

MONEY MANAGEMENT

Questions & Answers about Credit & Debt

Questions that you might have about credit include:

- ◆ Can I afford more debt?
- ◆ When can I afford more debt?
- ◆ Should I consolidate my loan?
- ◆ What will happen to me if I don't pay my bills?

Following are guidelines to help you answer these questions. Case studies are used to explain the answers.

Can I Afford More Debt?

You want to buy a washing machine, but you don't have the cash to pay for it. Can you afford to borrow the money to buy it? How do you decide if you can afford to borrow now or if you should wait until later to buy? Here are some guidelines to help you find out if you can afford to borrow the money.

Use the 20 percent rule as your general rule of thumb. Your total debt (except for your home mortgage) should not exceed 20 percent of your annual after-tax income.

For example, if you bring home \$2,500 a month, you can afford credit payments of \$500 a month according to the 20 percent rule. If your loans and credit card payments excel that \$500 mark, you will probably begin to feel yourself in a financial pinch.

How much credit can I afford?

1. Your monthly take-home pay \$ _____
2. Multiply by 20 percent \$ _____
3. Maximum acceptable debt limit. \$ _____
4. Your present monthly debt obligation: \$ _____

Write down how much money you bring home monthly. If you receive one check a month, write down the amount of money you have to spend. If you receive two checks a month, add the amount of those checks together for your monthly total. If you receive weekly pay checks, add the four checks together for your monthly total.

Once you have your monthly take-home pay total, multiply that by .20 to come up with your maximum acceptable debt limit.

Then compare this figure to your present monthly debt obligations. Here is what the numbers indicate:

If your present monthly obligations are **greater than** your maximum acceptable debt limit, you cannot afford the washing machine.

If your present monthly debt obligations are equal to your maximum acceptable debt limit, you cannot afford the washing machine.

If your present total monthly debt obligations are less than the maximum acceptable debt limit, you may be able to afford the washing machine if the monthly payment does not push you over your limit.

Case Study: Tom

Tom is single and works as a custodian. He earns \$1,800.00 a month and owes the following debts:

Debt	Total Owed	Monthly Payment
Bank card 1	\$ 1,876	\$ 76
Finance company	980	40
Bank card 2	886	36
Department store	432	20
Car payment	7,560	225
TOTAL	\$11,734	\$397

How much credit can Tom afford? First, apply the 20 percent rule to Tom's monthly income.

Tom's monthly take-home-pay	\$1,800.00
Multiply by 20 percent	.20
Maximum acceptable debt limit	\$360.00
Toms present monthly debt obligations	\$397.00

With Tom's monthly take-home pay, he can afford \$360 worth of credit, but he has overextended himself to \$397 worth of credit payments a month. The \$397 monthly debt obligation is a comfortable credit range for a person earning \$1,985 a month ($397 \div .20 = \$1,985$; $\$1,985 \times .20 = \397). No wonder Tom feels the financial pinch. He is trying to pay back debts that are affordable on a \$1,985-a-month income when he earns only \$1,800.

When Can I Afford More Debt?

You can afford more debt when your minimum monthly credit payments do not take more than 20 percent of your income. If you want to borrow money, you may have to set up a timetable to help you decide when you will be able to borrow more money. Here are some guidelines:

1. Write down your monthly take-home pay \$ _____
2. Write down your total monthly expenses. \$ _____
3. Write down how much you owe monthly for loan payments excluding your home mortgage. \$ _____
4. Subtract your loan payment (3) and expenses (2) FROM YOUR TAKE-HOME PAY (1). This difference is the amount that you have left to spend as you wish during the month. This is sometimes called discretionary spending money. \$ _____

If you are already in debt up to the maximum acceptable debt limit according to the 20 percent rule, here are your options for deciding when you can afford to borrow more money. You can borrow the money now if you are willing to cut back in other spending areas. However, stretching your credit budget can put you in a financial bind. Going beyond the 20 percent rule means less spending in your food, clothing, transportation or personal budget. Remember, you are increasing your out-go—what are you willing to sacrifice to make the debt payment?

You can wait to borrow until your take-home pay increases. Or you can wait to borrow until you pay off some of the debts you already owe.

Case Study: Mary & John

Since her recent marriage to John, Mary has been going to a nearby Laundromat to do their weekly laundry. This routine is driving Mary crazy. So, she is encouraging John to agree to buy a washer and dryer since their new apartment has washer and dryer connections. They do not have the cash to pay for the new appliances. When can they afford to buy? How much can they afford to borrow?

Look at some background information first. John is employed for a local manufacturer and brings home \$2,600 a month. Mary is a secretary and brings home \$1,800 a month. Their combined monthly take-home pay is \$4,400. Their present monthly expenses are listed in Table 1.

Table 1. Monthly expenses for John and Mary

Spending category	Dollar amount	Percent of take-home pay (%)
Housing	\$1,012	23
Food	792	18
Transportation	352	8
Medical	396	9
Insurance	308	7
Savings	176	4
Contributions	440	10
TOTAL	\$3,476	79

$$\frac{\$3,476}{\$4,400} = .79 \times 100 = 79\%$$

John and Mary's present debt obligations are listed in Table 2.

