

Types of mortgages

There are various ways to repay your mortgage. Here is a brief outline of the more popular repayment methods, and their advantages and disadvantages.

Repayment mortgage

How does it work?

You borrow a lump sum over a fixed period of time (usually 25 years, but it can be less). You pay the interest and some of the capital on a monthly basis to the lender.

ADVANTAGES: The only way you can be 100% certain the loan will be repaid (provided you keep up with the repayments.)

DISADVANTAGES: Only a small amount of capital is paid off in the early years.

Interest-only mortgage

How does it work?

Your monthly payments represent only the interest due to the lender, and do not include repayment of capital. Your total loan must be repaid at the end of the mortgage term. You may therefore need to arrange additional investments which will generate sufficient capital to repay the loan.

ADVANTAGES: You can choose from a variety of investments, some of which have tax advantages. Should you move or arrange a remortgage, your investment can usually be reallocated to the new mortgage.

DISADVANTAGES: Unlike a repayment mortgage, the amount of debt outstanding does not reduce over time, and there is no guarantee that the investments chosen will grow sufficiently to repay your loan. Also, investment-linked interest-only mortgages can be slightly more expensive than repayment mortgages.

Three well known types of interest-only mortgages are:

ENDOWMENT MORTGAGE

How does it work?

You make two payments per month. One to the lender to repay the interest on the amount borrowed, the other to an insurance company for an endowment contract. There are mainly two types of endowment: unit linked or with profits. Both invest in a broad range of assets including stocks and shares. The capital in the endowment builds up over the term of the mortgage to repay the outstanding capital.

ADVANTAGES: This one's very flexible. You can take the endowment policy with you if you move home or change mortgage lender. Endowments usually include some kind of life cover and some also include critical illness cover. This can be a cheaper method of buying such cover under usual conditions. If the endowment contract performs well, you may accumulate more funds than required to repay the loan. However, endowments are not risk-free as there is some investment in the stock market.

DISADVANTAGES: There is a possibility your fund may not build up sufficiently to repay the capital. Taking financial advice, carrying out regular reviews and generally keeping a watchful eye on your fund's performance will help to prevent this happening.

PENSION MORTGAGE

How does it work?

You make two payments per month. One to the lender to repay the interest on your borrowings and another into a personal pension plan. The aim is to build up your pension fund sufficiently to repay the loan and to provide you with a retirement income.

ADVANTAGES: Has tax advantages, as the contributions you make to the pension plan attract tax relief at the highest rate of tax you pay.

DISADVANTAGES: You must ensure your pension is well funded to ensure you have sufficient to repay your loan and provide for your retirement. The tax free lump sum which is paid on retirement is used to repay the mortgage loan, but there is no guarantee that there will be sufficient funds to do so.

INDIVIDUAL SAVINGS ACCOUNT (ISA)

How does it work?

You make a monthly payment to the lender to repay the interest on the amount borrowed, and start to invest into an ISA plan. The capital in the plan builds up over the term of the mortgage to repay the outstanding capital. ISAs allow you to invest in cash and stocks and shares, and work in much the same way as the endowment method.

ADVANTAGES: Your money could grow faster within an ISA fund than an endowment because of tax advantages and because ISAs invest most of your money into stocks and shares. This means they can grow very quickly if the stock market performs well. On the other hand, if there's a stock market slump, there's a risk that you may not be able to pay off your loan at the end of its term. They are more flexible than endowments and can work out cheaper.

DISADVANTAGES: Risk - Stockmarket fluctuations could adversely affect the value of the plan, as your capital is not guaranteed. Therefore, there is no certainty that you will be able to repay the mortgage. Also, you need to arrange separate life and ill health cover, if appropriate. There is no guarantee ISAs will continue indefinitely and certain tax benefits are available only until 2004. ISA contributions are currently restricted to a maximum of £7,200 in any tax year.

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

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