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Fact Sheet - Debt Management

This document provides some additional information to help you understand financial planning concepts in relation to **debt management**.

For more information, please contact the DPM Private Wealth team on (03) 9621 7000 or email info@dpmfs.com.au.

Below is a brief description of the main types of loan facilities, features and risks.

Fixed Rate Loan

Fixed rate loans protect you against the risk of an interest rate rise by fixing the interest rate applicable to all, or a portion of, your loan for a set period of time.

If interest rates rise you will have the security of knowing that the interest rate on the fixed portion of your loan and your regular repayments will not change until the end of the fixed period.

Factors to be aware of:

- Fixed interest rate loans are generally higher than variable rate loans
- Variable interest rates may fall during the term of your fixed interest rate term
- Fixed rate loans generally have limited features, and restrictions are applied on additional repayments, which may prevent you from accelerating the repayment of your loan
- Early payout fees usually apply to fixed rate loans.

Variable Loan

Variable rate loans have an interest rate that may change. Therefore, minimum repayments may vary with changing interest rates. Variable loans generally have more features than fixed loans, such as the ability to make additional repayments, vary payment frequency, redraw facility, offset facility and portability.

Factors to be aware of:

- If interest rates rise, your variable rate loan and repayments are also likely to rise
- You may be paying a higher interest rate than needed, if you are not using all the features of your variable rate loan.

Using a Redraw Facility

A redraw facility allows extra funds paid into the loan (above the minimum requirement) to remain available to you upon application to your lender. Additional repayments made directly into the loan result in less interest being charged and a reduction in the term of your loan.

Factors to be aware of:

- Depending on your loan contract, there may be fees payable and some restrictions on minimum amounts that can be redrawn
- If you make additional repayments directly into an investment loan and then redraw these funds for a non-income producing purpose, the interest expenses will not be fully deductible.

Using a 100% Offset Account

A 100% offset account can be operated as your normal transaction account, ensuring that you retain complete flexibility and access to your funds. It is a separate account to your loan, however, when your interest is calculated, the funds held in this account are 'offset' against your loan, effectively reducing your interest liability.

Using an offset account to its optimum involves keeping all of your income and any savings in this account for as long as possible. This minimises the daily balance owing used to calculate your loan interest and as a result can also reduce the term of your loan.

If you have an investment loan, there is an advantage in making additional repayments into an offset account rather than making the repayments directly into the investment loan. While in both cases you will reduce the effective loan balance and save interest, you are able to withdraw funds from the offset account whilst maintaining full deductibility of interest on your loan.

Factors to be aware of:

- You may have to pay a fee or higher interest rates for this facility.

Debt Management Strategies

Debt, or borrowed money, can play an important role in helping you to achieve your lifestyle goals and objectives. However, it is important that it be managed and structured effectively to minimise borrowing costs. The way debt is managed may depend on whether it is considered "efficient" or "inefficient".

Efficient Debt (Tax Deductible)

In most cases, debt used to purchase assets that produce income (for example, a portfolio of shares or an investment property) qualify for a tax deduction in relation to interest costs. This form of debt is considered to be "efficient".

Inefficient Debt (Non Tax Deductible)

Loans taken out to purchase services or assets which do not generate income (for example, to purchase a principal residence, a car or fund a holiday) do not qualify for a tax deduction in relation to the interest costs and are therefore inefficient.

Reducing Inefficient Debt

Wherever possible you should try to accelerate the repayment of your inefficient debt.

By reducing your inefficient debt, you can:

- Reduce your total interest payments and reduce the duration of your inefficient debts.
- Increase the equity you have in your home, which can be potentially used as security to borrow for investment purposes later on.
- Potentially provide you with more cash flow at the end of the loan term that can either be used to repay other debt or to make additional investments.

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Increasing Your Regular Repayments

Increasing the size of regular loan repayments involves transferring surplus cash into your loan on a regular basis. This will result in a reduction in the interest charged and principal owing on the loan.

Factors to be aware of:

- Loss of access to your funds, unless the payments are made into an offset account or redraw facility
- Many fixed interest rate loans limit additional repayments and may also charge a fee
- By reducing the term of a fixed interest loan, you may incur early payout fees.

Increasing Payment Frequency on Your Loan

As interest on your loan is calculated daily on your outstanding loan balance, the longer the period between your payments, the higher the average daily loan balance, and the greater the interest charged. More frequent loan repayments will result in less interest being charged and may result in a reduced loan term.

Making Additional Lump Sum Payments

Making an additional lump sum repayment involves a one-off cash payment into your loan.

The benefit of this strategy is that you will effectively be earning an after-tax return equivalent to your loan interest rate. It is unlikely that you could obtain an after-tax return as high as this from other investments with the same level of risk.

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Factors to be aware of:

- Loss of access to your funds, unless the payment is made into an offset account or redraw facility.

Utilising a Credit Card Effectively in Conjunction with your Loan

You can retain access to additional loan repayments through the use of an offset account. Therefore, an effective debt management strategy is to take advantage of your mortgage offset account and the interest free period on your credit card.

Instead of using your cash to pay your everyday expenses (and as a result taking those funds away from your offset account), using your credit card leaves your cash in your offset account longer, reducing the effective balance of your loan and the daily interest that accumulates.

It is important to note that this strategy will only be effective if you pay your credit card debt within the interest free period each and every month. This can be paid via a transfer from your offset account or from other cashflow.

Factors to be aware of:

- It is important that you pay the entire amount owing on your credit card each month within the interest free period.

Consolidating your Debt

A simple strategy to lower your overall interest rate and more easily manage your debt is to consolidate all debts into one loan that provides a lower interest rate and features to help you repay your inefficient debt faster.

Loan consolidation will save you interest where your new repayment and loan term are at least equal to your total current loan repayments and loan terms. Otherwise, you could be converting your short-term debts into longer-term debt and be paying more interest in the long run.

Be aware

- Early termination fees may apply to your existing loan(s).
- The interest rate on your new loan may be higher than the rate on your existing loan(s).
- Loan consolidation can significantly increase your total interest costs if you make smaller repayments over a longer time.
- Application fees and stamp duty may be applied to your new loan.

Debt Recycling

In some cases, it may be appropriate to consider replacing inefficient debt with more efficient debt that can be used to create wealth tax effectively. This strategy is known as debt recycling but should only be undertaken after a thorough analysis of your financial situation.

Debt recycling can be an effective strategy to accumulate wealth over the long-term. It is a process of using surplus capital or cashflow to reduce inefficient debt and then replacing it with efficient debt in the form of an investment loan. The investment loan proceeds are then invested to form part of your investment portfolio. The inefficient debt is eventually extinguished and an investment loan with fully tax deductible interest remains.

There is no tax benefit available on debt used for personal purposes, but a tax deduction is available on the interest expense on investment loans where the loan is used to purchase income producing assets. Debt recycling therefore results in a more tax efficient outcome and wealth accumulation benefits through the accumulation of an investment portfolio. Note the investment loan would need to be repaid at some point in time.

To implement this strategy, your tolerance for risk should allow you to feel comfortable with borrowing to invest. There are two ways debt recycling can be undertaken:

Lump Sum Debt Recycling

If you have available capital such as bank account savings, this can be used to repay any inefficient debt such as a home mortgage or personal loan. An investment loan can then be taken for the same amount and be used to invest in an investment portfolio.

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Regular Debt Recycling

If you have regular surplus income, this can be used to increase the regular repayments on your inefficient debt such as your home mortgage or personal loan. An investment loan can then be increased by a corresponding amount and the proceeds used to invest in an investment portfolio.

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