

The Tax / Returns Calculation.

Finance, November 1989.

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In the past three years endowment mortgages have boomed in popularity amongst both companies and individuals - a part reflection of their superior tax efficiency to annuity mortgages. However, their attraction depends on two key factors - the tax rate of the borrower and the fund performance of the institution. Pat Shallow sets out a tentative yardstick to assess the decision.

With the recent increases in mortgage rate mortgagors are understandably concerned with ensuring value for money in their choice of repayment method - whether via the newly available pension mortgage, the endowment mortgage, or the traditional annuity repayment method. The pension repayment method has limited applicability. It is restricted to the self-employed, and the disadvantages of setting aside a substantial portion of ones pension lump-sum for mortgage repayment makes this method unattractive to most mortgagors.

The entry of the associated banks to the mortgage market has established a direct relationship between the mortgage rate and the cost of wholesale funds on the Interbank market. Building societies future recourse to the wholesale market under the new legislation will reinforce this relationship. It is recognised that the mortgage rate has finally been depoliticised and will remain market-determined.

In consequence, the historic relationship whereby the mortgage rate held comfortably below the Interbank rate has now been reversed. In future, as currently, the mortgage rate may be expected to ride above 3 month DIBOR by some 1 p.c. and, more importantly, exceed the return on long dated gilts by some 2 p.c.

The significance of this is that so long as the cost of the mortgage held below the investment returns available from a life office, whether from gilts or other investments, it made good financial sense to defer capital repayments, effectively transferring such funds, via endowment premiums, to the life office in expectation of higher returns with a significant surplus at maturity.

Now, with the reversal of the gilt - mortgage rate gap, there is no reason to expect that a fund heavily invested in gilts - will be able to achieve higher returns from that source to generate the projected surplus. Further, recent research of actuaries WM Mercer Fraser on the rate of return experienced by Irish pension funds (similarly structured to life funds) over the last 25 years suggests that the overall rate of return on a typical portfolio, at 14 p.c. per annum, exceeded the return on gilts alone, 10.3 p.c., by 3.7 p.c. per annum. (It is also possible that the spectacular returns on Irish equities over the past five years will turn out to be short-run and atypical).

This scenario is projected over 20 years in the table:

| COMPARISONS OF PROJECTED NET RETURNS TO ENDOWMENT POLICY HOLDERS WITH PROJECTED NET MORTGAGE COSTS | | | | |
|---|-----|-----|-----|----|
| | | | | % |
| Projected investment returns to life office | | | | 14 |
| Gross return projected Less deductions: | | | | |
| - company overheads (estimated) | 2 | | | |
| - brokerage (annualised over 20 years) | 1 | | | |
| - 35% tax on net investment income (14% - 3%)* | 3.9 | | | 7 |
| Net return to endowment policy holder | | | | 7 |
| + This tax may be abated somewhat by allowance for relevant capital gains. | | | | |
| Projected gross mortgage rate (current & projected) | | | | 12 |
| deduct relief for relevant tax bands: | 32% | 48% | 56% | |
| i. tax relief @ 80% | 2.5 | 3.8 | 4.5 | |
| ii. Effective relief @83% of (i) | 2.1 | 3.2 | 3.7 | |
| Net mortgage rate (12.0% - ii) | 9.9 | 8.8 | 8.3 | |
| Projected potential under-performance of endowment policy | | | | |
| (net cost - net return on investment of 7.1%) | 2.8 | 1.7 | 1.2 | |
| * Based on 2% projected differential over mortgage rate | | | | |

For the exercise, it is assumed that the long term rate of return to the life office at 14 p.c. will again be 3.7 p.c. above gilts and that the mortgage rate will be, say, 1.7 p.c. above gilts (currently this is +2 p.c. over gilts), giving a 2 p.c. differential in favour of investment returns over the mortgage rate.

The rate of relief available will depend on the individual's marginal rate, 32, 48 or 56 p.c., and is 80 p.c. of this.

As the average mortgage is now over £40,000, it should also be recognised that at present interest rates, only 8.3 p.c. of that interest qualifies for relief.

These assumptions are reflected in the table and suggest a future net mortgage cost of 9.9 p.c., 8.8 p.c., and 8.3 p.c. for the 32, 48 and 56 p.c. tax bands respectively.

What is of most relevance to the mortgagor is of course the net return, after the deduction of all charges. Shown in the table are the following deductions: 35 p.c. tax on investment income; 2p.c. for life office overheads and 1 p.c., the annualised cost of brokerage commission. Combined, these charges reduce the projected 14 p.c. return to 7.1 p.c. net.

The projected net investment return of 7.1 p.c. compares unfavourably with the projected alternative net mortgage costs of 9.9, 8.8 and 8.3 p.c. suggesting the possibility of a shortfall rather than a surplus on maturity. (This possibility is reduced with low cost endowment mortgages since their structure provides against significant under-performance of investment). Nonetheless, should this scenario begin to emerge in, say 10 years, the life office would advise its members in time to increase their contributions appropriately.

In summary, there are currently good reasons to doubt the projected superior "value for money" of the endowment repayment method over the traditional annuity method - the 2 p.c. differential assumed in favour of investment returns may be insufficient to deliver the projected surplus on maturity. Further, possible future reductions in tax relief on either mortgage interest or on life assurance premiums threaten to neutralise the endowment repayment method further

An aspect of interest to lending institutions, especially building societies, is the statutory responsibility (under section 79 of the old act, carried forward in the new act) that they have for the independent valuation of all security (not defined) accepted in repayment of the mortgage.

The endowment policy forms part of that security so it is important that the prescribed procedure be followed in arriving at a conservative valuation of the policy. On current evidence the recent impressive investment performance of the Life Offices may not be a sufficient guide to such valuation.

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