8. Debt: Avoiding Debt Like the Plague

Introduction

Attitudes toward debt have fluctuated dramatically over the last 50 years. Many who lived through the 1930s vowed never to go into debt again. Yet gradually people grew to see debt as a tool to obtain what they wanted now. In the late nineties in particular, the stock market's upward trend encouraged consumers to acquire significant additional debt. Then, when the economy faltered, people realized once again we live in a time of great economic uncertainty. The decline in the stock market and the slowing economy during those years led to a major increase in bankruptcies throughout the United States.

Advertising has been instrumental in promoting the view of debt as a tool, "Get what you want," the advertisements say. "Get it now, and pay only $80 a month!" "Buy a car with zero down and make no payments for the next 12 months!" Get what you want now and pay it off over the next 15 years. Someone said "we borrow money we don't have, to buy things we don't need, to impress people who don't care."[1] Will Rogers summarized the current condition of our nation by saying, "We'll show the world we are prosperous, even if we have to go broke to do it."[2]

People comment on how difficult it is to pay back loans. What they don't realize is for every dollar borrowed, they must earn more than a dollar to pay it back. We are not consistent in our thinking. With debt, we are borrowing an after-tax amount. However, to pay it back, we must earn a before-tax amount. That difference can be significant depending on your taxes, contributions and savings.

Objectives

Once you have completed this chapter, you should be able to do the following:

A. Understand our leader's counsel on debt.
B. Understand the principles of using debt wisely.
C. Understand how to develop and use debt-reduction strategies.
D. Understand plans and strategies for debt reduction.

Understand our Leader's Counsel on Debt

We have been counseled for 6,000 years to "Pay thy debt and live."[3] Debt is a form of bondage, limiting both temporal and spiritual freedom. J. Reuben Clark reminded us:

> It is a rule of our financial and economic life in all the world that interest is to be paid on borrowed money. . . Interest never sleeps nor sickens nor dies; it never goes to the

> hospital; . . it never visits nor travels; it is never laid off work; it never works on reduced hours; it never pays taxes; it buys no food, it wears no clothes. . . Once in debt, interest is your constant companion every minute of the day and night; you cannot shun it or slip away from it; you cannot dismiss it;. . .and whenever you get in its way or cross its course or fail to meet its demands it crushes you. So much for the interest we pay. Whoever borrows should understand what interest is, it is with them every minute of the day and night.[4]

To help people avoid this bondage, Joseph F. Smith advised, “Get out of debt and keep out of debt, and then you will be financially as well as spiritually free.”[5]

More recently, James E. Faust stated: “Over the years the wise counsel of our leaders has been to avoid debt except for the purchase of a home or to pay for an education. I have not heard any of the prophets change this counsel.”[6]

Some might argue that their financial situation has nothing to do with their spirituality. Marion G. Romney pointed out that self-reliance is essential for spiritual growth to continue. He said:

> Independence and self-reliance are critical keys to our spiritual growth. Whenever we get into a situation which threatens our self-reliance, we will find our freedom threatened as well. If we increase our dependence, we will find an immediate decrease in our freedom to act.[7]

When we are in debt, our freedom to act and our ability to grow spiritually are reduced. Staying out of debt is not just a temporal commandment, as some suppose; it is also a spiritual commandment as well.

Debt is necessary at times when people may need to borrow for some goals that might otherwise be impossible to achieve. Such goals may include gaining an education and purchasing a modest home. Purchasing a second car or a new wardrobe on credit, however, may not be appropriate. Gordon B. Hinckley counseled, “Reasonable debt for the purchase of an affordable home and perhaps for a few other necessary things is acceptable. But from where I sit, I see in a very vivid way the terrible tragedies of many who have unwisely borrowed for things they really do not need.”[8]

When going into debt for a home or an education, you should use prayer and wisdom to make good decisions about the amount of money you borrow and the type of loans you take out. If you do go into debt, you should pay your debt off as soon as you can.

