



# If it's fixed, why break it?

The significant downward movement in interest rates in recent times has made fixed loan break fees, or **prepayment fees**, a topical one.

Since 2008, interest rates have dropped dramatically in line with the Reserve Bank's reduction of the Official Cash Rate and, consequently, many borrowers have sought to enjoy such lower interest rates where they had previously fixed a higher rate for a period not then expired.

Lenders charge prepayment fees to recover any **loss** arising from a borrower repaying its loan earlier than the date for repayment specified in the loan contract or seeking to move to some other rate.

So, let's take a closer look at whether a borrower is entitled to repay its loan earlier than the date for repayment as specified in the loan contract, a borrower's obligations under a loan contract, and the procedure used to calculate a prepayment fee.

## Borrower's Entitlement to Repay Loan in Full

If the loan is a consumer credit contract, the Credit Contracts and Consumer Finance Act 2003 provides that the borrower is entitled to repay their loan in full at any time. (A consumer credit contract is a loan to a person (not acting as trustee, and not companies) primarily for personal, domestic or household purposes. Say, to buy their home).

## Loan Contract Obligations

Prior to making a loan available, a lender will require a borrower to enter into a loan contract. With a home loan, the loan will be secured by a registered mortgage over the home. The loan contract will set out the terms of the lending between the lender and the borrower.

The loan contract will specify the interest rate for the loan. The interest rate can be floating (able to change at any time) or fixed so that it can't change for the specified time (say, two years). **Fixed rate loans** give certainty of interest cost. In addition, the loan contract will specify the borrower's rights in relation to repayment, and what fees the borrower is to pay to the lender in such circumstances.

In some instances, a loan contract will set out a formula to calculate a prepayment fee on a fixed rate loan.

So, if considering whether to break a fixed-term interest rate, it is important to consider your obligations under your loan contract and the amounts and/or fees that you will be required to repay.

## How is a Prepayment Fee Calculated?

Prepayment fees are limited by the Credit Contracts and Consumer Finance Act to a reasonable estimate of the lender's loss from a full prepayment using:

- a procedure prescribed by regulations, or
- an appropriate procedure set out in the loan contract for calculating that loss.

Calculating a lender's loss involves comparing the return a lender would have made on the original loan contract (had the contract run its course) with the return the lender would make when the money is re-lent at a lower rate.

The limitation as to the prepayment fees a lender can charge only applies to consumer credit and not to other loans (say, business loans).

Because the method of calculating a lender's loss assumes a fixed interest rate, prepayment fees will not apply to revolving credit contracts as these can be repaid at any time and, therefore, no issue of "loss" arises.

However, it doesn't work in reverse in that, if interest rates rise and the borrower seeks to break their contract, the lender does not pay the borrower the lender's gain from lending at the higher rate.

The Commerce Commission acts as the **consumer watchdog** to ensure that fees charged by lenders comply with both the Credit Contracts and Consumer Finance Act and the Fair Trading Act 1986.

So, if you're going to break it, weigh up all the costs first! ••



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