Debt Management Basics

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1. Understanding Your Personal Debt

The first step when organizing your finances or starting any debt management plan is to fully understand your personal debt. Debt is money, goods, or services owed by an individual to someone else. Having debt can be a burden that is hard to overcome without the right strategies, so it is important to understand where debt comes from and how to manage it over time.

10 Common Causes of Personal Debt

There are many causes behind personal debt, but the 10 most common reasons include:

1. Reduced income but the same expenses
2. Divorce
3. Poor money management
4. Underemployment
5. Gambling
6. Medical expenses
7. Saving too little or not at all
8. No money-communication skills
9. Banking on a windfall
10. Financial illiteracy

Identifying your sources of debt can help you find areas to improve or costs that could be cut. As you can see, the reasons that debt exists in someone's life may differ greatly from one person to the next. Some of these issues are out of our

control, while others may be deemed irresponsible financial behavior. In either case, recognizing the good versus the bad when it comes to debt is a must.

"Bad Debt" vs. "Good Debt"

The above causes are the most common to contribute to the accumulation of what experts describe as bad debt.

This is the more common form of debt, and the one most Americans are familiar with. Bad debt is accumulated when people forgo using savings and instead use credit to buy disposable items or everyday goods. It includes credit cards, auto loans, or putting things on layaway. This type of debt is not looked upon favorably and is a common cause of stress in people's lives.

On the flip side is good debt. If the debt is accumulated for a reason that is likely to produce value in the long run, it is commonly called good debt. It can include student loans, home mortgages, or business loans. All these types are looked upon favorably by creditors, and with good reason.

It's important to remember that not all debt is bad. Even the debts listed above that are categorized as bad can be manageable, so long as you have enough to pay what you owe each month along with other non-debt expenses.

How Much Debt Should I Have?

Asking how much debt you should have is a common question to ask yourself when trying to understand your personal debt situation. One way to gauge where you fall in terms of your debt is calculating your debt-to-income ratio.

First, add up your monthly debt payments, including your mortgage (principal, interest, taxes, and insurance) and home equity loan payments, car loans, student loans, your minimum monthly payments on any credit card debt, and any other loans that you might have. Do not include expenses such as groceries,

utilities, and gas. Take this total and divide it by your gross monthly income from all sources.

For example:

Monthly income: $6,000
Monthly debt: $1500
$1500/$6000 = 0.25

This gives you your debt/income ratio, which is 25% in this case.

Usually, you want to keep this number below 36%. Maintaining a lower debt-to-income ratio often means that your debt is manageable, given you have enough from income to cover other monthly expenses. However, if your debt has gotten to the point that it exceeds this level, or you are focused on getting out of debt, having the right strategies to do so is crucial to your success.

2. 3 Best Ways to Consolidate Personal Debt

An often-heard term when discussing debt management is consolidation. From the advertisements on TV to offers that come in the mail, debt consolidation has long been a buzzword. This debt management strategy involves taking all your debts (or the costliest debts) and combining them into a single loan.

Debt consolidation is often achieved through home equity loans, lines of credit, or refinancing. While consolidating debt can lead to a lower interest rate or a lower monthly payment, especially when compared to credit cards, there are several things to consider.

As with any debt management plan, consolidation is not the ultimate answer to debt management. Without changing the spending habits that brought you to this point, debt will never truly be under control. If you know you're ready to make progress toward paying down your debt, it's helpful to understand both the benefits and drawbacks of debt consolidation.

Debt Consolidation Benefits

Debt consolidation comes with an array of benefits, including the following:

- the ability to streamline your bill payment process (one payment versus several each month)
- an option to extend your repayment term
- lowering your interest rate
- switching from a variable to fixed-rate loan
- lowering the monthly payment amount

Debt Consolidation Disadvantages

However, you must consider the downsides to debt consolidation, including:

- paying more in total interest
- having a larger total loan repayment amount
- extending your loan period, meaning you'll be paying longer
- losing borrower benefits from your current lender
- turning unsecured debt into secured
- possible prepayment penalties

Top 3 Ways to Consolidate Personal Debt

Now that you are aware of the pros and cons, how does one go about a personal debt consolidation?

