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Flexibility key to cutting mortgage debt

By Tanya Powley

Mortgage debt has fallen by a record amount, but brokers have advised homeowners seeking to reduce their loans to use products with a facility to borrow back extra payments.

Last week, figures from the Bank of England appeared to show that Britons were paying off their home loans at a record rate. Mortgage debt fell by £9.1bn during the second quarter of the year – the biggest drop since records began in 1970.

However, the bank said this was more due to a lack of new borrowing, rather than large capital repayments – and brokers now say that overpaying a mortgage needs to be done flexibly.

Using an offset mortgage is the best option, according to many – as these products allow borrowers to retain access to overpayments made on their loans.

Most conventional mortgages allow borrowers to overpay up to 10 per cent of their outstanding balance each year, without triggering a penalty – and homeowners on penalty-free lifetime trackers or standard variable rates (SVRs) have no restrictions on the amount they can overpay.

Some lenders, including ING Direct, Halifax and Nationwide Building Society, also allow borrowers to underpay up to the amount they have overpaid. Others let borrowers take a "payment holiday".

But mortgage brokers have warned that, since the credit crunch, few lenders have let customers draw back previous overpayments as a lump sum.

Last year, Nationwide withdrew this option for new borrowers, and Northern Rock now limits the feature to its flexible two-year tracker mortgages. Only Woolwich, Northern Rock, Clydesdale Bank and Scottish Widows have products that allow drawdown of previous overpayments – and even these have drawbacks.

Woolwich will let customers borrow money back, but it is charged at the lender's SVR of 4.99 per cent, not the mortgage rate. It also refuses to refund overpayments after its mortgage year-end of September 30. So, if a borrower overpaid by £2,000 between January and July, this sum could be borrowed back in August, but not in October.

"In most cases, access to overpayments is subject to underwriting and so an offset [mortgage] is a much safer option if borrowers definitely want to know they can access overpayments," said Ray Boulger of John Charcol.

Offset mortgages work by linking a mortgage to a borrowers' savings – with the borrower only paying interest on the net balance. They typically benefit borrowers who have a variable income and need to retain access to savings. "You still retain full unrestricted access to your cash," explained Nigel Bedford of Largemortgageloans.com. "You can withdraw whatever you want for whatever purpose without having to ask the lender's agreement."

These loans are particularly cost-effective for higher-rate taxpayers as the savings are not subject to income tax. In effect, the savings generate a benefit equivalent to the mortgage interest rate grossed up at the saver's marginal tax rate.

For example, Accord's market-leading two-year offset tracker mortgage charges 2.59 per cent – Bank of England base rate plus 2.09 per cent. But customers avoid paying this rate of interest on borrowings "offset" by their cash on deposit. For a 40 per cent taxpayer, therefore, the cash generates an interest saving that is equivalent to earning interest at 4.32 per cent. For a 50 per cent taxpayer, the saving is equivalent to earning 5.18 per cent.

However, on the balance of the borrowing, the interest rates can be slightly more expensive than on standard mortgages.

"Offsets should only be selected if they are to be used in full, otherwise, generally speaking, cheaper standard mortgages exist," said Ben Thompson of Legal & General Mortgage Club.

According to Bedford, the best two-year fixed-rate offset deal for a homeowner borrowing £500,000 at 75 per cent loan-to-value is 2.99 per cent from Yorkshire Building Society, while the comparable best-buy standard deal is 2.74 per cent from Principality Building Society.

In order for the offset product to be better value than Principality's deal – with savings in an instant access savings account paying 2.75 per cent – a top-rate taxpayer would need to place more than £80,000 into the offset account.