

HOW MUCH DEBT IS ENOUGH?

Keeping your debt levels in check. By STUART WEMYSS

The thought of borrowing hundreds of thousands or even millions of dollars scares some people. So how do you work out how much debt is enough? How do you measure your personal maximum borrowing capacity? And what happens if you get into trouble and find yourself struggling with repayments?

GETTING IT RIGHT FROM THE START

Assessing your borrowing capacity is a very personal matter.

Some people aren't frightened and will borrow as much as any bank will lend them.

Others get nervous at the thought of borrowing any more than they absolutely have to. Sometimes, this fear is the result of a lack of education and knowledge. By crunching the numbers and really considering the risks involved, it may not look as daunting as first thought.

That said, you need to be totally comfortable with any debt you take on.

The last thing you want to do is borrow more than you can afford and get into trouble down the track.

Here are some simple tips and things to consider when planning your next mortgage.

Numbers game

Anyone with significant financial commitments, such as a mortgage, should be budgeting on a regular basis. If you don't budget, it's like a pilot taking off without checking how much fuel is in the tank. Budgeting helps you understand exactly where your money goes and allows you to plan for the future.

There are some free or cheap software packages that can assist with budgeting. A simple spreadsheet will also do the trick.

Budgeting is just like dieting. You need to be realistic when setting your budget. Whatever you plan to spend needs to be

maintainable and achievable. Planning to live on a few dollars a week is just not realistic and you'll end up throwing the budget out the window and deciding it's all too hard.

In addition, you need to be realistic with yourself. If you have a habit of spending lots of money on things like clothes then make sure that's reflected in your budget, but make it a reducing expense. You can then slowly massage your over-spending back to a sensible level. Tackle budgeting in stages. Start by monitoring expenses and then cut them down bit by bit.

The purpose of budgeting for investments is to ensure you can afford it. Sometimes a property rental income will be enough to pay for all expenses. Plus some expenses are paid for on an irregular basis, such as maintenance, and you need to budget for this.

BE THE DEVIL'S ADVOCATE

When budgeting, make sure that you always consider the worst-case scenario. Be conservative with income. And it's better to overestimate negative things. For example, if you're estimating rental income, perhaps look at the average vacancy rate for an area and double it.

You also need to overestimate when it comes to expenses. If you've been budgeting for a while you'll have a good idea of your average monthly expenses. Always include a buffer (say 10 per cent of total expenses) for unexpected expenses.

When it comes to variable interest rates make sure you build in a safety margin. Two per cent is a reasonable amount.

You might consider a fixed rate if your budget is interest rate sensitive; for example, if you don't expect a large surplus income after taking into account the mortgage repayments.

SECOND OPINION

Sometimes you can be too close to the action and you might want something so much that you "make the numbers work".

Often, getting a third party to run their eyes over your budget helps you to get perspective. They might be able to identify things that you have omitted or point out areas that appear unrealistic. An accountant can help with a second opinion.

PLAN B

Make sure that you have a plan B just in case things go wrong. Consider scenarios such as losing your job, or a number of rental properties becoming vacant for a long period of time. The plan B might be accessing some emergency cash, making sure you have adequate insurance (such as income protection or rental insurance), drawing down on a line of credit or even selling some assets/liquid investments. If you don't have a good, workable plan B then maybe it's not the right time to borrow more.

CRYSTAL BALL

It's important to consider the future when you're budgeting. People's incomes and expenses can change dramatically over time. Starting a family is probably the most significant change you can experience. Often one salary earner has to stop work for a period of time while expenses are actually increasing.

Ensure that you think about the foreseeable future. Planning at least five years in advance is a good idea. Undertaking this detailed planning and budgeting often reduces stress levels. For example, you don't have to be uneasy when there's talk about an interest rate increase because you've budgeted for at least a 2 per cent rise. Budgeting doesn't take long and it costs nothing. However, if you don't budget, it could cost you plenty.

STRUGGLING? WHAT DO I DO?

Take immediate action when you first realise that you're having difficulties making the repayments on your loan. There's nothing wrong with admitting you're having problems. And if you do something about it early, then a simple solution or arrangement can be put in place.

Your main aim should be to understand why you're having difficulties. What has changed? Your income? Rental? Expenses? Are these changes permanent or temporary?

If it's expenses then you may have to identify areas in which you can cut down. Return to your budget and compare your actual expenses to see if and where you are over-spending.

If income is the problem, then try to work out if the problem will be permanent. If not, then you may have to dip into your emergency money – that's what it's there for.

If you conclude that your income reduction or expense increases are permanent then you may have to take alternative action. Here are a few things to consider.

