How to Pay Off Debt

Getting clear of debt is an important contributor to one's financial health. This topic presents several strategies for paying off debts, and guides you through the process of creating a viable debt payoff plan.

Time Investment
1.5 hours

National Financial Educators Council

How to Pay Off Debt
Loans & Debt

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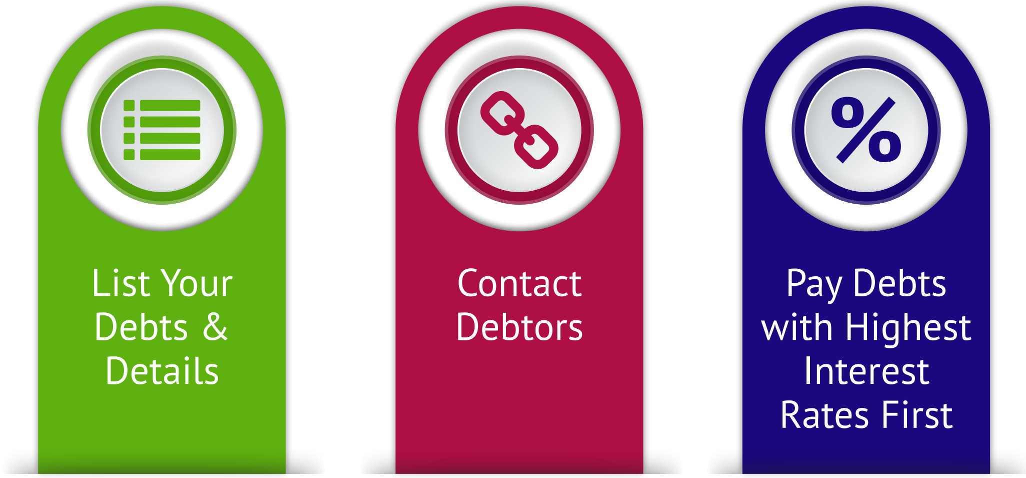
Before you even consider taking out a new loan, it is important to have a clear plan in place for paying back any money you already owe. Proactively creating a debt payoff plan for your existing loans is an important skill you can apply when you take on new debt. You can take the same skills you implemented in your debt payoff plan and apply them to effectively manage any new debts you take on in the future.



It is always important to completely understand the terms of any loan you take on. Basic components of a loan include the interest rate, repayment period (term), the minimum monthly payment, and the total amount owed (principal balance). Before you ever sign loan documents or a credit application, read the terms and conditions closely and consider how/whether the loan fits into your overall financial plan.

You should also understand the impact of the loan on your overall finances. For instance, mortgages and student loans may offer tax benefits that may help lower your tax liability. It's important to understand all the benefits and drawbacks of each various type of debt so you can plan accordingly.

Before taking on new debt, your first step is to know exactly how much debt you already have and the terms of all your loans. Vehicle loan(s), mortgage, credit cards, tax debt, and consumer credit lines (e.g. the credit cards you can use only at specific stores) are just a few common examples of debt.

Getting all the information into a single location helps you more easily identify the best path for chipping away at your debt.

Creditor Name	Type of Loan	Amount Owed	Interest Rate	Minimum Payment	Available Balance
Dept of Education	Student	$20,167	6.8%	$177	N/A
ABC Financial	Mortgage	$267,000	4.90%	$1,417	N/A
MasterCard	Credit card	$2,245	24%	$32	$4,755
Visa #1	Credit card	$567	27%	$20	$3,933

The Root Cause

For people who feel buried by debt or feel like things are a bit out of control, a critical first step before implementing a strategy is taking time to understand what got you into this situation in the first place. As with most things financial, it simply boils down to spending too much and not earning enough. But understanding the choices and financial sentiments that led you to this point is what you must discover.

- Spending money on lifestyle or status purchases
- Not being aware of income / expenses while you threw everything on a credit card
- Not understanding loan terms such as variable payments or minimum payments
- Letting insurance policies lapse and then having to deal with a loss or medical expense
- Spending money on gambling in hopes of "winning big"
- Reduced income or becoming underemployed

Implementing a strategy and sticking with it is important, but ensuring that you do not fall into the same financial traps – whether they come from an external source or within your own mind – is critical to being successful.

