Financial Review - afr.com

Jul 13 2018 at 11:00 PM
Updated Jul 13 2018 at 11:00 PM

Debt trap: act now to stop yourself drowning in mortgage, car and credit cards bills

by **Nicole Pedersen-McKinnon**

Ever looked at the cars in the office or school parking lot, or at the houses up and down a street, and thought: "All that must cost a fortune – how do they afford it?" It is very possible there's a simple answer; it's even possible your own lifestyle is dependent upon it – debt.

High net worth financial advisers quietly confide many big earners owe big money. And sometimes it's more than they can afford to repay.

While Australian Bureau of Statistics (ABS) data shows the average owner-occupier home loan is just shy of $400,000, that's not going to buy you much in Sydney or Melbourne. With a median house price of $1,150,357 and $914,518 respectively, according to the latest Domain House Price Report (for the quarter to end-March), those on higher salaries are more likely to live in multimillion-dollar dwellings.

The monthly repayments on a $1 million mortgage, even at current record-low interest rates, are $5169 (at 3.8 per cent over 25 years).

Then there are the credit cards that facilitate expensive lifestyles.

The Australian Securities and Investments Commission has just sounded a warning bell on Australia's collective plastic dependence, but *AFR Weekend* has obtained exclusive consumer research on high-net-worth individuals from comparison site RateCity. Of people earning $200,000 or above, 24 per cent have outstanding credit card debts of up to $20,000 and 5 per cent have between $20,000 and $40,000.

Across the population, Reserve Bank of Australia figures reveal the average card limit is just shy of $20,000 but for high earners there is far greater scope to spend. RateCity's database lists

$200,000 as the highest dollar amount, while multiple cards carry no upper limit.

Let's say you roll over a $30,000 debt from month to month on top-end card with a 20.99 per cent interest rate. Making just the minimum repayments of 2 per cent ($600) would result in $176,496 in interest – and 97 years in debt (ignoring the $700 annual fee).

Speeding on swiftly to the cars we drive, Paul Moran, principal of Moran Howlett Financial Planning, confirms what most of us suspected: "Virtually no one pays cash."

That's another debt of upwards of $20,000, whether via a personal loan, home loan extension or lease. Let's look at a four-year, $50,000 personal loan at 7 per cent. That's an extra $1197 a month.

All up – including the mortgage, credit card and car loan – that brings total monthly debt repayments to about $7000 (even if you don't clear any accrued credit card balance).

The latest ABS Household Income and Wealth Survey found high-income households are more, not less, likely to be over-indebted.

Only one in six low-income households (in the bottom 20 per cent) fall into that category, while one quarter of households in the top income quintile do. (Over-indebtedness is defined as having debt three or more times annual disposable income, or debt equal to 75 per cent or more of the value of your assets.)

Moran sums up the situation: "People with high household incomes, and particularly north of $400,000 a year, are more prepared to carry debt. Because they can – effectively they're a target group for banks because they have very high borrowing capacity. They also have very high aspirations and therefore want to live in choice suburbs."

If this level of borrowing commitment sounds a lot like you, you're not in "good" company but in "bad" debt. And you should react, not relax.

Changing mindset and finding motivation

Moran believes the equity people have in their properties lulls many into a false sense of financial security.

"Every couple of weeks we see someone who has a debt I know they will not be able to pay off in their lives. If you have a 30-year loan and you're 48 years old, what are you going to do? Rely on inheritances?" he says.

"People need to be proud of getting rid of debt rather than proud of the value of their property. That's what the BBQ conversation should be – not the $2 million house but only having $300,000 of debt."

He adds that all but one of his clients who on retirement have downsized to extract equity have ended up spending more, not less – they choose an inner-city townhouse for which they have to, often, dip into their super.

Besides, for that debt-reduction strategy to work, property prices need to at least maintain. And instead, in many areas, they are on the wane.

There are other possible threats to a debt-reliant approach too.

Divorce, job loss, interest rates jumping, inflation spiking and stocks crashing are just a few cited by Daniel Brammall, co-director Brocktons Independent Advisory and president of the Independent Financial Advisers Association of Australia.

"If a big bad economic wind comes blowing, will your house be revealed to be made of straw or stone?" he asks.

Even just from a lifestyle perspective, high debts mean low flexibility to work where and when you want.

Meanwhile, as Brammall puts it, today there's the "perfect opportunity" to repay what you've borrowed because it's never been cheaper. It's also possible you now have a one-year window before rates begin to rise.

Let's go back to that $1 million, $5169-a-month mortgage. With just four interest increases of 25 basis points each, it would cost you $561 extra a month. And the total extra you'd pay would go from $550,570 to $718,991 – for the same house.

Mortgage strategy

Advisers generally agree your mortgage is the main repayment game, even though the traditional advice is to knock off debts in the order of largest to smallest interest rate.

Moran's advice is to pick a date you want your home repaid and calculate what monthly repayments that would take if your interest rate was 1 percentage point higher (just Google "mortgage repayment calculator"). "Start that repayment today so your plan doesn't then fall over if rates go up 0.25 per cent," he says.

He adds: "If you can't make those repayments, that tells you straight away that you can't afford the house."

But it's always possible that, with some lifestyle changes, you could. A great motivator is the prospect of losing your home at retirement (because on that day you fall off what advisers call a potential "income cliff") or surrendering it even earlier (because you become a victim of circumstances and have no repayment wriggle room).

As Brammall says: "It might be time to hug the cactus" – ie, make a painful decision to cut back on consumables and put the mortgage at the forefront.

Next come cars, holidays, restaurant meals, children's activities and even private school fees. Could these discretionary spends be re-evaluated?

What to do if you're in debt danger

If the wealth walls are closing in on you and creditors are upping the repayment ante, you may not be thinking clearly. It is important to realise you have options – and like for anyone in financial trouble, many are free. Here is your action plan:

- Go to the National Debt Helpline website at ndh.org.au, where there is lots of information to help. If your situation is more complex or you have questions, pick up the phone (1800 007 007). Just be aware you might have to try a few times – they're busy (with a 12 per cent increase in calls last calendar year).
- Prioritise your debts. Most people put the roof over their heads and key utilities first. Seek to pay them. With your mortgage, however, it is worth going straight to a lender, explaining the situation and asking for "hardship" provisions. It must extend a degree of lenience, for example freezing your loan repayments or at least temporarily reducing them – and may even do so permanently if it means getting the money back

- Contact other creditors. Get in touch with the hardship departments of all other creditors to try and buy yourself time.
- See a debt counsellor – also for free. The National Debt Helpline will refer you.
- Think carefully about bankruptcy. If you have assets like a house, you could lose it.
- Be cautious about accessing super. The process is quite onerous, but it is possible to get at your super on hardship grounds. What you don't want, though, is to find yourself with no house *and* reduced super. It should be a last resort.

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