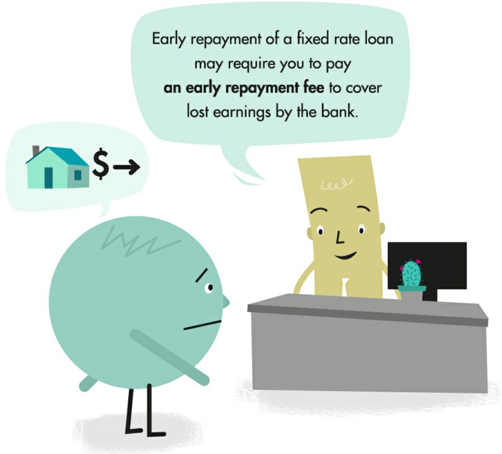
Early repayment charges

The early repayment charge applied for breaking a fixed rate loan can surprise some customers, but details about the charge, including how it is calculated, must be set out in the loan contract's terms and conditions.



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.

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 (other factors are also included in the calculation). If rates have risen since the loan was taken out, a charge usually won't be applied because the bank can lend the money again at a higher rate.

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.

Cash incentives and claw-backs

Banks will sometimes offer a cash incentive to encourage people to take out a home loan with them rather than with a competitor. If you accept such an incentive but switch to another bank before repaying the loan (or you break the terms of the loan in some way), the bank will often ask you to repay the cash incentive. This is called a claw-back. The bank's right to seek the return of a cash incentive must be set out in the terms and conditions of your loan agreement (or in a separate contract). Check whether this will be the case before accepting a cash incentive.

Read loan contracts carefully so early repayment costs and any administration fees don't come as a nasty surprise.