FPA FINANCIAL PLANNING PERSPECTIVES

Think The Subprime Debacle Is All About Housing?
It Hurts Small Businesspeople Too

If you're planning to go into business for yourself in the next year, you need to understand that the subprime lending debacle might have a significant impact on your ability to borrow not only for your business, but for your personal needs as well.

Self-employed people with excellent credit find out very quickly when applying for a mortgage or any other loan that lenders find it hard to "verify their income." Even if you show years of tax returns, invoices and copies of cancelled checks, individuals working for companies that track their income on a weekly basis for the IRS get a slightly better review from lenders who like to be able to see assets and liabilities that they can verify.

This doesn't mean you won't get a loan, but it may be a more arduous process and you very well might pay more than a person with a conventional job. You may be shifted into the "low-doc" or "no-doc" pile, which refer to low- or no-documentation loans that often cost the borrower more but allow approval based on less proof of income.

No one should pass up a chance at entrepreneurship simply because it might be tougher to get financing in a range of areas. But it does call for extra financial preparation before you take the plunge. It makes good sense to talk with a financial planner as well as a tax adviser as you plan your business. Your personal finances must be planned around it as well. Some key issues to discuss:

Consider your real estate plans before you leap: If you are happy in your current residence and believe you have the best financing option right now, then be happy to keep that situation in place. But if you want to downsize or refinance your current mortgage, it is considerably smarter to investigate those options before leaving your current employer for all the reasons we stated above. However, with the slow real estate market in most areas of the country, you need to take into consideration the average time on market for homes in your area before you list yours. It's pretty tough to start a business with two mortgages.

Continue your retirement savings: It's very easy in the first months of business while you're waiting to get the rhythm of cash flow in the business going to say, "I'll deal with retirement later." This is not just a mistake but a ticket to disaster. With all the other important issues you're committing to as part of starting a company, make absolutely sure you allot funds for retirement savings each year and don't miss those contributions.

-more-

Get your insurance options in place: Whether you purchase health insurance through COBRA at your old employer or whether you buy coverage on your own, get it in place before you quit your old company, and make sure you analyze your needs closely so your major health issues are covered.

Get disability coverage before you leave your employer: This is a really crucial step because disability coverage you buy is based on a percentage of current income. In the first few years of a business, you conceivably will not match your current salary, so you wouldn't be able to buy as much coverage as an independent. Get that coverage in place now. You should be able to specify the level of benefits you receive, up to 60 percent or 80 percent of your income from work. (Insurers won't cover 100 percent of income, because they want you to be motivated to return to work after a disability.) Generally, the higher your benefit level, the greater your premiums.

Extinguish as much debt as possible: Whether you're starting a business or working for a traditional employer, in this new lending environment, there's a very common piece of advice that all potential borrowers should share – pay off as much revolving debt as possible. Higher-rate revolving debt at more than 30 percent of a credit limit on an account will damage a credit score, and borrowers with lower credit scores generally get less attractive loan rates.

-30-

This column is produced by the Financial Planning Association, the membership organization for the financial planning community, and is provided by a local member of FPA