Managing debt

A guide to managing debt

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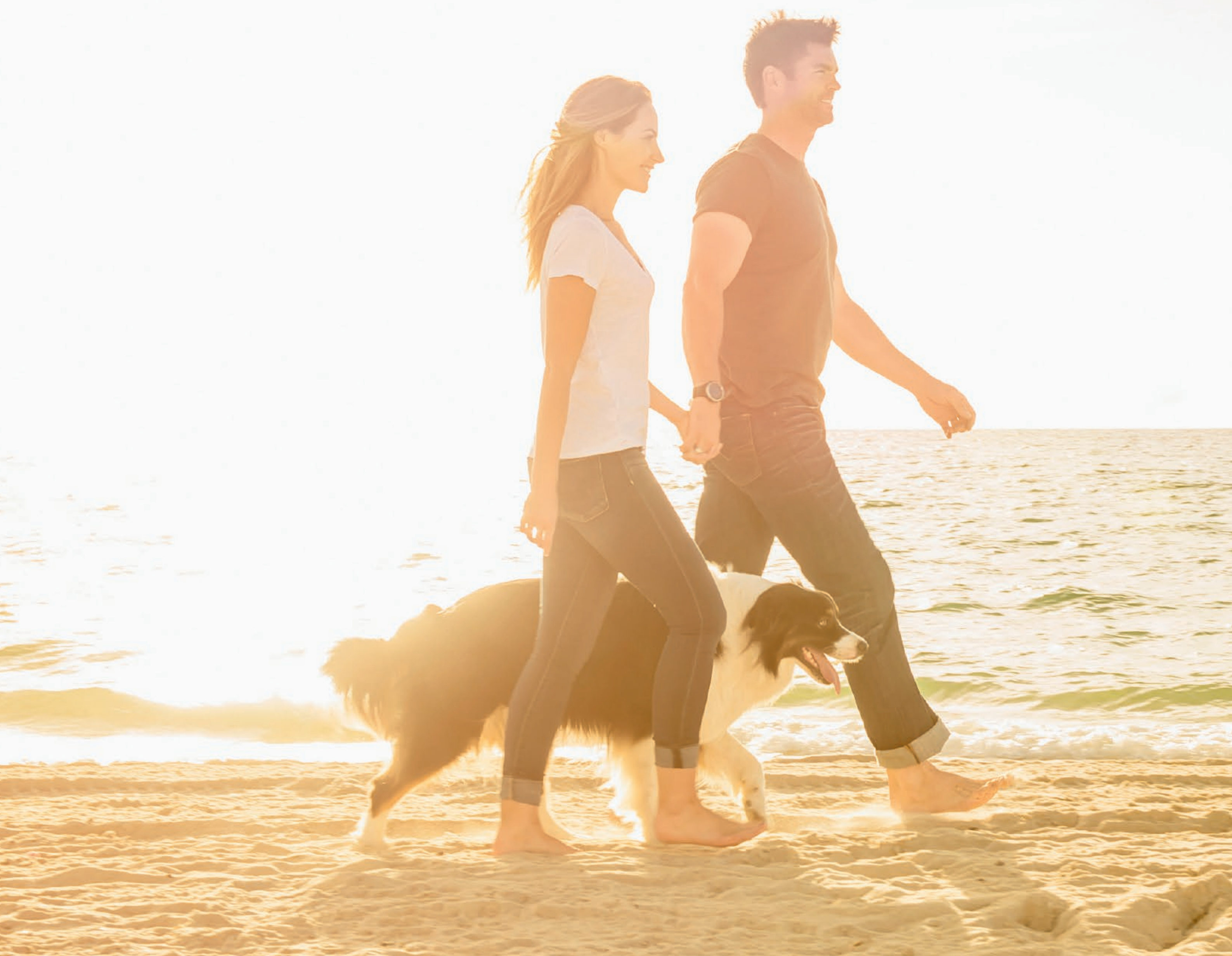
Debt can be a double-edged sword. When managed wisely, it can help you in the long-run, like helping you buy a home, get an education or pay for essential items. But it also has the potential to negatively impact your life, so it's important to know how to manage it well.

