A Guide To Mortgages – Your Questions Answered

DAVIDSON DEEM
LIMITED

Contents

Introduction

Whether you are a first time buyer, a mover or re-mortgaging, obtaining a mortgage is incredibly stressful and a time consuming process. For a purchase, it is probably the biggest, most expensive financial transaction you will ever undertake (well until the next purchase!).

A quality mortgage broker can take on board much of this stress, help reduce the time it takes, and most of all, provide you with invaluable advice throughout the whole process. Not only is this advice related to the amount you can borrow and what rate is best for you, but also a broker who knows their stuff will have detailed knowledge on the other stages of a purchase or re-mortgage, such as valuation and solicitors for example.

Before you read on through this guide, it would be a good moment to cover the basics.

What is a Mortgage

A mortgage is basically a long term loan secured on a property. In the event of your non-payment of this loan, the lender may be able to sell the property to repay the debt, i.e.,

YOUR HOME MAY BE REPOSSESSED IF YOU DO NOT KEEP UP REPAYMENTS ON YOUR MORTGAGE.

As mentioned above, the mortgage is generally a long term commitment. Terms of anywhere between 5 and 40 years can be arranged, subject to age and affordability. The longer the term of the mortgage, the lower your payments will be (unless your mortgage is interest only), but you will pay more interest in total over the mortgage term. The idea is to get the term as short as possible to minimise the total interest you will pay, but long enough to keep the mortgage payments affordable.

How much can you borrow?

Lenders make a very detailed affordability assessment when calculating how much they will lend you. Your total income, minus credit and living expenses are used to calculate disposable income and affordability. This affordability will be stress tested against potentially higher interest rates than today. All lenders work this way and have slightly different methods of calculating affordability against your disposable income, and so the results from one lender to the next will be quite varied.

Often, if you have minimal outgoings and in times of low rates, lenders will cap their maximum lend at a certain number of times your gross income. This is often referred to as an income multiplier, e.g., 4.5 times your income.

We will ask you to complete a budget planner form early in the advice process, so that we can collect the relevant information needed to assess affordability. We will then use this information against every lender’s affordability calculator to determine how much each can lend.

The Mortgage Process

A mortgage application is split into two main process – a decision in principle and a full application.

Decision in Principle (or 'DIP')

A DIP is basically the computer part of the decision making process. Lenders use complex algorithms and risk based models to allow computers to provide an indication as to whether they will lend to you. This part of the decision can be broken into 3 smaller sections: -

1. Affordability. This is where the computer looks at your income and outgoings and determines how much you can afford. We can access these affordability models prior to submitting a decision in principle.
2. Credit History. The computer will access your credit reports with various credit reference agencies and look in great detail at your credit commitments and how these are conducted. The cleaner you are the better.
3. Credit Score. This term should not be confused with your credit score with a credit reference agency. This is where your basic information is keyed online with the lender and the answer to each question carries a varying degree of points. You need to score an unknown total of points in order to pass the credit score. As an example, you will get more points for living in your current home for 5 years as compared to 6 weeks.

As a DIP is a computer based indication, we can obtain these prior to you finding a property, and indeed this is often a good idea as estate agents insist on seeing these.

Full Application

Once you have found a property and had an offer accepted, a full application must be submitted. This is where the remaining information is entered and supporting information (e.g., bank statements and payslips) are uploaded for a human underwriter to check. This is also the stage when a valuation is instructed.

If this all goes well, the lender will issue a written mortgage offer letter to you and your solicitor.

<u>**How to Repay Your Mortgage**</u>

Mortgages generally fit into two repayment types – Capital & Interest (sometimes referred to as ‘repayment’) and Interest only.

Capital & Interest

As the name suggests, your payment is made up of both capital & interest. This is by far the most popular type of repayment for residential mortgages. This repayment type ensures that your mortgage balance reduces over the term of the mortgage and by the end of your mortgage term you will have repaid the debt entirely.

Interest only

As the name suggests for this repayment type, you only pay interest each month. This means your debt does not reduce as no capital payments have been made. Instead, the debt is repaid at the end of the mortgage via other means. For a residential mortgage, these are difficult, but not impossible to arrange and available repayment routes for the mortgage can range from investments, pension, property sales, to even sale of the mortgaged property itself. We will discuss with you in depth the options and associated risks of an interest only mortgage.

In contrast, interest only is a popular repayment route for buy to let mortgages (where you let the property out). There may be less of a need to repay an investment property mortgage and potentially tax advantages with an interest only mortgage.

The Different Types of Interest Rates

Fixed

Your payments are fixed at a certain level for a set period, for example two, three, five or ten years, or maybe even longer.

Pros: Peace of mind, you know exactly how much your mortgage payments will be for a specified period, which can help you budget.