The three most common routes include a home refinance, a home equity loan or line of credit, or a personal debt consolidation loan:

1. Refinance Your Home Loan to Consolidate Debt

Also known as a 'cash out refinance', debt consolidation through a home refinance allows you to tap into your home's equity to pay down debts. The process involves taking out a new mortgage for more than you currently owe on the house and using the difference to pay off the other debts.

The interest rate is typically lower than a home equity loan or a personal loan; however, there are almost always closing costs associated with this route. You are also using an asset – your home's equity – to pay off debts, and this could prove costly if you plan to sell the home in the near future.

2. Obtain a Home Equity Loan or Line of Credit to Consolidate Debt

– *Home Equity Loan (HEL)*

A home equity loan is a separate loan on top of your primary mortgage. It is also secured by your property; however, as opposed to a refinance, you don't typically have to pay closing costs for a home equity loan. Rates are usually higher than a refinance, but the savings in closing costs can negate this difference.

– *Home Equity Line of Credit (HEL)*

Alternatively, a home equity line of credit may be an option for some homeowners. In contrast to the previous two ways mentioned, a home equity line of credit is more like a credit card. You agree with the lender on a limit which you can borrow up to, over a defined period of time. These limits are based on the available equity in your home.

As you borrow, you can also repay, reopening that credit for future use. The interest rates are typically variable, but you are only paying interest on the current amount borrowed.

3. Use a Personal Loan to Consolidate Debt

Finally, a personal debt consolidation loan may be a viable option, particularly for borrowers who are not homeowners. A personal loan can be taken out to pay off other outstanding debts. The personal debt consolidation loan often comes with a fixed interest rate, lower than a credit card, and predictable monthly payment.

Other Things to Consider When Consolidating Debt

– Interest Rates

It is important to consider the interest rate on your current mortgage if you plan to refinance. If you have secured a lower rate than currently available, then you would likely be best not to refinance unless you absolutely have to. There is no reason to start paying a higher interest rate on the entire amount of the home, to borrow a small percentage.

Likewise, if rates are currently much lower than when you took out your mortgage, refinancing may be a very attractive option.

The same is true for a personal debt consolidation loan. If you cannot secure an interest rate that is lower than your current debts, it may not be beneficial to consolidate in this way.

– Unsecured vs. Secured Debt

When you roll credit card debt into a home refinance or a home equity loan/line of credit product, you take the unsecured debt and make it secured (by your home). Regardless of threats made by credit card companies, they cannot take away your home for failing to repay.

Once that debt is secured by your home, if you are still unable to meet payments, now the mortgage lenders can come after your real estate. If you are still uncertain you can meet the payments, even after consolidation, you are best to look for other debt relief routes prior to putting your home on the line.

3. 4 Common Ways to Clean Up Debt

Consolidation of debts is often one of the most common routes to take when cleaning up money owed to creditors, but there are also many other popular options available. Any of these can be used as an alternative to conventional debt consolidation or as a supplement, depending on your needs and budget.

Here are four of the most common choices when cleaning up debt:

1. Rearranging credit cards
2. Refinancing auto loan
3. Tapping into 401k
4. Borrowing from friends and family

Let's take a closer look at each debt clean up option.

Rearranging Credit Cards to Clean Up Debt

When it comes to credit cards, not all are the same. In a time of financial distress, not all should be kept or managed in the same way. An important step in debt management is eliminating the cards which are keeping you the furthest in the red.

When starting to look over your current credit card situation, keep the following points in mind:

- Which card has the lowest interest rate? The highest?
- Do any of the cards charge an annual fee?

- Do you have any cards you never use?

Once these questions have been answered, follow these steps:

1. Pay off any cards with low balances to help gain momentum.
2. Transfer the rest of the balances to the card with the best interest rate through a balance transfer offer if possible. Be sure to check on the balance transfer fees.
3. Don't use the new card for new spending until it is paid off.
4. Determine which two or three cards to keep and repeat this process until only those remain.

Things to watch for when consolidating credit cards:

- Canceling a card with a balance can cause your rate to increase dramatically, as issuers often raise rates on the balance if they know you will close the account.
- Continue making minimum payments on all cards until transfers are complete. Assuming the transfer went through and missing a payment can be costly.
- Closing accounts can have a negative impact on your credit score. Try to keep accounts open so long as they are affordable (no significant annual fee or other charges) but make them unavailable for use.

