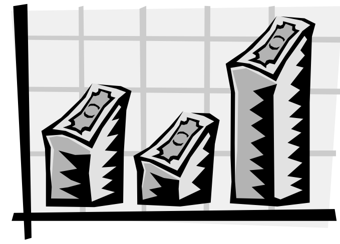
KOFA HIGH SCHOOL SOCIAL SCIENCES DEPARTMENT

ECONOMICS - PERSONAL FINANCE WORKSHOPS

 # 4 - CONTROLLING DEBT



*Vocabulary Keys : Words that are in **bold** = are terms that appear in one of the chapters , Words that are underlined = supplemental vocabulary . Ask questions about these words if you are not familiar with them !*

Top Things To Know

1. Americans are loaded with credit-card debt.

The average American household with at least one credit card has nearly $9,200 in credit card debt, according to CardWeb.com, and the average interest rate runs in the mid- to high teens at any given time.

2. Some debt is good.

Borrowing for a home or college usually makes good sense. Just make sure you don't borrow more than you can afford to pay back, and shop around for the best rates.

3. Some debt is bad.

Don't use a credit card to pay for things you consume quickly, such as meals and vacations, if you can't afford to pay off your monthly bill in full in a month or two. There's no faster way to fall into debt. Instead, put aside some cash each month for these items so you can pay the bill in full. If there's something you really want but it's expensive, save for it over a period of weeks or months before charging it so that you can pay the balance when it's due and avoid interest charges.

4. Get a handle on your spending.

Most people spend thousands of dollars without much thought to what they're buying. Write down everything you spend for a month, cut back on things you don't need, and start saving the money left over or use it to reduce your debt more quickly.

5. Pay off your highest-rate debts first.

The key to getting out of debt efficiently is to first pay down the balances of loans or credit cards that charge the most interest, while paying at least the minimum due on all your other debt. Once the high-interest debt is paid down, tackle the next highest, and so on.

6. Don't fall into the minimum trap.

*If you just pay the minimum due on credit-card bills, you'll barely cover the interest you owe, to say nothing of the **principal**. It will take you years to pay off your balance and potentially you'll end up spending thousands of dollars more than the original amount you charged.*

7. Watch where you borrow.

It may be convenient to borrow against your home or your 401(k) to pay off debt, but it can be dangerous. You could lose your home, or fall short of your investing goals at retirement.

8. Expect the unexpected.

Build a cash cushion worth three months to six months of living expenses in case of an emergency. If you don't have an emergency fund, a broken furnace or damaged car can seriously upset your finances.

*9. Don't be so quick to pay down your **mortgage**.*

Don't pour all your cash into paying off a mortgage if you have other debt. Mortgages tend to have lower interest rates than other debt, and you may deduct the interest you pay on the first $1 million of a mortgage loan. (If your mortgage has a high rate and you want to lower your monthly payments, consider refinancing.)

10. Get help as soon as you need it.

If you have more debt than you can manage, get help before your debt breaks your back. There are reputable debt counseling agencies that may be able to consolidate your debt and assist you in better managing your finances. But there are also a lot of disreputable agencies out there. Talk to Mr. Rothschild before doing this .

Good Debt vs. Bad Debt

Sometimes it makes sense to borrow -- a lot of times it doesn't.

It's almost impossible to live debt-free; most of us can't pay cash for our homes or our children's college educations. But too many of us let debt get out of hand.

*Ideally, experts say, your total monthly long-term debt payments, including your mortgage and credit cards, should not exceed 36 percent of your gross monthly income. That's one factor mortgage bankers consider when assessing the **creditworthiness** of a potential borrower.*

It's far too easy to spend more than you can afford, especially when you pay by credit card. Again , the average U.S. household with at least one credit card carries nearly a $9,200 balance, according to CardWeb.com, and personal bankruptcies have hit record highs in recent years.

Of course, avoiding debt at any cost is not smart, either, if it means depleting your cash reserves for emergencies. The challenge is learning how to judge which debt makes sense and which does not, and then wisely managing the money you do borrow.

Good debt includes anything you need but can't afford to pay for up front without wiping out cash reserves or liquidating all your investments. In cases where debt makes sense, only take loans for which you can afford the monthly payments.

Bad debt includes debt you've taken on for things you don't need and can't afford (that trip to Bora Bora, for instance). The worst form of debt is credit card debt, since it usually carries the highest interest rates.

Sometimes the decision to borrow doesn't hinge on how much cash you have, but on whether there are ways to make your money work harder for you. If interest rates are low, compare what you'll spend in interest on a loan versus what your money could earn if it were invested. If you think you can get a higher return from investing your cash than what you'll pay in interest on a loan, borrowing a small amount at a low rate may make sense.

