Which mortgage? How much can you borrow?

Taking out a mortgage on a property is a significant financial decision. For many people it represents the largest amount of money they will borrow in their lifetime, so it is particularly important to make an informed decision about which mortgage is best for you.

The credit crunch has resulted in all borrowers changing their lending criteria. Loans are now almost invariably with a requirement to pay an application fee - which in some cases is not refundable even though it is the lender who turns down the application.

There are a range of different types of mortgage available. There have been major changes in the number of mortgage providers and the lending criteria they all apply. The financial crisis and the recession have changed the mortgage landscape and therefore seeking qualified advice is important. There are a variety of ways of paying back a mortgage.

When choosing a mortgage, there are key issues to consider, including:

1. How you want to pay back the loan
2. The type of interest you want to pay; and
3. Which arrangement suits your particular circumstances.

Types of mortgage

Repayment

With a repayment mortgage, you repay both the interest due and the capital amount borrowed on a monthly basis. The overall sum outstanding reduces over time, until it is finally cleared at the end of the term.

One key benefit of a repayment mortgage is that you can be sure that the loan will be paid off in full.

Interest-only

With an interest-only mortgage, you pay only the interest as it accrues, and simultaneously invest funds elsewhere, with the aim of amassing sufficient returns to repay the capital amount of the mortgage at the end of the term.

It is important to understand that your savings will reflect the performance of the investment fund. Thus, a well-performing fund can result in a surplus at the end of the mortgage term - but equally a fund which performs badly could result in a shortfall. The performance of the investment should be regularly monitored, to ensure that you are still on track to repay the full mortgage.

The repayment of the capital for interest-only mortgages will typically take the form of an endowment, ISA or pension mortgage:

Endowment mortgage

An endowment mortgage involves taking out an endowment policy which provides life assurance cover, and a sum for investing. While these were popular in the 1970's and 1980's they are no longer a common choice.

ISA mortgage

This is similar to an endowment mortgage, only it uses an Individual Savings Account (ISA) to invest in stocks and shares, again with the aim of earning enough to repay the loan.

Pension mortgage

Pension mortgages make use of a pension fund to take advantage of tax-free savings. At the end of the term, the savings are used to repay the mortgage, and any remaining amount is used to provide a pension.

Paying the interest

Another key issue to consider when choosing a mortgage is the type of interest you want to pay. Interest rates may be fixed or variable.

Fixed rates

With a fixed rate mortgage, the interest rate is fixed for a given time. This can be an advantage if you want to know exactly what your payments are going to be. The main disadvantage used to be that if interest rates fall, you will still have to pay your set rate. However with rates as low as they are at the moment and bank base rates at rock bottom, this is not so currently important.

Variable rates

Variable rates are normally linked to the Bank of England interest rate, which is reviewed on a monthly basis, so your payments will reflect current interest trends. It is therefore advisable to ensure that you could continue to pay the mortgage should interest rates - and therefore your monthly payments - increase. The negative equity problems in the 1980s arose as a result of increasing interest rates accompanied by a fall in house values.

However rates linked to Bank of England interest rate are not generally available due to base rates having fallen so significantly in 2008/09.

A number of other interest rate packages are also available, including capped rates and discounted rates.

Some useful questions

When considering which type of mortgage is the best for you, it is important to consider the following:

- How much can I afford to pay?
- Which type of mortgage best suits my needs?
- Can I take a payment holiday?
- Can I pay off extra amounts or make lump sum payments?
- Are there any additional fees or redemption penalties?

You should always seek professional advice before committing to any new mortgage product.