

PEARSON NEW INTERNATIONAL EDITION

Personal Finance
Turning Money Into Wealth
Arthur J. Keown
Sixth Edition

Pearson New International Edition

Personal Finance
Turning Money Into Wealth
Arthur J. Keown
Sixth Edition

PEARSON

Should You Borrow or Pay Cash?

In any debt decision, control and planning are the key words. Overriding all your personal finance decisions is the act of setting a budget, living within that budget, and understanding the consequences of your actions.

Debt is, in general, quite expensive. Before you borrow to spend, STOP! Remember, not only do you pay more for what you purchase because of the interest on your loans, but making indebtedness a permanent feature in your financial portfolio tends to impair your future financial flexibility.

Don't borrow to spend if you can avoid it. Decide whether or not you really need to buy that new item. Does it fit into your personal financial planning program? If the answer is no, the process stops there. If the answer is yes, the question becomes whether or not to borrow. In deciding to use cash rather than credit, you must be sure that using cash doesn't materially affect your goal of having sufficient liquidity to carry you through a financial emergency. The answer to this question may leave you with no choice but to borrow. If not, you then have to ask whether the cost of borrowing to purchase the item is greater or less than what you are earning on your savings. Sometimes the interest rate you would be charged on the funds you borrow may be so low that you are better off borrowing at that low rate than using your savings. For example, if Ford is offering 0.9 percent financing on a new car, you might be better off keeping your money in a money market account where it is earning 3 percent, and borrowing the money for the car at 0.9 percent from Ford. On the other hand, if Ford is charging 7 percent financing, and you are only earning 3 percent on your savings, you are better off using your savings. In short, if the benefits outweigh the costs, borrowing makes sense.

MONEY MATTERS

Tips from Marcy Furney, ChFC, Certified Financial Planner™

AND NOW, A FEW WORDS FROM THE "LOAN RANGER"

When most people apply for a mortgage or other large loan, they often go into the process totally unprepared. This can result in delays, repeated trips, numerous phone calls, and possibly denial of credit if your situation is marginal. Make yourself as creditworthy as possible.

If you have no credit history, obtain a credit card or a small loan and make payments on time. You may need a cosigner to obtain a large loan, even if you have an excellent income. Ability to pay isn't the same as demonstrated willingness to pay.

Pay off all the debt you can before you apply. A relatively small credit card balance could cause your ratios to be too high to qualify.

Order your own credit reports and examine them for any errors. Make sure they're in good order before you proceed. If there's been a payment problem, write out the reason for the problem and the resolution. Also document thoroughly any reports that are being contested.

List all your investments and cash, show the name and address of the firm where they're being held, and include account numbers. Make copies of your current statement on each and attach them to the list. Do the same with all debt.

If you're applying for a mortgage be sure to provide the lenders' names, their addresses, and your loan numbers for any previous home loans.

Make copies of your last W-2 and most recent pay stub.

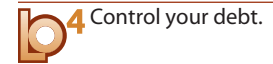
If you're self-employed, take copies of your proof of income, for example, Schedule C and Form 1040 from your most recent tax return.

Fill out applications neatly and concisely. Provide copies of all supporting documents. Don't try to hide anything and don't volunteer personal information that isn't requested and isn't directly related to your creditworthiness.

The more complete and organized the information you provide, the less the loan processor will have to do. That could give you a slight edge.

Once you've provided the lender with all the information needed to process the loan, take the initiative to check on your application's progress periodically.

Controlling Your Use of Debt



The first step in controlling debt is to determine how much debt you can comfortably handle. The debt level with which you're comfortable and which you may need changes as you pass through different stages of the financial life cycle. Early on, housing and family demands coupled with a relatively low income level make it natural for individuals to build up debt. In later years, as income rises, debt as a portion of income tends to decline.

The bottom line is that you must use your common sense in analyzing your commitments. However, there are several measures that you can use to control your commitments. They include the debt limit ratio and the debt resolution rule.

Debt Limit Ratio

The debt limit ratio is a measure of the percentage of your take-home pay or income taken up by nonmortgage debt payments.

$$\text{debt limit ratio} = \frac{\text{total monthly nonmortgage debt payments}}{\text{total monthly take-home pay}}$$

An individual's total debt can be divided into consumer debt and mortgage debt. Mortgage payments aren't included in the debt limit ratio because this ratio measures your commitment to consumer credit, which tends to be a more expensive type of debt. In order to maintain a reasonable degree of flexibility, ideally you should strive to keep this ratio below 15 percent. At that debt level, you still have a borrowing reserve for emergencies and the unexpected. That is, because of your low level of debt commitment, you should easily be able to secure additional borrowing without stretching your debt commitment to an uncomfortable level.

