TOPIC 23

Interest-rate options

LEARNING OBJECTIVES

In Topic 20, we emphasised that there are only two methods of repaying a mortgage: capital repayment or interest-only. However, there are a wide variety of mortgage products available that offer different interest-rate options. The variety of products means a prospective borrower should be able to find at least one that matches their needs. The wide choice can be confusing, so good advice is important.

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

- standard variable-rate products;
- discounted-rate products;
- tracker products;
- fixed-rate products;
- capped-rate products;
- flexible and offset products;
- product incentives.

THINK ...

Before you start work on this topic, take a moment to think about what you already know about these different interest-rate options. We introduced some of them in UK Financial Regulation and if you have been involved in buying a property you have probably had to decide which option to choose.

For instance, can you recall:

- the difference between a discounted-rate and a tracker mortgage?
- the main benefit of a fixed-rate mortgage?

- two types of flexible mortgage?

From your studies in Topic 20, can you remember the three different ways in which interest can be applied to an account?

PRODUCT AVAILABILITY

This topic covers the most common schemes available in a normal mortgage market. Some mortgage products may be withdrawn for a period, the popularity of products is influenced by prevailing interest rates, and new products may be introduced. Regard this topic as a guide to the main schemes, not an exhaustive list.

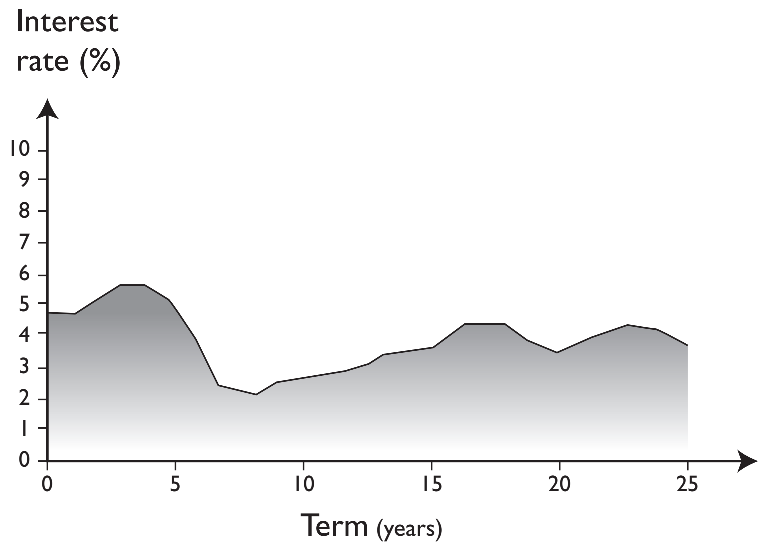
23.1 What is a standard variable-rate mortgage?

For many years the standard variable-rate (SVR) mortgage was the most common mortgage available. The development of the mortgage market has led to a wide range of products that may be more attractive to borrowers, and many lenders no longer even offer an SVR mortgage, preferring instead to offer discount or tracker mortgages. Many borrowers who have had SVR mortgages for many years with the same lender have remortgaged to take advantage of the benefits offered by new products.

The SVR mortgage does exactly what its title suggests – the interest rate varies with market rates in general. For example, an increase in Bank rate as a result of a Monetary Policy Committee decision will usually lead to lenders increasing their own standard variable rate, which in turn means that borrowers with a variable-rate mortgage will see their payments increase. If the SVR is reduced, the borrower's payments will decrease.

While there is a link between Bank rate and a lender's SVR, it is up to the lender whether to increase or reduce the SVR when Bank rate changes. Lenders have often been criticised for increasing the SVR quickly when Bank rate rises, but taking too long to reduce it when Bank rate is reduced.

