

# Financial Advice for Home Buyers

It has been said many times before, but for most of us investment in a home along with a pension is likely to be the biggest investment we make.



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Of course as an investment a home is fundamentally more exciting than a pension. Although at a basic level we all need a roof over our head, most of us derive a lot of satisfaction and pleasure from having a nice home. At the end of the day, however, investing in a home can be just as much a practical investment as investing in a pension. You may, for example, want to down-size and release equity from your home when you are older, or you may want a second or more properties purely for investment purposes on a 'Buy to Let' basis.

For most of us buying a property can only be done by taking out a mortgage loan. The decision is then whether to take out a capital and interest mortgage loan (known as a repayment mortgage), or an interest-only (sometimes called an endowment mortgage).

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The essence of a capital and interest mortgage is that the mortgage lender calculates exactly what amount needs to be paid each month in order for the mortgage loan to be fully repaid over its agreed term. The overall monthly payment will vary as the mortgage interest rate varies. Part of each monthly payment made will be interest due to the lender and part will be repayment of a bit of capital. The proportions of interest and capital repayment within the overall payment will vary over time (the proportion of interest will fall and the proportion of capital repayment will rise), but none of this particularly needs to bother the borrower.

The deal with capital and interest mortgages simply is that as long as mortgage repayments are made each month in full the mortgage loan is certain to be repaid. In this respect capital and interest mortgages are safe.

Interest only mortgages aim to be more clever. As the name suggests the borrower agrees with the lender that for the duration of the mortgage loan the only payments made are of interest. Because no capital is repaid the interest payments do not reduce over time as with a capital and interest mortgage. As with capital and interest mortgages the monthly payment to the lender will be affected by changes in the general mortgage rate of interest. Naturally the borrower has to repay the mortgage loan at the end of the term, but in the meantime he, in effect says to the lender "can I keep the regular capital payments that I would otherwise make to you and go off and invest them elsewhere?"

Why would anyone do this? The answer is simple — you would only do this if you expect to make more in investment returns than you would spend on mortgage interest. It is crucial to understand this point and the risk you take if you opt for an interest only mortgage. By investing the money elsewhere rather than using it to methodically repay your mortgage loan you have no guarantee that the invested sum will be sufficient to repay the mortgage loan at the end of the term. By deciding to become an investor with someone else's money you also

have to accept the consequent risks — many individuals who took out interest only mortgages in the late 1980s have found this out the hard way, due to poor market performance. You have to be prepared to take good advice as to where your money should be invested, and you have to take an active interest in your investment, review it periodically with your financial adviser, and not let your funds sit unreviewed for long periods in a “one-size-fits-all” fund.

Well, that’s capital and interest and interest-only mortgages explained and compared. In practice there is one other complicating factor, and that is tax, or rather tax relief. In Gibraltar it is possible to claim tax relief on mortgage interest. As you generally pay more interest on an endowment mortgage than a capital and interest mortgage this gives the former a relative advantage.

With both interest-only and capital and interest mortgages there is no tax relief on capital repayments, but with an interest-only mortgage it is possible to obtain tax relief on a very convenient investment vehicle in the form of a life insurance endowment policy.

The tax relief advantage of the endowment mortgage is therefore a powerful attraction, although the associated investment risk must never be forgotten. It should be noted that the lowering of comparative investment returns and, more importantly, the abolition of tax relief on mortgage interest and life insurance policies, has almost killed-off the UK interest-only mortgage market, although in fairness the rates of tax relief were lower in the UK than currently in Gibraltar.

Given the availability of tax relief at up to 45% on 100% of the mortgage interest and the endowment policy premium, it is also likely to be attractive to a house-buyer who has cash in hand to purchase outright, to consider a mortgage. Why tie up your own capital when money can be borrowed cheaply (due to historically low interest rates) and tax relief of up to 45% is available to boot? You could leave your own money in the bank or building society and earn a secure tax-free rate of return that could exceed the amount of tax relieved interest payable on the mortgage.

#### What other financial considerations are there when buying a house?

Clearly you need to budget for overheads such as legal fees, stamp duty, valuation or survey fees and other purchasing costs. You need to insure the property and you need to insure the mortgage. Life insurance is essential, and is included automatically within an endowment mortgage but has to be taken out as an extra with a capital and interest mortgage. Any appropriate life insurance policy should also include the option of critical illness insurance (the policy will pay out in the event of a serious illness and not just death), and premium insurance (if you become ill for a long period the insurance company will pay the premiums on your own policy). Both are worth considering.

#### Confused?

You really shouldn’t be but why not go and talk it over with a Financial Adviser who can help you find the best method for your own circumstances.

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