A guide to

Turn your debt to wealth

If you have debt, you need to manage it effectively before you can start to grow your wealth. To do this, it's important to know the difference between good and bad debt, give your bad debt the flick and turn your good debt to good use.

Bad debt

'Bad' debt is debt you use to buy anything that doesn't generate income for you and loses its value, or has no value once it's been used. It's bad debt because you can't claim a tax deduction on the interest you pay and you have to use your own resources to pay it off. Examples are credit and store cards.

Good debt

'Good' debt is debt you use to buy assets that can generate income and have the potential to increase in value, such as investment property or shares. You can use income generated by your investment to help repay your loan and, in some cases, the interest costs are tax-deductible. Not only can this kind of debt be easier to pay off, but you can also use it to accelerate wealth creation.

You can only start to create wealth when you have your debt under control.

Give bad debt the flick

It's important to try and rid yourself of your bad debts such as credit cards and personal loans first because this type of debt generally attracts a higher rate of interest than a home loan. Once you've done this, you can concentrate on using your good debt to grow your wealth.

Debt consolidation strategy

Here's an example of how bad debt can cost you hundreds each month.

Debt	Outstanding balance	Interest rate pa	Monthly repayment
Home loan (21-year term)	$220,000	7.25%	$1,667
Personal loan (7-year term)	$30,000	13.00%	$532
Credit cards	$10,000	18.00%	$139
Total	$260,000		$2,338[1]

John and his wife Mary are married with a young family. Their home is worth $500,000 and they currently have the following debts.

John and Mary's financial adviser recommends that they increase their home loan from $220,000 to $260,000 and use the extra $40,000 to pay off their personal loan and credit cards.

By consolidating their debts, they are now paying the lower interest rate of 7.25% p.a. Their monthly repayment is reduced to $1,970 – a saving of $368. But if they continue to pay the same monthly amount of $2,338, not only will this reduce their loan term, but they'll also save thousands of dollars in interest.

	Separate debts	Consolidated debts[1]
Outstanding balance	$260,000	$260,000
Monthly repayments	$2,338	$2,338
Remaining term	16.1 years	14.95 years
Total interest payable	$191,469	$159,117
Interest saved		$32,352[1]

1. Assumptions: A monthly repayment of $2,338 for the life of the loans for both options. For separate debts, once the credit card/personal loan is repaid, payments are redirected to the home loan.

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Use your cash reserves more effectively

Mortgage offset facility

It's always comforting to know you have cash in reserve for emergencies.

If you keep 'spare' cash in a normal bank account, the interest rate is often lower than what you're paying on your home loan. What's more, you pay tax at your marginal rate on what you earn in interest.

If you placed your spare cash in a mortgage offset account instead:

- you don't earn interest (so you don't pay tax) but
- the interest you owe on your home loan is calculated on a lower balance (your home loan minus the amount in the offset account) and
- your savings are still at call if you need them.

	Normal bank account	Offset account
How do interest rates compare?	Low	Higher*
Is the interest taxable?	Yes, *at your marginal tax rate*	No
Does it help pay off the home loan quicker?	No	Yes
Is the money easy to access?	Yes	Yes

* Full or 100% offset loan. Some lenders compensate for this by charging a higher interest rate.

Here's an example of how you can save interest and reduce your loan term using a mortgage offset account.

Lyn has a home loan of $260,000 at 7.25% p.a. interest with repayments of $2,338 per month. She also has $20,000 in a bank savings account earning 5.00% p.a. interest and she pays tax at her marginal rate on the interest she earns.

By placing her $20,000 in a mortgage offset account, the interest Lyn pays on her home loan is calculated on $240,000 instead of $260,000.

The graph on the right shows the difference Lyn pays in interest on her mortgage when using a mortgage offset account compared to keeping your spare cash in the bank.

Using a mortgage offset account, Lyn saves $33,213 in interest and reduces her loan term by just over a year.

Before strategy
Loan term: **14.95 years**
Interest payable: **$159,117**

After strategy
Loan term: **13.75 years**
Interest payable: **$125,904**

Interest saved $33,213

Assumptions: $20,000 is deposited and remains in the offset account for the term of the loan. Monthly repayment of $2,338 is maintained for the life of the loan.

Redraw facility

An alternative to having an offset account is to pay your savings into a home loan account and use a redraw facility. The redraw funds would be less accessible than an offset account as you may need to transfer money from the loan account into an account you can withdraw from. This may help you avoid the temptation to spend.

A redraw facility may not be available on all loan products, so check with your mortgage provider.

