

Smart Money

Expert view

The pain of early exit



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It is important that do-it-yourself superannuation investors with term deposits are aware of the penalties that can apply if an account is terminated before maturity.

A reader writes: "In September 2008, acting on incorrect financial advice from the branch manager of a well-known bank, I terminated four term deposits with a face value of \$1 million and accepted a total interest penalty of \$75,630."

He had previously asked Smart Money if the penalties could be treated as a capital loss.

In response to his question, tax and accounting manager at DIY super administrator Multiport, Kevin Sudlow said tax rules suggested penalties or break fees were more likely to be deductible against taxable income than a capital expense.

Sudlow added he had yet to come

across a case where a financial institution reduced the capital of a cash product for early termination. He described the cost as quite harsh.

The reader explained the penalty was made up of a combination of accrued interest that remained unpaid plus a principal or capital reduction.

His \$1 million in term deposits was reduced by about \$39,000 and he also didn't receive about \$37,000 of interest – described as accrued interest.

While financial institutions state they will charge investors a fee for early termination (amounts of about \$30 are often mentioned), the real penalty is in the sharply lower interest rate that will apply.

The sting in the penalty is its retrospective effect.

Say an investor commits \$100,000 to a five-year term deposit with an annual interest rate of 6 per cent. The income is calculated using a simple interest formula where the principal (the capital invested) is multiplied by the interest rate (\$100,000 time 6 per cent or \$6000).

If the interest is credited annually, then \$6000 will be added to the investment every year.

But what if after, say, 2½ years the investor wants to exit early. At this



FIIG Securities
fixed interest broker
Brad Newcombe.
Photo Glenn Hunt

\$6000 or \$2400 times 2½ years. The penalty translates into 60 per cent of the \$15,000 of interest earned or \$9000.

Given \$12,000 has already been credited and \$3000 is in the pipeline, the bank firstly reduces the \$9000 penalty by not paying the \$3000 of accrued interest.

Then it claws back the remaining \$6000 from the \$100,000 principal leaving a balance of \$94,000.

The bottom line is that the investor will be left with \$94,000 of principal plus \$6000 of interest earned at the reduced 2.4 per cent rate. The effect of the penalty is they won't have earned any income from the investment over the entire period. Furthermore, they will be asked to pay an extra fee.

While this does seem quite harsh, says Brad Newcombe of fixed interest broker FIIG Securities, it reflects the serious nature of the contract an investor has with a financial institution when they commit money to a term deposit.

Term deposits are an important part of a bank's business. It is money they rely on to run their lending operation and withdrawing it early is strongly discouraged.

While they have negatives such as early withdrawal penalties, term deposits also have their positives. They include competitive interest rates at the time investors commit their money and very high security with both the principal and interest guaranteed by the bank, building society or credit union. And since October 2008 they have also been guaranteed by the government.

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stage, the account will have earned about \$15,000 of interest: two years of \$6000 plus half a year of \$3000 yet to be credited.

To calculate the interest penalty, the bank uses an adjustment formula based on the proportion of time the investment has lasted. If the investment is 50 per cent into the term, then the interest rate offered by

the term deposit will be reduced by 60 per cent. For instance, a 6 per cent rate will be adjusted downwards by 60 per cent or by 3.6 per cent for the investment period.

So for the 2½ years, instead of earning \$15,000, the interest earned will be 2.4 per cent (6 per cent reduced by 3.6 per cent).

The new interest will shrink to