It's easy to exit from Exit Fees.

In the current brouhaha over bank loan exit fees, some simple points are being missed. There is one case (fixed rate loans) where early exit should involve a payment from, or to, the customer.

In all other cases they are not necessary and distorting, but attractive to lenders. To the extent that they reflect recoupment of deferred establishment fees, and where deferred payment is seen as desirable, the simple alternative is to add the establishment fee amount to the loan principal.

Rather than having an opaque, implicit, loan from the lender to cover establishment fees, the cost of which is hard for the borrower to assess, doing so by an explicit loan is transparent and non-discriminatory.

This is one of those situations where there appear to be several possible equilibria for loan contract design, and where competitive forces and fate have led us to the outcome which is the less socially desirable. A little regulatory push is warranted to move to the better alternative.

Loan exit fees reflect four main motives. One is as a *cost recovery* technique. If loan interest rates have been set to achieve recovery of various operating costs (both specific to the loan and more general overheads) over a long life of the loan, early loan repayment thwarts this objective.

That problem is, in principle, easily overcome by imposing explicit up front fees to recover such costs. But here the second motive, that of *competitive strategy*, comes into play. Borrowers may be unable to understand and assess the relative costs of up-front fees and regard them unfavorably relative to implicit fees built into loan interest rates or contingent fees in the form of early exit fees.

In those circumstances, individual lenders will see a competitive advantage in moving to an implicit/contingent fee model, even though there may be no social benefit when all do the same. Depending on how the implicit and contingent fees are set, there are bound to be distributive effects involved.

It may, and undoubtedly will, be argued that this outcome is the one preferred by borrowers – at least *ex ante* when they are comparing alternative loan contracts – and that the free market outcome should be allowed to hold sway. But that ignores the fact that many consumers have imperfect information and knowledge, and are unable to assess the likelihood of being "early terminators" and of relative costs incurred at differential times.

And the alternative equilibrium involves a simple, transparent, loan contract. It involves requiring lenders to state and quote the fees involved up-front, and providing an explicit loan (added to the loan principal) to those borrowers who do not wish to pay up-front. That way, it does not matter whether the borrower is an early terminator or not. The fees will be recouped by repayment of the augmented loan principal and interest over the life of the loan regardless of how long or short that is.

One objection to this may be that adding the deferred fees to the outstanding loan balance may push some borrowers above reasonable loan to valuation limits, precluding them from accessing a loan. If so, that is good – the excessive risk involved is explicit rather than hidden.

Another motive for exit fees is as a *deterrent* aimed at preventing existing loan customers from shifting their business elsewhere. It creates a switching cost, which borrowers may not have fully anticipated incurring when initially taking out the loan. It is difficult to justify exit fees on these anti-competitive grounds!

The final motive for exit fees is the *reinvestment cost* created when borrowers under a fixed interest rate loan terminate before the end of the agreed fixed-rate maturity. If interest rates have fallen since the loan was taken out, the lender will incur a loss when the funds raised for the original loan maturity to finance the loan are reinvested at a lower rate for the remaining maturity. A fair value for this cost to the lender can be easily derived and payment of that amount is warranted.

Of course if the fixed rate loan is terminated early in a situation where interest rates have increased, equity demands that there should be a payment from the lender to the borrower. Loan exit fees for fixed rate loans are warranted, as long as this symmetry prevails.

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