FREEDOM FROM BAD DEBT & BENEFITS OF MORTGAGE DEBT

SAMMAMISH MORTGAGE

BAD VS. GOOD DEBT

Owing a lot of money can be a hard burden to bear. Much of the debt many of us have is what we might call “bad” debt, such as credit card balances. Not only is it very expensive (sometimes with rates over 30%), but it is easy to get. Credit card companies issue cards readily, and keep increasing credit limits to encourage their “customers” to spend more and pay more interest and fees.

We should make a distinction here between “bad” debt, like credit cards and “good” debt, like mortgages. The first difference is obvious: very high interest rates. Where credit cards often carry interest rates over 30%, mortgages are typically below 5%--and the interest is deductible. This effectively lowers the already low cost of that money.

THE ASSETS

Credit cards are commonly used for consumable items, like restaurant meals, gasoline, vacations. Consumers who carry balances on their credit cards are literally paying money for items they no longer own! The $1,000 weekend getaway that was paid with plastic could easily cost another $25 a month indefinitely when we figure an interest rate of 30% on a card that is never paid off.

By contrast, the mortgage we take out to buy a home is part of an investment strategy. We are using some of our own money (the down payment) and someone else's money (the mortgage) to acquire a large asset that we will own for a long time. And based on history, that asset is likely to go up in value, providing a high rate of return. Because we are using that inexpensive "good" debt to buy the property, we are taking advantage of the principle of leverage to get an even higher rate of return over time.

What is Revolving Debt?

USEFUL CREDIT

But let's go back to the "bad" debt: credit cards, or what is called "revolving debt." While we refer to this in a negative way, we do not mean to imply that credit cards are bad. Used strategically, credit cards are extremely useful: we don't have to risk carrying around large sums of cash, for example. We have some recourse if a purchase goes bad, since most credit cards come with some sort of guarantee for faulty merchandise or unscrupulous vendors. We can keep track of our spending, since we can use the card even for very small purchases. They are convenient—buying goods and services on line is as simple as clicking a couple times with the mouse (more on that later). Finally, we may get extra benefits from credit cards: cash rebates and airline miles are commonplace.

One of the problems with credit cards is that they are so easy to use. That fact lends itself to impulsive purchases, and those impulsive purchases, often with little or no though behind them, can add up to a hefty sum.

There are some scientific theories about the ballooning of credit card balances. One suggests that we get a little rush of the chemical dopamine in our brains when we buy something we want. Dopamine is a brain chemical that contributes to a feeling of well-being. In a very real sense, the good feeling we get from buying cute shoes (ladies) or a new set of golf clubs (guys) is partly chemical.

What do you think of when using a credit card?

THE DELUSION

There is a downside to buying something nice, though. We make the buying decision (mood up), then reach into our pocket to get cash. Now we have a feeling of loss, because we are giving up something. We might call paying for the Jimmy Choos or Titleists a sort of buzzkill—literally.

That's where the siren song of credit cards come in. Instead of parting with actual cash, we get the slap the plastic down on the counter and walk out with our prize (or, in the case of the Jimmy Choos, wearing it). Because paying with a credit card doesn't feel like paying with money, we don't have that feeling of loss that we'd get parting with actual cash.

The bill always comes, though; and seeing that we've spent $1,000 on impulse purchases this month may shock us, but we are relieved to see that the minimum payment this month is just $100. So we pay the minimum. That is how credit card balances grow.

Here is how many people use credit cards today: the shiny new card arrives. It has a $2,000 limit. "Let's go break this baby in!" you say, and go out for a nice dinner with your significant other. You spring for cocktails and an appetizer as well. After all, you're celebrating this new arrival.

When the Party Pooper comes!

MATH TRAP

The statement arrives, and you pay just the minimum. Most credit card vendors require a minimum payment of just 3% of the outstanding. Some require just 2%. Paying 3% of the balance on a card with a 30% interest rate will pay off the balance in six years. But few people think of that mathematical reality. They use the card for both necessities and luxuries, until the card is at its limit. Now it doesn't work anymore. So they stop using the card until they can get the balance down. They reduce the balance by $1,000. Now the card works again, and they keep repeating the process.