Once this ratio reaches 20 percent, most financial planners would advise you to limit the use of any additional consumer debt. One problem when consumer debt payments reach this level is the lack of access to additional debt in an emergency. The importance of maintaining an adequate degree of financial flexibility can't be overemphasized. Obviously, as this ratio increases, your future financial flexibility declines.

Many lenders use what is called the 28/36 rule in evaluating mortgage applicants. That is, if your total projected mortgage payments (including insurance and real estate taxes) fall below 28 percent of your gross monthly income, and your total debt payments including these mortgage payments plus any consumer credit payments fall below 36 percent, you're considered a good credit risk. If you don't meet this minimum standard, you may be required to come up with an additional down payment, or you may simply be rejected.

Debt Resolution Rule

The debt resolution rule is used by financial planners to help control debt obligations, excluding borrowing associated with education and home financing, by forcing you to repay all your outstanding debt obligations every 4 years. The logic behind this rule is that consumer credit should be short-term in nature. If it lasts over 4 years, it's not short term. Unfortunately, it's all too easy to rely on consumer credit as a long-term source of funding. Given its relative costs, this type of funding should be used sparingly.

Controlling Consumer Debt

The key to controlling consumer debt is to make sure it fits with the goals you've set and the budget you've developed to achieve these goals.

CHECKLIST 1

Financial Danger Quiz

If you answer yes to any of these questions, you might be in financial trouble.

- ◆ Do you have little or no savings?
- ◆ Do you know what to expect when you get your bank or credit card statement?
- ◆ Have you been turned down for a loan?
- ◆ Do you carry credit card debt from month to month?
- ◆ Do your fixed expenses seem to eat up most or all of your income?
- ◆ Do you have insufficient health insurance?
- ◆ Do you live without a budget?
- ◆ Are you borrowing from one lender to pay another?
- ◆ Are you uncertain about the kind of mortgage you have?
- ◆ Have you ever taken out a payday loan?
- ◆ Do creditors call you about payments?
- ◆ Are you uncertain about the total amount of your debts?
- ◆ Have you had more than one check returned because of insufficient funds?
- ◆ Does the trip to the mailbox terrify you because you aren't sure what you'll find in the way of bills?
- ◆ Are your debts impacting your home life?
- ◆ Do you find your financial problems seem overwhelming?

What we're talking about here is control. As you know, control is a major issue in personal finance.

The inspiration for financial discipline must come with an understanding of how costly and potentially painful the alternative is. It's easy to walk out of college with a good deal of consumer debt. However, keep in mind the costs of borrowing and how borrowing limits your future financial flexibility.

What might tip you off that you might be in financial trouble? In the previous chapter we looked at some signs that you might have problems with your credit cards, now let's take a look at Checklist 1 for some clues that you might be in financial trouble.

What to Do if You Can't Pay Your Bills

Once you have gotten into trouble through the overuse of credit, getting out becomes a difficult and painful task. The first step is, of course, putting in place a budget that brings in more money than goes out. The second step involves self-control in the use of credit.

Go to Your Creditor The first place to go if you can't pay a bill is to the one to whom you owe the money. If you owe money to a bank, go there first. The bank may be willing to restructure the loan.

Go to a Credit Counselor If your creditors are unable or unwilling to help you resolve your dilemma, consider seeking help from a **credit or debt counselor**, a trained professional specializing in developing personal budgets and debt repayment programs. A credit counselor helps you organize your finances and develop a workable plan to pay off your debts. However, you must be careful when choosing a credit or debt counselor. One good place to find a reliable credit counselor is the Consumer Credit Counseling Service (800-388-2227 or on the Web at www.nfcc.org), which is a nonprofit agency affiliated with the National Foundation for Consumer Credit. Before you sign on with a credit counselor, make sure you investigate his or her qualifications by checking with your local Better Business Bureau and state consumer protection office to see if there have been any complaints registered against him or her.

Credit or Debt Counselor

A trained professional specializing in developing personal budgets and debt repayment programs.

Other Options In addition, there are other options, which we looked at in the previous chapter, that you might consider. First, you should make sure you're borrowing as inexpensively as possible. Small loan companies sometimes charge as much as 40 percent on loans. Avoid them and see if there's a cheaper way to get the funds you need.

A second option to consider is using savings to pay off current debt. You shouldn't do so more than once—when you're reevaluating and changing your spending and credit use patterns in a permanent manner. If you are only earning 4 percent after taxes on your savings, then using savings to pay off consumer debt at 10 or 12 percent may be a good idea. However, your borrowing should be controlled in such a way that it doesn't get out of hand and doesn't warrant this remedy on a regular basis. This is an emergency measure to be taken only in the extreme situation.

