TOPIC 13

Secured and unsecured lending

LEARNING OBJECTIVES

In this topic we are looking at secured and unsecured lending. The most well-known example of secured lending is the mortgage loan used to finance the purchase of a residential property. Examples of unsecured lending include overdrafts and credit cards.

There are two basic types of mortgage:

- a repayment mortgage, sometimes known as a capital-and-interest mortgage;
- an interest-only mortgage.

A number of different methods can be used to repay an interest-only mortgage and we will be looking at these. Later in the topic we will focus on equity release schemes, which are methods people can use to release the value that is 'locked up' in their homes.

By the end of this topic you should have an understanding of:

- repayment mortgages;
- interest-only mortgages and the different products that can be used to fund the capital repayment;
- the range of interest rate options available;
- different ways of charging interest on a mortgage;
- equity release;
- other types of secured lending, including bridging loans;
- unsecured lending including personal loans, overdrafts and credit cards.

This topic covers part of Unit 1 syllabus learning outcome U3.3.

THINK . . .

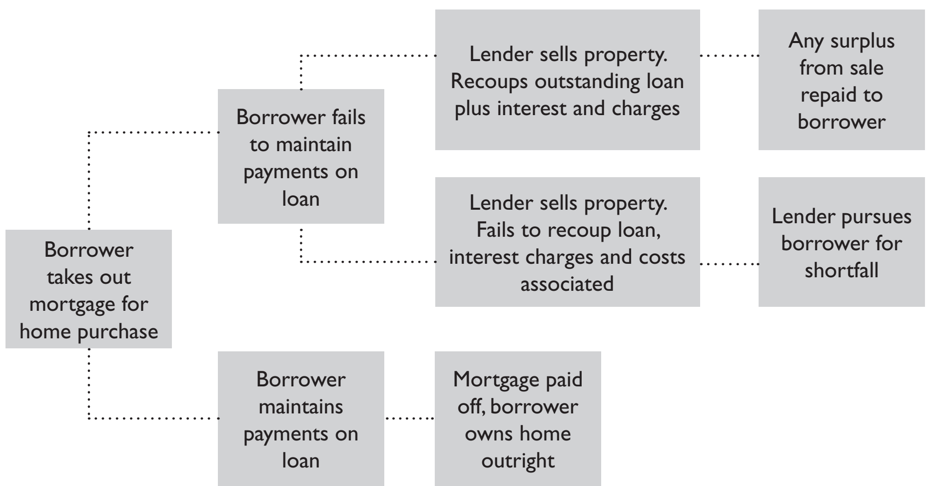
Many of the products we focus on in this topic will be familiar to you. For instance:

- Do you have a mortgage? If so, is it a repayment mortgage or an interest-only product?
- If you have a mortgage, how is interest charged on it? At a fixed rate? A variable rate? A capped rate?
- Do you have older relatives who have investigated releasing the equity tied up in their home to fund their daily living costs?
- Have you ever taken out a personal loan, or used an overdraft facility on your current account? How does the repayment of those types of borrowing differ?

13.1 How does secured lending differ from unsecured lending?

Lending is ‘secured’ when the borrower gives the lender the right to take possession of a specific asset if they (ie the borrower) fail to keep up repayments on a loan. In the event that repayments are missed and the matter cannot be resolved in any other way, the lender can then sell the asset to recoup the money it is owed. Figure 13.1 outlines the process in relation to lending secured on a home.

FIGURE 13.1 SECURED LENDING



Security for a loan does not always take the form of a property. With commercial loans, the loan might be secured on business premises or equipment. It could also be a financial asset such as shares or other investments.

With unsecured borrowing, the lender does not have the reassurance of an asset that they can sell to recoup the loan if the borrower fails to repay it. The lender has to rely on the borrower's agreement to repay. For this reason, unsecured borrowing represents a greater risk to the lender, and thus interest rates on unsecured loans tend to be higher than those for secured loans.

13.2 What is a repayment mortgage?

With a repayment mortgage, the borrower makes monthly repayments to the lender. Each monthly amount consists partly of capital repayment (ie the original amount borrowed) and partly of interest on the amount borrowed. The higher the interest rate (for any given mortgage amount and term), the higher the monthly repayment.

The repayment is calculated in such a way that it is evenly spread throughout the term of the mortgage. Thus if interest rates do not change over the whole term, the repayment will be the same each month. However, if interest rates do go up or down, then the monthly repayment increases or decreases, or alternatively the mortgage term can be extended or shortened.

KEY TERMS

MORTGAGOR

The individual borrower who transfers their property to the lender for the duration of the loan.

MORTGAGEE

The lender (bank, building society or other institution).

The relative proportions of capital and interest vary throughout the term. At the beginning, when most of the original amount borrowed has yet to be repaid, most of the monthly repayment is just paying the interest on the loan. Later in the term, when more of the capital has been repaid, the interest proportion of the repayment decreases and a larger proportion of the repayment goes towards repaying the capital.

