# HOME LOAN EXIT FEES
# THE COST OF ENDING A HOME LOAN EARLY#

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The fees charged by financial institutions are coming under increasing scrutiny. In this paper exit fees, or the fees charged by financial institutions for early termination of a variable rate mortgage, are analysed. The authors discuss why these fees are a concern, including the potential impact on competition in the home loan market, the high rate of refinancing, and the way in which exit fees can exploit human cognitive biases. The authors also review the regulation of exit fees and present data on exit fees drawn from a study of 198 home loans offered by a wide range of financial institutions and also data obtained from two consumer law centres. The authors conclude with observations relating to the regulation of exit fees under the new National Consumer Credit Protection Act.

## 1. INTRODUCTION

The purchase of a home is the largest single purchase most Australians will ever make.[1] Taking-out a home loan to pay for this is the largest financial obligation most Australians will ever incur.[2] The competitiveness of the home loan market is important to the welfare of most Australians.

The competitiveness of the home loan market is impacted by many factors. One obvious factor that will impact the market is the fees charged by credit providers. This paper examines the imposition of 'exit fees' (also known, variously, as 'deferred establishment fees' and 'early repayment fees',[3] amongst other expressions).

The paper examines exit fees for variable rate mortgages,[4] and does not consider the issue of exit fees for fixed rate mortgages. Fixed rate mortgages involve home loans for which the interest rate is set for a pre-determined period (for example, 3 years or 5 years). Fixed rate mortgages would not exist without substantial exit fees because consumers would

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# This paper has been produced with funding from the Victoria Law Foundation.
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1 Luci Ellis, Jeremy Lawson and Laura Roberts-Thomson, *Housing Leverage in Australia*, Research Discussion Paper 2003-09, Economic Group, Reserve Bank of Australia, 2003, p i.
2 Senate Economics Committee Inquiry into Australia's Mandatory Last Resort Home Warranty Insurance Scheme, Submission of the Building Action Review Group, 19 April 2008, p 2.
3 Australian Securities and Investments Commission, *Review of Mortgage Entry and Exit Fees*, Report 125, April 2008, p 5.
4 That is "an interest rate that is subject to variation by the lender at any time.": Ibid p 5.

always terminate when they 'lose' because the Reserve Bank of Australia (RBA) cash rate drops during the fixed period, but would never terminate when they 'win' because the RBA cash rate rises.[5]

A discussion of exit fees depends on common understanding of the concept. An exit fee has been defined as "any charge…imposed by the lender upon its borrower by reason of the borrower's payment of all or any portion of the loan on a date prior to the scheduled 'due' or 'maturity' date."[6] The definition adopted by the Australian Securities and Investments Commission (ASIC) in its 2008 report is: "Exit fees…are fees charged by the lender if the mortgage facility is terminated or refinanced."[7] These two definitions are functionally identical.

Given that credit providers charge many different fees, it can be asked 'why should exit fees be treated as especially important?' Why should this paper, for instance, debate the merits of exit fees and not establishment fees? There are a several reasons that exit fees are of particular concern. First, as explained in the next section, because they are back-loaded (appearing at the end not the beginning of the transaction), and contingent, individuals may be likely to discount them. Second, as also explained in the next section, there is evidence that exit fees as a percentage of the total fees charged for home loans have been increasing. Finally, consumer law centres[8] in Australia have noted that a small number of home loan credit providers have imposed high exit fees on their variable rate home loans and that this has caused substantial detriment to vulnerable consumers.[9]

The structure of this paper is as follows. Part 2 outlines the reasons exit fees are of concern. In Part 3 the law regulating exit fees in Australia is examined. Part 4 provides data on exit fees and Part 5 considers several issues relating to the regulation of exit fees under the new National Consumer Credit Protection Act.

## 2. CONCERNS WITH EXIT FEES

There are a number of concerns in relation to exit fees. First, exit fees can work as a disincentive to borrowers changing credit providers. It has been suggested that exit fees are now sufficiently high to "present a barrier to switching"[10] and such a barrier can be

5 Fixed-rate home loans constitute a liquidity risk for credit providers as the interest rate the credit provider pays for funds will change but the interest rate the credit provider charges will be fixed for a defined period. See Simon Perry, Stuart Robinson and John Rowland, *A Study of Mortgage Prepayment Risk*, Institute of Actuaries and Faculty of Actuaries, November 2001, p 4.
6 Kent H Roberts, 'Prepayment Penalties in Texas: the Triumph of Logic and the Need for Legislative Reform' (1993) 45 *Baylor Law Review* 585 at 587.
7 Australian Securities and Investments Commission, above n 3 at 3.
8 For example, the Consumer Action Law Centre in Melbourne and the Consumer Credit Legal Centre in Sydney.
9 See the case studies in Part 4 of this paper.
10 Australian Securities and Investments Commission, above n 3 at 17.

anti-competitive. Second, as contingent and deferred fees, exit fees can be less transparent and relatively hard for consumers to properly evaluate.[11]