Another type of debt that may be necessary is business debt. While we will not cover this in detail, we include some cautions from N. Eldon Tanner regarding business debt:

> Investment debt should be fully secured so as to not encumber a family’s security. Don’t invest in speculative ventures. The spirit of speculation can become intoxicating. Many

> fortunes have been wiped out by the uncontrolled appetite to accumulate more and more. Let us learn from the sorrow of the past and avoid enslaving our time, energy, and general health to a gluttonous appetite to acquire increased material goods.[9]

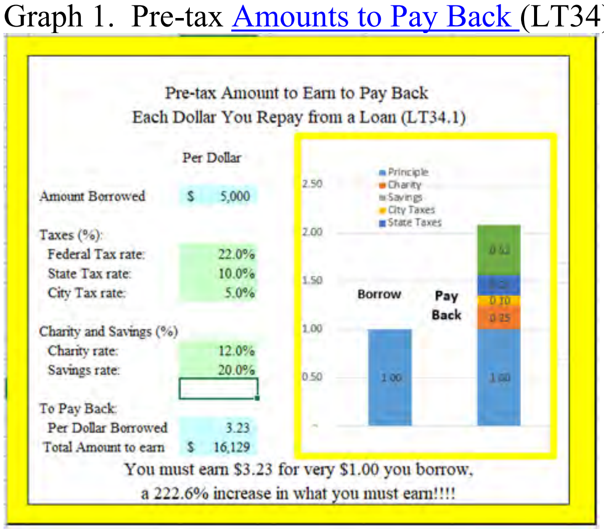
It may be acceptable to incur debt to undertake a business endeavor if (1) the debt does not jeopardize the personal or family finances of the business owners or managers, (2) the debt is used for a valid business purpose or investment opportunity, (3) speculative ventures and consumption under the guise of investment should be avoided. Using debt to finance a speculative venture magnifies the risk of the investment. And (4) business debt must be incurred with full commitment to repay the money. Failure to repay any debt—including business debt—is a form of dishonesty. Keeping these principles in mind will help us determine when debt may or may not be appropriate for a business investment.

Why is Repaying Debt So Hard

Most in debt find it difficult to pay it back. That is because when we borrow money, we are borrowing an after-tax amount, and to pay the debt back, we must earn a before-tax amount. The difference is significant.

For example, let's say you borrowed $1. In order to pay that dollar back, you must not just earn $1, but you must earn enough to pay your taxes, charitable contributions, and any savings you plan. Assuming your federal tax rate was 22%, your state tax of 5%, a city tax of 5%, charity of 12% and you are saving 20%, you would need to earn $3.23 for every dollar you will pay back, and this does not include interest (see Graph 1). For a tool to help you calculate how much you will need to earn, see Amounts to Pay Back (LT34).

Graph 1. Pre-tax Amounts to Pay Back (LT34)



For a $5,000 loan, you must earn $16,129 before tax to pay off the $5,000 debt assuming the percentages above. Borrowing is not cheap.

Understand the Principles of Using Debt Wisely

There are a few important principles of effective loan use. These include:

1. Know yourself. This includes your vision, goals and plans. What is important to you, not just now, but in the future? What do you want to accomplish with your life? What is the vision of what you want you and your family to become? The key is to have the vision of your bigger "yes" in the future so you can say no to the current temptations to spend. "Where there is no vision, the people perish."[10]

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the key areas of debt, and know where you are in your spending and your income. If married, do not hide any liabilities or assets from each other. How much do you owe, and what are your assets? In order to be able to get where you want to go, you must know where you are now. Have a realistic idea of your income, spending, debt and investment progress. Get on your budget and plan for the things you want to accomplish.

4. Set your priorities. Decide now the things you will do and what you will not do? Make those decisions now, so you won't have to re-decide time after time. Strive to learn from your experiences, the experiences of your family, and others. Thankfully, we have the teachings of leaders and scriptures who have given us counsel. Resolve to not go into debt except for a modest home and modest education. Be wise in your expenditures.

5. Finally, pay as you go. You cannot spend yourself into financial security. Live within your means, and do not spend that which you do not have, and follow your goals and decisions.

If you are in debt add, let me add a few points which will be discussed in the next chapter.

6. Prioritize your debts. Which are the most important? Give priority to secured debts for house or car. If the time comes that you cannot pay all your debts, determine which are most important, such as a roof over your head and food and transportation.

7. Develop a debt repayment plan. Automate it and follow it closely. A debt repayment plan is how you will pay back your debts. You must be able to continue to meet your current needs for yourself and your family, and have sufficient to repay the debt when it comes due.

8. Do not take on any new debt. Debt stops growth, both physically and spiritually. Do not add to your debt burden as you strive to pay off your debts.

Finding Balance

As you work on avoiding and eliminating debt, finding balance among doctrines, principles and application is important in helping you become better. Below are a few ideas.

Principles	Doctrines
Know yourself , your vision, goals and budget	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Know where you are financially	Accountability
Use debt only for a modest home and education	Agency
Live within your means	Stewardship
If you are in debt, add:	
Develop a debt repayment plan	Stewardship
Do not take on any new debt	Accountability
Once out of debt, continue paying yourself	Stewardship

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on being wise with our finances and avoiding debt, which is an application. From a higher perspective, or with increased vision,

> We are children of God (identity), striving to live worthy of the Spirit (obedience), showing what we believe by our actions and choosing to delay gratification (accountability). We are taking responsibility for our actions and using our agency (stewardship) to save for things and not borrow, and learning the lessons God would have us learn through distinguishing between our wants and needs (agency) so we can accomplish our individual missions and achieve our individual and family vision and goals.

