Free Yourself of DEBT

You must control spending and debt if you really want to be happy, says this noted financial planner

BY GAURAV MASHRUWALA

My favourite devil joke is where a TV anchor interviews Satan. "What's the most cruel thing you've done?" asks the anchor. "Everything I do is in that genre," replies the devil. "Epidemics, wars, terror attacks, orphans. It's all in a day's work."

"But isn't there something you're really, really proud of?"

"Ah, yes, credit cards."

* Names of all clients have been changed to protect their privacy.

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I've got that fact-checked by several of my clients, like Suresh and Sabina*, a young couple. "After we got married, we opened our joint account," Suresh told me. "That's when the bank manager told us about the advantages of owning credit cards. We applied immediately and soon started buying anything we wanted."

"The manager had cautioned us against any irresponsible use of our cards," Sabina interrupted. "But we were too engrossed in our dreams to pay any heed."

Soon, their joint monthly income, I learnt, was less than their total card debt, although they were paying their minimum monthly dues. Within two years, they were missing the minimum payments even as the interest kept mounting. Suresh and Sabina started getting phone calls from the bank's recovery personnel. Their lives became stressful. "Every time the card statements arrived," recalls Suresh, "we'd end up arguing and blaming each other for the mess." I'm sure the devil was enjoying all this.

When we spend using credit cards, or use any other kind of loan, we are actually spending our future income. But the future is always uncertain. Suresh and Sabina got into trouble because they were blowing up their unearned, uncertain future income.

In early 2007, there was the case of Mr and Mrs Iyer. I suggested that they prepay the home loan they had taken, since they had secure jobs and regular cash flow. "We're paying our EMIs on time and still have enough left after household expenses to invest in an equity fund," Mrs Iyer told me. I suggested that they repay an additional amount every month instead of investing in the equity fund. They did not agree.

But in 2008 the sky fell on the couple. The stock market crashed and their home-loan's interest rates moved up sharply for a while. Mrs Iyer also lost her job in the slowdown. In my long years as a financial planner and consultant, I've come across many such people who could have been much happier if only they had understood debt better. So here are seven key points to consider:

1. Limit your borrowings

While there are no crystal clear numbers to define prudent borrowing, you should, like any good manager, keep track of two account statements: First, your income and expenses. And, second, your assets and liabilities. A rule of thumb: your EMIs (equated monthly instalments) should never be more than 40% of your take-home pay, if you have a home loan to pay. For example, if your take-home pay is Rs10,000, then all your EMIs should not total more than Rs4000, provided this includes a home loan. If there is no home loan, restrict your EMIs to about 20 to 25% of take-home pay. Track this in your income and expenses statement.

Next, add up the value of your assets (all that you own, including investments, property, provident fund balance, etc) and your liabilities (all that you owe). Your outstanding liability should not exceed 50% of your assets. That means, if the total value of all assets put together is Rs30 lakh (include the value of your home, even if it was bought with a loan), then your outstanding liabilities (including the amount you owe for the home) must never exceed Rs15 lakh. This way you don't overstretch and your risk of getting into a debt trap is minimized.

2. Spend prudently

We borrow money to spend it. But there are basically two kinds of spending: I call them "spending for responsibilities" and "spending for pleasure and luxury."

The first includes building or buying a house, educating the children, funding their marriage without having to be wasteful, caring for aged parents, and paying for healthcare.

> It is better to pay EMIs on a home loan than to pay rent. But aim at paying off your loan as soon as possible.

The second includes borrowing to spend on exotic vacations, pricey branded goods or swanky gadgets you can live without.

Borrowing to spend for life's responsibilities is justifiable. If a family member is seriously ill and you are short of cash, you cannot wait to accumulate funds before treating them. Similarly, when it comes to a home to live in, it always makes sense to pay EMIs rather than pay rent. So smart people get out of debt as soon as possible.

3. Avoid leveraging

"Leveraging" is a word used often by companies who may have to borrow to invest and expand the business. But I think leveraging can be disastrous for individuals. Mr and Mrs Iyer didn't realize it, although they too were really leveraging when, instead of paying up their loan, they went on investing in other assets—the equity fund in their case.

While they did not realize they were doing so, in their account books, they had a loan on one side and investment on the other. You'll understand it better if you viewed it this way: What if their home was fully paid for and they went to the bank, mortgaged it and used the cash to invest in the stock market? Now, their house was not paid for and they owed money. Yet they were investing in stocks. I think both these scenarios are, in the end, much the same.