Third, there is evidence that exit fees have increased relative to other fees so that they constitute a larger percentage of total fees charged.[12] A lack of competitive restraint may be a reason for this.[13] According to 2008 research by ASIC, from 1995 to 2007 exit fees increased from 19.31% of total fees to 41.83% of total fees charged for home loans.[14] One potential explanation for this discussed in the ASIC research is that the exclusion of exit fees from the 'comparison rate' disclosure requirements has driven the growing prominence of exit fees as a percentage of the total fee take.[15] There is a suggestion that home loan establishment fees are declining,[16] and that exit fees are concomitantly increasing.[17]

Fourth, exit fees can exploit human cognitive biases to the detriment of consumers. It is well-known that common human cognitive biases include myopia[18] and hyperbolic discounting.[19] That is, people irrationally focus on the near-term and underestimate the significance of costs or benefits that are far in the future. This is not such a problem for up-front fees, such as establishment fees, as the consumer immediately and directly faces the prospect of having to pay a sum of money. But for a contingent fee, payment of which is deferred to the time of home loan exit rather than entry, the common human biases of myopia and hyperbolic discounting could lead consumers to poor decision-making. As exit fees are contingent it is harder for consumers to make accurate decisions about them,[20] and it is reasonable to conclude that consumers will discount the likelihood of having to exit a home loan early. This can impact vulnerable and disadvantaged consumers in particular.

Fifth, exit fees may also enable practices by credit providers that are undesirable for some consumers. One example of this is 'honeymoon rates'. Honeymoon rates are 'teaser' introductory rates that revert to a standard variable rate after a set period. Without exit fees there would be nothing to stop consumers from switching credit provider as soon as the honeymoon period ends, and therefore it may be that exit fees enable honeymoon rates. This is an issue because it has been suggested that honeymoon rates can seduce

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11 Australian Equity Research, *Banking Fee Comparisons – Will Australian Banks be Forced to Prune Fees?*, Australian Mortgage Industry, Volume 5, 16 March 2007, p 34.
12 Australian Securities and Investments Commission, above n 3 at 7.
13 Ibid at 7.
14 Ibid at 7.
15 Ibid at 18.
16 Australian Equity Research, above n 11, p 34. (According to this source, 40% of loans in 2007 required no application fee, whereas two years previously only 15% of loans had no fee).
17 Ibid, p 34.
18 Richard A Epstein, 'Behavioral Economics: Human Errors and Market Corrections' (2006) 73 *University of Chicago Law Review* 111 at 125.
19 Ibid at 130.
20 Australian Securities and Investments Commission, above n 3 at 34.

consumers and distract consumers from the real cost of the loan[21] which may undermine competition.

Sixth, because refinancing of existing home loans is an important part of the overall Australian housing finance market, exit fees therefore assume increased significance given they may be relevant to a consumer who wants to refinance an existing home loan. According to Australian Bureau of Statistics (ABS) data for total housing finance commitments (for owner occupied housing), in February 2010 there were 12,708 refinancings of home loans for established dwellings worth $2,981 million and 34,399 new financings for established dwellings worth $9,944 million.[22] It can therefore be seen that for February 2010, home loan refinancings constituted 27% by number of all financings for established dwellings and 23% by value of all financings for established dwellings. This is a significant proportion. It should also be noted that the ABS data underestimates the extent of refinancing. This is because the definition of refinancing adopted by the ABS is as follows: "For secured housing finance for owner occupation, only those loans where the refinancing lender is a different lender and the security is unchanged are included".[23] In other words, a refinancing with the same lender is excluded from the ABS refinancing data. However, even with this limitation on the ABS data, high exit fees are a concern given the high rate of refinancing.

## 3. HOW DOES THE LAW REGULATE EXIT FEES?

From 1 July 2010, exit fees are regulated by the *National Consumer Credit Protection Act* 2009 (Cth) (national Act). Prior to that date, exit fees were regulated by the *Consumer Credit Code* (Code). However, the changeover from the Code to the national Act is timetabled to occur in stages with some parts of the Act commencing on 1 April 2010 and other parts commencing on 1 July 2010 and 1 January 2011. This section reviews the regulation of exit fees under both the Code and the national Act and highlights differences between the two.

### *3.1 The Consumer Credit Code*

The *Consumer Credit Code* became the national credit code for Australian States and Territories beginning in 1994 when it was passed as an Appendix to the *Consumer Credit (Queensland) Act 1994*. Each State and Territory then passed their own various Consumer Credit Acts adopting the *Consumer Credit Code* as passed by the Queensland Parliament. For example, in Victoria the *Consumer Credit (Victoria) Act 1995* stated that: "The Consumer Credit Code set out in the Appendix to the Consumer Credit (Queensland) Act…applies as a law of Victoria…".[24] This method of legislative

21 Scott Ewing, *The Effectiveness of Mandatory Comparison Rates: Information, Capacity and Choice*, Final Paper, Swinburne Institute of Technology Institute for Social Research, May 2006, p 15.

22 Australian Bureau of Statistics, *Housing Finance – February 2010*, No 5609.0, April 2010, Table 1.

23 Ibid at 28.

24 *Consumer Credit (Victoria) Act 1995*, s 5.

implementation is unusual. However, it did create a national Consumer Credit Code. The Code has been replaced by the *National Consumer Credit Protection Act* (Cth) 2009 (national Act).

