Financial Literacy…the new E=mc2…Earning, Learning, Returning

Albert Einstein is said to have quipped that the rule of 72 is the eighth wonder of the world. Trust companies, banks and lenders would agree with Einstein. They know that if you pay off the $5700 Caribbean winter get away that you charged to your credit card at the minimum repayment schedule your trip will cost you ten times the sticker price after over 50 years of payments. While no one makes a conscious decision to delay repayment, an accident or loss of a job can set this scenario into motion.

Recently one of Canada's major banks was in the news when a couple purchased a new car using a sub-prime loan through a dealership with an interest rate of 25%. They went public with their plight when they read their agreement and found that their $21,000 car was going to cost them $46,000. They bought a car for $21,000 and were paying $25,000 to the bank for the privilege of their loan.

Simply stated, here's the rule of 72: (interest rate) X (years) =(double the initial amount).

That rule works both ways. A $1000 deposit to your TFSA or emergency account at an interest rate of 6% would more than double in 12 years.

A $1000 invested at 6% for 12 years (6 X 12) yields a guaranteed investment value of just over $2000 at the end of the period.

Let's look at a family scenario that could take advantage of the rule of 72.

The Bennett's benefited from financially literate parents and are believers in obtaining financial advice from a variety of professionals. They received reports from various institutions and advisors who offer debt consolidation and other debt management strategies. In the end they felt with their internet skills and current budgeting experience they would purchase a software package that keeps them on track financially in real time.

The Bennett's, aged 27 and 28 enjoy well-paying jobs with good benefits, two toddlers but also have credit card debt, student loans, new car payments, a new mortgage and child care costs of $1000 per month. The Bennett's are wondering how they will ever be debt free. Their net worth is near zero but they do have discretionary cash available each month of about $290 from a DJ job.

Both Bennett's are university grads with a total of $36000 in outstanding student loans. They are fairly confident that their contract jobs will provide a decent pension and a secure future for the family.

The other issues that concern them are the predictable surprises of being injured, becoming critically ill, dying too soon or facing the risks of higher health care costs that longevity brings.

They worry about the financial impact if one of their children became seriously ill and how will they ever manage all of these life variables? The Bennetts took a deep breath after an unexpected visit to the local emergency ward resulted in a long stay at a children's hospital for their eldest daughter. She was successfully treated for a rare inflammatory condition that if left undiagnosed and untreated could have had serious long term implications. Some day they will say thank you to the hospital with more than a box of chocolates and a card.

The Bennett's subscribe to one of the lender's computer applications that shows that their mortgage balance is declining very slowly. They owe $276000 on the $330,000 variable rate mortgage at 2.7%. They console themselves in believing they have good schools in the area along with attractive parks. They do worry about what will happen when interest rates eventually go up?

The car loans total $36000 including the new mini-van will take seven years to pay off. Will the cars last that long with all the travel they rack up?

The credit card balance is up to $20,000, costing them 9.9% interest on which they are paying the minimum because child care costs about $1000 a month.

Is there any way the Bennett's can use their human capital and their cash flow to re-engineer their debt repayment process, reduce interest costs and reduce the time to become debt free?

Thanks for the rule of 72 and some sophisticated software there are ways to reach the debt free goal with the $290.00 monthly discretionary cash.

The Bennett's ask their financial services provider to make budgeting and cash flow recommendations in addition to the life and critical illness coverage they purchased to supplement their employer group coverage. Following a full disclosure of fees, responsibilities and potential conflicts of interest the Bennett's subscribe to an online software debt management program. They feel the subscription fee will keep them on track for the duration of the plan which has been reduced from 25 years to half that time. They really have some skin in the game.

The analysis, done on line, shows that the 25 year mortgage and consumer debt can be paid off well in advance of the 25 years with budget discipline and no change in cash flow or life style. The Bennett's discuss the options outlined and chose to target the $290 discretionary income to use a strategy called snowballing.

Snowballing means that the debt with the highest interest rate is the first target to pay out. Once that debt is paid out, all the discretionary cash will all go to pay out to another debt. The process is repeated until the consumer debt and mortgage is eliminated.

All the while the Bennett's are following the plan, they are able to watch their progress with the on line connection they have with the software company. They find strong validation and motivation when viewing their financial accomplishments and seeing in real terms the long term impact of their prudent budgeting.

Should they not be able to stay on plan every month, they can still keep track of their progress. On the other hand should they come into addition funds like an income tax refund, they can see the impact of the additional lump sum payments just by logging onto their personal site.

Assuming the Bennett's follow the re-engineering of their debt, they can reduce the time needed to pay off the debts and be debt free years earlier.

The reduction of time to pay off the debt is one benefit and in addition they have saved tens of thousands of dollars in interest payments. Interest savings added to retirement savings, registered education plans or other family goals gives the Bennett's more options and control over the decisions they make.

As the mortgage debt repayment gains speed over the last few years of the repayment schedule the Bennett's can re-allocate the additional funds to other family goals because there is little advantage to be gained by continuing the accelerated mortgage repayment strategy. It may be time to take that family trip to meet over-seas relatives that will generate shared memories for years to come.

Do you remember when the Bennett's dreamed of leaving a legacy to the medical center? They discuss their dreams with their financial services advisor who recommends a number of philanthropic options that fall within their budget. With 10% of their interest savings to date they purchase a permanent life insurance policy and name the hospital the beneficiary. The Bennett's get the satisfaction of knowing their good deed makes their community a better place to live.

So why don't we hear more about living within our means and debt re-engineering? Why it is that stories about questionable car loans get the headlines? Why aren't our schools and financial institutions educating Canadians about the power of the rule of 72? Imagine the true spending power that debt free households could bring to the economy? Imagine the unseen benefits our communities would reap through savings in improved mental health, reduced drug and alcohol addictions and positive family health?

Not only do our schools, our institutions and our families need to embrace and share the lesson that Einstein noted nearly a century ago but so do not-for-profit organizations. They need to educate their alumni, volunteers, current and prospective donors to maximize their cash flow to reach family goals and attain their philanthropic intentions sooner.

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