Financial You

Personal Finance Education from LPL

THE BASICS OF MANAGING DEBT

CNB

INVESTMENT & PLANNING SERVICES

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THE BASICS OF MANAGING DEBT

It's practically impossible not to have some debt during your lifetime. Most Americans have loans and many college students typically graduate owing tens of thousands of dollars in student debt. According to a 2018 report from NerdWallet (updated in mid-2019), the aggregate level of U.S. household debt has never been higher.

Being in debt is certainly no fun, and it can sometimes take over your financial life. For a lot of people, debt can make it hard to cover even your everyday living expenses, not to mention saving for retirement or other financial goals.

As stressful as debt can be, some debt can be a smart financial tool. Here are two key things to consider when deciding whether or not you should take on some debt.

Two Keys to Taking on Debt

Check how much debt you can really afford.

The key is to take on only so much debt as you can easily afford to repay. Know how much disposable income you have each month (after accounting for all regular bills and necessities) and make sure not to sign on for debt payments greater than that month. You should always keep about 3-6 months of expenses in an emergency fund, in case you incur an unexpected expense.

Know the difference between good debt and bad debt.

Bad debt is high in interest and used to buy something you don't really need and is unlikely to retain its value over time. Buying the latest trendy gadget or splurging on designer clothes are typical examples.

On the other hand, good debt carries low interest and is used for something that is likely to appreciate in value or can help you improve your financial position.Taking out debt to buy a house, go back to school or purchase a car you need to get to work are some examples.

How do you determine if it's okay to take on debt for a purchase?

Here's a checklist to help guide you:

- You are buying something that is likely to grow in value or improve your earning ability
- You can handle the monthly debt payments easily
- You have an emergency fund in place
- You are already saving regularly for retirement
- You aren't overpaying for the item you are buying
- You're able to get a competitive interest rate for the loan

Managing Credit Card Debt Wisely

Without a doubt, credit cards make life more convenient, but not necessarily easier. If you use them too much, they can become the biggest obstacle to reaching your financial goals. When using credit cards, consider these valuable tips:

One Debt at a Time

Many people carry balances on their credit card and many carry balances on more than one card. When that happens, it can feel almost impossible to pay it off. Where do you start? There are a couple of strategies to consider.

Snowball Method

It's called the snowball method because your payoffs start small but get bigger over time. To use this payoff method, list all your credit card balances and other debts in order of size, from the smallest balance to the largest. The smallest debt on your list is the one to focus on first. When it gets paid off, the next smallest debt becomes your focus, until there is no more. For many people, the satisfaction of seeing that first debt get paid off quickly makes the snowball method the best choice.

Avalanche Method

This is called the avalanche method because you are paying off the most expensive debt first by focusing on the debt with the highest interest rate. To use this payoff method, list all your debts in order of interest rate, from highest to lowest. The card with the highest rate on your list is the one to focus on first. When it gets paid off, move on to the debt with the second highest rate until there is no more.

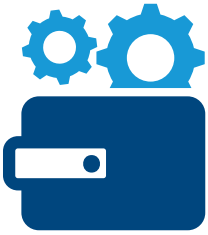
Bottom line: it doesn't matter which method you choose. By focusing on one debt at a time, you'll be able to pay off all of them.

6 Good Habits to Develop

- Review your credit card statements regularly to keep your purchases in check.
- Pay your bill on time to avoid late fee charges.
- Pay off your full balance every month to avoid paying interest.
- Reduce your credit card limit if you're tempted to overspend.
- Take advantage of rewards programs.
- Protect yourself against credit card fraud.

6 Bad Habits to Avoid

- Using card to make ends meet.
- Owning more than four cards at a time.
- Not researching other options before applying.
- Exceeding 25% of your credit line.
- Using rewards programs as an excuse to buy more stuff.
- Making large purchases unless you can pay off the balance quickly.



Understanding and Managing Your Credit Score

When it comes to managing debt, knowing your credit score is critical. A less desirable score can keep you from qualifying for a mortgage (or a more competitive interest rate), and could mean much higher interest rates on new credit cards. Knowing your score — and what goes into calculating it — can help you build better credit.

