Debt Management – Debt management

Reducing your debt provides savings because you pay less interest. Once your debts have been repaid, you will be able to increase your wealth by saving the repayment amount.

Benefits

- You will have potential to increase wealth once debts have been repaid.
- You will pay less interest over the life of your loan.
- Your financial burden will be reduced.

How it works

The cost of debt includes the interest you pay over the life of the loan and loan fees. Reducing these costs can provide you with significant savings which can help you reduce your debts quicker and increase your capacity to save.

Strategies that can help to reduce the overall cost of debt include making additional repayments, consolidating your debts, repaying debts with higher interest rates first and repaying non-deductible debt before deductible debt.

Additional repayments

Making extra repayments on your loan can help eliminate your debt faster and save on interest costs. Even a small increase in your repayments can provide you with significant savings over the life of your loan. Any lump sums you receive, such as tax refunds or bonuses, could be directed to your loan.

Putting your additional repayments into an offset account or redraw facility gives you the benefit of the reduced interest cost plus the security of knowing you can access the money again if you really need it. If your loan doesn't have an offset account or a redraw facility, it may be worth checking with your provider to find out if this feature can be added to your existing loan.

Consolidate your debts

Consolidating your debts into one loan can save you costs because you will only pay account fees on one loan account. You will also save on interest costs if your higher interest rate loans (such as credit cards and personal loans) are consolidated onto your home loan which has a lower interest rate.

To implement the strategy, you will need to increase one loan facility (such as your home loan) and use the funds to repay your other debts. It is important that you continue making the same overall loan repayment on the remaining loan after consolidating otherwise it may take you longer to repay the debts and you could end up paying more interest over the life of the loan.

It is also important to ensure you use a budget so you don't reaccumulate any other debts.

Repaying high interest rate debt first

If you have more than one loan, chances are that the interest rate applying to each loan will be different. As a general rule, credit card loans have the highest interest rate, personal loans next, then your home loan. Focusing on repaying the loan with the highest interest rate can create savings compared to repaying all of the loans at the same time.

It is important that you continue making the required repayments on all the loans whilst using surplus income to repay the higher rate loan first.

Repay non-deductible debt first

The interest on loans that are used to buy an income-producing asset (such as shares or an investment property) is tax deductible. This is called 'deductible debt'. The tax deduction effectively reduces the cost of the debt, with the value of the deduction being higher if you are on a higher marginal tax rate.

'Non-deductible debt' is a loan which has been taken out to buy a non-income producing asset, such as your home or car, or to pay for personal expenditure, such as a holiday. You are generally not eligible for an income tax deduction for the interest on these loans so these debts should be repaid as quickly as possible.

To accelerate the repayment of your non-deductible debt you could:

- use your surplus income to make additional repayments
- halve your monthly repayments and repay this amount fortnightly instead – this results in you making 26 repayments for the year, equating to 13 months instead of only 12
- change the repayments on your deductible debt to interest only to increase your surplus income and direct this income to repay your non-deductible debt more quickly.

Risks and Consequences

- Before making any changes to your loan, you should check what fees and penalties may apply.
- Some loans do not allow additional repayments to be made. You should check with your loan provider whether additional repayments are allowed and whether any penalties apply.
- You should have adequate life insurance to help meet loan repayments or payout your debt if your income stops because of death or illness.
- You should check with your accountant before making changes to investment related borrowings.

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