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» Examining different kinds of debt

» Erasing debt with different methods

» Steering clear of accumulating more debt

Chapter 1

Eliminating Debt: The Basics

Everyone hates having debt, but think about it: 99 percent of the population just can't feasibly make a significant purchase or tackle a crisis without taking on some kind of debt, like student loans, auto loans, and credit cards. However, that doesn't mean you can't do anything about it.

This chapter looks at the different types of debt to help you create a budget for paying it off. You find out how to rank the importance of each debt so you can create a payoff plan that works with your budget, and you get tips anyone can use to keep themselves from accumulating more debt. It's all fun and games when you come home with something shiny until you have to pay it back.

REMEMBER

The illusion that you're a terrible person if you have debt is a common misconception. In fact, many personal finance gurus even suggest that if you have debt, you shouldn't enjoy your life until you pay that debt off in full. Ignore them. Debt happens to everyone at one time or another, and you don't deserve a lower quality of life than the person down the street.

Looking at the Different Types of Debt

You acquire *debt* when you borrow a certain amount of money intending to pay it back. People can take on debt, but so can companies, corporations, and even countries. Heck, as of this writing, the United States is more than $33.7 trillion in the hole, according to U.S. Debt `Clock.org`.

Different types of debt affect your credit score in different ways, as you find out in Part 2. You want different types of debt paid off in full on your credit report so lenders can see that you're a trustworthy applicant capable of paying off more than one type of loan. You *do not* want too many open or any delinquent accounts. The following sections review the different types of debt so you can get organized and pay these monsters off.

REMEMBER

You often see people refer to debt as being "good" debt or "bad" debt:

- *Good debt* typically provides a return on your investment. Student loans are considered good debt because you're using them to secure a college degree, which helps increase your earning potential. Another example of good debt is a home loan because your home can appreciate in value over time, allowing you to sell for a profit.
- *Bad debt* is anything you've borrowed that doesn't further your finances; you can think of bad debt as anything that decreases your net worth over time, usually with depreciating assets. This type of debt includes auto loans (because cars lose their value) and credit cards.

Student loans

Student loan debt is money you borrow for costs associated with higher education, such as tuition, textbooks, laptops, and living expenses. If you attend a trade school or vocational school, additional expenses can apply. For example, you may need specific tools if you go into automotive repair or a stethoscope if you're a medical assistant.

These types of debts are considered *unsecured installment loans*. When a debt is *unsecured*, you aren't providing any collateral to the financial institution (or lender). An *installment loan* means that you'll pay back the loan at regular intervals, but the payment amount may change based on the type of interest rate you have (that is, a fixed rate versus an adjustable rate).

Student loan debt can be recalculated depending on the type of loan and repayment plan. The interest rates on a student loan can be fixed or graduated (the rate increases as income increases). The lender determines the frequency of payments, which can vary but usually occur once a month over several years. Repayment starts six months after graduation, a span known as a *grace period.*

You can receive either a federal loan from the U.S Department of Education or a private loan through a bank or alternative lender. Private loans are much harder for a younger student to obtain because these loans are typically based on your credit score and credit history. Federal loans, on the other hand, require you to complete the Free Application for Federal Student Aid (FAFSA). Each of these types of loans has different requirements as well as pros and cons, such as income-based repayment options or the ability to refinance at a lower rate.

TIP

Everyone who hasn't started their higher ed journey yet should at least fill out the FAFSA. A lot of schools award grants and scholarships based on the information you provide. You can find the online application at `https://studentaid.gov`.

Credit cards

Credit card debt is money you borrow from a financial institution or company through a line of credit. A *line of credit* is a preselected amount of money you can access at any time as long as you don't exceed the available credit limit. The length of time to pay back the money is typically a month. After the month is over, the funds you borrowed acquire interest, which means you have to pay back more than what you had initially borrowed in the first place.

Credit cards, like student loans (see the preceding section), may be unsecured. If a credit card is secured, the lender wants you to put some skin in the game by providing some collateral such as paying a hefty fee or providing a cash deposit when you open the account. The lender doesn't keep the collateral forever — usually a year, sort of like a deposit. After you've established a history of making your payments on time, it refunds your collateral and moves you to an unsecured line of credit.

Along with being unsecured or secured, credit cards are also known as revolving debt. *Revolving debt* allows you to borrow money and pay it back, only to repeat the cycle again and again with no end date. Credit cards can also come with perks such as free travel, cash back, and discounts meant to keep you using your credit card again and again. When you use credit cards responsibly, you can take advantage of these perks without spending additional money if you pay your card off in full every month. Many travel bloggers haven't paid for a room or flight in years!

