D1.03: MORTGAGE REPAYMENT OVERVIEW

SYLLABUS

- Repayment mortgages
- Repayment profile
- Interest only mortgages
- Full and low cost endowment mortgages
- Unit-linked endowment mortgages
- ISA mortgages
- Pension mortgages
- Life assurance
- Other associated protection policies
- Risks

Repayment mortgages

- Mortgages are arranged either on a capital and interest repayment basis or an interest only basis (or sometimes a mix of the two)

- Repayment loans (also sometimes described as annuity mortgages) require regular (usually monthly) payments consisting partly of interest, partly of a repayment of capital

- The outstanding balance reduces through the term and the loan will be fully repaid at the end of the term, so this method appeals to the risk averse, but no surplus can arise at the end of the term

- Life cover is advisable, and usually recommended, though not always required by lenders

- A decreasing term assurance fits this need because the outstanding loan reduces during the term of the mortgage

- A mortgage protection policy is a decreasing term policy specifically designed to cover mortgage borrowing

- Other protection policies such as IPI (Income Protection Insurance, also known as Permanent Health Insurance or PHI), critical illness benefit, redundancy insurance and mortgage payment protection insurance (MPPI) may be appropriate alongside any mortgage

- Repayment mortgages generally involve the lowest monthly outlay of all mortgage repayment methods if the costs of funding any alternative repayment vehicle are taken into account

- However, life cover costs also need to be taken into account for a full comparison

Repayment profile

- Generally the total monthly repayment remains constant (unless the interest rate changes) through the term

- This means that initially the payments are almost all interest, but the proportion which is a repayment of capital gradually increases through the term

- As an example, after ten years of a 25 year repayment loan, only around 25% of the borrowing will have been repaid assuming a 6% interest rate

- The lower the interest rate, the greater the proportion repaid over any given period, so a 4% interest rate would mean that around 29% would be repaid over ten years

- Conversely, at higher interest rates, the repayment is slower, with only about 15% repaid over ten years if the interest rate is 10%
• Although 10% sounds a very high rate of interest in today’s market, mortgage interest rates were commonly as high as 15% in the late 1980s, for example
• Given increasing property values, a borrower’s equity in his property will rise proportionately faster than the property value (because of the gearing effect of the loan)
• The increase is greater with a repayment mortgage than with an interest only loan because the outstanding loan amount is reducing as well

Interest only mortgages
• Interest only mortgages require payments to the lender of interest only, and (usually) contributions to an investment product to repay the loan at the end of the term
• Some lenders require details of the repayment vehicle, but others do not
• Some lenders require the assignment of a life policy to protect the loan on the borrower’s death, but this has become much less common in recent years
• Unlike the position with a repayment mortgage, the outstanding loan does not decrease during the term
• Interest only mortgages can be repaid in many ways, the most common being with an endowment policy, an ISA or a personal pension
• An endowment policy could be assigned to the lender, but the legislation does not permit the assignment of ISAs or pension policies in this way

Full and low cost endowment mortgages
• An endowment mortgage is a type of interest only mortgage
• The endowment policy is convenient, because life cover as well as investment is included, but it is often not the most tax efficient approach to mortgage repayment
• With an endowment policy of any type, waiver of premium can also be added (subject to this being available from the chosen product provider)
• The waiver would come into effect if the policyholder is incapacitated, and will meet premiums during the period of incapacity, usually after an initial ‘deferred period’ has elapsed
• Any surplus funds at maturity will be free of all personal tax assuming the policy is a qualifying policy (which is usually the case)
• No tax relief is available on endowment premiums however, unless the policy is qualifying, was established before 14 March 1984 and has not subsequently been altered to increase benefits
• A with profits policy appeals to some borrowers because it reduces risk compared to a unit-linked arrangement, or an equity-based product such as an ISA
• Although bonuses, once added to a with profits endowment, cannot subsequently be reduced or removed, the rate of future bonuses is not guaranteed
• A terminal bonus may be paid on maturity, or earlier death, but is also not guaranteed
• A full with profits policy has a minimum guaranteed sum assured (GSA) equal to the amount of the loan
• This guarantees that the policy proceeds at maturity (or earlier death) will be sufficient to repay the amount borrowed
• A full endowment policy is likely to produce a substantial surplus but also requires a substantial monthly premium, which generally exceeds the cost of other repayment methods
Occasionally, a non-profit policy may be used, which has a guaranteed sum assured on death or maturity, and so also offers a guarantee of repayment.

