KNOWLEDGE ORGANISER LIBF Unit 3 Topic 5 – Good Debt, Bad Debt

What is borrowing?

Borrowing means drawing from future income flows to finance an item of expenditure now. Someone who has borrowed money is in debt to the lender; this is a legal relationship and arrangements must be made to pay back the debt plus interest.

The benefits of borrowing

Borrowing can help people to smooth out differences in timing between their income and expenditure. Someone who is always short of funds at the end of the month can use their credit card or overdraft to finance their purchases until the next salary payment arrives in their bank account. A negative balance at the end of the month – the result of spending more than your monthly income – is a deficit. Borrowing money to cover this deficit is sensible if you know that you will have extra money next month to repay it. But if you have to carry the deficit over to the following month and add to it to cover that month's deficit, you will be in danger of accumulating a rising debt – money that you have borrowed, but which you cannot afford to pay back. Most people borrow money as a means of affording a substantial purchase, such as a house, a car or furniture, which they need to buy now, but which is too expensive to be funded only by current income. It might take someone too long to save up for an item that they need immediately or very soon; if they buy the item now with borrowed money, they can use it while they repay the loan. The most common example is the mortgage loan: very few people are able to buy a house without taking out a mortgage loan, which they pay back while they are living in the house. Although they will pay interest on the loan, interest rates are lower for a mortgage than for other loans because it is secured on the property. This means that there is less risk for the lender, as it can sell the property to recover its losses in the event that the borrower defaults on the loan (ie cannot afford to maintain their repayments).

The costs of borrowing

When someone borrows money, they agree to repay the debt from their future income. This means that they will have less left over from their future earnings until they have repaid their loans and so there is an opportunity cost, ie the value of the best alternative purchase that they could have made with this money. Borrowing is a product that must be paid for; the cost is called 'interest'. A borrower repays not only what was borrowed, but also a percentage interest charge on top of this to recompense the lender for the use of its money over the time of the loan and for the risk that it takes (that the borrower will default). Some types of debt (such as payday loans) are very expensive, while others (such as personal loans) are much cheaper – and mortgages offer the lowest rates because they are secured on the property.

Defaulting on a loan

Defaulting on a loan is a serious matter.

◆ If the loan is secured on an asset, such as a mortgage secured on a home, the borrower will lose that asset – their home – if they stop meeting the repayments. If the borrowing is in the form of a hire purchase agreement, the borrower will lose the goods – and will not be able to recoup the payments already made.

◆ If the loan is unsecured, the defaulter will obtain a bad financial reputation or 'financial footprint', which means that they may be unable to get credit again In the worst case, the person could be declared bankrupt.

Attitudes to borrowing and debt

Many people see borrowing as a normal thing to do and financial institutions compete for the opportunity to lend to people. Customers can shop around and get the best deal to suit their needs. Young people are more likely to have to borrow when they are starting out in adult life than older people who have been working for some years. Younger people will need loans to finance their studies, day-to-day cash flow and the larger items of expenditure. In recent years, there have been a lot of reports in the media about people who have not used their borrowing facilities wisely and now have too much debt. Providers have also been guilty of irresponsible lending – of providing credit too easily and lending money to people who could not afford to pay it back (see Topic 3). This was one of the factors that led to the 2007–08 financial crisis, and to several banks and other institutions in a number of countries ceasing to trade or needing government help to survive. This financial crisis was followed by a recession, during which many people lost their jobs – and the impact of becoming unemployed and losing your income is even worse if you already owe money. The numbers of house repossessions and of mortgage arrears increased considerably after 2007, according to the Council of Mortgage Lenders (CML). Some 46,000 homes were repossessed in 2009 – the highest number since 1995. During the third quarter of 2017, however, only 1,300 mortgaged properties were repossessed, which was the lowest repossession rate on record. The number of mortgages in arrears also hit a ten-year high of 196,000 in 2009, before falling to 169,600 in 2010.

Balancing the benefits and costs of debt

Someone who is considering financing expenditure with a loan should take both the benefits and costs of borrowing into account:

◆ The advantages and disadvantages of each individual loan should be considered not only independently, but also in light of any other loans that the prospective borrower might already have taken out. Prospective borrowers should look at their overall debt situation and not only at each loan separately.

◆ The price that the customer pays for a loan must be reasonable when compared with the purpose of the loan: are the items purchased worth the amount of interest being paid and could the money have been borrowed more cheaply elsewhere?

◆ The length of the loan should also correspond to the life of the article purchased. For example, the borrower will sensibly apply for a 25-year loan to fund the purchase of a new home – but not to finance the purchase of a computer.

Whether or not an individual decides to borrow also naturally depends on their attitude to debt and to risk – and remember that the cultural group(s) to which they belong and their ethical values are likely to have shaped these attitudes People borrow only to the extent with which they feel comfortable. To maintain sustainable personal finances, then, an individual's borrowing decisions should not be taken in isolation, but should be both integrated into their short-term and medium-term budgeting plans and cash-flow forecasts and fully justified as part of their long-term financial plan.