FIGURE 23.1 THE SVR MORTGAGE



Someone who does not want to be locked into early repayment charges may still opt for this product, whether on a capital repayment or interest-only basis. No protection is offered against steep interest-rate increases and, generally, the monthly payment must be amended in line with each change in the interest rate charged. At times of economic volatility, the interest rate might change frequently and this uncertainty can make it difficult to plan household budgets.

Variable-rate mortgages tend to have lower product fees than fixed-rate or capped-rate mortgages and do not usually carry early repayment charges.

When interest rates are low, few lenders tend to offer standard variable-rate mortgages, preferring instead to offer discounted or tracker mortgages, although they do show a standard variable rate for comparison and to illustrate the rate that could apply at the end of the discount/tracker term.

Variable-rate mortgages do not usually offer a portability option.

23.2 What is a discounted-rate mortgage?

The discounted-rate mortgage is a popular variation on the SVR mortgage. It simply offers a discount from the lender's standard variable rate for a given period and is designed to attract new mortgage business, in the same way as a fixed-rate product.

So, if the lender's SVR is 4 per cent and the discount offered is 1 per cent for two years, the borrower will pay 3 per cent initially. If the lender's SVR increases or decreases during the discount term, the borrower will still pay 1 per cent below the SVR. The discount is genuine in that the interest saved is not added to the loan.

Some discounted mortgage products offer what is known as a stepped discount: the discount may be 1.0 per cent in the first year, 1.25 per cent in the second year and 1.5 per cent in the third year, while some lenders reduce the discount over each of the first few years.

FIGURE 23.2 DISCOUNTED-RATE MORTGAGE: KEY CONSIDERATIONS

Product fee

If an arrangement fee applies, it is generally non-refundable.

Interest-rate 'floor'

The minimum interest rate that would apply – this is a relatively recent development as a result of the prevailing low interest rates.

Early repayment charge

Designed to deter part or full redemption of the loan during the discounted period.
May be calculated as:

- a fixed percentage of the amount redeemed; or
- so many months' interest on the amount redeemed; or
- the actual amount of discount received by the borrower up to the date of the part or full redemption.

Additional purchases required

Loan may be subject to compulsory purchase of an associated product, eg buildings and contents insurance, buildings insurance only or mortgage payment protection insurance, thus providing the lender with commission income. This is not common in today's market.

Increases in SVR

No protection against increases in the lender's SVR – the interest rate payable is discounted from whatever the SVR is. However, borrower does have assurance that, for a given period, they will be paying less than the lender's SVR.

23.3 What is a tracker mortgage?

Tracker mortgages are variable-rate mortgages that follow (or track) a stated interest-rate benchmark.

23.3.1 Base-rate tracker

A base-rate tracker follows the Bank of England (BoE) base rate (Bank rate) for a given period – typically up to five years, although some lenders offer lifetime trackers. During that period, the interest rate on the mortgage is set at a percentage rate above or below the base rate. For example, a base-rate tracker set at 2 per cent above base rate will follow the base rate but will always be 2 per cent above it. A base-rate tracker set at 1 per cent below base rate will follow the base rate but will be 1 per cent below it. The Bank's Monetary Policy Committee meets eight times a year to review and set the BoE base rate, and any changes to the interest rate are applied to the tracker mortgage. At the end of the tracker term, the mortgage will automatically revert to the lender's standard variable rate, although most lenders will allow the borrower to move to another product if one is available.

The interest rate charged is usually lower than the lender's SVR because the Bank of England base rate is usually lower than the average lender's SVR.

There may be occasions when a lender will make a small reduction in its SVR even though the Bank of England base rate has not been reduced. In these circumstances, borrowers with a base-rate tracker mortgage with that lender are unlikely to have their rate reduced.

WHAT HAPPENS TO TRACKER RATES WHEN INTEREST RATES ARE VERY LOW?

A potential problem with tracker mortgages came to light in early 2009 when the base rate fell to 1 per cent. Many borrowers had trackers set at 1 per cent or even 2 per cent *below* the base rate, which could, in theory, have led to the lender paying the borrower because the tracker rate could be minus 1 per cent.

