Offset vs. Redraw

Investors,

It is important to know the difference, and there is one, between the two types of facilities available. They both enable a borrower to pay more funds towards their mortgage with the aim of reducing the interest calculated on the loan facility. However if you use the additional funds again, it can make a significant difference whether they come from the offset or the redraw facility on the loan itself.

Redraw

A redraw facility is simply a feature of a loan where if you have paid more money towards the loan than that stipulated in your loan contract, it becomes available to withdraw again for your own use. The benefit of paying more money into your loan account is that the interest calculated is reduced. Depending on whether it is a principal and interest (P&I) loan or interest only (IO), the loan term may be reduced as well.

On a $300,000 loan at 6%, on a principal and interest (P&I) basis, repayments are $1,798 per month for 30 years. If at the end of the 1st year, you receive a bonus of $20,000 and use that to pay into the loan, while the P&I payments stay the same, the loan term will be reduced by 4.5 years. On an interest only (IO) basis, instead of paying $1,500 a month, the IO payment would reduce to $1,400 a month or a savings of $1,200 a year.

For a normal home owner, paying off your private (non tax deductible) debt is a good thing and generally a benefit to you. For an investor, conservation of capital is important and the timing to repay debt needs to follow a long term strategic plan.

An alternative is to bank this $20k in a cash management account earning, say 3%

interest, so $600 a year in interest income is added to your normal income and taxed accordingly, the net benefit may be $420 at a 30% marginal tax rate. The difference between this and use of an offset is $780 a year.

Not all loans have a redraw facility available and there may well be fees to redraw and restrictions on what you can redraw and how many times a year.

Offset

There are a number of different offset accounts, some are very poorly functioned or are simply a con by the banks. It is the 100% mortgage offset account that is discussed below. Make sure that the offset you have is a 100% mortgage offset.

An offset account is simply a savings transaction account that is linked to the loan. The credit balance is offset daily against your loan balance to calculate the interest payable on that loan. The calculation is the same as above for both a P&I loan and an IO loan, it will work to reduce your interest payable.

Using a $300,000 loan again at a 6% interest rate on an IO loan, a normal interest payment would be $1,500 per month. If your $20k bonus went into the offset account, interest will now be calculated on the net balance of the two accounts (i.e. $280k) and the interest charged would be $1,400 a month.

As the offset account is a normal transaction account, it is available for day to day access and generally suited to those wanting to minimise interest repayments without necessarily making principal repayments and to have easy access to additional funds. Note that if the associated loan is a P&I loan and the monthly repayments stay the same, the additional interest savings could go to reduce the principal depending on the type of offset.

The superficial difference is that paying additional funds into a loan account directly will reduce the principal, funds into an offset will just reduce the interest and preserve capital.

Subsequent Use of Funds

This is where there can be a significant difference, especially for investors.

The scenario is: A home owner with a property now worth $400k, purchased 5 years ago for $300k, (5.7% annual growth). The original loan was 80% being $240k. They are in a position to upgrade to a $500k home and looking at their options, either keep their existing home and convert to an investment property and buy a new home or sell their existing home to use the funds to help buy the new home.

They have been able to save an additional $10k a year for 5 years. Cost to sell is $10k. Income is $100k pa, rent yield is 4%, interest cost 6%, investment property costs $4k pa and stamp duty on the new home $23k.

A. Sell existing property:

1. Redraw. The $10k savings pa of $50k was put in redraw, the loan is now $190k ($240 – 50 = $190). On selling the existing home, they would have $200k ($400 – 10 – 190 = $200) funds to use to purchase their new home, borrowing $323k. Interest cost on new loan is $1,615 per month.
2. Offset would give the same result

B. Keep existing property and convert to investment, so needing to extract equity from existing property to be able to settle a new loan:

1. **Redraw**. As the funds have been paid into the loan, any subsequent redraw of funds constitutes a 'new' loan and the tax deductibility is determined by the use of those funds. As it is for an owner occupier home, the interest cost on this component is not claimable as a tax deduction. Ignoring depreciation, this would result in a neutral after tax position for the investment property based on the basis of the loan now being $190k. The interest cost for the new home would be $2,615 per month ($500 + 23 = $523 * 6%).
2. **Offset**. The investment property is refinanced to extract equity to help settle the new purchase, the $50k is used from the offset as well and the remainder borrowed. The investment property now returns an after tax cash loss of $1,456 per year based on the original loan of $240k. The interest cost for the new property becomes $2,375 per month ($523 – 50 * 6%). An overall after tax savings of $1,424 per annum by having used the offset instead of the redraw.

The decision to keep the original home and convert to an investment property or sell it is for a different discussion and analysis, it will depend on your long term investment and retirement goals. If the additional funds saved was $100k, the use of redraw would result in an after tax cash profit of $2,301 pa for the investment property with the same interest cost of $2,615 per month for the new home. If the offset was used, this would result in an after tax loss on the investment property of $1,456 pa and an interest cost of $2,115 per month for the new home. The net result being $3,699 pa difference in after tax dollars by having used the offset facility.

We have seen many cases of clients paying down their loans and are in a position in subsequent years to want to upgrade and start an investment property portfolio, yet find the past decision of paying down the original loan now comes at a significant cost to after tax cash flow. The use of an offset simply gives future flexibility as long as it is managed well.

A secondary benefit of using an offset against a home loan for investors is to give them the ability to debt recycle which you cannot do with a redraw facility easily.

Our Service to You

We provide a specialised service for investors wanting to create long term wealth for themselves and their families. We are finance strategists, credit advisers and mortgage brokers, helping you achieve your goals. Give us a call when you think it's time to consider your options.

As well as providing a service to investors, we will assist you in purchasing as an owner-occupier, or upgrading to a new property, or simply looking at better pricing or structuring options for your current loans and banking or assisting seniors looking at possible reverse mortgage options.

Our business is built on referrals provided by clients, so please don't keep us a secret, feel free to forward this e-mail to family and friends interested in their own financial future. Give us a call and book an appointment to see if it makes sense for you.

If you have any questions about any of these topics, give me a call.

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