Another alternative is to use a debt consolidation loan to stretch out your payments and possibly reduce your interest. A **debt consolidation loan** is a loan used to pay off all your current debts. The purpose of a loan of this kind is to lower your monthly payment. A debt consolidation loan doesn't eliminate your debt problems, it merely restructures the payments associated with paying off that debt. Before you sign on with a debt consolidation company, make sure you know what you're getting into—make sure you check it out with the Better Business Bureau and the state consumer protection office—that should tell you something about whether or not this is a company you'd like to assist you. Again, this isn't the optimum solution. The best solution is to take control of your borrowing from the onset.

Bankruptcy as the Last Resort A final alternative in the most extreme case of debt is personal **bankruptcy**. This is not a step to be taken lightly. It doesn't wipe out all your obligations—for example, student loans, alimony, and tax liabilities remain—but it relieves some of the financial pressure.

The primary contributing factor to bankruptcies is major illnesses and the costs and loss of income associated with them. Another factor contributing to the large number of bankruptcies is the easy availability of credit that leads to living beyond your means. Divorce and job loss are also major contributors to bankruptcy.

The two most commonly used types of personal bankruptcy are Chapter 13 bankruptcy, the wage earner plan, and Chapter 7 bankruptcy, straight bankruptcy. There are several other types of bankruptcy, but because they are so specialized, we discuss only Chapter 13 and Chapter 7 in detail. The primary difference between Chapter 13 and Chapter 7 bankruptcy is that under Chapter 13 you design a plan that will allow you to repay the majority of your debts, while under Chapter 7 bankruptcy, most of your debts are discharged. But in order to qualify for Chapter 7 bankruptcy as opposed to Chapter 13 bankruptcy, you have to meet a Chapter 7 means test that compares your income to the median income in your state. If your income falls below the median income in your state, you can file for Chapter 7 bankruptcy. However, if it's greater than the median income in your state, you'll have to do other calculations regarding your income and allowable expenses to determine if you can file for Chapter 7 bankruptcy. This means test went into place as the result of legislation signed into effect in 2005 and resulted in a sharp drop in the number of bankruptcies—it also resulted in a lot of people filing for bankruptcy just prior to the new law taking effect as shown in

FACTS OF LIFE

There are now over 20,000 payday loan shops in the United States.

Debt Consolidation Loan

A loan used to pay off all your current debts.

Bankruptcy

The inability to pay off your debts.

STOP & THINK

Debt consolidation loans are very appealing because they offer hope to those who can't keep up with their current payment schedules. Before taking out a debt consolidation loan, however, keep in mind that you may be paying a higher interest rate on the consolidation loan than you are on your current debt. If the problems that led you into this dilemma in the first place aren't solved, do you think a debt consolidation loan will result in a permanent solution? What would you need to do to solve your debt problems?

FIGURE 5 Chapter 7 and 13 Bankruptcy Filings

Bankruptcy filings peaked in 2005 just before the new bankruptcy laws went into effect. Those laws reduced the number of filers eligible for Chapter 7 bankruptcy.

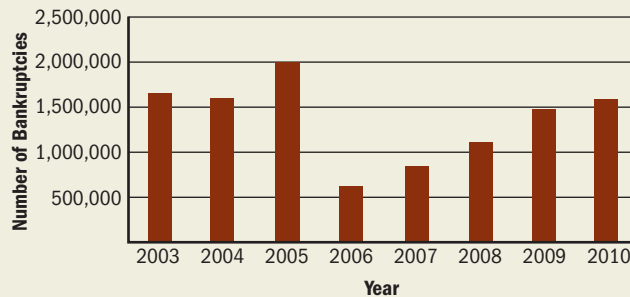


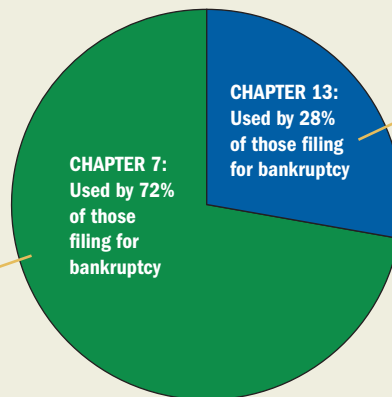
Figure 5. Prior to the new legislation, in 2005, there were over 2 million bankruptcies nationwide. That's about one in every 53 U.S. households. In 2006 that number had dropped to around 600,000, but since then has been creeping up as shown in Figure 5. Figure 6 provides a comparison of the two primary personal bankruptcy options.

