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Post-Recession Financial Strategies for Households: How to Deal with Debt

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What is the Issue?

For two decades prior to the Great Recession, U.S. households steadily amassed significant amounts of debt and eroded their liquid asset holdings. By 2007, households were increasing debt at a rate equivalent to 6% of aggregate consumption *every year*. The Great Recession, which hit the U.S. *and* global economy in 2007, had an enormous impact on U.S. household finances. The financial crisis caused large drops in income with American median household income declining by over 4% (see Figure 1).

Figure 1: Percentage Changes in Median Household Income Due to Recessions and in the First Two Years of Recoveries, 1973-2009

Notes: Changes in median household incomes due to recessions are computed for the following periods: 1973-1975, 1979-1982, 1989-1991, 2000-2001 and 2007-2009. Changes in median household income during recoveries are computed for the following periods: 1975-1977, 1982-1984, 1991-1993, 2001-2003 and 2009-2011.

Source: U.S. Census Bureau

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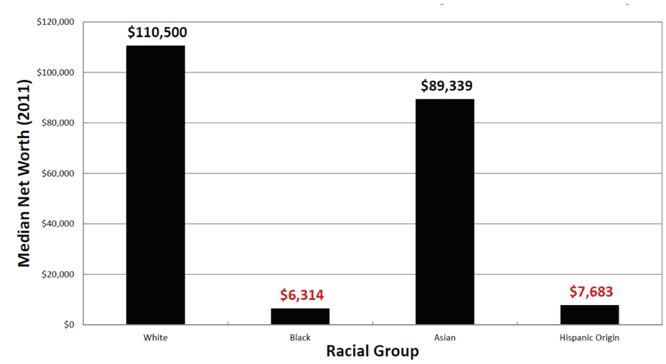
At the same time, there was a substantial erosion of household wealth due to the simultaneous and significant declines in the values of housing and equities.

For American households in general, the financial crisis of 2008 resulted in one of the largest deleveraging periods in recent history. Debt accumulation dropped from 6% to -4% of aggregate consumption. Liquid asset holdings declined by almost a factor of two[2]. Furthermore, there remain significant disparities in household net worth across racial and ethnic groups (see Figure 2).

Figure 2: U.S. Median Net Worth – by Racial Group



Source: U.S. Census Bureau-http://www.census.gov/people/wealth

Focusing on Debt Reduction

Given the nature of the most recent recession and the general household financial behaviors that predated the crisis, one of the most critical aspects of post-recession household financial management is debt reduction. To effectively eliminate debt, households must refrain from taking on any new debt and try to pay off existing debt as soon as possible. To pay off existing debt, the first step in debt reduction is to identify and quantify all sources of household debt. Specifically, it is important to understand the nature of the debt because not all debt is created equally. What are the terms of each loan? What are the interest rates for each loan? The three largest sources of debt for most U.S. households are: 1) home loans, 2) credit card debt, and 3) student loans.

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[2] Source: Federal Reserve Bank of St. Louis – Economic Synopses

Home Loans

With regard to home loans, first mortgages and home equity loans are very different in terms of the implications for household finances. A first mortgage is a loan used to purchase a house and its property in which the house and property serve as collateral for the loan. First mortgages have several benefits over other types of debt. First mortgage interest payments are tax deductible. First mortgages give households the option of refinancing, if overall mortgage interest rates decline and financing conditions become more favorable. First mortgages also allow home buyers to build equity. In most cases, buying a home means buying an asset that appreciates in value.

Home equity loans (second mortgages) do not have the same benefits as first mortgages. While the homeowner is still using the home as collateral for the loan, (s)he is not building equity. Moreover, interest rates for home equity loans are generally significantly higher than for first mortgages and the interest payments on home equity loans are not tax deductible. Additionally, home equity loans cannot be refinanced.

Despite the relative benefits of first mortgages over home equity loans, the decision to buy a home with debt should be considered carefully. In most cases, one should consider buying a home only when planning to stay in it for several years. The cost of the home (including taxes, maintenance and other costs) should not exceed 28% of monthly income. What type of first mortgage is best? As a general rule, one should not take a mortgage when the monthly payment is unaffordable. Interest only mortgages are also inadvisable. The risks associated with adjustable rate mortgages (ARMs) should be clearly understood. If overall interest rates go up, ARM interest rates can go up at the reset date.

Credit Card Debt

Understanding the amounts, terms, and rates for each credit card is important. Credit card bills should be paid in full every month. Revolving credit card debt means paying only the minimum required payment and one should try not to do that. If credit cards continue to be used while just making the minimum payments, the effect is of taking on new debt. This can lead to very high total costs and lengthen the amount of time it takes to pay off the debt. For example, consider having a credit card balance of $5,000 at 14% APR and the minimum payment is 2% of the balance. If only the minimum payment is made, it would take 22 years to pay off the credit card debt and would cost over $10,000 in total.

Student Loans

Student loans are becoming an increasingly common aspect of household finances. Nearly 20 million Americans attend college each year. Of that 20 million, close to 12 million – or 60% - borrow annually to help cover costs.[3] Not all student loans are the same. Federal Student Loans offer various repayment options including forms of income-based repayment. Federal student loans also have public servant loan forgiveness options in which student loan borrowers who are employed by an eligible public service organization or in a specifically identified public service field and meet the other eligibility requirements may be able to have a portion of their student loan debt forgiven. Private student loans are issued by banks and private companies, like Sallie Mae. Those with private student loans are not eligible for public service forgiveness programs. Charitable or college-provided loans can be the only education financing option for some students but they are not always a good deal with regard to interest rates or other terms.

As more and more people take on student loan debt, student loan default has become an increasingly important issue in the U.S. The consequences of student loan default can be more severe than for other debt default. The lender or servicer of the loan and the federal government will normally take all legal action to recover the money owed. The lender or loan servicer will notify the national credit bureaus of the default. This can affect an individual's credit rating for as long as seven years and makes it difficult to borrow money from a bank to buy things like a car or obtain a mortgage loan. There are other significant consequences for student loan default. The Internal Revenue Service can withhold U.S. individual tax refunds and apply it to the amount owed. The agency holding the loan might ask employers to deduct payments from the debtor's paycheck. The debtor will be liable for loan collection costs which can be substantial. Furthermore, if the individual returns to school, they may not be eligible for additional federal aid.

Next Steps

After the specifics of each loan are understood, consumers need to develop a plan for paying off each obligation. The minimum required payment on every loan should always be paid. However, an effort should also be made to try to pay extra toward the principal amounts of debts. Making extra principal payments on the highest interest rate loan first is a good step, as well as continuing to make extra principal payments until that loan is paid off. After the loan is paid off, then consumers should start paying extra toward their next highest interest rate loan. That process should be continued until all loans are paid in full. Since the interest on first mortgages is tax deductible, generally that is the last loan that should be paid off. Credit cards usually have the highest interest rates. Consumers should be aggressive in paying down their debt. Afterall, decreasing debt leads to increasing freedom.

[3] Source: Chronicle of Higher Education, http://www.asa.org/policy/resources/stats

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