Lastly, any strategy you select will not solve your problems overnight. It is important to set realistic expectations and understand that any debt payoff plan can take years to complete.

Strategies to Pay Off Debt

Once you have everything organized, you can implement a debt payoff plan that is suited to your specific situation. There are several different strategies for paying off debt. Each strategy has different pros and cons, but all are heavily dependent on your own financial psychology related to debt and spending.

The two primary methods for debt payoff are called Avalanche and Snowball. With Avalanche, you pay off debts based on targeting the one with the highest interest rate first. With the Snowball method, you pay off debts in order according to the balance owed.

The Debt Avalanche

With the Avalanche method, you pay off your debt accounts in order, starting with the one that has the highest interest rate. Then you pay off the one with the next-highest interest rate, and so on until all the accounts are paid.

The benefits of the Debt Avalanche are that you pay less total interest, and you get out of debt sooner than with other strategies. Although it takes time to see progress, once you get momentum going, your debts will begin sliding away…like an avalanche down a mountain slope.

This method is especially helpful for people who have a lot of high-interest debt, like credit card balances. We recommend Avalanche as the most effective debt payoff method.

How to implement the Avalanche payoff strategy:

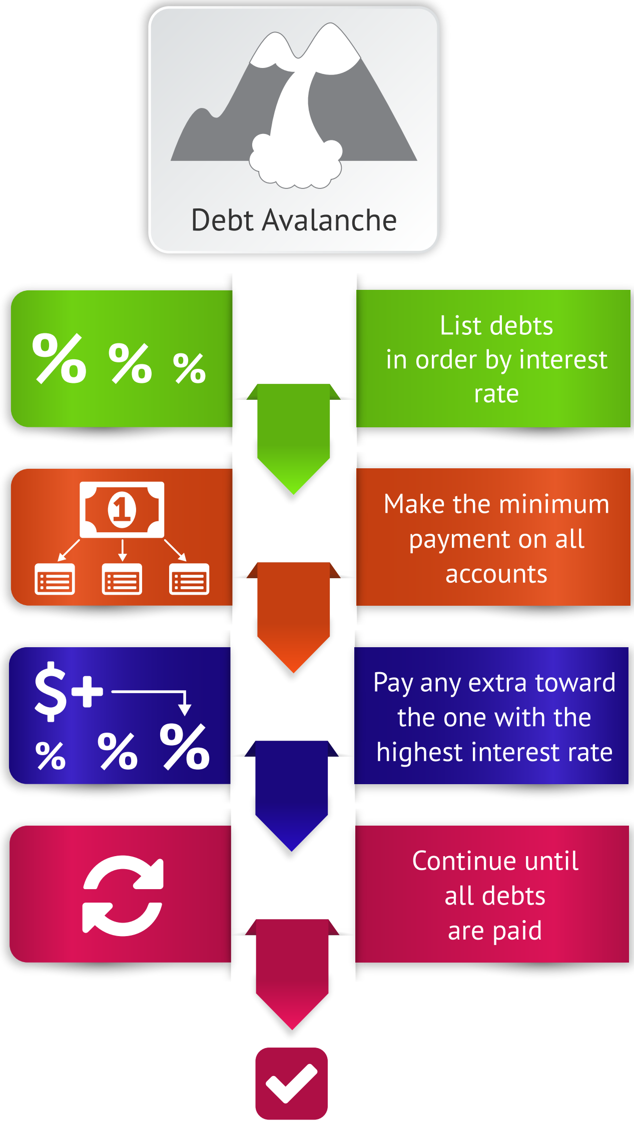
Step 1: List all your debts in rank order by interest rate, with the highest rate first.

Step 2: Always make the minimum required monthly payment on every debt.

Step 3: If you have extra money left over from your budget, pay as much as you can toward the debt with the highest interest rate.

Step 4: When you've paid off the debt with the highest interest rate, move on to paying extra toward the one with the next-highest interest rate.

Step 5: Continue in this vein until all your debts are paid off.



The Debt Snowball

The Debt Snowball method also has you pay off your debts in order, but in this case you start by targeting the account that has the smallest balance, then the one with the next-smallest balance, and so on.

