25 February 2011

By email: banking@treasury.gov.au

John Lonsdale
General Manager
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Lonsdale

Exposure Draft - National Consumer Credit Protection Amendment Regulations 2011

The Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to comment on the exposure draft of the National Consumer Credit Protection Amendment Regulations 2011 (the **Regulations**), setting out the proposed amendment to ban exit fees on new home loans.

We support the amendments in principle and broadly in the terms of the proposed Regulations. However, we recommend that changes be made to tighten the definition of "break fee" and that, while the intention is sound, the exemption for "discharge fees" be removed. Our comments are detailed more fully below.

About Consumer Action

Consumer Action is an independent, not-for-profit, campaign-focused casework and policy organisation. Consumer Action provides free legal advice and representation to vulnerable and disadvantaged consumers across Victoria, and is the largest specialist consumer legal practice in Australia. Consumer Action is also a nationally-recognised and influential policy and research body, pursuing a law reform agenda across a range of important consumer issues at a governmental level, in the media, and in the community directly.

Since September 2009 we have also operated a new service, MoneyHelp, a not-for-profit financial counselling service funded by the Victorian Government to provide free, confidential and independent financial advice to Victorians with changed financial circumstances due to job loss or reduction in working hours, or experiencing mortgage or rental stress as a result of the current economic climate.

Prohibition of home loan early exit fees

As we said in our evidence to the hearing of the Senate Economics Committee's inquiry into competition within the Australian banking sector conducted on 25 January 2011[1], we support the Government's move to ban home loan early exit fees. We are of the firm view that such a ban will allow the home loan market to operate more effectively and competitively.

As you are aware, advice provided by the Treasury (subsequently released through a Freedom of Information request) contained discussion about the possible effects of such a ban. Some aspects of the advice, which have been reported in recent days by the media, relate to concerns that we addressed in our evidence to the Senate inquiry. We would like to take this opportunity to set out our views on some of these concerns about a ban on mortgage early exit fees and reiterate our support for this regulatory measure.

Cost-shifting

One of the concerns that has been expressed is that a ban would force lenders to recover costs in other ways, such as by raising their interest rates or increasing other fees.

To the extent that early exit fees do represent genuine costs to the lender, there is no argument that lenders may move to recover these costs in their upfront fees or interest rates. However, that is essentially the main point of this reform. Far from being a problem, this cost shifting will actually benefit consumers and competition.

To drive effective competition, we need consumers to be able to make accurate assessments of the overall price or cost of the home loans they are considering and make an informed choice of home loan based on this information. The headline interest rate represents only one component of the total cost of the home loan, with up-front fees, monthly or annual account fees and exit fees also forming part of the total price of the product.

By back-ending some fees and expressing them to be contingent on an event occurring or not occurring, consumers are much less likely to be aware of them than if they were disclosed clearly upfront. Behavioural insights also teach us that consumers are less able to take these sorts of fees into account in calculating the total cost of the loan than an upfront fee, due to biases such as overconfidence and hyperbolic discounting. This may lead consumers wrongly to choose a loan that is actually more expensive in total.

The proposed Regulations may mean that lenders shift costs from early exit fees to interest rates or front-end fees. In doing so, lenders will be removing fees that are back-ended and expressed as contingent, and replacing them with fees or rates that are much more visible. This will mean it is much more likely that consumers will be better informed about the true price of different loans, allowing them to more easily choose which is best for them. In turn, making these prices more visible will make them more sensitive to competition, as consumers shopping around will take them into account, driving down the overall price of home loans to more efficient levels in the long term.

[1] The transcript can be viewed at http://www.aph.gov.au/Senate/committee/economics_ctte/banking_comp_2010/hearings/index.htm.

Arguably, at present deferred establishment fees (another name for early exit fees) are often charged for a certain period (say, five years), on the argument that the lender will recover those establishment costs during that period through other fees, charges and interest. In this case customers will currently be paying higher than efficient interest rates after the fifth year, given that their interest rates are set to recover establishment costs which have already been recovered.

