CHIEF INVESTMENT OFFICE

Debt and Homeownership

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As women save for retirement, it is critical to remember that retirement savings is part of a much bigger lifetime financial picture. Two important elements of that picture are debt and homeownership. Debt is very important for many families and for some, if not carefully managed, can interfere with financial stability. Housing is the biggest item of current expense for the vast majority of families. This article will link the topics of debt and homeownership to retirement savings. Focusing on important financial decisions made during a women's working years, such as whether you should pay off debt or save for retirement, what level of debt is acceptable, what debt should be paid off first, and how much one should spend on housing. As they near retirement, women need to make financial choices, such as: Should I pay off my mortgage, and where should I live in retirement?

Gender debt gap: Women on average pay more for mortgages, although women are better than men at paying their mortgages.[1]

DURING WORKING YEARS

In working years, there are a number of key financial decisions and choices that women typically need to make as relates to debt and housing.

Should I pay off debt or save for retirement?

Working-age women typically need to decide whether to pay off debt or save for retirement, or how much to do of each. Women should pay off high-interest debt, such as credit cards, as quickly as possible. For example, if you are paying a high rate of interest on your debt, say 18%, once you pay if off, you've just gained 18% that you had been losing. If you think of paying off debt as an investment, you just received an 18% return on your investment.

[1] According to the Urban Institute study "Women Are Better than Men at Paying Their Mortgages," September 2016-latest data available, which reviewed more than 60 million mortgage originations from 2004 to 2014, single women pay higher rates than single men on average on their mortgages.

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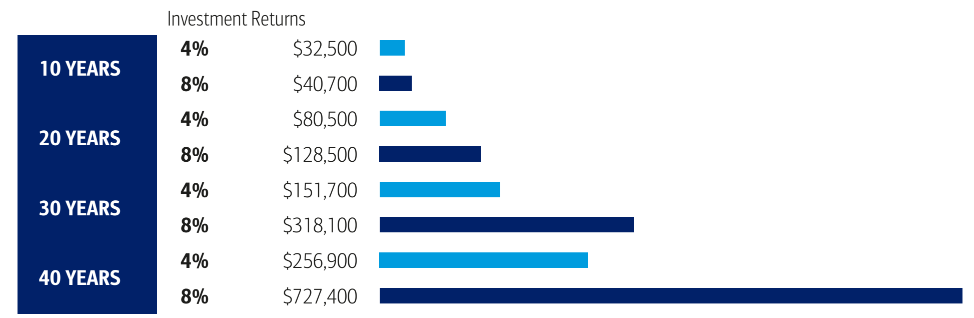
But it is also important to remember that putting off saving for retirement until you're debt-free could cost you the most valuable asset you have: time. Due to compounding, even small contributions to a 401(k) or similar retirement plan have the potential to grow significantly (Exhibit 1), especially if your company matches contributions. If you can't save enough money to hit the annual limits, or even come close to reaching them, you should at least consider contributing enough to get the company match. This will allow for an instant and guaranteed return on your investment, and you won't feel as if you are missing out on a benefit by not participating.

The bottom line is that while your creditors will go after you if you fail to pay your debts, nobody is going to force you to save for retirement.

Over time, saving a small amount each week could add up

The table below shows the impact of saving $50 each week. For example, Olivia saves $50 each week starting at age 25; by age 35, assuming a modest annual return of 4% per year, she would have saved $32,500. At age 45, Olivia would have saved $80,500 and by age 65 when she retires she would have saved $256,900.

Exhibit 1: The affect of saving $50 per week



For illustrative purposes only. These figures do not take into account taxes and fees.
Source: Calculations by Chief Investment Office. These mathematical calculations assume two investment returns of 4% and 8%. It is not tied to a specific allocation model or index returns. There are periods when returns can be higher or lower than these returns. No fees are assumed.

What is considered an acceptable amount of debt?

