



# Take an axe to what you owe

Getting into debt is easy; getting out of it takes a coherent, logical strategy, but it can be done, writes **Ashley Ormond**

FROM 1992 to 2008 Australians experienced a 17-year-long economic boom that handed us a golden opportunity to get into financial shape, but we blew it.

With an unprecedented run of uninterrupted economic growth following the 1990-91 recession up until the 2008 credit crisis, we had the best performing economy in the Western world, with rising incomes, low unemployment, low interest rates, low inflation, stable government, no major wars and low oil prices for almost all of this time.

Despite these superb economic conditions for such a long period, we didn't use it to get our houses in order. Instead we went on a debt-fuelled spending binge.

Having high levels of household debt is dangerous at a national level and for each household. With high debts we are vulnerable to economic shocks such as rising interest rates, rising unemployment, falling incomes, falling house prices and falling asset values.

Getting into debt is easy. We are bombarded all day and night with offers of easy credit on television and radio, at the cash register, the ATM, through the mailbox, via email, text messages on our phones, pop-up ads on the internet, on billboards, bus sides, trains: almost everywhere we look. Resisting these temptations and paying off debt may seem hard but it need not be.

Most people don't know how much they owe in total. They usually have some idea about how much they owe on the main loans — the mortgage, the car loan — but they usually get a nasty surprise when they add up the grand total of all their debts and look at it for the first time.

The first step is to write down what you think the total amount of all your debts may be. Next, make a list of the balances outstanding on each of your loans and debts. Don't guess this time; look up the most recent statements for each loan. These days you can access statements on most types of accounts via the internet.

What is even more important than the total amount of your debts is how it compares with your income. For example, consider two

families, the Joneses and the Davies. The Jones family owes \$200,000 but earns \$200,000 a year after tax, whereas the Davies family owes \$100,000 but earns only \$50,000 a year after tax. Even though the Davies family has less overall debt, it will take a lot longer to get rid of it because the family's income is much lower.

Work out your after-tax income a year. Include all sources of regular income. Use recent payslips to calculate the total after-tax income for one year. Next, work out how many years of after-tax income your total debts represent by dividing your total debt by your annual after-tax income.

For example, if your total debts are \$240,000 and your total annual after-tax income is \$85,000, then your debt equals 2.8 times your annual income. This does not mean that it will take 2.8 years to pay off all your debts because it doesn't include your living expenses and interest on the debts, but it is a good quick measure of the seriousness of your debt burden.

As a nation, Australian households had a ratio of 1.6 at the end of 2008, but it had risen from just 0.8 during the past 10 years.

Not all debts are created equal. Mortgages are a necessary evil (because it's virtually impossible to buy your first house without one), but mortgages on your subsequent houses and all other types of personal debts are just plain evil and should be banished forever as soon as possible. Generally the best kind of debt is:

Where the asset bought with the debt generates income and/or grows in value in excess of the loan interest rate.

Where the interest is tax deductible (which is usually where the asset bought with the debt generates taxable income).

Examples include debts used to buy investments or to fund a business where the profits and/or growth in value exceed the interest rate on the debt. Also included here are debts to pay for education and training that will increase your future income by more than the cost of the course and the interest.

The worst kind of debt is where it is used to buy items that depreciate in value (cars) or have no monetary value at all (living expenses or holidays). These types of debt carry the highest interest rates and the interest is not tax deductible.

The following table is a summary of the various kinds of household debts.

The No. 1 priority is to pay all bills that are in arrears (or past due). Once the arrears are under control, the general rule is that it is



always best first to pay off debts with the highest effective cost (including interest rates and fees less any tax deduction for interest). The most expensive debts are unsecured personal debts where the lender takes no security, such as credit cards, store loans (those buy-now-pay-no-interest-for-two-years loans for household items), personal lines of credit and personal loans. Once fees are added, the interest rates on these loans are generally 20 per cent to 30 per cent a year.

Once these are paid off, the next most expensive category of debts comprises those secured by depreciating assets, such as cars, boats, furniture and other household items. Interest rates on these loans are generally about 10 per cent to 20 per cent, lower than unsecured debts because the lender has some security they can repossess and sell if you default on the loan. If there is still a shortfall after they sell the item and take the proceeds, the lender can chase you for the rest.

Once these types of debt are paid off, attack

your debts secured by real estate that don't generate income. This category includes home mortgages, line of credit mortgages and the like.

The last category is debts with tax-deductible interest. These include investment property loans, margin loans, business leases, business overdrafts and other business loans. Debt used to generate business and investment income is good debt and can help build wealth if it generates income or growth in excess of the interest rate. But the ultimate aim is still to pay off these debts to maximise your wealth and financial freedom.

Rather than trying to pay off several debts at once, it is usually best to put every effort into paying off one debt at a time.

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