A quick and easy guide to mortgage basics.

What is a mortgage?

A mortgage is a loan made to you by a lender so you can purchase a property. You'll pay interest on the mortgage and your lender will use your home as security for the loan. This means that your lender may repossess your home if you do not keep up repayments.

Repayment options

At its most basic level, a mortgage has two parts – the loan (the money you borrow) and the interest (the charge made by the lender until the loan is paid back).

The most important points are how you pay back the loan you borrow and how you pay the interest on it. You can either pay interest plus a little loan each month (a repayment mortgage) or just pay interest each month and pay all the loan off at the end of the mortgage term (an interest-only mortgage). A repayment mortgage is widely considered to be the easiest to understand and the least risky type of mortgage.

Repayment mortgages

With a repayment mortgage, your monthly payments pay off the interest due each month plus a little of the loan you owe. With this type of mortgage, you have the benefit of seeing your mortgage amount get smaller over time. Plus, when the mortgage comes to an end, you'll have paid off everything you owe in full and have nothing left to pay (which wouldn't be the case if you'd opted for an interest-only mortgage).

Of course, you should remember that in the first few years of paying a repayment mortgage, you'll be mainly paying off interest. So if you want to repay the mortgage early or move house, you'll find the amount you owe won't have gone down by very much.

Interest-only mortgages

The name of this type of mortgage says it all. With an interest-only mortgage, your monthly payments only pay the interest on the amount you've borrowed; you won't actually be reducing the loan itself. This means that at the end of the mortgage term you'll still owe the full amount of the loan.

With an interest-only mortgage you'll need to make sure you have put plans in place to pay off everything you owe at the end of your term, for example an investment or savings plan. You'll also need to take the cost of doing this into account when comparing the costs of interest-only and repayment mortgages.

An interest-only mortgage is a higher risk than a repayment mortgage. In most cases, there is no guarantee that you will be in a position to fully repay the loan amount you owe at the end of the term. That's why you need to keep an eye on your intended repayment plan throughout the life of the mortgage to make sure it's growing accordingly. It is your responsibility to make sure you have a plan in place that helps you repay the balance. You need to make sure you'll have enough money at the end of your mortgage term to repay your loan, because if you don't you could lose your home.

Types of mortgages

When you apply for a mortgage, you'll be able to choose from several different types of deals. Most lenders offer a range of options on their mortgages, including:

- fixed-rate mortgages
- tracker mortgages

Fixed-rate mortgages

Your interest rate will stay the same for a set period. Many lenders offer fixed rates for two, three, five or ten years, sometimes longer. The benefit of a fixed-rate mortgage is that it helps you to budget more easily, because your interest rate will stay the same for the length of the deal. Early repayment charges will almost always apply if you switch away from the mortgage before the fixed rate period ends.

Tracker mortgages

With this type of mortgage, the interest rate tracks a rate that is outside the control of the lender, such as the Bank of England bank rate (also known as the Base Rate). Every time that rate goes up or down, so does the interest rate on your mortgage.

Naturally, you will be better off whenever the interest rates drop and your monthly payments will be less. But, you should make sure your budget will allow you to make higher monthly payments if interest rates were to go back up. Early repayment charges will sometimes apply if you switch away from the mortgage before the tracker deal period ends.

Buy-to-Let mortgages

With a buy-to-let mortgage, you take out a mortgage on a property that you intend to rent out. Lenders have different criteria for these types of mortgages, so it's best to shop around and consult an independent financial advisor who can give you the most current information. Buy-to-let mortgages have become less commonplace following the financial crisis of 2008/09, but they are still available to people who qualify.

You should be aware that when you buy to let, you become a landlord. You will own an investment property and this is not the same as owning your own home. You are running a small business and you must be prepared to put in some work to make this business a success (for example, find tenants, collect the rent, make repairs, etc).

How much can I borrow?

The amount you can borrow will be based on your annual income and personal circumstances – and on the property you're buying. Ultimately, that mortgage amount will come down to what the mortgage lender thinks is a sensible amount to lend to you and what you think you can afford.

To help your lender make a decision about how much you can borrow, you will need to provide information about the following:

Your income

You will need to show payslips and/or bank statements to confirm your income and to help make a decision on what size mortgage is sensible for you to take on.

Your outgoings

Even though two people may have exactly the same income, their outgoings can be very different. So, as well as taking your income into consideration, it's also important to tell your lender about your other financial commitments, and to discuss what effect possible changes in your personal circumstances and future interest rate rises could have on your finances. This is to help guard against your mortgage becoming unmanageable.

Again, you may be asked to show bank statements and other items showing your outgoings since a mortgage will not be agreed if there is any indication that you cannot afford the payments.

When considering how much to borrow or how you would like to repay your mortgage, please remember that changes to your personal circumstances can alter your financial circumstances as well.

Records of previous loans or credit

Before you apply for your mortgage, your lender will ask for your permission to search the information held about you and your financial situation.

You should be aware that other banks and financial services companies might have passed personal details about your financial history on to credit reference agencies. This includes records of previous loans, credit and store cards. Virtually all businesses use the information held by these agencies, as well as public information, such as whether you're on the electoral roll, to help them decide whether to lend you money.

If the lender is part of a larger financial services company, then details of any accounts you hold with that company may also be used to help with the lending decision.

The value of the property

When you apply for a mortgage the amount of money you want to borrow is compared with the value of the property, and often referred to as the 'loan to value ratio'. It is used as a percentage. For example, if you want to borrow £150,000 and the property is worth £200,000, the loan to value is 75% (£150,000 divided by £200,000). This means that you will need to raise a 25% deposit (£50,000) in order to buy the property.

The loan to value (LTV) is one of the key factors a lender will consider before agreeing a mortgage. The lower the percentage, the more favourable your interest rate might be. To achieve a better rate, you'll need to reduce the amount you want to borrow by increasing the amount of money you put into buying your home (i.e. your deposit).

The lender will often complete a survey to determine the value of the property. Or, they may use existing market data to make their decision. Often, you can ask to have an independent valuation done if you disagree with the lender's value of the property you're trying to buy. Either way, you will generally have to pay a fee for the valuation.

You should also note that some lenders have different lending limits for new-build properties. Therefore the maximum loan to value percentage on a newly built home may be lower. In other words, if you're considering a

new-build home, you may have to come up with a bigger deposit.

Closing the deal on your mortgage

If you have applied for a mortgage to buy a property or are switching your mortgage from another lender (remortgaging), here's what to expect:

- a decision in principle or mortgage promise
- a full mortgage application for your property or the property you wish to buy
- property valuation, if you're buying a property
- if your mortgage is approved, you'll receive a mortgage offer.

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TSB13656 (08/21)

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