In doing this, they are using only the "top" part of the credit line—the upper $1,000. But here's the catch (and it's a big one): They are continuing to pay interest on the "bottom" $2,000. If the rate is 30% the cost of having that card with its continuing balance of $2,000 is $50 per month. $600 per year.

There is a way out of this trap. It does involve some determination, and a bit of discipline, but it is worth doing.

CHANGE IS SCARY

You may be thinking that we are going to prescribe an unpleasant regimen involving austerity. You may assume that we are going to advocate suspending all the things that bring you joy in life: no more movies, dinners out or vacations until you get rid of that debt.

You assume wrong. We as a species are not good at austerity. One of the reasons so many diets fail is that they are unpleasant. Even with a worthwhile goal of getting healthy and slimmer, we can only deny ourselves for so long. Paying off debt through austerity works the same way.

This does not mean that you can magically retire all your credit card debt without changing anything. You will have to make changes. But if you do this right, you won't deny yourself much of anything.

THE PROCESS

There is one part of this process that you might consider unpleasant: you must make a budget. It is not important how you do this—spreadsheet, dedicated program, paper and pencil—only that you do it. You want to see where your money is going each month. If you are putting a lot of your regular purchases on credit cards, this part should be easy.

Once you see where the money has been going, you will determine which of the discretionary purchases are impulse buys. We should make a distinction here between those things that we need and those that we just want. Neither category is bad. Buying things we want is fine—as long as we actually want them. Looking at the list of "want" purchases, determine which ones were impulse buys. Was the restaurant meal that cost $100 including tip a matter of not having anything appealing in the house, so going out to eat was just easier? That could be an impulse purchase that you could avoid later.

Did you go to that renowned Seattle-based coffee company for a $4.00 latte out of a desire to get out of the office? Or were you truly jonesing for your daily caffeine jolt?

If it's the former, you could have come up with a different excuse to get out of the office. If it's the latter, we completely understand, and more power to you.

FIX THE LEAKS

The real message here is that you should make a distinction between those expenditures that mean something to you in some way and those that are impulsive and thoughtless. You may be surprised to discover the amount of money you've spent each month on things that you bought on the spur of the moment, but which didn't enhance your life or bring you joy. Those are the expenditures that you can forgo—and do it without affecting your quality of life. These impulsive, non-valuable items are what we might call the "leaks in the payroll." Fortunately, these leaks are easy to fix once you have identified them.

Another place to reduce expenditures without harming your quality of life is late fees and other punitive fees. For most people, late fees and overdraft charges are the result of oversights, not a lack of money. Many credit card companies charge $39 for each payment that they receive past the 10th of the month. This is a complete waste of money, and it is completely avoidable. You should arrange an automatic minimum payment for every credit card you have, transferring funds from your checking account to the credit card on or before the due date. Do this now, while it is fresh in your mind.

If you ever find yourself with the occasional NSF check fee, you should avoid this, as well. Many people don't bother to balance their checkbooks, but in these days of instant access to accounts on line, we should always know the condition of our accounts. If you tend to check your account balance only occasionally, consider doing it more often. If your bank offers a no-fee overdraft protection, set that up if you ever find your balance close to zero.

YOUR PLAN

You've created at least a simple budget. You have identified the "leaks in the payroll," those items that you have been paying money for, but which don't fill a need or bring you joy. Now it's time to make your plan to get out of debt.

Your first step is to determine how much money you can allocate to retiring these accounts. Some of this may come from cutting your discretionary impulsive spending, while some may come from other expenditures you have decided to suspend. It is completely up to you, but you must make a deal with yourself to stick to your plan. We will call this your "debt-killing money."

Next, gather recent statements for all your credit card accounts. Put them all in one place. Although there are multiple approaches in retiring credit card balances, we'll use the simplest one; we will identify the account with the smallest balance. Let's say that it has a balance of $1,000. You will direct your debt-killing money each month to that account until it is paid off. You will make minimum payments on the other accounts.

