Topic 1(f) Debt

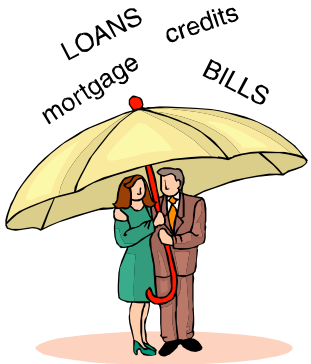
Meaning of the word 'debt'

What does 'debt' mean to you?

Being in debt

When people borrow money they are 'in debt' to the lender until the full amount they owe has been paid back. As well as the original amount they borrowed, people need to repay all interest and fees charged by the lender.

The amount they borrowed is known as the '**principal**' and the interest/fees charged is given as an annual percentage rate (**APR**).



People who borrow money often know what the amount borrowed and the APR are. However, it is not easy to work out exactly how much you might have to repay, especially if you miss a repayment or take a payment holiday. This is because further interest is charged on the interest that hasn't been paid off yet.

How old do you need to be to sign a contract to borrow money?

Working out what debt you can afford

Before agreeing to any borrowing, people need to work out what they can afford to repay.

The calculation is:

All money you know will come in – all money you know will go out = disposable income.

Some of your disposable income can be spent on debt repayments.

Did you know?

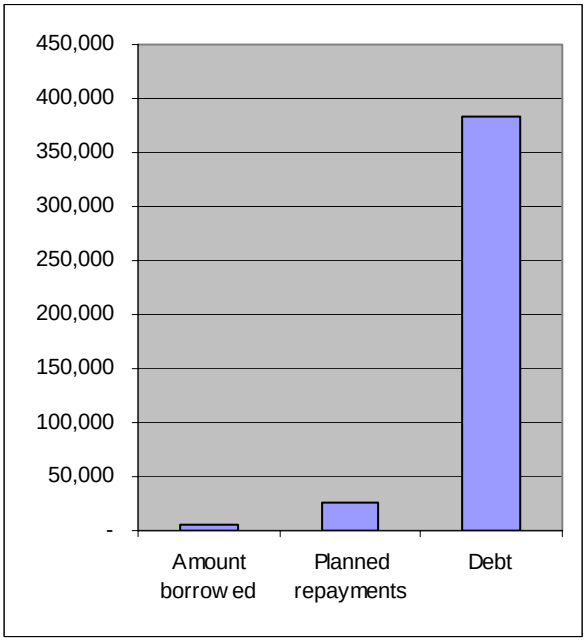
There was an item in the news recently about a couple who borrowed £5,740 in 1989 at an APR of 34.9% over 15 years (BBC News, October 2004).

If they had made all the repayments on time they would have repaid £26,000.

However, by 2004 they were unable to keep up the repayments and the debt grew to £384,000. You can see how the debt rapidly grew in the bar chart on the right.

This is an extreme example. However, it shows just how easily debt can get out of control.

The couple advises anyone thinking of taking out a loan to seek advice first.



The bar chart shows the huge difference between the original £5,740 borrowed, the planned repayments and the final debt.

Where do people get 'income' from?

Income can come from many sources including:

1. Salary from a permanent job.
2. Wages from a temporary job.
3. State benefits and credits.
4. Allowance or pocket money.
5. Gifts from family and friends for example, on birthdays and at Christmas, Diwali, etc.
6. Interest from savings.

Money coming in

Money going out

Outgoings include all the things you know you will buy, including:

1. Essentials like rent/mortgage payments, food, transport, clothes, water, heating and electricity.
2. Repayments of other borrowing.
3. Regular spending like mobile phone bills, entertainment (cinemas, takeaways, CDs), hobbies (football programmes, books, art materials, etc.), and personal items like fashionable clothes, toiletries and make-up.

4. Some anticipated items that need to be bought now and then, like presents for friends and family, extra bus tickets, emergency money for a taxi home late at night, replacements for items like batteries.

When you have worked out the money you have left after paying all outgoings, you may decide you can afford to spend some of it on debt repayments (if you need to take out a loan for a big purchase).

Why is it a good idea to spend only some of the money left over on debt repayments?

ANSWER: No matter how well we plan our budget, there will always be something that we have forgotten we spend our money on!

What are the consequences of not paying back debt

There are two types of debt – debt that is **secured** and debt that is **unsecured**.

Secured debt means that the lender has the legal right to take goods from you if you cannot repay the loan. Mortgages work like this. People who buy homes with a mortgage loan and cannot keep up the repayments can lose their home. The mortgage lender can sell the home and keep the money to pay off the mortgage loan.

'Unsecured' means that the lender has no right to property that the borrower owns. Credit cards are an example of unsecured borrowing.

If people do not repay loans, the provider makes a note on the person's financial record (known as their **credit history**). Other providers look at these records when deciding whether to lend money to people and what interest rate to charge. People who do not repay loans find it harder to get loans in the future as they have a bad **credit rating**.

What to do if debts get too large to repay

If a borrower finds they cannot make repayments, it is vital that they tell the lender and seek professional advice. If borrowers act soon enough, lenders can help them work out repayments that they can afford. This usually means paying back money over more years and can mean paying back more money in total.

