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Mortgages: A Guide

Introduction

A mortgage is a sum of money borrowed from a bank or building society in order to purchase property. The money is then paid back to the lender over a fixed period of time together with accrued interest. They can also be called secured loans or charges but in Scotland the correct terminology is a Standard Security. It involves the home owner or prospective home owner granting security over the title to their home in favour of the lender in return for the money borrowed. In the event of non-payment it is the Standard Security that is used by the lender to repossess, evict and sell the property in order to repay the initial loan, accrued interest and additional costs involved. If the property is repossessed but the amount the bank receives from the sale does not cover the sum owed then you still owe the bank the sum outstanding. This is why it is crucial to ensure you only borrow what you can afford.

Mortgages have become increasingly complex in recent years. The market is hugely competitive with banks and building societies continually changing their range of products. The near collapse of the bank industry following on from years or reckless lending has seen a reigning in of mortgage products and an extremely cautious approach now being taken by lenders in a complete reversal to past behaviour.

The purpose of this guide is to try and explain the types of mortgage that commonly exist at this time, the various methods of repayment and to point out some of the other factors you should be aware of and take into account when choosing the mortgage product right for you.

There are many different types of mortgages out there but the most important factors are how you decide to pay back the capital you borrow and how you pay the interest on it. It is a matter of deciding which suits you and your requirements.

Paying Back The Capital

There are three ways in which you can pay back the money borrowed. You can either, pay a little at a time as you go (capital and interest repayment mortgages), pay it all off at the end (interest only mortgages) or off set it (off set mortgages).

1. Repayment Mortgages

   With a repayment mortgage your monthly repayments consist of repaying the capital amount borrowed together with the accrued interest. Each monthly payment pays off a little of the underlying debt, as well as interest on the loan. On your mortgage statement, normally received annually, you will see that the outstanding balance decreases throughout the term. At the end of the term (usually 25 years) the mortgage is cleared. This is widely considered to be the most easy to understand and the least risky mortgage.

2. Interest Only Mortgages

   With this type of mortgage you only pay the interest on the loan. At the end of the mortgage term you are expected to repay the capital in full. The normal practice is that, at the same time as taking out the mortgage, the borrower takes out an alternative “repayment vehicle” (method of paying off the mortgage) such as an ISA, pension policy or endowment policy. The most important fact about an interest only mortgage is that the monthly repayments do not repay any of the outstanding balance. As a consequence it is important that payments are maintained into the repayment vehicle, otherwise it will not be possible to pay off the mortgage at the end of the term.

Interest only mortgages tend to be popular amongst buy to let investors and first time buyers because, put simply, monthly payments tend to be cheaper than a repayment mortgage. They were very popular in the 1980s but in recent years have received universal bad press coverage when many borrowers discovered that at the end of their loan period, the “repayment vehicle” had not generated enough funds to repay the capital in full. This led to shortfalls and universal allegations that brokers had miss-sold their products.

The vital thing to recognise is that interest only mortgages are risky with the historic problem being that people who took them out did so without realising there was a risk involved. The point is that the investment you use to generate funds to pay off the capital at the end of the loan term may rise or fall. If it rises you will have funds left over after repayment but if it falls you need to make up the shortfall. It is a gamble. Planning, understanding and managing that gamble is complicated so it is perhaps not something you should risk your home on.

Repayment Vehicles

The most common repayment vehicles for interest only mortgages are:

i) Endowment

This is the most common type of repayment vehicle. You use the endowment policy to provide life cover and save funds to repay the loan at the end of the term. It should be borne in mind however that there is no guarantee that when the endowment matures and pays out the balance will be sufficient to repay the mortgage. The life assurance aspect provides reassurance that in the event of death the mortgage is paid off. Endowments were once very popular and heavily marketed until allegations of miss-selling arose and both lenders and brokers faced huge claims for compensation. As a result they have declined sharply in popularity and relatively few endowments are sold today. There are still millions of policies yet to mature but these should not be cashed in early and certainly not before seeking advice from a suitably qualified Financial Advisor.

ii) ISA

The Individual Savings Account (ISA) is a tax free method of saving. Using an ISA as a repayment vehicle is growing in popularity but due to the ISAs complexity it is only for the financially sophisticated or borrowers taking advice from a suitably qualified Financial Advisor.

iii) Pension Plan

Life assurance cover is provided and monthly payments are made into a pension fund. When the benefits are eventually taken, the mortgage is repaid using tax free cash from the remainder of the funds. The plan holder can then draw a pension from the balance of the fund. This product, which tends to be used by the self-employed, is only for those taking advice from a suitably qualified Financial Advisor.