Borrowing to build wealth

It's important to build your wealth to meet long-term goals such as having enough money when you retire. But if you wait until you've paid off your home loan before you start investing, you may not give your investments enough time to grow.

By using gearing as part of a 'debt recycling' strategy, you can potentially pay off your home loan years earlier and then really concentrate on growing your wealth.

Gearing explained

Gearing is borrowing money to invest in shares and other financial products using your existing investments or assets as security. It allows you to invest more than you could afford using just your own money.

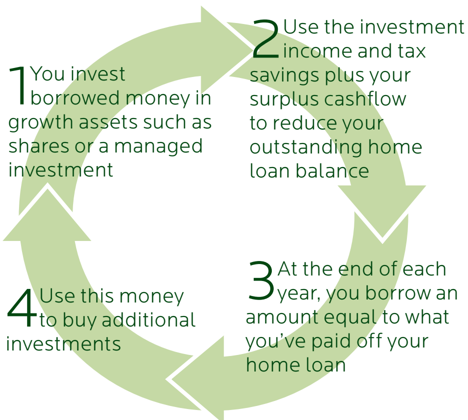
This means you can potentially get higher returns on your investment if it increases in value. You may also be able to claim the cost of investing (including interest) as a tax deduction, which means your overall tax bill may be reduced.

But gearing is risky because there's a chance your investment could fall in value. To reduce this risk, lenders will generally only lend you a maximum of around 70% of the value of your investment. They'll also take security over your investment so it can be sold to repay the loan if the value drops below a certain level.

Debt recycling

Debt recycling is about using the equity in your home to get an investment loan and repeating the cycle shown below until you've paid off your home loan.

After paying off your home loan, you can use all your surplus income (including investment income and tax savings) to buy more investments or repay your investment loan.



Debt recycling in practice

David and Jane have a home worth $500,000. Their mortgage balance is $300,000 to be repaid over 30 years at an interest rate of 7.25% p.a. They currently pay $24,000 per year in mortgage repayments and have surplus cashflow of $12,000 per year.

David and Jane's financial adviser recommends they increase their mortgage repayments by $12,000 per year and use a debt recycling strategy to borrow money to invest in a share portfolio. They are comfortable with maintaining their overall level of debt at 60% of the current value of their home.

After year 1 (taking interest charges into account) David and Jane have paid $15,550 off their home loan. They take out a $15,550 investment loan and invest in Australian shares through a managed fund.

They continue this process each year. After their home loan is paid off, David and Jane continue to direct all their surplus cash, income and tax savings into the share fund.

The table shows the benefits of a debt recycling strategy after 20 years compared to paying off the home loan first and then using surplus cash to invest.

	Debt recycling strategy	Repay mortgage before investing
Years to repay mortgage	12.7	12.3
Value of investment portfolio after 20 years	$931,672	$396,668
Outstanding debt after 20 years	$300,000	Nil
Net position after 20 years	**$631,672**	**$396,668[2]**

2. Assumptions: All investments and loans held in David's name. Share fund return of 9.5% (4.5% income and 5.0% growth), franking level 70.00% and interest on home loan 7.25%. All rates remain constant over the 20-year period. After 20 years, investments are sold and Capital Gains Tax plus loans are repaid. Calculated using a marginal tax rate of 38.5% including Medicare levy.

Budget

Take time to complete a budget planner. By keeping a written record of all your income and outgoings for at least three months you'll make sure your budget is based on accurate figures.

A budget will help you get an idea of where you're spending your money, where you can potentially cut back on spending and how much is left over after you've paid all your regular bills and living expenses. If you find your income is greater than your expenses, you can use the extra to pay off your debts.

Reduce your loan

Any extra payments you make on your home loan (especially in the early stages) will reduce the interest you pay. Using spare money to make extra payments can have a big impact in the long run, potentially reducing your mortgage term by years.

If you make extra payments towards the end of your loan it's less effective, as the interest component of the payments is lower. But any extra payments will still save you interest. Before you make any extra payments, check that your lender allows it. Some lenders may charge you for paying more than you should or paying out the loan early. You should also check if your lender allows you to redraw money from your home loan as this will give you peace of mind that you can get back any extra you've paid if you need to.

Time to review your debt?

It's a good idea to review your debt as your circumstances change throughout your life. Getting married or divorced, buying a house, changing jobs, inheriting money, getting ready to retire. All these life events can change your debt position.

Talk to your financial adviser about strategies to help rid yourself of bad debt and put your good debt to work to create a wealthier future for you and your family.

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