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mortgages

Free Guide to Mortgages

This Guide is supplied for general information only. You should seek specific advice for your individual circumstances before acting on any suggestions made.

What is a mortgage?

A mortgage is the name given to a loan secured on property. It is usually used to buy the home although it is becoming more popular to consider a new mortgage, where the property is already owned, to access a more competitive mortgage product or to raise capital for other purposes, such as school fees or business investment.

A mortgage is a long-term loan and has traditionally run for a fixed period, typically 25 years. However, most mortgages are flexible enough to allow for early repayment or, if your circumstances dictate, the term can be extended beyond the original loan period.

Mortgages were once the preserve of building societies and the high street banks, recently however far more competition has entered the market and there is now a raft of lenders offering mortgage loans on residential property.
This expansion in the number of lenders has lead to a vast array of different loan packages.

Nowadays there are loan deals to suit most people's needs, whether you are buying your first home, a retirement cottage or perhaps an investment property.

What different types of mortgage are there?

Although there are many different types of mortgage products on the market, generally they can be split into two basic types:

Repayment mortgage: under these arrangemnts you are required to make monthly payments which are made up of part capital and part interest. The structure of the repayment method normally means that during the early years of the mortgage, little capital is repaid. The rate of repayment accelerates over time.

Repayment mortgages are normally quite flexible as it is sometimes possible to extend the term of the loan but only with the written permission of the lender. Also, it is normally possible to increase the capital repayment of the loan so decreasing the term, allowing you to repay your debt early.

Interest only: these arrangements do not require you to make capital repayments until the end of the loan. The monthly payments to the lender are made up entirely of interest on your outstanding debt.

In order to clear capital, at the end of the loan term, you must have an amount equal to the outstanding debt. Most people achieve this by making regular contributions to a savings plan; this plan is targeted to accumulate an amount sufficient to repay the outstanding debt at the end of the mortgage term. Any such savings plan (e.g. Endowment Assurance or ISA plan) should be kept under regular review.

Flexible: these are a newer style of mortgage arrangement. They offer you the option to increase or decrease your monthly payments (and sometimes even the opportunity to stop them altogether for specified periods). This flexibility is designed to assist you to manage your cash flow. Many flexible mortgages offer daily or monthly calculation of interest. This system could normally be expected, when compared with a more traditional mortgage, to reduce the overall amount of interest you pay throughout the loan term.

The latest addition to the mortgage range is a combined system of current, savings and mortgage accounts. The mortgage element will still be a repayment, interest only or flexible loan, but the amount of money in your current and/or savings accounts are taken into consideration when the lender calculates the interest due on your mortgage.

For example if you hold a savings account with a balance of £1,000, this amount will be considered by the lender when calculating the interest due by effectively reducing the total mortgage by an amount equal to your savings. Such arrangements are known as 'offset' mortgages.

You may also find a ‘drawdown' mortgage, which is helpful if you have a property that requires renovation. You receive a basic amount, but as you complete renovation work on your home, further amounts become available for you to draw down as and when required.

Further differences occur in the way interest is calculated on your mortgage.
Variable: the interest rate you pay rises and falls in line with the bank of England base rate.
Fixed: the interest rate is fixed for a given time at the start of your mortgage normally from one to five years although this can be longer. Note that you may have to pay a higher interest rate when the fixed period finishes.
Discounted: the lender gives you a discount on its standard variable rate for a given time.
Capped: the interest rate is guaranteed not to rise above a certain percentage, but it may also have a ‘collar', i.e. it will not fall below a certain rate. However there is normally a fixed timescale for the capped rate period.

Different lenders will offer you different incentives to take out a mortgage with them, for example:

Cashback: on completion of your mortgage, you receive back in cash a payment of some or all fees: the lender pays for your survey, or your legal fees, or will meet the stamp duty charges. The cash back could be paid as either a percentage of the mortgage amount or as a lump sum.

Some lenders will charge you an early repayment charge if you redeem your mortgage early, or want to pay off a part of it.

Please note where immediate offers such as these are provided it is common for lenders to charge you an early repayment charge should you repay your mortgage during the early years of its term.

What should I think about when choosing a mortgage?