Home and auto loans

Unlike the student loan and credit card debt in the preceding sections, which can slowly creep up on you, purchasing a home or automobile can cause you to acquire a large amount of debt at one time. New cars can start at $20,000 and go up from there. Homes typically go for hundreds of thousands of dollars and, depending on the location, sometimes even more! We don't have that type of cash lying around, and you probably don't either.

Home loans

Mortgages, like student loans, are considered installment debt. When you're approved for a mortgage, the bank that has approved your financing sets up an arrangement with you to pay back the loan over time — usually 15 or 30 years. Still, the exact arrangement depends on your lender and other factors, such as what type of loan you're approved for, interest rates, and whether you have a down payment.

Mortgages are considered secured debt. A lender knows it's getting its money back no matter what when helping you finance a home. So if you end up short one month and can't pay your mortgage, no sweat — to the lender, not you. You'll have to pay when it shows up on your credit report. However, after you're 120 days late, the lender will start the foreclosure process and take the house back. Sure, it would've made more money if you had fulfilled the loan's terms, but it's still getting something out of the deal.

WARNING

You find out how to prioritize your debt within your budget later in this chapter, but please pay your mortgage. You don't want a foreclosure on your credit report! Foreclosures can prevent you from finding a new place to live, even when you're just looking to rent. This costly mistake can cost you thousands of dollars for years to come.

Auto loans

If you don't have enough cash to purchase a vehicle outright, you need a bank or credit union to finance you with an auto loan. Suppose you're buying a car through a dealership. In that case, its finance department reviews options with you based on your credit history and whether you're providing a down payment or a trade-in. Dealerships usually have preferred lenders they work with. You can choose to finance with them or look at your bank for finance options.

Auto loans are secured loans you pay off in installments. Because it's an installment loan, you make monthly payments over a timeline, usually no more than six years. Six-year loans are more common when you're purchasing a brand-new car versus an older model because the loan amount tends to be more significant. Auto loans also come with collateral, which is why they're secured. If you don't make your payments, the lender can take the vehicle in a process called *repossession.* It finds someone else to buy your car and then sticks you with the difference of what's still left on your loan. This process happens in a much shorter time frame than a home foreclosure (see the preceding section), but can you imagine? You're getting up to get a coffee one day, and then *bam!* Your car is gone!

Miscellaneous debt

If you've read the preceding sections, you may be thinking, "I owe someone money, but you haven't even mentioned it yet!"

Never fear, for this section talks about other types of debt you may need to include in your budget.

Government agencies

Child support, outstanding taxes, any debt owed to agencies besides the IRS, and any excess unemployment payments are all debt that falls into this category. Debt owed to the government is serious business. In fact, unpaid debt can lead to many repercussions, such as having your paycheck garnished or, in some cases, losing your driver's license.

The United States Department of Treasury's Financial Management Service operates the Treasury Offset Program, also known as the TOP. The TOP allows federal and state agencies to collect money however they see fit, such as by garnishing your wages through your employer or taking the money out of your tax refund. Your employer has no choice but to abide, which means a relatively smaller paycheck.

WARNING

Don't forget your property taxes. This bill is just as important as paying your mortgage. When your property taxes become delinquent, the state where the property is located can sell your property even if you own the home that's located on it. If you need assistance, ask your mortgage lender if you can open an escrow account.

Court-ordered debt

Specific crimes like unpaid parking tickets, breaking traffic laws, and more severe ones like misdemeanors and felonies carry a fine. Fines cost money and hopefully discourage you from committing the crime again. You usually pay this type of debt to the court, where a judge presides over your case. You may also be asked to pay court fees and, if applicable, restitution toward a victim.

Overdue bills turned over to collection agencies

Unpaid bills that go to a collection agency show up on your credit report to haunt you. Evictions, utility bills, and outstanding lines of credit from places like department stores all fall in this bucket.

REMEMBER

Bills you'd rather ignore don't go away, as much as you want them to, which is why your budget helps you figure out where the money to pay them comes from.

Medical bills

Recently, the Consumer Financial Protection Bureau reported that consumers collectively had $88 billion of medical debt. *Medical debt* includes any services you receive from your provider, testing, bloodwork, and hospital stays. It can even include medication and transportation to receiving medical care, like a ride in an ambulance. Many insurance companies charge high premiums, and despite the 2010 passage of the Affordable Care Act (or ACA), many Americans still struggle to afford healthcare coverage. Some employers cover part of the insurance premiums, but others don't. Even if you have health insurance, you're expected to pay what's known as a deductible before your health insurance provider covers any of the bill.