The Code was, until 2010, the primary source for the regulation of consumer credit. It covered numerous topics including, inter alia, requirements for contracts to be in writing and for disclosure to be made,[25] limitations on interest charges and fees,[26] limitations on mortgages and guarantees,[27] consumer rights in relation to hardship and unjust transactions,[28] and penalties for breach of the Code.[29] It is worth noting that the Code never applied to loans taken out to purchase investment properties.[30]

The most relevant sections of the Code in relation to exit fees were s 70 and, more significantly, s 72. The relevant Court or Tribunal had authority, under s 70 of the Code, to reopen unjust transactions. Section 70 was in the following terms:

> (1) **Power to reopen unjust transactions.** The Court may, if satisfied on the application of a debtor, mortgagor or guarantor that, in the circumstances relating to the relevant credit contract, mortgage or guarantee at the time it was entered into or changed (whether or not by agreement), the contract, mortgage or guarantee or change was unjust, reopen the transaction that gave rise to the contract, mortgage or guarantee or change.[31]

Among the factors the Court or Tribunal could consider in determining whether a transaction was unjust, were "the terms of other comparable transactions involving other credit providers".[32] Conceivably, if a particular credit provider charged an exit fee for a variable rate loan that was manifestly higher than that charged by other credit providers, the Court or Tribunal could reopen this. However, the generality of s 70 meant that it was not generally used as the principal basis of challenging exit fees. It was, rather, the more specific s 72 of the Code that was used for this purpose.

Section 72 of the Code allowed the Court or Tribunal "on application of the debtor or guarantor"[33] to "annul or reduce"[34] "a fee or charge for a prepayment of an amount under a credit contract"[35] where that fee or charge was "unconscionable".[36] (There is an effectively identical section in s 78 of the national Act.) Section 72 of the Code was in the

25 *Consumer Credit Code*, Part 2 Division 1.
26 Ibid, Part 2 Divisions 3 and 4.
27 Ibid, Part 3 Divisions 1 and 2.
28 Ibid, Part 4 Division 3.
29 Ibid, Part 6.
30 Ibid, s 6. (Credit to purchase an investment property is not credit wholly or predominantly for personal, domestic or household purposes and therefore is not a provision of credit to which the Code applied).
31 Ibid, s 70.
32 Ibid, s 70(2)(n).
33 Ibid, s 72(1).
34 Ibid, s 72(1).
35 Ibid, s 72(1)(d).
36 Ibid, s 72(1).

following terms:

> (1) The Court may, if satisfied on the application of a debtor or guarantor that—
> (a) a change in the annual percentage rate or rates under a credit contract to which s 59(1) or (4) applies; or
> (b) an establishment fee or charge; or
> (c) a fee or charge payable on early termination of a credit contract; or
> (d) a fee or charge for a prepayment of an amount under a credit contract;
> is unconscionable, annul or reduce the change or fee or charge and may make ancillary or consequential orders.[37]

Section 72(4) further explained the operation of s 72 in relation to exit fees, and it was in the following terms:

> (4) For the purposes of this section, a fee or charge payable on early termination of the contract or a prepayment of an amount under the credit contract is unconscionable if and only if it appears to the Court that it exceeds a reasonable estimate of the credit provider's loss arising from the early termination or prepayment, including the credit provider's average reasonable administrative costs in respect of such a termination or prepayment.[38]

Section 72(4) was therefore a promising section for consumers facing high early exit fees because it implied that such fees were unconscionable if they did more than cover the credit provider's loss. As the loans this paper is concerned with are variable rate loans, and as ordinarily variable rate lending does not expose the credit provider to the liquidity risk and funding risk of fixed rate lending,[39] it can be argued that the credit provider's loss should not be more than its administrative costs of discharging the mortgage and effecting settlement, and other specific and easily quantifiable costs.

Case-law on the issue has been scant and mixed. The recent 2009 case of *Broadfoot v RHG*[40] in the Consumer, Trader and Tenancy Tribunal of New South Wales seems to interpret s 72(4) in a way similar to the interpretation suggested in the immediately preceding paragraph.

Earlier decisions had suggested that the elements of unconscionability from the old common-law doctrine of unconscionability[41] must be made out. That is, the consumer must be under a special disadvantage, and there must be knowledge and unconscientious exploitation of this by the credit provider. In *Director of Consumer Affairs v City Finance Loans (Credit)*,[42] a case that was primarily about establishment rather than exit fees, obiter dicta comments suggested that the Tribunal might take a restrictive interpretation

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37 Ibid, s 72.
38 Ibid, s 72(4).
39 See Perry, Robinson and Rowland, above n 5.
40 *Broadfoot v RHG Mortgage Corporation Ltd* [2009] NSWCTTT 447 (14 August 2009).
41 As set out in *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447.
42 *Director of Consumer Affairs v City Finance Loans (Credit)* [2005] VCAT 1989 (30 September 2005).

of s 72(4). President Morris reasoned that, unlike s 21(1)(b) of the Code[43] which "is essentially concerned with the *amount* of fees"[44] s 72 of the Code "is concerned about whether a fee is *unconscionable*." And "[t]hese are two different concepts."[45]

President Morris then went on to list factors relevant to determining "whether a party has engaged in unconscionable conduct"[46] and recited the familiar list of factors that are considered at common law, a list which is not dissimilar to the factors explicated in s 70 of the Code. It appears from his decision that President Morris viewed s 72 as being an extension of the common-law doctrine of unconscionability to consumer credit. However, it can be argued that borrowers should not be required to prove common-law unconscionability to challenge exit fees under s 72.

