Debt Management
Handle with Care

CONTENT NOTE

Financial Education
FROM POVERTY TO PROSPERITY

When you borrow money, you enter the world of debt. It has rules, players and strategies. One of the best things you can do for yourself is to learn how to use debt well.

Definitions

Debt: What you owe when you borrow something—cash or tangible goods from someone else, or when you purchase on credit.

When you borrow money from another person or institution (such as a bank or credit union), the lender expects to be repaid. Usually the person who lends the money charges interest—a fee for the use of that money. One can be in debt to family members, friends, informal lenders or financial institutions.

SAMPLE SENTENCES OF WORD USAGE:

1. After borrowing money to purchase a refrigerator, Miriam is in *debt* to her mother.
2. With a loan for school fees and another one for her business, Alexa is carrying as much *debt* as she can afford.

Loan: Something lent for the borrower's temporary use. Commonly, a loan refers to a sum of money that a lender gives to a borrower for a certain period of time. The borrower makes a commitment to repay the money with interest.

For the borrower, the loan is a liability (a sum that is owed). This debt must be repaid regardless of income or cash flow.

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SAMPLE SENTENCES OF WORD USAGE:

1. Sarah has a small *loan* from her village bank that she must repay in four months.

2. The government program makes in-kind *loans* of seeds that farmers repay in produce at harvest time.

Credit: The ability to borrow, or the sum available for borrowing.

Banks and other financial institutions will approve credit to customers who have a good record of repaying their loans on time. Purchasing "on credit" means getting the item you want without fully paying for it at the time of purchase. The buyer makes a commitment to pay for the item in installments or on a certain date in the future.

SAMPLE SENTENCES OF WORD USAGE:

1. Because Marta repaid her last loan on time, she has a good *credit* standing at the bank.

2. Shopkeepers should only sell on *credit* to those customers they know and can trust.

Default: Failure to pay back a loan.

SAMPLE SENTENCES OF WORD USAGE:

1. Josephine *defaulted* on her loan after her husband was injured in a car accident and she had hospital bills to pay.

2. Elizabeth borrowed money from her brother to pay back her bank loan and avoid *defaulting*.

Components of Credit

If you borrow money from a bank or other formal lender, you will hear the following terms associated with your loan. It will be important to understand what each means for your specific loan.

- **Loan size:** The amount you borrow.
- **Loan term:** Period of time you have to use the loan money and repay it.
- **Interest rate:** Percentage of the total loan amount charged to the borrower for the use of money borrowed. Interest is usually charged on a monthly basis.
- **Fees:** Administrative charges in addition to interest which are usually paid once, at the time the borrower takes the loan.
- **Grace period:** Period after receiving a loan and before the first payment is due.
- **Repayment schedule:** The frequency of loan payments (e.g., weekly, biweekly, monthly).

Why Borrow?

We need to borrow money for many reasons. Mostly, we borrow to:

1. invest;
2. respond to an unexpected emergency; or
3. consume (purchase an item for which we do not have enough money at the time of purchase).

A loan provides you with a lump sum of money that might be difficult to obtain otherwise. It enables you to take advantage of business opportunities, respond to emergencies, make home repairs or purchase something you need. But borrowing money can be expensive and carries obligations to repay on time. For these reasons, taking a loan is not the same as using your own money that you may have through wages, business profits or savings. The chart below outlines the advantages and disadvantages of taking a loan.

Risks

For every borrower, debt is a risk. If you can't repay your loan, there will be consequences! Even with careful planning, you may have problems making loan payments. Many unplanned events can turn this risk into reality, such as the following:

- When your income is interrupted due to illness or necessary absence
- When the investment of the loan results in a loss
- When your household and business expenses are greater than your income
- When unexpected events create an urgent demand for cash (e.g. to pay doctors' expenses, funeral costs, etc.)

	Taking a Loan	*Using Your Own Money*
Advantages	You gain access to more money than you have in savings. You get money quickly when you need it for emergencies.	You avoid the costs of borrowing. You are free to use your money as you wish. You face less risk when you finance your business growth in smaller increments based on what you can afford to invest. You avoid the obligation of future loan repayments.
Disadvantages	You bear the cost of borrowing (with interest, fees and time to apply). You are responsible for repaying your loan on time, and face penalties for late payment. You must meet the requirements of group membership (attend meetings on time, etc.) if the loan is through a group.	You have limited access to needed capital. Your business grows more slowly. You have limited ability to respond to opportunities.

Situations like these are common among the poor. Yet, loans must be repaid, regardless. If you face difficulties making your loan payments, what are your options?

To get the money for loan payments, you might need to reduce your spending or sell something of value. You can ask your friends and relatives to help you, but there is a risk that you will eventually “use up” their goodwill towards you.

If you fail to pay altogether, or default on your loan, what are the consequences? You may lose access to sources of credit in the future. You may strain relationships with other members of your credit group; you might suffer humiliation in the community and lose the goodwill of your friends and family. Defaulting on a loan may damage your confidence and self-esteem.

