Repayments

How you repay your mortgage depends on your circumstances and how long you will own the property you are buying. There are two basic ways to repay what you have borrowed.

Repayment (Capital & Interest) Mortgage
With this method, you make monthly payments to the lender over an agreed number of years (called the mortgage 'term'). Many mortgages last for 25 years but they can be for shorter or longer periods.Your payments gradually pay off the whole amount you have borrowed (called the 'capital' or the 'principal') as well as the interest. Provided you make all the payments agreed with the lender, a repayment mortgage guarantees to repay the whole loan by the end of the term.

There is no built in life cover with this method and you will need to effect a life assurance policy to cover the amount borrowed should you die during the mortgage term.

Interest Only Mortgage
With this method, your monthly payments to the lender only cover the interest on the loan. They do not pay off any of the amount you have borrowed. This is why you usually make separate payments into an investment or savings scheme to build up a lump sum. When the mortgage term ends (or earlier), you use the lump sum to pay off the amount you originally borrowed. It is your responsibility to make sure you have sufficient funds available to repay the loan at the end of its term.

So which method is best for me?
When you are thinking about the repayment method there are many areas to consider. To help you decide what might be the most suitable method for you, we have set out some of the main advantages and disadvantages together with general comments on each method.

You can have a combination of more than one of the methods we have mentioned.

- Repayment Mortgage
- Interest Only
- Interest Only Repayment Vehicles
- Endowment Mortgage
- ISA Mortgage
- Pension Mortgage

Repayment Mortgage
Advantages

- You will have a guarantee that the mortgage will be repaid at the end of the mortgage term. You will need to increase your payments if interest rates rise. But, if interest rates fall, your payments can be reduced. Many lenders only change payments annually. The repayment method does not depend on the stock market or investment performance.

- It's straightforward in that each month you pay back some of the loan and interest on the loan.

- It's flexible - you can usually pay more to reduce the size of the loan and reduce monthly interest charges. If the lender agrees, you can change the monthly repayments or the length of the mortgage term.

- Monthly payments may be lower than other methods which can be an advantage if you have significant outgoings and are stretching to afford your mortgage payments.

- Should your circumstances change it may be possible to change to another repayment method in the future which more appropriately meets your needs at that time.

Disadvantages

- You do not have built-in life assurance - you will need to take out a separate life assurance policy to make sure the loan is repaid if you die before the end of the mortgage term.

- You may not always be able to transfer the life assurance policy if you move or increase your loan. The policy is normally arranged for the original loan only and you may need to cancel and start a new policy if you increase your mortgage loan.

General Comment

- Repayment mortgages are straightforward and are guaranteed to repay the loan. The outlay can be cheaper than other

repayment methods.

- You have to arrange life assurance protection and any other 'critical illness' cover separately.

Repayment mortgages could be very suitable if:

- you feel the payments are more affordable than the generally higher monthly payments of an endowment mortgage (this is important if you have, or will have, significant monthly outgoings over and above your mortgage payments);

- your long-term employment prospects are not very secure or if your earnings change or are seasonal and could fall below the level you would expect to be able to pay to maintain your mortgage repayments; or

- you consider some other change in personal circumstances may affect your future ability to keep up your mortgage payments.

Interest Only

Advantages

- You decide how to repay the loan at the end of the term - interest only mortgages can be linked to various types of investments: endowment policies, ISAs, personal pensions and other investment options.

Disadvantages

- The savings scheme or investment does not guarantee to provide enough to pay off the mortgage.

- With all interest only loans you need to accept some investment risk in building up a sum of money to repay the loan. Provided your investment grows as expected, the mortgage will be paid off. If the investment makes more than expected, you get a cash bonus after repaying your mortgage. If the investment grows more slowly, resulting in a shortfall in capital, you are responsible for making up the difference.

General Comment

You must be confident that you can repay the loan from your own sources at the end of the mortgage term. If you do not make adequate provision to repay the mortgage you cannot rely on the goodwill of the lender, who may demand repayment at the end of the mortgage term, which could mean putting your home at risk.Interest Only Repayment Vehicles

As already explained with an interest only mortgage you have the freedom to choose the savings or investment vehicle that you will use to repay the amount borrowed at the end of the mortgage term. Three of the more common methods are explained over the following pages.Endowment Mortgage

This is where you take out an endowment policy which is designed to end at the same time as the mortgage. The money you put into an endowment policy builds up over a set number of years (the policy 'term'). At the end of this term, your policy 'matures' and you get a lump sum, which you can use to repay your mortgage loan.

