Managing Your Debt

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Summary

Debt isnøt always a problem, but it can be ó if you have too much of it, or if you are paying high interest rates. This paper helps you think about mortgages, credit cards, and other kinds of debt and, if you are in trouble with your debts, provides some pointers about credit counseling and bankruptcy.

Your mortgage(s) and your retirement

Many people assume that they would be better off without a mortgage when they are retired. This is not necessarily true, however:

- Keeping a mortgage, rather than paying it off, means you can keep other assets where you want them. If you pay off your mortgage, you may have to withdraw tax-sheltered funds from a retirement plan, or liquidate investments that are doing very well for you or whose sale would trigger large capital gains taxes. You may make yourself cash-poor and vulnerable to an emergency.
- Some people have mortgages with low interest rates, perhaps even rates that are lower than the earnings they now receive on their retirement funds. It is unwise, generally, to use high-earning assets to pay off low-costing debts.
- Interest on most mortgages is tax-deductible, while interest on most other kinds of debt is not. And because a mortgage uses your property as collateral, unlike most other kinds of debt, interest rates on mortgages are usually lower. So generally (though not always), if you have debt at all, mortgage debt is the best kind.
- A home equity line of credit is a kind of mortgage. If you have one that is not all used up, it gives you flexibility. If a need arises, you can choose between liquidating assets or using your credit line, whichever works better at the time.
- Having to make a mortgage payment every month may impel you to control your other expenses. If you would have trouble imposing this discipline on yourself otherwise, your mortgage may be doing you a world of good.

Since you are probably accustomed to paying your mortgage every month, why not just leave it as it is? Well, there are still several reasons it can be smart to make a change:

- ***If your interest rate is too high:*** that is, if the interest you pay is distinctly more than what you earn on your savings and investments. Say your mortgage interest rate is 6% ó assuming this is fully deductible (and it isnøt always), and supposing you pay one-fourth of your income in taxes, the after-tax cost to you is 4½%. If your retirement savings earn 4%, and are fully taxable, then after taxes you get only 3%. For every $10,000 you pay off on your mortgage balance, in this example, you lose $300 of after-tax income, but you save $450 of after-tax interest expense. So you have an extra $150 in your pocket every year.

- ***If your interest rate is going up.*** Many people have adjustable-rate mortgages (õARMsö), which means interest rates change periodically. Changes are based on specific formulas and can be quite out of step with rates you earn on your assets. Sometimes this works to your advantage, but sometimes it works very much against you. It is possible, usually, to estimate (or even predict precisely) when your rate will change, and by how much. If you anticipate an increase, it may be time to pay off some or all of your mortgage, or maybe to refinance.

- ***If you need to raise cash.*** This may apply more often to younger people, but just because youøre retired doesnøt mean you canøt be caught in a cash bind. And even though you may have assets you could liquidate, maybe this is a bad time to do so (you might have tax penalties to pay, or maybe the financial markets are off). You might want to refinance your mortgage and take out some extra cash, or obtain a home equity loan or line of credit, or use a line of credit you already have.

- ***If you need to reduce expenses.*** If you do not have a great many years left to pay your mortgage, a large part of your monthly payment is probably going toward paying off your loan balance. If you refinance and get an interest-only mortgage, your balance will not go down any more, but your monthly payments will be a lot smaller. Or you could achieve a similar effect by refinancing to a longer-term mortgage. Either method will reduce your expenses and help you avoid draining your asset balances. You might think of these as a nice compromises between the extremes of expending cash by paying off a mortgage (which many retirees do) and raising cash by taking out a reverse mortgage (which many other retirees do).

- ***Peace of mind.*** Most people like the idea of being debt-free, and some positively crave it. You really should consider whether youød be financially worse off without your mortgage, but if youøre not, or if the financial hit is modest and the psychological reward is great, accelerating your mortgage payoff can make sense.

