

Early repayment charges on fixed rate loans

7 August 2017

Customers who borrow money at a fixed interest rate for a fixed term enjoy the benefit of knowing exactly what their repayments will be over the period of the loan. They are not affected by any rise or fall in interest rates during that time. In return, banks get a pre-determined return on their money.

But if customers repay their loan early (or make a significant lump sum payment before the end of the term), banks may not be able to lend that money to someone else at the same rate. That's because interest rates may now be lower than when the loan was taken out.

To recoup lost earnings, banks apply an early repayment charge (also known as a break fee). In order to apply an early repayment charge, it must be stated in the terms and conditions of the loan contract – hence the importance of reading a loan contract carefully. The terms and conditions may also allow for an administration fee when a loan is repaid early. This is a flat fee and quite separate from an early repayment charge.

Calculating the charge

The Credit Contracts and Consumer Finance Act 2003 regulates early repayment charges on *consumer* loans. Consumer loans are loans that have been advanced for personal, domestic or household purposes.

The Act allows lenders to recover their costs when a borrower repays a loan early. The Act contains a formula for lenders to use when calculating how much they lost, but it is not compulsory to use this formula (known as a “safe harbour” formula). They can use their own, but their formula must result in a reasonable estimate of how much they lost as a result of early repayment. Lenders must tell borrowers whether they are using the safe harbour formula or their own formula, and they must also explain how they will calculate the charge.

How to contact us

Calculating early repayment charges involves a complex formula. Many – but not all – banks base the charge on the difference between the wholesale interest rate on the loan and the wholesale rate applicable when the loan is repaid early.¹ If rates have risen since the loan was taken out, a charge won't be applied because the bank can lend the money again at a higher rate.²

Banks can't give prospective borrowers an indication of how much it might cost to break a loan early because the calculation requires two inputs that cannot be known in advance: the point at which the borrower will decide to repay the loan early, and the interest rate applicable at that future point in time. Only with that information can banks calculate any loss and any corresponding charge.

There is nothing preventing borrowers from trying to negotiate a lower charge, but banks are under no obligation to agree. Any reduction is entirely at banks' discretion. Borrowers should assume banks will apply the charge in full.

Problem areas

Customers are frequently surprised at the size of the charge they face during times of falling interest rates. That surprise often leads them to complain to us. But it is important to remember that an early repayment charge is not a problem in itself – provided the loan contract stipulates that the bank can take such a step if the loan is repaid early.

Complaints we receive include:

- A bank failed to tell a customer about the charge, either when the customer took out the loan or repaid it early. For example, a bank might have told a customer about an administration fee, but not about the early repayment charge. Or a bank might have failed to tell a customer about the charge when the customer said he or she might repay the loan early.
- A bank failed to tell a customer about how it would calculate the charge, or didn't explain the calculation properly. Bank staff might not, for example, have been able to explain how the charge was calculated, and did not refer the query to someone who could.
- A bank made a mistake in the way it calculated the charge. We will check whether the bank calculated the charge according to the contract. We may also refer complaints about methodology to the Commerce Commission, which enforces the Credit Contracts and Consumer Finance Act 2003 and has greater powers to take action against lenders that have breached it.
- A bank gave incorrect advice about the type of loan most appropriate to a customer's circumstances. A customer might, for example, have told a bank of his or her intention to sell a property within a specific time, and the bank recommended a fixed-rate loan whose term extended beyond the point when the customer was intending to sell.

¹ Other factors are also included in the calculation.

² A Commerce Commission investigation in 2009-10 concluded that the various methods used by banks to calculate early repayment charges were likely to result in a reasonable estimate of the loss suffered when borrowers repaid loans early. Such fees therefore complied with credit contracts and consumer finance law.

How to contact us

Case 1: Bank gave sufficient warning

Mr G and his partner Ms L approached their bank about fixed-term home loans. They were given the current rates and told they would face an early repayment charge if they broke the contract before the term ended. The couple later decided to take out a fixed-rate loan. When signing the documentation, the bank again advised them about the possibility of an early repayment charge.

