ACHIEVING FINANCIAL SECURITY BY CONQUERING PERSONAL DEBT

By Michael Leonetti

Overloading on debt is expensive. In addition, credit can be an important lifeline in the event of a crisis, and if you have used all your credit, you have removed a valuable cushion of security.

The good news is that in recent years Americans reduced their debt burden as a percentage of household income from 18.6% to 16.9%, according to the Federal Reserve Board.

The bad news is that Americans continue to charge instead of pay cash, and the debt continues to be the major hindrance to achieving financial security.

Here are some tips on how to conquer debt.

REDUCE USE OF CREDIT CARDS

Nearly three quarters of the people who use credit cards leave unpaid balances from month to month, and those unpaid balances average $2,500.

Compounding monthly the unpaid balance on a credit card that charges an 18% annual percentage rate means you're paying an effective interest rate of 19.56%, or nearly $500 in annual interest charges. If you paid off the $2,500 balance, you would earn, in effect, a 19.56% "return" on your money. Furthermore, that return is free of tax.

To put it another way, if you are in the 28% income tax bracket, you'd have to earn slightly over 27% on a $2,500 investment to end up with an aftertax gain of $500. Try to find a reasonably safe investment with that kind of return.

If you need a credit card for convenience, pay it off each month. If you can't control your charging, cut up your cards.

Debt experts find that people who pay cash instead of charging not only eliminate expensive interest charges, but also typically spend 25% to 30% less in the first place. The only tough part about spending cash is that it is more difficult to track when drawing up a spending diary.

REDUCE CURRENT DEBT

If you currently are heavily burdened with debt, there are several steps to consider. First, of course, is to start paying off your debt, and two approaches are possible: You can pay off the highest-interest debt first, which would save you the most money; or you could pay off the lowest balance first.

You may want to consider consolidating your loans. Home equity loans, whose interest rates can be reasonable and whose interest payments are usually tax-deductible, are a popular avenue. But you may be putting your home at risk to pay off, say, a car loan, when in fact it might be better to sell the car and buy a cheaper one. Remember, too, to be cost-effective the interest rate on the consolidation loan needs to be less than the interest rate you were paying before on the multiple loans, or the payoff time needs to be stretched out to lower monthly payments. Also, if you consolidate your loans, but then spend the savings, you're not coming out ahead.

DEVELOP A PLAN

Unless you develop a plan for paying your debts, frustration and bad credit

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can easily result. By developing a worksheet listing the name of creditors, dates last paid, when balances are due, interest rates being charged, monthly payments and totals due, you can address your credit obligations. Be sure to list all consumer debts, noting the maturity dates for non-revolving charges.

When you write down the interest rate of each loan, check to see if it exceeds the aftertax return on your invested savings. If it does, you have negative interest spread, and would be wise to pay off that loan from a savings account.

After you have totaled monthly debt obligations, calculate the percentage of take-home pay they represent. If the percentage is higher than 15% to 20%, you are in danger of overloading your short-term credit.

Ask yourself, could you pay off all your debts within an 18- to 24-month period? If not, you are probably exceeding your credit limit.

Remember that credit can be an important lifeline in the event of a crisis, such as temporary or permanent loss of employment or other financial crunch. If you have used all your credit you have removed a valuable cushion of security.

CREDIT PROBLEM RESOLUTION

Sometimes a variety of circumstances combine to cause a cash flow crisis and the result is an over-extension of credit. This can lead to emotional and marital problems in addition to the financial turmoil. When a person has reached this situation there are several steps to be considered:

- Immediately stop the use of credit.
- Evaluate the extent of the problem—list your debts.
- Consider declaring bankruptcy only as a last resort. It's expensive and it stays on your credit record for 10 years. Try negotiating with your creditors to stretch out payments. They would rather get late payments than no payment at all.
- Seek the services of a credit counseling service.
- Develop your own workout resolution.

Most persons recognize the problem long before it becomes serious enough to warrant that bankruptcy. But because they are not aware of the fourth and the fifth possible steps, they allow the situation to grow worse.

CREDIT COUNSELING SERVICES

In many areas there are credit counseling agencies that can provide help. These are non-profit organizations, frequently affiliated with local United Way and other service coalitions. If you are not aware of them, simply call the local services organization and ask for a referral.

Generally these groups help the consumer straighten out the credit and budget situation for a nominal fee. The bulk of their compensation, which is used to offset the expense of operations, comes from the merchants as a percentage collection fee. What these groups attempt is the following:

- Have merchants and creditors suspend collection efforts.
- Have creditors suspend all interest charges.
- Collect one check each pay period from the debtor.
- Make monthly disbursals to the creditors.

These organizations are quite distinct from the companies who market loan consolidation packages, which frequently increase the total interest expense and lower the monthly payment, significantly prolonging the payout period. The reputation of a credit counseling service can be easily confirmed by a few calls in the community, and the performance record of these services nationally is quite good.

RESOLVING IT YOURSELF

However, if local agencies are not available or you are reluctant to use their services, try to negotiate the same arrangement. Here are some steps to follow:

- Develop a complete list of all debts. This includes the names and addresses of the creditors, account numbers, the current amount owned, and the monthly payment expected.
- Prepare a budget, allocating income to cover fixed monthly expenses, variable monthly expenses, and a sinking fund for the periodic expenses which come up annually or semiannually.
- Cease using credit cards and charge accounts entirely. If you are concerned with temptation, then destroy the cards.
- Send a letter to all creditors requesting a special payment arrangement. If they do not respond in writing, insist that they do so. Otherwise you may be hit much later with a staggering amount of accumulated interest.
- Make monthly payments on schedule.
- If some crisis causes you to have to temporarily suspend payments, contact the creditors in writing immediately. Explain the situation frankly and send some payment, however small. Do not leave them in the dark. Communicate each month. Resume full payments as soon as possible.
- Do not open any new accounts or incur new debt.
- Start saving money so that you will have some financial resiliency. The best way to do this is through payroll deduction to a savings institution or credit union. Try to increase the amount of savings as your creditors are paid off and as you get any pay raises or bonuses. Just getting out of debt isn't enough—you have to feel that you are making progress. ✦