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Loan, Nick

From: Loan, Nick
Sent: Wednesday, 13 October 2010 5:01 PM
To: Lonsdale, John; Douglas, Justin
Cc: Mikula, Christian; Khalu, Ruth; Writer, Simon; MG FSD Bank Competition Unit; Dickson, Tom; Watson, Genevieve
Subject: Paper on possible measure to ban mortgage exit fees ~~[SEC=IN-CONFIDENCE]~~

Security Classification:

~~IN-CONFIDENCE~~

Hi John, Justin,

As discussed, Consumer Credit, Consumer Policy and ourselves have put together a short paper on the possible option to ban mortgage exit fees.

In short, there are lots of risks & sensitivities associated with banning exit fees (along the lines as we discussed this morning), but if the Government was minded to ban them, legislative amendment to the Credit Act would be the most appropriate mechanism.

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If you have any questions, or need more information, let us know.

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MORTGAGE EXIT FEES: CURRENT GOVERNMENT POLICY POSITION, POSITION & POSSIBLE FURTHER GOVERNMENT ACTION

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BACKGROUND

Mortgage Exit fees (MEF) is the commonly known collective term for:

- **Early exit / termination fees:** Fees applicable where the consumer decides to exit their mortgage before it matures; and

- **Mortgage Discharge Fees:** Fees relating to releasing the security over the property and updating the certificate of title.

On the basis of ASIC's preliminary views, 'early exit / termination fees' are currently able to be challenged under:

- the unfair contract terms (UCT) provisions of the *Australian Securities and Investments Act 2001* (which are the same as those which apply in the Australian Consumer Law for all non-financial services transactions), on the basis that such fees are contingent on the actions of the consumer); and

- the unconscionable fee provisions of the National Credit Code.

In both cases, the decision as to whether a fee is a UCT or is unconscionable is determined by a court on the application of a consumer or ASIC:

- Under the UCT law, a court would determine that the fees are unfair if they:
  - cause a significant imbalance in the rights and obligations of the parties;
  - are not reasonably necessary to protect the legitimate business interests of the mortgage provider; and
  - would cause detriment (whether financial or otherwise) if charged.

- Under the National Credit Code's provisions on unconscionable fees, a court could only determine that the fees are unconscionable if the fees exceeded the lender's reasonable loss (including lost profits) arising from early termination.

'Mortgage discharge fees' are not contingent on the actions of the consumer, and are paid by the consumer whenever they exit the mortgage, whether early or in accordance with its terms.

- Therefore, ASIC considers that these fees are part of the upfront cost of the mortgage and are not caught by the unfair contract terms nor the unconscionable fee provisions.

At this stage, there have been no cases taken against mortgage providers regarding MEF.

CURRENT ISSUES

There continues to be public and industry interest in relation to mortgage exit fees.

There remains concern amongst consumer groups that such fees may 'lock consumers in' to a mortgage, thereby inhibiting switching by consumers to mortgages that offer a better deal, and lessening competition.

In addition, there are concerns about the complex nature of mortgage fee structures. While fees are required to be disclosed to consumers, the myriad of fees can make selecting a mortgage more complex.

In that context,

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POSSIBLE FURTHER ACTION

In that context, the Government may be minded to consider further measures in relation to MEF, possibly including measures to ban such fees.

Banning MEF would make product comparison easier for consumers. The banks' costs of early termination are likely to be recouped by a combination of higher up-front fees and interest rates – making mortgage costs more transparent and simple.

Such an intervention would need to be mindful of the following issues, risk and sensitivities:

- Presentation: The Government implemented the national UCT law on 1 July 2010. It has been described as a means of addressing unfair MEF and other unfair terms in mortgage contracts which act as a barrier to switching.
  - By announcing a new power to ban MEF, so soon after the implementation of the UCT law (which have arguably not had sufficient time to have its effectiveness tested), it may be difficult to present the banning of MEF as being a new response to a new problem. It also has the potential to undermine the ASIC consultation process on the UCT law and MEF (see below).
- The ban on MEF would only apply to new loan contracts, therefore, its ability to substantially alter the competitive dynamic of the market for existing mortgages should not be overstated.
  - Were existing customers to seek a new provider following an out of cycle rate rise, they would still, at least initially, face the same barriers to switching as they always have. The consumer would not be able to obtain the benefit of any changes until they entered into a home loan after any changes came into effect, and then switched from that home loan.