Although the released Treasury advice appears to agree that customers may give more attention to upfront fees, and thereby increase competitive pressure on those fees, it also states:

> those same customers may be worse off as the fees they are more easily able to compare will be unavoidable, unlike exit fees.

This statement appears to suggest that it is better for consumers to stay with an uncompetitive loan (and avoid an inflated early exit fee) than to switch to a competitor who is offering a better deal. This is a poor outcome for consumers, who are discouraged from getting the best deal available. It is equally bad for competition, as it denies revenue to lenders who invest in creating a better product and rewards those with an inferior product but high exit fees, creating little incentive to lenders to compete by offering the better product.

Subsidisation

Another concern that has been expressed is that banning early exit fees would, as described in the Treasury advice, "force customers that rarely switch institutions to cross-subsidise those that do regularly".

There are a number of flaws with this argument. The first is that an exit fee ban still permits lenders to bill customers for genuine costs associated with establishing a home loan. To the extent that the set-up costs of home loans are currently being charged as exit fees, it could perhaps be said that customers who switch loans and pay an early exit fee are subsidising those customers who do not switch.

Secondly, this concern is simply a variation of the one discussed above under 'Cost Shifting'. The subsidisation argument assumes that it is better to have consumers continue paying for an uncompetitive product than it is for them to take their money elsewhere. On the contrary, customer switching is not a burden on the home loan market but an essential activity if we are to have an effectively competitive market. The argument essentially admits that exit fees do have the anti-competitive effect of locking customers into uncompetitive products.

Finally, this argument tends to imply that borrowers who exit their home loans early are a fickle minority, and their more loyal compatriots would be subsidising their switching were it not for early exit fees. As noted above, however, it is actually desirable to have a significant number of borrowers shopping around and switching home loans to drive competitive outcomes in the market. Further, in ASIC's *Review of Mortgage Entry and Exit Fees*, it is noted that 2006 research by Fujitsu Consulting and JPMorgan found that "the average Australian mortgage is terminated or refinanced within approximately three years".[2] The ASIC report went on to say that early termination fees were "typically charged for mortgages that are terminated in the first five years (though in some cases beyond this period)".

On these figures, the average (not the exceptional) customer can expect to pay an early exit fee. To the extent that these fees represent genuine costs, this might mean that their lender's overall interest rates are lower and it might then be argued that the average home loan customer is currently cross-subsidising interest rates for the minority of borrowers who avoid switching.

Effect on smaller lenders

Finally, the Treasury advice also notes concerns that banning exit fees may harm the ability of smaller lenders to compete, as smaller lenders typically charge greater exit fees to offset discounts elsewhere in the loans.

We agree that some lenders do use higher exit fees to offset front-end and ongoing costs to attract customers from other lenders. However, we do not agree that this necessarily represents effective or beneficial competition.

By offering a lower interest rate and offsetting those costs with a higher exit fee, a lender is simply making their product *appear* cheaper by obscuring some of the costs. Competition from smaller lenders is beneficial, but merely making a product appear better is not genuine competition, in the same way that attracting customers away from other suppliers in a market by using, for example, misleading or deceptive advertising or predatory pricing, would not represent effective competition.

The draft regulations

Consumer Action supports the proposed Regulations, including the break fee exclusion. In our view, the proposed amendment is generally well targeted. For example, we support the proposed definition of a "credit contract for a home loan" under draft regulation 79A(2), as it ensures that all loans relating to residential property are covered, regardless of whether the loan application expresses that the property purchase and/or loan are for owner-occupier or investment purposes.

However, we recommend that the break fee exception should be tightened and the discharge fee exception be removed, for the reasons set out below.

Break fees exception

The break fees exception is defined in the following terms:

> (3) In this regulation:
>
> ***break fee*** means a fee or charge that:

[2] ASIC's report is available at http://www.asic.gov.au/asic/pdflib.nsf/lookupbyfilename/rep_125_review_of_mortgage_entry_and_exit_fees.pdf/$file/rep_125_review_of_mortgage_entry_and_exit_fees.pdf

(a) relates only to the early termination of a credit contract for a fixed loan; and
(b) is payable as a result of a change in the cost of funds to the credit provider.