There are also bad reasons for refinancing or taking out a new mortgage or home equity loan:

- ***Don't take out or refinance a mortgage to make new investments:*** you will need investment performance well above average to make this pay off, unless you can get a *fixed*-rate mortgage at less than about a 5% rate. And unless your situation is very unusual, you should not, in your retirement years, be taking the kind of investment risk that would be needed to generate much higher returns than that. (See our other paper in this series: õCan You Afford to Take Investment Risks?ö)

- ***Don't take out or refinance a mortgage to do family favors.*** Everybody you know could use more money. Whether and how you help them is your choice, but your home equity is your own last line of defense against financial catastrophe, so putting it at risk is almost always going too far. (See our other paper in this series: õMaking Loans and Gifts to Family Members.ö)

If you want to reduce your mortgage, you can pay it off in full, or you can just make extra payments. Usually, you can add more to any monthly payment and the bank will adjust your future payments in recognition of the extra amount.

If you want to increase your mortgage, or take out a home equity loan or line of credit, think twice. For most retirees, this is not a good idea, unless itøs to cover a temporary expense that you expect to be able to pay back. But if your circumstances do warrant this step, you can either refinance your existing mortgage or, if you like the terms of your old mortgage and want to keep it, adding a second mortgage or home equity loan. If you already have a home equity line of credit that you have not fully used, though, increasing your mortgage balance may be as easy as writing a check.

If your interest rate is too high and you think you can get a lower one, you need to refinance. This may be easiest at your current bank (they may waive appraisals and most other fees, or maybe can just amend your existing mortgage), but you might be able to get better terms if you shop around. The trade-off between convenience and cost is your call.

Credit card debt

Credit card debt is easy to accumulate, but itøs almost always too costly to be worth it, especially for retirees. It is smart to have at least one credit card, so you can cover emergencies, so you can avoid carrying a lot of cash with you, so you can order products by telephone or online, and so you can maintain a good credit rating. But most credit accounts charge high interest rates ó often over 20% ó on balances you carry forward, so you should use your card wisely and pay off your balance every month.

Furthermore, these are *after tax* rates, whereas earnings on your savings are probably mostly *before tax*. If you pay one-fourth of your income in taxes, you need to earn 16% on your savings to pay 12% on your credit card. You have to earn 24% to pay interest of 18%. So even if you have tax or other penalties to pay, you are far better off liquidating assets to pay off high credit card balances, if you are paying double-digit interest rates.

Once you have done so, you should consider canceling some of your credit accounts. If you have accumulated a lot of debt once, you will be tempted to do it again. And while itøs smart to pay off high-interest credit accounts, itøs not smart to go through cycles of paying them off and running them up again. Most retired people need to exercise discipline in their expenses. If your credit accounts are leading you astray, then cut them off. You should also consider visiting a credit counselor for help in this effort.

Instead of paying off credit card balances by liquidating assets, you might pay them off by refinancing your mortgage or taking out a home equity loan or line of credit. Using assets to pay off debts is usually better, because there is usually a bigger difference between credit card interest and asset earnings than there is between credit card interest and mortgage interest. But if, as mentioned above, your assets are tied up where you canøt get them easily, or where they are doing especially well, you could consider increasing mortgage debt to pay off credit accounts. You are, in effect, however, then putting up your house as collateral for your credit cards. So if there is any chance of your defaulting (declaring bankruptcy), or if you are not sure you can resist running up your credit cards again, you should think hard about this ó and probably visit a credit counselor first.

Are there times when credit card debt is good? Yes, but rarely. Credit companies often offer low introductory rates if you open an account or increase your balance. Sometimes they offer airline miles, cash back, or other rewards. If you want to make a hobby of beating the system, you can. These offers are legitimate (though there is lots of fine print

to wade through, and you had better be sure to make all payments on time), and if you want to keep moving your money around to take advantage of good offers, you can actually maintain a moderately large level of debt at very low cost. But you have to pay attention. Financial companies make these offers because they know that most people take the low introductory rate and then forget about it, and soon the higher rates kick in. Then you lose. If you donøt want to play this game attentively and to win, then donøt play at all: keep your credit charges reasonable, and pay your bill in full every month.

Other debt

The general rule is: if the interest on the debt is higher than your after-tax return on savings and investments, then you are losing money, and the debt should be paid off.

This is not just a matter of making money off of interest rates (technically called õarbitrageö). You are also improving your risk profile. Even the safest assets are inevitably exposed to some risk, if only the risk that interest rates will go down in the future. When you pay off high-interest debt, however, you are *guaranteed* to save money on that debt forever ó as long as you donøt run up your debts again. That is a great trade for you.

