Flexible Mortgages: The Product for the Next Millenium?

by Chris Heard and Peter Williams

INTRODUCTION

It is quite clear that there are few universal truths about mortgage products. Market circumstances vary considerably between countries and what works in one might not work elsewhere. However, it is true that in broad terms there is a move to more flexible forms of working in most countries. This may take the form of contract working, part-time working and self-employment. It may also relate to maternity or other job breaks.

These emerging patterns must be viewed against an established high level of homeownership in some countries or on-going rises in others, against real interest rates and increased price/income ratios. The combination of high or increasing homeownership and changing job markets poses significant challenges for borrowers and lenders.

Clearly, the response to these types of conditions, where they occur, will vary. For countries where borrowers are required to put down a substantial deposit, the lower gearing may mean lenders are more able to tolerate periods of reduced payment. However, in other countries where there is less capacity to do this or less incentive to retain debt (because, for example, there is no tax relief on mortgage interest—see Freeman et al, 1997), the potential demand for more flexible mortgage products may be considerable. This article will explain how more flexible mortgaging is developing in the United Kingdom.

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THE U.K. MORTGAGE MARKET

Over the last decade the U.K. mortgage market has been characterized by intense competition and significant innovation. The two are clearly related, and there is every expectation that competition will further intensify and that innovation will continue apace. Competition has been characterized by not only mergers, takeovers, conversions and new entrants but also by discounting and cashbacks. This in turn has created a new concern with customer retention and an ever greater concern with raising the standards of service and better tailoring products to customer needs. New entrants to the market have been quick to introduce flexible products but otherwise offer a limited product range.

Recognizing the development of the more flexible labor market, lenders have been giving increasing attention to the need to create mortgage products which allow consumers to adjust their mortgage payments in line with labor market circumstances. Initially these were largely modifications of existing products (for example, the baby break or the negative equity mortgage), but in the last two years more radical developments in flexible mortgaging have taken place as market competition has intensified.

Flexibility can take a variety of forms, including the capacity to pay back more quickly, to suspend payments and effectively to convert the mortgage account into a current (checking) account. The current account mortgage (CAM) is where some in the industry are now focusing and is the subject of this article.

Another recent arrival, the shared appreciation mortgage (SAM), offers a different sort of flexibility and is not considered here. As the name implies, the borrower shares part of the appreciation on the value of the dwelling with the mortgage lender in return for having a low- or no-interest loan.

COMPETITION

In the mid- to late-1980s, it was possible to win mortgage market share in the U.K. by offering small discounts for short periods. However, in the 1990s, with substantially lower new business volumes and the renewed interest of the over-capitalized clearing banks, mortgage supply has outstripped demand, leading to an intensification of discounting and a growing practice of remortgaging to lower rates.

It is not unusual today to find 6% cashbacks or equivalent discounts from the standard

variable rate being charged on a mortgage. Heavily subsidized fixed rates are also freely available. To protect themselves lenders have been forced to re-introduce heavy early redemption penalties. While on balance this has been of benefit to new borrowers, inertia pricing has meant that existing borrowers and retail savers have fared less well. Not surprisingly, the regulatory authorities, the media and customers themselves are becoming increasingly critical of these short-sighted pricing strategies.

Those lenders that have rejected artificially low pricing have seen their market share fall rapidly, although recently developed loyalty schemes have helped slow the exodus of more profitable existing borrowers. At the same time, there has been an intensification of the battle for retail savings with the growth of postal accounts and the entry of the supermarkets.

All of these factors will in time force lenders to reduce the level of new business subsidies. In the interim, however, some lenders have sought refuge in niche products such as impaired credit and "buy to let" mortgages, the popularity of which owes much to the deep recession of the early 1990s.[1] An increasing number of lenders, around 20 at the last count, have also developed flexible mortgage products.

