The mortgage offset account: favourable and unfavourable consequences

08 July 2019

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Mortgage offset accounts, re-draw facilities and home equity lines of credit are excellent tools for managing savings and reducing interest if used wisely. But it's important to understand how they work, to help you understand saving and spending options.

An offset account is a savings account that is linked to your home loan. It operates just like a regular transaction account where you can deposit and withdraw funds. But instead of earning interest, the funds in it are used to offset, or reduce, the balance of your loan. This generally means you are only charged mortgage interest on the difference between your loan balance and the amount being offset.

Offset accounts allow you to use your savings to reduce the interest costs on your home loan, says Canstar's financial services group executive, Steve Mickenbecker.

"Say you have $20,000 in your offset savings account and a $400,000 home loan. You will not be charged interest on the first $20,000 of your loan, rather you will be charged interest on $380,000. You continue to make your regular repayments, but as you're being charged interest on a smaller amount, your principal is reduced quicker so you pay off the loan faster and you save money over the long term" says Mickenbecker.

Not all offset accounts are equal

Mickenbecker adds that you can also pay your salary into your offset account. Even if you spend it all each month, you still benefit from the average amount that is offset against the home loan.

"One thing to look out for is that not all offset accounts are fully offset," he says. "If your loan's interest is 4 per cent, it makes sense to have the balance in your offset account fully offset at 4 per cent."

Using the example above, say you have a $400,000 loan with $20,000 in the mortgage offset account and the interest rate is 4 per cent per annum. If you have a 100 per cent offset account you will be charged interest on $380,000. However, if you have a partial offset account, then only a portion of your savings are offset against your mortgage. For example, if you have a 50 per cent partial offset facility, then using the above example, only $10,000 (50 per cent of $20,000) will be offset against your balance. You will be paying interest on $390,000 ($400,000 less $10,000).

Accessing any savings you've built up in an offset account is easy, but Mickenbecker says this ease of access means you need to be very self-disciplined with your spending.

Re-draws and lines of credit

A re-draw facility is a common alternative to an offset account. The re-draw lets you make extra repayments on your home loan – thus reducing the amount of interest charged on your loan – with full confidence that if you need access to the money, you can get it out.

A redraw facility is slightly different from an offset in that it is not a separate account, says Mickenbecker.

"The re-draw doesn't require a separate account for you to make these extra repayments, although with some facilities there may be restrictions on the number of withdrawals you can make or on the amount you can withdraw."

Also requiring self-discipline are line of credit loans, which you can take out if you have built up equity in your home. The interest rate charged on these loans is generally higher than for standard home loans, although you only pay interest on the portion of the loan that you use. They don't require you to make regular repayments as long as you stay below your pre-approved limit, which makes them quite flexible. However, as you are borrowing against your equity you do want to make sure you keep an eye on your spending.

Questions to ask your bank – and yourself

Mickenbecker emphasises that when considering a feature such as an offset account there are a number of questions to ask.

"First, check whether 100 per cent of the savings balance is being offset against the loan," he says. "Also find out if there are any restrictions, such as the need for a minimum balance, and if there are any fees. Offset accounts are a good way to get ahead of your mortgage while parking savings that can be withdrawn when needed, but the key is to be disciplined with your spending."

The Australian Securities and Investments Commission (ASIC) advises consumers to consider whether the benefits of a mortgage offset account outweigh the possible extra fees[1].

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[1] https://www.moneysmart.gov.au/borrowing-and-credit/home-loans/choosing-a-home-loan

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