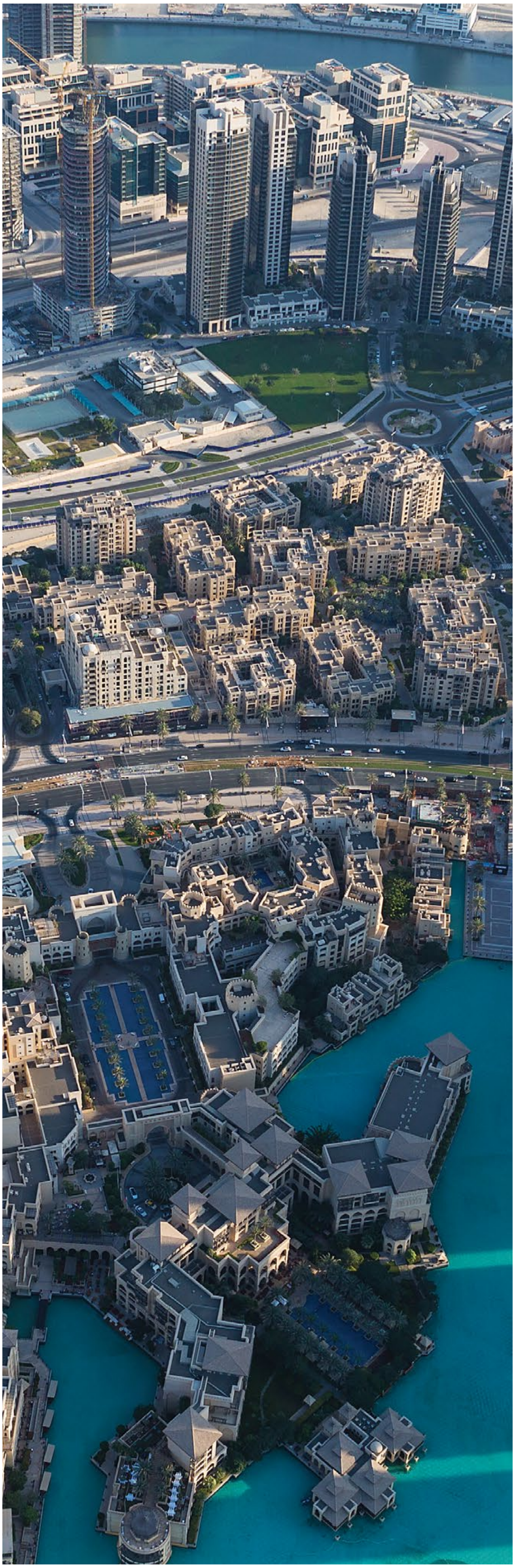
Cavendish Maxwell

# Mortgage Repayment Penalties: reasonable charge or restriction on competition?

OPINION



## What just happened?

The UAE Central Bank reduced the 3% early settlement fee ('exit') for mortgages introduced in June last year to 1%, or Dh10,000, whichever is lower.[1] Market participants generally reacted favourably to the announcement, noting that in principle at least, borrowers must always weigh up the benefits of lower interest rates against the up-front cost of the exit fee.

## Why does it matter?

Cutting exit fees in this way certainly makes it easier for borrowers to switch to another lender offering better interest rates or providing some other advantage such as offset. Another policy reason often cited for their elimination is that although they are transparent, borrowers may also not always take account of backended and contingent exit fees when deciding on which loan to take.[2] In other jurisdictions such as Australia, mortgage exit fees have been outright banned on the basis that they represent an infringement on competition, described by the Australian Government at the time as "one of the biggest roadblocks stopping Australians getting a better deal for their families"[3] especially as they were imposed on variable rate home loans often taken out relatively vulnerable consumers.[4] Analysis also pointed to the fact that they were creeping up over time, for example between 1995 to 2007, the total annual fee take against the aggregate Australian 'mortgage book' increased from 0.67% to 1.39% annually.[5] Economists also suggest that because low or zero refinancing fees will encourage some householders to refinance, when interest rates fall there may be an increase in spending as a result. Under a range of circumstances, prepayment of mortgage loans also makes good economic sense for borrowers, for example when:

• Interest rates are cut and the existing lender does not pass on the rate reduction, or does so to a lesser extent than its competitors. Because interest rates on savings have decreased while the rates on existing mortgages are generally fixed for some years, the value of prepaying a mortgage has increased. However, incentives to prepay explain a much larger part of prepayments for wealthier households and for households with a high net-of-tax interest rate differential.[6]

• Interest rates rise, and some other lenders either do not pass on the rate increase or do so to a lesser extent than that of the borrower.

• Fixed interest rate agreements terminate and the resultant variable interest rate is less attractive than those offered by competitors.

• Other mortgage conditions, e.g. restrictions on subletting, are perceived as more onerous by borrowers than those offered by competitors.[7]

• Mortgage holders are holding cash and wish to end their debt altogether,[8] for example if they are retiring early, planning to emigrate or for any other equivalent reason.[9]

• If the property is sold, although if the mortgage is 'ported' to a new property the charges may not apply.[10]

# *Counterarguments*

Critics have put forward a two principal objections to the widely accepted idea that exit fees are a form of restriction on competition.[11] The first is that because increasing consumer protection shifts risks to the mortgage provider, it is inevitable that the cost of borrowing will increase as a result. Effectively the clients' profit entails a loss to the bank as a mortgage provider.[12] Banks claim in particular that they may make a loss from re-arranging their own funding, and at least for fixed interest loans, this argument has been accepted.[13] The argument more widely however is familiar from any objection to regulation and can be countered by including externalities such as an increase in efficiency across all lenders and the benefits of greater actual (rather than merely performative) transparency of costs by borrowers in the overall calculation of costs and benefits. The second is that allowing borrowers to refinance without costs when interest rate falls allows debtors to profit from refinancing, without commensurate losses if interest rates remain constant or rise. Similarly, in an efficient market refinancing would be minimised as lenders will be aware of the threat to their loan book of any attempt to extract economic rent from borrowers.[14]

# Conclusion: Way to Go

Utilising changes in exit fees as a policy tool has been an effective way to control the mortgage market in the UAE. But these benefits must be weighed against the fact that reducing mortgage prepayment penalties, ultimately as Australia has done down to zero, does not challenge the financial performance of banks. Australian banks are some of the most financially secure in the world. But the policy of prohibiting mortgage repayment penalties does increase efficiency in the mortgage market, effectively removing a constraint to free competition. If the hallmark of a responsive, intelligent government is the recognition of a policy mistake by putting matters right, then it is only right to commend the UAE Government for reversing the decision taken in July 2018, and doing so in government policymaking terms with admirable swiftness. One can hope that the principle having now been established, the UAE Government will eventually look at completing the task and eliminating prepayment fees altogether, whilst remaining vigilant with regard to any backdoor reinstatement of fees via delayed administrative charges or other attempts to circumvent the legislation.

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