Debt Management – Debt recycling

Debt recycling is the process of replacing mortgage debt (non-deductible), with investment debt (deductible).

This strategy enables you to start building wealth while you are still paying off your home mortgage. You effectively take out equity from your home and invest somewhere else, where you can potentially achieve a high level of income and growth. Income from these new investments can be used to further reduce the mortgage balance, while the growth component contributes to wealth accumulation.

Although gearing can deliver benefits, the risks associated with gearing may mean it is unsuitable for you. It is essential to carefully consider these risks before proceeding with a gearing strategy.

Benefits

- You are able to invest immediately rather than waiting for the mortgage to be paid off. It allows the power of compounding earnings to start working earlier.
- By directing investment and other available income into a home loan, there is the opportunity to reduce it faster and therefore save on interest.
- Borrowing to invest can provide tax effectiveness through the deductibility of interest. This will reduce the net cost of the strategy to you. The higher your marginal tax rate, the more profitable this strategy is.
- You will be invested in a larger investment portfolio than available without borrowing.
- Gearing provides for a diversified approach to create wealth for your retirement. It can reduce the risk of adverse legislation changes regarding your retirement savings inside superannuation.

How it works

This strategy involves transferring your non-deductible debt of a home loan into a tax deductible debt of an investment loan. The primary objective is to reduce the non-deductible debt faster than just making regular repayments, while accumulating wealth.

All surplus cash flow, after the interest is paid on the investment loan (line of credit), is used to reduce a non-deductible home loan, thereby more rapidly increasing equity in the home. Home loan repayments are 'Principal and Interest' while the investment loan payments are 'Interest Only' to ensure that non-deductible debt repays earlier and deductible debt works to the maximum. All investment earnings, franking credits, tax refunds and other surplus cash flow, after paying the investment loan interest, should be used to further reduce the home loan and increase equity in the home. Over time, amounts equivalent to the increase in equity can be drawn down and invested in growth investments further, if desired (depending on your life stage and objectives). The above process is repeated over future years in a disciplined manner to reduce the non-deductible home loan more rapidly, whilst increasing investments into growth assets.

To commence a debt recycling strategy, you need to ensure you are able to achieve a desirable loan structure, please contact your financial institution to discover further details. A loan facility allowing separate sub-accounts is preferred, with the ability to choose between principal and interest and interest only repayments. As some of the investment debt will have deductible interest costs, these amounts should be kept separate.

Risks and Consequences

- Debt recycling can lead to compounding losses when markets experience a downturn.
- Interest rates associated with loan facilities used in debt recycling strategies are often higher than the standard variable mortgage rate.
- Debt recycling is not recommended for anyone with an investment timeframe of less than seven years.
- It is a risky strategy and only suited to investors with a reasonable risk tolerance and a secure income source.
- You should have adequate life insurance to help meet loan repayments if your income stops because of death or illness.

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