PERSONAL FINANCIAL MANAGEMENT

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Revised edition

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Preface

This new edition of *Personal Financial Management* is not only for people who want a practical explanation about how to manage their personal finances, but also for those who may be contemplating a career in financial planning. It describes information, skills and techniques that are easy to understand and simple to use. The book is divided into six parts:

- Part A is concerned with the initial steps in developing a personal financial plan. It focuses on a systematic approach to financial planning and useful techniques for cash management.
- Part B guides you through borrowing and credit. It looks at borrowing procedures, consumer credit, car loans and home loans.
- Part C examines insurance. It describes insurance principles, property and liability insurance, life insurance, disability insurance and health insurance.
- Part D presents elements of investing, including investment fundamentals, investing in the stockmarket and investing in property.
- Part E investigates important elements of taxation. It explores the basic operation of the income tax system and a systematic approach to tax planning.
- Part F focuses on retirement planning. It examines the nature of the superannuation system, what to look for in a superannuation plan and important issues when you enter retirement.

The authors' objective is to equip you to manage the continuing and predictable financial challenges that occur throughout everyone's life. We are indebted not only to those who have encouraged us to write this book, but also to our students who have inspired us to discover fresh and informative approaches to learning about personal financial management.

Part A
Getting started

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1 Financial planning

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Imagine how great it would feel to win Lotto and suddenly have enough money to pay off your debts and become financially secure for the rest of your life. Even if that dream came true, you would soon discover that simply having a lot of money does not end the need for personal financial management. In fact, the more money you have, the more important personal financial management becomes.

The starting point in personal financial management is establishing a financial plan. Everyone has different responsibilities, values, needs, wants and resources. You need to determine your own plan because you are the only one who fully understands how you live and work, your preferences, your obligations and your dreams for the future.

The purpose of this first chapter is to focus on your financial plan. We begin by looking at a variety of financial goals with a view to identifying the ones that are most important to you. Then we examine how your financial goals are likely to change during your lifetime. Having identified what you would like to achieve, we outline some steps in planning how to get there. The chapter concludes with a discussion about financial advisers.

FINANCIAL GOALS

In order to build a financial plan, you need to identify your wants and needs in terms of specific financial goals. Some financial goals are immediate, like paying your bills, running your car and buying food. Other financial goals focus on the next two or three years, like saving for a deposit on a house, buying a new car or taking an extended holiday. Long-term financial goals are the ones that you hope to reach in the next 10 to 20 years, like paying off a mortgage, putting your children through university or providing for your retirement. Let's begin the search for your financial goals by reflecting on the following questions.

- What is your biggest money problem?
- If you won $10 000, what would you do with the money?
- If you lost your job through redundancy and you needed to make a major cut in spending, what would you cut?
- Do you know how much you spend on rent or mortgage payments, food, transport, gas and electricity, clothing and entertainment?
- What are the things on which you would like to spend more money?
- What are the things on which you think you should spend less money?
- What is the most foolish thing on which you have ever spent money?
- What is the most sensible thing on which you have spent money?
- What is your attitude towards buying things on credit?

The way you answer these questions will tell you something about your financial values and how you feel about a number of money issues. Now look at the following list and try to decide which things are *most important* to you, which things are *somewhat important* and which things are *not important*.

- education
- holidays
- saving money
- your own business
- religion
- cultural events
- sports
- job success
- food
- insurance
- superannuation
- investments
- jewellery
- new home
- family
- health
- higher income
- friends
- new car
- paying off debts
- clothes
- entertainment
- boat
- other things

One of the reasons that people are different is because they value things differently. Your answers to these questions will help you to recognise many of the deeply rooted beliefs that you have about what is important to you and what is not. These values are not necessarily right or wrong. They simply express what matters to you and they will help you to identify your financial goals. Financial goals fall into one of the following categories.

Managing current expenses

The principal tool for managing current expenses is a budget. Just like a well-run business uses a budget to manage its finances, so can you. A personal budget provides you with a framework for planning your cash flow around your spending priorities.

Saving for future expenses

Saving money not only enables you to meet emergencies if they occur, but also provides cash for future expenses when they are needed. Saving is the first step towards achieving your investment goals. Saving money is not something you do after you have paid the bills. The amount you save depends on how much income you have and how important saving money is to achieving your other goals.

Credit and borrowing

There are many reasons why people use credit and borrow money. There are also different types of loans and credit for different purposes. When you decide to borrow money, you should be aware of the types of loans that are available, from whom, and on what terms and conditions. You also need to understand the procedures involved, what is required of you by lenders and credit providers, and what will happen if you default on your contract. The amount of borrowing that you can afford depends on your financial circumstances, your employment situation and your future prospects.

Insurance protection

Insurance is used to protect you and your family against financial loss caused by accidents, illness, death, loss or damage to personal property, and loss of income. The main types of insurance include life insurance, health insurance, disability insurance, credit insurance, car insurance and home and contents insurance. When you buy insurance, you need to consider what risks threaten you financially and how best to transfer these risks from yourself to the insurance company.

Investing

There are two reasons why people invest. The first reason is to accumulate assets and the second reason is to derive an income. What do you want to achieve by investing and over what period of time? Are you putting money away for your children's education? Are you building a nest egg for your retirement? Do you want to invest in the stockmarket or property? Your investment goals will be tempered by your financial position, your age, your tax position and the amount of risk that you are willing to bear.

Minimising tax

One of the responsibilities that goes with living in Australia is the obligation to pay your fair share of the taxes that are used to run the country. The tax laws are not only complex, but they are also subject to continual change. It is illegal to evade taxes, but it is not illegal to avoid them. That means you are entitled to use every legal means available to minimise the amount of tax that you pay. If your tax situation is straightforward, there is no reason why you cannot do your own tax return each year. If, however, you

are unsure about how to plan your tax affairs or file the necessary returns, then you can consult a tax adviser.

Providing for retirement

Retirement can be an exciting part of life. To make it comfortable, however, you need to plan for your financial security, your emotional and physical health, and what you are going to do with so much free time. An important part of retirement planning is to take control of your financial future by implementing a retirement savings strategy throughout your working years. When you retire, you want to be able to enjoy yourself without the stress of financial uncertainties.

FINANCIAL LIFE CYCLE

Your financial goals change as you navigate through life. When you are young and single, your financial goals are generally related to your own personal growth. During most of your working years, your financial goals are focused on maintaining a family, accumulating assets and providing for your eventual retirement. When you do retire, your financial goals are concerned with maintaining a secure and enjoyable lifestyle. This evolution of financial goals over a lifetime is called the *financial life cycle*. Table 1.1 contains the results of a survey that asked people how they ranked their spending priorities. Notice how the priorities change from one age group to the next.

The youngest group spends a significant proportion of their money on lifestyle. In the late twenties and thirties, the emphasis shifts to paying the mortgage and educating the children. In the forties and early fifties, paying

Table 1.1 Spending priorities (per cent of disposable income)

	Age group			
	18–24	**25–39**	**40–54**	**55+**
Paying off the house	14	48	38	12
Paying rent	36	22	12	14
Saving for retirement	1	2	24	25
Holidays	8	2	5	20
Children's education	2	10	10	1
Car	19	5	2	2
Entertainment	11	3	2	7
Clothes	0	0	0	1
Other	9	5	6	19

Source: 100F/ASSIRT Survey, *Australians and Their Money*, 1998

off the house and educating the children are still important, but a new emphasis on saving for retirement emerges. In the last group, saving for retirement continues to be important, but spending also increases on holidays and other things.

Not everyone experiences the same financial circumstances, so we each have our own financial outlook. Regardless of how unusual your life may be, you will find much in common with the typical stages of the financial life cycle. Find the stage that describes your current circumstances and think about your immediate financial goals. Then consider the succeeding stages of the financial life cycle and imagine how your financial goals are likely to change.

Young singles

Young singles represent the first stage in the financial life cycle. These are unattached young adults who are self-supporting even though they may be living with relatives or friends and sharing some household expenses. Finding that first job and becoming financially independent top the list of financial concerns that are mostly focused on personal, educational and financial development.

- *Current expenses:* The most pressing task at this stage of the financial life cycle is simply finding enough money to pay your expenses. It is likely to be the time when you first learn how to budget your money.
- *Saving:* This is a good time to establish savings habits. Putting a little money away for emergencies and saving for things like a car or an overseas trip are important priorities.
- *Borrowing:* This is the stage when you initially go about establishing credit. You need to find out how to borrow money and what you have to do to get a credit card.
- *Insurance:* Consider the pros and cons of private health insurance and disability insurance to protect your income if you suddenly cannot work. Make sure that your first car is adequately insured.
- *Investing:* Money is short and investing is not really an issue. However, this is an excellent time to learn about investing so that you are ready when the high-income years arrive.
- *Taxation:* Your first tax return may result in a refund. It is also likely to be a simple return that you can do yourself. Don’t start off on the wrong foot with the Australian Taxation Office by neglecting to file your first tax return on time.
- *Retirement:* Retirement is probably too far away to contemplate. The provisions of the Superannuation Guarantee Scheme, however, mean that you will automatically begin to accumulate something towards your

retirement when you get your first job. If you are self-employed, you are not covered by the Superannuation Guarantee Scheme and you may want to consider making a start on your own retirement savings program.

Young couples

This second stage of the financial life cycle is a period of personal and financial adjustment for two people who have decided to be together. There are no children at this stage and there are often two incomes. Important considerations are adjusting to each other's needs and agreeing on present and future financial goals. An increasing proportion of young couples will continue to rent, with less than half deciding to buy their first home.

- *Current expenses:* If there are two incomes, cash flow is suddenly very good. Budgeting revolves around how to allocate this spending power between household purchases, entertainment and saving.
- *Saving:* Now is the time to establish your savings program. Couples who defer buying their first home will be able to save much faster than those who are paying off a mortgage. Establishing a nest egg now is going to pay big dividends when you enter the next stage of the financial life cycle.
- *Borrowing:* You find it hard to resist the temptation to borrow in order to buy household goods and perhaps a home in which to put them. You have enough income to service the debt, so you find it easy to borrow. However, too much debt, especially too much short-term debt, can rob you of your financial flexibility.
- *Insurance:* Health and disability insurance may already be in place through your employer. However, you should recognise that you are entering a period in which you may also need to consider life insurance. If you own property, it will need to be insured.
- *Investing:* This is an excellent time to consider investing as part of your savings program. You will need extra cash in the next stage of the financial life cycle, so stick to investments that are easily liquidated.
- *Taxation:* Tax returns at this stage come as a shock when you discover that you are now funding the Government rather than the other way around. It is time to look for ways to minimise taxation, such as salary packaging and other tax incentives.
- *Retirement:* Retirement planning is likely to remain on the back burner. While the Superannuation Guarantee Scheme is making some contributions, this will not be enough on which to retire comfortably. For dual income couples, this is an early opportunity to top up their superannuation savings.

Young families

This stage of the financial life cycle is characterised by the leap into total adult responsibility and dominated by caring for dependent children. In many young families, the principal child carer may want to stay at home while the children are young and the family will have to get along on one income. With a little luck, this stage may coincide with the advancement of the principal breadwinner's career and a lift in earnings. An increasing proportion of young families are single parent families.

- *Current expenses:* This stage sees the return to a tight budget. There are so many expenses brought on by having a family, and there are so many things that new parents feel they must provide for their children. Dropping back to one income, childcare expenses and increased repayments on new borrowings cut savagely into income.
- *Saving:* Saving is generally limited to finding a deposit for a new house. Any savings accumulated earlier come in handy now. Further attempts to save money will probably be postponed in order to pay current expenses.
- *Borrowing:* A big mortgage emerges with the purchase of the first home, and a car loan is needed to buy a bigger family car. In addition, the need to furnish and equip your new home may call for more consumer credit. Now you really know what it is like to be in debt.
- *Insurance:* The recognition that you need insurance coverage escalates. You have health insurance for the whole family, disability insurance to replace your income if you cannot work, and life insurance to provide for your family if you die. In addition, there is a home and contents policy and insurance cover for the new family car.
- *Investing:* If there is anything left in your savings, you may want to invest now for later expenses like your children's education. However, for most young families, investing will be deferred until the cash flow catches up with the expenses.
- *Taxation:* The Government recognises that this stage in the financial life cycle is difficult, so assistance is given to families through the tax system. Sole parent and spouse rebates, together with other forms of family tax assistance, reduce the amount of tax you pay. Read through a *TaxPack* or get advice from a registered tax agent to see how it affects you.
- *Retirement:* Unless you have an employer-sponsored superannuation scheme, retirement planning may continue to be limited to the contributions from the Superannuation Guarantee Scheme. Keep in mind, however, that the sooner you put money away for your retirement, the more you will have when you leave the workforce. This may be a good

time to take advantage of the tax rebate available for superannuation contributions made on behalf of a low-income spouse.

Maturing families

This is the stage in the financial life cycle when your children grow up and you can look forward to some relief from your financial worries. You will begin to earn more than you spend because your earning power is at its peak when the pressure on the family budget is easing.

- *Current expenses:* Now it is easier to pay the bills. Spending priorities at this stage include things like upgrading your home, replacing some of your furniture and appliances, education for the children and perhaps more expensive holidays. This is also the stage when you may find yourself looking after your aging parents.
- *Saving:* Saving money is also easier and you realise that it is important to put some away during this prolonged period of high earnings. Your savings goals become part of a wider strategy that includes your investment goals and retirement planning.
- *Borrowing:* Your credit reputation is established and you can borrow whenever you wish. However, your house and car are probably paid off and your other borrowings are minimal. An exception may be investment borrowing.
- *Insurance:* You have learned to use insurance to protect your assets as well as your family. You have health insurance, disability insurance and life insurance to protect your family, and you have home and contents insurance, car insurance and public liability insurance to protect your assets.
- *Investing:* Your investment goals get serious. You may be interested in property, you may like the stockmarket or you may prefer managed investments. You feel the pressure of time slipping away and you want to accumulate investments that will work for you in the future.
- *Taxation:* Minimising your taxes is a major consideration. You are paying an enormous proportion of your earnings in tax and you want to take advantage of every legitimate means to minimise it. You discover that this is not a do-it-yourself exercise and you get some professional advice.
- *Retirement:* Suddenly the penny drops: unless you get serious about planning for your retirement, it may not be what you expect. You realise that you have not put enough aside so far and you are running out of time. With higher earnings and fewer expenses, you may be able to close the gap by seriously increasing your superannuation savings. At

this stage, it is essential to get professional advice about planning for your retirement.

Retired people

This stage of the financial life cycle consists of people who are no longer working. The age at which you are able to retire is largely influenced by how well you have provided for it. The main financial goal is to ensure that you have enough income and reserves to maintain your standard of living once you are no longer working.

- *Current expenses:* Your living expenses are lower, and as a result of 'downsizing' you may have some unexpected cash. You investigate your eligibility for retirement benefits, including the Age Pension and other concessions. You may need to cut your expenses in order to match your retirement income.
- *Saving:* You are no longer concerned with saving money, but you are concerned with managing the savings that you have accumulated.
- *Borrowing:* You no longer borrow money unless there are exceptional circumstances that require it. Rather, this is the time when you clear your debts so they are not hanging over your head in retirement.
- *Insurance:* You continue to review your insurance regularly. You may no longer need disability or life insurance, but you still need most other forms of protection. Health insurance is very important, especially protection for any expensive treatments or a long stay in hospital or a nursing home.
- *Investing:* You are liquidating many of your investments because you have become income-oriented rather than growth-oriented. You are much less likely to take risks because you are more concerned with preserving your money than accumulating more.
- *Taxation:* Taxation is no longer a pressing issue, but you have your affairs regularly reviewed by an adviser. Most of your taxation plans are in place and some have already served their purpose. Your main concern is that the politicians don't upset the apple cart by making radical changes to the tax system. If you are supplementing the pension with investment income, or if you are a self-funded retiree, then you are careful to plan for provisional tax.
- *Retirement:* Your working years have come to an end and you are ready for many more years of active enjoyment. It is a bit late to make major changes to your financial situation now, so you concentrate on making the most of what you have and your entitlements from the Social Security System. You also make sure that you have taken the necessary steps to protect your assets for your spouse and other heirs. Your Will,

any power of attorney that you may require, and your financial and other records are organised for safekeeping.

Separation and divorce

According to the Australian Bureau of Statistics, about 1 370 000 people in Australia are either separated or divorced. About half are aged between 35 and 49 years. These individuals have not only experienced the emotional pain of a marriage breakdown, but they are also confronted with an unexpected disruption to their financial life cycle. Separation and divorce can have an impact on your income, living expenses, savings, joint assets and investments, outstanding debts, taxation and superannuation. If this happens to you, you will need to recognise the financial consequences of such a change and adjust your financial plan accordingly.

FINANCIAL PLANNING PROCESS

The financial planning process consists of a sequence of steps. You begin by taking stock of your current situation and identifying the goals that you want to achieve. Then you examine alternative ways to fulfil these goals and implement the course of action that, in your judgement, will work best. Operate the plan for a time, then review your progress and make whatever revisions are needed. Now let's look more closely at each step.

Determine your current situation

Begin the process of financial planning by taking stock of your current situation. At what stage are you in the financial life cycle? What is your income and where does it come from? What are your living expenses? Do you have a savings program? What are your debts? What insurance protection do you need? Do you have investments? Is taxation a worry? What are you doing about retirement?

Establish your financial goals

Establishing financial goals means deciding what you want for the future. Some goals will be short-term and others will take longer. They should be specific, such as 'I am going to save $300 each month over the next three years for a deposit on a new home', rather than 'I should save for a deposit'. Make sure your financial goals are achievable so that you do not become

discouraged and abandon them. The objective is to identify one or more goals for each of the following categories.

- managing current expenses
- saving for future expenses
- credit and borrowing
- insurance protection
- investing
- minimising taxation
- providing for retirement

Identify and evaluate the alternatives

There is usually more than one way to reach a goal. The purpose of this step is to examine different strategies. Some strategies continue with an existing course of action, some expand on an existing course, and some consist of a new course of action. For example, suppose you have been trying to save $100 per week for a new car. You may decide to continue saving $100 per week, you may decide to try increasing your savings to $200 per week, or you may decide to have $200 per week deducted from your pay before you ever see it. Having identified different strategies, consider the consequences of each and choose the one you think is going to work best.

Implement a course of action

Implementing a course of action is the step in which you focus your efforts on achieving your financial goals. How you implement a course of action depends on the one you choose. For some matters, you may want to seek professional advice before you act. The important point is that you now have a plan, so get behind it and take whatever action is necessary to make it work.

Periodically review and revise your plan

Your financial goals will inevitably evolve as you proceed through the financial life cycle. You don't need an entirely new plan every time something unexpected occurs. Simply have a regular look at your plan, and the progress you have made, with a view to making minor changes if they are needed. That way, when changes do occur in your life, a review of your financial plan will enable you to adjust your priorities and bring them into line with your new situation.

FINANCIAL ADVISERS

An important question in personal financial management is deciding which tasks you will perform yourself and which will require some assistance. Financial advisers vary enormously in terms of their expertise and the services they offer. Not all financial advice is good advice, so it will always remain your responsibility to evaluate both the advice you receive and the individual who is providing it.

Financial advisers are inclined to specialise in one or two financial services, so it is difficult to find one who offers a comprehensive service. For this reason, it often becomes necessary to engage more than one adviser in order to get the job done properly. A comprehensive financial adviser should offer the following services.

- Review your financial history, including your tax returns, investments, insurance and retirement plans.
- Review your current financial situation, including your cash flow, assets and financial obligations.
- Help you to identify and develop financial goals based on your particular circumstances and personal preferences.
- Identify key areas that will contribute towards improving your financial circumstances, such as budgeting, tax savings, upgrading investments, insuring important risks, refinancing borrowings or adjusting your superannuation strategy.
- Provide a written financial plan based on your goals, together with a realistic timetable for achieving them.
- Help you to implement your financial plan, including referrals to specialists, such as a lawyer or an accountant, if it is necessary.
- Regularly review your progress with you and suggest changes to your financial plan if they are needed.

Some financial advisers are self-employed, such as independent financial planners, accountants and solicitors; others are appointed by the organisations for which they work, such as financial planning companies, stockbrokerage firms, banks and insurance companies. You may be invited to attend free financial seminars offered by financial advisers. This makes sense if you want to shop around before deciding which adviser you will use. However, these seminars are also a marketing tool, so expect to receive a sales pitch as well.

Financial planners

Financial planners generally specialise in managed investments and retirement planning. The Financial Planning Association of Australia (FPA) is the professional body for financial planners. There are three levels of members. The top level consists of the *principal members*, who are licensed dealers. They pass on their license authority to the *proper authority holders*, who are the individual advisers that deal with clients. The remainder are *general members*, who are yet to obtain practising member status.

Practising members belong to one of three categories: Associate, Senior Associate or Certified Financial Planner (CFP). Look for a CFP because they have fulfilled educational and experience requirements that are recognised as a professional qualification. Financial planners may be independent or they may work for an organisation. They either charge a fee for advisory services, a commission on what they sell, or some combination of a fee and a commission. The FPA has an Internet site at http://www.fpa.asn.au that contains information about finding and choosing a financial planner.

Brokers and agents

A *stockbroker* is licensed to buy and sell shares and other stockmarket investments. The *client adviser* works for the stockbroker and can tell you about direct investment in stockmarket securities as well as managed investments. Some stockbrokers charge separately for advice and other services. Otherwise, they charge a commission on the purchase and sale of securities.

A *real estate agent* is licensed to assist you to buy and sell real estate. The *sales consultant* can tell you about properties that are for sale and sometimes they can also help with financing advice. Some agents specialise in particular segments of the real estate market such as residential property, commercial property or small businesses. They are paid a commission by the seller. There are also *mortgage brokers* that can assist you to finance a purchase.

Banking institutions

Banks, credit unions and building societies are a source of financial advice about loans and credit, savings options and investments. Most banks employ financial planners, but they are generally limited to recommending the bank's own financial products.

Insurance companies

Insurance companies have been the traditional providers of life insurance, property insurance, liability insurance and health insurance. Advice about insurance products is available through independent insurance brokers and insurance company agents. Since their operations have always included investing policyholders' funds, insurance companies also offer investment services in the form of annuities, allocated pensions and other superannuation products. Like the banks, their advice is generally limited to their own products.

Accountants

Professional accountants are qualified to help you with taxation matters. Some also offer advice about borrowing, investing and superannuation. Use a qualified accountant with either a CPA or CA qualification. They are also required to keep their skills up to date by attending continuing professional development seminars. Accountants are a popular source of advice about investment and superannuation matters, so a number of them are licensed as financial advisers or agents for investment brokers as well.

Solicitors

Solicitors can offer you advice about a number of legal matters related to financial planning. If you want to write a Will, purchase a house or enter into a contract, it is a good idea to consult first with a solicitor. Some law firms are becoming licensed to broaden the range of financial services they can offer.

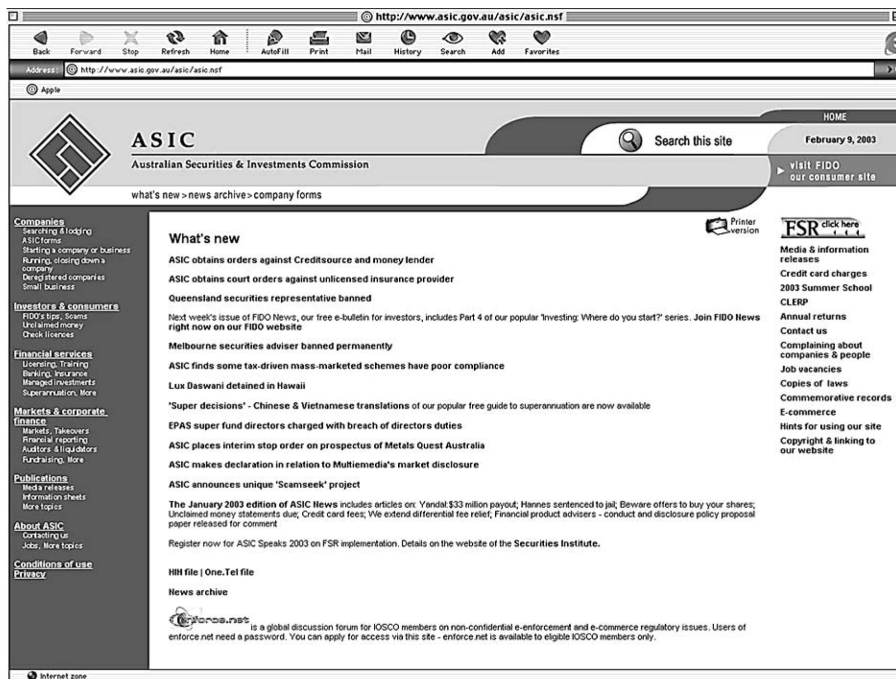
Financial counsellors

Financial counsellors specialise in giving advice about budgeting and debt management. Anglicare Financial Counselling Services, for example, offers free help to people who are in a debt crisis. They use the services of accredited and registered financial counsellors.

FINANCIAL SERVICES REFORM ACT

The *Financial Services Reform Act* came into force in 2002 and will be phased in over a two-year transitional period. The purpose of the Act is to

Figure 1.1 The Australian Securities and Investments Commission Internet site



streamline and improve the efficiency of financial sector regulation, increase flexibility, encourage market and product innovation, and empower consumers to make better informed personal finance decisions. The Act fundamentally changes the way in which providers of financial services and products do business with the public.

Financial services providers must have an *Australian Financial Services Licence*, or they need to be a representative of a licence holder. This includes banks, superannuation trustees, general and life insurers, responsible entities of managed investment funds, anyone who provides financial advice or sells financial products, and many others who provide services related to the financial services industry. In order to hold a licence, financial services providers need to have appropriate financial resources and internal controls; relevant competence, skills and experience; and adequate systems for training and supervising their representatives.

There is also a new disclosure regime for most financial products. These products include securities, managed investment products, derivatives, general and life insurance products, superannuation and other retirement products, and deposit taking facilities with banks and similar institutions. A *Financial Services Guide* must be given to retail clients before financial

services are provided. In most cases, a *Statement of Advice* must be given to a retail client before the service is provided. A *Product Disclosure Statement* must be given to a retail client when a recommendation is given to acquire a financial product or an offer is made for a financial product.

The Australian Securities and Investments Commission (ASIC) enforces company and financial services laws to protect consumers, investors and creditors. It also informs the public about Australian companies, financial markets, financial services organisations and professionals who deal and advise in investments, superannuation, insurance, deposit taking and credit. Its functions are defined by the *Australian Securities and Investments Commission Act 2001*, and include:

- upholding the law uniformly, effectively and quickly
- promoting confident and informed participation by investors and consumers in the financial system
- making information about companies and other bodies available to the public
- improving the performance of the financial system and the entities within it

The ASIC also works with other financial, consumer and law enforcement bodies in Australia and internationally. For more information, you can telephone the ASIC Infoline on 1300 300 630 or the ASIC Complaints Referral Service on 1300 780 630. You can also visit the ASIC Internet site for consumers and investors at http://www.fido.asic.gov.au.

2 Cash management

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Do you ever find yourself unable to make your pay stretch until the next one arrives? Do you find that after you pay your bills there is nothing left to put into savings? If this describes you, then you are a candidate for some cash management skills. Cash management is a system for spending and saving. It enables you to plan how your income will be allocated towards your expenses and it helps you to avoid impulse spending, decide what you can or cannot afford, know where your money goes and increase your savings.

A working cash management system does not have to be complicated or rigid. However, preparing one takes a little planning, and sticking to it takes a little determination. This chapter examines spending patterns, saving money and how to construct a budget. It concludes with a look at some of the cash management services that are available from financial institutions.

SPENDING MONEY

Before we can embark on a cash management plan we need to know something about how much we spend for day-to-day living expenses. Each of us is unique when it comes to the ways in which we spend our money. However, there are some basic principles that everyone can apply to make their dollars go as far as possible.

Housing

Whether you rent or buy, or even if your house is paid for, a substantial part of your income will be used for housing. Housing expenses include rent or mortgage payments, heating and cooling, rates, insurance, repairs, maintenance, improvements, furnishings and decorating. Renting can be suitable for people who are just starting out, families with a low income, retirees trying to cut down on expenses, people with irregular employment, and individuals who simply do not want the responsibilities of home ownership. Buying is generally more suitable for large families and those who want the investment and security of owning their own home. A large mortgage with high monthly repayments, however, can become a major hardship for a family experiencing hard times.

Food

Expenditure on food is another big slice out of the household budget. The amount spent on food depends on the number of adults and children in the household, personal preferences and nutritional considerations. Greater

quantities of meat, poultry, fish, fresh fruits and vegetables generally mean higher costs, whereas lower costs rely on a greater proportion of grains.

Clothing

The cost of clothing not only reflects an individual's taste, but also the amount of money they have available to spend on clothing. The cost for each household member depends on age (are they still growing?), activities (school, work, sport), standards (uniforms, peer pressure) and personal preferences. Clothing expense for employed adults is greater than for other adults, and clothing expense for school children increases with age. People who have the skill, time and equipment can save money by making some of their own clothes. When you go shopping for new clothes, make your money go further by planning your wardrobe in advance, shopping wisely, reading labels, recognising quality and following care instructions.

Transport

Dependable transport is important for every household. People who can rely on public transport are fortunate. Most households, however, have at least one car and it constitutes a significant expense. If you decide to purchase a car, make sure that you anticipate all of the costs involved. The size of a car is your best indication about relative maintenance costs, registration fees, fuel efficiency, repair costs and insurance premiums. Also, larger cars generally lose value faster than smaller cars. In some places, expressway tolls and parking fees are another big expense.

Utilities

Electricity, gas and fuel oil demand part of the household budget. Heating and cooling accounts for most residential energy expense. A telephone adds to the total cost of utilities. Learning to manage your utilities helps to contain your living expenses. Utility accounts vary from one billing period to the next, and this can make it difficult to budget for them. If this is a problem for you, ask if there is a level payment plan in which you pay an equal amount each billing period.

Medical

Medical expenses are difficult to anticipate, but they inevitably occur. Doctor's bills, dental care, optical expenses and pharmaceuticals all add to

the cost of health care. If you are unfortunate and suffer a serious illness or accident, hospital and other medical costs can be substantial. Fortunately, Medicare pays for some medical costs and private health insurance pays for more. However, it is impossible to avoid some medical expenses and the cost of private health insurance is expensive.

Children

The cost of raising children is an important part of a family's finances. Each child represents a long-term financial commitment lasting at least 18 years, and you should be aware of the costs so that you can plan early for how you are going to meet them. Some of the costs you should consider are maternity and other medical care, moving to a larger home, food and clothing, day care and education.

SAVING MONEY

Saving money is an important part of cash management. Saving enables you to meet emergencies if they occur, it provides for future expenses when they are needed, and it is the first step towards achieving your investment goals. Saving money is not something that you do after you have paid the bills. If saving money is truly important, then you should plan to pay yourself first. The amount you save depends on how much income you have and how important saving money is to your other goals.

There are many ways to save money. One strategy is to put part of your pay into a savings account before paying your other bills. Another strategy is to have your employer deduct a portion of your pay and deposit it directly into a savings account. Yet another strategy is to continue making payments into your savings after you pay off a loan.

Begin your savings program by establishing an emergency fund. The amount you decide to put aside for emergencies depends on the stability of your income and any other assets you may have that can be quickly converted into cash. The equivalent of two or three months' take-home pay is usually enough for an emergency fund. Your emergency money needs to be readily available, so you will probably keep it in some sort of savings account. When you have sufficient funds set aside for emergencies, you can begin to think about saving for the future.

Time value of money

The time value of money is one of the most important concepts in personal financial management. It is particularly useful when you plan a

savings program. The future value of your savings is affected by three things.

- The amount of money that you set aside.
- The period of time that your money stays in savings.
- The rate of interest that it earns.

Table 2.1 demonstrates how $1000 deposited today will grow, depending on the period of time that it is left on deposit and the rate of interest that it earns. The longer the period of time, the greater the future value. Similarly, the higher the rate of interest, the greater the future value. Their combined effect is called the *time value of money*.

Table 2.1 Future value of $1000

	Rate of interest	
Years	8%	10%
10	$ 2 159	$ 2 594
20	4 661	6 728
30	10 062	17 449
40	21 724	45 259

The driving force behind the time value of money is *compounding*. Compounding is the process of reinvesting the interest you earn so that you earn more interest on your interest. In Table 2.1, the future value of $1000 deposited today is $45 259 in 40 years' time if it earns 10 per cent interest compounded annually. If only *simple* interest were paid, then the future value would be only $5000, because simple interest assumes that the interest earned in each period is withdrawn and not reinvested.

The more frequently interest is compounded, the greater will be the future value of your savings. This means that it is not only the *rate* of interest that is important, but also the *frequency* with which it is compounded. Table 2.2 demonstrates how the effective annual rate of interest increases as the frequency of compounding increases. It also demonstrates how the frequency of compounding affects the future value of your savings. The future value of $1000 invested at 10 per cent *compounded annually* is $45 259. However, if it were *compounded daily*, the future value would be $54 568.

Savings goals

In order to achieve your savings goals, you need a target and a plan. The target is a sum of money that you want to make available for a particular

Table 2.2 Frequency of compounding

Frequency of compounding	Effective annual rate of interest (%)	Future value of $1000 in 40 years ($)
Annually	10.00	45 259
Half-yearly	10.25	49 561
Quarterly	10.38	51 978
Monthly	10.47	53 701
Weekly	10.51	54 389
Daily	10.52	54 568

purpose at some point in the future. The plan is the method by which you are going to set aside part of your income and the interest you expect to earn. Table 2.3 is an example of two savings goals. The first goal consists of accumulating an emergency fund of about $7000 by saving $100 per month over five years and depositing it into a savings account that pays 6 per cent interest. The second goal is also for five years and consists of accumulating $15 000 for a deposit on a new home by saving $200 per month and investing it in a fixed term deposit paying 9 per cent interest.

Table 2.3 Savings goals

Goal	Plan	Interest rate (%)	Balance after five years ($)
Emergencies	$100 per month	6	6 977
Deposit	$200 per month	9	15 085

A goal of any savings program is to keep pace with inflation on an after-tax basis. You can calculate the interest rate that you need in order to do this by dividing the expected inflation rate by 100 per cent minus your tax rate. For example, if you are on the 30 per cent tax rate and you expect the inflation rate to be about 4 per cent, then the *minimum* interest rate you need to earn on your savings is 5.71 per cent.

$$\text{Minimum interest rate} = \frac{\text{Expected inflation rate}}{\text{100 per cent} - \text{Tax rate}} = \frac{4\%}{100\% - 30\%} = 5.71\%$$

Table 2.4 contains the minimum interest rate, depending on the tax rate and the expected inflation rate, that is needed to maintain the purchasing power of your savings. The higher your tax rate, the higher the minimum interest rate. The higher the inflation rate, the higher the minimum interest rate. In extreme circumstances, minimising the loss to your spending power may be a better alternative than risking the loss of your savings by chasing high-risk investments.

Table 2.4 Minimum interest rate on savings (all per cent)

	Tax rate			
Inflation rate	**17**	**30**	**42**	**47**
2	2.41	2.86	3.45	3.77
3	3.61	4.29	5.17	5.66
4	4.82	5.71	6.90	7.55
5	6.02	7.14	8.62	9.43
6	7.23	8.57	10.34	11.32
7	8.43	10.00	12.09	13.21
8	9.64	11.43	13.79	15.09
9	10.84	12.86	15.52	16.98
10	12.05	14.29	17.24	18.87

BUDGETING

The principal tool for gaining control over your money is a budget. Just like a business uses a budget to manage its finances, so can an individual. The purpose of a budget is to provide a framework for planning your cash flow. It consists of four steps—estimating your income, estimating your expenses, determining your cash position and tracking your spending. A budget can be done weekly, fortnightly or monthly. Figure 2.1 is an example of a monthly budget.

Step 1 Estimate your income

Your regular income should be easy to predict, but you also need to anticipate any irregular income, such as interest received from a savings account, a gift or overtime earnings. It is equally important to be certain *when* you expect to receive this income so that you will actually have the money on hand when your bills need to be paid.

Step 2 Estimate your expenses

Estimate the amount and timing of your expenses. One way to handle your expenses is to group them into three categories—predictable expenses, anticipated expenses and discretionary expenses. You also need to budget for planned savings.

Figure 2.1 Monthly budget

	Month 1	Month 2	Month 3
Income			
Salary/wages			
Interest/dividends			
Pension/Social Services			
TOTAL INCOME			
Predictable expenses			
Rent/mortgage			
Loan payments			
School fees			
Council rates			
Insurance			
Subtotal			
Anticipated expenses			
Clothing			
Food			
Utilities			
Medical			
Repairs			
Transport			
Subtotal			
Savings			
Emergencies			
Superannuation			
Investments			
Other			
Subtotal			
Discretionary expenses			
Entertainment			
Restaurants			
Hobbies			
Gifts			
Holidays			
Subtotal			
TOTAL EXPENSES			
CASH BALANCE			

- *Predictable expenses* are fixed periodic payments that are easy to forecast. Examples include fortnightly rent or monthly mortgage payments, car loan repayments, school fees, insurance premiums and council rates.
- *Anticipated expenses* vary in amount from one period to the next and they may also come due at irregular times. For these reasons, anticipated expenses are not always easy to forecast in terms of the amount and timing. Examples are clothing, food, utilities, medical care, running your car and home maintenance.
- *Discretionary expenses* are completely under your control because you choose how much to spend and when to spend it. Examples include entertainment, eating out, hobbies, holidays and gifts.
- *Savings* are the amounts that you set aside for particular purposes, such as your emergency fund, superannuation contributions or a deposit for a new home.

If you do not have past records of your spending, or if this is your first budget, the best way to find out how much you spend is to keep track of your spending for a trial period. You can use this as a starting point to do your estimates. Do your predictable expenses first, tackle your anticipated expenses next, and then decide how much savings you are going to set aside. Leave your discretionary expenses until last.

Step 3 Determine your cash balance

Now you are ready to begin the balancing act. For each budgeting period, subtract your expenses from your income. If the resulting cash balance is a surplus, then make sure you have not overlooked any important expenses. Also, ensure there is enough flexibility in your budget to withstand minor emergencies or errors in estimating expenses. If the surplus is genuine, then you can be more generous with your discretionary spending or you can re-examine your savings goals.

If the resulting cash balance is a short-fall, then begin by going over your expenses. First, review your discretionary expenses with a view to making some serious cuts. Are there any discretionary expenses in which you are clearly over-spending? Are there others that you can wind back without too much pain? Second, look at each of your anticipated expenses to see if they are really justified. For example, could you cut down on your telephone bill or reduce your heating bill? Third, review your predictable expenses. Should you consider moving to a more modest flat in order to pay less rent? Do you need to think about selling your car and relying on

public transport? You need to decide which things are important and which ones can wait.

If you have cut back as much as you can, and you still have a cash short-fall, then consider ways in which to increase your income. You may want to look for a better-paying job or an extra part-time job. If only one spouse is employed, it may be time to become a dual-income family. If all avenues to reduce expenses and increase income have been exhausted, then it may be necessary to draw on your savings in order to balance a temporary short-fall in the budget. Don't be discouraged if an emergency cuts into your savings, just get back on your plan in the following month.

Step 4 Track your spending

It is important to track your actual spending and to compare it with your budget. Keep a record of your expenses. At the end of each budget period, compare your spending with your estimates. If your first budget does not come in on target, don't be disappointed. A budget is not something that you do only once. Keep revising it and keep using it until you have control over your cash flow.

CASH MANAGEMENT SERVICES

Shopping for cash management services is like shopping at the supermarket. Some products are plain and others are elaborate, some are economical and others are expensive. Since cash management services vary so much, it is worthwhile investigating the alternatives. Choosing cash management services consists of identifying the financial institutions that can serve your needs and then selecting the best cash management products from among them.

Financial institutions

There are scores of financial institutions competing very hard for the opportunity to provide you with cash management services. The main ones are the banks, credit unions and building societies.

- Banks are convenient and flexible financial institutions that offer a wide range of cash management services, including savings accounts, cheque accounts, term deposits and cash management accounts. The major banks also have the biggest branch networks.

- There are about 250 credit unions in Australia with a network of 2000 branches and agencies. About one-third of them are called *closed-access* or *bonded* credit unions, which operate exclusively for specific industries or community groups. The remainder are open to the general public and offer an alternative to the banks for cash management services.
- Building societies offer savings plans in order to attract deposits that are used to make housing loans. The number of building societies has been shrinking over the past 25 years, although some of the larger ones have become banks.

Cash management products

Cash management products include cheque accounts, savings accounts, fixed term deposits and cash management accounts. Keep in mind that account features and fees vary from one institution to the next, so be sure you know exactly what is involved before you open an account.

The first time you open an account with a financial institution, you will be asked to provide enough identification to score a total of 100 points. For example, your birth certificate, passport or citizenship certificate is worth 70 points. A driver's licence, pension card, public employee ID card or a student ID card is worth 40 points. A credit card, ATM card, store card or Medicare card is worth 25 points. There are many other ways to score the required 100 points as well. If the account pays interest, then you should also disclose your Tax File Number (TFN), otherwise tax will be withheld from your interest earnings.

Cheque account

A cheque account enables you to have quick, convenient and frequent access to your money for day-to-day transactions. You can make deposits into the account as often as you choose, and you can write cheques to withdraw money from your account and to pay bills. Some cheque accounts pay interest and some do not. Some institutions charge a maintenance or flat fee regardless of the balance in the account, some charge a flat fee if the balance drops below a certain minimum, and others charge a fee for every transaction or offer a number of free transactions before the fees apply.

Although a cheque account that pays interest may appear more attractive than one that does not, it is important to look at the fees as well. Cheque accounts that pay interest often charge higher fees and you can end up paying more in fees than you earn in interest. You can generally avoid the fee if you maintain a minimum monthly balance in the account. Some banks also offer fee-free accounts to pensioners, students and customers with other financial services such as a loan. If you have more than one account, you

might be better off by consolidating all of your accounts in order to avoid unnecessary fees.

Savings account

You will need to decide where and how to save your money. All financial institutions have a variety of *products* to attract your savings. You need to decide not only which savings institution to use, but also which type of savings account is best for your needs. Savings accounts generally pay a poor rate of interest; however, most pay a higher rate on larger balances. This is called *tiered interest* and if you want to make sure you are getting the best rate of interest, consider consolidating your savings into one account.

In the past, most savings accounts were *passbook* accounts in which your passbook had to be presented each time you made a deposit or a withdrawal. More recently, there has been a move to *statement* accounts, in which you do not need a passbook. You simply present a plastic card to make a transaction and the institution regularly posts you a statement that shows your deposits and withdrawals. There are a variety of possible fees on savings accounts—including administration fees, transaction fees and minimum balance fees—that you should try to avoid.

Fixed term deposit

Fixed term deposits pay higher rates of interest than savings accounts. You can choose to keep your money on deposit for a fixed period of time, such as three months, six months, one year or longer. The longer the term and/or the greater the amount, the higher the interest rate that your money will earn. However, if you lock your money away for a very long time and interest rates subsequently rise, you will be stuck with the lower interest rate. There is generally a penalty if you need to withdraw your money before the term expires. Most fixed term deposits automatically *roll over* unless you withdraw your funds at the end of the term.

Cash management account

Cash management accounts not only pay higher rates of interest than savings accounts, but they also enable you to have access to your money with a chequebook facility. These advantages are available in exchange for a higher minimum initial deposit, maintaining a higher minimum balance, and some limitations on withdrawals or transfers. The interest rate is calculated daily and it fluctuates with prevailing rates in the short-term money market.

Checklist

Use the following checklist to help you evaluate the cash management services offered by financial institutions.

- Are there minimum balance requirements?
- Are there penalties or fees for transactions?
- How convenient is it to make deposits and withdrawals?
- What interest rate is offered?
- How often is interest compounded?
- How often is interest paid?
- Can the institution change the rate of interest after you open the account?
- Does the institution pay different rates of interest, depending on the amount in your account?
- Are there any special features or services offered?

Electronic banking

Before electronic banking came on the scene, you had to go into your financial institution during regular business hours. Now electronic banking makes 24-hour financial services available in a variety of ways. A plastic transactions card, sometimes called a *debit card*, an *access card* or a *cash card*, is used to enter ATM and EFTPOS systems. Telephone and Internet systems enable you to bank from home. Electronic banking services are generally attached to your savings or cheque account.

- An *automatic teller machine* (ATM) is a computer terminal that allows you to make deposits, receive cash, pay some bills and transfer funds between your accounts without going into the bank. Many institutions charge higher fees if you use another institution's ATM network to access your account, so make sure you know what the fees are and which ATMs are affected.
- *Electronic funds transfer at point of sale* (EFTPOS) is located in thousands of retail outlets and enables you to pay for purchases through the electronic transfer of funds from your account to the merchant's account. EFTPOS transactions are still fee-free with most accounts.
- *Telephone transfer* allows you to transfer funds and pay bills by touch-tone telephone. You use the telephone keypad just as you would an ATM. No money can be withdrawn, it can only be transferred.
- *Internet banking* makes on-line banking possible from your personal computer at home. You can download special software to access account information, transfer funds and pay bills.

Throughout the financial services industry, there is increasing pressure to move customers to electronic services. The commercial banks, in particular, are trying to downsize their branch networks by asking customers to use telephone and Internet services, EFTPOS and ATMs instead of doing business over the counter.

Fees

Financial institutions have been increasing the fees they charge for cash management services. Be sure you know exactly what fees are going to be levied against your account. Many of these fees are avoidable and others are negotiable. Here are some questions to ask.

- Will you be charged a flat fee to have an account?
- Will you be charged a fee if the balance in your account falls below a specified minimum?
- Will you be charged fees based on the number of transactions you make?
- Can you use an ATM to make deposits and withdrawals? If so, is there a charge for this service? Does it matter if you use an ATM from another institution?
- For cheque and money market accounts, is there a fee charged for each cheque that you write?
- Are fees reduced or waived if you have other accounts with the institution such as a loan?
- Are fees reduced or waived if you have your pay deposited directly into the account?
- Are you charged a fee for asking how much money is in the account?
- Are you charged a fee for closing the account?
- Are you charged a fee if you deposit a cheque that is returned for insufficient funds?

