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Are offset loans still a better bet than saving?

With deposit rates up and mortgages down, it could be time to reassess. Basic-rate taxpayers could do better with a savings deal

Alexandra Goss Published: 29 January 2012



Neil and Prudence Oviatt moved to a two-year fixed offset from Accord (Adrian Sherratt)

Borrowers who pay basic-rate tax may be better off avoiding offset mortgages and taking advantage of top savings deals instead.

In the past, offset deals were good for most homebuyers because they set savings against their debt, with interest paid only on the difference. This allows the mortgage to be paid off earlier and, as you avoid paying tax on the savings, it has been considered one of the most efficient ways to use cash.

However, an increase in savings rates, combined with a fall in mortgage rates over the past year, has led experts to question the merits of offsetting for some borrowers.

The average interest rate on offset deals has fallen from 4.17% to 3.84% since January last year, said Moneyfacts, the comparison site, while the average instant-access savings rate rose from 0.83% to 0.91%.

The lowest rate on an offset deal at present is 2.18% for a two-year tracker from First Direct, compared with 2.59% in January 2010. A higher-rate taxpayer would have to find an instant-access savings account paying 3.63% before tax to be better off than with the First Direct deal, while a basic-rate taxpayer would need one paying 2.73%. In January 2010, the equivalent returns required would have been 4.32% and 3.24% respectively.

Basic-rate taxpayers can easily do better than 2.73%. The best instant-access account without a bonus is from Virgin Money at 2.85%. A borrower paying the basic rate could be more than £800 better off by choosing a standard mortgage and saving with Virgin instead, according to London & Country Mortgages, the broker.

However, higher-rate taxpayers will struggle to find a savings account to beat an offset. The best instant-access deal is from Santander at 3.1%, but this includes a bonus, so it drops to only 0.5% after a year.

Those who want to take out an offset may need to act sooner rather than later as lenders have been raising rates.

Woolwich, for example, imposed a 0.2 percentage point rise last week. Its two-year offset tracker rose to Bank rate plus 2.79 points, so 3.29%, while its lifetime tracker increased to Bank rate plus 3.39 points, so 3.89%. The deals are available to those with a 30% deposit or equity.

Basic-rate taxpayers

Suppose you took out the First Direct offset deal at 2.18% for two years, which is available to borrowers with a deposit or equity of at least 35% and has a £1,499 arrangement fee. Monthly payments on a £200,000 loan would be £865. If you put £50,000 in the linked offset account you would pay interest only on the remaining £150,000, saving £2,226 over two years.

If, instead, you chose a standard two-year tracker from First Direct at 1.99% (35% deposit or equity required, £1,499 fee) and saved £50,000 in the Virgin Money account, you would earn £2,306 in interest after tax after two years. Your monthly payments would also be £447 less over the two years because of the lower rate, so a total saving of £2,753.

You would have reduced your debt £1,929 less than with the offset, but this still leaves you a total of £824 better off than with the offset deal.

David Hollingworth at L&C said: “Even when you account for the fact that you would have reduced the mortgage balance more significantly in the offset deal, you would still save an extra £824 with the standard deal. However, whether you are truly better off will depend on individual circumstances, such as the amount of savings you have, and the margin between offset rates and standard ones.”

Higher top-rate payers

Offset loans are still a good deal for those paying higher rates of tax, according to the experts. Hollingworth said: “You would need to be paying a mortgage rate of less than 2.28% as a basic-rate taxpayer, 1.71% as a higher-rate taxpayer and 1.43% as a top-rate taxpayer to be better off putting your cash in the Virgin savings account rather than offsetting or overpaying your mortgage.

“There are no new deals that offer rates of less than 1.71%, although some borrowers with older trackers taken out before the credit crunch could be paying less than this.”

Ian Gray at largemortgageloans.com, the broker, said: “The higher your marginal tax rate, the more offset mortgages make sense.

“You also need to ensure that you are taking full advantage of the offset in terms of the balance you maintain in your account.”

For an offset to be better value than an instant-access savings account paying 2.85%, Gray said, a higher-rate taxpayer with a £200,000 mortgage would need to place more than £81,000 in the offset account, while a top-rate taxpayer would have to deposit more than £50,500.

RETURNS FROM OFFSETTING			
The gross returns required from a savings account to beat the benefits of offsetting			
Mortgage rate	Basic-rate taxpayer	Higher-rate taxpayer	Top-rate taxpayer
2%	2.5%	3.33%	4%
2.5%	3.13%	4.17%	5%
3%	3.75%	5%	6%
3.5%	4.38%	5.83%	7%
4%	5%	6.67%	8%
4.5%	5.63%	7.5%	9%

Source: L&C Mortgages

Existing offsets

Those who took out offsets before the credit crunch, and are on exceptionally low rates, would be better off withdrawing the cash from the offset account and putting it in a top-paying savings account, even if they pay 40% or 50% tax, said Ray Boulger at John Charcol, the broker.

He said: “Borrowers who took out deals from the likes of Intelligent Finance and Woolwich at Bank rate plus 0.5% — so a current rate of 1% — will earn better returns in an instant-access account, and can always transfer the money back into the offset when mortgage rates rise.”

Boulger said that withdrawing £50,000 from an offset account on a £200,000 loan would increase your mortgage payments by £500 a year.

However, if you deposited the £50,000 in the Virgin account paying 2.85% you would earn gross interest of £1,425, which is £855 net of 40% tax and £713 net of 50% tax.

“This means you get net benefits of £355 and £213 a year respectively for every £50,000 of savings,” Boulger said.

The self-employed

Offset loans are popular with the self-employed, who may accumulate funds throughout the year to pay their tax bills, brokers said.

Rather than gathering dust in a current account, the money can be used to cut their monthly mortgage payments before finally being handed to HM Revenue & Customs.

For instance, a 40% taxpayer with a £200,000 offset mortgage at an average rate of 3.84%, who held £50,000 in unpaid tax against his or her loan for six months, would cut their interest bill by £384 a year, saving £3,840 over 10 years, according to figures from Knight Frank Finance, the broker.

Aaron Strutt at Trinity Financial, another broker, added: “Borrowers with large amounts of cash moving through their accounts, such as landlords, often use offset loans. They can also be useful for those who need to draw down money at regular intervals, such as parents paying school fees.”

Offset v overpay?

Overpaying your mortgage, rather than taking a bespoke offset deal, creates the same effective returns — but may give less flexibility.

Hollingworth said: “The cautionary point with overpaying is that access to that cash at a later date will usually require a remortgage or application for a further advance. It therefore makes sense not to pour all your cash into repaying the mortgage and, if future access is a requirement, then offset is likely to be the preferred product.”

Most of the large lenders allow borrowers to repay up to 10% of their outstanding balances each year without triggering a penalty.

Case study: Smart way to draw pay

Neil Oviatt, 37, and wife Prudence, 34, a financial services worker, moved from a 4.89% fix to a two-year fixed offset from Accord, part of Yorkshire building society, at 3.09%.

Oviatt, the director of a recruitment company in Bristol, said: “I take dividends from my business annually and put those in the offset account, giving me a much higher effective return than from a savings account.

“We appreciate the flexibility of the offset and we are saving £400 a month on repayments.”

The couple, whose daughter Darcey is four weeks old, found their loan through L&C, the broker.