The benefit of the Snowball is that you experience small successes early in the process, which may help you stay motivated to stick with your plan. Every time you pay off a debt, you'll have more money to put toward the next one…like rolling a snowball and picking up more snow as you go along. However, the Snowball method takes longer and you'll end up paying more total interest.

This strategy is good for people who feel overwhelmed by the number of individual debt accounts they have, and who need to feel a quick sense of accomplishment.

How to implement the Debt Snowball:

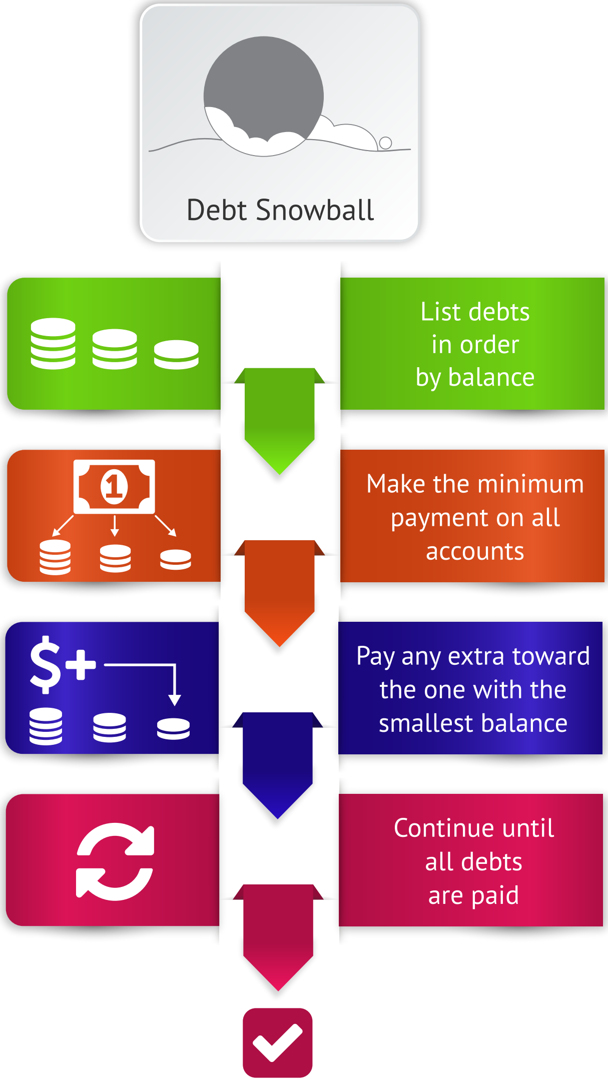
Step 1: List all your debts in rank order by balance owed, with the smallest balance first.

Step 2: Always make the minimum required monthly payment on every debt.

Step 3: If you have extra money left over from your budget, pay as much as you can toward the debt with the smallest balance.

Step 4: When you've paid off the debt with the smallest balance, move on to paying extra toward the one with the next-smallest balance.

Step 5: Continue in this vein until all your debts are paid off.



	Debt Avalanche (Preferred Method)	Debt Snowball
Pros	You pay less in interest Gets you out of debt faster You see high interest rates vanish	Provides motivation You see progress quickly
Cons	Visible progress takes time	You pay more in the long run The process takes longer You pay higher interest

Other Methods of Debt Repayment

There are a few other strategies for repaying debt, but they carry much greater downsides and risk. For most people, the (preferred) Avalanche method or the Snowball method, along with having a solid, realistic budget in place and concerted efforts to improve their financial psychology, are the best choice.

We present the following debt payoff tactics, then, with the strong caveat that you should consider your personal situation very carefully before developing your plan. Each of these methods may have benefits, but you must weigh those benefits against the potential risks and consequences. Remember, there is no "quick fix" for a debt problem! Your unique situation and financial psychology should determine which strategy(ies) you use.

Balance Transfers

If you have credit card debt, one option is to transfer the balance on your credit card(s) to another card with a lower interest rate. Some cards that offer balance transfer opportunities even have a 0% introductory interest rate for some period of time.

RISKS: The company may charge transfer fees for each balance you migrate to the new card. Be very sure that any transfer fees are less than the interest savings you get. Also, note that this strategy only works if you pay off your total balance before the 0% promotional period expires. Otherwise, all the interest debt you would have incurred during the promotional period will be compounded onto the principal. Schedule your full payoff payment a month prior to the end of the promotion, just to be safe.