In *Broadfoot v RHG*, Member Balding noted that while the onus to prove a fee is unconscionable falls on the consumer, it would be ordinary and normal for a consumer not to have evidence of what is a reasonable estimate of the credit provider's loss.[47] Member Balding argued that the onus of proof shifts onto the credit provider to provide evidence of its loss.[48] In other words, it appears that the onus of proof reverses: that is the credit provider must show its costs in order to establish that its exit fee is reasonable. This is appropriate because, as the Member said, the credit provider is usually the only party in a position to establish its costs.

Member Balding rejected RHG's argument that loss of profit from the loan was a loss, stating: "I do not take account of any unpaid interest in determining an estimate of the losses which RHG may suffer on early repayment."[49] As Member Balding noted, the repayment of the loan means that RHG could lend the amount repaid again. Whether or not a credit provider can claim loss of profit is critical. If a credit provider can claim loss of profit from the loan as a loss, it can probably justify high exit fees.

In *Broadfoot v RHG*, RHG presented a list of what it said its costs were. Some of these costs were the same as costs already incurred (and paid for) by the Broadfoots in establishment fees, so RHG was at times attempting to double-dip. In any event specific evidence of costs was absent. In light of this Member Balding found that RHG had not provided satisfactory evidence of its loss and thus its early repayment fee of $4,487.77 was annulled.[50] The argument of the Broadfoots' counsel was that if a credit provider

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43 21 Prohibited monetary obligations
(1) A credit contract must not impose a monetary liability on the debtor—
(b) in respect of an amount of a fee or charge exceeding the amount that may be charged consistently with this Code;
44 *Director of Consumer Affairs v City Finance Loans (Credit)* [2005] VCAT 1989 (30 September 2005), at paragraph 30.
45 Ibid at paragraph 30.
46 Ibid at paragraph 31.
47 *Broadfoot v RHG Mortgage Corporation Ltd* [2009] NSWCTTT 447 (14 August 2009). The decision is available at: http://www.austlii.edu.au/au/cases/nsw/NSWCTTT/2009/447.html
48 Ibid.
49 Ibid.
50 Ibid. See Order 1.

wishes to justify its exit fees it must "provide actual figures for its expenditure…".[51] Member Balding adopted this position.[52]

To summarise the impact of the Code, under s 72 of the Code as interpreted in *Broadfoot v RHG*, credit providers could only impose exit fees up to an amount that constituted "a reasonable estimate of the credit provider's loss". Exit fees that were above this amount could be struck down. While some early decisions indicated that common-law unconscionability must be made out to succeed under s 72, this was not the approach adopted in *Broadfoot v RHG*.

### *3.2 The National Consumer Credit Protection Act 2009*

As noted above, parts of the national Act commence at different times between 1 April 2010 and 1 January 2011.[53] The national Act is based on the Code,[54] and therefore it is likely that the jurisprudence relating to the Code will be influential when the Federal Court comes to consider actions brought under the national Act. Section 78 of the national Act is in similar terms to s 72 of the Code and s 78(4) of the national Act is in similar terms to s 72(4) of the Code.

The national Act makes a number of important changes to the Code. One such change is that investment properties are now included,[55] whereas they were excluded from the application of the Code. Thus, investment property owners will be able to challenge unconscionable exit fees under s 78 of the national Act. This will mean that investment property owners could also raise challenges through the External Dispute Resolution (EDR) scheme of which the credit provider is a member as outlined below.

Under the national Act there is compulsory licensing of all credit providers.[56] For consumers charged exit fees, a consequence is that every credit provider that wants a license to do business must become a member of an EDR scheme. This enables consumers to lodge their disputes with the EDR scheme. There is potentially a problem with this as the terms of reference of the two major EDR schemes may exclude fee disputes.

Access to EDR would greatly benefit consumers challenging exit fees. Thus it is important to determine whether exit fee disputes are determinable by the EDR schemes. The two major EDR schemes are the Financial Ombudsman Service (FOS) and the Credit

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51 Paul Batley, Barrister, Memorandum of Advice to Consumer Credit Legal Centre New South Wales, 31 October 2008, p 6.
52 Above n 47.
53 *National Consumer Credit Protection Act 2009* (Cth) s 2 and also see the section of the ASIC website dealing with the national Act and ASIC's role: http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Credit%20homepage
54 The operative sections of the *National Consumer Credit Protection Act 2009* (Cth) are contained in Schedule 1 of that Act which is entitled *National Credit Code*.
55 *National Consumer Credit Protection Act 2009* (Cth), s 5(1)(b)(ii).
56 Ibid, Chapter 2. Under s 29, an offence is committed if credit is provided by a non-licensee.