However, there are no bonuses, so there will be no surplus – everything under the policy is guaranteed and fixed.

In practice these are seldom used, because the assumed return in setting the sum assured is low, as a result of the guarantee built in.

A low cost endowment is in effect a combination of a with profit endowment assurance with decreasing term assurance, packaged within one policy.

The GSA starts off below the amount of the loan, and is designed to build up to at least the loan amount through the addition of bonuses, though this is not guaranteed.

The sum assured on death is guaranteed to at least equal the amount of the loan (this is where the decreasing term assurance comes in).

A low start low cost endowment is a variation of the low cost endowment, but with premiums starting lower and increasing at a set rate, usually over the first five years of the policy, after which they remain fixed.

This may appeal to a first time buyer who is particularly stretched financially at the start of the mortgage, though care is always needed to ensure the borrower does not over-reach.

**Unit-linked endowment mortgages**

A unit linked endowment can be used for mortgage repayment, but the maturity proceeds are not guaranteed and depend on growth to achieve a sufficient maturity value to repay the loan.

However, the minimum death benefit under a unit-linked mortgage endowment is set to equal the amount borrowed.

If greater, the value of units allocated to the policy is paid (this may be the case in the later part of the term).

Early repayment is possible if fund growth has been strong, allowing the policy to be surrendered early to provide capital to repay the loan.

Care is needed because endowment policies may include penalties on early surrender.

Also, a personal tax charge will arise on any gain on surrender if the policy has not remained in force with premiums paid for at least 10 years or, if less, three quarters of the term.

The tax charge is at the individual’s marginal rate less 20% and a liability will therefore only arise in the case of a 40% or 50% taxpayer.

It is possible to surrender with profits mortgage-related policies early in the same way, but this is less usual because surrender values are usually entirely at the discretion of the insurer.

Some mortgages also include early repayment charges.

**ISA mortgages**

These are interest only mortgages, with the ISA (Individual Savings Account) providing a tax efficient repayment vehicle.

An ISA is a tax efficient means of repayment because, in particular, investment growth is free of tax, except that dividend tax credits cannot be reclaimed.

An ISA cannot be assigned and the value at the end of the mortgage term is wholly dependent on growth, with no guaranteed value (the ISA itself generally does not have a fixed term).
• An ISA is probably the most flexible repayment vehicle available and the level of investment being made into the ISA can be varied at any time (subject to the limits imposed by tax law)
• In 2011/12, the maximum investment permitted is £10,680
• Of this, up to £5,340 can be invested in a cash ISA, with the balance in a stocks & shares ISA
• This gives reasonable scope to build up sufficient capital for repayment in most cases
• The ISA investment can also be accessed at any time
• However, ISAs are generally regarded as carrying a relative high level of risk because investment is usually largely in equities
• Also, there is no built-in life cover, so this protection needs to be arranged separately