Personal loans

You can also take out what's known as a personal loan from a bank or another financial institution. *Personal loans* are unsecured loans from a lender that you pay back in monthly payment or installments. Weddings, trips, and holidays are some reasons people take out personal loans.

Loans from friends or family

Sometimes loans don't come from a bank but from a friend or family member. These loans typically have no interest rate or payment schedule because the lender provides the money in good faith that you'll eventually pay them back.

Paying Off Your Debt

Your debt may seem overwhelming, and you may wonder what the purpose of creating a budget is when you have so many other bills to pay. But a budget is a money plan that tells your money where to go, not the other way around. If paying off debt is going to be a part of your budget, pull up a seat. The following sections discuss how to pay off your debt so you can eventually start putting your money toward your other financial goals.

REMEMBER

There's no right way to pay off your debt. Just like everything else about you, your debt is unique. You have different financial responsibilities than others do and vice versa. Your debt repayment plan will be different if you have kids or take care of an older family member. It will also look different based on your income and current expenses. That's why mapping out where your money goes, as Chapter 3 explains, is so important. After you've aced that step, you can strategize toward making your debt repayment plan.

Compiling a list of your debt

The first step to tackling debt repayment is to compile a debt assessment by making a list of the different types of debt you currently have. You need to see all this information in front of you so you aren't forgetting anyone you owe money to. You can include an amount as small as owing your spouse $5 for a coffee or as large as your mortgage. For each debt, log into your account online to make a note of the following things:

- **The company the debt is owed to, the amount owed, and the due date for payment:** If you haven't made payment arrangements, make a note of that, too.
- **Type of debt:** Is this debt your mortgage, car loan, or an unpaid bill? Look over the list in the earlier section "Looking at the Different Types of Debt" if you're unsure how to categorize it. You can also leave a reminder to ask someone or even call the company to which you owe the debt.
- **Secured or unsecured debt:** Both can be harmful to your credit report if you don't pay, but this information is important because secured debt usually means that you have some type of collateral the lender can confiscate if you don't pay the debt on time. The collateral can be vital to your and your family's survival if it's an auto or home loan. Unsecured debt has no collateral at stake.
- **Revolving loan or installment loan:** With an installment loan, you already have a payment arrangement in place. After you've paid off revolving debt, you can always borrow more.

» **Any pressing circumstances related to the debt:** A pressing circumstance may be a garnished paycheck or the threat of a suspended driver's license. You can even go so far as to say that any tension between you and a friend or family member over a loan is a pressing issue.

Next, you should reorganize the information in either a spreadsheet or in a notebook. First, list the name of the creditor, the type of debt, the payment amount, the due date, the interest rate or APR (annual percentage rate), and the total amount still owed. If an account has a payoff amount listed anywhere, you can add it as a note. Figures 1-1 and 1-2 are two formatting examples of a debt assessment.

	A	B	C	D	E	F
1	**Creditor**	**Type of Debt**	**Payment Amount**	**Due Date**	**APR**	**Amount Still Owed**
2	Bank of America	Mortgage	$1,978.55	1st of every month	4.50%	$345,231
3	Credit Union	Personal Loan	$150	5th of every month	3%	$2,450
4	Credit Union	Auto Loan	$497	10th of every month	3%	$16,679
5	SoFi	Student Loan	$358	15th of every month	7%	$28,766
6	Capital One	Credit Cards	$179	20th of every month	19%	$2,023
7	American Express	Credit Cards	$67.44	25th of every month	15%	$786
8	Mastercard	Credit Cards	$97	30th of every month	18%	$877
9	Dr. Smith	Medical Bill	$50	30th of every month	0%	$350

FIGURE 1-1: A debt assessment spreadsheet.

Debt Total, January

Creditor (Debt Type)	Payment Amount / Due Date / APR	Amount Still Owed
BOA (Mortgage)	$1,978.55 / 1st every month / 4.50%	$345,231
Credit Union (Personal)	$150 / 5th every month / 3%	$2,450
Credit Union (Car)	$497 / 10th every month / 3%	$16,679
SoFi (Student)	$358 / 15th every month / 7%	$28,766
Capital One (CC)	$179 / 20th every month / 19%	$2,023
Amex (CC)	$67.44 / 25th every month / 15%	$786
Mastercard (CC)	$97 / 30th every month / 18%	$877
Dr. Smith (Medical)	$50 / 30th every month / 0%	$350

FIGURE 1-2: A debt assessment compiled on a notebook page.

