# Mortgages: How residential mortgages work & Mortgage Capacity Reports

*This guide was kindly prepared for UEA Law Clinic by Diane Fish (Later Life, Mortgage & Protection Adviser at Just Financial Planning Ltd) but UEA Law Clinic is responsible for its contents.*

## How do residential mortgages work?

A mortgage involves the homeowner (the 'mortgagor') borrowing money from a lender (the 'mortgagee'). In exchange, the debt is secured against the house as a *legal charge*. This means that if the mortgagor fails to pay back the debt the mortgagee will seek a court order to repossess the house and sell it in order to get its money back.

Mortgagees comprises the standard high street lenders (banks and building societies), as well as a number of more specialist or second tier lenders for those with bad credit (you might have heard of 'sub-prime mortgages' or adverse lending).

The mortgagor will repay the loan every month. They might repay the loan and the interest (a repayment mortgage) or just the interest (an interest-only mortgage). If it's the latter, they will still the whole initial amount (the 'principal') to pay at the end of the mortgage and will to have some way to pay that off.

The *mortgage term* is how long you borrow the money for. Most mortgages run until the retirement age of the borrower, although some run up to age 75. Therefore, terms of 25, 30, 35 years are common. The longer the term, the lower the monthly repayments. However, you're paying more overall because the interest has more time to accumulate.

**Note, this guide does not cover 'Later Life' type lending products, options such as 'Retirement Interest Only' or 'Equity Release'.**

The *equity* in a property is its value after you take off the mortgage. For example, if a house is worth £150,000 and you borrowed £120,000 of that, the equity is £30,000. The equity is the real amount you own. In a recession, some houses will be in *negative equity*. This is where the mortgagors owe the bank more money than the house is worth, because the house has fallen in value since the mortgage was taken out.

The amount a person wants to borrow as a proportion of the total value of the house is the *loan to value ratio* (LTV). If you want to buy a house for £300,000 and need to borrow £200,000 of that, then the loan to value ratio is 60%: you are borrowing 60% of the value of the property. The higher the loan as a proportion of the house value, the more risk there is for the lender if house prices fall. They usually reflect this risk with higher interest rates for higher LTVs.

*Remortgaging* is the act of taking out a mortgage (with your existing lender or another lender) and using the money to pay off the previous mortgage. There are two reasons to do this. One would be to get a better interest rate elsewhere. The other would be to increase the mortgage. On divorce, a remortgage is a way to get a lump sum – the person wishing to stay in the house would need to remortgage for an increased amount, being the amount of the existing mortgage (to pay that off) and the lump sum needed to pay to their ex- spouse.

If the bank won't remortgage for a higher amount, then you could take out a *second mortgage* with a second charge lender. Their security is postponed behind the first lender, so you pay off the first lender then the second charge lender and anything left is your equity. Because it is riskier to be a second charge lender, interest rates are higher.

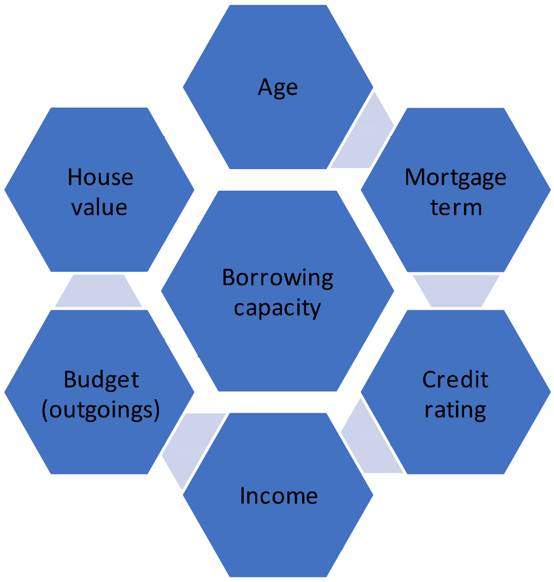
**How much can I borrow?**

The amount you can borrow depends on a number of factors:

- Your income (and your partner's, if you are borrowing as a couple). Most high street lenders will lend you 3.5 to 5 times your gross annual income.
- The value of the home you want to buy }
  Relevant to the loan to value ratio
- The amount you want to borrow }
- Your credit score. Have you ever defaulted on a payment on a loan, credit card, phone contract or utility bill? If so, the bank might be reluctant to lend (or charge you a higher interest rate) because you are a risk to them. You might be unable to borrow at all, or you might have to turn to a second-tier lender.
- The affordability of the repayments. The bank will look at your budget to ensure you can afford each monthly payment.
- Age - common practise is normally to have a mortgage that will end in line with your retirement, however, with the growing fact that people are living longer there are now a suite of products that people from the age of 55 years upwards (in some cases no upper age limit) can access. Some lenders will lend on a standard type basis, taking income and pension into account above the age of 70 years. Other options are via a group of products known as 'Retirement Interest Only' and then a third group of Later-life/Equity Release products.

