

# Mad to have an endowment mortgage, or mad not to?

European Financial Planning Group's Anthony Drew looks at the advantages and disadvantages of an Endowment Mortgage.

A year ago in this column I compared the merits of repayment and interest-only mortgages.

Repayment mortgages are sometimes called "capital and interest" mortgages, as the payment to the lender each month consists partly of interest and partly of capital repayment. The proportions of the interest and capital repayments will vary over time, as the amount of interest within the overall payment will fall as the loan is steadily repaid over the years.

The advantage of this type of mortgage is that the lender calculates exactly what amount needs to be paid each month for the mortgage to be repaid over its agreed term. The borrower knows that as long as they make mortgage repayments in full each month then the mortgage is guaranteed to be repaid. In this respect repayment mortgages are safe and worry-free.

In contrast, with interest-only mortgages

the only payment made to the lender each month is that of interest. A separate arrangement is established to provide for the capital repayment at the end of the mortgage term. Because this is usually an endowment life insurance policy these types of mortgages are often referred to as endowment mortgages.

The key difference with an endowment mortgage is that rather than repay capital in instalments each month, the borrower in ef-

**The key difference with an endowment mortgage is that rather than repay capital in instalments each month, the borrower in effect retains this money to invest it elsewhere**

fect retains this money to invest it elsewhere. He does so with the expectation of making more money in investment returns than the extra interest he will pay through hanging onto the capital for longer.

In my article a year ago I stressed it was crucial to understand this point if considering an interest-only mortgage. By investing the money elsewhere rather than using it to methodically repay the mortgage the borrower invests using someone else's money. There is usually no guarantee that the invested sum will turn out to be sufficient to repay the mortgage at the end of the term. For this reason, and because some endowments taken out in the past have failed to deliver their projected payouts, the popularity of this type of mortgage has fallen somewhat. But are the risks of endowment mortgages that great?

Endowment mortgages have not always been compared to repayment mortgages on a "level playing field" basis. In the past



Anthony Drew  
BCom FCII FPFS

endowment mortgages have been sold as being cheaper than repayment mortgages. Therefore when investment returns faltered there was not enough money going into them to provide the necessary payouts.

What if we compare an endowment mortgage with a repayment mortgage on the basis of equal initial cost?

As an example, a repayment mortgage for £100,000 over a 25 year term will, assuming an interest rate of 6% and tax relief of 42%, cost £442 per month in the first year. Note that the net cost after tax relief will increase in subsequent years, as the amount of interest within each payment on which tax relief is available reduces.

If the same mortgage was taken out on an interest-only basis then the monthly interest payment after tax relief would be £290. The difference between these figures is £152, and this can be used to save into an endowment. If so, tax relief would be available, and the gross equivalent of this amount for a 42% tax payer would be an endowment premium of £262 per month.

What rate of investment return would be needed to convert a premium of this amount, payable each month for 25 years, into a fund of £100,000 so as to repay the capital? Well the answer to this is surprisingly low at only around 2% p.a.

**What if we compare an endowment mortgage with a repayment mortgage on the basis of equal initial cost?**

In today's terms a return of this order is realistically attainable and without taking much, (or arguably, any) investment risk. Of course an endowment policy will have costs associated with it, but if the repayment mortgage route was chosen a separate life insurance would also need to be added to the cost.

So the conclusion here is that when set up on an equal-initial-cost basis endowment mortgages can still look very attractive compared to repayment mortgages (the net cost of which rises in later years), and the investment risk does not have to be high.

Generally, and as would be expected, the main factor determining the investment rate of return required from the endowment when comparing the two types of mortgage is the mortgage interest rate – the higher this is the more investment return the endowment has to earn. Other factors are the mortgage term and the rate of tax relief available. But as-

suming mortgage interest rates at or around current levels the returns that would have to be earned from an endowment policy in order for an interest-only mortgage to be competitive with a repayment mortgage are very low, and in some cases actually zero.

Of course some of the advantage for endowment mortgages comes from the fact that tax relief is available on endowment premiums. We know that there are some tax changes in the offing, but at the time of going to press we do not know what these are. In any event, even if in the extreme no endowment tax relief was available the investment return of the endowment in the above example would only have to be 6% p.a. to compare with a repayment mortgage.

My message is, then, that it could well cost you to dismiss the endowment mortgage option. Always take advice, and ask your financial adviser to go through the figures with you.

Life Insurance  
Health  
Mortgages  
Investments  
Pensions



European Financial Planning Group provides financial advice to thousands of clients who live in Gibraltar and Spain or who are considering moving to the area. At EFPG, we have adopted a tight regulatory and compliance stance equal to that practised by our UK-based associate company Yorkshire Investment Group, the largest privately owned firm of Independent Financial Advisers in Yorkshire.

Our (UK Qualified) advisers take the time to learn about each client's current financial situation and future objectives and applying their in-depth knowledge of available financial products and providers and the relevant tax regime, offer bespoke financial planning solutions in a clear and easy to understand manner.

We are able to recommend solutions to a wide variety of financial planning needs ranging from straightforward financial protection and mortgage-related needs to complex tax-efficient offshore investment requirements.

Check out [www.efpg.net](http://www.efpg.net) for more information.

european  
financial planning  
GROUP

#### Contact us

European Financial Planning Group (Gibraltar)  
PO Box 1483  
Suites 3A & 3B, 1 Corral Road, Gibraltar  
Tel: (00350) 49750 Fax: (00350) 49290  
Email: [enquiries@efpg.net](mailto:enquiries@efpg.net)  
[www.efpg.net](http://www.efpg.net)

#### European Financial Planning Group (Spain)

Oficina 1  
Centro Profesional Levante  
Plaza Juan Macias  
San Pedro de Alcantara 29670  
Malaga, Spain  
Tel: (0034) 951 275 312 Fax: (0034) 952 787 508  
Email: [spain@efpg.net](mailto:spain@efpg.net)  
[www.efpg.net](http://www.efpg.net)

Licensed by the Gibraltar Financial Services Commission No: FSC00812B  
EFPG hold professional indemnity insurance pursuant to the EC Insurance Mediation Directive