Part B
Borrowing and credit

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3 Borrowing basics

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Borrowing and credit appear in a variety of forms, including credit cards, store charge accounts, time payment, deferred payment, personal loans, home loans, investment loans and leasing. Using credit means that you are incurring a debt that you must repay at some time in the future. *Consumer credit* is the term used to describe finance provided to individuals for private, domestic and household purposes. These include using credit to purchase a home, motor vehicle, furniture and household appliances. There are national consumer credit laws that regulate loan and credit contracts and those who offer them.

There have been tremendous changes in consumer credit over the past 10 years. One of the most important developments has been the expanding use of credit cards. Another important feature has been strong competition between lenders in the consumer finance market. This competition has driven *pricing* (interest, fees and charges) and *product* innovations that have benefited consumers.

There are many reasons for using credit and there are advantages and disadvantages of doing so. You need to know what is available, from whom, and on what terms and conditions. You need to know the processes involved, what is required of you, and what will happen if you fail to make repayments. The purpose of this chapter is to examine these issues in order to provide a basic understanding of borrowing and credit. In Chapters 4 and 5, we consider specific types of loans and credit in more detail.

DECIDING TO BORROW

Borrowing enables you to buy goods and services now rather than having to wait until you have saved enough money to pay for them. It may take too long to save the entire amount for a large purchase such as a car or a home, so you save enough for a deposit and borrow the remainder. Alternatively, you may have enough in your savings to make the purchase but you want to keep part of your savings for emergencies. Some people also borrow money in order to invest in shares or real estate. If you want to borrow money, consider carefully why you want to do it and whether it makes sense. Is this something that you really need now, or is it something that you can defer until later?

There are plenty of reasons to think twice before borrowing money. Your future disposable income will be reduced because the repayments will take up part of your earnings. Borrowing will cost you money in the form of interest, fees and charges. You may experience the psychological discomfort of being in debt, and that can create stress and strain for you and

your family. Perhaps the biggest disadvantage is the temptation to overspend because you know that you can borrow.

Cost of borrowing

There is strong competition among lenders, so shop around in order to minimise the cost of borrowing. Not only compare interest rates, but also the fees and charges. Newspaper and television advertising is an obvious starting point. Ask lenders for their promotional literature. Many lenders have an Internet site with useful information and you can also e-mail your enquiries about the cost of a loan.

Draw up a short-list and make contact with the lenders that you have chosen. Use the telephone to ask questions. When you feel that you have enough information, make an appointment to discuss your needs personally. Don't be afraid to bargain with lenders. Tell them that you have compared their interest rates, fees and charges with those of other lenders and you are looking to them for favourable treatment. In the current climate, borrowers have a great deal of bargaining power.

The overall cost of borrowing is determined by the amount of interest, fees and charges that you pay over the life of the loan. You may be offered the choice between a loan with *fixed* interest, *variable* interest or a loan that offers both rates; that is, a fixed rate on some of the loan and a variable rate on the remainder. Housing loans, for example, are offered on this basis. If you choose a fixed interest loan, the interest rate remains the same and the amount of the monthly repayments does not change during the term of the loan. If you choose a variable interest loan, the interest rate may change during the term of the loan and your monthly payments can go up or down. Borrowers who locked into a fixed interest home loan some time ago when rates were higher are now paying more interest than borrowers who elected to take loans with a variable interest rate. The reverse can happen, however, if interest rates go back up again.

Borrowing and budgeting

Lenders will tell you how much they are prepared to lend based on your income and expenses. They have their own rules about how much of your disposable income you should allocate to loan repayments. They also have guidelines for joint borrowers to determine how much of the combined income will be taken into account. Many lenders have *calculators* at their Internet site. If you enter the amount, the interest rate and the term, the calculator will give you the amount of the monthly repayment. Alternatively,

you can enter the amount that you can afford to repay each month and the calculator will show you how much you can borrow.

The larger the loan, the more cash flow you need to service it. Decide if you can afford the repayments by preparing a budget. If your budget tells you that you don't have the cash flow to comfortably make the repayments, then ask yourself if it is prudent to borrow. Can you delay borrowing in order to save a larger deposit and reduce the amount of the loan required? Alternatively, can you reduce your spending on other things in order to generate enough cash flow to make the repayments?

Establishing a credit rating

In order to use credit, you need a good credit rating. To establish a good credit rating, you need to use credit. This sounds circular, but it means that you start out by borrowing small amounts that are comfortably within your means. Apply for a store charge account or a credit card with a modest credit limit. Be sure to make the repayments on time. Once you have established your credit reputation, you can refer to your credit history when you apply for a new loan. As long as you maintain a good credit record, you should be able to borrow and use credit whenever you wish.

LENDERS

There are several types of consumer lending institutions. The main ones are banks, finance companies, building societies, credit unions and private lenders. They offer a variety of consumer finance products.

- store charge accounts
- lay-bys
- credit cards
- time payment and deferred payment plans
- personal loans
- car loans
- home loans
- home equity loans
- investment loans
- leasing

Banks

Banks offer the widest range of consumer credit, including home loans, land loans, home construction loans, home equity loans, investment loans, personal loans and credit card facilities. The four major banks are the largest consumer lenders; however, the smaller banks offer similar products. Sometimes the smaller banks offer more attractive terms in an effort to lure

customers away from the majors. Bank product information can be found at the following Internet sites.

Commonwealth Bank	http://www.commbank.com.au
Westpac	http://www.westpac.com.au
National Australia Bank	http://www.national.com.au
ANZ	http://www.anz.com.au
Other banks	http://www.bankers.asn.au

When you find a bank product you like, you can get more information through the Internet or you can contact your nearest branch. There are brochures and other promotional material available and copies of the terms and conditions. Ask questions if you need further explanation or information.

Finance companies

In addition to the banks, some finance companies offer consumer loans and credit. A number of finance companies are owned by banks. As a result, if you approach a bank for a personal loan to buy a car, you may be surprised to find that you are referred to the bank's finance company. The rate of interest charged by a finance company may be much the same as the rate charged by a bank. This wasn't the case some years ago when finance company interest rates were much higher. Not all finance companies provide loans and credit for consumers because some have chosen to specialise in business finance.

Finance companies that provide consumer credit usually have arrangements with retailers. For example, a finance company may provide finance through a car dealership in which the dealer refers a customer to the finance company for a loan to buy a car. The dealer provides you with the information and the forms that you need to make your loan application. There are similar arrangements between finance companies and retailers of household goods and appliances.

Building societies and credit unions

Building societies were originally formed to provide home loans, but some now offer a full range of consumer credit. You need to become a member before you can borrow. There is an Internet site for building societies at http://www.aapbs.com.au.

Credit unions are also a popular source of consumer credit, especially for personal loans. They are also becoming an increasingly popular source of home finance. You need to be a member to borrow, and they offer the

same types of credit facilities as banks and building societies. They promote themselves as more customer-oriented than the banks and sometimes you can get a better deal on interest rates, fees and charges. There is an Internet site for credit unions at http://www.cu.net.au.

Other lenders and brokers

If you look through the Yellow Pages under 'Finance—Mortgage loans', 'Finance—Motor vehicle', or 'Financiers', you will find other types of lenders and credit providers. They include large insurance companies as well as motor vehicle financiers and small private mortgage lenders. If you are unable to borrow from banks, finance companies, building societies or credit unions, these may be an alternative source of finance. However, they may charge higher interest rates and fees.

Mortgage brokers and *finance brokers* are in the business of obtaining loans for their clients. They are in contact with many lenders and credit providers and they are familiar with individual lending practices. They may be able to find a particular lender who is more likely to consider your application favourably. Fees are charged by brokers. It is important to get independent legal advice if you intend to engage the services of a broker. Be aware that some brokers earn a fee for simply introducing you to the lender.

APPLYING FOR A LOAN

The lender or credit provider will ask you to complete an application form. In it, you will need to list the following information.

- name, age and qualifications
- address and telephone
- employment details
- salary
- expenses
- assets
- liabilities
- referees and guarantors
- purpose of the loan

The lender will examine your application and verify the information that you have provided. The application form generally states that the lender relies upon the information you have provided, so you need to exercise great care in filling it out. The information is entered into a computer that automatically *scores* your answers. You get high points if you own your own home, have been at your rented accommodation for a long time or held the same job for a long time.

Lenders use credit scoring to speed up the process of loan approval. It is also more objective and removes the subjective judgement of lending officers. The results of credit scoring are generally accepted unless there are good reasons to override the result. The score will probably be combined with an on-line computer search of your credit history and the result can be a very quick loan or credit approval.

Credit report

When a loan or credit application is received, it is standard practice for lenders and credit providers to obtain a credit reference. *Credit Reference Limited (CRL)* holds records on millions of individuals and does most of the consumer credit reporting in Australia. Its members include lenders, credit providers, retailers and others. Members have access to the information about you that is held in credit files. This enables them to verify information that you have provided in your application. For example, they can find out about your other loans and debts and see if you have a good or bad credit record. The following types of information are held by CRL in its credit files.

- Personal information necessary to identify you, such as your name and address. Information on lifestyle, sexual preference or religion, or information about your spouse, cannot be kept.
- The names of credit providers who have requested a report when you applied to them for credit.
- Payments more than 60 days overdue where the credit provider has commenced recovery, bankruptcy orders, court judgements, and any cheques over $100 presented and dishonoured twice.
- Names of current credit providers.

If you have cleared any overdue payments, this must be notified and recorded. CRL is required by law to keep your credit file up to date so that information supplied about you at any time is correct. If your application for a loan or credit is refused because of information in a CRL report, then the lending institution must take the following steps.

- Tell you that credit was refused because of the CRL report.
- Give you the name and address of CRL.
- Inform you of your legal right to get a copy of your credit file information from CRL.

If you discover that your file is incorrect, you can request immediate rectification. If you are dissatisfied with the action, you can forward a

formal complaint to the *Office of the Federal Privacy Commissioner* (OFPC) in Sydney. The OFPC has an Internet site at http://www.privacy.gov.au that contains information about credit reporting.

Privacy

A standard credit application form contains a *Privacy Notice* and you will be asked to sign a *Privacy Declaration.* There is a federal law that protects privacy, including the privacy of your credit records. Lenders and credit reporting agencies like CRL are required to observe this law, otherwise the Privacy Commissioner can take action against them.

Privacy law limits access to information that is kept about you by agencies like CRL, as well as lenders and credit providers. It also requires information to be stored securely. Credit information can only be disclosed in the following circumstances.

- You provide consent.
- The information goes to a credit reporting agency and you have been informed of this.
- You have committed a 'serious credit infringement', like default, on your loan.
- You are at least 60 days overdue in making a repayment and the credit provider has taken steps to recover the loan or credit.

Discrimination

If you are refused credit, it may be difficult to do anything about it because commercial lending decisions are for lenders to make. However, in limited circumstances it may be possible to challenge the refusal if there has been some form of discrimination against you. The *Human Rights and Equal Opportunity Commission* (HREOC) may investigate discrimination based on race, social justice, disability or gender. HREOC has an Internet site at http://www.hreoc.gov.au that contains information about discrimination.

Loan and credit insurance

Loan and credit insurance is an area that causes confusion. Some credit insurance policies protect lenders and some protect you. If the lender asks for insurance and you agree to it, you simply fill out the application form and the premium is included with the other fees and charges. There are three types of loan and credit insurance.

- *Lender's mortgage insurance* is usually required by lenders who lend more than 80 per cent of the value of the property offered as security for a housing loan. The premium is high and it is typically deducted from the loan. The policy protects the lender against loss in the event that the property is sold following default and the amount recovered on the sale is less than the amount of the loan. This insurance is for the lender; it does not protect you.
- *Home loan mortgage repayment insurance* pays the outstanding balance of your mortgage in the event of your death or disablement. However, there are limitations on the maximum death benefit and the maximum monthly disablement benefit. An alternative is a standard life insurance policy on your life and/or the life of your spouse. In some cases, you may be required to buy this type of insurance and transfer the policy to the lender as a condition of the loan approval. You will be responsible for paying the premium. The lender can claim on the policy in the event of your death, and so it provides a form of security for the loan.
- *Consumer credit insurance* is for personal loans, credit cards and personal lines of credit. *Credit Life Insurance* is a life insurance policy for personal loans. In the event of your death, the policy pays the balance of the loan or the maximum benefit, whichever is less. *Credit Sickness and Accident Insurance* policies protect against loss of income caused by incapacity resulting from illness or accident. *Credit Unemployment Insurance* protects against loss of income through unemployment. Usually the protection is only for 60 or 90 days in any one period of unemployment. Legally, the lender cannot insist on consumer credit insurance and this should be stated on the application form.

Insurance has obvious benefits, especially when you owe a large amount of money. In the event of death or disablement, your loan can be repaid and your family will not face hardship. It also helps with any short-term inability to make repayments caused by illness, injury or unemployment. There are always policy *exclusions* and *limitations*. Read the policy carefully and contact the insurer if you need assistance. In particular, do not rely on assurances given by sales staff, because they may not fully understand what the policy covers.

Security

For larger loans the lender will ask for *security* over the property that you wish to buy or some other property that you already own. The requirement for security will be stated in the loan approval. The most common form of

security is called a *mortgage*. Lenders can take a mortgage over most forms of property, including houses, land, motor vehicles, boats, household goods and appliances, shares and life insurance policies. When you give a mortgage, you are called the *mortgagor* and the lender is called the *mortgagee.* If you default on your loan, the lender can take possession of the mortgaged property and sell it to repay the loan. Generally, the lender will *register* the mortgage. Registration protects the lender against claims made by others in respect of the mortgaged property.

It is up to the lender to decide if a mortgage is required. For smaller loans, the lender may not require a mortgage. If a lender takes a mortgage, its aim is to have enough value in the mortgaged property to repay the loan in the event of default. If the property is sold and there is not enough money to repay the loan, the lender can take legal action against the borrower to recover the outstanding balance. A mortgage will increase the cost of the loan because there are extra expenses for inspection and valuation fees, legal fees, survey fees, stamp duty, and fees to register the mortgage.

Loan guarantee

Some people find it difficult to borrow because they do not meet all of the lender's requirements. Perhaps they are too young, or they have no property to offer as security, or their income is too low. In these cases, they may ask someone like their parents or a relative to be a *guarantor* for the loan. A guarantor agrees to be liable for the loan if the borrower does not repay it. If the loan is large, the lender may also ask the guarantor to give a mortgage over property to secure the guarantee. If you are ever asked to be a guarantor, get independent legal advice about the consequences if the borrower defaults on the loan.

REPAYMENT

The amount you borrow and the balance that remains outstanding at any time is referred to as the *principal*. In credit contracts such as store charge accounts, and credit card accounts, it may be referred to as the *unpaid balance.* The principal is repayable in accordance with the terms and conditions of the contract. Most commonly, it is repaid by monthly or other periodic instalments over the term of the contract. However, the borrower can repay the full amount early, or it may be possible to make part payments in addition to the normal instalments.

Interest is payable on the principal or unpaid balance at *fixed* or *variable* rates and it is usually paid by monthly or other periodic payments. If the principal or unpaid balance is also repayable by monthly or other periodic instalments, you pay interest on the *reducing balance*. With reducing balance loans, payments made in the early years are mostly for interest charges, whereas later payments pay off an increasing proportion of the principal.

An *interest-only loan* is one in which there is no repayment of principal during the term of the loan. You pay only interest during the term of the loan and the principal is repayable in full at the end. This arrangement may be appropriate for an investment loan in which income from the investment is used to pay the interest until the investment is sold and the proceeds are used to repay the principal.

The lender provides a schedule for payments of principal, interest, insurance premiums, and any other fees and charges. For larger loans such as housing loans and personal loans, you receive a statement once or twice each year that shows your payments, interest charges and the outstanding balance. If you have a credit card account or a store charge account, you receive monthly statements showing the unpaid balance and the minimum payment required.

RESOLVING DISPUTES

If you have a dispute with a lender or credit provider, the first step is to discuss the matter with them and try to resolve it. If this is not successful, there are dispute resolution procedures available.

There is a national *Code of Banking Practice.* You can get a copy of it from any bank branch or you can download it from the Bankers Association Internet site at http://www.bankers.asn.au. The Banking Code provides free dispute resolution and it applies to banking services that are 'wholly and exclusively for your private or domestic use'. If you have a dispute with your bank about your credit card, personal loan or home loan, you can lodge a complaint. Brochures and complaint forms are available at bank branches. If the dispute is not resolved in a manner that is acceptable to you, the bank must provide reasons and inform you about what further action you can take. If you are not satisfied with the outcome, you may lodge a complaint with the *Australian Banking Industry Ombudsman* (ABIO).

The ABIO provides dispute resolution for customer complaints against banks for disputes under $150 000. Disputes arising out of a bank's refusal to lend are excluded, but other loan disputes are not. The Banking Ombudsman will try to resolve the dispute as quickly as possible. Dispute resolution

is free and the step-by-step process is explained at the ABIO's Internet site, http://www.abio.org.au, or you can phone the ABIO on 1800 337 444.

Customers of building societies and credit unions also have access to free dispute resolution procedures similar to the Banking Code. The aim is to provide a prompt and effective dispute resolution process. Information booklets and complaint forms are available from building society and credit union branches.

If your loan is from another type of lender, you have no access to free dispute resolution procedures. In these circumstances, you can ask for free advice that is provided by government consumer agencies. With their help, you may be able to resolve a dispute with a lender. Otherwise, you are likely to need a lawyer.

DEFAULT

A loan or credit contract will list a series of *defaults* that can result in the principal or unpaid balance and any accrued interest or other charges becoming immediately due and payable. The most crucial defaults are *monetary* defaults, like failing to make repayments on the due dates or failing to repay a loan on time. If a mortgage has been given to secure a loan, there will also be further default provisions that protect the value of the mortgaged property. These include:

- Failure to pay insurance on the property—homes, vehicles and boats.
- Renting the property without consent—homes.
- Parting with possession of the property—vehicles and household goods.
- Failing to pay rates, taxes, registration or other fees and charges.
- Failure to maintain the property in a good state of repair.

There are many reasons why an individual might get behind with their repayments. If this ever happens to you, make an appointment to discuss the problem with your lender or credit provider. The key is not to ignore the problem in the hope that it will go away, because the sooner you act the better your chances of coming to an arrangement. If you do end up in default, the national consumer credit laws give you considerable protection. (These laws are examined in Chapter 4.)

If a borrower defaults by failing to make payments, they will receive a letter stating that payments have not been made and requesting that they do so immediately. If the borrower fails to respond, they may get another letter in stronger terms. If they do not respond to these letters, the lender may phone the borrower. If the loan is unsecured, the lender may refer the

matter to a debt collection agency for recovery of the loan. The agency will forward a written demand advising that if the loan is not repaid, together with costs, legal action will be taken. The agency may also telephone the borrower. If all of these demands are ignored, the agency may commence court action on behalf of the lender to recover the loan.

A lender, or a debt collection agent acting on the lender's behalf, is entitled to take reasonable action to recover the loan provided the borrower is not unduly harassed. Certainly, the borrower cannot be subjected to threats of any kind. If the borrower is harassed or threatened, they should seek advice from a government consumer agency or a lawyer.

Legal procedures

If a consumer defaults on a loan or credit contract, the national consumer credit laws require that they be served with a formal *default notice* by the lender or credit provider before action can be taken to recover the loan. The notice specifies the reason for the default and allows the borrower 30 days in which it may be rectified. If the default is not rectified, the lender or their collection agent will typically apply to the court for a summons and serve it on the borrower. If the borrower does not respond within 28 days, the lender can apply to the court for a *judgement* against the borrower. The judgment may be enforced in one of three ways.

- *Instalment order:* The lender serves the borrower with a summons that requires the borrower to appear at court. The court will examine the borrower in relation to their income, expenses, assets and liabilities. The outcome may be a court order against the borrower to pay the judgement by periodic instalments.
- *Garnishee order:* The lender applies to the court for the issue of a garnishee order addressed to persons who hold money on behalf of the borrower. These include employers with wages that are due and banks that hold money in deposit accounts for the borrower. The garnishee order is served on the employer or bank and they cannot give the money to the borrower; it must be paid to the lender. However, if it is the borrower's wages that are garnisheed, the borrower is left with enough money on which to live.
- *Writ of execution:* If the borrower owns property, such as a motor vehicle or household goods and appliances, the lender applies to the court for a writ of execution. This is an order of the court that empowers the *sheriff*, who is an officer of the court, to seize property and sell it at public auction. The amount recovered from the sale is used to repay the debt.

If a loan is secured by a mortgage over property, the lender does not have to take action in the courts. They need only serve the default notice and wait 30 days. Then they have the right under the mortgage to recover the property. If the security is a motor vehicle or other goods, the borrower will be asked to deliver them to the lender. If the borrower fails to comply with the request, the lender can seize the goods for subsequent sale at auction. If the security is a home or land, the lender can appoint an agent to conduct an auction. The borrower has a legal right to repay the loan at any time before the security is sold, but they will be liable for all of the costs, fees and charges that have been incurred as a consequence of their default.

Involuntary bankruptcy

If a borrower defaults on a loan and the lender obtains a court judgement in excess of $2000, the lender may apply to the *Federal Court* to have the borrower declared bankrupt under the *Bankruptcy Act*. The borrower will be served with a *Bankruptcy Notice* that gives them 21 days to pay the amount of the judgement plus court costs. If they fail to pay the amount, the lender can apply to the court for bankruptcy. A hearing date will be set and on that date the court will decide whether the borrower should be made bankrupt. Unless the borrower can pay the judgement or have the application adjourned or set aside, the court will make an order declaring the borrower bankrupt. From that date, all of the debtor's property will pass to a *registered bankruptcy trustee* who will sell it for the benefit of the lender and other creditors.

Arrangements to avoid bankruptcy

To avoid bankruptcy, a borrower can make an informal arrangement with the lender to repay the loan. However, it is not binding, because the lender can later change their mind. The *Bankruptcy Act* offers two alternatives that are binding: these are called Debt Agreements and Formal Arrangements.

A *Debt Agreement* is available if the borrower hasn't been previously bankrupt, had a prior debt agreement, or had a formal arrangement with creditors for the past 10 years. The borrower must have unsecured debts of less than $64 082.20, after-tax income of less than $32 041.10, and property that is not exempt under bankruptcy worth less than $64 082.20. These amounts change in accordance with quarterly movements in the Consumer Price Index. The amounts are current as at March 2002. Exempt property includes a car worth less than $5500.

A registered bankruptcy trustee, a financial counsellor or *Insolvency*

and Trustee Service Australia (ITSA) can help a borrower to make a debt agreement. No fees are charged for the agreement. A lender can reject the offer of a debt agreement, but if they accept they are bound by it. ITSA has an office in each capital city and you can find them in the White Pages. ITSA has an Internet site at http://www.law.gov.au which contains information about bankruptcy and alternatives to bankruptcy.

A *Formal Arrangement* is available for borrowers with larger incomes and more assets. A borrower can contact ITSA for information and they can seek advice from a registered bankruptcy trustee to see if an arrangement is feasible. Fees are charged for formal arrangements.

Voluntary bankruptcy

A borrower who is in serious financial difficulty that could possibly lead to bankruptcy should obtain advice from a financial and debt counselling service, an accountant, a registered bankruptcy trustee, government agencies or other similar organisations. If a borrower has taken advice and is certain that there is no chance of repaying their debts or securing an arrangement, it may be appropriate for them to consider putting themselves into bankruptcy. This is a very serious step, but in some cases it may offer some advantages. ITSA can provide information about voluntary bankruptcy. A borrower will be told of the consequences of bankruptcy and they should consider these carefully before they act. Bankruptcy is not permanent, and the standard period of bankruptcy is about three years. Bankruptcy comes to an end when the bankrupt is *discharged*. In some cases a bankrupt can apply for an early discharge after six months.

4 Consumer credit

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In Chapter 3 we identified the basic borrowing and credit arrangements that apply to consumers. The purpose of this chapter is to consider consumer credit in more detail by examining credit cards, store charge accounts, lay-bys, time payment, deferred payment and personal loans. The chapter concludes with a discussion of the national laws that apply to consumer credit. In the next chapter, we shall complete the examination of consumer credit by examining finance for cars and homes.

CREDIT CARD

A credit card is a convenient way to borrow. A cardholder is offered a *credit limit* that they can draw on whenever they wish. Credit cards are also used to buy items that otherwise might be purchased on time payment or deferred payment. It is possible to obtain cash directly from the card issuer by requesting a *cash advance*. Credit cards offer *continuous credit* up to the credit limit, and this avoids the hassle of having to fill out separate credit applications each time you need to borrow.

Banks offer *Bankcard*, and banks and other financial institutions offer *Master Card* and *Visa*. Bankcard is used in Australia and New Zealand, and Visa and Master Card can be used overseas as well. Some cards earn points that can be redeemed for goods and services. In addition, there are other cards, such as *Diners Club* and *American Express.*

Obtaining a card

The application form for a credit card will be much the same as any other type of credit application. In some cases, you can apply on-line using the Internet. When your application is approved, you get a letter of offer with notification of your credit limit. Legally, this is the offer of a contract. The card is posted to you or you are asked to collect it from a nearby branch. You accept the offer by using the card.

The letter will also contain a booklet entitled *Conditions of Use for your Card.* It is a standard form that contains the terms and conditions of your contract with the card issuer. You can get a copy of the booklet before you apply for a card. Read all of the booklet before using the card, especially the sections entitled, 'Your PIN', 'Lost or stolen cards or unauthorised transactions' and 'Reporting lost or stolen cards or unauthorised transactions'. These sections explain that you must safeguard your card and PIN and how to avoid being liable for any unauthorised use of the card. Keep the booklet for future reference.

Your PIN

You will be issued with a *Personal Identification Number* (PIN). The PIN is your electronic signature. It allows you to use your card at ATMs (automatic teller machines), EFTPOS (electronic funds transfer at point of sale) outlets and in branches of the card issuer. You will be told to safeguard your PIN, and the only safe way to do this properly is to memorise it. If you write it down, there is a danger that it will be found and used with the card.

Using the card

Credit cards enable you to pay for goods and services from merchants who have an agreement with the card issuer. They display the card symbol to let you know that your card will be accepted. The merchant uses the plastic card to create a voucher for you to sign. For purchases that are greater than their *floor limit*, the merchant contacts the card centre to get approval. Alternatively, if the merchant has EFTPOS, your card is swiped through a computer terminal, you enter your PIN, and approval is given electronically. You get a record of your transaction in addition to the normal sales docket. You can also get cash advances from ATMs, branches of the card issuer and some EFTPOS outlets.

You receive a monthly statement that contains details about purchases, interest charges (if any), and other fees and charges debited to the credit card account. Check the statement against the vouchers and cash advances for the preceding month. Errors are not common but they do occur, and this way you can have them quickly corrected. The statement indicates the amount of the *minimum monthly payment* that you are required to make by the *due date*. You can pay this amount, a larger amount or the entire outstanding balance.

Interest, fees and charges

Some credit card accounts have an *interest-free period* and others do not. If you choose a card with an interest-free period, you are not charged interest as long as you pay the outstanding balance on or before the due date. Otherwise, interest is charged at a relatively high rate. If your card does not have an interest-free period, you will be charged interest from the date of your purchase. However, this type of card has a lower rate of interest. For a cash advance on either type of card, interest is charged from the day that you received the cash advance. Credit card accounts pay government duties and these appear on your statement.

Lost and stolen cards

If your card is lost or stolen, the booklet of terms and conditions explains exactly what steps you must take. The procedures are similar for most cards, but you need to know what your particular card contract requires. Consult the booklet as soon as you know the card is missing and do exactly what it says without delay. You can avoid liability for unauthorised use of your card provided you take the steps required.

Joint cards and additional cards

You may apply for a *joint card* account with someone such as your spouse. Like all joint loans, you will each be separately liable for the entire card debt. This is something to remember if you separate. There can be similar problems with *additional cards* issued to your spouse or children. You are liable for all charges incurred with the card.

Standard terms and conditions specify that you return all of the cards that have been issued before an account can be closed. Otherwise, you may be liable for continuing card purchases even though you want to close the account. For this reason, it may be in your interest to avoid joint cards and additional cards.

STORE CHARGE ACCOUNT

Department stores and other retailers offer *charge accounts.* They are similar to credit cards because you can either pay the full amount at the end of the month or you can make a minimum monthly payment. Unlike credit cards, however, purchases can only be made from the one store. Charge accounts offer an interest-free period like credit cards and, if you do not pay the outstanding balance within that period, you are charged interest. The interest rates are higher than for credit cards. It is also possible to get cash advances on some store charge accounts.

When you open a store charge account, you will receive a plastic card and a standard booklet of terms and conditions. Read this booklet before you use the card. You are required to safeguard your card and you can be liable for any unauthorised use of the card. There is no PIN. The terms and conditions of the account will allow for the return of goods and refunds. With some stores and retailers, the card can be used to buy goods on *deferred payment* when these offers are available. The offers are usually referred to as *special promotions* in the terms and conditions booklet.

In addition to charge accounts, stores may allow their customers to purchase goods on *lay-by*. A deposit is required and the balance of the purchase price is paid by instalments over a relatively short period. When the last instalment payment is made, the goods can be collected. No interest is charged on lay-bys and, for this reason, they are an alternative to a store charge account.

TIME PAYMENT AND DEFERRED PAYMENT

Deferred payment plans are popular and they are largely replacing *time payment*. In a time payment plan, interest is added to the purchase price of the goods and each payment includes repayment of the price plus interest. In a deferred payment plan, no interest is added to the price. You are offered a period of time to pay, such as 6, 12 or 24 months, and there may be a deposit required. You only pay interest if you do not make the payments required by the contract. Merchants like deferred payment schemes because, with no apparent interest to pay, some customers are more likely to make a purchase.

Information about the terms and conditions of the offer are available in the store and there is an application form for you to complete. In many cases the information is entered directly into a computer that is on-line to the financier. When the financier's computer receives the data, an on-line credit check is undertaken. When your application is approved, a letter of offer is printed and you sign it to accept the offer and take the goods.

Retailers spread the cost of their deferred payment plans by adding it to the price of goods sold in the store. This means you should shop around for the best price if you want to buy on deferred payment. The hidden cost may be larger in some stores than others and this will be reflected in their prices. If you have the money to pay cash, then negotiate a lower price because the retailer does not have to bear the cost of financing your purchase.

If you are offered a deferred payment plan by a department store, it is common practice to ask you to apply for a store charge account with a card. You go through the same process of credit application and approval. Your monthly statement will show deferred payments separately because interest is not charged on them during the deferred payment period. You can have several deferred payment purchases at one time as long as your balance remains under your credit limit.

PERSONAL LOAN

Personal loans are available from a variety of lenders for 'any worthwhile purpose' subject to the usual credit conditions. Lenders include banks, building societies, credit unions, finance companies and other lenders. The term of the loan will usually be from one to five years with a minimum amount of $2000. The loan may be secured or unsecured, depending on the amount you borrow and the policy of the lender.

A personal loan may be used to purchase a car, boat, caravan or a holiday. Generally, personal loans are appropriate when the amount required is larger than you would obtain on a credit card, charge account, time payment or a deferred payment plan. Interest rates for personal loans are lower than interest rates for store charge accounts and credit cards, so you may be able to save money by using a personal loan to consolidate your charge accounts and credit card accounts.

NATIONAL CONSUMER CREDIT LAWS

The *Uniform Consumer Credit Code* applies in all states and territories and is referred to as the *Credit Code*. It applies to the types of consumer credit we have examined in this chapter and also to car loans and home loans. There are three reasons why you should have some knowledge of the Credit Code.

- Lenders must follow strict procedures when they lend or provide credit. If you know what these are, you will have a better understanding of the process.
- The loan or credit contract must comply with strict requirements as to form and content. If you are aware of these requirements, it will help you to read and understand the contract and other documents.
- The Code offers important protections for consumers at the beginning of the contract and later during the term of the contract. If you know your rights, you can enforce them.

The Credit Code provides protection for consumers, but the following requirements must be satisfied before it will apply.

- The credit is for an individual and not a company.
- The credit must be used wholly or predominantly for private, domestic and household purposes and not for business or investment purposes.
- A charge, such as interest, must be made for providing the credit.
- The credit must be provided in the course of or incidentally to a

business. Banks and financial institutions are in the 'business' of lending, but a loan from a friend or relative is not subject to the Credit Code.

Pre-contract disclosure

When your loan or credit application is approved, the lender is required to give you a *Pre-contractual Disclosure Statement* before you sign the contract. It contains all the important terms and conditions of the contract and is designed to overcome situations in which you are asked to sign a contract without knowing what is in it. It also overcomes the problem of written loan offers that fail to draw attention to all of the important terms and conditions. The Disclosure Statement frequently takes the form of a full copy of the contract. Under the Credit Code, there are a number of terms and conditions that must be contained in the Disclosure Statement and the contract. They are as follows.

Amount borrowed

Home loans, personal loans, time payment and deferred payment have a fixed amount of credit that must be disclosed. However, credit cards and store charge accounts depend on how much you spend and only your 'credit limit' can be specified.

Annual percentage rate

The annual percentage rate (APR) is an important disclosure because the higher the rate of interest the more expensive the loan. The APR can be fixed or variable, or a combination of both. Fixed rates can be disclosed, but the lender will only be able to quote the current variable rate as an 'indicator'. If an *indicator rate* is quoted, be aware that it can go up or down before the loan is settled.

If the variable rate of interest is based on another rate that is not disclosed in the contract, details of that rate and how it can be determined must be provided. For example, banks may charge variable interest on their home loans and they publish the rate in the newspaper each week. The requirement to specify the APR allows you to compare rates charged by different lenders.

Method of calculating interest charges

The APR is applied to the *unpaid balance* to calculate the interest charge. The unpaid balance or closing balance is the difference between amounts credited and amounts debited. Interest is generally calculated on a daily

basis and debited or charged monthly for credit cards, personal loans and home loans. The APR is divided by 365 to find the daily percentage rate (DPR). The Credit Code allows a percentage rate to be rounded off to not less than four decimal places so, if the APR is 15 per cent, then the DPR would be shown on the contract or a statement as 0.0411 per cent.

The maximum amount of interest that can be charged under the Credit Code is the amount determined by applying the DPR to the unpaid balance. Daily interest is good for lenders, but it is also good for you. For example, if you make an extra payment today to reduce your credit card balance, from tomorrow you will only pay interest on the remaining balance. You won't have to wait until the end of the month to get the benefit. Interest is not only charged on the amount that you borrow, but also on unpaid interest charges if you fail to make your loan repayments on time.

If you have a fixed interest loan for less than seven years, the total interest to be charged over the whole period must be disclosed as a lump sum. This enables you to see the total cost of the loan. However, the amount cannot be stated if the contract has variable interest.

Repayments

The amount of the repayments, the minimum payment if there is one, the number of repayments and the period over which they are to be repaid, must be disclosed. If the interest rate is variable, then the amount of your repayments will also vary and so the lender can only give an 'indicative' amount for the commencing repayments. In the case of credit cards and store charge accounts where the loan has no specified term, there is nothing specified about the number of payments or the period of the contract. However, the method of calculating the minimum payment will be specified.

Credit fees and charges

These may include loan application fees, valuation fees, service fees, fees for changing the terms and conditions, and early repayment fees. If the amounts are known, they must be disclosed and you must be notified about when they are payable. Fees and charges are becoming more common, and you need to add them to the interest charge in order to determine the true cost of your loan.

Changes to the contract

Some loan contracts give the lender the right to make changes without asking for your consent, such as credit cards, store charge accounts and home loans. Lenders can sometimes change the interest rate, the amount of the repayments, the term of the loan, the fees and charges, and many

other important terms. Read this part of the Disclosure Statement and the contract carefully. If the contract does not expressly allow the lender to make changes without your consent, then they may not do so.

If a change imposes additional obligations, you must be notified in advance. Monthly statements provide lenders with the opportunity to give this notice without the need for a separate letter. Lenders also place notices of changes in the newspaper. You will get notice of a change to the APR no later than the day it takes effect by written notice or newspaper advertisement. You will get 30 days' advance written notice for a change to the method of calculating interest, a change in the fees and charges, and any other changes. However, you will not receive a notice if the change reduces what you have to pay under the contract, such as a lower monthly repayment, or if the change happens automatically under the contract.

Statement of account

The frequency with which statements of account will be provided must be disclosed. Many statements are monthly, although some may be less frequent. It is important to check the statements against your own records to make sure they are correct. This is why the Credit Code ensures that you get them.

Interest charges on default

The rate of interest that can be charged when your payments are not made on time must be disclosed. This is referred to as the *default rate*. A default means that you are in breach of the contract. The rate charged on default is generally 2 per cent higher than the normal rate under the loan, but it can be higher. If you make a late payment, the default rate can be charged on that payment. If your next payment is on time, the default rate will no longer be charged. If you default on your loan and stop making payments altogether, the default rate applies from the time the default starts until the time the entire loan is repaid to the lender.

Enforcement expenses

There will be a statement that says enforcement expenses may become payable if you breach the contract. These include the cost of sending demand letters, preparing and serving summonses, and enforcing court judgements. The Credit Code provides that enforcement expenses must be reasonable and, if they are not, you can challenge the amount claimed. If you have given a mortgage to secure a loan, the expenses will also include the cost of recovering mortgaged property and selling it.

Mortgage or guarantee

The address of the mortgaged property and title details must be disclosed. If there is a guarantor, their details must be shown.

Commission

If a commission is to be paid by or to the lender, the particulars must be disclosed. This requirement ensures that there are no secret commissions. If you do not want to pay the commission, ask that it be waived or decline the offer of a loan.

Credit insurance

If you buy credit insurance and the loan money will be used to pay the premium, information must be provided about the insurer, the kind of insurance, the premium, and any commission paid to the insurer. Sometimes, lenders and insurers are associated with each other or there is some arrangement between them. You do not have to buy loan insurance and, legally, it cannot be made a pre-condition of the loan. If it is offered and you want it, you must be given all the necessary information. There may be a better policy available from another insurer, or you may be able to get a lower premium elsewhere.

Information statement

Before you sign a loan or credit contract, the lender is also required to give you another document called *Information Statement—Things you should know about your proposed credit contract*. It tells you about your rights and obligations under the Credit Code and the contract. It takes the form of a series of questions and answers. Read this document and keep it, because it contains important information that you may need in the future.

Plain English and no small print

The Disclosure Statement, the Information Statement and the contract must all be in plain English with no small print. As a result, you should be able to read and understand each of these documents without difficulty. Any special terms that are used will be defined. Allow plenty of time to read the documents. In fact, you may need to read them several times. Ask questions if you are unclear about anything.

Completing the contract

Once you have read the Disclosure Statement and Information Statement, you are ready to enter into the contract. There are two ways in which this may take place.

- You will be presented with a contract. You sign, the lender or credit provider signs, and the contract is dated. You may receive the loan or credit on that day or shortly thereafter as agreed. Interest will accrue from the day you get the money or the credit.
- The Disclosure Statement may contain the offer of a loan. You can accept it by signing the form of acceptance provided and returning it to the lender or credit provider. Returning the acceptance means that you have accepted all the terms and conditions contained in the offer. You will receive the loan or credit immediately or on an agreed date and interest will accrue from that day.

You may also need to sign a mortgage if the contract is subject to security. Loans for cars, boats and homes usually require security. A copy of the mortgage will be given to you and there may also be other documents to sign, such as a payment authority to authorise deduction of loan payments from your account.

If you decide not to go ahead with the contract before you receive the loan or credit, you are entitled to write to the lender and ask for your contract to be terminated. You may have to pay fees that were incurred before the lender was notified. If you have possession of goods obtained on credit, it may be too late to terminate the contract unless you can return the goods or the credit provider agrees to termination of the contract. For this reason you need to be careful when you acquire goods using deferred payment plans or time payment. With a housing loan, you have more time to reconsider and to change your mind.

The lender must give you a copy of the contract within 14 days of the date on which it is made unless it is a credit card contract. The date of the contract can be the day you sign the contract, the day the lender receives your acceptance, or the day on which the loan or credit is made available. With credit cards, the day that you first draw on the card is usually taken to be the day the contract is made. The card issuer is not required to send a copy of the contract after this day, because a copy of the terms and conditions is posted with the original offer of the card. You may be given your copy of the contract on the day it is made or it may come later in the mail. Keep your copy so that you can refer back to it if the need arises.

Early repayment

Some borrowers want to repay their loan early or make extra payments when they have the cash. The Credit Code gives you the right to repay the contract in full at any time. However, there is no right to make part payments unless it is permitted by the contract or the lender agrees. The contract may impose restrictions on early repayment. With home loans, for example, the lender may charge a fee for early repayment that is equivalent to one or two months' repayments. However, if the fee is excessive, you may be able to challenge it.

If you want to repay early, you can request a *payout figure*. The lender must provide a statement of the payout figure within seven days of your request. You may be charged a fee for the statement. Once you have the statement and you are happy with the amount, you can arrange with the lender for early repayment. If there is security for the loan, give the lender reasonable notice so that a document to discharge the mortgage can be prepared.

Hardship

If you become ill, lose your job or have other good reasons for not making repayments on time, you are entitled to ask the lender to change your contract. You can ask for repayments to be deferred or reduced, and you can ask for the term to be extended. If you request a change and the request is unreasonably refused, you can apply to the court for an order to change the contract despite the lender's opposition. You will need the help of a government consumer agency or a lawyer to do this.

Government consumer agencies

The Credit Code is enforced by state *Fair Trading* or *Consumer Affairs Offices*. Staff at these offices are available to give advice if you have a problem with your loan or credit contract or a complaint against a lender or credit provider. Look in the front section of the White Pages telephone directory under 'State Government—Consumer Affairs & Fair Trading' to locate the telephone number for your state or territory. The first thing to do when you have a problem is to telephone for advice. If the problem is more complex, you can make an appointment to see someone. The Government consumer agency may speak to the lender on your behalf. If there is a serious problem, you may need a lawyer, and the staff at the agency will be able to advise you about this.

5 Finance for cars and homes

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Car finance and home finance deserve special attention because they involve larger sums than most other forms of consumer finance. They not only represent the largest purchases that most consumers will ever make, but also the largest loans that they will ever repay. The more you understand about car finance and home finance, the better equipped you will be to negotiate with lenders to get the best deal.

The purpose of this chapter is to focus on the types of finance that are available for cars and homes, and to consider how to make the best choice for your circumstances. To finance the purchase of a car, we examine personal loans, car loans, buy-back plans and leasing. To finance the purchase of a home, we discuss several types of loans, depending on the purpose of the loan and your requirements. We also examine what happens if you default on a car loan or a home loan.

CAR LOANS

You have decided to buy a car and the next question is how to finance it. If you simply want to borrow the money to pay for the purchase, then you will be looking for a personal loan or a car loan. A personal loan can be used for any purpose, including the purchase of a car. A car loan is a specific purpose loan that is only used to finance the purchase of a car. It is wise to shop around, because lenders differ regarding the amount that can be borrowed on a particular car, the term for repayment, interest rates and fees. The application for a personal loan or a car loan is simple and in most cases it is approved quickly.

Personal loans are general purpose loans and many people use them to purchase new or used cars. They are offered by banks, finance companies, building societies and credit unions. The term of a personal loan is usually one to five years, with terms of four or five years more common when it is used to finance a car. The minimum amount is usually $2000 and there are fees to pay. Interest rates on the loan can be fixed or variable, and your repayments may be weekly, fortnightly or monthly. You can generally borrow 85 per cent of the purchase price of the car, although some lenders will go higher. The larger your deposit, the less you need to borrow and the lower your repayments will be. There may be a requirement for a mortgage over the vehicle. The mortgage is called a *bill of sale* or a *motor vehicle security* and is registered at the *Motor Registry.* It remains registered on the vehicle until the loan is repaid and prevents the sale of the vehicle without the consent of the lender.

Car loans are essentially the same as personal loans except that they are limited to financing cars. Some car loans are offered by banks, credit

unions and consumer finance companies. Others are offered by finance companies that are affiliated with motor vehicle manufacturers. Most lenders have arrangements with car dealers whereby the dealer introduces prospective customers seeking finance.

Loan repayments

An important element in negotiating for a car loan is the loan repayment. The loan repayment depends on how much you need to borrow, the interest rate charged by the lender and the term over which the loan will be repaid.

- The more money you need to borrow, the higher will be the repayments.
- A higher interest rate results in higher repayments, and a lower interest rate results in lower repayments.
- A shorter term results in higher repayments, and a longer term results in lower repayments.

Table 5.1 can be used to calculate the monthly repayment for each $1000 borrowed, including principal and interest. The monthly repayment per $1000 borrowed is found where the interest rate and the loan term intersect. If the interest rate is 10 per cent and the loan is to be repaid over 60 months, then the repayment will be $21.25 for every $1000 borrowed. If you want to borrow $15 000, then your monthly repayment will be $318.75.

$$\text{Monthly repayment} = 15 \times \$21.25 = \$318.75$$

You can see from Table 5.1 that the monthly repayment is lower if you choose to repay your loan over a longer term. However, a longer term makes the loan more expensive. This is demonstrated in Table 5.2, which is the total amount of interest over the life of the loan. The total amount

Table 5.1 Monthly car loan repayment per $1000 borrowed

nterest rate (%)	Term of loan in months				
	12	24	36	48	60
8	$86.99	$45.23	$31.34	$24.41	$20.28
9	87.45	45.68	31.80	24.89	20.76
10	87.92	46.14	32.27	25.36	21.25
11	88.38	46.61	32.74	25.85	21.74
12	88.85	47.07	33.21	26.33	22.24
13	89.32	47.54	33.69	26.83	22.75
14	89.79	48.01	34.18	27.33	23.27

Table 5.2 Total interest per $1000 borrowed

Interest rate (%)	Term of loan in months				
	12	24	36	48	60
8	$43.88	$85.52	$128.24	$171.68	$216.80
9	49.40	96.32	144.80	194.72	245.60
10	55.04	107.36	161.72	217.28	275.00
11	60.56	118.64	178.64	240.80	304.40
12	66.20	129.68	195.56	263.84	334.40
13	71.79	140.96	212.84	287.84	365.00
14	77.48	152.24	230.48	311.84	396.20

of interest per $1000 is found where the interest rate and the loan term intersect. The longer the term, the greater the interest cost. From the previous example, the total amount of interest for this loan is $4125.

$$\text{Total interest} = 15 \times \$275.00 = \$4125$$

If the term of the loan in this example is reduced by one year, it would be repaid over 48 months. The repayments would be higher at $380.40 per month, but the total interest cost would be less at $3259.20. Interest savings would be $865.80 by repaying the loan over a shorter term. This illustrates the tradeoff between repayments that fit into your budget and minimising the interest cost of the loan.

