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Your Money

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Steps to control property debt [P4]

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Good, bad or ugly?

Defining exactly what kind of property debt you have is the first step to paying it off, writes **Anthony Keane**

REAL estate debt can be dangerous and debilitating, but for thousands of investors it has also been their ticket to financial freedom.

The key is to understand the type of property debt you have – good, bad or ugly – and work hard to slash the latter two as quickly as possible.

Some people may say the only good debt is no debt, but Australia's tax system can help make a properly planned and structured property loan a valuable tool for building wealth.

We asked a range of financial experts for their definitions of good, bad and ugly property debt, and received a mix of answers.

Let's take a closer look.

GOOD DEBT

This one's simple and generally agreed by all: Good property debt is debt used to fund an investment that will generate long-term gains.

"Good debt is the kind that produces income or capital growth and, importantly, involves tax deductions," says MBA Financial Strategists principal Mark Borg, an AMP financial planner.

Investors get to claim a tax deduction for the interest they pay on an investment loan, which usually reduces the net cost to them of the loan.

For example, someone on the typical 30 per cent tax rate and paying an investment loan with a 7 per cent interest rate gets a tax deduction equal to their 30 per cent tax rate, which gives them an after-tax interest rate of 5 per cent.

In many cases rent from tenants can cover most or all of this.

KeyInvest Lending Services chief executive Chris Burns says investment property owners can benefit from debt.

"In most cases, rental properties are a very efficient way to build wealth as tenants essentially pay off the owner's debt as the value of the home increases," he says.

Rents will continue to rise over time, while the original debt will stay the same or fall.

"However, a steady flow of rental income is not guaranteed, so a specialised form of insurance is recommended to protect investors from many of the risks associated with owning rental properties," Burns says.

Oracle Lending Solutions broker Tony Musolino says savvy investors maximise their tax-deductible debt over other kinds of debt.

"An investment loan that allows you to benefit from rental income from a property steadily increasing in value is that very rare breed of debt that may make you money instead of taking it away," he says.

A "good" property debt can also be used to buy other investments such as shares, which in some cases – such as the big banks at the moment – can pay dividends much higher than the cost of the loan.

But, of course, if the shares lose value, you lose money if you sell.

BAD DEBT

Here's where things get a bit blurry. For example, your home loan is technically not good debt because you don't get a tax deduction for it, but many experts say paying off a mortgage is better than renting for life because at least you'll have free shelter one day.

"Bad debt includes expenses you can't get deductions on, such as your home loan – although it's not all bad news because you still end up with a valuable asset," Borg says.

Musolino says bad property debt can also be when you take on too much to handle, or borrow heavily to spend on renovations.

"If you cannot comfortably pay off a personal loan with your existing income, you're heading into dangerous waters," he says.

"A home loan is usually one of the safest forms of debt to manage, but only if you've done your homework. Many people fall into the trap of signing up for a variable loan when the interest rates are low but don't look ahead to check if their income can still cover the repayments if the rates rise."

Mortgage Choice spokeswoman Kristy Sheppard sees a home loan as more good than bad.

"There's deep emotional benefits of owning your own home rather than sitting in a rental property watching rental prices increasing," she says. "Also, you can build equity within your own home and use that to purchase other investments such as an investment property or shares. So, it can become good debt."

Burns says those with a home loan should not be stashing cash in a savings account, even if it's a high-interest one.

"Due to the fact that the interest you pay on your home loan is often higher than the interest you earn on a savings account, making extra

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DON'T BE RUINED BY RISING DEBT

Despite the global financial crisis and subdued consumer and investor confidence, the value of housing loans on the books of the major banks has surged in the past five years.

Bank	Housing loans for 2006		Housing loans for 2011	
	Owner	Investor	Owner	Investor
ANZ	$65.7 billion	$28.1 billion	$115 billion	$43.8 billion
Commonwealth Bank	$85.1 billion	$45.7 billion	$175 billion	$84.4 billion
National Australia Bank	$66.2 billion	$39.7 billion	$122 billion	$51.7 billion
Westpac	$98.9 billion	$47.2 billion	$198 billion	$88.3 billion
Total:	**$315.9 billion**	**$160.7 billion**	**$610 billion**	**$268.2 billion**

repayments on your home loan can save you more money than by depositing funds into a dedicated savings account," he says.

"If your home loan is eligible for redraw, then you may find it a better option to put savings into your loan and attach a redraw facility. Offset accounts are another option for people with home loans, which can link your loan to your transaction account in order to offset the interest you pay on your loan."

UGLY DEBT

Ugly property debt is much easier to define. Have you added debt to your mortgage to pay for a car, holiday or big screen TV?

That's ugly debt, where you are left with a bill for personal items that have depreciated faster than the loan gets repaid.

Consolidating personal debts such as credit cards and store cards is also ugly debt if you don't learn from your mistakes and rack up those card debts again.

"Ugly debt is the kind that attracts an above-market interest rate, is inflexible or involves you being locked into paying off a high amount off the principal loan," Borg says.

"A good example is bridging finance, which enables you to borrow money over a short term to pay for a new property before you sell the existing one.

"This kind of debt can often attract a higher interest rate and lead to you being painted into a corner. In some cases you might have to accept less than you want for your existing property because of the need to finalise a sale to avoid further costs."

Sheppard says there is a broad range of ugly debt out there, including borrowing against your home equity to fund things that don't add value.

"A lot of people take on significant extra debt after their mortgage because they feel the need to keep up with the Joneses."

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