To assist you to narrow down the search for your new mortgage, you should first decide which payment method best suits you. Whether it is to be a repayment or interest only. To help you decide on the method most suitable for you, it would be sensible to take into account your attitude to risk. Only a repayment mortgage can guarantee, assuming all mortgage payments are maintained properly, that your mortgage debt will be repaid at the end of the original mortgage term.

Always shop around for the best rates, but be sure you are comparing like with like. To do this check the overall cost of comparison of the loan. You also need to bear in mind that the interest payments in respect of fixed rate mortgages can rise or fall once the initial 'fixed' period ends. Therefore your planning should always include the possibility of changes to future interest payments.

If you are intending to sell your home in the near future, check whether there are any early repayment charges attached to the mortgage or if your mortgage deal will allow you to take the mortgage on to the next property.

Check what arrangement fees the lender charges and whether these are refundable should you decide not to proceed midway through the application process.

Check for additional costs such as higher lending charges and buildings and contents insurance.

Consider using a mortgage broker and taking professional, whole of market financial advice, this can save you a lot of time checking the differences between the various lenders; it can also help clarify which mortgage package best suits your circumstances.

More information on interest only mortgages:

If you elect to have an interest only mortgage then your payment to the lender only represents the interest due on the outstanding debt. In order to repay that debt then, you would normally use an additional savings vehicle. This is likely to be one that enables you to build a fund of money from which you can clear the mortgage at the end of the agreed term. The lender may also expect you to have sufficient life assurance cover to enable your next of kin to repay the debt if you die during the term of the mortgage.

The three most common savings vehicles used for mortgage repayment are:-

ISA: you can benefit from the tax concessions available within these plans. Under current legislation any income or gains achieved from your ISA plan are tax-free. It is the proceeds of your plan that pay off your mortgage. An added opportunity, if your ISA performs exceptionally well, or you can afford additional payments to it, is that you may be able to repay your mortgage ahead of schedule. On the other hand, if your ISA does not perform well, you may not have sufficient funds to repay your mortgage. You should regularly review how your ISA is performing throughout the term, to ensure you are on track to repay your mortgage and be prepared for short term fluctuations in the value.

All types of ISA are free of capital gains tax. So, if your ISA increases in value, you make a 'capital gain', but you do not have to pay capital gains tax on this increase.

Pension: by using the tax-free lump sum facility available from your pension plan to pay off your mortgage debt, you can take advantage of the tax relief that may be available on pension contributions. You must remember that under normal circumstances the benefits under pension plans may not be drawn before age 50 increasing to 55 from 2010. Therefore the earliest likely date at which you could repay your mortgage debt would be 50 increasing to 55 from 2010.

If pension benefits are provided by your employer, these cannot normally be taken until you actually retire from that employment. If you are looking to pay off your mortgage earlier than when you retire then a pension may not be the appropriate repayment vehicle for your needs.

Since part of your pension fund is being used to clear the mortgage debt, you should be aware that your income in retirement will reflect this fact as less money will be available for the provision of income. Careful consideration needs to be given to this repayment method. You would be wise to seek advice from your financial advisor before adopting this approach.

Endowment: these are Life Assurance policies that serve two purposes. Firstly they provide financial protection in case you die before the end of the mortgage term. Secondly, if you survive throughout the policy term, the investment element of the policy provides a lump sum (maturity value) that can be used to repay the outstanding mortgage debt.

The use of these arrangements has been very popular in the past but has received negative press coverage during in the 1990s. There is some suggestion that many of the problems were associated with poor advice when homebuyers first took out the endowment policies along side their mortgage loans. It must be understood that endowment policies are long-term investments, the value of which may rise and fall in line with the stock market. However over 25 years, they may yield more than the amount you need to pay off your mortgage although there are no guarantees available.

There are three types of endowment policy:

With profits: you share in the profit of the life company through which you buy the policy. This profit is added to the amount in your funds

Unit-linked: the value of your units rise and fall in line with the underlying funds into which your money is being invested

Unitised with profits: a new version of the traditional with profits concept that provides the ability to value the policy quick and allows the charges to be specified and collected in a similar manner to a unit linked plan.

Please note that none of the above methods are guaranteed to repay your mortgage at the end of the mortgage term.

If you have any questions or concerns about your mortgage repayment method, please contact us.

How large a mortgage can I have?