Providing that all the repayments have been made when due, and that the repayments have been adjusted to reflect changes in the interest rate, the mortgage will be repaid at the end of the term.

If the borrower dies before the end of the mortgage term, the repayments still have to be made or the loan has to be repaid in full. Borrowers need to take out life assurance cover to make sure these conditions can be met.

COVENANTS

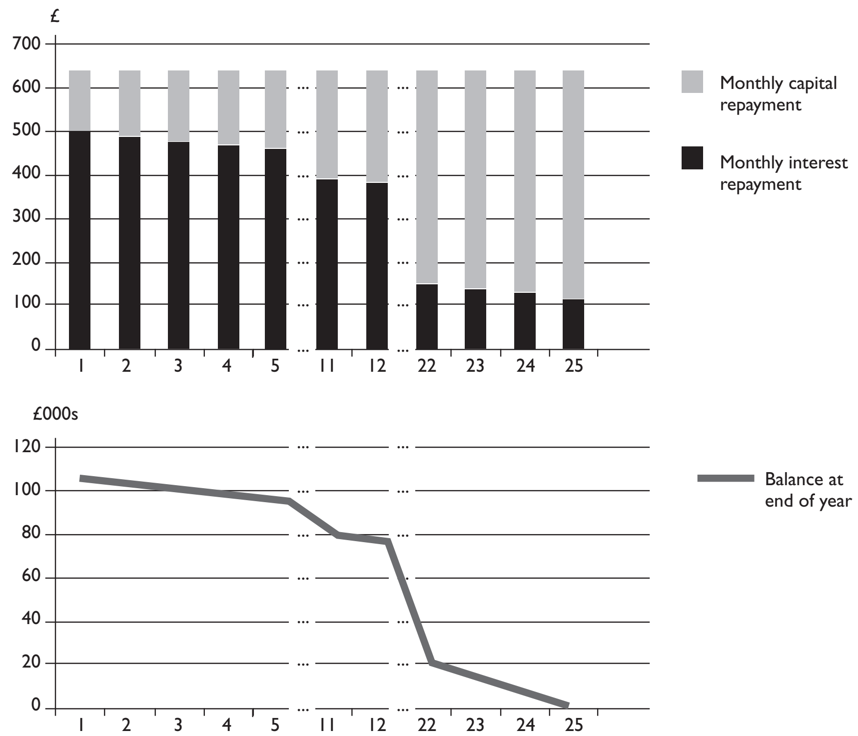
A lender's security depends on the property being maintained in an acceptable condition. For that reason, borrowers have to covenant (ie promise under the terms of the mortgage deed) to maintain the property in good condition.

They also have to covenant to insure the property adequately. A lender is permitted by law to:

- insist that a property subject to a mortgage is continuously insured by means of a policy that is acceptable to the lender;
- have its interest as mortgagee noted on the policy;
- secure a right over the proceeds of any claim and to insist that the proceeds be applied to remedy the subject of the claim or to reduce the mortgage debt.

FIGURE 13.2 EXAMPLE BREAKDOWN OF CAPITAL AND INTEREST ON REPAYMENT MORTGAGE

£100,000 repayment mortgage over 25 years, average 6% interest per year.



Note that the time period on the graph is not continuous, ie the rapid falls occur over several years, not single years.

13.3 What is an interest-only mortgage?

With an interest-only mortgage, the monthly payments made to the lender are solely to pay interest on the loan. The capital amount outstanding therefore does not reduce at all. For this reason, the monthly payments are lower than those for a repayment mortgage. However, the borrower still has to repay the original amount borrowed at the end of the term.

The FCA's Mortgages and Home Finance: Conduct of Business (MCOB) Sourcebook rules relating to interest-only mortgages changed in April 2014, following the Mortgage Market Review, which was a major investigation into the mortgage market by regulators. New rules were introduced following concerns that, among other issues, people were being encouraged to borrow more than they could afford and borrowers were able to arrange an interest-only mortgage without being required to make arrangements to fund repayment.

An interest-only mortgage can now only be arranged if the lender has obtained evidence that the borrower has a credible repayment strategy in place. A credible repayment strategy would be, for instance, a savings scheme guaranteed to provide the borrower with the sum needed to repay the mortgage at the end of the term. In addition, lenders must contact the borrower at least once during the term of the mortgage to establish whether the repayment strategy remains in place and still has the potential to repay the capital.

In response to these changes, many lenders stopped offering interest-only mortgages to new borrowers. More recently, lenders have started offering interest-only mortgages again, and there are many borrowers who have interest-only mortgages that were taken out before the MCOB rules changed.

> **!**
>
> **MORE ABOUT MCOB**
>
> You will find out more about mortgage regulation and the MCOB rules in Topic 21.

When an interest-only mortgage is taken out, the two main issues to be addressed are:

- putting in place a funding mechanism to repay the debt at the end of the term; and
- ensuring there is sufficient protection to enable the debt to be repaid should the mortgagor die before the end of the term.

