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Interest-only loans disappearing fast

By Tanya Powley

Borrowers who want to use alternative methods of paying off a mortgage are fast running out of options, brokers have warned, after the Co-operative Bank became the latest lender to restrict its interest-only deals.

From Tuesday, Co-op will stop giving any new customers the option of taking out an interest-only home loan, and will insist that all mortgages are set up on a capital and repayment basis.

Existing interest-only borrowers with the bank will be able to switch to other products from Co-op Bank's mortgage range and continue paying just the interest when their current deals expire – provided they are borrowing the same amount or less.

However, experts warned that Co-op's move will further restrict the remortgage options for homeowners with an interest-only loan.

Lenders have been making it increasingly difficult for borrowers to get an interest-only mortgage following moves by the Financial Services Authority (FSA) to stop borrowers taking on more debt than they can afford.

While the FSA has not banned interest-only loans, it indicated in its latest rules on responsible lending that they should be used only by consumers with a "realistic and credible" repayment strategy.

Banks and building societies have been tightening their criteria for interest-only lending for some time, with several lenders – including Santander and Nationwide – restricting these loans to homeowners with a deposit, or equity, of 50 per cent or more.

Other lenders have imposed tougher rules on what they class as an acceptable method of repaying an interest-only mortgage. Lloyds Banking Group, for example, will no longer accept cash savings. It also uses more conservative valuations of accepted repayment vehicles – only lending up to 80 per cent of the current value of any stocks and shares individual savings accounts (Isas), unit trusts, equities or investment bonds. In addition, any investment fund must already be worth at least £50,000 to be deemed an acceptable repayment vehicle.

These changes mean that many existing borrowers will struggle to meet the criteria, and must either switch to a capital repayment mortgage or stay on their lenders' standard variable rates – which are starting to rise.

David Hollingworth of London & Country, the mortgage broker, said most lenders have effectively “closed the door” on interest-only lending without officially pulling out of the market like Co-op Bank.

According to Aaron Strutt of broker Trinity Financial, the Post Office remains fairly competitive for interest-only deals.

It has a five-year fixed rate at 3.59 per cent, with a £, 1495 fee, for those borrowing up to 75 per cent of a property's value. Accepted repayment vehicles include stocks and shares Isas, pensions or endowment policies that have been in place for at least 12 months.

Some banks are now developing mortgage products that aim to combine an element of interest-only lending with capital repayments.

Private banks are increasingly offering “bullet repayment” loans. Borrowers pay interest only for, say, 11 months of the year but in the final month make an agreed capital reduction, explained Strutt. He said private banks such as Coutts, Barclays and Investec offer this option.

“The bullet repayment plan is becoming more popular with more private banks,” said Nigel Bedford of Largemortgageloans.com. He pointed out that this simply replicates what many wealthy borrowers did anyway: paying interest until a bonus or dividend made a large capital repayment possible.

However, some private banks have started to make the capital repayment a contractual obligation.

One high street lender is also considering a new interest-only product that would automatically switch to a repayment basis after a couple of years. Brokers said Clydesdale Bank was evaluating a five-year fixed-rate deal, where payments would be on an interest-only basis for the first two years, and on a capital repayment basis for the final three.