Borrow Wisely

The risks that come with taking a loan should make you think carefully about when and how much to borrow. Loans can open new doors, but you need to know when taking a loan is a wise decision. Good uses of loan capital include the following:

- Purchasing inputs in bulk at a lower price that will increase profits
- Financing productive assets such as machines that help you improve productivity, i.e., a water pump that enables an additional harvest, or food-processing equipment that adds value to a crop
- Purchasing an asset that makes a new business possible, such as a cell phone or a refrigerator

Simply put, borrowing is good when it helps you gain financially and bad when it becomes a financial burden.

Use of the Debt	***Good Debt***	***Bad Debt***
Purchasing an Asset or Consumer Durable	The asset or goods purchased outlast the time it takes to pay off the lender. The income earned from the asset exceeds the cost of the loan.	Debt is still owed after the item is consumed or the income earned from the asset is less than the cost of the loan.
Working Capital	The loan makes it possible to pursue a business opportunity that is profitable enough to repay the loan and have something left. The loan helps you save money on inputs or inventory and thus increase your earnings from the final product.	You cannot earn enough to repay the loan. You have other less-costly sources of financing. You cannot get the loan in time to take full advantage of a specific opportunity.
Emergency Loan	The loan helps you solve an immediate problem without undue hardship.	The loan terms are too costly, or cannot be adjusted to your ability to repay.

The Costs of Borrowing

The main cost associated with a loan is the interest charged for the use of the money. This is usually calculated as a percentage of the total loan amount, and you typically pay it in monthly installments as part of your loan payment. In addition, many lenders also charge administrative fees which you usually pay once, when you take the loan. Interest and fees are charges that you pay directly to the lender. These “direct costs” are usually cash payments.

However, there are other expenses associated with borrowing that may not be so obvious. Sometimes applying for and taking a loan forces you to spend money for transportation to attend meetings or go to the bank to fill out application forms. These activities may take you away from your business, forcing you to close it or hire someone to “mind the store” while you are away. Although these additional “indirect costs” may not be part of the cash loan payment, they are real and should be considered when choosing a lender.

Choosing a Lender

The cost of a loan will vary depending on the type of loan you seek and the lender’s policies regarding interest rates, fees, savings requirements, and collateral. Before you borrow, compare the costs of the loan you want among several lenders.

Choosing a lender is not only about costs. You might also want to consider the following:

- Location (Is the lender close to your home or business?)
- Product offerings (Does the financial institution offer other types of loans or savings services that interest you?)
- Customer service (Do you feel comfortable there? Is the staff friendly and helpful?)

QUESTIONS TO ASK A LENDER

- What types of loans are available?
- What are the collateral requirements?
- What are the savings requirements?
- What is the interest rate?
- What fees are charged?
- What are the penalties for late payments?
- How long does it take to get a loan?
- How many times do you have to actually go to the loan office to complete the application?

How Much Debt Can You Afford?

Too much debt can cause serious problems. The term "over-indebtedness" refers to household debt that is too high relative to household income. How do you figure out how much debt is too much? Unfortunately, there is no rule of thumb about a safe debt-to-income ratio, although 20 to 30 percent of household income is widely used. Should your household always avoid carrying more than one loan at a time? Not necessarily, especially if you face a crisis and need cash urgently.

Before taking on a loan, you should consider both the costs and risks of borrowing. Answer the following questions based on your own circumstances:

1. What percentage of my household and/or business budget can I afford to make available for debt repayment? Will I have enough left over to adequately cover other household expenses?

2. Can my guarantors afford to repay my loan? How will they feel towards me if they have to do so?

3. What are the consequences if I cannot repay my loan? What is the value of the collateral (for example, a motorbike, house, etc.) I have pledged?

Controlling Debt

As a borrower, the debt trap can sneak up on you. Because it occurs slowly, you may not see it coming. Suddenly you owe more than you can afford to pay and the way out is nowhere in sight!

The persistence of debt is one factor that keeps poor people in poverty. For most of us, living with debt has always been and continues to be a reality. Because your need for credit typically does not go away, you are likely to renew existing loans. In fact, given ever-changing circumstances, at some point you may need more than one loan at a time. This can happen when you are faced with an unexpected crisis and need cash urgently.

Whether managing existing debt, or deciding if you can afford to take a second loan, make sure your debt obligations will not control your life—that you will still be able to pay for your basic needs and daily expenses. Two simple rules will help you control your debt:

1. **Don't borrow more than you can afford to repay.**

2. **Save money regularly for emergencies so you do not always have to borrow.**

The Bottom Line

Debt is not our enemy. Bad credit habits are. Use credit well and use it wisely.

WARNING SIGNS: DEBT IS OUT OF CONTROL!

As your debt mounts and becomes a burden, warning signs appear. They include the following:

- Using credit to purchase things you once bought with cash
- Getting loans or extensions to pay your debts
- Using savings to repay loans
- Using credit for living expenses

References

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