Popular methods of funding interest-only mortgages are endowments, ISAs and pensions. Level term assurance is a popular way of providing protection in the event that a borrower dies during the mortgage term. We covered level term assurance in section 11.1 and endowments are detailed in section 11.5. ISAs and pensions are described below.

CHECK YOUR UNDERSTANDING 1

How much can you remember about the different types of endowment policy we looked at in Topic 11? Try to write brief notes explaining the main features of the following products:

- non-profit;
- full with-profits;
- low-cost with-profits;
- unit-linked;
- unitised with-profits.

Look back to Topic 11 to check how accurate your notes are. Work through the section again if you don't feel confident about these products.

13.3.1 Pension mortgages

One of the benefits of a personal pension plan or stakeholder pension is that up to 25 per cent of the accumulated fund can be taken as a tax-free cash sum when the pension payments commence. Depending on the rules of the pension provider, it may also be possible for holders of a personal or stakeholder pension plan to draw an additional amount, over and above the 25 per cent tax-free cash, as a taxable sum. The availability of a lump sum from normal minimum pension age means that these pension plans have the potential to be used as mortgage repayment vehicles.

KEY TERMS

PERSONAL PENSION

A pension product that is arranged on an individual basis (ie rather than a pension scheme run by an employer). The benefits eventually received depend on the performance of the funds into which the individual's pension contributions are invested.

STAKEHOLDER PENSION

A simple, low-cost pension product that meets government standards on charges and levels of contribution.

The plans have other financial benefits in comparison with endowment policies:

- Pension contributions qualify for tax relief at a person's highest rate of tax, up to the annual maximum contribution limit. There is no tax relief on endowment policy premiums.
- The fund in which the contributions are invested is not subject to tax on income or capital gains, meaning that it should grow faster than an equivalent endowment policy fund, which is taxed on both income and capital gains.

On the other hand, there are a number of factors a borrower might feel are possible drawbacks to the use of a pension plan for mortgage repayment purposes.

- **Lifetime allowance** – this is the maximum tax-privileged pension investments an individual is able to accrue during their lifetime. It effectively limits the amount of tax-free cash that can be taken to 25 per cent of the lifetime allowance. For example, if the lifetime allowance was £1,000,000, the maximum tax-free cash that could be taken would be £250,000. Therefore, someone who wanted to use a pension plan for mortgage repayment must either restrict themselves to a capital repayment of no more than £250,000, or be prepared to take a further taxable lump sum beyond the 25 per cent from their pension.

FACTFIND

Find out the current lifetime allowance and how it has changed over time at: www.gov.uk/government/publications/rates-and-allowances-pension-schemes/pension-schemes-rates.

- **Minimum pension age** – in most cases, the minimum age at which benefits can be taken from a pension is 55, but this is expected to increase in the future. This means that the term of the mortgage must run until the mortgagor reaches pension age and the mortgage cannot be paid off earlier, even if the fund has grown to a sufficient value. A longer mortgage term will add to the total cost of the mortgage as a result of the additional interest payments incurred.
- **Provider restrictions** – not all providers offer the facility to take a taxable lump sum in excess of the tax-free amount (although it is possible to switch to a provider that does). If only 25 per cent of the fund can be taken as a tax-free cash sum, a fund of four times the loan value must be built up. This may mean that total contributions are more than the borrower can afford or more than are permitted by the pension scheme regulations.

- **Impact on income in retirement** – using a portion of the pension fund to repay a mortgage means there is less money available to provide an income in retirement.
- **Need for separate life assurance** – a personal pension or stakeholder pension, unlike an endowment assurance, does not automatically carry with it any life assurance, so a separate policy will be required to cover the repayment of the loan in the event of death during the term.
- **Assignment** – as with all pension contracts, personal pensions and stakeholder pensions cannot be assigned to a third party as security for a loan or for any other purpose. The lender cannot, therefore, take possession of the plan or become entitled to receive benefits directly from it, as it can with an endowment policy. This is a potential disadvantage to a lender but has not, in practice, prevented the majority of them from moving into the pension mortgages market.

13.3.2 Individual savings accounts mortgages

In order to use an ISA as a mortgage repayment vehicle, ISA managers calculate the amount of regular investment that would be required to produce the necessary lump sum at the end of the mortgage term, based on an assumed growth rate and on specified levels of costs and charges. All managers allow investments to be made on a regular monthly basis, provided, of course, that the overall annual limits are not exceeded.

The main benefits of using an ISA as a mortgage repayment vehicle are that the:

- funds grow free of tax on capital gains, thus reducing the cost of repaying the mortgage;
- mortgage can be repaid early if the fund's rate of growth exceeds that assumed in the initial calculations.

If, on the other hand, growth rates do not match the initial assumptions, the final lump sum will fall short of the mortgage amount. Performance needs to be monitored and adjustments made to the amount of regular investment if necessary.

