Partial Payment of Home Loan vs. Investing

We will be analyzing an exciting scenario that most of us would have experienced at least once in our lifetime. One of our clients had a lump sum amount of Rs.22 Lakhs in an arbitrage fund. He wants to understand which of the options below would benefit him.

1. **Investing in Equity Funds.**

2. **Repay one of the existing loans and invest the EMI amount systematically into Equity Funds.**

Before entering into the analysis part, let me briefly introduce the **client's existing loans**. Our client had **three home loans**; We can see the details of the loans in the table below.

Particulars	Outstanding	Annual EMI	Interest Rate	Term of the loan	Monthly EMI
Home Loan 1	24,15,419	4,44,684	7.30%	176 months	37,057
Home Loan 2	15,55,512	2,68,524	7.15%	48 months	22,377
Home Loan 3	1,19,01,736	12,22,404	7.50%	216 months	1,01,867
Total Outstanding	**1,58,72,667**	**19,35,612**			**1,61,301**

Since the client has three different loans with different tenures, we will consider multiple scenarios accordingly.

Scenario 1:

Here we will **switch entire arbitrage funds into equity funds**. The rationale for changing funds from Arbitrage to Equity is arbitrage funds yield a return of 6-7% on a CAGR basis and are suitable to hold for a short-term period, whereas the client's intention here is to gain maximum returns. Hence we are switching from Arbitrage to pure equity funds. The tenure considered for investing would be **15 years**. Considering we invest **Rs.22 Lakhs** with a conservative rate of return for the equity asset class as **12%**, the **maturity amount** at the end of 15 years would be **Rs. 1.20 Crores**.

Scenario 1 :- Switch from Arbitrage to Equity Funds	
Cash in Hand	Rs.22,00,000/-
Tenure	15 Years
Rate of Return	12%
Maturity Value	Rs. 1,20,41,845/-

Scenario 2:

Here we will be **pre-closing Home Loan 1**, because the funds available match the outstanding loan amount, and whatever **EMI** the client is paying monthly will be **redirected into Equity Funds as SIP's**. The **outstanding loan amount** on Home Loan 1 is **Rs. 24,15,419**. Considering he closes home loan 1 he will potentially save **Rs. 37,057/-** every month. So We will invest Rs. 37,057/- every month into equity funds for the next 15 years with a conservative rate of return for the equity asset class as 12%. The **maturity amount** at the end of 15 years would be **Rs. 1.86 Crores**.

Scenario 2 :- Pre-Close Home Loan 1 & Start a SIP	
Cash in Hand	Rs.22,00,000/-
Outstanding Loan Amount	Rs.24,15,419/-
Monthly EMI	Rs. 37,057/-
Loan After Pre-Payment	Rs. 2,15,419/-
Monthly SIP amount	Rs. 37,057/-
Tenure	15 Years
Rate of Return	12%
Maturity Value	Rs. 1,86,98,073/-

Scenario 3:

Here we will be **pre-closing Home Loan 2, since the funds available in hand are higher than the outstanding loan amount in home loan2** and whatever **EMI** the client is paying on a monthly basis and **left over Lump sum** (22 lacs- 15.55lacs) will be redirected into **Equity Funds as SIP's**.

The **outstanding loan amount** on Home Loan 2 is **Rs.15,55,512/-**; considering he closes home loan 2, he will be potentially saving **Rs. 22,377/- every month and lump sum of Rs. 6,44,488/-** . So We will be investing Rs.22,377/- every month along with a one time investment of Rs.6.44 Lakhs into Balanced advantage Funds for the next **4 years** with a conservative rate of return of **8%**. Balanced Advantage fund is considered here since the time horizon is lower. The **maturity amount** at the end of 4 years would be **Rs. 21.5 Lakhs**.