Each major credit bureau in the U.S. (Experian, TransUnion, Equifax) can calculate a credit score for any borrower applying for a loan. If you've ever applied for a loan of any kind, chances are you recognize at least one of these names.

Credit scores are 3-digit numbers that can range from a low of 300 to a high of 850. In general, a score of 720 or higher is considered excellent. And while the scores can vary by credit bureau, they are mainly calculated based on these five factors:

- Payment history is simply whether or not you pay your bills on time or at all. To maintain a good credit score, make sure you pay your bills on time!
- Total outstanding debt is how much you owe right now. To maintain a good credit score, make sure your credit card balance is no more than 25% of your available credit. If you have a card with a credit limit of $10,000, make sure your balance is no more than $2,500.
- Your credit types are the mix of debt you have now. For example, a mortgage, a car loan and credit card debt. Successfully managing a variety of loan types can get you a higher credit score. Lenders will consider you an experienced borrower if you have, for example, a mortgage, a car loan, and a couple of credit cards. If all you have is credit card debt, you will be considered inexperienced and score lower.
- Length of credit history is simply how long you've had credit. The longer your track record is of maintaining good credit and paying back loans and credit cards, the better your credit score will be.

- Credit applications history is the number of times you've tried to get credit (whether or not you were successful). You should avoid opening several new accounts to take advantage of special offers such as airline miles or cash-backs on purchases. Having too much credit capacity can actually make you more of a credit risk.

It takes time and discipline to improve your credit score – sometimes a few years. But by paying attention to these five components of your credit score and managing your credit responsibly, you can maintain ideal debt management, and improve your overall financial health.

Your Debt-to-Income Ratio: an Important Financial Tool

Calculating your debt-to-income ratio – or DTI – is a great way to check that your level of debt falls within an acceptable range (or not). Your DTI is a percentage calculated by dividing your total recurring monthly debt by your monthly gross income.

[Monthly Debt Payments] ÷ [Monthly Gross Income] = DTI%.

EXAMPLE	
Minimum Monthly Debt Payments	
Mortgage or rent payment	$1,300
Car loan or lease payment	$400
Credit card payment	$300
Student loan payment	$200
Total	**$2,200**
Gross Monthly Income	
Salary	$3,000
Spouse/Partner's salary	$4,000
Total	**$7,000**
Debt-to-Income Ratio = $2,200 ÷ $7,000 = .314 or 31.4%.	

Once you've calculated your DTI ratio, you'll want to understand how lenders view it when they're considering your loan application. Guidelines can vary widely by lender, but here are some general guidelines used by Wells Fargo, one of the largest mortgage lenders in the U.S.:

35% or less: *Looking Good.* Relative to your income, your debt is manageable. You most likely have money left over for saving or spending after you've paid your bills.

36% to 49%: *Opportunity to improve.* You're managing your debt adequately, but may want to consider lowering your DTI. This could put you in a better position to handle unforeseen expenses. If you're looking to borrow, keep in mind that lenders may ask for additional eligibility criteria.

50% or more: *Take Action.* With more than half your income going toward debt payments, you may not have much money left to save, spend, or handle unforeseen expenses. With this DTI ratio, lenders may limit your borrowing options, or refuse to lend to you.

YOUR PERSONAL DEBT-TO-INCOME (DTI) WORKSHEET

What you'll need:

- Online bill payment history or checkbook register
- Monthly bill statements
- Most recent pay stub (for yourself and any spouse/partner)

Minimum Monthly Debt Payments	Amount
Mortgage or rent	$_____
Car loan payment(s)	$_____
Credit card payment(s)	$_____
Student loan payment(s)	$_____
Other payments	$_____
TOTAL MONTHLY DEBT:	$_____

Gross Monthly Income	Amount
Your salary	$_____
Spouse or partner's salary	$_____
Interest/dividends	$_____
Other income	$_____
TOTAL MONTHLY INCOME:	$_____

Your Debt-to-income ratio:

Minimum monthly debt payments $_____ ÷ monthly income $_____ = _____ percent

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