



## MANAGING PERSONAL DEBT

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### WHAT IS DEBT?

Debt is the money you owe, a financial obligation. It exists when you receive something of value now and you pay for it later, usually with interest. It usually involves making high-dollar purchases you could not normally afford.

Almost everyone needs to take loans or debts in life to fulfill some basic needs. However, the repayment of these debts and the risk of an uncontrolled debt load can create serious problems.



### YOUR RESPONSIBILITIES AS A BORROWER

As a borrower and user of credit, you have certain responsibilities to your lenders and other parties who issue you credit. Upholding these responsibilities is an obligation to your creditors and helps you maintain a good credit score.

- Understand what you are committing yourself to when it comes to borrowing. Be familiar with the terms, interest rate, fees, etc.
- Pay the loan back in full and on time. The creditor has loaned you money and you agreed to pay it back in full, with interest and possible fees, within a certain time. It is your obligation and responsibility to honor the loan agreement.

### RECOGNIZE THE NEED FOR BEHAVIORAL CHANGE



When it comes to debt, you must understand your situation and take the steps necessary to reduce and eventually eliminate your debt. This may mean replacing poor financial habits with conscientious actions to manage your finances better. It may also require making serious adjustments to your lifestyle that include changing your spending habits.

You can start by:

- Recognizing the effect that indebtedness has on your health—both physical and mental
- Evaluating your spending habits and recognizing the role they play in the creation of a debt load
- Making the decision to change your poor financial habits
- Creating, maintaining, and sticking to a budget
- Developing debt reduction goals and incorporating them in your budget
- Not spending money you don't have!

## TYPES OF DEBT

Personal debt comes in several forms and can be categorized as a few main types.

**Secured debts** are those such as mortgages and car loans where the lender can repossess the house or car (the collateral) if the debt is not paid.

**Unsecured debts** are those represented by credit cards, personal loans, lines of credit, department store cards, medical bills, etc., that are not guaranteed by collateral.



**Revolving debt** is that from credit cards or lines of credit that allow you to carry, or revolve, a balance from month to month. You can borrow as much money as you'd like—up to the predetermined credit limit—and interest rates are subject to change. Your monthly payment may vary depending upon how much you owe.

**Installment debt** is represented by mortgages, car loans, student loans, personal loans, etc. In most cases the amount of money you borrow, the interest rate, and the size of your monthly payments are fixed at the start.

## HOW DIFFERENT TYPES OF DEBT AFFECT YOUR CREDIT SCORE

For both revolving and installment debt you must make payments on time. When you miss a payment, your lender could report it to the credit bureaus—a problem that can stay on your credit reports for seven years. You may also have to pay late fees, which won't affect your credit scores but can still be burdensome.

Aside from your payment history, the way each type of debt affects your credit is quite different. For installment debt, like student loans and mortgages, having a high balance doesn't have a big effect on your credit.

Revolving debt is another matter. If you carry high balances compared to your credit limits from month to month, it will likely have a negative effect on your credit scores—especially if it occurs in multiple accounts.

In addition, different factors go into determining your credit score. Credit mix—the diversity of your credit accounts—accounts for 10 percent of your FICO (credit) score.

Maintaining different types of credit accounts, such as a mortgage, auto loan, student loan, and credit cards, indicates to lenders that you are adept at managing your debt. It also helps them get a clearer image of your finances and your ability to pay your creditors. The more types of credit accounts you have the better, as long as you pay on time.

### GOOD DEBT VS. BAD DEBT

Is debt good or bad? Some people strongly say that debt should be avoided at all costs. Others argue that paying with cash is not smart if opportunities to borrow with no or low interest rates are available.

But not all debt is equal, and there is both good debt and bad debt.



**Good debt** is the debt you incur by purchasing an asset that grows in value or tends to generate income, such as a home loan or mortgage to buy a home or real estate. It is a debt that can be steadily repaid and usually contributes to your financial well-being.

In addition to a home loan or mortgage, a student loan is another good example of good debt. A college education can help you attain a career with higher income potential.

Also, both mortgage and student loans normally carry relatively low-interest rates and some of the interest you pay on these may be tax-deductible.

**Bad debt** occurs when you purchase an asset that loses value, does not generate income, or cannot be reliably repaid.



Credit card debt is generally considered bad debt because credit cards tend to have higher interest rates that contribute to high debt very quickly.