It's easy to build up small debts here and there. On their own, they may seem manageable, but together, you might find you owe more than you realise and you're paying more interest than you need to. This can become overwhelming and stressful for you and your family, so it can be helpful to know where you stand and have a plan for paying it off.

This guide outlines ways that could help you to plan and manage your debt more effectively.



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Not all debt is created equal

The first step to good debt management is understanding the difference between 'good debt' and 'bad debt'. Knowing this can help you to set priorities and optimise your income. But, don't let the names mislead you: good debt can turn bad when managed poorly, and vice versa.

Good debt

Good debt is the debt that can help you build your wealth. Like helping you buy assets that aim to grow in value over time and/or generate an income or provide shelter, like your home. For example: borrowing money to buy a property or invest in shares with the expectation that they can increase in value and create an income stream. Another potential benefit of good debt is that the interest you pay on it is typically tax deductible. However, if you overextend yourself and can't afford the debt, it doesn't matter whether it's good debt or not, you could find yourself in financial trouble. Staying within the limits of what you can afford is key.

Bad debt

Bad debt usually doesn't help you build your wealth. It's typically a loan used to pay for day-to-day expenses, something that decreases in value or doesn't provide an income, such as a car or a holiday. It's also not typically tax deductible. Examples of bad debt include credit card debt, car loans and personal loans. Generally, you may want to consider paying bad debt off first due to the possible higher interest rates charged.

Although, when managed well, there are times when bad debt can help you manage your cash flow.

Bad debt examples

Scenario 1

Michael uses a credit card for his day-to-day expenses, but he always pays off the balance in full every month. This month, he must pay his electricity bill of $1,500, which is due tomorrow. He also knows he has a lump sum payment of $2,200 coming into his bank account next week. He decides to use his credit card to pay his bill, as he knows he can clear the balance of the card the following week within the interest-free period, so he won't have to pay any interest.

While credit card debt is typically considered bad debt given the high rates of interest on purchases, Michael used his card effectively to help manage his cash flow without incurring extra interest charges. By paying off his credit card in full, Michael was able to pay his bill on time without incurring any late fees.

Scenario 2

Chris uses a credit card for his day-to-day expenses, and often doesn't pay off the balance in full every month. This month, he also needs to pay his electricity bill of $1,500. He decides to use his credit card to pay his bill, but he's not too sure where he's going to get the money to clear the balance of the card in time to avoid paying interest. So, although he pays the bill on his credit card, he will also likely need to pay interest on this amount plus any amount he still has outstanding.

Credit card debt is typically considered bad debt given the high rates of interest on purchases. When Chris was unable to pay the balance of the card in time, extra interest charges were incurred and Chris is now paying interest on his day-to-day expenses and his electricity payment.

This example is illustrative only and is not an estimate of the investment returns you will receive or fees and costs you will incur.

Strategies for dealing with debt

Whether debt is good or bad, it's generally a good idea to try to pay them off as quickly as possible. If you find yourself with personal loans, credit card debt, a car loan or other debt that you want to be free from, there are strategies and tips you could use to help you get back on track.

Work out the debts you have and what they total

The first step is to get clear about your current financial situation. An easy way to do this is to create a list of all your debt – good and bad – including the interest rates, repayments, terms of the loan and balance owing for each. Ask yourself how much do you owe? How much are you paying? How often are you making repayments? How many debts do you have? Write down your answers.

Prioritise

Once it's clearly written down, it's easier to start prioritising. In general, it makes financial sense to eliminate bad debt first, as there may be some tax advantages to having good debt. It's also usually a good idea to start tackling the bad debt with the highest interest rate first, to avoid paying more interest than you need to.

Set a budget

The next step could be to set up a budget. Create a view of your total income and expenses, either on a weekly, fortnightly, monthly or yearly basis. That way, you'll be able to see where you might be able to cut back on your spending so you can make best use of your income to reduce your debt. A budget can also help you to avoid getting into further debt as you'll have a clearer view of what you can and can't afford. To create a budget, there are many options, such as a spreadsheet or taking advantage of budgeting tools like the **budget planner calculator.**

Consider consolidating your debts into one

Debt consolidation is one way to take control of your finances and potentially pay off your debts sooner. It involves combining or consolidating your debts into one loan with a lower overall interest rate. Assuming you can cover your repayments, by using a larger loan with a lower interest rate (like your home loan), you may be able to pay off the smaller loans faster. This is because, as long as you continue to make the same repayments on the original debt, you might pay less interest overall. Note: the consolidated debt will be spread out over the life of the bigger loan.

