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NF91-3 Setting Reasonable Debt Limits

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Setting Reasonable Debt Limits

Adapted by Kathy Prochaska-Cue, Family Economics and Management Specialist

The use of consumer credit has become a major component in the management of money. To be effective, credit must be used responsibly. Before beginning to manage credit effectively, ask the following questions:

1. Can I afford additional debt?
2. When can I afford additional debt?
3. What happens if I cannot pay my bills?
4. How will I know if I am heading for credit trouble?

Can I Afford Additional Debt?

To help guide credit use, develop a personal or household debt ceiling. This ceiling is the maximum percent of take-home pay to be committed to credit debt payments. Exclude mortgage payments and those payments normally paid in full each month. Traditionally, a 20 percent guideline has been used but that figure may not apply for a particular situation.

To develop a personal debt ceiling figure, consider the following four questions:

1. **WHAT SPECIAL LIVING EXPENSES DO I HAVE?** These special expenses might be based on needs such as care for a disabled household member, or based on values such as hobbies or interests like music, sports, arts, carpentry, or crafts. The larger the commitment to special living expenses, the lower the debt ceiling figure will need to be.

2. **HOW MUCH AVAILABLE CASH DO I HAVE FOR EMERGENCIES?** For most situations, $2,000 to $5,000 in readily available cash and unused credit capacity is one guideline recommended by many personal financial planners. If you have less than that figure, take on only absolutely necessary credit until the emergency fund is adequate.

3. **HOW LONG WILL IT TAKE ME TO PAY OFF CURRENT DEBTS?** Exclude mortgage and bills normally paid in full each month. Total debts and divide by the amount of money realistically available for debt payment. If the answer is more than 12 months, do not add to your

present debt load.

WHAT PERCENT OF TAKE-HOME PAY IS ALREADY COMMITTED TO DEBT PAYMENT? Again, exclude mortgage and bills normally paid in full. Compare to the credit guidelines developed by Fred Waddell, Ph.D., for Genesis Press.

a. Total the amount you are billed each month on all loans, credit cards and other credit payments. Do not include your mortgage payment.

b. Find your approximate take-home pay in the left column.

c. Read across to the column where your total debt payments fall to assess your financial condition from credit obligations.

d. Use the top column heading if your income is very DEPENDABLE. Use the middle column heading if your income is SOMEWHAT DEPENDABLE. Use the bottom column heading if your income is UNDEPENDABLE.

Following these four steps will help you determine just what your personal credit ceiling figure should be.

MONTHLY TAKE-HOME PAY	10%* Excellent Excellent Excellent	12 1/2%* Excellent Good Fair	15%* Good Fair Poor	20%* Fair Poor Very Poor
$ 850	$ 85	$105	$130	$170 or more
900	90	115	135	180
1,000	100	125	150	200
1,250	125	155	190	250
1,500	150	190	225	300
2,000	200	250	300	400
3,000	300	375	450	600
4,000	400	500	600	800

*10% (or less) of monthly take-home pay.
12 1/2% (maximum) of monthly take-home pay.
15% (maximum) of monthly take-home pay.
20% (maximum) of monthly take-home pay.
25% (maximum) of monthly take-home pay.

WHEN CAN I AFFORD ADDITIONAL DEBT?

Since this depends on your personal credit ceiling figure, list all debts, and for each the total owed, monthly payment, number of payments left, and date debt will be paid in full (*Table 2* provides an example). To find the month when total debt payments fall below the ceiling, develop a timetable similar to *Table 3*. When the total monthly figure falls below the debt ceiling, that is the month additional debt could be considered.