Table 2. Present debt obligations.

Debt	Total owed	Minimum monthly payment	No. of monthly payments left	Date paid in full
Car note	\$8,845	\$491	19	1 year, 8 months
Finance company	364	40	11	11 months
Dept. store 1	939	156	7	7 months
Dept. store 2	218	40	6	6 months
Bank card 1	557	185	4	4 months
TOTAL	\$10,923	\$912		

Table 3. Calendar of when debts are due. (Assume that this is June.)

Month	Minimum monthly payment due
July–October	$\$491 + 40 + 156 + 40 + 185 = \912
Nov–December	$\$491 + 40 + 156 + 40 = \727
January (seven months from now)	$\$491 + 40 + 156 = \687
Feb–June (11 months from now)	$\$491 + 40 = \531
July–Feb (1 year, 8 months from now)	\$491

By using the 20 percent rule, John and Mary are already stretching their budget with debt obligations. Since they really can't afford to borrow now, when can they afford to borrow? We will use the guidelines listed earlier to decide when they can afford to buy the washer and dryer.

1. Monthly take-home-pay	\$4,400.00
2. Subtract total monthly expenses	3,476.00
3. Subtract monthly loan payments	912.00
4. Discretionary spending money	12.00

John and Mary have \$12 left uncommitted each month. That is why Mary had to go into her savings account to buy groceries the other day. One thing is for sure: They cannot afford to buy a washer and dryer now. They need to devise a plan. They need to pay off some of their debts and cut back on their daily living expenses.

In the last column of Table 2, we see a list of when each debt payment will be completely paid off. Table 3 shows when each debt is paid off. After October, the minimum monthly payments will be reduced to \$727 a month. After December, the minimum monthly payments will be reduced to \$687 a month. By February, the monthly debt payments will be \$531. By July next year, the payments will be \$491.

Using the 20 percent rule, John and Mary can afford \$880 worth of credit ($\$4,400 \times .20 = \880). By November they will only owe \$727 in minimum payments. Using the 20 percent rule, they can afford 153 more debt ($\$880 - \$727 = \$153$).

John and Mary now know how much credit they can afford. They know when they can afford to borrow more money. Their next step is to shop around for the best buy on a washer and dryer. They also need to shop around for the best buy on a loan to finance the washer and dryer.

Should I Consolidate My Loans?

If your monthly debt payments are overwhelming you, loan consolidation may seem like an easy solution. But before you rush out to consolidate, ask yourself a few questions.

1. What is the total of the debt obligations I want to consolidate? List each debt and the total amount you owe for each debt. (See the example in Table 5.)
2. Beside each debt, write down the amount of your monthly payment (Table 5.)
3. Next, figure out how many payments you have left for each debt (Table 5).
4. Finally, write down the month and year when you expect to pay off each debt (Table 5).
5. Make a chart of the above information so you can get a visual picture of your debts (Table 7).

6. Contact a minimum of three lending institutions to compare the costs of borrowing. Ask the following questions when comparison shopping for the consolidation (Table 6).
 - ◆ What is the annual percentage rate?
 - ◆ What is the total cost of the loan in dollars?
 - ◆ How long will it take to pay back the loan?
 - ◆ What are the number, amounts, and due dates of payments?
7. Select the loan that is the best buy and compare it to your situation. Put the figures together on a chart so you can visualize whether you should consolidate or make the payments without consolidating. Look at the cost of consolidating and not consolidating; then ask yourself these questions:
 - ◆ If I consolidate, what will my monthly payment be and for how long?
 - ◆ If I don't consolidate, what will my monthly payment be and for how long?

Let's look at a case study and apply the guidelines for deciding whether to consolidate.

Case Study: Susie

Susie brings home \$2,853 a month from her job as a county employee. Her rent is \$725 a month and her loan obligations are \$1,070. She owes the following debts.

Table 4. Susie's debts.

Debt	Monthly payment	Number of payments to be paid	Total owed
Bank card 1	\$149	26	\$3,188
Loan 1	120	25	2,402
Bank card 2	109	13	1,303
Department store 2	35	4	109
Bank loan (car)	657	52	27,518
TOTAL	\$1,070		\$34,520

Her monthly loan payments of \$1,070 make up 38 percent of her paycheck.

$$\frac{1,070}{2,853} = .375 \times 100\% = 38\%$$

Susie is wondering if she could consolidate her bank card 1, loan 1, and bank card 2 so her monthly payments will be lower than \$378 (\$149 + 120 + 109 = \$378). Should she consolidate or not?

First, Susie needs to make a table and include the following items describing the loans she wishes to consolidate (see Table 5):

- ◆ Her creditor's name
- ◆ Amount of monthly payment
- ◆ Number of payments left to be paid
- ◆ Total dollars owed to creditor
- ◆ Date paid in full

Next, she needs to shop around to decide how much it would cost for her to consolidate the three loans. Table 6 illustrates the cost of loan consolidation at three different financial institutions.