Another drawback of using an ISA is that, should the borrower die during the mortgage term, the value of the ISA investment is unlikely to be sufficient to repay the loan. Additional life assurance cover is required to meet this eventuality.

The limits on annual contributions can make it difficult to build a sum sufficient to pay back a large loan or one with a short term. This is less of an issue for couples, as each individual has an ISA allowance. Also, as we saw in Topic 9, the government has introduced schemes such as the Help-to-Buy ISAs (no longer available for new applications) and Lifetime ISAs, which are intended to help those looking to purchase a property to fund their deposit.

13.4 Mortgage interest rate options

A distinction can be made between the way a lender charges interest to the mortgage account and the different interest rate options that can be applied to the mortgage.

For both repayment and interest-only mortgages, there is a variety of ways in which interest can be charged to the mortgage account. For instance, some lenders charge interest on an annual basis, some on a monthly basis, and some on a daily basis. Generally, it is the lender who decides how interest is charged, although this may vary between different mortgage products.

Lenders will generally offer a range of different interest rate options or 'mortgage products' such as fixed or variable rates, and the ability to defer interest or take an interest payment 'holiday'. The main types are summarised in Table 13.1.

TABLE 13.1 MORTGAGE INTEREST OPTIONS

Product	Description	Notes
Variable rate	Monthly payments rise and fall in line with interest rate changes	Hard to predict what future payments will be, making budgeting difficult
Discounted rate	Interest rate is a discount from the standard variable rate	May be penalties for early repayment
Fixed rate	Interest rate is fixed for a specific period (usually between one and five years), then reverts to the standard variable rate (SVR)	▪ Makes it easier for borrowers to budget ▪ May be a substantial arrangement fee and penalties or restrictions on switching to another lender
Capped rate	Interest rate is variable but cannot rise above a specified upper limit (the cap) Products that also have a specified lower limit are 'cap and collar' mortgages	▪ Allows borrowers to budget within set parameters ▪ Borrowers can benefit from falls in interest rates down as far as any collar limit set
Base-rate tracker	Interest moves up and down in line with (ie 'tracks') changes in Bank rate	Note that a tracker mortgage rate is not the *same* as Bank rate – the lender's rate will be slightly higher

Flexible	Facility to overpay, underpay and/or take payment holidays without incurring penalties	▪ Interest calculated on daily basis ▪ Options include current account and offset mortgages
Low start	▪ Repayment mortgage with lower initial payments during which capital is not repaid ▪ Higher payments required after the initial period to achieve repayment of capital	Suits borrowers keen to keep outgoings low in the early years
Deferred interest	Interest payments deferred until later in the term	▪ Suits borrowers who expect their income to increase over the term of the mortgage ▪ Not suitable for those who borrow a high proportion of the property value because of the increased risk of negative equity
CAT-standard	Charges, Access and Terms (CAT) meet standards set out by government	Likely to appeal to borrowers who want clearly stated limits on charges

13.5 Flexible mortgages

The flexible mortgage gives the borrower some scope to alter their monthly payments to suit their ability to pay, as well as the opportunity to pay off the loan more quickly. Although there is no precise definition of a flexible mortgage, it is generally considered that such a product should offer the following basic features:

- interest calculated on a daily basis;
- the facility to make overpayments at any time without incurring an early repayment charge;
- the facility to underpay, but only within certain parameters set out by the lender when the mortgage was arranged;

- the facility to take a payment holiday, again within certain parameters laid down at the outset.

Two key benefits of these features are as follows:

- The combination of a daily interest calculation and occasional, or regular, overpayments will result in considerably less interest being paid overall and the mortgage term being reduced.
- The ability to reduce monthly payments, or suspend them entirely, for a limited period will benefit a borrower who is experiencing temporary financial difficulties. If required, a borrower in this situation can borrow back overpayments made earlier in the term.

Many lenders now offer flexible mortgages with a fixed, discounted or capped rate for an initial period. Early repayment charges do not normally apply to these products but an arrangement fee may be payable and, in some cases, it may be a condition of the loan that a particular insurance product is purchased from the lender.

Most flexible mortgages allow the borrower to draw down further funds as and when required, although the lender will have set a limit on total borrowing at the outset. Flexible mortgages involve a much easier administrative process than is usual when dealing with further advances. The wording of the mortgage deed generally used for flexible mortgages is such that all additional funds withdrawn, within the limit on total borrowing, will automatically take priority over any other subsequent charges registered against the property.

CURRENT ACCOUNT AND OFFSET MORTGAGES

An increasingly popular version of the flexible mortgage is the current account mortgage. This enables the borrower to carry out all of their personal financial transactions within a single account. The account is able to receive salary credits and pay standing orders and direct debits in exactly the same way as a conventional current account. The borrower will be provided with a cheque book and a debit/credit guarantee card.

The combination of salary credits and the calculation of interest on a daily basis considerably reduces the amount of interest payable and consequently also the mortgage term.

