Offset vs redraw which is better?

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Minimising the interest you pay on your loan is a worthwhile goal, but there are some pitfalls to watch out for.

Offset accounts and redraw facilities can dramatically reduce the interest you pay on a home mortgage or investment loan and impact how quickly that debt is paid off.

Offset and redraw facilities both allow you to make extra repayments against your loan, but offset accounts offer more flexibility for both home buyers and investors. For most borrowers, flexibility is a good thing, but for those who want to make lump sum repayments into their loan and don't want easy or regular access to that money, a redraw facility could be suitable.

Which one is best for you?

A redraw account is part of your loan, while an offset account is separate from it. You can use the money sitting in your offset account much as you would any savings account. Accessing the money sitting in redraw, however, can take one or more business days and there may be restrictions on the amount you can withdraw and how often.

There's another catch with redraw facilities, if you're an investor claiming the interest on your loan as a tax deduction. If you withdraw funds that have been sitting in redraw and use them for a holiday or other purpose unrelated to investing, you will no longer be able to claim tax deductions for that portion of your loan.

Let's look at an example. You've bought an investment property by taking out a $500,000 loan. At tax time, you can claim the interest on this loan as a deduction. An inheritance of $100,000 comes your way, so you put it in redraw, reducing your loan balance to $400,000. You later decide to use $70,000 of that money to buy a new car. The downside with redraw facilities is that you can only continue to claim interest on the $400,000 portion of the loan, even though your loan balance has gone up to $430,000.

If you had signed up for an offset account instead of redraw when you took out the loan, in the same scenario you'd still be able to claim interest as a tax deduction on the loan balance of $430,000.

More powerful tool

Matt Turner, managing broker at GSC Finance Solutions, says offset accounts are much more popular than redraw, particularly with investors, because making extra repayments and then later withdrawing them doesn't affect the tax deductibility of the debt.

Turner recommends borrowers use an offset account rather than redraw, despite the probability of having to pay a fee for doing so and the possibility of a minor rate differential between loans that have an offset account attached and those that don't.

"Having an offset account gives you full control," he says. "Nine times out of 10, we're setting a client up with the offset account, even with those initial costs, because the tool is that powerful."

On a 30-year home loan of $600,000 with an interest rate of 6.5%, if your offset account has a starting balance of $20,000 and you make additional repayments of $100 a month, you'll pay the loan off 3.5 years sooner and save $159,870 in interest. In the same scenario, but making $500 in additional payments, you would shave six years and seven months off your loan and save more than $300,000 in interest.

Getting the most out of your offset account can depend on your savings habits and self-discipline. Some borrowers direct their monthly pay straight into their offset account, live off their credit card and pay it off in full at the end of every month with the funds in their offset account. But this approach doesn't work for all people.

"We find that can lead to some poor behaviours," says Turner. "If you don't pay it off in full in time, you're saving 6% on the home loan but then spending 20% on the credit card."

Instead, he recommends using the offset account as you would a savings account, putting every dollar you don't need for life's essentials into that account. ■