Ways to repay your mortgage

Capital & Interest Repayment mortgage

Every month, your payments to the lender go towards reducing the amount you owe as well as paying the interest they charge.

Each month you are paying off a small part of your mortgage loan and in the early years the majority each monthly payment consists of interest, so there will be very little reduction in the outstanding amount of the mortgage loan. In the later years, the amount of capital repaid by each payment increases and the amount of outstanding mortgage loan reduces much more quickly towards the end of the term. Provided you keep up to date with your payments each month you will know that the loan will be repaid.

Interest Only mortgage

For residential property, only lender shave very strict criteria on who qualifies for this type of mortgage repayment method.

Each month your monthly payment only pays the interest charges on your mortgage loan. The whole amount of the mortgage loan remains outstanding until the end of the term when it needs to be repaid to the lender. Therefore, it is very important you consider at the outset how you will repay the capital. The benefit of an interest only mortgage is that the monthly payments are much lower, as no capital repayment element is included in the monthly cost.

Ways to repay the capital

This could be by using an investment or savings plan, the sale of the property (if appropriate and/or practical) or from any potential inherited wealth.

Using bonuses that you receive each year.

By using the tax-free lump sum from your pension

If you are relying on savings and investments to repay the capital balance, you will need to check on a yearly basis that they are growing sufficiently so that at the end of the term you will have enough money to pay off the loan. If you have a shortfall you will need to think about alternative arrangements of making this up. If you are unable to repay the loan at the end of the term you could lose your home.

For investment property

This is the most common way of purchasing investment property with the sale repaying the mortgage at the end of the term.

Mortgage Interest Rate Types

Whether you choose a repayment or an interest only mortgage, you will be paying interest on the money that you borrow. Lenders offer many different interest rate schemes.

Standard Variable Rate (SVR)

Your payments may increase or decrease according to decisions made by the lender. This may or may not be in line with changes to the Bank of England base rate. If rates rise rapidly, you could struggle to keep up with your mortgage repayments. Usually you can leave your lender or pay back extra amounts at any time without penalty.

Fixed Rate

The interest rate you pay will be fixed for a given period, usually between 1 and 5 years, although some lenders offer a lifetime fixed rate. Your monthly payments will stay the same in that fixed period, even if variable interest rates change. This gives you the security of knowing that you can afford your payments should rates rise, making it easier for you to budget. However, if rates go down you won't benefit, and your payments will stay at the higher fixed rate. At the end of the fixed rate period the mortgage will normally revert to the lender's Standard Variable Rate which may be higher. There are generally early redemption penalties applied during the fixed rate period (and sometimes beyond), which can be quite punitive.

Tracker Rate

This is a variable rate at a set differential above or below the Bank of England or some other bank base rate. It tracks (increases or decreases in line with) that rate and at the end of the initial Tracker Rate term your payments normally revert to the lender's Standard Variable Rate. As with a Standard Variable Rate, your Tracker Rate mortgage payments could increase rapidly leaving you struggling to keep up your mortgage repayments.

Discounted Rate

This gives you a gentler start to your mortgage at a time when money may well be tight. The lender gives you the opportunity to pay less than their Standard Variable Rate for an agreed period, typically 2, 3 or 5 years. But you must be confident you can afford the payments when the discount ends, as after this period the mortgage will usually revert to the lender's Standard Variable Rate. If you want to repay your mortgage during the discount period, you will normally have to pay an early repayment charge (or redemption penalty). Some of these schemes also require you to stay with your lender on their standard terms for a fixed period after the discount finishes.

Offset mortgage

Your mortgage account is coupled to your savings and the capital debt is offset against any deposits you hold with the mortgage provider. In most cases your main current account, savings account or both are linked in this way. Each month the amount in these accounts is offset against your outstanding mortgage before calculating the interest you owe, which can save significant amounts of money over the course of the mortgage term. You are unlikely to earn interest on the savings which are offset against your mortgage, but the tax advantages to certain groups of people (especially higher rate tax payers) can often be far more beneficial. These schemes can also be attractive to the self-employed who accumulate savings over the year towards their annual tax payment. However, they are often charged at higher rate.

What next

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The information in this guide is correct as at the date on the document.