The different type of borrowing

There are 3 term of borrowing:

- Short Term
- Middle Term
- Long Term

1. Short Term ---Friend and Family

Advantage: You can borrow money from your parents, sisters, brothers and relation easily.
Disadvantage: You can only borrow small amount of money.

2. Middle Term ---Bank personal loan

What is personal loan?
It means a personal loan is money you borrow from a financial institution - for example a bank or a building society.

Advantage: Personal loans are available in varying amounts with different rate which usually depend upon the purpose for which you require the loan.

Disadvantage: Unsecured personal loans are usually more expensive than homeowner loans as the lender doesn't take a charge on your loan. In other words you do not guarantee your loan with your home.

How do they work?

You borrow an agreed sum of money for an agreed length of time (normally anything from 6 months to 10 years or more). The lender makes money by charging interest on the loan. The interest rate can be either fixed or variable.

The Headline Interest Rate

This is the interest rate you'll see quoted in the adverts and best buy tables. Basically you shouldn't take it too seriously. It's a means the lenders use to attract enquiries.

The interest rate they offer you may well be different because of your personal credit score.
Headline rates are usually expressed as a monthly interest rate. However, you should always compare loans using the Annual Percentage Rate (the APR).

The APR

The APR (Annual Percentage Rate) is a method of providing a true comparison between different loans. It shows the true interest rate of the loan.

The lower the APR on a loan the better because it means you have less interest to repay - so the loan is cheaper.

The APR is worked out according to strict legal guidelines and takes all the costs of the loan into account.

Without this certain charges could be hidden: for example, while a headline interest rate in an advert may claim to be only 1% a month, the APR may be 15%. In other words the monthly interest rate quoted cannot be correct (15% a year is more than 12 times the 1% monthly charge).

The lender has to include everything in the APR, whereas they can effectively lie about the monthly rate.

The APR is a legal requirement. Lenders have to make clear what the APR is on each of their loans and make it more prominent than the headline rate.

3. Middle Term ---Credit Card

Credit cards are a convenient way of obtaining credit. They are available from all major lenders and provide flexibility for the consumer. Repayment periods can be as high as 56 days if you clear your balance in full.

When you choose a card you should look at the APR (Annual Percentage Rate, or rate of interest charged); the initial rate if there is one (many providers offer very low or no initial rates for a period); and the balance transfer rate (as above) if you are transferring a balance from another card.

When you are applying for a new credit card there are a couple of things you should base your decision on:

- **APR.** The annual percent rate of interest on your credit card tells you how much interest you will pay on outstanding balances on your credit card.
- **Initial Rate.** Many credit cards offer lower than standard introductory or initial rates as an offer when you sign-up. These rates tend to last for limited initial periods.
- **Balance Transfer Rates.** If you have an outstanding balance on other credit cards and you want to transfer this to your new credit card, some credit cards offer reduced rates on initial or all transfers.

4. Long Term--- Mortgage

What is mortgage?
It is a sum of money borrowed from a bank or building society in order to purchase a property. The money is then paid back to the Lender over a fixed period of time together with accrued interest.

There are essentially two different types of mortgage:

- Repayment only, (capital and interest mortgage)

- Interest only, (ISA, pension or endowment mortgage)

Repayment only

Your monthly repayments consist of repaying the capital amount borrowed together with accrued interest. On your mortgage statement, normally received annually, you will see that the amount borrowed decreases throughout the term.

ADVANTAGES

- At the end of the term, you are safe in the knowledge that the total amount of the debt has been repaid.
- Overpayments and lump sum payments into your mortgage account can be made reducing both the interest and capital amounts repayable.
- Life assurance cover is not always necessary in taking out this type of mortgage.

DISADVANTAGES

- There may be financial penalties for making lump sum/overpayments into your mortgage account. In the early years of a repayment mortgage the majority of the monthly repayment is interest rather than capital. For borrowers moving house regularly, this can result in little of the capital being paid off.

- If you have no life assurance cover in place and die before the loan is repaid, the mortgage will still need to be repaid. This may result in the property having to be sold to repay the debt owed.