THE FLEXIBLE MORTGAGE

The pressure to find new market niches, retain customers and maintain more acceptable new business spreads, has moved some lenders to redesign the mortgage contract to give significantly increased flexibility, increased borrower control and substantial long-term interest savings. Part of the rationale for doing so lay in the recognition that there was a need to adjust to the increasing trend towards more flexible but uncertain employment patterns and that demand for a different type of mortgage was building.

While flexible mortgages currently struggle to compete with the powerful short-term attractions of big discounts and heavily subsidized fixed rates, for the reasons outlined above it is perhaps only a matter of time before these artificially low new mortgage rates are withdrawn.

It is then that flexible mortgages can be expected to capture serious market share. There are a number of reasons for this: first, the vast majority of borrowers is now more risk averse; second, most borrowers now recognize that houses are for living in and not a speculative investment; and third, that with reduced mortgage interest tax relief and low inflation, mortgages are a necessary evil but there is considerable sense in paying them down as quickly as possible.

PRODUCT CONCEPTS

Unlike conventional mortgages, which make it difficult to accelerate or make ad hoc monthly payments, most flexible mortgages make this a freely available option. The real incentive to prepay, however, lies in the ease of access to those prepayments. By positioning the account as a real alternative to instant access savings accounts, flexible lenders are able to demonstrate extremely attractive returns on these "savings" (see Table 1).

In other words, for an extra £154.36 per month, this borrower reduces the term by nine years and saves £54,487 in interest.

A key principle of flexible mortgages is that all the borrower's cash flow and savings are automatically being put to use. The golden rule is that customers should repay debt in preference to leaving money in a current account or saving in accounts where income is taxable. (There is only minimal tax relief on mortgage interest in the U.K.) Interest paid is often very low or nonexistent. Lenders with a genuine concern for the best interests of their customers might take more of a lead in re-educating customers on the virtues of debt reduction, although it is a point not lost on today's borrowers with higher interest rates and an economy moving towards recession.

Few, if any, instantly accessible savings vehicles will yield constant, after tax interest at a sufficient level to outperform interest on a

Table 1. Flexible Loan 'Saving'

Using the example of a £100,000 mortgage, repaid by principal and interest over 25 years at an assumed stable interest rate of 8%. Interest monthly in arrears. Prepayments benefit from daily rests.[2]

Normal Monthly Repayment	*Resultant Term (months)*	*Monthly Over-payment*	*Interest Charge Over Term*	*Interest Saved*	*% Term Redution*	*Interest Saving*
£771.82	300	Nil	£132,012	Nil	Nil	Nil
£810.41	261	+ 5%	£111,280	£20,732	13%	15.70%
£849.00	232	+10%	£96,810	£35,202	22.67%	26.67%
£887.59	210	+15%	£85,988	£46,024	30%	34.86%
£926.18	192	+20%	£77,525	£54,487	36%	41.27%

mortgage. The only exceptions, over the longer term, are equity based investments; and here the borrower will need to decide whether the tax-free or after-tax return on these is likely to yield a sufficient premium over long-term average mortgage rates to justify the risk of capital losses.

Current Account Mortgage

The most developed form of flexible mortgage is the so called "Current Account Mortgage" (CAM). Pioneered by the small lender, Mortgage Trust, and recently adopted by one of the new direct mortgage providers, Virgin, as its primary vehicle for an assault on the mortgage and banking market, this product offers an all-purpose revolving credit facility combined with full banking service (provided in partnership with a major lender, the Royal Bank of Scotland).

Operating on a daily rest basis, this account accepts salary credits and other repayments of any amount at any time, with immediate access to these prepayments via the full range of money transmission options, including direct debits, standing orders, ATM access to cash at home and abroad, debit card/check guarantee card and checkbook. This account therefore removes the need to move money around between different accounts in order to avoid overdraft interest or excess balances lying idle.

Uncertainty or Peace of Mind?

