What is Debt Management?
As a consumer in today’s world, you need credit. The average cost of a house, car, or college education has increased rapidly in comparison to average household incomes. Therefore, it is not unusual for consumers to borrow money if they want to purchase a home, drive a car, or educate themselves or their family. And with greater credit needs, the appropriate management of debt becomes essential to financial flexibility and freedom.

Proper debt management ensures that you will not only have credit when you need it, but be able to make wise borrowing decisions and avoid disaster if you become overextended. If you are just getting started:

1. You can ensure that loans are available when you need them by establishing and maintaining a positive credit record.
2. You can benefit from many specialized loan programs if you are aware of your borrowing options.
3. And you can save money by taking steps to reduce the cost of debt and save yourself from disaster if you know what to do when you can no longer meet your financial obligations.

Establishing Credit
In order to have access to loans you need to establish a good credit record. Your credit record is established by borrowing money from a lender or using a creditor who reports to a credit bureau. Unfortunately, it is a catch-22 because most lenders won’t give you a loan without a credit record and a large proportion of your credit record is determined by the amount you borrow.

However, there are other variables that make up your credit record, which brings us to our next point and something we should all be familiar with: your credit score.

FICO Score Break Down

Based on your FICO credit record, lenders calculate your credit score so they can assess the risk you pose to them before they decide whether they will give you credit. The higher the score, the less risk you pose to creditors. Your score can range anywhere from 300 to 850. Aiming for a score above 700 will most often put you in good standing.

The first step in maintaining a good credit score is to pay your obligations. However, simply paying your bills is not enough. It is not uncommon for credit reports to contain errors that are more clerical in nature or caused by misidentification (someone’s bad credit gets put on your report). Although these errors may not be your fault, they can impact your ability to get a loan.

In order to avoid such complications, you should consider getting copies of your credit reports from the various national credit reporting: Experian, Equifax, and TransUnion. Usually copies of your credit report require a fee; however, you may
request up to one free credit report each year. Once done, you need to review the information and determine if there are any errors. If you do find some inconsistencies you can contact one of the agencies and request an investigation of the error and they will correct, confirm or delete the error. Regularly reviewing your credit report is a great habit to get into and is also a good way to ensure your identification has not been stolen; something that has become a growing problem with the dawn of social media and use of credit cards.

If you have no credit experience, don’t worry; there are still other ways to build your credit history. You could put down a large down payment or post collateral to increase lenders and creditors confidence that you will be able to pay them back. Another good way is to open a credit card. Once you begin to build up a history of consistently meeting your obligations, lenders will be more willing to offer you credit.

Borrowing Options
So you’ve established a credit record and now need to borrow some money, what’s the next step? Knowing what borrowing options are available to you is important when shopping for credit. Some types of loans carry lower interest rates, some have tax-deductible interest, and others are subsidized by the government or have special repayment terms.

When you have the need to finance an expense, it is important that you educate yourself about borrowing options to ensure you do not end up making a mistake that could cost you thousands or tens of thousands of dollars.

Be aware that lending is a competitive and lucrative industry. You may be asking yourself, “Isn’t competition good for the consumer?” While it does help in the way of lowering the cost of loans, it can also force lenders to loosen credit standards and make loans available to those who can’t afford them or for those which they may not be appropriate (as we saw in the recent credit collapse that ignited a recession in 2007-2009). In order to make loans more appealing, lenders may also incorporate low-cost start-up fees, but more often than not those loans include inflexible terms that may end up costing the borrower more over the entirety of the loan than they were originally aware of. It is important to know your options and be willing to shop around. If you find yourself confused or hesitant, talk to a professional that can guide you through costs, benefits, and other available alternatives.