A more recent development is the offset mortgage. This requires the borrower to have savings or other accounts with the lender and enables the interest payable on such accounts to be offset against the mortgage interest charged. For example, if a borrower has an offset interest-only mortgage for £80,000 and £25,000 in a savings account with the lender, they can opt to waive payment of interest on their savings, enabling interest to be charged on a net loan of £55,000. This calculation is repeated on a daily basis.

Even more complex offset mortgages enable the borrower to offset interest payable on various savings accounts against interest charged on their mortgage and on any other secured or unsecured loans held with the lender.

CASHBACK

Cashback is a relatively common incentive offered by many lenders. A lump sum is paid to the borrower immediately after completion of their mortgage, either as a fixed amount or as a percentage of the advance. Generally, the lower the loan-to-value ratio (LTV), the higher the cashback, as the risk of the lender losing money is reduced and a lower LTV makes the borrower a more attractive proposition for the lender. For example, the cashback may be 1 per cent of the advance for a loan-to-value ratio of up to 80 per cent, and 0.5 per cent for a higher loan-to-value ratio.

It is usually a condition of the mortgage that some or all of the cashback must be repaid if the loan is repaid within a specified period.

Discounted rates and cashbacks are sometimes used by lenders either to tempt borrowers away from competitors or as a loyalty bonus to persuade them to stay. Payment of legal fees is another offer that is commonly made to encourage switching of the loan between lenders while incurring minimum costs.

LOAN-TO-VALUE (LTV) RATIO

The amount of the loan in relation to the value of the asset used for security, expressed as a percentage. For a mortgage loan of £80,000 on a property valued at £100,000, the LTV is 80 per cent.

13.6 CAT-standard mortgages

The government introduced specified CAT (charges, access and terms) standards that can be applied to mortgage products, although lenders do not have to offer CAT-standard mortgages, and there is no guarantee by either the government or the lender that a CAT-standard mortgage will be the most suitable product for a particular borrower.

CAT-standard mortgages are likely to appeal to borrowers who wish to have clearly stated limits on charges. Examples of the limits set on charges and other costs are the following.

- The variable interest rate must be no more than 2 per cent above Bank rate and must be adjusted within one calendar month when Bank rate is reduced.
- Interest must be calculated on a daily basis.
- No arrangement fees can be charged on variable-rate loans and no more than £150 can be charged for fixed-rate or capped-rate loans.
- Maximum early redemption charges apply to fixed-rate and capped-rate loans.
- No separate charge can be made for mortgage indemnity guarantees (see below).
- All other fees must be disclosed in cash terms before the potential borrower makes any commitment.

Other rules relating to access and terms include the following.

- Normal lending criteria must apply.
- The borrower can choose on which day of the month to pay.
- All advertising and paperwork must be clear and straightforward.
- Borrowers cannot be required to buy associated products from the lender in order to receive a mortgage offer.

MORTGAGE INDEMNITY GUARANTEES AND HIGHER LENDING CHARGES

A mortgage indemnity guarantee (MIG) is an insurance policy that protects the lender in situations where the loan has a high loan-to-value ratio (generally over 75–80 per cent). If the borrower defaults on repayments and the property is sold, the lender might not get back the full amount that it lent. The insurance is designed to make up any shortfall in these circumstances.

Although the lender is the beneficiary of the policy, it is the borrower who pays the premium; it can either be a one-off payment when the loan is taken out or can be added to the amount borrowed. Note that, even if the lender fully recoups the money owed by claiming under the MIG, the insurance company (MIG insurer) is still entitled to pursue the borrower for the shortfall arising from the default.

MIGs are a form of higher lending charge (HLC) or mortgage insurance. 'Higher lending charge' is the term the FCA requires providers to use in explaining a MIG to a customer, but the term is not exclusive to MIGs. Some lenders will, for example, make a higher lending charge but, rather than arrange a MIG, simply place the money into a fund that can be drawn upon if required.

13.7 Shared ownership

Shared-ownership schemes are designed to help people on relatively low incomes to become owner-occupiers, even though they cannot afford a conventional mortgage. These schemes are usually arranged by housing associations.

Shared-ownership schemes enable a borrower to buy a stake in the property and pay rent on the remainder. For example, a borrower can purchase a 25 per cent stake in the property, funded by a mortgage, with the option of buying further 25 per cent shares in the future. As the borrower increases their share in the property, the mortgage element increases and the rental element reduces. This process of increasing the mortgage element is sometimes called staircasing. Note that not all lenders offer mortgages for shared-ownership arrangements.

CHECK YOUR UNDERSTANDING 2

There are several products that cover mortgage payments in circumstances where the borrower finds themselves unable to make repayments. This is potentially confusing, so check your understanding by matching the terms below to their **correct** definition.

