. Where the number of repayments reduced, the early termination fee ranged between three and four monthly repayments in year one and one and three monthly repayments in the final year in which the early termination fee was applicable

105 We included one lender in the proportionate fee category that charged an early termination fee based on the upfront commission the lender paid in respect of the loan. The percentage of the commission that was payable as the early termination fee reduced over time from 100% in year one to 75% in year two, 50% in year three and 25% in year four.

106 Two lenders used a hybrid proportionate fee (e.g. where the fee was either a percentage of the loan amount or a certain number of months interest payments, depending on when the loan was terminated).

Combination fees

107 Two lenders charged early termination fees (one ADI and one non-ADI lender), which were a combination of fixed dollar and proportionate fees, with multiple components applicable depending on when the loan is terminated (e.g. a percentage of the loan amount plus a fixed dollar amount). As there are few early termination fee structures in this category, and the structures differ substantially, we have not provided further analysis of this category.

Time period for charging fees

108 In general, early termination fees applied when a loan was terminated in the first three to five years, although some lenders had fees which applied for longer periods. Not all lenders explained why they chose this time period, with those that did most commonly citing market or competitive forces.

109 We expect that lenders will recover establishment costs through other means (such as interest payments) as well as early termination fees. To the extent that establishment costs have been recovered through interest payments, they should not be recovered through early termination fees.

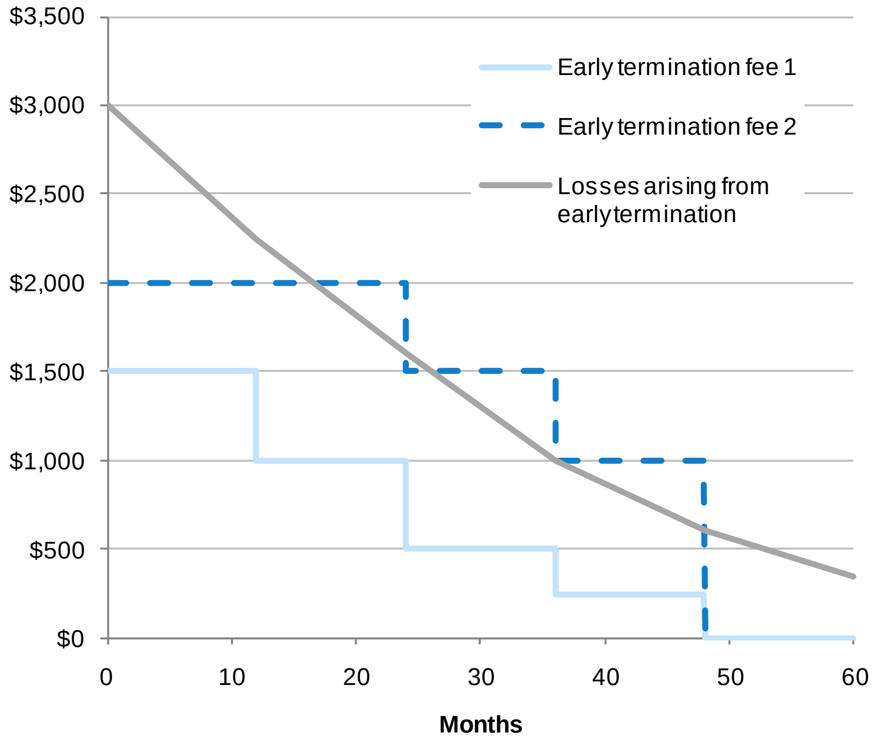
Our analysis of early termination fee structures

110 Some early termination fee structures are more likely to result in the lender recovering more than a reasonable estimate of its loss. This may be

particularly the case for lenders that use early termination fees that do not take into account other methods of loss recovery, including some early termination fees that do not reduce over time. These fees are at increased likelihood of not accounting for the incremental recouping of unrecovered establishment costs through other methods, such as interest payments. RG 220.41 notes that a loss 'is not suffered if an amount reflecting that loss has already been recovered'.

111 Figure 6 gives a hypothetical example of two reducing dollar amount fixed fee structures (i.e. the fees are staggered to reduce over time). The losses arising from early termination are also plotted and demonstrate the recoupment of losses over time through methods other than the early termination fee, such as through interest payments. Fee 1 is structured to avoid recovering more than a reasonable estimate of the lender's losses at all points in time by always keeping the early termination fee below its losses. However, Fee 2 is structured in a way that causes it to recover more than the lender's losses arising from early termination at certain points during which the fee applies.

