Types of Debt

Debt is sometimes necessary, for example when taking out a mortgage or a loan for a very expensive item that would otherwise take years to save up for. As long as a debt is planned for and managed, it shouldn't cause financial difficulties. But unmanaged debts can be expensive and can lead to **bankruptcy**, stress and unhappiness.

Mortgages

Mortgages are loans to buy a property. For most people, a house or flat is the most expensive purchase they make in their lives. Because they involve a large amount of money, mortgages should be carefully researched and planned for. One of the most important things to consider is the **interest rate** and whether this is likely to change (see Fact Sheet FC3 - Risk and Return). People taking out a mortgage also need to consider the terms and length of repayment, cost of monthly **repayments**, hidden charges or fees (e.g. the cost of valuing the property or a charge if you pay back the mortgage early) and whether or not the mortgage can be transferred to another property, if the person decides to move. The mortgage is 'secured' on the property. If you fall behind on repaying the debt the creditor may reclaim the property.

Loans

Loans could be as simple as borrowing ten pounds from family or friends, but could also involve larger amounts borrowed from a bank, building society or credit union. The amount a bank or building society will loan you usually depends on your **'credit rating'**. The lender will carry out an assessment of how likely it is that you will be able to pay the money back and therefore how risky it is to lend money to you. The rating usually considers your age, whether or not you are married, the type of work you do, how much you're paid, your **assets** (the things you own that are valuable), whether you've been in debt before, and how you deal with your debts. There are also companies that lend money and charge extremely high interest rates so you have to be very careful what you agree to. The worst are called 'loan sharks'. A loan can be secured or unsecured:

- **Secured** – If you take out a secured loan, you have to back up your agreement to pay the money back by offering collateral (something of value that you own already, such as your property or car) which can be taken if you fail to pay the loan back. Usually, a secured loan allows you to borrow more money and may allow you a longer period of time to pay it back.

- **Unsecured** – Unsecured loans are far more risky for the lender, as there is no guarantee that the money will be paid back, and interest rates are usually higher than secured loans. You should not only try to find a low interest rate (shown as an Annual Percentage Rate or **APR**) but also check the terms of your loan for hidden charges and fees. For example, there is sometimes a charge if you pay off the loan earlier than agreed.

Cont'd

Types of Debt cont'd

Credit cards and store cards

A common way that people get into debt is through using credit cards and store cards. These let you buy something with **borrowed** money and send you a bill each month for the money you owe. In most cases, if you pay the full amount of money back straight away then you don't get charged but otherwise you have to pay a high rate of interest on the money – this can be expensive! Paying by card can mean that people end up spending more, as it can be more difficult to keep a sense of how much you are paying when not physically handing over cash.

Buying on credit

You've probably seen the signs inviting you to **'Buy now, pay later'**. With this type of offer (usually from a store or catalogue) you receive the product straight away but have to eventually pay back the money in instalments, usually with a high rate of interest. You usually end up paying far more for the product than if you had saved up and bought it. It may be convenient, but could cost a lot.

Hire purchase

With hire purchase, you take out an agreement on a particular product (e.g. car or sofa). You are able to use the product straight away but start paying a monthly fee (often with a high interest rate) towards the cost of the product. However, you are essentially **hiring** it. The product remains the property of the seller until the cost and interest is fully paid off. It can be taken back at any time if you don't keep up with the repayments.

Overdrafts

Overdrafts are agreements with your building society or bank to pay money on your behalf if you spend more than you have in your account. The credit limit is agreed by the bank or building society but interest is charged, even on your agreed overdraft amount, and you'll be charged extra if you exceed it.

Unexpected expenses

Unexpected expenses can throw a person into debt. For example, you might create a sensible budget for your monthly spending but then your mobile phone is stolen or washing machine breaks down. This is why it's important to save for a 'rainy day'.