Pension mortgages
• A personal pension is also very tax efficient, because tax relief is available on contributions in the normal way
• The investment growth is tax advantaged in the same way as within an ISA
• However, only part of the fund (the pension commencement lump sum, which is limited to 25% of the fund) is available as a lump sum for loan repayment
• The monthly outlay for a pension mortgage is therefore likely to be relatively high, because the fund needed is four times the amount of the loan
• However, a pension benefit is being built up too
• If the investment product performs well, early repayment of an interest only mortgage may be an option worth considering
• However, Personal Pensions cannot usually be accessed before age 55
• Some arrangements have an expected retirement age written into their terms and penalties may apply if a Personal Pension is accessed earlier than expected
• Other types of pension arrangement (for example, occupational schemes and AVC – additional voluntary contribution – arrangements) can be used for loan repayment, but this is less common, and fewer lenders will accept them
• In the past, most AVC arrangements have not produced lump sum benefits at retirement but from 6 April 2006, the same rules apply as for other registered pension schemes and 25% of the fund can be taken in cash

Life assurance
• Life cover is advisable alongside any mortgage, though not always required by lenders
• Endowment mortgages build this in as part of the endowment policy, and comparisons with other mortgage repayment methods should allow for this
• A decreasing term assurance is suitable alongside a repayment mortgage because the outstanding loan reduces during the term of the mortgage
• As mentioned above, a mortgage protection policy is a decreasing term policy specifically designed to cover mortgage borrowing on this basis
• Level term is usually preferred alongside other mortgages because the build up of any repayment vehicle is not predictable
• The benefit payable on death under a term assurance policy is free of income tax
• Separate life cover would not be necessary with an endowment mortgage, since this cover is built into the endowment itself

Other associated protection products

• Other protection policies such as IPI (PHI), critical illness benefit and redundancy insurance may be appropriate alongside any mortgage

• Mortgage Payment Protection Insurance (MPPI) covers a range of risks, generally including sickness, accident and unemployment, and provides an short term income benefit linked to mortgage costs

• Note that ‘unemployment’ for this purpose generally excludes voluntary redundancy, resignation and dismissal, so claims for unemployment are effectively limited to compulsory redundancy

• Even this is excluded for an initial period immediately following the establishment of the policy (often three or six months)

• Waiver of contribution can also be built into some products, to ensure premiums can be maintained in the event of incapacity

• Endowment policies often allow this option (which must be selected at outset)

• Personal pensions may also include the option, or allow it to be written as a separate policy alongside, though tax treatment varies

• In general, older PPs may include the option, so the cost attracts tax relief

• PPs issued on or after 6 April 2001 cannot include it, and if it is written alongside, no tax relief is available on the cost

Risks

• Repayment at the end of the term is guaranteed under a repayment mortgage (assuming payments are kept up)

• A full endowment policy also guarantees repayment of the amount borrowed because the GSA equals the loan amount with bonuses adding to this (and the GSA cannot reduce)

• A non-profit endowment is also established so that the (fixed) maturity value equates to the amount borrowed

• Other products (including low cost endowment policies) depend on the growth or bonus rates, so there is no guarantee that the proceeds will be sufficient to repay the borrowing at the end of the term

• There is therefore a risk of a shortfall at that point

• The level of risk reflects the product, so equity based arrangements such as ISAs tend to carry relatively high risk, compared to, for example, with profits endowments which have some element of guarantee

• However, the choice of investment fund under a unit-linked endowment will determine the degree of risk involved

• The potential volatility of equity related products can cause problems as asset values build up in the repayment product and this should be monitored, particularly as the end of the term approaches

• Consideration could be given to switching to less volatile areas or arranging partial repayment, though care is needed as regards any penalties or tax charges under the investment product, and any early repayment charges under the mortgage
• On death before the end of the term, with profit endowment policies, whether full or low cost, will provide a minimum sum assured equal to the amount borrowed, so repayment is certain
• This is also the case with unit-linked endowment policies
• Non-profit policies also do so
• If the policy is assigned to the lender, the proceeds will be paid to the lender who will pay any surplus on to the borrower’s estate
• Any shortfall (for example outstanding interest) would be a debt on the estate
• As discussed above, sufficient money to repay the amount borrowed is certain on death during the term of an endowment mortgage, but otherwise depends on the level of life assurance arranged alongside other repayment methods