

Managing Debt and Credit

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Credit was once defined as "Man's Confidence in Man." But in fact, the definition of credit today is more like "Man's Confidence in Himself." Using credit today means you have confidence in your future ability to pay that debt. Forty years ago, your parents may have paid cash for their homes and their cars, a largely unheard-of event today. If they borrowed money at all, chances are it was from a relative or friend, and not a financial institution.

Today debt and instant credit are part of our everyday lives. The convenience of instant credit, however, has taken its toll. Many individuals use credit cards to spend more than they earn, and a few of these people actually build themselves a debt prison from which some never emerge. On the other hand, those who never use credit can be denied a loan or credit when they have a justifiable need or use for it. Using credit establishes a history of financial responsibility: Until you establish a credit history, your chances of qualifying for an important loan, such as a mortgage, are greatly reduced.

What is the balance between using credit wisely and staying out of overwhelming debt? Let's look at the facts and some pros and cons.

Installment Debt

Debt comes in many forms, and most types help us in our daily lives -- when used responsibly. Most people cannot buy a home without some financial help, and many cannot buy a car (especially a new one) without some sort of financing. The money borrowed to purchase large-ticket items is called installment debt: The debtor pays a portion of the total at regular intervals over a specified period of time. At the end of that time period, the loan with interest is paid off.

Installment debt allows you to purchase items at a competitive interest rate: for example, 4% to 7% for a 30-year home mortgage and 7% to 9% for a car loan. The loan is paid back on an amortizing schedule, monthly payments of a fixed amount that remain constant over the life of the loan. At first, most of the monthly payment consists of interest. In later years, principal begins to be paid down.

Installment debt is easily budgeted and the debt is eliminated on a predetermined date. Even for those who may actually have the cash to purchase the desired item, installment debt can make financial sense if you can earn a higher return (after taxes) on your investment of cash than you must pay on your installment debt.

Revolving Credit

A revolving line of credit, also called "open-ended credit," is made available to you for use at any time. Examples of revolving credit are credit cards such as Visa, Mastercard, and department store cards. When you apply for one of these cards, you receive a credit limit based on your credit payment history and income. When you use the credit line, you must make monthly minimum payments based on the total balance outstanding that month. Some lines of credit will also have an annual account fee.

While revolving credit is a convenient way to borrow, it can also become an endless pit of minimum payments that barely cover the interest due. Many cards charge annual rates of interest of 18% or higher. As you pay off your debt, the minimum payment is also reduced, thus extending your payoff period and, consequently, the interest you pay. Paying just the minimum due on a \$2,000 credit card loan could mean making monthly interest payments for 10 or more years!

Revolving credit, in addition to being convenient, eliminates the need to carry a lot of cash and can help establish you as a creditworthy risk for future loans. The itemized monthly statements also can help you track your expenses. But some people can easily yield to the temptation that the convenience of credit cards offers. Impulse buying, failing to compare costs, and purchasing large items you can't afford are all downfalls brought on by always available purchasing power. Spending more than you earn in any given period is a dangerous practice at best, but doing it over an extended period of time can be financial suicide.

Installment Debt vs. Revolving Debt

Lower interest rates and an amortizing repayment schedule can make installment debt a much cheaper alternative to revolving credit.

	Installment	Revolving
Beginning Balance	\$2,500	\$2,500
Interest Rate	10%	18.5%
Years to Repay	4	30*
Interest Cost	\$544	\$6,500

*Paying 2% minimum monthly payment.

Sources and Costs of Debt

Source	Type of Debt	Cost
Banks and Credit Unions	Personal, secured	Low
	Personal, unsecured	Moderate
	Mortgage	Low
	Credit Card	Low to High
Mortgage Companies	Mortgage	Low
Department Stores	Revolving	High
Insurance Companies	Personal, unsecured	High

Using Credit Wisely

To use credit intelligently, start by examining the terms of the card(s) you are currently using. Keeping track of your cards, their rates, and your current balances will help you to be aware of how you use credit cards. Increased competition in recent years has led some credit card companies to offer enticing features to attract new cardholders, including no annual fees and low interest rates for an introductory period. (And credit card companies sometimes will give their introductory rates to existing cardholders so that they won't transfer their balances to another credit card company.)

Eliminating Credit Card Debt

If you think you may have too much credit card debt, begin to address it by honestly evaluating your spending habits. Examine your existing expenses to analyze how your money is spent. You will most likely be able to identify the problem areas where you are more likely to spend too much or too readily with credit cards. Then, based on your current spending practices, create a realistic budget to pay off your credit card debt in the shortest time possible while not adding any more debt to it. For assistance, you may want to turn to your financial advisor, who can help you to allocate your resources wisely to address your credit card debt.

The Role of Debt

Today, carrying installment debt is almost a fact of life. Mortgages, car loans, or small-business loans (to name a few) are part of almost everyone's life. On the other hand, carrying credit card debt is usually not a good idea. At interest rates of 16% and up, it's hard to justify keeping savings that could pay off that 18% department-store credit card in the bank at 2%.

Debt and credit play increasingly important roles in our lives. As the aging Baby Boomers get closer to their peak earning years, many are realizing the need to reduce debt and increase savings. Even though analyzing your spending habits and creating a budget to address your debt may seem a little overwhelming, the simplicity of the philosophy of the Depression era still stands: Never spend more than you earn. Once you have come to grips with this basic fact, managing your debt will become far easier and more rewarding.

Points to Remember

1. Installment debt means the loan is paid off in a specified period of time by making predetermined payments periodically.
2. Revolving credit is a line of credit that is instantly available through use of a credit card (and sometimes a check).
3. As you pay down your debt in a revolving line of credit, the minimum payment is also reduced, thus extending your payoff period and, consequently, the interest you pay.
4. Spending more than you earn in any given period is a dangerous practice at best, but doing it over an extended period of time can be financial suicide.

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