Lenders turn backs on interest-only borrowers

Shamim Jane Basheer pictured at her home in Battersea, South London. Jon Enoch for The Times.
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Even homeowners with an excellent credit history are finding it tougher to secure an interest-only home loan as lenders continue to clamp down on the availability of these once-popular deals.

This week the Financial Services Authority announced plans for restrictions on interest-only deals to help to tackle irresponsible lending. It comes as Scottish Widows, which is favoured by young professionals, introduces a ban on such deals worth more than £500,000. The move brings it into line with Lloyds TSB and Halifax, which are also owned by Lloyds Banking Group.

Here *Times* Money offers advice to existing borrowers considering their options or those who were hoping to secure an interest-only deal in the future.

High street lenders

The majority of banks and building societies still offer the loans but restrictions apply and interest rates can be higher. Lloyds Banking Group, the UK's biggest lender, charges borrowers who want to repay only the interest on their loan an extra 0.2 percentage points, making many of its loans uncompetitive. It also caps the size of interest-only loans at £500,000.

Most lenders, including HSBC, Barclays, Santander and NatWest, now limit the value of interest-only deals to 75 per cent loan-to-value (LTV). There are exceptions, including Lloyds Banking Group and Alliance & Leicester, part of Santander, which offer interest-only deals up to 85 per cent LTV. The Post Office introduced 90 per cent LTV mortgages recently that are available on an interest-only basis.

However, lenders have also started restricting the list of suitable repayment vehicles. Borrowers who plan to repay the capital on their loan with inheritance, bonus payments or other irregular income or through the sale of the property will struggle to get a loan on the high street, experts have warned.

Many high street lenders now insist that borrowers have either an Isa, endowment, pension or investment-linked plan in place. Banks will also commonly ask to see evidence of these plans, such as annual statements.

James Cotton, of London & Country Mortgages, the broker, says: "Borrowers should be prepared to have their means of repaying the debt scrutinised a lot more than in the past."

Existing borrowers who fear that they would not meet the new stricter criteria introduced by banks and building societies should remain with their existing lender when they remortgage, brokers suggest. Those who simply want to switch interest-only deals and are not increasing their borrowing will face significantly fewer hurdles than if they moved to a new bank.

Ray Boulger, senior technical manager at John Charcol, another broker, says: "Borrowers who planned on paying off their debt with an inheritance or bonuses could be better off staying with their existing lender. Banks don't usually ask many questions if you're simply moving on to a new deal."

Extending the term of the loan

The cost of monthly repayments on a £150,000 loan at an interest rate of 4 per cent will jump from £500 to £791 in the switch from interest-only to capital repayments. However, there are a number of steps that borrowers could take to ease the transition and lower the cost of repaying both the debt and the interest accumulating on their loan.

Borrowers could consider extending the term of the mortgage. By stretching the term from 25 years to 35 years, homeowners could reduce the capital repayments on a £150,000 mortgage at an interest rate of 4 per cent from £791 to £664 a month However, extending the term will also increase the total amount of interest paid on the loan. In the example above, the borrower would be outlaying an extra £41,000 in interest payments by increasing the loan term by ten years.

Borrowers should also be careful not to exceed their retirement age and lenders may require proof of pension income if the end date for the extended term will be after the borrower's 65th birthday.

Making overpayments

Another option could be to pay down a large chunk of the mortgage with any savings built up as a repayment plan for clearing the debt later on. Mr Cotton says: “This can be a good move as long as you have sufficient savings to do so. In the current market many people are earning a pretty paltry return on their savings, so using the money instead to repay a debt with a higher interest rate can save them money.”

Borrowers should ensure that they are switching to a new capital repayment deal that allows overpayments.

Saffron is offering a competitive three-year discount deal at 3.3 per cent, a discount of 1.9 points below its standard variable rate. It allows unlimited overpayments and is available up to 80 per cent LTV.

Accord has a five-year fixed rate at 4.59 per cent, available up to 75 per cent LTV, with a £995 fee and unlimited overpayments.

However, homeowners should remember that it is considerably harder to switch back to an interest-only deal if capital repayments become too much of a strain, for example because of a rise in interest rates.

Even borrowers in financial difficulty are finding it impossible to switch from capital to interest-only repayments, despite government demands that the option is available for borrowers who risk defaulting on their loan.

Aaron Strutt, of Trinity Financial Group, a broker, said: “Banks are making it as difficult as possible for borrowers who want to repay only the interest on their loan. A call to the customer services department will lead to a flat rejection.”