Most lenders responded by invoking (or trying to invoke) a minimum rate (or 'collar'), ie a rate below which the tracker rate was not permitted to fall. Given that the base rate then fell to 0.5 per cent, and then even lower for a prolonged period, it is now common for new trackers to have a minimum interest rate (collar) to ensure the problem does not arise in future.

As with a discounted-rate mortgage, a number of charges and conditions may apply:

- **Product fee**.
- **Application fee** – to cover the lender's application processing costs.
- **Early repayment charge** – on full or part redemption within a specified period.
- **Compulsory purchase of associated products** – eg buildings, contents and/or mortgage payment protection insurance, although this is not common in today's market.

Most arrangements allow the borrower to make overpayments or lump sum payments without penalty within specified limits – typically up to 10 per cent of the initial mortgage per year.

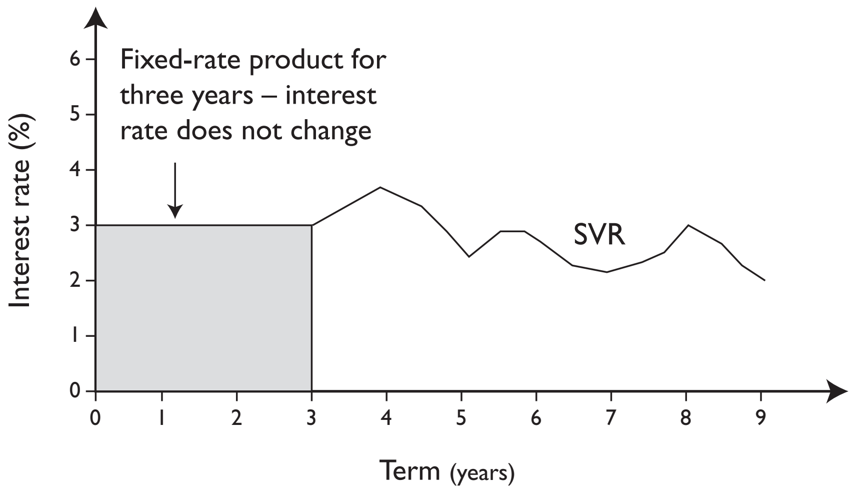
LIBOR TRACKER MORTGAGES

Until the end of 2020, it was not uncommon for commercial mortgages and some sub-prime mortgages to track Libor, rather than the Bank of England base rate (BBR). Since Sonia became the interest rate benchmark, lenders realistically have three alternatives to Libor: the BBR, a rate derived from Sonia or fixed rates.

23.4 What is a fixed-rate mortgage?

With a fixed-rate mortgage, the rate of interest (and so the monthly payment) is fixed for an agreed period, typically between one and five years, but sometimes as long as ten years. At the end of the fixed-rate term, the rate normally moves to the lender's standard variable rate (SVR), known as the 'reversion' rate. The market for fixed-rate mortgages is highly competitive, and with the Bank of England base rate and general interest rates low, fixed interest rates are very low when compared to the past.

FIGURE 23.3 THE FIXED-RATE MORTGAGE



HOW DOES THE LENDER RAISE FUNDS FOR FIXED-RATE MORTGAGES?

The rate at which interest is charged is linked to the rate paid by the lender on a tranche of funds raised on the wholesale money markets. If a lender raises £100m from the market at a fixed rate of 3 per cent over a five-year period, then this amount will be made available to new borrowers in the form of five-year fixed-rate mortgages. The lender will charge a higher rate to borrowers (its premium) to cover its costs and make a profit – for example, it might offer mortgages at between 4 and 4.5 per cent. Once the £100m has been lent, the product will be withdrawn, and possibly replaced with a new product at an interest rate linked to the prevailing money market rates at that time.

