How do I manage my debt?

by Jon Robertson, CFP®

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Most Americans have some form of debt such as a mortgage, student loans, credit card debt, or business debt. One of the most common questions financial advisors hear from their clients is "How do I manage my debt?" People maintain debt for many reasons. The most common reason for keeping some debt is competing financial goals: saving for retirement, saving for college, building an emergency fund, or maintaining current lifestyle. If you are thinking about the best way to manage your debt, ask yourself some questions. Should I refinance or renegotiate my interest rates? How do I develop a strategy to pay off my remaining debt? Which debt should I keep? Let's consider each of these questions in depth.

Should I refinance or renegotiate the interest rate?
Lowering your interest rate is often possible. Some ways to lower your interest rate include rolling credit card debt to a lower interest credit card, consolidating student loans, or refinancing your mortgage.

Credit card companies frequently make special offers, such as 0% for one year. While this may seem like a good solution to managing debt, one frequently overlooked factor is that while the credit card charges no interest, it may charge a fee for transferring your balance from another card. Carefully read the credit card contract to fully understand potential fees. Then, compare the transfer fees to the interest fees. If you have chosen to transfer your credit card balance, stay mindful of your goal to decrease your overall debt to avoid the pitfall of even more credit card debt.

Currently, mortgage interest rates are exceptionally low. You may want to consider refinancing your current mortgage to a lower interest rate to help with your debt. Talk with your banker or mortgage broker for assistance in determining your options for refinancing. Be sure to consider the length of your loan. For example, if you have owned your house for 10 years and are considering refinancing, you may want to consider a 15-year loan rather than a 30-year loan. If you choose the 30-year option, you will be paying for your house for 40 years. You should also consider the total amount of A lack of equity in your home due to reduced property values may cause refinancing problems. If this is true for you, consider paying down your existing mortgage rather than other debts so that you will be eligible to refinance while interest rates remain at a low level.

What do I pay down first?
One common approach to paying off debt is to rank outstanding loans by their interest rates, and pay down the debts starting with high-interest loans and work down to paying off low interest loans. This strategy makes the most sense from an interest-savings perspective, but can be daunting if the high-interest loan also has a large balance because of the frustration created from spending so much time to pay off the same loan.

Another approach to pay off your debt is to start with the loan with the lowest balance, which allows for quick progress and momentum. This method also frees up cash flow. After paying off the low-balance loan, apply the newly created cash flow to pay off the next-lowest balance loan. This process often works well because the personal satisfaction may encourage the debtor to continue paying down debt.

Which debt should I keep?
The most obvious factor in determining which debt to keep and which debt to pay off is the interest rate of your existing loans. It is important to consider the after-tax interest rates of your loans because some interest payments are tax-deductible. Common examples of tax-deductible interest include mortgages, student loans, and business loans.

It is often easy to overestimate the value of your tax deductions. The best way to determine the after-tax benefit of interest payments is to prepare your tax returns as they exist now, and compare the tax returns to how they would be if you were not able to deduct the interest.

Developing a plan for managing and paying down debt is a cornerstone to being financially sound. Talk with your financial advisor to develop a plan. Stick to the plan, and you will be well on the path to financial success.

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In his free time, Jon enjoys playing with his two dogs, running, cooking, and camping.