Build your Debt Snowball!

GOOD DEBT TRANSITION

If your debt-killing money starts at $200 a month, you'll have the balance paid off in six months, assuming the interest rate is 30%. With that account paid to zero, you have freed up another $30 to add to your debt-killing money (the minimum payment on a $1,000 balance is $30 per month). You'll direct your $230 a month to the next account until it is paid off. Some have called this a "debt snowball," since the amount you have available to retire these accounts grows as each account is paid off, just as a small snowball gets bigger as it rolls down a snowy hill.

One important component of the "snowball" plan is that you do not add to any of your credit card balances! If you make a purchase with any of your cards, you must may the full amount of the purchase in addition to the interest on the statement. It is critically important that you not allow the balances to increase.

There are some self-styled financial "gurus" who say that you should close each credit card account as you pay it off. This is terrible advice. Reducing the number of active accounts in good standing will reduce your credit score. A good credit score means that borrowing money later—"good" debt, like a mortgage—will be far less expensive.

POSITIVE RESULTS

There is a reason why we suggest paying off the smallest balances first, rather than those with the highest interest rates. This is because seeing an account's balance go down to zero should give you a feeling of satisfaction. You mentally (or physically) pat yourself on the back for your small victory. The good feeling you get for taking another successful step in your plan is what respected psychologist B.F. Skinner called "operant conditioning." The feeling of satisfaction you get from accomplishing that goal is positive reinforcement. It is powerful. Appreciate it.

Once you have completed your plan, however long it may take, you may find that you have changed your spending patterns. This doesn't mean that you are denying those things in life that make you happy. It is not necessary to deny yourself, only to give some thought to what you do with the money you have.

Finally, a word about refinancing. If you are a homeowner with a mortgage rate above the prevailing rates, you should consider refinancing as a way of reducing debt with little or no pain. If you can reduce your rate even slightly, you may be able to integrate that change into your debt elimination strategy.

Here is what we mean.

REFINANCING

Let's say you have a mortgage balance of $400,000 at a rate of 5%. You've had your loan for several years and your monthly payment is $2,300. You're comfortable with that amount, even though you could reduce your rate to 4.5%. You'll have closing costs to deal with, including prorated interest and possibly a new escrow account for taxes and insurance. You will finance all these items into your new loan, so your balance will increase to $406,000 in this example.

By reducing your rate to 4.5% from 5%, your monthly payment will drop by $240 per month. You will also have one month without a mortgage payment. This may feel like a free ride, but you will still be paying interest on your loan; it will just be added to your loan balance. If you have an impound account to pay taxes and insurance, you will also get a refund from your old lender after the close of escrow. It will feel like money dropping from the sky, but they are just giving you back your own money.

You can get the most benefit from your refinance by allocating the money according to your debt-killing plan. First, use the money from the payment you don't have to make for that month to apply to your smallest credit card. When you get the refund from your old lender, do the same with that money—use it to reduce another balance.

RESULTS

By refinancing, you have reduced your monthly payment. In this example, you have freed up $240 each month because of your lower payment. Apply that money to your debt-killing plan. If you have already allocated money from your budget, you'll be able to accomplish your goal even faster.