Ombudsman Service Limited (COSL). From the FOS's latest Terms of Reference[57] it is unclear if it could hear an exit fee dispute, [58] but certainly it is arguable that it could. An exit fee dispute is arguably within FOS's jurisdiction where although it is a fee dispute, the consumer argues the fee is a breach of the credit provider's legal obligations under s 78 of the national Act. Thus, the exception in paragraph 5.1(b) (ii) of the FOS's Terms of Reference gives the FOS jurisdiction.

The COSL Rules contain an exclusion of jurisdiction in relation to fee disputes with exceptions similar to those in the FOS's Terms of Reference. Thus, as for the FOS, it is arguable that the COSL could hear an exit fee dispute where this involves an alleged breach of the credit provider's legal obligations.[59]

Compulsory licensing may help consumers who are charged high exit fees to exit a variable rate home loan in other ways. Some credit providers that charge high exit fees have, in the past, not been members of an EDR scheme. But they will have to be under the national Act. Under compulsory licensing, all consumers who have home loans could lodge a dispute in an EDR scheme challenging exit fees. What is not presently certain is whether the EDR schemes will properly investigate these disputes, or whether they will reject them as fee disputes outside of jurisdiction.

Another change brought by the national Act is the introduction of a responsible lending requirement for credit providers.[60] The general responsible lending requirement prohibits credit providers providing credit under a contract that is "unsuitable for the consumer…".[61] A credit contract is "unsuitable" if:

(a) it is likely that the consumer will be unable to comply with the consumer's financial obligations under the contract, or could only comply with substantial hardship; or
(b) the contract does not meet the consumer's requirements or objectives; or

57 Financial Ombudsman Service, Terms of Reference, 1 January 2010, paragraph 5.1(b).
58 Under paragraph 5.1(b) of the Terms of Reference, the Financial Ombudsman Service cannot consider complaints "about the level of a fee, premium, charge or interest rate - unless:
(i) the Dispute concerns non-disclosure, misrepresentation or incorrect application of the fee, premium, charge or interest rate by the Financial Services Provider having regard to any scale or practices generally applied by that Financial Services Provider or agreed with that Applicant;
(ii) the Dispute concerns a breach of any legal obligation or duty on the part of the Financial Services Provider…".
59 Credit Ombudsman Service Limited, Service Rules, 5th Edition, 20 August 2009, paragraph 34. "COSL will not deal with a dispute …(d) to the extent that it relates to a fee, charge, commission or interest rate, unless:
(i) the Complaint concerns the non-disclosure, misrepresentation, miscalculation or incorrect application of the fee, charge, commission or interest rate; or
(ii) the charging of the fee, charge, commission or interest rate is in breach of the law or is unconscionable…"
60 *National Consumer Credit Protection Act 2009* (Cth) Chapter 3. This chapter contains specific disclosure requirements and a general responsible lending obligation.
61 Ibid, s 133(1).

(c) if the regulations prescribe circumstances in which a credit contract is unsuitable—those circumstances apply to the contract.[62]

This responsible lending requirement has nothing specifically to say about exit fees. However, in most cases the highest exit fees are charged by non bank credit providers who advance more loans to less creditworthy customers.[63] Under the responsible lending requirements in the national Act, it is possible that some of the credit contracts with particularly vulnerable consumers that include very high exit fees will be in breach of the new responsible lending requirement. If they are, the credit provider has committed an offence, and the consumer's position to challenge an exit fee would be strengthened.

The national Act has also changed the law to give the regulator, ASIC, standing to initiate proceedings for breaches of the prohibition on the imposition of unconscionable fees (contained in s 78 of the national Act).[64] This change is consistent with draft legislation presented by the Ministerial Council on Consumer Affairs.[65]

The other inclusion in the national Act, that will be of benefit to consumers, is that disputes under s 78 of the national Act will be costs-free. That is, costs can only be awarded against a party if:

(a) the court is satisfied that the party brought the proceedings vexatiously or without reasonable cause; or
(b) the court is satisfied that the party's unreasonable act or omission caused the other party to incur the costs.[66]

The only cost a consumer will ordinarily incur, then, is his or her own legal costs (if any).

This has been the case in some States, such as Victoria and New South Wales, and the national Act allays concerns that consumers in these states will lose access to a no-cost forum. In fact, the national Act benefits consumers as under it all Australian consumers challenging exit fees will have access to a no-cost forum.[67]

## 4. DATA ON EXIT FEES

In this section we present two types of data on exit fees. First, we present data on levels of exit fees collected by the authors and compare the findings to earlier research on levels

62 Ibid, s 133(2).
63 Chris Ryan and Chris Thompson, *Risk and Transformation of the Australian Financial System*, Reserve Bank of Australia, 16 August 2007, p 56.
64 *Consumer Credit Protection Act 2009* (Cth) s 79. (Note that under s 79 ASIC has standing to take proceedings for breaches of any section of Division 3 of Part 4 of Schedule 1 of the national Act. This includes the sections on unjust transactions and financial hardship).
65 Ministerial Council on Consumer Affairs, *Consumer Credit Code Amendment Bill 2007, Consumer Credit Amendment Regulation 2007 Consultation Package*, August 2007, draft s 72A.
66 *National Consumer Credit Protection Act 2009* (Cth), s 200(2).
67 Section 79 of the *National Consumer Credit Protection Act 2009* (Cth) also extends cost-free litigation to other areas important to consumers such as hardship variations.

of exit fees collected by ASIC. Second, we present information the authors obtained from two consumer law centres.