Considering different payoff methods

What does a debt payoff plan even look like? Well, you can keep doing what you're doing now and pay your monthly payments. Or you can try one of these three main debt payoff methods:

- The snowball method
- The avalanche method
- The fireball method

REMEMBER

If making the minimum payments is where you are right now in your money journey, that's okay. You'll eventually work your way to where your financial goals allow you to pay off more of your debt. For example, you may pay your monthly car payment without trying to pay it off because you have other priorities. You're not a bad person for not wanting to pay off your debt faster than you have to.

The snowball method

The *snowball method* works like this: You pay your regular debt payments, and then anything extra you can come up with to pay on your debt goes toward the smallest one first. You then continue this process until your smallest debt is paid off. The goal of the snowball method is to keep you consistent with your debt repayment by motivating you with small wins. When you continually succeed in any area of your life, it's easier to stay on track consistently. Consistency is what's going to enable you to achieve your goals.

Using your debt assessment from the previous section, arrange your debts from smallest amount owed to largest amount owed. It may look like Figure 1-3 or Figure 1-4.

For example, say your first smallest debt is a bill you owe the dentist. It's $350, and you're currently paying $50 a month. Your next smallest bill is a credit card for $786, and you're paying $50 on this one as well.

	A	B	C	D	E	F
1	**Creditor**	**Type of Debt**	**Payment Amount**	**Due Date**	**APR**	**Amount Still Owed**
2	Dr. Smith	Medical Bill	$50	30th of every month	0%	$350
3	American Express	Credit Cards	$67.44	25th of every month	15%	$786
4	Mastercard	Credit Cards	$97	30th of every month	18%	$877
5	Credit Union	Personal Loan	$150	5th of every month	3%	$2,450
6	Capital One	Credit Cards	$179	20th of every month	19%	$2,023
7	SoFi	Student Loan	$358	15th of every month	7%	$28,766
8	Credit Union	Auto Loan	$497	10th of every month	3%	$16,679
9	Bank of America	Mortgage	$1,978.55	1st of every month	4.50%	$345,231

FIGURE 1-3: A debt spreadsheet organized by the amounts still owed.

Debt Total, January		
Creditor (Debt Type)	**Payment Amount / Due Date / APR**	**Amount Still Owed**
Dr. Smith (Medical)	$50 / 30th every month / 0%	$350
Amex (CC)	$67.44 / 25th every month / 15%	$786
Mastercard (CC)	$97 / 30th every month / 18%	$877
Credit Union (Personal)	$150 / 5th every month / 3%	$2,450
Capital One (CC)	$179 / 20th every month / 19%	$2,023
SoFi (Student)	$358 / 15th every month / 7%	$28,766
Credit Union (Car)	$497 / 10th every month / 3%	$16,679
BOA (Mortgage)	$1,978.55 / 1st every month / 4.50%	$345,231

FIGURE 1-4: Debt compiled on a notebook page, organized by the amount still owed.

You're able to cut some expenses in your budget, which frees up $100 per month (good job!), and you've decided to put this money toward debt. Throw the extra $100 on top of the regular $50 payment and pay the dentist bill in full within two months.

Now you have an extra $150 a month in your budget to use toward debt repayment (the $100 you freed up in expenses, plus the $50 you were putting toward that dentist's bill). You can apply this $150 toward your next smallest debt, your credit card. When your next payment is due, you pay $200 rather than the regular payment of $50. You've snowballed your old debt payment amount toward another debt payment amount. This approach is going to enable you to pay off this debt faster, too.

WARNING

The one con with this debt repayment strategy is that you pay more interest over time. Paying more in interest and other fees means you're paying more money in the long run than you would with something like the avalanche method, which is discussed in the following section. But if using the snowball method means you're motivated to actually stick to your debt repayment strategy, that trade-off may be okay for you.

The avalanche method

If you'd rather save money and possibly get out of debt faster, then the avalanche method may be a better fit for you than the other methods in this chapter. The *avalanche method* requires you to focus on paying down your debt by homing in on your interest rather than the amount owed. The longer you take to pay a creditor back, the more interest your loan accrues. Depending on the type of debt you have, the interest can fluctuate and collect on different amounts of money at different times.

Using your debt assessment from earlier in the chapter, organize your creditors from the highest to lowest interest. Figures 1-5 and 1-6 show two formatting examples that use the avalanche method.