Combining multiple debts into one loan may also help you take control and potentially save on multiple fees and interest charges. It might also help you simplify your finances by reducing multiple repayments into one monthly payment.

For example, you may have credit cards, store cards, a car loan and a personal loan with high interest rates. You could consider consolidating them all into a single loan to simplify your finances and potentially save on interest. However, fees and costs may apply. Check your existing loans to see if any early termination fees apply. And, if you're applying for a new loan, confirm the application fee costs.

Another example is, if you have a home loan, you may have enough equity in your home to consolidate your debt with your home loan. This approach is sometimes used because home loans typically have lower interest rates than other loans. Before you go ahead, make sure you crunch the numbers to avoid paying more interest in the long-term – remember, the timeframe for home loan repayments is often over many years.

Things to keep in mind when consolidating debts:

- Debt consolidation will only be effective if you're disciplined about making your repayments.
- If you end up with a lower interest rate but keep your monthly repayment amounts the same as before, you'll likely be able to pay off your debts sooner. However, if you let your consolidated loan repayment reduce to a lower repayment amount, you might be paying off your consolidated 'bad' debt over an unnecessarily extended period at extra interest cost. So, you may want to consider maintaining the same repayment schedule of your old debts (or even more) in the new loan.

Tip Credit card balance transfers

If you have multiple credit cards, you could consider consolidating the balances into one lower interest rate card by using a balance transfer. Typically, the lower interest rate will only be available for a certain period of time before jumping back up. So, if you consider a balance transfer, the aim is to commit to paying off the debt in full before the interest rate increases. However, be aware there is more to a balance transfer than a temporary low interest rate and you should weigh up all the features of a balance transfer before you move your debt. Find out more on the **Moneysmart website**.

Look at whether you can afford to make extra repayments

In certain circumstances, increasing the frequency of your loan repayments can save you money over the long-term and help you to pay off your debts sooner.

For example, many people make monthly repayments on their home loans. However, switching to fortnightly repayments could save you money and shorten your loan.

Because there are 26 fortnights in a year (rather than 12 months split into two, which equals 24 fortnightly payments), this means you'll end up making extra repayments each year, paying off more of your loan and potentially freeing you from debt sooner.

Be mindful that when making extra repayments, there could be fees and other considerations involved depending on your loan agreement so be sure to check with your provider. Also, look at your overall personal finances, immediate goals and responsibilities to make sure this is the best choice for your circumstance for the long-run.

Case study Switching to fortnightly payments

David and Sam have a $500,000 home loan with 4% pa interest rate. Currently, they make monthly repayments, but they're curious to see if they could save money over the long-term by switching to fortnightly payments.

Scenario 1
Monthly repayments

Loan amount	$500,000
Repayment frequency	Monthly
Repayment amount	$2,387
Time to repay	30 years
Total interest paid	$359,458

Scenario 2
Fortnightly repayments

Loan amount	$500,000
Repayment frequency	Fortnightly
Repayment amount	$1,194
Time to repay	26 years
Total interest paid	$302,963

Simply by switching to fortnightly repayments, David and Sam reduced their loan term by four years and one month and saved $56,495 in interest.

Assumptions

This case study is illustrative only and is not an estimate of the investment returns you will receive or fees and costs you will incur. This case study is based on the following assumptions:

a. Interest rates do not change for the life of the loan.
b. Interest is calculated by compounding on the same frequency as the repayment selected, ie weekly, fortnightly, monthly, quarterly or annually.
c. No fees are taken into consideration for both scenarios including monthly account fees or account up-front fees such as loan establishment fees.
d. All repayments are made on time and every period they fall due.

Our **rapid pay calculator** and **loan repayment calculator** can help you to find out how you could potentially save, and pay off your home loan sooner.