Tables 1 and 2 contain information that has been extracted by the authors from the Infochoice website by reviewing the fees payable on 198 home loans offered by Australian financial institutions. Infochoice is a finance comparison website. It provides consumers with the ability to compare products from over 100 Australian financial institutions. The website provides product comparison data for home loans, savings and term deposits, personal loans, credit cards, transaction accounts, business banking products and investment products.[68]

The authors have classified the home loans according to the type of financial institution and according to whether the home loan has an exit fee. For purposes of comparison, the data in Tables 1 and 2 relate to a $250,000 variable rate loan terminated within three years. The data was obtained in March 2010.

Table 1 indicates that the highest exit fees are charged by non-Authorised Deposit Taking Institutions (ADI)[69] home loan providers. The next highest exit fees are charged by large banks. However, the non-ADIs have exit fees that are, on average, 180% more than the large banks. The third highest exit fees are charged by other banks and the smallest exit fees are charged by credit unions and building societies. The difference between the exit fees charged by the non-ADIs and by credit unions and building societies is, on average, 353%.

Table 2 indicates the prevalence of exit fees classified according to type of financial institution. It can be seen that large banks have the highest proportion of home loan products with exit fees. Non-ADI home loan providers have the next highest proportion, followed by the category of other banks and then credit unions and building societies. The difference between the home loan provider category with the highest proportion of home loan products with exit fees (large banks) and the home loan provider category with the lowest proportion of home loan products with exit fees (credit unions and building societies) is significant. Large banks have, on average, almost twice the proportion of home loan products with exit fees than is the case for credit unions and building societies.

It is important to understand how exit fees are changing over time. Tables 3 and 4 tabulate data from the 2008 ASIC report on home loan exit fees.[70] It can be seen that non-ADI home loan providers have not altered their exit fees – they remain at around $1,900. Neither have credit unions and building societies altered their exit fees – they remain at

68 This information is taken from the Infochoice website:(http://www.infochoice.com.au/infochoice/about-us.aspx)

69 Institutions authorised under the *Banking Act 1959* (Cth) to take deposits. See Australian Prudential Regulation Authority: http://www.apra.gov.au/adi/. Institutions that are not Authorised Deposit Taking Institutions must source their funding from the wholesale markets as they cannot take deposits.

70 Australian Securities and Investments Commission, above n 3.

around $400. The most significant differences are in relation to large banks and other banks. Large banks have reduced their exit fees from $1,081.25 to $678.95. This represents a decrease of 37%. Other banks have also decreased their exit fees from $703.33 to $588.71. This represents a decrease of 16.3%.

Over the period 2008 to 2010, the highest exit fees continued to be charged by non-ADI home loan providers and the lowest exit fees continued to be charged by credit unions and building societies. However, the trend is that the non-ADI home loan providers are now more of an outlier in 2010 than they were in 2008. We saw above that in 2010, the non-ADIs have exit fees that are, on average, 180% higher than the large banks. In 2008, the non-ADIs had exit fees that were, on average, 44% higher than the large banks.

Comparing table 2 and table 4, we can see that there has been a decrease in the proportion of home loans with exit fees that have exit fees. In 2010, 57.58% of home loans had exit fees compared to 65.52% in 2008. All four types of home loan providers decreased the proportion of their home loans with exit fees. Large banks have reduced the proportion of their home loans with exit fees in the period 2008 to 2010 by 15.59 percentage points, followed by large banks with a reduction of 14.8 percentage points, non-ADIs with a reduction of 12.05 percentage points, and credit unions and building societies with a reduction of 4.59 percentage points.

**Table 1**

**Early termination fees by lender type**
**$250,000 variable rate/loan terminated within 3 years**
**2010**

| Type of lender | Early termination fees (ETF) |
|---|---|
| Large bank | $ 678.95 |
| Other bank | $ 588.71 |
| Credit union/building society | $ 419.38 |
| Non-ADI | $1,900.65 |

**Table 2**

**Prevalence of early termination fees**
**2010**

| **Institution type** | **Number of loan products** | **Number of loan products ETFs** | **Percentage of loan products with ETFs** |
|---|---|---|---|
| Large bank | 19 | 15 | 78.95% |
| Other bank | 31 | 21 | 67.74% |
| Credit union/building society | 93 | 38 | 40.86% |
| Non-ADI | 55 | 40 | 72.73% |
| TOTAL | 198 | 114 | 57.58% |

**Table 3**

**Early termination fees by lender type**
**$250,000 variable rate/loan terminated within 3 years**
**2008 – ASIC report**

| **Type of lender** | **Early termination fees (ETF)** |
|---|---|
| Large bank | $1,081.25 |
| Other bank | $ 703.33 |
| Credit union/building society | $ 400.91 |
| Non-ADI | $1,944.62 |

**Table 4**

**Prevalence of early termination fees**
**2008 – ASIC Report**

| Institution type | Number of loan products | Number of loan products ETFs | Percentage of loan products with ETFs |
|---|---|---|---|
| Large bank | 16 | 15 | 93.75% |
| Other bank | 24 | 20 | 83.33% |
| Credit union/building society | 88 | 40 | 45.45% |
| Non-ADI | 46 | 39 | 84.78% |
| TOTAL | 174 | 114 | 65.52% |

Further information on exit fees has been obtained by the authors from two consumer law centres - the Consumer Action Law Centre in Melbourne and the Consumer Credit Legal Centre in Sydney. The case studies below all focus on two non-ADI credit providers that have both charged high exit fees.