A variety of lending metrics can help you determine whether your overall debt level is appropriate. Below is a commonly used measure:[2]

Debt-to-income (DI) ratio, the ratio of debt payments to total income, is calculated by lenders to determine whether a potential borrower can bear additional debt.

$$\text{DI} = \left(\frac{\text{Annual mortgage payments} + \text{annual student loan payments} + \text{annual credit card payments}}{\text{Gross family income}}\right)$$

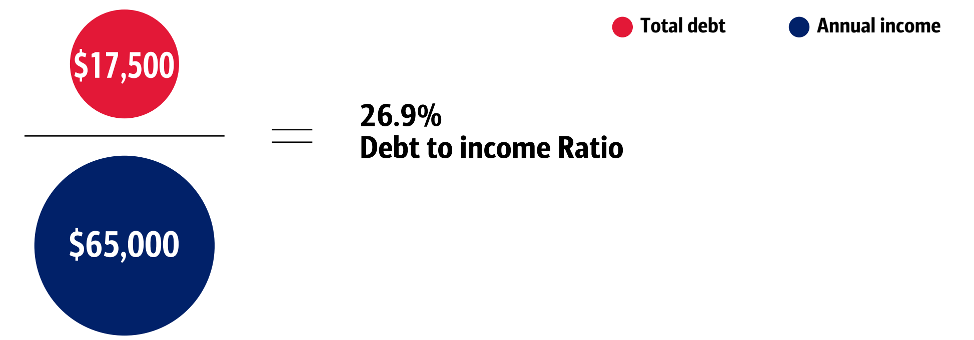
Lenders generally consider a result less than 36% indicative of an acceptable level of risk for homeowners.[3]

Consider Jane, a working professional with a monthly mortgage payment of $1,000 (annual payment of $12,000), an annual student loan payment of $3,000, annual credit card payments totaling $2,500, and a gross family income of $65,000. This would give her a DI ratio of 26.9% (= $17,500÷$65,000). Based on the benchmark of 36%, Jane appears to be carrying an acceptable amount of debt (see Exhibit 2).

[2] A variety of additional metrics can be considered. For further discussion, refer to Shawn Brayman, "*Introducing the 'Debt Policy Statement.'*" Journal of Financial Planning, Vol. 24, No. 4, April 2011.

[3] Source: Consumer Financial Protection Bureau, "Your Money, Your Goals." June 2020.

Exhibit 2: In this example, what is considered an acceptable amount of debt?



Source: Chief Investment Office. For illustrative purposes only.

One way to avoid getting too deeply into debt is to set aside some money to cover emergencies like a major illness, car or home repairs or a job loss. It is recommend that you have enough to cover three to six months of everyday expenses. Use part of each paycheck to build an emergency fund. Keep in mind also that some financial emergencies can be anticipated and planned for with different types of insurance.

Which debts should I pay off first?

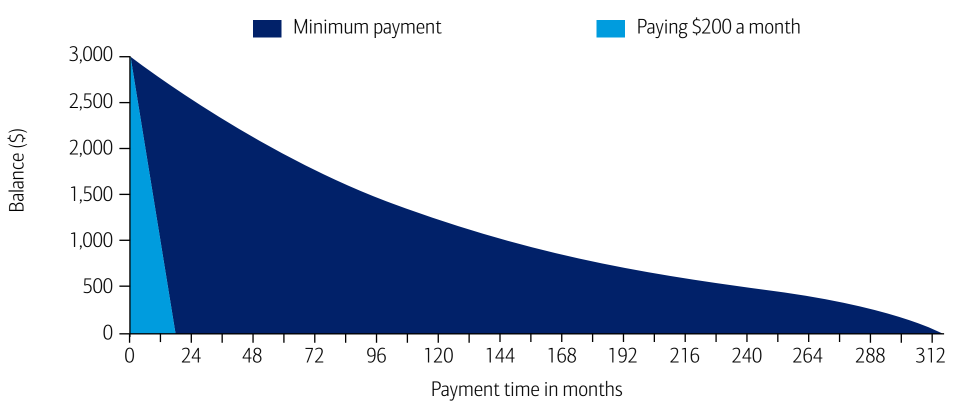
It is important to distinguish between "good" and "bad" debt. Money you borrow for a home or an education is considered "good" debt. That's because these items can help boost your financial position. In addition, some home and student loan debt may be tax-deductible. There's no need to put pressure on yourself to repay those loans as long as you can continue making regular installment payments. "Bad" debt, on the other hand, includes anything that doesn't improve your financial position. "Bad" debt is usually in the form of credit card debt or a personal bank loan.

