



Know when to part prepay a home loan.

By Renu Yadhav

If you have a home loan, it is possible that you might have faced the dilemma at least once whether to make part prepayment of your home loan or invest that extra sum you might have received as your bonus. As home loan is generally one of the biggest loans one might avail of during the lifetime, and there is no prepayment penalty, you would want to get rid of it as soon as possible and be debt-free. However, making the decision whether to make part prepayment or invest the sum is not that easy in case of home loans because there are multiple factors that you need to consider, including the rate of interest on loan, remaining tenure, rate of return from the investment, tax benefit forgone on interest and principal repayment, among others. However, there are certain situations when it is advised to make the part prepayment rather than investing. Let's explore them.

Rate of return is lower

In case you are planning to prepay your loan, you first need to calculate the opportunity cost that is the benefit forgone for not investing the same sum that you are planning to prepay. In case the opportunity cost is lower than the money saved through interest, it would make sense to make part

prepayment of home loan. In case you have taken a home loan of ₹ 50 lakh with a tenure of 20 years at an interest rate of 7.5%, and if you make partial prepayment of ₹ 5 lakh at the end of the fifth year, then you will save an interest of ₹ 8.8 lakh over the tenure of loan. At the same time, if you invest it in a fixed deposit, which is currently giving an interest rate of around 5.4%, you will earn ₹ 6 lakh at the end of 15 years. So, if one calculates the post-tax return on FDs, the gains would go down further.

Given the fact that the rate of interest on FDs and other small saving instruments is at a multi-decade low, planners are advising people to make prepayment on home loans. "The home loan interest rates have come down to below 8% and there is hardly any debt instrument that can deliver a return of around 8% post-tax. If one invests in equity there is a probability of earning higher return, but then it carries risk as well, as there is no guarantee of earning such return," said Melvin Joseph, a Sebi-registered investment adviser and founder of Finvin Financial Planners.

Experts say while comparing the rate of return from the investment with the rate of interest on loan, borrowers should also remember that as the loan tenure is long, it is expected that the interest rate cycle may reverse. So, though the rate of interest is low now but it may go up going forward in case the Reserve Bank of India (RBI) raises rates. In case of floating rate home loan, lenders will revise upwards. Therefore, the interest rate on loan may go up, and hence, will increase the debt burden.

"RBI has not deducted interest rates in the past two monetary policy reviews, and given the fact that inflation has started rising, we may not see further rate cuts," said Joseph.

Limit credit utilization

When buying a house people generally overstretch, assuming that their financial situation will get better going forward, as salaries increase. Higher equated monthly instalments (EMIs) means higher credit utilization, which is the percentage of your total credit limit you are using.

With a lot of people facing job threats, it is advisable to prepay home loan and bring down credit utilization to a lower level as it will be difficult to pay EMIs in case the earning member faces a job loss or pay cut.

Generally, it is advisable that EMIs shouldn't go beyond 30-40% of the monthly in-hand income, as it will lead to higher credit utilization on your part. "The proportion between EMI and monthly income should be below 40% of the take-home monthly income. This should be inclusive of all the EMIs. If the EMI is exceeding 40%, then one should consider renting over buying. For someone who is already paying EMI above the prescribed levels, prepaying could make sense, but on the other side, they should also ensure to build a corpus for their future financial goals," said Nitin Vyakaranam, founder and CEO of ArthaYantra.

By limiting the EMIs to 40%, one can allocate the rest towards savings and investments as well as expenses.

"Since buying a home is unlikely to be the only financial goal, with other goals like retirement and education for children, among others, it is best to stick to 30%. That allows multiple goals to get achieved as well. In an uncertain job environment, prepaying loans in tranches consistently may be a good idea to pay off the loan faster than planned," Vishal Dhawan, founder, Plan Ahead Wealth Advisors.

Higher credit utilization also impacts the credit score, and hence, may impact the future borrowing capabilities. Therefore, it's better to restrict EMIs to up to 40% of the monthly take-home salary.

Finding the fine balance

Being debt free is a bliss, but it's difficult to achieve, therefore, experts advice to find a fine balance. "Although no debt is an excellent situation to be in, but one has to be mindful of the fact that they must have proper emergency fund and health insurance to take care of any exigencies," said Pankaj Mathpal, founder, Optima Money Managers.

In case you have an extra sum, first you should ensure that you have proper emergency corpus. Given the fact there is a lot of uncertainty in the job market, planners are advising people to ensure they have an emergency corpus to take care of up to one year of expenses in case of single-income families. Whatever is left after that can be utilized towards prepaying home loan to reduce the debt.