Understand How to Develop and Use Debt-Reduction Strategies

What if you are already in debt? Is there a process that can help you get out? The good news is that there is. The following process is essential for debt-reduction:

1. Recognize and accept that you have a debt problem.

2. Stop incurring debt. Don't buy anything else on credit. Be especially careful about using home equity to pay down debts until you have your spending under control. Will Rogers commented, "If you find yourself in a hole, stop digging."[11]

3. Make a list of all your bills.

4. Look for many different ways of reducing debt, not just one. Examples might include consolidating balances to a lower interest rate credit card, having a yard sale to earn money to pay down debt, or using savings to reduce debt.

5. Organize a repayment or debt-reduction strategy and follow it.
6. Follow through on the Plan until total debt elimination.

There are three basic types of debt-reduction strategies:

Personal strategies: These are strategies you can use on your own; they include the use spreadsheets and financial management software, such as Quicken, Mint.com, YNAB or Mvelopes, or other programs to help you organize your financial situation so you can make payments to get out of debt.

Counseling strategies: These strategies require outside help and include debt consolidation and debt negotiation strategies from credit counseling agencies.

Legal strategies: These strategies require professional legal help and may consist of declaring bankruptcy.

Personal Strategies

In this chapter, we will focus on personal strategies to help those in debt organize a plan to get out of debt. Even if you are not in debt, it is still helpful to learn these debt-reduction strategies because you will probably know someone who would benefit from these suggestions.

Debt-elimination Calendar: Most expensive debt first. In his article "One for the Money," Marvin J. Ashton discusses his debt-elimination strategy. His logic is that you should organize your debts and pay off your most expensive ones first.

He recommends that you set up a spreadsheet or ledger with a row for every month you will be making payments on your debts and a column for each creditor (see Table 1). You start by paying off the debt with the highest interest rate; this way you are paying off your most expensive debt first, which will save you the most money. Once your most expensive debt is paid off, continue applying the same total amount of money to other lines of credit until all of your debts are paid off. This is the critical point. After you have paid off one debt, you must keep paying the same amount of money but use that additional money to pay off the next most important debt. Then, once you have paid off your all your debts, you can continue paying yourself consistent with your personal and family goals.

Debt-elimination Calendar: Smallest Balance First. Dave Ramsey, in his book The Total Money Makeover (2003), recommends you pay off your smallest balance first. His logic is that as you see your debt decreasing, it will increase your motivation to continue attacking your debt until you get it paid off.

He recommends that you set up a spreadsheet or ledger with a row for every month you will be making payments on your debts and a column for each creditor (see Table 1). You sort the columns by the debt with the smallest balance first, and the next smallest next. As you pay off the smallest balance, you see success quickly and it helps keep you motivated. Once the first debt is paid off, continue applying the same total amount of money to other lines of credit until all of your debts are paid off. This is the critical point. After you have paid off one debt, you must keep paying the same amount of money but use that additional money to pay off the next most important debt. Then, once you have paid off your all your debts, you can continue paying yourself consistent with your personal and family goals.

Table 1: Debt-Elimination Calendar

	Credit Card	Consumer Loan	Dentist	Piano Loan	Auto Loan	Student Loan	Total Payments
Interest Rate	16%	13%	10%	8%	6%	5%	
Amount Owed	$215.68	$533.66	$613.61	$1,399.94	$10,006.37	$7,002.64	$ 19,772
Min. Payment	110	70	50	75	235	120	660
March 20xx	110	70	50	75	235	120	660
April	110	70	50	75	235	120	660
May		180	50	75	235	120	660
June		180	50	75	235	120	660
July		52	178	75	235	120	660
August			230	75	235	120	660
September			30	275	235	120	660
October				305	235	120	660
November				305	235	120	660
December				129	411	120	660
January					540	120	660
February					540	120	660
March 20xx					540	120	660
April					540	120	660
May					540	120	660
June					540	120	660
July					540	120	660
August					540	120	660
September					540	120	660
October					540	120	660
November					540	120	660
December					540	120	660
January					540	120	660
February					167	493	660
March 20xx						660	660
April						660	660
May						660	660
June						660	660
July						245	245

Note that with both highest rate and smallest balance, if you have extra money, you can add an accelerator to your payoff. This can allow you to pay off your debt even faster.

