

FINANCE SOLUTIONS – Getting ahead on your loans[^]



We are currently experiencing some of the lowest interest rates we have had in decades, what we need to remember, is that the interest rates will not stay this way forever. You should be taking this time to pay down your loans as best as you are able to.

You probably don't want to be a borrower forever. Presumably you don't want to live the rest of your life with large debt hanging over your head. If you are like most borrowers, you'll want to have your loan paid off and be debt free as quickly as possible.

If you've just borrowed or you're just about to borrow, the day when you make the final payment on your property/car/business may seem like a very long way away. And let's face it, it probably will be.

But don't despair. You can take steps to pay your loan off faster and save a heap of money in the process. Below is a guide to getting ahead on your loans.

Warning: Strategies to reduce your home loan faster may not be the best tax strategy if you intend to keep your home as a future rental property and upgrade to a better home. Contact us for alternative strategies.

Saving on interest payments

Paying off a loan early can literally save you thousands of dollars in interest repayments. The way it works is simple.

Your minimum monthly loan repayment for a principal and interest loan is calculated on how much per month is needed to pay off the balance of the loan or principal over the loan term, plus the interest that has been accrued on that balance.

Understanding Principal and Interest

If interest rates didn't change, the dollar figure amount of your loan repayment wouldn't change either. What would change, however, is the percentage or ratio of how much of the repayment is paying off principal, and how much of that repayment is servicing interest costs. When you begin paying back a loan, the majority of the loan repayment is servicing the interest, while the remainder of the repayment is paying off the principal.

As you pay more and more off the principal, the interest portion of the repayment will be less, which means that the principal portion will be more. Towards the end of the loan term, the majority of the repayment is principal, while the remaining portion of the repayment is servicing the interest.

Benefits of extra repayments

One of the main benefits of making extra repayments towards your loan is that it takes less time to pay off a loan and you pay less in interest. What this means to you is that the more principal you can pay off by putting extra funds into the loan, the more of your repayment will go towards paying off the loan, rather than being dedicated to servicing the interest.

Let's have a look at this a little more closely. Let's say you took a principal and interest loan of \$150,000 over a term of 25 years, and your interest rate was 6.50 per cent. Let's also say, for the purpose of this example that your interest rate didn't change for the term of the loan.

If you had been paying only the minimum monthly payment and nothing extra, when you make your last repayment, or 300th monthly payment, not only will you have paid back \$150,000 of principal, but also about \$153,800 of interest as well. That is a very significant amount.

If you had paid the loan off in 20 years, you would have paid about \$118,400 in interest. That is \$35,400 you save in interest costs if you pay off your loan five years more quickly.

If you repaid the loan in 10 years, your interest repayments drop to about \$54,000, which is a difference of nearly \$100,000 compared to repaying the loan over 25 years. That's \$100,000 in your pocket!

So, plan wisely and try to repay as much as you can earlier. Later in this section, we'll look at some ideas and loan products you can use to help repay your loan more quickly.

Organise a budget and have a plan!

If you don't know where you are going, how do you know when you get there? It's fine to throw a few extra dollars into your loan each month, but it is much easier to motivate yourself when you have some goals. You can do this in two ways.

The first option is to sit down and work out a budget for yourself. Work out what your total monthly after-tax income is, then subtract all your necessary expenses. Don't forget to include your minimum monthly loan repayment. Factor in lifestyle expenses, such as entertainment and holidays as a monthly figure, and don't forget to add in one-off annual expenses such as insurance, car registration, etc.

What you have left will be savings. You can then work out how much time and money you will save by paying off what you have left over on a regular basis.

The second option is to work out the maximum time for which you want to be in debt. Let's say you said 10 years is the longest you want to take to pay off your loan. You can calculate your

required repayments over a ten year period using the calculators on the Nash Solutions website. This will give you a weekly or monthly figure that you will be required to pay if you want to be debt free in ten years.

Make sure you get the right loan

Getting the right loan the first time is a huge consideration when it comes to saving money. You need to make sure your loan is best suited to your circumstances.

Most variable-rate loans will allow you to make extra repayments with no extra costs, and will not limit the amount or regularity of extra repayments you can make.

This may not apply to fixed-rate loans or interest-only loans. Most lenders will limit the amount of extra repayments you can make without incurring extra fees over a specific period of time on fixed rate loans. This may be around \$5,000 to \$10,000 per year, so make sure if you want that flexibility in a fixed-rate loan, ask for it.

Not being able to make extra repayments may also apply during the 'honeymoon' period of a honeymoon or introductory-rate loan. Again, check with your lender or broker what limitations the products you are being offered have.

Let's now have a look at some of the variable-rate product features that will allow you to use extra funds to pay your loan off earlier.

Redraw facility

A redraw facility allows you to put what money you have left over on a regular basis into the loan, and then take out those extra funds should you wish to do so

A loan with a redraw facility is generally cheaper by way of the interest rate and fees charged than 'bells and whistles' type loans with added features. However, limit yourself to only putting what you have 'extra' into the loan itself.