All of these factors affect each other. For example, if I am young, I can borrow over a longer borrowing term. This means I can keep payments relatively low, because repayment is spread over a longer period of time. If I have a high income then the bank will lend me more, because I can more easily repay it and am less likely to default, so I am less of a risk to them. If I owe money on credit cards, then the bank will lend me less, because I have those to repay too, and thus a competing call on my income.

**Illustration**




Mike's house is worth £150,000. He has a mortgage of £120,000 and therefore has equity of £30,000. If the house falls in value, it will wipe out some or all of that equity. If it falls in value by more than £30,000 then the house will be in **negative equity**: Mike will have no equity but will still owe the bank £120,000, even though the house will be worth less than that.

Because of the risk of negative equity when lending such a high proportion of the total value, the bank will charge him a higher interest rate. Of course, if they charge him a higher interest rate, then the repayments are more, which means it's more likely he will struggle to pay it back, and fall into arrears and get repossessed. The bank's priority is to get repaid in full.

**Repaying the mortgage**

All mortgages have to be repaid, with interest. The interest accrues either daily, weekly, or monthly, but all lenders have to show an **APR** (annual percentage rate, also known as the **APRC**) to allow you to make comparisons between them. The borrower wants as low an interest rate as he can get.

Interest rates can be fixed for a certain period, tied to the Bank of England base interest rate (a base rate tracker), or tied to the Bank's own standard variable rate (SVR). Some mortgages are fixed for the first few years and then, unless you remortgage, you go onto the standard variable rate. Many people hop from one fixed rate to another every few years so as not to end up on the standard variable rate. The Standard Variable Rate is normally a higher rate than taking a new follow-on product with your current lender or a re-mortgage with a new lender. As at the date of writing this article - NatWest have a SVR rate of 7.74% but are offering a 5 year fixed rate of 4.29% if borrowing no more than 60% of the value on a new purchase.

**Illustration**

Here are the best high street interest rates available 6 September 2018 where the interest rate is fixed (cannot rise or fall) for the first two years of the mortgage. After this time, the interest rate will increase ('revert'). ERC stands for early redemption charge - a fee if you repay the mortgage early.

You can see that the interest rate is lower where the loan to value ratio lower. A higher LTV means more risk for the lender of negative equity and that is reflected in the interest rate.

**Compare the Best 2 Year Fixed Rate Mortgag**

| Compare Up to 3 products side by side | Rate | APRC | Mortgage Type | Period | Max LTV | ERC |
|---|---|---|---|---|---|---|
| Leeds Building Society | 1.49% reverting to 4.69% | 4.8% | Fixed | 31/10/2020 | 65% | To 31/10/2020 |
| Product Fee: Arrangement £999 | | | | | | |
| Yorkshire Building Society | 1.75% reverting to 4.25% | 4.3% | Fixed | 31/12/2020 | 85% | To 31/12/2020 |
| Product Fee: Completion £495 | | | | | | |
| Sainsbury's Bank | 1.85% reverting to 4.49% | 4.1% | Fixed | 30/09/2020 | 75% | To 30/09/2020 |
| Product Fee: None | | | | | | |
| Sainsbury's Bank | 1.94% reverting to 4.49% | 4.1% | Fixed | 30/09/2020 | 80% | To 30/09/2020 |
| Product Fee: None | | | | | | |
| Post Office Money | 1.98% reverting to 4.74% | 4.3% | Fixed | 30/09/2020 | 75% | To 30/09/2020 |
| Product Fee: None | | | | | | |
| Sainsbury's Bank | 2.10% reverting to 4.49% | 4.2% | Fixed | 30/09/2020 | 90% | To 30/09/2020 |
| Product Fee: None | | | | | | |

Someone taking out one of these mortgages will probably remortgage with another lender at the end of the cheap 2 years to stop them having to go onto the SVR.