While the "most expensive debt first" framework is better from a "total cost" point of view, both methods have the same objective and both can be helpful in eliminating debt. Debt Elimination Spreadsheet with Accelerator (LT20) on this website is a useful tool for determining which method will repay debts the quickest. With this tool, you have the option to pay down either the highest interest rate or smallest principal first. Most times, the difference is not significant and either method will accomplish the same objective. The key is to act now.

Home equity loans: Exchanging for Secured Debt. You have probably heard radio and TV advertisements for debt consolidation loans. Debt consolidation loans are home equity loans, or loans against the equity in your home. Home equity loans have some benefits: because they are secured loans (credit cards are unsecured loans), they have lower interest rates, which reduces the monthly payment on your debt. In addition, the interest on home equity loans may be tax deductible.

However, there are two drawbacks to this type of loan. First, by taking out a home equity loan, you may not be addressing your real problem: the bad habit of spending money you do not have and living beyond your means. If your spending habits have not changed, your spending will continue even after you take out the home equity loan.

Second, if you take out a home equity loan and do not pay it off, you run the risk of losing not only your credit score but your home as well. Home equity loans put your home at risk because your home is used as collateral for the loan. Experience has shown that over 80 percent of those who take out a home equity loan to pay credit card debt have the same amount of debt they had at the time they took out the loan within three years. No spending changes have occurred, and the people soon find themselves back in debt. As their spending continues, they may now suffer both reductions in their credit ratings and the loss of their homes.

Should you take out a home equity loan to consolidate and pay off your debts? The answer is not straightforward. It's likely that you will get into the same problem again in the near future if you have not changed your spending habits. If you have already addressed the spending problem that got you into debt in the first place, a home equity loan may be a useful option.

If you find yourself too far in debt for personal strategies to work successfully, you have a few choices:

Counseling Strategies

Regarding counseling strategies, you may be able to get help from either nonprofit credit counseling agencies (CCAs), which can help you reduce your monthly interest charges, or for-profit agencies, which can help you consolidate and negotiate your debt. Regardless of your choice, check out the company you select with the Better Business Bureau before you spend any money.

Nonprofit credit counseling agencies. These agencies are set up specifically to help people reduce their credit card debt. These nonprofit agencies have arrangements with many credit card companies, and by working with those credit card companies, you can have your interest payments reduced or even eliminated with specific creditors. The creditors give these nonprofit agencies a rebate that comes from what the creditors are able to collect from you. Creditors are generally willing to work with credit counseling agencies because they would rather get some money back than none at all.

Using these services will cost you about \$15 to \$20 for setup and about \$12 per month after that.

If you work with a credit counseling agency, realize that it will likely show up on your credit reports. However, your goal is to reduce your debt—not to increase it through paying high fees. If you successfully complete the program, your success may be noted on your credit reports as well.

Nonprofit credit counseling agencies can be found by calling the National Foundation for Credit Counseling (1-800-388-2227). The following are a few questions you should ask nonprofit credit counseling agencies before you sign up to work with them:

- Is the agency licensed? (To verify their answer, ask for their tax ID)
- Is the agency a member of the National Foundation of Consumer Credit (NFCC)?
- Is the agency accredited through the Council on Accreditation?
- Are the agency's counselors certified by the NFCC?
- What is the agency's monthly management fee? Is it tax-deductible?
- How long would I be in the program? (It should rarely be longer than five years)
- How much would I be paying on my debts each month? (Payments are usually taken directly from a checking or savings account)
- Will I talk with the same person every time or with many different people?

For-profit credit counseling agencies. These agencies make money by helping people get out of debt. There are two main methods through which they work: debt consolidation and debt negotiation.

Debt consolidation: The goal of this strategy is to consolidate debt into a single loan with a lower interest rate. For-profit agencies make money on *loan-origination charges* and other loan fees as they help homeowners take out an interest-only home loan and use the excess cash that would have gone to pay down principal to pay off debt. Borrowers should realize, however, that interest-only mortgages have an interest-only option for a specific period, i.e., one to seven years. After the interest-only period, the loan becomes fully amortizing and the loan principal must be repaid in a shorter amount of time, increasing monthly payments.

Debt negotiation: Debt negotiators work with creditors to reduce the interest rate and principal on certain types of loans, especially credit card loans. Initially, the consumer makes monthly payments to the debt management company, which may hold those payments until the consumer's accounts are long overdue. At this point, the debt management company attempts to negotiate with the creditors to reduce the consumer's interest rate and principal. They are sometimes able to significantly reduce the amount owed; however, help from these companies is not cheap. They typically charge a two-month retainer fee up front to work with your creditors. In addition, should this strategy backfire, you may have many months of nonpayment history on your credit report even though you made monthly payments as required to the for-profit credit counseling agency.

