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Banks get strict on interest-only loans

By Tanya Powley

Mortgage lenders are making it harder for homeowners to take out an interest-only mortgage, with one major high street bank now insisting that borrowers need a deposit of at least 50 per cent to get a loan.

Santander, one of the UK's biggest lenders, this week imposed tougher rules for interest-only mortgages, cutting the maximum it will allow customers to borrow from 75 per cent to 50 per cent of a property's value.

The change, which came into effect on Friday, limits the options for homeowners seeking an interest-only mortgage on the high street. It will also hit existing customers that want to move home and "port" their mortgage as they will have to meet the new lending criteria, or switch to a capital repayment mortgage.

Santander's move comes as part of a continuing clampdown on interest-only lending by banks and building societies. Lenders have introduced stricter criteria over who can take out an interest-only loan following moves by the financial regulator to stop borrowers taking on more debt than they can afford.

This has caused lenders to restrict the maximum amount homeowners can borrow on interest-only and introduce stricter requirements on what they class as an acceptable repayment vehicle. Most high street lenders now only accept an endowment policy, pension plan, stocks or Individual Savings Accounts (Isas) as repayment vehicles for interest-only loans.

Some lenders have imposed even tougher rules on repayment vehicles. Last month, Barclays said acceptable repayment vehicles must have been in existence for over 12 months, and that it would no longer take into account the potential growth of any investment plans when deciding how much it will lend to a customer on an interest-only basis.

"This is a significant step for a lender of Santander's size," said David Hollingworth of London & Country, the mortgage broker. "We're reaching a point now where interest-only is being squeezed out of the market through criteria changes, rather than by any specific rule."

Mortgage Brokers argue that interest-only mortgages remain a sensible option for many borrowers. They are often a cost-effective way for higher earners with variable income levels to pay low monthly interest payments, and then use annual bonuses to pay off the capital in large chunks.

"Interest-only borrowing is not necessarily reckless," argued Mark Harris of SPF Private Clients. "As long as the borrower has a repayment strategy in place, it is not reckless borrowing."

The Financial Services Authority indicated in its latest rules on responsible lending that interest-only mortgages can be a valid option for consumers with a "realistic, credible" repayment strategy.

In spite of the recent tightening in criteria, homeowners still have a choice of lenders offering interest-only mortgages at up to 75 per cent of a property's value. This includes lenders such as Nationwide, Halifax, HSBC, Northern Rock, Yorkshire Building Society and Barclays.

According to mortgage brokers, many of these lenders offer better mortgage rates than Santander. "A total of 11 lenders offer better two-year tracker deals and better two-year fixed-rate deals than Santander," noted Nigel Bedford of Largemortgageloans.com.

For example, Yorkshire Building Society has a best buy two-year interest-only tracker at 2.49 per cent – Bank of England base rate plus 1.99 per cent – with a £999 fee, compared to Santander's rate of 3.09 per cent. Meanwhile, Principality Building Society has a market-leading two-year fixed-rate at 2.79 per cent with a £999 fee, compared to Santander's comparable deal at 3.19 per cent.

Individuals looking to borrow over £1m on an interest-only basis are likely to be better off with a private bank as they take a more flexible approach. "All private banks are comfortable with interest-only, particularly as their usual terms are five years with a reviewable facility, rather than a 25-year repayment commitment," explained Adrian Anderson of Anderson Harris, the high-end mortgage broker.

Private banks are also likely to accept a wider range of repayment vehicles than high-street lenders. "Private banks view the interest-only question in a far more realistic way, understanding that interest-only repayment vehicles are not limited to regular contribution savings plans," said Bedford. "For many borrowers, repaying the debt via such routes as excess income, bonuses, deferred compensation, downsizing or future sale of other assets are totally viable."