Accident, sickness and unemployment insurance	Provides a lump sum that can be used to repay the outstanding mortgage loan if the life assured dies.
Income protection insurance	Covers the difference between the sale proceeds after a lender has taken possession of a property and the amount outstanding on the loan.
Mortgage protection insurance	Provides a regular income for an indefinite period if the beneficiary is prevented by illness from working.
Mortgage indemnity guarantee	Covers mortgage repayments, usually for a maximum of two years, if the beneficiary is prevented from earning an income.

13.8 What is equity release?

In a mortgage context, ‘equity’ is the excess of the market value of a property over the outstanding amount of any loan or loans secured against it. Equity release plans are designed to enable homeowners who do not have a mortgage on their property to release some of the equity in order to provide capital or supplement their income. The schemes are commonly used by older homeowners who may have limited pension income, but own a property. A homeowner with a small mortgage would also be eligible; the existing mortgage would have to be paid off as part of the arrangement. Most of the schemes are available only to property owners over the age of 60, and many have a minimum age of 70.

EQUITY RELEASE COUNCIL

The Equity Release Council represents all participants in the equity release market including product providers, advisers, lawyers and surveyors. Its Standards Board formerly existed as a body called SHIP – Safe Home Incomes Plans, which was incorporated into the Equity Release Council. The Council's role is to ensure that equity release products are safe and reliable for customers. Members sign up to its Statement of Principles, which sets out standards of conduct, particularly in relation to product standards and the information provided to customers, and to its Rules and Guidance.

FACTFIND

More information about the role of the Equity Release Council is available at:

https://www.equityreleasecouncil.com/ [Accessed: 18 February 2020].

13.8.1 How does a lifetime mortgage work?

For a lifetime mortgage, a lender will usually be prepared to lend up to a maximum of 55 per cent of the property value, depending on the borrower's age. The majority of lifetime mortgages are on a fixed-rate basis and take into account the fact that, unlike with a standard mortgage product, the term of the loan is unknown.

Interest is charged at the lender's lifetime mortgage rate, but generally no regular payments of capital or interest are made. Instead, the interest is added to the loan (rolled up). When the borrower dies or moves, the property is sold and the mortgage loan plus rolled-up interest is repaid to the lender. If any of the sale proceeds remain once the loan has been repaid, the borrower, or their estate, receives the balance. If the property is owned jointly, the mortgage continues until the second death or vacation of the property.

Most lenders provide a 'no-negative-equity' promise, which means that the borrower cannot owe more than the value of the property when the loan is due to be repaid.

A lifetime mortgage can be arranged on a drawdown basis. The lender agrees a maximum lending limit and the borrower can borrow an initial minimum loan and subsequently draw down lump sums as they wish, subject to a minimum withdrawal, typically £2,000 to £5,000. Interest is charged on the amount outstanding, but is rolled up rather than paid each month. The benefit of this type of loan over a standard lifetime mortgage is that interest only accrues on the amount actually borrowed, so the borrower has a degree of control and the debt will not increase as rapidly. It will allow the borrower to provide an annual 'income' while maintaining control over the speed at which the debt builds up.

13.8.2 How does a home reversion plan work?

Home reversion plans involve the homeowner selling a percentage or all of their property to the scheme provider. The customer(s) retains the right to live in the house, rent-free (or for a nominal rent), until their death(s) or until they move into permanent residential care. At that point the property is sold and the provider receives a share of the proceeds equivalent to their share of ownership. Thus if they owned 40 per cent of the property, they would receive 40 per cent of the sale proceeds.

HOME INCOME PLANS

Home income plans were launched in the 1980s. A homeowner could release equity from a property by taking out an interest-only mortgage. The funds released were used to buy a lifetime annuity (some schemes allowed homeowners to take some of the funds released as cash). The provider deducted the monthly mortgage interest from the annuity payment and paid the remainder to the homeowner as an income. The benefit of this approach over the lifetime mortgage was that interest was not rolled up, so the equity was not reduced further, and it also provided an income.

Unfortunately, as annuity rates fell, these products became increasingly unattractive. Few, if any, plans are sold today.

13.8.3 How are equity release schemes regulated?

Equity release schemes, defined as lifetime mortgages and home reversion plans, are regulated by the FCA under the Mortgages and Home Finance: Conduct of Business (MCOB) rules. MCOB 8 and 9 are the sections of MCOB specifically directed at equity release and lifetime mortgages, although the general MCOB rules regarding suitability and affordability also apply.

Anyone who advises on or arranges equity release must hold a specialist qualification. The requirements are detailed in the FCA Training and Competence sourcebook.

13.9 Other secured private lending

With all secured loans, the borrower offers something of value as security for the loan so that, in the event of default, the lender can take and sell that asset (or, in financial services terminology, 'realise the security') and be repaid out of the proceeds.

The most common form of secured personal lending is, of course, the mortgage loan for house purchase, the security being a first charge on the borrower's private residence.