BUY-BACK PLAN

Motor vehicle dealers and finance companies have combined to offer finance plans called *buy-backs* that can be used to purchase a new car. You choose the car from the dealer and then apply to the finance company for a loan. A deposit is normally required and the loan is repayable over a short term of one to three years. The monthly repayments are lower than they would be for a standard car loan over three to five years because there is a balloon payment at the end of the term. If you want to reduce the size of the balloon payment, you can pay a larger deposit. When the buy-back plan comes to an end, you can choose one of three options.

- *Trade in the car and buy another car using the same dealer/financier.* Your contract will provide for a guaranteed minimum buy-back price for your trade-in when the contract ends and you buy a new car. This arrangement enables you to have a new car every few years. You must pay the difference between the buy-back price and the price of the new car, which you can usually borrow.

- *Return the car.* You have the assurance of a guaranteed minimum buy-back price when you return the car. There will be nothing to pay, provided you have complied with the contract that requires you to look after the car and maintain it in good condition. There may also be a requirement not to exceed a specified number of kilometres. The financier sells the car and takes the gain or loss on the sale.
- *Keep the car.* You make the final balloon payment and keep the car. However, the payment will be large. If you don't have the cash, you can refinance the vehicle by borrowing the amount of the balloon payment.

The main advantages of a buy-back plan are lower repayments and a guaranteed minimum trade-in. A guaranteed trade-in may be attractive for those who want to have a new car every few years and they can apply to the same financier each time for a loan. The disadvantage with a buy-back plan is the large balloon payment at the end that either has to be paid or refinanced.

LEASING

There are some circumstances in which you may want to acquire a car by entering into a *lease.* Leases are offered by leasing companies and finance companies, in which you make monthly lease payments over a term that is usually three to five years. You do not own the car, but you pay all of the expenses including registration fees, insurance, repairs, maintenance and running costs. The lease stipulates the value that the car will have at the end of the term and this is called the *residual value.* Residual value is important because it is directly related to the amount of the lease payments. The higher the residual value, the lower the lease payments. The lower the residual value, the higher the lease payments.

At the end of the lease term, you return the car to the leasing company and they sell it. If the price they receive is less than the residual value, then you must make up the difference. If the price they receive is more than the residual value, they keep the difference. In practice, however, you can offer to buy the car from the leasing company for its residual value and this is most commonly the result. If you do not have the cash, you can finance the purchase.

Novated leasing is a scheme in which an employer and employee arrange with a finance company for a car to be leased in the employee's name. The car is then sub-leased to the employer, who becomes responsible for the expenses associated with its use, including the lease payments. At

the end of the lease term, the employee can offer to purchase the car from the finance company for the amount of the residual value. If the employee stops working for the employer, the contract provides that the employee becomes liable for the remaining lease payments. Novated leasing is often used in conjunction with *salary sacrifice* in order to gain a taxation advantage.

CAR LOAN DEFAULT

If a borrower fails to make loan repayments, they are in default. However, if a borrower cannot make loan repayments because of unemployment, illness or other good reason, the Credit Code allows them to apply to the lender or the court for additional time to pay. The Credit Code also provides protection if the amount owing under the loan at the time of default is less than 25 per cent of the amount originally provided, or $10 000, whichever is less. Under these circumstances the lender cannot repossess a car without going to court for an order. This may give the borrower time to find the money to repay the loan or re-finance it with another lender.

If there is a default and the loan is secured by a mortgage, the borrower will be required to return the car or disclose its whereabouts to the lender so that it can be recovered. The borrower has a legal duty to provide this information and they can be prosecuted if they don't cooperate. If the borrower does not give up the car, the lender can get a court order to take possession. After repossession, the lender has to give the borrower a written notice within 14 days that contains the estimated value of the car, the amount of the enforcement expenses, and a statement of the borrower's rights and obligations. The lender cannot sell the car until 21 days after service of the notice. The borrower may pay out the loan during this period and recover the car.

Under the Credit Code, the borrower has the right to nominate someone to buy the car for the amount due under the loan plus the enforcement expenses. Otherwise the car will be sold as soon as reasonably practicable for the best price obtainable. If there is any money left from the sale, it will be paid to the borrower. If the lender does not recover enough money from the sale to repay the loan, they can take further action against the borrower to recover the outstanding amount.

HOME LOANS

Home loans are offered by banks, building societies, credit unions, finance companies, insurance companies, superannuation funds and private lenders.

There are many types of home lending designed for different purposes. You can borrow to buy an existing property, or you can borrow to buy land and build a new home. Lenders also offer home improvement loans and home equity loans. If you want to move into a new home before you sell your old one, you may need a *bridging loan* for a short time. In some situations, it may be to your advantage to refinance an existing home loan with a new lender.

Loans to buy an existing home

The most common form of home lending is to buy an existing home. It is basically the same for a house, a unit or a townhouse. These loans are available from all home lenders and they are specifically used for 'owner-occupied housing' and not for investment. Special interest rates and loan terms may apply and the loan is secured by a first registered mortgage over your home.

Land loans and building loans

If you want to build your own home, you can borrow the money to buy the land. Banks and building societies are the main providers of land loans. Generally, you can get a land loan on the same terms and conditions as a home loan, but there will be two conditions. First, you have to start building within a certain time period, such as three years. Second, the loan must be converted into a home loan when you start building. The loan will not require another mortgage and this saves costs. The lender will want to see building plans, council approvals, insurance coverage and all the necessary documentation before the loan goes ahead.

Home improvement loans

If you already own your home you may wish to borrow for improvements such as an extension or a new kitchen that will increase the value of your home. Home improvement loans cover the cost of extending or renovating your home. You may be required to provide plans, approvals, insurance and other documentation if it is major work. These loans can usually be added to your original home loan, and in most circumstances they can be secured by your existing mortgage.

Home equity loans

If you have a home loan and you have repaid a significant proportion of it, you can borrow against the equity in your home. The same applies if you have repaid your home loan in full. They are called *home equity loans* and they are similar to home improvement loans in the sense that they are secured by the mortgage over your existing home. However, a home equity loan can be used for any worthwhile purpose, such as the purchase of a car or an overseas holiday. The attraction of home equity loans is that they are very flexible and you can borrow at home loan interest rates rather than higher personal loan rates.

Bridging loans and refinancing

When people sell one home and buy another, they generally arrange for both contracts to settle on the same day. This enables them to vacate the old home with the proceeds of the sale, and to pay for the new home so that they can occupy it. However, if you find yourself in a situation in which you need to pay for the new home before you complete the sale of the old one, then you may need a *bridging loan*. You can borrow the money to settle your purchase and then repay it later with the proceeds from the sale. Bridging loans incur costs, such as application and establishment fees in addition to the interest charges, so try to avoid them by careful planning.

There may be an occasion when it is to your advantage to refinance your housing loan. The loan may have been drawn some time ago when the terms and conditions were not as favourable as they are now. If the lender refuses to allow a change to the terms and conditions, you may choose to repay the loan with the proceeds of a new loan on better terms and conditions. Alternatively, your loan may have been for a fixed term and it is about to expire. If the lender does not want to extend the term, then you will need to refinance the loan. Borrowers are occasionally forced to refinance a loan if they are in default and the lender refuses to waive the default. Refinancing is costly, so try to avoid it by carefully considering the terms and conditions of your initial home loan.

CHOOSING A HOME LOAN

The first step in choosing a home loan is to collect information about the types of loans that are available from different lenders. Ask for brochures and pamphlets about *home loan products* and look at the Internet if you have access. Many lenders provide helpful tips for home buyers, advice

about the home loan interview process, commonly asked questions and answers, and glossaries of housing and legal terms. The Australian Bankers' Association Internet site at http://www.bankers.asn.au offers a useful *Loan Selection Guide*. Doing your homework will overcome any confusion caused by the number of options that you may be offered. It will also enable you to ask sensible questions and give you the knowledge to ask for the best deal. There is strong competition between home lenders and you should take advantage of it.

Home loan package

Finding the best deal involves more than looking for the cheapest interest rate. What you want is the best *home loan package.* A home loan package is made up of a combination of features, and lenders usually have several packages from which to choose. There are a number of standard features that you can compare.

Fees

Lenders charge different types of fees for home loans. Some fees are imposed at the outset, and other fees are charged during the term of the loan or on repayment.

- The lender may ask for an *application fee* when you apply for a loan. By imposing a fee, the lender seeks to ensure that only genuine applications are received. Look for loans with no application fee or special offers for low fees. Even if an application fee is advertised, ask the lender to waive it.
- The *establishment fee* covers the cost of approving a loan, including valuation, search fees and other incidental matters. Some lenders are prepared to negotiate a reduction or a waiver of the establishment fee. It may include other fees and charges, such as legal fees, registration fees and government duties.
- *Annual or account keeping fees* are common, although a few lenders waive them. They add significantly to the cost of a loan and the lender usually has the right to increase the fees during the term of the loan.
- *Early repayment fees* are sometimes imposed if you repay your loan before the end of its term. If you accept a loan with an early repayment fee, make sure you understand how the fee will be calculated.
- *Switching fees* are generally imposed if a borrower asks to switch between a variable interest loan and a fixed interest loan. The fee is intended to compensate the lender for the financial loss it may suffer because of switching, and the amount charged can be substantial. Make

sure you understand the manner in which the fee will be calculated if you switch.

Fixed interest

A *fixed interest rate* gives you certainty because the interest cost remains the same for the term of the loan and your repayments remain level. Banks and building societies generally offer fixed rates for periods of one to five years of the loan term. The longer the fixed term, the higher the rate. When the fixed term ends, the loan automatically reverts to the bank's variable interest rate unless you negotiate another fixed term. If interest rates are unstable, you may prefer a fixed rate loan to protect yourself. You can use Table 5.3 to calculate the monthly repayment for a fixed rate home loan. It indicates the monthly repayment for each $1000 borrowed, including principal and interest.

Table 5.3 Monthly home loan repayment per $1000 borrowed

Interest rate (%)	Original term of loan in years			
	15	20	25	30
6.00	8.44	7.16	6.44	6.00
6.50	8.71	7.46	6.75	6.32
7.00	8.99	7.75	7.07	6.65
7.50	9.27	8.06	7.39	6.99
8.00	9.56	8.36	7.72	7.34
8.50	9.85	8.68	8.05	7.69
9.00	10.14	9.00	8.39	8.05
9.50	10.44	9.32	8.74	8.41
10.00	10.75	9.65	9.09	8.78

For example, if you want to borrow $100 000 over 20 years at a fixed interest rate of 8 per cent, then your monthly repayment will be $836 per month.

$$\text{Monthly payment} = 100 \times \$8.36 = \$836$$

Variable interest

Home lenders also have a *standard variable rate* for home loan borrowers. Lenders' rates are published weekly in the newspaper. The monthly repayment goes up or down according to changes in the interest rate. If interest rates go up unexpectedly, you will need to find more money for higher repayments and this can be a serious problem if the loan repayments are already large. Variable interest rates may be higher or lower than fixed rates at the time you borrow, depending on the loan term. Some lenders offer a

reference rate that is specifically set for your loan. Rather than varying from month to month, it varies from year to year. This gives you the certainty of knowing that your payments will only be varied once each year, but you will need to be prepared for the increase if it occurs.

If interest rates become volatile, you may want to ask the lender if you can switch to a fixed interest rate. However, in times of volatile interest rates, fixed rates are likely to be high. If your loan is large you may want more certainty, but if it is small you may be prepared to run the risk of increases in your repayments. It is sometimes possible to negotiate a loan in which a portion of the principal is subject to a fixed interest rate and the other is subject to a variable interest rate.

Loan term

Banks, building societies, credit unions and other institutional lenders commonly offer home loan terms up to a maximum of 30 years. However, most borrowers want to pay off their loan much sooner, so lenders offer a variety of flexible repayment plans. If you choose a shorter term, however, the repayments are higher.

Interest only

Loan repayments generally include principal and interest. However, lenders sometimes offer *interest-only* loans that may be fixed or variable. You pay interest during the term of the loan and repay the principal at the end. Generally, interest-only loans are not long-term. Your intention may be to resell the home to repay the loan and you want to avoid large repayments in the meantime.

Low start loans (honeymoon loans)

Banks offer loans with low interest rates for the first year that may be fixed or variable. If they are variable, the rate will be less than the standard variable rate. After the first year, the rate changes to the standard variable rate, or you can negotiate a new fixed rate. Honeymoon loans are designed to help you in the first year when you need money to pay outgoings and to get established in your new home. After the first year, it is expected that you will be able to make higher repayments.

Flexible repayment

You may be offered the opportunity to pay off your loan weekly, fortnightly or monthly. Lenders point out that if you pay fortnightly, you will effectively make an extra month's repayment each year. This is a great idea if you can afford it. You may also be able to repay the loan in part or in full

at any time without prepayment fees, or increase the frequency or amount of your repayments or make additional lump sum payments. This gives you some flexibility if your personal and financial circumstances change. For example, your salary may increase over time and you can afford to repay more. You can save thousands of dollars in interest costs if you reduce the time it takes to pay off your loan.

Redraw facility

Some loans allow you to redraw some principal that you have repaid. The amount that you can redraw is determined by a formula in the contract. Redraw loans are useful for meeting financial emergencies if they arise.

Interest offset account

Banks, building societies and credit unions offer home loan interest offset accounts. The interest that would otherwise be credited to the balance in the account is used to reduce the interest on your loan account instead. The amount of the offset varies and you need to be clear about this. Some banks offer a 100 per cent offset, which means that you are credited with the same rate of interest on your offset account balance as you are charged on your loan. However, it is more likely that you will receive a lower rate on your offset account. It is a tax-effective feature because you don't pay tax on the interest credit from the offset account.

Choosing a home loan package

There are many factors that may influence your decision about home finance. What works best for one borrower may not be best for another. The key to making your choice is to compare competing packages across a consistent set of criteria.

- *Purpose:* The purpose of the loan is an important factor. If it is a first home loan, you may choose a longer term like 30 years so that you can reduce the amount of your monthly repayments. A shorter term may be more suitable for a home improvement loan or a home equity loan.
- *Cost:* Shop around for the home loan that offers the cheapest interest rate and the lowest fees. Don't be bashful about negotiating; the result may save you thousands of dollars over the term of the loan.
- *Certainty and security:* Fixed interest loans offer the certainty of a fixed monthly repayment but, unlike borrowers with variable rate loans, you cannot make savings if interest rates fall. Also, banks and other lenders may only offer a maximum fixed interest period of three to five years,

and the interest rate increases with the length of the period you choose. If you want a series of fixed interest rate periods, you cannot avoid the uncertainty of having to renegotiate the rate at the end of each period.

- *Flexibility:* Choose a loan that offers maximum flexibility in making repayments. For example, low start loans and redraw loans allow you to adjust for future changes in your financial position. Flexible repayments enable you to repay more when funds are available and this reduces the overall cost of the loan. Fixed rate loans may not offer the same flexibility as variable rate loans.

Negotiate for as many features as possible in your home loan package. This will overcome the need to renegotiate your loan at some future date. Renegotiation involves time and money and there is the uncertainty about whether the lender will agree to new terms and conditions.

HOME LOAN PROCESS

When you are ready to apply for a home loan, fill out the lender's loan application form and submit it. Some lenders allow you to make an on-line application on the Internet. The lender does the usual credit checks. However, with home loan applications there are additional steps taken by the lender before the loan can be approved. The most important of these is a valuation of the property.

The valuation may be undertaken by the lender or by a licensed valuer. You may be asked to pay a valuation fee. The purpose of the valuation is to fix the value of the property so that the maximum amount of the loan can be calculated. If the price you are paying for the home is more than the valuation, you may not be able to borrow as much as you need. For this reason, it is important to ensure that you are not paying more than the lender's valuation for a home if you are relying heavily on loan funds.

The lender also conducts title searches to ensure that the title is in order and the property is not adversely affected in any way. The lender does not want to inherit any problems that could prevent or delay a mortgagee sale if the need ever arises. Your lawyer will do the same searches for your own protection before you sign the purchase contract. If any problems are discovered, they will need to be corrected before the lender will advance any funds.

When your loan application is approved, you will receive a formal offer of a loan together with a *Pre-Contract Disclosure Statement* and *Information Statement*. There will also be provided a copy of the loan contract and the mortgage. There is much to read and understand before you sign

the acceptance attached to the offer. You will be required to take up the home loan within a time limit—usually two months. If you do not take up the loan in this time, the lender can insist on a renegotiation of the loan. This could be a problem if you have a fixed interest loan and the lender increases the interest rate. Be aware that the interest rate at the time the loan is settled will determine the amount of your monthly repayments and it may be different from the estimate provided by the lender at the time of the loan offer.

Joint borrowing

If you want to borrow money in conjunction with another person, you will need to make a *joint* application for the loan. Joint borrowers are each liable for the whole loan and not just their agreed share of it. If you have agreed to share the monthly repayments and one of you can't pay their share, the other will have to make up the difference. You cannot say to the lender, 'Here is my share. Recover the balance from the other borrower.' If a joint loan is called up, the lender will take action against all borrowers.

If one borrower does not wish to continue with the loan, it can create problems for the other borrower. It may be necessary to buy out the departing borrower. The mortgage will have to be repaid and a new loan taken out in the name of the continuing borrower. Hopefully, the existing lender will agree to the change, but it will depend on the circumstances of the continuing borrower. There will be fees to pay, as well as legal costs and stamp duty on the property transfer. If the loan is a commercial arrangement to acquire property jointly, then you should have a contract in writing that sets out what will happen in the event that one borrower does not wish to continue with the loan and wants to sell their share of the property.

The final steps

Once you have accepted the loan offer, you can enter into the purchase contract and pay the deposit to the seller. Do not enter into the purchase contract until your loan is formally approved, unless the purchase contract is *subject to finance*.

The lender will deduct fees and charges from the loan, including loan fees, government duty on the mortgage and a mortgage insurance premium in some cases. These will add up to a significant amount for which you will need to budget. The *Disclosure Statement* required by the Credit Code sets out all of the loan deductions. There are also legal fees, home and contents insurance premiums, moving costs and service connections to pay.

The loan approval will be subject to a *first registered mortgage* over the property unless it is a home equity loan or home improvement loan in which there is an existing mortgage. You will need to make an appointment with the lender to sign the mortgage documents, or your lawyer may receive the documents from the lender for you to sign.

When you, the seller and the lender are ready, a *settlement date* is arranged. On the settlement date the loan will be *advanced* and the lender will receive the title documents for the property from the seller. Subsequently, the mortgage that you signed will be registered on the title to your home. You will receive a letter from the lender confirming all the details in relation to settlement. Your repayments commence after the date of settlement.

HOME LOAN DEFAULT

If a borrower is in default on a home loan, the lender can commence the process of arranging for a *mortgagee sale*. First, the borrower will be asked to vacate the home. If they fail to do this, they can be evicted. This will incur extra default costs that will be deducted from the sale proceeds, so it is best to go voluntarily. The borrower should also ensure that they leave the home in good condition because it is then more likely that it will be sold for a better price. The borrower may be able to delay a mortgagee sale if they make an early application to the court based on sickness, unemployment or other good reason. The court can order the lender to withhold enforcement action for a period of time. Up until the day that the property is sold, the borrower has the right to repay the loan by paying all of the principal, interest, fees, charges and default costs. This may be possible if the borrower can refinance the loan with another lender.

The responsibility for selling the home will be passed to a real estate agent. They will place advertisements in newspapers and conduct inspections with potential purchasers. The usual advertising time will be four to six weeks. The objective is to attract as many interested buyers as possible. On the auction day, the property will be sold to the highest bidder. Later, when the sale is settled, the lender will receive the proceeds of the mortgagee sale. The money will be applied to repayment of the loan, interest, fees and charges, including the cost of the auction sale. The balance, if any, will be paid to the borrower. However, if the money is insufficient to repay the loan together with fees and charges, the lender can take legal action against the borrower to recover the outstanding amount.

Part C
Insurance

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6 Insurance principles

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We each face the risk of financial loss every day. Loss of income can result from perils such as sickness and premature death. Our property may be exposed to other perils such as fire and theft. The risk of financial loss is uncertain and unpredictable and one way to protect yourself is to have a risk management plan. An important part of a risk management plan is insurance. Insurable risks are classified as *personal*, *property* and *liability.*

- *Personal:* Loss of income and depletion of financial resources due to sickness, accident, disability and premature death.
- *Property:* Loss and damage to your home, contents or motor vehicle.
- *Liability:* Loss caused by legal claims for damages made against you as a result of your negligence.

The purpose of this chapter is to present an outline of insurance principles. It examines risk management strategies, types of insurance, who sells insurance, and on what terms and conditions. What may be required of you by insurers, and what happens if you make a claim or have a dispute, are also explained. Chapters 7 and 8 examine individual types of insurance in more detail.

RISK MANAGEMENT STRATEGIES

There are four strategies that you can adopt to manage risk. They are: accepting the risk, avoiding the risk, reducing the risk or transferring the risk to someone else. A risk management plan will have some elements of each strategy, depending on the nature of the peril, the financial loss that it may cause, and your ability and resources to deal with it.

Risk acceptance

If there is a low probability of a peril occurring, then you may decide to accept the risk of financial loss. If the probability is high but the amount of the potential loss is low, you may also decide to accept the risk. If insurance is not available or it is too costly, you may be forced to accept the risk.

Risk avoidance

Some activities are inherently dangerous, like car racing. These are referred to as *hazards* because they increase the probability of an accident occurring. You can avoid these risks by avoiding the hazardous activity. Insurance

policies commonly exclude liability for claims that result from high-risk situations or activities and you need to avoid them because you are not insured for the loss and damage that may result.

Risk reduction

Some activities cannot be avoided or you may not want to avoid them. Driving is an example. You can give up driving and avoid the danger on the roads, but if you want to continue driving there are strategies that you can adopt to reduce the risk. For example, you can drive more carefully and make sure that your car is properly maintained. In some cases, an insurance policy may require you to adopt risk reduction strategies as a condition of providing protection.

Risk transfer

The obvious way to transfer the risk of financial loss is to buy insurance. You choose an insurance policy that provides *cover* against loss and damage. You pay a *premium* and from that time the policy is current and the insurer is *on risk.* Nevertheless, your policy may require you to have risk reduction and risk avoidance strategies in place, or you may be rewarded by lower premiums if you have them. For example, there are lower premiums for life insurance if you do not smoke. If the loss or damage insured under the policy occurs while it is *current,* then you can *claim* on the policy and recover the *amount insured* or the amount of the *indemnity against loss and damage* provided by the policy.

Another method of transferring risk is to contract with someone on the basis that they will take out insurance that protects you in the event that you have a claim against them. This avoids the cost of insurance, but you need to make sure that they actually have insurance when you deal with them. A good example is liability insurance for builders when they do work for you. You should ask to see evidence of current insurance coverage before you enter into a contract with them to do work.

Risk transfer may also occur if you are an employee or an agent of another person or organisation and you cause financial loss to someone in the course of doing your job or performing your duties as an agent. The risk should be transferred to your employer or principal who is liable for your actions. For this reason, your employer or principal should have liability insurance.

Risk management plan

You need to manage your risk exposure so that you can reduce or eliminate the financial loss that you will suffer if perils occur. Purchasing insurance is an important part of risk management. Your risk management plan will probably combine elements of each of the four strategies. You should seek professional advice from insurers, insurance agents and brokers, or risk assessors. Many insurers also have useful brochures. Designing your own risk management plan consists of establishing objectives, developing strategies and monitoring your exposure.

Establish objectives

- *Personal:* Protect your family and yourself against loss of income as a result of sickness, accident, disability or premature death.
- *Property:* Protect your family and yourself against loss and damage to your property caused by fire, storm and tempest, burglary, theft, vandalism and other perils.
- *Liability:* Protect your family and yourself, your property and financial resources against legal claims arising out of your negligence.

Develop strategies

- *Risk acceptance:* Examine your position. You may choose not to insure, or insurance may be unavailable or too expensive. For *personal* risks, you can rely on *Medicare, workers compensation*, *third party injury insurance* and *public liability insurance* held by others who may cause loss to you. For *property* risks, you can rely on third party property insurance taken out by others. For *liability* risks, there may be nothing that you can fall back on unless you are an employee or agent and protected by the insurance held by your employer or principal.
- *Risk avoidance:* For *personal* risks, avoid activities that could lead to accidents and avoid conditions and circumstances that could give rise to infection, disease and ill health. For *property* and *liability* risks, avoid activities and circumstances that could cause damage and loss to your property or expose you to liability claims at home, in the workplace or elsewhere.
- *Risk reduction:* For *personal* risks, take positive actions such as giving up smoking and alcohol, eating healthy food and taking regular exercise. This will also help if you decide to insure, because it may reduce your premiums. For *property* risks, you also need to act positively to protect your home and contents by installing smoke detectors and security systems. Ensure that your home is waterproof and arrange regular pest inspections. For *liability* risks, be aware of the manner and extent to

which your actions or failure to act may cause loss and damage to others and act accordingly.

- *Risk transfer:* Obtain the most comprehensive insurance that you can afford in relation to the *personal*, *property* and *liability* risks to which you are exposed. Get advice from brokers, agents and others. Make sure that professionals, tradespeople and others who do work for you carry appropriate and adequate insurance on which you can claim in the event of loss. Ensure that you act within the terms of your own employment or, if you are an agent, comply strictly with your contract so that you can avoid personal claims made against you by third parties.

Monitor exposure

Your risk exposure changes over time and you need to make regular adjustments. More or less insurance coverage may be required and you may want to change insurance policies or insurers. You may decide to put more emphasis on risk avoidance and risk reduction strategies, or it may become possible to transfer some risks that could not previously be transferred. Risks that were once unlikely may become more likely and you will need to institute appropriate risk avoidance, reduction and transfer strategies that were previously unnecessary.

When you identify changes in the risks to which you are exposed, first ask yourself if there is a risk management strategy that you can adopt to avoid the cost of insurance. How much will it cost compared with insurance? How effective will it be compared with insurance? If you decide to insure, what risk avoidance and risk reduction strategies will you use to minimise the cost of premiums and ensure that you meet the terms of the insurance policy?

Classes of insurance

Insurance has traditionally been divided into two *classes*, referred to as *life* insurance and *general* insurance. Some insurers offer both classes and others offer only one. Each class consists of various types of insurance.

- *Life insurance*, also known as *contingency insurance*, includes life insurance, accident insurance, sickness and disability insurance, and health insurance.
- *General insurance*, also known as *indemnity insurance* or *property insurance*, includes insurance of property such as homes, contents and motor vehicles against risks including fire, floods, storm and tempest, explosion, impact, vandalism, burglary and theft. General insurance also includes public liability insurance, consumer credit insurance, travel

insurance and workers compensation insurance. Strictly, the last of these is related to life insurance, but traditionally it has been included in the general class.

Insurers

Insurers fall into one of three groups, depending on the class of insurance they offer. There are life and general insurers, life insurers only and general insurers only. In most cases they are companies and there are Australian companies and overseas companies that operate within Australia. Some companies operate nationally and others operate mainly within a state. Banks also offer insurance to their customers through insurance subsidiaries or in conjunction with insurance companies.

It is important to choose an insurer that is financially sound and reputable. Like banks, there are large, well-known companies that have operated for many years, but there are also new companies that are not so well known. Insurers must be licensed by the *Australian Prudential Regulation Authority* (APRA). APRA can provide information if you have concerns about the financial position of a particular insurer. The *Australian Securities and Investments Commission* (ASIC) is responsible for consumer protection in relation to insurance. ASIC can provide a wide range of information, including an insurer's complaints record and whether it is under investigation. Insurance brokers are also a useful source of information about the insurers with whom they deal.

Large national and international insurance companies sometimes *underwrite* insurance policies sold by smaller or newer companies. This means that the larger insurance company is also backing your policy and this provides extra reassurance and protection. There are also government insurers that have traditionally provided cover for compulsory insurance schemes such as workers compensation and third party motor vehicle insurance for personal injuries. These markets have also been opened up to private insurance companies in order to encourage competition.

INSURANCE AND THE LAW

APRA and ASIC enforce laws that protect people who buy insurance. There are different laws for life insurance and general insurance, as well as separate laws for health insurance, marine insurance, and insurance brokers and agents. To find information about their role and activities, you can find APRA's Internet site at http://www.apra.gov.au and ASIC's Internet site at http://www.asic.gov.au.

APRA is responsible for licensing and prudential supervision of insurance companies, banks and other financial institutions. ASIC is responsible for consumer protection and it has a Complaints Referral Centre at its Internet site where you can find out how to make an insurance complaint. There are also state and territory insurance laws that apply to workers compensation and motor vehicle third party insurance for personal injury that are enforced by government agencies.

Insurance contract

When you complete and deliver an *application for insurance*, also called a *proposal*, to an insurer, you are making a legal offer to the insurance company to enter into a contract with you on the terms and conditions set out in the *policy document*. The insurer can accept or reject your offer. If it is accepted, then you pay the premium and you have a policy of insurance that is your contract. The policy provides *insurance cover* until the next premium payment is due. While the policy is *paid up,* you are entitled to make claims in accordance with the terms and conditions of the contract. You can terminate the contract by not paying the premium, and in some cases the insurer can terminate the contract as well.

The contract or policy has two parts. There is a *certificate of insurance* issued by the insurer which contains all of your personal insurance particulars such as your name, address, the risk insured and the amount of insurance. It is combined with a printed booklet in standard form that contains the terms and conditions of the contract. The policy will be written in *plain English* so that you can easily read through its various provisions. You may be offered insurance cover in addition to that provided by the standard policy. If you accept, the details will be noted on the certificate and this is called a *policy endorsement*. It is part of your contract and you usually pay extra for the increased cover.

Duty of disclosure

An insurance application form contains a series of questions. First, there are questions about your personal details such as your name, address and occupation. Second, there are questions that ask for your insurance history and information about the risk to be insured.

- Have you had insurance before?
- Have you ever been refused insurance?
- Have you had an insurance claim refused?
- Have you been convicted of an offence involving fraud or dishonesty?

If your answer to any of these questions is ‘yes’, then the application form will ask you to provide additional information. The insurer can choose to make enquiries about these matters and you may be asked to supply further information. The insurer will not offer you a contract of insurance until it is satisfied that it has all the information it needs.

When you complete an application for insurance, you have a legal duty to provide truthful and complete answers. You also have a legal duty to disclose every matter that you know, or could reasonably be expected to know, is relevant to the insurer’s decision to accept the risk or the terms of acceptance, such as the amount of the premium or any conditions. The reason for the duty of disclosure is to enable the insurer to obtain all of the *material* information it needs to make a decision. For example, if a person once had a claim refused because it was fraudulent, the insurer may decide not to approve an application for another policy.

The policy terms and conditions state that the information you provide in your application becomes part of the insurance contract. As a result, if a person fails to disclose material information in answer to questions in the application or in accordance with their general duty of disclosure, the insurer may be entitled to refuse claims or cancel the policy. The insurer is entitled to take such action whether your failure to disclose is innocent or deliberate. However, the law provides protection in respect of innocent failures to disclose information. For example, the legal duty to disclose does not require disclosure of any matter that diminishes the risk to be insured, is common knowledge, or is known or ought to be known to the insurer.

You are also protected if you provide information that puts an insurer on notice and the insurer does not pursue the matter by making further enquiries. In such cases the insurer may be taken to have *waived* disclosure of the facts that an enquiry would necessarily have revealed.

The legal duty to disclose arises when you first apply for insurance, but it also arises later when you *renew*, *extend*, *vary* or *reinstate* your contract of insurance. This means that if something has occurred during the last period of insurance that affects the risk, you must disclose it voluntarily. You may have to write a letter to the insurer explaining the circumstances. An example in relation to car insurance would be a conviction for a serious driving offence. This would have to be disclosed to the insurer before or at the time of renewing the policy. If it is not, a subsequent claim on the policy may be rejected.

Because the duty to disclose is so important, you will see a statement about it on the insurance application. You are also asked to sign a declaration that says you have read and understood the duty of disclosure. If you are uncertain about what you must disclose or how much information you need to provide, ask the insurer.

Insurable interest

The law requires you to have an *insurable interest* before you can buy insurance or claim on an existing insurance policy. Examples of insurable interest include the following situations.

- You have an insurable interest in your own life and the lives of your spouse and children. In the event of death, you may suffer financial loss. The potential loss gives rise to an insurable interest.
- You have an insurable interest in your property or property in respect of which you have a legal responsibility, such as a car under lease. In the event of theft or damage, you will suffer financial loss and therefore you have an interest that you can insure. You will only have an insurable interest in the property of others if you have some legal responsibility for it.
- Lenders have an insurable interest in property owned by borrowers that is offered to them as security for a loan. If it were lost or damaged, the lender would have less protection in the event of default by a borrower. It is common practice for the insurance policy to insure both parties for their 'respective interests'.

BUYING INSURANCE

The process of buying insurance begins by choosing the insurer and the insurance policy. Insurance companies and banks maintain Internet sites that include information about insurance. You can also look in the Yellow Pages under 'Insurance'. Insurers have brochures and printed material as well as their policy documents. The printed material must include a *Product Disclosure Statement* (PDS) that is separate from any promotional material. The PDS is required by the ASIC. Before the *Financial Services Reform Act 2002*, a similar document was required for life insurance and it was called a *Key Features Statement*. The PDS is intended to help you decide whether the insurance policy offered meets your needs. It also allows you to compare the product with other similar products. The PDS is a summary of the most important policy conditions and is written in plain English. Read the statement carefully and ask any questions if there is something that you do not understand.

Obtain copies of all the documents and read them carefully. If you have any questions, contact the insurer and ask for an explanation. It is essential that you fully understand the cover provided before you proceed with an application.

The law regulates the terms and conditions of policies in six areas of

domestic insurance, including motor vehicle (property damage only), home buildings and home contents, sickness and accident, consumer credit and travel insurance. This means that when you compare policies offered by different companies, there will be considerable similarity in the insurance offered. There will also be important differences, such as the amount of the premium, differences in cover, or differences in the amount of the *excess*.

Having decided on an insurer and a policy, the next step is to complete and lodge your application. The policy you choose may have options. For example, you can choose to have an excess or no excess. In many cases, choosing an option means the premium will change. The options are recorded on your certificate of insurance as endorsements to the standard policy.

When the application is accepted and the premium is paid, the insurer will issue the policy document together with the certificate and any endorsements. From that time, the insurer is on risk and you have *insurance cover*. You will receive a copy of the policy and if there is another interested party, such as a mortgagee or lessor, they will also receive a copy of the policy. Keep your policy and certificate in a safe place.

Cooling-off period

When your proposal for insurance has been accepted and the premium paid, you have a cooling-off period of 14 days to be sure that you want to keep the policy. Until the introduction of the *Financial Services Reform Act 2002,* this cooling-off period was only for life insurance but now it is available for general insurance as well. The 14-day period starts at the end of the fifth day after the day on which the policy was issued or sold to you or when any confirmation requirement (if it applies) is complied with. You can cancel the policy and obtain a refund of the premium, unless, for example, you have made a claim under the policy. The insurer may retain a portion of the premium and any reasonable administrative and other costs. If you want to exercise your right, it can be done in writing or electronically.

Cover note

With some types of insurance it is possible to obtain insurance cover, referred to as a *cover note*, before you lodge an application and pay the premium. Cover notes are common if you purchase a home or a car and want immediate cover. You can apply for a cover note over the telephone by providing your personal details and particulars of the risk to be insured.

You receive a cover note identification number and a document will be sent to you.

The insurance cover usually lasts for one month during which time you lodge a formal application and pay the premium. The cover note provides insurance cover subject to the issue of a policy and subject to the terms and conditions of the policy. If you do not take out insurance within the required time, the cover ceases. In some circumstances an insurer can cancel a cover note, but you must be given at least three days' notice first.

Brokers and agents

Brokers and agents can provide advice and assistance to enable you to choose an insurer and a policy that suits your needs. Brokers act on their own account, whereas agents act for an insurer. Brokers can help you to choose between competing insurers and policies. They can point out which policy has the best cover or which policy has the lowest premium, and they can advise you about which insurers are particularly helpful if you have a claim. Agents can tell you about the insurance products that their insurance company offers.

It is important to recognise that agents and brokers earn commissions on the policies they sell, so you need to be confident that they are acting in your best interests when they recommend an insurer or a policy. Insurance brokers have a professional association known as the National Insurance Brokers Association (NIBA). The NIBA can provide assistance if you have a complaint against a broker. If you have a complaint against an agent, however, it should be taken up with the insurance company. In either case, if the matter is not resolved, it can be referred to one of the dispute resolution schemes examined at the end of this chapter.

Terms and conditions

The terms and conditions of policies vary according to the type of insurance. However, some general comments can be made that will assist you to read and understand your insurance policy.

- The policy comprises the standard pre-printed policy booklet together with the certificate of insurance. The certificate has precedence over the booklet. Various options or *endorsements* may be included in the booklet, but you will not have the benefit of them unless they are recorded on your certificate. An example is the choice between indemnity and reinstatement insurance on your home. One or the other will be recorded on your certificate as an endorsement.

- The policy lists and describes the nature and extent of the insurance cover it provides. It is common for policies to have *exclusions* and *exemptions* from cover and you should be aware of these. They may appear under a section headed, 'General Exclusions and Conditions' and/or they may appear in other parts of the policy where they will be 'Particular' exclusions or exemptions. Read through the whole of the policy and identify all of the exclusions and exemptions. It may be possible, by paying an extra premium, to obtain cover for these.
- There will be a 'Definitions Section' that defines terms used throughout the policy. Read the definitions because they help you to understand the risks covered. An example is a home contents policy with definitions that contain a limit on the amount of claims for certain types of items. If you want full cover, you must apply for it and pay an extra premium.

MAKING A CLAIM

Insurance policies contain a section dealing with claims that explains the steps you need to follow. Do exactly what it says in order to reduce the likelihood of a delay in paying your claim and ensuring that your claim is accepted. You must give prompt notice of your claim. This provides the insurer with the opportunity to investigate the claim as quickly as possible. In some cases, prompt action by the insurer can reduce its loss and it can also help you to reduce the possibility of further loss and damage. A good example would be the appointment of a solicitor to act for you if you receive notice of a legal liability claim.

In the past, it was necessary to complete a written claim form. More recently, some property and liability insurers have dispensed with this requirement and allow you to make your claim over the telephone or in person. The practice is likely to become more widespread and it enables the insurer to provide immediate assistance in emergency situations such as car accidents and bushfires. The insurer will take the details of your claim and sometimes further information will be required or it may be necessary to provide a written statement. You may be required to substantiate a claim with proof of loss, such as a sales receipt to prove ownership of property that has been stolen. You should receive written confirmation of your claim in the mail. Consider it a big plus if your insurer has a *fast claims service*.

It is in your interest to provide the insurer with all of the information it needs to process your claim. Take special care when you make a claim to include details of your loss and damage. Claims made in haste can create problems later. For example, if your house is burgled and you forget to

claim for valuable jewellery that was taken, there may be problems later when you try to add this to your claim. The insurer may have reason to query the loss and the onus will be on you to prove that it has been stolen. When you give notice of a claim over the telephone, it is easy to overlook important details in the course of the conversation. With a written claim, however, you are likely to have more time to collect your thoughts. The person that you speak to at the insurer's office will have a series of standard questions. If you have difficulty in answering any of the questions, say so and ask if you can provide the information required at a later time rather than give an incorrect or incomplete answer. It is also a good idea to keep documentation such as evidence of ownership, repair and maintenance of property, evidence of medical treatment and hospitalisation, receipts for expenditure, and salary and employment records.

RENEWAL AND CANCELLATION

Insurers may allow you to pay your premium monthly, six-monthly or yearly. If you have a loan, you may be able to arrange for your premium to be paid together with your repayments. Having paid the premium for the period you choose, you have insurance cover provided by the policy until the expiry of that period. Policies provide that cover will cease from 4 pm on the expiry date; if you wish to renew your insurance, you must pay the next premium on time.

If you choose to insure for 6 or 12 months at a time, the insurer will post you a *renewal notice.* It will specify the amount of cover, the premium and the due date for payment. With property insurance, it is common for insurers to take account of inflation and your renewal notice may invite you to increase the amount of your cover by paying a higher premium. If you fail to pay your renewal on time, your policy will *lapse.* Often an insurer will allow a period of grace after the expiry date within which you can apply to *reinstate* the policy by paying the overdue premium. If the policy is reinstated, the insurer will accept claims despite the fact that the loss or damage occurred after the policy expired.

You can cancel your insurance policy at any time and claim a refund of the unused premium. This may occur if you sell the insured property. The policy will require refund requests to be made in writing. You can choose not to renew a policy when you receive your renewal notice. You can apply to *extend* the cover for a higher premium. If you acquire new property, you may need to buy more insurance or, if the property is included in an existing policy, you may need to increase the cover. You can apply to *vary* your insurance if circumstances have changed. In certain situations,

the insurer can cancel an insurance policy provided it gives written notice. The insurer will refund any unused premium. This could happen if the insurer becomes aware that the insured has failed to disclose material information or made a fraudulent claim.

RESOLVING DISPUTES

Disputes with insurers, agents and brokers sometimes arise for a variety of reasons, such as rejection of a claim or misrepresentation when insurance was purchased. The insurance industry has introduced dispute resolution schemes that avoid the need to incur legal expenses to resolve disputes.

Insurance Enquiries and Complaints Ltd

The *General Insurance Code of Practice* is a self-regulatory code that aims to raise standards of practice and service in the industry. Insurance Enquiries and Complaints Ltd (IEC) is responsible for the implementation and administration of the Code. The Code requires each insurer to have an internal dispute resolution process that is readily accessible, free of charge, and provides a fair and timely method of handling disputes. Insurers are required to have brochures available and you should ask for one if you have a complaint. If you cannot resolve the dispute with the insurer, then you can refer the matter to a *Panel, Referee* or *Adjudicator* of IEC. This is a free service. An Adjudicator can make determinations that are binding on insurers for amounts not exceeding $3000. A Referee or Panel can make determinations that are binding for amounts not exceeding $120 000. A Referee or Panel can also recommend settlements up to $290 000. If you are dissatisfied with the outcome, you can take the matter to court. You can phone IEC on 1300 780 808. There is also an Internet site for IEC at http://www.iecltd.com.au.

Financial Industry Complaints Service Ltd

There is also a *Life Insurance Code of Practice* that aims to raise standards of practice and service in the life insurance industry. The Code requires life insurers to have an internal dispute resolution process for complaints. If they are not resolved, they can be referred to the Financial Industry Complaints Service Ltd (FICS), which deals with complaints in the financial services industry, including complaints about life insurance. The service offers two main procedures. First, a conciliation process in which an officer

of FICS tries to resolve a complaint by talking with the parties. If conciliation fails, there is an arbitration by an *Adjudicator* or a *Panel* that will lead to a decision on the complaint. An Adjudicator deals with complaints if the amount is no more than $10 000 and a Panel deals with complaints for larger amounts. If you are dissatisfied with the outcome, you can take the matter to court.

FICS cannot consider complaints that exceed the following monetary limits in relation to life insurance:

- Insurance Lump Sum Investment—$250 000
- Insurance Lump Sum Risk—$250 000
- Advice related to the above products and services—$250 000
- Insurance Income Stream Risk and related advice—$5000 per month

Insurance for investment is considered in Chapter 8 in relation to superannuation. Risk insurance is considered in Chapter 14. For further information you can phone FICS on 1300 780 808 (IEC is also at this number) or you can visit the Internet site at http://www.fics.asn.au.

Insurance Brokers Dispute Facility

The National Insurance Brokers Association (NIBA) has developed a self-regulatory scheme for its members that includes a *General Insurance Brokers Code of Practice* and the *Insurance Brokers Dispute Facility* (IBDF). The Code requires brokers to have their own dispute resolution service for complaints; if they cannot be resolved, they are referred to IBDF. The dispute goes to a conciliation relations manager and if it is not resolved, it goes on to a referee. The referee has the power to make orders, including a payment or refund up to $50 000. You can phone IBDF on 1800 064 169 or visit the Internet site at http://www.niba.com.au.

7 Property and liability insurance

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You can insure your home and contents, personal effects, car, boat and other property. The insurance will provide protection in the event that you suffer financial loss if the property is accidentally damaged, destroyed, lost or stolen. You can also obtain liability insurance to provide protection against financial loss in the event that legal claims are made against you or your family following an accident. For consumers, such claims are most likely to arise in connection with the use and enjoyment of their property, so insurers usually package the two types of insurance together and you only need to make one application and pay one premium. The exception is compulsory motor vehicle third party insurance, which you obtain when you pay your motor vehicle registration fee.

If you own a house or an investment property, you will need insurance on the building. You can insure the contents of your home, including furniture and furnishings, carpet, appliances and other household goods. You will also need insurance for your personal effects and valuables, such as clothing, jewellery, sporting equipment and musical instruments. These items should not only be insured while they are inside your home or on the property, but also when they are temporarily removed for various reasons, including local and overseas travel. If you have items in your home that are on loan or for which you are responsible, then they should also be included in the cover. If you own a rental property, then you may also require contents insurance if your tenants use furniture, furnishings and appliances that belong to you.

If you own a car, motor cycle, trailer or caravan, then you can insure against financial loss in the event that your vehicle is damaged or destroyed as a result of an accident caused by you or another driver. There is also insurance to protect you from loss and damage associated with the theft of your car and its contents. If you own a powerboat, a yacht or some other vessel, you may need insurance to cover the same risks.

In each situation—whether it is driving your car, sailing your boat, inviting people into your home or renting a property—there is the possibility that someone may be killed, injured, or suffer loss and damage to their property as a result of an accident that is your fault. These people can hold you responsible and make legal claims against you, your family or persons acting on your behalf. If this ever happens, it is essential to have liability insurance to cover the costs of your defence, court proceedings, settlement of claims and any judgments against you in the courts.

The purpose of this chapter is to examine the types of insurance that you can buy to protect yourself from loss and damage to your property and to provide protection against legal claims made by others as a result of accidents. We shall look at the types of policies that are available, the insurance cover they offer, policy extensions and exclusions, and making claims.