These types of loans are generally good for low to medium income earners, or for those that have trouble saving money or budgeting. The extra money you put into your redraw facility is not only coming off your loan for interest calculations, but is a way of 'forcing' you to save money at the same time.

Offset loans

A 100 per cent offset account is similar in principle to an all-in-one account. Rather than holding all of your money in one home-loan account, a 100 per cent offset facility is a separate account run in conjunction with your home-loan account. It operates like a transaction account with an interest rate equal to that charged on your loan account.

For example, if your loan balance is \$120,000 in a regular loan account, interest would be calculated on a daily basis and charged to the account each month on that full amount. If you have a 100 per cent offset account where you place all your earnings, and the balance of your savings is, say, \$10,000, that money acts to reduce the balance on your home loan. Rather than earn interest on the \$10,000 at the current term-deposit rate, which is always lower than the interest you pay on your home loan, the money in the 100 per cent offset account effectively reduces the balance of your loan, so you only pay interest on \$110,000.

The poorer cousin to the 100-per-cent offset account is the partial offset account. When you put cash into a partial offset account, you only offset the home loan by the difference between the interest charged on your home loan and the interest earned on your savings account.

Use credit cards with interest-free days

You can use your credit card to pay bills and keep your money in your offset account longer. Every day that your money is in your offset account is another day that interest is being calculated on a lower home-loan balance. As soon as you take money out of your offset account, interest is being charged on a higher loan amount.

Pay all your major bills on your credit card, and take full advantage of your interest free days (as well as any reward points you may have), and pay off your credit card out of your offset account just before your interest-free days are up. This way, you have left the maximum amount of cash in your offset account for the maximum amount of time, and have interest on your loan calculated on a lower loan balance for that time.

You can also use this principal with all-in-one facilities.

All-in-one loans

All-in-one loan accounts allow you to pay your salary and extra income such as rent directly into the loan account, and effectively combine all your accounts such as loan, cheque, and savings accounts into one. This obviously brings down the amount you owe and as such, reduces the amount that interest is calculated on thus allowing you to pay off your loan more quickly. Any amount above your minimum monthly repayment can be accessed from your all-in-one account, much the same as normal transaction accounts.

To take further advantage of this system, most lenders will allow you to connect a credit card to your all-in-one account. You should try and keep the maximum amount of money in the loan account for the maximum amount of time, as interest is calculated daily but charged monthly. You could pay most of your major bills and expenses by credit card and take full advantage of the interest-free period. You then clear your credit card once per month, preferably just before or just after your next lot of income has been added to the all-in-one account. This means that you have kept the majority of your income in the loan account for the longest time, have gained some more frequent flyer points, and have effectively used a credit facility to keep the wolves at bay while not paying interest on your credit card bills.

All-in-one or offset-account loans are generally a little more expensive by way of rate and fees, however, they give you more flexibility by having all your regular funds offset the loan amount for interest calculations.

In summary, all-in-one loans or 100-per-cent offset loans allow you to use your loan as your key financial product and your savings and income to reduce the amount of interest you pay. Having a loan 'account' where you can deposit all of your income and draw on for living expenses can make a huge difference to the speed at which you pay off your loan.

Because your whole pay effectively goes into your loan account, you are reducing the principal on which interest is charged every day.

Pay fortnightly or weekly

Most loan repayments are calculated on a monthly basis. Most lenders, however, will give you the option of repaying your loan monthly, fortnightly, or even weekly. By paying your loan off weekly or fortnightly, you essentially get the equivalent of one extra month's repayment each year.

How does this work? Ok, let's say your minimum monthly repayment is \$1200. You make twelve lots of monthly \$1200 repayments each year as there are 12 months in the year, giving you a total of \$14,400 in loan repayments for that year.

If you halved your monthly repayment, so that you were paying \$600 per fortnight, you would be making 26 payments of \$600 each year. As there are 26 fortnights in a year, your total repayments for that year paying fortnightly would be \$15,600; the equivalent of one month's repayment extra.

This extra repayment is helping to pay down your principal more quickly. If you paid fortnightly instead of monthly on a \$150,000 loan over a 25-year loan term, with an interest rate of 6.57 per cent per annum, you could take just under 5 years off your loan and save about \$52,000 in interest costs.

Paying weekly will also give you the same sort of savings as you will still get the equivalent of one month's extra repayment in each year.

Making the same repayments when interest rates reduce

If interest rates go down, make sure your repayment doesn't go down with them. If you've been used to paying a certain amount on a regular basis, then you won't miss it. If you can maintain your repayment even if rates go down, you will save time and money in interest repayments.

One of the simplest ways to repay your loan more quickly is to refinance your loan to a lower rate, but don't change the amount of your repayment. Continue to make payments at your old 'higher' rate.

This will allow you to pay off more of the principal with each payment, and will allow you to pay off your loan earlier. If you refinanced a loan of say \$150,000 from an interest rate of 6.57 per cent to say 5.97 per cent, but continued to make repayments at the rate of 6.57 per cent, you could potentially shave over 2.8 years off your loan, and as much as \$35,800 in repayments.

