NebGuide
University of Nebraska–Lincoln Extension, Institute of Agriculture and Natural Resources
Know how. Know now.
G1790

Setting Reasonable Debt Limits

Kathy Prochaska-Cue, Family Economics and Management Specialist
Sandy D. Preston, Extension Educator

This NebGuide explains the consequences of too much debt and how to establish a PCL.

Using credit is a major part of managing personal or family finances for most people. But unfortunately credit and the resulting debt may allow people to spend beyond their means. Knowing how much debt you can afford without negative consequences by setting a Personal Credit Limit (PCL) is one way to manage credit use.

To manage credit effectively, ask the following questions:

1. How much debt can I afford?
2. When can I afford additional debt and how much?
3. How will I know if I am heading for, or already in, credit trouble?
4. What will happen if I cannot pay my bills?

How Much Debt Can I Afford?

The amount of affordable debt differs for each individual and family. Look at the situation and develop a personal credit limit (PCL) to help manage your credit use. Your PCL is the total amount of debt you're comfortable having at any one time. Think in terms of both the overall total amount of debt and the total monthly amount needed for debt payments. If you have a family situation, be sure everyone agrees to the PCL and is willing to live with it.

The following questions can help you develop a PCL:

What special living expenses do I have?

Special expenses include care for a disabled household member, high medical expenses because someone has a chronic medical condition, the need to travel a distance for a job, or an unstable income source. Some special expenses are based on values such as private or college education for children, a commitment to charity or religious contributions, or interests such as music, sports, crafts or carpentry. The more income needed for special living expenses, the lower a PCL needs to be because less money will be available for debt repayment.

How much cash and unused credit do I have available for emergencies?

Financial planners often recommend a figure equal to three to six months of living expenses as an emergency fund. Remember the amount available for emergencies includes both cash plus unused credit. Do not add any more credit obligations if an amount of less than three-months living expenses is available in cash plus unused credit. Once three months of living expenses is available, continue adding to your cash stash and paying off credit until the equivalent of six months living expenses is available. The less cash set aside for emergencies, the smaller your PCL will need to be.

What percent of take-home pay is already committed to debt repayment?

To maintain flexibility in your financial situation, experts advise keeping debt payments under 15 percent of after-tax income excluding first mortgage and any credit account paid in full every month. To find out what your percentage is, total the amount you are obligated to pay each month on all loans, credit cards and other credit payments. Do not include your first mortgage payment. Divide the total of all debt payments by the amount of your after-tax income. The resulting figure needs to be below .15 or 15 percent of after-tax income.

How stable are my income sources?

How likely will each source of income last for the next year? For the next five years? Is someone who is employed thinking about quitting the job or retiring in the near future? The more stable income sources are, the higher a PCL should be.

When Can I Afford Additional Debt And How Much?

The answer to both of these questions depends on the PCL set and the present debt owed. When total debt payments fall below the PCL, additional credit may be used. When debt payments exceed the PCL, determine the month payments fall below the PCL by first listing all present debts. Let's use Cara as an example. Her monthly take-home pay is $1,503. She has set her PCL at 15 percent of her take-home paycheck or $225 for all debts beyond a first mortgage.

Cara's Current Debt

Debt Item	Total Owed	Monthly Payment	Number of Payments Left	Month Debt is Paid in Full
Car loan	$2,430	$ 135	18	December next year
Student loan	$1,035	$ 69	15	September next year
Credit card	$ 153	$ 51	3	September this year
Credit card	$ 258	$ 43	6	December this year
Credit card	$ 60	$ 30	2	August this year
Finance Co.	$ 10	$ 10	1	July this year
TOTALS	$3,946	$ 338		

Cara's total monthly payments at $338 exceed her PCL of $225. She can develop a timetable like the following example to find out when her debt payments will fall below her PCL.

Cara's Payment Time Table

Month	Monthly Payment(s) Due
July this year	$135 + 69 + 51 + 43 + 30 + 10 = $338
August this year	$135 + 69 + 51 + 43 + 30 = $328
September this year	$135 + 69 + 51 + 43 = $298
October to December this year	$135 + 69 + 51 = $247
January to September next year	$135 + 69 = 204
October to December next year	$135

In the above table, Cara sees that her debt payments will fall below her PCL after she makes the December payments. She could then afford an additional debt payment of $19.

When the total monthly figure falls below the PCL, additional debt might be considered. Before Cara actually commits to more debt, she should consider whether saving part of what she had been paying for debts and saving at lease part of the cost of something she might want to buy. She would also save the additional interest charged when using credit.

How Will I Know If I Am Heading For Credit Trouble?

Early warning signals of potential credit trouble include:

- Paying only the minimum on credit card bills
- Struggling to make ends meet every month
- Relying heavily on overtime or a second job to help buy essentials
- Forgetting that credit is really debt
- Finding it harder and harder to save
- Having a nonexistent or inadequate emergency fund
- Paying bills late
- Defaulting on bills including rent
- Anticipating a pay raise already committed to paying debts
- Losing track of the total amount owed for all debts
- Taking out a consolidation loan
- Using the overdraft loan feature of your checking or debit account frequently

Any one of the above situations is a potential problem. Stop using credit. Live with a bare bones budget and use all extra money to pay more than the minimum payments on credit bills. Seek help from a legitimate financial counselor who can teach you how to negotiate with creditors.

What Will Happen If I Cannot Pay My Bills?

If payments cannot be made, the most important thing to do is to contact any creditor before a bill is due. Ask for a lower payment amount, an extension on a due date, or a reduction of interest and late fees.

If you choose to ignore your creditors, a number of things may happen. Depending on a creditor's policies, action may be taken if you are even a few days late. Or late payment notices may not be sent until the bill is at least 30 days late.

After 60 days late, another request for payment will generally be sent. Beyond 60 days, creditors usually will turn a debt over to an attorney or collection agency or to their own collection unit. Expect to pay an additional fee if a creditor turns your account over for collection.

Court action may happen if the debt has not been collected for an even longer time period. If the court rules in favor of the creditor (called a judgment), expect to have your wages to be garnished or certain assets frozen or taken by the creditor including money in a checking or savings account up to the value of the judgment. Personal property also may be seized and sold.

Creditors can legally repossess any property collateral for a loan. This means you lose the car, truck, motorcycle or other item for which you borrowed the money. The creditor then usually sells the property. If the collateral item does not sell for enough money to pay off the loan, the creditor files another suit for a deficiency judgment to make up the difference between what was owed and the sale price of the collateral item. So you can lose the item and still owe money for a loan.

For example, assume you borrowed $20,000 to buy a truck. However, you missed payments and it was repossessed. If the unpaid loan balance was $18,750 and the creditor sells the truck sells for $10,000, you would probably be sued for the remaining $8,750. If you failed to pay the amount of the deficiency judgment, your wages will be garnished or the creditor could seize other possessions valued up to the amount of the judgment to satisfy the debt.

Do not ignore any lawsuit. Contact an attorney immediately. If you fail to file an answer to the suit and do not appear in court, the creditor wins the suit by default. Try to work out an acceptable plan for repayment with the creditor before the scheduled court date or during the court proceedings. Failure to appear in court means you cannot defend yourself against the creditor's claim.

Carefully monitor your financial situation. Consider amount and stability of income, amounts of both overall debt and monthly payments, and determine a personal credit limit. Knowing and accepting responsibility for your debt situation is a step toward future financial stability.

UNL Extension publications are available online at *http://extension.unl.edu/publications*.

Index: Financial Management
Credit and Debt
Issued November 2007