



Article 7

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## **Avoid the Financial Danger Zone**

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Credit can be an important financial tool, especially for people who are trying to start or grow a small business. Credit can be used to buy inventory, finance the start-up of a business, or make purchases for large-ticket items like equipment or office space.

But like all tools, performance must support cost. Credit is not extra income — it is money that must be paid back. If it's not managed well, it can become overwhelming and can prevent you from reaching your financial goals.

When your level of debt outpaces your ability to pay for it, you are in the financial danger zone. You are much less likely to qualify for additional credit and you need to take steps toward better financial health.

One tool lenders use to determine if you're in the financial danger zone is a mathematical expression of the relationship between your debt level and your income. It's called *debt-to-income ratio* and it is calculated by dividing your total monthly debt payments by your total monthly net income – or your take-home pay after taxes and other deductions. Generally, a debt-to-income percentage that exceeds 20 percent is a sign you need to take care of your current obligations before taking on any more debt.

The first and most important step to avoiding the financial danger zone is arming yourself with information about your own financial picture. Start by making a list of your current debt obligations, including your current balance and your typical payment amount. If you are a small business owner, look at your personal and business debt – you want to consider both! At the top of the list, record your most expensive debts, or those with the highest annual percentage rates.

Remember that interest rates may be fixed or variable. While a fixed rate will not change, a variable rate may move up or down based on changes in the underlying rate index.

A lender may structure your credit as an installment loan or as a revolving account. Installment loans help you purchase big-ticket items with equal payments for an established period of time. Car loans and mortgages are typical installment loans.

Revolving credit, like that associated with a credit card, is a loan with a limit against which you may make purchases at any time. Your account balance may go up or down over any given time

period and your scheduled payment will vary accordingly. Revolving credit generally has higher interest rates than installment loans.

Once you've listed your debts, note where you might be able to commit a little extra money every month to accelerate your debt payment. The faster you pay off credit, the less money you will spend on interest.

Next time you sit down to speak with a lender, ask these questions to make sure the purchase you are considering on credit fits into your budget:

- What is the interest rate?
- Is the interest rate fixed or variable?
- What are the loan terms?
- What are the fees and penalties?
- What is the total cost of the loan?

If your current debt obligations are overwhelming and you cannot make payments, begin by calling the lender. Explain the situation and see if they are willing to negotiate different terms such as temporarily or permanently reducing monthly payments.

If you are having serious problems with credit or money management, there are resources available to help. Credit counseling agencies provide money management advice, offer help with budgeting monthly income and expenses, and may be able to negotiate with creditors to modify payment terms.

It is vital that you ensure that the counseling agency is reputable. The Center for Financial Education is a good first step toward learning more about credit and finding reputable credit counseling member agencies. Visit them on the Web at [www.crediteducation.org](http://www.crediteducation.org) or call 1-800-308-2227. For more information about financing for your business, go to [www.FinanceNewMexico.org](http://www.FinanceNewMexico.org).

*Finance New Mexico is an initiative of the New Mexico Small Business Investment Corporation (NMSBIC), New Mexico Small Business Development Center (NMSBDC), Empowering Business Spirit (EBS), the New Mexico Venture Capital Association (NMVCA) and other partners to assist individuals and businesses in obtaining skills and funding resources for their business or idea. To learn more about resources available to New Mexicans, go to [www.FinanceNewMexico.org](http://www.FinanceNewMexico.org).*