	A	B	C	D	E	F
1	**Creditor**	**Type of Debt**	**Payment Amount**	**Due Date**	**APR**	**Amount Still Owed**
2	Capital One	Credit Cards	$179	20th of every month	19%	$2,023
3	Mastercard	Credit Cards	$97	30th of every month	18%	$877
4	American Express	Credit Cards	$67.44	25th of every month	15%	$786
5	SoFi	Student Loan	$358	15th of every month	7%	$28,766
6	Bank of America	Mortgage	$1,978.55	1st of every month	4.50%	$345,231
7	Credit Union	Personal Loan	$150	5th of every month	3%	$2,450
8	Credit Union	Auto Loan	$497	10th of every month	3%	$16,679
9	Dr. Smith	Medical Bill	$50	30th of every month	0%	$350

FIGURE 1-5: A debt spreadsheet organized by APR.

Debt Total, January		
Creditor (Debt Type)	**Payment Amount / Due Date / APR**	**Amount Still Owed**
Capital One (CC)	$179 / 20th every month / 19%	$2,023
Mastercard (CC)	$97 / 30th every month / 18%	$877
Amex (CC)	$67.44 / 25th every month / 15%	$786
SoFi (Student)	$358 / 15th every month / 7%	$28,766
BOA (Mortgage)	$1,978.55 / 1st every month / 4.50%	$345,231
Credit Union (Personal)	$150 / 5th every month / 3%	$2,450
Credit Union (Car)	$497 / 10th every month / 3%	$16,679
Dr. Smith (Medical)	$50 / 30th every month / 0%	$350

FIGURE 1-6: Debt organized by APR on a notebook page.

Let's look at the creditors with the highest interest rates, which looks like this:

1. Credit card 1 at 19 percent with a $179 monthly payment
2. Credit card 2 at 18 percent with a $97 monthly payment
3. Credit card 3 at 15 percent with a monthly payment of $67.44

You've cleared up an extra $100 in your budget for debt repayment. Because you're paying the most interest on your credit card, you focus on that bill first. Rather than paying $179 on credit card 1, you're now paying $279. After you pay off that credit card, you then move onto the next credit card. You take that $279 and apply it to the monthly credit card payment until that debt is gone. Then you continue onto your student loan and so on until you've paid everything off.

If you don't have a problem with consistency, this payoff method may work for you. You're paying off your debt at a much faster rate than before while also paying less money overall. Depending on the type and amount of loan, you don't always have small wins along the way, so this debt payoff method requires you to be patient. But saving money is always a win because you can then apply that cash to your budget somewhere else.

The fireball method

Though debt is still debt at the end of the day, the fireball method, coined by SoFi, allows you to categorize your debt to pay it off on a timeline that works for you. This method plays off the snowball method covered earlier in the chapter.

First, refer to your debt assessment from earlier in the chapter and categorize your debt as either good or bad. (Check out the earlier section "Looking at the Different Types of Debt" for more on this distinction.)

Figures 1-7 and 1-8 show the two formatting examples to categorize good and bad debt.

	A	B	C	D	E	F
1	**Good Debt**					
2	**Creditor**	**Type of Debt**	**Payment Amount**	**Due Date**	**APR**	**Amount Still Owed**
3	SoFi	Student Loan	$358	15th of every month	7%	$28,766
4	Credit Union	Auto Loan	$497	10th of every month	3%	$16,679
5	Bank of America	Mortgage	$1,978.55	1st of every month	4.50%	$345,231
6						
7	**Bad Debt**					
8	**Creditor**	**Type of Debt**	**Payment Amount**	**Due Date**	**APR**	**Amount Still Owed**
9	Capital One	Credit Cards	$179	20th of every month	19%	$2,023
10	Mastercard	Credit Cards	$97	30th of every month	18%	$877
11	American Express	Credit Cards	$67.44	25th of every month	15%	$786
12	Credit Union	Personal Loan	$150	5th of every month	3%	$2,450
13	Dr. Smith	Medical Bill	$50	30th of every month	0%	$350

FIGURE 1-7: A spreadsheet separating good and bad debt.

Then arrange each list debt from smallest amount owed to the largest amount owed. Figures 1-9 and 1-10 show two formatting examples that use the fireball method.

Debt Total, January - Good		
Creditor (Debt Type)	**Payment Amount / Due Date / APR**	**Amount Still Owed**
Credit Union (Car)	$497 / 10th every month / 3%	$16,679
SoFi (Student)	$358 / 15th every month / 7%	$28,766
BOA (Mortgage)	$1,978.55 / 1st every month / 4.50%	$345,231

Debt Total, January - Bad		
Creditor (Debt Type)	**Payment Amount / Due Date / APR**	**Amount Still Owed**
Dr. Smith (Medical)	$50 / 30th every month / 0%	$350
Credit Union (Personal)	$150 / 5th every month / 3%	$2,450
Capital One (CC)	$179 / 20th every month / 19%	$2,023
Mastercard (CC)	$97 / 30th every month / 18%	$877
Amex (CC)	$67.44 / 25th every month / 15%	$786

FIGURE 1-8: A written list separating good and bad debt.

