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Loans and Debt Management

Having debt doesn't have to be a bad thing!

What's important is how you manage it, because having an outstanding bill is only a good thing if you're a duck.

This guide explains the foundations of loans, credit and debt, and breaks down the need-to-knows when it comes to accessing different types of loans, repaying what you owe, staying safe with credit, and what to do if you can't make your payments.

Loans, debt, credit — what's the difference?

Ultimately, loans, debts and credit are all the same thing.

Credit is a term used to describe funds borrowed from a bank or financial institution (as opposed to money you've earned). The term credit encompasses everything from mortgages to personal loans to credit cards. These are all forms of credit, and are often described as debt because you have to pay the money back.

How credit works

Okay, we've established that credit is borrowed money. But how does credit actually work? When a bank or financial institution lends you money, they do so by applying an interest rate to the funds you've borrowed, so they make money by lending you money. Interest works by applying a percentage increase to the funds you've borrowed each year, so overall you pay back more than you borrowed, as a fee for accessing that money.

Example: If you borrow $10,000 at an interest rate of 10%, and you pay that back in one year, you'll pay back $11,000. That's $10,000 of what's known as 'principal' (the actual money you borrowed), and $1,000 of interest.

Good debt and bad debt

Debt is often broken down into two categories — good debt and bad debt. While it's not quite as clear-cut as good and bad, the two categories do have some important distinctions.

Good debt refers to debt that could allow you to be in a better financial position than you may have been without it. This includes mortgages or home loans and student loans. That's because you used the borrowed funds to acquire something that could make you money e.g. an asset like a house, or an education.

Bad debt refers to debt that doesn't bring any of those potential benefits. That includes credit cards and personal loans, for which funds are often used for day-to-day spending, bills and expenses, and luxury purchases.

Secured and unsecured debt

When you borrow funds, that money is either secured or unsecured. Secured means that the funds are associated with a specific asset, like a car or a property. If you don't make the repayments, the lender can acquire possession of the asset to recoup their funds. For this reason, these types of loans often carry lower interest rates, as the risk to the lender is lower than unsecured loans.

Unsecured loans aren't linked to any particular asset, and therefore give you more freedom in terms of how you spend the money. That said, this comes at a price — which is usually a higher interest rate.

Types of Debt

Different types of debt work differently.
Here's a breakdown of how different methods of borrowing behave.

Personal loan

A personal loan is a lump sum that is loaned to you by a bank or financial institution, and paid back over a fixed term with interest. Personal loans tend to be unsecured, carrying a higher interest rate but greater freedom on what you can use the funds for.

Student loan

A student loan is funding that you can spend on tuition at universities and education institutions. These loads are income-contingent, meaning you make repayments that are proportionate to how much you earn.

Car loan

A car loan is similar to a personal loan, but is for the specific purpose of purchasing a vehicle. These are often secured loans, carry a slightly lower interest rate than a personal loan, and often require a deposit payment to be made on the vehicle.

Home loan

Also called a mortgage, a home loan provides borrowed funds for the purchase of a property. These loans are secured loans, meaning if you can't make your repayments for an extended period of time, your lender can acquire the property. Generally, you pay a lump sum of your own money (between 5-20%) as a deposit or down payment for the property, and borrow the rest over 25-35 years.

Credit cards

Credit cards work differently to loans, in that rather than borrowing a lump sum of money, you're given a credit limit up to which you can spend. You spend by paying with the credit card as normal, and you're charged interest on the balance monthly, if you don't pay it off. Credit cards tend to have higher interest rates than loans, because there is no fixed repayment schedule.

Buy Now Pay Later

Buy Now Pay Later is a new form of credit that allows you to purchase an item, receive it now, and pay for it in regular installments. This type of borrowing doesn't use an interest rate. Instead, you pay a late fee if you miss your repayments.

Pros and cons of debt

In theory, it's safer to only spend money you've already earned. This type of spending doesn't carry the risks of borrowing, but it can be limiting. 'Good' debts like mortgages and student loans can drastically improve your future financial position, and allow you to access resources and assets that you wouldn't have been able to do with cash alone.