Personal Loans / Debt Consolidation

Some banks and financial companies offer personal loans that you might use to pay off credit cards and other debts. If you have a lot of credit cards with different statement and due dates, a personal loan may benefit you by streamlining your debts into a single monthly payment. This option only benefits you if the interest rate on the personal loan is lower than the rates on the debts you use the loan to pay off.

RISKS: First, the personal loan may have an origination fee. Check very carefully to ensure that the origination fee is lower than the amount you'll save in interest. Second, you are taking out another loan to clear old debts – meaning you still have the same amount of debt. A personal loan is not free money; you're just shifting the debt from one place to another. Third, you must avoid using the available credit on the cards you pay off, or you will actually increase your debt load! You should not use this option unless you absolutely trust yourself to keep any bad habits in check.

Debt consolidation programs are similar to personal loans, combining multiple debts into a single payment. That is, you make one monthly payment to the debt consolidation company, and they forward the individual payments on to all your creditors for you. These programs typically are offered by credit counseling companies or organizations.

RISKS: First, there's no guarantee that your interest rates will be lower. Consolidating debt into a smaller monthly payment just means you pay more in interest and stay in debt longer. That's part of the trap. Second, debt consolidation companies profit from your irresponsibility. They are businesses – they're selling a product. Many of these too-good-too-be-true offers exist solely to take advantage of the fact that some people are not good at managing their money.

Remember that you cannot borrow your way out of debt. Loans and debt consolidation do not eliminate your debt – they just move your exact same debt load to a different place.

Debt Settlements / Bankruptcy

In debt settlement, you negotiate with the creditor (such as a credit card company or collection agency) to accept a smaller lump sum than the balance you owe to pay off the debt. If you've encountered a hardship like losing your job or becoming disabled, such negotiation may be easier. The benefit is that you get rid of your debt for a lesser amount than the balance you owed. The downside is that all the accounts you settle will be closed, while their negative effect on your credit remains.

RISKS: Although debt settlement can stop your late payments or collections from nicking your credit score further, the damage is already done. Negative marks stay on your credit report for at least seven years.

Bankruptcy is a last-resort option that legally erases your debts. However, the destruction bankruptcy causes to your credit will be nuclear – and it will take seven years (or more) to recover. The legal process can be lengthy and expensive, but talking with an attorney is 100%, absolutely essential before you ever consider filing for bankruptcy.

Conclusion

Debt can be a serious threat to your financial security and peace of mind. But if you're already in debt, it's not the end of the world. It's simply a good time to get organized and create a payoff plan that works for you. Although implementing your debt payoff strategy will be a key contributor to your financial health, it's also important to evaluate how and why you got into debt in the first place. Addressing the root causes of any debt problems you've experienced can potentially improve your chances of reaching your financial goals.

Activity:
Paying it Down

In this activity, you will apply the information you learned in the topic to making informed decisions about debt payoff strategies.

Review the information presented in the table and use it to answer the first three questions.

Creditor Name	Type of Loan	Amount Owed	Interest Rate	Minimum Payment	Available Balance	Notes
Subsidized Loan 1	Student	$12,860	6%	$108	$0	
Stafford (unsub)	Student	$20,009	6.8%	$177	$0	
Perkins Loan	Student	$15,020	5%	$159	$0	
Grad Plus	Student	$5,000	7.90%	$47	$0	
MasterCard	Credit card	$2,245	24%	$32	$255	
Visa #1	Credit card	$4,977	27%	$87	$33	
Visa #2	Credit card	$6,200	0%	$71	$5,800	1 year at 0%, then 9.9%

1. Using the example above, toward which debt should the maximum payment be applied using the recommended Avalanche method?

2. Using the example above, toward which debt should the minimum payments be applied?
- ◯ a. Perkins Loan
- ◯ b. Visa #2
- ◯ c. Subsidized Loan 1
- ◯ d. All besides the one with the highest interest rate

3. Using the example above, which balance would be best to transfer to Visa #2?
- ◯ a. Visa #1
- ◯ b. Stafford, Unsubsidized
- ◯ c. MasterCard
- ◯ d. Grad Plus

4. Use the information below to help Sara make the proper decisions about handling her credit card debt.

Sara Clarkson

Age 33
Interior Designer
Lives above her means

She owes $8,000 on a credit card with a 27% rate.