Good vs Bad Debt
When evaluating borrowing options, it is important to understand which debts can be considered good debt and which can be considered bad debt. You are probably asking yourself, “Is there such a thing as good debt?”. The answer is yes, some debt can be favorable when the money borrowed is used for an investment, or something that will increase your ability to earn more. For example, a home purchase can be considered a good debt because homes tend to appreciate in value.
Another example of good debt is a student loan taken out to finance college or graduate school. Learning specialized or professional skills can increase your earning power over your lifetime, thus is an investment in yourself.

Consistently maintaining an outstanding balance for longer than a few months is a red flag that you are spending too much.

Just like there is good debt, there is bad debt too. When you use debt to finance something that is consumed or considered a depreciating asset, you are taking on bad debt. Credit card debt can be considered bad debt because it is usually used for everyday items like food and clothing. If a credit card is used for those types of items, you should be able to pay the balance off each month. Consistently maintaining an outstanding balance for longer than a few months is a red flag that you are spending too much.

It is important to understand that the way we define good vs. bad debt is a matter of concept and context. In practice, good debt is obtained through making wise decisions about your future, not for the sole purpose of having good debt.

For example, you may make the decision to obtain a Master degree in Engineering to increase your earnings potential as an electrical engineer. Taking out a student loan, if you have no other way of financing your education, is a good reason for taking on additional debt. However, taking out a student loan for a Master degree in Art History when you plan to make a living as an electrical engineer may fall into the bad debt category. Additionally, student loans usually are interest free while enrolled in school and for up to 6 months after graduation. But you must be careful, the interest rates on these loans can become extra-neous when payment begins so it is an important consideration in your debt management strategy.

In another example, you may take out a mortgage to finance the purchase of a home with manageable monthly payments. In addition to providing the opportunity to purchase a home, the interest is tax-deductible and can make the purchase more favorable than renting over the long-term. However, simply being tax-deductible does not create a good use of debt. Taking out a mortgage that requires a monthly payment equal to half of your income or more can easily turn un-manageable if you were to lose your job or even inherit a short-term disability. It is important to realize a tax deduction lowers your taxable income, but it is not a dollar off taxes for every dollar you spend. For example, if you are in the 25% tax bracket, for every dollar you deduct you only receive a 25 cent tax break, NOT a dollar.

Below you can find some examples of good and bad debt, but remember just because certain debt may be classified as “good” debt does not make it good debt for you personally, as everything is within context. If you are overloaded with debt, then it doesn’t matter whether debt is good or bad, it still hurts your financial health.
<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
<th>Tax-Deductible Interest</th>
<th>Appreciating Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Home Loan</strong></td>
<td>Good</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Home loans (Mortgages) are considered good debt because homes tend to be appreciating assets and mortgage loan interest is deductible.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Home Equity Loan</strong></td>
<td>Okay</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Home Equity Loans are considered acceptable debt, because they may be deductible. They make sense for home improvements, but probably not for consumer luxury goods.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Margin Loan</strong></td>
<td>Risky</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Margin loans are secured by an investment portfolio to purchase additional investments.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Consumer Debt</strong></td>
<td>Bad</td>
<td>✓</td>
<td>X</td>
</tr>
<tr>
<td>Consumer credit loans are used to purchase items that rapidly decrease in value like furniture, appliances, and automobiles.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Credit Card</strong></td>
<td>Bad</td>
<td>✓</td>
<td>X</td>
</tr>
<tr>
<td>If not paid off each month, credit card obligations can lead to serious debt problems and increase the real cost of purchases.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Student Loan</strong></td>
<td>Good</td>
<td>✓</td>
<td>X</td>
</tr>
<tr>
<td>Student loans provide opportunities to increase earning power for yourself. They typically come with very favorable short to intermediate term financing options, however can become an excessive burden if the payoff is not managed properly.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Business Loan</strong></td>
<td>Good</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>This is usually a term loan to invest in your business to increase its value and income</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Type of Loan</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Term Loan</strong></td>
<td>A loan with a fixed maturity and an amortization schedule. These loans are usually used for autos and homes.</td>
</tr>
<tr>
<td><strong>Line of Credit</strong></td>
<td>When a lender extends an amount to a borrower, usually without a fixed maturity. Examples of these types of loans are credit cards and home equity.</td>
</tr>
<tr>
<td><strong>Secured Debt</strong></td>
<td>When a lender loans money secured by some form of collateral, such as a home.</td>
</tr>
</tbody>
</table>
Reducing the Cost of Debt