Scenario 3 :- Pre-Close Home Loan 2 & Start a SIP	
Cash in Hand	Rs.22,00,000/-
Outstanding Loan Amount	Rs.15,55,512/-
Monthly EMI	Rs. 22,377/-
After Pre-Payment	Rs. 0/-
Monthly SIP amount	Rs. 22,377/-
Tenure	4 Years
Rate of Return	8%
Maturity Value	Rs. 21,55,949/-

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Scenario 4:

Here we will be doing a **partial payment on Home Loan 3** and **opting for revised reduced EMI** for the same tenure. The **difference between the existing EMI and the new revised EMI will be put in to Equity Funds** on a monthly basis as SIP's. The **outstanding loan amount** on Home Loan 3 is **Rs.1,19,01,736/- after repaying Rs. 22 Lakhs our outstanding(available cash In hand) amount will be Rs. 97,01,736/-**. Similarly, the **EMI reduces from Rs.1,01,867/- to Rs.81,468/-** and the difference of this two amount will be **Rs.20,399/- which he will be investing for next 18 years** with a rate of return of **15%** as the time horizon is long. The **maturity amount** at the end of 18 years would be **Rs. 2.25 Crore**.

Scenario 4 :- Partial Payment of Home Loan 3 & Difference in EMI as SIP	
Cash in Hand	Rs.22,00,000/-
Outstanding Loan Amount	Rs.1,19,01,736/-
Monthly EMI	Rs. 1,01,867/-
After Pre-Payment	Rs. 97,01,736/-
EMI after Partial Payment	Rs. 81,468/-
Monthly SIP amount	Rs. 81,468/-
Tenure	18 Years
Rate of Return	15%
Maturity Value	Rs. 2,25,25,806/-

Analysis:

Along with the four scenarios, we should also remember that the **housing loan interest rates are flexible**. It may increase or decrease based on the economic conditions of the country. Of the above-evaluated scenarios, **Scenario 1 & Scenario 3 is not beneficial**. The **maturity value** in **Scenario 1** is around **1.2 Cr**, **whereas** if we **repay Home Loan 1 and save subsequently**, our **maturity amount is much higher**. Similarly, in **Scenario 3**, since the **number of years is shorter**, two things play against us.

- The Loan tenure remaining is just four years. Hence a **significant part of the EMI will be used for the principle**, and the interest amount would be comparatively less.

- It is **not advisable** to stay invested in **equity for a shorter time horizon**, and we won't be able to create great wealth.

Hence Scenario 1 & Scenario 3 can be eliminated.

Scenario 2 is an **excellent option** as the **maturity value would be 1.86 Cr**, and the investment time horizon would be around 15 years. The magic that works here is since we are **closing the loan**, our **outstanding loan amount would be minimal or zero**, and the **interest we would pay would be lesser**

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or nil. Also, the **EMI** currently paying towards that Home loan, if **converted into a SIP**, the **corpus created would be significantly higher than in Scenario 1**.

Regarding **Scenario 4**, we get an additional three years' time horizon for investment. Here the client will make a **partial payment** which will **reduce his outstanding loan and his EMI** as well. The **difference between the initial EMI and Revised EMI** would be the **surplus** which he will continue to **invest for 18 years**, and he would be getting a number of **Rs. 2.25 Cr at the end of 18 years**.

After careful evaluation of each scenario 2 & scenario 4, both would be beneficial options to consider. **My bias** would be more towards **Scenario 2** because of the following reasons.

- Psychologically **1 out of 3 Home Loan** is **instantaneously closed**.
- At the end of 15 years, whatever **lump sum he receives** can be used to **close the home loan 3**. Doing this, he will be saving some amount on the interest part.

Conclusion:

As mentioned above, **Scenario 1 & Scenario 3 was ruled out**. The **pros & Cons** said above for **Scenario 2 & Scenario 4 were explained to the client**. Finally, the **client opted to go with Scenario 2**. He **pre-closed Home Loan 1** and **started a SIP of Rs. 37,000/- monthly into Equity funds**.

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