3. Offset Mortgages

So far the focus has been on mortgages that are variations on a simple theme. You borrow a set amount of money and you pay back the sum (either monthly or at the end of the term) along with interest. For ultimate flexibility there are two further completely different types of mortgage that allow you to use your savings and/or the money which sits in your current account to reduce the amount of money you owe. These are often in conjunction with fixed or discount rates described below. The two mortgages referred to in this section are:

i) <u>Current Account Mortgages (CAMs)</u>

This combines your mortgage and current account to give one balance. So for example with £1,000 in your current account and a mortgage of £90,000 you are effectively £89,000 overdrawn. Your debt is smallest just after your salary is paid in and then creeps up throughout the month. You make a standard payment early every month which is designed to clear your mortgage over the term you have chosen. The extra money lying in your account is like an overpayment, which should mean you pay the loan off much more quickly. Any extra cash savings can be added to reduce the balance further or you can transfer other debts like credit cards or personal loans to the account to take advantage of the lower interest rates. If used correctly, someone who spends less than they earn each month is effectively overpaying their mortgage every month and so should clear it more quickly potentially saving thousands of pounds. This is not however unique to CAMs. You have to be extremely organised with your money. Whilst a mortgage is always a debt, when linked to your current account it is more obvious on a day to day basis and can create the feeling of being permanently overdrawn. The interest rates charged on Current Account Mortgages are often higher than those on other types. To work well you would need to have a reasonable amount of money coming into, and remaining in your current account.

ii) <u>Offset Mortgages</u>

An offset mortgage keeps your mortgage, savings and current accounts in separate pots but like CAMs your savings are used to reduce or "offset" your mortgage. So for example if you have a mortgage of £150,000 and savings of £15,000 you only pay interest on the £135,000 difference. Again you make a standard payment every month, but your savings act as a permanent overpayment, wiping out more of the capital every month helping to clear the mortgage early. The advantage of such mortgages is that you are effectively overpaying your mortgage every month so should clear it quicker, potentially saving you thousands of pounds. Your savings and debts are kept separate so it is easier to keep track of your money and they are also tax efficient especially for higher rate taxpayers. The disadvantages are that, as with CAMs, the interest rates are higher than on more straightforward mortgages. You also need to have savings of at least 10% or more of the mortgage amount to make the sums worthwhile. If you need to spend your savings for any reason, then your mortgage will become more expensive.

These types of mortgage are not for the financially disorganised and you also need a reasonable amount coming in every month or a decent amount of savings to make the most of the advantages.

You should be especially careful with offset mortgage illustrations that suggest that you will save many tens of thousands paying your salary into your mortgage. It is not as simply or as straightforward as that and you should check the numbers behind these illustrations carefully as the alleged savings are often a myth.

<u>Choosing between repaying, interest only and offset</u>

The wisdom is that, unless you have a compelling reason, repayment is the only way to go. It is the only option that guarantees that you are actually paying off some of your debt every month.

Some mortgages designed for first time buyers suggest that you just pay the interest for the first couple of years and then convert to a repayment mortgage later on. This may be of attraction if you are struggling to get on the property ladder but it is important to make sure that you actually do shift to the repayment mortgage as soon as you can.

The sooner you start paying off the capital the sooner you will clear your debt. This should always be the ultimate aim behind your mortgage choice.

Interest Rates on mortgages

Once you have chosen the right mortgage type for you, whether it be repayment, interest only or offset, you then require to consider the mortgage interest rate best suited to you.

Any debt involves the payment of interest. It is the main way that lenders make money from their investment and mortgages are no different.

There are three main mortgage interest rates available, namely, fixed, variable and capped;

1. Fixed rate mortgages

   With a fixed rate mortgage the amount you repay the lender each month can be at a fixed interest rate for specific periods of time, regardless of changes to the interest rate in the market place. It is common for lenders to offer rates fixed for a period of two to five years but shorter and longer periods can be found. At the end of the fixed rate (or benefit) period the rate will normally convert to the lenders standard variable rate (SVR). It is normal for lenders to charge upfront fees in the form of booking and/or arrangement fees. In addition lenders frequently apply an Early Repayment Charge (ERC). This acts as a "lock in" resulting in a heavy charge for borrowers paying off their mortgage early. ERC's can sometimes last longer than the fixed rate period. For example a three year fixed rate with a five year ERC. That way the very low rates tempt you in but then trap you into paying over the odds at a future date. The lender makes money out of you during this period. This type of interest is ideal for budgeting or if you think rates may increase. The advantage is that you know exactly what your mortgage payments will be monthly and your payments will not go up no matter how high interest rates may go. You do not benefit if actual interest rates fall and you face financial penalties if you try to quit the mortgage within the ECR period.

