DIRHAMI

وعي مالي شخصي

Personal Financial Literacy

Lesson 4

Managing and Controlling Debt

www.dirhami.ae

مجلس أبوظبي للتطوير الاقتصادي

ABU DHABI COUNCIL FOR ECONOMIC DEVELOPMENT

Lesson 4

Managing and Controlling Debt

For most of us living without some debt is just not possible. We need to borrow some amounts to finance major purchases such as our house and our vehicles, or for emergencies. Having debt involves using credit, or funds that we would borrow from a lender. Borrowing can be in two forms. One option is formal secured loans such as a mortgage for a home or an automobile loan where the asset (the home or car) is pledged as security to the lender. The second popular form on credit for individuals is revolving debt. The most common method for this type is credit cards where the credit card issuer (normally a bank) grants temporary credit (usually 30 days) to the credit card holder for routine purchases. The credit card holder is a borrower and is expected to repay this temporary loan each month. If they do not there are severe costs and penalties involved.

Given that it is just not likely that we can live debt free, what are the good and bad uses of debt?

Appropriate Uses of Debt/Credit

There appropriate uses of credit and several benefits of using sound credit practices can make your financial life more enjoyable.

1. Convenience

Having a credit card makes shopping more expedient and secure than carrying large sums of cash. Sometimes, if there is a dispute about a purchase, the credit card company can offer leverage in resolving the matter with the merchant. Another advantage is having accurate and accessible records for your purchases. Safety and security also are advantages for the use of credit cards. If you were to lose your cash it is probably gone. If you lose a credit card you can call the issuer and they will cancel the card and often protect you from fraudulent use.
However, all of these advantages rapidly disappear if you do not pay off the balance each month because the issuer will charge fees and penalties that are often excessive.

2. Major Purchases

Buying a home or an automobile for cash would involve many years of saving, if it were feasible at all. Since these types of purchases involve large sums, lenders such as banks are very cautious to be sure the borrower has both the financial means and personal character needed for repayment. Lenders also require security and will hold the title to the vehicle or deed to the home in order to guarantee the borrower will repay as promised. Using credit makes the borrower able to enjoy the use of a home or car much sooner that otherwise would be possible.

3. Emergencies

Unfortunately in some cases we experience unplanned events such as medical costs not covered by insurance or major repairs to a vehicle or to our home. While we should have established a cash reserve fund of at least six months' of salary, these emergencies require the prudent use of credit to cover the medical costs or repairs.

4. Education

Paying for higher education is an investment, an investment in you. Securing a higher level of education will allow you to benefit in the future from a better job, higher earnings, and a better quality of life so the use of credit for student loans can be a positive use of credit.

The Disadvantages of Credit

Despite the benefits there are several negative aspects to the use of credit.

1. Using credit reduces your financial flexibility in your personal money management because each month you have fixed obligations to repay your loans. This reduces the funds you will have available to spend elsewhere. Also, lenders charge a fee or profit on the loan you the costs of any purchase you make will be greater.

2. Using credit sometimes causes overspending. By borrowing the money for a purchase you may tend to spend more than you otherwise might have if you had paid cash.

3. When you undertake credit the above loss of flexibility, possible overspending, and increased costs also reduce your ability to save and invest.

4. The use of credit, particularly revolving credit can be a "slippery slope" that leads to credit cards balances that are almost impossible to repay, financial setbacks, and poor credit status that impacts your financial future.

Acceptable Levels of Debt

The table shown below, combined with your personal financial budget, can help you determine the appropriate debt level as a percentage of your disposable income (total income less mortgage and car loan payments):

Debt/Disposable Income Percentage	Debt Situation
0%	No debt
<10%	Little debt
11% – 14%	Safe but at limits
15% – 18%	Over indebted
19% – 28%	Seriously over indebted
>29%	Excessively over indebted

In conclusion, using debt is a little like using electricity. If one knows what they are doing and practices safety it can provide wonderful benefits, but if we are not knowledgeable and are unsafe there can be painful consequences.