Money and You: Good debt, bad debt

by Carrie_Schwab_Pomerantz

Personal debt has been grabbing the headlines - and there is no shortage of cautionary tales. I must admit, in general, I am not a fan of debt. Interest payments are expensive, along with late fees and penalties if you don't pay on time. Easy access to credit prompts many people to spend beyond their means. And every dollar you spend on interest is another dollar you can't save and invest.

But some debt is inevitable and even useful when used judiciously. Most people simply could never buy substantial assets like houses and cars without taking on debt (just as most businesses can't grow without access to credit). The trick is to learn the difference between good debt and bad debt - borrowing wisely - and to manage your debt prudently.

GOOD DEBT

Good debt means inexpensive debt, and inexpensive debt is typically backed by collateral: A home or a second home, for example, along with a home equity line of credit (HELOC). The fact that most interest payments for home-related loans are tax-deductible only adds to their attractiveness. You can deduct the interest on a home or second home loan as large as $1 million (combined). For a second mortgage or HELOC, you can deduct interest up to $100,000. As always, tax issues can be complicated by your personal situation, so consult your tax adviser if you're unsure about tax deductibility.

The caution, as we've seen played out in virtually every city across the country, is not to take on more mortgage debt that you can comfortably repay, and to fully understand the terms of your loan before you sign on the dotted line.

BAD DEBT

Consumer credit, particularly credit cards, is the poster child for bad debt; it's often extremely expensive and, for some, extremely addictive. As I write this article, the national average credit card interest rate, according to IndexCreditCards.com, is just under 14 percent - that's almost three times the average home mortgage rate and just about twice the average HELOC rate. And individual store credit cards are typically higher still. I just took a look at one of my store cards, which charges a whopping 21 percent on balances. I never keep a balance on it.

This does not mean you should avoid using credit cards. They're essential for many purchases and easier to use than checks. Having and using credit wisely (paying promptly) will help build your credit rating. Plus, many cards now offer pretty valuable rewards: points, airline miles, buyer protection, or even cash back. But don't maintain a balance unless you positively must.

Let's take a simple example. You have a mainstream credit card with a balance of $1,000 that charges you 14 percent, and you pay the minimum of $25 per month. It will take you about 55 months - that's more than 4.5 years - to pay off that $1,000 debt, and you will pay $364 in interest charges. Don't miss a payment: You could pay substantial late fees and may see your interest rate rise dramatically. If lesson No. 1 is to avoid balances, then lesson No. 2 is to understand the terms and conditions of your card.

MANAGING YOUR DEBT

The first step in managing debt is to determine how much debt you can really afford. There's a commonly used guideline called the 28/36 rule: No more than 28 percent of your pretax household income should go to servicing home debt. This includes principal and interest costs, your mortgage payment, plus property taxes and insurance. And no more than 36 percent of your pretax household income should go to all debt: your home debt plus credit card debt and auto loans. Consider yourself in great shape if your total debt burden is less than 30 percent of your pretax income; you're in OK shape if it falls between 30 percent and 36 percent. Between 36 percent and 40 percent is borderline. And if your debt burden is more than 40 percent of your pretax income, your financial situation may be precarious.

If you're "borderline" or "precarious," your first priority should be to reduce your level of debt. Pay off credit cards first, starting with those bearing the highest rates. Consider consolidating credit card debt using your HELOC if you have one. If you don't, consider opening a HELOC if you own a home. Be extra careful about missing payments. If you simply have no choice in the matter, call the credit card company and work out a plan. And, obviously, don't take on any new debt.

There are, of course, other kinds of debt. Auto loans, for example, are essential for many people, and while they're not deductible, they usually feature relatively low rates for people with good credit histories. Student loan interest rates are also relatively low, and pursuing higher education can be a great investment in your future. In addition, some student loan interest is tax-deductible depending on your income level.

Debt is a part of life, and few of us can live without it. So rather than shun debt altogether, the key is to learn how to use it most effectively.

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