Society of Mortgage Professionals
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Good Practice Guide

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Offset mortgages for Mortgage Professionals

This paper is in response to members' requests to provide a summary of good practice within one source document and is based upon the Society of Mortgage Professionals' understanding of the regulator's rules and current stance. Whilst a summary, it is not intended to be exhaustive and should not be relied upon at the exclusion of other sources of information.

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Foreword

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Offset mortgages enable your clients to take control of their mortgage and make their savings work harder, by using them to reduce their outstanding debt.

You may not have arranged these mortgages before, but they are an important part of the mortgage mix.

It's good practice to ensure you understand the benefits and potential drawbacks of offsets, so you can confidently explain them to your clients.

Borrowers may not ask for an offset directly, but that doesn't mean they wouldn't benefit from one, so it's worth knowing exactly who these products suit – which might be more potential clients than you think.

In the current low interest rate environment, it's difficult to see a real return after inflation on savings, making now a great time to talk to clients about offset mortgages.

This Good Practice Guide runs through how offsets work, the pros and cons of these products, and examples of good practice when introducing them into the client conversation.

What are offset mortgages?

An offset mortgage puts your client in control of their homeloan. It links their savings account to their mortgage account.

This enables them to effectively overpay their mortgage without losing access to their money. By doing so, they can either reduce their ongoing monthly repayments or cut their mortgage term, depending on the product and the client's preference.

This benefit occurs because, by offsetting savings against their mortgage, they are effectively making an overpayment.

This means the outstanding capital debt reduces and therefore less interest is charged on this smaller debt. Over time the impact of this can be significant, saving thousands of pounds in saved interest and potentially years off a mortgage term.

It's the same benefit your client gets from overpaying their mortgage, but what stands offsetting apart is that they are only 'effectively' overpaying. And this can be very appealing to clients.

Access to cash

With offset mortgages your client still has easy access to their money in the linked savings account, instead of literally using their savings to overpay their mortgage.

This means they get the financial benefits of overpaying without the loss of access to their cash. Instead they agree to sacrifice the ability to earn interest on their savings, in exchange for saving interest on a lower mortgage debt and reducing that debt.

For example, if your client has a £200,000 mortgage balance and offsets £50,000 of savings against this, that £50,000 is then effectively overpaid into the mortgage and they are only charged interest on an £150,000 debt. Of course, they sacrifice earning interest on their savings (see **Benefits of offsets** for specific examples).

The borrower can withdraw and add to their savings account freely, often online.

Because offset deals usually calculate interest daily, your clients can spend and add to their savings, and the system sweeps across their linked savings and mortgage each day to work out the interest they will incur for that day.

Background to the sector

Flexible mortgages have been around for over 20 years and became prevalent in the early noughties. At the same time innovative current account mortgages and offset mortgages were introduced, taking the flexible concept one step further.

They originated in Australia where they were a more common choice for borrowers.

Offsets were only offered by a handful of lenders in the early stages and usually as a one-off product. Rather than a mainstream mortgage, they were perceived as specialist mortgages for a distinct set of clients.

That's changed now, with some lenders now offering offsetting across their entire mortgage range. It's now a feature of some standard mortgage products rather than a specialist product, although offsets are still not commonplace.

Different types

Offsetting is usually done by linking a savings account with the mortgage account, but there have been other iterations along the same theme. In the past products linked with a current as well as savings account, while others allowed the borrower to hold multiple but separate linked pots, including a mortgage, savings accounts, a current account, and a credit card.

Offsets have also come down in price in relation to mainstream mortgages, so there is no longer the same premium to pay for the advantages of offsetting as there was 20 years ago. However, it's still the case that the cheapest mortgage rates available usually don't allow offsetting.

Borrowers can also now choose from short-term deals, such as a two-year fixed rate for example, so offset mortgages no longer represent a long-term commitment where the client is necessarily tied to one provider. There are remortgage opportunities for offsets.

Benefits of offsetting

No limits on overpaying

Your client can offset far more than they would usually be allowed to overpay. Remember that on a standard mortgage borrowers are typically only allowed to overpay 10% or sometimes 20% of their mortgage balance each year.

An offset gives far more scope for borrowers with sufficient funds to realise huge benefits of overpaying. They could hold 50% of their mortgage balance in a linked savings account for example, or even more.

