SmartMoney

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Choosing the Debts to Pay Off Now (and Later)

People struggling to repay debt often hear the same advice -- budget better, make more money, negotiate debts, get professional help -- but what happens when repayment is difficult even after following that guidance?

It's a question more debtors are asking themselves. The rate of serious delinquencies (90+ days late) on consumer debt is up more than 3% in the last year and total household consumer debt has risen from just over $5 trillion in 2000 to $11.7 trillion in 2010, according to *a study by the Federal Reserve Bank of New York*[1]. Now, many people -- even those who had stellar debt repayment records in the past -- are faced with picking which debts to repay.

To be sure, it’s unwise to stop paying bills or skirt debts altogether. Most financial advisers recommend that consumers pay at least the minimum on all debts, especially those that affect your credit score, like mortgages, credit cards and home equity lines of credit, auto and other loans. But if you can’t cover everything and have exhausted other possibilities, here are some guidelines to help determine which debts you might consider setting aside.

Prioritize paying the essentials

Pay for the things that have the most impact on your life first, experts advise. Make payments on the debts you can go to jail for not repaying -- like alimony, taxes and child support, says Ted Connolly, a bankruptcy and finance lawyer at Edwards Angell Palmer & Dodge and the co-author of “*The Road Out of Debt*[2].”

Determine which debts have the least favorable terms

Paul Winter, president of Five Seasons Financial Planning, a Salt Lake City, Utah-based financial planning firm specializing in investments, says it is important to consider the interest rate (how much of each payment is interest; whether the rate is fixed or variable) and the tax benefits (mortgage interest can be deducted on taxes; auto loan interest cannot) to determine which debts have terms that are least favorable.

Weigh the cost of non-repayment

Once you have funded the essentials and negotiated the best terms possible on your existing debts, it’s time to examine what remains. Connolly recommends first deciding which non-repayments would hurt the least. First, examine secured debts -- those backed by collateral -- and assess what you’ll be giving up if you don’t repay, such as a house or a car.

Consider the potential hit to your credit score and how that would negatively affect your ability to get loans in the future. Delinquencies on almost all debts – both secured and unsecured – will have a similar effect on your credit score. “What matters is the delinquency's recency, severity (how many months the payment is delinquent), and frequency (how often has the person been reported delinquent on this and any other accounts),” says Craig Watts, a spokesperson for the Fair Isaac Credit Organization.

A recent foreclosure, for example, can “inflict severe pain to your credit,” says Wayne Blanchard, a CFP at the Money Professionals Group based in Orlando, Florida. Scores usually fall between 100 and 175 points after a foreclosure, according to Wayne Sanford, owner of New Start Financial.

So which repayments should you consider skipping first if you can’t renegotiate terms and you’re strapped for cash? Here are three.

1. Debts that don’t affect your personal credit score

Many individual investors are involved in partnerships, like limited liability companies, that have non-recourse loans attached to them. Clark Kendall, founder of Kendall Capital, says that when you feel like you cannot pay off all debts, this type of loan could be one to walk away from.

The consequences: "In this case, the bank can't come after you personally, just the asset," Kendall says. "But you need to consider what the cost is of this -- maybe it will harm your reputation, or hurt your chances of doing business with a local bank in the future."

2. A home mortgage that is “underwater”

Nearly one in four (23%) U.S. homes with mortgages were underwater at the end of June 2010, meaning that the borrower owed more on the home than it’s worth, according to real estate data service CoreLogic. Some financial advisers say strategic default on an underwater mortgage can make sense, with limits.

“Psychologically, it feels right to eliminate all debt, but practically it can be a very poor use of funds,” says Eve Kaplan, chief executive of Berkeley Heights, N.J.-based Kaplan Financial Advisors. That’s especially germane if the home has more room to depreciate in the coming years and you need the money to help pay for other critical expenses, she says.

For many people, a mortgage is their single biggest liability, so walking frees up cash that could be used for other expenses.

The consequences: A strategic default will cripple your credit score, and your ability to get a loan on anything will be severely impacted. You'll also lose your home.

Ask yourself whether you will want to buy a home or get a loan with a decent interest rate in the next few years. If you do, think twice about defaulting on your mortgage.

3. Unsecured debts

When you cannot repay all of your debts, consider not paying an unsecured debt, like hospital or credit card bills. Non-repayment of unsecured debts will not result in you losing an asset like your home.

But first, try to negotiate with the lender. Connolly says that many hospitals, for example, are willing to negotiate down to delayed payments or even tiny payments made over time -- and some do not report debts to collection agencies. "Many hospitals can be very sympathetic to people who cannot pay and often will work with you and negotiate and help put you on payment terms," he says.

Many credit card companies are also willing to negotiate, though they are less likely to give you terms as favorable.

The consequences: The impact of not paying unsecured debts varies, but expect your credit score to take a hit in most cases. Credit card companies will quickly report delinquencies to credit agencies. Also be aware that the organization you owe money could sue you for payment.

Remember that if your debts get out of hand, bankruptcy may be the best option. Consult an organization like the National Foundation for Credit Counseling at *NFCC.org*[3] if you are considering this option.

[1]http://retirementincomejournal.com/upload/567/QuarterlyNYFedReport_Q22010.pdf
[2]http://www.roadoutofdebt.com/
[3]http://nfcc.org/
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