Three Examples Of Good Debt

Home, school and your chariot qualify .

Debt is not always a bad thing. In fact, there are instances where the leveraging power of a loan actually helps put you in a better overall financial position.

Buying a home: The chance that you can pay for a new home in cash is slim. Carefully consider how much you can afford to put down and how much loan you can carry. The more you put down, the less you'll owe and the less you'll pay in interest over time.

Although it may seem logical to plunk down every available dime to cut your interest payments, it's not always the best move. You need to consider other issues, such as your need for cash reserves and what your investments are earning.

Also, don't pour all your cash into a home if you have other debt. Mortgages tend to have lower interest rates than other debt, and you may deduct the interest you pay on the first $1 million of a mortgage loan. If your mortgage has a high rate, you can always refinance later if rates fall .

A 20 percent down payment is traditional and may help buyers get a good mortgage deal . If you do not put 20 percent down , you'll end up paying higher monthly mortgage bills because you're borrowing more money and you will have to pay for primary mortgage insurance (PMI), which protects the lender in the event you default.

Paying for college: When it comes to paying for your children's education, allowing your kids to take loans makes far more sense than liquidating or borrowing against your retirement fund. That's because your kids have plenty of financial sources to draw on for college, but no one is going to give you a scholarship for your retirement. What's more, a big 401(k) balance won't count against you if you apply for financial aid since retirement savings are not counted as available assets.

It's also unwise to borrow against your home to cover tuition. If you run into financial difficulties down the road, you risk losing the house.

Your best bet is to save what you can for your kids' educations without compromising your own financial health. Then let your kids borrow what you can't provide, especially if they are eligible for a government-backed Perkins or Stafford Loans, which are based on need. Such loans have *guaranteed low rates; no interest payments are due until after graduation; and interest paid is tax deductible under certain circumstances.*

*Financing a car: Figuring out the best way to finance a car depends on how long you plan to keep it, since a car's value plummets (it's a depreciating **asset**) as soon as you drive it off the lot. It also depends on how much cash you have on hand.*

If you can pay for the car outright, it makes sense to do so if you plan to keep the car until it dies or for longer than the term of a high-interest car loan or pricey lease. It's also smart to use cash if that money is unlikely to earn more invested than what you would pay in loan interest.

Most people, however, can't afford to put down 100 percent. So the goal is to put down as much as possible without jeopardizing your other financial goals and emergency fund. Typically you won't be able to get a car loan without putting down at least 10 percent. A loan makes most sense if you want to buy a new car and plan to keep driving it long after your loan payments have stopped.

*You may be tempted to use a home **equity** loan when buying a car because you're likely to get a lower interest rate than you would on an auto loan and the interest is tax deductible. But before going this route, make sure you can afford the payments. If you default, you could lose your home. And be sure you can pay it off while you still have the car, since it's painful to pay for something that has been consigned to the junkyard.*

Leasing a car might be your best bet if the following applies: you want a new car every three or four years; you want to avoid a down payment of 10 percent to 20 percent; you don't drive more than the 15,000 miles a year allowed in most leases; and you keep your vehicle in good condition so that you avoid end-of-lease penalties.

Whatever route you choose, shop for the best deals. Remember, it's in the car dealer's best interest to finance at the highest rate possible, so look at what you'll pay overall, not just the monthly amount. If you tell your car dealer you can spend $400 a month, you could end up with a new car for $400 a month based on an uncompetitive interest rate.

Borrowing For Other Expenses

A home-equity loan or home-equity line of credit is smart in some instances.

Besides life's big-ticket items - home, car, and college -- you may be tempted to borrow money to pay for an assortment of other expenses such as furniture, appliances and home remodeling.

Generally speaking, it's best to pay upfront for furniture and appliances, since they don't add value to your home and are depreciating assets. If you do finance such purchases, however, read the fine print.

Retail stores often charge high interest rates. And even if they offer a low-interest or no-payment period for several months on a purchase, you may be required to pay for the item in full at the end of that period or risk being charged a high interest rate dating back to the day of sale.

Taking a home equity loan or home-equity line of credit makes sense if you're making home improvements that increase the value of your house, such as adding a family room or renovating your kitchen. The interest you pay in many cases is deductible and you increase your equity.

If, however, a home project doesn't boost your house value, consider paying cash or taking out a short-term, low-interest loan that will be paid off in five years or less.

Taking A Loan To Pay Off Credit Cards

It can work, but there are drawbacks.

