

### FOS's Jurisdiction

The Financial Ombudsman Service (FOS) is an independent dispute resolution service established as an alternative to the courts for customers of financial services providers with specific types of disputes. FOS does not regulate the financial services industry but rather provides a dispute resolution service. Under FOS's Terms of Reference we are not empowered to review a general policy of a financial services provider unless the policy breaches a specific duty or obligation owed by the financial services provider to its customer.

### Disputes about Break Costs

FOS will not review a financial services provider's general policy decision to charge a fee for its services or to recover its costs. Where a dispute involves a complaint about a particular fee charged to a customer by a financial services provider FOS 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 services provider;
- Whether a fee has been correctly applied by the financial services provider, having regard to any scale of charges generally applied by that financial services provider; and
- If the loan is regulated by the National Credit Code (the Code) (formerly Uniform Consumer Credit Code (UCCC)), whether the break cost exceeds a reasonable estimate of the credit provider's loss arising from the early termination.

FOS often receives disputes from customers with fixed interest rate loans who say that the financial services provider 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.

This office accepts that a financial services provider 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 services provider 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 (since 1 July 2010) and formerly the UCCC, provides that any break cost charged should not exceed a reasonable estimate of the loss suffered by the financial services provider. 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 dispute 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 services provider 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 dispute 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 services provider. We will also independently calculate an estimate of the loss to assess whether the break cost charged or quoted by the financial services provider was reasonable.

### **FOS’ assessment of whether the break cost was reasonable**

The financial services provider will generally make its calculation of the break cost based on the movement in its cost of funds. FOS accepts that how a financial services provider 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, FOS has concluded that the movement in a financial services provider’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 rate<sup>i</sup> 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.

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 services provider 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 dispute 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 this office reaches a view that the financial services provider 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 services provider'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 services provider 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 the role of this office to provide advice.

Given a financial services provider's cost of funds may vary significantly on a daily basis, if a customer maintains their fixed interest rate loan while a dispute is being reviewed by this office, the break cost may change significantly. We encourage customers to obtain regular quotes from their financial services provider as to any break cost payable and seek independent financial advice.

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For fixed interest rate terms from 1 to 5 years, FOS 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).