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Strategy 3 Harness your cash flow to reduce inefficient debt

If you are currently spending less than you earn, you may want to consider using your surplus cashflow to accelerate the repayment of your home loan.

What are the benefits?

By using this strategy, you could:

- save on interest, and
- create equity in your home that could be used as security for a loan for investment purposes.

How does the strategy work?

The interest on many home loans is calculated on the daily balance, even though it may be charged against the loan less frequently.

You can therefore reduce the average daily loan balance (and save a considerable amount of interest) by:

1. Increasing the repayment frequency

(eg from monthly to fortnightly).

This can reduce your average daily loan balance even though the annual repayments remain the same.

Note: These benefits are only available if your salary is paid more frequently than you are making loan repayments.

2. Increasing the repayment amount.

This involves using your surplus cashflow to pay off your loan sooner.

3. Crediting your entire salary

automatically into your home loan or a 100% offset account (if available).
By doing this:

- Your salary hits your loan account sooner, having the same effect as increasing the repayment frequency.
- Your salary is immediately used to reduce the size of the loan, having the same impact as increasing the repayment amount.
- You may achieve a higher after-tax return than if your salary is paid into a cash account.
- You can access your money (either from a 100% offset account or using the loan's redraw facility) to meet your living expenses during the month.

For more information contact;

Your financial advisor or Equilibria Finance: support@equilibriafinance.com.au | www.equilibriafinance.com.au

Note: This is for general information purposes only and does not constitute advice. With all of these options there are a number of considerations outside the scope of what is covered in this article that you need to understand to ensure your personal circumstances are taken into consideration.





Case Study 3 Harness your cashflow to reduce inefficient debt

Carolyn and Ian have a home loan of \$303,000 after consolidating their debts and transferring their emergency cash of \$12,000 into a 100% offset account.

Ian receives a fortnightly salary of \$2,215 after tax and Carolyn receives \$1,841 after tax. They are making home loan repayments of \$2,717 per month and their combined living expenses are \$4,800 per month (excluding loan repayments).

Their financial adviser and mortgage broker in consultation recognise they are spending less than they earn and outlines some ways they could use their surplus cashflow to reduce the daily loan balance and save on interest. These include:

- **Increasing the repayment frequency** from monthly to fortnightly (by paying \$1,254 each fortnight rather than \$2,717 per month).
- **Increasing the repayment amount** by \$20 per fortnight to \$1,274.
- **Crediting their entire salary into a 100% offset account** and withdrawing money as required to meet their living expenses.

The incremental advantage of adopting each of these strategies is:

	Loan term	Total interest payments
Before strategy	16 years	\$217,930
Changing payment frequency	15 years 9 months	\$213,473
Increasing regular repayments	15 years 4 months	\$206,262
Salary crediting	8 years 7 months	\$107,413

By using these strategies, Carolyn and Ian could reduce their home loan term by over seven years and save up to \$110,517 in interest.

Also, by paying off their inefficient (non tax deductible) home loan debt as quickly as possible, they'll build a considerable amount of equity in the family home each year. Assuming they then wish to build their wealth further, they could use this equity as security for a more-effective investment loan .

Note: This case study illustrates the importance of speaking to a financial adviser and mortgage broker about using your surplus cashflow to pay off your inefficient debts faster. They can also address a range of potential issues and identify other suitable strategies – see Tips and Traps.

Tips and traps

- To accelerate the repayment of inefficient debt, it is essential that you maximise income, limit expenditure and claim all the tax deductions and offsets you are entitled to. To help you determine your tax deduction and offsets we recommend you speak to a registered tax agent.
- Many home loan simulations show a dramatic reduction in the loan term as a result of changing the payment frequency from monthly to fortnightly. However, these simulations often divide the monthly repayment by two (eg \$500 per month to \$250 per fortnight). This results in annual repayments of \$6,500 pa compared to \$6,000 pa with monthly payments.
- If you are considering salary crediting, check your payroll provider can pay your salary either directly into your home loan or a 100% offset account.
- Your lender may not allow you to make additional repayments into the fixed rate component of the loan.
- Some lenders allow you to automatically transfer money from your offset account to repay your credit card (in full) within the interest-free period.
- If you have debt, you should ensure you have enough insurance to protect your income and enable the loan to be repaid in the event of your death or disability.

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