While customers may initially feel nervous about putting all of their eggs in one basket until the concept is firmly established and service is fully proven, there is no denying the peace of mind that can come from knowing that all cash flow and savings are being put to use. A borrower with a £100,000 mortgage who repays £15,000 from savings at the start of the loan automatically shortens the mortgage term and achieves substantial savings in monthly outgoings in later years. Such a borrower may also secure the right to reduce payments, for example, during a period of reduced income, higher expenditure or interest-rate increase, paying what they can, when they can, until such time as their credit facility has been fully used up or any government safety net cuts in. This is seen as preferable to having to go "cap in hand" to the lender for a concessionary reduction in repayments and, in the event of redundancy, the flexible mortgage makes the perfect home for their redundancy check.

While the more elementary forms of flexible mortgage now offered provide "baby breaks," Christmas repayment holidays or summer breaks, the truly flexible mortgage incorporates all of these without any of the restrictions that apply to narrower specified purpose schemes. Prepayment creates the right to further credit in the same way as saving in a traditional savings account gives savers the right to withdraw that cash at any time and with no questions asked. The one area where lenders have understandably been more cautious is the "right" to underpay when in financial difficulties. This has typically been by agreement.

It must be recognized that flexible mortgages do make demands upon the consumer. Managing the mortgage account is not what most borrowers have been used to, and there clearly are questions of skills and awareness as well as financial discipline. Lenders recognize this and have been careful in their screening of applicants. However, it is evident from experience that borrowers do learn and quickly become comfortable with more flexible arrangements.

FUTURE DEVELOPMENTS

Where do flexible mortgages go next? Sensible financial planning also includes the appropriate use of a number of related insurance and interest-rate-risk management products. For example, borrowers concerned about the risk of interest rates rising above a certain critical level should be able to buy interest-rate caps from the lender covering all or some of their current balance.

Where the lender finds it difficult to offer these facilities at competitive prices they might be better served acting as a retailer of other more competitive offerings in order to retain the custom and trust of their customers. The convenience of purchasing these from the flexible mortgage provider, debiting their cost to the integrated account and keeping track of these and other purchases via a single monthly statement, will be an attractive feature. For the customer using the full flexibility of a CAM, the basic mortgage statement will look much like today's bank statement, listing all income credits and outgoing debits and the resulting balance.

Single Statement Potential

The statement could also provide, in a single point of reference each month, a summary of all other financial services purchased. This might include pension and other investment valuations and details of any insurance whose premiums will have passed across the unified account. Providing that the customer felt they were getting acceptable value on each product purchased, the unified statement would be a powerful incentive to buy more products from the trusted supplier.

The ultimate statement, provided by E-mail or on disc for those who prefer it, will be able to be sub-analyzed into expenditure categories to give a better understanding of family finances. A further enhancement would be to import the statement contents into a home finance management package, such as Microsoft Money, perhaps provided free by the lender as part of the mortgage package.

THE MARKET POTENTIAL

In an age when customers are demanding ever increasing value for money on all their purchases, it must only be a question of time before the major lenders, insurance companies and other retailers wake up to the potential of the wealth-creating CAM, with its monthly statement as the lynchpin for the sale of their full range of products. It is estimated that flexible mortgages (excluding shared appreciation mortgages) took about £1.25 billion of business in 1997 (i.e., less than 2% of the total gross lending) but that this will probably quadruple in 1998.

The creation of genuine long-term customer loyalty and reduced sales costs on subsequent product sales will also reduce supplier's costs, some of which can be passed on to the client to improve product value, creating a virtuous circle. In other words, the unified monthly statement will play an important part in creating the golden scenario of multiple product sales and customers for life that most big financial services companies are apparently striving for.

Short-term Preference

In the short term, however, most lenders see a greater attraction in maintaining multiple secured and unsecured personal loan and credit card products, at significantly higher margins, than to give their customers the benefit of the lower rates to which the security of their property and other chargeable assets entitles them.

Who are the early users of this new mortgage product? Early evidence points to those with substantial but irregular income, such as the successful self-employed and those on substantial annual bonuses. The flexible mortgage provides a tax-efficient home for bonuses or irregular income, enabling cash flows to be smoothed during the following year.