Refinancing Auto Loan to Clean Up Debt

Another point to consider when rearranging your debts is your car loan. Often, there are ways to reduce your monthly payment, interest rate, or loan term, all potentially saving you money.

The first and easiest step involves contacting your current lender and inquiring about a rate modification. If you have been regularly paying on time, there is a chance a simple phone call could land you at a lower rate.

If you have not been paying on time, or the lender is not budging on the rate, it is time to look into refinancing.

- Obtain your credit report and score to determine where you stand.
- Determine if your current loan has any prepayment penalties.
- Estimate the current value of your car and compare that to the amount owed.
- Use this knowledge to shop for a better rate.

There are many routes to take here, and speaking with lenders is the best way to find out if a refinance is the right move. However, if you owe more than your car is worth, it will be difficult to find a lower rate. A lender will not have enough collateral to replace funds loaned if things go south, so they won't likely even approve your refinance request. Be sure to do your homework beforehand.

Tapping Into a 401k to Clean Up Debt

A last resort option may be to use your 401k or other retirement savings plan. To determine if this is a viable option for you, first, speak with your company's 401k administrator. This person will likely work in accounting or human resources. Also, there is often a toll-free number on your plan's statements. Explain what you would like to do, and they should be able to help if a loan or distribution option is available. Take note that not all plans offer this option.

Prior to making that phone call, it is important to understand some of the pros and cons of taking money out of your 401k.

Pros

- You are borrowing from (and paying interest back) to yourself, not a credit card company or lender.
- The rate is usually low, 1 or 2 percent above the prime rate.
- There is no credit check.
- Repayment is through payroll deductions, which is easy for most people.
- There are often low transaction costs compared to other loans options.

In most 401(k) plans, you can borrow up to 50 percent of your vested balance, but not more than $50,000. You have to pay the money back with interest over five years.

Cons

- Plan management companies may charge fees up to $400 for an application or processing fee.
- Money removed does not appreciate as it would if left in the account if it is invested.
- Once repayment begins, your overall paycheck deductions could double if you are to maintain your current contribution schedule.
- If you leave the job, the loan accelerates and must usually be paid within 60 days to avoid it being viewed as a distribution.
- If the loan is not repaid, it is considered an early withdrawal and taxed, and a 10% early withdrawal penalty applies.

Of course, if you're already retired that could change things slightly. You won't have access to a 401(k) loan if you no longer work for that company, but you can look to your individual retirement savings (IRAs) as an alternative. However, a

distribution from an IRA is not a loan, so there may be tax consequences, and most importantly, a reduction in your overall retirement savings balances.

Retirement savings should be earmarked for retirement first and foremost. However, if rearranging your debt is a dire need, you can look to retirement savings as a back-up. It is crucial to understand the nuances to this route before deciding if it is the right option for you.

Borrowing from Friends and Family to Clean Up Debt

Borrowing from friends and family will always depend on the relationships. As often stated, mixing finances with family and friends is an easy way to hurt feelings and ruin relationships.

However, if you decide this is the route for you, it is important to put things in writing first. Although we all assume nothing bad will happen, it is a prudent step to put the following down on paper:

- The names of the lender and borrower
- The date of the loan initiation
- The amount
- The date by which the loan is to be repaid
- The interest rate, if one is applied
- The number of payments
- How often payments are to be made (weekly, biweekly, monthly)
- The minimum amount to be paid
- Each party’s signature

Another step to ensure comfort on both sides would be to put up some type of collateral. Many lenders would require this, and it should be no different with friends and family.

If these options are not available to you or will not work to clear up debt with your current financial situation, be sure to read our next section covering credit counseling services.

4. When to Seek Credit Counseling Services for Consumer Debt

Getting out of debt is hard. For many, turning to professional help offers the necessary support to get them on the road to success. When considering this route, remember the earlier the better. Reaching out for professional assistance before it is too late will help those involved assist you in the best manner.

Several debt management solutions exist in the world today, and navigating the options can be difficult. Below are some of the most common solutions, along with what to consider when thinking of turning to a pro.

