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Some forms of debt are good

Debt is bad. If your parents ever gave you any financial advice when you were growing up, that was probably it. Even in adulthood, the debt-is-bad mantra is something that we keep hearing from financial experts. Indeed, just about every personal-finance book or article that touches on the issue of personal borrowings recommends trying to be debt-free as soon as possible. So, it's no wonder that an aversion to debt is deeply ingrained in our belief system.

However, while the advice of our ancestors is certainly well meant, it perhaps misses the role that reasonably priced debt can play in a well-structured financial plan. Similarly, much of the advice that the most famous financial experts offer on the subject is based on loan products and tax regulations in Western countries. In fact, if you put aside the lifelong conditioning to which you have been subjected and coldly analyse the loan products available in Singapore, you will probably find that some forms of debt are worth having and keeping for as long as possible.

Housing loans are one such form of debt. Banks in Singapore consider these loans to be low risk because they are backed by solid collateral — namely, your house. Thus, the interest rates they charge for these loans tend to be lower than any other form of credit they would offer you.

Currently, the effective rates of interest charged by banks for housing loans are about half of what they charge for car loans and less than a quarter for personal credit loans. In the course of my work though, I have come across people who choose to pay down their housing loans, while taking out car loans. Obviously, this doesn't make any financial sense. They would be better off directing the cash they are using to reduce their housing loans towards purchasing their cars.

However, your housing loan isn't just a good alternative to other forms of debt. I would even suggest that the low rates of interest that banks charge for these loans make it worthwhile to consider saving and investing even before paying them down. The key to seeing the logic of putting cash aside for other things before fully paying down one's mortgage loan is to understand that paying off the loan doesn't actually improve your net worth.

Suppose you have a condominium with a market value of $500,000, a mortgage loan of $400,000, other investments worth $100,000 and cash in your bank and Central Provident Fund (CPF) accounts totalling $100,000. Using the cash in your bank and CPF accounts to reduce your mortgage loan by $100,000 to $300,000 doesn't leave you any richer. All you would have done is cut $100,000 off your liabilities by reducing your assets by $100,000. So, before trying to reduce your housing loan whenever you have some extra cash in the bank or in your CPF account, think about what the money could be used for instead.

Use insurance products

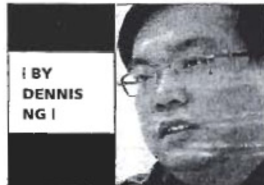
For starters, paying down a housing loan too aggressively and failing to have a sufficiently large "emergency fund" could land you in trouble if you were to lose your job, meet with an accident or fall ill. Hanging on to your cash instead of paying down your mortgage would enable you to comfortably meet these contingencies. No doubt, you could buy some form of disability income insurance or medical insurance to transfer some of these risks to an insurer. But even so, the cash that you free up could go towards your investments instead of being used to pay down your mortgage loan.

Indeed, the insurance policies that you often have to purchase as part of borrowing money to buy a house is another reason not to pay down your mortgage loan too quickly. For instance, if you buy a Housing and Development Board (HDB) flat with a loan from the HDB, you are actually required to get some form of mortgage insurance. It could either be the Home Protection Scheme offered by the CPF Board or a mortgage insurance policy from a private insurer.

In the event of your death or total and permanent disability, these insurance policies would kick in and fully settle your mortgage loan. And, the larger the outstanding loan, the more the insurer would have

Currently, the effective rates of interest charged by banks for housing loans are about half of what they charge for car loans and less than a quarter for personal credit loans

to pay. In that instance, your family would actually be better off financially had you used your spare cash for investments instead of using it to reduce your mortgage loan.



BY DENNIS NG

Buyers of private property might not be required to take up mortgage insurance. But it would probably make more sense to get some anyway instead of using your spare cash to quickly reduce your housing loan.

Reducing balance versus compounding

The big question is whether using a "spare" $100,000 of cash for investing instead of paying down your mortgage loan will actually leave you financially better off? After all, interest rates that banks charge you for a housing loan are higher than those they pay for deposits.

Interestingly, even if the interest rate you pay on your housing loan is 4% whereas the return you hope to earn on your spare cash is 3%, you would still be better off investing it instead of using it to reduce your housing loan. The reason is that the housing loan principal is reduced every month when you make your instalments. Hence, the interest that you pay on your loan is not constant but reduces over time.

Assuming you have an annual housing loan interest rate of 4%, your annual interest expense for a $100,000 loan would be approximately $3,961 in the first year. But it would fall to about $2,863.21 by the 10th year. On the other hand, the power of compounding means that the opposite happens when you save money and invest it. Every year, your principal increases as the interest you earn is added on. Assuming annual returns of 3%, the interest you earn in the first year is $3,000. But that increases to $3,914 by the 10th year.

The total interest you would pay on a $100,000 loan at 4% for 20 years works out to only $46,169, whereas the total interest you would earn from your $100,000 savings at 3% interest rate for 20 years works out to $80,611. That's a difference of $34,442.

Even when you take into account the principal portion of your monthly instalments that wouldn't have been tied up if you didn't have a loan, you would still come out ahead by some $2,815 (assuming the money also earns 3% annually). Clearly, if the rate of return you earned from your savings were, say, 4% per year rather than 3%, you would come out ahead by a much wider margin. At that rate, the total interest you would have earned would be $119,112.30 over 20 years, leaving you about $41,316.30 better off.

That's a substantial amount of money to be squeezed out by doing nothing more than restructuring your finances. You wouldn't have to take on a second job or work an extra minute for it. So, if you are about to pay down your housing loan, perhaps you should stop and think about it again. Your housing loan is really the last loan you should repay. ◻

Dennis Ng is a certified financial planner who regularly speaks and writes on financial planning issues

Housing loans are the cheapest form of credit

TYPE OF LOAN	ANY COLLATERAL?	ESTIMATED EFFECTIVE ANNUAL INTEREST RATE*
Housing loan	Secured by property	1% to 2%
Car loan	Secured by motor vehicle	4%
Renovation loan	None	6%
Personal credit	None	8% to 14%
Credit card debt	None	Up to 24%

** Annual interest rate charged after adjusting for the reducing balance effect*

Paying off debt doesn't change your net worth

Before			**After**		
Assets:			Assets:		
Cash/CPF	$100,000		Cash/CPF	$0	
Other investments	$100,000		Other investments	$100,000	
Property (market value)	$500,000		Property (market value)	$500,000	
Total assets		$700,000	Total assets		$600,000
Less total liabilities:			Less total liabilities:		
Housing loan		$400,000	Housing loan		$300,000
Net worth	$300,000		Net worth	$300,000	