

Managing Debt

While earlier generations may have followed a “cash only” spending philosophy, most Americans today cannot imagine living without at least some debt. Relatively few of us are able to pay cash for a home or car. The ability to borrow money, when it’s needed and on favorable terms, is a privilege earned by carefully managing your debt obligations.

Why Borrow Money?

Many advisors regard borrowing money as a two-edged sword. It can, for example, be used to finance long-term goals such as a home, a business, or an education. Over time, these “investments” tend to increase in value and return far more than the cost to purchase them.

Used to excess, or to constantly pay for short-term consumer items, such as clothing, vacations, or a night on the town, debt can become an overwhelming burden.

Managing Your Credit Record

Most lending decisions are made on the basis of your credit record, also known as your credit report. When lenders size you up to determine how much credit, if any, to grant you, they count on the three Cs:

- **Character:** How responsibly will you handle your credit obligations? Lenders will look at how well (or how poorly) you have repaid previous debts.
- **Capacity:** What is your financial ability to assume a certain amount of debt? Do you have enough money coming in the door each month to pay all of your bills?
- **Capital:** What financial assets are at your disposal to pay off debts? If you don’t repay the debt as promised, do you have other financial assets that could be used by the lender to pay off the debt?

How well you manage each of these issues is reflected in your credit report. Because your credit report is constantly changing, you should review it at least once a year to check for errors, credit card fraud or identity theft.

What Are My Choices?

Today's consumer has many methods of borrowing money. You could, for example, use your credit card to finance a college education. However, a better choice might be a government- subsidized student loan which typically carries a lower interest rate and defers payments until after the student has finished school. Similarly, you could use part of your home equity line of credit to pay for a car, but do you really want to be making car payments for the next 10 or 20 years?

Whether you do the homework yourself, or seek the help of an advisor, understanding the loan options available, and then appropriately matching the type of loan to the need, is a key part of effective debt management.

Managing the Cost of Your Debt

Interest rates constantly move up and down. Thus, the loan that you took out several years ago at what was then a great rate may not be such a good deal today. Lower interest rates may allow you to refinance an existing loan and lower your monthly payment. Or, if you keep the same monthly payments, a lower interest rate may allow you to pay off the loan sooner.

- **Mortgages and other consumer loans:** As a general rule, the interest saved must be greater than the cost (pre-payment penalties and other closing expenses) of acquiring the new loan before it makes sense to refinance.
- **Credit cards:** The competition between credit card issuers can be intense. You can sometimes “surf” your credit card balance from one issuer to another to take advantage of issuers’ low introductory rates. If you do move your balance from one card to another, be sure that you make at least the minimum payment when due; otherwise, the interest rate can permanently jump from the low single digits to the high 20s.

Seek Professional Guidance

The advice and guidance of a professional financial advisor can be useful in helping sort out the various options for borrowing money. In addition, a qualified advisor can help you understand the impact of any borrowing upon your personal financial and income tax situation.

Other Resources

The federal government makes a number of resources available to the public:

- Consumer Financial Protection Bureau: On the internet at <https://www.consumerfinance.gov/>.
- The Federal Trade Commission has a number of free publications available. On the internet, go to <https://www.consumer.ftc.gov/topics/credit-and-loans>.
- The Federal Consumer Information Center, at <https://publications.usa.gov/>, has a number of free and low-cost publications on a number of topics on interest to consumers.

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