

Breaking a fixed rate loan

About AFCA

AFCA provides fair, free, and independent dispute resolution for consumers and small businesses who are unable to resolve complaints with member financial firms. AFCA does not regulate the financial services industry. It provides an independent complaint resolution service as an alternative to the courts.

Complaints about Break Costs

AFCA will generally not review a complaint about the level of a fee, premium, charge, rebate or interest rate applied by a financial firm. Where a complaint is about a particular fee charged to a customer by a financial firm AFCA will consider:

- Whether a fee has been properly disclosed to the customer
- Whether a fee has been properly charged in accordance with the customer's contract with the financial firm
- Whether a fee has been correctly applied by the financial firm, having regard to any scale of charges generally applied by that financial firm, and
- If the loan is regulated by the National Credit Code (the Code), whether the break cost exceeds a reasonable estimate of the credit provider's loss arising from the early termination.

AFCA often receives complaints from customers with fixed interest rate loans who say that the financial firm did not:

1. Inform them that a break cost would be charged if they terminated their loan before the expiry of the fixed rate period; or
2. If some explanation was given, it did not adequately describe the manner in which the break cost would be calculated.

We accept that a financial firm may suffer financial loss if a fixed rate contract ends early or is partly prepaid. In assessing whether a loss has in fact been incurred, and to determine if the financial firm is entitled to recover a break cost, we will review the terms & conditions of the loan contract, relevant interest rate movements and any applicable law.

The Code (and before 1 July 2010, the Uniform Consumer Credit Code), provides that any break cost charged should not exceed a reasonable estimate of the loss suffered by the financial firm. However, it is important to understand that these provisions do not apply to loans which are not regulated by the Code ("unregulated loans").

Assessment of Break Costs for loans not covered by the Code

Examples of loans to which the Code does not apply may include market linked fixed interest rate small business loans, Commercial Bill finance and commercial loans and, prior to 1 July 2010, fixed interest rate loans provided for non-owner occupied residential investment properties.

Where there is a complaint about the amount of the break cost charged or quoted in these cases, we will review the wording of the loan contract and assess whether the break cost charged or quoted exceeds the amount the financial firm was entitled to charge under its contract or at law.

Assessment of Break Costs for loans regulated by the Code

Examples of such loans include all consumer fixed interest rate loans secured by a residential property and, since 1 July 2010, fixed interest rate loans secured by a residential property.

Where there is a complaint about the amount of the break cost charged or quoted for regulated loans, we will have regard to the provisions of the contract and the information supplied by the financial firm. We will also independently calculate an estimate of the loss to assess whether the break cost charged or quoted by the financial firm was reasonable.

AFCA's assessment of whether the break cost was reasonable

The financial firm will generally make its calculation of the break cost based on the movement in its cost of funds. AFCA accepts that how a financial firm determines its cost of funds is commercially sensitive and it is under no obligation to disclose that information to its customers.

In order, therefore, to determine, in a transparent way, whether a break cost is reasonable, based on information obtained from the financial services industry, AFCA has concluded that the movement in a financial firm's cost of funds is best verified by comparing movement in interest rates in the wholesale interest rate market, by assessing the difference between:

1. The fixed term wholesale market interest rate¹ for the relevant term of the customer's loan; and
2. The fixed term wholesale market interest rate for the remaining term of the fixed interest rate period at the time the loan was fully or partly prepaid. As an example, if a fixed rate loan with a five-year fixed interest rate is repaid after two years, so three years before the contracted fixed interest rate was due to expire, we will use the relevant three year fixed term wholesale market interest rate in this part of our calculation.

¹ For fixed interest rate terms from 1 to 5 years, AFCA references the fixed term wholesale market rates as published daily in the Australian Financial Review for "Swap rates: Quarterly in arrears". For fixed terms longer than 5 years the reference point is the relevant "Swap Rate" as published daily by the Australian Financial Markets Association (AFMA).

The movement in the wholesale interest rates between the two points in time is then used in our break cost calculation to assess whether the loss claimed by the financial firm represents a reasonable estimate of its loss. In addition to the relevant wholesale market interest rates, our assessment of the loss takes into account the amount repaid, the remaining term of the original fixed rate contract, the contracted repayments and the time value of money.

Ability to dispute a Break Cost

If a customer decides to repay the fixed interest rate loan this does not prevent them from lodging a complaint with us to assess whether the break cost was properly incurred. If we conclude that the break cost or any portion of the break cost has been charged incorrectly we will require the amount incorrectly charged to be refunded.

Assessment of Loss and Duty to Mitigate

Where we reach a view that the financial firm has acted in error when quoting or charging the break cost, in awarding compensation we will assess what actual loss has been incurred as a result of the financial firm's actions. In certain circumstances, a loss may not arise unless a break cost has actually been paid.

A customer who has suffered loss as a result of an error made by the financial firm is under a duty to take action to mitigate that loss. It follows that a party who has suffered loss is unable to claim compensation for any loss which could reasonably have been avoided by that party. It is not our role to provide advice.

Given a financial firm's cost of funds may vary significantly on a daily basis, if a customer maintains their fixed interest rate loan while we are considering the complaint, the break cost may change significantly. We encourage customers to obtain regular quotes from their financial firm as to any break cost payable and seek independent financial advice.