How bad debt will stop you dead in your tracks

When it comes to debt, there's the good, the bad and the downright ugly. *Helen Collier-Kogtevs*, director of Real Wealth Australia, explores how you could be shooting yourself in the foot and limiting your opportunities to invest if you get it wrong

One of the most common mistakes that property investors make is to take on too much bad debt – that's debt that isn't income producing, or attracts interest that's not tax deductible. Typically, bad debt includes credit card and personal loan debts.

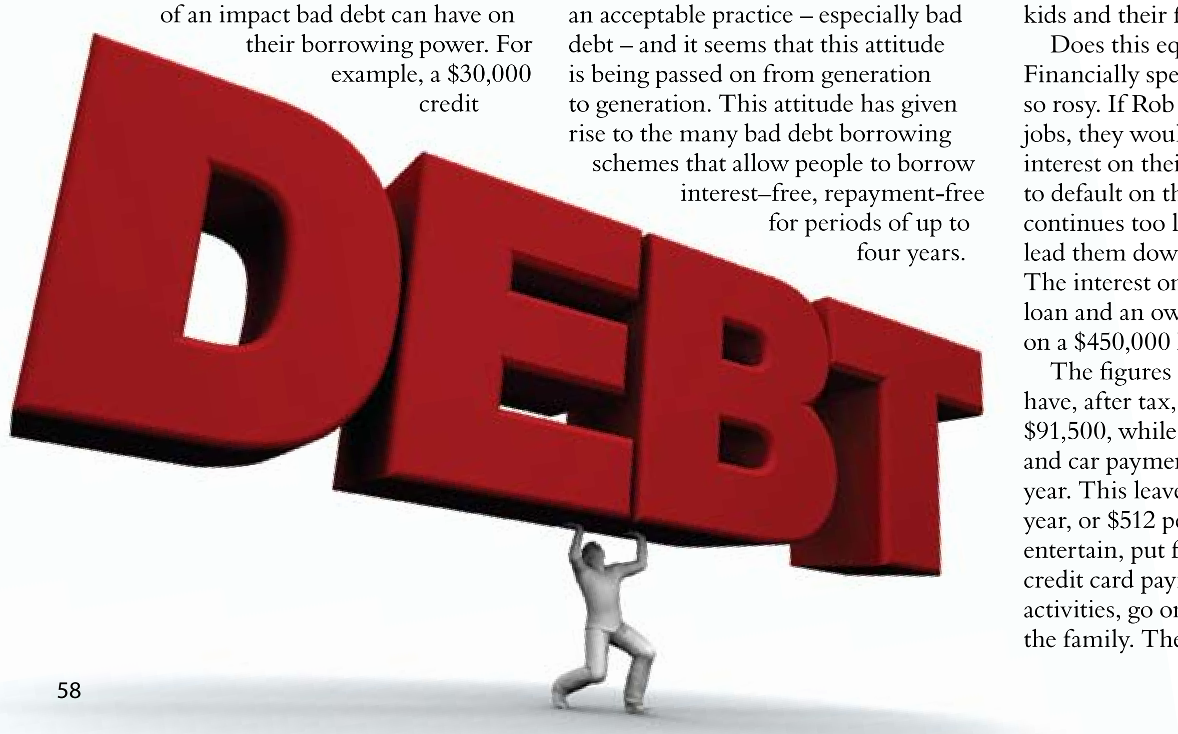
When it comes time to apply for a new loan to buy an investment property, the amount of your income that's needed to service your bad debt is deducted from your total income, which is then used to calculate the amount that you can borrow. The end effect is that your borrowing capacity is diminished by your bad debt – just how much, however, will depend on how much bad debt you've actually got.

Many people don't realise how much of an impact bad debt can have on their borrowing power. For example, a $30,000 credit card limit could reduce your borrowing power by $109,500.

The message is simple: how do you expect the banks to lend you money to build a property portfolio if all you have is a stack of credit card bills, personal loan statements and a massive mortgage over your dream home?

I struggle to understand how people can borrow all that they can to spend on their own home, leaving them nothing for any future investments. They max their bad debt, make minimum repayments each month and then wonder why the banks won't lend them any more money to buy an investment property.

I understand that we've been raised in a society where borrowing money is an acceptable practice – especially bad debt – and it seems that this attitude is being passed on from generation to generation. This attitude has given rise to the many bad debt borrowing schemes that allow people to borrow interest–free, repayment-free for periods of up to four years.



Statistically, most don't end up paying by the due date, and get slugged with exorbitant interest rates as a result.

Bad debt is actually what keeps you in the day job longer; if you've visualised retiring at an early age, laying back on a deck chair, enjoying life and playing golf, then keep bad debt out of your investing equation.

Consider this typical scenario

Rob and Jane are married with two children and live in the outer suburbs of Brisbane. Rob earns $90,000 pa while Jane works part-time, earning $30,000. They have a mortgage of $450,000 on their family home. Their credit card limits total $25,000 and they've purchased a new 4WD worth $50,000 with monthly lease payments of $1,037.

