

Understanding and Managing Debt

By Jane Leibbrand

The Good, the Bad, and the Toxic Debt

All debt is not created equal. Debt that creates something of value is considered good debt. You may have had school loans to help pay for college, which helped make you more employable. A mortgage on your home almost always builds equity over a number of years.

On the other hand, debt can become a psychological and financial burden if youâ??re saddled with too much of it. Debt that doesnâ??t help you in the future is considered bad debt. For instance, the minute you drive a car off the dealerâ??s lot, that car depreciates in value. Not being able to pay your credit card debt in full each month isnâ??t a good deal for you, either, because the interest you pay each month makes your purchases more expensive than what theyâ??re worth. When the credit card debt becomes higher each month and you canâ??t make a dent in it, or if your medical bills have gone to a collection agency, itâ??s become toxic debt.

Know Your Debt-to-Income Ratio

Figuring out your debt-to-income ratio is a good method of determining whether youâ??re handling too much debt. When you apply for a home mortgage, your lender examines your debt-to-income ratio to make sure youâ??ll be able to make the monthly payments. Generally speaking, the debt-to-income ratio for your mortgage should be less than 36 percent, with 28 percent or less of it going to

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pay down your mortgage[1]. Car loans, personal loans, and child support are just some loans that are included in your debt-to-income ratio. If youâ??re a millennial or member of gen z, you may have deferred home ownership because youâ??re paying off student loans.

Jason Bart, account manager for CAPTRUSTâ??s Advice & Wellness team, says keeping the debt-to-income ratio below 36 percent can be difficult for those who live in cities with high real estate prices. His philosophy is always â??pay yourself first,â• meaning save for retirement with every paycheck. Then examine what you have left to see what type of mortgage you can afford. If you overspend on a luxurious home or an expensive boat now but donâ??t save adequately for retirement, your older years are likely to be difficult. For example, high medical costs, which you may not have now, are more likely as you age.

What to Do Before You Tackle a Large Amount of Debt

Bart says the first step is to face the debt. â??Some clients are fearful,â• he says. â??They havenâ??t added it up and donâ??t know how big the balances are or what theyâ??re supposed to pay.â• If this describes you, work with a financial advisor who can help you form a plan. Bart has his clients make a list of the debts, the interest rate on each, and how much is owed.

Prioritize Debts

The next step is prioritizing which debt to pay off first. Normally, you want to tackle the debt with the highest interest rate first, but Bart notes, â??It depends. If you have a $10,000 loan with a 10 percent interest rate and a $20,000 loan at a 7 percent rate, do the math; you have a bigger payment of interest on the loan with the smaller rate.â•

Consolidate Debts When Possible

If you have three different credit cards youâ??re trying to pay down, consider debt consolidation. Youâ??re likely paying 18 to 24 percent interest on each of the credit cards. Since you already have credit, youâ??re probably getting offers of 0 percent annual percentage rate (APR) for 12 to 18 months. Consolidate the debt onto that new card. Youâ??ll pay an initial transaction cost (find out what it is), but zero interest gives you a clear path to make a big dent in your debt. Be careful not to miss a payment; otherwise, youâ??re right back to where you started, with a sky-high interest rate.

Bart also says some of his clients donâ??t realize they could snag a lower interest rate with a phone call. Rates are at historic lows now. â??Once you say you know you can get a card for zero percent for a number of months, your current cards are going to make offers,â?? says Bart. Negotiate. You should be able to slash the rate youâ??re paying.

Unexpected and Unaffordable Bills

If a loved one has a serious illness or has been sidelined from an accident and has medical bills in the thousands, your first instinct may be to reach for your credit card. Or perhaps youâ??ve come into an inheritance and the tax bill is overwhelming. Take a deep breath. There are better alternatives than using a credit card, or worse, succumbing to a payday loan. You may have seen ads for those loans

on TV. Bart advises, â??Avoid them at all costs. There are better options for handling your debt.â?•

If the issue is a huge medical bill, call the hospital directly and request a payment plan. Decide on the amount you can afford to pay each month and negotiate. You may need to speak to a supervisor. If the event was catastrophic or if you or a loved one have a chronic and expensive illness, a patient advocate may be helpful, but the service isnâ??t free. Analyze the cost versus the benefits. You may be eligible for a government program that helps families with unaffordable medical bills.

Another option: Many clinics now offer medical credit cards. You usually pay a small fee for the card, but you may receive 0 percent interest for well over a year. The catch is that you must make your payments on time. If you donâ??t, youâ??ll be paying exorbitant interest rates. Before investigating a medical credit card, ask your provider if you can make monthly payments at a low or zero interest rate; itâ??s well worth the phone call.

If the issue is a sizable tax bill from a recent inheritance, call the Internal Revenue Service and ask to set up a payment plan. With interest rates at historically low levels, you could also check into the rate for a personal loan.

If Youâ??re Making No Headway on Debt

If youâ??ve tried to manage your debt but itâ??s not working, donâ??t hesitate to ask for help. Make an appointment with your financial advisor sooner rather than later. Bart says a conversation with clients in this situation isnâ??t all about the numbers; instead, itâ??s about helping them examine their habit of not living within their means, and then shifting the focus to the futureâ??not just the present.

For those without a financial advisor, nonprofit credit counseling agencies like the National Foundation for Credit Counseling (NFCC) can help. Talk to an NFCC Certified Financial Counselor by calling 800.388.2227. The counselor performs a review of your financial situation and may find additional resources to help you. Youâ??ll likely end up with a debt management plan that will allow you to pay off your debts within a certain number of years if you stick to it.

Borrowing from Family

Should you borrow from family? Bart says, â??From a numbers standpoint, this solution is a winner. Youâ??ll likely get a better interest rate from a family member than you could from a bank.â?• He recommends â??making it officialâ?• with a written contract that spells out the interest rate and terms. You can find forms on the Internet that contain elements needed to make the contract legally binding. However, with a family loan, personalities and history are involved. What if you have an unexpected problem paying back the loan? Will there be uncomfortable interpersonal dynamics at Thanksgiving? Only you can decide.

[1]Folger, Jean â??Calculate Your Debt-to-Income Ratio,â?• investopedia.com, 2020

Have questions? Need help? Call the CAPTRUST Advice Desk at 800.967.9948 or schedule an appointment with a retirement counselor today.

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