She owes $5,000 on a credit card with a 22% rate.

She owes $6,000 on a credit card with a 14% rate.

She owes $0 on a new credit card and can transfer up to $8,000 from her other credit cards. She would receive 0% interest on the new card for 6 months; after that the interest rate becomes 16%. There is no balance transfer fee.

4a. Should Sara transfer her $8,000 balance to the new credit card she owes $0 on?
- ◯ Yes
- ◯ No

4b. Why?

4c. Assuming it takes Sara more than 6 months to pay down her debt, which loan should Sara pay off last?

○ Her new credit card, which will have an interest rate of 18% after 6 months.

○ Her credit card with a $5,000 balance.

○ Her credit card with a $6,000 balance.

4d. Why?

5. Use the information below to help Rob make the proper decisions about handling his debt.

Rob Golac

Age 27
Computer Technician
Trying to pay off student loans

He owes $20,000 on a Perkins loan with a 5% interest rate.

He owes $10,000 on a Stafford loan at 7% interest.

5a. Rob can qualify for a student loan consolidation that would consolidate the debt into a single payment. The new loan would be for $30,000 with an interest rate of 8%. Should he do it?

○ Yes, so he just has one payment.

○ Yes, so his loan is consolidated.

○ No, because the interest rate is higher on the consolidated loan.

○ No, because his Perkins and Stafford loans are paid on different dates.

5b. If Rob does not consolidate, which loan should he pay down first?

○ Perkins loan at $20,000.

○ Stafford loan at $10,000.

○ Both loans at the same time.

Activity:
Create Your Debt Payoff Plan

This activity guides you to develop your own individual plan to pay off your current debts.

Make a list of all your current debts. Include the debtor name, type of debt (i.e. student loan, vehicle loan, mortgage, credit card), the amount you owe, the debt's interest rate, and the current minimum monthly payment.

Decide on the repayment strategy with which you feel most comfortable: Avalanche (paying down the debt with the highest interest rate first) or Snowball (paying down the debt with the smallest balance first). Keep in mind that Avalanche is the preferred and recommended method because it saves you the most money.

Select the debt you plan to pay off first (highest interest rate or smallest balance, depending on the strategy you chose). Calculate how much extra payment you could add. While you're fighting the first debt, it'll feel difficult, because you will need to shave some money off your budget elsewhere to make the additional payment. But once you pay off the first debt, things will start to move faster.

Calculate the number of payments left on the debt you have chosen to attack first. You can use an online loan repayment calculator to get an exact number, or you can roughly estimate the number by dividing the amount you owe by the total payment you intend to make (minimum PLUS additional). Your estimate will be off by a few months because it does not account for interest payments, but it is easy to estimate if you don't have online access at the moment.

Example:

Debtor Name	Type of Loan	Amount Owed	Amount Rate	Minimum Payment Amount	Additional Payment Amount	# of payments left at maximum payments	Notes
Dept of Education	Student	$20,167	6.8%	$177			
ABC Financial	Mortgage	$267,000	4.9%	$1,417			
Visa #1	Credit card	$567	27%	$20	$120	4	
MasterCard	Credit card	$2,245	24%	$32			

Activity: Create Your Debt Payoff Plan

Once you finish your first debt, apply the full payment of your previous debt (minimum PLUS additional payment) to the next debt:

Debtor Name	Type of Loan	Amount Owed	Amount Rate	Minimum Payment Amount	Additional Payment Amount	# of payments left at maximum payments	Notes
Dept of Education	Student	$20,167	6.8%	$177			
ABC Financial	Mortgage	$267,000	4.9%	$1,417			
Visa #1	Credit card	$0	27%	$20	$120	4	
MasterCard	Credit card	$2,245	24%	$32	$140	13	

Complete your debt payoff plan:

Strategy

- ◯ Avalanche: Pay off highest interest debt first.
- ◯ Snowball: Pay off lowest balance debt first.

Activity: Create Your Debt Payoff Plan

Debtor Name	Type of Loan	Amount Owed	Amount Rate	Minimum Payment Amount	Additional Payment Amount	# of payments left at maximum payments
Notes						
Notes						
Notes						
Notes						