Did you know?

You can get free advice on debt from many councils and the Citizens Advice Bureau.

Some people decide to declare themselves **bankrupt** if they are in financial difficulty. Bankruptcy is a legal way of saying that you are unable to pay your debts. This is a serious step that is best avoided because people who are bankrupt are very carefully monitored whilst 'bankrupt' and often find it difficult to access financial services in the future.

Is all debt a bad thing?

ANSWER: No! Most people need to borrow to buy things like cars and homes. Debt is only a 'bad thing' if you cannot repay it.

Having said that, there are people who do not want to get into debt at all because their culture and/or religion disagrees with borrowing money.

Review questions

1. What is 'debt'?
2. How do you work out if you can afford a debt repayment?
3. Name three types of income.
4. Name three things that young people living at home might spend their money on each week.
5. What happens if someone with a mortgage cannot keep up the repayments on the loan?
6. Tick which items most people get into debt to buy:
   a. Car ☐
   b. Clothes ☐
   c. Home ☐

Case study

Hetty is 19 years old and has a full-time job. She has just got her first credit card. For the first three months she buys lots of clothes and CDs on her card. She only makes the minimum repayment each month.

After three months Hetty realises that she owes £2,700.53 on her card. She can only afford to repay £170 every month, so if she stops using her card now it will take her more than a year to pay the debt off. Hetty isn't sure how much more interest will be added to her debt over the next year. If her interest is 10% her monthly interest will be £270. If she only pays off £170 a month the difference of £100 will be added to the amount she owes. Therefore, she will end up paying interest on her interest! She will never pay off the debt unless she pays more than the interest charged each month. If Hetty increases her payments to £300 she will start to decrease the amount she owes.

For example, if Hetty pays back £170 a month the amount owed each month will increase:

	owed	payment	amount still owed	interest at 10%	new amount owed
Jan	£2,700.53	£170.00	£2530.53	£253.05	£2783.58
Feb	£2,783.58	£170.00	£2613.58	£261.36	£2874.94
Mar	£2,874.94	£170.00	£2704.94	£270.49	£2975.43
Apr	**£2,975.43**				

However, if she manages to increase her payments to £300 a month the amount owed each month will decrease:

	owed	payment	amount still owed	interest at 10%	new amount owed
Jan	£2,700.53	£300.00	£2400.53	£240.05	£2640.58
Feb	£2,640.58	£300.00	£2340.58	£234.06	£2574.64
Mar	£2,574.64	£300.00	£2274.64	£227.46	£2502.10
Apr	**£2,502.10**				

Gareth earns the same amount as Hetty, but he uses his credit card in a different way. Whenever he has large or unexpected expenses like a new tyre for his bicycle or a present for a friend, he pays on his credit card. Gareth pays the total amount on the card back as soon as he can. Sometimes this takes a few months, but this way he can spread the cost and pay as little interest as possible. For example:

	owed	payment	amount still owed	interest at 10%	new amount owed
Jan	£426.35	£170.00	£256.35	£25.64	£281.99
Feb	£281.99	£170.00	£111.99	£11.20	£123.19
Mar	£123.19	£123.19	£0.00	£0.00	£0.00
Apr	**£0.00**				

Learning activities

Internet

1. Go to www.moneyfacts.co.uk and the websites of different providers to find out the cheapest way for an 18-year-old to borrow £1,000 over 12 months.
   - Find out how car loans are secured and what they cost.
   - Find information about debt advice in your area.
   - Find out what the minimum wage is for young people.

Group

1. Find out how much different activities cost, such as going to the shops on the bus or train, buying a pizza or a burger, going to the cinema, buying CDs, DVDs and toiletries.
2. Now work out an example budget for someone aged 16 who lives at home, has a part-time job, goes to school and likes going to the cinema.
3. Find out about loans that are tailored to the needs of particular cultures or religions, such as Islamic mortgages.

Key points for Debt

- ☐ People who borrow money are 'in debt' until they have paid back the money they borrowed (the principal) and all interest and fees charged.
- ☐ Interest rates/charges must be quoted as an annual percentage rate so that people can compare credit prices.
- ☐ You need to be aged 18 or over to sign a credit contract.
- ☐ To work out what repayments you can afford, add up all the money you know is coming in (income), take away all the money you know is going out (outgoings) and use **some** of the money left over for debt repayments.
- ☐ If people do not keep up repayments on a secured loan they lose the goods that the loan is secured on.
- ☐ Anyone who does not repay a loan will get a bad financial reputation or 'credit rating'. This can affect whether or not they can borrow money in the future.
- ☐ If people cannot make the repayments on their debt they should seek professional help immediately. Debt can grow very quickly.
- ☐ Debt is not necessarily a bad thing, as long as people can afford to pay back what they have borrowed.
- ☐ If managed well, taking on debt can let you spread costs over time while paying the minimum interest possible.
- ☐ Most people need to borrow money at some time, for example to buy a car or a home.
- ☐ It is wise to shop around for the best credit deal for your needs, considering all the different products available such as loans, overdrafts and credit cards.