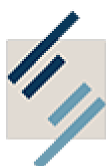
Managing Personal Debt



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While it's a topic that currently seems to be attracting a great deal of attention, personal debt is nothing new. It has, in fact, been with us for centuries—probably since the invention of currency and perhaps even earlier. What is likely new, at least for Canadians, is the amount of personal debt which is being incurred on both an individual and a household or family basis, and our attitudes, as a society, about the carrying of such debt loads.

Many Canadians likely perceive all personal debt in the same way, whether that perception is positive or negative. However, the reality is more complex, as personal debt can take a number of forms and be structured in an almost limitless number of ways. Some personal debt, properly handled, can in fact be used to build net worth and financial security, while other types of borrowings almost invariably signal—or lead to—financial trouble.

Evolving attitudes toward personal debt—and the results

While there have always been and continue to be individual differences, it's probably fair to say that our attitudes toward personal debt, as a society, have undergone a sea change over the past couple of generations. In the first half of the 20th century, carrying personal debt for anything other than the purchase of a family home was perceived generally as something that, while sometimes necessary, wasn't particularly desirable. And, if it was necessary, for whatever reason, to take on such debt, paying it off as soon as possible was a priority. That perception has altered to the point that borrowing money simultaneously from a variety of sources and being in debt on a continuous, ongoing basis has become unremarkable. Borrowing to finance acquisitions and even a lifestyle has become, if not the norm, the exception no longer. The rarity now is the person who pays for a major acquisition like a car or even a new appliance in full, without the use of credit, at the time of purchase.

Along with (or perhaps in part because of) that change in perception has come a virtual explosion in the availability of personal credit. It's almost impossible now to imagine daily life without credit cards, but it was, in fact, only in the late 1960s that the first bank credit card (then known as CHARGEX, which later changed to VISA) became available to Canadians. And, at the time, credit vehicles such as personal lines of credit were all but unknown to the average Canadian. Forty years ago, borrowing money usually meant scheduling a meeting with the manager or loan officer at the local bank branch, completing a loan application and awaiting the bank's decision on whether to grant the loan. Now most Canadians find unsolicited "pre-approved" credit card application forms in their mailboxes on a regular basis, and can log on to their bank's Web site 24/7 to request a loan or an increase in an existing credit facility. While the time available to make purchases was once limited to the hours that stores were open, it's now possible to purchase goods and services from anywhere in the world, online, on a 24/7 basis. Nearly every advertising flyer for big ticket items now includes some kind of "buy now, pay later" offer. And, in many cases, the goods advertised are represented, not just as something the consumer might desire, but as something he or she "deserves".

Given all that, it's not surprising that the level of personal debt held by Canadians, in both absolute terms and as a percentage of household income, has soared over the past few years. In the fourth quarter of 2012, the debt of Canadian households was, on average, about 162% of their disposable income, meaning that for every dollar of disposable income, the average Canadian household had $1.62 of personal debt.

Types of personal debt

It's clear from the statistics outlined above that the personal debt load of Canadians and Canadian families is on an upward trajectory. But in many ways, the kind of debt incurred can be nearly as important as the amount, and many Canadians don't really have a clear understanding of the nature and potential costs of the kind of debt they take on.

While the number and variety of ways in which debt instruments can be structured is limited only by the creativity of those who create it, all personal debt falls into one of two categories – secured debt and unsecured debt. In the first type—secured debt—the lender "secures" the debt against an asset owned by the borrower, meaning that if the debt is not repaid as agreed, the lender has the right to seize and sell the underlying asset in order to be repaid. Although any asset can serve as security for money loaned (car loans being one example), the kind of secured debt most familiar to Canadians is, of course, a mortgage. The mortgage lender loans money to a borrower for

the purchase of a house, but retains the right to seize and sell that house if the mortgage is not repaid as required. Because the lender has the security of the asset to fall back upon should the debtor default, the rate of interest imposed on secured debt is usually lower than the rate levied on unsecured debt.