CONTACT THE LENDER

You can discuss your concerns with your lender and potentially come up with a way to work through the difficulties.

Some solutions might include a repayment holiday (no requirement to make repayments for a period of time). This is normally only available if you're ahead with your repayments.

Some people feel reluctant to tell the lender about their

issues, fearing that their property might just be sold from underneath them. In reality, the lender prefers to do anything but sell the property. This is time consuming and costly. It's also not good business for them, because they would prefer to charge you interest into the foreseeable future.

RESET YOUR MORTGAGE TERM

For example, assume that you took out a \$400,000 mortgage five years ago for a term of 30 years, and the balance is now \$350,000. What you could do is reset the existing balance over 30 years again, thereby reducing the minimum repayments. In this example, repayments would be reduced by approximately \$315 per month (based on an interest rate of 6.5 per cent).

SWITCH TO INTEREST ONLY

Request a short interest-only term (say for 12 months). Most interest-only loans allow principal repayments at any time. This gives you the flexibility of lower monthly repayments. Each month you can choose to either repay interest only or interest and principal (whatever you can afford).

REDUCE EXPENDITURE

This may go without saying, but try to cut down on any surplus expenses. This comes back to budgeting and knowing where your money is going.

CONSOLIDATE DEBTS

Consolidating debts can reduce the monthly repayment commitments and often reduces the effective interest rate. However, consolidating debts into a mortgage may actually end up costing you more in interest because the debt is repaid over a longer term (eg. 30 years as opposed to five years for an unsecured loan).

INCREASE INCOME

Consider taking on a second job to earn some additional income. This may be difficult if you have a young family but there might be some jobs that you can do from home.

SEEK HELP

If you have problems with managing your finances then seek help from a professional. Most of these solutions are only temporary and should only be used in situations where you won't be experiencing ongoing difficulties. But if the difficulties are going to be permanent then you may need to consider selling one of your properties or reducing your debt in another way.

WHAT WILL THE BANK DO?

It's in everyone's best interests to not have to sell a property when borrowers get into trouble. The bank would prefer not to have to take possession of your property and sell it because it takes up a lot of time and money. Following is a brief overview of what steps the bank may take. These steps actually depend on the individual circumstances surrounding the loan and may differ from bank to bank. This process normally

takes several months.

- ▶ If a repayment is not made on time then the bank will issue you with a letter, as they are required to do by law for home loans. This letter will tell you that the repayment is required within a certain time.
 - ▶ If the repayment is not made (say within 30 days) then the bank will contact you to try and work out a solution. This may involve a number of steps, possibly including resetting the loan term or providing a repayment holiday (if you're experiencing temporary financial difficulty).
 - ▶ If a suitable solution can't be agreed on, or if the bank hasn't been able to make contact within a couple of months (60 days), then the file is transferred to the bank's legal area or lawyers to manage the loan. They will comply with all legal requirements (including issuing letters of default).
- The default will be recorded on your personal credit file. •
- ▶ At this point you have two options. You can refinance the loan or you could sell the property and pay out the loan. You have approximately 30 days to make this decision. You're normally encouraged to investigate both options for yourself, independent of the bank, so that you retain control of the process. These days it's a lot easier for borrowers to refinance their loan because there are many lenders that specialise in assisting borrowers who are in default. Once refinanced, borrowers in default will end up paying a higher interest rate, approximately 1 to 2 per cent above the standard variable rate. If you need to sell your property, you're better off retaining control and selling it before the lender does because the bank doesn't necessarily have an obligation to act in your best interest.
 - ▶ If you can't repay the loan through a refinance or sale then, as a last resort, the bank will take possession of the property. Relevant notices would be issued, and a real estate agent would be engaged to sell the property on the lender's behalf.

There are three legal requirements that must occur before the lender is allowed to take possession and sell your property.

1. There must be a default (either through non-repayment of principal or interest, or not fulfilling another provision contained in the mortgage contract).
2. A notice must be served on the mortgagor requesting repayment of the overdue amounts. The mortgage documents will set out how this notice is to be served.
3. The default must continue (without remedy) for a period of 30 days or one calendar month from the service of the notice.

However, in reality, lenders will usually work with a borrower for many months before deciding to sell your property.

MORE THAN JUST NUMBERS

When deciding to borrow more money, you need to do more than just crunch the numbers. You need to feel comfortable that you can afford the debt. If not, you may spend hours in the future worrying if you'll be able to make the repayments on time. Borrowing tolerance is a very personal thing, so

don't be bullied into borrowing more by anyone else.

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