

What you need to know about...

PAYING OFF DEBTS EARLY

Most people use short term debts, such as personal loans, credit cards or store cards, at some point during their lives. However, few realise how significant an impact this can have on their financial well-being. Albert Einstein once remarked that 'the most powerful force in the universe is compound interest,' and it is this interaction that this factsheet attempts to explain. Basic financial planning says that you should always attempt to pay your debts off before you save.

Why pay off your debts early?

Basic financial planning states that you should always attempt to repay your debts before you try to save for other long-term goals. This is a fact of life because most debt will have greater interest rates than that achievable through savings.

For example, if you examine a bank savings account you might be able to achieve interest of 4% to 5% per year, and this interest will usually be taxable. In comparison, personal loan rates vary from 7% to 20% per year, and some credit cards will cost up to 30% per year.

From this point of view it makes sense to clear your debts as soon as possible.

How debt affects our ability to plan

Debt obviously allows us some short-term aid. For example, you might use a loan to make a significant purchase or make an improvement to your home. However, the resulting interest can have a significant impact on your future financial well-being. While you are paying interest, you are paying this to someone else. If you could avoid paying interest, this money can be used to your advantage.

Compound interest applies to every debt you have. What happens with compound interest is that interest will be added to the balance, so that over time interest can be paid on the interest. If repayments are not made, or are not of sufficient levels, this can

lead to the debt growing over time.

Making minimum repayments

It is common, especially with credit cards, for a provider to insist that you make minimum debt repayments. It can seem attractive to simply make these repayments because they keep your outgoings low. However, in the long run this will make you pay more interest.

For example, it is typical for a credit card to require repayments of 2% to 3% per year. This payment would result in only a small proportion of the debt being repaid, the majority being interest. This can mean that you would take many years to clear the debt. When you consider the very high interest rates on credit cards, this can mean thousands of pounds in extra interest.

The effect of overpaying

If you can overpay on your debt, even by a small amount each month, this can reverse the effect of compound interest. The overpayment (if allowed by your contract), will reduce the balance quicker, leading to less interest being paid. Overleaf, are some calculations of how this could work in practice, given a generic charging structure.

A note of caution!

You should always bear in mind that your own debts

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may have penalties to redeem the balance. We advise that you examine your contract carefully!

Also, different contracts will calculate interest in different ways, so you need to be careful in your calculations. Each loan will give a comparative indicator, called the APR (annual percentage rate). This will give a percentage annual rate based on the total charges for the scheme.

Which debt to repay first?

The general advice is to combine all your resources into the repayment of one debt at a time, to repay this as quickly as possible. Normally, we would recommend that you repay the debt with the greatest interest first.

Some examples

In these examples we have assumed that interest is applied monthly and there is no penalty for making regular overpayments.

Credit card balance: £5,000
Interest rate: 25%
Minimum repayment: 2.5%
Monthly repayment: £125.00

Total interest: £5,862.28
Total repaid: £10,862.28
Paid off in: 7 years and 3 months

Example 1

Extra monthly repayment: £5.00
Interest saved: £674.27
Paid off: 8 months early

Example 2

Extra monthly repayment: £15.00
Interest saved: £1,609.32
Paid off: 1 year 8 months early

Example 3

Extra monthly repayment: £25.00
Interest saved: £2,236.78
Paid off: 2 years 5 months early

Example 4

Extra monthly repayment: £125.00
Interest saved: £4,326.86
Paid off: 5 years early

These figures hopefully go to show the benefits of repaying your debts early!

Equivalent tax-free growth

If you were to calculate the amount your overpayments would have to grow by each year to generate the interest saved, this equates to a tax-free growth figure. In the case of example 4, this equates to a growth of 57%. There are few 'investments' that could promise this level of 'growth'.

Work it out for yourself

We have a **free calculator** available on our website. The figures are for information only, but will give you a useful indication of the interest you can save.

Go to: www.woodruff-fp.co.uk/debt.htm

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