Some months later, the couple decided to take advantage of falling interest rates by reverting to a floating interest rate. They were unhappy to learn they would face a charge of several thousand dollars and complained to us that the bank had not given them sufficient warning of the likely cost of early repayment. Furthermore, they said they would not have signed such a contract if they had understood the possible size of the fee. They wanted the bank to reduce or waive the fee.

We found the bank met its obligations when it set out the early repayment charge in the contract. The bank also verbally explained the charge to them. We did not accept the couple's argument that the bank should have warned them the charge could be substantial because banks have no way to predict the size of any charge.

Case 2: Bank erred over estimate

Mr L wanted to refinance his fixed-rate mortgage with another bank and, realizing he might have to pay an early repayment charge, asked the bank for an estimate of what he would have to pay. The bank said it would be about \$8,000 and no more than \$9,000. Such estimates, or quotes, are usually valid for only a short period of time because interest rates fluctuate daily, thereby affecting the size of the charge. But the bank didn't tell Mr L this.

The bank also made a mistake when calculating the estimate, and when Mr L broke his loan six weeks later, he was charged \$17,500. The bank offered Mr L compensation for stress and inconvenience from discovering the charge would be much higher than expected, but wouldn't reimburse the \$8,500 difference between the estimate and actual charge. It acknowledged the estimate was incorrect, but said the amount actually charged was correct and the bank was entitled to charge the fee under the loan contract. Furthermore, it said Mr L should have sought a second quote nearer to the time he broke the loan. Mr L complained to us.

We concluded that the bank had not made Mr L aware that the quote applied for only a short period of time. In addition, Mr L had taken the trouble to ask the bank officer if the quote was still the same on numerous occasions in the weeks before refinancing his loan. Each time the bank officer reconfirmed the original quote.

Based on our finding, the bank offered to pay Mr L \$9,000 – the difference between the maximum estimate and actual fee as well as \$500 for stress and inconvenience. Mr L accepted the offer.

How to contact us

Case 3: Bank used correct formula

Mr H sold his home and repaid his fixed interest rate loan early. The bank applied an early repayment charge. He did not dispute the bank's right to impose the charge, but he questioned whether the bank had used the correct interest rate when calculating the charge. The bank's explanation did not satisfy Mr H, so he contacted us.

We asked the bank for the rates applicable on the day Mr H took out the loan and the day he repaid it. Those rates were 7.921 per cent and 3.25 per cent respectively. The bank also supplied the rates at the close of business on both days (8.12 per cent and 3.325 per cent respectively, the variances being due to money market fluctuations within each day). We confirmed that the bank had used the correct rates in its calculation.

Mr H accepted our explanation and withdrew his complaint.

Case 4: Customers did not disclose plan to sell property

Mr and Mrs T decided to rent out their property and move to Australia. They had a fixed-term loan and, before moving, refixed the loan for five years, breaking the existing fixed-term loan. Through an administrative error, the bank did not impose a \$4,000 early repayment charge.

Six months later, the couple contacted the bank about selling the property. The bank estimated the early repayment charge at \$50,000. When the property sold three months later, Mr and Mrs T were charged \$30,000.

Mr and Mrs T complained to us that the bank had been aware they planned to rent the property for six months only, and then sell in the summer. They said the bank should have told them about the early repayment charge, which they wanted refunded.

We looked at whether the bank was aware of their intention to sell. If so, the fixed-term loan would have been unsuitable for them.

We found the bank was unaware that renting the property was a temporary measure. The bank's diary notes showed it was Mr and Mrs T's decision to refix the loan, and they did not mention their plans to sell the property in six months' time.

We also noted that the loan documents the couple signed when refixing the loan formed the basis of their legal relationship with the bank and clearly stated that an early repayment charge could apply. The formula to calculate any charge was also stated.

We found the bank acted correctly and could not uphold the complaint.

How to contact us