Young Doctors and Debt: A Script for Success

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As the expected income of medical residents and fellows goes down, their student debt goes up. This produces a squeeze for young MD professionals. They have less money to pay back what they owe. This situation initiates feelings of frustration in young doctors starting out in practice. Cynicism and depression related to debt can follow.* Never has there been a time when attention to debt repayment and finances has been more important for a young physician.

For example, both Dr. Oblivious and Dr. Wise owe $130,000.00 in student loans and $20,000.00 for a car loan. Dr Oblivious is a good doctor, but is more interested in caring for his patients than himself. He says, "I'll pay off all my debt at the same time." Dr. Wise, on the other hand, recognizes the benefit of an organized plan for his financial life as well as patient care. As a result, he pays off his car loan preferentially while just paying the minimum required each month for his student loans. This allows Dr. Wise to keep thousands of dollars in his pocket instead of paying it out for loan service. At the same time, he is also able to invest in his new practice's retirement plan.

How did Dr. Wise do this? A second year resident I recently met with could have been Dr. Wise. He asked me, "What should I do with my expendable dollars? Should I pay down debt or invest the money? If I should pay down debt, how should I do it?" The physician brought me a list of the dollar amount of each loan, its interest rate and the term. He had also figured the exact amount of expendable dollars he could afford each month for debt service and repayment. He calculated this by subtracting his cash outflows each month from his inflows.

My reply to this resident was, "Know your risk free investment return because that is the benchmark for your decision about whether to pay down the debt versus only the interest as opposed to preferentially investing the money. The risk free investment return is used because any other market return is hypothetical and money could be lost. A reliable risk free return is a bank issued certificate of deposit (CD). This can be found on Bankrate.com.

A Nugget worth its Weight in Gold

There generally are two loan categories: High interest without a tax deduction (credit card and car) and low interest with a tax deduction (student loan and mortgage). Deductibility will make a difference in the final cost of the loan to the borrower. Therefore, **it is most often best to pay off high interest non-deductible interest loans first and low interest deductible loans second.**

First we looked at the doctor's **high interest loans** and worked out the figures based on $1,000.00, a sum that could easily be multiplied to reflect the actual amount of the loan. We found that **paying down high interest debt that can't be deducted is advantageous**. **This includes credit card and car debt.** The only exception is when the risk free return is high, which it has not been since the early 1980s. ***To delay paying off high interest debts is hazardous to a young doctor's financial health.***

This is how we did the figures. We used the current 12 month certificate of deposit (CD) annual percentage yield (APY) of 3.48% and the credit card (or car) interest rate of 16%. We figured that if Dr. Wise invested in the CD, he would have his original $1,000.00 plus $34.80 in interest leaving him with $1,034.80 after 12 months. In the 25% tax bracket he would owe $8.70 in taxes on the sum. His net gain on this investment would be $26.10. If he paid down his credit card or car debt, he would save $1,000.00 x 16 % or $160.00 in non-deductible interest charges. Therefore, Dr. Wises' net gain is $160.00 if he pays down his high interest debt, considerably more than the $26.10 he would yield on his CD.

The next area we looked at was Dr. Wise's **low interest loans**, the interest of which could be deducted. We found that **it is best to pay down the student loan (and often mortgages) after the credit card and car debt. This is because they cost less for the debtor than the high interest debt.**

This is how we made this determination. We worked out the figures for the low interest loans based on $1,000.00 using the same current 12 month CD APY of 3.48%, but a student loan interest rate (or mortgage) of 4.50%. The figures on the CD are the same, a gain of $26.10. By paying down his student loan (or mortgage), he would save $1,000.00 x 4.5% or $45.00 in annual interest charges. These interest charges are tax deductible, so they effectively increase in value due to their tax deduction. That means he gained $45.00 x 25% or $11.25 in saved taxes. His net gain was $56.25, a better return than investing in a CD.

From the information above, it is seemingly advantageous to pay off all loans and mortgage before investing in any other kind of investment. But, the apparent is not always real. This is because young doctors can often enroll in a 401K or another retirement plan with matching dollars provided by their group. Then, the risk free return is double because half the money he/she invests up to a certain point is matched free. Therefore the risk free return is double up to the matching point.

If we were to run the numbers above for the low interest loan compared to a 2 X 3.48% return rather than a 3.48%, it is easy to see that investing in an employer's 401K or other retirement plan up to the matching dollars is a better choice than paying down the low interest, tax deductible student loans immediately. This approach gives several benefits:

- Matching dollars provided by the employer;
- Money not taxed going in plus grows tax free;
- Tax advantaged dollars compound. This is particularly advantageous with an early start date.

The only caveat to this is that an emergency fund (3-6 months) and disability insurance should be in place as a priority before investing, or paying down low interest, tax deductible student loans.

A Nugget worth its Weight in Gold

If your employer has a retirement program that provides matching dollars, invest in it up to the limit of the matching dollars before paying back the low interest deductible loan.

Happily, there are even ways not have to pay back some of the debt altogether. One is if your new practice will take the student loans as part of your employment contract. Another is if you chose to serve in an area that the government qualifies as underserved and your debt is forgiven for that reason.

Finally, if nothing seems to be working to pay off that debt, a debt consolidator could be an option. I do have a word of caution. These organizations are running a business to make money. Their primary concern is to keep their balance sheet healthy, which means directing revenues to itself more than to you. Therefore, in signing on the dotted line, you almost certainly will be paying more than if you had handled the debt yourself. In my mind, a consolidator is a solution of last resort.

In summary, a doctor who wants to put more money in her/his pocket instead of the debtors will follow a logical, methodical plan rather than a haphazard one. The dollars that are saved do not have to be earned in traditional sweat labor. This increases a physician's overall financial health, but without the stress associated with everyday practice. This intelligent approach leads to feelings of empowerment rather than helplessness, an important asset to performance as a physician and in one's personal life as well.

The Script

1. Your working information:

   How much expendable money do you have each month to pay down debt?

   What kind of debt do you have; what is its interest rate and when it is due. Can any debt be refinanced?

2. Your process:

   First, pay down those debts with the highest interest rates that are not tax deductible. Some lower interest tax deductible debts will have to be paid down simultaneously if they cannot be refinanced.

3. After paying down the initial debt that is costing more, pay down lower interest rate debt that is tax deductible. If your employer has a retirement program that provides matching dollars, invest in it up to the limit of the matching dollars before paying back the low interest deductible loan.

4. A Caution. Additionally, an emergency fund (3-6 months) and disability insurance should be in place as a priority before investing or paying down low interest, tax deductible student loans.

5. Eureka! Make some of your debt vanish:

   Negotiate with your new practice to take over your student debts upon signing your contract.

   If you are interested in helping the underserved, choose a location compatible with student loan forgiveness.

6. If all else fails—consider a debt consolidation:

By taking out a loan from a debt consolidator to pay all of your debt in one payment, you can simplify your life, at least for the time being. This may make you momentarily feel better. However, there will be a cost. Though the payment may be lower than servicing all your debts every month, you almost certainly will have to pay off debt for a longer period of time. Ultimately, this will cost you more. This is not a smart move unless you have not other choice. The deeper problem is that use of a debt consolidator suggests your financial affairs are not in order, a potential sign of a more serious problem with money. More about loan consolidation can be found at the Association of American Medical Colleges website loan consolidation primer.

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A Nugget worth its Weight in Gold

The Association of American Medical Colleges website offers education debt management for residents. It is a helpful resource.

*Stress in Medical Residency