

Liability and Debt Management

Principles of Debt Management

Very few people avoid debt completely throughout their lives - nor should they. Debt is the vehicle that allows you to even your lifelong consumption. In addition, it is a shopping convenience, and it can help you hedge against inflation by permitting you to buy assets that match or beat the inflation rate. But debt must be managed carefully. You must avoid excessive debt and make sure that you tap the lowest-cost sources of credit. Why borrow at 18 percent if you have access to funds costing 8 percent or less? Unfortunately, many Americans do.

- Controlling Your Debt
- Avoiding Excessive Debt

Controlling Debt

The first step in controlling debt is to determine how much debt you can comfortably handle. Unfortunately, there is no easy formula to determine your level of debt.

In personal finance, the ideal debt level changes as you pass through different stages of the financial life cycle. Early on, housing and family demands coupled with a relatively low-income level make it natural for individuals to build up debt. In later years, as income rises, debt as a portion of income tends to decline.

You must use your common sense in analyzing your spending.

The key to controlling consumer debt is to make sure it fits with the goals you've set and the budget you've developed to achieve these goals. Control is a major issue in personal finance.

The inspiration for financial discipline must come with an understanding of how costly and potentially painful the alternative is. It's easy to walk out of college with a good deal of consumer debt. However, keep in mind the costs of borrowing and how borrowing limits your future financial flexibility.

Avoiding Excessive Debt

Adequate liquidity protects you from temporary cash emergencies. Liquidity ratios are designed to warn you of liquidity problems. However, they do not tell you whether total debt

is being used properly or is excessive. *Excessive* doesn't mean too much debt in absolute dollars but rather in relation to your underlying assets and income that support the debt.

These two important ratios are often used to evaluate total debt:

Liabilities to Total Assets

Technically, you are judged insolvent when your total liabilities exceed your total assets. Being insolvent doesn't automatically mean you are illiquid. You might still have sufficient cash to pay your bills for a while. What it does mean is that, unless the situation changes, you will ultimately not have enough assets to pay all your bills. Many people in this position eventually file bankruptcy as a means of settling with creditors or establishing an orderly plan for paying their bills over an extended period of time.

Bankruptcy is not to be taken lightly or viewed as a convenience to avoid paying obligations. The *debt ratio*, which measures total liabilities against total assets, is one such signal.

Debt Service Coverage

Take home pay divided by debt service charges is the *debt service coverage*.

Your capacity to carry debt is reflected not only in the market value of assets you own but also by the relationship of your take-home pay to your total debt-servicing charges. By debt service, we mean monthly (or yearly) payments of both principal and interest on those loans requiring periodic repayment. The debt service coverage ratio measures take-home pay against total debt service charges.

When your ratios in either one of these areas exceed manageable levels a crisis is sure to develop.

Smart Debt

Find out whether you should move credit card debt to your home's equity.

Home equity debt generally is tax-deductible, with rates that are far below those on credit cards. You can save a lot of money by paying off your credit card debt with a home equity loan or equity line of credit.

You could also lose money if you're foolhardy or unlucky. Credit card debt is unsecured, so if you lose your job or your health and you can't pay your credit card bills, you can declare bankruptcy and walk away from your credit card debt. But home equity debt is secured, meaning that if you don't pay the bills, you have to walk away from your house.

The surest road to ruin is to consolidate your credit card debts into a home equity loan, then charge up the cards to the max again.

- Get a home equity line of credit (HELOC) for emergencies.

"It's the most flexible way to access cash," Hall says. "It's cheap and it's deductible."

If you lose your job, you probably won't be able to open a HELOC. But if you already have a HELOC and you lose your job, you can tap into it to pay living expenses. A HELOC can pay for emergency medical procedures, surprise expenses, bail or almost anything you could imagine.

Be Your Own Banker

As necessary as debt may seem the ideal situation is to develop liquid assets you can access to avoid borrowing. Even though you lose interest on your money you essentially earn tax free income through the interest you are saving. Borrowing against a 401k, IRA, insurance policy or CD can all be forms of being your own banker. This is can be sure and steady path to financial independence.

