Good Debt, Bad Debt: Knowing the Difference

It's often smart to borrow to boost your income and your assets.

With U.S. household debt at a record-breaking $14 trillion at the end of 2019, more Americans are learning to live with and manage debt. Since the financial crisis, consumer credit in its many forms—from student loans and mortgages to auto loans and credit cards—has grown. In recent years, a strong economy and job market have encouraged many people to spend and borrow more.

Not all debt is harmful to your financial health. In fact, many people divide borrowing into good debt and bad debt. Good debt is used to finance goals that will increase your net worth, such as earning a college degree, buying a home or owning a small business. Good debt is even better if it carries a low interest rate and is tax-deductible. Bad debt is money borrowed to buy things that won't last or that you can't afford, such as a handbag that you charge to your credit card but don't pay off, or a vacation that you finance with a home equity line of credit or personal loan.

Sometimes the boundaries between good and bad debt aren't as clear. Many experts consider loans for cars or other depreciating assets to be bad debt. But if you take on debt to buy or repair a car you need to get to work or to pay for a necessary medical expense, that debt falls somewhere between good and bad, says Michele Cagan, a certified public accountant and author of *Debt 101*.

Still, too much debt of any type is overwhelming. And even good debt can turn bad when you have too much of it, as happened for many households in the years leading up to the 2008 financial crisis. But rather than forgoing debt altogether, the key is understanding the purpose of the debt and what you can afford, says Cagan. If you're considering taking out a loan, make sure you understand the details—including when you'll need to start making payments, what the interest rate is and other repayment terms. Consider how those payments will fit into your budget.

Strategies to pay it off. Once you're on the hook to pay back money that you borrowed, the strategy is the same, no matter how much you owe. Start by taking inventory of the amount you've borrowed, the payment dates, the lenders and the interest rate for each of your debts. Build the minimum payment for each debt into your monthly budget. (If you're having trouble meeting the minimum-payment amounts, see below.) Then see how much more you can afford to put toward your debts, and make a plan to speed up repayment. It might stretch your budget to make larger payments, but paying down your debts more aggressively will help you wipe them out more quickly and save you hundreds, if not thousands, of dollars in interest.

Simple math shows that paying off your debt with the highest interest rate first, while making minimum payments toward the others—known as the avalanche method—will save you the most money. But some borrowers prefer what's called the snowball method. With this strategy, you tackle the debt with the smallest balance first, then roll that payment into the next smallest debt. Creating a snowball isn't the fastest way to get out of debt, says Cagan, but it can help borrowers stay motivated because they can see their progress.

Other strategies to manage your debt will depend on the types of debts that you have. Because today's interest rates are low compared with historical rates, you may be able to refinance some of your debts at a lower rate and use the extra cash to speed up repayment or boost your savings.

With most credit card interest rates hovering between 15% and 20%, any credit card debt you have is likely costing you a bundle and is a prime candidate for faster repayment. While you're paying down the debt, you might also consider a balance transfer, shifting the balance to a new credit card that charges no interest on transfers for a period of time. Most issuers give cardholders a year to 15 months to carry an interest-free balance. A few also waive promotional balance transfer fees. Just make sure you can pay off the balance by the end of the introductory period, when higher interest rates typically kick in. If you don't qualify for a balance transfer or need more time to pay your debt, try negotiating with your issuer for a lower interest rate.

Another option is credit counseling**. Click here to learn more about the NYSUT Member Benefits Corporation-endorsed Cambridge Credit Counseling program.**

Dealing with student loans. For students who borrowed to attend college, the average debt at graduation was $29,000 among those who graduated in 2017–18, according to the College Board. In recent years, interest rates for federally backed student loans ranged from 3.4% to more than 7%. Fixed interest rates from private lenders currently range from about 4% to 14%, and variable rates range from roughly 3% to 12%.

If you have federal student loans, consolidating them through the government can make payments more convenient, but it won't lower your interest rates or save you money. The interest rate of the new loan is the weighted average of the interest rate of the loans that you combine. If you go this route, consider excluding your highest-rate loan and targeting it for early repayment.

But consolidating will allow you to pick a new federal repayment plan. There are three main options beyond the traditional 10-year plan: plans that stretch your payment over longer periods, plans that gradually increase the amount of your monthly payments and plans that base the amount of your payments on income. To see what your monthly payment and loan terms would be under different repayment plans, visit StudentAid.gov and use the Repayment Estimator. The longer the repayment period, the more you will ultimately pay in interest, so pick the plan with the highest monthly payment you can afford.

Click here to learn more about the NYSUT Member Benefits Corporation-endorsed Cambridge Student Loan Counseling program.

To lower the interest rate on your student loans, you'll have to refinance with a private lender. Private lenders will refinance both private and federal student loans into one loan. Assuming you've established a good credit history since college, you'll likely be able to score a lower interest rate on private loans than you did when you were a student; you may be able to lower the rate on your federal loans, too.

If you refinance federal loans with a private lender, you'll typically lose benefits and protections that come with federal student loans, such as deferment and forbearance. But some borrowers, particularly those with high-paying jobs, conclude that the savings from lower interest rates are worth the trade-off.

When you need a helping hand. If you're having trouble repaying your loans or think you may miss a payment, call your creditors. Explain the situation and ask about any repayment options that lower the interest rate or monthly payments while keeping the account in good standing. Many creditors will change due dates, waive interest and late fees for a while, or offer other options that can help.

If you're still struggling to repay your debts, consider credit counseling, a service that offers financial advice and debt-management plans.

NYSUT NOTE: The NYSUT Member Benefits Corporation-endorsed Cambridge Credit Counseling program can help NYSUT members gain a better understanding of credit card consolidation and debt management. Learn more.