...

fixed loan means a credit contract under which, at the time of early termination of the credit contract, the annual percentage rate is fixed for the whole or part of the amount due under the credit contract.

While the exception correctly defines a fixed loan to include part fixed and part variable loans, the definition of the fee does not then limit the break fee to a fee payable with regard to the fixed element of a part fixed loan only. As a result, where a loan is part fixed and part variable, the regulation could be read as allowing break fees to be calculated with regard to the total amount due under the contract rather than only the amount subject to a fixed annual percentage rate.

We acknowledge that the break fee definition attempts to prevent this problem by stating that a break fee is a fee payable 'as a result of a change in the cost of funds to the credit provider'. However, we do not believe that this ensures that a break fee can only be charged with regard to the fixed part of the amount due under the credit contract.

We suggest that the regulation be amended so that the definition of a break fee also refers to the fee relating only to the amount due under a credit contract for a fixed loan for which the annual percentage rate is fixed (where the loan is part fixed and part variable). Although this is clearly the intention of the proposed regulation, we feel that adding this detail is necessary to remove a possible loophole.

Discharge fees exception

While we agree with the intent of the discharge fee exception, we believe it provides a loophole which will allow lenders to continue effectively charging early exit fees. On the other hand, removing the exception will not cause any harm, as lenders will be able to recover discharge costs through establishment or ongoing fees. For this reason, we recommend the exception be removed.

The discharge fee exception is defined in the following terms:

(3) In this regulation:

...

discharge fee means a fee or charge that only reimburses the credit provider for the reasonable administrative cost of terminating the credit contract.

...

(4) For the definition of ***discharge fee***, a cost is a reasonable administrative cost only if it does not exceed a reasonable estimate of the average reasonable administrative cost to the credit provider of terminating that class of credit contract.

We accept that there are genuine administrative costs involved in terminating a credit contract. However, we understand that the intention of this exemption is to allow only those genuine administrative costs associated with termination at any point in time, not the costs associated with an *early* termination specifically, otherwise it would be enabling early exit fees. In its current form, we believe the proposed regulation could allow lenders to charge for early termination.

For example, lenders could offer to waive a loan discharge fee after a certain time, making early exit more expensive than later exit. Although in this scenario the fee charged for an early exit would still need to be reasonable in itself, the offer to waive the fee at a later point would still act to discourage exit in the same way early exit fees do now.

Allowing an exemption for discharge fees provides a method for avoidance of the exit fee ban. The example given above in one possible means of avoidance, and another would be for a lender to inflate the fee above its administrative costs but not obviously so. Neither consumers nor even the regulator, ASIC, are in a position to assess whether a particular discharge fee imposed by a lender is set at a level that is reimbursing the lender for more than their reasonable administrative costs, without significant and costly investigation.

We also make the point that if the cost of discharging the credit contract is the administrative cost associated with ending the contract whatever the time of discharge, and it is being determined upfront, this cost could just as easily be incorporated by a lender into an upfront fee.

For these reasons, we do not think an exemption for discharge fees is necessary. As it is not necessary and opens up an avenue for avoidance, we recommend it be removed from the Regulations.

At the very least, we suggest that this definition could be improved by specifying that a discharge fee is one that reimburses the credit provider for the average reasonable administrative cost of terminating the contract at any point during the loan term (not also the cost, if any, of exiting a contract early), and that a fee or charge is not a discharge fee if it is greater than the fee which the customer would pay if they terminated the contract at a later date.

Thank you again for the opportunity to comment on the proposed amendment. Please contact us on 03 9670 5088 or at david@consumeraction.org.au if you have any questions about this submission.

Yours sincerely
CONSUMER ACTION LAW CENTRE

Nicole Rich	David Leermakers
Director, Policy and Campaigns	Policy Officer