Figure 6: Example of the incremental recoupment of costs over time compared with a reducing dollar amount fixed early termination fee

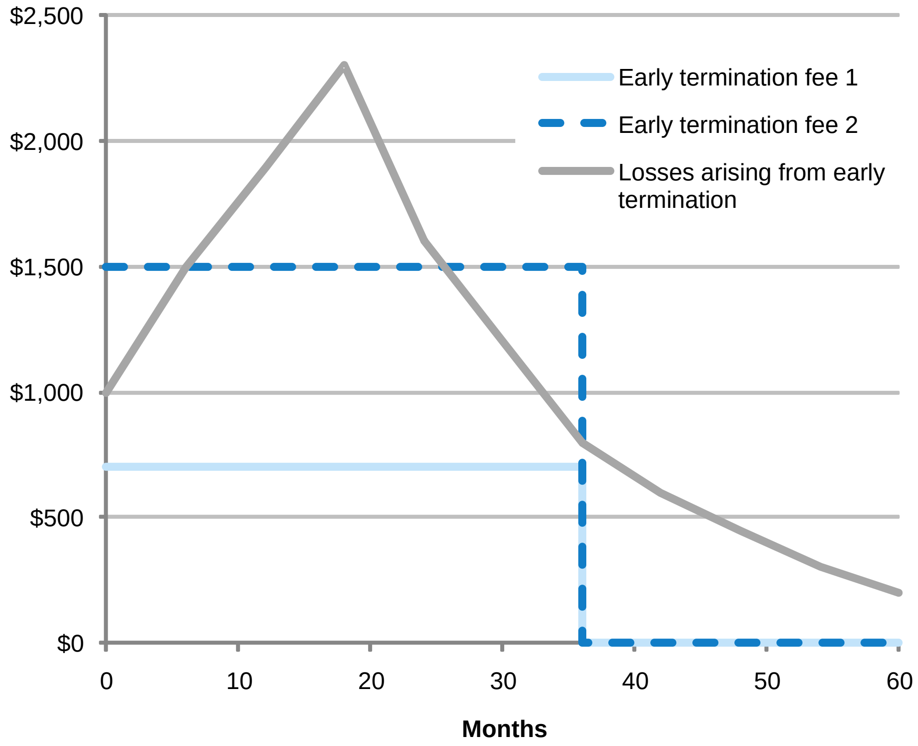


112 Some lenders have reduced the likelihood of their early termination fees exceeding a reasonable estimate of their losses by setting early termination fees well below their estimated losses and, importantly, structuring them so that they cease to apply at a point in time before they have fully recovered their losses through other means, such as interest payments. See, for example, Fee 1 in Figure 6.

113 Lenders that are able to claim the benefit of commission clawbacks or lenders' mortgage insurance refunds from the entities to which they were paid are often able to recoup these losses at greater levels in the early period during which the loan is on foot. For example, a lender may be able to recoup 80% of commission if the loan is terminated in the first six months, 50% in the following six months and so on, usually for a period of no longer than two years.

114 Lenders that recoup losses through refunds and clawbacks reduce the amount of loss that may lawfully be recovered through an early termination fee. Figure 7 demonstrates that the total losses that are recoverable from a borrower by charging an early termination fee may actually increase in the early period of a loan as the amounts recouped through other means (such as refunds) reduce (i.e. from point A to B in Figure 7). Lenders should ensure that, where they recoup losses through refunds and clawbacks, their early termination fee is adjusted to reduce the likelihood of it exceeding losses in the early period of the loan where the actual losses of the lender arising from early termination may be lower than they would be later on. See paragraph 73 on averaging these losses.

Figure 7: Example of the effect of refunds and clawbacks on losses arising from early termination in the early years of the loan compared with a fixed dollar fee



Note: The above figure demonstrates the hypothetical losses that arise out of early termination, taking into account commission and lenders' mortgage insurance amounts that are recouped from entities to whom these amounts were paid. These losses are recouped in larger amounts if the loan is terminated closer to origination. As time passes less of these losses can be recouped (as shown by the overall losses increasing from point A to B). In addition, losses are incrementally recouped through other means, such as loan repayments (as highlighted from point B to C).