Cons: If interest rates fall, your payments will still stay the same - they won't go down. Fixed rates normally carry early repayment charges if you wish to repay the mortgage before the end of the fixed rate.

Tracker

With this variable rate loan, you agree that your mortgage rate will follow a set amount above the Bank of England Base Rate (or another bank rate), for a set period of time.

Pros: Your payments will go down if the Base Rate falls and often they are available with no early repayment charges, giving the maximum flexibility.

Cons: You need to have enough flexibility in your budget to absorb any payment increases caused by Base Rate increases.

Discounted

Your payments are variable, but unlike a tracker rate, they are set at a level below the lender’s standard variable rate for a set period of time.

Pros: If the lender reduces their standard variable rate (usually following a Base Rate reduction), then your payments go down. They are often available with no early repayment charges, giving the maximum flexibility.

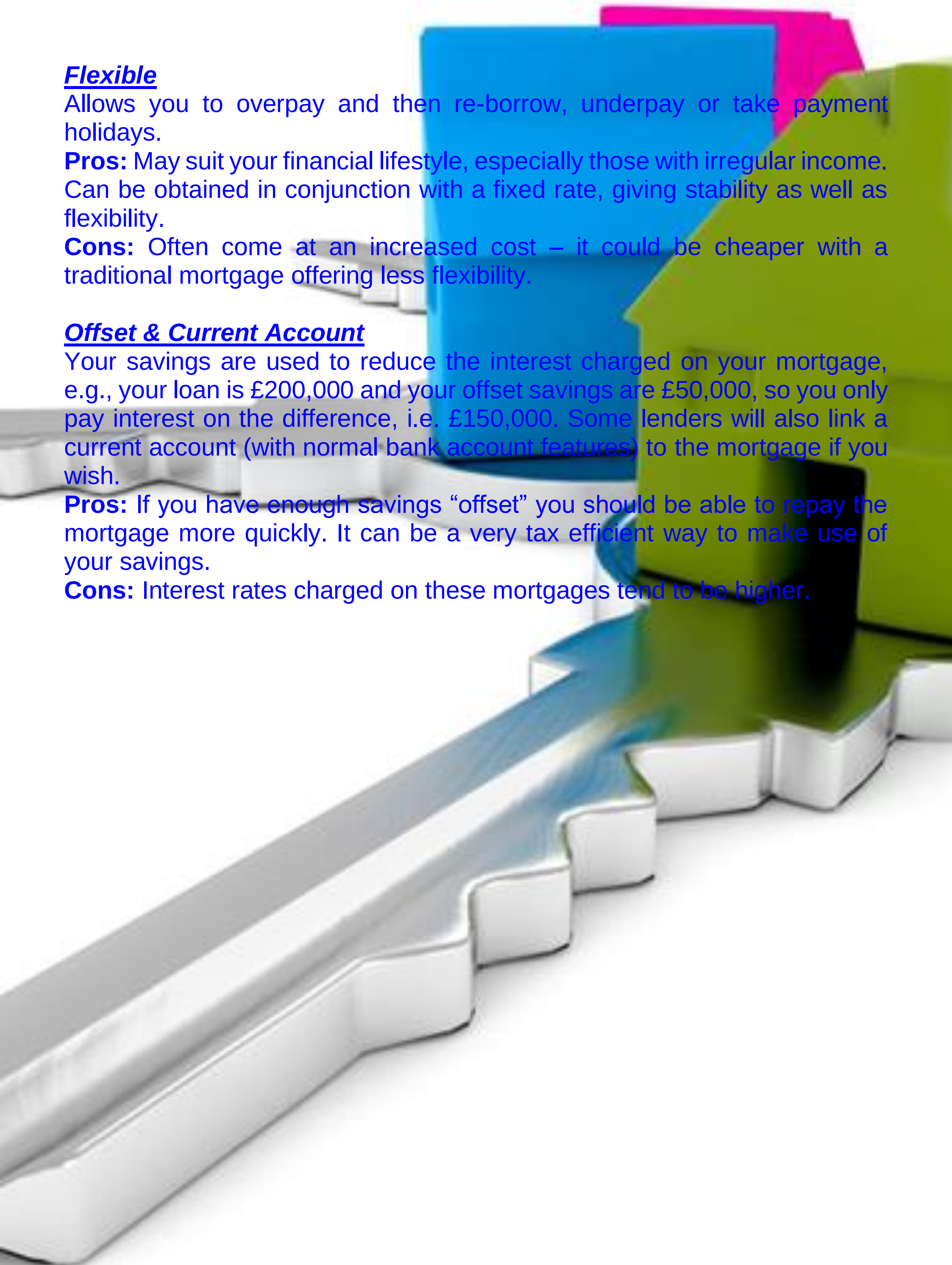
Cons: Remember, your lender sets the rate, so if it increases the standard variable rate, your payments will increase and there is no guarantee the lender will follow the Base Rate down in all cases.

