Debt strategies

Use emergency cash more effectively

Using emergency cash to reduce your mortgage could provide a higher after-tax return than a cash account and reduce the home loan term.

How does the strategy work?

Holding a cash reserve for emergency purposes is always wise. You might need the money for an unplanned trip, urgent repairs to your home or an unexpected illness.

Many people keep their emergency reserve in a cash account because it gives them immediate access to their money.

But the problems with cash accounts are that:

- the interest rate is usually much lower than the rate that you pay on your home loan, and
- every dollar you earn is taxable at your marginal rate, which could be up to 49%[1].

A potentially better option is to hold your emergency cash in an offset account[2] or your home loan (provided it has a redraw facility[3]).

By doing this, you will reduce the balance on which your home loan interest is calculated. As a result, you will effectively earn the rate of interest charged by your home loan and no tax is payable on these savings.

If you then continue your repayments at the same level, you'll pay even more off your loan and eliminate your debt sooner. Plus, you can usually access your emergency cash via a redraw facility or 100% offset account within 24 hours.

Other considerations

- An offset account may be a better option for your emergency cash because fees and restrictions may apply to a redraw facility.
- Some lenders allow you to establish multiple offset accounts to help you better manage your cashflow.
- You should ensure you have enough insurance to protect your income and cover loan repayments in the event of your death or disability.

Seek advice

A financial adviser can help you assess all the issues that need to be considered and determine whether you could use your emergency cash more effectively.

	Earn higher interest rate	Tax-effective	Repay home loan sooner	Fast access to emergency funds
Cash account				•
Home loan / 100% offset account	•	•	•	•

1 Includes Medicare levy and Temporary Budget Repair levy.

2 An offset account is a transaction account that is linked to a home (or investment) loan and the balance is directly offset against the loan balance before interest is calculated.

3 If your home loan has a redraw facility, you can make extra payments directly into your loan and withdraw the money if necessary. You should confirm with your lender whether any fees apply.

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Case study

Max and Sue have a home loan of $400,000, the interest rate is 7.5% pa and they are making the minimum repayment of $3,153[4] per month.

Sue recently received an after-tax bonus of $12,000 and the money is sitting in their joint cash account earning 4% pa.

Although they can access these funds at any time to meet unexpected bills or expenses, the after-tax return is only 2.44% pa, assuming they both pay tax at a marginal rate of 39%[5].

To use their emergency cash more effectively, their financial adviser recommends they transfer the money into a 100% offset account linked to their mortgage.

By using this strategy, they will reduce the home loan balance on which interest is calculated from $400,000 to $388,000. As a result, their emergency cash will effectively earn the home loan interest rate of 7.5% pa, which should not be subject to tax.

Their adviser also explains that if they continue to make home loan repayments of $3,153 per month, they will save a total of $36,711 in interest and cut over a year off the term of their loan (see table below).

Furthermore, they will be able to withdraw their emergency cash from the offset account at any time.

4 Assumes loan term is 20 years.

5 Includes Medicare levy.

	Retain emergency money in cash account	Transfer emergency money to offset account
Loan balance on which interest is calculated	$400,000	$388,000
Monthly home loan repayment	$3,153	$3,153
Time taken to repay home loan	20 years	19 years
Total interest payments	$355,988	$319,277
Interest saving		**$36,711**

Note: They could gain the same benefits by transferring the money directly into their home loan, as long as it has a redraw facility. This doesn't consider any fees and charges which may be payable if funds are redrawn.

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