Should you cash in your pension to pay off debt?

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A young woman recently asked me if it would make sense for her to cash in her pension, settle her debts and start all over again. It sounds like a good idea.

On the one hand, you have debt with interest as high as 25% a year. On the other hand, you have an investment that will grow at 10% a year. People, however, underestimate how powerful compound growth can be over the period of one's career, while at the same time overestimating their willpower or ability to change.

Say, for example, you are 30 with a pension fund of R100 000. You change jobs, cash it in and settle your debt. What you have failed to deal with is the reason you are in debt in the first place – namely, your lifestyle.

In this scenario, you have not learnt to write up a budget and stick to it, and you have not learnt how to develop a repayment plan. What you have learnt is that in the short term, there really is no negative consequence to living beyond your means because you can always borrow from the future.

Based on my experience of how most people handle money, I would say that there would be a 95% chance that, within five years, you will be back at the same level of debt again. That new job with the higher salary would just allow you to take on more debt. In the meantime, you have lost out on the potential growth of that R100 000.

At 35, you are now worse off than you were when you were 30, with less years ahead of you to rectify your financial situation. If you focused on paying off your debt by budgeting and cutting back on your lifestyle, you could probably pay off your debts within five years with a payment of R2 900 a month, or by using your bonuses and tax rebates to pay it off even faster.

Over five years, at an interest rate of 25%, you would spend R174 000 to settle the R100 000 debt. You would also have become used to living on less each month and, hopefully, have developed the discipline to start saving R2 900 a month once those debts had been paid off. In the meantime, if your R100 000 is growing at 10% a year, it doubles in value every seven years. So after seven years, it is worth R200 000, after 14 years it is worth R400 000 and after 21 years, at the age of 51, it is worth R800 000.

If you cash in the money and pay off your debts, those debts will in effect cost you R800 000. Settling your consumption debt with investment money is nothing more than stealing from your own future.

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