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Manage your Debt – Swim Don't Sink

Kiwi households are struggling to service debt after years of borrowing against the increasing value of their house. Now the value of houses have turned downward it's time to manage your debt so you have more money to spend, says the Institute of Financial Advisers (IFA).

According to Reserve Bank statistics, household debt was around 60% of disposable income in 1991 and has now escalated to almost 160% of disposable income.

Lyn McMorran, president of the IFA says that is alarmingly high. "Although interest rates have declined over that time, debt servicing as a percentage of household disposable income has dropped from almost 16% to around 9%. This means that people are paying off less of their debt every month with the result that the debt is not decreasing."

Not all debt is bad says the IFA. 'Good Debt' is debt that is incurred to buy something that increases in value over the long term. A good example is a house. 'Bad debt' is borrowing to buy something that decreases in value like a car or a boat. In the example below, it is easy to see why debt for a car would be considered bad debt.

	House	Car
Buy for	\$125,000	\$10,000
Borrow	75%	75%
Interest rate	8.5%	13.95%
Own for	20yrs	5 yrs
Sell for a net	\$393,000	\$2,500
Gain / Loss	\$268,000	-\$7,500
Total interest	-\$101,510	-\$4,445
Overall profit	\$166,490	-\$11,945

McMorran says it is important to only incur efficient debt. "Efficient debt has a lower interest rate, it is flexible and allows you to make early repayments without paying a penalty and

you are able to deduct it from taxable income. A good example is a mortgage on an investment property.”

Inefficient debt by comparison is debt that draws a high interest rate, will result in high penalties on early repayment and is paid from after-tax income. An example would be a car financing.

Do you know the cost of your debt? Do you know how much interest will you pay over the term of your loan? McMorran says these are questions you should be able to answer if you want to actively manage your debt. “The golden rule is to eliminate bad debt and then to avoid it.”

IFA has a number of tips to help you manage your debt.

- Rank your debt according to its cost. Pay off the most expensive debt first, namely hire purchase and personal loans. Your mortgage is usually the cheapest.
- Lower the cost of your debt by switching to lower cost debt, such as consolidating your debt. For example increase the mortgage to pay off unsecured loans or credit card debt.
- Borrow against the house rather than getting car finance, as it is normally cheaper.
- Spread your risk with your mortgage by having some of your mortgage on a fixed rate and some on a floating rate. You can usually make early payments on the floating rate portion without penalty.
- Make your mortgage payment date the same as your pay-day, so that you reduce the amount of interest paid.
- If you have a mortgage with a monthly payment, consider paying half the monthly amount each fortnight. This will mean you make 13 rather than 12 payments in a year and will clear debt more quickly and therefore will save a lot of interest.
- If the rate of interest on your mortgage falls, try to keep your payments at the same level as you will pay off the loan faster and pay a lot less interest over the term of the loan.
- Consider a revolving credit mortgage, but only if you are sure that you have the discipline to keep making repayments rather than borrowing more.
- Commit to a “debt free date” before retirement, as you will be able to save heaps after this.

ENDS

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