

Offsetting behaviour

Executive Summary

- The potential advantages of offset mortgages include flexibility and financial savings for borrowers and better customer retention for lenders.
- While offset mortgages have not matched the popularity they enjoy in Australia, they have nevertheless become an important part of the mainstream mortgage market in the UK.
- Numerous lenders have introduced offset products in the past few years, encouraging further product innovation and segmentation of the market. Newer offerings include offset products tailored to the self-cert and buy to let sectors, as well as family offset products that allow the savings of parents or other relatives to offset some of the mortgage costs facing first-time buyers.
- The vast majority of firms offer simpler offset products rather than current account mortgages.
- Helped by higher sales via intermediaries, offsets have recently experienced much stronger year-on-year growth than the mortgage market as a whole. Lenders advanced offset mortgages totalling £23.9 billion in 2006, representing 7% of gross new mortgage lending.
- Offset borrowers still tend to be older and to have higher incomes than those taking out other mortgage products, but the earlier dominance of remortgages has fallen away as offsets have become more popular with house purchasers.

Introduction

Offset mortgages are those that combine the balances in a borrower's mortgage account and savings account, whilst allowing these accounts to be managed separately. In their simplest form, no interest is payable on any savings balance but the amount held as savings is offset against, and so reduces, the mortgage balance for the purposes of calculating interest charges.

As with other mortgage products, there are many variations around this basic theme. Current account mortgages (CAMs) are a specialised form, by virtue of also incorporating a bank current account. But CAMs work along broadly similar lines to other offset products, and they are included in this article unless otherwise stated.

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Offset mortgages offer a number of potential benefits for borrowers:

- Lower total interest payments and shorter mortgage term as interest is charged against a reduced mortgage balance.

- Flexibility – as well as being able to withdraw their savings at any time, offset mortgages provide a range of opportunities for borrowers to make over- and under-payment, take payment holidays and sometimes draw down previous capital repayments.
- Tax efficiency – in effect, any savings balance earns a rate of interest equivalent, or similar to, the mortgage rate, but no income tax is payable.
- Cushion against interest rate rises – any savings balance serves to reduce interest costs, and this potentially helps to mitigate the impact on mortgage payments arising from higher interest rates.

Offset mortgages also convey a number of advantages for lenders, over and above the general one of complementing the product range, by virtue of sitting well with the financial circumstances and life styles of some households.

By requiring consumers to hold both mortgage and savings accounts with the same firm, offsets are likely to be positive for customer retention. Offset borrowers tend to be more financially astute and more likely to own complex financial products (O’Leary and Farquhar, 2003) than others, and this should also enhance opportunities for the cross-selling of financial products.

Lenders first introduced offset mortgages into the UK in the late 1990s, amid high expectations that they would enjoy the same success as in the Australian market. This article aims to explore how offset mortgages have performed in comparison to the wider market, the characteristics of offset borrowers and future prospects for the sector.

Market developments

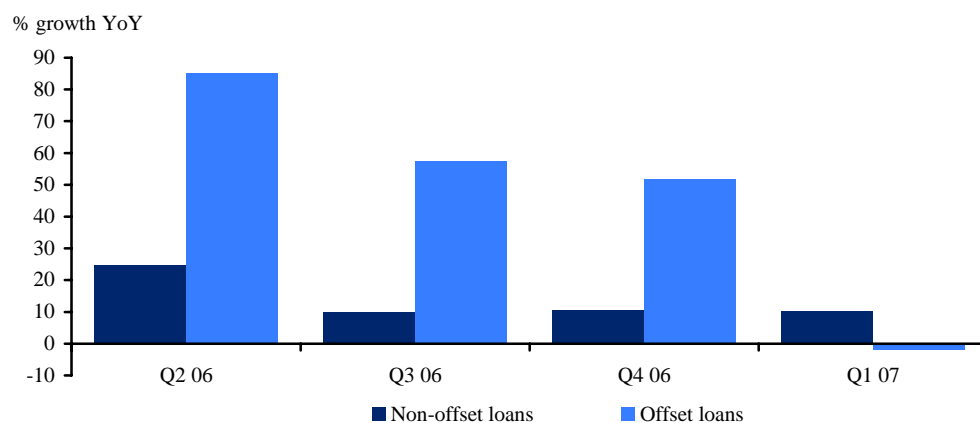
Market size and growth

Results from the Survey of English Housing¹ suggest that about 8% of owners with a mortgage have an offset product. We estimate that 170,000 offset mortgages worth £23.9 billion were taken out in 2006². This represented roughly 7% of all new mortgage advances.