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- Banning MEF will remove a fee that is designed to address the legitimate cost of offering a mortgage product. has estimated that its current exit fee of around $900 is justified based on the un-recovered component of reasonable mortgage establishment costs. As such, mortgage providers will need to find alternative ways of covering their costs, which could lead to a range of unintended consequences from the Government's action that could outweigh the benefit of the ban:

  – Increasing interest rates: in order to cover the legitimate costs of providing a mortgage, providers may seek to cover their actual or potential loss in revenue from the ban of exit fees through increasing their interest margins.

  – Increasing other fees: providers may seek to cover their costs through upfront establishment fees. By international standards, Australia has relatively high exit fees but relatively low establishment and ongoing fees. The key difference being that exit fees can be avoided by not switching. Therefore, if exit fees purely move to increased establishment or ongoing fees, customers may be worse off.

    : While customers may be more inclined to focus on these upfront fees rather than exit fees, and hence drive further fee-based competition, those same customers may be worse off as the fees they are more easily able to compare will be unavoidable, unlike exit fees.

  – Increasing other fees will increase providers advertised comparison rate on mortgages, as establishment and ongoing fees are included in comparison rate calculations, while exit fees currently are not.

  – Removing exit fees would reduce the transparency of bank fees, by forcing greater cross-subsidisation across fee categories, and may force customers that rarely switch institutions to cross-subsidise those that do regularly.

  – Increasing establishment and ongoing fees could disproportionately impact first home buyers, as they would need additional money at the beginning of their loan, potentially conflicting with the Government's goals in relation to First Home Saver Accounts.

- As exit fees are generally higher for credit unions and building societies, this measure may adversely affect these institutions more than the major banks, and therefore reduce the ability of credit unions and building societies to effectively compete.

- If customers are not charged prices reflective of costs, due to a ban on MEF, this could lead to inefficiently high levels of mortgage switching in the financial system.

  – This could flow through to increased costs to the financial system, higher prices for securitization (reflecting increased uncertainty of the loan book), flowing through to higher interest rates, and higher capital requirements demanded by APRA as a result of increased mortgage book uncertainty.

- If the Government intervenes to ban exit fees, it may set a precedent creating expectations of further government intervention in the credit market, such as the banning of other specific terms, fees or charges, the regulation of mortgage interest rates or interest margins.
  - The Government may face intense and ongoing pressure from interest groups and market participants to ban certain market conduct, fees, charges, or other aspects of banking. Such precedents could also be extended to other high profile industries such as petrol and groceries.

Amending the Credit Act

Should the Government wish to implement an outright ban on mortgage exit fees, the most appropriate mechanism would appear to be legislative amendment to the *National Consumer Credit Protection Act 2009* (the Act).

- Due to a referral of power from the States, the Commonwealth would be in a position to act unilaterally to make this change. This would obviate the need to consult and obtain the agreement of the States and Territories, as would be the case under other potential vehicles such as the UCT provisions of the ASIC Act (and the Australian Consumer Law).

This option is also focused on credit market regulation and mortgages. Alternative approaches, such as amending the UCT provisions of ASIC Act (and consequently the Australian Consumer Law) would apply more widely to other forms of financial services and other economic sectors, and the implications of this would need to be considered carefully.

As noted above, the NCCP Act currently contains a provision (s78) that **a court** may annul or reduce "a fee or charge payable on early termination of a credit contract" if it finds that the fee is unconscionable.

- ASIC issued a consultation paper in July 2010, "Mortgage early exit fees: Unconscionable fees and unfair contract terms" to assist in informing ASIC's guidance on factors it will consider in deciding whether to take action on unfair and/or unconscionable fees. This consultation process is scheduled to conclude later this month.

To ban mortgage exit fees outright, the NCCP Act could be amended to:

- define an 'unconscionable fee' as one found by a court to be unconscionable under section 78 of the NCCP Act or prescribed to be an 'unconscionable fee' by Regulation;
- prohibit the use of an unconscionable fee in a credit contract;
- impose a civil penalty or a criminal sanction (as appropriate) for including such a fee in a credit contract or levying such a fee on a consumer.

A regulation could then be made on the advice of the Minister to ban mortgage exit fees.

The form of the regulation making power and the regulation itself would need to be subject to consultation.

Moral Suasion

Additionally, the Government could continue to exercise moral suasion in relation to exit fees by:

- listing a general category of such fees as an example of a UCT in the ASIC Act (having first obtained the agreement of the States and Territories to do so through the Corporations Agreement process);

Comment [SZW1]: We probably need to do this.

- encouraging banks to continue to review such fees;
- encouraging consumers to be mindful of such fees, and shop around to get the best overall deal on their mortgage; and
- highlighting where market participants have reduced such fees (such as

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NEXT STEPS

Legislation and regulation to ban mortgage exit fees would require consultation with industry and relevant stakeholders to ensure that it did not have any unintended consequences.