2. Variable Rate

   This means your mortgage rate can change over time and means you pay the going rate on your loan. Your mortgage rate changes every time the Bank of England mortgage rates change or, as in most cases, the overall effect of any interest rate change is calculated once a year and payments altered accordingly. The benefit is that you get the full benefit of the Bank of England's rate falls and in times of low interest rates but likewise you get the full cost if the Bank of England's rates increase and in times of high interest rates. Whatever kind of mortgage you start with, it is likely to change into a variable rate at some point.

   Variable rates fall into three categories:

   a) Tracker Rate

      A tracker follows the UK Bank of England Base Rate so that if the bank rate rises by one percentage point your mortgage rate rises by the same margin. But if it falls by one percentage point your mortgage drops by the same amount. Some trackers only run for a couple of years but you can get ones that last the life of your loan. You should be aware however that many deals have what is called a "collar", which is a minimum level below which the rate will not drop. Most trackers revert to standard variable rates on expiry.

   b) Standard Variable Rates (SVR)

      This is the simplest and most straightforward option, though it is not always available to new customers. Many introductory fixed or tracker rates revert to SVR on expiry of the introductory rates so it is important to understand them.

Each lender offers a SVR (or rate with a similar name) which tends to follow the Bank of England's base rate. SVR's are generally two or more percentage points above the base rate. As the base rate moves up or down your lender traditionally move their SVR's, although not always by the same amount or the same speed. For example, they may only drop rates by 0.2% when the base rate drops by 0.25%. This means the lenders increase their profits.

c) Discount

These deals usually offer a discount off a tracker or standard variable rate (SVR). The discount tends to last for a relatively short period, typically two or three years. The problem can be the way such deals are marketed in that they can make expensive deals seem cheaper than they really are. It is therefore important to work out how big the discount actually is, what rate is being discounted and how that compares to other interest rate deals available.

3. Capped Rate Mortgages

This is a hybrid of the variable and fixed rate option. If the variable rate drops below the capped rate, the borrower makes payments based on the lower available rates. However, should rates increase the payments will be "capped" and will note rise over the capped rate. Again, as with fixed rates, up front charges and lock-ins are common. The advantage is that you benefit should interest rates fall and have some protection if interest rates rise but the negative is that the cap tends to be set quite high and the starting interest rate is usually higher than normal variable or fixed interest rates.

Additional Fees

In addition to charging you interest for the duration of your loan lenders also have a number of ways of obtaining money from you just for giving you the loan. These include:

1. Arrangement Fee

These have risen sharply since the "credit crunch". They vary enormously but estimate to pay anything from £500 to £1,500. They are often non-refundable even if your purchase does not proceed.

2. Reservation Fee

Some lenders charge a separate reservation fee to secure a fixed rate. This is always non-refundable and generally costs around £100 to £200.

3. Valuation Fee

This is a valuation fee for a survey. This is for the lender to check that the property offers them sufficient security for the loan. The cost depends on the property value and the lender chosen but estimate at least £250. This fee is incurred often whether or not a Home Report exists over the property, whether or not you get your own survey in addition to the bank valuation and whether or not the actual surveyor's fee comes to the sum due to the lender.

These additional costs should be taken into account when considering which lender to go with. It also makes long term economic sense to pay these costs up front rather than adding them to your mortgage. This may not always be possible, especially for first time buyers but please bear in mind that adding them to your mortgage does not mean they are free. It simply means you pay them when you repay the mortgage but in the meantime you pay interest on the sum for the duration of your mortgage, usually 25 years.

Other Factors

Other factors to be aware of and to take into account when deciding the mortgage product best suited to you include:

1. Additional Fees

   Most lenders now charge you for the work involved in setting up a mortgage or to reserve a loan at a particular rate. These are known as arrangement fees, reservations fees and bookings fees. The amount can vary considerably between lenders and they have in recent years risen dramatically. Paying more does not mean a better deal for you it is simply another way the lender makes money out of you.

2. High Lending Charge

   If you are borrowing more than 90% of the property value, check to see whether you will be charged an extra fee. This is to protect the lender in case you fail to keep up payment but not all lenders make this charge.

3. Insurance Tie Ins

   Some lenders will offer you a lower mortgage rate if you buy their Home Insurance products. They will also encourage you to take out their mortgage payment protection policy. It is however always better to shop around for insurance deals. Also be wary of the hard sell as brokers receive significant levels of commission for signing you up to these financial products.