The main benefit of a fixed-rate mortgage to the borrower is that it helps them to budget. They know exactly what their monthly payment is for a given period of time and they are protected against interest-rate increases during that period. The borrower may also be permitted to make overpayments or one-off additional repayments each year within specified limits without incurring charges. The typical limit is 10 per cent, although some lenders set higher limits, and one or two set no limit. The lender's terms will specify whether the 10 per cent is based on the original mortgage or the amount outstanding at the time of the repayment. There are, however, other matters that the borrower needs to consider:

- **Interest rates** – they cannot take advantage of any reductions in the lender's standard variable rate during the fixed-rate period. They must also bear in mind the possibility that interest rates will rise during the fixed-rate period, resulting in a substantial increase in monthly repayments when the fixed-rate period ends.
- **Fees**
  - An application fee may be payable at the time the application is made – it may be a stated amount or it may be a set percentage of the advance.
  - There may also be a product fee to ensure the product remains profitable for the lender. The fees are not usually refundable if the application is subsequently cancelled by the borrower.
- **Early repayment charges** – an early repayment charge will almost certainly be applied if the loan is fully or partly redeemed during the fixed-rate period. This penalty may be calculated either as:
  - a fixed percentage of the amount redeemed; or

— a number of months' interest on the amount redeemed.

At one time it was quite common for the early repayment charge to apply beyond the end of the fixed-rate period. These 'overhang' penalties are now rarely found, although they are not banned.

- **Associated purchases** – although it is uncommon in the current market, due to regulatory constraints, some lenders may insist on the purchase of associated products such as buildings insurance, contents insurance or mortgage payment protection insurance as part of the arrangement.

PORTABILITY OPTION

Many fixed-rate and 'special deal' mortgages feature a portability option. This allows the borrower to take the existing arrangement to a new property without incurring an early repayment charge. The existing rate can be transferred to a new property for the same amount and the same remaining term as on the previous property. If the borrower needs a larger mortgage, the excess will be on whatever product the lender offers at that point and, if the borrower requires a smaller mortgage, there is likely to be an early repayment charge on the difference between the old and new amount. The lender also needs to ensure the new arrangement is affordable and meets its current lending policy.

WHY DO LENDERS IMPOSE EARLY REPAYMENT CHARGES?

The early repayment charge is to allow the lender to recover some of its losses on cancelling the fixed-rate deal. The funds would have to be lent to another borrower, possibly at a lower rate of interest, and the lender's profit margin would be reduced.

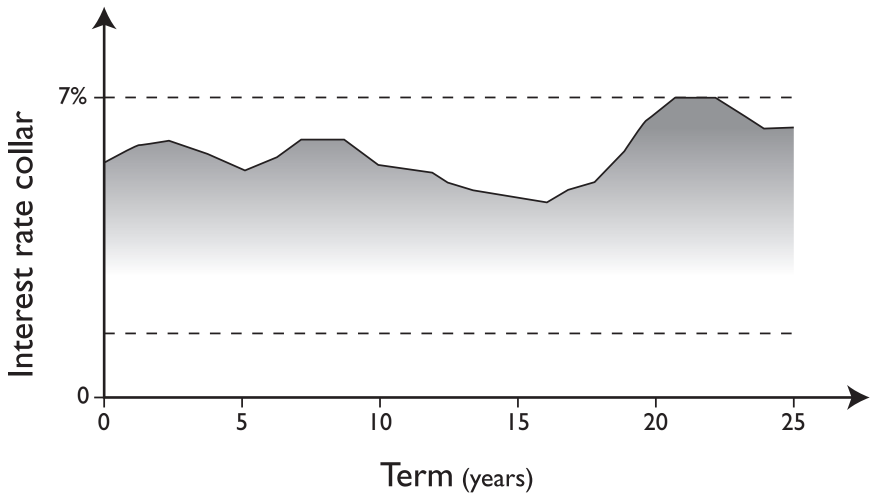
23.5 What is a capped-rate mortgage?