You should typically tackle bad debt first. Student loans can generally come second. These loans, especially federal loans, have lower rates than most other types of consumer debt, and you may be able to deduct up to $2,500 of the interest. To free up more for retirement, consider paying the minimum required each month under the terms of your loan.

Paying off debt sooner rather than later

Sarah has a credit card balance of $3,000, and the interest on the card is 15%; it takes nearly 26 years to pay off the balance if she pays only the minimum of 2%, with $4,457 paid in interest. But it takes less than 1.5 years to retire the debt if Sarah can pay $200 each month (see Exhibit 3).

Exhibit 3: Paying off debt sooner rather than later



Source: Calculations by Chief Investment Office. For illustrative purpose only.

It is important to have a plan in place to pay back "good" or "bad" debt and to stick to the plan. The scale of outstanding student loans and an increasing share of borrowers who fail to repay mean that many Americans have become aware of student debt as a challenge for individuals. But many do not think of student debt as a women's issue despite the fact that women represented 59.5% of those enrolled in American colleges and universities in the spring of 2021. A recent American Association of University Women (AAUW) report[4] reveals that women take on larger student loans than do men. As a result, women hold nearly two-thirds of the outstanding student debt.

How much money can I spend on housing?

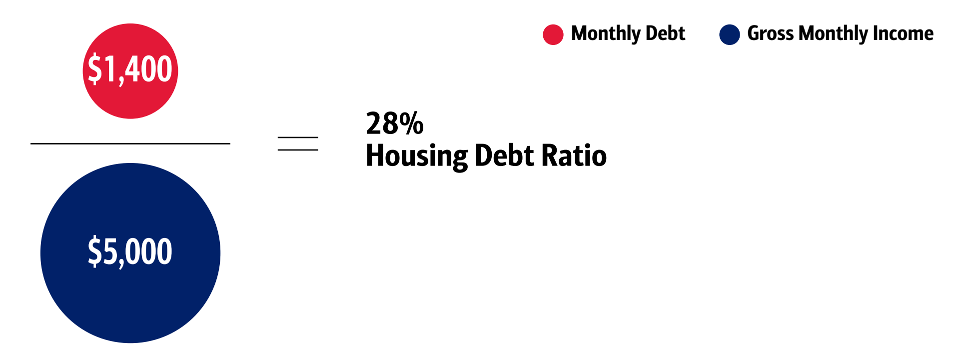
Buying a house is a significant decision for many households and for many one of the largest financial transactions they will ever make. Some people buy houses thinking that their earnings are likely to rise and that the house value will probably go up. There is uncertainty on both of these points. Women should remember how important it is to save for retirement and include retirement savings in their budget calculations when they decide how much they can afford to spend on a house.

You can use 28% as your rule of thumb when making a budget for buying a home. Here's an easy formula: Multiply your gross monthly income by 28, then divide that by 100. The answer is 28% of your monthly income.

$$\text{Monthly housing expense} = \left(\frac{\text{gross monthly income x 28}}{100} \right)$$

Consider Sue. Her annual income is $60,000, or $5,000 per month; 28% of that monthly income comes out to about $1,400. That means Sue could spend $1,400 on a mortgage. Remember, 28% is the top of the spectrum when it comes to how much of her monthly income she should spend on her mortgage. Paying less means a smaller strain on Sue's budget (See Exhibit 4).

Exhibit 4: How much can I spend on housing?[5]



Source: Chief Investment Office. For illustrative purposes only.

Owning a house or condominium also probably increases the need for an emergency fund, since there are a number of uncertainties involved. Repairs are always a part of the picture ,some of them major, and special assessments are part of the picture in condominiums. Taxes may also go up if the local community needs more money.

On the positive side, taxpayers who itemize deductions can usually deduct home mortgage interest and real-estate taxes. You may be able to use your home as a source of income in the future by trading down to a less-expensive home, perhaps by moving to a lower-cost area or by tapping into your home equity through a loan or a reverse mortgage.