Unsecured debt, by contrast, is money provided to a borrower on no more than the strength of the borrower's promise to repay—and the best example of that type of debt familiar to most Canadians is a credit card. A lender agrees to provide a borrower with credit up to a specific amount (known as the credit limit). Within that credit limit, the borrower can make any purchases he or she wishes. A monthly payment against any outstanding balance is required, with the minimum monthly payment specified by the lender. Should the borrower fail to make monthly payments as required, the lender can pursue the borrower for the total amount owed. However, since there is no specific asset against which the credit card debt is secured, the lender must, in the last resort, obtain a Court judgment against the borrower for

the amount owed and seek to satisfy that judgment through, potentially, a variety of means, including garnishment of the borrower's wages or by seizure and sale of the borrower's property. When a loan is unsecured, it's obviously riskier for the lender and so the rate of interest charged on unsecured borrowings like credit cards is always higher than rates imposed on secured loans.

Secured debt—mortgages and HELOCs

From a borrower's perspective, a major benefit of a secured loan is ownership of the underlying asset. Most household secured debt in Canada is in the form of mortgages, and with mortgage debt the borrower has an asset whose value, except in rare circumstances, exceeds the amount of the debt. In the event that a borrower can no longer meet his or her mortgage obligations, the option of selling the underlying asset and repaying the debt from the proceeds of sale is always there. And, while it's neither easy nor pleasant to have to sell a family home because a spike in interest rates or a job loss means that carrying the mortgage is no longer possible, that sale will at least eliminate the underlying debt. The other usual feature of a mortgage is that both the amount owed (the principal) and the amount of each payment is fixed, providing a great deal of certainty to the debt repayment. Each mortgage payment made has two components: an amount of interest owed to the lender, and a portion of the mortgage principal sufficient to ensure that the loan is paid off within a pre-determined time period. Structuring a loan in this way has two benefits for the borrower. First, since the mortgage principal amount is fixed, the total loan amount which will have to be repaid is known up front and does not change. Second, since each required payment made by the borrower includes both an interest and a principal component, the borrower reduces the principal amount owed with each payment. Consequently, the time which it will take to pay off the entire amount is known in advance to both borrower and lender, and payments are structured to ensure that result.

The mortgage repayment process outlined above was the standard and, until a few years ago, the only way in most Canadians could borrow to finance the purchase of a home. However, all that changed with the advent of the "home equity line of credit" or HELOC. While a HELOC is, like a mortgage, a debt secured by the value of a property, the similarities between the two end there. With a HELOC, a lender agrees to provide credit to a borrower, not for a fixed amount, but up to a maximum amount, based on the value of the property. Once the HELOC is in place, the available funds can be used for any purpose, whether that purpose is related to home ownership or not. And, while monthly payments are required, the borrower can usually, if he or she wishes, pay only the interest amount which has accrued since the last payment, without reducing the principal at all. The HELOC is a vastly more flexible lending arrangement than a mortgage, but its attributes—the ease with which borrowed funds can be obtained, the complete lack of restriction on the uses to which those borrowed funds can be put, and the ability to defer indefinitely repayment of anything but interest—create risks of their own.

Unsecured debt—personal loans, lines of credit, credit cards, and payday loans

The other major category of personal debt is unsecured debt. As is the case with secured debt, unsecured debt comes in various forms, some of which are more costly than others.

The most straightforward type of personal debt is a personal loan provided by a financial institution. In most cases, such a loan will carry both a fixed rate of interest and a fixed repayment schedule, meaning that both the borrower and the lender will know what the total interest cost of the loan will be and when it will be paid off.

A personal line of credit (PLC) is a type of personal loan but, as with the home equity line of credit, a PLC offers both benefits and risks which are absent from traditional personal loans. With a PLC, the financial institution agrees to allow the borrower to borrow up to a specific amount of money, to be used for whatever purpose the borrower wishes. Because the loan is an unsecured one, the rate of interest levied is always higher than that which would be charged for a HELOC, but as with a HELOC, there is no fixed schedule for repayment. While the borrower must make monthly payments against the current balance, those payments can be as low as the interest amount accrued during the previous month.

