Endowment Mortgages v Capital Repayment Mortgages

STANDARD LIFE

MORTGAGE ENDOWMENTS

Please discuss this leaflet with your Financial Adviser.

The poor performance of the stock market over the past three years has led to projected shortfalls on many mortgage endowments. In light of these potential shortfalls, mortgage endowment policyholders may ask whether they would have been in a better position had they opted for a capital repayment mortgage.

The purpose of this document is to illustrate how each method might compare at different intervals and for a variety of start dates (as shown in the table on page 2). It is not intended to prove which method is more suitable or appropriate as this is very much dependent on the individual customer.

Typically a mortgage endowment will be taken out with an interest only mortgage and a life assurance policy will be taken out with a capital repayment mortgage. The different level and timing of payments into each repayment method make the comparison complex.

What costs are involved?

As a starting point, it is useful to compare the costs of each mortgage type for a typical example. The comparison shown below is based on a standard Halifax mortgage taken out on 1 January 1992. In this example, mortgage payments were reviewed yearly and changed if the Halifax changed the rate of interest on the loan. The monthly payments **at the start** of the mortgage are:

Endowment mortgage		Capital repayment mortgage	
Endowment:	£50.00 *	Life cover payment:	£10.49 *
Interest only:	£316.04 **	Mortgage payment:	£343.35 **
Total payment:	£366.04	Total payment:	£353.84

* (this amount does not change over the mortgage term) ** (this amount varies with interest rates)

In this case, the total monthly payment on the endowment mortgage was £12.20 a month more than the capital repayment mortgage. However, as a result of falling interest rates, the payment into the endowment mortgage has fallen by a greater amount than the capital repayment mortgage.

The corresponding monthly payments on **1 February 2003** are:

Endowment mortgage		Capital repayment mortgage	
Endowment:	£50.00	Life cover payment:	£10.49
Interest only:	£248.92	Mortgage payment:	£299.21
Total payment:	£298.92	Total payment:	£309.70

By 1 February 2003, the monthly payment under the endowment mortgage was £10.78 less than the capital repayment mortgage. The total amount paid under the endowment mortgage, from the start date until 1 February 2003, was £736.41 less than the capital repayment mortgage.

It is worth highlighting the fall in regular payments on the endowment mortgage. The falls in interest rates which have resulted in a monthly saving of £67.12 are part of the same economic conditions which have led to lower recent and expected returns on endowment policies. These regular savings can be used to reduce the mortgage debt or alternatively, set aside to supplement the maturity value of the endowment policy. In the above example, the value of these monthly savings between now and maturity on 1 January 2017 would be £11,141 (£67.12 x 166 months) if conditions did not change further.

Comparison of Endowment Mortgage with Capital Repayment Mortgage

The policy used in the examples is a conventional 25-year Minimum Cost Plan (80) taken out by a male aged 30, for a total payment of £50 a month. The target loan is £40,160.

The table below compares the surrender value of the mortgage endowment (A) with the additional capital repaid using the capital repayment method (B). Some capital may be repaid on an interest only mortgage due to interest rates reducing before changes to payments are made and this has been allowed for in value (B). In the example below, the payments into the capital repayment mortgage are higher than those into the endowment mortgage. We need to take these higher payments already made (C) into account when comparing the two methods. The figures in the final column allow for these higher payments.

Date of comparison	Start date	Surrender Value of endowment * (A)	Additional capital repaid on repayment mortgage** (B)	Comparison (A)-(B)	Extra payments made on repayment mortgage (C)	Comparison (A)-(B)+(C)
1 Jan 2001	01/01/1988	£14,451	£10,430	£4,021	£62	£4,083
	01/01/1990	£10,062	£8,067	£1,995	£587	£2,582
	01/01/1992	£6,454	£6,812	-£358	£830	£472
1 Jan 2002	01/01/1988	£16,724	£11,900	£4,824	£276	£5,100
	01/01/1990	£11,922	£9,299	£2,623	£782	£3,405
	01/01/1992	£8,039	£7,985	£54	£1,053	£1,107
1 Feb 2003	01/01/1988	£12,391	£13,777	-£1,386	£840	-£546
	01/01/1990	£9,016	£10,899	-£1,883	£1,289	-£594
	01/01/1992	£6,325	£8,392	-£2,067	£736	-£1,331

How an endowment mortgage compares against a capital repayment mortgage will depend on the date of risk and the term of the policy. Also, as can be seen from the table, the comparison will be different at any point in time depending on the conditions experienced up until that time.

This is illustrated particularly well with the mortgages taken out on 1 January 1992. After 9 years (on 1 January 2001) the surrender value of the endowment, £6,454, is lower than the £6,812 capital repaid, but a year later the surrender value is higher at £8,039 than the capital repaid, which amounts to £7,985. When you also consider the additional payments into the capital repayment mortgage, the mortgage endowment compares well at both January 2001 and January 2002.

On 1 February 2003, the position changes, as even after considering the additional payments, the capital repayment mortgage looks more favourable. This is as a direct result of the recent poor investment conditions, which have adversely affected endowment values in 2003. Of course, these example policies still have up to 14 years to run until maturity, when the loan would be due to be repaid, and the comparable position with a capital repayment mortgage is likely to continue to fluctuate between now and then.

These examples highlight how sensitive each method is to investment conditions and interest rates. It is still our view that, for most customers, 6% p.a. is a reasonable assumption for the rate of future investment returns for the purposes of long-term financial planning. If this rate of return is achieved and interest rates remain low, mortgage endowments should continue to be an effective way to repay a mortgage for many people.

* The surrender values quoted include allowance for Surrender Value Reductions where applicable.

** The capital repaid and the regular payments are based on a standard Halifax mortgage and the interest rates available over the periods shown. Standard MIRAS allowances have been made.

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