Increasing your repayments

If you can afford it, another way to pay off your debts sooner is by increasing the amount of your loan repayments.

There are two ways you can increase your loan repayments – either by increasing your regular loan repayments (even if only by small amounts), or by making occasional lump sum payments towards your loan. These options can potentially reduce the length of your loan, as well as the amount of interest you pay.

However, some lenders charge fees for making extra payments towards your loan. Also, some fixed rate loans don't allow extra repayments. So, before making extra repayments, check if any fees or penalties apply from your lender and crunch the numbers to make sure it's worthwhile.

Case study Minimum repayments

Janine recently returned from a month-long European holiday. After spending most of her savings, she now owes $3,000 on her credit card with an interest rate of 18%. Janine decides not to make any other purchases on the card until she pays off the existing debt. The minimum repayment in the first month is $61.00.

Scenario 1
Pay the minimum monthly repayment (2% of owed balance)

If Janine only makes the monthly minimum repayments, it will take her 25 years to pay off, and she'll pay $6,521 in interest.

Scenario 2
Increase the monthly repayment

If Janine increases her monthly repayments to $148, she will pay off the card in two years and pay $541 in interest.

See how much you could potentially save in interest by increasing your monthly credit card repayments with ASIC's Credit Card Calculator.

This case study is illustrative only and is not an estimate of the investment returns you will receive or fees and costs you will incur. This case study is based on the following assumption – the minimum monthly repayments is 2% of the balance, which equates to $61 for the first month as it is calculated at the end of the month after interest added.

Set up automatic payments

One approach to paying off debt is to arrange automatic payments. This works by setting up your online banking so when you get paid, an amount you choose, is automatically transferred to pay off your loan or credit card. For this approach, a common practise is to prioritise the debt with the highest interest rate first (if you have more than one). At the same time, you should also consider paying the minimum amounts required on any other debts you have, to avoid extra fees or charges and an adverse credit report.

Setting up automatic transfers is usually easy to do and can help reduce some of your day-to-day money management stress. It may also help you to avoid accidentally missing a payment or incurring any late fees. You may want to consider the impact of these transfers on your available spending money so you're not left short.

Once you've paid off one debt, you could then change that automatic transfer to the next debt on your priority list. Also, it may be a good idea to close each loan account as the debt is paid off, so your money management is streamlined.

Tip Create a bill calendar

A calendar can be a handy visual tool to help you plan which bills to pay and when. Record each bill's payment amount next to the due date. Next, fill in the date your salary is paid. You'll be able to easily see which monthly or weekly salary your bill will likely be paid from. You'll also be prepared if you know ahead of time that you won't have enough money to pay a particular bill.

Negotiate with your lenders

If you're struggling to meet your debt repayments, it may be worthwhile contacting your lenders to see if you can negotiate a mutually agreeable payment plan. After all, it can't hurt to ask and many companies have hardship policies that may help you.

If your lender is willing to negotiate, you may be able to request additional time to pay the debt, ask for a lower interest rate, reduce ongoing payments, postpone payments for a period of time or even agree to a lump sum payment to settle the debt.

Tip Avoid payday lenders

Payday loans, also known as short-term loans, provide fast cash so they may seem like a quick fix for money troubles. However, you could end up paying back more than you borrowed in higher fees and interest. These loans don't tend to address the root cause of debt problems and can potentially trigger borrowers to spiral into deeper debt distress.

Tips to help you avoid credit card debt

1. **Have an emergency savings fund**

   If something unexpected happens, you can consider using your savings rather than going into debt to pay for it.

2. **Consider paying off your balance in full every month**

   This means only spending what you can afford, which will help stop you getting into credit card debt.

3. **Don't miss repayments**

   If you miss repayments, the harder it is to catch up and the more fees and interest you'll have to pay.

4. **Understand your credit card's terms and conditions**

   Understand when and how interest will apply, what fees you'll be charged to avoid paying more than you have to.

5. **Limit the number of cards you have**

   Less available credit means less temptation. You might even like to consider getting rid of all your credit cards and using a debit card instead – especially if you're struggling to manage the repayments.

6. **Avoid using your credit card for cash advances**

   Fees could apply and interest may be charged from the time you make the withdrawal.

