Paying off debt

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If you have both personal debt and some spare money (either capital or income), should you invest the money for your retirement or use it to pay off the debt?

Like any investment decision it depends on the expected return, the relative risks of each option, and your preference. For most people, until the introduction of KiwiSaver, the answer was simple - pay off debt. With the introduction of KiwiSaver, the answer is now often, save the minimum through KiwiSaver to minimise the subsidies and pay off debt with the balance. The working of KiwiSaver is looked at later. If it were not for schemes like KiwiSaver and alternative employer subsidised superannuation, it is generally better to pay off debt.

Besides achieving a better return net of tax and fees, paying off debt normally lowers your future investment risks.

- Most people should pay off debt before they save.
- Paying off debt gives a high effective return.
- Paying off debt reduces risks.
- Not taking on new debt is normally a good idea.
- The main exceptions are KiwiSaver and other employer sponsored superannuation schemes.
- SuperLife is a flexible, registered superannuation scheme that provides access to a range of savings and insurance benefits.

A better return

If the interest rate you pay on the debt is 7%, then in order for the "invest" option to be the better option than the "pay off debt" option, your return after-tax and after-fees has to be more than 7%. If your net return is 7%, the gross return before expenses, at 28% tax, is:

Net return	7.0%
Tax	2.7%
Gross return	9.7%

Your potential investment has to produce a return of at least 9.7% each year after fees to make the "invest" option more attractive. At higher tax rates, e.g. 33%, your required return is higher at 10.4%. At higher levels of interest rates on debt, your required gross return is also higher.

There are not many investments that will deliver a required gross return of 9.7% each year. Those that might will generally be very volatile. Also, remember that a return of 9.7% p.a. only achieves the breakeven point while the 9.7% on paying off the debt (e.g. the mortgage) is effectively guaranteed. It is also an after-expense return.

The breakeven gross returns before fees, at various combinations of tax and interest rates are:

	Mortgage interest rate				
Tax rate	5.0%	6.0%	7.0%	8.0%	9.0%
10.5%	5.6%	6.7%	7.8%	8.9%	10.1%
17.5%	6.1%	7.3%	8.5%	9.7%	10.9%
28%	6.9%	8.3%	9.7%	11.1%	12.5%
30%	7.1%	8.6%	10.0%	11.2%	12.9%
33%	7.5%	9.0%	10.4%	11.9%	13.4%

General rule

The general rule is pay off debt before you invest. There are some exceptions to this general rule.

- **Employer schemes.** If you have access to an employer subsidised superannuation scheme; you should probably join and contribute at the level that maximises the employer subsidy. Contributions above that level (i.e. voluntary contributions) are best used to pay off debt.
- **KiwiSaver.** Because of the government payments to KiwiSaver and the employer contributions if you are an employee, you should probably join KiwiSaver.
- **Student loans.** As student loans are interest free, there is normally no financial advantage in paying them off quickly.
- **Tax deductibility**. If your debt results in the interest you pay being tax deductible, the required gross return is equal to the interest rate plus fees. This can make the “invest” option a better choice but normally doesn’t because of fees unless the investment option is your own business.
- **Inflexible**. If your debt is inflexible and cannot be repaid back faster or earlier, or if by paying the debt back you don’t change the total payments required, the “invest” option may normally be better.

Lowering your risk

Paying off debt also tends to reduce your risk. Lowering your outstanding debt puts you in a better position to withstand events such as sickness, redundancy etc. It will also mean that you have greater future borrowing power, should the need arise.

Tips

When it comes to debt and mortgage repayments, the best practices include:

- **Frequency of payment.** Make your mortgage payments with the same frequency as you receive your pay - ideally, the day after your pay day.
- **High debt first.** Pay off your higher interest rate debt first, e.g. credit cards before your lower debt, e.g. mortgage. In fact, you should look to consolidate your higher interest debt into your mortgage.
- **Avoid debt.** While paying off debt is normally the best option, avoiding debt in the first place, particularly hire purchase and credit cards, is an even better option.
- **Long term.** Your long term objective is to reach retirement with no debt.

KiwiSaver

The KiwiSaver rules are complex and depend on whether you are an employee or not an employee. In both cases you get "free" money from the government that increases the effective return on your savings.

If you are an **employee** then joining KiwiSaver:

- you pay 3% of your pay, for at least 12 months.
- the government pays a kick-start of $1,000 plus subsidises your savings $1 per $2 up to $521.43 a year.
- your employer pays a minimum of 3% unless they are saving to an "existing" scheme.

The combination of the government and net employer money, makes KiwiSaver a better return then paying off your mortgage.

If you are **not an employee**, the employer subsidy does not apply, but you still get the government money and this normally makes it better than paying off debt. If you are not an employee and are 18 or older, the optimal contribution is $1,042.86 a year i.e. $87 a month but you can choose to pay nothing.