Signs You Should Consider Professional Help

Not everyone needs credit counseling to help manage their debt. However, the following circumstances warrant giving it some thought.

1. Credit card payments are rising while income is steady or decreasing.
2. Unable to meet minimum payments.
3. Using one credit card to make payments on another.
4. You are at or very close to the limit on all your credit cards.
5. You add more debt than you pay off each month.
6. You are unsure how much you owe and afraid to find out.
7. You have received phone calls or letters about delinquent bill payments.
8. You are buying everyday things such as groceries with credit cards out of necessity.
9. You are dipping into savings or your IRA to pay your monthly bills.
10. You use your credit card not as a convenience but as a necessity.

If any of these sound like your current financial situation, take a look at the following solutions that may bring some much-needed respite.

Types of Credit Counseling Services

Most of the services offered to debtors fall under the umbrella of credit counseling – an individually tailored plan that provides guidance and support to those who need help getting out of debt. The goal most often is to avoid bankruptcy. However, credit counseling also offers an opportunity to gain education on financial management to help avoid getting into unmanageable debt in the future.

Many of these services also negotiate with a person's creditors on their behalf to reduce interest or rearrange repayment structures.

– Debt Management Program

A Debt Management Program is another phrase often mentioned when discussing professional debt management. This is not separate from credit counseling, but instead, a tool used under the same umbrella. A DMP is a proposal usually made by your credit counselor agreed to by the creditors.

The DMP uses the money left over after developing an accurate budget with your counselor. The disposable income is directed towards the credit counselor, who in turn allocates it to the various creditors. The credit counselor acts as the intermediary, to help facilitate communications from both ends.

– Debt Settlement Programs

Debt settlement is the final term often discussed within credit counseling. This is a process by which a large, one-time payment is made for the forgiveness of any remaining debt. Although the thought of paying back less than what is owed is tempting, there are no free lunches.

Any amount forgiven is typically viewed as taxable income by the IRS, which can come back to haunt you, unless you file for bankruptcy. In addition, it will show up on your credit report for several years and make it very unlikely a lender will approve you for the most affordable loan during that time.

How to Seek Out the Best Credit Counseling Companies

As with anything else, it pays to comparison shop. Several companies offer credit counseling, and finding the best deal can take a little research. But don't be fooled if the company claims to be nonprofit. This is often misleading, as these service providers may charge higher fees than other for-profit businesses.

According to the Federal Trade Commission (FTC), the following questions should be asked to any prospective credit counselor:

- What services do you offer?
- Will you help me develop a plan for avoiding debt issues in the future?
- What are your fees?
- What if I can't afford to pay your fees?
- What qualifications do your counselors have? Are they accredited or certified by an outside organization? What training do they receive?
- What do you do to keep information about me (including my address, phone number, and financial information) confidential and secure?
- How are your employees paid? Are they paid more if I sign up for certain services, if I pay a fee, or if I make a contribution to your organization?

Here is a list of approved consumer credit counseling agencies by state.

5. Bankruptcy Types, Consequences & Myths

If you have explored all the other options available for dealing with debt, including professional help, bankruptcy is there. Previously a taboo subject, bankruptcy has seen a rise in recent years. And to some, it does not carry the stigma it once did.

However, considering it and going through with it as a debt reduction strategy affects your financial life for seven to 10 years. It is not something to take lightly. Individuals are eligible to file for bankruptcy under Chapter 7, 11, 12, or 13, so let's take a closer look at each option.

Common Types of Bankruptcy Filings

– Chapter 7 Bankruptcy

Under this form of bankruptcy, individuals or businesses forfeit nonexempt assets to repay debts to the fullest amount and walk away from the rest. To qualify, individuals must take a 'means test' to determine if they make less than the state's mean income.

– Chapter 11 Bankruptcy

Also known as reorganization, this type of bankruptcy is for individuals and more commonly, businesses to restructure debt. Here the debtor maintains ownership of assets and attempts to work out a plan to pay back creditors. It is the most complicated form and usually reserved for businesses or very wealthy individuals. The reorganization and payment plan are due in under 120 days, as part of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act.