HOME AND CONTENTS

These policies provide cover for loss and damage that is caused to your *home and contents*. The words 'home' and 'contents' are defined and you should read the definitions in your policy carefully to be sure what parts of your home and which contents are insured. The word 'home' is generally defined as a home building that is used principally and primarily as a place of residence. The word 'building' is commonly defined to include outbuildings such as garages and sheds, structural improvements, fences and gates, fixed swimming pools, saunas and spas. If you own a strata unit, the body corporate will be responsible for insuring the building, but certain strata townhouses can be insured separately by the owner.

'Contents' are defined as home contents and consist of items that are generally kept in or about the home. Contents include furniture and furnishings, household goods and appliances, clothing and personal effects. Carpets are often excluded from the definition of home and included under contents. Motor vehicles, motor cycles, trailers and boats are always excluded from contents because they are insured separately. However, many people are not aware that contents policies also exclude the spare parts or accessories for these items if they are stolen. If you are unclear about the insurance cover provided by your home and contents policy, ask the insurer.

Home and contents policies provide the following standard cover: fire or explosion; lightning or thunderbolt; storm or tempest; earthquake; theft or attempted theft; malicious acts; impact by vehicles, animals or other specified objects; riot or civil commotion; and escape of water or other liquids. These perils are usually referred to as *defined* or *listed events* and they are carefully defined to exclude certain loss and damage. For example, 'storm and tempest' is commonly defined to exclude entry of water into the home through openings not caused by a storm. Read the policy for each of the defined events so that you know what is covered and what is not.

Contents insurance will cover most items kept in the home and they are frequently described in the policy as *unspecified items.* This means that they do not have to be itemised in the certificate/schedule that forms part of your policy. However, in the event of loss or damage it will be necessary to prove ownership of the items and that they were kept in the home at the time. To do this you can provide receipts, photographs or other evidence. There is often a limit placed on the amount that you can claim for unspecified items. For example, there may be limits on jewellery, antiques, works of art and computer equipment. To overcome this problem, the insurer will permit you to insure the items separately under the policy as *specified items* or *special personal effects and valuables.* They can be insured for their full value, provided they are individually listed and

described in the policy certificate/schedule and their separate values are provided. Be aware that the insurer may require valuations for these items. An additional premium will be payable for this extra cover. It is possible to have a separate policy for personal effects and valuables either with the same insurer or another insurer.

When personal effects are insured, the policy usually provides cover up to a certain limit if the items are taken outside Australia and New Zealand. You can pay an extra premium to increase this cover. Policies may impose special security requirements in relation to personal effects and valuables and you must comply with these requirements. You will also be required to take reasonable care to protect the items, such as placing valuable jewellery in a safe. If the insured items comprise a pair or set and there is loss or damage to one part, the insurer will commonly have the right to compensate you for the loss and damage to that part only.

Policy extensions are usually available to cover *accidental breakage* of glass that forms part of the building or the contents. Breakage is not normally covered unless it is caused by a defined event such as a storm and there are common exclusions to this cover, such as breakage of glasshouses, conservatories, and picture tubes in televisions and computers.

In all policies there are *general exclusions.* These are separate from the *specific exclusions* in relation to *defined events* and the definitions of 'home' and 'contents'. General exclusions commonly include the following items.

- Depreciation, wear and tear.
- The action of insects or vermin. You can protect against this risk by having regular pest inspections.
- Flood, the action of the sea, tidal wave, high water or tsunami.
- The carrying on of a business, trade or profession. To cover such loss and damage, you should have separate business insurance.
- Erosion, landslide, subsidence or earth movement. There may be an exception in some policies when they are caused by earthquakes or storms. If your home is built on sloping ground, ask about your insurance cover.
- Inherent defects and defective or faulty workmanship, design or manufacture. Such claims can be made against builders and manufacturers, who are likely to have insurance.
- When the home is unoccupied for more than 60 continuous days without the consent of the insurer. This exclusion can cause problems if you are away from your home on holidays or you own a holiday house. You should make appropriate arrangements to safeguard your cover, particularly in relation to theft and burglary.
- Failure to maintain your home and contents in good condition and

repair. Claims may be refused if lack of maintenance or failure to repair has caused or contributed to a loss.

Of all the general exclusions, flood has been the biggest source of confusion and heartache. Read the definition of 'flood' in your policy carefully, because the wording varies between policies and some insurers offer more protection than others. For example, the policy may state that the insurer does not consider the escape of stormwater from any water main, pipe, drain or surface stormwater run-off from surrounding areas to be a flood. It is possible to obtain flood insurance in some situations and you should make enquiries if this risk concerns you. People who build on a floodplain are unlikely to get cover.

If you are renting, then you do not need insurance on the building. Insurers offer separate home contents and personal effects insurance. The policy also provides cover for fixtures and fittings belonging to the landlord for which you are responsible under the rental agreement. Landlord's fixtures include items such as carpet, stoves and airconditioning. Fittings include furniture, furnishings and appliances provided by the landlord. The policy also covers items that you affix to the property for your own use and enjoyment. Accidental breakage of the landlord's property will usually be covered by the policy. You can extend your policy to cover specified personal effects and valuables, or you can obtain a separate policy.

MOTOR VEHICLES

There are three types of property and liability insurance for motor vehicles. They are comprehensive insurance, third party property damage insurance, and compulsory third party insurance for death and personal injury. Comprehensive policies include protection against third party property damage, but they do not cover liability for death and personal injuries caused to third parties. You pay for this type of insurance when you register your vehicle, and it is compulsory. We shall examine third party property damage insurance and compulsory third party insurance for death and personal injury under the heading of 'Liability' later in this chapter.

Comprehensive insurance provides cover for damage to your vehicle as a result of an accident. It does not matter whether the accident was caused by you or the other driver. The insurer will pay the claim in either case. However, if the accident was not your fault, then the insurer will have the right under your policy to sue the other driver to recover the amount that it paid to you. Having comprehensive insurance means you are relieved of the necessity to take legal action against someone who causes loss and

damage to your vehicle. This is an important benefit of comprehensive insurance in addition to the protection against loss and damage to your vehicle.

If you have more than one car or vehicle, including a trailer or caravan, they must be separately insured. The policy will define 'vehicle' or 'car' to include certain specified equipment or accessories as well as tools and appliances that are standard for the vehicle. Read the definitions carefully and ask questions if you are unclear about the cover. If other items are added to the vehicle, such as a car stereo or airconditioning, then you must notify the insurer and obtain agreement to cover these items or they will be uninsured. You should also notify the insurer before making any modifications to the vehicle, such as affixing larger wheels or turbo charging the engine. In some cases, insurers may refuse to insure vehicles that have been modified.

The policy also provides limited cover for the value of any personal belongings that are lost or damaged at the time of an accident. The policy covers towing costs and the cost of protecting the vehicle after an accident. Policy extensions are available to cover the cost of hiring a replacement vehicle for a limited period. Policies provide cover only if you are using the vehicle for the purpose stated in the policy schedule/certificate, which will either be 'private' use or 'business' use. Standard policies contain general exclusions from liability that apply when the vehicle is lost or damaged in the following circumstances.

- The insured or other driver of the vehicle is under the influence of any intoxicating liquor or drug. However, the exclusion will only apply if the insured knew, or should reasonably have known, that the other driver was so affected.
- The insured or other driver is unlicensed. Again, the exclusion will only apply if the insured knew, or should reasonably have known, that the other driver was unlicensed.
- The vehicle is being used in an unsafe condition and the insured was, or should reasonably have been, aware of this.
- The insured fails to secure the vehicle after a breakdown or an accident.
- The vehicle is being used in a race, trial or contest.

BOATS

There are different types of insurance for boats, including comprehensive and third party property damage. Comprehensive policies provide cover for loss and damage to your boat as a result of an accident. Special policy extensions are available, such as legal liability that arises in connection

with waterskiing. It is also possible to insure sails, masts and rigging that may be damaged when yachts are racing. The protection provided in respect of loss and damage to the boat or damage to other boats and property is similar to that provided by motor vehicle insurance. However, the circumstances surrounding marine accidents may be different and this will be reflected in the policy. There are also similar policy exclusions. For example, claims may be refused where you knew, or should reasonably have known, that the boat was not in a good state of repair at the time of an accident and this contributes to the loss or damage. Here are some examples of exclusions to be found in boat policies.

- Rusting and corrosion.
- Damage to moorings.
- Theft of the boat, including trailer, if it is left unattended on land and reasonable steps have not been taken to make sure it is secure.
- Loss or damage to motors, electrical machinery or equipment unless they are stolen, the boat is submerged or sunk, or there is a collision or fire.
- The boat is used in power boat or waterski races or time trials.

Read your policy carefully to ensure that you are aware of the exclusions and take appropriate action to manage the uninsured risks. Obtain policy extensions if you need them.

LIABILITY

Liability cover provided by standard policies protects you against claims for death and personal injury, and claims for loss and damage caused to the property of others. Comprehensive policies for home and contents, motor vehicles and boats include liability cover for you and your family. In the case of motor vehicles and boats, other persons are also covered if they drive your vehicle or they are in charge of the boat with your permission. They may include friends and relatives and your employer, partner or principal.

If you have a motor vehicle or boating accident and it is your fault, you may be sued for the amount of the loss and damage caused to the other vehicle or boat. If the owner is comprehensively insured, their insurer may pay their claim and then seek to recover the amount from you. If the owner is not insured, they may take legal action themselves to recover the amount of the loss and damage. As a result of the accident, there may be damage to other property as well and you will face further claims for compensation. In each case, liability insurance will cover you for the cost of retaining a lawyer to conduct your defence and other expenses that may be

subsequently incurred. If the matter is settled or it proceeds to court, your insurer will also pay the amount of the settlement or a court judgement up to the sum insured.

In the case of motor vehicles and boats, an alternative to comprehensive insurance is third party property insurance. It provides cover against liability claims that arise from accidents, but it does not cover the cost of repairing or replacing your car or boat. For this reason, it is cheaper than comprehensive insurance. However, third party policies commonly include an *uninsured motorist extension* that provides limited cover for damage to your vehicle and towing costs when the other driver is uninsured. You can also extend the policy to cover loss and damage to your vehicle as a result of fire or theft. Third party property insurance policies contain specific and general exclusions. Many overlap with the exclusions in your own property insurance, and others relate to liability for third party property damage. You should carefully read the parts of the policy that deal with the exclusions and try to avoid or reduce the risk of loss and damage.

Third party insurance for death and personal injury as a result of a motor vehicle accident is compulsory in all states and territories. In Victoria, Western Australia, Tasmania and the Northern Territory, there are government agencies that provide cover in the registration fee for your vehicle. In New South Wales and Queensland, you can choose one of several private insurers. In New South Wales, you arrange insurance through agents such as motor vehicle inspection stations and newsagents. In Queensland, you choose the insurer when you pay your fees. Vehicles cannot be registered without third party insurance, and therefore protection is provided to members of the public who may be injured or killed as a result of a road accident. However, death or personal injury may also result from the use of off-road vehicles that do not have to be registered, such as farm vehicles, trail bikes and quads. It will be necessary to obtain separate third party insurance for these vehicles. The third party insurance cover provided across Australia is not uniform and there are situations in which it is not available. To enquire about the protection provided by your insurance, you can obtain information from the following agencies.

New South Wales	Motor Accidents Authority
Victoria	Transport Accident Commission
Queensland	Motor Accident Insurance Commission
Western Australia	Insurance Commission of Western Australia
South Australia	Motor Accident Commission
Tasmania	Motor Accidents Insurance Board
Australian Capital Terrritory	Department of Urban Services
Northern Territory	Motor Accident Compensation Authority/ Territory Insurance Office

SPECIAL POLICIES

There are special types of insurance that you can purchase to add to the protection provided by standard policies. In some cases, the insurance cover can be included in your standard policy as an optional extra. This is called an *extension* to the policy. In other situations you will need to buy a separate policy. There is also insurance that you pay for indirectly. The following are examples of special policies.

- *Domestic workers compensation extensions:* The liability cover provided by your home and contents policy does not usually cover liability that arises when you employ someone in your home or on your property. Examples include baby-sitting, household cleaning and lawn mowing. If the service is provided by someone in business, an *employment relationship* will not usually arise and they will be unable to make a workers compensation claim against you if they are injured. However, if you employ a friend or associate to do work for you, it may be necessary to have insurance. Ask your insurer about this problem and make sure that you obtain the necessary protection. The additional premium required to extend your policy cover is modest in most cases.
- *Bicycle insurance:* There has been a dramatic increase in the number of people riding bicycles on the roads and off road. Policies are available to cover the same types of risks and liabilities that arise in connection with motor vehicles.
- *Travel insurance:* Travel insurance policies are packaged to provide cover against various risks while travelling overseas. Travel policies supplement the cover provided by contents and personal effects policies.
- *Car hire insurance:* When you hire a car, you are required to have comprehensive insurance. Take time to read the details of the cover provided before you drive away with the car. There are likely to be special and general exclusions and you need to be aware of them. The same applies to any other property hire insurance. Try to avoid being liable for a large excess if you have an accident that causes damage to the vehicle. You can usually reduce the excess by paying a higher premium.
- *Strata insurance:* If you own a strata unit, you pay a periodic levy to the *body corporate* that manages the strata building on behalf of all the owners. Included in the levy is the cost of insuring the building and providing for liability insurance that is arranged by the body corporate. You are not prevented from obtaining your own insurance to cover your carpet, fixtures and fittings. Make sure that the strata insurance is adequate and, if you are unhappy about the amount of cover, raise this issue at a meeting of the body corporate.

SUM INSURED

The maximum amount of property and liability cover that an insurer will provide is the *sum insured*. It is up to you to choose the amount of cover that will adequately meet your needs. The amount will be specified on the certificate/schedule that forms part of your policy. You can increase or reduce the sum insured. Your insurer will recommend annual increases in the sum insured based on the increased value of your property resulting from inflation.

When you insure your home, you are insuring the building and other improvements. Therefore, the sum insured should be equal to the market value of your property less the value of the land. If you are insuring property that you already own, take account of depreciation and wear and tear, because these reduce its value for insurance purposes. If you are not sure about the value of your property, insurers have information about home building costs. If you provide them with information about size, features and building materials, they can give you an estimate of the value of your home. However, insurers will recommend that you use a qualified builder to provide expert advice regarding rebuilding costs.

Car insurers have similar information about the current market value of cars. If you provide information about your car, including the make, model, series, age, optional extras, modifications and general condition, they can give you a value for insurance purposes. The insurer may also inspect your car to verify the information you provide. If you disagree with the valuation, you can ask the insurer to cover your car for a higher value. This may be appropriate if the car is in particularly good condition, has special optional extras or is modified. A new car can be insured for its purchase price; however, new cars depreciate very quickly so you should review your insurance cover regularly.

Insurers commonly include a fixed amount of liability cover in their standard home and contents, car and marine insurance policies. You can apply for more cover and pay a higher premium. However, insurers set a maximum cover because damages awards made by the courts in liability cases are often very large and insurers do not want to accept the risk of such large claims.

INDEMNITY

Property and liability insurance come under the heading of *general insurance* and there are special rules and laws that apply to this type of insurance. The most important of these is the *indemnity* principle which

provides that you can only be compensated for the amount of financial loss that you actually suffer. This means that you may not profit from the loss. For this reason, there is no point in having two insurance policies for an identical risk. If you claim on both policies for the same loss and damage, each insurer will be entitled to pay only their proportion of the claim and you will have wasted the extra premiums.

An important factor in choosing indemnity insurance is the method used by the insurer to calculate the amount for which you are indemnified and the manner in which it will be satisfied. The most you can receive under any policy is the *sum insured*. In this respect, all policies are the same. However, many property insurance policies provide for the payment of a lesser amount that indemnifies you for the loss and damage you actually suffer. The insurer will offer policy choices such as *pure indemnity*, *agreed value*, or *reinstatement or replacement value*—each with a different premium.

There will also be indemnity options that the insurer chooses, and you are obliged to accept the insurer's choice in the event of a claim. For example, if you make a claim on a home contents policy for an item that has been damaged, the insurer can choose to pay the sum insured, pay the reasonable cost of repairing or replacing the item, or repair or replace the item. This means that the insurer can choose to repair or replace the property itself, or pay you the money so that you can do it, and you must accept the insurer's decision.

Pure indemnity

Property insurance that provides a pure indemnity is commonly based on the *current market value* of the insured property. Market value takes account of wear and tear and depreciation. A standard policy may state, 'In the event of loss or destruction of the insured property, the insurer will pay the sum insured or the market value, whichever is the lower'. Alternatively, the policy may state, 'The insurer will pay the sum insured or up to the sum insured'. An indemnity policy provides that the market value is to be calculated immediately prior to the event that caused the loss or damage. It is important to insure for the current market value so that you are not over- or under-insured.

Agreed value

The indemnity principle does not prevent you from agreeing with the insurer on the value of the insured property. A*greed value* policies are available

for cars and boats. If your car or boat is destroyed as a result of an accident, you can claim the agreed value.

Reinstatement or replacement

Reinstatement or replacement policies are also called *new for old* and they differ from pure indemnity policies. The policy generally differentiates between claims in which the property is *wholly* or *partly* destroyed, damaged or stolen. If the property is wholly destroyed or stolen, the insurer usually has the right to replace it with similar property in a condition that is equal to but not better than its condition when it was new. With partial damage, the insurer has the right to repair the damage or replace the destroyed part only.

You do not have reinstatement and replacement cover unless there is an endorsement on your insurance certificate. If you want this cover, make sure you request it when you complete the application for insurance. You can later change between reinstatement and replacement cover and indemnity cover if you wish. With car insurance policies, the reinstatement or replacement option may be referred to as a 'replacement vehicle option' whereby the insurer agrees to provide a new vehicle of the same make and model. This is usually limited to cars that are less than 12 months old.

A home contents policy usually limits reinstatement or replacement to items that are less than 10 years old. A home building policy will cover the reasonable additional expenses necessarily incurred in complying with the requirements of any public authority when the home is damaged or destroyed. For example, local council building requirements may have become more stringent so that it will cost more to rebuild. Generally, reinstatement or replacement must be commenced or completed within a reasonable time or the insurer can avoid liability to make full payment on a claim. Home policies often exclude reinstatement or replacement cover if the home building is not in a sound condition and well maintained immediately prior to being damaged or destroyed.

An important consideration when you select an indemnity policy or a reinstatement or replacement policy is the amount of insurance cover that you need. If you choose an indemnity policy, remember that you can only recover the depreciated value of the property. Therefore, there is no point in insuring for its cost of replacement because you will not get that amount in the event of a claim. If you choose reinstatement or replacement insurance, be careful to insure for an amount that will cover the cost of reinstatement or replacement. If you fail to insure for the full amount, you will be under-insured. To overcome this problem, insurers recommend an

increase in the insured sum on your policy when they send a renewal notice. You can choose the higher cover by paying an extra premium.

CLAIM PROVISIONS

When you make a claim on property and liability insurance, the policy will impose conditions and provide special requirements. Some of these matters include the prevention of further loss and damage, legal representation, excesses, no claim bonuses, proof of loss and damage, legal liability claims, under-insurance and averaging.

Prevention of further loss and damage

Your policy will require you to take all reasonable precautions to prevent further loss, damage or liability. In a burglary, for example, it would include securing the broken door or window through which the burglar entered. In the case of theft, burglary, house breaking or malicious property damage, you are required to inform the police and provide full details. You are also required to give the insurer any assistance that it may reasonably require. This is important in the case of liability claims where court action may be taken against you. Your policy will also prohibit you from making any admissions of liability or agreeing to settle a claim without the consent of the insurer.

Legal representation

With liability claims, the policy provides that the insurer can choose to appoint a lawyer to represent you or any person covered by the insurance. The lawyer will be responsible for undertaking the defence to a claim made against you, the conduct of any proceedings in court, or any settlement of the claim. The insurer has complete discretion in relation to such matters.

Excess

When you make a claim, your policy may require you to pay the first part of the loss. This is called an *excess*. You can avoid paying an excess if you pay a higher premium. There are different types of excess, including a standard excess, age excess, inexperienced driver's excess or a compulsory excess. The nature of the excess, and when it applies, are stated in the policy.

No claim bonus

Insurers offer a discount, called a *no claim bonus*, on premiums for motor vehicle insurance. If you have no claims in the first year, the premium will be reduced by 20 per cent. Thereafter, the discount increases by 10 per cent per year to a maximum of 60 per cent. You can usually transfer your no claim bonus if you change insurers. If you have a claim, the no claim bonus is usually reduced. Shop around to see who offers the best deal on a no claim bonus, because it can save money on your car insurance.

Proof of loss and damage

The insurer requires proof of loss and damage, and there are a number of other requirements depending on the nature of the claim. If property has been lost, stolen or destroyed, the insurer will require you to provide full particulars of the property. If your home has been completely destroyed by fire, it is a big job to list everything that is missing or destroyed. Keep evidence of ownership, such as purchase receipts, invoices, delivery notes and photographs of individual items. It will also help if you have photographs of each room and its contents. Keep this evidence in a safe location away from your home. If you need to make a claim, you will be able to present this evidence and it will assist in handling the claim. If you do not have this evidence, it does not mean that your claim will be rejected, but it is up to the insurer to decide what and how much evidence is required.

If your property has been damaged, the insurer can inspect it to determine the nature and extent of the damage. The insurer will be able to estimate the age of the property and its condition prior to the damage. The inspection will be undertaken by the insurer's loss assessor or a valuer appointed by the insurer. This will provide the necessary proof of claim. The report of the loss assessor or valuer will be used by the insurer to determine the manner in which the claim will be met. The insurer generally has the option under the policy to pay money or to make the repairs itself.

Legal liability claims

If you cause loss or damage to the property of others and they make a claim against you, it is necessary to give notice of the claim to your insurer immediately. Your insurer will have its loss assessor or valuer inspect the damaged property. If the property has been completely destroyed, further proof of loss may be required from the owner. The insurer will make these arrangements for you, and if you receive a legal demand in writing, deliver it to the insurer immediately. If it is a claim for death or personal injury

as a result of a car accident, contact the Motor Accidents Authority or equivalent body in your state or territory.

Under-insurance and averaging

Home and contents insurance policies generally include an *averaging* clause that applies if the building is insured for an amount that is less than its value. If the sum insured is less than 80 per cent of the value of the home, the insurer only has to pay a proportion of the cost of rebuilding or repairing the home up to the sum insured. Figure 7.1 is an example of how this proportion is calculated. The value of the home is $100 000 and the sum insured is only $70 000. If the home sustains $50 000 in loss and damage, the insurer is only required to pay $43 750 against the claim, leaving the owner $6250 out of pocket. To avoid averaging, make sure that you insure for the full value of your home by using the insurer's valuation tables or ask a builder for advice.

Figure 7.1 Effect of averaging

	$
Value of the home	100 000
Sum insured	70 000
Amount of loss	**50 000**

$$\text{Amount payable} = \frac{\text{Amount of loss} \times \text{Sum insured}}{80\% \times \text{Value of the home}} = \frac{\$50\,000 \times \$70\,000}{.80 \times \$100\,000} = 43\,750$$

Out of pocket	**6 250**

8 Life, disability and health insurance

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The majority of Australians have the protection of health insurance provided by Medicare. In most cases, you are also protected by workers compensation for work-related illness and injuries. If you have superannuation, there is a benefit payable on death. You might ask, therefore, 'Why should I pay for life, health or disability insurance?' The answer is that these forms of insurance provide further protection for you and your family against the financial loss resulting from sickness, injury or death.

The purpose of this chapter is to examine the types of life insurance, disability insurance and health insurance that you can buy to add to the protection provided by superannuation, workers compensation and Medicare. We will look at the insurance cover provided, policy extensions and exclusions, and the provisions for making claims.

LIFE INSURANCE

Life insurance companies have traditionally offered policies that enable people to save and invest their money, as well as providing cover in the event of premature death. They are called *whole of life* and *endowment* insurance. The premium is high because part of it is invested on behalf of the insured. These policies were popular when there were few alternative forms of savings and investment. Another form of life insurance, called *term life insurance,* has lower premiums because there is no savings or investment component. Term life insurance has gained popularity, especially for people with home mortgages who require protection for their family in the event of premature death.

Life insurance companies have also developed new products to attract savings and investment. These are known collectively as *personal superannuation plans* or *savings plans* and they are different to whole of life, endowment and term life insurance. They are largely aimed at self-employed people and provide a means to save for their retirement. Life insurance companies have also revitalised an older product, called an *annuity*, to attract investment of lump sum superannuation payouts made to employees when they retire. Personal superannuation and annuities are examined in Chapters 14 and 15.

General principles

Traditional or *ordinary* life insurance involves purchasing a policy from a *life insurer* that pays an agreed amount when you die. Alternatively, it could be a policy that provides the option of paying an agreed amount on death or when you attain a specified age, whichever occurs first. Term life and

whole of life insurance fall into the first category and endowment insurance is in the second category.

You can buy insurance on your own life or on the lives of your spouse and children. If you buy insurance on your own life, you will be referred to in the policy as the *insured.* You will also be the *owner* of the policy and you can nominate the person or persons who will receive the *sum insured* on your death, such as your estate or a nominated beneficiary such as your spouse. The policy owner will be different to the life insured if you have insurance on the life of your spouse or child. If the proceeds of the insurance policy go to your estate, the executor or administrator will distribute the money to the beneficiaries under your Will or to the persons entitled by law. If you have an endowment policy and attain the specified age, the proceeds will be paid to you.

The principle of indemnity does not apply to life insurance. This means that you can choose whatever amount of cover you require and cost will be the only restriction. Term life is the cheapest form of life insurance and the easiest to obtain. Policies with cover ranging from $100 000 to $200 000 are common. Because the indemnity principle does not apply, you can have more than one life insurance policy and claims can be made on all of them. Your estate will also be entitled to receive any death benefits provided by your superannuation.

Why buy life insurance?

If you are young and without dependants, you are unlikely to need life insurance. However, if you have a spouse and children and you are the major breadwinner in the family, you may want life insurance to protect them against the financial consequences of your unexpected death. It is sometimes recommended that you insure for an amount equivalent to three times your annual salary plus an amount to cover your mortgage and other debts. If you have a young family, it may be appropriate to insure both yourself and your partner so that the costs of child care and household help will be covered in the event of either partner's death.

Whole of life insurance

Whole of life insurance costs more because part of the premium goes towards an investment or savings component. Whole of life policies are usually designed to *mature* at the age of 65. You will not get the full value of your investment in the policy unless you are prepared to maintain the insurance policy until maturity. You choose the sum insured and the policy provides for payment of that amount on your death. In addition, there are

reversionary bonuses on death or maturity, whichever occurs first, and these represent a return on the investments made by the insurer with the premiums you pay. The amount of the premium is determined at the commencement of the policy and depends on your age at that time and the amount of cover. For an extra premium, you can choose a policy that provides automatic CPI increases in the sum insured.

If you have a family business, whole of life insurance may be attractive in the form of *keyman insurance.* This provides protection against loss of profits by the business in the event that the person insured as the keyman dies or becomes disabled. The proceeds of the insurance policy will help to preserve the value of the business for the dependants of the keyman.

During the first two or three years of a whole of life policy, the insurer's sales commissions, administration fees and other expenses eat up that part of the premium allocated to investment. Thereafter, the policy begins to accumulate a *cash value.* However, if you want to *surrender* the policy before maturity, you will only receive a discounted cash value called the *surrender value.* An alternative to surrendering your policy is to ask the insurer for a loan using the cash value as security.

Endowment insurance

Endowment insurance is similar to whole of life insurance, but with two main differences. First, endowment policies generally mature at age 65, when you can claim the proceeds. Second, the sum insured is only a nominal amount because most of the premium is allocated to the investment component of the policy and not to the death benefit. When the policy matures, the proceeds consist of the sum insured plus bonuses. If you die before maturity, your estate or beneficiary will receive the proceeds of the policy. As with whole of life insurance, the policy will have a cash value after the early years and a surrender value if you wish to cancel the policy. The premium remains level unless you choose a policy that provides for CPI increases in the sum insured.

Term life insurance

Term life insurance pays the sum insured if you die. There is no savings or investment element in term life insurance and so the annual premium is considerably lower than for whole of life or endowment insurance. You buy term life insurance annually and the amount of the premium depends on your age. For people over the age of 40, the premium increases each year.

Some people purchase *mortgage repayment insurance* or *loan insurance* to cover the amount of their home mortgage in the event of death or

disablement. These are term life policies that are packaged to provide both death and disablement cover. You can also obtain *decreasing* term insurance in which the insurer automatically reduces the cover each year and adjusts the premium accordingly. Either way, you can offset the increase in premiums in your forties and fifties with reduced cover that is still adequate for your needs.

Not all term life insurance policies are the same and you can shop around to compare terms and conditions. Premiums are generally higher for males than females because of different mortality rates. There are also lower premiums for non-smokers. Some term insurance is *convertible* to whole of life and endowment, but you pay a higher premium for these policies. Some policies are *guaranteed renewable*, which means that once you are accepted for insurance you will be able to renew each year by paying the premium. Some policies provide for an advance payment of the sum insured in the event of *terminal illness* if your life expectancy is not more than six months. A doctor approved by the insurer must certify the diagnosis and prognosis of the illness.

When your family has grown up and left home and your house and other debts have been paid off, you may no longer need term life insurance. Reassess your position each year and take account of other death benefits available, such as superannuation.

Applying for life insurance

When you complete a life insurance application, there are a number of matters that you are asked to disclose.

- Your personal details, including height, weight, occupation, smoker/non-smoker, and whether you take alcohol or participate in hazardous activities.
- Your medical history, including whether you have had or received medical advice or treatment for a heart disorder, raised cholesterol, high blood pressure, a mental or nervous disorder, and any other conditions.
- The medical history of your parents, brothers and sisters in relation to similar conditions.
- Your current health, including any intention to seek medical advice or treatment for any existing condition and whether you take medication of any type.

You will be asked to sign an AIDS declaration as to whether you are suffering from AIDS or have been exposed to the HIV virus. If you do not provide this declaration, an AIDS exclusion will apply and you will not be covered if you contract AIDS. Finally, you will be asked to provide your

doctor's details so that the insurer can make further enquiries about the matters that you have disclosed in your application.

Be especially careful when you answer the questions in the application, because insurers can refuse a claim by your estate or beneficiary if they discover that you failed to disclose *material* information. This could come about as a result of information disclosed in a claim form or through discussions with the claimant, your doctor, hospital staff or other persons who know your medical history and the circumstances surrounding your death. Before an insurer pays a claim, it will make whatever enquiries it thinks are necessary. In some cases a post-mortem examination may be required. Avoid giving the insurer any reason to reject a claim because of alleged non-disclosure.

- Provide complete and detailed answers in the application. There will rarely be adequate space to do this and you should always provide additional pages if necessary.
- When the question requires you to recall past health and treatment, think carefully and make sure that you do not overlook relevant facts. Refer to past records such as diaries and health records.
- If a question asks about your parents, brothers and sisters and you are uncertain as to the answer, ask them for information. If they are not alive, ask other relatives.
- If you are uncertain about what you should disclose, ask the insurer, the agent or the broker to assist you.

Medical examination

Many term life insurance policies do not require a medical examination because the insurer relies upon the information supplied in your application. For whole of life, endowment and term life policies for large amounts, a medical examination is commonly required. The insurer will appoint a doctor to conduct the examination and a written report will be provided. You may also be required to undergo medical tests. During the examination, questions will be asked and your replies noted. You need to exercise care when answering questions, because failure to disclose material information to the insurer's doctor can have the same consequences as failure to disclose material information in your application. The result of the medical examination and any tests will determine whether you are offered insurance. If your policy is *guaranteed renewable*, you can continue with the policy each year despite poor health and no further medical examination is required.

Brokers and agents

You can buy term life insurance without using the services of a broker or an agent. For example, many banks send customers invitations in the mail to buy term insurance. All you need to do is read the promotional material and *Product Disclosure Statement* (PDS) to decide whether you want the policy.

Whole of life and endowment insurance is not usually sold in this way, and term life insurance for large amounts is also sold differently. Agents of insurance companies sell these policies and they may approach you or you can arrange to have them visit you. Alternatively, you can approach a broker to get advice about the products offered by different insurance companies and the cost.

Insurance agents and brokers earn a commission on the life insurance policies they sell. Ask your financial adviser to recommend a reputable broker, or deal with a reputable agent recommended to you by the insurer. Remember the cooling-off period and don't hesitate to cancel the policy if you wish. Look for a broker who is a member of the *National Insurance Brokers Association* (NIBA) because it provides the *Insurance Brokers Dispute Facility* (IBDF) in the event of a dispute. If you have a dispute with an agent, you can contact the *Financial Industry Complaints Service Ltd* (FICS).

Exclusions

Here are common exclusions in life insurance policies. They will be described in the key features statement.

- Suicide or an intentional self-inflicted act occurring within a specified period from the date that the policy commenced, the date of any increase in the sum insured or the date of any reinstatement of the policy.
- Death caused by or contributed to by AIDS if an AIDS exclusion applies.
- Alcohol and drug abuse.
- War or any act of war.

Reinstatement

If you fail to pay your premium on time, your policy will *lapse* and you will be uninsured. However, insurers commonly allow you to reinstate the policy if you pay the premium within 30 days. Always remember to pay

your premium on time, especially during a period of illness that could result in death.

DISABILITY INSURANCE

Recovery from an accident or illness can result in many weeks or months away from work. You may be able to rely on sick leave, annual leave or possibly long service leave. If the accident or illness is work-related, you may be entitled to workers compensation benefits. When all of your entitlements have been exhausted, you may be forced to rely upon Social Security sickness benefits. For the self-employed, disability can be devastating and not only result in loss of income, but also the loss of the business and their future livelihood. Disability insurance offers protection in these circumstances. It provides lump sum benefits and/or income replacement during periods of total or partial disability and it has become more popular as the number of self-employed people increases. There are various types of disability insurance, and it can be packaged with life insurance or be bought separately.

Total and permanent disability insurance

Total and permanent disability insurance (TPD) provides a lump sum if you become totally and permanently unable to work as a result of illness or injury. The cover may be added to a life policy for an extra premium. The definition of TPD varies between insurers, so it is essential to understand what is insured and what is not. For example, consider these two definitions of TPD.

- Disablement caused by accident, injury or illness that completely prevents you from ever engaging in or attending to the occupation you specified on your proposal.
- Disablement caused by accident, injury or illness that renders you unable ever to perform any gainful occupation for which you are reasonably suited by education, training or experience.

The first definition allows a claim if you cannot carry on your occupation, whereas the second will provide a benefit only if you cannot perform some work for which you are reasonably suited. You must prove your disability by providing medical evidence at your own expense. If the insurer is not satisfied, it can arrange for its own doctors to examine you.

An alternative type of policy is one that pays a lump sum not only for

TPD, but also for specified events that are listed and defined in the policy. These may include loss of sight, hearing, speech or limbs. For example, the full sum insured may be payable for loss of sight in both eyes or 50 per cent of the sum insured for loss of one eye. Typically, the lump sum benefit for TPD will only be payable after the disablement has continued for a specified period, such as 6 or 12 consecutive months. In the meantime you may be without an income. For this reason, you may consider an alternative to TPD, such as trauma insurance or disability insurance that provides income protection.

Trauma insurance

If you experience serious illness or injury and you are unable to work for an indefinite period, you are likely to need money to assist with your recovery, to provide financial support for your family, and to pay your mortgage and other outgoings. To provide this protection, you can buy trauma insurance that is often packaged with term life insurance. The policy provides for early payout of a proportion of the sum insured if you suffer one of the specified traumas such as heart attack or stroke and survive for a period of 14 days. Medicare or private health insurance may pay your medical and hospital expenses, but trauma insurance provides money to pay the bills.

Income protection

Income protection policies differ considerably and they are also expensive. They provide a replacement income if you are unable to work because of sickness or accident. The benefit is payable monthly in arrears and you receive benefits for as long as you are disabled. If you are disabled for life, you will typically receive benefits until you reach whatever expiry age you nominated in the policy, usually 60 or 65. If you return to work, the benefits cease. If you can only work part-time, the policy may provide for payment of a partial benefit. Some policies may also provide cover for a proportion of the cost of nursing care and rehabilitation while you are disabled.

The application asks for details about your occupation and employment. If you are self-employed, you are asked to provide information about your business, including how long it has been established, the number of employees, turnover and profits. The reason for these questions is to enable the insurer to verify that the amount of cover you seek does not exceed 75 per cent of your pre-tax salary or business income. If a claim is made, the insurer will seek further verification of your income at the time the disability occurs and benefits will be calculated based on that amount.

The policy is usually guaranteed renewable despite any changes to your health.

The cost of income protection increases with your age. For example, you can expect to pay twice as much at age 40 as you would pay at age 30. The occupational dangers to which you are exposed also affect the premium, and people in some occupations may be refused insurance. Other factors that affect premiums include gender, high-risk sports and smoking. The premium is waived during any period of disability.

If you make a claim, there is an initial waiting period that is not covered by the insurance. You can pay a higher premium for a shorter waiting period. You may be able to reduce your premiums and elect a longer waiting period if you can rely on accumulated leave entitlements at work. A number of options are generally offered at extra cost, such as benefits with CPI increases while you are disabled. If you are self-employed, you can also cover your business expenses during disablement, such as rent, wages, services and any other outgoings that must be paid before you can draw a salary from the business.

HEALTH INSURANCE

What to do about health cover is a complicated question. If you rely on Medicare, can you get satisfactory health care when you need it? If you want to insure privately, can you afford it?

Medicare

Medicare is a universal system of health insurance that provides hospital and medical cover for most people in Australia. It is administered by the Health Insurance Commission (HIC) through a network of customer service centres. The Medicare Internet site has a tremendous amount of information, including Medicare forms that you can download and print. It can be found at http://www.hic.gov.au.

It is necessary to *enrol* in Medicare before you can access the health benefits that it provides. The benefits are based on a *Schedule of Fees* set by the Commonwealth Government and there is a schedule fee for each health service covered by Medicare. Benefits include services such as consultations, treatment, certain surgical procedures out of hospital, X-rays and other diagnostic imaging, pathology and other medical tests, examinations and eye tests. However, not all health and related services are covered by Medicare. Exclusions include dental examinations and treatment, ambulance services, home nursing, physiotherapy, occupational therapy, speech and eye therapy,

chiropractic, podiatry, psychology, acupuncture, glasses and contact lenses, hearing aids and other appliances, the cost of prostheses and surgery solely for cosmetic reasons.

Medical practitioners, including doctors, specialists and participating optometrists, must be registered with Medicare before benefits can be claimed for the services they provide. Medicare allows you to choose the practitioner who treats you outside of a hospital. When the service is rendered, you are provided with an itemised account and you are entitled to claim a benefit equal to 85 per cent of the schedule fee. You are required to pay the remaining 15 per cent, which is referred to as the *gap*. The maximum gap payable in a calendar year is capped, and Medicare benefits increase to 100 per cent of the schedule fee for any further out-of-hospital services. This is called the *Medicare safety net*. Doctors can charge more than the schedule fee and you pay the difference between the schedule fee and the amount they charge if this happens. These additional amounts do not count towards the safety net. There are three ways to pay an account using Medicare.

- You can pay the amount due, obtain a receipt and claim a benefit from Medicare.
- You can hold the account and claim the benefit from Medicare. You will receive a cheque made out to the doctor which you forward with your payment for the gap.
- Some practitioners have *direct billing* arrangements with Medicare and you can assign your benefit to them without the need to make a claim. The practitioner accepts 85 per cent of the schedule fee as full settlement of the account and you have nothing further to pay.

The cost of medicines is not covered by Medicare but it is subsidised by the Commonwealth Government's *Pharmaceutical Benefits Scheme* (PBS). Most prescription medicines are covered, and to obtain the subsidy you are supposed to present your Medicare card. There are concessions for some people and there are safety net thresholds. Detailed information about PBS is available on the Internet at http://www.hic.gov.au.

If you require hospitalisation, Medicare provides access to public hospital accommodation and nursing and to treatment by doctors appointed by the hospital. You will not be charged for most care and treatments provided while you are in hospital, including outpatient services. However, if you are admitted as a private patient in a public hospital or to a private hospital, Medicare does not meet the cost of accommodation and nursing. If you are a private patient, you can choose who will treat you in hospital, but Medicare will only pay a flat rate benefit of 75 per cent of the schedule fee.

The Medicare levy and surcharge

Medicare is partially funded by the *Medicare levy* that is paid as part of your income tax return. The levy is a flat rate of 1.5 per cent of your taxable income; however, no levy is payable if your taxable income does not exceed $14 539. Further relief is available for people on a low income.

In addition to the levy there is a *Medicare levy surcharge*. It applies to high-income taxpayers and their spouse at the rate of 1 per cent of taxable income if the taxpayer, their spouse and dependants are not covered by private hospital insurance. The surcharge is payable on top of the 1.5 per cent levy. The taxable income threshold is $50 000 for a single taxpayer and $100 000 for a couple. The threshold increases by $1500 for each dependent child after the first. The levy is charged on a pro rata basis according to the number of days that you do not have private health insurance during a tax year. Further information about the Medicare levy and surcharge is available on the Internet from the Australian Taxation Office at http://www.ato.gov.au.

Medicare and private health insurance

There are 44 funds providing private health insurance in Australia, with some funds operating nationally and others operating only within a state. There is a distinction between funds with *open membership*, like Medibank Private and MBF, and organisations with *restricted membership*, such as funds for specific employment groups, professional associations or unions. Private health insurance is *community rated* rather than *risk rated*, so premiums are not adjusted for things like age or gender. When you buy private health insurance you are adding to the benefits provided by Medicare, with the result that you have a combination of Medicare and private cover. There are four categories of health fund membership.

- *Single membership* provides cover only for the person named as the member on the application form (the contributor).
- *Family membership* provides cover for the contributor, one other adult and one or more dependent children.
- *Couple membership* provides cover for the contributor and one other person who is not a dependent child of the contributor.
- *Single parent family membership* provides cover for the contributor and one or more dependent children.

Dependent children are the contributor's unmarried dependent children, stepchildren and foster children who are under 19 years of age. This age limit extends to 25 if the dependent child is a full-time student

who depends on the contributor for maintenance and support. For more information about private health insurance, you can visit the Internet site at http://www.phiac.gov.au or telephone the Private Health Insurance Information Line on 1800 676 296.

Why choose private health insurance?

The reasons why people buy private health insurance depend on their needs, circumstances and preferences. If you want to be admitted as a private patient in a public or private hospital and you want to be able to choose the doctors who provide your treatment, then you will need private health insurance. This is called *hospital cover* and it is offered by all health funds. It will cover the cost of accommodation and nursing and the 25 per cent gap between the schedule fee and the Medicare benefit. If you have private insurance, it does not prevent you from choosing to be treated as a public patient in a public hospital.

If you have hospital cover, you may have more choice about when you are admitted to hospital. There are currently substantial waiting lists for elective surgery in public hospitals and you may be able to avoid delays in admission if you have private insurance.

You may be able to obtain cover for the exclusions from Medicare, such as dentistry, physiotherapy and ambulance fees. This is provided by the health funds and is called *extras* or *ancillary cover*. There are a variety of extras from which to choose. You can buy extras cover separately or in conjunction with hospital cover.

Tax incentive for private health insurance

The Commonwealth Government offers a 30 per cent rebate for private health insurance premiums paid for 'appropriate' health insurance. To qualify, the insurance policy must:

- Be held with a registered health fund
- Provide hospital cover, ancillary cover or combined cover; and
- Cover persons who are eligible to claim Medicare benefits.

There are three options for claiming the rebate:

- Lodge a claim form with Medicare for a direct payment to be made to you.
- If you are a member of a 'participating' (registered) health fund, you are eligible to register in the premium reduction scheme. You can complete an application for registration and lodge it with the fund. Once

accepted, the rebate will be offset against the amount of the premium you pay to the fund each year.

- You can claim the rebate as a refundable tax offset when you complete your income tax return. This will reduce the amount of tax that you have to pay and if no tax is payable, you will receive the amount of the rebate.

Further information about the rebate is available from the Internet site for the Australian Taxation Office at http://www.ato.gov.au.

Lifetime Health Cover

Lifetime Health Cover (LHC) was introduced on 1 July 2000 to encourage people to join and remain in private health funds. If you take out hospital cover before the age of 30 and maintain membership throughout your life, your premiums are lower than for people who join when they are older. There is a 2 per cent premium loading for each year that you are over the age of 30 when you join. The loading is capped at 70 per cent above the premium payable by a person who joins at or before the age of 30. You can drop your cover for a total of up to 1094 days during your lifetime, for whatever reason, and still maintain the base rate. Those people who had hospital cover with health funds on 15 July 2000 will continue to pay the base rate premium, no matter what their age, for as long as they remain members. Further information about LHC is available from private health insurance funds, the Internet site at http://www.phiac.gov.au or telephone the Private Health Insurance Information Line on 1800 676 296.

Assessing your health insurance needs

Buying health insurance is no different to buying other types of insurance. You need to assess your requirements, consider what you can afford, obtain the best deal and thereafter review your needs regularly. If you are in the 18–25 age bracket, the risk of illness is low but the risk of having an accident is high. If you are a family in the 25–35 age bracket, the risk of becoming involved in an accident decreases but the risk of hospitalisation increases with pregnancy, early childhood illnesses and accidents. Your children may also need dental care or glasses. In the 35–55 age bracket, your risk of accidents remains low but the risk of illness increases for ailments such as heart disease and cancer. Your children are approaching the period when the risk of accidents increases. Over the age of 55, the risk of illness increases significantly.

Reducing the cost of private health insurance

Private health insurance is expensive and the cost is likely to rise in the future, so you need to consider ways in which you can reduce the cost. Health insurance funds provide options that enable you to do this. You can choose one of three health cover options: hospital and extras cover, hospital cover or extras cover. Within each category, you can choose to pay an excess. You can achieve substantial savings by agreeing to pay an excess if you have a claim. This makes sense if your reason for buying private health insurance is to cover the big, unexpected costs and not the smaller ones.

Private Health Insurance Ombudsman

If you have a complaint about your private health insurance, such as a claim that is disputed and cannot be resolved, you can seek the services of the Private Health Insurance Ombudsman. The office is located in Sydney and you can phone on 1800 640 695. Free advice and assistance is provided to members of all private health funds. There is also an Internet site at http://www.phio.org.au.

Part D
Investing

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9 Investing fundamentals

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There is much more to investing than simply throwing your money at something and following what happens to it. An investment program consists of a logical sequence of steps.