Access to savings

The client doesn't have to lock up their cash in their mortgage. They can withdraw it, add to it and use the linked savings account like any other easy access savings and the lender will usually work out the interest by using daily interest calculation. This is more flexible than making an overpayment where they lose access to their money.

Reduce monthly repayments

Your client can choose to keep their original mortgage term but use their offset benefit to reduce their monthly mortgage repayment.

For example, by putting £25,000 in an offset savings account against a £200,000 mortgage over 25 years a client can reduce their monthly repayments by over

£23,000 in total and be able to repay the loan 24 months early[1].

Cut years off the mortgage term

By choosing to maintain their mortgage repayments at the same level more of your client's monthly mortgage payment is used to repay the balance of their loan. This could allow them to pay off their mortgage quicker.

For example, if they offset £25,000 in savings against a £200,000 mortgage over 25 years, and made monthly payments of £100 into their savings account, the term of the mortgage would be reduced by three years and five months, and £46,440 would be saved in interest payments. Plus, there would be enough in the saving account to repay the mortgage balance seven years and one month early[2].

1 Based on a:

• £200,000 mortgage over 25 years on a repayment basis. A product fee of £999 and a CHAPS fee of £25 have also been added to this, giving an overall borrowing amount of £201,024

•2-year fixed rate of 3.49% with a product fee of £999, reverting to a standard variable rate of 3.99% after two years

•The overall cost for comparison is 4.0% APR

•£25,000 lump sum in the linked savings account from completion. The completion date in this example is 15th January

In total, £23,673 would be saved in interest payments during the mortgage term, and there would also be sufficient money in the savings account to repay the mortgage balance 24 months early.

Source: Scottish Widows Bank

2 Based on a:

• £200,000 mortgage over 25 years on a repayment basis. A product fee of £999 and a CHAPS fee of £25 have also been added to this, giving an overall borrowing amount of £201,024

• 2-year fixed rate of 3.49% with a product fee of £999, reverting to a standard variable rate of 3.99% after two years the overall cost for comparison is 4.0% APR

•£25,000 lump sum in the Offset Saver Account from completion. The completion date in this example is 15th January

•An additional £100 regular monthly payment to the savings account

By offsetting, the term of the mortgage would be reduced by 3 years and 5 months, and £46,440 is saved in interest payments. In addition, there would be enough savings in the saving account to repay the mortgage balance 7 years and 1 month early.

Source: Scottish Widows

Tax-free savings

If the client has significant savings elsewhere, and has already exceeded their tax-free Personal Allowance on savings, they can benefit from effective tax-free savings.

Instead of earning interest, which they could be taxed on, they are saving interest, so no tax is due. This is especially helpful for higher and additional rate taxpayers.

Drawbacks of offsetting

No savings = no benefit

If your client won’t have any surplus savings after buying their home or remortgaging, and they don’t have the money to regularly add to a savings account, an offset is unlikely to appeal to them.

However, if they have a modest savings pot, it’s worth showing them the potential benefits. Of course, the more a client has in their savings account the greater the benefits. But small regular payments into an offset savings account can make a difference.

Client wants a simple mortgage

Not all clients want to take control of their overall finances in this way and some simply want a straightforward mortgage.

Offset mortgages may not be highly complex financial products, but they are more complicated than a standard mortgage.

For a first-time buyer who simply wants a mortgage to help them get onto the property ladder, for example, an offset may not be appropriate.

Client doesn’t want to switch savings

If your client has their savings account with a preferred provider, they may be wary of switching them to an offset savings account. They might also prefer to keep their savings completely separate from their mortgage provider.

However, it’s worth reassuring them that they maintain access to their savings and that switching is a straightforward process you can help them with.

Offset mortgages are not the cheapest

The cost of offset mortgages has fallen in the last five years, in line with the market trend. In fact, average two-year fixed offset rates dipped below non-offsets during April 2020, when some lenders restricted high LTV mortgages during the coronavirus lockdown.

Average offset two-year fixed rates fell to 1.9% in April compared to 1.96% for non- offset two year fixed rates (28.4.20 Moneyfacts). However, the absolute lowest rates on the market are still non-offset products, with rates starting at sub-1.2% in May 2020 for example.

If your client is only interested in getting the lowest rate, an offset is unlikely to be suitable.

Limited choice

The number of offset mortgage products has reduced from 370 in 2015 to 95 today (18.2.20 Moneyfacts and 28.2.20 Moneyfacts).

