Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

T +353 1 224 6000 F +353 1 671 5550

Bosca OP 559, Sráid Wapping Nua, Cé an Phoirt Thuaidh,
Baile Átha Cliath 1, Éire.
Po Box No. 559, New Wapping Street, North Wall Quay,
Dublin 1, Ireland.

www.centralbank.ie

<u>BY EMAIL AND BY POST</u>

Deputy Michael McGrath TD
Leinster House
Kildare Street
Dublin 2

26 September 2018

Re: Breakage fee methodology for fixed-rate mortgages

Dear Deputy McGrath

Thank you for your letter of 29 August in which you enquire about the early repayment provisions contained in the European Union (Consumer Mortgage Credit Agreements) Regulations 2016 (the "Regulations") which transpose the Mortgage Credit Directive [1] (the "Directive"). This is an important consumer protection issue and the Regulations set clear criteria which lenders are required to observe. The Regulations apply to relevant mortgage loans that came into effect after 21 March 2016 (I have described these loans as "mortgage loans" for the purposes of this letter). The Consumer Credit Act 1995 ("CCA") applies to relevant mortgage loans that came into effect

[1] Directive 2014/17/EU

before 21 March 2016[2]. Appendix 1 sets out in further detail the statutory and regulatory protections available to borrowers who wish to repay their mortgage loans early as follows:

- the Regulations apply to mortgage loans entered into after 21 March 2016;
- the CCA applies to mortgage loans entered into before 21 March 2016; and
- the Consumer Protection Code 2012 applies to all mortgage loans.

Your letter enquires about early repayment charges under the Regulations and so I have concentrated on these early repayment charges for the purposes of this letter.

<u>Regulation 26 of the Regulations</u>

Regulation 26(1) of the Regulations gives consumers a right to fully or partially repay their mortgage loans early. In such cases, the consumer will be entitled to a reduction in the total cost of the mortgage loan with such reduction consisting of the interest and the costs for the remaining duration of the contract.

Regulation 26(2) of the Regulations provides:

> *"A creditor shall be entitled to* ***<u>fair</u>*** *and* ***<u>objective</u>*** *compensation, where justified, for* ***<u>possible costs</u>*** *directly linked to the early repayment, but shall not impose a* ***<u>sanction</u>*** *on the consumer, and any such compensation shall not exceed the* ***<u>financial loss</u>*** *of the creditor."*[3]

Regulation 26(2) of the Regulations transposes Article 25(3) of the Directive which provides:

> *"Member States may provide that the creditor is entitled to fair and objective compensation, where justified, for possible costs directly linked to the early repayment but shall not impose a sanction on the consumer. In that regard, the compensation shall not exceed the financial loss of the*

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[2] Section 121 of the Consumer Credit Act 1995 permits lenders to charge an early redemption fee in respect of certain fixed interest housing loans but does not prescribe the manner in which such a redemption fee should be calculated.

[3] Emphasis added

creditor. Subject to those conditions Member States may provide that the compensation may not exceed a certain level or be allowed only for a certain period of time."

The Directive is a maximum harmonisation measure subject to certain national discretions, which means that national law may not exceed the terms of the Directive. In transposing the Directive, Ireland elected not to avail of the national discretion contained in article 25(3) to provide that compensation may not exceed a certain level or be allowed only for a certain period of time.

It should also be noted that compensation is only permitted where the borrowing rate provided for in the credit agreement:

- may not be changed; or
- may not be changed over a period of at least one year; or
- is capped, for at least 5 years, at a rate no greater than 2% above the interest rate that applies on the date that the credit agreement is made.

You have asked how the Central Bank defines the term 'financial loss' in the context of the early repayment provisions in the Regulations. As stated in Regulation 26(2) above, the Directive is maximum harmonisation and neither it nor the Regulations prescribe how an early repayment charge may be imposed but rather set out the criteria that must be followed by lenders in imposing an early repayment charge, as follows:

a) Criterion 1: The compensation must be fair and objective;
b) Criterion 2: The compensation must be justified;
c) Criterion 3: The compensation must be for possible costs directly linked to the early repayment;
d) Criterion 4: The compensation must not exceed the financial loss of the creditor; and
e) Criterion 5: The compensation must not impose a sanction on the consumer.