One of the best examples of bad debt is a payday loan. In exchange for an immediate advance on wages or salary, a borrower pays a high interest rate and fee. If you fail to repay the full loan, fee, and interest by the expiration date, this unsecured personal loan "rolls over" and incurs another processing fee. For example, a \$300 loan could result in combined interest and

fees of up to 35%, or an annual interest rate over 900%! Title loans, which use your vehicle for collateral, also tend to have very high interest rates and fees for rolling over the loan.

## EVALUATING YOUR DEBT SITUATION

How much debt do you have? How much can you afford? Do you have too much debt? When you're trying to assess your debt situation it can be difficult to know exactly where you stand.



A certain level of debt may be manageable and may not be a strain on your budget. However, even though you can afford the monthly payments, having too much debt can affect your ability to meet some of your other financial and life goals.

If you fear you might have too much debt, rather than guessing you can calculate your level of indebtedness relative to your income and determine whether your debt load is more than you can afford by using the following methods:

### **20-10 Rule of Debt**

This rule says that your total consumer debt should be no more than 20% of your *annual* take-home income and your payments should not exceed 10% of your *monthly* take-home income. (Don't include mortgage debt in this calculation.)

This can help you decide whether you're spending too much on debt payments and help you limit the amount of additional debt you're willing to take on.

### **Debt-to-Income Ratio**

Debt-to-income ratio (DTI) is a personal finance measure that compares the amount of debt you have to your overall income. Lenders, including issuers of mortgages, use it as a tool to measure your ability to manage the payments you make each month and repay the money you have borrowed.





To calculate your debt-to-income ratio, add up your total recurring monthly obligations such as mortgage, student loans, auto loans, child support, and credit card payments, and divide that by your gross monthly income (the amount you earn each month before taxes and other deductions are taken out).

Lenders prefer to see a debt-to-income ratio lower than 36%, with no more than 28% of that debt going to your mortgage. Your lender will also look at your total debts, which should not exceed 36%.

In most cases, 43% is the highest ratio a borrower can have and still get a mortgage. Above that, lenders will likely deny a loan application because the monthly expenses for housing and other debts are too high when compared to the income.

### DEBT REDUCTION STRATEGIES

There are various strategies available to help you manage, and even reduce, your debt. The same strategy does not work for everyone, so you need to select one that's best for your needs. Some of the more common debt reduction strategies are:



#### Debt Reduction Schedule

This projects a possible solution to eliminate your debts using a preplanned schedule instead of merely making the same current payments.

In this approach, you first list all your debts along with the monthly payment, the current balance, and interest rate for each.

The next step is to calculate and compare how long it will take to pay off the entire debt using various payment strategies:

- Highest to lowest interest rate
- Highest to lowest balance
- Lowest to highest balance

In the example table on the next page:

- Highest to lowest interest rate: Once the Credit card 2 balance is completely paid off, the money going to that debt would be applied to the Electronics Store, the next highest priority debt, then the Auto loan, and so on. This increases the payment amount to the highest priority debt and creates interest savings by paying the loan sooner than planned.
- Highest to lowest balance:  
The Auto loan balance would be paid first, followed by Credit card 1, Student loan, and so on, with the payment to the Electronics store being the last in payment priority.
- Lowest to highest balance:

The Electronics store balance would be paid first, then Credit Card 2, and so on, with the auto loan being the last in payment priority.

Debt	Payment Per Month	Balance Due	Interest Rate
Auto loan	\$ 367	\$ 8,200	12%
Student loan	\$ 60	\$ 3,150	8%
Credit card 1	\$ 55	\$ 3,490	11%
Credit card 2	\$ 35	\$ 1,003	21%
Electronics store	\$ 63	\$ 510	19%
<b>TOTAL</b>	<b>\$ 580</b>	<b>\$16,353</b>	

In our example, monthly debt payments totaled \$580. If just \$75 is added to raise the total debt repayment to \$655 per month, the \$16,000 debt can be eliminated in fewer than 3 years, with a savings in interest of almost \$1,800!

Potential savings making payments of \$655/month:

- Highest to lowest interest rate
  - Debt-free in **31** months
  - Save **\$1,795.18** in interest
- Highest to lowest balance
  - Debt-free in **31** months
  - Save **\$1,645.49** in interest
- Lowest to highest balance
  - Debt-free in **31** months
  - Save **\$1,715.45** in interest

However, a debt schedule is only successful if you continue to pay at least the same monthly total to the debt and do not create any new debt. The additional money made available by paying off one debt should be applied to the next until all debts are paid.