Different mortgage products are available depending on whether you are a first-time buyer, remortgaging, or taking out a buy-to-let mortgage.

Many mortgages have a product application fee that you pay upfront when you apply for the mortgage, or which can be added to your mortgage borrowing. They vary from around £500 to around £1500. Always pay upfront – if you add it to the mortgage principal you will pay interest on it for the whole term of the mortgage!

Each month, the borrower must make a payment towards the mortgage. There are different types of mortgage:

- **Interest only**. As the borrower only pays the interest, the capital sum stays the same. This means at the end of the term of the loan, the borrower will have to pay back £200,000. All she has done is clear the interest as she goes. This means that payments are lower than if she was paying interest and some of the principal sum. Where a borrower has an interest only mortgage, lenders like to ensure borrowers have savings or investments that will pay off the capital at the end of the mortgage term. Otherwise, the borrower could get to the end of the mortgage term and have no way of paying back the £200,000 that is due then.

- **Repayment mortgages**, where each monthly instalment is made up of the interest that has been applied to the mortgage that month plus some of the principal. This means that by the end of the mortgage term, there will be nothing left to pay.

- **Offset mortgages**. This is where savings in a bank account linked to the mortgage are treated as available to pay the mortgage, and the interest is calculated as less as a result.

**Example**

My current outstanding mortgage is £60,000 (it's a repayment mortgage) and my property is worth £200,000. This means that my equity is about £140,000. If I sold my house and paid back the rest of what I owe on the mortgage, then I would end up with £140,000.

I have a terrific interest rate of 0.99% above bank of England base rate which is currently 0.75%. This means I currently pay interest at 1.74%. I pay £250 per month and £90 of this is interest that has been added to the loan that month. The rest reduces the principal sum I owe. So, the amount I owe increases by £90 per month and then falls by £250 per month.

Refer to NatWest Rate 4.29% 60% LTV - Purchase Product No attaching Fee

| | In | Out | Balance |
|---|---|---|---|
| Balance at 1 September | | | £60,000 |
| Interest added | £90 | | |
| Payment received | £250 | | |
| Balance at 1 October | | £59,840 | |

My interest rate is for the life of the mortgage so it's not an introductory rate, and there is about 27 years left to run, which would take me to my retirement age of 67. As long as I stay in my house, I will have this great interest rate. If I move, I can take the mortgage with me and secure it on the next house. The only problem is that if I need to borrow more, then either I need a second mortgage (which will be expensive) or the bank will want me to remortgage, and they don't currently have such good interest rates as they did when I took out this mortgage about 5 years ago.

**Remortgaging**

Remortgaging is the act of taking out a mortgage (with your existing lender or another lender) and using the money to pay off the previous mortgage. So, if I wanted to move lenders, I could borrow £60,000 and pay off my existing lender and then I would owe the new lender £60,000. There are two reasons to do this. One would be if I could get a better interest rate elsewhere. The other would be if I wanted to increase my mortgage. Let's say I want to build an extension on my house and that will cost me £25,000. I would remortgage for £60,000 plus £25,000 (£85,000). I would use £60,000 of that to pay off the old mortgage and would have £25,000 cash for the extension.

On divorce, a remortgage is a way to get a lump sum – instead of £25,000 for an extension I could give it as a lump sum to my ex-spouse.

**Illustration**

Jane and Phil decide to divorce. Conveniently for the purposes of this illustration they have one asset – a house!

| | |
|---|---|
| House value | £250,000 |
| Mortgage | (£100,000) |
| Equity | £150,000 |

If Jane wanted to stay in the house, then she needs to pay Phil a lump sum. They decide a fair split is 50-50, so Jane would need to be able to remortgage for £100,000 plus £75,000 to give to Phil. Whether the bank will lend her 175,000 on a house value of £250,000 (a LTV of 70%) depends on her earnings and her credit rating – but she won't get as good an interest rate as if the LTV was below 60.

To be able to afford to borrow £175,000, Jane would need an income of about £50,000: 3.5 times her income. Some lenders will lend more, some less. She will also need a good credit history, and the repayments will need to be affordable. Whether they are affordable depends on the mortgage term (and thus on her age) and her other outgoings.

**Second mortgages**

If the bank won't remortgage for a higher amount, then you could take out a second mortgage with a second lender. Their security is postponed behind the first lender, so you pay off the first lender then the second lender and anything left is your equity. Because it is riskier to be a second lender, interest rates are higher – they're more akin to personal loan rates, so around 7-8%. This type of lending is subject to overall maximum 'Loan to Values' and many second charge lenders cap this at 80%. This may in certain circumstances not allow sufficient funds to be released. The first charge lender has to always agree to a second charge loan.

