

Two sides to debt

WE previously discussed the five principles of borrowing. Let's recap before we proceed:

1. Borrow for something you need, not want
2. Borrow an amount that is within your repayment capacity
3. Avoid borrowing to finance depreciating assets
4. Avoid being a guarantor
5. The borrower has a moral and absolute commitment to repay

This week, we will discuss the different types of debt. What's the difference between good debt and bad debt? Is there such a thing as good debt?

Well, good debt is debt that can provide a financial pay-off. Borrowing to buy a home, paying for a child's education, advancing your career skills, or starting a business can provide long-term financial benefits.

Bad debt is when you borrow for things that don't provide financial benefits, or last as long as the loan. This includes borrowing for vacations, clothing, furniture, home appliances or even dining out.

In the process of sorting through the negatives of debt, it's possible to draw a somewhat hasty conclusion that all debts are bad and counter-productive. But there's productive use of debt by individuals, businesses and even charities.

To understand that, we must define productive and non-productive debts:

- If I borrow money to buy an experience or things that I can't pay for and incur debt with high interest charges, I have burdened myself with a non-productive debt.

- If I borrow money to acquire an income stream that contributes to repaying the debt incurred, as in buying a shoplot which is being rented out (to a good tenant, hopefully!), I have made a productive use of debt.

- If I borrow money on my margin account to speculate on a "hot" stock based on hearsay or gossip, I have saddled myself with a dangerous and non-productive debt. In essence, I can lose the money (in most cases) and still owe the debt.

- If I borrow money to buy a house that I intend to live in for the foreseeable future. I will probably break even over time through the capital appreciation of the house. In any case, it would have saved me on the rentals had I rented a house instead of buying one, of which I have made productive use of a debt.

- If I borrow money to buy a new car and owe more than 90 per cent of its value, I'm immediately down on the use of debt if the car is stolen. Are you aware that in most cases, a car depreciates about one-fifth in value the moment it leaves the showroom?

As your insurer only pays the market value of your car at the time of loss, you'd need to make good the shortfall.

- If I borrow money to start a

business, I could write-off the interest costs against the revenue of my business and so save myself some taxes. I could even use the amount borrowed to expand my business, and this would be a productive use of a debt.

Borrowing can be a productive, wealth-enhancing activity or a "slave to the lender" type of experience. A wise man uses debt as a tool to build wealth, obtain favourable tax treatment and expand the assets under management while a not-so-wise man most frequently thinks of debt as a tool to buy something he has not had the discipline to save for nor the patience to wait for.

Not all debts are counter-productive. Sound financial practice requires the benefits produced by the debt to service the debt and repay the original capital. When we apply these principles to business, the result is the same. The cash flow created by the application from proceeds of the loan must provide an expanded flow of income able to service the credit requirements, plus repay the original loan.

Another type of debt

Despite your best efforts, you may find yourself in severe debt. This is when the bad becomes worse and you're totally consumed by it.

Some tell-tale signs if you're encountering "ugly debt":

- Borrowing to pay off other loans
- Creditors calling for payment
- Paying only the minimum on credit cards
- Maxing out credit cards
- Borrowing to pay regular bills
- Being turned down for credit
- Your friends and relatives start avoiding you

- The ultimate — red paint splashed across the walls of your house!

But all's not lost. Help is just a phone call away. A credit counselling service can help you set up a plan to work with your creditors and reduce your debts. All that's required is your total commitment to change to a more prudent lifestyle and be disciplined with the plan.

Debt is a double-edged sword. Use it wisely and it can help you leverage on your wealth-enhancing activities and provide you with long-term financial benefits. Abuse it and it will not only cut you but may even cause you to bleed to "death"! So, before you start "swinging" it, make sure you understand the principles behind it and use it responsibly.

AKPK is an agency set up by Bank Negara Malaysia to provide free services of financial education, counselling and debt management programme. Call 1 800 88 2575, or visit www.akpk.org.my or www.speaksens.com.my. Get *Money Sense* and *Celik Wang* books and keep a lookout for the Mandarin version at all its 11 offices nationwide.

