APCI FEDERAL CREDIT UNION

Debt Management

Reduce, Repay, and Rebuild

Is Having Debt Normal?

Debt is a common part of life, and in some cases it can even be beneficial. While many people strive to be debt-free, certain types of debt can help improve financial stability and grow wealth.

As an example, many people go into debt to get a mortgage for a house. Depending on the current housing market, as you pay down your mortgage balance you are likely building equity.

On the other hand, other types of debt, such as high-interest credit card debt, are not so beneficial to your financial health.

Regardless of income, anyone can find themselves overwhelmed with debt and in need of assistance. Managing debt can become challenging if circumstances change, such as increased living expenses or income.

Understanding Good Debt

Good debt is typically considered an investment that has a potential to increase your income or net worth over time. When used wisely, it can be a strategic tool for financial growth.

Examples of Good Debt:

- Education – Higher education and technical training can significantly increase earning potential and job opportunities. While student loans should be carefully considered, they can often pay for themselves within a few years of entering the workforce. It is important to research career paths before getting a degree since all degrees are not of equal value.
- Homeownership – Taking out a mortgage allows you to build equity in a property rather than just spending money on rent. Homeownership may offer tax benefits and can create possible future avenues for income, such as selling for a profit or renting.
- Business Investment – Borrowing money to start or expand a business can be a financial move that leads to profitability and long-term success. While entrepreneurship can be risky, a successful business can provide financial rewards that outweigh the initial debt.

Understanding Bad Debt

Conversely, bad debt generally involves borrowing money for purchases that do not appreciate in value or generate income. High-interest credit card debt, excessive personal loans, or financing depreciating assets can strain finances.

Debt that does not improve your finances typically has a higher interest rate. Having too much debt can negatively affect your credit score.

If there is something that you want to purchase that will not increase in value or provide income, you should consider if it is worth going into debt for.

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Examples of Bad Debt:

- Clothes and Everyday Necessities – While essentials like clothes, food, and furniture, are necessary, using a high-interest credit card to purchase these items is not the best idea. If possible, pay with cash. Try to only use a credit card if you can pay the balance off in full at the end of the month.
- Vacations – Unlike housing or education, vacations are a discretionary expense. When the trip is over, there is little financial value left to justify the cost. If you are borrowing money to fund a trip, ensure that your budget allows for quick repayment to minimize interest charges.
- Boats – While enjoyable, boats and other similar luxury items depreciate in value and come with ongoing maintenance costs. To be best prepared, research additional costs of ownership for these items before purchasing them.
- Cars – Although a car may be necessary for transportation, cars are depreciating assets that lose value the moment you drive them off the lot. If financing a car is unavoidable, look for an auto loan with a low interest rate and minimal fees.

Other Reasons for Debt

Not all debt fits neatly into the categories of "good" or "bad." The impact of certain financial decisions depends on the individual and how the debt is managed. Depending on circumstances, one type of debt that is good for one person may be bad for another.

Borrowing To Pay Off Debt

For individuals struggling with multiple high-interest debts, consolidating them into a single loan with a lower interest rate can be beneficial. However, the key to using this strategy is to pay off the loan and not accumulate new debt in the process.

Borrowing To Invest

Some brokerage firms offer margin accounts, which allow investors to borrow funds to purchase securities.

This strategy is known as buying the margin. It can amplify potential returns if the investment increases in value. However, it can also carry significant risk if the security loses value. Due to its high risk, margin trading is best suited for experienced investors who can afford potential losses.

What is Debt Management?

Debt management is the structured approach to reducing and eventually eliminating outstanding debt through financial planning and budgeting.

The goal of a debt management plan is to help individuals regain control over their finances by lowering their debt burdens and creating a path towards financial stability.

Individuals can manage their debt independently or seek assistance from a credit counselor or debt relief company. Each approach has its own advantages and disadvantages.

Debt Management Plans

Do-It-Yourself (DIY) Debt Management

Involves creating a budget that enables individuals to consistently pay down their debts. This method includes budgeting tools, repayment strategies, and negotiation attempts.

DIY Debt Management is best for:

- Individuals that can afford their monthly debt payments, but struggle with overspending.
- Disciplined and motivated individuals who will follow a structured repayment plan.

Advantages of DIY Debt Management:

- Protects a person's credit score if payments are made on time and in full.
- Offers a personalized approach with clear milestones and timelines.

Disadvantages of DIY Debt Management:

- Lacks professional guidance.
- Creditors may refuse to negotiate lower rates or adjusted payment terms.

Debt Management with a Credit Counselor

Working with a credit counselor provides individuals with professional guidance that the DIY method does not. The first step to working with a credit counselor is finding a reputable one. Organizations like the National Foundation of Credit Counselors can help locate trustworthy nonprofit or for-profit counselors.

Credit counselors will help to create a plan that can last up to 5 years. They can work with creditors if necessary to negotiate lower rates or payment terms. Before committing to anything, understand the associated costs as some counselors charge fees.

<u>Working with a credit counselor is best for:</u>

- Individuals that need a plan created for them to pay off debt.

<u>Advantages of working with a credit counselor:</u>

- Access to expert advice.
- Potential to reduce interest rates and fees through the creditor's negotiations.
- Provides structured support through the repayment process.
- Credit scores are less impacted when compared to debt settlement.

<u>Disadvantages of working with a credit counselor:</u>

- Some agencies charge fees, so it is important to choose a reputable, nonprofit organization if possible.
- Credit accounts may not be accessible during the repayment period. Individuals may not be able to open new lines of credit during this period.
- The plan can be derailed if one payment is missed.
- Plans are created for credit card debt and cannot be used for student loans, medical debt, or tax obligations.

Debt Management with a Debt Relief Company

For individuals struggling with significant unsecured debt, a debt relief company may be an alternative to bankruptcy.

These companies negotiate with creditors to settle outstanding debts for less than the full balance of what is owed. Before a settlement is reached, the debt relief company may advise the individual to stop making payments. Be careful as this can negatively impact credit scores.

Once an agreement has been made the individual will make monthly payments to the debt relief company, who will in turn pay the creditor. The debt relief company will also collect a settlement fee.

<u>Working with a debt relief company is best for:</u>

- Individuals with high levels of unsecured debt who have unsuccessfully tried to settle the debts on their own and are seeking an alternative to bankruptcy.

<u>Advantages of working with a debt relief company:</u>

- Potential for lower monthly payments, easing financial strain.
- May help individuals become debt-free faster, depending on the settlement agreements.

<u>Disadvantages of working with a debt relief company:</u>

- Creditors are not obligated to accept settlement offers, and unpaid debts could lead to lawsuits.
- Credit scores will be negatively impacted since debts are settled for less than the full balance.
- Student loans, medical bills, or tax obligations are not covered by debt relief plans.
- Any forgiven debt over $600 may be considered taxable income by the IRS.

By understanding different types of debt and available management options, individuals can make informed decisions that align best with their needs.

For more information on money management, visit **apcifcu.org** and click on Helpful Links, Financial Resource Center, or Calculators under the Learn tab.

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