



# Advice Guide - Debt Management

## How to read this document

This document contains general information about the benefits, costs and risks associated with certain product classes and strategies. It is designed for use in conjunction with a Statement of Advice that takes into account the circumstances and objectives of an individual. Before making a commitment to purchase or sell a financial product, you should ensure that you have obtained an individual Statement of Advice prepared by WARR HUNT Pty Ltd.

As legislation may change, you should ensure you have the most recent version of this document. Please contact your Adviser if you do not understand anything or need further information.

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# Debt Facilities – property secured

## Loan 'principal' and 'interest'

Your home loan is made up of two parts: the loan principal and the interest.

- The loan principal is the amount you borrow to fund your property purchase. This is the difference between the full cost of the property and your deposit.
- The interest is the amount you're charged by the lender for borrowing the principal amount.

Below is a brief description of the main types of loan facilities secured against Property Assets.

## Principal and Interest loans

If you have this type of loan, you'll need to pay both the principal as well as the interest charged on it.

The repayment required is based on the outstanding principal, interest rate and term of loan. Generally, the repayment is reset on the anniversary of the loan commencement or where the principal outstanding requires a higher repayment due to rising interest rate and reducing term.

## Interest Only loans

This is when you only pay the interest portion of your loan for a set period, for example the first five years of your loan. As you're not making payments on the 'principal', this will remain the same, unless you choose to make additional repayments.

At the end of your interest-only period, you'll need to start paying off the principal at the current interest rate at that time. While interest-only repayments are lower during the interest-only period, you'll end up paying more interest over the life of the loan.

## Line of Credit facility

A Line of Credit facility is a facility with a limit of amount of funds you can draw. You may start with a zero balance and draw progressively or in one full amount. The advantage of line of credit facilities is you can draw down as required and only pay interest on drawn funds.

Some banks offer split line of credit facilities, this may be split into two or multiple accounts, and allow offset facilities (see Offset Accounts).

### Factors to be aware of

- *A line of credit requires discipline and should be used as part of a structured plan.*
- *If the loan is not fully drawn interest may capitalise and accelerate the loan balance toward the limit.*
- *You only have to meet the minimum monthly amount once fully drawn and without a disciplined structure may never pay down the loan.*

## Offset Accounts

An offset account can be operated as your normal transaction account, ensuring you retain complete flexibility and access to your funds. When your interest is calculated, the funds held in this account are 'offset' against your loan, effectively reducing your interest liability.

Using an offset account to its optimum involves keeping all your income and any savings in this account for as long as possible. This effectively minimises the daily balance owing used to calculate your loan interest and as a result, can also reduce the term of your loan.

If you have an investment loan, there is an advantage in making additional repayments into an offset account rather than making the repayments directly into the investment loan. While in both cases you will reduce the effective loan balance and save interest, you are able to withdraw funds from the offset account whilst maintaining full tax deductibility of interest on your loan.

## Redraw Facility

A redraw facility allows extra funds paid into the loan (above the minimum requirement) to remain available to you upon application to your lender. Additional repayments made directly into the loan result in less interest being charged and a reduction in the term of your loan.

### Factors to be aware of

- *Depending on your loan contract there may be fees payable and some restrictions on minimum amounts that can be redrawn.*
- *If you make additional repayments directly into an investment loan and then redraw these funds for a non-income producing purpose, the interest expenses will not be fully tax deductible.*

## Variable Rate loan

Variable rate loans have an interest rate that may change. Therefore, minimum repayments may vary. Often, variable rate loans have a lower interest rate than fixed rate loans. Variable rate loans also have greater features than fixed rate loans, such as the ability to make additional repayments, vary payment frequency, redraw facility and offset facility (see Offset Accounts).

## Fixed Rate loan

Fixed rate loans protect you against the risk of an interest rate rise by fixing the interest rate applicable to all or a portion of your loan for a set period of time. If interest rates rise, you will have the security of knowing the interest rate on the fixed portion of your loan and your regular repayments will not change until the end of the fixed period.

