Smart Debt Management: Six Tips for Keeping Your Debt in Check

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Debt is a subject about which most people feel conflicted. While debt makes it possible for many people to achieve important goals like buying a home, it can also undermine their financial position if mismanaged. For some, getting rid of outstanding debt, especially as they approach retirement, is a top priority. For others, debt is an important source of liquidity while providing leverage for their investments.

Debt for most of us is a fact of life, but it is smart to be thoughtful about how you manage it. At the risk of oversimplifying things, there is generally good and not-so-good (or even bad) debt. Good debt is used to purchase appreciating assets or where the interest paid is deductible, such as home mortgages or home equity lines of credit (HELOCs), provided the amount isn't excessive. Student loan debt would generally fall in the good debt category as well, as it represents an investment in a career and future earning potential. Less desirable debt, while difficult to avoid, includes auto loans, credit card balances, medical bills or money owed to the IRS. The interest on this debt is nondeductible, and the money is owed on depreciating assets or sunk costs.

Basic Approaches to Debt Management

Debt should be considered in aggregate as part of your overall finances. To begin with, create a running balance sheet for your family and update it regularly. Balance sheet templates are available online or in personal finance programs like Quicken. Your personal balance sheet will list all of your assets and compare it to all of your debt. Over time, you want to see your assets grow relative to your debt.

Using that information, a borrower can better answer the question of "How much debt is right for me?" To evaluate this, financial institutions often look at a measure called debt-to-income ratio:

$$\text{DEBT-TO-INCOME RATIO} = \frac{\text{Total monthly debt payments}}{\text{Monthly gross income}}$$

Lenders like to see this ratio below 43% in order to meet the requirements of a qualified mortgage.[1] However, many financial planners suggest keeping total monthly debt payments at no more than 36% of net income, with housing-related debt being no more than 28%.[2]

While ratios like these can be helpful in evaluating whether you should take on new debt, what about paying off existing debt? There are two ways to approach this:

Financial – Looking at the return you are earning on your available cash can help determine whether or not to pay off your debt. For example, if you have cash in a savings account earning less than 1% and the interest rate on your HELOC is 4%, it's probably a smart move to pay off the line of credit. But if you are consistently making money on your investments that exceeds the interest rate you are paying on your debt, then you are mathematically ahead.

Emotional – If you can't sleep at night because the debt you have makes you uneasy, then do what you can to pay it off. While maintaining some leverage can make good financial sense in certain instances, everyone needs to balance it against their emotional well-being.

Here are six tips for managing the debt you have in a smart way:

1. Consider debt carefully. The easiest way to manage debt is to avoid taking it on in the first place, so think twice before applying for those new loans or even serving as a co-signer on someone else's loan. In particular, be careful about taking on debt to purchase a depreciating asset, such as a car. Home improvement debt can be good debt if it will improve the value of your home, especially if it can be paid for via a HELOC, where the interest paid is deductible. However, some home improvement projects do little to improve the value of a home, and paying for these projects with a high-interest credit card where you carry a balance forward each month would be a mistake.

2. Understand your debt. Ask questions to make sure you understand the details of your debt. What is the payment schedule and when are payments due? What are the prepayment penalties or late charges? When will it be paid off? For example, some HELOC payments are interest-only – if you don't make extra payments, that debt will never go away.

It's also important to understand which forms of interest are tax-deductible and which aren't. As

[1] "What Is a Debt-to-Income Ratio?" Consumer Financial Protection Bureau, https://www.consumerfinance.gov/ask-cfpb/what-is-a-debt-to-income-ratio-why-is-the-43-debt-to-income-ratio-important-en-1791/.

[2] "Tips for Balancing Financial Obligations While Saving for Retirement." Certified Financial Planner Board of Standards, http://www.letsmakeaplan.org/blog/view/lets-make-a-plan-blogs/tips-for-balancing-financial-obligations-while-saving-for-retirement.

Case Study

Jeanne and Bill, a working couple in the 25% tax bracket, would like to retire in five years. They have accumulated a variety of debts, each with a different interest rate and outstanding balance:

Type of Debt	Amount	Interest Rate	After-Tax Interest Rate
Jeanne's credit card	$4,000	18%	18%*
Bill's credit card	$5,000	15%	15%*
Mortgage loan (five years from maturity)	$60,000	4%	3%
HELOC with a $100,000 limit	$20,000	5%	3.75%
Consolidated student loans for their three children	$20,000	7%	7%**
Total debt	**$109,000**		
Weighted average interest rate		**5.8%**	**5.0%**

*Credit card interest is not tax-deductible.
**Student loan interest is tax-deductible, subject to limitations. In this example, the couple does not qualify.