With that said, there are some dangers of debt to be aware of. One of the most important considerations of debt is your credit score. Any applications for loans or credit, and any funds that are lent to you by a bank or financial institution are recorded on your credit file. Your behavior with borrowed funds is then reflected in your credit score.

So, if you take out a mortgage and a credit card and you manage that debt well, consistently making your repayments and keeping on top of your balance, you'll likely have a good credit score. If you're unable to make your debt repayments, your credit score can fall. This can impact your ability to access more credit in the future, and cause a significant amount of stress and anxiety if your repayments exceed what you can comfortably afford.

What happens when you can't repay your debt?

When you’re unable to make repayments, it’s called defaulting.

Depending on the type of debt and your lender, you can often apply for hardship consideration if you’re struggling to pay. This can allow you extra time to pay, or give you a break from making repayments, for example, if you’re off work or have lost your job.

Persistent defaults will negatively impact your credit score, and you may be contacted by debt collectors. Debt collectors act on behalf of your creditor, and can take possession of household items or assets if you can’t make your repayments. You may also find yourself facing bankruptcy, which has serious long-term implications on your life.

Things to know before taking on debt

Throughout your life, you'll probably encounter several opportunities to take on loans or credit.

When you buy a car, you might be encouraged by a salesperson to finance the asset — this means taking out a loan for it. Your bank might offer you a credit card. You might see advertisements for Buy Now Pay Later products or other short-term lenders. You might want to buy your own home with a home loan. One of the most important things to consider before taking on these debts is the long-term impact. Often credit is sold to us based on the low monthly repayments, and we forget that we must commit to consistently being able to afford that repayment for several years to come.

- Before taking on any form of debt, take the time to think it through and consider how you'd make your repayments if you were to lose your job or have to take time off work for illness or injury.
- If you do choose to take on debt, make sure to shop around for the best interest rate. Small differences in rates can cost you hundreds or thousands of dollars in the long term.
- Lastly, all debt you take on is considered a liability from a financial perspective. If you take on a car loan, your obligation to make these repayments will then be considered if you apply for any other kind of credit like a mortgage.

How to manage debt

With the right process and structure, managing debt doesn't need to be worrisome.
Here are some ways to manage debt.

Make a debt management plan

Debt management plans are designed to simplify your debt pay-off process and assist you in dealing with your creditors. With a DMP, you can work with a third party to arrive at an achievable repayment amount based on what you currently earn. They can then help you negotiate with your creditors and make paying back your debts more manageable.

Consolidating debt

Another way to manage your debts is consolidation. This involves rolling all your debt balances together into one simple repayment. Doing so can reduce the amount of admin required to meet your debt obligations, and simplify the debt pay-off process.

Applying for hardship

If you're struggling to repay your debts, you can apply for hardship with your lender, and you may do so on the grounds of an unforeseen circumstance that has resulted in your inability to meet your obligations. This includes job loss, death of a spouse, or breakdown of a relationship.

You can request a repayment holiday (temporarily paused repayments), or an extension to the term of your loan, to give you more time to pay or reduce your repayments.

Knowing your rights

When you're consistently unable to pay debts, interactions with creditors and debt collectors can be extremely stressful and unpleasant. It's important to know your rights when it comes to these interactions.

A creditor or debt collector can request that you make repayments or ask you for information on when you'll be able to pay. A debt collector can also notify you of repossession of items listed within the credit contract — for example, secured assets like a car from a car loan.

Debt collectors cannot use force to enter your home, take advantage of vulnerability, or enter your home unlawfully. If you have applied for hardship, debt collectors aren't permitted to contact you.

Help if you're struggling with debt

Financial counseling is free across New Zealand. You can speak to qualified financial counselors about your debt and get help managing the emotional and financial aspects of your debt. If your organization has an Employee Assistance Provider, there may be money management coaching services you can access. There are also charities available to help you manage your debt and take control of how to move forward.

Some support options are listed below:

- Christians Against Poverty NZ
- Citizens Advice Bureau
- Dunedin Budget Advisory
- FinCap
- MoneyTalks
- Presbyterian Support

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