From a standing start 10 years ago, such market penetration is impressive, but it falls well short of the Australian experience – where offsets are believed to have accounted for almost 50% of the market (Bird, 2005). It is also substantially lower than some market expectations, for example Datamonitor which foresaw offsets reaching a 30% market share by 2009 (Datamonitor, 2005).

Monthly data from the Regulated Mortgage Survey³ suggests that the offset market has recently been growing rapidly (Chart 1). The average year-on-year growth (by value) for the months April 2006 to March 2007 is 49%, much stronger than the 15% seen for non-offset lending.

Chart 1: Total gross advances for offset and other mortgages

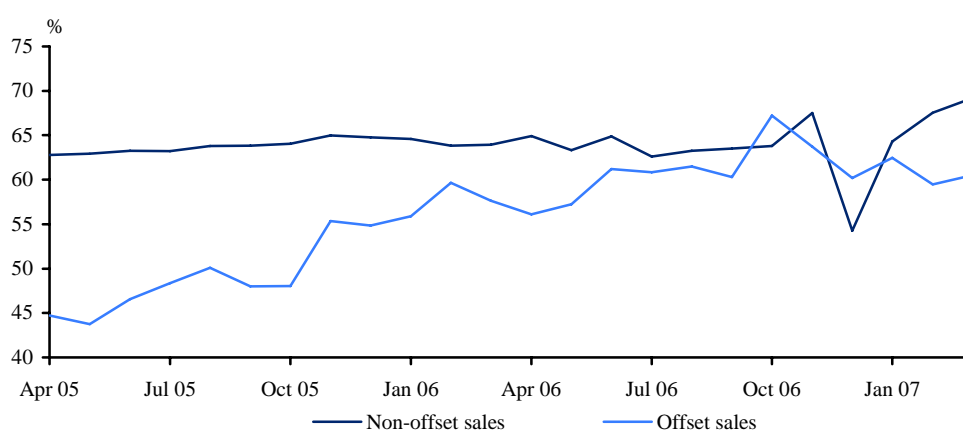


Source: CML/BankSearch Regulated Mortgage Survey

A wide range of factors has contributed to offset mortgages becoming mainstream products. Intensive marketing activities by a few large lenders have undoubtedly promoted awareness of these products. According to a 2005 research report by ICM⁴, 60% of UK home-owners knew about offset mortgages, more than double the 25% in 2000⁵.

Offset mortgages have also become more firmly entrenched with the intermediary sector, with positive benefits for consumer understanding and sales. Over the past two years, intermediary sales of offset products have seen year-on-year growth exceeding 100% in some months. By the end of 2006, intermediaries accounted for 60% of offset sales by value, compared to 45% in April 2005 – broadly reaching a par with the wider non-offset market (Chart 2).

Chart 2: The proportion of lending via intermediaries



Source: CML/BankSearch Regulated Mortgage Survey

Notes: One large offset lender only started to provide data in November 2005.

This spectacular growth in sales of offset products by intermediaries may appear surprising, given that the lenders are likely to retain mortgage customers for longer than with other products.

But anecdotal evidence suggests that lenders have worked hard to nurture their relationships with intermediaries, explaining how offset products can align with their business models and the benefits of such products for their clients.

Innovation and product development

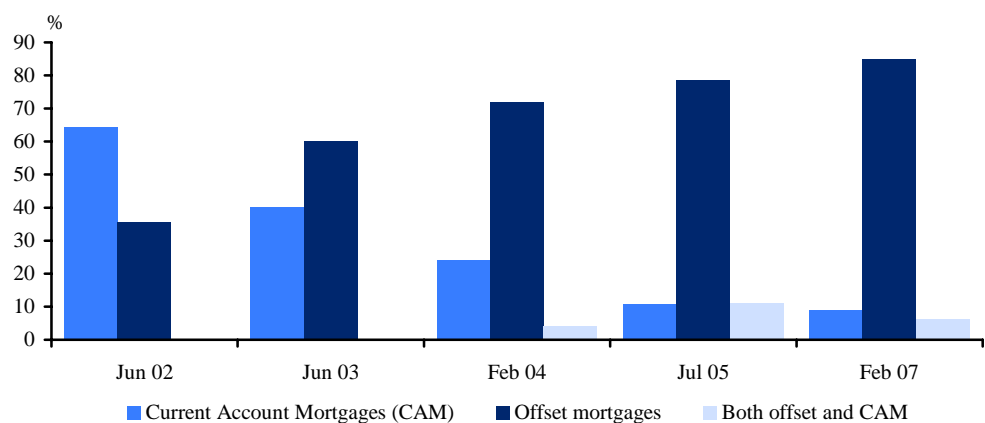
As with other parts of the mortgage market, there has been significant product innovation in the offset market.