115 Although Fee 1 is structured to avoid recovering more than the lender's losses arising out of early termination at all times, Fee 2 will recover more than the lender's losses at earlier and later periods during which the fee applies. When structuring early termination fees, lenders should ensure they take into account other methods of cost recovery, such as refunds, clawbacks and interest payments. For example, for the purposes of determining its losses, one lender reduced the likelihood of its early termination fee recovering more than its losses by assuming that the maximum amount of clawback on commissions was recovered and reducing its estimated loss and fee amounts as relevant over the period.

Recommendation 4: Non-reducing fees

Thirteen lenders had early termination fees that did not reduce over the period the fee was payable. This increases the likelihood of recovering more than their losses arising out of the early termination where the early termination fee does not take into account the gradual recoupment of losses through other means (such as interest payments) over the time the loan is repaid.

Lenders can reduce the likelihood of an early termination fee being declared unconscionable by ensuring the fee reduces over time to take into account other methods of loss recovery, or by ensuring that there is a sufficient buffer between the fee amount and their estimated losses.

116 We also note that, although commission payments are often the largest single loss item for a lender and are usually proportionate in size to the amount of the loan, other types of loss arising out of early termination are fixed and unlikely to increase in conjunction with the size of the loan. Proportionate early termination fees are therefore more likely to recover more than a lender's estimated losses arising out of early termination and be declared unconscionable, with a greater likelihood the larger the loan size.

117 For example, if a lender had an early termination fee of 1% of the loan amount payable when the loan was terminated during the early termination fee period, and the same lender estimated their losses from early termination to be $3,000, the early termination fee would be more likely to exceed that lender's loss estimate for loans over approximately $300,000.

118 We identified only one lender who imposed a cap on their proportionate early termination fees that prevented the fees from exceeding a certain dollar amount. The capping of early termination fees is one method by which lenders can reduce the likelihood of proportionate early termination fees exceeding a reasonable estimate of their losses.

Recommendation 5: Fees calculated by reference to loan amount

Fifteen lenders had early termination fees that were calculated by reference to the loan amount, placing them at increased likelihood of having the fee declared unconscionable. This is because many of the losses that arise out of early termination are fixed and do not increase relative to the size of the loan. A proportionate early termination fee is therefore more likely to exceed the losses it is aimed at recovering, particularly for larger loans.

Lenders can reduce the likelihood of having a proportionate early termination fee declared unconscionable by capping the total fee amount payable.

119 Another lender had in place a process to assess its early termination fees in light of each loan's circumstances to reduce the likelihood of its fees exceeding a reasonable estimate of its losses arising from individual loans.

Recommendation 6: Individual fee assessment

Some lenders had specific practices which reduced the likelihood of their early termination fees being declared unconscionable. Best practice was to review each individual early termination to ensure that the early termination fee did not exceed a reasonable estimate of the lender's losses.

Waivers, reductions or variations of early termination fees

120 Most lenders would waive, reduce or vary an early termination fee in certain circumstances. Only two lenders indicated they did not waive, reduce or vary early termination fees in any circumstances over the review period.

121 In most cases, the relevant circumstances (listed below) led to the lender waiving the early termination fee entirely. Common reasons for a lender waiving an early termination fee included:

(a) internal refinance, product switches and splitting of loan(s) (15 lenders);

(b) a loan increase or top-up (eight lenders) or other variation of the loan where a new contract is not required; and

(c) hardship (eight lenders).

122 Other factors that may lead to a waiver, variation or reduction included:

(a) for mortgagee-in-possession loans, when there is a shortfall from the sale of the property and the amount is unrecoverable from the borrower;

(b) when a customer holds more than one loan with a lender and at least one loan remains open;

(c) loans terminated near the end of the period during which an early termination fee applies; and

(d) extenuating and/or personal circumstances, including marital breakup.

123 Three lenders repaid the borrower for the early termination fee if the borrower took out a new loan with them within six months of discharge.

124 Some lenders noted that if a loan was internally refinanced the early termination fee may still have been payable on the original loan. However, one lender indicated an adjustment would have been made to the

establishment fee for the new loan and another lender indicated that the early termination fee amount would be credited to the new loan.

125 Notwithstanding that the majority of lenders will waive or vary the early termination fee on a loan where an existing client refinances into a new loan with the same lender, an early termination fee may still be payable on the new loan. However, the losses which would arise upon early termination of the new loan for the existing client would be less than that for the same loan for a new client to the extent that the establishment costs for the existing client are lower.

Recommendation 7: Early termination fees on refinanced loans

Most lenders waive early termination fees on loans where the consumer internally refinances into a new loan with the lender. Where existing clients refinance into a new loan, lenders will not necessarily incur the same level of establishment costs, as they would for a new loan for a new client.