The Central Bank has not issued any guidance on the interpretation of the Directive as any such guidance would more appropriately issued at a European level given that the aim of the Directive is to harmonise consumer protection in this area. While the European Banking Authority ("EBA") has issued guidance on the implementation and interpretation of the Directive[4], it has not released guidance on methodologies used by lenders to calculate early repayment charges. The European Parliament, in a paper entitled 'Mortgage Credit, Mis-selling of Financial Products'[5], notes that it would be appropriate for the EBA to issue guidelines on the early repayment of mortgage loans. In its paper, the European Parliament recommends the introduction of guidelines by the EBA in respect of the interpretation of 'fair and objective compensation' and its difference to a penalty concerning early repayment under Article 25(3) of the Directive.

With the above in mind, in monitoring compliance with lenders' imposition of early repayment charges, the Central Bank has regard to the five criteria referred to above and to the ordinary and natural meaning of the terminology used in the Regulations.

Central Bank's engagement with lenders in relation to early repayment charges

I note your concern regarding deviations in the calculation of compensation by lenders where a consumer seeks to repay a fixed interest mortgage early. As you know, the Central Bank uses information on any specific cases to inform ongoing supervisory work, which includes the issue of early repayment charges. The focus of such supervisory work is to verify compliance with relevant regulatory requirements.

On the issue of possible costs directly linked to the early repayment, one possible reason for a deviation in compensation by different lenders linked to early repayment of a fixed rate mortgage could be the cost to the lender of adjusting the funding in place for that mortgage (or portfolio of mortgages, as relevant). Lenders typically fund lending activities (including fixed interest rate mortgages) in a variety of ways, including for example, customer deposits, wholesale market deposits and bonds. The cost of these sources of funding will vary from one funding source to another; from one lender to another (depending on the credit rating of the lender, for example); and also over time in response to market changes. In addition, a lender may engage in interest rate hedging for fixed interest rate mortgage lending including, for example by entering into Interest

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4 https://ec.europa.eu/info/law/mortgage-credit-directive-2014-17-eu/implementation/guidance-implementation-and-interpretation-law_en
5 http://www.europarl.europa.eu/RegData/etudes/STUD/2018/618995/IPOL_STU(2018)618995_EN.pdf

Rate Swaps. When a consumer seeks to discharge his or her obligations under a mortgage prior to the expiry of the agreement, the lender may incur a cost to adjust the funding source or any Interest Rate Swap entered into.

Importance of switching

I agree with your point in relation to the importance of switching. Given that our research has shown that a significant number of people in Ireland could save money by switching their mortgage, the Central Bank has introduced new measures, which come into force on 1 January 2019, imposing information requirements on lenders in relation to cheaper options for consumers. In summary, the new measures mean that from 1 January 2019, lenders must:

- Inform consumers about cheaper options 60 days prior to the expiry of a fixed rate mortgage;
- Inform consumers whether they can switch to a cheaper mortgage based on how much equity is in their home;
- Clearly explain the pros and cons of any mortgage incentives such as cashback offers;
- Provide consumers with a comparison of how much their mortgage costs versus other options offered by their lender if the consumer asks for such a comparison;
- Provide consumers with all the information they require to switch, including how long it will take; and
- Provide consumers with a decision within ten business days of receiving a completed mortgage application in respect of all mortgage applications.

Thank you again for your letter, I hope this response addresses your concerns.

Yours sincerely

Derville Rowland

Derville Rowland
Director General, Financial Conduct

APPENDIX 1

European Union (Consumer Mortgage Credit Agreements) Regulations 2016

"Regulation 26 Early repayment

(1) A consumer has a right to discharge fully or partially his or her obligations under a credit agreement prior to the expiry of that agreement. In such cases, the consumer shall be entitled to a reduction in the total cost of the credit to the consumer, such reduction consisting of the interest and the costs for the remaining duration of the contract.

