Beware the fees for breaking fixed loans

Bank charges Expensive penalties often hit when exiting a fixed-rate mortgage, writes **Matthew Cranston**.

Peter Cooper says banks need to be more transparent about how they calculate break fees. PHOTO: TAMMY LAW

If you are an investor or an owner-occupier, chances are you have thought about trying to lock in a home loan on a fixed rate in expectation of rising borrowing costs.

You might even have a fixed loan from earlier this decade and be looking to break out of that in order to lock in a new, much lower fixed rate before they start rising again.

In August last year, the cash rate hit a record low of 1.5 per cent, having fallen from 4.75 per cent since mid-2011, and while few economists are calling an end to the interest rate easing cycle, speculation is mounting that at some stage rates will need to rise.

But before you join the rising number of people looking to do this, it might be worth thinking about the break fees involved. They can be hard to work out – and expensive.

About 22 per cent of all new home loans written are on fixed rates, up from 19.4 per cent a year ago, according to Mortgage Choice data.

"We are definitely seeing an increase in the proportion of customers wishing to fix part or all of their mortgage," Mortgage Choice chief executive John Flavell says.

"And looking ahead, we would expect to see even more people choosing fixed-rate home loans."

Hidden traps

But borrower beware. Mortgage brokers around the country have seen the hidden traps creeping into fixed loans. One of the key ones to watch is the break fee, which can be thousands of dollars.

The managing director of Brisbane-based Cooper Financial Connections, Peter Cooper, says borrowers need to do thorough homework on how the bank calculates the break fee. He says there needs to be much greater transparency from the banks.

"When explained to the borrower, most understand the need for a break fee. However they are generally surprised at the size of the compensation sought by the bank," Cooper says.

"Over the years, there has been greater emphasis on disclosure of fees and charges so a borrower can make an informed decision when comparing loan products, but this trend to greater transparency does not appear to apply to banks disclosing break funding calculations."

Cooper uses a recent example involving a client who repaid over $2 million in fixed-rate loans.

"The loans were taken when interest rates were higher and the bank, as was its right, charged the customer a break fee. But in this instance the fee exceeded $80,000."

That's 4 per cent just to exit the loan.

"This is abnormally large and the client, while understanding why the fee was charged, justifiably requested the basis on which the fee was calculated.

"Yet banks are very reluctant to disclose how the break fee is calculated. Numerous requests for this information to satisfy the client fell on deaf ears."

Calculation components

In order to calculate the break fee, there are four main parts including the remaining term of the loan, the balance outstanding, the bank's funding cost when the loan was written, and the bank's funding cost when the loan was discharged.

Mortgage Choice broker John Sinclair has bearish news for anyone moving to break a fixed-rate loan in favour of a cheaper fixed-rate loan.

"I have never seen a client make money out of breaking a fixed-rate loan; 99 per cent of the time it's just not worth it," Sinclair says.

His daughter had locked in a fixed 7.25 per cent rate and when she went to refinance at a fixed 5 per cent rate, it was still going to be more expensive to exit and pay the break fee. This is because the bank's own funding cost for providing a loan at 7.25 per cent means it's too hard for the bank to profitably lend that money out again if the borrower gives up the loan.

A Commonwealth Bank of Australia spokesperson says: "If we estimate that we've made a loss as a result of the fixed rate being repaid earlier than expected, we calculate an early repayment adjustment (ERA) as our reasonable estimate of our loss in accordance with our usual formula.

"This formula takes into account the difference between our wholesale market swap rate for the fixed-interest period on the date the interest rate was fixed and the wholesale market swap rate as at the date of the early repayment for the balance of the fixed-interest period."

Details of the settlement fee and administrative fee are available on the fees and charges guide on the CBA website, while details of the early repayment adjustment are available on the ERA fact sheet, also on the bank's website.

Mitigation strategies

Trinity Wealth Service financial planner Peter Bond says that while having to pay some kind of a fee is almost inevitable, there are some mitigation strategies to be aware of when it comes to exit fees:

- See what interest rates have done since you started the loan. If the bank bills swap rate, or BBSW, was higher at the time the loan was started than when you are exiting the loan, you can expect to have an exit fee upon exiting or changing the loan.
- Ask the bank for a quote. Banks are usually happy to give you a quote for what the penalty will be should you exit the loan early. This gives you a chance to decide whether you are comfortable with paying that much in fees before deciding to terminate the loan.
- If you are not sure about your future, don't lock in your loan. Like all financial decisions, it is important that the product matches the individual. So if you know your situation might change in the next couple of years, you need to consider the effects of exit fees before locking in a fixed-rate loan.
- Many borrowers choose to split their loan between fixed and variable portions. The fixed portion should normally be no greater than the certainty of your circumstances.