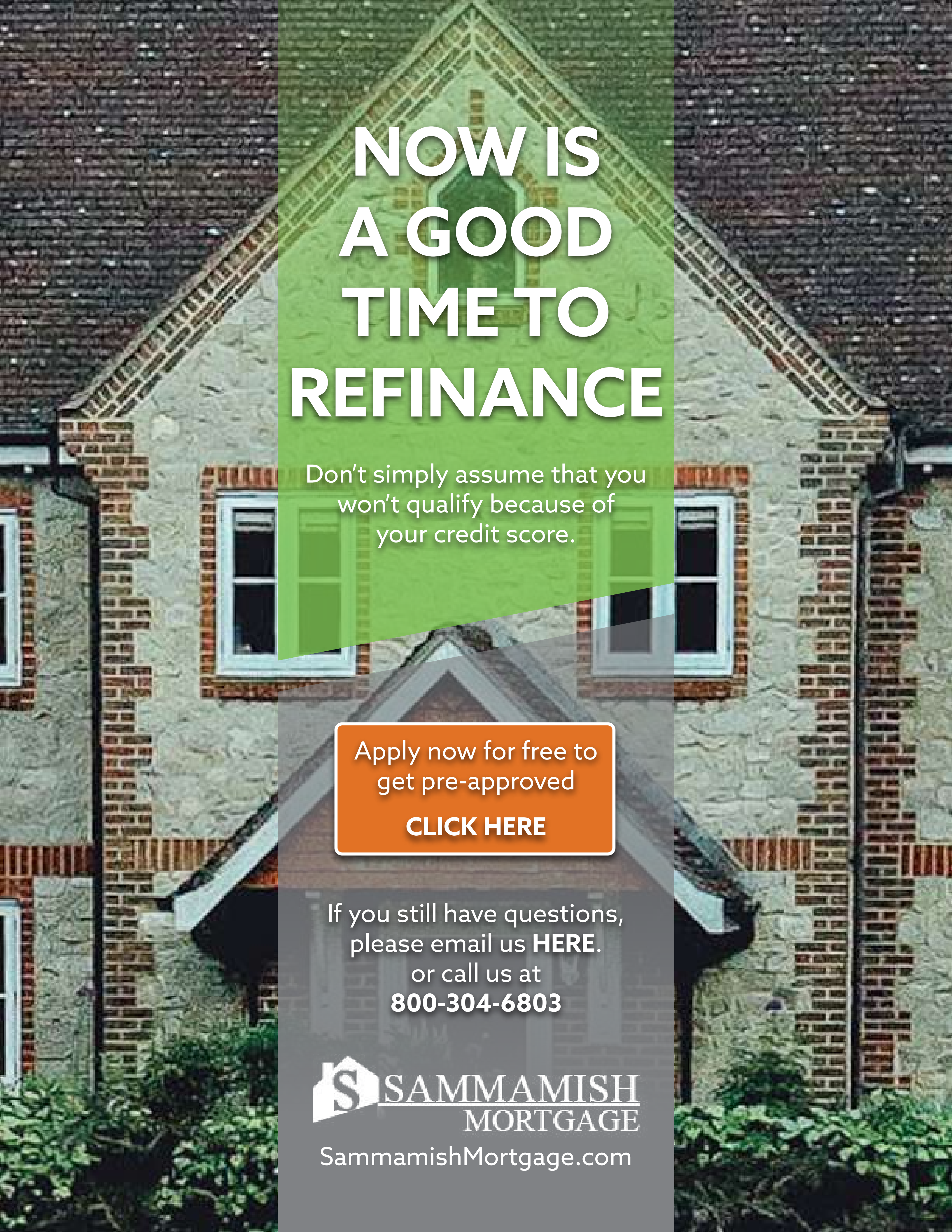
There will come a time when you have retired all your credit card debt. You will have freed up money from the high interest that you no longer need to pay. The money that used to go to paying that interest is now available for you to do with as you please. One suggestion we might offer is to accelerate the pace at which you pay your mortgage—that "good" debt.

When you refinanced, you did two things: you increased your loan amount because you added closing costs to your new loan, and you extended the term of your loan. If your previous mortgage had 26 years remaining and the new one has 30 years, you have obviously extended the term by that amount. Once you have completed your debt-killing plan, you can apply your extra cash flow to speed up the amortization of your new loan. By adding just $150 to your regular mortgage payment each month, you'll pay off your new mortgage on the same schedule as the old.

IN CLOSING

Accomplishing everything we have discussed in this book requires, as we said starting out, some determination and a bit of discipline. What it does not require is self-denial. If you pay attention to the details in this simple plan, you'll find that you can save thousands of dollars, and maybe even more.

Our whole team here at Sammamish Mortgage wish you the very best. We are here to help you in any way we can.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