	A	B	C	D	E	F
1	**Good Debt**					
2	**Creditor**	**Type of Debt**	**Payment Amount**	**Due Date**	**APR**	**Amount Still Owed**
3	Credit Union	Auto Loan	$497	10th of every month	3%	$16,679
4	SoFi	Student Loan	$358	15th of every month	7%	$28,766
5	Bank of America	Mortgage	$1,978.55	1st of every month	4.50%	$345,231
6						
7	**Bad Debt**					
8	**Creditor**	**Type of Debt**	**Payment Amount**	**Due Date**	**APR**	**Amount Still Owed**
9	Dr. Smith	Medical Bill	$50	30th of every month	0%	$350
10	American Express	Credit Cards	$67.44	25th of every month	15%	$786
11	Mastercard	Credit Cards	$97	30th of every month	18%	$877
12	Capital One	Credit Cards	$179	20th of every month	19%	$2,023
13	Credit Union	Personal Loan	$150	5th of every month	3%	$2,450

FIGURE 1-9: A spreadsheet arranging bad and good debt by amount owed.

Now focus on your bad debt, paying off your smallest loan first. Like the snowball method, you'll still be making your minimum payments, but any extra money goes toward eliminating your smallest debt first. After you pay it off, you apply that payment amount to your next highest debt. Unlike the snowball method, you're focused on only your bad debt for now.

Debt Total, January - Good		
Creditor (Debt Type)	**Payment Amount / Due Date / APR**	**Amount Still Owed**
Credit Union (Car)	$497 / 10th every month / 3%	$16,679
SoFi (Student)	$358 / 15th every month / 7%	$28,766
BOA (Mortgage)	$1,978.55 / 1st every month / 4.50%	$345,231

Debt Total, January - Bad		
Creditor (Debt Type)	**Payment Amount / Due Date / APR**	**Amount Still Owed**
Dr. Smith (Medical)	$50 / 30th every month / 0%	$350
Amex (CC)	$67.44 / 25th every month / 15%	$786
Credit Union (Personal)	$150 / 5th every month / 3%	$2,450
Mastercard (CC)	$97 / 30th every month / 18%	$877
Capital One (CC)	$179 / 20th every month / 19%	$2,023

FIGURE 1-10: A written list arranging bad and good debt by amount owed.

After you've taken care of the bad debt, you then turn to your good debt. But instead of throwing all the money you were applying toward your bad debt to the good debt, you put it toward your savings goals, such as paying for a down payment on a house. Essentially, you're starting a new snowball for your good debt. Because you're still paying off your good debt, this method encourages you to work on your other goals simultaneously. Most people take advantage of this time to work on catching up on retirement. Wherever you put the money, this method can help you determine what debt you should take care of first while motivating you with small wins.

REMEMBER

The only issue we have with this method is the significance of designating something as good or bad. People often associate the word *bad* with shame, and personal finance shouldn't be shameful. You don't always choose to take out bad debt; sometimes things happen, like medical emergencies, car repairs, and sick pets.

THE DEBT CONSOLIDATION METHOD

We don't actually recommend the debt consolidation method, but we feel you as a consumer deserve to know all your options to make the best choice for you.

Debt consolidation is when you combine multiple debt repayments into one. So instead of paying everything to multiple creditors separately, you only have one to pay. Many debt consolidation companies allow you to consolidate only lines of unsecured debt.

You find three different types of debt consolidation:

- **Credit counseling:** Various nonprofits offer credit counseling services as well as debt consolidation programs. These outfits are strictly regulated by law in what they can and can't do when serving you. Because they must act in your best interest, that means providing you with financial education and discussing what your debt relief options are, including debt consolidation or bankruptcy. It also means debt relief options that are free or low-cost. ***Note:*** With credit counseling, you can get budgeting help and options for getting out of debt for free, with no obligation to consolidate. If you're considering consolidation, but you aren't sure, credit counseling can be a good option.
- **Debt relief or settlement companies:** Instead of looking at your individual situation to provide you with helpful and productive solutions, a debt relief or settlement company offers to negotiate with your creditors when you enroll in a debt management plan through its organization. Along with requiring additional fees on top of your monthly payment, it directs you to stop paying your creditors so it can negotiate a better rate on your behalf.