(2) A creditor shall be entitled to fair and objective compensation, where justified, for possible costs directly linked to the early repayment, but shall not impose a sanction on the consumer, and any such compensation shall not exceed the financial loss of the creditor.

(3) Notwithstanding paragraph (2) and without prejudice to paragraph (4), a creditor's entitlement to compensation under this Regulation shall arise only in the circumstances where the borrowing rate provided for in the credit agreement: -

(a) may not be changed, or

(b) may not be changed over a period of at least one year, or

(c) may not, for a period of at least five years, exceed the rate applicable on the date of the making of the credit agreement by more than two percent.

(4) A creditor shall not in any event be entitled to compensation under this Regulation in respect of -

(a) subject to subparagraph (b), any period of the credit agreement that remains after early repayment,

(b) if the case is one falling within subparagraph (b) or (c) of paragraph (3) and the early repayment occurs before the expiry of the period referred to in that subparagraph, any period of the credit agreement that remains after the expiry of the period so referred to.

(5) Where a consumer seeks to discharge his or her obligations under a credit agreement prior to the expiry of the agreement, the creditor shall provide to the consumer without delay after receipt of the request, on

paper or on another durable medium, the information necessary to consider that option. That information shall at least quantify the implications for the consumer of discharging his or her obligations prior to the expiry of the credit agreement and clearly set out any assumptions used. Any assumptions used shall be reasonable and justifiable.

(6) A creditor who contravenes a provision of this Regulation commits an offence."

Consumer Credit Act 1995

"121. Redemption of housing loans.

(1) Subject to subsection (3), a borrower may, at any time before the time agreed, repay to the mortgage lender the whole or any part of a housing loan and shall not be liable to pay any redemption fee in relation to the loan or any part of the loan.

(2) The exemption from redemption fees in subsection (1) shall not apply to a housing loan in respect of which the mortgage or loan agreement provides that the rate of interest:

> *(a) may not be changed, or*
>
> *(b) may not be changed over a period of at least one year, or*
>
> *(c) may not, for a period of at least 5 years, exceed the rate applicable on the date of the making of the said agreement by more than 2 per cent.*

(3) The exemption from redemption fees in subsection (1) shall apply at any time during the period of the loan at which the period referred to in paragraph (b) or (c) of subsection (2) have elapsed.

(4) The Minister for Finance may, after consulting the Minister for the Environment and Local Government and the Bank, make a regulation varying -

> *(a) the period referred to in subsection (2)(b), or*
>
> *(b) the period or years or the rate of interest, referred to in subsection (2)(c).*

(5) A mortgage agent shall, where a redemption fee is payable on a housing loan by virtue of subsection (2), ensure that a statement to that effect, specifying how the amount of such fee is to be calculated, shall be included in or attached to:

(a) any information document which refers or relates to such a loan,

(b) any application form issued for the purpose of applying for such a loan or, where application for the loan is made otherwise than by way of an application form, such a statement shall be sent to the applicant within 10 days of the receipt of the application,

(c) any document sent to the applicant approving the loan, and

(d) any communication in relation to a variation of, or any offer to vary, the terms of the housing loan which would have the effect of making the loan liable to a redemption fee in accordance with subsection (2).

(6) In this section "redemption fee" means, in relation to a housing loan, any sum in addition to principal and any interest due on such principal (without regard to the fact of the redemption of the loan) at the time of redemption of the whole or part of the loan."

Consumer Protection Code 2012

All regulated entities providing financial services within the State are also required to comply with the Central Bank's Consumer Protection Code 2012 (the "Code").

The Code's General Principles provide that a regulated entity must ensure that in all its dealings with customers and within the context of its authorisation, it makes full disclosure of all relevant material information, including all charges, in a way that seeks to inform the customer.

Under Provision 4.25 of the Code:

"Where a regulated entity:

a) offers credit on a fixed interest rate to a personal consumer; or

b) offers a personal consumer the option to fix their rate or to switch to a fixed rate, on an existing credit agreement;

the regulated entity must provide, in the credit documentation, a worked example specific to the personal consumer of the early redemption charge in monetary terms and details in relation to the calculation of this charge."