Capped

Your mortgage rate is variable and often linked to a base rate, but it won’t rise above a set level (“cap”) during the product period. These rates are extremely rare nowadays.

Pros: Peace of mind your payments won’t rise above the agreed cap and your payments will go down if interest rates fall

Cons: Often more expensive than a traditional fixed or tracker rate for the same period.



Flexible

Allows you to overpay and then re-borrow, underpay or take payment holidays.

Pros: May suit your financial lifestyle, especially those with irregular income. Can be obtained in conjunction with a fixed rate, giving stability as well as flexibility.

Cons: Often come at an increased cost – it could be cheaper with a traditional mortgage offering less flexibility.

Offset & Current Account

Your savings are used to reduce the interest charged on your mortgage, e.g., your loan is £200,000 and your offset savings are £50,000, so you only pay interest on the difference, i.e. £150,000. Some lenders will also link a current account (with normal bank account features) to the mortgage if you wish.

Pros: If you have enough savings “offset” you should be able to repay the mortgage more quickly. It can be a very tax efficient way to make use of your savings.

Cons: Interest rates charged on these mortgages tend to be higher.

Surveying and Valuing Your Property

Banks and Building Societies will always want the property valued before making a mortgage offer. We strongly recommend that you obtain a more detailed report on the condition and value of the property (survey 2 or 3 below). There are three types of report available: -

1. Basic Valuation – A brief inspection of the property for the lender, so they can ensure it is suitable security for the mortgage.
2. Survey (House Buyers Survey) – A detailed report for you on the condition of the property you are planning to buy.
3. Survey (Full Building Survey) – As above, but in even more detail – often used for older or unusual properties.

Recently lenders are increasingly using a fourth type of valuation – a computer generated desktop valuation or AVM (automated valuation model). This is where a surveyor does not visit the property at all and simply relies on historic purchase price information and adjusts it for property location, size, and price inflation / deflation. They may also access Google Street View, estate agent's links to the property and even historic valuations carried out in the past. Although mainly used for remortgages, these are now appearing as free valuations for purchases. The property is not visited by anybody and therefore should not be relied on in anyway as an indication to the property's value or suitability as security. These reports are also usually non-disclosed. This means you will not get a copy of the report.

Please let us know as many details as possible about the property you are purchasing / re-mortgaging, such as age, construction type, location, length of lease, property usage and state of repair, as surveyors use this information to assess the suitability of the property as security for the mortgage.

If you need any further guidance, please contact us, or ask your solicitor, legal adviser or a qualified surveyor for help.

Insurances

Buildings Insurance
It will be a condition of the mortgage offer that the property is insured to the satisfaction of the lender. We will inform you if it is a condition that the lender's own insurance is required, otherwise it is your responsibility to arrange and maintain such insurance throughout. The lender may charge a small administration fee if you arrange your own buildings insurance.

Life Assurance
We strongly recommend that life cover to repay the balance of the loan outstanding is in place prior to drawdown of the mortgage funds. We also recommend that you monitor the adequacy of the life cover arrangements on a regular basis.

Critical Illness Cover
A Critical Illness plan is designed to pay out a lump sum on the diagnosis of certain specified illnesses. It is often 'bolted on' to a life assurance policy as an additional benefit but can also be a standalone plan.

Income Protection
An Income Protection plan is designed to pay out a regular income in the event you are unable to work due to an accident or illness. These types of plans continue to pay out an income for as long as you are unable to return to work up until the end date of the policy (typically your normal retirement age). Cover can sometimes also be arranged for redundancy, but this may have to be on a separate policy.

Davidson Deem Ltd do not arrange any form of life, accident, sickness or unemployment insurance. We will inform you if it is a condition of the mortgage that the above or some other form of compulsory insurance is taken with the lender. If it is not compulsory with the lender then it is your responsibility to arrange and maintain throughout such insurance, if required. To protect you and your family, we strongly recommend that you seek independent financial advice regarding all of the above insurances.

Re-mortgaging (Switching Lenders)

A re-mortgage is when you keep your property, but move your mortgage from one lender to another (e.g. for a better interest rate). We would urge you to check if your current lender will offer you another rate or product. **It is most important that details are obtained as soon as possible regarding any early repayment charges which would be payable should you pay off your current mortgage, or change your mortgage product**.

If you are re-mortgaging, you should be aware that the average time period from formal application to completion is 6 – 8 weeks. We should start the process in sufficient enough time for this to complete, but not too soon so that either the product reservation expires, or the term of the product is drastically reduced.