**Case study 1**

> The consumer took out a variable rate home loan of $250,000. When the consumer sought to exit the loan she was informed by the credit provider that she would be charged exit fees of approximately $6,000.

**Case study 2**

> The consumer took out a variable rate home loan of $130,000. At the time she sought to discharge the loan, she owed approximately $108,000 on the loan. The credit provider demanded the consumer pay early repayment fees of approximately $3,000 to exit the loan.

**Case study 3**

> The consumers, a married couple, took out a variable rate loan of $540,000. The credit provider demanded the consumers pay early repayment fees of approximately $9,000 to exit the loan.

**Case study 4**

The consumer took out a variable rate home loan of $700,000. When he wanted to exit the loan, he was advised by the credit provider he would have to pay approximately $14,000 in exit fees to exit the loan.

**Case study 5**

The consumers, a married couple, took out a variable rate home loan of $322,000. The loan was to refinance the consumers' existing home loan. Over the life of the loan the variable interest rate rose as high as 10.46% in July 2008, putting great financial strain on the consumers. When the consumers tried to exit the loan they were sent a 'notice' indicating the payout amount would be a total of $2,695 but in fact the credit provider demanded a total of approximately $7,400, an amount that included a 'discharge fee' as well as an 'early repayment fee'.

**Case study 6**

The consumer took out a variable rate home loan of approximately $500,000. The loan was for the purchase of an investment property. The interest rate rose as high as 10.53% in July 2008 and the consumer tried to exit the loan. The consumer was advised by the credit provider that a 'mortgage discharge' fee of $990 plus an 'early repayment fee' of $9,920 would be required to exit the loan.

**Case study 7**

The consumers took out a variable rate home loan of $302,000. The consumers wished to exit the loan and were advised by the credit provider that in order to exit they would have to pay exit fees, including a 'mortgage discharge' fee, of $695 and an 'early repayment' fee of $6,000.

**Case study 8**

The consumer took out a variable rate home loan of $448,000. The loan was to refinance an existing loan and to pay out an ex spouse under a divorce settlement. When the consumer wished to exit the loan, the credit provider demanded the consumer pay exit fees including an 'early repayment fee' of $11,200 (which amounts to an exit fee of 2.5% of the principal) a 'discharge fee' of $695 and 'legal and other costs' of $295.

**Case study 9**

The consumer took out a variable rate home loan of approximately $175,000 for the stated purpose of home improvements. The consumer sought to exit the loan and was advised by the credit provider that to do so she would have to pay a discharge fee of $7,001.40 (amounting to 4% of the principal of the loan). The consumer, in financial difficulty, could not afford to pay this fee. The consumer complained to the Credit Ombudsman Service Limited (COSL), only to be advised by the COSL that the COSL could not intervene because fee disputes are outside its jurisdiction.

## 5. CONCLUDING OBSERVATIONS

We conclude with a number of observations. First, with home loan exit fees now regulated by the national Act, there is an important issue regarding the legality of exit fees that exceed a reasonable estimate of the credit provider's loss arising from the early termination of the loan. We observed in Part 3 of this paper that s 78(4) of the national Act, which draws upon s 72(4) of the Code, provides that for the purpose of determining if a fee or charge payable on early termination of a credit contract is unconscionable, such a fee or charge is unconscionable "if and only if it appears to the court that it exceeds a reasonable estimate of the credit provider's loss arising from the early termination or prepayment, including the credit provider's average reasonable administrative costs in respect of such a termination or prepayment".

We also noted in Part 3 of this paper that, according to the decision in *Broadfoot v RHG,* any unpaid interest is not to be taken into account in determining the credit provider's loss arising from the early termination of a variable rate home loan. Moreover, according to this same decision, the onus is on the credit provider to provide evidence of its loss. However, this was a decision of the New South Wales Consumer, Trader and Tenancy Tribunal under the Code. The important issue is whether this interpretation will be adopted by the Federal Court when interpreting s 78 of the national Act. In the opinion of the authors, the decision in *Broadfoot v RHG* is one that is an appropriate interpretation of an important statutory provision designed to provide protection to consumers.

Based on the decision in *Broadfoot v RHG*, there is an issue whether some of the exit fees that we have identified in Part 4 of this paper are legal under s 78(4) of the national Act. Of course, each such exit fee would need to be examined carefully to ascertain whether or not it exceeds a reasonable estimate of the credit provider's loss arising from the early termination. However, it can be argued that exit fees that are a fixed percentage of the home loan principal would not satisfy s 78(4). Variable home loan rates change in relation to the RBA cash rate, and the funding rates for the banks, such as the money market rates.[71] Consequently, there should be no funding risk[72] for credit providers providing variable rate home loans (contrary to the situation for credit providers providing fixed rate home loans). This may mean there is no justification for an exit fee for a variable rate loan that is a percentage of the principal. In addition, it is not obvious that exit fees of the magnitude indicated in the case studies presented in Part 4 of this paper would comply with s 78(4).