Dealing with a Debt Crisis

Having trouble paying your bills? Getting dunning notices from creditors? Are your accounts being turned over to debt collectors? Are you worried about losing your home or your car?

You're not alone. Many people face financial crises at some time in their lives. Whether the crisis is caused by personal or family illness, the loss of a job, or simple overspending, it can seem overwhelming. But often, it can be overcome. The fact is that your financial situation doesn't have to go from bad to worse.

If you or someone you know is in financial trouble, consider these options: realistic budgeting, credit counseling from a reputable organization, debt consolidation, or bankruptcy. How do you know which will work best for you? It depends on your level of debt, your level of discipline, and your prospects for the future.

Contacting Your Creditors

Contact your creditors immediately if you're having trouble making ends meet. Tell them why it's difficult for you, and try to work out a modified payment plan that reduces your payments to a more manageable level. Don't wait until your accounts have been turned over to a debt collector. At that point, your creditors have given up on you.

Dealing with Debt Collectors

The Fair Debt Collection Practices Act is the federal law that dictates how and when a debt collector may contact you. A debt collector may not call you before 8 a.m., after 9 p.m., or while you're at work if the collector knows that your employer doesn't approve of the calls. Collectors may not harass you, lie, or use unfair practices when they try to collect a debt. And they must honor a written request from you to stop further contact.

Credit Counseling

If you're not disciplined enough to create a workable budget and stick to it, can't work out a repayment plan with your creditors, or can't keep track of mounting bills, consider contacting a credit counseling organization. Many credit counseling organizations are nonprofit and work with you to solve your financial problems. But be aware that just because an organization says it's "nonprofit," there's no guarantee that its services are free, affordable, or even legitimate. In fact, some credit counseling organizations charge high fees, which may be hidden, or pressure consumers to make large "voluntary" contributions that can cause more debt.

Most credit counselors offer services through local offices, the Internet, or on the telephone. If possible, find an organization that offers in-person counseling. Many universities, military bases, credit unions, housing authorities, and branches of the U.S. Cooperative Extension Service operate nonprofit credit counseling programs. Your financial institution, local consumer protection agency, and friends and family also may be good sources of information and referrals.

Reputable credit counseling organizations can advise you on managing your money and debts, help you develop a budget, and offer free educational materials and workshops. Their counselors are certified and trained in the areas of consumer credit, money and debt management, and budgeting. Counselors discuss your entire financial situation with you, and help you develop a personalized plan to solve your money problems. An initial counseling session typically lasts an hour, with an offer of follow-up sessions.

Auto Loans

Your debts can be secured or unsecured. Secured debts usually are tied to an asset, like

your car for a car loan, or your house for a mortgage. If you stop making payments, lenders can repossess your car or foreclose on your house. Unsecured debts are not tied to any asset, and include most credit card debt, bills for medical care, signature loans, and debts for other types of services.

Most automobile financing agreements allow a creditor to repossess your car any time you're in default. No notice is required. If your car is repossessed, you may have to pay the balance due on the loan, as well as towing and storage costs, to get it back. If you can't do this, the creditor may sell the car. If you see default approaching, you may be better off selling the car yourself and paying off the debt: You'll avoid the added costs of repossession and a negative entry on your credit report.

Home Loans

If you fall behind on your mortgage, contact your lender immediately to avoid foreclosure. Most lenders are willing to work with you if they believe you're acting in good faith and the situation is temporary. Some lenders may reduce or suspend your payments for a short time. When you resume regular payments, though, you may have to pay an additional amount toward the past due total. Other lenders may agree to change the terms of the mortgage by extending the repayment period to reduce the monthly debt. Ask whether additional fees would be assessed for these changes, and calculate how much they total in the long term.

If you and your lender cannot work out a plan, contact a housing counseling agency. Some agencies limit their counseling services to homeowners with FHA mortgages, but many offer free help to any homeowner who's having trouble making mortgage payments. Call the local office of the Department of Housing and Urban Development or the housing authority in your state, city, or county for help in finding a legitimate housing counseling agency near you.

