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Mortgage types

We explain the mortgage terminology

This guide is designed to give you an insight into the different types of mortgages that are available in the United Kingdom. Your mortgage advisor will discuss this with you and recommend a suitable product for you and your circumstances.

Interest-only or capital repayment

In general, mortgages can come as either interest only, capital repayment or a mix of both… but what do these terms actually mean?

Interest only means you only pay the interest owed on the mortgage each month and so you owe the same debt at the end of the mortgage as you did at the start. This can mean that monthly mortgage payments are lower, but you will need a credible way of repaying the mortgage at the end of the term for it to be feasible.

Capital repayment is where each month your payment pays the interest – as well as some of the capital – off the mortgage. This means at the end of the term of for example 25 years, provided you have made your payments in full and on time, you will have repaid the mortgage debt and be debt-free.

Fixed or variable?

You may have heard people talking about fixed and variable rates, but what does this actually mean?

Fixed-rate mortgages: This is where the interest rate will not change (it is fixed) for a period of time, and is sometimes referred to as an introductory period – typically this is two to ten years. During this time your monthly repayments will remain the same, even if interest rates change. This means if interest rates go up, your payment will stay unchanged and if rates come down, you won't benefit from a reduction in payments.

Fixed rates can give people peace of mind that their repayments will not change, but sometimes the initial interest rates can be higher than those of variable rates.

At the end of any fixed period you should look for a new mortgage deal 12 weeks prior to your current one ending, or you'll likely be moved automatically on to your lender's standard variable rate which is usually higher.

Variable-rate mortgages: The interest rate can change at any time and this may mean your monthly repayment could also change. It is advisable with any mortgage to have some savings or to budget accordingly so that you can afford an increase in monthly payments if rates do rise.

There are various forms of variable rate mortgages and, as with fixed-rate mortgages, they typically have an introductory period of between two and ten years. The various types of variable rate mortgages are described below:

Standard-variable-rate mortgages (SVR): This is the default rate a mortgage lender charges and is usually the rate a mortgage will default to after an introductory period has ended. If no new mortgage deal is taken it is likely a mortgage would remain on this rate for the remainder of its term. SVR mortgages may change with rises and falls in the Bank of England base rate and are usually more expensive than other forms of fixed or variable-rate mortgages available. They are, however, extremely flexible and typically have no early repayment charges or overpayment limits.

Discounted-rate mortgages: This is a variable-rate mortgage that offers a discount from the lender's SVR described above. The advantages of this are they usually offer a cheaper mortgage product for a set period of time and if the lender reduces its SVR rate then the repayments will likely reduce.

However, the reverse is also true and if the lender increases its SVR rate then your repayments will likely increase.

Tracker-rate mortgages: Tracker-rate mortgages move in line with other interest rates, the most common of which is the Bank of England Base Rate. There are, however, other interest rates they can follow, and your mortgage advisor will discuss these with you. This means, for example, if the Bank of England base rate goes up or down your interest rate will usually move by the same amount, so your repayments could go up or down.

Capped mortgages: These are variable-rate mortgages with an element of stability. This means the interest rate and your monthly payments can go up as well as down, but that there is a cap on how much they can go up by. This means for a period you know what the maximum you could be charged is (which gives an element of stability).

Now you have an insight into some of the mortgage products available it is also worth discussing

Offset mortgages

These types of mortgages can incorporate features we have discussed above but also work by linking your savings to your mortgage, so you only pay interest on the difference between your savings balance and your mortgage balance. For example:

Savings = £40,000 and the mortgage = £100,000. The difference is £60,000. In this scenario on an offset mortgage you would only pay interest on the £60,000. You still make your monthly repayment but the reduction in interest charged (the interest not charged on the £40,000 in the above example) acts as an overpayment to help clear your mortgage early.

Introductory period and mortgage term

When considering a mortgage, it is also important to consider the length of any introductory period and the mortgage term.

Introductory period: The period of the initial mortgage product; typically, this is two to ten years. This is important as mortgage lenders usually put Early Repayment Charges into their product during their introductory periods, and this can have real-life consequences for you. An Early Repayment Charge is usually a percentage of the loan, typically 1% to 5%, that you need to repay if you leave the mortgage early. As you can see, a 5% charge on a £100,000 mortgage is £5000 and that is a cost you may wish to avoid. For example, if you buy a house but plan to move again in four years' time, it may not be advisable to go for a mortgage product that has Early Repayment Charges for five years.

Mortgage term: The mortgage term is very important as this is how long you will be paying your mortgage for. Terms can range typically from five to 40 years and the general rule of mortgages is the shorter the mortgage term, the less interest you will pay back overall. On the flip-side of that, generally the shorter the term, the higher the monthly payment. Therefore, a careful balance needs to be struck between what you are comfortable paying, what is affordable and what your long-term goals are. This is something we will discuss and consider as part of our advice to you.

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