

Early Repayment of fixed rate loans – understanding why early repayment costs are charged

The information in this brochure is designed to give a general overview of how early repayment costs* – often referred to as economic or break costs – are calculated and why the lender[^] charges them. This brochure does not replace or form part of your loan contract.

For the purposes of this brochure, early repayment cost or break cost will be referred to as economic cost.

Explanation of economic cost

Fixed rate loans offered by us provide borrowers with interest rate and repayment certainty for a fixed term up to 5 years. Economic costs may apply in some circumstances and borrowers need to be aware when they may apply.

What is an economic cost?

An economic cost is the lender's[^] calculation of its loss on a fixed term due to movements in the cost of funds. In simple terms, it represents the difference between the cost of funds at the start of the fixed rate period and the cost of funds on the date of the early repayment over the remainder of that period.

Economic costs may occur, if before the end of the fixed term of your loan:

- The loan is fully repaid.
- A partial prepayment is made to the loan.
- The loan changes from fixed to variable or to another fixed term.
- The total outstanding loan amount is payable because you are in default and it is necessary to end the fixed rate contract early.

As it can be seen, these events are typically customer driven which triggers a significant change in the original fixed term of the loan and can in turn potentially incur a sizable loss to the lender[^].

Before fixing all or any part of your loan, you should consider whether you intend to sell your property, make extra principal repayments or change your lender during the fixed rate term.

Why is an economic cost charged?

To understand why an economic cost is charged, you need to understand what happens when money is lent to you to fund your loan. In order to lend money to you at a fixed rate for a fixed term, the lender[^] typically borrows funds from someone else (e.g. other banks, small business, personal depositors) for the same period. The interest rate at which the lender[^] borrows from the market to fund your loan is called the 'cost of funds rate'.

Just as there is an obligation for borrowers to repay their loan, there is also an obligation for the lender[^] to repay those in the market who originally lent the money to fund the fixed rate loan or to continue to pay the fixed interest on this borrowing.

Therefore, if you repay your fixed rate loan before the end of its fixed rate term, it is necessary to calculate any economic costs the lender may incur on breaking their own funding arrangements or in using the repaid funds to fund another loan.

As such, in some circumstances, the lender[^] looks to recover the economic cost associated with the initial fixed loan from the borrower.

What factors are taken into account for calculating an economic cost?

An economic cost is based on a number of factors including:

- The amount of the loan being repaid.
- The remaining fixed rate period.
- The contracted loan repayments.
- The cost of funds at the start of the fixed rate term of the loan ('original cost of funds').
- The cost of funds at the time of repayment ('current cost of funds') adjusted for the remaining fixed rate term of the loan.

The following quick reference table provides you with an indication of the economic cost in \$ for every \$1,000 of loan principal repaid early.

Difference between original cost of funds (p.a.) less current cost of funds (p.a.)	Number of months before fixed rate term expires							
	1	6	12	18	24	30	36	
1%	1	5	10	15	20	25	30	
2%	2	10	20	30	40	50	60	
3%	3	15	30	45	60	75	90	
4%	4	20	40	60	80	100	120	
5%	5	25	50	75	100	125	150	

It is important to note that this table shows a selected number of scenarios only.

Finally, this amount is discounted at the current cost of funds to reflect the present day value of the future cash flows.

A working example#

A borrower elects to take a 3 year fixed rate loan for \$250,000 with interest only payments.

The 3 year original cost of funds is 7% p.a.

With 24 months of the fixed rate loan term to go, the borrower decides to repay the loan in full. The 24 month current cost of funds is 4% p.a.

The economic cost in this instance is based on:

- Loan repayment = \$250,000
- Interest rate difference between the original cost of funds and the current cost of funds = 3% p.a. (i.e. 7% p.a. less 4% p.a.)
- Remaining term = 24 months

By referencing the above table along with early repayment information, the economic cost per \$1,000 principal repaid early = \$60.

The approximate total economic cost would be \$15,000 (i.e. 250 x \$60).

Discount rate applied to reflect the present day value of the future cash flows = 4% p.a.

APPROXIMATE TOTAL ECONOMIC COST PAYABLE BY THE BORROWER = \$14,400.

When is an economic cost charged?

An economic cost may be charged when you repay a fixed rate loan prior to the end of its fixed rate term. This will typically occur when the original cost of funds exceeds the current cost of funds at the time of repayment, resulting in a loss to the lender.[^]

An economic cost will not be incurred when a partial prepayment is made provided that these extra payments **do not** exceed \$20,000[†] within the fixed rate term.

Obtaining an economic cost quote

If you are considering prepaying your loan during its fixed rate term, an estimate of the economic cost may be obtained by contacting Customer Care on 1300 543 558.

IMPORTANT: Quotations will be valid for a period of 3 days only.

*Referred to as 'break costs' or 'Lender Early Payment Loss' in your loan contract.

[^]Refers to AFSH Nominees Pty Ltd ACN 143 937 437 (AFSH), a member of the National Australia Bank Group. National Australia Bank (NAB) makes facilities available to AFSH for AFSH to fund loans. Your loan contract document will advise your lender. If your lender is Perpetual Trustees Victoria Ltd please request the document entitled "Information bulletin: Funding fixed rate mortgages, why break costs are charged and how they are calculated.

[#]For illustrative purposes only. Economic costs can be complex. Please contact the above numbers in this brochure for an estimate of economic costs.

[†]Applicable for loans approved from Friday, 27 September 2013.