While fewer people are actually selling their houses and exiting their loan (house listings are down 9 per cent, according to Corelogic), the low interest rate environment might actually work in favour of exiting.

This is because if funding rates on fixed rates were to rise then a mortgage discharge allows the bank to replace that loan at a higher rate and make a profit.

If that is the case, then the customer should receive a benefit in exiting the loan.

The prospect of higher interest rates has sparked interest in fixed-rate loans.

Best home loans

Top 5 mortgages v deals from the big banks for a $500,000 home loan*

Standard variable owner-occupied loans

Institution	Product	Interest	AAPR	Upfront fees	Ongoing fees
Reduce Home Loans	Rate Buster	3.35%	3.29%	$570	Nil
Mortgage House	Pure & Simple Summer Special	3.49%	3.49%	–	Nil
Freedom Lend	Freedom	3.53%	3.53%	–	Nil
loans.com.au	Essentials - Owner Occ	3.59%	3.60%	$520	Nil
Pacific Mortgage Group	Variable	3.60%	3.60%	–	Nil
Major banks					
CBA	Standard	5.22%	5.26%	$800	$8/mth
ANZ	Variable	5.25%	5.28%	$760	$5/mth
NAB	Tailored Variable - P&I	5.25%	5.29%	$600	$8/mth
Westpac	Rocket Repay Home Loan P&I	5.29%	5.33%	$750	$8/mth

Standard variable investment loans

Institution	Product	Interest	AAPR	Upfront fees	Ongoing fees
Freedom Lend	Investment Freedom PI 50-749k 80%	3.69%	3.70%	$395	Nil
Reduce Home Loans	Investor Rate Buster	3.79%	3.77%	$570	Nil
Pacific Mortgage Group	Investment	3.79%	3.79%	–	Nil
loans.com.au	Essentials – Investor	3.79%	3.80%	$520	Nil
Mortgage House	Pure & Simple 30 – COMBO	3.84%	3.84%	–	Nil
Major banks					
NAB	Investment Tailored – P&I	5.55%	5.59%	$600	$8/mth
Westpac	Rocket Investment Loan – P&I	5.56%	5.60%	$750	$8/mth
CBA	Investment	5.56%	5.60%	$800	$8/mth
ANZ	Investment	5.60%	5.63%	$760	$5/mth

Three-year fixed loans

Institution	Product	Interest	AAPR	Upfront fees	Ongoing fees
Pacific Mortgage Group	Residential	3.65%	3.61%	–	Nil
iMortgage	Fusion Fixed PI 80	3.84%	3.77%	$363	$120p/a
AMO Group	Residential	3.59%	3.79%	$1180	$120p/a
loans.com.au	Fixed - Owner Occupier	4.19%	3.80%	$520	Nil
Freedom Lend	Freedom Fixed PI	3.79%	3.85%	–	$395p/a
Major banks					
CBA	Residential	4.24%	5.03%	$800	$8/mth
NAB	Standard	4.19%	5.04%	$600	$8/mth
ANZ	Residential	4.34%	5.07%	$760	$10/mth
Westpac	Fixed Options	4.29%	5.09%	$600	$8/mth

Five-year fixed loans

Institution	Product	Interest	AAPR	Upfront fees	Ongoing fees
Freedom Lend	Freedom	4.04%	3.71%	–	Nil
Pacific Mortgage Group	Residential	4.39%	3.88%	–	Nil
Click Loans	The Online Offset Home Loan	4.49%	4.07%	$363	$198p/a
iMortgage	Fusion PI 80	4.74%	4.11%	$363	$120p/a
AMO Group	Residential Fixed	4.58%	4.12%	$1180	$120p/a
Major banks					
Westpac	Fixed Options	4.59%	5.07%	$600	$8/mth
NAB	Standard	4.69%	5.08%	$600	$8/mth
CBA	Residential	4.74%	5.08%	$800	$8/mth
ANZ	Residential	4.74%	5.09%	$760	$10/mth

*Rates correct as at January 23, 2017. The search results do not include all home loan providers, and may not include all features relevant to you. Ranked by AAPR (based on loan amount of $150,000 over 25 years). WWW.CANSTAR.COM.AU