MORTGAGE ADVICE MAKES FINDING THE RIGHT MORTGAGE LESS SCARY

Mortgages – an introduction

by Andrew Stuart, formerly editor-in-chief of Your Mortgage magazine

Mortgages can be confusing, since there seem to be so many different types of home loans available. However, with a little homework, it is possible to gain a sound working knowledge of the subject and an understanding of the terminology.

Even armed with this information it makes sense to talk to a professional mortgage adviser. With the number of mortgage choices available – well over 1,000 different deals (which are constantly changing), from over 100 lenders – an independent financial adviser (IFA) is well placed to help you select the type of mortgage that best suits you. Such an IFA should have access to most, if not all, of the latest mortgages (including many that aren't available through high street lenders), and can provide invaluable assistance in highlighting potential pitfalls.

However, to help you make sense of the mortgage market we have prepared a brief description of each type of mortgage, with handy summaries.

Right at the outset it is important to understand that there are two facets to a mortgage: how the loan is repaid; and how interest is charged on the debt. Get this clear in your mind, and logically everything else should fall into place.

Repayment or interest only mortgage?

There are two basic ways of paying off a mortgage: repayment and interest-only (backed by a separate investment):-

Repayment mortgage

With a repayment or capital and interest mortgage, you pay your lender a monthly sum, which is partly repayment of the outstanding debt and partly interest on the outstanding loan. Month by month the debt reduces.

Every time you move home or remortgage, you have to take out a new loan, and start your repayments from scratch.

However, providing you make all your monthly payments in full, the loan will be paid off at the end of the agreed term (which is usually 25 years, but could be longer or shorter).

Pluses:-

- Easy to understand.
- Loan guaranteed to be repaid if all payments made.

Minuses:-

- Very little capital is repaid in the early years of the loan.
- Monthly payments higher than for an interest-only mortgage.
- You'll need to arrange separate life assurance.

Interest only mortgage

As the name suggests, you simply pay interest to the lender during the course of the loan. Your debt never reduces and at the end of the agreed mortgage term you owe your lender exactly the same sum as at the outset.

Monthly payments to your lender are lower than for a repayment-type mortgage, but you will have to clear the debt at the end of the term.

In order to pay off your mortgage you will normally have to make payments into a separate investment plan, which is designed to build up sufficient funds to repay the loan in full. You have a number of choices of investments, some of which are outlined in the following pages.

Opening up endowment policies

Endowment policies

An endowment is an investment plan with built-in life assurance (which will pay off the loan if you die before the end of the mortgage term).

If the funds perform well, it may be possible to pay off the mortgage in advance of the expected date. Conversely, if the funds do not perform as well as expected you may have a 'shortfall' when you have to repay your mortgage and have to find the difference between the value of the endowment and the amount of your outstanding mortgage from other sources.

With-profits

A life assurance company invests your premiums on your behalf. Each year annual bonuses can be added to your fund, and once awarded they can't be taken away. At the end of the term a one-off terminal bonus may be added to produce a final payout.
With-profits policies aim to produce steady growth. The ultimate value of a with-profits investment is dependent upon the level of future bonuses, if any, and cannot be guaranteed.

Unit-linked

Your premiums buy units in funds, normally invested in the stockmarket. The prices of units are published daily, so you can find out exactly how much your fund is worth.
The value of your investment may go down as well as up.

Unitised with-profits

Your premiums buy units in a with-profits fund.

An endowment policy is designed for the long term but should your circumstances change, seek independent advice before you cash in your endowment as there are alternatives that may be more suitable for you. If you want to alter your endowment or if you have any potential ‘shortfall’, an IFA can advise you on what to do or even recommend an alternative source of mortgage repayment.

Pluses:-

- May pay off your mortgage in advance of the expected date if funds perform well, and therefore save future mortgage interest payments.
- Built in life assurance.
- Tax efficient.

Minuses:-

- Rely on investment performance.
- Potential ‘shortfall’ in value of fund when mortgage is due to be repaid.
- May have to make additional investments to build the required lump sum to match the outstanding mortgage amount.

Other ways to repay

Tax advantaged investments

You can choose an Individual Savings Account (ISA) to help pay off your mortgage. There are many different ISAs available to suit your investment outlook. The beneficial tax treatment of an ISA means that you do not have to pay any income tax or capital gains tax on any income or investment growth.

You may have to arrange separate life cover.

The value of your investment may go down as well as up.

Pluses:-

- Tax efficient.
- Potential for growth.
- Choice of many investment funds.
- You can cash in whenever you want.

Minuses:-

- Value of the fund can go down.
- Potential ‘shortfall’ in the value of the fund when mortgage is due to be repaid.

Pensions

It is possible to use some of the tax-free cash available from a pension, such as a stakeholder pension plan, to repay a mortgage.

Personal pensions enjoy considerable tax concessions, making them an efficient way to save.

However, you must be aware that you will use a significant amount of what is designed for your retirement in order to clear the mortgage debt.

In effect, you are remortgaging your pension in order to pay off your mortgage.

Pluses:-

- Tax efficient investment.

Minuses:-

- A pension is designed to provide for your retirement, not to clear a debt.
- The tax free cash cannot be taken before your normal retirement age.

Other

You can use unit trusts, OEICs, investment trusts, shares or maybe an inheritance to provide the funds to pay off an interest-only mortgage. However, a mortgage is a long-term commitment, and can you be sure that you will have the funds available from whatever means to clear the debt?

Pluses:-

- Flexibility of ways to pay off the debt.
- Choice of many investment funds.
- You can cash in whenever you want.

Minuses:-

- Uncertainty of future value of funds available for mortgage repayment.