## Debt Consolidation Loan

Debt consolidation loans take all or most of a person's current loans and combines them into a single new loan.

How does it work? You find a consolidation loan with a lower overall interest rate than your combined existing debts. The lower rate and single payment make a consolidation loan appealing; it should result in lower overall payments and less interest paid on the loan.

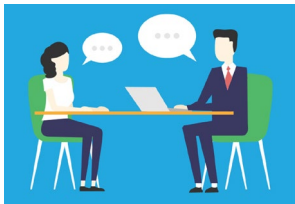


A debt consolidation loan also requires a change in behavior and a commitment. Success assumes that you will make the payments on the new loan on time, put the difference in payments into savings, and avoid running up new debt.

Some sources of consolidation loans are:

- Personal loans
- Home equity loans
- Balance transfer cards
- Family or friends

## Debt/Credit Counseling



Debt counseling, also called credit counseling, means working with a counselor who helps you assess your financial situation and work out practical solutions for improving your financial health, including paying down or paying off debt. The credit counselor also provides financial education geared toward behavioral change.

Consumers should be aware that there are companies that claim to offer credit counseling services but really do nothing more than collect fees in exchange for negotiating an easy monthly payment debt reduction plan. These companies are often affiliated with other companies that offer debt consolidation loans and do not provide counseling services at all.

## Debt Management

Depending on your situation, a credit counselor may suggest a debt management plan to help you get out of debt faster, usually by lowering your interest rates and setting up a payment schedule. This is typically a last resort, so beware of credit counselors who push this as the first or only option.



Under a debt management program, the credit counseling agency works with you and your creditors on a financial plan. You deposit money with the credit counseling organization each month, and the organization uses your deposits to pay your creditors according to an agreed-upon schedule.

It's important to note that a debt management plan isn't necessarily the same thing as credit counseling—and it's not the right solution for everyone. Also, unlike many credit counseling sessions, there may be a fee for services. The fees will vary depending on the agency, but there's typically a set-up fee and a monthly fee. You may be eligible for a fee waiver if the cost is too much of a burden for you.

### **Debt Settlement/Debt Relief**

Debt settlement is also known as debt relief or debt adjustment. Debt settlement companies negotiate reduced payments with your creditors, generally in exchange for a fee.



You may pay less than the full amount of your debt, but the debt settlement company will probably ask you to stop making payments on your debt. These late payments will appear on your credit report and can damage your credit history.

If the settlement process is successful, the account will appear as "settled for less than originally agreed" on your credit report, which can also result in credit score harm. Records of late payments and settled accounts stay on your report and affect your credit score for up to seven years. It's best to avoid debt settlement unless bankruptcy is your only other option.

There are some risks involved in using debt settlement services:

- Your creditors may not agree to negotiate  
The debt settlement company may not be able to reach a settlement for all, or even one, of your debts. Some creditors will not negotiate with debt management companies.
- You could end up with more debt  
If you stop making payments on a debt you may have to pay interest or late fees. You may also have to deal with a debt collector or a lawsuit filed by the creditor or debt collector. In addition, any portion of your debt that is forgiven would be considered to be taxable income by the IRS and must be reported on your federal and perhaps your state income tax return.
- You may be charged fees even if your whole debt isn't settled  
If you have more than one creditor and the debt settlement company settles with just one of the creditors, the company can start charging their fee as soon as they receive a result. Similarly, if a debt settlement company settles a portion of your total debt, it can charge that same proportion of its total fee.
- It could damage your credit history  
While your debt settlement company is negotiating with your creditors, it may ask you to stop making payments so you can save for a lump sum payment. This would result in delinquent accounts on your credit report, which would affect your credit score. Each settled debt creates a negative item in your credit report that will remain on your report for seven years.  
Debt settlement may not be a good option if you are trying to maintain a good credit record and score. However, if your accounts are already in collection and your credit record is not as important, debt settlement may be your **best option**.



- Settlement is not a quick process

Debt settlement not only takes money, but also time. It usually takes 36 to 48 months to save enough money in an escrow account so the debt settlement company can make an acceptable offer to the creditor(s). This can result in a significant increase in the debt load resulting from interest and late fees from delinquent payments.