7. **Only pay for what you can afford**

   It sounds like a no-brainer, but temptation can often win. If you can't afford to pay for it in cash or clear your next credit card bill, think twice before charging it to your credit card.

Using good debt to build wealth

Borrowing money to invest (sometimes referred to as gearing) can be a successful strategy when done sensibly. It may help you to build wealth faster than just using your savings, as you'll have more money to invest. For example, rather than saving the full amount to purchase an investment property, most people borrow money to be able to buy the property and start to benefit from potential increases in its capital value and rental income.

There can also be tax advantages associated with gearing, as the interest payments on the loan are generally tax deductible.

Typically, investors borrow money to buy an investment property or shares. The strategy usually is successful when the long-term returns from your investments (income returns and capital growth) are larger than interest payments and fees associated with the loan.

Depending on the type of investment chosen, considering an investment timeframe of at least five years may help make the most of its potential to build wealth. Generally, an effectively geared investment:

- needs a reliable cash flow to cover loan repayments, this should come from your main source of income without having to rely on income generated by the investment
- generates a reliable, long-term income
- needs to gain enough in value (capital growth) during the time it is held, and
- as debt decreases the investment's net yield increases (eg rent from an investment property) so you're earning more (but may have to pay more tax).

At the same time, borrowing to invest generally increases your risk, as it can increase your losses. Remember loans need to be paid back regardless of how the investment performs. For example, if a property was purchased with a home loan and a quick sale was needed shortly after the house price had dropped, the owner would still be liable to pay back the full loan amount even if the property sale didn't cover it.

Margin loans

A margin loan is used to borrow money to invest in shares or managed funds. The lender takes the shares or managed fund as security for the loan which means they can sell them to repay the loan if necessary. Margin loans can be made on either a one-off, upfront lump sum basis, regular or instalment basis, or as a combination of the two. In addition, other investments you already hold can be used as security for the margin loan.

Margin loans typically require the borrower to maintain a maximum loan to value ratio (LVR) of 70% or less.[1] The initial LVR may be limited to, say, 66%. The difference to 70% is a buffer allowing for a decrease in value before a margin call is made.

The value of these investments fluctuate daily. So, if their value drops, your lender may require you to pay a margin call which means you will either need to top up your investment or repay some of the loan to restore the LVR. This can greatly increase the risk, as you may be forced to sell part of your investment to make the repayment at a time when markets have fallen. That's why when it comes to borrowing for margin loans you may want to consider your risk appetite and potentially borrow an amount well below the maximum LVR.

1 ASIC Moneysmart, website, **Margin Loans**

Example

Gill is a savvy investor. She decided to take out a margin loan to increase the amount of money she can invest in the Australian share market. Gill used her existing share investments as security (60%) and borrowed another 40% of the total investment amount (eg total investment $100,000), even though her lender offered her up to a 60% LVR. Gill's initial LVR was 40%, she bought the shares she wanted and they started increasing in value over time.

However, a major geopolitical event took place, which sent shockwaves through global share markets. The value of Gill's investments tumbled by 30% below her initial $100,000 investment. Some of Gill's fellow investor friends were facing margin calls, as they had borrowed at a higher LVR. Luckily Gill had borrowed conservatively, which helped her to avoid a margin call. Even with a fall like this the LVR on Gill's margin loan is still 57.14%, which is within the margin lender's allowable limit. She was able to hold on to her shares in the hopes that they would once again increase in value, instead of being forced to sell them at a lower price.

This example is illustrative only and is not an estimate of the investment returns you will receive or fees and costs you will incur.

Debt can be a tool to help you to get closer to your long-term goals, but there are no guarantees. If you are considering a margin loan, be sure to research the limits and risks with your lender.

Getting help with debt

If you're finding it hard to keep up with your repayments, call your providers as soon as you can and tell them you're experiencing financial hardship. They can assess your situation and see if alternative payment plans may be able to assist you during difficult times.

We’re here to help

- **Read more about how to manage your money.**
- **Access support and information about how to manage in times of need**.
- **Get in touch** with AMP Bank on 13 30 30 or the AMP Super and Retirement team on 131 267.

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