What if your problem is not access to debt, but the amount of debt itself? It is good to periodically evaluate your debt situation and determine whether you can reduce the cost of debt. In other words, it makes no sense to be paying more money for interest if you can be paying less.

There are several ways to reduce the cost of debt: you can refinance loans to get lower interest rates, use the equity in your home to pay off high interest loans and credit card balances, or transfer your credit card balances to cards with lower rates. Other options include prepaying debts and liquidating assets to pay off loans to avoid further interest charges. You may also seek to reduce or eliminate noninterest costs related to borrowing, such as private mortgage insurance (PMI). If you have kept your mortgage payments current and built up sufficient equity in your house, you may be able to cancel your PMI coverage. Many of these options have tradeoffs. For more information, see a financial professional.

Options When You Can’t Meet Your Financial Obligations

You should never take on more debt than you can afford, but if you are past that point, then your next action should be to recognize when you are financially overextended and do something about it today. While a mountain of debt can cause many people to give up trying, doing nothing is the worst possible choice! The longer you wait, the faster your financial troubles will spiral out of control which can cause not only stress on you, but your family.

The simple answer is to increase your income, but in reality that is not always feasible. If additional income is not an option, there are several things you can do to reduce your debt obligations. Reducing the cost of debt, or negotiating directly with your creditors, may enable you to lower monthly payments by either lowering your interest rate or restructuring your terms. If you need professional advice, you can hire a credit counselor or contact a nonprofit credit counseling service, such as Consumer Credit Counseling Services, which can help you organize a repayment plan. If the debt is more severe, you may want to consider a consultation with an attorney about bankruptcy. The most important thing is that you get started today!

The longer you wait, the faster your financial troubles will spiral out of control...

An Effective Debt Payoff Strategy

If you have found yourself in a pile of debt or are simply looking to reduce your debt load, there are a number of strategies for paying it off that you may want to consider:

Make more than the minimum payments

Lenders typically set a minimum payment that you are required to pay monthly in order to avoid penalties, increase interest rates, and/or default. The minimum payment is usually what is quoted on statements or account logins or may be what you have considered the “regular monthly payment.”
However, simply making minimum payments can result in long repayment schedules, which can cost you a lot of lost money to interest. **To truly tackle debt, you need to consider larger payments.**

For example, let's assume you have current debt on which you owe $100,000, the interest rate is 10%, the monthly payment is $1,075, and you have a remaining term of 15 years. If you make regular payments, your total interest over the life of the loan is $93,429. However, if you pay an additional $250 per month it will only take you 10 years to pay off the loan and total interest paid will only be $58,318. You would save $35,111 in interest alone.

However, it is always a good idea to confirm there are no prepayment penalties on the debt in question.

Payoff highest interest rate debt first
One way to optimize the payment of your debt is to first make the minimum payments required for each debt, then allocate any remaining dollars to debt with the highest interest rates. Once one debt is paid off you add the payment to the next highest interest rate debt. Over the last few years this method has been popularized and is often referred to as ‘snowballing debt payments.’ However, the key driver in this method is to attack that highest earning debt first.

For example, let's assume you have 2 credit cards, you owe $10,000 on each, and each has a monthly payment of $200. The interest rate for one card is 10%; the interest rate for the other is 20%. If you make regular payments, it will take you 109 months (about 9 years) until both debts are paid off and you will pay total interest of $14,670. However, if you make monthly payments of $600, with the extra $200 paying off the 20% interest rate first, it will take you only 46 months (about 4 years) to pay off the credit cards and you will save $7,585 in interest.