Advantages

- Life insurance - this is built into an endowment policy which means that the mortgage will be repaid if you die within the period of the loan.

- Portability - you can use your existing endowment policy for your new loan when you move house. If you move home it makes financial sense to keep your existing endowment policy and simply cover any more borrowing by whatever method you find suitable.

- Another way of saving - if you decide to sell your property and not buy another one you could repay your mortgage by another method.You can keep your endowment in force to boost your long term savings.You also have valuable life assurance protection for your family throughout the lifetime of the endowment.

- Other additional benefits can be included in your policy, such as Permanent Total Disability benefit, Critical Illness cover or Waiver of contribution benefit, giving you and your family even greater security.

Disadvantages

- Inflexibility - there are financial penalties if you stop an endowment policy before the end of its full term. Endowments are long-term contracts designed to provide for repayment over the period of the loan.You need to keep the plans in force until the maturity date so you get the full value.

- Possible need to top up your savings - there is no guarantee that the final amount will be enough to repay the loan at the end of the mortgage term. Many endowment plans have regular reviews built in to help keep your investment on track. If investment returns are less than expected, you may find you have to pay extra contributions to achieve your target value. Alternatively, you may select other options to make up a shortfall.

- If you ever have financial problems and are struggling to meet your payments, it may not be possible to take a payment break or reduce your contributions.

General Comment
- Endowments can offer you a package of benefits as long as you keep the plan in force until the end date.

- Returns on your policy are subject to performance and it is important that you maintain the contributions to your policy over its full term.

- If you have an endowment policy - keep it in force - you could still use it. The financial penalties can be high if you decide to cash it in to take out a new one.You should only consider cancelling the plan after taking proper advice.

ISA Mortgage

This is where you put regular savings into an individual savings account (ISA), up to the annual limits set by the government. Over time your savings build up a lump sum which you can use to repay the amount you borrowed.You can use ISAs to invest in a wide range of savings and investments.

Advantages
- Tax efficiency - the return on the investments is tax-free. There is no tax on withdrawals from an ISA.

- Wide choice of investments - you can use cash, stocks and shares and life insurance to build up your ISA savings.

- Flexibility - you can stop paying into an ISA at anytime and you can withdraw your savings at any time. This makes them very flexible if you decide you'd like to pay off your mortgage early.

Disadvantages
- Annual investment limit - the most you can pay into an ISA in each tax year is £7,000. If you have a very large mortgage, the lump sum from this level of saving might not be enough to eventually pay off your mortgage loan.Tax legislation is subject to future change.

- No life insurance - most mortgages which will be repaid from the proceeds of ISAs will not include any life cover.You will need to buy life cover, perhaps in the form of term insurance, which is not linked to any savings scheme.

- Possible need to top up your savings - there is no guarantee that the final amount will be enough to repay the loan at the end of the mortgage term, in which case you are responsible for making up the value of any shortfall.

- Stock market risk - this could be a problem if you need access to your investment when share prices are low.

The value of an ISA is not guaranteed and can go up and down depending upon investment performance.

General Comment

Whether an investment backed interest only mortgage is suitable for you depends on your attitude to risk.Pension Mortgage

This is where, alongside an interest only loan, you make payments into a personal pension. When you start to take the pension (between age 50 and 75), you can take part of your pension fund as a tax-free lump sum. A pension mortgage uses this lump sum to pay off your mortgage loan.

Advantages
- Tax - using your personal pension can be a very tax efficient type of mortgage. The lump sum from your pension fund

is tax-free.You also get income tax relief at your highest rate on contributions.*

- Tax legislation is subject to change. The value of any tax relief will depend on your own financial circumstances.

Disadvantages

- Less at retirement - by using all or part of any tax-free cash lump sum (currently up to 25% of the total fund value), from the pension fund at your chosen retirement age to pay the mortgage loan, you will get a reduced pension to live on.

- Tied to retirement - generally you are not allowed to take the pension and the lump sum from a personal pension plan before age 50. So you may be locked into paying interest over a longer mortgage term than you would like.

- Inflexible - a personal pension may not be the best way for many people to save for retirement. This could be the case, for example, for someone who takes out a personal pension but is able, later on, to join an employer's pension scheme which is better value for them. They may then need to find another way of building up a lump sum to repay their mortgage.

- The value of a personal pension plan is not guaranteed and can go up and down depending upon investment performance. There is no guarantee that a pension mortgage will repay your loan at the end of the mortgage term and you would be responsible for making up any shortfall.

General Comment

Pension mortgages are very tax efficient. The amounts you can contribute to your personal pension plan are limited under rules laid down by the Inland Revenue.