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Borrowing and financial footprints

When a potential borrower approaches a bank or finance company for a loan, the lender researches their credit history. There are three large credit reference agencies
in the UK:

- Experian;
- Equifax
- TransUnion

These companies compile files on consumers using information from banks, building societies and credit card companies, and also from county court judgments (CCJs), the electoral register, bankruptcy orders and house repossessions. The details of every loan, credit card or other credit agreement that an individual has or has had are recorded in these files, which builds up a picture of how much the individual has borrowed and how good they are at making the required monthly payments. The credit reference agencies themselves do not make decisions on whether or not customers should be granted a loan and they do not keep a 'blacklist'; they simply supply information to lenders on request. Every time a person applies for a borrowing product, the lender will search the credit file, and this search leaves an electronic 'footprint' in the person's personal credit history. If they apply for an unusually large number of loans, a note is put on their record. 'Shopping around' for the best loan or mortgage deal can also cause a problem, because lenders may view multiple credit searches by different credit providers as a sign that the individual is finding it hard to get a loan agreed. Making payments late or missing payments, building up payment arrears and defaulting on a loan credit agreement (ie failing to pay it all back) all show up as negative footprints on a person's record.

Informal Payment Plans

If the debtor's income is enough to leave a surplus after paying priority bills and their essential spending (eg on food, drink and household goods), the debtor should then use this surplus to offer regular repayments on the remaining nonpriority, unsecured debts, negotiating lower monthly payments spread over a longer repayment term. The debtor should contact the banks and credit card companies to which they owe money (on outstanding loans, overdrafts, credit card balances, etc), and explain the situation and what payments they can afford to make. A creditor will usually agree to accept a reduced monthly payment, and to stop charging interest and missed payment fees, if it sees evidence of a regular income and no spending on non-essential 'luxuries'. The monthly amount that the debtor negotiates with each creditor should be in proportion to the size of the total debt, so that all the creditors are fairly treated and the debts are all repaid over the same time period.

Debt Management Plan

Anyone who does not feel capable of making all these arrangements by themselves can get free help to set up and maintain a more formal DMP. They will contact the debtor's creditors and agree affordable monthly payments to each creditor. The debtor then sets up a single monthly payment to the DMP manager, who passes it on to the creditors in the agreed amounts. DMP's are provided by Stepchange, National Debtline, Payplan and Debt Advice Foundation.

Administration Orders & CCJs

The structure of an administration order is similar to that of a DMP, but in this case the debtor pays the single monthly payment to the court rather than to a DMP manager. Likewise, the CCJ represents a legally binding requirement to pay what the court has decided is owing, either in full or by instalments, by a certain deadline. That payment may be made to the court or directly to the creditor. Administration orders and CCJs both incur court fees, payable by the debtor, but these can be added to the total debt and included in the debtor's monthly repayment.

Individual voluntary arrangement (IVA)

This is a formal agreement between debtor and creditors; creditors representing at least 75 per cent of the total debt value have to agree to the arrangement for it to become legally binding. It is set up and supervised by a licensed insolvency practitioner (IP), ie a firm of accountants or solicitors who will examine the debtor's finances – income, expenditure and assets (what they own) – and decide how much they must pay into the IVA each month (typically at least £200) for a fixed period (usually five years). The creditors will often agree to an IVA only if the payments that they receive amount to at least 30 per cent of the money owed (and some insist on repayment of 40 per cent or 50 per cent). If the debtor makes the monthly repayments for the full term of the IVA, their debts are then classed as 'discharged' and they are officially 'debt-free' as far as unsecured debts are concerned.

Debt Relief Order (DRO)

If the debtor has quite a low level of debt (ie total unsecured debt of less than £20,000), low surplus income (no more than £50 per month after paying normal household expenses) and few or no assets (no more than £300), a DRO is an alternative to an IVA or bankruptcy. Debt relief orders offer a route towards being free of debt that is quicker and easier than IVAs or bankruptcy, because the debtor can simply apply online using one of the four authorised free debt advice agencies (StepChange Debt Charity; National Debtline; Payplan; Debt Advice Foundation). The agency will then forward the application to the court's Official Receiver, who will decide whether or not to make an order. There is an administration fee for DROs that can be paid in instalments.

Bankruptcy

A debtor might not able to use an IVA – perhaps because their surplus income is not enough to support an acceptable monthly repayment, or because they have tried to set up an IVA, but the insolvency practitioner (IP) has failed to get the required 75 per cent creditor support, or they have agreed an IVA, but then defaulted on their monthly repayments. In these circumstances, the debtor may be forced into bankruptcy. Any creditor who is owed at least £5,000 on an unsecured loan can also ask the court to declare a debtor bankrupt, or an individual struggling to pay back unsecured debts can apply to the court themselves for voluntary bankruptcy.