A five-step guide to your household's debt level

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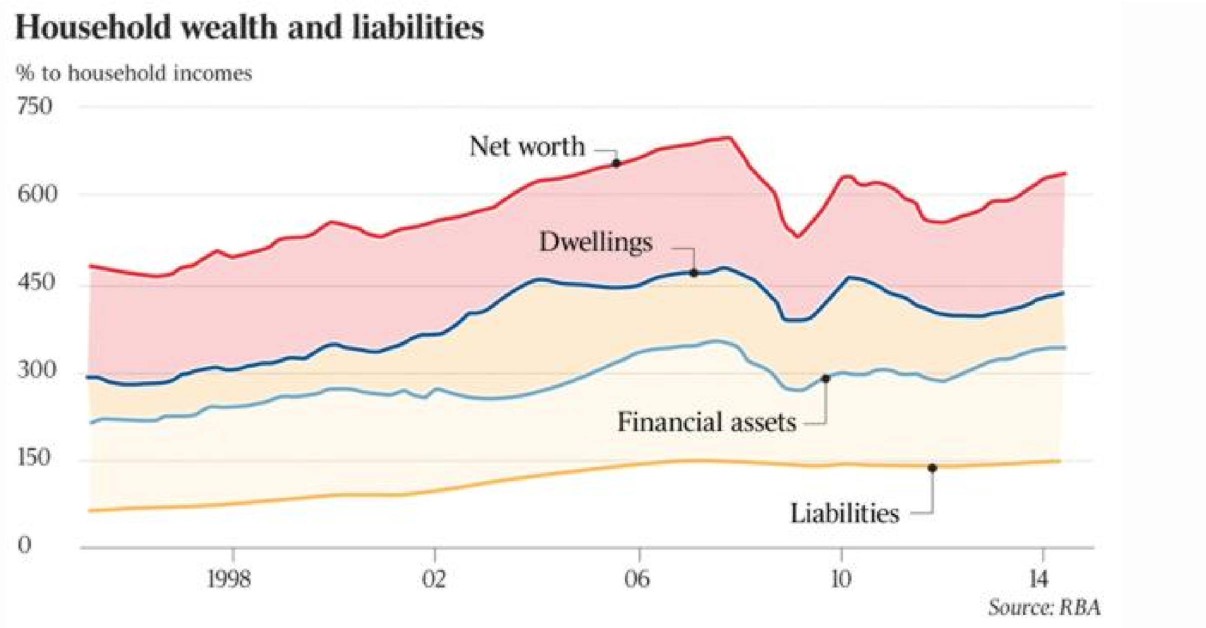

Household wealth and liabilities. *Source:* TheAustralian

THESE days, debt is ubiquitous — and abundant. Debt enables people, businesses and governments to spend and invest beyond the limits set by their current incomes. But it brings with it the burdens of repayment and increased risk.

Australian households have gross debts of $2 trillion. Relative to population and incomes, that's one of the highest levels of indebtedness in the world. And many people are concerned the current surge in borrowing for investment housing will lift household debt to levels that create pain for many borrowers and destabilise housing and some financial institutions.

By contrast, listed companies have, on average, relatively little debt. Their "gearing ratio" — debt as a proportion of equity capital — moves up and down cyclically. The level at present (about 50 per cent) is well below the long-term average. And the Australian government now has a relatively modest level of debt (net debt is less than 20 per cent of GDP). But its borrowings will balloon dangerously in coming years unless the serious underfunding for DisabilityCare (the national healthcare program for disability), education and population ageing is corrected.

Household debt rose markedly in Australia between 1990 and 2006 — those were years the Reserve Bank terms as the "extended period of adjustment to lower inflation and financial deregulation". The ratio of household debt to income then levelled out, but is likely to rise again next year.

In my view, the level of household debt is not, as yet, a national problem. On average, households have increased their saving (to about a tenth of disposable income) and largely seem comfortable in managing their debts: mortgage loans in arrears are 0.6 per cent of loans by value; non-performing debts on credit cards stand at about 1 per cent by value; and balances in mortgage offset and redraw facilities are the equivalent of more than two years of scheduled repayments of housing loans at current interest rates. And, as the chart reminds us, household assets have been rising strongly.

It will be a minority of households — those who experience shocks such as job loss, higher interest rates, ill health, or falling asset values — that will be seriously hurt by the high and rising level of household debt. That said, with household borrowing again under the intense spotlight, it's timely to look again at the five key guidelines for taking on and dealing with debt.

● First, each household should be aware of how much debt it has. People may know what is owed on the mortgage (at least, most remember how much they initially borrowed!). But they should calculate and periodically update the total level of their debt, including the mortgage, credit cards, car loan, personal loans, educational loans, taxes and all.

● Second, it's useful to classify each of the components of borrowings as "good debt" or "bad debt". The former would include, at least within reasonable limits and after careful thought, borrowings for the family house, family businesses, investments and education. The latter might include borrowings that pay for living expenses and holidays, however enjoyable.

● Third, households that borrow to buy a house to live in, an investment property or shares, need to allow that assets can fall in value. Also, their taxable incomes from which any "negative gearing" is deducted can disappear; and tax rules can change.

● Fourth, the widespread use in this country of "variable interest rate" loans imposes on borrowers the risk of higher monthly repayments when interest rates increase. This can be mitigated by households using "fixed rate" loans for at least a part of their borrowings and by their getting ahead of the required monthly repayments on the mortgage when interest rates have fallen.

● Fifth, it's important to allow that debt can be built indirectly into an investor's portfolio: shares and many structured investments are effectively "geared" investments. Many investors are more heavily borrowed than they often realise when they hold these sort of investments that have gearing "built in".

Don Stammer chairs QV Equities, is a director of IPE, and is an adviser to the Third Link Growth Fund, Altius Asset Management, Philo Capital and Centric Wealth. The views are his alone.