  Not paying your creditors does more harm than good. Being delinquent on one account can harm your credit score, but being delinquent on several is truly bad news. This type of debt consolidation can prey on you as a consumer and ruin

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your credit score without your knowledge. Ruining your credit score can make your financial situation even worse.

- **Debt consolidation loans:** A debt consolidation loan through a financial institution allows you to borrow an amount of money that covers the amount you owe your creditors for your current debt. If approved for the loan, you may receive the funds to pay off your creditors, or the financial institution may offer to pay them off directly. You then get a monthly payment plan to repay the loan with a fixed interest rate.

You can do a lot of the work that debt relief management companies charge you for. This approach allows you to save money and also your credit score. You don't have to sign up for a debt repayment plan, because you can pay the debt independently. Companies just want you to think that you can't.

The idea of one monthly payment can sound tempting, especially if you have tons of debt to pay. And you can make debt consolidation loans work if you use them appropriately. But debt consolidation loans aren't a quick fix.

If you choose this route, you may not be addressing the root issue of your debt. You can also get into more debt because you're making your credit cards and other lines of credit available again. Telling yourself you'll just use the card once and pay it back, only to find yourself right where you started, is so easy.

Applying additional strategies

You can implement a variety of other strategies to help pay your debt off even faster.

Make a debt payoff settlement

When you fall behind while paying your debt, you become delinquent. Your creditor may work with you to get back on track, but if it sees no progress, it eventually gives up and, in the case of unsecured debt, sells your debt to a collection agency.

Debt sold to collection agencies shows up on your credit report, so you want to avoid this scenario as much as possible. But if you're stuck with a collections bill, call the agency and see whether you can settle for less than the amount you owe. Collection agencies don't really have people banging down their doors to pay their debt, so they're more likely to work with you and accept an amount less than you owe.

A collection agency will most likely accept half of what you owe. Say you have a creditor $500 debt in collections. When you have $250 to part with, call the agency and ask to speak to someone about a settlement offer. First, kindly thank them for taking your call and for being patient with you while you get your financial affairs in order. Next, acknowledge the fact that you do owe them money and ask whether they'd be willing to settle your account today if you could make a cash payment.

If they say yes, great! Ask them for an amount they're willing to accept and then go from there. ***Tip:*** You always ask what they can do first because they may come back with a lower amount than you had originally thought to offer. After you agree on a payoff amount, ask to receive it in writing via email so you can pay while still on the phone.

REMEMBER

After you've received confirmation in writing, go ahead and make your payment. Make sure to ask for a receipt via email and also by mail. Keeping detailed records of payment is important; selling someone's debt from collection agency to collection agency is a common practice, and you don't want to have to pay for the same debt mistake twice.

Negotiate with creditors

You don't have to wait for your debt to end up being turned over to collections to negotiate with your creditors. If you have a bill like medical debt, call the medical provider to see what it can do. A lot of doctor's offices will allow you to settle your bill for an agreed-upon portion because getting a small guaranteed payment is better than never receiving any payment.

Some medical providers, like hospitals, have financial relief departments. The financial relief department assigns a case worker to look over your medical bills along with your finances to see whether you qualify for assistance. Depending on the amount, they may agree to put you on a payment plan or waive the debt entirely.

TIP

To find a nonprofit hospital located closest to you, type "nonprofit hospital (city you're currently located)" into an online search engine. You can then filter results to find one that meets your needs.

When you have medical emergencies, try to seek medical care at a nonprofit hospital. By law, nonprofit hospitals must offer financial assistance programs. You can also call your local community resource center to see whether any other organizations in your area can help with medical assistance.

Ask about hardship programs

If you have credit card debt that you need assistance with, ask your creditor whether it offers any payment assistance. Some credit card companies have hardship programs that can allow you to go on a monthly repayment plan with more affordable payments. They may also lower any fees or interest you currently pay for a few months. Circumstances that can qualify for hardship include but aren't limited to divorce, death of a loved one, loss of job, or health issues.

TIP

Your other creditors may offer financial assistance programs as well. Some creditors offer a pause on payments by extending the length of your loan. Other options can include moving your payment due date into the future to give you some time to catch up.

REMEMBER

Asking for help can hurt your pride. But you know what? It shouldn't. Instead of being sad or ashamed you had to ask for help, be proud. It takes a strong person to know when they need help, and it takes an even stronger person to ask out loud. Needing help is okay, and your finances will be better off too!

