Mortgage offset accounts: An explainer

"Mortgage offset accounts", "offset home loan", "interest offset account" or simply "offset account" — they are all interchangeable labels for the same financial product provided by banks. It is essentially a savings account that is linked to a loan account.

An offset facility contains two bank accounts: (1) a transaction account (meaning you have access to the funds) that is linked to (2) a loan account. The transaction account offsets the interest that is charged to the loan (hence the consistent use of the term "offset").

So unlike a straight-out loan arrangement, the offset account also works like a regular savings account. Also any notional interest on savings may be earned at the same rate as the linked loan.

Savings in your offset account can help to reduce the loan principal over time, allowing you to pay off your loan sooner or build up equity. Take for example the scenario of a couple with a $100,000 mortgage (not realistic, but used just for simple arithmetic) and $10,000 in a linked offset account:

- the principal on the $100,000 loan is reduced by the $10,000 offset account to $90,000
- as a result, interest only accumulates on the $90,000 balance of the loan
- repayments continue to be made on the entire $100,000 principal and applicable interest
- savings in the offset account are actively working to reduce the loan, while repayments are working more effectively to reduce both the principal and interest it attracts.

Potential strategies

While the old-school sage advice may have been to pay off the home loan as soon as possible, using a mortgage offset account can provide more benefits, especially when used tax effectively.

One strategy to consider centres on the fact that a mortgage offset account can actually be used as an all-in-one transaction account to manage your cash flow on a regular basis.

If you have an investment loan and a home loan, you could direct your salary as well as any rental income into an offset account that is linked to your home mortgage. This will give you the advantage of having both income sources (salary plus rental income) contribute to offsetting interest on your home loan. In any event, you will continue to pay principal and interest on your investment loan from your personal cash flow. An interest deduction however may be available in respect of the investment loan.

Another tactic (which will very much depend on how financially disciplined you are) can be to put all your monthly living expenses on your credit card, thereby being able to leave aside as much money as possible in an offset account for most of the month. The "plastic" debt is then cleared once a month (so discipline and timing are essential) from the funds held in the offset account. Some lenders have a set-and-forget "sweep" function to allow this to be done automatically.

By doing this, your salary and any other income that is directed to the offset account works to reduce your interest bill for the month. When making your regular loan repayment, more of it can go towards paying off the principal as you will have saved a bit of interest.

With both of the above, the icing on the cake comes from the fact that most home loans have interest calculated on a daily basis. Over the month, the days spent with extra funds sitting in the offset account is actively working to reduce your overall interest liability.

Potential pitfalls

One thing to keep in mind however is that not all home loans are offered with an offset facility. Generally the very basic home loans that are on offer do not, so having an offset account may require you to go for a more fully featured mortgage account, and the problem with some of these is that they may come with a higher interest rate. There also may be a difference in fees charged.

Therefore, before deciding to go for the home loan featuring an offset facility, you will probably need to consider your financial situation and calculate whether or not you will expect to generally have enough money placed in the offset account to make it worthwhile. If you don't expect to be able to maintain a decent balance in the offset account, a cheaper home loan may be a better option.

It is also worth noting that the ATO has been known to crack down on certain mortgage structuring arrangements whereby increased interest deductions are claimed in respect of investment loans. Particular emphasis has been placed on "split loan" arrangements and other such structures. If an arrangement sounds too good to be true, it could result in you getting into trouble with the taxman.