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Debt, a 3-Way Loser

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By Michelle Singletary
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For the past several weeks, I've been spending my Wednesday evenings taking a class at my church called "Financial Freedom." Among other things, the class aims to teach how debt can put you in bondage.

"Debt is not something you flirt with," Charles Ellerbe, my instructor, said during the first class.

That's a hard lesson to learn in a society in which we're encouraged to embrace debt, contends Ellerbe, who has been teaching the biblical principles of managing your money for more than 10 years at First Baptist Church of Glenarden. He has helped hundreds of people get out of debt.

I thought again about Ellerbe's warnings after some readers wrote to say that I was reckless for recommending recently that someone take a $30,000 life insurance payoff and put it all toward paying down a $39,000 student loan debt carrying a 3.5 percent interest rate.

You would have thought I suggested the person burn the money.

"Why in the world would you pay off a 3.5 percent loan when you can put that money in the bank?" one reader asked. "Were you sleeping in your finance classes?"

Others criticized me for not suggesting the person stick to the scheduled loan payments because the interest is tax deductible. Still others thought I was being irresponsible for not recommending that the borrower invest the money.

I did reconsider what I suggested. In fact, recognizing that some people need a second opinion, I consulted a finance economist. Specifically, I asked Lewis Mandell, professor of finance and managerial economics at the University at Buffalo, to analyze the following choices:

· Paying down a 10-year student loan debt of $30,000 versus keeping it for a tax deduction. (We picked $30,000 to simplify the math.)

· Paying off the debt at 3.5 percent compared with putting the cash in a savings account earning 4 percent.

· Paying the debt versus investing the money.

Let's take the first point. If the former student has a modified adjustable gross income of less than $65,000 (single) or $130,000 (married filing jointly), qualified student loan interest is deductible up to $2,500 per year. This particular tax deduction is available regardless of whether you itemize tax deductions on your tax return.

Under this scenario, the 3.5 percent interest on a $30,000 loan would be $1,050 the first year. (To keep things simple, Mandell used annual figures and did not factor in changes due to amortization.) If the former student is in the 28 percent tax bracket, she'd pay $756 in interest the first year, saving $294 because of the tax deduction.

However, she still has to make interest payments if the loan is stretched out for 10 years. Yes, she'll pay less because of the tax deduction, but she's still paying interest.

Round one goes to me.

Oh, and might I point out that student loan debt won't be cheap in the future. Federal student loans disbursed after July 2006 are now at a fixed rate of 6.8 percent. That should make the decision to pay off this type of debt early a little easier.

Now what if the borrower put the $30,000 in a savings account earning 4 percent interest? She would earn $1,200 the first year. Keep in mind, however, she only keeps 72 percent, or $864, of the $1,200 (you've got to pay taxes on the earnings).

The difference between $864 and the $756 equals $108, which is a positive result of higher interest on the investment and the tax deductibility of the loan, Mandell said.

Okay, if the loan is $30,000 I'll have to give this one to the keep-the-debt crowd, assuming of course that the money would earn a guaranteed 4 percent each year for the 10-year period.

However, in the case of the reader with a $39,000 loan, the math changes: The interest would be $1,365; after taxes, that translates to $983. Subtract that from the $864 earned on the $30,000 savings account, and you get minus $119. Round two goes to me.

Even if the terms are more favorable, Mandell says there are other things to consider. Because repaying a loan is a risk-free investment (your return is guaranteed and equal to the interest on the loan), you must be able to invest the funds in an equally risk-free investment with identical cash flow characteristics.

"While a savings account may be free of default risk, it has no guaranteed return since rates may go down tomorrow and you may end up getting only 3 percent or 2 percent on your money," Mandell said. "And, since you must make monthly payments of $296.66 on the loan for a 10-year loan at 3.5 percent annual interest, you must find an instrument that will pay you exactly $296.66 per month for 10 years."

You could purchase an annuity from a life insurance company, but the fees would undoubtedly eat up the difference in interest rates, the economist pointed out.

"If we invest our money in something with risk (as compared to no risk when you pay down a loan), we may have a higher expected return, but we also take on more variance or fluctuation in the value of our asset," Mandell said.

Under this circumstance, Mandell says, strongly consider paying down the debt.

Round three goes to me.

On a personal note, Mandell said he and his wife recently sold some property and used the proceeds to pay off the mortgage on their home, which had an interest rate of 5.875 percent.

"Even though I teach investments and realize that I probably would have done better keeping the loan and investing in stocks, we just don't like having debt and feel that we just invested in the equivalent of a risk-free Treasury bill that pays 5.875 percent, which is more than they actually pay today," he said.

The lesson here is to consider your choices when given the chance to pay off a debt with a lump sum.

But I would urge you to weigh heavily what I've been learning from Ellerbe and the financial freedom class. That is, the peace you get from being debt-free is priceless.

· On the air: Michelle Singletary discusses personal finance Tuesdays on NPR's "Day to Day" program and online athttp://www.npr.org.

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