Interest only

With this type of mortgage, only the interest is paid off with each mortgage payment. The borrower also takes out at the same time, an alternative ‘repayment vehicle’ (method of paying off the mortgage) such as an ISA, pension plan or endowment policy. More information about endowments (which in the 1980’s and 1990’s were extremely popular), ISAs and Pension plans are below. The most important fact about an interest only mortgage is that the monthly repayments do not repay any of the outstanding capital balance. As a consequence it is important that the payments are maintained into the repayment vehicle otherwise it will not be possible to pay off the mortgage at the end of the term.

- Endowment
- ISA Plan
- Pension

Endowment

The most common type of interest only mortgage which also provides life assurance cover and a fixed payment for investment. The fixed payments are based on the amount of the loan together with the mortgage term and are designed so that, at maturity, the amount invested and earnings are sufficient to pay off the mortgage. Much maligned in the press because of the poorer investment growth rates achieved in a low inflationary environment this form of investment is less popular these days. Note there is no guarantee that, when the endowment matures and ‘pays out’, the balance will be sufficient to repay the mortgage.

Nonetheless millions of borrowers have one or more endowment policy and as a rule of thumb these should not be cashed-in early and certainly not before seeking advice from a suitably qualified financial adviser. Customers cashing-in an endowment policy in the first few years after inception can receive less than the amount invested. Existing endowments can be used to support a new mortgage with any ‘additional lending’ over the value of the projected maturity balance being covered on a repayment basis or with an alternative repayment vehicle e.g. an ISA. It is also worth pointing out that historically the returns on endowment policies have been pretty good (provided they go full term).

Endowments provide life assurance so that in the event of death the mortgage is paid off.

ISA

The Individual Savings Account (ISA) is a tax free method of saving. Using an ISA as a repayment vehicle is growing in popularity but due to the ISAs complexity it is only for the financially sophisticated or borrowers taking advice from a suitably qualified financial adviser.

Pension Plan

Life assurance cover is provided and monthly payments are made into a pension fund. When the benefits are eventually taken, the mortgage is repaid using tax-free cash from the remainder of the fund. The plan holder can then draw a pension from the balance of the fund. This product, which tends to be used by the self employed, is only for those taking advice from a suitably qualified financial adviser.

ADVANTAGES

- If the proceeds of the plans exceed the amount required to repay the mortgage, then this is received as a cash lump sum by the borrower.

- Some plans are tax-efficient.

DISADVANTAGES

- If the proceeds of the repayment vehicle do not achieve the amount expected, then there will be a shortfall. The borrower remains liable for any shortfall on the mortgage hence the outstanding balance will need to be paid off from other resources. Regular checking of the policy fund itself by the borrower and the lender should minimise any risk. If the plan is not reaching its expected target, the borrower can increase payments into the policy or invest in another product to cover any anticipated shortfall.

- Cashing in the plans early may result in financial penalties. These will be provided for in the initial agreement. In addition the lender has no way of tracking some of the more modern repayment vehicles, such as an ISA, which will result in some instances where a borrower lets an investment lapse forgetting or not realizing it is to be used to pay off the mortgage. This will result in situations where there is no method of paying off the mortgage and the lender will only become aware at the end of the mortgage term.

INTEREST RATES ON MORTGAGES

When you have chosen the right mortgage for you, whether it be a repayment or an interest only mortgage, you will need to consider the 4 main mortgage rate options available.

- FIXED
- CAPPED
- DISCOUNT
- VARIABLE

Fixed Rate Mortgage

The amount you repay the lender each month can be at a fixed interest rate for a certain period of time, regardless of the interest rate in the market place. It is common for lenders to offer rates fixed for a period of 2 to 5 years, but shorter and longer periods can be found in the market. At the end of the fixed rate (or 'benefit') period the rate will normally convert to the lenders Standard Variable Rate (SVR).