They have a healthy retirement savings in their employers' retirement plans and IRAs along with additional cash savings of $15,000 in a money market account. Jeanne and Bill are on track to pay down their mortgage by retirement, but it might be smart for them to eliminate some other debt in the meantime. They are considering using some of the cash in their savings account to pay off their credit cards while paying off the student loan debt using the line of credit. These steps reduce the cash in the money market account to $6,000, still a healthy emergency cash reserve, and increase the HELOC balance to $40,000. This still leaves an additional $60,000 available for borrowing. As a result, their weighted average interest rate drops to 4.4%, or 3.3% on an after-tax basis. Additional payments can be put toward the HELOC, but Jeanne and Bill should consider keeping this loan active into retirement.

noted earlier, generally interest on mortgage and home equity lines is tax-deductible, but up to a limit. The interest on the first $1 million of debt used to purchase a primary and secondary home is deductible; interest on debt exceeding that is nondeductible. Some investment loans can be tax-deductible too, but it depends on the use of the funds. Interest on loans used to buy investments is deductible, but if the loan proceeds are used to buy a boat or take a vacation, it is not.

3. Be strategic about paying down debt. Always pay off loans with a higher interest rate first. Making an extra payment each month can drive down your ultimate costs and enable you to pay off the loan sooner. Round up your monthly payments to the nearest $100 – that small increase can make a difference over the life of the loan.

After that, shift your focus to chipping away at nondeductible debt. If you are deciding whether to put extra money against a home mortgage or car loan, pay off the car loan first, all else being equal, as the interest on the mortgage is deductible.

If you have built up credit card debt, the issuer typically requires just a minimum payment each month. Those minimum payments, however, will usually only pay the accrued interest and a small amount of the loan principal. The less principal you pay each month, the longer the debt is outstanding – and the more expensive it is over time.

Be smart about refinancing. Too often when homeowners refinance, they extend the loan back to the original 30 years instead of paying it off as originally intended. When you refinance a mortgage to get a lower rate, avoid taking additional money out or borrowing more than you need, even if it is offered. Once the refinancing is complete and you have a lower payment, maintain your original monthly payment and use the extra against your principal to accelerate your payoff date.

4. Use credit cards for convenience. Credit cards are now integral to financial life. For example, a credit card, in many cases, is required to reserve a hotel room or rental car. They're also a key way to demonstrate responsible borrowing behavior, which credit agencies consider as part of your credit score. By saying "I'll never have a credit card," you might actually be doing yourself a disservice.

It's not the credit card itself that's bad – it's how it can be misused. Here are a few rules to live by when using credit cards:

- Pay the balance off every month. The interest rates on unpaid credit card balances are often 12–18%, higher than almost any other type of debt. That means tracking what you charge and only charging what you can pay off every month.
- Set up automatic debits to make every payment by the due date. Even if you set it up to just pay the minimum, using automatic payments means you can avoid late fees and their negative impact on your credit score. Be sure to keep a cash reserve in your account so you don't overdraw your checking account when the payment is due.
- Don't carry too many cards. Hold one all-purpose card – preferably one with cash-back or travel benefits – and only a select few department store cards that you use frequently. Consolidate purchases on the card with the best benefits and keep one back-up card just in case. Continually opening new credit cards will likely hurt your credit score, costing you more money in the long run.

5. Monitor and try to improve your credit score. FICO® credit scores range from a low of 300 to a perfect score of 850, with 740 being the rough breakpoint to get a better-than-average interest rate on a loan.[3] If your score dips down to 650, it can mean a 1% increase in the interest rate you might be charged on a mortgage. This can be a significant additional cost over the life of a loan – on a $300,000 mortgage, an additional 1% can mean $3,000 more in interest paid in the first year, or $65,000 or more over the life of a 30-year loan.

Making payments on time and prudently managing your debt are factors considered in credit scores. Your credit utilization – how much debt you are using relative to the debt available to you – also plays a role.

6. Consider keeping some debt in retirement. While it's not uncommon for people to retire once they've paid off their mortgage, having some debt in retirement isn't necessarily a bad thing. Think about debt in terms of leverage – if you use up all of your liquidity to pay off a mortgage, you might find yourself in a compromised position should a

[3] "What Is a Good Credit Score?" Experian, http://www.experian.com/blogs/ask-experian/credit-education/score-basics/what-is-a-good-credit-score/.

significant expense come up that you don't have the cash to cover, such as a health issue or emergency home repair.

It can also be harder to access debt after retirement. Most lenders require some proof of employment or regular income. Keeping a line of credit open or putting one in place while you are still employed can be a smart idea. A line of credit can serve as an emergency reserve should you need it to cover an unexpected expense.

The flip side to paying off debt before retirement is taking out a reverse mortgage in retirement. This is a form of liquidity available to some during retirement and works similarly to a line of credit. Reverse mortgages are designed for those who need more income – instead of selling the home and living off the proceeds, you can augment income by borrowing against your equity and staying in the home.

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