If you're saddled with a lot of high-interest credit card debt, you might be tempted to pay it off quickly by borrowing from your 401(k) or taking out a home-equity loan.

There are two key advantages to home-equity loans: They typically charge interest rates that often are less than half what most credit cards charge. Plus, the interest you pay in most instances is deductible. (Note, however, when you use a home equity loan for non-housing expenses, you may only deduct the interest paid on the first $100,000 of the loan, according to the National Association of Tax Practitioners.)

But there is one potential and very significant drawback when you borrow against your house to pay off credit cards: if you default on your home equity loan payments, you may lose your home.

Borrowing from your 401(k) is even less advisable. That's because you lose out on two of the biggest advantages to workplace retirement plans: tax-deferred compounding of your money and tax-deductible contributions. Sure, you pay yourself back with interest, but that interest is paid with after-tax dollars and it will be harder for you to make new contributions while you're repaying your old loan.

Also, if you quit or lose your job, you'll probably have to repay the entire borrowed amount within three months. If you aren't able to do that, you'll owe income taxes on the money, plus a 10 percent penalty if you're under 59-1/2.

One other word of caution if you take any kind of loan to pay off your credit cards: Once your credit card debt is paid off, you have to be vigilant about not running up your balance again, because you still will have big loan payments to make.

If you're having chronic trouble paying off your credit card debt, it may be time to consult a debt counseling service for help managing your finances in the future.

Managing Your Debt

Simple steps put you -- not your bills -- in charge.

Outside of fixed monthly bills such as your housing or car payment, you probably don't have a precise idea of how you spend most of your money.

If you want to get your debt under control, start by figuring out your spending patterns and identifying unnecessary expenses.

For one month, write down every cent you spend. "Every" means "every," including that $2 cup of coffee that starts your workday or that $4 magazine you buy on a whim. That will clarify in black and white how much of your spending is fixed and how much is variable (and hence easier to curb).

Tally the expenses on the list and compare the sum to your monthly income.

How much do you bring in after taxes? How much do you have left at the end of the month after paying ***fixed expenses****? How much do you spend on* ***variable*** *items like that $2 cup of coffee every morning?*

Consider, too, whether there's any way to boost your take-home pay. If you get a big tax refund every year, that means you're having too much withheld from your paycheck. If that's the case, you can reduce your withholding by changing your W-4 at work.

Next, make a list of all your debt obligations and the interest you're charged for each.

Once you've done all that, you're ready to start lightening your debt load.

The basics of debt reduction are simple: Cut down on your variable spending and put the extra money toward your debt payments. Once you determine the maximum amount you can pay off each month, pay down the debt with the highest interest rate first -- that usually means your credit card balance -- while paying at least the minimum monthly amount due on all other revolving bills.

Once the debt with the highest rate is wiped out, put your money toward paying the debt with the next highest rate. One exception: If you have a credit card with a low teaser rate that will go up after a fixed amount of time, strive to eliminate that balance before the low rate expires.

You might also consider moving some of your high-interest credit card balances to a card with a lower interest rate. But read the fine print on any invitation to transfer balances. Sometimes such low-interest-rate offers are only in effect for short periods of time, after which the rate skyrockets. What's more, consolidating your debt on one card may lower your credit score if your debt-to-available-credit ratio worsens.

For many people, reining in discretionary spending for a few months goes a long way toward tackling debt. But if that's not enough, try to reduce your fixed expenses. Take steps to lower your household bills; refinance your mortgage to get a lower interest rate; or, if you have a good payment history, ask your credit card company to lower the interest rate you're charged.

Get Your Credit Reports And Scores

Know what information lenders have on you.

While you're cleaning up your debt, order copies of your ***credit reports and credit scores****, since the information contained in them will directly affect the interest rates you're offered on credit cards, mortgages and other loans.*

There are three major credit bureaus: Experian, Equifax, and TransUnion. Each collects information on your credit history, which is culled into a credit report. From that report, a credit score is derived. That score is a quick way for lenders to assess how risky you are as a potential borrower. The higher your score, the less risk you pose to lenders and the more likely it is that you'll get their best available rates.

The score most commonly used by lenders is the ***FICO score****, developed by Fair Isaac.*

When lenders review your credit reports and resultant FICO scores, they take into account not only how much you owe, but also how much credit you have available to you. Too much of either and they may not loan you any more money.

So when you get your reports, check for inaccuracies; the bureaus are required to investigate and correct them once you report them. Look, too, for things that may lower your credit rating, including open lines of credit you never use or accounts you thought had been closed long ago.

The bureaus may have different information about your credit history, which means your credit score can vary somewhat from bureau to bureau. So it's important to view reports from all three.