Three factors determine the size of mortgage you can have:

The deposit you pay on the property: a lender would usually expect you to put down at least 5% of the purchase price of the property, though some lenders will consider a 100% mortgage

Your salary: generally, you can have a mortgage equivalent to 3.5 times your salary. If you have a joint mortgage, you could apply for 2.5 times your combined salaries, or 3.5 times the main salary, plus 1 times second salary.

The amount of any existing commitments you have: the amount of personal loans, hire purchase agreements may be deducted from the amount available for you to borrow.

The lender will expect to see proof of your salary and will write to your employer for confirmation. If you include commission or bonuses in your salary amount, the lender would expect confirmation from your employer that these are regular payments.

Self certification should only be used when an individual is unable to prove their income and whilst having a large deposit is usually a requirement for most lenders, it should not be used as a reason to self certify.

I am self-employed: how can I get a mortgage?

A lender will usually need proof of your income, but sometimes, they will rely on your own assessment of income (‘self certification'). Self-certified mortgages were designed to cater for people who are self-employed and have difficulty in showing that their earnings are enough to make the payments on the mortgage they are applying for. This could be because they have not been trading for long enough, they have more than one job, or they rely on bonuses for a large part of their total pay.

Don't let anyone persuade you to overstate your income in order to get a very large loan. If you lie about your income, you could end up with a loan you can not afford. You will also be committing a fraud and could get a criminal record.

My income is erratic: does that put me out of the running for a mortgage?

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What is Higher Lending Charge?

Typically if you take out a mortgage for more than 90% of the value of your home the lender will normally ask you to provide additional security to cover their potential loss should you default on the loan. The most common method of providing this additional security is for the lender to effect an insurance policy (the premiums for which will be paid for by you). The lender uses the money received from the insurance policy to cover the costs they incur involving the repossession and resale of the property.

Please note that after any claim the insurer will normally look to recover, from you, any payments they make to the lender. The amount they will try to recover would include any legal fees they have incurred during the process.

What about protecting my mortgage payments?

There are now very limited state resources for meeting mortgage payments. It is sensible to look at insurance policies that pay out if you lose your job or are unable to work because of illness. Mortgage Payment Protection Insurance policies generally pay out up to 12 months' mortgage payments. They are frequently combined with other insurances such as critical illness or permanent health insurance.

What other costs are involved when buying a house?

In addition to your mortgage, you should bear in mind the following one-off costs at the time of purchase (or re-mortgage if you are changing mortgage lenders):

Legal fees: unless you intend to carry out your own conveyancing, you will need to pay a solicitor or other suitably qualified person to complete the legal work.

Land Registry fee: the Land Registry registers your ownership of the property.

Searches: your solicitor (or you) will need to check to see if there are any plans for the neighbourhood which could affect the value of your property, such as the building of a new road.

Survey and valuation: the lender will insist that a survey and valuation is done on the property. You should think about a more comprehensive survey to check for structural or other defects.

Stamp duty: all transfers of property of £125,000 or over attract stamp duty. For property transfers between £125,001 and £250,000 stamp duty is charged at 1% of the property price, for properties between £250,001 and £500,000 then the rate is 3.0%. The rate of stamp duty for transfers of property over £500,001 is 4%.

What is a CAT standard mortgage?

A CAT standard mortgage meets the requirements set up by the Government for fair Charges, easy Access and decent Terms.

To achieve the Government's mortgage CAT standard:
- All fees must be explained from the beginning
- Interest must be calculated on a daily basis
- The interest rate must be no higher than 2% above the Bank of England rate
- No early repayment charges for variable rate mortgages
- Repayment charges on fixed or capped mortgages can only be charged
  a) during the lower rate period
  b) at no more than 1% of the loan for the remaining years
- Maximum £150 arrangement fee if the mortgage is capped or fixed rate
- No separate charge for mortgage indemnity insurance
- The mortgage can move with you to another property
- You can choose the day of the month you want to make payments
- You can repay earlier if you wish
- No products can be tied in to the mortgage (such as buildings insurance)
- The terms must be fair, clear and not mislead

What if I can't meet my mortgage payments?

Contact your lender as soon as you realise you have a problem. Although your mortgage is secured on your home, lenders see repossession as the last resort: they stand to make more money from your mortgage than the sale of your home. Lenders may work out a plan with you to reduce your payments for a time or stop them temporarily, and work out a new term for your mortgage.

Your home may be repossessed if you do not keep up repayments on your mortgage.