Before you begin working with a for-profit credit counseling agency, be sure you understand how the agency makes money. If it doesn't make sense to you, go with another company. The following are a few questions you should ask for-profit credit counseling agencies before you sign up to work with them:

- What types of loans will the agency help consolidate or negotiate?
- How much will the agency's services cost?
- How does the agency get paid? Who pays the agency?
- When does the agency get paid?
- What is the monthly fee? Is it tax deductible?
- How long would I be in their program? (It should never be longer than five years)
- How much would I be paying on my debts each month? (Payments are usually taken directly from a checking or savings account)
- Will I talk with the same person every time or with many different people?

There are benefits to using these types of programs. First, these companies may be able to significantly reduce the interest charges and even the principal of some types of debt. Second, they may be able to help you out of extreme debt if you follow through with them.

There are also drawbacks to working with these organizations. Most importantly, they are very expensive, and there is no guarantee they will be able to help. In addition, these organizations are established mainly to make money, which means you will pay much more for their help than you will pay for the help of nonprofit credit counseling agencies. Remember, these companies stop making payments before they begin to negotiate, so working with them may have a significant negative impact on your credit reports. Watch for the following warning signs, and go elsewhere for help if you notice any of them:

- High, up-front or "voluntary" fees
- Vague contracts that do not explain fees
- Promises that sound too good to be true (for example, a promise that creditors will cut the principal owed by 50 percent)
- Fees for just distributing payments to creditors
- Pressure to sign up for debt-repayment services immediately before fees are disclosed
- Fees for phone consultations

Remember, you are working with your money. Use it wisely, and find a program that can help you resolve your debt issues in a consistent, logical way and within a reasonable time frame.

Legal Strategies—Bankruptcy

Legal help should be your last resort; however, if there is no possible way that you can repay your debts, you may want to consider this option. There are two major types of bankruptcy: Chapter 7 and Chapter 13.

Chapter 7. If you declare *Chapter 7 bankruptcy,* your assets will be liquidated and used to pay creditors according to procedures outlined in the Bankruptcy Code. This is the quickest, simplest, and most frequently selected type of bankruptcy. Under Chapter 7 bankruptcy, certain debts cannot be waived, including child support, student loans, and drunk driving fines.

Chapter 13. If you declare *Chapter 13 bankruptcy,* a repayment plan is set up in which the court binds both you and your creditors to set terms of repayment. You retain your property and make regular payments with future income to a trustee, who pays creditors slowly over the life of the bankruptcy plan.

Research on bankruptcy has shown some interesting trends. The majority of bankruptcies are caused by loss of relationships (divorce, death, or separation); unpaid medical expenses; and loss of the primary source of employment. You can substantially reduce your risk of these events by further developing your relationships, obtaining life and health insurance and continuing your education.

Unfortunately, some have come to see bankruptcy as a way of getting out of paying the obligations they can honestly pay on their own. If you are considering bankruptcy, ask yourself the following questions:

- Is it honest, or is it just a way to get out of debt legally? Remember, things that are legal may not necessarily be honest.
- Is your integrity worth more than money?
- Is it really necessary to declare bankruptcy?

A bankruptcy filing will remain on your credit reports for up to 10 years after you make your last payment. This will hurt your chances of getting the credit necessary to purchase a home or a business. Filing bankruptcy should not be taken lightly; it should be your last resort.

Understand Plans and Strategies for Debt Reduction

If you are out of debt, we are pleased. It is not an easy thing to get and stay out of debt. But it is important. If so, your Consumer Loans and Debt Plan will be short.

For those in debt, your Debt Reduction Plan and Strategies are part of your Consumer Loan and Debt Plan. For your Plan, continue from what you did with your Credit Plan previously on credit, and add your views on debt. Then add you're your debt reduction plans and strategies that may be helpful. Start with your views on debt. What is the place of debt in your life?

Plans and Strategies – Debt
Overall

- I will keep an emergency fund of 3-6 months at all times. When I use these, I will repay them in 6 months

- I will avoid debt except for a home and education, and will pay off my home by age 45
- I will pay cash for all transportation purchases and toys
- I may need to borrow for my first car. If so, I will pay it off within 3 years and pay cash for all future vehicles
- I will save money for my children's education and missions by saving $20 per child per month so I will not need to go into debt for these things
- I will save 20% of my income and will invest wisely. I will get the company match, save 15% of my income for retirement. And not borrow against my 401k

Debt Reduction

- Once school is out, put enough in the company 401k for the match, then save 20% minimum to build our emergency fund.
- After that, use 20-30% of income to pay off debt as quickly as possible paying the highest interest rate first (LT20). Once debt is paid off, continue to pay 20% into savings
- Continue to live like a student after college, build my emergency fund, then pay 20%+ each month against my debt using the debt snowball method until debt is all gone. After that, I will then keep paying myself 20% into saving and investing.