A personal line of credit is in many ways like a credit card, a kind of borrowing with which most Canadians are familiar. With a credit card, the issuer (usually a financial institution) agrees to make funds available to the borrower up to a certain amount (known as the credit limit) and, as with a PLC, the available funds can be used for any purpose the borrower wishes. Repayments must be made monthly, and the issuer will specify a minimum monthly payment. Interest rates charged on credit card borrowings are, however, usually significantly higher than those levied on PLCs—sometimes twice as much. Where a credit card is issued by a specific merchant, like a department store, that card can be used only for purchases in that department store, and interest rates charged are among the highest levied for credit card borrowing.

In recent years, a new form of lending—the payday loan—has become available to Canadians. The payday loan industry is a controversial one. Its proponents argue that it provides a service in that it gives access to credit for borrowers who would not be granted credit through more traditional sources. Its detractors maintain that the industry takes unfair advantage of such borrowers, through high interest rates and exorbitant "administration" fees. While several of the provinces have enacted legislation to curb what were viewed as unfair lending practices which effectively kept borrowers continually in debt, payday loan companies still remain, for most Canadians, lenders of last resort.

Assessing a borrower's creditworthiness

While the cliché is that it's easy to borrow money from the bank as long as you can prove you don't really need it, there are in fact standard measures used to determine whether and to what extent a prospective borrower is "creditworthy".

Understanding TDS and GDS

When a borrower seeks to obtain funds from a financial institution, whether by way of secured or unsecured debt, the two measures which are used to determine creditworthiness are the borrower's Total Debt Service and Gross Debt Service ratios. Both are measures of just how much of the borrower's income is required for debt repayment.

The first measure—Total Debt Service (TDS) measures the amount of gross (meaning before the payment of income taxes) annual income required to service all of the borrower's debts—mortgages, car loans, lines of credit, and credit card balances. As a general rule, lenders want to see that no more than 40% of the borrower's gross income is needed for all debt repayment.

The other measure of creditworthiness—the Gross Debt Service (GDS) looks at how much of the borrower's gross income is required to meet his or her housing costs. For purposes of the GDS, housing costs are measured as payments of mortgage principal, mortgage interest, property taxes, and heating costs (or monthly maintenance fees for a condominium owner). When it comes to GDS, lenders want to see that the homeowner can meet his or her housing costs with no more than about one-third, or 32% of gross annual income.

TDS and GDS are, of course, standard measures. Lenders can and do depart from these standard measures where in their judgement doing so does not create an unacceptable risk of default. For instance, a borrower who is just starting on a professional career may well be able to borrow an amount which puts him or her over the standard ratio of gross income to debt repayment amount, on the assumption that future increases in income will allow him or her to easily handle the higher debt load.

Finding out your credit rating

If TDS and GDS represent measures of how a prospective borrower will be able to handle future borrowings, a credit rating is a gauge of how that same consumer has managed debt in the past. Both will likely form part of a lender's decision on whether to grant credit.

A credit rating is simply a number which represents a summary of the status of a person's total current and past borrowings. Institutions which have granted credit provide information on an ongoing basis with respect to the current status of those borrowings to credit reporting agencies. In Canada, there are two such agencies—Equifax Canada

(www.equifax-canada.ca/index.html) and TransUnion Canada (www.transunion.ca/). Information provided includes the amount of any borrowing, the percentage of available credit (for lines of credit and credit cards) which the borrower has utilized and, of course, the payment history—whether payments have been made on time or whether the account is currently in arrears. If there have been late payments in the past, the credit report will summarize how many payments were made late and how late those payments were (under 30 days, 30 to 60 days, etc.). All of this information is compiled by the credit reporting agency and reduced to a single number—the borrower's "credit rating" —which can range anywhere from 300 to 900. A higher score indicates that the individual has handled credit well in the past and is therefore considered more creditworthy and less likely to default on any borrowings. When it comes to a credit rating, about 45% of Canadians have scores which fall between 700 and 800.

Canadians are entitled to obtain a written copy of their credit report, free of charge, once per year. Information on how to obtain that credit report can be found on the Web sites of the two Canadian credit reporting agencies. A credit report, along with a credit rating can also be obtained online through the agencies' Web sites, but a charge of about $30 is levied for that service.

Tax treatment of personal debt

The general rule is that interest is deductible for tax purposes only if it is paid on money borrowed to earn income from a business or income from property. Unfortunately for most Canadians, that means that interest paid on loans to finance personal acquisitions such as a house, car, boat, vacation, or home improvements is not deductible for tax purposes. The single legislated exception to that rule is the tax credit allowed for interest paid on student loans which were provided through federal or provincial student loan programs.