Lenders can reduce the likelihood of having an early termination fee on a loan resulting from an internal refinance declared unconscionable by ensuring that the early termination fee takes into account any reduced establishment costs for the loan.

Changes to early termination fees after 1 July 2010

126 We asked the lenders in our review to describe any changes to fees that they had implemented since July 2010 and any other planned changes. The purpose of this question was to determine what changes lenders had made to early termination fees since ASIC commenced regulating consumer credit and the introduction of unfair contract terms legislation on 1 July 2010.

127 Nine out of the 20 lenders advised that they had implemented changes to their early termination fees since 1 July 2010. Five lenders had either abolished or planned to abolish on 1 July 2011 the early termination fees on new loans, and another lender had already abolished the early termination fee on new and existing loans. The remaining changes included:

(a) a reduction of the percentage applied for an early termination fee on any new loans;

(b) a reduction of the flat fee applied for an early termination fee on new and existing loans;

(c) a capping of a percentage-based early termination fee; and

(d) a switch from a percentage-based early termination fee to a flat fee.

128 One lender indicated that they would be implementing a change to the early termination fee charged for existing loans. This included the introduction of a tiered approach, which reduces the amount of the early termination fee each year for the period the fee applied.

129 We note that six lenders responded that competitive forces had influenced their decision to change their early termination fees. Six lenders also indicated that they had changed their early termination fees to align with the National Credit Act and RG 220.Other reasons included:

(a) anticipation of forthcoming regulatory changes (i.e. the move to prohibit all early termination fees);

(b) a periodic review of products and fees;

(c) customer and staff feedback; and

(d) shareholder returns.

130 Although many responses indicated changes were made due to compliance with the National Credit Act, the test for determining whether an early termination fee is unconscionable did not change with the introduction of the National Credit Act. It may be that RG 220 provided lenders with greater awareness of the unconscionable fee provisions in s78 of the National Credit Code and the ability for ASIC, under s79, to take representative action.

D Fee disclosure

Key points

Lenders employed a variety of methods to disclose early termination fees. Although disclosure methods may vary based on the distribution model (e.g. additional disclosure for broker-originated loans), the method of disclosure was generally the same irrespective of fee structure.

Lenders who have complex early termination fee structures are less likely to have their early termination fees declared unfair where they provided consumers before loan settlement with a worked example of the early termination fee as a dollar amount.

How early termination fees are generally disclosed to consumers

131 Early termination fees are sometimes disclosed to consumers as ‘deferred establishment fees’, ‘early repayment fees’, ‘deferred administration fees’ or ‘deferred settlement fees’, among other expressions. All these fees are payable because of the early repayment of a residential loan and in addition to standard discharge fees (which are paid regardless of whether a loan is terminated early): see RG 220.2.

132 In determining whether a term of a contract is unfair, a court must take into account the extent to which the term is transparent: see RG 220.66.

133 All the lenders that responded stated that fees, including early termination fees, are disclosed through the loan documents.

134 Other methods of fee disclosure reported include:

(a) in home loan standard fees and charges summaries and brochures;

(b) in the first and third-party training material;

(c) verbally through the broker or loan consultant (during the application phase);

(d) online via the lender’s website;

(e) in the first and third-party sales tools;

(f) in broker software and origination systems;

(g) in internal staff policy and procedures documents;

(h) verbally by branch and call centre staff during the loan application process, and also when advising pay-out figures for loans;

(i) in the product disclosure certificate;

(j) in the lending guidelines; and

(k) in a product description matrix.

135 One lender advised that its early termination fee, which is based on a percentage of the original loan amount, is highlighted in a box on the front page of the loan contract, in addition to being listed in the fees and charges section of the loan contract, as a warning to consumers.

136 Two lenders provided disclosures in their loan contracts that customers have the option to pay the early termination fee upfront at settlement of the loan, or alternatively at the time of discharge if the loan is repaid within the term that the fee applies. By clearly specifying an upfront dollar amount that may be paid at settlement, these lenders may have reduced the likelihood of the early termination fee being considered to not be transparent and thus unfair.

137 Lenders often rely on brokers to verbally advise and distribute disclosure materials to consumers that detail lenders' fees. Brokers therefore rely on the broker system portal and training provided by lenders to keep consumers updated with any changes to fees and charges. One lender advised that brokers must certify that they have discussed the features of the loan, including the early termination fee, with the customer by signing a certification clause. Customers are also asked to certify that the broker had talked to them about the early termination fee.