It is normal for lenders to charge up-front fees in the form of booking and/or arrangement fees. In addition lenders frequently apply an Early Redemption Charge (ERC) for fixed rate mortgages. This acts as a 'lock-in' making an often heavy charge for borrowers paying off their mortgage early. Watch out – the ERC can sometimes last longer than the fixed rate period e.g. a 3 year fixed rate with a 5 year ERC.

Capped Rate Mortgage

A capped rate mortgage is very similar to a fixed except that if the variable rate drops below the capped rate, the borrower will make payments based on the lower variable rate. However should rates increase the payments will be 'capped' and will not rise over the capped rate. So as a rough 'rule of thumb' a capped rate is better to have than a fixed if all other factors are equal. Again, as with fixed rates, up-front charges and 'lock-ins' are common.

Discounted Rate Mortgage

The Lender offers a discount on the Standard Variable Rate (SVR) for a specific period of time. For example, the variable rate may be 5% with a discount of 1.5%. The initial pay rate would therefore be 3.5%. If the variable rate rose to say, 6%, then the rate payable would rise to 4.5%. As the discount is linked to the standard variable rate, the borrowers payments will increase, if rates rise – so there is no certainty in budgeting. However should rates decrease the borrower will benefit from lower payments.

It is still possible to have up-front charges for discounted products and an Early Redemption Charge is common.

With discount mortgages borrowers need to watch out for ‘payment shock’. Some short term discount products offer a ‘deep discount’ e.g. 4% off for 1 year. In such circumstances the borrower will be facing a significant increase in their monthly mortgage payment at the end of the discount benefit period.

Variable Rate Mortgage

Borrowers paying the Standard Variable Rate will have their payments increase or decrease as the lender adjusts the rate in accordance with market conditions.

FEATURES AND OTHER BENEFITS OFFERED WITH MORTGAGES

There are other key features and benefits to be considered when determining the best mortgage for a prospective borrower.

- **A Flexible or lifestyle mortgage**
- **Current Account Mortgage**
- **Cashback**
- **Free Legals or a Contribution Towards Conveyancing Costs**
- **Free Valuation or Refund of Valuation**
- **Other benefits**

Flexible / Lifestyle Mortgages

A Flexible or ‘lifestyle’ mortgage is designed to let you to make extra repayments when you have extra money, and to reduce or even skip payments when necessary. Borrowers will normally have to build up a reserve through overpayments before being allowed to underpay or skip payments. The main benefit of flexible mortgages is that many schemes are offered on a Daily or Monthly Interest Calculation basis (sometimes referred to as ‘daily rest’ or ‘monthly rest’). Until the arrival of flexible mortgages most, if not all, UK lenders were charging interest on an annual basis which meant that borrowers making over-payments were not getting the benefit straight away because it could be a year before the capital was reduced by the over-payment. Whereas, on a mortgage where the interest is being calculated on a daily basis, any over-payment reduces the mortgage balance immediately hence the borrower will be charged less interest from the next day. Without going into detail to explain this feature the up-shot is that over-paying the mortgage on a monthly or regular basis, even by a relatively small amount, will reduce your mortgage term by years (hence saving payments).

Many flexible mortgages come without any Early Redemption Charge so the borrower is not ‘locked-in’ to any particular lender. In addition the interest rate charged is often lower than the usual Standard Variable Rates charged by the other more ‘traditional’ mortgage lenders.The flexible mortgage concept was imported from Australia so occasionally you may hear them referred to as ‘Aussie style mortgages’.

Current Account Mortgage (CAM)

A flexible mortgage linked to a current account. These mortgages take the benefits of the flexible mortgage and use the funds held in the current account to offset the interest e.g. on a particular day a borrower has a mortgage balance of £50,000 and has £2,000 held in the current account. The customer is charged mortgage interest on £48,000 i.e. the mortgage balance minus the positive balance held in the current account.

Some of the newer entrants into this sector are also linking savings accounts, credit cards and personal loans into the mix.

For a borrower wanting one home for their finances this is an attractive option.

Cashback

The Lender, as an incentive, will offer a lump sum of cash once the mortgage has been taken out. The amount will vary from lender to lender and on the size of the mortgage. The amounts can range from a flat fee e.g. £200 to a percentage of the loan e.g. 3% of the loan.