TIPS

- Maintain a good credit rating. Paying attention to your credit rating will help keep your options open.
- Don't get involved with expensive payday loans—paying these off should be a priority; they are extremely expensive. Credit card debt is also very expensive, and paying it off should be a priority.
- Be sure to maintain an emergency fund.
- Carefully evaluate the need, the terms and the plan for repaying it before borrowing money.
- Don't spend too much—and particularly not on housing.
- Married women (and partners of single persons) should be very careful about co-signing loans and about how they are structured. Many people have found themselves liable for a partner's debt after a relationship has ended.

[4] 68% of students borrow money to pay for their undergraduate education. Among those who take out loans, women—who borrow an average of $31,276—take on more debt than men, who borrow an average of $29,270, American Association of University Women "Deeper in Debt: Women and Student Loans," May 2021.

[5] This is a commonly used financial planning rule of thumb as it relates to calculating housing expense allocation.

Should I upgrade my house versus save more for retirement?

This is a combination of a lifestyle choice and of priorities. If you're on target to have adequate resources in retirement, there is no problem upgrading the house. But if you're behind target for retirement, it is probably better to save more for retirement and put off home improvements. It is also depends on how necessary they are.

NEARING RETIREMENT

As you near retirement, there are a number of choices regarding debt and housing that need to be made.

Should I pay off my mortgage before I retire?

Although it remains the goal of many households to repay their mortgage by the time they retire an increasing portion of the population now enters retirement with a mortgage. At the same time, households are increasingly likely to hold substantial amounts of financial assets, as a result of the growth of 401(k) and similar plans. Among households aged 55 to 64 in 2019, 51 percent had a mortgage.[6]

Analysis by the Center for Retirement Research at Boston College indicates that retired households are, in theory, better off repaying their mortgage. In addition to their conclusion, there is also a very practical argument against borrowing to invest. If a household with a mortgage mismanages its investments or overestimates the rate at which it can decumulate those investments, it risks losing the house—its only remaining asset. One argument that is sometimes cited in favor of not repaying the mortgage is that retaining a mortgage increases the household's liquidity and enables it to better cope with sudden unexpected expenses.

Where should I live in retirement?

Housing is one of the largest expenses people have in retirement. Where to live in retirement can be a lifestyle decision, a financial decision or a health care decision. Many people assume that once they retire, they will downsize their home. However, a study conducted by Bank of America showed pre-retirees who expect to downsize when they retire may be surprised to learn that half (49%) of retirees didn't downsize in their last move. In fact, three in 10 upsized into a larger home.[7]

Many retirees can "age in place." Others find their homes have become unaffordable, too difficult to maintain, or unsuited to increasing physical or cognitive limitations. Of those who must move, many prefer to remain in the communities they know, while others, often after a great deal of planning, opt to move elsewhere—to live in a warmer climate, to be near their kids, to experience something new, or to address other goals and purposes.

It is best to think about retirement housing well before the need to move arises. After all, it can take a long time to sell a house, and values can go down as well as up. In addition, housing decisions, once acted upon, are likely to be difficult and costly to change.[8]

IN CONCLUSION

Women face many financial decisions and choices surrounding debt and homeownership in their working years and as they near retirement. Although not always apparent, many of these decisions will influence their ability to achieve long-term financial and retirement security. It is important that women not neglect retirement savings when taking on debt and deciding how much debt to take on or when purchasing a home or deciding where to live in retirement. Keeping debt and housing expenses to affordable levels and establishing a debt repayment plan and sticking to it can help women achieve a more secure retirement.

TIPS

- Evaluate where you are on the path to an adequate retirement.
- Adjust your saving rate so you can meet retirement goals.
- If you are a homeowner, figure out when your mortgage will be paid off. If it is after your planned retirement date, determine whether you should accelerate payments.
- Evaluate debt and whether you can (and should) reduce it and pay it off
- Consider whether you will stay in your own home or relocate. The affordability of your home is a factor in the decision. (Remember that there is a wide variation in housing costs by location.)
- Evaluate whether you can afford to retire at the planned time.

[6] Based on the 2019-latest data available-Survey of Consumer Finances, Federal Reserve Board.

[7] Bank of America "Housing in retirement: Your life, your choice" 2023.

[8] For a more detailed discussion of this topic, refer to: Society of Actuaries: Managing Retirement Decisions Brief: "Where to Live in Retirement," 2017-latest data available.

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