The first UK offset products were current account mortgages (CAM), introduced in 1997. Simpler offset mortgages, not linked to bank current accounts, followed in 1999.

The number of products and range of providers has mushroomed in recent years. Currently, there are about 250 offset products in the market (Moneyfacts, Feb 2007). The number of lenders has grown more than five-fold over the past decade. Most of these provide simple offset products (as opposed to CAMs) – according to Moneyfacts, 85% of lenders active in the offset market in early 2007 offered simple offset mortgages, compared to 33% at the end of 2000 (see Chart 3).

We do not have figures showing actual rates of take-up of CAMs versus simple offset products, but it is not surprising that most lenders have opted to introduce the simpler offset products as these avoid the complications of providing full retail banking facilities. The simpler products may also better reflect consumers' preference for managing their finances in separate buckets.

Chart 3: The proportion of offset lenders providing CAM and simple offset products



Source: Moneyfacts

Some lenders have added extra features or extended the offset concept to target different niche segments of the market.

Echoing developments in the Australian market, some firms have positioned their offset products as financial management or debt consolidation tools (O'Leary and Farquhar, 2003), by incorporating links to unsecured loans or credit cards that charge favourable rates of interest based on the mortgage rate. At present, there are 35 such products in the UK offset market.

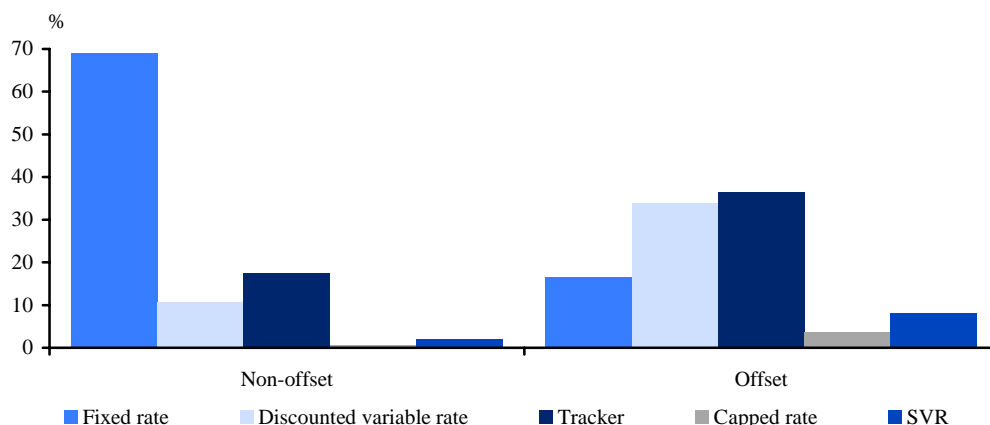
The flexibility and other benefits of offset mortgages would seem instinctively attractive to the self-employed, given the potential for their earnings to vary from month to month. Aiming at this particular group, some lenders combine their self-certified products with offset features. There are currently some 20 of these products available.

Elsewhere, some providers have targeted the buoyant buy-to-let market by building offset features into their buy-to-let products. For these mortgages, borrowers can pay or overpay their regular rental income into their savings or current accounts to offset the outstanding mortgage balances. Currently, there are only five offset buy-to-let loans in the market, but there is potential for this to expand.

Although offset products are most readily associated with home movers and remortgagors, there are now several products that specifically cater for first-time buyers. These include the 'family offset' which allows the borrower's family or friends to use their saving balances to offset the borrower's mortgage debts.

Historically, all offset mortgages were at variable rates, and although the majority still are (Moneyfacts, 2007), there has been a substantial shift here too. Our Regulated Mortgage Survey shows that variable rate products – mainly tracker and discounted - accounted for 80% of offset loans in 2006. Fixed-rate loans represented only 16% of offset lending compared to 69% for non-offset (Chart 4). But growth for fixed-rate offset was on average twice that seen for variable rate lending, reflecting more fixed rate offset offerings in the market.

