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When does it pay to exit a mortgage early?

By Tanya Powley

Banks and building societies have cut the cost of new fixed-rate mortgages by so much that borrowers on existing deals could now be better off paying the redemption penalties to switch loans.

On Thursday, HSBC launched a five-year fixed rate of 3.34 per cent, available for borrowers with a deposit of 40 per cent or more. Nationwide Building Society and Yorkshire Building Society have also reduced the rates on their five-year fixes this week, with the latter offering a deal at 3.39 per cent to those borrowing up to 75 per cent loan-to-value.

Mortgage brokers said they have now started to receive enquiries from clients on high fixed rates of around 6 per cent, taken out before the financial crisis, asking if it is better value to pay an early repayment charge (ERC) and remortgage to a new five-year fix, given the historically low rates.

Five-year fixed rates reached a peak in July 2008 of 6.49 per cent, according to Ray Boulger of broker John Charcol. By contrast, the cheapest five-year deals today charges less than 3.5 per cent.

However, whether it works out cheaper to redeem an existing fixed-rate mortgage depends on the rate, and the lender's policy on ERCs – because banks and building societies impose different penalty charges for breaking a contract.

"Some [ERCs] are level throughout the five years whereas others decrease year by year," explained Nigel Bedford of Largemortgageloans.com. "Sometimes, they even vary from scheme to scheme with the same lender."

Mortgage brokers advised homeowners to check the penalties that will apply to them, and when.

"One of our clients is keen to come off of his five-year fix at 5.99 per cent and he is taking a shorter term fixed-rate," said Aaron Strutt of Trinity Financial. "But he is waiting to remortgage next month, as the early repayment charges will be 1 per cent lower. By waiting a few months, borrowers could potentially save thousands."

As a general rule, brokers said that most homeowners with 12 months or less to run on their existing fixed-rate period would be unlikely to save money by redeeming a mortgage now – simply because there is not enough time to recoup the ERC through monthly interest savings. It is still worth checking, though, as some lenders only charge a penalty of 1 per cent in the final year.

Bedford said homeowners with just one year left should “sit tight” and apply for a new deal six months before the end of the mortgage term. Lenders will often let borrowers secure a mortgage deal up to six months in advance of drawing the funds, he explained.

Mark Harris of Savills Private Finance said borrowers would need to be on a relatively high fixed-rate mortgage with two or three years left to run to make a switch worthwhile.

For example, borrowers who took out a five-year fix at 6.49 per cent from Cheshire Building Society in July 2008 could save 3.1 per cent a year in interest by switching to the 3.39 per cent fixed rate from Yorkshire – provided they still have at least 25 per cent equity in their properties. As Cheshire Building Society charges a 2 per cent ERC in year four of the term, the homeowner would recoup the outlay and the remortgage costs within one year – and benefit from a low fixed rate for a further four years.

However, homeowners on Abbey or Northern Rock’s 6.49 per cent rate from the same period would take longer to recoup their losses from the ERC as it is levied at a flat rate of 4 per cent throughout the mortgage term.

Boulger said borrowers should make sure they factor in the arrangement fees on the new deal as well as the valuation and legal fees involved with remortgaging.
For homeowners in doubt over whether they can save money, any mortgage broker should be able to carry out a quick feasibility check.

Harris said **Savills** offers a service free of charge where they will calculate the break even interest rate needed to offset early redemption charges if borrowers are thinking of breaking a fix.

Another factor to consider is whether your existing lender will let you switch to one of its new deals. While Nationwide will let borrowers redeem a mortgage early if they pay the ERC, it said it had no obligation to provide an alternative product to customers who break their contract early.
“At the current time, we believe it to be in the best interests of our wider membership not to offer this as an option,” said a spokesman. “This is because, when a customer exits a fixed mortgage deal early, the society incurs a cost – and the early repayment charge does not always cover this cost, in particular when rates are so volatile.”

Some lenders may also restrict the types of product that an existing borrower can move to. For example, Yorkshire Building Society, which offers some of themost competitive five-year deals, will only offer customers who redeem early a product from their "existing customer" range, which is less competitive than its new business range.

However, a spokeswoman for the lender said existing Yorkshire customers would be able to take out a new fixed rate from its sister brands: Chelsea Building Society and Accord Mortgages. Chelsea currently has the cheapest five-year deal at 3.29 per cent, available at up to 70 per cent loan-to-value with a fee of £1,495.