One-off Debt Reduction Strategies

- Bump up your debt repayment percentage. Pay more than the minimum balance, and use 30-50% of income to get out of debt.
- Negotiate a lower interest rate. Call the credit card company and request a lower interest rate which can reduce your interest costs. If they will not do this, move your balances to another card that has a lower interest rate (but make sure transfer fees are low)
- Use savings to pay down debt after you have your Emergency Fund
- Use any salary increase to pay down debt. Live at your previous salary and use increases to pay debt
- Use your tax refund check entirely to pay down debt.
- If possible, exchange consumer debt for mortgage debt. If you have equity in your home and you have changed your spending habits, use your equity to pay down debt.
- Sell assets. Have a yard sale and sell those things you probably should not have bought in the first place to reduce your debt.

Summary

You have studied what the scriptures and other leaders have said concerning debt. Avoiding debt is important for both our temporal and spiritual well-being and growth. Debt stops growth, both temporal and spiritual.

We discussed different personal strategies for debt-reduction as well as counseling and legal strategies for debt-reduction. Personal strategies include using debt-reduction spreadsheets and payoff accelerators. We talked about counseling strategies in terms of both nonprofit and for-profit credit counseling agencies. Finally, we talked about the legal strategy of bankruptcy, and why it should be filed only as a last resort.

We concluded with ideas for those in debt, of a Debt Reduction Strategy, which is part of your Consumer Loans and Debt Plan. This Plan can be powerful in helping you stay away from and eventually reducing your debt.

Assignments

Financial Plan Assignments

Your assignment is to finish your Consumer Loan and Debt Plan. You have already worked on consumer loans as part of the PFP Loans Template (LT01-08), and now you will add more to the debt and debt reduction portion. Your Consumer Loan and Debt Plan includes four main areas: Consumer Loans, Student Loans, Mortgage Loans, and Debt and Debt Reduction. You will include each of these four areas as you develop your plans for using debt.

If you are in debt, or know others in debt, think through the reasons for that debt. Are there things that could have been done differently or things you could have done without that would have reduced the need for debt?

Review any debt you may have, including consumer, auto, mortgage and student loans. Write out your debt situation for each debt, including the following: creditor, phone number, reason for the loan, principal owed, interest rate, minimum payment, additional costs, fees, and the date by which you expect to have the loan paid off. Once you have written down all your debts, plan how to reduce your debt.

Write down your views on how you will use debt in the future. Will you use it? What type of debt is acceptable? What are your thoughts and what are the reasons you feel the way you do toward both acceptable and unacceptable debt?

If you are in debt, create a Debt Reduction Strategy, and include it as part of your Consumer Loan and Debt Plan.

Learning Tools

The following Learning Tools may also be helpful as you prepare your Personal Financial Plan:

Debt-Elimination Spreadsheet with Accelerator (LT20)
This Excel spreadsheet gives a framework for paying off debt; it encourages you to pay off your debts in order of expense until you have paid off all your debts. You can also choose between paying highest interest or smallest balance first.

Debt Amortization and Prepayment Spreadsheet (LT09)

This Excel spreadsheet gives a debt amortization and prepayment schedule to help you as you reduce and eliminate your debt.

Credit Card Repayment Spreadsheet (LT18)
This Excel spreadsheet gives information on how long it will take to pay off credit cards and other debt.