Table 2. Present debt obligations

Debt	*Total owed*	*Monthly payment*	*Number of payments left*	*Date paid in full*
Car loan	$2,430	$135	18	December (next year)
Student loan	1,035	69	15	September (next year)
Bank card	153	51	3	September (this year)
Department store 1	258	43	6	December (this year)
Department store 2	60	30	2	August (this year)
Finance company	10	10	1	July (this year)

Table 3. Payment timetable

Month	*Monthly payment due*
July	$135 + 69 + 51 + 43 + 30 + 10 = $338
August	$135 + 69 + 51 + 43 + 30 = $328

September	$135 + 69 + 51 + 43 = $298
October	$135 + 69 + 43 = $247
November	$135 + 69 + 43 = $247
December	$135 + 69 + 43 = $247
Jan. to Sept. (next year)	$135 + 69 = $204
Oct. to Dec. (next year)	$135

Before actually committing to more debt, consider whether saving at least part of the cost would be wise. As of January 1, 1991, there is no longer any tax deduction allowed for consumer debt interest.

WHAT HAPPENS IF I CANNOT PAY MY BILLS?

CONTACT THE CREDITOR BEFORE DEBT PAYMENT IS DUE. If you know you will not be able to make the full payment, let the creditor know before the bill becomes past due. Creditors are much more cooperative at this point.

Offer the creditor some alternatives such as a partial payment, deferring the payment until you can pay the full amounts, or refinancing.

IF YOU CHOOSE TO IGNORE YOUR CREDITORS, a number of things may happen depending on the creditor's policies and accounting procedures. Some creditors take action against late payments if you are a few days late. Others do not send late notices until you are at least 30 days late.

If you get 60 days behind, you generally 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 to collect the late payment. Some creditors have had their own employees who collect debts. If a creditor turns your account over to an attorney, expect an additional cost in attorney fees.

Expect some court action if the debt has not been collected for a longer time period. The creditor will file a suit in an effort to get the court to make you pay your bill. 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 assets taken (attached). If the court rules that your wages be garnished, the creditor notifies your employer of the garnishment action. About 25 percent of your wages will be 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 that exceeds the Federal minimum wage. This does not apply to garnishing money for alimony or support of a dependent. Also, creditors can legally attach the assets in your checking or savings account up to the value of the court judgment Your personal property can be seized and sold.

The creditor may already have or can obtain the legal right to repossess the property. This means you lose the car, truck, motorcycle or other item for which you borrowed the money. Frequently, the creditor sells the property for less than the amount you still owe on it. If the item does not sell for enough money to pay off the loan, the creditor 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, assume you borrowed $2,000 to buy a stereo. However, you missed payments and it was repossessed. If the loan balance was $1,750 and the stereo sold for $1,000, you would be sued for the remaining $750. If you failed to pay the amount of deficiency judgment, your wages could be garnished or the creditor could seize other possessions for the amount of the 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 the suit by default. If you appear in court, you possibly work out an acceptable plan with the creditor. If you do not appear in court, you cannot defend yourself against the creditor's claim.

CHANGE HABITS. Add no more credit debt until your financial situation improves. Establish a "bare bones" budget for your living expenses and use all extra income for debt repayment. Seek help from someone who is a legitimate financial counselor and can help you negotiate with creditors.

HOW WILL I KNOW IF I AM HEADING FOR CREDIT TROUBLE?

Early warning signals of potential credit debt trouble include:

- Struggling to make ends meet every month.
- Relying heavily on extra income such as overtime and a second job to help you buy essentials.
- You start to forget that credit is really debt.
- You find it harder and harder to save.
- You don't have an adequate emergency fund.
- You do not pay bills on time.
- You pay only the minimum due on credit cards and charge accounts.
- You have defaulted on a payment or your rent.
- An anticipated pay raise is already committed to paying debts.
- You've lost the total amount of debt you owe.
- You've taken out a consolidation loan.
- You use the overdraft loan feature of your checking account frequently.
- The total of your debts exceed the total of your assets.

Seeing yourself in two or three of the above situations may mean debt problems are possible. Become familiar with the above danger signs. Then take positive action to stop the potential problem early.

Adapted from Managing Credit Fact Sheet 435, University of Maryland, by Kathy Prochaska-Cue, Extension Family Economist and Management Specialist, University of Nebraska, 11/90.

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