- Identifying the investment goals that you want to achieve.
- Determining the level of risk that is appropriate for your individual circumstances.
- Analysing the characteristics of potential investments.
- Implementing an investment strategy that is consistent with your investment goals.
- Monitoring your investment performance and making periodic adjustments.

The purpose of this chapter is to describe a framework for investing. It focuses on fundamental concepts and principles that form the basis for the next two chapters on stockmarket investments and real estate investments.

DETERMINING YOUR GOALS

At some stage in the financial life cycle, you will inevitably contemplate becoming an investor. One way to begin is by asking yourself a number of important questions.

- Should I invest at all?
- How much money do I have to invest?
- What can I hope to get out of it?
- What risks can I afford to take?
- What types of investments suit me best?
- What types of investments should I avoid?

The answers to these questions will be a reflection of your personality, your financial circumstances and your financial ambitions. The answers will also provide you with a basis for determining your investment goals.

There are two reasons why people invest. The first reason is to accumulate wealth. The second reason is to derive an income from the wealth that has been accumulated. Most individuals spend their entire working life trying to accumulate wealth. They may not recognise this as an investment goal, but it is nevertheless their primary financial objective. Undertaking a genuine investment program, however, requires goals that are more specific. Unless you have clear investment goals, how will you know which investments are right for you?

What do you want to achieve by investing? Are you putting money away for your children's education? Are you building a nest egg for your retirement? Do you want to experience the excitement of speculating? Your investment goals will necessarily be tempered by your financial position, your age, your tax position and the amount of risk that you are willing to bear.

- *A sound financial position* and adequate income are important pre-requisites for becoming an investor. Do you have ample provision for normal living expenses, some savings for emergencies, moderate debts and adequate life insurance?
- *Your age* is perhaps the next consideration in determining your investment goals. While there are no hard and fast rules, generally from the twenties through the forties the main objective is capital growth. During the fifties growth is still significant but income becomes increasingly important. From the sixties onward, retirement income and avoiding risk are the main emphasis.
- *Tax effectiveness* will also be an important factor in shaping your investment program. The prospect of tax avoidance, however, should not be allowed to distort good investment judgement.
- *Your attitude towards risk* should be reflected in your investment goals. You assume some risk simply by deciding to be an investor. The question is: how much uncertainty and possibility of loss can you withstand before you exceed your threshold for risk?

People generally do not like to take financial risks, and they can only be enticed to do so by the promise of greater rewards. This is called risk-aversion and it describes most investors. However, individuals vary enormously in their degree of risk-aversion, ranging from conservative to speculative. The important point to remember is that each of us has a different attitude towards taking risks, and recognising our attitude is vital in determining our investment goals. Sometimes we forget about some of the following concerns that may also restrict the risks we can afford to take.

- income and job stability
- essential living expenses
- debt repayments
- age and health
- family responsibilities and dependants
- insurance coverage
- emergency cash reserves
- tax position
- remaining working life
- superannuation arrangements

When you are clear about your individual circumstances, you are in a good position to translate this information into investment goals. Investment goals come in three dimensions—risk, income and growth.

- Avoiding *risk* is an important goal for everyone, but its importance varies according to your circumstances and your investment temperament. It means more than simply guarding the value of your investments; it also means protecting the purchasing power of your money against inflation.
- The amount and stability of *income* is important for retired individuals and others who need an income. An income goal focuses on investments that reliably pay interest, dividends or rents. The emphasis may be on interest-bearing securities, shares with regular dividend increases or rental properties.
- *Growth* is important to people who are trying to accumulate wealth. There are different ways in which to pursue a growth-oriented investment program. One growth investor may follow a speculative growth strategy, while another may prefer long-term investments in high-quality stocks or real estate.

If your primary goal is income, then you want investments that provide interest, dividend or rental payments regularly and dependably. If your primary goal is growth, then you want investments that are likely to increase in value so they may be resold for more than their initial cost. If, however, your primary goal is to avoid risk, then you want investments that offer the greatest safety of capital and protection from inflation. Unfortunately, there is no single investment that can simultaneously offer maximum income, maximum growth and minimum risk. These three investment goals are like the corners of a triangle. The closer you move towards one corner, the further you move away from the others.

CLASSES OF INVESTMENTS

There are thousands of investments and each has its own risk, income and growth characteristics. The main categories of investments, or *asset classes*, are interest-bearing securities, shares, managed funds, real estate and collectibles.

Interest-bearing securities

Investors in interest-bearing securities are lending money to the issuers. Interest-bearing securities are issued by the Commonwealth and state governments, semi-government instrumentalities and companies. They include bonds, debentures, unsecured notes, convertible notes and mortgages. They promise to pay a fixed amount of interest on specific dates

and to repay the *face amount* on a *maturity* date. The term *cash securities* refers to high-quality, short-term money market securities such as bank deposits, bank bills or treasury notes. Interest-bearing securities are generally considered safer than most other investments because the issuer not only promises to repay the full amount at maturity, but also the interest payments are fixed and secure so long as the issuer remains solvent. However, you can lose money if you are forced to sell when interest rates are rising or if the financial condition of the borrower deteriorates.

Shares

Investors in shares are part owners of a company. Every public company must issue ordinary shares. They may also issue other types of shares such as preference shares. Each type of share differs according to the rights and benefits that they confer upon the owner. For example, preference shares generally take precedence over ordinary shares for the payment of dividends. Historically, shares have performed best for growth and protection against inflation. They offer potential for capital gains and increases in income so long as the company remains successful. However, shares are also susceptible to wide fluctuations in market price, and if the company experiences misfortune, share investors can suffer significant losses.

Managed funds

Managed funds are arrangements in which individual investors pool their money so that it can be managed by a professional funds manager. Managed funds are particularly attractive to small investors because they offer diversification and professional investment management. There are thousands of managed funds in Australia, with diverse investment objectives ranging from conservative to speculative. There are a number of ways in which managed funds are administered, including listed and unlisted unit trusts, insurance and friendly society bonds, superannuation funds, approved deposit funds, mutual funds, investment companies and common funds.

Real estate

Anyone who is buying or owns their own home is a real estate investor. However, most home owners regard their home as something more than an investment. Genuine real estate investors are more concerned with the appropriate tradeoff between risk, income and growth. Real estate investors can choose to invest directly in vacant land, residential properties or

commercial properties. Alternatively, they can choose to invest indirectly through listed or unlisted property trusts.

Collectibles

Some collectors regard their hobby as an investment, and some collections are indeed quite valuable. However, in order to be a genuine investor, one should not approach collecting as a hobby but according to sensible investment principles. Popular collectibles include stamps, coins, art and antiques.

INVESTMENT PRINCIPLES

Investing sometimes appears to be a complicated pursuit. However, it is actually based on five simple principles. The first principle is *asset allocation*, or how your investments should be spread among various asset classes. The second principle is *timing*, or how asset allocation decisions are affected by changes in the business cycle. The third principle is *asset selection*, or identifying the individual investments that will be included within each asset class. The fourth principle is *diversification*, or how various investments can be mixed together to minimise risk. The last principle is *liquidity*, or the ability to resell investments at short notice and maintain some cash reserves.

Asset allocation

Asset allocation refers to the proportion of investments held in different asset classes, depending on your investment strategy. Table 9.1 illustrates hypothetical asset allocations between cash securities, interest-bearing securities and shares for different investment strategies.

The *income* strategy has 80 per cent of its funds in cash and interest-bearing securities, with only 20 per cent in quality shares. The *balanced* strategy has 50 per cent in cash and interest-bearing securities, balanced

Table 9.1 Asset allocation (all per cent)

Strategy	Cash securities	Interest-bearing securities	Shares
Income	15	65	20
Balanced	10	40	50
Growth	5	15	80
Speculative	0	0	100

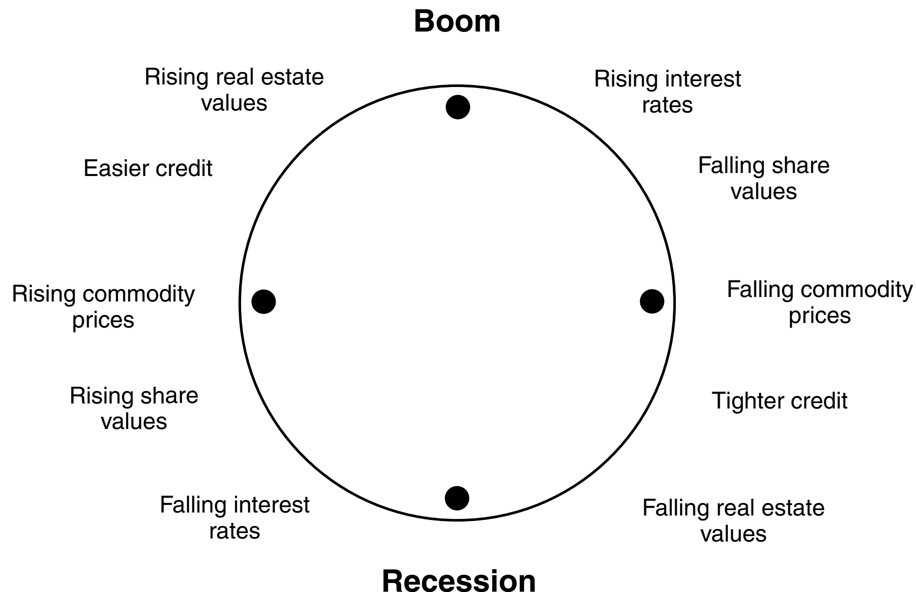
by 50 per cent in shares. The *growth* strategy is 80 per cent in shares and 20 per cent in cash and interest-bearing securities. The *speculative* strategy consists entirely of shares. Asset allocation decisions do not have to remain fixed. As your investment goals change, the asset allocation in your portfolio will change as well.

Timing

Asset allocation also depends on the economic and market conditions at the time you are making your investment decisions. For example, you might be more interested in shares when the economy is growing vigorously and then switch to interest-bearing securities when the economy is sliding into recession. This ebb and flow of the economic tide is called the business cycle. As the business cycle moves from boom times to recession and back again, each asset class reacts differently. Figure 9.1 illustrates what happens as the business cycle sweeps around the *economic clock*. Understanding the economic clock is one key to investment timing.

The top of the business cycle occurs when the economy is booming. After it peaks and begins to slow down, interest rates rise and share values begin to fall. This is followed by falling commodity prices, tighter credit and, eventually, falling real estate values until the economy reaches the

Figure 9.1 Economic clock



bottom of a recession. When the economy shows signs of recovery, interest rates fall and share values begin to rise. This is followed by rising commodity prices, easier credit and increases in real estate values until the top of the business cycle arrives again. Changes in interest rates are usually the trigger. Share values are the first to fall in a downturn and the first to recover when the economy improves. Real estate values tend to be the last to fall and the last to recover.

Asset selection

Asset selection is the process of identifying individual investments within each asset class. You can simplify the process of asset selection by using *decision rules*. Decision rules consist of defining criteria for accepting or rejecting individual investments, such as a minimum level of profitability. Deciding what decision rules to use is important, because it causes you to think carefully about what kind of investments you want to own. Once they have been defined, decision rules reduce the search time and the cost of finding suitable investment candidates by acting as a filter. Decision rules differ enormously from one investor to another, depending on the type of investment program each has chosen and the amount of risk they are prepared to accept.

Diversification

Having a good mix of investments is an important issue. Diversification affords protection against near catastrophic loss if the market turns against any one of your investments. However, over-diversification produces only average results. A survey by the Australian Stock Exchange revealed that over half of investors own only one or two securities. This is important because it suggests that many investors in Australia are under-diversified. Diversification is not just a matter of dividing your investment dollars among different investments. The key to diversification is to have a combination of investments in which each is affected differently by changing economic and financial market conditions. The result is that the ups and downs for various investments tend to offset each other.

Concentration is the flip-side of diversification. It calls for limiting the number of investments to only a few that are carefully selected. Clearly, this is putting all of your eggs in one basket. If you are correct, you will reap the benefits. If you are not correct, you will suffer serious losses. Diversification versus concentration is important in the risk–return tradeoff. For most investors, the best approach is some form of selective diversification.

Liquidity

Market liquidity and cash reserves play an important role in the design of your investment program. Market liquidity refers to investments that can be sold easily if you need cash at short notice. Market liquidity is greatest when you invest in the shares of listed companies with high daily trading volume, and least when you invest in real estate and collectibles.

Holding some cash in reserve enables you to take advantage of sudden price breaks or new opportunities. Cash reserves are usually kept in the form of bank accounts, cash management accounts or very liquid interest-bearing securities such as bank bills. Cash reserves can be set aside from interest payments, dividends, rent receipts or the periodic sale of some of your investments. The amount of cash that you decide to keep in reserve depends upon the investment environment and your investment goals.

INVESTMENT STYLE

There are different ways in which an individual may want to approach their investment program. At one extreme is the passive individual who is not interested in spending too much time or effort managing their investments. At the other extreme is the individual who wants to be actively involved with every detail of their investment program.

A *passive* style of investing consists of simply buying good-quality investments with no particular view about selling them in the future. The biggest advantage of passive investing is its simplicity. It also discourages inexperienced investors from needlessly or repeatedly changing their investments. The disadvantage is that a passive buy-and-hold policy simply fails to manage the investments. Under-performing investments are not replaced, profits are not harvested and the mix of investments may drift away from the investor's goals. An alternative form of passive investing is to put your money into a managed fund and let a professional funds manager make the decisions for you.

An a*ctive* style of investing consists of changing the exposure between and within different asset classes in order to take advantage of emerging opportunities. If you decide to increase the exposure of one asset class beyond its usual allocation, then your portfolio would be described as *overweight* in that asset class. Similarly, if the exposure to an asset class is less than its usual allocation, then it is called *underweight* in that asset class. When a portfolio is actively managed, there may be times when it will vary significantly from its usual asset allocation strategy. An active approach to investment management means continuously adjusting the asset

mix to match your outlook for the economy, various industry sectors or individual companies. If your skill and judgement are good, then you should earn higher rewards. If your skills turn out to be poor, then active investment management is more likely to produce losses.

INVESTMENT STRATEGIES

An investment strategy is designed to achieve a particular investment goal. Investment strategies can be divided into four types: income strategies, balanced strategies, growth strategies and speculative strategies.

Income strategy

The goal of an income strategy is safety of principal, a good yield, and enough growth to offset inflation. Income strategies may focus on short-term cash securities, longer-term interest-bearing securities, high-occupancy rentals, preference shares or very good quality ordinary shares that regularly pay *franked* dividends.

Asset allocation in an income strategy is relatively constant. It is unlikely that the asset mix would be altered in reaction to temporary market moves. After significant market shifts, however, the portfolio would be readjusted. For example, if shares increased relative to interest-bearing securities, then readjusting would consist of selling some of the lower-yielding shares and using the proceeds to buy higher-yielding interest-bearing securities. Most income strategies are fully invested with little in the way of cash reserves.

An income strategy performs best when the investment environment is stable. It may lose ground in a strong market or in the initial stages of a fundamental change in the investment environment. Of the four investment strategies, an income strategy requires the least effort to manage.

Balanced strategy

The goal of a balanced investment strategy is stability of income and principal, an average income, and enough capital gains to offset inflation and achieve moderate long-term growth. A balanced investment strategy may include quality ordinary shares, preference shares, real estate and interest-bearing securities. However, the proportion of shares is greater than for an income strategy.

Asset allocation decisions are based on anticipated future returns from different asset classes. A balanced investment strategy will generally ignore short-term market movements in order to benefit from longer-term trends. Changes to the asset mix are made on the basis of an assessment of the relative value of different asset classes. Over a full investment cycle, the portfolio weighting may alter significantly. Balanced investment strategies usually include some modest cash reserves.

A balanced investment strategy has the potential to avoid major downturns because it places emphasis on the relative value of different asset classes. It performs well in a rising market because it is realising capital gains and reinvesting the proceeds in under-valued assets. It may well under-perform, however, during a prolonged period of price decline. It takes a bit more effort to manage a balanced investment strategy than it does to manage an income investment strategy.

Growth strategy

The goal of a growth investment strategy is to realise significant capital gains over the medium to longer term. Income is not important. The way in which growth is pursued, however, depends upon the amount of risk that the investor is willing to accept. A growth investment strategy usually focuses on ordinary shares of varying quality and it may also include real estate. It is not unusual for a growth portfolio to experience significant price fluctuations.

Asset allocation in a growth portfolio is based on an attempt to predict short- to medium-term market fluctuations. There are frequent changes to the asset mix. A growth investor needs to be prepared to completely change their investment strategy and alter the asset allocation in order to protect the portfolio against short-term risk or to take advantage of a change in the investment environment. Growth portfolios typically maintain some reserves in order to take advantage of new opportunities.

A growth strategy will achieve superior returns if the investor can correctly predict the market's reaction to events and take advantage of developing trends. A growth strategy can also result in large losses, however, if the investor gets into an uncertain market or if their predictions are wrong. A growth strategy is generally accompanied by active investment management.

Speculative strategy

The goal of a speculative investment strategy is maximum capital gains, with the least amount of invested capital, in the shortest period of time. The speculator is willing to accept very high levels of risk and they have

little concern for income, current business conditions or long-term trends. At different times, a speculative portfolio may have positions in interest-bearing securities, real estate, equity securities, rights, warrants, options or futures contracts. A speculator will probably pursue concentration as opposed to diversification, and they may be fully invested on some occasions and completely out of the market on others.

The fact is that there are very few individuals who are genuine speculators. Most people have more conservative objectives for the majority of their investments and if they speculate they do so with only a small portion of their funds. Ordinary investors simply cannot afford the time and effort that goes into managing a speculative investment strategy.

EVALUATING PERFORMANCE

There are several ways to evaluate investment performance. You can compare your performance with your expectations. You can compare your performance with a benchmark index. Or you can compare your performance with the results that you would have achieved if you had invested in something different.

Whenever you make a new investment, you should have in mind the amount of income or capital gains that you expect from it. This makes a good basis for evaluating the results. In fact, you should regularly evaluate the performance of each investment in your portfolio in order to determine where you got it right and where you did not. It will not only help you to make better investments in the future, but it will also identify those parts of your portfolio that may need to be adjusted.

Another way to evaluate your investment performance is to compare the rate of return for your portfolio with a broad benchmark like the Australian Stock Exchange *All Ordinaries Share Price Index* which measures the movement in the overall stockmarket. Is your performance better or worse? Is your performance strongly or weakly related to swings in the stockmarket? How well does your portfolio perform in a good market? How well does it perform in a poor market? Keep in mind that your portfolio most likely represents a different asset mix than the All Ordinaries Share Price Index. Therefore, your performance comparison needs to take into account the relative differences in risk.

You not only need to evaluate your overall performance, but you also need to evaluate the performance for each individual investment. The objective is to determine which investments you want to continue to hold, which investments you want to increase and which investments need to be sold. The performance criteria for individual securities can be as detailed

or as brief as you wish, depending on the amount of time and effort that you are prepared to give to it.

PERIODIC ADJUSTMENTS

Having evaluated the overall performance of your portfolio and each of its component parts, you need to decide if any adjustments are in order. A good way to begin is to rank your investments according to their performance and your expectations. Then ask yourself, 'Why should I continue to hold an investment that I would not be prepared to buy today?'

- If stability and safety are your most important considerations, then high-risk investments with roller-coaster price fluctuations can be replaced with investments that are more reliable.
- If income is your goal, then investments with low or falling income can be replaced with ones with better yields.
- If your portfolio has been constructed for growth, then slow-moving investments can be replaced by ones with better prospects for capital gains.

From time to time, your portfolio will deviate from its intended asset allocation as a result of changing market prices. When this happens, it needs to be rebalanced. There are a number of rebalancing methods. Two popular methods are the constant ratio plan and the variable ratio plan. They can free you from having to make frequent judgements about when to buy and when to sell. For some investors, this is a welcome relief from the anxiety and worry that sometimes accompanies investment management. These plans encourage buying during price declines and selling when prices are higher. They are based on the premise that there is less risk in making adjustments as a result of actual changes in market prices than in relying on the guesswork that accompanies most forecasting techniques.

If you use a *constant ratio plan*, then your intention is to keep the asset allocation proportions constant. Suppose we decide to construct a portfolio consisting of 50 per cent shares and 50 per cent bonds. The price volatility of the bonds will generally be less than for the shares. Therefore, fluctuations in the value of the portfolio will occur mostly as a result of changes in share prices. When share prices rise, the proportion of shares in the portfolio will rise. Let's set a trigger to rebalance the portfolio if the proportion of shares varies by more than 10 percentage points. If the value of the shares rises to 60 per cent of the portfolio, then profits are taken in the shares and the proceeds used to purchase more bonds to rebalance the portfolio. If the value of the shares declines to 40 per cent of the portfolio,

then some of the bonds are sold or new funds are added so that more shares can be purchased to rebalance the portfolio.

A *variable ratio plan* is a more active version of the constant ratio plan. It calls for a change in asset allocation proportions according to changes in the investment environment. Changes to the proportions are usually triggered in accordance with movements in the economic clock. When the economic clock reflects low share prices (good share value), the investor sells bonds and purchases shares with the intention of increasing the proportion of shares in the portfolio. When the economic clock indicates high share prices (poor share value), the investor sells shares and purchases bonds with the intention of increasing the ratio of bonds in the portfolio.

Rebalancing is only effective if it is used during poor markets as well as good markets. Some investors find it psychologically or financially difficult to stick to a rebalancing plan. Since these plans encourage selling as prices rise, it is possible that sales will be made prematurely, limiting possible profits. Similarly, since they encourage buying as prices decline, it is also possible that purchases may take place before prices completely bottom out. A rebalancing plan helps to signal *when* to buy and sell; it does not select *what* to buy and sell.

10 Investing in the stockmarket

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The notion that stockmarket investing is only for wealthy executives is a myth. Millions of individuals with relatively modest means are the backbone of the stockmarket. The word *securities* is a general term that includes a variety of financial instruments. There are several reasons why many investors prefer to invest their money in stockmarket securities rather than other types of investments.

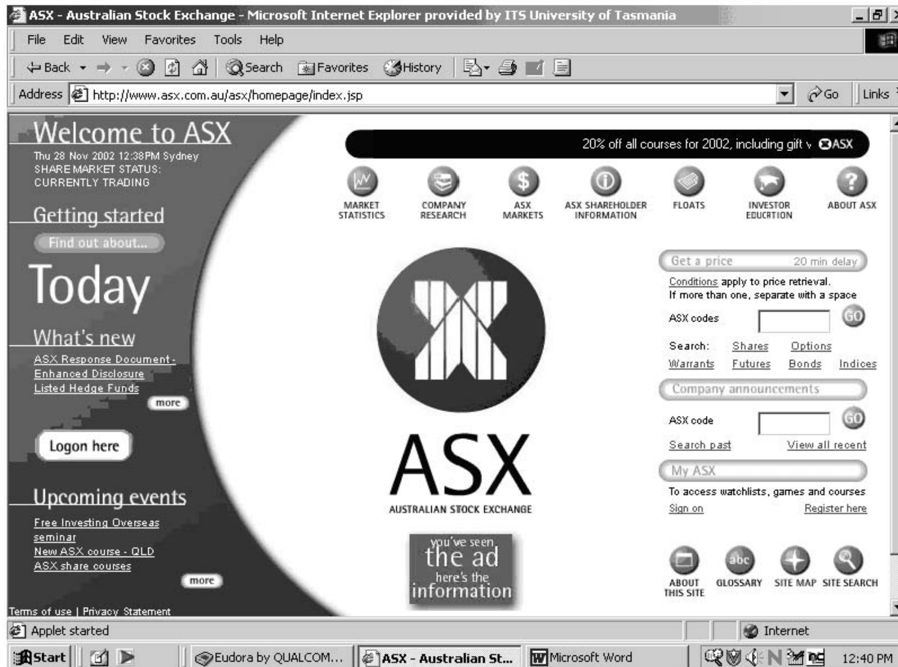
- *Liquidity:* Securities can be bought or sold at any time when the financial markets are open for trading. The advantage of liquidity is that you can convert your investment back into cash whenever you have the need.
- *Information:* You can monitor the market price of your securities. Quotations for listed securities are published in the newspaper, and up-to-the-minute quotes on all securities are available on the Internet and from your stockbroker.
- *Flexibility:* It is possible to accommodate transactions of any size with securities. You can build a portfolio with whatever types and proportions of securities you wish, and you can easily adjust the composition of your portfolio whenever you like.
- *Protection:* Investors are protected through regulation of the securities markets by organisations within the industry and the Government.
- *Cost:* The cost to buy and sell securities is perhaps the lowest for all types of investments. Commission rates vary from one stockbroker to another, but most are in the range of 1–2 per cent of the amount involved.

The purpose of this chapter is to examine stockmarket investments. We begin by describing the Australian Stock Exchange, the role of the stockbroker, the procedures for trading, and the types of stockmarket securities that are traded. Then we look at sources of investment information and the approaches that can be used to analyse potential investments. The chapter concludes with an explanation of managed funds.

THE AUSTRALIAN STOCK EXCHANGE

The Australian Stock Exchange (ASX) offers investors a range of information and services. A good place to begin is the *ASX Information Source Guide*. It is a central location in which you can search for stockmarket information, products and services. The guide lists a number of information categories to make your search easier. Other features include links to stockmarket distributors' websites. You can access the guide by visiting http://www.asx.com.au and clicking on the icon for *Investor Courses & Services* and then selecting the *ASX Information Source Guide.*

Figure 10.1 The Australian Stock Exchange Internet site



The ASX Internet site is one of the most popular investment sites in Australia because you can explore a vast range of information, products and services. The ASX Internet site contains information about the following topics.

- About ASX and Australia
- ASX Charity Sharemarket Game
- ASX Investor Relations
- ASX/Employment Opportunities in Australia
- ASX/Dymocks Bookshop
- ASX Investor Education
- Information Source Guide
- ASX Careers
- The Information Centre
- How to Invest in Shares
- Broker Referral Service
- Simulated Trading
- Enterprise Market
- ASX Derivatives
- Companies

- Share Prices
- Glossary
- What's New
- Site Guide

Information on investing in shares is available in a step-by-step guide or as magazine pages covering topics ranging from buying and selling shares to maintaining a share portfolio. At the close of business each day, a market summary is available to keep you up to date with market movements, and the *All Ordinaries Index* is live on the site during ASX trading hours. You can also use the Broker Referral Service. By answering questions about the type of advice you are after, the area in which you live, or even the language that you speak, the service will provide you with the names of firms that can help.

CHOOSING A STOCKBROKER

A stockbroker is licensed to buy and sell securities for the public. The same firm, however, may serve the client either as a broker or as a dealer and they should always disclose the way in which they have filled, or *executed*, a client's order.

A *broker* acts as the client's agent. This means that they execute your orders to buy and sell securities. They neither buy from you directly nor sell to you from their own holdings. They charge a fee for this service and that is their compensation for handling the transaction. Securities that are listed on the Australian Stock Exchange (ASX) are almost always bought and sold for private investors by stockbrokers who carry out the transactions as an agent.

A *dealer* acts as principal rather than as the client's agent. A dealer buys from other dealers, brokers and clients and they also sell from their own account. The dealer's profit or loss is the difference between the price they pay and the price they receive. Dealers are most active in unlisted securities, unit trusts and securities that are offered to the public for the first time.

The public face of the stockbroker is the *client adviser* or the firm's representative. This individual provides the liaison between the client and the investment services offered by the firm. Many investors refer to the client adviser as their *broker*, but technically this is not correct. Client advisers are subject to an examination of their past career and their knowledge of investments before they can be licensed to accept orders from the public.

Finding a stockbroker is easy. Just look in the telephone directory or

contact ASX. Finding a stockbroker and a client adviser that suits your particular needs, however, is a very personal decision. It is like choosing a doctor, an accountant or a solicitor. Ask your friends about their stockbroker or talk to people like your banker, your accountant or your solicitor. A client adviser makes their living by helping you to invest your money. If you strike one that does not do the job to your satisfaction, then there are plenty of others. There is also nothing to stop you from having more than one stockbroker. There are a number of things to look for when you select a stockbroker:

- courteous attitude and quality service
- ease and promptness of communications
- efficient execution of orders
- amount and flexibility of brokerage fees
- quality and availability of research and advice
- financial planning and superannuation advice
- margin lending facilities
- fixed interest advice and dealing
- portfolio review and management services
- access to floats, managed investments, derivatives and foreign securities

Some stockbrokers specialise in particular types of securities while others deal in nearly all types of securities. Some stockbrokers prefer to concentrate on large clients, and others base their business on small and medium-size clients. It is important to weigh up the services offered and the fees charged before you choose a stockbroker.

At one end of the spectrum is the *full-service* stockbroker. They will spend the time to provide you with advice and information. A commission fee for buying and selling securities is the principal method of charging for stockbrokers' services. However, some stockbrokers want to reduce the emphasis on brokerage fees and charge separately for each of the services they provide. A stockbroker sets their own commission rates and they can charge different rates to different clients. Sometimes there is a sliding scale depending upon the amount of the transaction. A representative example would be 1 or 2 per cent of the value of a transaction (buy or sell) subject to a minimum fee that varies between $30 and $100 per transaction. Brokerage rates are negotiable so don't be bashful about asking for a reduced rate.

At the other end of the spectrum is the *discount* stockbroker. They charge the lowest commission rates but they also provide the least service. Discount stockbrokers depend on volume to make money so they simply take your order and do not give advice. Discount stockbrokers are particularly appealing to the do-it-yourself investor who does not need the services of a full-service stockbroker. Discount stockbroker commissions

are generally between 0.1 per cent and 0.5 per cent and minimum fees are as low as $16.

A recent development in stockbroker services has been the introduction of the Internet. Many full-service stockbrokers offer optional Internet services as a supplement to their existing services. However, discount stockbrokers offer services that are designed specifically for the Internet.

TRADING PROCEDURES

The procedure for buying and selling securities consists of the following steps.

- You select the securities that you want to buy or sell and instruct your client adviser to execute the order.
- The client adviser enters the order into the stockbroker's computer system and it is transmitted to the appropriate securities market.
- The order is filled at the best possible price.
- Confirmation of the completed order is transmitted back to the client adviser who subsequently informs you.

The simplest way to buy or sell securities is to place your order *at market*, *at discretion* or *at best*. These are approximately equivalent terms meaning that the transaction will take place at the market price that is prevailing at the time. If you do not want to give your stockbroker complete discretion over the price, you can enter a *limit* order. A limit order to buy establishes the maximum price that you will pay, and a limit order to sell establishes the minimum price that you will accept. If the stockbroker cannot fill the order within your limit, then it will not be filled.

Trading on the 'floor' of the Australian Stock Exchange ended in 1990 when computers replaced the floor traders. Now all securities listed on the Australian Stock Exchange are bought and sold using the computer-based *Stock Exchange Automated Trading System*, or SEATS. A glance at the SEATS computer screen tells the client adviser where your order is in the system. The screen also shows the *depth* of the market, consisting of the number of shares bid and offered at each price. It is possible for the client adviser to tell you how close your bid or offer is to the prevailing price and how many shares are ahead of you in the queue. The result is that your client adviser can assess the likelihood of an order being executed and advise you if the order should be changed or cancelled. In some cases, your order will be completed and confirmed before you hang up the phone.

The over-the-counter market is a network of dealers who trade in securities that are not listed on the Australian Stock Exchange. If you want

to trade in unlisted securities, your stockbroker employs a different set of procedures. First, the client adviser transmits your order to the firm's over-the-counter dealer who contacts another dealer who *makes a market* in that particular unlisted security. The dealers trade between themselves at a *wholesale* price and then trade with the public at a *retail* price.

When you buy shares, your stockbroker sends you a buying *contract note* that itemises the cost of the securities, the brokerage fees for executing the order and the stamp duty. You need to pay the amount of the contract note without further notice. Your stockbroker advises the company's registrar of shareholders that you are now a shareholder. Traditionally, a share certificate, known as *scrip*, was issued as evidence of your ownership in the company. If the shares are listed on the Australian Stock Exchange, you no longer receive a share certificate. Now you receive a CHESS statement that records your share ownership in a way that is similar to a bank statement. CHESS stands for the *Clearing House Electronic Sub-register System*. Because it is electronic, ownership of securities can be transferred without having to rely on paper documentation

When you sell shares, you receive a selling contract note. Traditionally, you delivered the share certificate to your stockbroker and you were sent a cheque for the proceeds of the sale. Now that listed shares are held in the CHESS system, there is no need to bother with the share certificate.

TYPES OF SECURITIES

There are five principal types of stockmarket securities—ordinary shares, preference shares, convertible notes, company-issued options and rights. Each represents a different type of investment in the issuer and each has its own risk and return profile.

Ordinary shares

Ordinary shares are the most common form of stockmarket securities. Every public company has ordinary shares. Each ordinary share represents a fractional ownership interest in the company. Ordinary shares confer a number of rights on the shareholder.

- The right to limited liability, which means that a shareholder's financial liability is limited to the amount paid for the shares.
- The right to a proportionate part of the company's profit; however, it is the Board of Directors who determine if the profits will be distributed in the form of a dividend payment or reinvested in the company.

- The right to a proportionate part of the company's assets, after all of the debts are paid, if the company is ever wound up.
- The right to attend, speak and vote at company shareholder meetings.
- The right to receive prescribed information about the company.
- The right to sell the shares, including the right to accept or reject offers under proposed takeovers.

The potential rewards from investing in ordinary shares consist of dividend income and capital gains. The long-term average rate of return on the shares that make up the All Ordinaries Index has been about 16 per cent per year. Dividend income has averaged about 4 per cent per year and capital gains have averaged about 12 per cent per year.

The Board of Directors decides how much of the profits will be paid out in dividends. Some companies do not pay dividends. Companies that do pay dividends generally do so twice each year. The first is a smaller *interim dividend* paid after the middle of the financial year. The second is generally a larger *final dividend* paid after the end of the financial year. In a particularly good year, the Directors may also declare an *extra dividend*. Dividends paid by Australian companies attract dividend imputation credits provided that the dividends are paid out of company profits on which company tax has been paid. These are called *franked dividends* and the tax ramifications are discussed further in Chapter 12.

Occasionally you may encounter c*ontributing* or *partly-paid* ordinary shares. For example, a contributing share may be issued at $3 with $2 payable on subscription and $1 payable at call. This means that shareholders are legally obliged to pay the remaining $1 of the issue price whenever the company asks them to do so. Shareholders in *no liability* companies, however, may opt to forfeit their shares instead of paying the call.

Preference shares

Preference shares have a fixed dividend rate. Preference dividends must be paid before dividends on ordinary shares can be paid. Under certain conditions, however, the Board of Directors may decide not to pay the preference dividend. If the company is wound up, preference shareholders rank after creditors but ahead of ordinary shareholders in the distribution of liquidated assets. Preference shares can take a variety of forms.

- *Cumulative* preference shares accumulate the liability for any dividends that may not have been paid. Ordinary shareholders do not receive any ordinary dividends until the arrears in the preference share dividends have been paid.

- *Participating* preference shares receive additional preference dividends, depending upon the company's profit.
- *Redeemable* preference shares mature on a specified date when the shareholders receive the *face value*.
- *Convertible* preference shares may be converted into the ordinary shares of the company under specified conditions at the option of the shareholder.
- *Converting* preference shares automatically convert into the ordinary shares of the company under specified conditions.

Convertible notes

Convertible notes are the interest-bearing securities of a company that can be converted into its ordinary shares. Convertible noteholders have the right to convert their notes to ordinary shares on specified dates or during a specified period. If the notes are not converted, then they are repaid at face value at the end of the term. Convertible noteholders not only receive interest payments, but they also have an opportunity to participate in any capital appreciation that accrues to the ordinary shareholders. At the same time, they have the downside protection of being creditors if the company should encounter hard times.

Company-issued options

Company-issued options enable the optionholder to take up new shares in the company at a fixed price for a certain period of time. Company-issued options are sometimes offered as an incentive, called a *sweetener*, when ordinary shares are first sold to the public. Optionholders are not shareholders, because they have not purchased the shares. The advantage is that, for a small outlay, optionholders can benefit from any increase in the share price because it will be reflected in the option price as well. Therefore, the options can be bought and sold without the need to actually buy and sell the shares. The disadvantages are that options have no voting rights, no dividend entitlements and a limited life.

Rights

Companies use rights issues to raise additional share capital from existing shareholders. The rights permit existing shareholders to purchase additional shares at a predetermined price until they expire. The new share price is generally at a discount to the current market price and this gives the rights value. Some shareholders decide not to exercise their rights, so they sell

them. The rights trade in the stockmarket along with the company's shares. The value of a right depends on the terms of the rights issue and the current market price of the shares. The reason some investors like to trade in rights is because when the shares fluctuate by a given percentage, the value of the rights fluctuate by an even greater percentage.

INVESTMENT INFORMATION

The whole process of stockmarket investing is driven by information. The newspaper is perhaps the most traditional and convenient source of investment information. Newspapers contain market quotations, general business news, financial opinion and financial advertising. *The Australian Financial Review* is Australia's only comprehensive daily financial newspaper. The financial section of newspapers such as *The Age, The Sydney Morning Herald* and *The Australian* also offer broad coverage. There are other publications that cover investment topics, including investment magazines and journals, company prospectuses and annual reports, stockbrokers' research reports and books.

Financial publications are a rich source of information on broad economic and business trends. News items that reflect overall business conditions include reports about levels of production, retail sales, housing approvals or changes in government policy. Other reports may reflect conditions in particular industries, such as exploration and production in the mining industry. Important items about individual companies may include earnings, dividends, takeovers, new products, management changes, industrial relations and new financing. Financial publications not only report factual information, they also publish opinion. Financial writers interpret economic developments, analyse trends, examine current developments and predict future prospects. When you read financial opinion, however, keep in mind that it can range from inspired prophecy to pedestrian axe grinding.

Newspaper quotations

Share price quotations are reported daily in most newspapers, but not all newspapers use the same format. Industrial and mining shares are listed separately. The broadest coverage will be found in the major metropolitan newspapers and in *The Australian Financial Review*. Table 10.1 is an example of a newspaper quotation for the ABC Company.

- The first line is for ordinary shares, the second line is for preference shares and the third line is for rights.

Table 10.1 Newspaper quotations

52-week High	52-week Low	Day's High	Day's Low	ASX code	Company name	Call code	Last sale	+ or –	Vol 100s	Buy	Sell
5.35	3.55	5.13	5.06	ABC	ABC	1234	5.13	+7	4775	5.11	5.14
1.49	1.25	1.39	1.37	ABCP	ABC pref	5678	1.38	+1	25	1.38	1.40
.25	.05	.21	.20	ABCR	ABC rts	3456	.21	+4	225	.20	.22

- The first two columns are the highest price and the lowest price during the previous year.
- The next two columns are the highest price and the lowest price during the day's trading.
- The *ASX code* is used to identify the shares in the Australian Stock Exchange computer system.
- The *Company name* is usually shortened or abbreviated.
- The *Call code* is a four-digit code that can be used to obtain real-time telephone quotations during trading hours.
- The *Last sale* is the closing price for the day, followed by the net change (+ *or* –) in price since the closing price on the previous day.
- *Vol 100s* is the number of shares traded, or trading volume, expressed in multiples of 100.
- The *Buy* column is the highest price bid at the close of trading.
- The *Sell* column is the lowest price offered at the close of trading.

You will also find other types of quotations appearing in the financial pages. One is a listing of share prices called the *Course of Sales.* Its purpose is to report how the price of each share changed during the course of the day's trading. Financial indices that measure broad changes in the value of securities in different sectors of the stockmarket are also reported. *Price* indices reflect changes in prices only. *Accumulation* indices reflect the reinvestment of interest payments or dividends as well and measure the total change in accumulated value. Australian listed shares are reflected in the *Australian Stock Exchange All Ordinaries Share Price Index*, which is reported in the media daily.

Magazines

There are a number of magazines that publish investment information. In addition to general business and news publications, the following are especially useful.

- *Asset* (Fairfax Business Media: 11 issues per year) contains ideas, opinions and strategies for financial planners and other investment specialists. http://www.assetmag.com.au

- *Business Review Weekly* (BRW Media: weekly) is Australia's foremost business magazine. In addition to a wide range of business topics, it contains a great deal of current information that is relevant to private investors. http://www.brw.com.au
- *Ethical Investor* (Ethical Investor Pty Ltd: 11 issues per year) focuses on a variety of ethical issues related to investing. http://www.ethicalinvestor.com.au
- *JASSA* (Securities Institute of Australia: 4 issues per year) was previously known as the *Journal of the Australian Society of Security Analysts*. In addition to research, it contains views and information about matters affecting the securities industry. http://www.securities.com.au
- *Money Magazine* (APC: 12 issues per year) is the magazine spinoff from Paul Clitheroe's popular television show 'Money'.
- *Personal Investor* (Fairfax Business Media: 12 issues per year) is Australia's foremost investment magazine aimed at individual investors. Each issue consists of a number of feature articles plus a wide range of regular columns. http://www.personalinvestor.com.au
- *Shares* (Fairfax Business Media: 12 issues per year) is marketed with *Personal Investor* magazine and contains the Australian Stock Exchange Tables which are updated monthly for all listed securities plus market indices. http://www.sharesmag.com.au

FUNDAMENTAL ANALYSIS

Fundamental analysis attempts to determine a share's fair value. If fair value is greater than the share's current market price, then an investor may decide to buy the shares in anticipation of a capital gain. In practice, establishing the fair value of a share is more of an art than a precise science. It has a great deal more to do with making judgements about things that may happen in the future than it does with merely analysing current facts. The ability to anticipate likely future events and their effect on a company's share price is a key element in identifying potential capital gains.

Fundamental analysis can be approached in two ways: the growth rate approach or the out-of-favour approach. The *growth rate approach* says that companies with above-average earnings growth will produce share values that result in above-average capital gains. The objective is to identify companies with significant potential for future earnings growth before it becomes reflected in the share price. The *out-of-favour approach* says that there are times when a company's share price may be depressed simply because it is unpopular with investors. With few buyers and many sellers, the share price becomes depressed

relative to its fair value. You can learn a great deal about a company by focusing on the performance drivers that affect earnings.

- *Management:* Who is the management team? How much experience do they have? Do they have the skills necessary to make this company perform well? How well have they performed in the past? Do they have a well-articulated plan, or do they simply react to events?
- *Production:* Is the company a high-cost or low-cost producer? Is the company a quality producer? Are earnings substantially influenced by the cost or availability of raw materials? Are wages a significant component of production? Does the company face aggressive trade unions? Does the company benefit from technology in the production process? Is there enough capacity to achieve the growth targets?
- *Marketing:* Is the main market industrial, commercial or consumer? Is it primarily domestic or export? Does the company depend on a few large customers or many small ones? Is the product line diversified or specialised? Do the company's products have a good reputation and customer brand loyalty? Is the market large enough to sustain sales growth? How aggressive is the marketing effort and what is the rate of sales growth?
- *Investment:* How is the company improving its product line and productive capacity? How much is spent on research and development? What new products or new applications of existing products are in the pipeline? How much is spent on new plant and equipment, and how will modernisation and expansion improve company earnings?
- *Government regulation:* How much does government policy affect earnings? Are sales affected by domestic incentives such as subsidies or overseas restrictions such as tariffs? To what extent do government agencies dictate how the company may operate and what prices it may charge?

TECHNICAL ANALYSIS

Technical analysis is an attempt to determine when and how a share's current market price is likely to change. It is based on the assumption that history repeats itself. Those who engage in technical analysis specialise in the investigation of share price cycles and patterns. There are many forms of technical analysis. Some are concerned with simply identifying the direction of a trend, some try to establish the strength or momentum of a trend, and others attempt to forecast an impending reversal in a trend.

Technical analysis can be approached in two ways: the market timing approach and the price pattern approach. The *market timing approach* says that a company's share price will fluctuate within some normal range. The

objective is to buy the shares when the price is near the bottom of its normal range and to sell them near the top of its normal range. In more sophisticated versions, the normal range may be adjusted for other influences such as changes in the business cycle. The *price pattern approach* says that share prices tend to produce chart formations that recur. Changes in price patterns are the result of shifts in the balance of supply and demand for the shares. A familiarity with past price patterns can be used to predict future share price movements. Some very sophisticated techniques have been developed to analyse and predict share price patterns.

Investors who use technical trading systems hold the view that all of the fundamentals are already built into price. Therefore, they concentrate on identifying a trend at an early stage in order to take a position that profits from it. A strong upward price trend is called a *bull market*. A strong downward price trend is called a *bear market*. When no trend is apparent, the market is described as going *sideways*. If the price drops briefly during a bull market, it is called a *correction* or a *reaction*. If the price rises briefly in a bear market, it is called a *rally*. When the price levels off, it is variously referred to as a *consolidation, congestion* or *building a base*. Buy and sell signals are based upon evidence of *accumulation* (buying) or *distribution* (selling).

The foundation of technical analysis is *support* and *resistance* levels. A support level is a price at which a substantial surge in demand is expected because heavy buying has typically occurred around this price in the past. A resistance level is a price at which a substantial surge in supply is expected because heavy selling has typically occurred around this price in the past. Prices tend to 'bottom out' at support levels and 'top out' at resistance levels. Any price movement that breaks through these levels is a strong indication that a new trend has developed.

MANAGED FUNDS

A managed fund allows individuals with limited savings or investment resources to acquire part of a much larger portfolio. By pooling your money with other investors, you not only gain access to a professional investment manager, but also the ability to diversify effectively. The most popular form of managed fund is the unit trust. It enables you to invest indirectly in shares, interest-bearing securities, property and international securities. A unit trust may be listed or unlisted.

A listed unit trust sells a fixed number of units to investors in a public offering that is similar to the float of a new company. Subsequently, the units are traded on the stock exchange with the price fluctuating according

to supply and demand. Since the number of units issued is fixed, listed unit trusts are referred to as *closed-end* funds.

Unlisted trusts do not trade on the Australian Stock Exchange. They are sold by the fund manager based on a written prospectus. The price of a unit depends on its *net asset value*. Net asset value consists of the total value of the investment portfolio divided by the number of units outstanding. Net asset value, therefore, fluctuates according to changes in the prices of the investments in the trust portfolio. An unlisted trust is referred to as an *open-end* fund because it continuously offers to sell new units and stands ready to buy back existing units. Some unlisted unit trusts are closed to new investors.