The re-mortgage process requires the services of a solicitor or legal adviser, who liaises with the new and existing lenders and ensures correct completion of all legal paperwork. You are free to use (and pay for) your own solicitor. However, many lenders as part of your new product will provide this basic service free of charge, via their own nominated firm of solicitors. However, there will be instances when they may charge you a fee (and a delay could occur), e.g., such as adding or removing parties on the deeds, dealing with second charges and telegraphic transfer fees (this is not an exhaustive list)
Pros of using free solicitors: Your own solicitor is likely to cost you £500 or more, so using a free legal package results in a big saving. Also, due to large volumes, these specialist firms have streamlined their processes so that straightforward cases normally complete relatively quickly.
Cons of using free solicitors: They represent and are paid for by the lender, not you, so they will not provide you with any detailed legal advice. The quality of service from these firms is also not the best.

We are also able to arrange a new rate with your current lender. This carries a lot less hassle and is much quicker. However, the rates available may not be as competitive as remortgaging.

Stamp Duty & Other Costs

Stamp Duty Land Tax (SDLT) is a “property” tax payable as a percentage of the purchase price on properties in **England & Northern Ireland** (unless the purchase price is less than £125,000, when no amount is payable). Rates are determined by H.M. Treasury and can vary from time to time. It is currently payable on all purchases above £125,000 on a tiered basis. Purchase price 0 - £125,000 nil, £125,001 - £250,000 at 2%, £250,001 - £925,000 at 5%, £925,001 - £1.5 million at 10% and above £1.5 million at 12%. For example, a property with a price of £260,000 would pay 0% on the first £125,000, 2% on the next £125,000 and 5% on the final £10,000. Your solicitor should advise you of the exact amount and when it is payable by you. First time buyers currently enjoy slightly better terms in that they pay 0% on the first £300,000 and then 5% between £300,001 and £500,000. Standard rates apply after this amount.

From April 2016 HMRC introduced an additional 3% surcharge on second property purchases (in addition to the above calculation). The exact cases when this extra surcharge will apply are complex, so if you are in any doubt you should confirm with your solicitor.

In addition, HMRC are now apply existing stamp duty rules more rigorously to re-mortgages. In cases where there is a change of ownership or transfer of equity, stamp duty has been levied. If this is the case, your solicitor will confirm if you are liable and how much you will have to pay.

Properties in **Scotland** are not subject to SDLT, but instead are subject to Land and Buildings Transaction Tax (LBTT). LBTT differs in rates from SDLT. Purchase price 0 - £145,000 nil, £145,001 - £250,000 at 2%, £250,001 - £325,000 at 5%, £325,001 - £750,000 at 10% and above £750,000 at 12%.

Scottish purchases will attract a second property surcharge. This is 4% of the total purchase price above an initial £40,000.

Properties in **Wales** are not subject to SDLT, but instead are subject to Land Transaction Tax (LTT). LTT differs in rates from SDLT. Purchase price 0 - £180,000 nil, £180,001 - £250,000 at 3.5%, £250,001 - £400,000 at 5%, £401,000 - £750,000 at 7.5%, £750,001 - £1,500,000 at 10% and above £1,500,000 at 12%. In addition, Welsh second property purchases attract the 3% second property surcharge the same as for England and N.I above.

Stamp duty is one of your biggest expenses, but other costs to consider are as follows: -

- Estate Agents Fees. These are payable by the seller
- Solicitor Fees. These are payable on both sales and purchases
- Mortgage Broker Fees.
- Valuation fees. On purchases you should budget for a more detailed report
- Removal Fees. If you intend to employ a removal firm to move your belongings this needs to be budgeted for.

Solicitors

When buying (and selling) a property, you will need a solicitor. You will need a solicitor who is also on your lender's 'panel'. These panels often have hundreds, if not thousands of firms on them. However, before spending money on the legal process, we would recommend checking with us that the solicitor is on your lender's panel.

For a purchase the solicitor arranges for searches to be carried out to check on any local planning issues that could affect the value of the property. A contract is then prepared, which if leasehold will include details of the lease and financial management of the property. If the contract is then acceptable, all parties sign it and once everybody in the chain is ready, contracts are exchanged and a completion date is agreed.

On completion day the solicitor forwards on the purchase monies to the vendor's solicitor (once received from you and the lender) and arranges for the keys to be released to you.

In addition to acting for you in the above, the solicitor also acts for the lender, to ensure that the lender has good title over the property, should they ever have to issue proceedings to repossess the property.

When purchasing, it is usual to have to pay a deposit at exchange of contracts – this is usually 10% of the purchase price. Your solicitor will tell you the correct amount.