You don't necessarily have to change lenders. Most lenders will let you conduct a 'loan variation' to change from one product to another for as little as \$100 to \$300.

Most lenders also have a suite of products, and if you don't need a loan with all the bells and whistles, a simple cheaper loan product may be more beneficial for you.

If you do decide to change lenders, find out what, if any, incentives the new lender will give you to get your business. Competition among lenders is at unprecedented levels. They are all dead keen to get your business. Try twisting their arm a little bit. Asking your lender for half a percentage point off their rate might not work, but see whether they will give you a break on establishment costs or ongoing fees.

Cutback on some minor luxuries

This is the bit you don't want to read. Once you have a loan, you may need to have a few less luxuries in your life, depending on how quickly you want to pay off your loan. Unless you are a professional investor who can get higher returns than the equivalent benefit of your loan interest rate, perhaps your extra money should go to reducing your principal and saving you money in the long run. The easiest way is to do a budget and make comparisons on the difference making various amounts of extra repayments will have on the overall time it will take you to repay your loan. That way you'll know what the effect is of putting some extra dollars into your loan rather than spending it on that weekly massage, car magazine, or KFC Bucket.

Double or multiple incomes

Another strategy for paying a loan off quickly if you have two or more income streams, is to dedicate one income directly into the loan, and live off the other one.

The benefit of doing this is again that you never see the money from the income stream going into the loan, and therefore won't adjust your lifestyle to spend more. You also have the peace of mind that each time the salary is being paid to you, it's being used to pay off your loan at a much faster rate than if you were just meeting the minimum monthly repayments.

Structuring your loan

If you have a few loans you need to make sure you are paying off the right one. As a general rule it always best to pay off your personal loans before any loans that may offer tax deductions or offsets.

Consolidate

One of the best ways of ensuring you can continue to pay off your loan quickly is to protect yourself against interest rate rises. And if your home loan rate starts to rise, you can be absolutely positive of one thing - all of your other loans will increase in cost. Your personal loan rate will rise and so will your credit card rate and any hire purchase rate you may happen to have.

Another thing you can be certain of is that the rate you are paying on your credit card and personal loan will be much higher than your home loan. Many lenders will allow you to consolidate all of your debt under the umbrella of your home loan. This means that instead of paying 14 or 15 per cent on your credit card, you can transfer this debt to your home loan and pay about half the interest. You may want to consider refinancing at the same time if you can get a better interest rate.

If you do decide to consolidate, make sure you don't fool yourself into thinking that you have paid these debts off. You haven't. You have just transferred them to a cheaper interest rate. Cut up that credit card or at least reduce the limits on it; don't think you have a free rein to run it back up to its limit, or you'll find yourself on the debt merry-go-round.

GST for self-employed

If you are self-employed, you may want to look at putting the money you save for your quarterly GST payment into an offset account for your home loan.

Every day that this money sits in the offset account is another day that interest on your loan is being calculated on a lesser amount. When it's time to pay GST, you simply transfer the funds back into your business account and start all over again for the next quarter. You may want to check with your accountant on the best way to do this, and the effectiveness of so doing.

Pay all your loan fees and charges up front

Some lenders allow you to add to the amount you borrow instead of coming up with cold hard cash for your upfront costs such as establishment fees, valuation fees and lender's legal costs. While this can seem a blessing when you take out your loan, try to avoid doing this. Although these amounts may be small, they will be spread out over the term of the loan, earning interest, year in year out. Paying them upfront can you save a heap of time and money in the long run.

The other thing you can do straight after getting a loan account is to make your first payment early. Most lenders will not expect you to make a payment until around 30 days after the loan settles. Why not make your first payment straight away and effectively be one payment up from day one? Remember, each day this payment is in there is another day that interest will be calculated on a lesser amount. You can continue this practice every year by giving your loan an 'anniversary present' and double your monthly repayment for that month every year.

Post loan

Once you have paid off your loan, you will suddenly find yourself with extra money as you no longer have loan repayments to make. It is often said that we change our lifestyle to suit our income. If you have lived comfortably without this 'extra' money for so long, why not look at continuing to invest your repayment amount, or set up a separate savings account or fund for it? If you've not had it for some time you won't miss it, and it's a good opportunity to increase your wealth by saving or investing. You can even use this money as deposit for your next investment property.

Most of the above hints centre around putting extra funds into your loan. Only you can make a judgment on what is a comfortable compromise between lifestyle and paying off a loan early. You may be able to pay off your loan in five years, but what's the point if during that time you have been eating boiled shredded newspaper and making your own dog food? On the other side of the coin, some short-term pain by way of lifestyle curbing can have a long term gain by allowing you to live the remainder of your life debt free.

If you come across an unexpected financial windfall, why not give yourself a reward and take half, and put the other half into your loan? Whatever you decide to do, make sure you update yourself regularly and see if the loan product you have, or the strategy you are following, best suits your needs at the time.