Fees

Investors in managed funds are subject to a number of fees. Some fees are paid directly by the investor and some are paid indirectly by the fund. The fees may include a cost to purchase units, called an *entry fee*; a cost for managing the fund, called a *management fee*; and a cost to redeem units, called an *exit fee.*

Most funds charge a front-end entry fee of 3–5 per cent when units are purchased. A substantial part of the entry fee is paid as a commission to brokers, financial advisers and financial planners who sell managed investments. One way around this is to deal with a discount broker. Provided that you know what you want and do not ask for advice, discount brokers will rebate as much as 90 per cent of the initial entry fee. The entry fee is a big problem for the managed investments industry. It deters many investors from putting their money under management. For this reason, there are increasing numbers of no-load funds appearing in the Australian market that do not charge an entry fee. However, watch out for no-load funds that try to claw back the entry fee over several years in the form of higher management fees and exit fees.

Annual management fees are deducted from a fund before the returns accrue to the investors. The investment manager is entitled to charge an annual management fee, and some funds charge a separate administration fee to cover running costs such as stamp duty, auditors' fees, custody fees, interest expense, bank charges, postage and printing. The overall cost of operating a managed fund is measured by the *management expense ratio* (MER). It is calculated by taking the total annual fees and expenses paid out of the fund and expressing it as a percentage of the fund's value. MERs range from 1 per cent to 3 per cent, with the average MER around 2 per cent. If a fund is actively managed, its MER can be expected to be higher. Smaller funds, however, usually mean a higher MER as well.

To resell units in an unlisted fund, the unit-holder sends an application to the fund manager who is obliged to buy the units back within a prescribed time. A number of funds charge an exit fee. Others charge an exit fee that is based on a sliding scale depending on how long your money was under their management. Many funds do not charge an exit fee. Units in a listed trust may be resold on the stock exchange without the fund manager's participation. There are no exit fees for listed trusts except for normal stockbroker's commissions.

Types of unit trusts

Fund managers are a diverse group of institutions offering a wide range of managed investment products. The main players include investment management companies, banks, life insurance companies, stockbrokers, financial planners and investment advisers. Unit trusts generally fall into one of the following categories.

- *Cash management trusts* are an attractive alternative to holding short-term funds in accounts that earn little or no interest. They invest in short-term money market securities. An investment in a cash management trust is virtually at call, with some offering cheque access. Cash management trusts do not normally charge entry or exit fees.
- *Fixed interest trusts* are also called *income* trusts or *bond* trusts. They invest in interest-bearing securities issued by the Commonwealth, state governments and statutory authorities. Their objectives are high interest yield with some profit from trading activity. The value of the units is affected by changes in market interest rates.
- *Mortgage trusts* loan money on first mortgages over real estate. They also invest in some fixed interest securities for liquidity purposes. The interest rates on the mortgages may be fixed or variable. The returns from mortgage trusts tend to be more stable than cash management trusts and fixed interest trusts. Short-term fluctuations in interest rates also have less impact. Mortgage trusts do not charge an entry fee, but there may be an exit fee.
- *Property trusts* differ according to the type of property (commercial, retail, industrial, residential or tourism) and its location (central business district, outer urban growth area or suburban shopping centre). Property trusts have an income component and a growth component. If the trust borrows in order to maximise growth, then the income component will be reduced in order to pay the interest on the borrowings. Depending on the manager's strategy, a property trust may be targeting high income and low growth, balanced income and growth, or low income and high growth. A *split* property trust enables you to choose between separate

income units and growth units. Unlisted property trusts have periodic revaluations of the property portfolio that determine the net asset value of the units.

- *Equity trusts* invest in shares. The investment strategies pursued by individual equity trusts can vary enormously. Equity trusts that emphasise *growth* are exposed to greater risk by investing in particular market sectors. Equity trusts that emphasise *income* tend to stick to blue chip stocks or stocks with fully franked dividends and varying proportions of fixed interest securities. In between are equity trusts that are *balanced* between moderate income and moderate growth.
- *Overseas trusts* are generally managed by a fund manager in Australia with overseas links. The purpose is to gain exposure to securities in other countries. The globalisation of securities markets together with the advantages of international diversification have increased the popularity of overseas trusts. Overseas trusts may invest in interest-bearing securities, shares, property and currencies. Most of them emphasise growth and emerging markets.
- *Index trusts* are a passive approach to managed funds in which the fund manager puts together a portfolio that will *track* the performance of a benchmark index such as the All Ordinaries Index or the Composite Bond Index. These funds are less expensive to run because they require less research and fewer transactions.

11 Investing in residential property

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Traditionally, residential property has been a popular investment choice. Unlike the stockmarket, it is a tangible asset that you can see and touch and it has been a good hedge against inflation. At some time in your financial life cycle, you will decide whether or not to buy your own home. You may also consider investing in rental property. This chapter examines sources of property information and advice, home ownership, the legal processes involved in property transactions, income-producing property and property syndicates.

INFORMATION AND ADVICE

Many people are inclined to offer an opinion about property investment, but good advice is not always easy to find. Despite regularly published information on property markets, getting the right information from reliable sources requires some digging. Property markets are just as complex as the stockmarket, but there is no stock exchange equivalent or other regulatory bodies to guide the property investor. Sources of information and advice include advertising, publications and property advisers.

Advertising

Real estate agencies regularly advertise properties in the newspaper. These advertisements are generally financed by the seller and are therefore deliberately optimistic. However, they are a good starting point to find out what sort of properties are available, in what locations and at what asking prices.

Some property developers also advertise. Developments include suburban or inner-city residential housing and commercial complexes. House and land packages are also advertised by building contractors. Commercial properties include small industrial sites, office space, hotels and other traveller accommodation. Advertisements are sometimes presented as an invitation to express your interest in a proposal.

Published information

The real estate market responds to changes in economic activity and follows the business cycle. The Australian property market is also influenced by conditions overseas, such as the recent Asian economic crisis. Domestic influences, like the Sydney Olympics or the trend to inner-city living, also affect some segments of the property market. Information about these and

other important factors is reflected in the statistics gathered and published by a number of public and private organisations.

- The financial pages of the daily newspapers periodically publish information, including trends in the real estate market, indicative price levels, rental returns and building activity.
- An analysis of the real estate market is regularly undertaken by major banks and industry organisations. Their published reports are a useful source of information.
- Other sources of expert advice are published in a variety of magazines that are aimed at the property investor. Two examples are *Personal Investor Magazine* and *Australian Property Investor*. You can also find them on the Internet.

Personal Investor Magazine http://www.personalinvestor.com.au
Australian Property Investor http://www.apimagazine.com.au

Property advisers

Another source of information comes from professional property advisers. They are licensed real estate agents, accountants or financial planners, who specialise in the property industry. They market investment properties and they sometimes manage them as well. Property investment advisers are not licensed or regulated, so look for a qualified member of the Real Estate Institute or a qualified professional. The Real Estate Institute of Australia has an Internet site at http://www.reia.asn.au where you can find a list of registered members operating in your state.

A property adviser can identify the operating costs for an investment property, they are familiar with good property management practices and they know how particular locations ought to perform. They will consider your needs and priorities, including capital growth, income generation and tax benefits. They may offer you the opportunity to learn about property investment in a seminar. Syndication opportunities, as well as direct property purchases, are presented at these seminars. Some property investment opportunities are fully subscribed in this way without public advertising or marketing.

Valuers are also involved in real estate investing and they are generally independent of the projects they value. Part of their job is to monitor trends in the industry. They can tell you about different sectors of the property market, property values and current demand. They are concerned with things like construction quality, redevelopment opportunities and investment potential.

YOUR HOME AS AN INVESTMENT

Home ownership was once an Australian dream, but today only one in four households are paying off a mortgage. Younger people, in particular, are looking at other options because of career issues, family structures and accommodation preferences. For many people, remaining employed means being prepared to move to new cities and countries. The increasing cost of housing, particularly in inner-city areas, also pushes potential first-home buyers out of the market. Home ownership is increasingly the domain of people with sufficient wealth to own their home outright and a luxury for those who face uncertainties and volatility of employment.

Renting or buying

Whether you should rent or buy is a decision that depends on your lifestyle preferences and your financial constraints. Each option has advantages and disadvantages.

Renting

Renting is a popular option for younger couples and singles, families with a low income or few assets, people with jobs that are not permanent or that require frequent transfers, or anyone who does not want the responsibilities of home ownership. There are advantages and disadvantages of being a tenant.

Advantages

- Renting is generally less expensive in the short-term because there is no purchase deposit or debt servicing to pay, and rental bonds are relatively modest compared with a purchase deposit.
- Renting is more flexible because you and your family have greater freedom to move.
- The landlord is responsible for maintenance, so renting avoids the costs of repairs, rates and insurance.

Disadvantages

- You have little or no freedom to improve the property or significantly change it to your taste.
- Renting means that you are not building an equity in your home, nor are you benefiting from any increase in value.
- You cannot prevent a landlord from raising the rent or forcing you to move when your lease expires.
- Pets may not be allowed in rented premises.

Buying

You are more likely to consider buying your home if you have a large family requiring lots of space, a young family with plans for more children, or if owning your home is an important personal preference. You will be paying a purchase deposit, transaction costs and mortgage repayments, so you should carefully consider your other needs and financial prospects. A large mortgage with high monthly payments can become a major hardship for a household that experiences prolonged unemployment, illness, disability, decreased income or adverse interest rate movements.

Advantages

- Historically, home ownership has been a safe form of investment.
- Home ownership has provided protection against inflation and a means for building a sizeable equity over the years.
- Owning your own home can give you and your family a feeling of permanence and pride.
- No capital gains tax applies to your main place of residence.
- You have the freedom to make changes to your home.
- Paying off a mortgage is a form of disciplined saving.

Disadvantages

- Purchasing your home requires a large initial deposit.
- Interest charges sometimes make monthly repayments greater than paying rent.
- You are responsible for maintaining the house and gardens, which can be costly in time and money.
- You may not be able to afford to buy in your preferred location, resulting in higher transport costs and less leisure time.

Many of the reasons for buying versus renting centre on financial and lifestyle flexibility. Renting generally involves lower monthly payments and avoids the responsibility of being an owner while at the same time maximising flexibility. Alternatively, buying means you have the freedom to remodel and redecorate while building your equity as you pay off the mortgage.

One way to analyse renting versus buying is to compare the costs of each alternative. The cost of renting consists of the rental payments. The cost of buying consists of the initial deposit, transaction costs (such as stamp duty and various fees), ownership costs (such as rates, maintenance and insurance), and mortgage repayments consisting of interest and principal. However, a house can be expected to increase in value over time and the benefit accrues to the owner.

Figure 11.1 compares the cumulative cost of renting versus buying over different periods of time. The house in this example can be purchased for \$185 000 or rented for \$180 per week. Your savings of \$36 000 are used

Figure 11.1 Cumulative cost of renting versus buying

At the end of:	Year 1	Year 5	Year 10	Year 15	Year 25
Renting	9 360	46 800	93 600	140 400	234 000
Buying					
Deposit and costs	36 000	36 000	36 000	36 000	36 000
Ownership costs	2 000	10 000	20 000	30 000	50 000
Repayments	14 652	73 260	146 520	219 780	366 300
	52 652	119 260	202 520	285 780	452 300
Cash difference	**(43 292)**	**(72 460)**	**(108 920)**	**(145 380)**	**(218 300)**
Equity	28 822	38 796	57 192	84 330	185 000
Capital appreciation	7 400	40 081	88 845	148 175	308 180
Net difference	**(7 070)**	**6 417**	**37 117**	**87 125**	**274 880**

to pay the deposit of \$26 750 and to pay the transactions costs of \$9250, leaving \$158 250 to be borrowed over 25 years at a fixed interest rate of 8 per cent. The monthly repayments are \$1221, annual ownership costs are \$2000 and capital appreciation is expected to be 4 per cent per year.

The *cash difference* between renting and buying favours renting. At the end of the first year you are better off renting by \$43 292 and after 25 years you are better off renting by \$218 300. However, the comparison changes when we include increases in equity as a result of repaying the loan and capital appreciation.

The *net difference* is negative in the first year, which favours renting. However, the net difference becomes increasingly positive thereafter, which favours buying. The benefit of buying over renting increases the longer you stay in the house. At the end of 25 years, you are better off by \$274 880 if you buy the house rather than rent it.

Rent versus buy analysis is sensitive to forecasts of interest rates and property appreciation rates. To the extent that interest rates are higher and/or the rate of capital appreciation is lower, renting becomes more attractive compared with buying. To the extent that interest rates are lower and/or the rate of capital appreciation is higher, buying becomes more attractive compared with renting. Renting may still be the preferred option if the cash difference is placed in investments that earn a better return after tax than the purchase of a home.

Affordability

If you decide that you want to buy a house, then you need to determine how much you can afford to spend. The main considerations are the savings that you have available for a deposit, your income and expenses, and the maximum repayments that you can afford. As a general rule, 25 per cent

Table 11.1 Monthly repayments for a $158 250 mortgage

Years	5%	6%	7%	8%	9%	10%	11%	12%
10	1678	1757	1837	1920	2005	2091	2180	2270
12	1464	1544	1627	1713	1801	1891	1984	2078
14	1312	1395	1480	1569	1660	1754	1850	1949
15	1251	1335	1422	1512	1605	1701	1799	1899
16	1199	1284	1372	1464	1558	1655	1755	1857
18	1113	1200	1291	1385	1482	1582	1685	1791
20	1044	1134	1227	1324	1424	1527	1633	1742
22	990	1081	1176	1276	1379	1485	1594	1706
24	945	1038	1136	1238	1343	1452	1564	1678
25	925	1020	1118	1221	1328	1438	1551	1667

of your after-tax income is the repayment limit that lenders allow. This amount is used to calculate the maximum loan for which you qualify.

Lenders have schedules showing the monthly mortgage repayments to repay loans with different interest rates and different terms. Table 11.1 shows how the monthly repayment varies depending on the term of the loan and the interest rate for a loan of $158 250. The monthly repayments are lower as the term of the loan increases, and they become greater as the interest rate increases. Notice that the monthly repayment is exactly the same for a 10-year loan at 5 per cent interest and a 24-year loan at 12 per cent interest. However, total repayments for the 10-year–5 per cent loan are only $201 360, compared with total repayments for the 24-year–12 per cent loan of $483 264.

It is important to be sure that you can afford the mortgage repayments before you make a commitment. Can you comfortably save the difference between your current rent and the amount of the mortgage repayments for a trial period? Interest rates may fluctuate, so you also need to take this into account. If the repayments are going to put a squeeze on your budget that makes life impossible, then perhaps this is not the right time to buy a home.

Taking the plunge

Your lifestyle and your needs, constrained by your budget, provide the main focus for choosing a home. Your options include a unit, a townhouse, a suburban house, or vacant land on which to build a new house. You are more likely to compromise on the type of home you choose if you want to live in the city rather than the suburbs. Lifestyle is also an important criterion in choosing a home. Children, schools, pets, privacy, social contact and mobility are some of the concerns that may affect your choice.

Real estate agents will gladly help you find a suitable home. Give the agent as much detail as possible about your preferred choice and price range. They will show you what they have available and keep you informed

about new listings as they come onto the market. They will accompany you to inspect suitable properties and this is a good opportunity to ask about the housing market generally.

When you find the right home, step back and calmly review what may be the biggest decision in your life. Does it make sense to go ahead with a purchase now or are there reasons why it may be better to defer it until later? Is your income and family life stable? Is financing available? Are current interest rates acceptable? Does the offer represent good value? Would it be cheaper to build a new house or buy an existing one?

An emotional decision may cost you dearly. Make sure you know exactly what the vendor is selling before you make an offer. Check the government valuation and pay for a building inspection. Decide what the house is worth to you and be cold-blooded about negotiating the best price. Go back for a second look and a third look before you make an offer, then be patient and let your offer lay on the table until the vendor shows a willingness to negotiate.

The aim of the negotiation process is a formal contract covering the details of the purchase. There are a number of matters over which you and the seller may have differences. Depending on your relative negotiating positions, the final contract for purchase may reflect compromises by both of you or capitulation by one of you. The central negotiating issue is usually price. What is actually paid for a home can be quite different from what it is worth. In other words, price and value are not the same thing. The price paid reflects the negotiating positions of the parties. If the seller's desire to sell is stronger than your desire to buy, then the value you receive may be greater than the price you pay. On the other hand, if you are unable to raise enough money to finance the purchase, then the seller may offer to accept deferred payment if you will agree to a higher price. In this case, you are paying a price that is greater than the value of the house in order to get vendor finance.

THE LEGAL PROCESS

The purchase contract is a legal document between the buyer and seller setting out the terms and conditions of the sale. When the buyer and seller have agreed to the conditions in the purchase contract, it becomes a binding agreement that creates rights and obligations for both parties.

Purchase contract

You and your solicitor should carefully examine the purchase contract to be sure that you understand exactly what is included in the sale. The following items should be included.

- The purchase price.
- The method of financing.
- A description of the property and a list of all items being sold with the property.
- If you are buying off the plan and the building has not commenced or been finished, plans and specifications should be included.
- A statement regarding who is responsible for the property from the date of the contract to the date the property is conveyed to you.
- The amount of the deposit and the conditions under which the buyer or the seller can cancel the contract, such as the buyer's failure to sell another house, inadequate financing, an unsatisfactory inspection report or failure to obtain legal title.
- The date that the contract becomes unconditional and the date for settlement.

You can purchase a property at auction or by an exchange of contracts. An auction is a public sale in which a property is sold by a licensed auctioneer to the highest bidder. It is the bidders who set the price rather than the seller. When the hammer falls at an auction, the highest bidder is legally committed to purchase the property. Under a contract, you are committed to the purchase once the signed contracts have been exchanged. However, you may be entitled to a *cooling-off period* that varies from three to five days, depending on the state in which the property is located.

If the property is to be owned together with another person, then you need to nominate the type of shared ownership in the contract. It can either be *tenancy in common* or *joint tenancy*. If you are a joint tenant and you die, the survivor automatically owns your share. If you are a tenant in common, you can leave your share to whomever you wish in your Will.

There is usually about four to six weeks between the exchange of contracts or auction date and final settlement. During this time, your solicitor will organise legal searches and arrange for you to sign a mortgage if you are borrowing. At settlement, your solicitor receives a signed transfer of the property and the certificate of title to the property. If you have borrowed for the purchase, then the title is held by the lender as security until the loan is repaid. After settlement, the property is yours and you are responsible for insurance, rates and any other costs.

Transaction costs

Transaction costs for a purchase can represent as much as 5 per cent of the price, so you need to budget for them. They include stamp duty, lender's fees and solicitor's fees. The largest transaction cost for a purchase is stamp duty. Stamp duty is a state government tax levied when property is transferred. A first-home buyer can get an interest-free loan over three years to pay stamp

duty. Stamp duty is calculated on the purchase price and it may also be payable on mortgage documents. Your solicitor can give you a quote for conveyancing fees, including disbursements for certificates, survey reports, pest control reports and pre-purchase structural inspections. Other costs include council and water rates adjustments and insurance. Lenders also charge a variety of fees, including a loan application fee and a valuation fee.

Transaction costs for selling a property include solicitor's fees and often a sales commission to a real estate agent. Some real estate agents may also ask you to pay for advertising. The commission rate varies depending on where you live and which agency you choose. It is calculated on a sliding scale that is generally about 3–4 per cent of the selling price. Some people handle their own sale to avoid paying the sales commission by taking over the responsibility for placing advertisements, answering the phone, showing the home and negotiating with potential buyers.

INCOME-PRODUCING PROPERTY

Having paid off your home, you may be tempted to buy another house, a block of flats or a unit. Investing in property means committing your investment funds for the medium- to long-term. Property is not a very liquid asset because you cannot always sell when you wish. There are substantial transaction costs in buying and selling property, and simply holding property results in considerable costs as well. A successful property investment will need to give you a return over and above these costs.

Net rental return and cash flow

Real estate agents typically sell an income-producing property based on the *gross* rental return. For example, a property valued at $200 000 that is rented for $200 a week produces a gross rental return of 5.2 per cent annually. *Net* rental return takes operating expenses into account and represents a more realistic measure of rate of return. A gross rental return of 5.2 per cent may sound satisfactory, but if the property also has annual operating expenses of $5000 for rates, land tax, insurance, repairs and maintenance, the net rental return is only 2.7 per cent.

Net rental return is important, but the cash flows from a property investment are what really count. Many investors borrow money to purchase an income-producing property. Interest is not an operating expense when net rental return is calculated, but it is a significant cash outflow. An investment that is fully or partly financed with borrowed money is said to

be *geared*. An investment is *negatively geared* when there is a short-fall between the rents received and the total expenses, including interest on the loan. This short-fall is tax deductible. While the tax benefits may be attractive, negative gearing means there is always a cash short-fall that the investor will need to finance from other sources.

To get the maximum tax benefit from negative gearing, ensure that all legitimate tax allowances are claimed. Deductions include repairs (not structural alterations or improvements), maintenance, rates, insurance, agent's fees to collect rent, land tax, preparation and registration of leases, and legal fees for recovering unpaid rent or evicting tenants. Deductions can also be claimed for depreciation. Depreciation allows you to write off the cost of an asset as it wears out over time. Depreciation is allowed on fittings and fixtures, including floor coverings, furniture, hot water services, stoves, blinds, refrigerators and other white goods. However, depreciation is not allowable on stainless steel sinks, bathroom cabinets, wash basins, laundry tubs and other items that are generally built-in. The incidental costs of borrowing to buy an investment property, such as loan application fees and legal fees, are deductible over the period of the loan or five years, whichever is shorter.

Figure 11.2 is an example of the annual cash flow for an investor who purchases a $200 000 rental property with an interest-only loan at 7 per cent for the full amount. The gross annual rent is $10 000 before interest expense of $14 000 and other deductible expenses of $2000 per year. The pre-tax cash short-fall is $6000, but that is reduced by a tax saving of $2820 if the investor is in the 47 per cent tax bracket. The resulting after-tax cash short-fall is only $3180.

Figure 11.2 Annual cash flow

	$
Gross rent	10 000
Less interest expense	(14 000)
Less other expenses	(2 000)
Pre-tax cash shortfall	**(6 000)**
Tax saving at a marginal tax rate of 47%	2 820
After-tax cash shortfall	**(3 180)**

After-tax capital gain

Net rental return captures only part of the return from a property investment, because the annual cash flow forecast does not include the resale of the property. The overall success of negative gearing relies on a capital gain that compensates for the cash short-falls over the life of the investment. Figure 11.3 includes the effect of the capital gain when the property in Figure 11.2 is sold

after five years for $235 000. The inflation component of a capital gain is not taxable and $25 000 of the sale price is due to inflation.

Figure 11.3 After-tax capital gain

	$
Sale price	235 000
Purchase price	(200 000)
Capital gain	35 000
Capital gains tax	(4 700)
After-tax capital gain	**30 300**
Accumulated cash short-fall (5 years x $3180)	(15 900)
Overall return	**14 400**

The capital gain is $35 000. When the inflation component of $25 000 is subtracted, the result is a taxable capital gain of $10 000. At a marginal tax rate of 47 per cent, the tax on the capital gain is $4700, leaving an after-tax capital gain of $30 300. Over five years, the accumulated cash short-falls are $15 900. When this amount is recovered from the capital gain, it leaves an overall return of $14 400.

The overall return in Figure 11.3 is very sensitive to rates of capital growth and changes in interest rates. For example, if the sale price had been only $215 000, the capital gain would not be enough to cover the accumulated cash short-fall. This analysis illustrates the risks involved in property investment. The assumptions you make about the selling price, net rental return, interest rates on borrowed funds, and inflation all contribute to estimating the final return. However, each of these is subject to changes than may significantly alter the final return.

Banks, building societies, credit unions and other lenders provide *property investment* loans for those who wish to finance part of their property investments. The interest rate is higher and the repayment term is shorter than for an equivalent home loan. Most of the home loan options are also available to property investors, including fixed or variable interest loans, interest-only loans and flexible repayment options.

Managing the property

Direct property investments include management responsibilities such as finding good tenants and maintaining and improving the property. It is an active form of investing in which time, energy and knowledge are important. A *Tenancy Act* operates in each state that governs the obligations of tenants and landlords. These include drawing up leasing agreements, use of bond money, commitment of the landlord to maintain the property, rules of vacating and eviction, and the landlord's right of entry to the property. If

you do not want to be involved in the day-to-day management of your property, most real estate agents provide property management services for a fee.

The secret to regular rental income is to invest in property that is highly sought after by tenants. Evaluate a prospective property investment with the tenant's wants and needs in mind. Managing a rental property means keeping it attractive to ensure high occupancy rates and increasing its capital value by refurbishing, renovating and extending. Regular maintenance is critical in attracting and keeping good tenants. It also preserves the value of a property when the time comes to resell it. Rental properties do not maintain themselves, so you need to decide who is going to be responsible and what it is going to cost for various types of maintenance.

- internal and external painting
- repairing leaking taps and pipes
- replacing loose or broken wiring
- treating rising damp on walls and floors
- keeping timber floorboards oiled or varnished
- clearing gutters and downpipes
- pruning and clearing garden rubbish

There are other ways to add value, such as extending or renovating. If you buy a property that is already fully developed, then you may not have much scope for adding value. Look for a property with the potential to make improvements that add value. Landscaping is also a way to add value. If you are skilled at renovating or landscaping, then you may not only find these projects financially rewarding, but also personally satisfying.

The cost of renovations and extensions depends on the design of the building and the materials chosen. Other costs include council fees, architect's fee and builder's fees. Consider these costs before you begin and satisfy yourself that renovating or extending *will* add value. Be careful not to over-capitalise a property by spending more money on it than you can get back when you resell it.

PROPERTY SYNDICATES

If you do not want to be actively involved in property investment, you can invest in a property syndicate. Property syndicates are an opportunity to become a part owner of a building. You are part of a group of investors with a property manager. Investment in a property syndicate is long term, because your money is tied up until the syndicate terminates and the building is sold. Syndicate assets include regional shopping centres, suburban office buildings, petrol stations and factories. The prospectus is an invitation to invest and it includes the following information.

- forecasted income distributions and capital gains
- assumptions used to forecast returns
- level of fees charged
- level of borrowings
- quality of assets purchased

The prospectus does not tell you very much about the quality of the property manager, and this may make the difference between a good investment and a bad one. Look for a manager with experience in renewing leases and the ability to handle things like losing a major tenant or refurbishing the building if the need arises. If you are unsure about the investment, get advice before you take the plunge.

Part E
Taxation

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12 The taxation system

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Taxes are levied at the Commonwealth, state and local government levels. Taxes can be raised directly by taxing income, or indirectly when income is spent. Currently, more than half of tax revenue is derived from Commonwealth income tax, including income taxes levied on individuals and enterprises. The remainder comes from the GST and other indirect taxes such as taxes on international trade and excise duties.

The Commonwealth shares part of the income tax revenue with the state governments so that they can deliver the education, health and other services for which they are responsible. The states also levy taxes of their own, such as payroll tax, stamp duties, gambling and other taxes. Rates and other charges are paid to local government to fund the services provided to households and businesses by municipal councils.

The purpose of this chapter is to outline the fundamental operation of our tax system. It explains the types of taxes we pay, how to do your income tax, how to calculate a capital gain and the benefits of dividend imputation. The next chapter focuses on tax planning.

THE TAXES WE PAY

The taxes we pay can be divided into three categories. Expect to pay tax on much of what you buy. If you own property, expect to pay tax for the privilege of owning it. If you earn income, expect to pay tax on that as well.

We pay tax on a variety of purchases, known as GST. GST is added to the retail price of goods and services. GST is charged at 10 per cent on most goods and services we buy and is included in the price. GST replaced sales tax in July 2000. It resulted in an increase in the prices of some goods and a reduction in the price of others.

We pay taxes on property. Rates on land and buildings are a major source of revenue for local governments. Land tax is paid to state governments on properties that are not your main residence. Rates and land tax are based on the value of land and buildings, so if you decide to increase the value of your property, expect your taxes to go up as well. State governments also impose stamp duty on the transfer of property such as land and buildings, shares and motor vehicles.

Income tax is the biggest and most visible tax for people in paid employment. Throughout the year, your employer withholds income tax payments on your behalf and sends them to the Australian Tax Office (ATO). If you are self-employed or earn income from investments, then you may be making Pay-As-You-Go (PAYG) tax payments yourself. You prepare an income tax return at the end of the financial year and that is

when you find out if you will get a refund or if you must pay more tax. Since you have more discretion to manage your income tax affairs than you do with GST and property taxes, we shall focus on income tax.

INCOME TAX

The income tax system is a self-assessment system. Although income tax rates are set by law, the amount of income tax you pay depends on the assessment of your taxable income. Your tax return tells the ATO what your income is and the deductions to which you are entitled. There are information guides and people like tax agents that can help you to complete and lodge your tax return. The taxation process consists of a series of steps.

- Making payments during the year.
- Preparing a tax return.
- Lodging the return with the ATO.
- Receiving an assessment notice.
- Receiving a refund or making a further payment.

Pay-As-You-Go (PAYG)

The majority of income taxes are withheld from wages. This is known as Pay-As-You-Go (PAYG). The idea is to collect taxes gradually during the year so that, when your taxes become due, you won't be paying your tax in one lump sum. Otherwise, you may be tempted to spend the money that you should be saving to pay your taxes.

You do have some control over how much is deducted for taxes from your wages. Your withholdings are determined by your income and the information you provide to your employer or employers if you have more than one job. You pay income tax on amounts greater than $6000. This is called the *tax-free threshold*. If you receive wages from more than one employer, then you can only claim the tax-free threshold with one of them.

If you are eligible for a rebate for a spouse or as a sole parent, or you receive a family tax benefit, then you can arrange to have less tax withheld. Some people don't bother to reduce their withholdings and prefer to receive a tax refund at the end of the year. However, if they saved this money instead, they could earn interest on it.

If you derive income from services other than salaries and wages you are also required to make income tax instalments under the Pay-As-You-Go (PAYG) system. For example, if you operate a business as a sole proprietor or partner, or you earn investment income, you will pay PAYG instalments. The ATO uses a formula to determine your instalment rate, and you are

notified of this rate. The tax is normally paid either annually, each quarter or each month if the business is withholding tax on a monthly basis. Payments are made using an activity statement which is used to report and pay PAYG instalments and withholding amounts.

Preparing your income tax return

You need to lodge a tax return if you had tax deducted from your income, or if you were required to lodge a PAYG activity statement, paid an instalment during the year and the instalment has not been fully refunded. You may also have had amounts withheld from interest, dividends or trust distributions because you did not quote your tax file number or Australian Business Number. Lodging a tax return is the *only* way to get your money back if you have overpaid your tax. You also need to lodge a tax return if you received a government benefit or allowance and you had other income. Tax is paid on income in excess of $6000 in any year. If your income exceeded this amount, you need to lodge a tax return. If you ceased full-time education for the first time, you will have a lower tax-free threshold.

To complete your own tax return, you need a *TaxPack*. It contains the tax forms that you send to the ATO by 31 October and it also contains the information you need to complete the form correctly. A *TaxPack* is sent to every household that used one for the previous year; it is also available from newsagents and the ATO.

The *TaxPack* may look daunting at first, but you will find that it is easy to use. If a question at the top of a page doesn't apply to you, simply turn to the next question. *TaxPack* asks questions about your income, your deductions and whether you are eligible for rebates. Completing your tax return consists of the following steps.

- Identify your *assessable income.*
- Identify and document your *allowable deductions.*
- Calculate your *taxable income* by subtracting your allowable deductions from your assessable income.
- Calculate your *tax liability* by applying the tax rates to your taxable income.
- Reduce your tax liability by subtracting any *tax offsets* to which you are entitled.
- Increase the amount you owe if you are liable for the Medicare levy or a HECS debt.
- Compare the amount you owe with the income tax payments withheld or made during the year to determine if you need to pay an additional amount or if you will get a refund.

Assessable income

If you are a resident of Australia, your assessable income includes income from all sources whether in or out of Australia. If you are not a resident, your assessable income includes only income from all sources in Australia. Gross assessable income consists of earned income and investment income.

Earned income is money received for personal effort. It usually takes the form of wages, salaries, commissions, fees, tips and bonuses. If tax has been deducted from your wages, your employer will issue you with a *payment summary* at the end of June. Figure 12.1 is an example of a payment summary. It shows your tax file number, your name and the period of employment with that employer. It records your gross income for the tax year and the amount of tax that has been withheld. It also lists any allowances or lump sum payments that you may have received and any union fees deducted from your salary. You attach your group certificate to your tax return. Profits from a business or profession are also earned income. Other records are kept to report assessable income for a business or profession.

Investment income is received in the form of interest, gains or losses on the sale of investments, royalties, dividends, annuities and rent from investment properties. A variety of records are kept to report investment income. These are listed in the next chapter.

Some types of income are *excluded*. An exclusion is not included in gross income and it is referred to as tax-exempt income, or income that is not subject to tax. Lottery winnings and prizes are exempt income. Maintenance payments and child support are exempt income. Gifts are not taxable unless they are given as a reward for services or where there is some connection with your profession. For example, prizes and awards received by amateurs in sport are generally not income, whereas prizes received by a professional are generally treated as income because winning prizes is how they earn a living. Gains from gambling are also exempt from income tax.

Allowable deductions

A tax deduction is an amount that is subtracted from gross income to arrive at taxable income. Employment-related expenses are deductible. These include work-related car expenses, travel expenses, payments for uniforms and protective clothing, and self-education expenses. If your employer makes tax-deductible payments on your behalf, such as union dues, the amounts will be listed on your group certificate. If expenses are directly connected with earning your income they are deductible, but if they are of a private or domestic nature they are not allowed. This is why travel to and

Figure 12.1 PAYG payment summary

Australian Taxation Office

PAYG Payment Summary - Individual Non Business

00460300

Payment Summary for year ending 30 June

FBT year
1 April to 31 March
Reportable fringe benefits amount
$ .00

Payer details
Payer's ABN or withholder payer number
Branch number
Payer's name

Payee details
Payee's tax file number
Payee's date of birth (optional)
Payee's surname or family name
Payee's given name(s)
Payee's address – Street number and street name
Suburb/town/locality
State
Postcode

Period during which payments were made
To

Total tax withheld (whole dollars)
$ .00

Total tax withheld – whole dollars only in words
Thousands Hundreds Tens Units

Gross payments (whole dollars) (excluding amounts shown under 'Allowances', 'Lump sum payments', CDEP salary or wages and any 'Other income')
$ .00

CDEP salary or wages (whole dollars)
$ .00

Other income (whole dollars)
$ .00

Allowances (give details)
Amount (whole dollars)
$ .00
$ .00
$ .00
$ .00
Total allowances $ .00

Lump sum payments (whole dollars)
A .00
B .00
D .00
E .00

ATO Original

Union fees, etc.
Name of organisation
Amount (whole dollars)
$ .00

NAT 46-3.2000

Signature of authorised person
Date
/ /

SAMPLE ONLY

from work and childcare expenses are not tax deductible. Gifts or donations of $2 or more to eligible organisations, known as deductible gift recipients, are deductible. If you borrow money to invest in income-producing assets like shares or rental property, then the interest is deductible.

Calculating your tax liability

In order to calculate your tax liability, you begin by subtracting your allowable deductions from your assessable income to find your *taxable*

income. Then apply the tax rates to your taxable income. Table 12.1 is the income tax scale for the 2001/02 tax year.

Table 12.1 2001/02 income tax scale

Taxable income ($)	Tax rate (%)
0–6000	0
6001–20 000	17
20 001–50 000	30
50 001–60 000	42
60 001+	47

No tax is payable for taxable income up to $6000 unless you are a non-resident. Tax is calculated at the rate of 17 per cent for taxable income between $6001 and $20 000. Taxable income between $20 001 and $50 000 is taxed at 30 per cent and taxable income between $50 001 and $60 000 is taxed at 42 per cent. Taxable income over $60 000 is taxed at 47 per cent. The amounts of tax in each bracket are added together to arrive at your total tax. The 17 per cent, 30 per cent, 42 per cent and 47 per cent rates are referred to as *marginal tax rates*. If you are in the 30 per cent tax bracket, it means that your top rate of tax is 30 cents for every dollar of taxable income in that bracket. Your marginal tax rate is important because it not only tells you the amount you will pay in tax on any additional income, but also the amount by which an allowable deduction will reduce your tax.

Family Tax Benefit

A benefit called the *Family Tax Benefit* (FTB) is available to families either at the end of the income year as a lump sum or as a fortnightly payment. The FTB is divided into two parts. The first part provides assistance with the cost of raising children, and the second part provides extra assistance for families with one main income. These benefits are subject to an income test, which reduces the amount payable.

Tax offsets

You can reduce your tax liability with the tax offsets to which you are entitled. Offsets are tax credits or rebates that are subtracted from your tax. Tax offsets are different from tax deductions. An offset gives you a reduction in tax equal to the amount of the offset. A deduction reduces taxable income, so it only reduces the amount of tax by your marginal tax rate.

This means that a tax offset is worth more than a tax deduction, and a tax deduction is worth more to high-income earners than to low-income earners A $100 tax *offset* reduces your tax by $100. A $100 tax *deduction* reduces your tax by $17 if you are in the 17 per cent tax bracket, by $30 if you are in the 30 per cent tax bracket, by $42 if you are in the 42 per cent tax bracket, and by $47 if you are in the top tax bracket. There are many forms of tax offsets, including credits, concessional rebates and miscellaneous rebates.

Credits are allowed for

- foreign tax paid
- franked dividends
- group certificate tax instalment deductions

Concessional offsets are targeted at

- people facing higher domestic costs due to dependants such as spouses, child-housekeepers and invalid relatives
- people with housekeepers
- people on low incomes
- medical expenses

Miscellaneous offsets are for

- pensioners and Social Security beneficiaries
- superannuation contributions
- health insurance premiums

Offsets can only be used to reduce your tax liability, so you will not get a refund if your total offsets exceed the amount of tax payable. Nor can offsets be used to reduce the Medicare levy or a HECS debt. These are not tax debts; they are obligations that are based on your taxable income which are collected through the tax system.

Medicare levy

A resident of Australia is liable to pay a *Medicare levy* based on their taxable income for the year. This is a levy to support the national health system. The present rate is 1.5 per cent of taxable income. Relief is provided for low-income earners. High-income earners without adequate private hospital insurance are liable for an additional 1 per cent *Medicare levy surcharge*.

Higher education contribution scheme (HECS) debts

HECS is a compulsory fee imposed on university students which they can elect to defer until their *HECS repayment income* reaches a minimum level which is presently $23 242. HECS debts owed to the Commonwealth Government are collected through the tax system. The higher the taxable income, the greater the rate of repayment. For example, when taxable income reaches $23 242, then repayments begin at the rate of 3 per cent of taxable income. If taxable income goes over $41 838, then the repayment rate becomes 6 per cent of taxable income.

Lodging the return

Ask for help if you are uncertain about any sections that you are asked to complete in TaxPack. The first place to get help is the Australian Tax Office. In addition to the instructions in *TaxPack*, the ATO has a number of free booklets. The ATO also provides a phone service for tax questions. The ATO has an Internet site where you can access the latest publications and tax rulings at http://www.ato.gov.au.

There are a number of computer software packages available for tax preparation. If you use one, make sure it is an ATO-approved package, otherwise they will not accept your return. *TaxPackExpress* is available from post offices. If you take your completed return to the post office, it can be keyed in and lodged electronically for a fee of $21.50. Lodging your return electronically means faster assessment and a prompt refund. Direct credit of your tax refund to your bank account is also available. You can also complete and lodge your return using the ATO electronic lodgement system, *e-tax*. This allows individual taxpayers to lodge their personal income tax returns over the Internet. The e-tax Internet address is http://www.etax.ato.gov.au.

Another alternative is to engage the services of a tax agent. If you do this, remember to choose a *registered* tax agent. A tax agent may be employed by a franchise organisation, or they may be an independent tax agent. The franchise organisations give their employees standardised training that keeps them current with the latest tax law changes and ATO tax rulings. Their services are generally focused on less complicated tax returns. Independent tax agents are formally trained in tax law with a university degree in Commerce or Law. If your return is done by a registered tax agent, make sure you understand and approve the information that is submitted on your behalf. If the 31 October deadline is looming and you have run out of time, you may want to be on a tax agent's lodgement list.

Tax agents are able to lodge returns throughout the year and this may avoid having to pay late lodgement penalties.

Assessment

After you lodge your tax return, you will receive a written notice of assessment. It explains your tax liability and the amounts credited. The expected processing time for paper returns is six weeks. If your return is lodged electronically, a refund takes 14 days. If there is something more to pay, the assessment is not due until 21 November at the earliest. Check your assessment carefully. If you change your address, tell the ATO immediately, otherwise a refund cheque, assessment or other notice might go astray.

Your assessment notice shows your tax file number and the date of issue. The taxable income is listed, including any capital gains. Tax payable is shown as a debit amount. The Medicare levy and HECS repayment are also listed separately. Offsets and tax withheld are shown as credit amounts. When you receive your assessment notice, check to make sure that all details are correct.

If you are dissatisfied with your assessment, you can object. The objection must be in writing and lodged within four years of receiving the assessment. It does not need to be in legal terms, but it must clearly show the particular item in dispute and your reasons for believing that the assessment should be altered.

Correcting mistakes

Sometimes people make a mistake on their tax return or later realise that an important deduction was omitted. The ATO has amendment forms that you can lodge, but there are some limitations on the use of an amended return. An amendment reducing your liability must be made within four years.

Taxpayers' Charter

The Taxpayers' Charter sets out your rights and obligations under the law, the service and other standards you can expect from the ATO, and what you can do if you are dissatisfied with its decisions and service. Copies of the Taxpayers' Charter are available from the ATO. In general terms, this is what you can expect from the ATO.

- To be treated as honest in your tax affairs unless you act otherwise.
- To be treated fairly and reasonably.

- To be accountable for what it does.
- To offer professional service and assistance to help you understand and meet your tax obligations.
- To respect your privacy and keep information confidential.
- To explain decisions it makes about your tax affairs.
- To give advice and information on which you can rely.
- To help minimise your costs in conforming with the tax law.
- To give you access to information they hold about you.
- To accept that you can be represented by a person of your choice and get advice about your tax affairs.

You also have the following obligations when you deal with the ATO.

- To be truthful.
- To keep records in accordance with the law.
- To take reasonable care in preparing tax returns and other documents.
- To lodge tax returns and other required documents or information by the due date.
- To pay taxes and other amounts by the due date.

CAPITAL GAINS TAX

Income tax is paid on gains from selling assets that you bought after 19 September 1985. The sale of an asset is known as a CGT event. There are special rules for calculating the gain relating to a CGT event, and the ATO applies further rules to determine the tax. This part of income tax is called *capital gains tax* (CGT). You show the capital gain or loss in your income tax return. Some of the assets which, when sold, give rise to a CGT event include real estate, shares, options, and units in unit trusts.

Motor vehicles and your home are generally not subject to CGT. Personal use assets, such as clothes and household goods, are excluded from CGT. Other personal use assets, called *collectibles*, are not excluded. Collectibles can be anything from jewellery and art work to stamp collections and antiques that were worth more than $500 when you acquired them.

Capital gains can be *rolled over* for certain assets. This means the gain will not attract CGT at the time ownership of the asset changes. It will be deferred until the new owner sells the asset. This happens when assets are transferred as part of a financial settlement in a divorce or when assets pass to beneficiaries on the death of the owner.

Calculating a capital gain

How you calculate your capital gain depends on when the asset was acquired and when it was sold. For assets held for 12 months or more the alternative methods are indexation or the discount method. Indexation applies to assets that were acquired after 19 September 1985 and before 21 September 1999. The discount method applies to assets purchased after 19 September 1985. You can generally choose to use either the indexation or discount method when calculating a capital gain; however, the indexation method cannot be applied to assets acquired after 21 September 1999. For assets held for less than 12 months you simply subtract the cost of the asset from the sale price. The remaining amount is the capital gain.

The indexation method

A capital gain results when the proceeds from selling an asset are greater than the cost base. The *cost base* consists of the original purchase price, the incidental costs of buying and selling the asset, the capital costs of improvements and some current expenses. The cost base is adjusted for inflation if you hold the asset for longer than 12 months. The adjustment factor used is the CPI in the quarter of the sale divided by the CPI in the quarter of the original transaction. Table 12.2 is the CPI since the September quarter of 1985, until indexation was frozen in September 1999. If the asset is sold after September 1999 and the indexation method is used, the CPI figure used to calculate the capital gain is September 1999 (123.4).

Table 12.2 Consumer Price Index (CPI)

	March	June	Sept	Dec
1985	–	–	71.3	72.7
1986	74.4	75.6	77.6	79.8
1987	81.4	82.6	84.0	85.5
1988	87.0	88.5	90.2	92.0
1989	92.9	95.2	97.4	99.2
1990	100.9	102.5	103.3	106.0
1991	105.8	106.0	106.6	107.6
1992	107.6	107.3	107.4	107.9
1993	108.9	109.3	109.8	110.0
1994	110.4	111.2	111.9	112.8
1995	114.7	116.2	117.6	118.5
1996	119.0	119.8	120.1	120.3
1997	120.5	120.2	119.7	120.0
1998	120.3	121.0	121.3	121.9
1999	121.8	122.3	123.4	

In order to index the cost base, it is important to keep good records of transaction dates. Original documents such as purchase and sale agreements,

Figure 12.2 Capital gain—indexation method

Gross sale price		**$400 000**
Less indexed cost base		
Mar 1988: purchase price + costs $220 000 indexed by 1.418 (123.4/87.0)	$311 960	
Sept 1990: improvements $50 000 indexed by 1.195 (123.4/103.3)	59 750	
Dec 1999: costs of sale $15 000, not indexed	15 000	**386 710**
Taxable capital gain		**13 290**

invoices, construction contracts, brokers' statements and valuation records need to be retained. Figure 12.3 is an example of how to calculate the indexed cost base and capital gain using the following information.

- An investment property was acquired in March 1988 for $200 000, with incidental costs of purchase of $20 000.
- Improvements costing $50 000 were made in September 1990.
- The property was sold in December 1999 for $400 000 and the selling costs were $15 000.

The adjustment factor is calculated by dividing the CPI at the time of sale by the CPI at the time of the original transaction.