138 Some early termination fee structures were relatively complex and at times this may have made it difficult for consumers to assess the actual dollar amount of the early termination fee that may become payable. In particular, this may arise when the early termination fee relates to a percentage of the original loan amount, a number of monthly repayments and/or interest components of those repayments.

Recommendation 8: Transparency of early termination fees payable

Lenders generally did not provide any additional disclosure for more complex early termination fee structures than they did for more simple early termination fee structures, increasing the likelihood of having their early termination fees declared unfair. Two lenders reduced the likelihood of having an early termination fee declared unfair by providing consumers before loan settlement with a worked example setting out in dollar terms the amount of the early termination fee that would become payable on early termination of their specific loan.

E Complaints handling

Key points

Less than 1% of instances where an early termination fee was paid resulted in complaints to lenders.

In more than half the cases where a complaint was made, the early termination fee was waived or reduced.

Non-ADI early terminations were more than twice as likely to result in complaints. Non-ADIs were also more likely to waive or reduce their early termination fees as a result of a complaint.

Dispute resolution and complaint numbers

139 Persons who hold a credit licence must have an internal dispute resolution (IDR) process that complies with Regulatory Guide 165 *Licensing: Internal and external dispute resolution* (RG 165), as well as being a member of an ASIC-approved external dispute resolution (EDR) scheme.

140 Lenders provided information covering 74,668 instances where an early termination fee was paid between 1 July 2010 and 15 February 2011. This resulted in 510 complaints about early termination fees.

141 On average, non-ADIs charged higher early termination fees than ADIs, and were more likely to have more complex fee structures where the early termination fee was a percentage of the loan amount, number of repayments and/or did not reduce over time. Accordingly, it may be expected that non-ADI lenders would have a higher incidence of complaints. We examined the ADI and non-ADI complaints data to see if this was the case: see Table 5.

Table 5: Summary of complaints about early termination fees

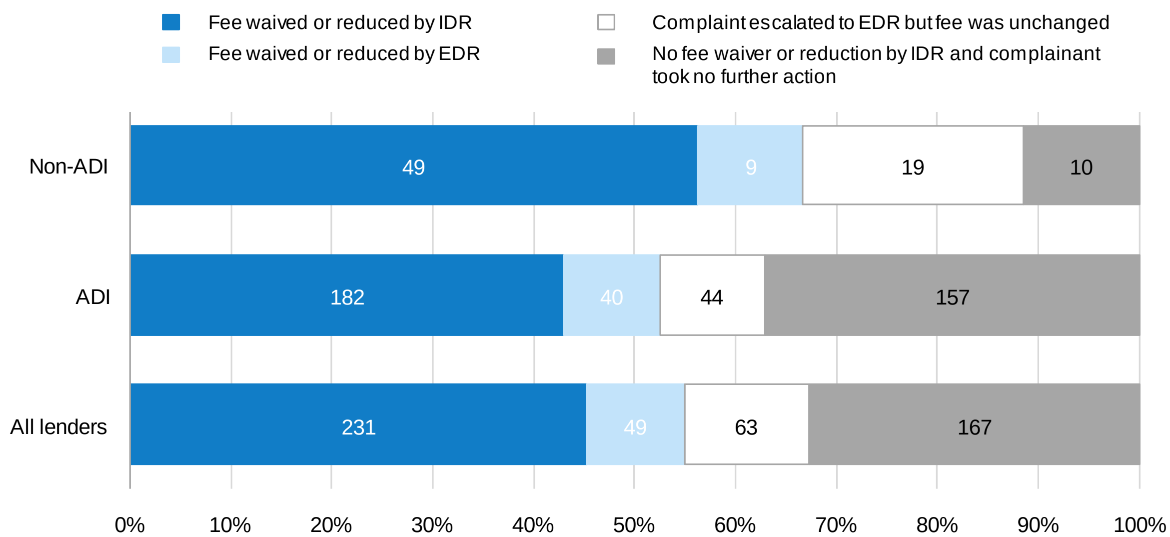
	All lenders	ADI	Non-ADI
Instances where fee was charged	74,668	67,868	6,800
Number of complaints	510	423	87
Percentage of complaints	0.68%	0.62%	1.28%

Outcome of complaints

142 In more than half of all cases where a complaint was made, the early termination fee was either waived or reduced by the lender's IDR or the applicable EDR scheme. Borrowers who were charged an early termination fee by a non-ADI were more than twice as likely to complain as those who were charged an early termination fee by an ADI. Non-ADI borrowers were also more likely to have their fee waived or reduced by either IDR or EDR.