The capped-rate mortgage varies with the lender's SVR, up to a preset cap (or maximum). If the SVR is reduced, the rate the borrower pays is reduced. If the SVR moves above the cap, the borrower pays the capped rate. In other words, there is a limit (cap) on the rate the borrower pays. They can take advantage of reductions in the lender's SVR while at the same time knowing the maximum that they will pay. The rate payable below the cap may include a small premium over the lender's standard variable rate (SVR) – it might, for example, be the SVR plus 0.25 per cent.

A capped-rate mortgage is suitable for somebody who feels that interest rates are about to rise and wants the security of knowing the maximum they will have to pay each month, but would like to benefit if rates drop. Other points to consider are as follows:

- There is likely to be an application and/or product fee.
- There will probably be an early repayment charge on redemption during the capped period.
- As with fixed-rate mortgages, lender may allow charge-free overpayments or single repayments within specified limits.
- Most capped-rate mortgages offer a portability option.

FIGURE 23.4 THE CAPPED-RATE MORTGAGE



When fixed-rate mortgage rates are low, capped-rate mortgages are not particularly attractive and many lenders withdraw them until rates increase.

With Bank rate at an all-time low, lenders have not offered capped-rate mortgages for some time, but if mortgage rates in general start to increase they could become available again.

WHAT IS AN INTEREST-RATE COLLAR?

In the same way that the cap represents the maximum rate that the borrower will pay, the 'collar' represents the minimum interest rate payable during the term. Thus the lender sets an upper and lower limit to the interest payable: a mortgage with a 5.5 per cent cap and a 2.5 per cent collar will allow the rate to vary within those limits, but if rates were to go above 5.5 per cent, the borrower would pay 5.5 per cent, and if they were to drop below 2.5 per cent, they would pay 2.5 per cent.

23.6 How does a flexible mortgage work?

There is no specific definition of a 'flexible mortgage' as such, but it is generally accepted that it will have the following basic features:

- daily interest calculation;
- the facility to make overpayments, within specified limits, at any time without incurring a penalty;
- the facility to underpay (lower than normal monthly payments) if the borrower's circumstances warrant it;
- the facility to take a payment holiday, again if circumstances warrant it;
- the mortgage arrangement can be transferred to another property without penalties;
- most flexible mortgages offer an offset facility.

Underpayments and payment holidays are usually subject to the account holder having overpaid at some point to build a 'credit' above the amount that would normally have been paid off at that point through normal payments. Some flexible mortgages also offer a 'payback' facility, where the borrower can take back any overpayments they have made in the past.

CHECK YOUR UNDERSTANDING 1

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Think back to the work you did in Topic 20. What is the advantage of calculating interest on a 'daily rest' basis and in what circumstances does it provide real benefit to the borrower?

Flexible mortgages may offer more than the basic features described above. The lender might offer a 'drawdown' facility, where:

- a maximum borrowing amount is agreed at the start, typically 75 per cent of the initial property value;
- the borrower takes initial borrowing below the maximum limit;
- the borrower can drawdown additional funds from the account as and when they wish, providing total borrowing doesn't exceed the agreed limit. This also allows the borrower to 'borrow back' money they repaid from the original loan amount.

When the drawdown concept was originally introduced, the maximum borrowing was underwritten at the start of the contract, and withdrawals were not subject to further affordability checks: a simple request form would allow cash to be released. This involved less administration than a further advance, and the wording of the mortgage deed used for this type of product is such that all further advances automatically take priority over any other charges registered against the property; the need for a subsequent mortgagee to postpone its charge in favour of the further advance is eliminated.

However, with the introduction of more stringent affordability checks as a regulatory requirement, lenders undertake a further affordability assessment before releasing more funds.

