Mortgage Fees Must be Transparent

In thinking about banning mortgage exit fees, two things need to be kept in mind. First, banks and other lenders need to structure contracts to cover their cost of funding, operating costs and a fair profit margin. Second, the design of mortgage contracts used by the sector will be endogenously determined as part of the competitive process.

Where borrowers are myopic, or unable to fully assess the implications of contingent contracts (such as exit fees for early mortgage discharge) there is no guarantee that the contract design which emerges will be socially optimal. That appears to be the case currently, and provides an argument for banning of such fees.

Banks incur costs in establishing mortgages which must be recouped either through the interest rate charged or fees. And borrowers will generally prefer that such recoupment does not require them to make up-front cash payment. Hence competition for borrowers will lead to costs being impounded in interest rates charged, ongoing account fees, or back-end (exit) fees.

If borrowers discharge their mortgages early, the bank will be faced with incomplete recovery of costs in the absence of an early-termination exit fee.

But, and this is the critical point, by not charging explicit fees up front for costs incurred, the bank is making an implicit loan of that amount to the customer. And, particularly when customers are myopic and don't fully appreciate the future costs associated with that implicit loan, competition will encourage this outcome of implicit loans and exit fees.

That is not necessarily a socially optimal outcome. Borrowers do not necessarily understand the full cost of borrowing, particularly if contingent exit fees are not included in publicized cost, and may habitually underestimate the likelihood of incurring such fees. And it is likely that these problems are greater for those whose financial literacy levels are low.

What is an alternative which consistent with banning exit fees? Simple – require lenders to make the implicit loan explicit. Thus if a $300,000 loan involves the bank in costs of $2,000, make the loan for $302,000.

If the borrower does not discharge the loan early, the costs are recovered through loan repayments. If the borrower exits the loan early, the repayment obligation also covers the bank's costs.

If it is so simple, why doesn't it happen without government intervention to ban exit fees? The answer is that competitive forces will lead to a mortgage design which exploits borrower myopia. Loans offered by lenders which charge exit fees will appear cheaper than those which recoup costs up front (or by way of an explicit loan), causing all lenders to sink to the lowest common denominator.

Imposing mortgage exit fees, by itself, will cause lenders to recoup costs in other ways, such as explicit up-front fees, ongoing account keeping fees, and/or higher interest rates. Note that it is only the first of these which ensures that costs are recovered from borrowers who exit their mortgages early.

Competition amongst lenders will no doubt lead to different types of contract design, involving different mixes of up-front fees, explicit loans to cover those fees, and recoupment via higher interest rates. On average, in a competitive loan market, lenders should end up in the same financial position.

The difference is that there will be more transparency about loan costs and terms for customers, and the impact of early mortgage termination will be clearer to all those entering a mortgage.

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