When property values increase significantly, it is common for people to borrow against the increased equity in their property. For instance, they might take out a further loan from their existing mortgage lender (ie a further advance), arrange a second mortgage from a different lender or remortgage for a larger amount. They then use the loan to fund purchases that are not related to the house purchase but which improve their lifestyle in other ways.

Sometimes, bridging finance is required to enable a homeowner to bridge the funding gap that arises when they complete on the purchase of a property before they have received the funds from the sale of their existing property.

Most secured lending, therefore, is secured on 'bricks and mortar', even where its purpose is not directly – or even indirectly – related to house purchase or improvement.

KEY TERMS

BRIDGING FINANCE

Can be used by those arranging a loan to finance a new purchase before they have sold their existing property in order to 'bridge' the finance gap.

FIRST CHARGE

A legal right to have 'first call' on a property if a borrower defaults on repayment of the mortgage loan.

SECOND CHARGE

A legal call on a property after all the liabilities to the holder of the first charge have been settled.

13.9.1 Second mortgages

A second mortgage is one that is created when the borrower offers the property for a second time as security while the first lender still has a mortgage secured on the property. The new lender takes a second charge on the property;

the original lender retains the deeds and its charge takes precedence over subsequent charges. This means that, in the event of a sale due to default, the original lender's claim will first be met in full (if possible) and, if sufficient surplus then remains, the second mortgagee's charge will be met.

Lenders will, of course, only offer a second mortgage if there is sufficient equity in the property and, since second mortgages represent a higher risk to lenders, they are likely to be offered at higher rates of interest than first mortgages.

Second charge mortgages have been regulated by the FCA under MCOB since 21 March 2016; prior to that date they were regulated under the Consumer Credit Acts.

13.9.2 Bridging finance

Bridging finance may be required when a borrower wishes to move house but has not managed to sell their existing property, or the funds from the sale will not be available at the time completion of the new purchase is due. It is short-term lending that is repaid when the original property is sold and the owner is able to secure a mortgage on their new home.

There are two types of bridging finance:

- **Closed bridging** – the borrower has a feasible plan for repaying the loan within an agreed timescale. Typically, this is through the sale of the existing property and requires the borrower to have a firm buyer.
- **Open bridging** – the borrower needs finance to buy the new property, but does not yet have a firm buyer for their existing property.

Open bridging represents a higher risk to the lender than closed bridging. Interest rates for open bridging are therefore higher than those for closed bridging.

13.10 Commercial loans

There is an extensive market for what might be called commercial lending, ie loans to businesses of all sizes, from sole traders and partnerships to family companies to multinational traders. Loans may be required to start up or expand businesses, to purchase shops, factories or hotels, or to refurbish premises.

All the high-street retail banks have departments operating in this field, and there is also a wide range of companies that specialise in commercial lending.

Such lending is normally secured on the company's property or other assets, with the interest rate set at a specified margin above the lender's base rate. The exact interest rate will depend on the risk that the lender believes is involved in lending to the particular company; this will be assessed by looking at the company's past performance (where applicable), business plans, projected profits and management quality, as well as the business sector in which it operates.

13.11 Unsecured borrowing

In contrast to secured loans, an unsecured loan relies on the personal promise, or covenant, of the borrower to repay. Unsecured loans are, therefore, generally higher risk than secured lending, with the consequence that they are subject to higher rates of interest and are normally available only for much shorter terms. For example, while a mortgage secured on a property will be available for 25 years or even longer, a personal loan is rarely offered over much more than six or seven years.

Unsecured personal lending takes a number of forms, the most common of which are described below.

13.11.1 Personal loans

Personal loans are offered by banks, building societies and some finance houses. They are normally for a term of one to five years; the interest rate is generally fixed at the outset and remains unchanged throughout the term. Many of the larger lenders assess loan applications on a centralised basis, using a form of credit scoring to assess the suitability of the borrower.

A customer can use a personal loan for any (legal) purpose: typically, it might be used to purchase a car, fund a holiday, or consolidate existing higher-cost borrowing such as a credit card balance.

The purpose of the loan determines whether it is regulated under the terms of the FCA's Consumer Credit (CONC) rules. Most loans are regulated under CONC unless they are for house purchase or home improvement, and therefore subject to FCA regulation under MCOB rules. (You will learn more about MCOB in Topic 21 and about CONC in Topic 22.)

13.11.2 Overdrafts

An overdraft is a current account facility that enables the customer to continue to use the account in the normal way, even though its funds have been exhausted (although the provider does set a limit on the amount by which the account may be overdrawn). It is a convenient form of short-term temporary borrowing, with interest calculated on a daily basis, and its purpose is to assist the customer over a period in which expenditure exceeds income – for instance, to pay for a holiday or to fund the purchase of Christmas gifts.

