RICHARDSON Wealth

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How to manage the mindset around debt as the cost of borrowing increases

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See the column on The Globe and Mail's website here.

A crucial component in determining if a certain type of debt is good or bad is assessing whether a loan is appropriate for the unique situation.

In a persistently low-interest rate environment, the often-painful consequences of taking on debt are minimized.

Borrowing money during the past 14 years or so has felt almost free, leading borrowers to assume that their rates will stay low and debt payments will remain the same. However, during the past year, interest rates have risen faster than in any other one-year period during the past 30 years. While this sharp increase has affected most asset classes negatively, many people are feeling the pain most acutely when it comes to managing debt.

Conversations about debt management are a critical part of managing an overall wealth management strategy. Working with an advisor to look at both sides of a balance sheet can ensure Canadians understand how the amount and type of debt they take on will affect their financial goals.

Good debt versus bad debt

While it's prudent to try to live and retire debt free, for many, taking on debt may be the only way to purchase big-ticket items such as a house or post-secondary education. While those types of loans are usually justifiable and can provide value to the borrower, debt can also be taken on carelessly to fund purchases outside of one's financial means.

Generally, “good debt” builds equity, while “bad debt” doesn’t. Good debt is typically taken on for assets that will appreciate over time, such as a mortgage on a home. In these instances, debt is taken on with the expectation that the asset will grow in value and the loan will be repaid over time with the goal of building long-term equity.

Meanwhile, bad debt is typically used to finance purchases that don’t provide a return on investment.

It often has a high or variable interest rate, which could mean clients end up paying more for purchases that will be worth less over time.

A crucial component in determining if a certain type of debt is good or bad is assessing whether a loan is appropriate for the unique situation. For example, a mortgage on a principal residence is generally considered good debt for someone who has the income to afford the mortgage payments, as the value of the house could grow tax-free and provide security to them and their family.

However, the same mortgage may be considered bad debt for people who overextend their finances to meet the payments, as it could result in the need to take on riskier debt elsewhere, or in a worst-case scenario, lose their home entirely.

Setting clients up for success

With credit cards and lines of credit easier to access than ever, living beyond one’s means can be a serious risk. Whether it’s borrowing against the equity in a home to renovate a kitchen or buying the latest e-bike on a credit card, there should be a plan to pay off the purchase and the subsequent interest payments quickly.

Setting clients up for success in managing debt can be as simple as automatic payments to ensure they never carry an overdue balance on their credit card. A missed payment can cost 20 per cent interest and affect their credit rating, making it harder to get approved for good debt, like a mortgage, in the future.

Another key step in managing debt is having honest and ongoing conversations about the kinds of debt a client can afford and understanding the associated trade-offs that may be necessary to pay it off. That may mean cutting down on registered retirement savings plan contributions, reducing the number of holidays taken that year, or cutting back on support they may be providing for children or family members.

For those who are unable to resist the temptation of spending and struggle to live within their means, debt management may mean cancelling a line of credit or credit card altogether. Just like how people would remove all junk food from their house if they’ve made a resolution to eat healthier, it’s sometimes better to remove the option of bad debt entirely if they cannot resist its temptations.

Planning for debt

Wealth advisors bring value to clients by taking a holistic approach to assessing the suitability of debt.

When evaluating whether clients are prepared to take on more debt, advisors can create payment plans based on their personal and financial goals. Plans for repaying debt should be revisited regularly to assess how unexpected personal circumstances and changing economic environments would affect overall financial goals.

Even for those with a high income, debt can lead to delays in achieving financial goals, at best, and make them impossible to accomplish, at worst. Taking on more debt than a client can afford can unravel their whole wealth management strategy if not managed carefully.

More important, advisors can help ensure that clients avoid the financial and emotional stress debt can create.