Total net income: $91,500 pa
Total debts: $64,476 pa
Available cash: $26,625 pa or $512 per week

They want to buy an investment property and, to their utter disappointment, find that the banks won't lend them any money. Can you seriously blame the banks for not lending them any more? With over $500,000 of bad debt, the risk is a high one for the banks to take on.

This couple has worked hard for their money, and believe they should be able to enjoy the fruits of their labour. They own a 109cm wide screen plasma TV, and have a swimming pool for the kids and their friends to play in.

Does this equate to your dream? Financially speaking, this dream isn't so rosy. If Rob and Jane both lost their jobs, they wouldn't be able to pay the interest on their loans and would have to default on them. If the situation continues too long, it could potentially lead them down the path of bankruptcy. The interest on the credit cards, car loan and an owner-occupied mortgage on a $450,000 house all add up.

The figures show that Rob and Jane have, after tax, a total net income of $91,500, while their current mortgage and car payments total $64,476 per year. This leaves them $26,625 per year, or $512 per week, to feed, clothe, entertain, put fuel in the car, cover credit card payments, attend sporting activities, go on holidays, and educate the family. They'd be considered to be living on the cusp, and vulnerable to interest rate increases.

With the above financial position, Rob and Jane would only be able to borrow approximately $3,000 towards any wealth creation.

However, let's review the figures:

If we reduce the credit card limits to $5,000 and instead of a brand new 4WD, Rob and Jane lease a second-hand 4WD valued at $20,000, then their borrowing power will now be increased to $133,000.

To add to this, let's change the mortgage payments from principle & interest to interest-only to increase cash flow. This simple change would increase their borrowing power to $159,000.

Then by adding an investment property earning a weekly rent of $250, their borrowing power would jump to $251,000, from the initial $3,000.

Imagine what the figures would be if Rob and Jane purchased a cheaper property with a smaller mortgage of $350,000, then their borrowing power would increase again to $329,000.

If Jane chose to work full-time instead of part-time, therefore increasing her income to $55,000 per year, their borrowing power would increase to a whopping $402,000.

If you use cash flow to reduce your debt, you'll increase your borrowing power over time.

The more personal bad debt you have, the more you're trapped in having to earn an income to pay for it all. If you don't have so much bad debt, it takes the pressure off you to earn more.

Paying off bad debt is a simple strategy and something that should be taught to all Australians.

Debt reduction strategy

By completing a budget, you can work out how much extra cash you can manage to put towards reducing the bad debt each week. It's important that you maintain your repayments each month for all loans while you're reducing the debt on one loan.

Let's assume bad debts of the following monthly payments:

Hire purchase:
repayments of $90 per month
Personal loan:
repayments of $140 per month
Credit cards:
repayments of $250 per month
Car loan:
repayments of $500 per month

The idea is to take the lowest bad debt (ie, hire purchase) and increase the repayment each month by $50, therefore paying $140 per month instead of $90. Pay this new amount until the loan is paid off.

Then take the next lowest bad debt, which is the personal loan with a monthly repayment of $160, and add the additional $140 that you're no longer using for the hire purchase. Your new repayments for the personal loan are now $300 per month. Pay this new amount until the loan is paid off.

Once you've paid off the personal loan, you'll have spare cash flow of $300 per month. Add this amount onto your credit card repayments, increasing to $550 per month. Provided you don't re-offend by spending the available credit on your credit cards, you should be in a position to quickly reduce your credit card debt.

The spare cash flow of $550 per month that you'll have from your credit cards will help to quickly reduce the debt against the car loan.

It takes discipline, but managing your money can be very rewarding.

The power of good debt

The key to a wealthier, earlier retirement is having no bad debt and only good debt. Good debt is debt that earns an income and/or attracts interest that's tax deductible. Investment properties provide income through rent and the Australian Taxation Office (ATO) allows owners of investment properties to offset the property expenses against their own earned income and the income from the property, effectively allowing investors to pay less tax than they'd normally have to.

The added bonus that creates real wealth is the capital growth in the property, as it appreciates in value over the years. Repeat this process in a balanced way a few times, and the results are truly magnificent.

On a personal level, I've experienced the magnificent power of good debt and the adverse negative impact of bad debt, and I know which I prefer. I spent my youth working hard for the money to pay off credit cards and personal loans for things I didn't really need, but just had to have.

If I had my time over again, I'd have saved more of my income and put it towards income-producing assets. I still like my retail therapy, but these days it's based on reward for effort in accumulating more wealth, rather than my desire to have it now.

Until next time,
happy investing.

Helen's top tip

Unless you can use your credit cards responsibly, opt for a debit card

Helen Collier-Kogtevs is an investor, educator and author of '47 Biggest Mistakes Made by Property Investors and How to Avoid Them'. To grab yourself a copy, go to: www.realwealthaustralia.com.au