143 Figure 8 shows the outcome of complaints for non-ADIs, ADIs and the total sample.

Figure 8: Outcome of complaints for the total sample: ADI and non-ADI lenders



Key terms

Term	Meaning in this document
ADI	Authorised deposit-taking institution—has the meaning given in s5 of the National Credit Act
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
break fee	A type of fee charged for early termination of a fixed rate loan due to the part of the credit provider's loss, arising from the early repayment, that is a result of differences in interest rates (sometimes called 'break costs')
combination early termination fees	This early termination fee is a hybrid of the fixed dollar fee category and the proportionate fee category
commission clawback arrangements	An arrangement where lenders who have paid commissions to brokers, or other intermediaries, are entitled to recoup some or all of this amount in the event that the loan is terminated within a specified period of time (usually in the first few years of a loan)
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
credit licence	An Australian credit licence under s35 of the National Credit Act that authorises a licensee to engage in particular credit activities
early termination fee	A fee that is payable because of the early repayment of a residential loan that is additional to standard discharge fees (which are paid regardless of whether a loan is terminated early)
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 *Approval and oversight of external dispute resolution schemes* (RG 139)
fixed dollar early termination fees	A set early termination fee charged regardless of the size of the loan. It may be a flat dollar amount or the amount may reduce over the period of the loan (usually over the first three to five years)
IDR	Internal dispute resolution
IDR procedures, IDR processes or IDR	Internal dispute resolution procedures/processes that meet the requirements and approved standards of ASIC under RG 165

Term	Meaning in this document
lender	A 'credit provider' as defined in s5 of the National Credit Act. In relation to the unfair contract terms provisions, it is the lender under the loan agreement. In both cases, it includes ADI and non-ADI lenders
lenders' mortgage insurance refund arrangements	An arrangement where lenders who have paid lenders' mortgage insurance premiums to insurers in respect to a particular loan are entitled to recoup some or all of this amount in the event that the loan is terminated within a specified period of time (usually in the first few years of a loan)
National Credit Act	*National Consumer Credit Protection Act 2009*
National Credit Code	National Credit Code at Sch 1 of the National Credit Act
non-ADI	A lender that is not an authorised deposit-taking institution
proportionate early termination fees	This early termination fee is based on the size of the loan amount. It may be determined by reference to a percentage of the loan amount, or by reference to a number of monthly repayments (and, in some cases, only the interest component of those repayments). It may be a flat percentage or a set number of repayments, or the percentage or number of repayments may reduce over the time the fee is payable
residential loan, or loan	A home loan and/or a residential investment loan
RG 220 (for example)	An ASIC regulatory guide (in this example, numbered 220)
s78 (for example)	A section of the National Credit Code (in this example, numbered 78), unless otherwise specified
standard discharge fee	A type of fee payable on termination of a loan, whether the termination is early or not
UCCC	Uniform Consumer Credit Code, which applied before the National Credit Code
unconscionable fees provisions	Section 78–79 of the National Credit Code
unfair contract terms provisions	The unfair contract terms provisions in Subdiv BA of Div 2 of Pt 2 of the ASIC Act

Related information

Headnotes

credit contract, credit provider, deferred establishment fee, early termination fee, home loan, lender, loan agreement, mortgage, residential investment property loan, residential loan, unconscionable conduct, unconscionable fee, unfair contract terms

Regulatory guides

RG 165 *Licensing: Internal and external dispute resolution*

RG 220 *Early termination fees for residential loans: Unconscionable fees and unfair contract terms*

Legislation

ASIC Act, Pt 2, Div 2, s12BF, 12BG

Corporations Act, s912A(2)(b), 1017G(2)(b)

National Credit Act, s5, 11(1)(a), 49

National Credit Code, s5, 66, 66(1), 66(3), 76, 76(6), 78(1), 78(3), 78(4), 79

National Credit Regulations 2010, regs 72 and 79A

UCCC, s72

Consultation papers and reports

CP 135 *Mortgage early exit fees: Unconscionable fees and unfair contract terms*

REP 125 *Review of mortgage entry and exit fees*

REP 216 *Response to submissions on CP 135 Mortgage exit fees: Unconscionable fees and unfair contract terms*