23.7 How does an offset mortgage work?

An offset mortgage is similar in most ways to a flexible mortgage. The main difference is that the account holder's mortgage and savings are held in linked accounts. The savings held in the linked savings account are offset against the mortgage account, which means that mortgage interest is only charged on the balance. The savings are not tied into the mortgage account and can be taken out at any time without notice or penalties.

Some offset mortgages allow the borrower to link the mortgage to a current account as well, which means that a positive balance will be added to savings to be offset against the mortgage.

Mortgage payments are based on the amount borrowed at the start, which means that a healthy savings balance will result in lower interest each month and a payment surplus because the interest charged is lower than expected. In relation to the surplus, the borrower is likely to have the choice of either reducing the payments or maintaining them and reducing the mortgage term.

USING AN OFFSET ARRANGEMENT TO REDUCE INTEREST PAYMENTS

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Monique has a £100,000 interest-only mortgage (this is simpler to illustrate than a repayment mortgage). She has savings of £25,000. Interest rates are 5 per cent on the mortgage and 2 per cent on a 'normal' savings account.

If Monique were to pay interest on the full £100,000 mortgage, the monthly interest would be £417. She would receive £500 interest on her savings account over the year.

In an offset arrangement, her savings of £25,000 would be offset against the mortgage of £100,000, leaving a balance of £75,000 on which interest would be charged. With this arrangement, her monthly interest payment would be £312.50 per month.

She would not receive any interest on her £25,000 savings, but she would reduce the amount of mortgage interest she has to pay by £104.50 each month.

Although offsetting would mean lower interest charges each month, Monique could choose to reduce her monthly payment or maintain the payments and reduce the term. Assuming interest rates did not change, maintaining the payments would result in an overpayment of £104.50 in the first month to reduce the capital outstanding. In month 2 she would pay interest on £74,895.50, which would be £312.06 – resulting in an overpayment of £104.94, and reducing the capital to £74,790.56, and so on.

Assuming the savings remained linked to the mortgage and interest rates stayed the same, at the end of the first year offsetting would have reduced the mortgage outstanding by approximately £1,400 compared with a conventional mortgage. The longer the savings remain linked to the mortgage, the more the outstanding mortgage would be reduced, allowing Monique to repay the mortgage over a shorter term.

If Monique were to decide to keep her mortgage and savings in separate arrangements, she would receive £500 in interest, but if she opted for the offsetting arrangement she would reduce her mortgage by £1,400. It could be said that offsetting the savings means they would be working harder for her.

While an offset mortgage sounds like a good idea, it is really only of value to those who will be able to maintain a significant and consistent level of savings in the arrangement. In the example given, if Monique were to reduce her savings to £10,000, she would only achieve a reduction in the mortgage of around £560 – not so impressive but still worth considering.

More sophisticated and complex offset mortgages are now becoming available. These enable a borrower to offset interest payable on various savings accounts against the interest charged on their mortgage and other secured and unsecured loans held with the same lender.

The flexibility afforded by these mortgages often comes at a price: the interest rate charged may be slightly higher than the lender's SVR. It is, however, becoming increasingly common for lenders to offer flexible mortgages with a fixed, discounted, tracker or capped rate for an initial period. Early repayment charges may apply and some products may incorporate a product fee and/or the requirement to purchase an insurance product from the lender.

Although the number of people arranging flexible mortgages is increasing rapidly, lenders tend to regard these products as being more suitable for those who are perhaps at the higher end of the market in terms of financial awareness. At this stage in the development of flexible and offset mortgages, it is probably true to say that they are not appropriate for all borrowers.