It's possible to find companies or advisers who promise to arrange or restructure a home mortgage in such a manner as to ensure that the mortgage interest paid becomes deductible for tax purposes. While it is true that, in limited circumstances, Canadian taxpayers have been able to structure their affairs to create a tax deduction in relation to mortgage interest, two serious caveats apply. The first is that the factual circumstances required to carry out those transactions are not those of most Canadian families, as they have generally involved the use of private family companies or professional partnerships. Second, it is almost certain that any transaction which attempts to make home mortgage interest deductible will be challenged by the Canada Revenue Agency. A taxpayer who wishes to engage in such a course of action should be prepared for what could be a long and expensive dispute with the revenue authorities including, quite possibly, tax litigation.

When personal debt becomes a problem

Any determination of the point at which the level of personal debt becomes problematic is very subjective. For some borrowers, carrying any kind of debt (except possibly, a mortgage) is uncomfortable. At the other end of the spectrum, some borrowers are content as long as they are able to meet the minimum monthly payments on their credit cards and aren't actually in default on any loans.

That said, however, there are some yardsticks which credit counsellors and financial advisers suggest should act as a "red flag" or warning that personal debt is approaching or has reached levels which create real risk to one's financial future. Some of those are as follows.

- Making only the minimum payment on outstanding credit card balances month after month.
- Reaching the credit limit on multiple credit cards (or repeatedly requesting credit limit increases on a single card—and then exceeding the new limit).
- Using credit from one source to pay a different lender (e.g., using funds from a line of credit to make a credit card payment).
- Needing to use credit to pay for necessities, like groceries or utilities.

Almost everyone encounters temporary cash flow crises which might make one of these strategies necessary on a stop-gap basis. The key word, however, is temporary—where use of credit in any of these ways is an ongoing, regular feature of one's financial life, then personal debt levels are likely about to become—or are already—a problem.

How to get help

The good news, for those whose personal debt levels have reached unsustainable levels, is that help is available through many not-for-profit organizations and agencies, many of which belong to the Canadian Association of Credit Counselling Services. That organization represents credit counselling agencies in all provinces and territories, whose mandate is to assist those for whom debt has become a problem. As outlined on their Web sites, a credit counsellor at a credit counselling agency will provide an objective assessment of the situation and help formulate a plan to deal with outstanding debt. The agency can offer debt repayment programs for consumers having difficulty meeting their monthly payment obligations.

Assistance provided can include contacting creditors on behalf of the debtor and proposing a payment schedule based on the debtor's ability to pay. The aim is to create a debt repayment program which consolidates the individual's monthly debt payments and provides him or her with a plan to repay all debts while maintaining a reasonable budget.

All services provided by a credit counselling agency are provided on a confidential basis—no information is disclosed to anyone without the permission of the client. While a not-for-profit credit counselling agency may, where the client can afford it, levy a small fee for its services, as part of cost recovery, such agencies will provide the same credit counselling services to anyone who requests them, regardless of ability to pay. The Web site for the Canadian Association of Credit Counselling Services, which provides links to credit counselling agencies across Canada, can be found at www.caccs.ca.

There are also a number of for-profit companies which offer a variety of credit-related services, or promise to drastically reduce or eliminate anyone's debt, or to eliminate a bad credit history, all for a fee. However, such companies provide essentially the same services which can be obtained for little or no charge through not-for-profit agencies.

Conclusion

There are two sides to the personal debt coin. Prudently handled, personal debt can help in the acquisition of valuable assets like a post-secondary education or a home, which might not be obtainable any other way and which will ultimately increase the earning potential and net worth of the borrower. However, as many Canadians have discovered, taking on personal debt, especially for the acquisition of consumer goods or other non-appreciating assets can be a slippery slope. Especially when interest rates are high, debt can quickly accumulate to unanticipated levels, causing personal and family stress and threatening the debtor's financial stability. The best course of action, where it seems that personal debt is about to or has become a problem, is to face that problem head on, often with the help of a credit counsellor.