– Chapter 12 Bankruptcy

Unusually reserved for farm owners and fishermen, the debtor still owns assets and works out a repayment plan. It works very much like Chapter 13, but usually stretches out over three years.

– Chapter 13 Bankruptcy

Much like Chapter 11, but for individuals with personal debt. The debtor remains in control of assets, but repayments are repaid in planned structure.

7 Myths on Bankruptcy

1. Everyone will know I've filed for bankruptcy – unless a person is a well-known celebrity or corporation, there is little chance of people finding out, outside of their creditors. Although the filings are made public, with a large number of filings happening it is unlikely people will find out without doing an extensive background search on you.

2. All debts are wiped out under Chapter 7 bankruptcy – some debts are not discharged or erased. Child support and student loans, for example, will remain afterward, so it does not completely wipe the slate clean.

3. I'll lose everything if I file for bankruptcy – every state has exemptions from judgment, including housing, cars, and household possessions. That means you can keep some of the essential items you need, as long as you show you will be able to afford them after discharge.

4. I'll never be able to borrow again following bankruptcy – often it will be the contrary. You will usually start receiving many offers right after filing for bankruptcy, particularly from sub-prime lenders offering credit at high interest rates.

5. Bankruptcy is too difficult to file – actually, it's not even necessary to have an attorney. If you can fill out the paperwork, you can go at it alone if you want to.

However, it is highly recommended to obtain professional help throughout this legal process.

6. Filing bankruptcy will help my credit score, as the debts are removed – very incorrect. On a credit report, bankruptcy is about as bad as it gets. It can remain on a report for up to 10 years. However, in some cases, your credit score may go up shortly afterward depending on how badly you let things get out of hand before you filed. Either way, having it on your record will be worse overall.

7. You can only file for bankruptcy once – Chapter 7 is once every eight years. Chapter 13 you can file more often. Of course, it is extremely bad for your future credit score if you have multiple bankruptcies.

Consequences of Bankruptcy

Credit – after bankruptcy it should come as no surprise that both your credit score and report will be severely affected. It will linger on a credit report for seven to 10 years, regardless of your situation. Getting credit cards or loans will be more difficult than before, especially at a reasonable rate.

Employment – most employers today run not only a background check but also a credit report on potential employees. With the weak job market and employers being able to be more selective than ever, bankruptcy can be a reason against hiring you for the job. This is especially true in careers that involve handling money or those that fall within the category of finance or banking.

Emotional – many times people feel a strong sense of guilt after bankruptcy. Although the stress of creditors calling has ceased, the stigma remains. This negative thinking, however, will not help. Remind yourself that you are not alone, with over 2 million Americans filing in previous years.

Housing – even renting an apartment or home can become a challenge. As most places require a credit report for the rental application, approval is difficult with bankruptcy on the record. An additional deposit or co-signer will most likely be needed.

Managing Your Finances After Bankruptcy

- **Make a budget** – As basic as it sounds, keeping and maintaining a budget is essential. If you need help, there are many services that can lend a hand in creating and maintaining a budget so you can live within your means.
- **Use cash** – Learn to use cash more, and plastic less. It is easy to fall back into the same harmful habits; however, learning the old phrase "cash is king" is an important step after bankruptcy.
- **Pay on-time** – Pay everything on time. Even power and phone companies will report late payments. It is crucial to keep your credit record clean if you are to rebuild your credit over time.
- **Watch your credit report** – with the new clean slate you are given, it is important to keep an eye for any mistakes. Monitoring your credit is a necessary step after bankruptcy.
- **Get a new credit card** – A secured credit card can be a great step in the right direction after bankruptcy. Here you deposit a set amount of money in an account, and this becomes your credit limit. By charging small amounts each month, and repaying on time, you begin to rebuild solid credit history.
- **Watch for scams** – There are many offers out there to take advantage of people in their fragile state after bankruptcy. Watch out for any companies offering to fix everything, especially if they require a large upfront fee. There is no quick way out, and anything that sounds too good to be true most likely is.

Be sure to consider each of these points before filing for bankruptcy to get out of debt.

If you found this e-book helpful, please take a moment to link to it here, and share this page on your favorite social network.

Wishing you the very best!