Debt Management

Borrowing money can help you to buy assets before you have saved the full purchase price. Most people borrow to buy personal assets like a home but you can also borrow to access investment opportunities to boost your wealth accumulation.

The cost of borrowing can be high so you need to be disciplined and consider strategies to reduce the total interest cost.

Repaying debt is considered a low risk strategy as you achieve savings through a lower interest cost. If you are disciplined, once your non-deductible debts have been repaid you should consider directing the repayment amount towards a savings strategy.

How this Strategy Works

Borrowing creates opportunities but it also requires discipline. You must be able to meet your loan repayments when they are due.

The cost of a loan is primarily the interest rate charged but fees may also be charged on some loan accounts. The interest rate varies depending on the type of loan and the type of security used. For example, home loans generally have a lower interest rate than personal loans or credit cards.

Strategies for how to manage your loans are important to not only help manage your cash flow but also to reduce the total interest payable. This may include strategies such as:

- Making additional repayments
- Repaying non-deductible debt first
- Combining loans into one loan account with a lower interest rate

Making Additional Repayments

A simple strategy to reduce your debt is to make additional repayments if you have some extra cash flow or savings. This benefits you in two ways:

- Reduces the time to fully repay the debt
- Achieves a saving by reducing the total interest payable

This is a low risk strategy that can provide significant cost savings. However, you need to first check your loan contract to see if there are any restrictions on additional repayments. For example, some fixed term loans may not allow additional repayments or may charge a penalty.

Debt Consolidation

Debt consolidation involves combining several loans into one loan account. For example, you may increase your home loan to repay your car loan and credit card debt.

This may provide advantages such as:

- Ease cash flow – annual repayments may be less than the total previous repayments
- Reduce fees – you will only have one loan account which may reduce account fees and transaction costs
- Improve manageability – you will only have one monthly statement and one monthly repayment

Potential disadvantages include:

- Longer repayment period – a loan which might have been paid over a shorter period will now be extended unless total repayment levels are maintained
- Increase interest cost – if the term of a loan is increased this may result in an increase in total interest cost over the term
- Fees – the restructure may incur additional fees and charges

You need to be disciplined when consolidating your debt to ensure that you do not simply re-accumulate debt from other sources. In particular be careful with how you use credit cards. You may wish to lower your credit limit or make sure you pay off the balance every month.

Repaying Debt with the Highest Interest Rate First

You may hold a number of different types of loans such as:

- Home mortgage
- Personal loan
- Credit card

The interest rate is higher on some loans than on others. The quicker you pay loans with a higher interest rate, the greater your savings.

Your credit card usually charges the highest rate of interest so you should aim to pay this debt off quickly by directing extra savings to additional repayments. Remember it is important to still make the required repayments on your other loans.

Deductible versus Non-Deductible Debt

If you borrow to buy an investment the interest cost and other expenses may be tax deductible. This can apply to loans used to buy a rental property, shares or managed funds.

The tax deduction provides you with a tax benefit to reduce the cost of borrowing. The value of the deduction will depend on your marginal tax rate. The higher your marginal tax rate, the higher is the deduction value.

Example

Tom borrows $100,000 to buy a portfolio of shares on an interest only loan. The interest rate is 9% per annum and Tom is on the 31.5% tax bracket (including Medicare).

The interest payable each year is $100,000 x 9% = $9,000. Tom can claim this amount as a tax deduction to reduce assessable income from the investment or another source. This reduces his tax otherwise payable by $9,000 x 31.5% = $2,835.

Tom has reduced his tax by $2,835 so the effective interest cost has been reduced to $6,165.

The interest on loans to buy personal assets (such as your home and credit cards) is not deductible. Therefore it is worth considering paying these loans as quickly as possible.

Some options to accelerate the repayment of non-deductible loans include:

- Make additional repayments regardless of how small (check that you are able to make additional repayments)
- Consolidate non-deductible loans into one loan if you can reduce the interest rate on some of the loans

- If repayments are calculated monthly, halve this amount and make fortnightly repayments. There are 26 fortnights in a year compared to 12 months so you will make additional repayments across the year and reduce your total interest cost and the loan term

Other Things You Should Know

The fees to establish loans may depend on the type of loan. It is important to understand all the costs associated either charged by the lender or government. This includes the cost of making extra or increased repayments and the cost of any restructuring.

All lending requires discipline to ensure that you do not over-commit yourself and are able to meet interest and loan repayments as these fall due.

You should ensure that you have adequate life insurance (e.g. life, total and permanent disability and income protection) so that you can continue to meet your loan repayments or repay the debt if your income stops or reduces due to death or illness.