### Factors to be aware of

- *If variable interest rates fall during the term of your fixed interest rate loan, you won't benefit from this.*
- *Fixed rate loans generally have limited features and restrictions are applied on additional repayments which may prevent you from accelerating the repayment of your loan.*
- *Early payout fees usually apply to fixed rate loans.*

# Debt Management Strategies

Debt or borrowed money can play an important role in helping you achieve your lifestyle goals and objectives. However, it is important it be managed and structured effectively to minimise borrowing costs. The way debt is managed may depend on whether it is considered 'efficient' or 'inefficient'.

## Efficient debt (tax deductible)

In most cases, debt used to purchase assets that produce income (for example, a portfolio of shares or an investment property) qualify for a tax deduction in relation to interest costs. This form of debt is considered to be 'efficient'.

## Inefficient debt (non-tax deductible)

Loans taken out to purchase services or assets which do not generate income (for example, to purchase a principal residence, a car or fund a holiday) do not qualify for a tax deduction in relation to the interest costs. This debt is considered to be inefficient from a wealth creation perspective and is often draining on your long-term wealth accumulation capacity when not managed properly.

Wherever possible you should try to accelerate the repayment of your inefficient debt.

## Reducing inefficient debt

By accelerating the reduction of your inefficient debt, you can:

- Reduce your total interest payments and reduce the duration of your inefficient debts
- Increase the equity you have in your home which can be potentially used as security to borrow for investment purposes later on; and
- Potentially provide you with more cash flow at the end of the loan term that can either be used to repay other debt or to make additional investments.

There are various debt management strategies that can be used to reduce inefficient debt. We have listed some common strategies below.

- **Increasing the loan repayments** - This will result in a reduction in the interest charged and principal owing on the loan.
- **Increasing payment frequency on your loan** - As interest on your loan is calculated daily on your outstanding loan balance, the longer the period between your payments, the higher the average daily loan balance and the greater the interest charged. More frequent loan repayments will result in less interest being charged and may result in a reduced loan term.
- **Making additional lump sum payments** - The benefit of this strategy is you will effectively be earning an after-tax return equivalent to your loan interest rate. It is unlikely you could obtain an after-tax return as high as this from other investments with the same level of risk.

## Consolidating your debt

A simple strategy to lower your overall interest rate and more easily manage your debt is to consolidate all debts into one loan that provides a lower interest rate and features to help you repay your inefficient debt faster.

Loan consolidation will save you interest where your new repayment and loan term are at least equal to your total current loan repayments and loan terms. Otherwise, you could be converting your short-term debts into longer-term debt and be paying more interest in the long run.

## Debt recycling

Debt Recycling is a process of using surplus capital or cashflow to reduce inefficient debt and then replacing it with efficient debt in the form of an investment loan. The investment loan proceeds are then invested to form part of your investment portfolio. The inefficient debt is eventually extinguished and an investment loan with fully tax deductible interest remains.

Debt Recycling is a Gearing strategy – see **Advice Guide – Gearing**. Debt recycling can be an effective strategy to accumulate wealth over the long-term. To implement this strategy, your tolerance for risk should allow you to feel comfortable with borrowing to invest. There are two ways debt recycling can be undertaken:

### Lump sum debt recycling

If you have available capital such as bank account savings, this can be used to repay any inefficient debt such as a home mortgage or personal loan. An investment loan can then be taken for the same amount and be used to invest in an investment portfolio.

### Regular debt recycling

If you have regular surplus income, this can be used to increase the regular repayments on your inefficient debt such as your home mortgage or personal loan. An investment loan can then be increased by a corresponding amount and the proceeds used to invest in an investment portfolio.

## Other Types of Debt – Non-Property

Other types of debt are, but not limited to, as follows:

- Credit Cards
- Personal Loans
- Margin Loans
- Chattel Mortgage
- Asset Finance
- Business Loans

Each of these have a specific purpose and your advisor can explain the features, benefits and use of these where appropriate.