Consolidate your debt
If you have multiple debts with high interest, it may be possible to transfer the higher interest rate debts to your lower interest rate debt. For

Cash out some of your savings
You could use some of your cash savings or investments as debt repayments. Of course this is not ideal, but sometimes it makes sense.

For example, if the interest on a loan is 15%, your investments would have to return 15% after federal and state taxes to equal that outflow in dollars. Paying off debt with a 15% interest rate is the same as getting a 15% return without the risk of loss. The higher the interest rate on your debt, the more attractive repayment becomes compared to investing.
example, you may be able to transfer the balance on a higher interest credit card to a lower interest rate card.

Do you own your own home? If so, another option is to pay off those debts by getting a consolidated loan. This type of loan will typically be a home equity loan (or HELOC). Therefore the interest rate on it would most likely be much lower than interest rates on the debt being consolidated. Another advantage is that if you itemize deductions, any interest paid on home equity debt up to a certain limit ($100,000 in 2015) is generally deductible for income tax purposes. However, it is important to realize that you are potentially putting your home at risk because it serves as collateral. Additionally, closing costs and other charges should be considered.

**Renegotiate terms with your creditors**

What if you’ve done all you can and all your savings are gone? Even your friends and family will no longer lend you money. Is bankruptcy the only choice? No. Before actually filing for bankruptcy, use the threat of bankruptcy to negotiate with your lenders. Call your creditors and tell them your situation and if they are unable to renegotiate terms, you’ll have no choice but to declare bankruptcy. Points of negotiation could include a lower repayment schedule or even a lower interest rate. Rather than take a loss, many creditors will do what they can to avoid a total loss. If you are unable to do this yourself, there are several non-profit organizations that exist to help you out.

**File bankruptcy**

If none of the above methods are feasible, then as a last resort you must consider bankruptcy. There are two types of bankruptcy relief: Chapter 7 and Chapter 13.

1. **Chapter 7** is straight bankruptcy that allows the discharge of almost all debts. However, be aware that certain debts can’t be discharged and include alimony, child support, taxes, loans obtained through filing false financial statements, legal judgments and student loans. Often times you will be required to surrender much of your property to satisfy debts, but each State has different laws and exemptions in place.

2. **Chapter 13** allows you to keep your property, but you surrender control of your finances to the bankruptcy court. The court approves a repayment plan based on your financial resources over a stated period of time. During that time creditors are not allowed to harass you for repayments and, if all conditions are met, you will come away debt free at the end of the stated period.

It is important to consult a lawyer because different states may have different laws and regulations regarding bankruptcy.
Pay Down Debt or Save for Retirement?

According to the Federal Reserve Board, nearly a third (31%) of U.S. adults say they had no savings or pension to help them afford retirement and a quarter didn't know how they would afford their golden years. Not only that, but according to a 2014 survey conducted by creditcards.com, one in five Americans believe they will die while still in debt.

 Those are two very scary statistics. With that in mind, many are beginning to ask if it is more important to pay down debt or save for retirement? Just as with all other things financial, there is no one answer that’s right for everyone, but here are some factors to consider when making your decision.

Rate of investment return versus interest rate on debt

Probably the most common way to decide whether to pay off debt or save is to consider the opportunity cost; that is, can you earn a higher after-tax rate of return by investing than the after-tax interest rate you pay on your debt?

For example, say you have a credit card with a $10,000 balance on which you pay nondeductible interest of 15%. By getting rid of those interest payments, you’re effectively getting a 15% return on your money. That means your money would generally need to earn an after-tax return greater than 15% to make investing a smarter choice than paying off debt.

However, the decision about whether to save for retirement or pay off debt can sometimes be affected by the type of debt you have. For example, if you itemize deductions, the interest you pay on a mortgage is generally deductible on your federal tax return.