Private banks

Wealthier borrowers have increasingly turned to private banks since the outbreak of the credit crunch as high street lenders clamped down on larger loans. There has been a 162 per cent rise in the number of loans approved worth more than £500,000 over the past year, according to research released this week by Knight Frank.

Private banks continue to offer interest-only mortgage deals worth at least £1 million, which are usually for shorter terms than typical loans.

However, there are restrictions. HSBC Private Bank offers loans of at least £1 million, but new clients must have £2 million of investments with the lender. Others, such as Coutts and Barclays Wealth, are open only to people with at least £500,000 of investable assets.

Melanie Bien, of Private Finance, the broker, says: “The private banks are still happy to lend on an interest-only basis to the right sort of client.

“Many borrowers in this position rely on bonuses to pay down the capital on their interest-only deal, giving them maximum flexibility and enabling them to pay back their mortgage over a shorter period than the typical 25-year term for a repayment loan.”

Barclays Wealth offers competitive fixed-rate and tracker interest-only deals, including a five-year fix available at up to 75 per cent LTV at 4.49 per cent, with a 0.5 per cent fee.
Coutts, the private bank owned by the Royal Bank of Scotland, has longer-term deals, including a seven-year fix at a rate of 5.69 per cent, available up to 80 per cent LTV.
Smaller private banks can be even more flexible. Investec Private Bank, for example, is happy to offer its small base of clients interest-only deals worth more than 100 per cent of a property's value. However, it is open only to borrowers earning more than £300,000 a year, with £3 million in assets.

Endowments
Hundreds of thousands of borrowers who took out interest-only deals in the 1980s and 1990s were also sold endowments, which were designed to run alongside the mortgage and clear the debt at the end of the term.
However, many of these borrowers are now finding that such endowments have a shortfall. These homeowners will need to prove to their lender that they have a repayment in place for the proportion of the debt not covered by the endowment.
Mr Boulger says: "These borrowers could benefit from splitting their loan into interest-only and capital repayments, repaying both the capital and interest on the portion of the loan not covered by the endowment."
Most lenders will allow you to split your loan and pay arrangement fees at least once.
However, if the total loan is worth more than 75 per cent of the property's value, lenders may not allow this.
Alternatively, borrowers could sell the endowment and switch to capital repayment, using the cash to pay down the loan in a lump sum.
However, Mr Boulger says: "Many endowments include life cover, which is relatively expensive. This means that even if you are not sure if your endowment is worth keeping on investment grounds, it might still be worth keeping the life cover, particularly if you have had a medical problem in the meantime."

New mortgage deals on the market
The tightening of criteria for interest-only deals combined with the higher cost of mortgages worth up to 90 per cent of a property's value have made buying a home simply too expensive for many young borrowers.
Recent figures from the Council of Mortgage Lenders, a trade body, found that first-time buyers accounted for only 35 per cent of new house purchase loans in April, the lowest figure since September 2007.
However, lenders are slowly coming to the market with new deals aimed at breaking the deadlock. Bath Building Society has introduced the Parent Assisted Mortgage, available up to 95 per cent of a property's value, which

works by securing part of the loan against the parents' property. It has a discounted rate of 5.10 per cent.

Guarantor mortgages remain widely available in the market, according to Melanie Bien, of Private Finance, the mortgage broker. She says: "Lenders are ultra-cautious about offering deals at higher LTVs. Naming a parent on an application is a popular solution for young buyers."

Other deals include the Lend a Hand scheme from Lloyds TSB and Halifax, also available at up to 95 per cent LTV. It requires relatives to save 20 per cent of the property's value in a savings account, giving buyers access to competitive interest rates typically reserved for borrowers with much larger deposits.

'I had planned to switch'

Shamin Basheer, 36, recently decided that it was time to switch from interest-only to capital repayments. The teacher, from Battersea, southwest London, took out the interest-only deal seven years ago and has not set up a repayment vehicle to clear the debt at the end of the term.

Ms Basheer, who is married with two children, says: "I had always planned to move to capital repayments but this has always depended on monthly outgoings."

Her second child is now 16 months old; Ms Basheer recently returned to work and could afford the move to repay both the debt and the interest on her mortgage, particularly with lower interest rates in the current market.

Her monthly repayments have jumped from £660 to £1,060 after moving on to her Halifax lifetime tracker deal, which is pegged at 3.5 points above base, giving a pay rate of 4 per cent.