4. Redemption Charge and Penalities

   With mortgage special offers, e.g. fixed rates deals etc, you will normally be charged a penalty if you pay off your loan within the offer period. You should try and avoid offers that have redemption penalties that extend beyond the end of the initial offer period as you will be stuck on the lenders standard variable rate during that period.

5. Cash Back Deals

   This is when a lender offers money back to you if you take out a particular product. However nothing is for free and cash back mortgages are often weighed down with hefty penalty charges if you later want to switch lender. In reality you end up paying more in the long term than the token sum paid as cash back.

6. Free Legal Work

   Some deals offer the legal work to be done free of charge by the lenders own solicitor or a solicitor of their choice. Such offers should be avoided at all costs. The work should always be carried out by the solicitor representing you in the purchase. That way your solicitor can have an element of control and can coordinate the transaction and protect your position. Another solicitor becoming involved, operating to their own time frame and who is solely looking out for the interest of the lender and not yours, simply has the effect of always complicating matters, often delaying the transaction and always increasing the cost to the borrower as his own legal fees increase due to the extra work and risk and responsibility incurred by his own solicitor.

7. Making Over Payment

   The most popular flexible factor is the ability to over pay because it results in clearing the debt substantially quicker so that you pay less interest overall. Many mortgages now allow you to do this, but they restrict the amount of money you can over pay and penalties exist if you go over these limits, which can be steep. Such deals usually involve higher rates of interest.

8. Payment Holidays

This typically allows borrowers to miss one or two payments and their monthly payments are recalculated to spread the costs of their payments over the rest of the life of their loan. There could also be an extra penalty and administrative charge on top.

9. Moving House Within A Mortgage Term

Many mortgages are now "portable" so moving house does not have to involve a new deal which can be important if you have redemption penalties. Bear in mind that you will have to make a fresh application to your existing lender for the new property you are purchasing as in reality it is not as simple as simply transferring the mortgage from one property to the other. Security over your existing property still requires to be discharged and a fresh Security granted over your new property. A solicitor is required to carry out both.

10. Discharge

Repayment of the sum lent is not in itself sufficient to bring a mortgage to an end. The Standard Security granted in favour of the lender in return for the loan requires to be formally discharged. This can only be done by a solicitor and can be done either when you sell, remortgage or repay your final monthly payment at the end of your loan term.

11. Remortgaging

It is standard practice to look to remortgage every two to five years. In particular at the end of any introductory offer period and after any redemption penalty period has expired in order to ascertain your mortgage remains the best mortgage product for you or whether another mortgage product, possibly with another introductory rate (even if it is with the same mortgage provider) is now the better option for you. For those who prefer fixed rate mortgages it is usual for them to move mortgages every time a fixed rate period comes to an end. You should always therefore plan ahead and check the market place prior to the expiry of your introductory rate and/or redemption penalty period.

12. Initial Disclosure Documents and Key Facts Illustrations

Mortgage providers are legally bound to present customers with a key facts illustration (KFI). The Financial Services Authority (FSA) which regulates the profession stipulates that key facts illustrations should deliver clear, simple and user friendly information about the mortgage offer. The key facts illustration outlines the mortgage costs over its term, repayment, fees and the interest rate expressed as an annual percentage rate (APR).The APR tells prospective customers the interest rate over the life of the mortgage. It takes into account any initial offer rate and then the lender's standard variable rate, which the mortgage reverts to, as well as the impact of fees. It does not however take into account the fact that many customers switch to better deals than remain with their lenders standard variable rate (SVR) after the initial offer expires. Nor does it include the potential costs of leaving the mortgage, such as administrative fees and early repayment charges.

In recent times brokers have began providing initial recommendations without disclosing the name of the potential lender. Whilst the aim is to avoid customers bypassing them and going to the lender direct this practice is entirely unacceptable. You should always insist on being provided with the key fact illustrations. You should also obtain key fact illustrations on a variety of mortgage offers to enable you to compare as many different options as possible.

It would be advisable to look not just at the initial interest rate offered but also at the total sum actually paid over a fixed period, say two to three years and use this as the true cost of your mortgage.

Whilst we are not authorised to give financial advice we are always happy to help explain the contents of a key fact illustration to you.

Conclusion

The material in this guide is for general information only and does not constitute investment, tax, legal or other form of advice. You should not rely on this information to make (or refrain from making) any decisions. Always obtain independent, professional advice for your own particular situation.

This guide should also be read in conjunction with our guides on the buying process, credit rating and mortgage brokers. We also have a selection of information sheets on a variety of topics that will assist you in understanding the legal process.