Something to keep in mind too is that investment returns are anything but guaranteed. In general, the higher the rate of return, the greater the potential risk. If you make investments rather than pay off debt and your investments incur losses, you may still have debts to pay, but you won’t have had the benefit of any gains. By contrast, the return that comes from eliminating high interest rate debt is a sure thing.
An Employers match may change the equation
If your employer matches a portion of your workplace retirement account contributions, that can make the debt versus savings decision more difficult. Let’s say your company matches 100% of your contributions up to 3% of your salary. That means that you’re earning a 100% return on that portion of your retirement account contributions.

If surpassing a 15% return from paying off debt is a challenge, getting a 100% return on your money simply through investing is highly unlikely. This may make saving at least enough to get any employer match for your contributions a higher priority than focusing on debt.

And don’t forget the tax benefits of contributions to a workplace savings plan. By contributing pretax dollars to your plan account, you’re deferring taxable income. Depending on your federal tax rate, that could be anywhere between 10% and 40% that you’re able to put to work immediately, money that would ordinarily go toward taxes.

A life of balance
A successful strategy will most likely include a mix of paying off debt and saving for retirement. For example, let’s say you’re paying 5% on your mortgage and 15% on your credit card debt, and your employer matches 100% of your retirement account contributions up to 3% of your salary. You might consider first meeting your company contribution match while continuing to pay tax-deductible mortgage interest, and then putting some extra money toward your credit card debt.

There is another good reason to explore ways to address both goals. Time is on your side when saving for retirement. If you say to yourself, “I’ll wait to start saving until my debts are completely paid off,” you run the risk that you’ll never get to that point, because your good intentions about paying off your debt may waver at some point. Putting off saving also reduces the number of years you have left to save for retirement.

Other considerations
When deciding whether to pay down debt or to save for retirement, make sure you take into account the following factors:

- Having retirement plan contributions automatically deducted from your paycheck eliminates the temptation to spend that money on things that might make your debt dilemma even worse. If you decide to prioritize paying down debt, make sure you put in place a mechanism that automatically directs money toward the debt.

- Do you have an emergency fund or other resources that you can tap in case you lose your job or have a medical emergency? Remember that if your workplace savings
plan allows loans, contributing to the plan not only means you’re helping to provide for a more secure retirement but also building savings that could potentially be used as a last resort in an emergency. Some employer-sponsored retirement plans also allow hardship withdrawals in certain situations if you have no other resources to tap. For example, payments necessary to prevent an eviction from or foreclosure of your principal residence.

- If you focus on retirement savings rather than paying down debt, make sure you’re invested so that your return has a chance of exceeding the interest you owe on that debt. While your investments should be appropriate for your risk tolerance, if you invest too conservatively, the rate of return may not be high enough to offset the interest rate you’ll continue to pay.

Talking to a Financial Planner can help you sort through the options available to you to reduce debt and also prioritize retirement savings. But regardless of your choice, perhaps the most important decision you can make is to take action and get started now. **The sooner you decide on a plan for both your debt and your need for retirement savings, the sooner you’ll start to make progress toward achieving both.**

### About RFA

Reilly Financial Advisors is a fee-only Registered Investment Advisor, aimed at helping our clients both define and achieve their individual financial goals through four unique service offerings:

1. **Wealth Building** – for those still accumulating their investment portfolios

2. **Wealth Management** – for those who have amassed their savings and have specific needs associated with their wealth

3. **Wealth Legacy** – for those who have accumulated a significant amount of wealth and face unique wealth transition needs

4. **Corporate Retirement Services** – tailored solutions for plan sponsors and participants

RFA, founded in 1999, services clients around the United States and in more than a dozen countries worldwide. As an independent advisor, we are able to provide our clients with the highest level of Fiduciary services which allows us to make investment decisions based solely in the best interest of our clients. Our goal is to be our client’s first point of contact for all of their financial needs, serving as a trusted financial partner for the long term.