Debt Settlement

Some tips on settlement negotiations from attorney are shown below from Robin Leonard's book *Money Troubles* Published by Nolo Press.

- Be honest but paint the bleakest picture of your finances. Elaborate on any illness, layoff, accidents, repossessions, back taxes, etc.
- If considering bankruptcy, say so. But do not incur any other debt after saying so. If you do you may not be able to discharge them in bankruptcy.
- Never disclose where you work or bank. If you are later sued by this same person and get a judgment against you, you have just made their job that much easier. Simply answer the question, "No comment".
- Rather than sending a check from your bank, get a money order or cashier's check so as to protect the name of your bank.
- If considering a lawyer, remember that though a lawyer carries clout and can do a good job, they cost money. Don't hire one unless you owe a great deal and have a reasonable chance of a very good deal. If you have to pay a lawyer, sometimes what you save in settlement you lose.

- If contacted by more than one creditor for the same debt, it probably means the debt was sold a second time and you have avoided the first collector superbly well. In other words you are very difficult to get hold of and it is a very old debt. Many secondary and tertiary collectors at this stage might be willing to accept 33-50 cents on the dollar and possibly even less.
- If the collector agrees to settle for less, be sure it is also agreed to indicate "satisfied in full" in your credit report.
- If the collector agrees to far less than the original amount, make sure the deal makes financial sense.
- You may owe income tax on the debt owed. Any write off of \$600 or more is considered income to you the consumer. The creditor will send you and the IRS a Form 1099-C at the end of the tax year.

Debt Consolidation

You may be able to lower your cost of credit by consolidating your debt through a second mortgage or a home equity line of credit. Remember that these loans require you to put up your home as collateral. If you can't make the payments — or if your payments are late — you could lose your home.

What's more, the costs of consolidation loans can add up. In addition to interest on the loans, you may have to pay "points," with one point equal to one percent of the amount you borrow. These loans usually have tax advantages that are not available with other kinds of credit.

Bankruptcy

Personal bankruptcy generally is considered the debt management option of last resort because the results are long-lasting and far-reaching. A bankruptcy stays on your credit report for 10 years, and can make it more difficult to obtain credit, buy a home, get life insurance, or sometimes get a job for a few years until you reestablish your credit worthiness. It is a legal procedure that offers a fresh start for people who can't satisfy their debts. People who follow the bankruptcy rules receive a discharge — a court order that says they don't have to repay certain debts.

There are two primary types of personal bankruptcy: Chapter 13 and Chapter 7. Each must be filed in federal bankruptcy court. As of January 2005, the filing fees run about \$185 for Chapter 13 and \$200 for Chapter 7. Attorney fees are additional and can vary.

Chapter 13 allows people with a steady income to keep property, like a mortgaged house or a car that they otherwise might lose. In Chapter 13, the court approves a repayment plan that allows you to use your future income to pay off a default during a three-to-five-year period,