Review Materials

Terminology Review

Average Daily Balance (ADB). A common way of calculating interest to charge. Computed by adding each day's balance for a billing cycle and then dividing by the number of days in the cycle.
Cash Advance. Using a credit card to obtain cash, such as through an ATM or over the counter at a bank. This is an extremely expensive way to borrow, and carries several pricy fees.
Credit Bureau. Private organizations which maintain credit information on individuals, which it allows subscribers to access for a fee. The three major credit bureaus to know are Equifax, Experian, and Trans Union.
Credit Card. A financial instrument that allows the holder to make purchases through an open line of credit.
Credit Limit. The maximum amount that one can borrow on a single credit card. This amount is often influenced by one's credit score.
Credit Report. Information collected by credit bureaus from subscribers, creditors, public court records, and the consumer.
Credit Score. A numerical evaluation of your credit based on specific criteria determined by the credit scoring company.
Debit Card. Unlike credit cards, debit cards act like a personal check. When used, money is taken straight from the connected account to pay for the purchased item.
FICO Score. This is the most commonly used credit score. It ranges from 300 to 850.
Grace Period. The amount of time given by a credit card company to pay a due balance before interest starts to accrue. Normally 20 to 25 days, excluding cash advances. It does not apply if the card already carries a balance.
Secured Credit Card. Similar to a standard credit card, but is tied to a checking or savings account. The card cannot be used once the money in the account is gone, until more funds are added. Useful for building credit.
Smart Card. Similar to a debit card, but rather than being connected to a certain bank account, they magnetically store a certain amount of money linked to the card itself.
Teaser Rates. Very low introductory interest rates used to attract new customers to a certain credit card. They increase soon after the card is in the user's hands.

Review Questions

1. What are two debts that, according to leaders, are okay to incur?
2. What are principles of avoiding debt and why are they important?
3. What key doctrines, if understood better, would help you avoid debt?

Case Studies

Case Study 1

Data

A family friend has asked you to help one of his children, who is having some financial problems. The son gave you the following information: They have four children, ages three months to 18 years. Their bills include a mortgage of $150,000 at 6 percent, a second mortgage of $20,000 at 7.5 percent (because they were too far in credit card debt), debts to various financial institutions of $10,000 at between 12 percent and 28 percent (she lost her job due to the latest pregnancy), a lease on a new truck of $18,000, a loan on her car for $5,000, and miscellaneous Christmas bills totaling $3,000. After some work using Debt-Elimination Spreadsheet with Accelerator (LT20), you determine that debt payments represent 83 percent of their income for living expenses.

Application

What suggestions do you have to help them get out of debt?

Case Study 1 Answers

The above was a real case that occurred a few years ago. I have included below my suggested process to help (there are likely other ways to help as well).

1. Help them determine what is important to them—their personal vision of where they want to be.
   - I shared with them the importance of perspective and that personal finance is just part of the gospel of Jesus Christ.
   - I share with them doctrines, principles and application, the “why’s”, “whats’” and “how’s” of personal finance and why the Lord wants us to be financially secure.
   - They recognized that they had a debt problem. They were finally sick and tired of being sick and tired.
2. Help them realize where they are financially, and that their habits were not taking them to their goals.
   - I helped them develop a balance sheet for the family.
   - We worked together to determine what assets were available and how much was owed. We developed an income statement and ratios
   - We worked at finding out where the money was going so we could put it to the best use.
   - We put them on a very strict income and expense plan, and we worked on both areas.
3. Determine individual ways of reducing debt, the more the better.

- I had them fill out their income taxes quickly so they could receive their income tax return.
- They borrowed money against their cash-value insurance policy to reduce their debt.
- I had them sell assets that they could do without (i.e., truck, old vehicles, etc.).

4. Help them determine a course of action and debt reduction plan, and committed them to that course.
    - We worked together to make a debt reduction plan, and then we all worked together to follow that plan.
    - I enlisted other people as part of a team approach to help them with talking to creditors and paying off their debts.
    - We met together every week and I held them accountable for their plan.
5. Help them follow through with their plan (until total debt elimination*)
    - We worked together on their debt reduction plan (not our plan) and held them accountable for it
    - We met with them weekly to see how they were doing and to encourage them to stick with the Plan

We continued to offer encouragement and support in a non-judgmental manner
Now, many years later, they are still in debt, but their debts have become much more manageable and they are working to pay them off completely. Has it been easy? No. Is it worthwhile? Yes. The wife commented recently, "I just didn't realize that it would be so hard for so long. You run into debt, but you crawl out of it."

Case Study #2

Data

Emilee has been thinking about how much she has to earn to pay back her loans once she leaves school. Assume she will be in the 25% Federal tax bracket after school, living in New York (10% state tax rate) and New York City (5% city tax rate), and she pays 12% gross of her income to charity.

Calculations

How much must she earn to pay back $1.00 in student loans (this assumes 0% interest)?

Case Study #2 Answer

Calculations

To pay back $1.00 in student loans will require:

- Taxes:
- Federal tax rate: 25%
- State tax rate: 10%
- City tax rate: 5%
- Charitable contributions: 12%

The formula is:

- x - .25x - .10x - .05x - .12x = 1. Solve for x?

- X = 2.08 (1/(.25+.10+.05+.12)

Emilee must earn $2.08 for every dollar she borrows (and that assumes a 0% interest rate). That's expensive (see Loan Amount to Pay Back (LT34).

