

Does an offset loan still make sense?

Homeowners could lose out from changes to compensation rules, writes James Charles

LENDERS have been criticised for failing to warn hundreds of thousands of offset mortgage borrowers about changes to the government compensation scheme, which could see them lose money if their bank fails.

Experts have warned that the new rules, combined with a sharp fall in traditional mortgage rates, could spark a fall in the popularity of offset loans among wealthier borrowers.

Most offset mortgages work by holding savings in a linked account, thereby reducing the cost of the loan because interest is charged only on the difference between the amount in savings and the amount owed.

Under current rules administered by the financial services compensation scheme (FSCS), when a lender fails, borrowers with an offset loan would see their entire savings pot held with the bank used to cancel out part of the debt, even if it exceeds the current £50,000 limit for compensation.

If a borrower had a £500,000 mortgage and £100,000 in sav-

ings, their entire savings would be used to offset their debt, meaning they owed £400,000. From December 31, the scheme will move to a system of "gross payouts" in which savings will not cancel out debt. Savers are to be compensated up to the new higher limit of €100,000, about £85,000 but deposits above the compensation limit will be lost for good.

So, in the example above, the saver would get back £85,000 of their £100,000 savings, meaning they would still owe £415,000 once this had been offset against their debt — so they would be £15,000 worse off under the new rules.

Offset customers are likely to be hit hardest as they have an incentive to put as much of their savings as possible in one place — although couples with a loan in joint names would be protected up to £170,000.

The FSCS said: "From the end of 2010 the scheme will pay compensation on a gross basis if a bank, building society or credit union fails, so set off will no longer be applied."

Brokers have criticised the FSCS and the institutions for failing to alert customers. First Direct and Lloyds Banking Group, owner of Scottish Widows and Intelligent Finance, one of the earliest offset providers, confirmed they had not highlighted the issue. Santander said it did not think that its customers were at risk because it operated offset mortgages like a single overdraft, rather than using linked deposit accounts.

David Hollingworth at London & Country Mortgages, the broker, said: "As it stands, offset customers are fully protected and that will not be the case from the beginning of next year. In practical terms, lenders will need to make it very clear to borrowers that the rules will change."

Ray Boulger at John Charcol, the broker, said: "Borrowers with large amounts of savings will need to take this on board and it will certainly reduce the attractions of offsets for some borrowers. However, in many ways it is more of a theoretical risk than a practical risk."

Melanie Bien at Private Finance, another broker, said: "Borrowers may be better off using anything above £85,000 to pay off a chunk of the mortgage rather than keep it in an account linked to their offset."

Offset borrowers typically hold savings equivalent to 20% of their loan in a linked account. The deals are popular with buy-to-let landlords, who hold rental payments in offset accounts to cut the interest bill on their residential mortgages.

They are also popular with wealthier borrowers, who would otherwise earn a low interest rate in a deposit account. By offsetting the cash against their loan, they are in effect earning its gross rate on their savings.

However, the sharp fall in mortgage rates has reduced the benefit of offset deals, which are typically more expensive than standard loans.



Flexibility is the key

SARAH GREENWOOD, 50, from Brixton, south London, remortgaged last month so she could renovate her home in a converted 19th-century school. Cost was not the main

concern of the film production designer, who chose an offset deal through largemortgages.com. "As a freelance, I needed a deal that was flexible," she said.

extended the availability of its two-year tracker at 1.49 points above Bank rate, so 1.99%, with a £999 fee, while Santander introduced a 2.09% deal last week with a £999 fee. Both require a 40% deposit.

With the best instant-access rate at 2.99% from Nationwide building society, a higher-rate taxpayer with a £500,000 mortgage and £100,000 savings in an offset account would save almost £2,000 after higher-rate tax and arrangement fees by opting for the RBS deal and the Nationwide instant access account separately.

The RBS repayments would be £19,900 over two years and the savings would earn £3,588 after tax for a higher-rate payer (£4,664 at the basic rate), giving a total cost with fees of £17,311.

The best-buy offset deal is from First Direct, costing 2.39% for the life of the loan, with a

£99 fee, available to those with a 35% deposit. The cost for someone offsetting £100,000 of savings would be £19,219 over two years — so £1,908 more than if they held their savings and mortgage separately.

Those who were willing to put their cash in the market-leading two-year fixed-rate bond, currently paying 3.65% from the Post Office, would save even more. Higher-rate taxpayers would earn £4,380 in two years after tax (£5,694 at the basic rate), resulting in a lower total cost of £16,519. They would be £2,700 better off than if they had held their savings and mortgage in the offset deal.

Ian Gray at largemortgages.com, the broker, said: "The less savings you have as a proportion of your loan, the better it is to opt for a market-leading mortgage deal, putting

your savings in a deposit account. However, if you have a higher level of savings, the benefits of offsetting begin to outweigh the higher interest rate charged on offset deals.

"You don't have to worry about paying income tax on your savings. It also means you don't have to fish round for competitive savings rates when the return on your savings account inevitably falls."

Boulger said: "Look at what is likely to be your average balance over the year and the way you use those savings, which determines whether it is better to offset."

A number of lenders offer offset deals but the terms vary. For example, Clydesdale and Yorkshire banks insists borrowers are charged a fixed repayment each month, even if an increase in savings has cut the interest due on the loan.

WHEN THE DEALS PAY OFF

Size of mortgage	Size of saving	Cost of offset	Cost with separate savings	Verdict
£200,000	£50,000	£7,269	£7,165	£104 better off with separate savings
£200,000	£100,000	£4,879	£5,371	£492 better off with offset
£500,000	£100,000	£19,219	£17,311	£1,908 better off with separate savings

Based on an offset at 2.39% with a £99 fee compared to a tracker at 1.99% with a £999 fee and an instant access account paying 2.99% net of higher-rate tax. Source: largemortgages.com