Normally the cashback is offered as a package of benefits e.g. linked with a discount, but pure cashback products are not uncommon. Mortgages offering a 5 or even 6% cashback can be found which would mean a borrower taking a £70,000 mortgage would receive £4,200 on completion (at 6%).

As you would expect lenders apply an Early Redemption Charge with cashback mortgages. Typically a borrower will be locked-in for 5 to 7 years where a substantial cashback has been paid.

Free Legals or a Contribution Towards Conveyancing Costs

More common on products aimed at the remortgage market but a frequent product 'enhancement'. To take advantage of the offer the mortgage applicant will normally need to use a firm of solicitors or licenced conveyancers nominated by the lender.

Free Valuation or Refund of Valuation

A free valuation requires no up-front payment from the mortgage applicant whereas a refund will only be made when and if the mortgage application completes. Hence an applicant paying for a valuation and then not proceeding due to, say, a poor valuation, will not have their valuation fee refunded.

Other Benefits

A whole range of other benefits can be applied to mortgages including the significant benefits of no Mortgage Indemnity Charge and no Early Redemption Charge. See below for more information about these features.

OTHER FEATURES / CONDITIONS AND CHARGES ASSOCIATED WITH MORTGAGES

Early Redemption Charge (sometimes referred to as a 'redemption penalty')

Given that the mortgage market is very competitive many mortgages are sold as 'loss leaders' i.e. the mortgage has to be held for a number of years before the lender breaks into profit. As a consequence lenders frequently 'lock-in' borrowers by applying Early Redemption Charges for those paying off the mortgage early. Charges can be significant e.g. 6 months interest or repayment of the amount of benefit received, be it cashback or reduced interest. The period an Early Redemption Charge applies can vary. Sometimes it will match the period of the discount/fix but often it can go beyond the benefit period e.g. a 5 year discount with a 7 year ERC. This is referred to as a 'redemption overhang'.

On this subject see 'No Redemption' and 'No Overhang' below.

No Redemption

Selecting the 'No redemption' option means that the mortgage schemes on screen will allow you to repay the loan in full at any time without applying an Early Redemption Charge.

Most mortgage schemes, in return for offering you a lower initial rate, will require you to stay with that scheme at least for the period of the Discount, Fix or Cap, and often longer. If you wish to repay the loan in this time, or you remortgage with another lender, you will have to pay an Early Redemption Charge which can cost £thousands (6 months interest is common) depending on the lender and scheme.

With 'No Redemption' mortgages you will not have to pay this redemption fee (although there may still be other costs such as sealing fees and legal fees.) As a consequence of not being 'locked-in', the rate offered on these schemes will usually not be as competitive as for mortgages with redemption penalties, making them most suitable for those who are likely to keep track of current rates and wish to remortgage quickly if they find a better rate, or those who may have to repay their loan in the first few years.

No Overhang

Selecting the 'No overhang' option means that the mortgage schemes on screen will allow you to repay the loan without penalty once the benefit period has ended i.e. the mortgage does have an Early Redemption Charge but it does not last longer than the fixed, capped or discount period. This means that a mortgage with, for example, a

discount to 31st January 2006 will have a redemption charge to either the same date or a date prior to this.

The Early Redemption Charge can represent a significant sum although the amount will differ between lenders and between products.

With 'No overhang' mortgages you will only have to pay this redemption fee if you redeem the loan or remortgage whilst you are still subject to the scheme's special rate. Once you have reverted to paying the lender's Standard Variable Rate (SVR) you will be able to redeem the loan without penalty (although there may still be other costs such as sealing fees and legal fees.) As a consequence of not locking-in the borrower to the lender's SVR, the rate offered on these schemes will usually not be as competitive as for rates with redemption overhangs, making them most suitable for those who wish to benefit from a lower initial rate without needing a very low initial rate, and who are likely to want to remortgage to another Discount, Fix or Cap once they are no longer benefiting from the initial rate.