- The adjustment factor for the purchase consists of the CPI for the September quarter of 1999 (123.4) divided by the CPI for the March quarter of 1988 (87.0). It is multiplied by the original cost of purchase to find the indexed cost base of $311 960.
- The adjustment factor for the improvements consists of the CPI for the September quarter of 1999 (123.4) divided by the CPI for the September quarter of 1990 (103.3). It is multiplied by the original cost of improvements to find the indexed cost base of $59 750.
- The $15 000 in costs associated with the sale is not indexed.
- The gross sale price is $400 000. Subtracting the total indexed cost base of $386 710 leaves a taxable capital gain of $13 290. Indexing results in a smaller taxable capital gain because the part that is due to inflation is not taxed.

The discount method

The discount method can be applied to a capital gain when the asset was purchased after 19 September 1985 and sold on or after 21 September 1999, and has been held for a period of 12 months or more. Using the discount

Figure 12.3 Capital gain—discount method

Gross sale price		**$400 000**
Less cost base		
Mar 1988: purchase price + costs	$220 000	
Sept 1990: improvements	50 000	
Dec 1999: costs of sale	15 000	**285 000**
Capital gain		**115 000**
Less 50% discount		**57 500**
Taxable capital gain		**57 500**

method, a capital gain results when the proceeds from selling the asset are greater than the cost base. Unlike indexation, the cost base is not adjusted for inflation. Any capital gain calculated using the discount method for individuals is reduced by a 50 per cent discount. Figure 12.3 is an example of how to calculate a capital gain using the discount method. Using the same information as for the example shown in Figure 12.2, the discount capital gain is calculated by taking the proceeds from selling the asset from the cost base of the asset.

The gross sale price is $400 000. Subtracting the total cost base of $285 000 leaves a capital gain of $115 000. The 50 per cent discount is then applied to the capital gain, resulting in a taxable capital gain of $57 500.

Where an asset was acquired before 19 September 1999 and sold after that date, and was owned for at least 12 months, individuals have a choice of whether to use the indexation or discount method. The choice will depend on which method produces the smallest capital gain. In the example above, the taxpayer would choose to use the indexation method as it results in a gain of $13 290, compared to the discount capital gain of $57 500.

However, the indexation method will not always produce a smaller capital gain. It depends on how long the asset has been owned, when any improvements were made, as well as other factors. It is best to calculate any capital gain using both the indexation method and discount method to determine which one produces the best result.

How to calculate a capital loss

A capital loss results when the proceeds from the sale of an asset are less than the original cost. In the case of a capital loss, the cost base is not indexed. A loss can only be used to reduce a capital gain and not your ordinary income. If it is not used in the current year, it can be used in

future years. Figure 12.4 is an example of how to calculate a capital loss using the following information.

- Shares were purchased in April 1992 at a cost of $25 000 and sold six years later in February 1998 for $22 000.
- Stockbroker commissions on purchase and sale were $1180.

You show the net capital gain (or loss) in your tax return, consisting of the difference between all of your capital gains and all of your capital losses during the tax year. If there is any tax payable, you will be advised on your assessment notice. If you have a net capital loss, although it must be shown in your tax return, it cannot be used until you have an offsetting capital gain.

Figure 12.4 Capital loss

Sale price		**$22 000**
Less cost base		
Original purchase price	25 000	
Costs of acquisition and disposal	1 180	**26 180**
Capital loss		**(4 180)**

DIVIDEND IMPUTATION

Dividends paid by Australian companies attract dividend imputation credits provided that the dividends are paid out of company profits on which company tax has already been paid. These are generally referred to as *franked dividends*. The amount of the franking credit depends on the amount of tax that the company paid. Unfranked dividends carry no franking credits. The company sends you a statement of your franking credits along with your dividend.

The amount of the dividend and the amount of the credit are added together, or *grossed up*. The grossed-up amount is included in your assessable income and the credit is included in your tax offsets. If you are on

Table 12.3 Tax on dividends

Gross amount ($)	Tax rate (%)	Gross tax ($)	Franking credit ($)	Net tax (credit) ($)
1000	47	470	300	170
1000	42	420	300	120
1000	30	300	300	0
1000	17	170	300	(130)
1000	0	0	300	(300)

the top marginal rate of tax, then you will pay some tax on fully franked dividends. If you are on a lower tax rate, you may actually receive surplus tax credits from fully franked dividends. For example, suppose you received a dividend cheque for $700 together with a statement indicating a franking credit of $300. The amount of tax that you will pay depends on your marginal tax rate on the grossed up amount of $1000. Table 12.3 demonstrates how the net tax or credit results, depending on your tax bracket.

If you are in the 47 per cent tax bracket, the gross tax will be $470. You can use the tax credit of $300 to offset this amount, leaving a net tax of $170. If you are in the 17 per cent tax bracket, gross tax will be $170. When the tax credit of $300 is offset against this amount, a tax credit of $130 remains that may be offset against tax on other income.

The dividend imputation system has significant tax implications for people in the top tax bracket who are considering shares versus fixed interest investments. For some taxpayers, a fully franked 6 per cent dividend yield is equivalent to a 9 per cent interest yield on an after-tax basis.

TAX AUDITS

The ATO randomly audits the returns of thousands of taxpayers. No one likes to be audited. Unless you are deliberately evading tax, however, there is nothing to worry about. The Income Matching System uses your tax file number to match information provided in your tax return with information from your employers, banks and financial institutions and government departments. If you earn income from interest, dividends, trust distributions, Social Security benefits, pensions or rental income, an audit checks to ensure that you have disclosed all the income that you have earned from these sources.

Desk audits are designed to check the accuracy of returns of salary and wage earners, property income earners and investors. You attend an interview with an ATO auditor and you will be asked to bring to the interview documentary or other evidence to support your claims. The most common areas that are checked include the following items.

- undisclosed income
- unexplained periods of unemployment
- car expenses
- deductions for work-related expenses
- travel expenses
- gifts to approved charities
- dependant rebates

Penalties are imposed if you are found to have understated your assessable income or overstated your deductions. A flat penalty of up to 25 per cent can be imposed if you failed to take reasonable care in preparing the return. While it is your responsibility to provide information and answers to an auditor's queries, you can have your tax agent present to help answer questions and to protect your rights.

13 Taxation planning

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The objective of tax planning is to arrange your affairs in ways that permit you to minimise your tax liability. Knowing the current tax law enables you to take advantage of the tax benefits that match your personal and financial circumstances. Moreover, tax laws change and each year the Australian Tax Office (ATO) modifies the *TaxPack* and lodgement procedures. The purpose of this chapter is to examine the following components of an overall tax plan with a view to minimising the amount of income tax that you pay.

- reducing assessable income
- maximising deductions and offsets
- income splitting
- capital gains
- tax-effective investments
- tax records

REDUCING ASSESSABLE INCOME

Knowing when income is due and how it is taxed means you may be able to plan employment income, investment income, capital gains or retirement payments to take place in low-income years. Marginal tax rates mean you can pay less tax if your total annual income does not unnecessarily creep into the next tax bracket.

Employment income

Salary and wages are assessable in the tax year they are paid, which may be different to the tax year in which they are earned. If a cheque for wages or a bonus is posted to arrive after 30 June, it becomes part of your assessable income in the next tax year. Wage earners can also arrange for employers to divert bonuses and incentives into superannuation at the end of the tax year. This strategy is called *salary sacrifice*. Salary sacrifice enables an employee to replace a part of their salary with other benefits so that their income tax is based on a reduced salary and the benefit is received untaxed.

The value of the benefit may be subject to *fringe benefits tax* (FBT) paid by your employer. The optimum remuneration package depends on your age, lifestyle, financial circumstances and whether your employer is exempt from paying FBT. Some salary packaging options are listed below.

- Items that are an allowable deduction for your employer or that are exempt from FBT, including superannuation and employer-sponsored child care.

- Expense payments such as professional membership fees.
- Items that are used primarily for business purposes, such as a mobile phone and a laptop computer, that are not subject to FBT.
- Provision of a motor vehicle.

Another form of salary packaging is called a *novated lease*. This is a leasing arrangement in which an employee leases a car and then sub-leases it to their employer. The car is recognised as a company-provided car and therefore a fringe benefit. All of the rights and obligations of the lessee must be transferred from the employee to the employer.

Figure 13.1 demonstrates the tax benefit of salary packaging with a novated lease. The employee has the choice of receiving an annual salary of $60 000, or an equivalent annual salary package consisting of a $48 000 salary and a motor vehicle that costs the employer $12 000. Take-home pay after income tax is less for the salary package. When car expenses are deducted, however, the salary package is worth $4800 more than the straight salary.

Figure 13.1 Example of salary packaging

	Straight salary	Salary package
Gross salary	60 000	48 000
Novated lease	0	12 000
Total package	60 000	60 000
Income tax on gross salary	15 580	10 780
Take-home pay	44 420	37 220
Less car expenses	12 000	0
Net cash remaining	32 420	37 220

Investment income

Interest, dividends and net rental income are taxable income in the year they are received. You can transfer income into the next tax year by investing your money so that interest is paid after the end of the financial year. If you own a rental property, there are tax planning opportunities in bringing tax-deductible expenditure forward by incurring expenses for repairs sooner and updating depreciable plant and equipment. Claims can also be made for the cost of extensions, renovations and improvements to income-producing buildings averaged over 40 years.

Trust distributions must be declared in the year the income is earned by the trust, not the year in which the distribution is received by the beneficiary. For example, suppose your discretionary family trust earns net

income of $25 000 for the year ended 30 June and the trustee distributes some of that net income to you in August. You disclose this income in your tax return for the year ended 30 June. This is not the case if you receive a distribution from a public trading trust like unit and property trusts, in which distributions received after 30 June can be declared in the following tax year. Investing in a managed fund or other projects that defer income can be an attractive tax-planning device for the following reasons.

- Next year's marginal tax might be lower than this year's marginal rate. This can occur if you retire or if you are not working.
- Even if you pay the same amount of tax, deferring it means the funds can be invested until the tax is due.
- Any investment that defers your return into the future offers tax advantages. For example, shares in a growth company may pay little or no current dividends that would be taxable and you may be able to realise your total return as a capital gain when you eventually sell the shares.

Termination of employment

The lump sum you receive when you retire is called an *eligible termination payment* (ETP). Concessional rates of tax apply to lump sum ETPs. The tax you pay depends on your age, what your ETP consists of and the *low tax threshold* that applies in that year. The threshold increases according to movements in the Average Weekly Ordinary Time Earnings and was $105 843 for 2001/02. It is possible to take advantage of the increasing low tax threshold by delaying retirement until the next or future years. If you are not able to do this, part of your ETP can go into a rollover fund to be withdrawn later. If your ETP has a pre-July 1983 component, then only 5 per cent of this will be taxed at your marginal tax rate.

For the post-June 1983 component, the rate depends on whether it is being paid from a superannuation fund, which is taxed, or from a non-taxed source like a golden handshake. If you retire before age 55, you do not get the benefit of the low tax threshold. Payments from a non-taxed source are taxed at a greater rate than a taxed source. Table 13.1 shows that if you retire when you are 55 and receive your ETP from a superannuation fund, there is no tax on the first $105 843 and the remaining balance is taxed at 15 per cent. However, if you receive a termination payment that is from an untaxed source, then you will be taxed at a greater rate.

Table 13.1 Tax rates for ETPs

Source	Under 55 years	Over 55 years
Taxed source such as a superannuation fund	20%	15% on amounts over $105 843
Untaxed source such as a golden handshake	30%	15% on the first $105 843 plus 30% on the balance

MAXIMISING DEDUCTIONS AND OFFSETS

Maximising deductions minimises your taxable income. You can maximise deductions by knowing what expenses you are allowed to deduct and keeping the documentation that proves you paid them. Work-related expenses and investment expenses can be claimed, and you may be able to take advantage of superannuation deductions if you are self-employed. Eligible gifts and donations may also be deductible. Make sure that your deductible expenses are paid before 30 June if you are claiming them in the current tax year.

Work-related deductions

A deduction from employment income can be claimed if the expense is related to your income, it is not a private or capital expense, and you have written evidence of the expense. General work-related expenses include union fees, self-education expenses, some travel expenses, business tools and tools of trade. There are also specific deductions allowed for particular occupations. Your employer or the ATO has information about these.

Private expenses are generally living expenses like food, clothing and shelter. Travel to and from work is a private expense, as is childcare expense. Capital expenses are generally amounts paid for capital assets that you use in your work. If the cost of the asset is $300 or less, or its estimated life is less than three years, the full amount is deductible in the year of purchase. Otherwise the cost is depreciated or written off over the number of years that you expect to use the asset in your work.

You can claim the cost of buying and maintaining a uniform if it is compulsory, the design is registered by your employer, it is protective clothing, or it is specific to your occupation. The cost of replacing, repairing and insuring tools of trade is fully deductible. If the cost of the tool or equipment is less than $300, it is fully deductible. If the cost is $300 or more, it is depreciated. Union fees and professional subscriptions are deductible in the year in which they are paid. Trade publications and technical journals are deductible if used in your work, but lifestyle magazines are not.

Written evidence substantiates or supports your expenses. If the total work-related expenses claimed are $300 or less, no substantiation is required. However, you need to be able to show that those expenses were paid and how they were calculated. The $300 limit does not apply to car expenses and travel and meal allowance expenses.

Travel expenses

A travel diary must be maintained if you travel away from your home for six nights or more and you want to claim the travel expenses. If you receive a travel allowance from your employer for the travel and you do not claim more than the amount considered reasonable by the ATO, no travel records are required. But if the travel is overseas, you are required to obtain written evidence of your travel and accommodation expenses.

Car expenses

There are four methods for claiming car expenses. You can use only one method in any one year. There are different record-keeping requirements for each method and there can be higher or lower claims, depending on which method is used. Choose the method that gives you the highest claim. It pays to keep all receipts and maintain a log book to ensure you can claim the highest deduction.

Under the *cents-per-kilometre method*, there is no need to substantiate any of the car expenses. You make a claim based on the number of work-related kilometres the car travelled during the year. The claim is limited to a maximum of 5000 business kilometres and should be based on a reasonable estimate. You can use this method if you travelled more than 5000 kilometres, but your claim is limited to a maximum of 5000 kilometres.

Under the *12 per cent of original cost method*, there is also no need to substantiate the expenses. The method is only available if the car has travelled more than 5000 kilometres in the tax year. You claim 12 per cent of the cost of the car when it was originally bought or its market value when leased.

If the number of work-related kilometres travelled by the car exceeds 5000, you can use as an alternative the *one-third of actual expenses method*. You can claim one-third of the expenses for the car, including operating expenses, financing charges and depreciation, provided they can be substantiated.

The *log book method* can be used whether or not the vehicle travels 5000 kilometres. You must substantiate all of your car expenses under this method, including registration and insurance, repairs and maintenance, fuel and oil, depreciation if owned and lease charges if leased. A deduction is

allowed based on the work-related percentage of the total kilometres travelled by the car during the year. You need to keep a log book and odometer records to record the total number of kilometres travelled by the car during the year. The log book must be maintained for a continuous 12-week period in the first year in which a claim is made.

Investment deductions

If you are a share investor, you can claim deductions for related expenses. If you borrowed to buy shares, the interest can be claimed. A management fee paid to an investment adviser can be claimed, but not the fee for drawing up the initial investment plan. You may be able to claim travel expenses to your broker or for a company meeting. You can also claim the cost of buying specialist investment journals.

Rental property investors can claim expenses relating to the rental property, but only for the period the property was rented or available for rent. You can claim interest paid on money you borrowed to purchase the rental property, advertising for tenants, bank charges, council rates, depreciation on fittings, insurance, property agent fees or commission, repairs or maintenance, stationery, telephone, and travel undertaken to inspect the property or to collect the rent.

Superannuation

Superannuation is a good opportunity for tax planning purposes and there is the added bonus that you are saving for your retirement. The attraction of making contributions to superannuation is that the earnings are taxed at a maximum of 15 per cent. Employer contributions are similarly taxed at 15 per cent. You can only claim a deduction for personal superannuation contributions if your assessable income from all sources contains less than 10 per cent of wages or salary income. The deduction is limited to $3000 plus 75 per cent of contributions over $3000. There is also an age-based limit on deductions.

If your employment income is 10 per cent or more of your total income, you cannot claim a tax deduction for personal superannuation contributions. However, if your assessable income is below $31 000, then you may be entitled to a *superannuation rebate* of up to $100. This is currently under review; refer to Chapter 14. A rebate is also available if you make superannuation contributions on behalf of your non-working or low-income spouse.

Maximising offsets

Tax offsets are subtracted from tax payable on taxable income. You can maximise tax offsets by ensuring that foreign tax paid on salary or investment income, dividend imputation credits, and tax withheld from wages and salaries are all included when your return is prepared. Tax offsets are also known as rebates or credits.

You maximise offsets by finding out which ones apply to you and your financial situation. This can change from one year to the next as your income changes and your number of dependants increases or decreases. Some offsets, like the low-income rebate, are automatically calculated by the ATO when you lodge your tax return, but others you will need to claim. If your spouse stops work, you may be entitled to a spouse rebate. If you separate and have responsibility for a child, there is a sole parent rebate. A 'first child' tax refund, or 'baby bonus', is also payable for children born after 30 June 2001. A part rebate can be claimed by both parents where joint custody applies. If medical expenses paid for you and your family are large in any year, you may be entitled to a medical expenses rebate. Medical expenses include payments to doctors, hospitals, chemists, dentists and dental mechanics, and for purchases of medical aids, artificial limbs and eyeglasses. If you belong to a private health fund, you may get a rebate. Your health fund will send you information about this rebate at the end of the financial year.

INCOME SPLITTING

You cannot split wage and salary income, because it is a result of your own personal effort. However, investment income or income from carrying on a business can be split between taxpayers. People often place investments in their own name without considering other tax saving options. If you have a business, it should be held in a structure that provides flexibility so that income can be distributed to taxpayers with the lowest income in order to minimise tax. Income splitting usually involves holding investments in joint ownership or partnership, a discretionary trust structure or a private company.

If you invest in your name only, income and capital gains are taxed at your marginal rate. If your salary is above $60 000, this means almost half of your investment income is lost in tax. If you direct investment income to another adult who does not have income, or pays tax at a lower marginal rate, you can save tax. Table 13.2 shows the tax saved when income is split equally between adult taxpayers who have no other income. The tax payable

on income of $48 000 is $10 780. If you split this income between two taxpayers, total tax payable is $7160, or $3580 each. This is a tax saving of $3620. If income is split between four taxpayers, total tax payable is $4080, a tax saving of $6700.

Table 13.2 Tax savings from income splitting

	Individual	Joint ownership		
Number of taxpayers	1	2	3	4
Taxable income for each taxpayer	48 000	24 000	16 000	12 000
Tax paid by each taxpayer	10 780	3 580	1 700	1 020
Total tax paid	10 780	7 160	5 100	4 080
Tax saving		3 620	5 680	6 700

Income splitting takes advantage of the $6000 tax-free threshold and sliding marginal tax rates. A portion of your investment income could be used to pay the university fees of an adult child or the school fees of your grandchildren. If you have children who are students or not in paid employment, $6000 of income can be distributed to each of them tax free. But watch out for penalty tax provisions that apply to investment income for children under 18 years. The tax-free threshold is $416, income between $416 and $1445 is taxed at 66 per cent, and income above $1445 including the first $416, is taxed at 47 per cent.

Partnership

A *partnership* for tax purposes is seen as an aggregation of partners, each of whom has an individual interest in the net income and assets of the partnership. If no written partnership agreement exists, income and losses are shared equally between the partners, as are capital gains. Compared with discretionary trusts, partnerships are limited in the following ways.

- The income flow to partnership members cannot be easily changed.
- Tax laws prevent a single person having control.
- Individual partners are jointly and individually responsible for partnership debts.
- Partners share capital gains and losses.

Discretionary trust

A *discretionary trust* is a legal arrangement that allows assets to be managed by a *trustee* for the benefit of the *beneficiaries*. It is wise to seek legal advice if you want to establish one.

- The trustee has the discretion and flexibility to adjust how much each beneficiary receives each year.
- You can change the distribution of income, depending on the tax and financial situation of each of the beneficiaries.
- If you are the trustee, you can maintain control over the assets.
- Different types of income, such as franked dividends and capital gains, can be directed to different beneficiaries.

For parents or families with a business trust structure, distributing business income to family members can be an efficient tax minimisation process for the family group. If you are contemplating the use of a discretionary trust, however, you should take into account some other considerations.

- Trustees must distribute all income and capital gains to the beneficiaries.
- Automatic exclusion from the tax-free threshold for land tax in those states where your main place of residence is exempt.
- Tax losses stay in the trust; they cannot be distributed to beneficiaries. Partnership losses can be distributed and used by partners to offset against other income.
- Loss of the CGT exemption if the family home is in a trust.

Private company

Many investors mistakenly believe that there are compelling tax advantages in holding investments through a private company. In fact, the opposite is often true. A company is treated as a separate taxpayer from its share-holders. Company income is taxed at a flat rate of 30 per cent. There is no tax-free threshold. However, after-tax income does not have to be distributed to shareholders. This means that income can be distributed to shareholders when it is most tax effective for them to receive it. When dividends are paid, they are taxed at the shareholder's marginal rate after claiming imputation credits for the company tax already paid.

It does not always pay to hold assets that are expected to rise in value in a company. The capital gain cannot be distributed to shareholders as a capital gain, only as dividends. This means that although the company gets the capital gains tax relief for inflation, shareholders will not. They get the full amount of the capital gain as a dividend. Capital gains made on assets sold by a partnership or discretionary trust are distributed as capital gains to partners and beneficiaries.

A company may be a viable structure for succession planning. This means a family business or investments can pass between generations with

minimum tax obligations and financial hardships. There are also other factors to take into account with a company structure.

- Loss of CGT exemption if the family home is owned by a company.
- Loans to shareholders can be deemed to be unfranked dividends. This can happen if your private company owns the investments and you withdraw money.

The choice of structure will usually involve both tax and non-tax considerations, and whether it is the initial choice of structure or a reorganisation. Matters to consider include the rate of tax, liability of the owners, formation costs, continuing administrative costs, ability to distribute and transfer losses, flexibility with income splitting and the method of financing.

CAPITAL GAINS

Another tax planning technique is to have capital assets owned by taxpayers with low marginal tax rates. Capital gains are income and they are taxed at ordinary marginal rates.

Planning the sale of assets can also minimise tax. Holding assets while they increase or decrease in value does not give rise to a capital gain or loss. It is only when you sell the asset that a gain or loss occurs.

- Realise capital losses if you have earned a capital gain from selling other assets. You can offset the loss to reduce the gain.
- Try to delay selling an asset until after it has been held for 12 months, because the 50 per cent discount can apply.

The Tax Act effectively eliminates capital gains tax on the sale of your main residence. For many people, this is the only significant asset they own, so they will probably not have to worry about capital gains tax. However, if you have rented your house for any length of time or used part of it to run a business, the exemption does not apply for that time or for that area of the house.

The exemption of CGT on the main house of residence may cloud investment choices. For example, what if you have savings that could be invested in shares or a rental property, but you decide to upgrade your house instead in the belief that this will save CGT when you sell? Unlike shares and rental properties, your main residence is not an income-producing investment. Tying up capital in your home means you may not have access to it later on. Don't let tax issues cloud your financial goals and lifestyle.

TAX-EFFECTIVE INVESTMENTS

Many *tax shelters* are based on *gearing*, or borrowing money to buy income-producing assets that are also expected to increase in value. Interest on borrowing is tax deductible. When the asset is sold, tax is minimised on the capital gain because capital gains are indexed for inflation. Gearing is likely to be more effective during periods of high inflation than when inflation is low.

Figure 13.2 is an example of gearing. You have $100 000 to invest in a rental property. You can choose between paying cash for a $100 000 property or using the cash for a deposit on a $400 000 property and financing the remaining purchase price with an 8 per cent interest-only loan. You expect a net rental return of 6 per cent annually on both properties and your marginal tax rate is 47 per cent. You also expect the value of both properties to double after six years.

If you invest your cash in the $100 000 property, at the end of six years you will have $19 080 in after-tax income plus $76 500 in after-tax capital gain for a profit of $95 580. If you use your cash as a deposit to gear up to a $400 000 investment, at the end of six years you will have no after-tax income because you used it to pay the interest on the loan. However, you will have a $306 000 after-tax capital gain that is more than three times the profit of the smaller property.

Figure 13.2 Gearing

	Cash purchase $	75 per cent financed $
Equity	100 000	100 000
Borrowing	nil	300 000
Cost	100 000	400 000
Income		
Net rental income @ 6%	36 000	144 000
Interest @ 8%	nil	(144 000)
Taxable income	36 000	nil
Tax @ 47%	(16 920)	nil
After-tax income	**19 080**	**nil**
Capital gain		
Sale price	200 000	800 000
Cost	(100 000)	(400 000)
Capital gains tax (discount method)	(23 500)	(94 000)
After-tax capital gain	**76 500**	**306 000**
Profit	**95 580**	**306 000**

Negative gearing

Gearing describes the relationship between the deposit and the loan you use to buy an investment. It may be a parcel of shares as well as a rental property. When the net rental income or the dividend income is less than the interest on the loan, the investment is said to be *negatively geared*. In Figure 13.2, net rental income exactly matched the interest expense for the geared investment.

Figure 13.3 demonstrates what would happen if the net rental income was only 4 per cent instead of 6 per cent over the six years that you held the property. Net rental income is only $96 000, resulting in a tax loss of $48 000. However, the tax loss can be applied against other taxable income. For a taxpayer in the 47 per cent tax bracket, the tax savings would be $22 560.

A negatively geared investment enables you to offset the loss against other income before calculating your tax. This reduces taxable income by an amount equal to the loss. Non-cash deductions like depreciation on property can boost the tax saving. Saving tax in this way means negative gearing is an attractive tax planning tool. If you borrow to invest in income-producing assets, you can claim a full tax deduction for interest and other expenses associated with the borrowings and the investment.

Figure 13.3 Negative gearing

	$
Net rental income at 4%	96 000
Interest at 8%	(144 000)
Tax loss	(48 000)
Tax saving at 47%	22 560

Figure 13.4 demonstrates how negative gearing becomes more tax effective as your marginal tax rate becomes higher. Assume that we have a pre-tax loss of $3000 per year. The higher the tax rate, the greater the tax benefit and the less the cost after tax.

Figure 13.4 Negative gearing at different tax rates

Marginal tax rate	17%	30%	42%	47%
Pre-tax loss	(3000)	(3000)	(3000)	(3000)
Tax benefit	555	945	1305	1455
Cost after tax	(2445)	(2055)	(1695)	(1545)

The tax benefit partly compensates for the pre-tax loss, but you still need to find enough cash to finance the remaining cash deficit. When you

sell your investment, you hope the capital gain will exceed the accumulated losses. Negative gearing is a popular investment choice in times of high inflation and increasing prices. It is not very effective in periods of low inflation. There are other advantages and disadvantages of negative gearing.

Advantages

- Assets may be built up from a small capital base.
- Gearing enables the purchase of a larger investment than could be bought from personal savings.
- Gearing enables you to more easily diversify your investments.

Disadvantages

- If your income from other sources is reduced, there may not be sufficient cash flow to cover repayments.
- Tax advantages may be less than predicted if your marginal tax rate becomes lower.
- Interest rates may rise, and you may not have sufficient cash flow to cover the increased payments.
- If the capital gain is less than the tax saving and other expenses, a net loss can occur that may be greater than your equity in the investment.

Tax schemes

Investments that are undertaken for tax purposes can bring benefits, but they need careful scrutiny. Some schemes are speculative, high-risk ventures that are specifically devised to minimise tax. Financial advisers are aware of these schemes and can give you advice. If you are interested in one of these schemes, there are some important questions that you should ask.

- Apart from the tax advantages, what are the investment risks?
- Is the scheme legally structured?
- Does the scheme have a prospectus or offer document with enough information to make a judgement?

The ATO has a system of *public product rulings* that enables the Tax Commissioner to rule on whether the tax benefits that scheme promoters advertise are actually available. The ruling process does not offer a guide to the financial viability of a product. However, if a scheme promoter has not applied for a public ruling from the ATO, then alarm bells should be ringing. If a public product ruling has been issued, it formalises the right to tax deductions for investors.

Obtaining tax deductions may be important to you, but it should not be the only factor in evaluating an investment. Look for an investment that is

sound in its own right before including any tax savings. Be sure you understand the proposal, and look closely at the following matters.

- *Quality of management:* Be assured that the directors of the venture have the necessary knowledge, depth of management experience and expertise to maximise investment returns for investors.
- *Fees and expenses:* Establish that the fees and expenses are similar to other projects on offer.
- *Forecasts:* Financial forecasts included in the prospectus are not guaranteed and should be used as a guide only. Are they reasonable and on what factors do they depend?
- *Taxation:* Is the venture structured so that expenses will be allowed as deductions? Is there a public product ruling from the ATO? Tax deductions are only allowed if the expenditure is used to produce income or if the project involves primary production.
- *Questionable features:* Be wary of a scheme that includes features like guaranteed returns, inflated management fees or an intention to exit the scheme when the claimed tax deductions have been allowed but before the income flow has commenced.

TAX RECORDS

Records need to be kept so that you can substantiate the income and deductions disclosed in your tax return. Figure 13.5 indicates what is required for work-related car and travel expenses.

Figure 13.5 Records for work-related expenses

Car expenses	Travel expenses for five nights or more
Receipts for	*Receipts for*
Registration	Accommodation
Insurance	Food and drink
Fuel and oil	Incidental expenses
Repairs	
Log book showing	*Travel diary showing*
Total kms travelled	Nature of activity
Business kms	Day travel began
When log book starts and ends	Length of travel
Odometer readings at start and end	Place of travel

Figure 13.6 indicates what records you need to keep for your investments. For capital gains, keep proof of purchase and disposal records as well as ongoing costs. There are also records that need to be kept for

Figure 13.6 Records for investments

	Purchase and sale	Capital costs	Taxable income	Deductible expenses
Securities	Contract note Carry forward losses	Transaction costs Brokerage	Dividends Franking credits Bonus shares	Interest on loan
Property	Contract of sale Title deeds	Major repairs or extensions Cost of buying and selling	Rent	Body corporate fees Mortgage interest Insurance Depreciation Minor repairs and maintenance
Collectibles	Contract of sale	Repairs Transport Restoration Maintenance Agent's fees		

investment income and expenses. If you don't keep records, the ATO can make its own valuation of capital gains tax and deny expense deductions. Penalties may also apply for not keeping records. You are required to keep these records for five years from the date that you lodge your return.

Part F
Retirement planning

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14 Essentials of superannuation

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Many people put superannuation in the 'too hard basket' because the Government has made so many changes to superannuation laws over the last decade. The relationship between superannuation, taxation law and the Social Security system is complicated. However, the essentials of superannuation as a form of retirement saving are an important part of retirement planning. This chapter explains what superannuation is, why it is an effective form of saving, how you can make contributions to a superannuation fund and how to access your benefits. It concludes with a brief examination of the types of retirement products to choose from when you stop working.

WHAT IS SUPERANNUATION?

Superannuation is a system designed to help individuals save for their retirement. Compared with most other savings products, however, superannuation has a very long time horizon. Money invested in superannuation is generally not available until you retire from the workforce. Money may be contributed to a superannuation fund by yourself or by another party, such as your employer or your spouse, on your behalf. Your contributions are combined with the contributions from other fund members and invested by the trustees of the superannuation fund. The contributions and earnings are retained within the fund to provide retirement benefits in the form of a lump sum or an income when you retire.

Types of superannuation funds

There are two main types of superannuation funds: an *accumulation* fund and a *defined benefit* fund.

Accumulation fund

In an accumulation fund, all of your contributions are recorded in your own separate *account*. Contributions are usually based on a percentage of your current salary. Your share of the fund's investment earnings is added to your account and any costs, losses or taxes are deducted from it. At any time, the balance of your account reflects your accumulated savings in the superannuation fund.

Your retirement benefit depends on both the amount of your contributions and the investment performance of your fund. If your fund performs poorly, this will be reflected by lower or possibly negative returns accumulating in your account. If the fund performs well, your account will be

greater. There is no certainty about the amount that will accumulate when you reach retirement.

Defined benefit fund

In a defined benefit fund, your contributions are not separately recorded in your own account. They become part of the fund's pool of investment funds. Your retirement benefit is determined by a formula that relates to a multiple of your salary on retirement. The amount of the multiple depends on how long you have been in the fund and whether you have worked full-time or part-time. Your employer does not always make a fixed contribution to the fund but will contribute an amount determined by an actuary that will be sufficient each year to ensure that the fund is able to meet its retirement benefit obligations.

You receive your retirement entitlements regardless of the actual investment performance of the fund. This makes your retirement planning easier, because there is more certainty about the amount that you will receive from the fund on retirement. Defined benefit funds are becoming less common.

Why superannuation is a tax-effective form of saving

In order to encourage people to provide for their own retirement, the Government gives superannuation funds favourable taxation treatment. Superannuation fund earnings are taxed at a rate of 15 per cent, provided the fund complies with relevant legislative requirements. Investment income earned on your behalf, therefore, is taxed at a much lower rate than if the same income was earned from a non-superannuation investment product.

For example, assume that you save $2000 each year for the next 20 years and you have the choice between saving in a regular bank account or through a superannuation fund. Both the bank and the superannuation fund are expected to earn 7 per cent each year on your money. If you put your savings into superannuation, the earnings will be taxed at a maximum of 15 per cent. After 20 years, you will have accumulated just over $77 500 in your superannuation fund.

If you choose the bank account, interest earnings will be taxed at your marginal rate of tax plus the Medicare levy. Let's say your tax rate plus Medicare levy is 31.5 per cent. After 20 years, you will have accumulated just under $10 000 less in your bank account than in the superannuation fund. If your marginal tax rate is higher, the difference will be even greater. There is a tradeoff, however, for earning the higher amount in a superannuation fund. You can access your bank account funds at any time for any purpose, but your superannuation savings are only available in very specific and limited circumstances.

The tax paid by a superannuation fund can be even lower than 15 per cent if some of the earnings come from franked share dividends. The reason is because companies currently pay tax at 36 per cent, which is much higher than the 15 per cent tax levied on superannuation funds. The extra franking credits from dividends are used to offset other taxes that would otherwise be paid by the fund.

MAKING CONTRIBUTIONS

If you are employed, your employer already makes contributions to superannuation on your behalf. As a part of a National Wage Case in 1985, employers were required to make contributions at a rate of 3 per cent of an employee's salary. Some employers may be contributing to their employees' superannuation as a result of award or enterprise agreement arrangements. Since 1992, compulsory employer-funded superannuation has been extended with the introduction of the Superannuation Guarantee Scheme. If you are self-employed, there is no legal requirement to contribute to superannuation. It is your own responsibility to determine whether you will accumulate superannuation benefits and to determine the amount of any contributions that you make.

Superannuation Guarantee Scheme

In 1992, the Government introduced the Superannuation Guarantee legislation in which an employer must make superannuation contributions for all employees who earn more than $450 per month. From July 2003, the earnings threshold for Superannuation Guarantee contributions will be $1350 per quarter. The rate of contribution is 9 per cent of salary. Employer contributions are called *deductible* contributions. When they are paid into a superannuation fund, they attract an entry tax of 15 per cent. When they are ultimately withdrawn from the fund on retirement, they may also attract taxation.

Personal contributions

Individuals can make their own contributions to a superannuation scheme. Some employees are required to make contributions as part of an award or workplace agreement. Others may do so voluntarily in order to take advantage of the favourable taxation treatment that superannuation earnings receive and to accumulate retirement savings.

If you are an employee, you cannot claim a tax deduction for your personal contributions if you also have superannuation support from your employer. Your contributions are called *undeducted* contributions, which means that they have been paid by you from a taxed source (your salary) and you have not been able to claim a tax deduction for them. These contributions do not attract any tax on entry to your superannuation fund. They are returned to you tax-free when you withdraw them, usually on retirement.

If you are a low income earner, you may be entitled to a taxation rebate on your superannuation contributions (see Chapter 13). In the 2002/03 Budget, the Government proposed a change from the rebate scheme to a system of co-contributions for low income earners. When the relevant legislation is enacted, if you are a low income earner who contributes to superannuation, you may be eligible for a superannuation co-contribution from the Government. To be eligible, you must have received superannuation support from your employer during the year and have a taxable income of less than $32 500. The maximum co-contribution is $1000 if your taxable income is less than $20 000 and you make personal superannuation contributions of $1000 or more. The co-contribution reduces by 8 cents for each dollar earned over $20 000 and phases out once your taxable income reaches $32 500. The minimum amount of co-contribution is $20. The co-contribution is paid into the superannuation fund into which your personal contributions have been made.

The Government has also proposed in the 2002/03 Budget that a parent who receives the 'baby bonus' and who would otherwise not be able to make superannuation contributions, can contribute the bonus and any other amount to superannuation.

Spouse contributions

You may make contributions to a superannuation fund on behalf of your spouse, provided that your spouse is less than 65 years old. These are treated as undeducted contributions and there is no limit on the amount that may be contributed. The benefits are subject to preservation rules, which means they cannot be accessed until your spouse has reached retirement age. From 1 July 2003, the Government intends to allow most superannuation contributions, including employer contributions, to be split with your spouse. One benefit that may flow from spouse contributions is the ability to split superannuation entitlements on retirement, which may offer taxation advantages for those with large accumulated entitlements.

Since 1 July 1997, it has been possible to obtain an income tax rebate for contributions made on behalf of your spouse, provided that your spouse is a low income earner. If your spouse has an assessable income of no more

than $10 800, you can claim a rebate for spouse contributions. This is calculated as 18 per cent of the contributions made, up to a limit of $3000 of contributions. The maximum rebate available is $540. This reduces by one dollar for every dollar that your spouse's income exceeds $10 800, and cuts out when income reaches $13 800.

Contributions for children

The Government has proposed in the 2002/03 Budget that any person can make superannuation contributions for a child under 18 years of age. The amount of contribution is limited to $3000 per child per three-year period. These contributions are made into the child's superannuation account and will not attract the government co-contribution.

Self-employed persons

There is no legal requirement for a self-employed person to contribute to superannuation. However, self-employed people can take advantage of the favourable taxation treatment of superannuation in order to accumulate wealth for retirement. To encourage superannuation saving by the self-employed, a tax deduction is available for personal contributions made to a superannuation fund. Under the '10 per cent rule', if income derived with employer superannuation support is less than 10 per cent of your assessable income, you are also eligible for a tax deduction for personal contributions to a superannuation fund.

The amount of the deduction is calculated as the lesser of:

- the actual personal contribution if less than $5000
- $5000 plus 75 per cent of the amount over $5000, or
- your aged-based deduction limit

The age-based deduction limits for 2002/03 were:

- < 35 years old $12 651
- 35–49 years old $35 158
- 50 or over $87 141

These limits are indexed annually. If you intend to claim a tax deduction for the allowable part of your contributions, it is essential that you notify the trustee of your superannuation fund of this intention.

Eligibility to make contributions

To be eligible to make contributions to a superannuation fund, you need to meet some employment and age-based criteria. The employment criterion

revolves around the concept of *gainful employment*. You are considered to be gainfully employed if you are employed or self-employed in any occupation, business, profession, trade, calling or vocation. This would include, for example, members of the clergy, musicians, artists and performers. It would not include someone who derives their income solely from investments. To be gainfully employed on a full-time basis, you must be employed or self-employed for at least 30 hours per week. To be considered gainfully employed on a part-time basis, the requirement is at least 10 hours per week.

If you are less than 65 years old you may make contributions to superannuation provided you have been gainfully employed on at least a part-time basis during the last two years. If you are between 65 and 75 years old, you must have been gainfully employed for at least 10 hours per week throughout the last year to make superannuation contributions. If you are aged 75 or over, you may only continue to contribute to superannuation if you are gainfully employed for at least 30 hours per week.

The contributions surcharge

A surcharge applies to the deductible contributions of an individual whose *adjusted taxable income* exceeds a specified threshold. Deductible contributions for an employee are those made by the employer. Adjusted taxable income is taxable income plus deductible contributions made on your behalf. For example if you have a taxable income of $30 000 and your employer contributes $3000 to superannuation on your behalf, then your adjusted taxable income would be $33 000. The planned surcharge rates are:

- 13.5% for 2002/03
- 12% for 2003/04
- 10.5% for 2004/05 and beyond

In 2002/03, the threshold at which the surcharge phased in was $90 527, rising gradually from 1 per cent to 13.5 per cent when adjusted taxable income reaches $109 924. These thresholds are indexed annually. Once the minimum threshold has been reached, the relevant surcharge rate applies to *all* deductible contributions made in that year. The surcharge is levied against the superannuation fund on behalf of the individual.

For high income earners, the surcharge may act as a disincentive to make additional contributions to superannuation in the form of deductible contributions because these contributions will attract the 15 per cent entry tax plus the 15 per cent surcharge. They may also attract tax of up to 15 per cent upon withdrawal at retirement, so the tax benefits from investing

in superannuation are considerably reduced. If you are in this position, you may want to look at other options for repackaging your salary to try to reduce adjusted taxable income to below the threshold limits.

Choice of fund legislation

The Government has been trying for some time to introduce legislation that requires employers to provide employees with a choice of superannuation funds. This choice need only apply to the compulsory employer superannuation contributions made under the Superannuation Guarantee Scheme. At the time of writing, the applicable legislation was not yet enacted, but the Government reaffirmed in the 2002 Budget that it intends to proceed with choice of fund legislation. Some employers already make choice available. If you are given a choice, it is likely that you may be offered some of the following:

- *A company fund*—a fund that has been established by an individual private sector employer for the purpose of providing retirement benefits for its employees. These funds are more likely to exist in larger corporations than in smaller ones.
- *An industry fund*—one that has been established by a group of employers within an industry, often to accept superannuation contributions made under an industry award.
- *A public offer fund*—a managed fund that is open to entry by the public at large. They are typically promoted and managed by life insurance companies, investment fund managers and banks.
- *A retirement savings account (RSA)*—a low risk, low return alternative offered by institutions such as banks, credit unions, building societies and life insurance companies. They operate in a manner similar to a normal deposit account, except that the account must be maintained for the purpose of providing retirement benefits and cannot be readily accessed. RSAs are capital guaranteed. This means that your capital cannot be reduced by negative investment earnings. However, the low risk nature of these accounts means that they are likely to offer very low investment returns.

You should review the *Key Features Statement* or the *Product Disclosure Statement* of each fund. These provide you with information about the fund, the benefits provided, past financial performance and administration costs. It is important that you analyse the type of investments which each fund makes. The higher the return associated with a fund, the higher the risk.

Resolving superannuation complaints

The Government has established an independent tribunal called the *Superannuation Complaints Tribunal* (SCT). The purpose of this tribunal is to resolve complaints through conciliation or through formal review if conciliation is not successful. The SCT will only hear individual complaints involving unreasonable or unfair conduct in relation to a particular member. It is not able to consider general complaints about the management of a fund, such as dissatisfaction with investment strategy or fund returns.

Any complaints in relation to the Superannuation Guarantee Scheme should be addressed to the Australian Taxation Office if they cannot be resolved with your employer.

ACCESSING YOUR BENEFITS

Government regulations require some part of your superannuation entitlements to be preserved until a specified retirement age. This is called *compulsory preservation* and it means that you are unable to convert these entitlements into cash benefits when you leave a job prior to retirement. Currently, any employer contributions to which you are entitled under an award, employment agreement or the Superannuation Guarantee Scheme must be preserved.

The Government has proposed a change to the preservation rules in which all contributions and fund earnings are to be preserved, including your own undeducted contributions. The preservation age is currently 55 years, but it will gradually rise to 60. For individuals born after 1 July 1964, the preservation age will be 60.

If you have changed jobs, you may have preserved benefits in more than one superannuation fund. It is important that you notify the trustees of any changes in your address so that you can be located when your benefits become payable.

Termination of employment prior to retirement

When you leave a job, you typically receive a lump sum termination payment. Part of it will be from the employer and part will be from your superannuation fund. There are important financial consequences that result from what you decide to do with this money.

Eligible termination payment

A large part of your termination payment will probably be an *eligible termination payment* (ETP). There are two important points to remember about an ETP. First, only an ETP may be *rolled over*. Second, an ETP can have several components and each component may attract a different taxation treatment.

You can defer taxation on some of your termination payment by paying all or some of your ETP into a complying superannuation fund, an approved deposit fund or an appropriate annuity. Taxation is not paid at the time the ETP is rolled over, but is paid when it is withdrawn as a retirement benefit. Your financial adviser will be able to assist you with these choices.

You have 90 days in which to roll over your ETP. Once it has been taken in cash, you cannot later decide to roll it over. However, if you do change your mind, you can pay the cashed amount into a superannuation fund as new undeducted contributions. You would not avoid the tax on the lump sum payment, but you would be placing your funds into a concessionally taxed environment.

Employer payments

An employer ETP may include payment in lieu of notice, unused sick leave and compensation for job loss. The taxation of ETPs was discussed in Chapter 13. Tax is only payable, however, if you choose to take your eligible termination payment in cash. You can defer the tax by rolling the termination payment over into a superannuation fund or an approved deposit fund.

Some employer-paid termination payments are not ETPs. Accrued annual leave is not an ETP. Accrued leave payments are usually taxed at your marginal rate. Similarly, any payments made in lieu of long service leave are not ETPs. Payments made for genuine early retirement or redundancy are not ETPs and they are exempt from income taxation provided certain limits are not exceeded.

Payments from your superannuation fund

You may also receive an ETP from your superannuation fund. Some of your superannuation benefits will be preserved until the retirement date specified by legislation. Your undeducted contributions made prior to July 1999, however, can be cashed and these do not attract taxation. You should carefully consider the benefits associated with maintaining these in a superannuation environment by rolling them over. If you invest your undeducted contributions in a non-superannuation investment, your earnings will be taxed at your marginal rate, while earnings in a superannuation fund

attract taxation at only 15 per cent. Moreover, by withdrawing your contributions, you may not meet your retirement goals.

Early release of superannuation benefits

Preservation rules generally prevent you from accessing your superannuation entitlements until you have reached the specified retirement age. Therefore, you should treat amounts accumulated in superannuation as inaccessible until retirement. There are two very limited and specific circumstances in which some part of your accumulated superannuation might be released prior to retirement. These are financial hardship and compassionate grounds.