Now she needs to decide what alternative is the best for repaying the debt. If she chooses to pay off her debts without consolidating, she will pay back \$378 for 13 months, \$269 for the next 12 months, and finally \$149. This assumes that she does not borrow any more money. In 26 months, she will have repaid \$8,291 (Table 7).

If she consolidates by borrowing from bank 1, she will pay \$357 each month for 23 months and end up paying a total of \$90 less than if she had not consolidated. Consolidation will lower her monthly payment \$21 for 23 months. In the twenty-fourth month she would pay nothing if she consolidated and \$269 if she did not consolidate. Table 7 shows how much Susie will have to pay if she chooses to consolidate and if she chooses not to consolidate. Consolidation loans from three different institutions are shown.

Table 5. Debts to consolidate.

Creditor	Monthly payments	No. of payments	Total owed	Date paid in full
Bank card 1	\$149	26	\$3,188	Sep (year 3)
Loan 1	120	25	2,402	Aug (year 3)
Bank card 2	109	13	1,303	Aug (year 2)
TOTAL	\$378		\$6,893	

Table 6. Loan consolidation options for a \$6,893 loan.

Institution	APR (%)	Monthly payment	No. of months	Total owed	Cost to borrow
Bank 1	18	\$357	23	\$8,201	\$1,308
Finance company 1	29	219	60	13,128	6,235
Finance company 2	25	274	36	\$9,866	\$2,973

Table 7. Should Susie consolidate her loans?

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct	Nov	Dec	Total paid
Current Year													
Cost if not consolidated							378*	378	378	378	378	378	
Cost if consolidated							357	357	357	357	357	357	
Year 2													
Cost if not consolidated	378	378	378	378	378	378	378	269**	269	269	269	269	
Cost if consolidated	357	357	357	357	357	357	357	357	357	357	357	357	
Year 3													
Cost if not consolidated	269	269	269	269	269	269	269	149					8,291
Cost if consolidated	357	357	357	357	357								8,201

$$\$8,291 - 8,201 = \$90$$

*\$378=\$149+ 120 + 109; to be paid for 13 months until Bankcard 2 is paid off.

** \$269 = \$149 + 120; to be paid for next 12 months until Loan 1 is paid off.

*** \$149 = amount left to be paid the last month.

What Will Happen If I Don't Pay My Bills On Time?

When you borrow money from a financial institution, you sign a contract promising to repay the debt. What happens when you fail to make those payments on time?

Creditors vary on the exact time they start taking action against late payments. Some creditors send you a notice of late payment if you are 10 days late. Others don't send late notices until you are 30 days late.

If you are 60 days behind, you will receive another request for payment. At the end of 60 days, some creditors will turn the debt over to an attorney or collection agency for them to collect the late payment. Some creditors have their own in-house representative collect debts.

At the end of 75 to 90 days, if the debt has not been turned over to a collection agency or attorney, expect a personal visit from your creditor. If a creditor turns your account over to an attorney, expect an additional cost of 15 percent in attorney fees.

After 90 days, if the debt has not been collected, you can expect some type of court action by the creditor. The creditor will file a suit in small claims court, magistrate court or state court in an effort to get the court to make you pay your bills. The court's decision is called a judgment.

If the court rules in the creditor's favor, you can expect your wages to be garnished or your assets to be attached. Your savings or checking account can be seized. Your personal property can be seized and sold. If the court says your wages can be garnished,

the creditor notifies your employer of the garnishment action and about 25 percent of your wages are sent to the creditor unless this amount would leave you with a paycheck of less than 30 times the federal minimum wage; then no more can be taken than the amount of money which exceeds the federal minimum wage. This rule does not apply to garnishing money for alimony or for support of a dependent. A creditor can also legally take the assets from your checking or savings account equal up to the value of the court judgment.

After 120 days, the creditor can file a formal foreclosure in court and repossess the property. This action is taken if you are unemployed, self-employed or the money can't be collected in any other way. If the court rules in favor of the creditor, the collateral is repossessed. This means you lose the car, truck, appliance or other item for which you borrowed the money.

The creditor sells the collateral, which usually does not sell for the amount you still owe on it. If the creditor does not sell the item for enough money to pay off the loan, she or he will file another suit for a deficiency judgment to make up the difference between what was owed and the sale price of the item.

For example, if you borrowed \$2,000 to buy a stereo and it is sold for \$1,000, you would be sued for the remaining \$1,000. If you fail to pay the amount of deficiency judgment, your wages are garnished or the creditor seizes your checking or savings account for the amount of judgment.

Do not ignore the suit. Contact an attorney immediately. If you fail to file an answer to the suit and fail to appear in court, the creditor will win his suit by default. If you appear in court, you can possibly work out an acceptable plan with the creditor. If you don't appear in court you cannot defend yourself against the creditor's claim.

Adapted from “Money Management: Questions & Answers about Credit & Debt” by Esther McAfee Maddux,
Extension Home Economist, University of Georgia Cooperative Extension Service.

Approved for use in Kentucky by Suzanne Badenhop, Family Resource Management Specialist.

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