Banks get tough on interest-only loans

- **Sam and Angela Skelton keep their mortgage as flexible as possible.** Matt Lloyd for The Times

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Tighter lending criteria mean that many borrowers face an unpleasant surprise when they remortgage, reports Leah Milner

Borrowers with interest-only mortgages face a shock rise in costs when they come to remortgage, with lenders adopting a tougher stance on these deals.
Banks and building societies are taking a more cautious approach because of the regulator's fear that many borrowers may have taken out interest-only mortgages without properly considering how they will repay the outstanding debt at the end of the term. In the past month Lloyds Banking Group and Nationwide Building Society have tightened criteria.

Many homeowners took out these mortgages in an era of steadily rising house prices, believing that capital appreciation would guarantee that they would be able to downsize and pay off the balance at the end of the term. But since the property crash and subsequent price volatility, some lenders will no longer accept the "sale of a main residence" as a repayment method and expect borrowers to have other investments. Some lenders have also increased the size of the deposit that they require for an interest-only mortgage.

The Financial Services Authority (FSA) is proposing that all mortgage lenders should have to assess borrowers' ability to afford an interest-only mortgage as if they were paying back the capital as well. Even though the rules have yet to be finalised, most lenders have been adopting a more cautious approach in anticipation of the new regulations.

But Melanie Bien, of Private Finance, the mortgage brokers, says that interest only is still a sensible option for many borrowers: "Interest-only borrowing is not necessarily reckless. For those on modest incomes who will earn more at a later date, such as barristers and doctors, it may make sense to start off with an interest-only loan as a way of getting on to the property ladder, before switching to repayment when they earn more, or paying off chunks of the capital as their earnings improve." She adds that the same is true for borrowers who receive large bonuses that they can use to pay off mortgages in lump sums.

What do the main lenders allow?

Lloyds Banking Group, the government-backed bank, owns the Halifax, Bank of Scotland, Lloyds TSB, Cheltenham & Gloucester and Birmingham Midshires brands. All these lenders will now restrict interest-only mortgages to borrowers who have a deposit of at least 25 per cent.

They also require borrowers to provide proof of a suitable method of repayment before a mortgage completes. The types of repayment plan that they allow are now more restrictive. None of the Lloyds-owned lenders will allow the sale of the borrower's main residence as a repayment strategy, although the sale of a second property is permitted. Likewise, an expected inheritance is not allowed because there is no certainty over if or when this may materialise. Endowment policies, a pension lump sum, stocks and shares, investment funds and bonds and savings are all methods that Lloyds will accept for repaying an interest-only mortgage, but the lender requires evidence in the form of projected performance statements or property deeds to approve the application.

Santander also restricts interest-only mortgages to borrowers with a 25 per cent deposit, but it has fewer restrictions on acceptable repayment methods. It will not allow an anticipated inheritance, but it will consider the eventual sale of the mortgaged property if the borrower plans to move out and downsize, or, alternatively, the sale of a second home. It will consider all the usual savings and investment vehicles or a pension lump sum and make a judgement on whether or not the borrower's repayment plan is realistic.

Barclays' mortgage arm, Woolwich, also has a 25 per cent deposit rule for interest-only deals. In line with the FSA's planned rules, Woolwich assesses whether a borrower can afford an interest-only mortgage on the basis of whether they can pay back the capital as well as the interest over a 25-year term. Woolwich also requires that the repayment vehicle has already been in place for 12 months when a borrower applies for an interest-only home loan. It will allow the sale of the mortgaged property, but in this case imposes a maximum loan-to-value ratio of 66 per cent and requires the borrower to have at least £150,000 of equity in the property.

HSBC, Nationwide Building Society, NatWest and Royal Bank of Scotland (RBS) also all now limit interest-only deals to borrowers with a 25 per cent deposit. NatWest and RBS — part of the same group — will not lend to first-time buyers on an interest-only basis.

Which lenders are the most flexible?
There are still some lenders that offer more flexible terms on interest-only mortgages. Leeds Building Society will lend to borrowers with only a 15 per cent deposit with a suitable repayment vehicle in place, while National Counties Building Society will consider lending against a 20 per cent deposit in certain circumstances. Aldermore, which offers mortgages only through brokers, will also lend to borrowers with a 20 per cent deposit on an interest-only basis. Wealthy borrowers can also get very flexible deals from private banks.

Paul Welch, managing director of Largemortgageloans.com, the mortgage brokers, says: "It seems that private banks are pretty much the only places where you can get a large, high loan-to-value, interest-only mortgage nowadays, especially if you have complex financial affairs or receive irregular income via bonuses."

Private banks are often secretive about their mortgage offers, because they are tailored to individual clients. But Mr Welch says that his brokerage recently arranged a £2.3 million interest-only deal for a Premier League footballer who had a 10 per cent deposit.

What should you do to prepare for remortgaging if you are on interest-only now?
Many borrowers who have taken out an interest-only mortgage in recent years may find that they are unable to remortgage on the same terms since lenders have introduced stricter rules.

David Hollingworth, of London & Country, the mortgage brokers, says: "Homeowners whose properties have fallen in value will find it even harder, as they may no longer satisfy their lender's maximum loan-to-value requirements."
These borrowers will either have to revert to their lender's standard variable rate, which will put them at the mercy of future increases to the Bank of England base rate, or they will have to switch at least part of their mortgage to capital repayment. Borrowers in this situation should prepare for a payment shock."

Aaron Strutt, of Trinity Financial, another broker, says: "Capital repayment mortgages are much more expensive. Borrowers taking a £200,000 mortgage at a rate of 4 per cent will pay about £360 more a month on capital repayment. This makes tough affordability criteria even harder to meet."

Need to know

• Repayment mortgages cost considerably more than interest-only, although those only paying back interest should be saving an equivalent amount elsewhere or have another strategy for repaying the capital at the end of the mortgage term, such as selling a second home.

• A borrower with a £200,000 mortgage on a rate of 4 per cent with a term of 25 years would pay £750 per month on an interest-only basis or £1,112 per month on a capital repayment deal — a difference of £362. Over the course of a year a borrower on a capital repayment mortgage would pay £4,344 more than a borrower on interest-only.

Case study: interest-only is flexible

Sam and Angela Skelton from Streatham are expecting their first child in September. Mr Skelton, 36, is a recruitment manager and Mrs Skelton, 34, is a production accountant. The couple took out an interest-only mortgage from Santander through their mortgage broker, Trinity Financial, because they want to keep their monthly costs down.
The couple own a three-bedroom Victorian house and a buy-to-let property, which they could sell if they needed to in order to repay their main mortgage.

Mr Skelton receives quarterly bonuses, which he can use to pay lump sums off his mortgage in order to reduce the capital that the couple owe. However, he is putting these windfalls into a savings account so that he can still access it if he needs to. Because Mr and Mrs Skelton will have extra costs when their baby arrives it suits them to keep their mortgage as flexible as possible.