Which clients do offsets suit?

Received wisdom has long been that offsets are just for those with large savings pots and the self-employed but, in fact, they can benefit a much wider range of clients.

Many borrowers could benefit from offsetting and may consider these products if they fully understood the long-term advantages.

Any clients with savings, even modest savings pots, could potentially achieve a better effective return on their money by offsetting.

However, the following groups are particularly likely to benefit:

- Borrowers with a large savings pot, who can save significant amounts of interest on their mortgage by offsetting the money they have in credit against their mortgage debt.
- Those who are already exceeding their tax-free Personal Savings Allowance. Offsetting makes even more sense for them – if they can save paying mortgage interest rather than earning interest, they incur no tax.
- Self-employed borrowers who set aside a portion of their income for tax over the course of the year and then pay it to the Revenue – often twice a year. This means they have significant savings that they can neither spend nor tie up in a long-term fixed rate savings product. By offsetting that money against their mortgage, they can save interest while retaining instant access to it when they need to pay their tax bill.
- Clients with variable income such as seasonal workers can add extra savings when they have the money and let it work hard on reducing their mortgage debt, and then access those savings during leaner months.
- Those who have a commission-based income and may receive large bonuses.
- Borrowers with family members willing to offset their savings. It's possible for a parent to offset their savings against their child's mortgage, for example, to reduce their monthly payments. By sacrificing earning interest, they can help their children reduce their monthly repayments.

Good practice

Your initial factfind will help you to identify those clients who could benefit from offsetting. But they may be unaware that these products even exist. So, where do you start?

1. Explain the products simply.

You understand how offsets work but remember your client is simply looking for a mortgage, so a product that involves them moving their savings may sound unnecessary and confusing.

Try to introduce offsetting by using visual examples or diagrams that clearly show how it works. These are available on the websites of most offset providers.

2. Highlight the potential savings.

The savings that borrowers can achieve are significant and worth highlighting to your client. Over the term of the mortgage they could potentially save thousands of pounds in saved interest and cut years off their mortgage term. Give them examples based on their specific circumstances so they can see exactly how offsetting would impact them. Again, tools are available on the websites of most offset providers to help demonstrate this.

3. Could they put down a larger deposit?

If your client has a significant savings pot, it's worth first exploring whether or not they would benefit from using some of it to put down a larger deposit, potentially tipping them into a different LTV bracket. This would therefore open up more competitive mortgages for them to choose from.

4. Consider standard mortgage with overpayments.

Perhaps your client could take a standard mortgage and simply make overpayments.

Assuming they don't want to overpay more than 10% each year and they are happy to lose access to those funds, they could benefit from a potentially cheaper mortgage.

5. Highlight any drawbacks.

Your client may be able to achieve a higher savings rate by locking up their savings in a fixed term account, or by investing their money elsewhere.

Ensure they understand they are sacrificing the ability to earn interest on their money in order to save interest on their mortgage.

6. Keep in touch with existing offset clients.

Once you've arranged an offset mortgage for a client keep in touch to see if it's working for them and what else they could do to boost the offset benefits.

Perhaps they have recently had a pay rise or received an inheritance. And, of course, when their initial product term is due for renewal, they'll need your help to remortgage or take a product transfer.

7. Include offsets in your mortgage mix.

As a whole of market broker, you should consider all types of mortgage products, including offsets, for your clients.

Interest rates are currently so low that savings rates are not necessarily going to beat inflation and offsetting could financially benefit some borrowers.

Plus, offsets give you plenty of opportunity to stay in touch with clients, to find out how if they've had any change in circumstances and are making the most of the account features.

Conclusion

Offset mortgages are a well-established mortgage product, having been in the UK mortgage market for 20 years. They provide clients with the means to take control of their mortgage – sacrificing interest on their savings to instead save interest on their mortgage debt.

The overall savings can be significant, with clients able to both cut their term and save on overall interest payments or choose to reduce their monthly repayments.

While they remain a limited product, there were 95 offset options available to mortgage borrowers in April 2020 from a range of lenders.

The current low interest rate environment could make offsets more appealing to your client who aren't able to realise a real return on their savings.

And while they can be suitable for all clients, they are particularly useful for the self- employed, those with variable incomes or large savings pots, and higher and additional rate taxpayers.

Remember to bring offsets into the mortgage conversation when you can see your client could benefit.