Chart 4: Lending by type of interest rates in 2006, % of loans



Source: CML/BankSearch Regulated Mortgage Survey

Borrower profile

When offset mortgages were first introduced, the early adopters of these products were slightly older, higher income individuals. This reflects factors such as the higher financial savings likely to be associated with this group, more financial sophistication and the greater value of the tax efficiency on savings for higher-rate taxpayers.

Interestingly, as Table 1 shows, borrowers still continue to be older and have higher incomes. And on average they purchase more expensive properties with larger advances. But because of their stronger financial position, they are less constrained in terms of affordability, with typically lower loan-to-value ratio and income multiple. So despite the fact that offset mortgages are generally a little more expensive – with average interest rate charged 0.12% higher than non-offset loans, debt servicing cost as a proportion of income is still lower than for other borrowers.

Table 1: Borrower profile in 2006

	Age	Purchase Price	Loan Amount	Gross Income	Loan to Value	Income multiple	Initial Gross Interest Rate	Initial mortgage interest payments as a % of income
	Median	£	£	£	%	Ratio	%	%
Offset	41	225,458	121,223	49,143	57.5	2.56	5.13	13.1
Non-offset	38	164,972	103,724	38,245	68.7	2.82	5.01	14.0

Source: CML/BankSearch Regulated Mortgage Survey

Although offset lending is traditionally dominated by remortgage borrowers (O'Leary and Farquhar, 2003), there has also been considerable house purchase related activity recently. Most of this relates to those moving house (83% by value in 2006) rather than first-time buyers.

Throughout 2006, house purchase offset loans have achieved double the growth seen for remortgages and gone up sharply as a proportion of all offset lending from 34% to 50% by the year-end.

As discussed above, offset mortgages continue to be attractive to borrowers who are self-employed or have irregular working patterns. RMS shows that 21% of offset borrowers in 2006 were self-employed, compared to the 16% for non-offset borrowers. The self-employed workforce has grown by about 11% in the last nine years⁶, bringing with it an increased potential customer base for whom offset is particularly well-suited.

Concluding remarks

The marketing efforts of several large lenders have raised consumer awareness and improved understanding of offset mortgages, making it easier for other lenders to subsequently enter this market. The number of offset mortgage providers has risen more than five-fold over the past six years, bringing increased diversity in the number and type of products in this market. The apparent conversion of intermediaries to the cause serves to confirm that offset mortgages are now very much part of the mainstream market and an important element of lenders' product mix. Although additional efforts are needed to communicate the benefits of offset products to borrowers, they have the potential to raise fewer TCF ("treating customers fairly") issues with regulators. With continuing innovation, lenders seem likely to enhance the market potential for offsets further over the medium- to long-term.

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Endnotes

- ¹ The Survey of English Housing collects data from 20,000 households across the UK each year. The sample coverage for the survey item on offset mortgages was around 8,000. The figures used in this article relate to the period Q2 05 – Q1 06.
- ² The CML estimates on offset gross advances are based on the combined figures from the Regulated Mortgage Survey and the section of the offset market that does not contribute to the RMS, which did provide headline figures for this article.
- ³ The RMS started in April 2005 and collects data on all new regulated mortgages, that includes house purchases, remortgages and lifetime mortgages, but exclude buy-to-let and further advances. The RMS has about 75% coverage for the offset mortgage market.
- ⁴ The Intelligence Finance commissioned research was undertaken by ICM, which interviewed a cross-section of 1007 UK adults aged 18 and over.
- ⁵ The 2000 research report was by Future Foundation, commissioned by Virgin One.
- ⁶ National Statistics' Labour Force Survey – data available in calendar quarters only goes back to 1997.

Further information on Housing Finance

Housing Finance is an authoritative online journal which provides in-depth articles on a wide range of mortgage related issues. For free online access to other recent articles and a subject index see <http://www.cml.org.uk/cml/publications/research>. A package of CML Statistics that complement Housing Finance online is free to members and associates or can be subscribed to by non-members (for details see <http://www.cml.org.uk/cml/statistics/statsub>). For further information on Housing Finance articles contact the editor Bob Pannell at bob.pannell@cml.org.uk.