Chapter 13: The Wage Earner's Plan

To file for Chapter 13 bankruptcy, you must have a regular income, secured debts of less than \$1,081,400, and unsecured debts of less than \$360,475 (these are figures accessed in March 2011 and are adjusted each year for inflation). Under Chapter 13,

FIGURE 6 Personal Bankruptcy Options**CHAPTER 7**

- **Who Can File:** If you make less than the median income in your state, have less than \$100 a month of disposable income, or do not have enough disposable income to repay at least 25 percent of your debt over 5 years.
- **Repayment Requirements:** Assets are liquidated to pay off creditors; however, filers generally are able to keep their car and some basic household possessions, with the homestead exemption limited to \$125,000 if the property was acquired within the previous 3.3 years.
- **Long-Term Effect on Your Credit File:** Bankruptcy information remains in your credit file for 10 years.

**CHAPTER 13**

- **Who Can File:** If you make more than the median income in your state, have more than \$100 a month of disposable income, or have enough disposable income to repay at least 25 percent of your debt over 5 years.
- **Repayment Requirements:** You design a repayment schedule in such a way that you can continue to cover normal expenses while still meeting the repayment schedule. Assets are not liquidated, and disposable income after living expenses is used to pay off debt over a 3- to 5-year period.
- **Long-Term Effect on Your Credit File:** Bankruptcy information remains in your credit file for 7 years from the end of repayment.

you design a plan that will allow you to repay the majority of your debts, whereas under Chapter 7 bankruptcy, most of your debts are discharged. The repayment schedule under Chapter 13 is designed so that you can continue to cover normal expenses while still meeting the repayment obligation. You maintain title and possession of your assets and, other than the new debt repayment schedule, continue on with life as before. For your creditors, it means a controlled repayment of debt obligations with the court's supervision. For the individual, it may mean relief from the harassment of bill collectors and the pressure of never knowing how future obligations will be met.

Bankruptcy happens to all kinds of good people, and it can provide breathing room to start over when there's no hope. Burt Reynolds, Hollywood's number 1 box office draw from 1978 through 1982, along with Kim Basinger, Toni Braxton, Marion "Suge" Knight, and Antonio Tarver (the WBC light heavyweight boxing champ) have all filed for bankruptcy. Although Burt Reynolds made a ton of money in movies such as *Smokey and the Bandit* and *Cannonball Run*, he also lost around \$15 million in Po-Folks restaurants. When he finally filed for bankruptcy he had \$11.2 million in debts and assets worth only \$6.65 million. Because he exceeded the debt limits of Chapter 13 bankruptcy, he was forced to file under Chapter 11. Among his debts were a loan from CBS of \$3.7 million plus interest and \$121,797 to his custom wigmaker. Chapter 11 bankruptcy gave him the breathing room to begin again and regain control of his finances.

FACTS OF LIFE

Bankruptcies went up dramatically in the last century. Before then people didn't live as long, and when they did get sick, they died—in effect, death kept them out of financial trouble. Today, medicine can do wonders, but it can also put you in a financial predicament that is hard to recover from.

Chapter 7: Straight Bankruptcy

Chapter 7 bankruptcy, or straight bankruptcy, is a more severe type of bankruptcy. Under Chapter 7, the individual who doesn't have any possibility of repaying debts is given the opportunity to eliminate them and begin again. Exactly what assets you can keep varies from state to state, but your home equity exemption is limited to \$125,000 if the property was acquired within the previous $3\frac{1}{3}$ years.

To qualify for Chapter 7 bankruptcy as opposed to Chapter 13 you must pass a "means test" that attempts to determine if you are earning enough to be able to pay off at least some of your debt. In effect, the major intent of bankruptcy reform is to require people who can afford to make some payments toward their debt to make these payments, while still affording them the right to have the rest of their debt erased. These people must file Chapter 13 as opposed to Chapter 7. If you make more than the median income in your state, have more than \$100 a month of disposable income, or have enough disposable income to repay at least 25 percent of your debt over 5 years, then you may have to do a Chapter 13 bankruptcy. In addition, within 6 months of when you can file for bankruptcy you must complete a credit counseling course, the purpose of which is to inform consumers of the consequences of bankruptcy. Then, before any debts are discharged, you must also take a course in personal financial management.

The bottom line is that while you will not lose everything, you will have to sell a good portion of your assets in order to satisfy Chapter 7 requirements. Most of your debts will be wiped out, but some will remain, such as child support, alimony, student loans, and taxes. A trustee arranges to

FACTS OF LIFE

According to Elizabeth Warren, a professor of law at Harvard, and the individual initially in charge of setting up the Consumer Financial Protection Bureau, over half of the families that file for bankruptcy do so in the aftermath of an illness or accident.