Again, you should consider what tax or other penalties you might incur by liquidating assets, and whether future tax advantages or expected gains in the assets make them worth keeping. And also as noted earlier, if you this is not a good time to liquidate assets, and if you are a homeowner, you might consider using mortgage debt to pay off other high-interest debts.

There is also another kind of interest rate õarbitrageö you might consider. If you have a close relative or good friend with assets to invest, you could take a private loan from that person and use the funds to pay off your higher-cost debts. If you are paying, say, 12% on some personal loans, and your financial buddy can get only a 4% return on investments s/he is comfortable making, you could split the difference. Your pal could lend you money at 8%, so you save 4% a year on interest charges and s/he earns an extra 4% on assets. You both win. If you decide to do this, however, both parties should be protected by having the agreement in writing, and the lender should pay income taxes on the interest received from you. (See our other paper in this series: õMaking Loans and Gifts to Family Members,ö for information about tax rules for family loans.)

Debt and asset allocation

Debt is, in effect, a *negative* investment, and you should treat it that way when you consider the overall allocation of your savings and investments.

Mortgages and other long-term debts are like bonds and certificates of deposit (CDs): someone borrows money and promises to repay it over time. If you buy a bond or CD, you are, in effect, a lender. If you take out a mortgage, you are a borrower. But the transaction itself is very similar. So you can look at long-term debt as a sort of *negative* bond or CD.

When thinking about how your assets are allocated, therefore, you should mentally offset the amount you have in safe investments like bonds and CDs by the amounts you owe on mortgages and other debt. Seen this way, your portfolio may be riskier than you thought.

Some analysts like to consider Social Security and pension income as a form of conservative (bond-like) investment, too. They use this as an argument for increasing oneøs position in the stock market, or in other higher-risk investments. If you hear this from someone, make sure the analysis also takes into account your mortgage and other debt, too.

If you are in serious trouble with debt

If your debt is so far out of control that you do not see any real possibility of paying it off, you should consider bankruptcy. Unfortunately, changes in federal law have made it harder to walk away scot-free from your debts than it used to be. Hereøs what to do:

- ***Collect your financial information:*** Put together a complete list of your assets and debts ó and donøt hide anything! Also itemize income sources and expenses.
- ***Find a credit counselor in your area:*** You will be required to do this before you can petition for bankruptcy in any case. Furthermore, the counselor may be able to create a workable õdebt management planö for you ó perhaps even enabling you to avoid bankruptcy. See the end of this paper for ways to find someone reputable ó this is an area that has been rife with fraud.
- ***Hire a bankruptcy lawyer.*** Different states have different rules about how bankruptcy affects pensions, 401(k) plans, life insurance, mortgages, child support, state tax obligations, and so on. You will need an expert to guide you through the process. But you will also have to pay for it ó up front ó possibly as much as a few thousand dollars.

For More Information

- ***Papers available from this same source:***
  - õOptions for Obtaining Cash from Your Homeøs Equityö
  - õShould You Use a ÷Reverse Mortgageø to Raise Cash from the Value of Your Home?ö
  - õMaking Loans and Gifts to Family Membersö
- ***General information:***
  - BankRate.com provides general information, rate comparisons, and some helpful calculators relating to all kinds of debt (http://www.bankrate.com/)
  - A good selection of books about mortgages, refinancing, credit card management, debt management, and bankruptcy should be available at your favorite bookstore or library. These are popular topics!
- ***Debt management and credit counseling:***
  - For helpful consumer information about debt problems, including info on your rights, visit the U.S. Federal Trade Commission site, at: http://www.consumer.ftc.gov/topics/dealing-debt.
  - For a list of accredited pre-bankruptcy counselors, go to the U.S. Trustee Program, at http://www.usdoj.gov/ust/eo/bapcpa/ccde/index.htm.

- If you’re not sure you’re heading for bankruptcy, you can locate a not-for-profit credit counseling agency in your area using the National Counsel for Credit Counseling website (http://www.nfcc.org) or the Association of Independent Consumer Credit Counseling Agencies website (http://www.aiccca.org).

- ***Bankruptcy:***
  - James Caher, *Bankruptcy Laws for Dummies*.
  - Matt Pelc, *When You Have to File for Bankruptcy: Step-by-Step Instructions to Take Control of Your Financial Future*
  - The Personal Bankruptcy Information website is a great online resource. Go to: http://www.bankruptcyinformation.com/.