## Brief Indicative Material (Mortgage Capacity) Reports

Brief Indicative Material Report was initially the formal name for what is more widely known as a Mortgage Capacity Report. This is a document required normally by the Family Court to detail the level of mortgage borrowing a person/s are likely to be successful in obtaining post-separation. There are different types of assessment depending on what stage you are at in the divorce proceedings with different levels of detail.

The most common one that people are asked to provide is normally the basic model. These were originally designed that they were done as a joint report so both sets of Solicitors could see very quickly the situation for both clients. However, very often these are done on a singular basis by the qualified advisor.

Each advisor and firm will have their individual procedures when engaging these types of clients. When I am doing these reports, they are engaged as clients of the company which means we issue the necessary Compliance documents to gain their authority to hold their personal data.

- A basic Factfind is completed – **see pages 8-10 for an idea of what this looks like.**
- A copy of the person's Credit File is requested. This is very important as the information contained within this report will dictate who will lend. If the person has adverse/impaired credit then the report needs to reflect the type of lender, rates and products that would apply, otherwise a very distorted picture could be provided, and the person may not be able to borrow what had been indicated leading to a very difficult situation.
- Supporting documents normally requested to verify Factfind details – payslips, P60, benefit letters pension statements, self-employed income verification etc.,
- Different advisors will have different approaches, but I always like to talk to the clients and see what each are trying to achieve, whether this is to remain in the matrimonial home or move on. I like to ask about their health, if someone has an underlying health issue that could affect their borrowing ability and longer-term affordability, I like to be able to note this within the report.
- Once the above is collated together research would then take place and the report put together with factual information and personal opinions appertaining to specific points if applicable.

## Mortgage Questionnaire
### for Court Purposes

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CHARTERED FINANCIAL PLANNERS

### Personal Details

| | |
|---|---|
| Title (Mr, Miss, Mrs, Dr, etc) | |
| Surname | |
| First name(s) | |
| Any previous surnames | |
| Date of birth | |
| Nationality | |
| Address including postcode | |
| Date moved in | |
| If you have lived in your property for less than three years, please provide previous address(es)<br><br>Min 3 year record required | |
| Preferred contact number | |
| Preferred e-mail address | |

### Your Dependents

| | | |
|---|---|---|
| Do you have any financial dependents? | Yes ☐ No ☐ | |
| If yes, please supply their details: | Name | Age |
| | | |
| | | |
| | | |
| | | |

**Contact**
**Tel:** [illegible]
**Email:** [illegible]
**Web:** [illegible]

**Find us**
[illegible]

**Registered Office**
[illegible]
Registered in England & Wales
**Company No.** [illegible]

Just Financial Planning Ltd is Authorised and Regulated by the Financial Conduct Authority

## Your Employment Details

| | |
|---|---|
| Your Employment Status | Employed ☐ Self-Employed ☐ Retired ☐ Other ☐ |
| If other, please provide details | |
| Occupation | |

| | |
|---|---|
| Income from employment: | |
| Basic gross annual income | |
| Regular overtime – *please detail estimate of annual overtime received* | |
| Regular bonus - *please detail estimate of annual overtime received* | |

| | |
|---|---|
| Income from Self-Employment/ Company Director: | |
| Nature of self-employment | Partner ☐ Sole-trader ☐ Company Director ☐ |

| | |
|---|---|
| Last 3 years net profit/ salary/ dividends | |
| Year | £ |
| | |
| | |
| | |

## Mortgage & Liability Details

| Estimated value of your property | Existing Mortgage (£) | Current lender | Monthly payment (£) | Remaining Term |
|---|---|---|---|---|
| | | | | |
| Please provide details of any penalty that would apply if repaid early. | | | | |

| | | | |
|---|---|---|---|
| Other Liabilities: | | | |
| Lender | Outstanding Balance | Type | Total Cost (per month) |
| | | | |
| | | | |
| | | | |
| | | | |

## Savings & Investment Details

| Provider | Value | Type |
|---|---|---|
| | | |
| | | |
| | | |
| | | |
| | | |

## Other Information

| In this section, please tell us about anything that you think could be relevant to a potential mortgage lender that might affect your ability to obtain a mortgage: |
|---|
| |