Pre-tax Amount to Earn to Pay Back
Each Dollar You Repay from a Loan (LT34.1)

	Per Dollar	Specific Amount
Amount Borrowed	1.00	$ 3,500.00
Taxes (%):		
Federal Tax rate:	25.0%	25.0%
State Tax rate:	10.0%	10.0%
City Tax rate:	5.0%	5.0%
Charity and Savings (%)		
Charity rate:	12.0%	12.0%
Savings rate:		0.0%
Amount Necessary to pay Back	2.08	$ 7,291.67

You must earn $2.08 for very $1.00 you borrow, a 108.3% increase in what you must earn!!!!

Amount Necessary to Pay Back Student Loans
ling Principle, Interest, Taxes and Contributions (LT

	Loan 1		Total
Loan Information:			
Amount Borrowed:	$5,000.00	*Total Amount Borrowed*	$ 5,000.00
Interest Rate (APR):	12.0%	*Weighted Interest Rate*	12.0%
Education Information:			
Months Until Education is done?	24		
Subsidized? (1 = yes, 0 = no)		*Total amount due:*	
Amount due at end of education	$6,348.67	*at end of education:*	$6,348.67
Repayment Information:			
How Many Months to Pay off?	60	*Average months to pay off*	60
Payment per Month	$141.22	*Total Payments per month*	$141.22
Total Amount to Pay off	$8,473.36	*Total Amount to Pay*	$8,473.36
Ratio of Earned (P&I) to Borrowed:	1.69		1.69
Taxes:			
Federal Tax Rate:	25.0%	*Average Federal Tax Rate*	25.0%
State Tax Rate:	10.0%	*Average State Tax Rate*	10.0%
City Tax Rate:	5.0%	*Average City Tax Rate*	5.0%
Charity and Savings:			
Charity rate (%):	12.0%	*Average Charity Rate*	12.0%
Savings rate (%):			
Ratio of Earned (PITSC) to Borrowed:	2.08		2.08
Total Amount Needed to Pay Back	17,652.84	*Total Amount to Pay Back*	$17,652.84
Ratio:	3.53	*Ratio of amount borrowed to amount earned to pay back*	3.53
Annual Percentage Rate	68.0%		

You must earn $3.53 on average to pay back every $1.00 you borrow!!!!!

* APR is calculated from graduation until the time the loan is paid off. I haven't figured out how to calculate the i

Case Study #3

Data

Use the tax and charity information from the previous case. Emilee is in her second to last year in school (24 months till graduation) and is considering a $5,000 alternative loan at 12% and plans to pay it back in 60 months after she graduates.

Calculations

How much must she earn to pay back that alternative loan of $5,000 (which is not subsidized and accrues interest while she is in school) at 12% interest over 60 months and including taxes and charitable contributions?

Case Study #3 Answers

To pay back $5,000 in student loans requires:

- At 12% interest and in her second to last year of school, she will add 24 months of interest or $1,349
  - PV for 60 months will require a payment of $141.22 per month
  - PV=5,000, rate = 12%/12, Periods = 60 months, Solve for her Pmt = ?
  - Payment = $141.22
  - Her total payments will be $141.22 * 60 months or
- Total Payments = $8,474 or 68% more than borrowed

To determine how much she needs to earn to pay back this $8,474, we determine:

- Taxes:
  - Federal tax rate: 25%
  - State tax rate: 10%
  - City tax rate: 5%
  - Charitable contributions: 12%
- The formula is:

- $x-.25x-.10x-.05x-.12x = 1$. $X = 2.08$
- To pay back this $8,474, Emilee must earn 2.08 * $8,474 or $17,653
  - Emilee must earn $3.53 for every $1.00 she borrows ($17,653/$5,000=3.53). Again, very expensive.

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[1] Anonymous.
[2] Will Rogers Legacy, California Department of Parks and Recreation at http://www.parks.ca.gov/?page_id=23998.
[3] 2 Kings 4:7.
[4] J. Reuben Clark, Conference Address, April 6, 1938.
[5] Conference Report, Oct. 1903, 5
[6] "Doing the Best Things in the Worst Times," Ensign, August 1984, 41.
[7] "The Celestial Nature of Self-Reliance," *Ensign*, Jun. 1984, 3
[8] "I Believe," *Ensign*, Aug. 1992, 6
[9] "Constancy Amid Change," *Ensign,* Nov. 1979, 80
[10] Proverbs 29:18.
[11] Nina Coleman, "The Manly Wisdom of Will Rogers," in *The Friars Club Bible of Jokes, Pokes, Roasts, and Toasts* (2001), p. 316