Take independent advice

If you are considering taking out an interest only mortgage, you need to be aware that only an independent financial adviser can scour the whole investment market on your behalf to find the most suitable investment product to repay your mortgage.

Interest. Which option rates best with you?

Whether you have a repayment or interest-only mortgage, you'll have to pay interest to the lender. There are a number of options:–

Variable rate

Some people take a mortgage with a variable rate – the rate goes up and down, usually in line with movements in bank base rates. Falling rates are good news, since the monthly payments go down, but of course rising interest rates mean increased payments.
Most lenders offer a standard variable rate mortgage.

Pluses:-

- The chance to benefit from falling interest rates.

Minuses:-

- Rising interest rates mean higher monthly payments.
- Lender's variable rate may not be competitive.

Discounted rate

Many lenders offer variable rates with an initial discount for a period of months or years.

Pluses:-

- The chance to benefit from falling interest rates.

Minuses:-

- Rising interest rates mean higher monthly payments.
- Lender's variable rate may not be competitive.
- Possible redemption penalties.

Cashback

Some lenders offer new borrowers a variable rate mortgage with a cashback – a lump sum, which is normally a percentage of the loan, which is payable when the mortgage completes.

Pluses:-

- Handy upfront cash payment.
- The chance to benefit from falling interest rates.

Minuses:-

- Rising interest rates mean higher monthly payments.
- Lender's variable rate may not be competitive.
- May have to pay back some or all of the cashback if you redeem the loan within a certain period.

Fixed rate

You can get a fixed interest rate mortgage, with a known interest rate for a set period. Most people choose to fix for between two to five years.

Many fixed rates are lower than the standard variable rate, and usually the longer the fixed term, the higher the rate.

Fixed rates are good for budgeting, since you know exactly how much you will pay each month for a set period. They also provide protection, should variable rates rise during the fixed period. However, if variable rates drop below the fixed rate, you could pay over the odds.

Most fixed rates have early redemption penalties during the fixed term, and possibly after the fixed rate runs out. This is a fine, which is often equivalent to several months' interest, that you have to pay if you cash in your home loan before the end of the fixed term. And, in some cases, early redemption charges may apply for some years after the fixed period runs out.

Pluses:-
- Good for budgeting.
- Rate may be lower than variable rate.
- Choice of periods to fix over.
- Protection against rising variable rates.

Minuses:-
- Don't benefit from falling variable rates.
- Hefty early redemption penalties (during and even after the fixed rate period) may lock you into the lender and loan for a long time.

Capped rate
Offers the benefits of variable and fixed rates. Great for budgeting as there is a maximum interest rate (the cap) you will be charged for a period of years. But if the lender's variable rate falls below the capped rate, so will your rate, and you benefit from lower monthly payments.

Some capped rates have a collar or floor, which is the minimum rate that will be charged for a period.

In some cases, early redemption penalties may apply.

Pluses:-
- Good for budgeting.
- Protection against rising variable rates.
- Chance to benefit from falling variable rates.

Minuses:-
- Limited choice of loans.
- Possible collar or floor below which the interest rate won't fall.
- Early redemption penalties may lock you into the lender and loan, for a long time.

Current account and offset mortgages
Current Account Mortgages (CAMs) and offset mortgages allow you to run all of your finances through the same account.

With a CAM, your current account, savings, mortgage, credit card and personal loans are all combined in one account and interest is applied at the mortgage

rate, which is always higher than savings rates. So the money that would normally be in your savings or current account goes into your CAM instead to reduce your mortgage debt. So you pay less interest on this reduced amount, and your money is working harder.

The offset mortgage works in a similar way to the CAM, but your mortgage, savings and current account are kept as separate products. So the saving and borrowing rates are offset against one another, but you can view your different ‘pots’ of money separately.

Pluses:-
- Very efficient way to manage your finances.
- Pays off your mortgage quickly if always in credit.
- Interest on savings applied at the mortgage rate.

Minuses:-
- May have to pay in all of your salary into a CAM thereby losing choice.
- Can have restrictive entry levels.

The importance of independent financial advice.
When arranging your mortgage, there’s more than one reason to head for an independent financial adviser.

Your mortgage is likely to be your single largest financial commitment, so it pays to explore all your options, from product type to repayment method. IFAs are legally obliged to act on your behalf, without bias toward one mortgage provider or another. They have access to the whole product market, covering all of the latest mortgage deals, as well as exclusive offers that you can’t get from bank or building society branches.

In addition, an IFA will be able to highlight and explain any potential pitfalls, like early redemption penalties and tied-in insurances, that can often take the gloss off mortgages that have attractive headline interest rates.

These might include life insurance or other forms of financial protection to cover your mortgage should you suffer a long-term illness or injury and be unable to keep up your mortgage repayments. You may choose to have an 'interest only' mortgage in which case it is important that you have the most appropriate savings vehicles to repay the loan. This may be a combination of investments, Individual Savings Accounts or even pensions. There are over 30,000* financial products available and the costs, terms and conditions vary. Only an IFA can give you unbiased advice across the whole financial products and mortgage marketplace.

A mortgage specialist IFA will consider your overall circumstances, to ensure your mortgage works as cost-effectively as possible alongside your other

financial arrangements. So in the long run seeing an IFA could save you a pretty penny.

For further information on the subject contained in this guide, please contact your IFA.
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IFA Promotion Ltd.
Head Office, 2nd Floor, 117 Farringdon Road, London EC1R 3BX.
Tel: 020 7833 3131 Fax: 020 7833 3239 Web address: www.unbiased.co.uk

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* Source: DTI, IMA, AKG.

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