Understanding Debt  Part 1 of a two-part article
Nathalie Rush, CFA

What is debt?
What exactly is debt? Strictly speaking, debt as defined in the dictionary as: “something, typically money, that is owed or due”, or “the state of owing money”. So, basically, if you have debt, you owe something to someone.

Is Debt a bad thing to have?
Well…it depends. As a borrower, debt is not always a bad thing to have, in fact it is often necessary to take on debt in order to obtain future security. There are instances where debt is considered “good debt”, for example where you take out a mortgage to buy a house, or some sort of loan that will help you grow your net worth over the long term – perhaps a small business loan to help you get started on your road to making money through a passion of yours.

Debt is often considered to be “bad debt” when you’ve borrowed money that you can’t afford to pay back, spending that takes you further away from what’s truly important to you and leaves you with little or nothing to show for it.

How do I determine if I have “Good” Debt or “Bad” Debt?
In general, bad debt decreases your net worth (i.e. the total value of what you own minus what you owe), has higher interest rates, may hinder your goals and achievements and can be avoided with good money management. Good debt on the other hand, helps grow your assets, has lower interest rates, furthers your goals and objectives and can be considered an investment for the future. However, there are always exceptions depending on your personal circumstances – for example, if you take out a loan to pay for medical care to save a loved one’s life, although this may decrease your net worth and hinder your goals and achievements, it could very possibly be considered “good debt”.

Key Components of Debt
Below are explanations of terms you may have heard used to describe different components of debt:

Principal is the amount borrowed, whether it’s the initial amount, or, later on, the amount outstanding (i.e. initial amount minus amount already paid off).
Interest is the fee charged for the privilege of borrowing money. The interest rate, expressed in percentage terms of amount borrowed, is dependent upon the type of loan, the collateral borrowed against and the creditworthiness of the borrower.

Collateral is an asset to help secure a loan. It is the safety net for the lender in case of default. Common examples for debts that use collateral are mortgages, where your home is the collateral, and car loans, where the car is the collateral. In the event of default and in a worst case scenario, the lender can take that home or car and sell it to help pay off that loan. Then there is debt where there is no collateral, prime example being credit card debt. Yes, you may have bought items using that credit card, but the credit card can’t take those items back and use them as collateral. In cases of debt where there is no collateral, interest rates tend to be higher. That’s because this is riskier debt in the eyes of the lender and so they expect to be paid more to take that higher level of risk.

The term of a loan is the amount of time a loan is outstanding, or how long the loan will last if you make the required payment every month.

A default is when a borrower fails to make a payment on a loan according to the arrangement made.

Prepayments are when you pay off part or all of the principal before the payment is due.

**Types of Debt**

There are many different types of debt. Examples include the following:

- Credit cards
- Mortgage
- Education such as student loans
- Retail charge accounts
- Vehicle loans
- Overdue bills
- Loans from friends or family

All of these examples are debt, they represent money owed to somebody else. However, each of these types of debt have different characteristics and, depending on how they are used, can be considered either good or bad debt.
In part 2 of this article, we’ll discuss more fully the different types of debt and focus on the most common forms of debt, credit cards and mortgages.

**Debt Considerations**

There are questions you can ask yourself before you take out a loan, to try and determine whether taking on particular debt is a good or bad idea.

- What is the purpose of the loan? Am I borrowing because I can’t otherwise afford the item? Is it for a necessary expense or for something that I just want to have?
- Does the loan support my financial goals?
- How much total debt do I have? Will I be able to access any more debt in the future should I need to?
- What amount of monthly payment can I comfortably afford to make? Do I bring in enough money each month to cover the amount required to pay off the debt in the expected time period? Is there a chance that the interest rate on my debt will increase?

Questions to ask your potential lender include the following:

- What is the interest rate? Is there any way to reduce this? Perhaps a larger downpayment, perhaps different terms?
- What are the fees charged?
- What is the term; how long until the loan will be paid off?
- Can the loan be paid off early; are prepayments allowed?
- What happens if I cannot pay?

Depending on the type of debt, it’s often a good idea to shop around and speak to different lenders to secure the best terms you can find.

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