To satisfy the criteria for financial hardship, you must have been receiving some form of Commonwealth Government income support for a continuous period of at least 26 weeks. Furthermore, you must be able to satisfy the trustee of your superannuation fund that you cannot meet reasonable family living expenses. There are also criteria for releasing benefits on compassionate grounds.

- treatment of life-threatening medical conditions
- preventing mortgage foreclosure
- essential medical transport
- palliative care
- domestic modifications required for severely disabled people
- funeral and burial expenses

Superannuation and divorce

Superannuation has typically been considered to be a personal asset. The benefits vest in the individual member and are not transferable to other parties under the current law. However, in the event of a marriage breakdown, superannuation is treated as a joint asset like any other in the settlement by making superannuation transferable between spouses. This does not mean that benefits can be cashed on divorce, but that some part of the accumulated superannuation entitlements at that time would transfer from the superannuated party to vest with the other party. Each party would then have some share of the superannuation in their own right and normal preservation rules would apply. Each spouse would then also be individually responsible for the maintenance and management of their superannuation in the future.

Compulsory payment benefits

A superannuation fund is required to pay out accrued member benefits if the member:

- dies
- is aged between 65 and 75 and not gainfully employed on at least a part-time basis
- is 75 years old, or more, and is not gainfully employed on a full-time basis

Payment may be made as a lump sum, an ongoing pension or annuity, or a combination of the two.

RETIREMENT BENEFIT PRODUCTS

Most superannuation funds offer a choice about the form in which you receive your retirement benefit. Essentially, the choice is between receiving a lump sum or an income.

Lump sum

A lump sum is a flexible form of retirement benefit. You receive all of your accumulated benefits in one payment. It is your responsibility to manage this sum to provide for your retirement. There are advantages and disadvantages with a lump sum payment.

Advantages

- You control how the sum is to be invested to provide for your needs throughout your retirement years.
- You have the flexibility to make emergency withdrawals from your capital if unforeseen circumstances arise.
- Taking at least some of your benefits as a lump sum allows you to make large planned purchases such as an overseas holiday or a retirement home.
- You can plan to leave part of your lump sum as an inheritance for your beneficiaries.

Disadvantages

- There may be stress associated with being responsible for managing your own investments and providing your own retirement income.
- The possibility that you may squander your lump sum instead of seeing it as the source of your retirement income for the next 20 years.

- You may not foresee the impact that inflation will have on your income during retirement.
- The possibility that you may run out of money during your retirement and you will be forced to look to the Age Pension for support. If you use your lump sum to accumulate personal assets, you might not qualify for the pension.

Annuities and superannuation pensions

An *annuity* is a stream of regular payments from an annuity provider, such as a life insurance company, in return for a lump sum payment. A similar income stream may be provided by your superannuation fund and is referred to as a *superannuation pension.* The term *annuity* is used here to refer to both annuity products and superannuation pensions. The annuity payment is made up of two parts: a return of the capital that was used to purchase the annuity, and interest income. Annuities generally offer you a range of features.

- An annuity can be for a specified term, often 25 years, or it can be for a lifetime.
- An annuity can be for a single life or joint lives.
- There may be a part of the benefit payable to your spouse or beneficiary, called the *reversionary annuitant*, in the event of your death.
- A residual capital value can be included that is returned at the end of the term of the annuity.
- Annuity income can be linked to the Consumer Price Index to provide protection against inflation.

The features you choose become part of the terms of the annuity contract and they determine the price of the annuity. For example, an annuity that is indexed for inflation will be more expensive than one that is not indexed. Annuities offer a number of potential advantages and disadvantages.

Advantages

- Security and certainty about the level of payment.
- Certainty about the period of payment—a lifetime annuity guarantees an income for life.
- The possibility of indexing against inflation.

Disadvantages

- Annuities are inflexible—once the contract terms have been agreed, they are not normally varied.

- You generally cannot convert your annuity into a lump sum, so you have little flexibility if you need a large sum of money unexpectedly.
- Payments usually cease on the death of the annuitant or the reversionary annuitant and any remaining capital is forfeited.
- If your annuity is not indexed, you have no protection against inflation.
- If you have poor health, a lifetime annuity is not attractive because it is determined by average life expectancy and not individual circumstances.

Allocated products

Many superannuation funds and life insurance companies sell allocated products in the form of *allocated annuities* or *allocated pensions*. Allocated products include some of the features of a lump sum and some of the features of an ordinary annuity. Allocated pensions are offered by superannuation funds and approved deposit funds. Allocated annuities are offered by friendly societies and life insurance companies.

An allocated pension maintains a separate *account* for you that works like an investment bank account. The balance in the account is invested on your behalf and the earnings are added to your account. You draw regular payments from this account to provide an income. The amount of these payments can vary, but they are subject to a maximum and a minimum specified by legislation. These limits depend on your age and the balance in your account. You can commute some or all of the balance of your pension fund into a lump sum at any time. There are a number of advantages and disadvantages associated with an allocated product.

Advantages

- You can vary your income, within the prescribed limits, in any particular year to maximise taxation and Social Security advantages.
- You have the flexibility to withdraw any of your balance as a lump sum at any time.
- While they remain within your allocated pension fund, investment earnings are not subject to tax.
- The balance of your account is not forfeited when you die—you generally have the choice of having a reversionary pension continuing for your spouse or having the remaining capital paid to a beneficiary.

Disadvantages

- The term and amount of your payments are not guaranteed, because payments can only be made if there is enough money in your account.
- You bear the investment risk associated with the returns earned by your invested funds.

15 Superannuation planning

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The main objective in planning for your retirement is to accumulate enough money to maintain a good standard of living. There is a risk that you may not reach this goal, however, if you have unrealistic expectations about the Age Pension or if you do not have a satisfactory retirement savings plan. The purpose of this chapter is to highlight the key issues in planning your superannuation. It begins by demonstrating what happens if you wait too long to get started. Then it describes a series of steps that will assist you to accumulate enough superannuation savings to retire comfortably. The chapter concludes by explaining what you need to do if you want to run your own superannuation fund.

IMPORTANCE OF STARTING EARLY

Most people don't get serious about retirement until later in life. The reality is, the longer you put off a retirement savings plan, the more difficult it becomes to accumulate enough savings for a secure retirement. If you want to enjoy the same level of income in retirement that you had during your working life, you should be saving about 15 per cent of your earnings throughout your entire working life.

How much do you think you should save if you if you want to retire with a lump sum of $300 000? The answer depends on the number of years until you retire and the rate of interest on your savings. Table 15.1 assumes 5 per cent after-tax interest earnings on your savings. If you are aged 25 and you intend to work until you are 65, then you have 40 working years in which to save $2483 each year. If you wait until you are 55, however, then you have only 10 years to save and you will need to put away $23 851 each year. The longer you postpone saving, the more difficult it becomes to save enough for retirement.

Accumulated superannuation benefits increase dramatically the longer you are a contributor. Table 15.2 indicates how much would accumulate in a superannuation fund, depending on the length of membership. It is based on a current salary of $30 000 that increases by 2 per cent each year,

Table 15.1 Required annual savings to accumulate $300 000

Years to retirement	Savings needed each year ($)
40	2 483
35	3 322
25	6 286
15	13 902
10	23 851

Table 15.2 Accumulated superannuation for different contribution periods

Years in the fund	Accumulated lump sum ($)	Annual income for 20 years ($)	Inflation-adjusted income after 20 years ($)
10	34 340	3 240	1 480
15	64 865	6 120	2 790
20	109 415	10 330	4 710
25	173 815	16 400	7 480
30	266 260	25 130	11 460
35	398 260	37 590	17 140
40	585 970	55 310	25 220

employer contributions equal to 9 per cent of salary and fund earnings of 7 per cent per year.

The first column is the number of years in the fund. The second column is the accumulated lump sum from contributions and fund earnings. The third column is the annual income that would be generated over 20 years if the lump sum is taken as a pension. The last column demonstrates how inflation erodes the purchasing power of the annual income if inflation is only 4 per cent. For example, a $25 130 annual pension would be worth only $11 460 in purchasing power after 20 years of retirement. There are two key lessons to be learned from this example.

- The longer you delay making regular contributions, the more difficult it will be to accumulate an adequate nest egg for retirement.
- You need to make allowance for the effect of inflation because it can seriously erode the purchasing power of your retirement income.

YOUR CURRENT POSITION

Planning your superannuation begins by assessing your current position. Your superannuation fund will report to you at least once each year and send you a *Member Statement* outlining your superannuation entitlements. If you are a member of an *accumulation* fund, your statement will look like the one in Figure 15.1.

If you are a member of a *defined benefit* fund, your statement will look like the one in Figure 15.2. This statement looks different because your retirement benefits are determined by a multiple of your salary at retirement.

When you have identified your current position, the next step is to estimate what your existing superannuation will provide when you retire. This is much easier with a defined benefit fund because the statement gives you important information. You need to estimate your final salary and the

Figure 15.1 Accumulation fund statement

Vested benefit at 30 June		$62 624.34	①
Portion that must be preserved		$58 143.89	②
Vested benefit at the same time last year		$53 178.57	③
Opening balance		$53 178.57	
Add			
Contributions received	$3 904.90		④
Less			
Contribution tax	$570.88		
Administration charge	$47.32		
Insurance charge	$48.12		⑤
Add			
Interest credited	$6 207.19		⑥
Closing balance		$62 624.34	

① The closing balance of your 'account' showing the current accumulated amount of your contributions and net fund earnings at the end of the year.
② The part of your benefit that is preserved, or unavailable to you until you reach retirement age.
③ The amount that you had accumulated in the fund at the start of the year.
④ The contributions made by you, or on your behalf, during the year.
⑤ Your account is reduced by contributions tax on employer contributions, your share of the running costs of the fund, and any insurance premiums.
⑥ Your share of the investment earnings that your fund earned throughout the year. It could be negative if your fund performed poorly.

Figure 15.2 Defined benefit fund statement

Contributions made by you during the year					$3 604	①
Estimated lump sum benefit if you had resigned at the end of this year					$105 947	②
Preserved component					$72 867	③
Death benefit					$465 756	④
Disability pension					$30 574	⑤
Retirement benefit factors:						
Age at retirement	55	57	60	62	65	
Lump sum multiple	7.5	8.2	9.1	9.8	10.8	⑥
Pension percentage	45.4	51.2	60.6	67.3	77.9	⑦

① The personal contributions you have made during the year.
② The amount to which you would be entitled if you had resigned or retired at the end of this year.
③ The portion that you cannot access until you reach retirement age.
④ The amount that would be paid to your beneficiary if you died.
⑤ The pension you would receive if a disability prevented you from continuing to work.
⑥ The multiple of your final salary that you will receive if you take a lump sum payment when you retire. The multiple depends on when you retire, so the longer you work, the bigger the multiple becomes.
⑦ If you retire on a pension, this is the percentage of your final salary that you would receive as your retirement income. The longer you work, the greater the percentage becomes.

age at which you will retire. Multiply your final salary by the lump sum or pension factor for the retirement age you selected.

In an accumulation fund, there is far less certainty about your retirement position. What you receive depends on the level of contributions you make and the investment performance of your fund. Your financial adviser can help you with this. If you enjoy browsing the Internet, you will find that many superannuation funds provide interactive calculators on their Internet page. These enable you to enter different assumptions about contribution rates and fund earnings to estimate your accumulated benefit. The Australian Superannuation Funds Association has a calculator at http://www.superannuation.asn.au/calculator.

SETTING YOUR GOAL

Now you are ready to determine the amount of savings that you will need when you retire. What will be your living costs in retirement? Most retirees are comfortable with a little less income because their debts are paid off, they no longer have dependent children and they no longer incur work-related expenses. You may also have a few new expenses for things like hobbies or travel that were not part of your pre-retirement lifestyle. Don't forget to consider the impact of inflation and taxation on your future purchasing power as well. Once you know how much retirement income is necessary, then you can determine the amount of savings required to generate this level of income. Setting your goal is crucial to retirement planning, and your financial adviser can assist you with the calculations.

Having determined your savings goal, what will be your likely financial position as you enter retirement? Superannuation is probably going to be the key plank in your retirement strategy, but you also need to take into account other savings, investments, likely inheritances and any outstanding debts. With this information, you can determine if your current savings strategy is going to achieve your goal. If it is not, then you need to modify your savings strategy to ensure that you accumulate enough for retirement.

Take advantage of opportunities to boost your retirement savings—for example, when you are a double-income family with no children, or when you have cleared your mortgage or other major debts. It is equally important to maintain a balance between your short-, medium- and long-term savings strategies. You don't want to commit all of your surplus funds to superannuation, because it is not available until you retire. However, superannuation is the most tax-effective way to accumulate retirement funds and it should be a major part of your retirement savings strategy.

Seriously question the adequacy of your current superannuation contributions. Don't assume that your employer's contributions under the Superannuation Guarantee Scheme will be enough to provide for a comfortable retirement. If you look back at Table 15.2, for example, a member with 40 years' contributions will have accumulated $585 970 when they retire. It will provide an annual income of $55 310 for 20 years following retirement. At retirement, the member's final salary would have grown to about $65 000, so they would be retiring on 85 per cent of their final salary. This may seem more than adequate, but keep in mind that if inflation averages 4 per cent, the $55 310 annual pension will have only $25 220 in purchasing power after 20 years of retirement.

TOPPING UP

The previous example illustrates the importance of questioning whether your current level of contributions will be enough to meet your retirement goals. You may find that you need to *top up* your superannuation by making your own personal contributions in addition to those made by your employer. Some award and enterprise arrangements already include employee contribution requirements. Topping up superannuation is particularly important for the *squeezed generation*, consisting of people caught between the tightened Age Pension requirements and the employer-funded superannuation system.

Topping up your superannuation will give you more comfort in retirement and it may enable you to retire earlier than would otherwise be the case. In addition, you get the benefit of favourable taxation treatment of superannuation earnings. If you are in a defined benefit fund, or you cannot or do not wish to make extra contributions to your existing fund, you can choose one of the many public offer superannuation funds managed by life insurance companies, investment funds and banks.

The higher the returns earned by a fund, the higher the investment risks they are taking. However, the rate of return earned by a fund has a dramatic effect on the retirement benefits that are accumulated. Table 15.3 illustrates what you would accumulate if you saved $2000 each year for 20 years, depending on the fund's rate of earnings. If the fund earns only 2 per cent each year, then fund earnings will be $16 560 and you will have accumulated $56 560 at the end of 20 years. If, however, the fund earns 12 per cent each year, then fund earnings will be $104 104 and you will have accumulated $144 104 at the end of 20 years.

If you have plenty of time until you retire, you may want to consider a superannuation fund with more aggressive investment policies because

Table 15.3 Accumulated savings after 20 years

Earnings rate %	Principal saved ($)	Fund earnings ($)	Accumulated total ($)
2	40 000	16 560	56 560
4	40 000	19 556	59 556
6	40 000	33 571	73 571
8	40 000	51 524	91 524
10	40 000	74 550	114 550
12	40 000	104 104	144 104

they generally earn above-average returns over time. However, you need a sufficiently long time horizon to be able to weather the adverse fluctuations in investment returns that inevitably occur in financial markets. The closer you are to retirement, the more likely you will prefer a stable fund with a conservative investment policy in order to protect your capital.

SALARY SACRIFICE

Salary sacrifice can be a tax-effective way of topping up your superannuation contributions. As part of a salary packaging arrangement, your employer may offer you the opportunity to sacrifice some of your salary in return for greater employer contributions to your superannuation fund. If you make the contributions yourself, they come out of your *after-tax* income. If your employer makes them for you, they come out of your *pre-tax* income resulting in greater take-home pay.

Let's say you earn $40 000 annually and you want to make additional superannuation contributions of 7 per cent of your salary. Your employer offers you a choice between making the contributions yourself, or a salary sacrifice. If you choose to make the contributions yourself, the result is illustrated in Figure 15.3. You pay income tax and the Medicare levy, resulting in a salary after tax of $31 020. After you make your personal superannuation contributions of $2800, you are left with a disposable income of $28 220.

If you choose the salary sacrifice, your employer makes superannuation contributions on your behalf. Employer contributions are *deductible*, meaning the employer receives a tax deduction for them, so they are taxed at 15 per cent when they enter your superannuation fund. Therefore, you need to sacrifice 8.25 per cent of your salary to achieve a contribution of 7 per cent and pay the entry tax.

By choosing to sacrifice 8.25 per cent of your salary, your gross salary is reduced to $36 700, as shown in Figure 15.4. You pay income tax and

Figure 15.3 Disposable income before salary sacrifice

Gross salary	**40 000**
Income tax	8 380
Medicare levy	600
Salary after tax	**31 020**
Personal superannuation contributions (7 per cent)	2 800
Disposable income	**28 220**

Figure 15.4 Disposable income after salary sacrifice

Gross salary	**36 700**
Income tax	7 390
Medicare levy	550
Salary after tax	**28 760**
Personal superannuation contributions	nil
Disposable income	**28 760**

the Medicare levy on this lower salary, resulting in a salary after tax of $28 760. Since your personal superannuation contributions have already been paid by your employer, your after-tax disposable income is $28 760 which leaves you with an extra $540 in your pocket.

For high-income earners, there may be additional taxes applied to employer contributions in the form of the Contributions Surcharge. Each case needs to be evaluated individually to determine whether the gains from salary sacrifice make it an attractive proposition. For high-income earners, salary sacrifice in some other form may be more attractive. Superannuation contributions for a spouse, for example, may be a better option. People on lower incomes may find that any benefit from salary sacrifice is outweighed by the loss of the taxation rebates available on savings and superannuation.

CHOOSING A RETIREMENT PRODUCT

When you approach retirement, you need to think about how you want to receive your superannuation and retirement benefits. For example, do you want to have your benefits paid in a lump sum?

- How will you invest and manage this money during your retirement?
- How will you ensure that your funds do not run out?

- What are the taxation implications?
- How will you hedge against inflation?

Alternatively, would you rather use your retirement benefits to provide an income?

- Will you need access to larger sums of capital periodically?
- How many years will your income need to last?
- How frequent will payments need to be?
- How will your income keep pace with inflation?

In Chapter 14, we outlined the key features and differences between the major types of retirement products. You need to evaluate the features that are important to you so that you can choose a product that suits your needs. Your main choices are retiring on a lump sum investment that you manage yourself to produce an income, or buying some form of income product such as a fixed term annuity, a lifetime annuity or an allocated pension. Your financial adviser can help you. However, the answers to some frequently asked questions are provided in Table 15.4.

Table 15.4 Retirement product choices

	Lump sum	Fixed term annuity	Lifetime annuity	Allocated pension
Can I withdraw capital whenever I like?	Yes	No	No	Yes
Will any remaining balance or entitlement be available to provide an inheritance if I die?	Yes	No	No	Yes
Will I have a guaranteed income for life?	No	No	Yes	No
Is the amount of my income payment certain?	No	Yes	Yes	No
Do I bear the investment risk?	Yes	No	No	Yes

Reasonable benefits limit

Superannuation benefits usually receive more favourable taxation treatment than other forms of income. However, there is a limit to the amount of superannuation benefits that will be taxed at concessional rates. This is called the *Reasonable Benefits Limit* (RBL). Undeducted contributions are excluded from your RBL because these are personal contributions that have been made by you for which you did not receive a tax deduction. Employer contributions for which a tax deduction was claimed, fund earnings, and eligible termination payments made by employers are generally included in your RBL.

The RBL is specified as a flat dollar amount, indexed annually to movements in average earnings. The amount of the RBL also depends on

whether you take your benefits in the form of a lump sum or an annuity. The annuity limit is more generous than the lump sum limit. The limits for 2002/03 were $562 195 for lump sums and $1 124 384 for pension annuities.

The pension RBL usually applies when at least 50 per cent of the benefits that count towards the RBL are taken in the form of an appropriate pension or annuity. Otherwise the lump sum RBL applies. These limits do not mean that you cannot accumulate superannuation benefits in excess of them. It means benefits that exceed the relevant RBL will attract higher rates of taxation. If you have an excess benefit, your financial adviser will be able to assist with strategies to minimise the impact of the RBL with an appropriate mix of lump sum and pension benefits and/or choosing annuities that enable you to qualify for the maximum RBL.

Taxation of superannuation benefits

The way in which your superannuation benefits are taxed depends on whether you receive them as a lump sum, an income annuity or superannuation pension, or an allocated pension.

Lump sum

If you choose a lump sum, the part which represents the return of your personal contributions is not taxed because you have already paid tax on that income. In 2002/03, the first $112 405 of the remainder is also tax-free. Amounts above this threshold are taxed at 15 per cent plus the Medicare levy. The threshold is indexed annually. Any part of your lump sum that exceeds the lump sum RBL will attract tax at the highest marginal rate of tax, regardless of your personal rate of tax. This is currently 47 per cent plus the Medicare levy.

Income annuity/superannuation pension

An annuity payment is made up of two parts: a return of the capital that you used to purchase the annuity, and interest income. Some part of your annuity payment will be assessable income for taxation purposes. The amount assessable is determined by subtracting the *deductible amount* from the purchase price of the annuity. This is basically the amount of your own contributions and represents the return of your capital. This amount is apportioned over the term of the annuity, and the remainder of your pension payments are taxed at your marginal tax rate. However, a 15 per cent tax rebate is available under the following conditions.

- The annuity was purchased with a rolled-over ETP or provided by a complying superannuation fund.

- It is paid from a taxed source, such as a superannuation fund or life insurance company.
- The price of the annuity does not exceed the RBL.

An annuity purchased with non-superannuation money is not rebatable. Your annuity provider will deduct the appropriate taxation from your annuity payment on a PAYG basis.

Allocated pension

A regular pension income drawn from an allocated pension account is taxable in the same manner as an ordinary superannuation pension. There is a deductible amount that is tax-free and the 15 per cent rebate applies provided that the RBL is not exceeded. Your investment earnings are tax-free while they remain in your allocated pension fund account. It is important to note that allocated pensions are assessed against the lump sum RBL and not the pension RBL. Allocated pensions are not considered to be qualifying pensions for RBL purposes, so the lower lump sum standard always applies. If you withdraw some or all of the balance of your account as a lump sum, it will attract the normal taxation that applies to lump sums.

Financial advice

In Chapter 16, we look at how the assets and income tests are applied to determine your eligibility for the Age Pension. When you choose a retirement product, you should be aware of how it will be treated under these tests. In general, longer-term annuity products receive more favourable treatment than short-term ones, lump sums and allocated pensions. The Department of Social Security or your financial adviser can tell you about the implications of different retirement products on your Age Pension eligibility.

The Government funds the *National Information Centre on Retirement Investments* (NICRI), which provides free financial advice to retirees and those approaching retirement. It can help you assess your current financial situation and assist in financial planning issues. NICRI also has a range of free brochures about retirement and financial planning. You can contact NICRI by phoning 1800 020 110.

RUNNING YOUR OWN SUPER FUND

Self-managed or do-it-yourself superannuation funds are becoming popular. These funds are more properly termed *excluded funds*, because they are

exempt from some of the legal requirements that apply to larger superannuation funds. However, there are still a number of requirements that must be met for an excluded fund to be a *complying* superannuation fund.

The fund must have less than five members, all of whom are related to the trustee. There must be at least one trustee who is responsible for the fund and ensuring that it complies with relevant legislation. The fund must be established with the sole purpose of providing superannuation and retirements benefits for its members. It cannot carry on other business activities. It must be resident in Australia, and have its management and control in Australia. If the fund does not comply with all relevant requirements, it will be taxed at the rate of 47 per cent rather than the 15 per cent rate that applies to complying funds.

The first step in setting up your own fund is to establish a *Trust Deed*. This is a legal document that sets out the rules and conditions under which your fund can operate and nominates the trustees. The trustees may be an individual (or individuals) or you can choose to set up a company to act as a corporate trustee. Your accountant and/or lawyer will be able to assist with the establishment of the Trust Deed.

You also need to become a *regulated fund*—that is, to meet the regulatory requirements in order to be a complying fund for taxation purposes. You do this by lodging an *Election Notice* with the Australian Tax Office.

Next, you need to set up a fund bank account and obtain a Tax File Number for your fund. You also need to establish administrative and accounting arrangements to receive contributions, meet required auditing and reporting requirements, and pay retirement benefits. A formal investment strategy must be established and followed.

You need to have sufficient initial assets to make the fund cost-effective. Most advisers suggest that a minimum of $100 000 in initial assets is needed to make a self-managed fund worthwhile. These assets may come from existing superannuation entitlements that can be rolled over into the new fund, or they may result from the sale of other personal or business assets. Be careful about directly transferring non-cash assets to your fund, because the investment rules may prohibit or restrict how these transfers can be carried out.

Benefits and costs

One of the major attractions of managing your own superannuation fund is that you have control over your fund's assets and the types of investments it makes. Provided you do not breach the investment rules, you have the flexibility to choose your investment portfolio and the ability to change

your investment mix as you see appropriate. There are also a number of other benefits.

- Flexibility in how retirement benefits are paid.
- Taxation at the concessional rate of 15 per cent, when private savings attract taxation at your marginal rate.
- In the event of personal bankruptcy, assets in your superannuation fund are protected, provided their value does not exceed your RBL.

Assets in your superannuation fund are subject to the same preservation rules that apply to all superannuation fund contributions and earnings. There are also some potential indirect costs.

- Ensuring that you meet all of the legal requirements relating to fund management, with respect to compliance, investment and administration.
- The necessity to keep up to date with the investment environment and the relevant legislation.
- The personal time and responsibility involved in managing a fund.
- Limited opportunities for investment diversification if your fund is small.

Ensure that the direct costs of running your fund do not exceed the benefits. Many costs can be claimed as tax deductions for the fund.

- The initial set-up costs incurred in establishing your trust deed and obtaining advice.
- Annual administration, accounting and audit costs, including preparing your annual return, your taxation return and reports to members.
- Investment advice, brokerage fees and transaction costs incurred in managing your investment portfolio.
- Actuarial costs to ensure that you have sufficient funds to meet expected retirement benefit payments as they become due.

Rules and responsibilities

The trustees of a superannuation fund are legally responsible for its management and for ensuring compliance with legislation. Here are some of the broad responsibilities.

- Acting honestly with due care, skill and diligence.
- Formulating an appropriate investment strategy and putting it into effect.
- Keeping the fund assets separate from other assets.
- Ensuring that all accounting and reporting requirements are met.
- Always acting in the best interest of members.

The law requires that all superannuation funds formulate and put into practice an appropriate investment strategy. To do this, you need to consider a variety of investment policies and specific investment rules.

- An appropriate risk/return profile for your fund.
- Achieving a diversification of investments in your portfolio.
- Maintaining adequate levels of liquidity.
- The ability of the fund to meet current and future liabilities.
- All transactions must be at arm's length.
- Loans cannot be made to members or their relatives.
- You cannot borrow for investment purposes.
- You may not acquire assets other than listed shares at market value from members or their relatives. (Excluded funds may acquire real business property from members under certain conditions.)
- Investments in associated parties, such as the employer organisation, are restricted.

16 Entering retirement

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Financial security and peace of mind are the key to entering a comfortable retirement. Government policy is to encourage retirees to be self-sufficient by providing incentives for individuals to accumulate enough savings to fund their own retirement. However, these are recent changes and there continue to be many thousands of retirees who qualify for the Age Pension. Peace of mind also comes from planning your estate so that you can get on with enjoying your retirement knowing that your affairs are in order.

Deciding how you want to live in retirement is a very important issue. Will you stay in the family home, relocate to a different type of housing or move into a retirement complex? What sort of clubs and associations are there for retired individuals, what do they offer and how do you find them?

The purpose of this chapter is to focus on the transition into retirement. It outlines the eligibility criteria for the Age Pension and some basic aspects of estate planning. Then it looks at a number of options for retirement living and concludes with a discussion of clubs and associations.

AGE PENSION AND OTHER BENEFITS

In 2002, the maximum Age Pension for a single was around $11 000 annually and for a couple it was a little over $18 000. The pension is adjusted regularly to reflect changes in the Consumer Price Index. Pension payments are taxable income, but if your only income is the Age Pension, you do not need to file a tax return. If your total income is above the tax-free threshold, you may be entitled to a *pensioner rebate* that reduces the amount of tax that you pay.

Eligibility requirements

To receive an Age Pension you need to be of pension age, meet residential qualifications and satisfy certain financial criteria. The pension age is currently 65 for men and 61 for women. The minimum age for women is gradually increasing and it will be 65 for everyone from July 2013. You must be an Australian resident, and you must have resided in Australia for at least ten years of which five have been continuous. The residence requirements may be varied if you are from a country that has a reciprocal pension agreement with Australia or if you qualify for an exemption based on humanitarian grounds. If you meet the age and residence requirements, then you need to satisfy two financial tests: the *assets test* and the *income test*. The test that applies to you is the one that results in the lowest pension.

Assets test

The value of your assets can affect your pension entitlement. Assets are any items of value that you own, wholly or in part, anywhere in the world. They are assessed at today's market value less any outstanding debt such as a mortgage. The following are examples that would be assessable under the assets test.

- cash, regardless of whether it is held in an interest-earning account
- term deposits
- shares, debentures and managed investments
- investment properties
- holiday homes and vacant land
- collections, such as stamps and coins
- cars, boats and caravans
- businesses and farms
- loans made, regardless of whether they are interest-bearing
- life insurance policies
- the contents of your home and your personal effects
- short-term superannuation annuities
- the balance of an allocated pension fund

Some people have tried to bypass the assets test by giving away assets to relatives or friends. You can make gifts up to $10 000 each year. Anything over $10 000, however, is included in the assessment of your assets even though you have given it away, and it will continue to be included in the assessment for five years. You may, however, dispose of assets in order to meet expenses. Some items are not counted in the assets test.

- the value of the home in which you live, including up to two hectares of attached land
- money you have paid for a cemetery plot, a prepaid funeral or invested in funeral bonds
- most long-term superannuation annuities

Threshold limits for the assets test depend upon whether you are single or a couple and whether or not you own your home. The 2002 limits are set out in Figure 16.1 and they are indexed each July. If you reach the minimum threshold, your pension payment reduces by $3 each fortnight for every $1000 worth of assets that you have above the threshold.

Income test

The amount of your other income may affect your pension entitlement. Income not only includes cash payments, but also any *in-kind* consideration including gifts. Overseas pensions or overseas income are also included, but Social Security payments are not.

Figure 16.1 Assets test thresholds in 1998

	You will receive the full pension if your assets are less than:	You will receive a partial pension if your assets are less than:
Single home owner	$145 250	$288 000
Single non-home owner	249 750	392 500
Couple home owners (per couple)	206 500	443 500
Couple non-home owners (per couple)	311 000	548 000

The income test also assesses *deemed* income from financial assets. *Deeming* means that financial assets are assumed to earn a specified rate of income regardless of what you actually earn from them. The current deeming rates are 2.5 per cent on the first $34 400 of financial assets for a single pensioner, and on the first $57 400 of the combined financial assets of a pensioner couple. A rate of 4 per cent is applied to investments above these levels. For example, a single pensioner with financial investments of $50 000 would be deemed to have earned $1484 of income from their assets.

$$\text{Deemed income} = 2.5\% \text{ of } \$34\,400 + 4\% \text{ of } \$15\,600 = \$1484$$

What you actually earn is not considered, so try to maximise your earnings subject to the risks that you can afford to take. There is no benefit in keeping your money in low- or no-interest accounts to beat the income test, because it is the deemed income that matters. Financial institutions offer *deeming accounts* that earn interest at rates similar to the government deeming rates. Assets that are considered to be financial investments and subject to deeming are listed below.

- cash
- accounts held with financial institutions
- shares, debentures, bonds and managed investments
- loans made
- gold
- gifts that exceed $10 000 in a pension year
- shorter-term superannuation annuities

Some items are assessed based on the actual income earned.

- Business, farms or self-employment
- your family home—for example, from boarders
- real estate
- antiques
- coin and stamp collections
- family trusts
- deceased estates
- some superannuation products
- some overseas pensions

In 2002, a single pensioner could earn up to $116 per fortnight and still receive the full pension. A couple could earn a combined income of $204 per fortnight before their pension entitlement was reduced. These limits are called the *pension free area*. Your pension reduces by 40 cents for every dollar that your income exceeds the limit. You would have been eligible for a partial pension in 2002 if your fortnightly income did not exceed $1185 for a single or $1979 for a couple.

Other benefits

Try to structure your financial position so that you qualify for at least a partial pension. Even if you receive just 50 cents per week as a partial Age Pension, you will be eligible for a number of additional benefits. For example, you will receive a *Pensioner's Concession Card* that gives you concessions on such things as health, transport and utilities.

You will also be entitled to benefits under the *Pharmaceuticals Benefits Scheme* (PBS). This means you will be paid an extra allowance of $5.80 per fortnight to off-set the cost of prescriptions. Under the PBS, most prescriptions will cost only $3.60. If you have paid for 52 prescriptions in any year, any more are free. It is important to keep a record of your PBS prescriptions so that you can take advantage of this scheme.

Pension Loans Scheme

If you are receiving a partial Age Pension, it may be possible to increase your pension rate to the full pension with a low-interest loan. You need to have property to secure this loan. You receive regular pension payments at the higher level: one part is your normal pension entitlement and the other part is effectively borrowing from the Government. The loan can be repaid at any time or you can defer repayment until your death when it is repaid by your estate. You can choose to revert to your partial pension at any time.

The Pension Bonus Scheme

A bonus scheme exists to encourage those of pension age to defer taking up the Age Pension. If you are eligible for the pension but choose to continue in paid employment for at least 960 hours per year, you will receive a bonus payment when you ultimately do take up your pension. This bonus is paid as a lump sum and is tax exempt. It is calculated as 9.4 per cent of your pension entitlement for each year that you defer, up to a maximum of five years. The minimum period is one year. You must register with Centrelink to be part of this scheme.

The Commonwealth Seniors Health Card

If you are not entitled to the Age Pension because of the assets or income tests, you might qualify for the *Commonwealth Seniors Health Card* which provides you with some benefits under the Pharmaceuticals Benefits Scheme. For example, you can obtain most prescriptions at a cost of $3.60 each compared with over $20 per prescription without the concession. In 2002, you should be entitled to the Health Card if your taxable income is less than $50 000 per annum for singles and $80 000 for couples. Your latest income taxation assessment notice is all that is required as proof of your income.

Role of Centrelink

Centrelink is the government agency that administers the Age Pension and related concession cards, including the Commonwealth Seniors Health Card. Its staff will help you with applications for the pension and benefits and assist you with any enquiries you might have. They can be contacted by phoning 13 2300. Information is also available from the Centrelink Internet site at http://www.centrelink.gov.au.

Seniors Card

The *Seniors Card* is an Australia-wide scheme initiated by state governments in partnership with other public and private sector organisations. You are entitled to a Seniors Card if you are over 60 and not working full-time. When you receive your card, you get a directory of participating organisations that offer concessions, special services or discounts to Seniors Card holders. The card is free, and having one does not affect any other concessions or benefits to which you are entitled. To contact your Seniors Card organisation, look under 'Seniors Card' in the White Pages telephone directory.

BASIC ESTATE PLANNING

Your *estate* refers to all of the property, other assets and personal possessions that you own, together with any debts for which you are responsible upon your death. *Estate planning* means arranging your assets and liabilities so that your estate will have sufficient funds to cover your debts and to provide for your beneficiaries. Your solicitor and your financial adviser can assist you with estate planning.

Making your Will

It is important to have a current, valid Will. This ensures that your assets and possessions are passed to your beneficiaries in accordance with your wishes. If you die without a valid Will, a situation called *intestacy* occurs. If this happens, your estate is allocated in accordance with the intestacy rules in your state. This may not reflect your wishes, and the process may be more costly and take longer to finalise than would be the case if you had a valid Will.

A Will is a written document in which you, the *testator*, specify how you want your estate to be dealt with upon your death. This must be signed by you and witnessed by two independent people. Beneficiaries must not be witnesses, otherwise they will not be legally able to benefit from your estate. You must also specify in your Will at least one *executor*. Your executor is the person you nominate to carry out the wishes expressed in your Will. They are responsible for overseeing the finalisation of your estate.

In selecting an executor, consider if they have the skills to administer your estate, if they would be prepared to accept the responsibility, and the possibility that they may predecease you. If your estate is relatively straightforward, you might choose a family member or friend as executor. An executor can be a beneficiary in your Will. If your estate is complex, you might want to appoint your solicitor or use the services of a trustee company, such as the Public Trustee or various state trustee companies, who administer estates for a fee.

You can make a Will without the services of a professional by using Will forms available from stationers. This might be appropriate if your estate and your wishes are straightforward. Otherwise, it may be safer to engage a solicitor or the services of a trustee company. They can advise you about different ways in which interests in your property can be left to your beneficiaries and explain the potential taxation implications of your bequests.

Although there are no Commonwealth or state death duties, your bequests can have capital gains tax (CGT) implications. CGT is not payable when your property is transferred to the beneficiary, but it may apply if the property is sold. For example, an investment property will attract CGT when it is sold, but your family home will not. Once you have made your Will, store it in a safe place and ensure that a responsible person, such as your executor or next of kin, knows where it is.

You may need to change your Will as your personal and financial circumstances change. Marriage automatically makes your Will invalid and you need to write a new one. In Victoria, Queensland, New South Wales and the Australian Capital Territory, divorce renders any bequests to a

former spouse invalid. In Tasmania, it invalidates the entire Will. In other jurisdictions, your existing Will remains valid. You may also want to review your Will after the birth or death of family members, when personal relationships change, or when you acquire or dispose of assets. You can revoke an existing Will by making a new one or by destroying all copies of it.

Power of attorney

A *power of attorney* is a formal legal document in which you give someone, called your *attorney*, the power to act on your behalf. There are two types.

- An *enduring* power of attorney allows another party to act for you, make decisions and manage your assets, if you become incapacitated and cannot manage your own affairs.
- A *restricted* power of attorney allows another person to act only in specified functions and/or for a specified period of time. For example, if you are planning to travel overseas, you may wish to grant a restricted power of attorney to enable another party to manage your investments while you are away.

Drawing up a power of attorney gives many individuals peace of mind from the knowledge that their affairs will be managed if they are not capable of doing so themself. Simply drawing up the power does not give the attorney the right to act, however, as long as you are capable and interested in managing your own affairs. The power of attorney is only invoked if you become incapable or no longer want the responsibility. A power of attorney may only be drawn up when you are competent to do so, and it can be revoked at any time provided you are of sound mind.

You can create a power of attorney using a standard document available from stationers. However, the law in this area is complex and it is wise to get legal advice when drawing it up. It is important that the party you choose to empower is one that you trust and are confident will administer your affairs appropriately. If you want to avoid possible conflicts of interest, you can use a trustee company to provide independent attorney services.

Funeral arrangements

For your own peace of mind, and that of your family, you may wish to consider your funeral arrangements. Although this is not an easy topic to discuss, it is important for someone responsible to be aware of your wishes. A professional funeral director will be able to help you.

- What type of service would you like, religious or civil?
- Would you prefer to be buried or cremated, and where?
- Where would you like the service to be held?
- Are there any special arrangements you would like, such as flowers, music or participation by family?

Some people arrange and prepay their own funeral. This reduces the emotional stress and financial burden on your family. It consists of entering into a contract with a funeral director that specifies the type of funeral you want and the cost. You pay this amount into a fund held by an independent organisation such as an insurance company or friendly society. When the service has been provided, the funds are transferred to the funeral director.

RETIREMENT LIVING

Retirement is a time when many people reassess their housing requirements. The majority of older Australians choose to live independently in their own home. If you feel that you are unable to continue to live independently, the *Aged Care Assessment Team* (ACAT) can assess your needs. ACAT is a group of professionals who will visit you to establish your requirements and advise you about suitable accommodation arrangements and assistance. You can approach ACAT directly, through your local hospital, or you can ask your doctor or community nurse to arrange an assessment.

Some choices may have implications for your pension entitlements through the assets test or the income test. Other choices may make you eligible for Rent Assistance. The rules and requirements are various and complicated, so it is important to get advice before you make a decision. Centrelink has a free *Financial Information Service* that provides information if you are moving house or contemplating changes to your accommodation arrangements.

Staying in your own home

Many people stay in their own home because it suits their needs and provides financial and emotional security. It also means that they can remain in a neighbourhood where they have social contacts and they can participate in community events and other interests.

Consider renovations if you want to stay in your own home but you worry about things like difficult access or a cramped bathroom layout. Compared to the cost and stress of selling your home and relocating, renovation may be a better alternative. Before you make a decision, get

some quotes for the work that you require. Use a registered builder and ask to see testimonials from previous clients. If you do not receive the full pension, you may qualify for the Pension Loans Scheme to help pay the renovation costs.

Don't be discouraged from remaining in your own home simply because a few of the day-to-day tasks are becoming a bit difficult, because there are a range of services available through Home and Community Care (HACC). Fees may apply for some of these services.

- assistance with personal care
- help in the home, including cleaning and laundry
- assistance with banking
- help with transport
- arranging food services
- community nursing
- some home and garden maintenance

Right sizing

Some retirees decide to move into new accommodation that better suits their needs. You may prefer a low-maintenance property or one that is closer to your retirement interests. Draw up a checklist of the features that you want in your new home. Try to retain the features that make your current home attractive and avoid those with which you are not happy. You may also want to consider alternatives such as a unit, a granny flat or dual occupancy, as well as standard residential housing.

The decision to sell your home and relocate is a major one. You need to be fully informed about your options and the implications for your lifestyle and your financial position. The Department of Social Security and Centrelink have a range of free publications that explain the major choices and their implications. Your financial and legal advisers can also help.

You may want to engage the services of a real estate agent to sell your home. Consult a number of agents and compare the services offered and the fees. Think about where you will live in the interim if you sell your existing home before you buy a new one. If you buy a new home before you sell the old one, you may need to arrange bridging finance. Not only is bridging finance costly, but it also puts pressure on you to lower your asking price in order to sell more quickly. One way out of this potential problem is to enter into a contract to buy the new home that is conditional on the sale of your existing home.

Some retirees prefer to rent because the landlord is responsible for repairs, maintenance, building insurance and council rates. Renting gives you some flexibility because you can relocate from one type of rental property to another or from one locality to another at the end of your lease.

However, you may not be able to make alterations, keep a pet or stay on after the lease expires.

Retirement village

Retirement village living suits many people. It has the advantage of giving you security about your accommodation and the opportunity to become part of a community of people with similar interests. Retirement villages vary a great deal in terms of price, ongoing fees and the types of services provided. Most offer independent living with optional assistance services, such as help with home maintenance, emergency assistance and shared dining if you want them. Recreational facilities are usually available as well.

Entering a retirement village begins with a private contractual arrangement between you and the village. You pay an *entry contribution* that may range from a relatively small amount to the full purchase price of the unit. You may get the ownership title to your unit, or you may be buying the right to lifetime use. If you leave the village, you may be entitled to a return of some of your contribution, but this is not always the case. Often a deferred management fee is deducted that is based on the length of time that you stayed in your retirement unit. Be sure you understand the terms and conditions of the contract and ask your solicitor to explain the implications of any matters that are not clear.

As well as your entry contribution, there are ongoing fees that depend on the services you use and the facilities provided. For example, you may choose a full service arrangement whereby your fee covers meals, cleaning, laundry and maintenance. Alternatively, you pay a lower fee if you choose to live more independently. It is important to be clear about what ongoing fees you are asked to pay and what services you receive for them.

Residential care facility

Residential care facilities are nursing home and nursing hostel accommodation. These are suitable for people who need some form of ongoing support and care. You will need to be assessed by the Aged Care Assessment Team before you can enter a residential care facility. Residential care facilities differ in what they offer, from basic accommodation services with on-call care, through to continuous nursing care. Hostels typically provide accommodation and personal care services with occasional nursing care, while nursing homes provide more continuous nursing care. Some facilities, called *extra service facilities,* provide a higher standard of accommodation and services for which you pay more.

You may be asked to pay an *accommodation charge* when you enter residential care. The amount will depend on the particular facility that you choose, but you cannot be charged more than you can afford and you cannot be forced to sell your home to pay the charge. Part of your accommodation charge is refundable if you leave the facility. In addition to the accommodation charge, you also pay basic daily care fees. The basic care fee should not exceed $25 per day and it is indexed to changes in the Age Pension. Residents who are not on the full Age Pension pay an additional daily fee not exceeding $31, depending on their income. Fee reductions can be arranged in cases of genuine financial hardship. You can obtain more information on aged care services by calling 1800 500 853 or by visiting the Aged Care Internet site at http://www.health.gov.au/acc/index.htm.

CLUBS AND ASSOCIATIONS

Clubs and associations are a great way to discover new hobbies and friends. Look in the Yellow Pages under 'Clubs' to find out what is available in your area. In addition to sporting, community and special interest clubs, there are a number of national associations that have been formed to represent and promote the interests of retirees.

- *National Seniors Association* is a community organisation for people aged 50 and over. It represents its members' concerns to government, organises social activities, and provides member benefits such as travel and insurance savings and access to investment advice. It operates in each state.
- *Australian Retired Persons Association* provides information, support and activities for retired people. It offers free counselling and retirement seminars, various social activities and group travel opportunities. It has branches in every state.
- *Council on the Aging* represents the rights and interests of older people. It also provides a range of information and seminars on topics relevant to seniors, as well as some insurance and financial services. It operates in all states and territories.
- *Association of Independent Retirees* is open to the retired and semi-retired who do not receive a full Age Pension. Its aim is to protect and advance the interests of people who are funding their own retirement. It has branches in each state and the Australian Capital Territory.
- *Probus Clubs* are locally organised clubs of retired and semi-retired professional and business people. They provide fellowship and a range of social activities. They operate in many cities and towns throughout

Australia. The local Rotary Club can give you information about clubs in your area.

There are also a number of associations that provide advocacy services. They exist primarily to protect the rights and interests of people living in supported accommodation, particularly residential care facilities.

Australian Capital Territory	ACT Disability, Aged & Carer Advisory Service	(02) 6242 5060
New South Wales	The Aged-Care Rights Service	1800 424 079
Northern Territory	Top End Advocacy Service	(08) 8981 5883
Queensland	Older Persons Advocacy Service Inc	1800 818 338
South Australia	Aged Rights Advocacy Service	1800 802 030
Tasmania	Tasmanian Advocacy Inc	1800 005 131
Victoria	Residential Care Rights	1800 133 312
Western Australia	Advocare	1800 655 566

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