It has been suggested there was an assumption in government policy, reflected in the Code, that exit fees "were really only legitimate where there was a fixed rate contract and

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71 Australian Securities and Investments Commission, above n 3 at 5.

72 Perry, Robinson and Rowland, above n 5, pp 4 and 16.

the debtor had terminated the contract at a time when interest rates were lower than at the time of contract entry".[73] This is because the assumption was exit fees can only be imposed to compensate loss, the implication being there is no real loss to a credit provider when a consumer exits a variable rate home loan early.[74] If there was an assumption in government policy that exit fees should not be charged for variable rate home loans, this was not expressed sufficiently clearly in the Code.

A second observation relates to the fact that under the national Act, all Australian consumer credit providers will have to be licensed.[75] Such licensing may help to limit exit fees to as close as possible to the credit provider's actual loss. In the United Kingdom compulsory licensing has been successful in putting downward pressure on exit fees.[76]

There are a number of reasons why compulsory licensing may reduce exit fees, one of which is it can reduce the writing of sub-prime loans (the kind of loans that often have the highest exit fees). Compulsory licensing also makes it easier for consumers to challenge the actions of a credit provider.

In the United Kingdom all consumer credit providers must be licensed. Substantively, all consumer credit providers must obtain a license from the Office of Fair Trading[77] to carry on business. If the credit provider is providing credit that is a first-charge[78] home loan then it also needs to obtain a license from the Financial Services Authority (FSA) to carry on business.[79] It appears that the experience in the United Kingdom with compulsory licensing has been positive in terms of curbing high exit fees.

A compulsory licensing system could stop the imposition of high exit fees if charging of high exit fees was a factor the regulator could consider in deciding whether or not to grant or renew a license. This has not been the case. Typically, there are key principles that a credit provider must meet in order to obtain and retain a license (for instance, being 'a fit and proper person'). Regulators typically issue guidance outlining how they will determine whether or not an applicant meets the 'fit and proper person' requirement.

Through its Handbook, made pursuant to authority granted by the *Financial Services and Markets Act*,[80] the FSA has stated that an exit fee "must be able to be expressed as a cash

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73 David Niven and Tim Gough, *The Operation of the Uniform Consumer Credit Code*, Consumer Credit Legal Service Inc, August 2004, p 19.
74 Ibid, p 19.
75 *National Consumer Credit Protection Act 2009* (Cth), Chapter 2.
76 Australian Equity Research, above n 11, pp 33-34.
77 *Consumer Credit Act 1974*, United Kingdom, s 21.
78 Perimeter Guidance Manual, Financial Services Authority Handbook, Financial Services Authority, 1 July 2005, paragraph 2.6.27.
http://fsahandbook.info/FSA/html/handbook/PERG/2/6

79 *Financial Services and Markets Act 2000*, United Kingdom, ss 19 and 20, and Schedule 2, Part II, paragraph 23.
80 Ibid, Part X Chapter I.

value"[81] and must be "a reasonable pre-estimate of the costs as a result of the customer paying the amount due under the regulated mortgage contract before the contract has terminated."[82] Thus it seems that only exit fees that constitute a genuine pre-estimate of loss (a concept discussed earlier in this paper) are acceptable.

In the United Kingdom exit fees are lower than in Australia,[83] and it has been suggested that this may be attributable to the compulsory licensing system in the United Kingdom.[84] There are a number of possible reasons for this, including that in the United Kingdom the FSA has issued specific guidance on exit fees.

Applying the above guidance from the FSA, it can be argued that many of the exceptionally high exit fees identified in the case studies above would not comply with this guidance. Exit fees charged by some Australian credit providers that constitute a percentage of the principal (for example, 2% or 4%) would not, it is suggested, comply with the FSA guidance. For a variable rate home loan, the credit provider's costs will be administrative and explicitly quantifiable discharge costs (for example, legal fees for discharge) and these cannot be calculated as a percentage of the principal[85] but would be largely amounts that would not normally vary greatly depending on the amount of the principal.

In the opinion of the authors, now that ASIC has responsibility for consumer credit under the national Act, [86] it would be desirable for ASIC to issue guidance about how exit fees charged by a credit provider should be calculated**.**

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81 Mortgages and Home Finance: Conduct of Business Source Book (MCOB), Financial Services Authority, 12.3.1 (http://fsahandbook.info/FSA/html/handbook/MCOB/12/3)
82 Ibid.
83 Australian Securities and Investments Commission, above n 3 at 11.
84 Ibid at 11.
85 It has been noted that exit fees that are a fixed percentage of the principal may not represent the underlying cost to the credit provider: Ibid at 17.
86 *National Consumer Credit Protection Act 2009* (Cth), Chapter 2, Part 2-2 outlines ASIC's function as licensor.