Overdrafts are offered by all banks and some building societies. Because it is essentially a short-term facility, the agreement is usually for a fixed period, after which it must be renegotiated or the funds repaid. Overdrafts that have been agreed in advance with the provider are normally an inexpensive form of borrowing, although there may be an arrangement fee. Unauthorised overdrafts, on the other hand, attract a much higher rate of interest. The typical fee for an unauthorised overdraft can vary depending on the amount of the overdraft and time it runs for, but it can be anything from around £1 to £5 a day (some banks have transaction fees during an overdraft period and monthly charge caps).

As part of its 2016 market investigation into the banking market in the UK, the Competition and Markets Authority published a number of remedies to make fees transparent and open up bank data for other parties to help them enter the market. It also recommended that banks should set a monthly maximum charge for unauthorised overdrafts on personal current accounts, and send alerts to people before they breach their limit.

Since April 2020, banks can only charge overdraft users a single annual interest rate without additional fees and charges. MoneyHelper explains the three main changes in the following link: www.moneyhelper.org.uk/en/blog/savings/what-the-changes-to-overdraft-fees-mean-for-you.

13.11.3 Credit cards

Credit cards enable customers to shop without using cash or cheques in any establishment that is a member of the credit card company's scheme. Most retailers have terminals linked directly to the credit card companies' computers, enabling online credit limit checking and authorisation of transactions.

As well as providing cash-free purchasing convenience, credit cards are a source of revolving credit. The customer has a credit limit and can use the card for purchases or other transactions up to that amount, providing that at least a specified minimum amount (usually 3 per cent of the outstanding balance) is repaid each month. The customer receives a monthly statement, detailing recent transactions and showing the outstanding balance. If the balance is repaid in full within a certain period (usually 25 days or so), no interest is charged; if a smaller amount is paid, the remainder is carried forward and interest is charged at the company's current rate.

Credit cards are an expensive way to borrow, with rates of interest considerably higher than most other lending products. There is also normally a charge if the card is used to obtain cash either over the counter or from an ATM, or if the card is used overseas.

Credit card companies charge a fee to retailers for their service. This is deducted as a percentage (typically around 3 per cent) of the value of transactions when the credit card company makes settlement to the retailer. Despite the fee, credit cards offer a number of advantages to retailers:

REVOLVING CREDIT

An arrangement whereby the customer can continue to borrow further amounts while repaying existing debt.

- the retailer might achieve more sales if the convenience of payment by credit card is available to customers (and facilities to accept card payments of some kind are of course essential for most online retailers);
- payment is guaranteed if the card has been accepted in accordance with the credit card company's rules;

- the retailer can reduce their own bank charges because the credit card vouchers paid into a bank account are treated as cash.

CHARGE CARDS AND DEBIT CARDS

Although a charge card is used by the customer in the same way as a credit card to make purchases, the outstanding balance on a charge card must be paid in full each month. The best-known examples are American Express and Diners Club. Thus a charge card is a form of unsecured lending only in a very limited sense.

Like credit cards, debit cards can be used to make payments for goods and services, and to withdraw cash from ATMs. They are operated in the same way: a cardholder makes a payment by inserting the card into a card-reader and entering a PIN (alternatively, for small-value transactions, most debit cards can be read by contactless card-readers). However, a debit card is not a credit facility. The effect of the transaction is that funds equal to the amount spent are transferred electronically from the cardholder's current account to the account of the retailer. This is known as EFTPOS (electronic fund transfer at point of sale).

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the difference between secured and unsecured lending?
- describe how capital repayment and interest-only mortgages work?
- summarise the different interest options for mortgage repayment?
- describe two types of equity release product?
- explain what is meant by 'revolving credit'?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 13. Review the text if necessary.

Answers can be found at the end of this book.

1) Define a) a mortgagor and b) a mortgagee.

2) Which of the following is not true in relation to a repayment mortgage?

    a) The higher the interest rate, the higher the monthly repayment to the lender.

    b) Life cover is built in.

    c) The loan is guaranteed to be fully repaid at the end of the term, providing monthly repayments are maintained.

    d) At the beginning of the term most of the monthly repayment is paying interest on the loan.

3) For what reason might an ISA not be suitable for someone who is arranging an interest-only mortgage of £300,000 over a five-year term?

4) It is not the responsibility of the lender to ensure that a borrower has a repayment vehicle in place for an interest-only mortgage. True or false?

5) Chris is 53 and is pleased to see from his annual personal pension statement that his pension pot has grown enough to enable him to take a tax-free lump sum and pay off his interest-only mortgage. Will this be possible?

6) An advantage of a flexible mortgage is the ability to take further advances up to the lender's prearranged limit. True or false?

7) What is the main advantage of a capped-rate mortgage?

    a) If interest rates go up, the mortgage interest rate will not exceed a prearranged limit.

    b) The mortgage interest rate will never exceed Bank rate.

    c) The amount payable is fixed for the duration of the capped rate.

    d) There is a discount off the normal variable mortgage interest rate.

8) Describe how a home reversion plan works.

9) Which form of borrowing is likely to have the highest interest rate: a 25-year repayment mortgage or a personal loan with a 5-year term?

10) What is revolving credit?