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5 Ways to Keep Your Financial Books Clean

The Financial Week

MON	GROWTH INVESTING
TUE	INCOME INVESTING
WED	INSURANCE
THU	FINANCIAL PLANNING
FRI	REAL ESTATE & SPENDING

Follow these rules and ensure you do not fall into a debt trap in the new year

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Like any other New Year, this year too has brought in its share of optimism. But if you take a hard look at reality, things may not be all that hunky-dory: be it the economy — global or domestic — the stock market, the job market, and the general mood. In a situation like this, before you step on the gas and do the things that you had set out to, it makes sense to exercise a bit of caution. And the best way to do this is to tighten your purse strings and make sure that you don't fall into a debt trap.

Here's a list of five things you should do to ensure your financial books are clean and you are not over-leveraged.

LIMIT YOUR HOME LOANS

Housing loan is a necessary evil today, thanks to the rising property prices. It is definitely not a bad idea to take a loan to buy a house as it is an asset. However, you should resist the temptation to over-leverage banking on future income and appreciation of the property.

"Some borrowers often believe that even if the current EMIs may be a strain, future income growth will help in servicing the EMIs more easily," says Jayant Pai, CFP, vice-president, Parag Parikh Financial Advisory Services.

Besides, as this is usually the debt with the longest tenure compared to other forms of borrowing, we should ensure that it does not become a millstone around our neck during times of economic difficulty (such as a job loss or a disability).

"Hence, while some text books

indicate that you could borrow up to 50% of your income, I suggest you do not go beyond 40% of your current income. This is especially true with respect to floating rate loans where rising EMIs may creep up insidiously, thereby converting what was just-affordable to an unaffordable loan," Pai adds.

AVOID OVERLEVERAGING

Overleveraging may lead you to cut back on certain other essential expenditures (such as on insurance) in order to service the loan (especially in the case of floating rate loans where your liability is fluctuating), which may have a detrimental effect.

"If you are overleveraged in terms of intangible debt (say for credit card spends or holiday loans) there is no real asset which you can jettison in order to rid yourself of the debt, unlike a home or a car loan where the asset could be repossessed and free you of (or partly reduce) the debt," Pai of PPFAS adds. While home loans do offer certain tax benefits (Sec. 80C and Sec. 24), these should not be the main reason for opting for a loan.



The Loans You Should Go For & The Ones To Avoid



Good Loans

Housing loans are good as you are paying EMIs to create an asset

Appreciation of the property will earn good return in future

It can, however, turn into a bad loan if the loan amount is beyond your repayment capacity



Bad Loans

Car loans & personal loans

Car loans are bad because the value of the car depreciates faster than the principal amount

You should self-finance at least 40-50% of the car value unless used for commercial purpose



Worst Loans

Credit cards, travel loans, loans from private money lenders

The interest rates are almost 40-45% and the end use is consumption

Take a low-rate loan and pay the credit card debt

Encash low-yield investments to pay off costly loans and invest again when you have excess cash

DON'T GET TOO PERSONAL WITH LOANS

Personal loans should be taken only if one has exhausted all other avenues for raising capital — for this will be a costly source of funds (18-20% might be the interest rate). It should be taken in case of urgencies like medical emergencies or personal requirements if not planned for. Some people have the habit of taking personal loans for even buying white goods or holidays. This is not a good idea.

"In case of personal loans, a lot of your savings will go into servicing the interest cost itself, which could have potentially gone as savings. Hence, these loans have two negative aspects: 1) Cashing in on the future earnings for present use. 2) Due to the high interest servicing cost, a lot of money will get channeled into interest payments rather than into savings for future needs," says Suresh Sadagopan, CFP & founder Ladder 7 Financial Advisories.

DON'T FALL FOR CAR LOAN OFFERS

A car is a depreciating asset. It depreciates faster than the rate you settle your loan. Hence it is pref-

erable to self-finance it as much as possible and borrow only the remaining (unless you are using it for commercial purposes and will be able to use the interest as a tax shelter). Don't stretch your loans beyond 3-5 years. "Fix the EMI at a level you can easily afford to pay every month. Do not fall under the temptation of buying a costlier car at the same EMI spread over a longer duration. Rather, buy only what you can afford and try to pay it off at the earliest," says Rishi Nathany, CFP & CEO, Dalmia Securities.

Often car manufacturers offer attractive loans at very low interest rates to push sales. But you have to check the details before you fall for such offers. Understand the scheme very well and compare it with other schemes from different finance companies. "There have been instances wherein a non-standard loan product at 7% interest rate works out more expensive than a 12% interest rate standard loan because the non-standard product had a different compounding base and wasn't monthly reducing," says Banwari Lal Sharma AVP - marketing, CarWale Auto-

motive Exchange.

So, the next time a dealer doles out the 'best' car loan offer to you look at three things.

First, the car loan should be offered on reducing balance. Otherwise even a low 7% rate offer can in effect be as high as 12% interest rate offer. Second, do your EMI math by getting separate quotations from banks based on your loan affordability before getting dealers' quotations. Lastly, always negotiate on cash discount. This will lower your loan amount, EMI and the interest outgo.

WIPE OFF YOUR CREDIT CARD DEBT

It is well known that a credit card loan is the costliest form of debt. Hence try to pay up the entire amount in full each month and not roll it over. "Besides, it is prudent to utilise only around 80% of your credit limit, as a high utilisation may impact your credit score even though you pay your bills on time," says Pai.

If you are burdened with debts of multiple credit cards, transfer it to one card. It will be easier to manage debt and make timely repayments. Have a look at all your credit cards and identify the one

with the lowest interest rate. Secondly, you can take loans against your insurance policies, PPF etc to repay the credit card loan, which comes at an annual rate of 10-12% because they are secured. You can also liquidate the low-yielding investments when you have to repay such debts. The fact is that no instrument fetches such a high interest rate which would off set the rate at which you repay the loan.

However, this should be a one-time exercise otherwise you would realise that the debt is eating into all your investments. Once this is done, you can use the monthly income to build your investment kitty.

Sign in for net banking and substitute your credit card with a debit card this year. Use a debit card/net banking for recurring expenses such as groceries and bill payments. This will help you curb overspending in bouts of indulgence as it is limited by the funds in your bank accounts. Save a lot, spend smart and borrow wise to make this a financially healthy and happy New Year.

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