# Managing Loans, Leases, and Debt

**Questions and Concerns:**

- What is the best loan to meet my goal or dream?
- Should I refinance?
- Is it better to borrow or to lease?
- How do I make my debt manageable?

In business, the ability to borrow to expand, revitalize or purchase inventory is often vital for the success and survival of a company. It is not the same for individuals. For individuals, credit is used to provide for transportation, shelter and maintain or pursue a life style. Individuals also use credit for investment purposes. Ideally when dealing with debt, you want to have your heart and mind aligned on borrowing decisions. It is not an easy task. This brief will concentrate on the numbers approach to making a decision.

Financial Ratios
Prior to addressing the above questions, one should first review their financial ratios. In order to do that you have to have a prepared net worth statement and cash flow statement. To determine borrowing risk an example of an abbreviated annual net worth and cash flow statement and ratios are illustrated below.

| Net Worth | | | | Cash Flow | | |
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| Cash and Savings | | 10,000 | | Income | | 102,219 |
| Other Assets | | 543,139 | | Less Loan Payments | | (15,366) |
| Total Assets | | 553,139 | | Less Other Expenses | | (64,891) |
| Less Total Liabilities | | (92,000) | | Total Expenses | | (80,257) |
| Net Worth | | 461,139 | | Net Cash Flow | | 182,476 |

*Liability to Total Asset Ratio* – The liability to asset ratio is .17 ($92,000/553,139). This is less than 1/3 of the total assets and this is considered strong. It is not unusual for individuals, who have steady employment, to have total loans and a mortgage with a .80 liability to asset ratio.

*Loan Payment to Income Ratio* – This ratio is .15 ($15,366/$102,219). Prudently, the loan payment to income ratio should not exceed .33. At .15 this would be considered strong.

*Number of Months of Savings to Cover Expenses* - If there was a loss of income, savings would only provide for living expenses and loans for just over a month (10,000 Annual Savings÷(80,257 Annual Expenses÷12 months in the year))=1.5 months. Having only 1.5 months of savings would create hardship in the event there is income disruption due to loss of job or disability.

In this example, although two of the ratios indicate there is more borrowing capacity, there is risk to consider if there is income disruption. It might benefit the above individual to defer additional debt by building savings. Please note this is a simplified illustration. One must consider the purpose, other assets, employment stability and numerous other considerations.

**What is the best loan to meet my goal or dream?**

This all depends on the purpose of the loan. For automobile loans, credit unions and automobile company credit often provide the best interest rate and terms. Home equity loans can be shopped around through banks, credit union, mortgage companies and other financial institutions. Mortgages are available from the same sources. One should compare the following:

*Interest Rate* – This may appear obvious however you must compare "apples to apples". An adjustable interest rate may initially appear to be favorable to a fixed rate loan until the date the rate is subject to adjust. Usually interest rates are lower for the short-term loans. One other factor is the size of loan: title car loans interest rates are usually higher than larger regular car loans and jumbo real estate loans are usually higher than smaller conventional real estate loans. Finally, your credit rating will factor in the interest rate.

*Costs to Originate the Loan* (Points and Closing Costs) – In terms of mortgages and home equity loans, there are several additional costs that one should consider. Ask a mortgage lender for a sample closing statement that is similar to your loan request. This information goes beyond a percentage estimate but into actual dollars.

*Adjustable or Fixed Rate* – Fixed rate loans protect you from rising interest rates, however the rates are usually higher than the initial adjustable rate loan. Most adjustable rates have a ceiling and/or floor based on an index. Know what the payments will be if the rate meets the ceiling. Know what the period of time is for the adjustments. An adjustable rate loan may be attractive if you intend to pay off the loan prior to the rate adjustment.

*Length of term* – The longer the term means a lower payment and a higher interest rate. Shorter terms are the opposite. Choosing is predicated on the amount you can pay.

*Balloon Payment* – A loan is established for a set term, say five years and an amortized payment schedule is established over a 20 year period. This means that you will be making payments as if you had a twenty year loan and the fifth year the balance on the loan is due. Interest only payments are sometimes available with the balance on the loan upon the term maturity. This loan is usually good for individuals who intend to pay off the loan prior to the balloon payment.

*Amortization Schedule* – This is the schedule of your payments. Amortization can be set for 10, 15, 20 or any other agreed terms in years.

*Collatera*l – Interest rates vary depending on the liquidity and marketability of the loan. A loan on marketable securities is usually lower than loans that use commercial real estate as collateral.

*Tax Deductible* – Mortgages and home equity as well as certain other loans can be tax-deductable if they meet IRS guidelines.

*Prepayment Penalties* (If any) – It is important to be aware of loans that have prepayment penalties. Often these prepayment penalties are applied to complex loans for investment property. The underlying originator of the loan could be supporting an annuity or life insurance.


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Loans for investment purposes require additional review with an attorney and CPA because provisions can be much more complicated.

**Should I refinance?**

As indicated above there are several consideration in selecting a loan. Although you may be providing monthly cash flow savings, be aware of changes in terms. Will you be extending the length of the loan? Is the interest rate adjustable and subject to higher interest rates? Are there prepayment penalties? Would it be beneficial to shorten the term to a 15 or a 10 year mortgage? Smart Money provide a calculator that helps make this estimate.

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| Smart Money Refinance Calculator | http://www.smartmoney.com/calculator/real-estate/should-i-refinance-my-mortgage-1302835660427/ |

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**Is it better to borrow or to lease?**

Smart Money provides an article, calculator, and the link below to help you guide a decision. One word of caution is to use your rate of return expectation.

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| Smart Money: Borrow or Lease Comparison | http://www.smartmoney.com/calculator/autos/buy-or-lease-a-car-1302833645461/ |

**How do I make my debt manageable?**

It is important to have a thorough understanding of your financial picture. That means having a prepared net worth statement, cash flow statement, tax return and financial ratio calculations. List your liabilities; sort them from the highest interest rate to the lowest. If interest is tax deductable, determine your after-tax interest rate. Your tax advisor can assist you in determining the after-tax interest rate. Each loan should be then reviewed and determined where additional principal payments should be made to retire the debt. Finally, as one debt is retired, the extra cash should be considered to retire another debt or added to savings such as retirement plans that have tax benefits.

As each debt is reviewed there can be several options to consider as you manage debt such as paying off debt from lenders offering more competitive rates or refinancing. Take extra caution on consolidating debt with a home equity loan. Doing so you will further encumbering your home. If you default on your home equity you could subject your home to foreclosure. You should be also very careful about borrowing from your 401(k) or 403(b) retirement plan. If you default on your retirement plan loan, the outstanding balance of payments could be classified as a distribution and subject to ordinary income tax as well as premature penalties.

**How can a financial planner help a clients manage loans, leases and debt?**

If you feel overwhelmed, seek a planner who can assist you to come up with a solution to resolve your debt situation. They will use the steps above and discuss your debt management options. You may have to make some lifestyle decisions and it is best that you do not go this alone.

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