### **Do It Yourself**

If you have debt but aren't overwhelmed by it, self-help may be all the help you need to manage it. You can take certain steps that a debt counselor would take on your own. To start, set up a budget so that you know where your money is going each month.

Then, set up a debt repayment plan. A common plan is to list all your debts, apply extra money to the debt with the highest interest rate until it is paid off, and then move on to the next debt. You can also negotiate lower interest rates yourself by calling your creditors to ask for a lower rate or transferring your credit card balance to a balance transfer card that charges less or even no interest.



In the balance transfer approach, you acquire a credit card with an introductory 0% APR balance transfer offer. This option gives you some time to pay down your debt without paying interest on it. However, be aware that if you haven't paid your balance in full by the time the introduction period ends, you'll start accruing interest on that balance at the card's regular interest rate. You'll also need to avoid adding to the debt you're paying off by making new purchases with the card.

### **DOES DEBT/CREDIT COUNSELING AFFECT YOUR CREDIT SCORE?**

Although working with a debt counseling service or starting a debt management plan won't directly affect your credit score, the fact that you're using one may be added as a note to your credit report. In addition, a debt management plan may lead you to close credit accounts, which can lower your credit utilization and negatively affect your score. Alternately, it can help you develop a history of on-time payments, which can improve your credit score.

### **DEBT CONTROL CONSIDERATIONS FOR MILITARY MEMBERS**

Service members have a lot of critical issues with which to concern themselves, and debt is usually not at the top of the list, though it should be. This is especially true during or following deployment. Here are some considerations for service members to address and control their debt situation.



## Use the Servicemembers Civil Relief Act (SCRA)



The SCRA created a program for military members who need help with their debt. Some of the SCRA's benefits that can affect your debt are a 6% interest rate cap on financial obligations incurred before you entered active duty and protections regarding apartment lease terminations, evictions, mortgage foreclosures, and installment contracts like car loans, restrictions on repossessing your vehicle, and others.

The SCRA can help:

- Delay civil court cases
- Postpone foreclosures and repossessions
- Prevent evictions
- Protect against default judgments
- Terminate various contracts, such as leases
- Defer income taxes
- Reduce interest rates

## Consider a Debt Management Program

Debt management programs are great options for service members with high levels of debt. When searching for a debt management plan company always mention that you are an active duty member. You may be eligible for lower, or even zero, program setup and administration fees.

As a service member your pre-service interest rates should be reduced to six percent or lower because of the Servicemembers Civil Relief Act. If you're enrolled in a debt management program, call your credit counselor to ensure that your qualifying interest rates have been reduced correctly.



## Before Deploying

Deployment is a stressful time, and it can be difficult to improve or repair your finances if you're already overseas. Therefore, there are some things that you should do before deployment to secure your finances.

- Consolidate your debt
- Arrange for a Special Power of Attorney to designate someone to manage your personal finances in your absence. They will need it to be able to revise your allotments and make other changes to your accounts.
- Put a credit/security freeze on your credit card accounts. This will help prevent unauthorized charges and protect against identity theft.
- Place an Active Duty Fraud Alert on your credit report. When this is in place, creditors must take extra steps to confirm your identity before opening new credit in your name. The alert remains in place for one year and can be renewed to match the length of your deployment.

- Set up allotment payments The money you earn while deployed can be paid directly from your paycheck to creditors and lenders. You can set up six such discretionary allotments.
- Participate in the DoD Savings Deposit Program (SDP) Service members who receive Hostile Fire Pay/Imminent Danger Pay (HFP/IDP) and meet deployment duration requirements can enroll. The Savings Deposit Program is a special savings account that earns ten percent interest, much higher than you will get in a regular savings account at any bank or credit union.



## MAJOR LAWS THAT PROTECT BORROWERS AND DEBTORS

There are a some federal and state laws that protect debtors and borrowers.

**Truth in Lending Act:** Requires lenders to tell you the terms and costs of all loan plans.

**Fair Credit Billing Act:** Regulates how creditors bill individuals and sets up procedures for disputing bills and resolving mistakes.

**Fair Debt Collection Practices Act:** Prohibits debt collectors from engaging in unfair, deceptive, or abusive practices while collecting debts.



**Military Lending Act:** Servicemembers cannot be charged more than 36% interest for credit products and will receive additional protections for loans.