23.8 What product incentives might be offered?

From time to time, lenders offer additional incentives to prospective borrowers, and these may be added to any of the products previously described. Examples of such incentives include the following:

- No valuation fee payable by the applicant (although sometimes a fee is charged when the application is made and then refunded in full on completion of the mortgage).
- All legal fees paid by the lender.
- Free insurance cover for a given period, normally 12 months – this usually applies to mortgage payment protection insurance, income protection insurance or critical illness insurance.
- A cashback facility – a tax-free lump sum paid to the borrower when the mortgage is completed. The cash could either be a fixed amount or a percentage of the amount borrowed. The cash is a gift and not added to the debt, but could be clawed back if the borrower redeems the mortgage within a set period. Some years ago it was possible to receive a significant sum from a cashback mortgage, but in the current market sums of £200 to £500 are likely to be the limit.
- Portability on fixed-rate, discounted-rate and capped-rate products.

CHECK YOUR UNDERSTANDING 2

The table below lists features of the main product types that borrowers need to consider. However, the description in the right column might not be opposite the correct product. Try to match the description to the product type to check you have assimilated the information in this topic – there are a lot of product features to remember!

Product	Considerations for borrowers
Standard variable rate	Can be a good option for a borrower with significant savings and no plans to withdraw them
Discounted rate	Simple structure but exposes borrower to risk of interest-rate rises, making budgeting difficult
Tracker	Allows borrower to make overpayments, or take a repayment holiday or make underpayments if they have previously made overpayments and thus are ahead of the anticipated repayment schedule
Fixed rate	Suits borrowers who want to make sure their payments will not exceed a certain level but also want to benefit from reductions in interest rates
Capped rate	Gives borrower certainty in terms of monthly repayment required but means they cannot benefit from reductions in interest rates until the end of the agreed period
Flexible	Interest rate moves up/down in line with Bank rate
Offset	Borrower pays less than SVR for a given period but interest rate can still fluctuate

THINK AGAIN . . .

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

For instance, can you:

- outline the advantages and disadvantages of an SVR mortgage?
- explain the difference between a discounted-rate mortgage and a tracker mortgage?
- explain why a lender might impose an early repayment charge on some mortgage products?
- explain how the drawdown facility works on a flexible mortgage?
- describe how an offset mortgage works?

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 23. Review the text if necessary.

Answers can be found at the end of this book.

1) Discounted-mortgage interest rates are guaranteed not to change for a defined period. True or false?

2) Discounted-rate mortgages usually have an early repayment charge. True or false?

3) Which of the following is true in relation to a base-rate tracker mortgage?

    a) The rate is linked to the lender's standard variable rate.

    b) Any change to the interest rate is at the lender's discretion.

    c) The initial rate is likely to be higher than the lender's standard variable rate.

    d) There may be application and early repayment fees.

4) Which of the following is a feature of a typical capped-rate mortgage but **not** a typical fixed-rate mortgage?

    a) An application fee.

    b) Early repayment charge.

    c) Variable monthly costs.

    d) Overpayment facility.

5) One feature of flexible mortgages is that interest is calculated on a daily basis. True or false?

6) The Prudent Building Society is offering a flexible mortgage with a maximum loan-to-value lending limit of 80 per cent. Will and Grace are looking to borrow an initial £130,000 on a property valued at £220,000; this figure is well within their assessed affordability. One of the attractions of this mortgage is that Will and Grace can draw down further funds to finance a holiday home later on with minimal administration. How much can they draw down, assuming they passed the lender's affordability assessment when drawing down the funds?

7) Bob and Luka have an offset mortgage with an outstanding balance of £120,000 and a current interest rate of 4 per cent. They have no savings linked to the mortgage but they do have

£20,000 in a savings account with a local building society, earning 2 per cent gross. Their financial adviser has suggested that they move their savings into a linked offset account. Comment on this advice, giving facts and figures to support your position.

8) A fixed-rate mortgage will automatically switch to the latest fixed-rate deal at the end of the term. True or false?

9) A capped-rate mortgage will always have a collar. True or false?

10) Ellen is considering a mortgage that offers a cashback facility. Which of the following is true? The cashback received:

    a) will be subject to income tax.

    b) may be clawed back if the mortgage is redeemed early.

    c) will always be based on a percentage of the mortgage.