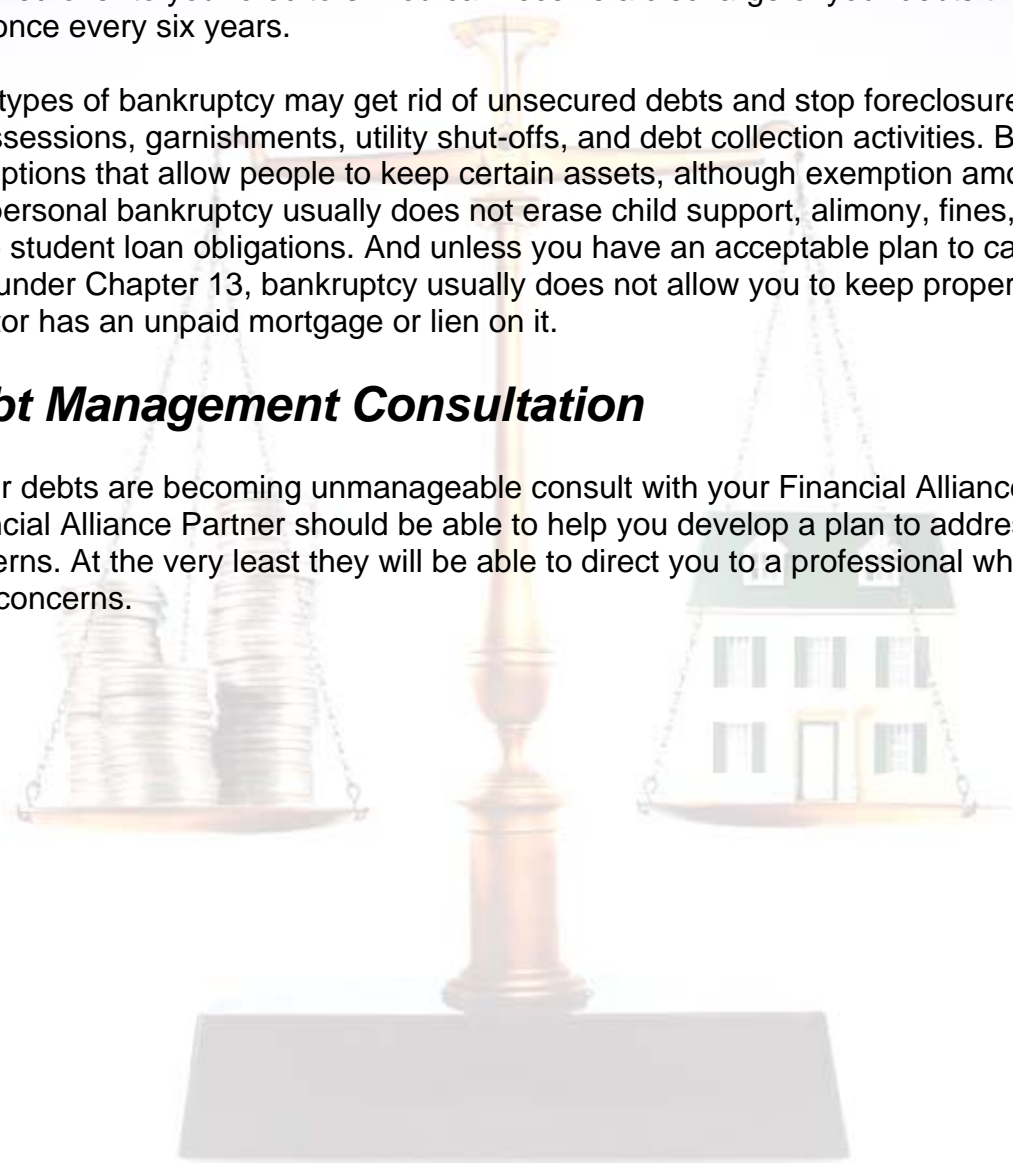
rather than surrender any property. After you have made all the payments under the plan, you receive a discharge of your debts.

Chapter 7 is known as straight bankruptcy, and involves liquidation of all assets that are not exempt. Exempt property may include automobiles, work-related tools, and basic household furnishings. Some of your property may be sold by a court-appointed official — a trustee — or turned over to your creditors. You can receive a discharge of your debts through Chapter 7 only once every six years.

Both types of bankruptcy may get rid of unsecured debts and stop foreclosures, repossessions, garnishments, utility shut-offs, and debt collection activities. Both also provide exemptions that allow people to keep certain assets, although exemption amounts vary. Note that personal bankruptcy usually does not erase child support, alimony, fines, taxes, and some student loan obligations. And unless you have an acceptable plan to catch up on your debt under Chapter 13, bankruptcy usually does not allow you to keep property when your creditor has an unpaid mortgage or lien on it.

Debt Management Consultation

If your debts are becoming unmanageable consult with your Financial Alliance Partner. Your Financial Alliance Partner should be able to help you develop a plan to address your concerns. At the very least they will be able to direct you to a professional who can address your concerns.



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