Strategy 3
Harness your cashflow to reduce inefficient debt

If you are currently spending less than you earn, you may want to use 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 family home that could be re-borrowed for investment purposes.

How does the strategy work?

The interest on many home loans is calculated on the outstanding 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 level of repayments are the same each year.

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

2. **Increasing your regular repayments.** 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 your regular repayments.
- You may achieve a higher after-tax return on your money when compared to directing your salary into a cash account (see Strategy 2).
- 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.

4. **Paying the majority of your living expenses with a credit card.** Provided the credit card is repaid within the interest-free period, this strategy enables you to use the credit card provider's money to fund your living expenses, while applying your own funds to reduce your average daily loan balance.

Case study

Steve and Karen (from the previous case studies), have a home loan debt of $220,000 (having transferred their $10,000 emergency cash into a linked 100% offset account). They currently make regular monthly repayments of $2,173.

Steve receives a fortnightly salary of $1,812 after tax, and Karen receives $1,315 after tax. Their living expenses (excluding loan repayments) are $3,500 a month.

They recognise that by using their cashflow more effectively they can pay off their home loan sooner and save a considerable amount of interest. They are therefore considering the following options:

- Increasing the frequency of their loan repayments from monthly to fortnightly (ie paying $1,003 per fortnight instead of $2,173 per month).
- Reducing their living expenses to increase the repayments by $20 to $1,023 per fortnight.
- Crediting their salary into a 100% offset account and withdrawing money as required to meet their living expenses.
- Using a credit card to pay the majority of their living expenses (75%) and then transferring money from the offset account to the credit card within the interest free period.

The incremental advantage of adopting each of these strategies is shown in the table below.

	Loan term	**Total interest payments**
Before strategy	12.8 years	$113,633
Changing payment frequency	12.8 years	$113,108
Increasing regular repayments	12.4 years	$109,159
Salary crediting	6.8 years	$58,852
Credit cards	6.7 years	$56,608

As you can see, by adopting these strategies, Steve and Karen can reduce the term of their home loan to 6.7 years and pay only $56,608 in interest over the life of the loan. This is a considerable improvement from their starting position in Strategy 1 of paying off their home loan over 14.3 years and paying $142,531 in interest!

Most importantly, by paying off their non-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 create wealth by acquiring investments, they could use this equity as security for a tax-effective investment loan (see Strategy 4).

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 to which you are entitled.
- Many home loan simulations show a dramatic reduction in the loan term as a result of changing the payment frequency from monthly to fortnightly. 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 a salary crediting arrangement, check your payroll provider can pay your salary either directly into your home loan or 100% offset account.
- Your lender may not allow you to make additional repayments into the fixed rate component of the loan.
- Some loan providers allow you to automatically transfer money from your offset account to repay your credit card (in full) within the interest-free period.