Leveraging can be a high-risk, low return game. Assume you are paying 9% interest on a loan. Now if the equity market goes up by 20%, your effective returns would be 20% minus 9% = 11%. So, when the market generated 20%, you only got 11%. On the contrary, if the market was to fall by 20%, you would lose 20% plus 9% = 29%. Remember, when that happened to the Iyers in 2008, the market actually fell 60%! As far as possible, stop leveraging and play safe. "Leverage gives the illusion of wealth," said the noted investment strategist Richard Bernstein. "Saving is wealth."

4. Differentiate between cheap and costly loans

Home and educational loans (both in my "responsible" category) tend to be the cheapest, because they carry lower interest rates. But your credit card loans are the costliest (carrying about 36 to 42% interest annually). If you, like Suresh and Sabina, decide only to repay the minimum 5% of outstandings each month, it gets even costlier, since you'll pay that high interest on any new purchase made using your card after that—until

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you've paid up everything. Other personal loans, too, are costly with interest rates and service charges that will drain you out by as much as 15 to 25%.

5. Consider prepayment

By all means borrow to buy a house. It is better to pay EMIs than to pay rent, and the value of your house increases exponentially over your lifetime. But aim at paying off your loan as soon as possible.

"Prepayment penalty" is a phrase coined by financial institutions to deter even responsible borrowers from paying loans back early. Another client of mine, Mr Venkat, was very reluctant when I suggested he prepay his loan. "Why should I pay a penalty?" he asked. The word "penalty" is reminiscent of fines, maybe even jail, and hits you hard. The rate of any prepayment penalty is always much lower (about 2%) than the rate of interest you pay on your loan (about 8 to 9%). It always makes sense to pay prepayment penalty and end your debt, if you can, rather than pay the interest for years to come.

Some lenders don't take any prepayment penalty after three years.

And there's some good news coming: the RBI may soon abolish all prepayment penalty on home loans.

The other deterrent is the lure of the tax benefit. This is a myth, because I have calculated that if you paid off your loan early, and did not have to pay the EMIs, you'll lose that tax benefit, but end up with more tax-paid money in your hands. So, if you have surplus funds, get rid of your loan as soon as possible.

Take a close look at all your investments. If any of them is generating returns that are much lower than the rate of interest you're paying on the loan, then it makes sense to consider liquidating it to help you become debt-free.

6. Think of alternate exit options

If you're in a debt trap and can't repay, talk to your lenders rather than hide from them. The only time you should ever take a personal loan, in my opinion, is to exit large credit card debt, since the card demands about twice the rate of interest. The other time may be for medical emergencies. Even here, if you find it hard to pay back, talk to the bank that lent you the money. They may restructure it so that you get more time to repay. Even your credit card debt may be converted to easier monthly instalments at a reduced rate of interest, if you politely negotiated and gave them good reason. Also consider paying back a loan when you have stocks or other assets like gold you can sell.

7. Insure your loan

The future is always uncertain. If you take a loan, then take term insurance on your life too (often the insurance is linked to the loan and this is available for home and educational loans, even for credit card debt). The insurance company will repay the debt if the borrower dies and not shift the burden on to legal heirs. (In the case of credit card debt, there may be a Rs1-lakh limit.) Read the rules and check all conditions before signing up for any insurance.

Finally, Benjamin Franklin's advice: "Rather go to bed without dinner than to rise in debt."

Gaurav Mashruwala, author of this article, is a certified financial planner. Until recently he was chairman, Global Advisory Council of the Financial Planning Association.

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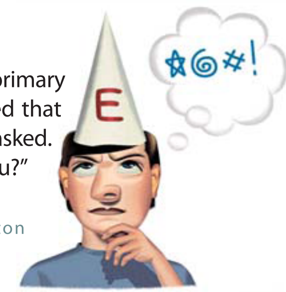

Name-calling and profanity are not tolerated at our primary school. So I was concerned when a student complained that another student had called him the *e* word. "E word?" I asked. I couldn't think of even one. "What *e* word did he call you?"

He lowered his voice and muttered, "Idiot."

Kay Pennington

DO WE KNOW EACH OTHER?

The New York Times recalled a rather embarrassing event that reportedly occurred some 40 years ago to Britain's then foreign secretary, George Brown. In Peru for a reception, and quite intoxicated, Brown invited a guest in flowing purple robes to dance, but he was rebuffed. "'First, you are drunk,' the guest is said to have replied. 'Second, this is not a waltz; it is the Peruvian national anthem. And third, I am not a woman; I am the Cardinal Archbishop of Lima.'" Submitted by *Patrick Barry*