**Servicemembers Civil Relief Act (SCRA):** Regulates interest rates for credit cards, auto loans, and other financial services for certain loans for active duty military. It also requires landlords to let you out of your lease, without penalty, for deployment and other service-ordered moves. Interest rates can be reduced to six percent or lower for loans you incurred before entering active duty.

**State statutes of limitations for debt:** A state statute of limitations for debt is the time during which a debt is relevant under the law. Once it expires, any lawsuit brought to recoup money that you owe will be dismissed.



## **RESOURCES AVAILABLE TO HELP YOU WITH DEBT-RELATED PROBLEMS**

### **General**

#### National Foundation for Credit Counseling

This nonprofit financial counseling organization provides debt counseling, bankruptcy counseling, homeownership counseling, reverse mortgage counseling, and student loan debt counseling.

#### Consumer Financial Protection Bureau

This U.S. government agency assures fair treatment of consumers by banks, lenders, and other financial companies, as well as credit reporting agencies and debt collection companies. It provides educational materials and accepts consumer complaints



#### Federal Trade Commission

This U.S. government agency protects consumers from anticompetitive, deceptive, and unfair business practices. It regulates advertising, marketing, and consumer credit practices and prevents antitrust agreements and other unfair practices. Consumers may report fraud, scams, and bad business practices to the commission.

### **Military**

#### Military Service Financial Assistance

Each military service has a network of counselors to help you learn to manage your finances and stay, or get, out of debt. Personal Financial Managers and other financial counselors are available through the Airman & Family Readiness Center, Army Community Service, Fleet and Family Support Center, Marine Corps Community Services, and Coast Guard Financial Specialists. Each service also has source for grants or low-interest loans, such as Army Emergency Relief and Coast Guard Mutual Assistance. If you need assistance or suspect you are in financial trouble reach out to your service counselors and affiliated aid agencies.

#### Military Debt Consolidation Loan

If you have a VA home loan you can get a Military Debt Consolidation Loan (also known as a VA Consolidation Loan), a home equity loan that can help you get out of debt. Some important points to remember regarding a MDCL are:

- Must have a VA home loan to qualify
- Usually have to pay closing costs again to get the new loan
  - Increases your financial risk since the SCRA will no longer protect you against foreclosure
- Increases your monthly payment because the amount you are financing is higher
- Interest rate on your MDCL will change depending on economic and market circumstances
- Won't work if you don't have equity since you have nothing to borrow against

### VA Compromise Sale

You may be eligible for a VA Compromise Sale through the Department of Veteran Affairs if you have a VA debt due to a home loan guaranty, education loan, or accidental overpayment of benefits. This is similar to a settlement but does not require the help of an outside firm. You must meet specific requirements for this program.

### Military and Veteran Student Loan Payment Plans

Members of the military, especially new enlistees, can receive help from several loan forgiveness programs not available to civilians. Some of the programs that either help repay or discharge student loans completely include:

- **Military College Loan Repayment Program.** The Army will provide up to \$65,000 in loan repayments for qualified federal loans for qualified enlistees or those who reenlist. The Navy also offers up to \$65,000 in repayment for three years of service. The Air Force has a similar program, paying up to \$10,000.
- **National Defense Student Loan Discharge.** Offers a partial discharge of federal Perkins student loans for those whose military service included at least one year in hostile fire or imminent danger areas.
- **Veterans Total and Permanent Disability (TPD) Discharge.** Available to service members who suffered total and permanent disability. If you have a TPD discharge, your Ford Federal Direct, FFEL or Perkins loans can be discharged.
- **Army Reserve College Loan Repayment Program.** If you incurred student loans before you entered active duty, are in a qualifying military occupation specialty, and enlist for six years, you could have 15% of your federal or private student loan balance, up to \$20,000, paid off.





- **Health Professions Student Loan Repayment Program.** Doctors, dentists, and other healthcare professionals could receive \$40,000 per year in federal and private student loan repayments for up three years.
- **Air Force Judge Advocate General's Corps Loan Repayment Program.** If you serve in the Air Force Judge Advocate General Corps, you could get up to \$65,000 to pay back loans.

### IMPORTANCE OF MANAGING DEBT

As you have seen, debt can be a very useful tool, but it requires careful handling. A responsible person treats debt with care and by using it with caution ensures it doesn't become a burden.

If debt does become a problem, ensure you take proactive action to resolve it. If you can't eliminate your debt problem yourself, there are numerous resources that can provide help.

