

Student loans, credit cards compound debt

Money Manager/by Karin Price Mueller/ www.businessstoday.com

Sunday, November 25, 2001

PROBLEM:

Making the transition from college student to working professional is trying for most young adults.

Often, young adults, who have never before managed a budget or been solely responsible for paying their own bills, use credit to bridge any financial gaps as they try to find their place in the world. Add that new debt to student loans from college, and many young people are facing an uphill battle before they start their first day of work.

That's what happened to Jenna, 26, who came for the Herald for help with her debt.

"I was constantly going into debt and living beyond my means," Jenna says of her first years out in the working world. "Everything was crazy expensive."

And now, Jenna owes \$13,000 to three credit cards, with high rates of 19.99 percent, 18 percent and 12.75 percent. The two higher-rate cards, in fact, are maxed out. She makes monthly payments of \$300 toward the cards, but that barely covered the accumulated interest.

And because her credit history has been less than stellar, Jenna hasn't been able to transfer the balances to lower-rate cards.

"I wasn't always making payments on time, but for the past six months I've been able to get my feet back on the ground," she says. "After grad school I wasn't making very much money."

Even more than the credit card debt, the cost of Jenna's education is also weighing her down. She has a substantial amount of student debt - four different loans totaling a whopping \$65,300, toward which she pays \$500 a month.

"I'm kind of overwhelmed," Jenna says of the student loan debt. "I think the credit card debt I can get over in three to five years, but the loans - they're so much money."

Jenna also has some concerns about her job situation. Working for an advertising agency, Jenna has seen how the slowing of the economy has affected many of her colleagues and friends at other companies.

"You never know if you're going to get laid off," Jenna says. "So many of my friends already have."

She'd like to accumulate a cash emergency fund worth \$2,000 to help her get through lean times, should they head her way. Today, her savings account has a \$50 balance, and her expenses don't allow for extra savings, she says.

Jenna shares an apartment in Greater Boston for \$487.50 a month, and she pays another \$200 a month for utilities, phone and cable television. Food, dining out and snacks cost Jenna \$450 each month, and she spends \$80 a month on such personal care expenses as dry cleaning and toiletries. She has no car payment, but spends \$145 a month on commuting costs and car insurance. By the time she pays miscellaneous medical expenses and buys a book or two, there's nothing left to save - and she even adds to her credit cards sometimes.

"I spend a lot of money at Starbucks and going out to lunch," she says. "I've been trying to cut back but if I really want to go out I use a credit card."

Still, Jenna has thoughts about saving for the future. Her employer offers a 401(k) plan, to which she started to contribute in February. But pressed for cash, she stopped her contributions after only one month.

“They didn’t match contributions,” she says of the account, which has a balance of \$79. “And I felt the money would be better spent paying off my high-interest debt.”

SOLUTION: Spending must be controlled

Jenna's future is bright, despite all of her debt challenges. She's going to have to reduce spending, carefully control the use of credit cards and allocate any increase in cash flow, such as pay increases, toward paying down debt.

It will be a tough road, but she can get there, says Nicholas Fichter, a certified financial planner with Fichter & Co., based in Hingham, and a member of the Financial Planning Association of Massachusetts.

“She's done what many people do, which is go through school living hand-to-mouth, and she's now in the working world earning a good paycheck,” Fichter says. “But there was an explosion of spending she's overdone it a bit.”

Fichter examined Jenna's expenses and has tried to put her on a plan to get her in control of her finances by age 30. Instead of cutting out all spending, Fichter wants Jenna to follow a realistic plan that won't frustrate her in a few months.

The first step is cutting expenses. Fichter calculates Jenna's spending at least \$65 more per month than she's taking in. At the same time, she's spending more than \$400 per month on largely discretionary items, such as eating out and cable TV. This is the first place to look for money that can be diverted toward other costs.

For starters, Fichter says Jenna should reduce spending by a minimum of \$160 per month - \$65 to cover her shortfall in income, and \$95 per month that she can use to build up an emergency fund.

“It's not like she has a rich uncle, and she can't depend on her parents for a serious financial emergency,” he says.

That, coupled with the fact that Jenna doesn't have a lot of available credit to rely on in a financial emergency, means a healthy emergency fund is very important. If Jenna lost her job next week, she wouldn't have anything to fall back on.

He'd like to see her develop, over the next few years, a fund worth three to six months of expenses. He recommends that she save the money in either a short-term bond fund with checking privileges, which offers a better interest rate than money market funds with only a modest increase in risk. He likes the Strong Advantage Fund, which allows you to start with \$50 if you enroll in an automatic investment plan.

Next, Fichter suggests Jenna increase her payments to her credit cards from \$300 a month to at least \$370 a month, directing the extra toward the highest cost card.

“She will most likely need to rely on credit in the future for car or home purchases, so it is vital that she pay at least the minimum required by each card company on time so as not to damage your credit rating,” he says.

She should also try to get the rates on her cards lowered by asking the credit card issuers. If that doesn't work, Jenna should try again to transfer the high-interest balances to another card.

Because her credit history hasn't been perfect, this may not be possible, but if Jenna is vigilant about making on-time payments, she may get another chance to transfer balances after a few months.

To help stop Jenna from adding debt to her cards, Fichter recommends that she cut up all but one.

“She admits her discipline is not that good,” Fichter says. “If she incurs new debt she has to make sure to pay it off or her cards will creep back up to the max.”

As part of the plan, Jenna has to keep a close eye on her expenses, and Fichter recommends she let her expenses grow no faster than the rate of inflation over the next few years, though age 30.

Any extra money should go to pay debt through this time, he says. By then, credit card debt will be paid off and Jenna can divert what she had been paying for credit cards to another expense, such as a new car.

Over the next few years, Fichter expects Jenna's her income will grow significantly. That will help her pay down the credit card debt, and maybe even accelerate her college debt payments by the time she's 30.

At that time, she can start to save for her future, Fichter says.

``Mark you calendar with this item for your 30th birthday: `I will go to the Human Resources office and have them start taking \$100 a month from my pay to put into the 401(k) plan.' ''