For the self-employed paying lumpy VAT, income tax or other bills at a later date, this form of temporary saving maximizes their return and eliminates all the problems of operating a separate account and having to account for taxable interest when filling in one's tax return. Even for more ordinary income earners, the savings mechanism can provide a valuable vehicle for dealing with periodically higher spending, such as Christmas, holidays or the purchase of capital items such as the family car.

More Innovation Possible

This committed facility need not arise only through prepayments, of course. If borrowers have sufficient equity and income, they should be able to arrange an additional undrawn facility at the outset or at any time during the duration of the loan. This is an area where there remains excellent scope for further innovation from lenders–perhaps index linking property values, if this was the restricting factor, or updating the available facility annually in response to reconfirmed income. When carefully targeted, a regularly increased facility provides significant additional comfort from the borrower's perceived risks.

The creation and extension of instant credit facilities opens up some interesting new options for borrowers, particularly for the more active investors. Such a facility will make it easier to buy and sell shares or property at times when the net returns look capable of outperforming the mortgage rate, the proceeds of sale being returned to the account at a later date for reuse, or simply to reduce the term still further.

CONCLUSIONS

In the final analysis, customers will continue to search for increased value in all their purchases and some are now aware that there are other ways of managing their finances. As they and those that advise them become better informed, it is almost inevitable that demand for these products will grow.

The U.K. mortgage market is thus seeing a greater spread of product types which reflect the lenders' desire to meet the needs of an ever more segmented market. Further innovation will take place, but there are perhaps two cautionary points to make. First, consumer demand still seems to be lagging behind product development. The U.K. consumer is particularly focused on price and, despite the added benefits of CAMs, the fact that other simpler and cheaper products are available has meant that acceptance has perhaps been slower than some have anticipated. The evidence suggests this is now changing. A recent Council of Mortgage Lenders (CML) survey pointed to a significant appetite from consumers for greater flexibility.

Second, it must be recognized that for the largest providers the creation and operation of new flexible mortgages have considerable implications for established computer systems. With a large existing customer base to service, the rate of change for the largest lenders is understandably slower. However, given the competition which exists, we can expect significant developments in 1998 and 1999, and the entry of the largest players in the market will also impact upon innovation and pricing.

The prospect therefore is for continuing development of flexible mortgages. Flexible mortgages, alongside the better selling of mortgages which the CML's Mortgage Code is bringing to the market, does suggest the consumer will be both better informed and better able to ride the economic and domestic cycle.

Flexible mortgages provide one element in an array of products and procedures which help households to enter into and sustain homeownership. Such mortgages cannot

solve all of the problems households may face, nor will all households choose to have them. Other developments which give borrowers greater control through mechanisms such as annual review schemes and fixed-rate mortgages are also important. Changing mortgages in line with circumstances has been eased and lender forbearance is a standard procedure for those who have genuine difficulties. Lenders have also introduced better credit assessment techniques so that with better advice and guidance there is less likelihood of borrowers having inappropriate loans.

The flexible mortgage is thus part of a more general process of making mortgage lending in the U.K. more consumer friendly. Having said that, the flexible mortgage concept is a very significant step forward. The question now is will market demand build strongly and if it does how will the product develop? Even as the investment-based endowment and the fixed-rate mortgage became core products in the latter half of this century, so will the flexible mortgage become mainstream in the next century. Time will tell, but on the basis of fit with the emerging world of work and lifestyle, it is hard to see how it cannot happen.

REFERENCE

Freeman A. et al (1997) Is the UK different? International comparisons of tenure patterns (London, Council of Mortgage Lenders).

NOTES

[1] "Buy to let" is a scheme through which lenders provide mortgage finance to individuals who want to buy homes to let (rent) out.

[2] "Daily rest" is the charging for interest on a daily basis in terms of the sum outstanding that day. Most lenders charge interest on an annual basis based upon the amount outstanding at the beginning of the year and do not reflect amortization occurring during the year.