Use balance transfers

Another strategy you can look into is opening a new credit card for a balance transfer. A *balance transfer* is when you move your debt from one creditor to a new creditor for a lower interest rate. Sometimes the interest rate on a balance transfer is as low as

0 percent. The goal of the balance transfer is to save you money in finance fees by offering you a low rate for a predetermined time period. You may also be able to move other types of debt with the balance transfer, such as an auto or personal loan.

To apply for a credit card that offers a balance transfer, you most likely need to have a credit score of 670 or above. You find out more about credit scores in Part 2, but for now, know your credit score can range from 300 to 850. The higher the credit score you have, the better.

WARNING

Make sure you're aware of the terms and conditions of your new balance transfer credit card. With balance transfers, your 0 percent APR typically only lasts 12 to 18 months. After that, your credit card balance starts collecting interest on the debt you've transferred over. The whole point of a balance transfer is to save money on fees and interest, so take advantage of it as much as possible. Also, make sure you know what if any circumstances, such as making a late payment, may cause you to lose your 0 percent interest rate.

If you're approved, double-check how the debt will be transferred over. A creditor may contact the other creditors directly on your behalf to pay your debt off, or it may expect you to take care of it on your own. Make sure to transfer the debt incurring the highest interest rate first so you can take advantage of the lower interest rate as much as you can.

Make extra payments

If, after creating your budget, you find yourself with extra money, consider using it to make extra payments on your debt. One way to approach this strategy is by making a payment that's applied to the loan principal, such as on a mortgage.

When you pay extra on your mortgage, you can ask your loan provider to apply the money to your loan principal. Every time you pay additional money to your loan principal, you're paying less interest. By lowering the amount you owe directly, you lower the amount you pay over time in financing fees. You can even accomplish this goal by splitting up your monthly mortgage payment and applying half every two weeks. By using this tactic, you're making 13 payments a year rather than 12. ***Note:*** Not all creditors allow extra payments to go to the loan principal, so always research the terms of your loan.

TECHNICAL STUFF

If you're interested in seeing how you can apply this strategy to your situation, check out the extra payments calculator from Freddie Mac. This calculator allows you to input different payment amounts across different scenarios. It allows you to see that even small additional payments here and there can add up over time. Find the calculator at `myhome.freddiemac.com/resources/calculators/extra-payments`.

Use financial windfalls

Using any *windfalls* (unexpected money) you receive can help you get out of debt faster. Because you've already covered your expenses, put that extra money to work. If you get a bonus or overtime pay, put it on your car loan. Taking advantage of extra money you weren't expecting can help get you ahead further than you think.

TIP

If you feel the urge to use that windfall to treat yourself, consider the 80-20 rule. Apply 80 percent of your windfall toward your debt and then keep the remaining 20 percent for fun. With this approach you're taking care of business, but you're still making fun a priority. Prioritizing fun is one way to keep you motivated on your debt journey.

Avoiding Accumulating More Debt

Paying your debt off is important, but so is keeping yourself from getting into more debt. Incurring more debt is easy to do and can happen quickly. However, you can be proactive while keeping your budget intact.

Here are a few tips to keep in mind when you're reviewing your debt and debt repayment:

- **Know your rights.** Before you speak to any debt collector or creditor, be aware of the questions they can and can't ask. Also beware of illegal debt collection practices, such as contacting you by phone after you've asked them to stop. Check out the Fair Debt Collection Practices Act for more information: `www.federalreserve.gov/boarddocs/supmanual/cch/fairdebt.pdf`.

- **Check your budget to ensure the amount you can pay toward your debt.** Don't promise an amount you can't pay.
- **Make a list of debts you want to negotiate.** Refer to the earlier section "Considering different payoff methods" for information on compiling a debt assessment.
- **Call your collector.** Use the following phone script for reference:

  "My name is [insert your name], and I am calling to discuss my current account status. I know I'm late, but I am currently facing an unforeseen financial hardship that has affected my finances, including this account. I would like to see what we can do to help bring my account to good standing. Can we discuss what my options are? Is it possible to arrange a payment plan?"

  REMEMBER

  If you're arranging a payment plan, always be sure to get it in writing and do not offer to pay more than you can realistically afford based on your current budget.

- **Make sure you get the settlement agreement in writing.** Before you hand over the case, ensure you've received the debt repayment agreement in writing, even if that's email, from the debt collector. Also document what time your phone call took place and to whom you spoke.

REMEMBER

- **Stick to the repayment plan.** Follow through with your end of the agreement. If you don't, the collector can then decide that you must pay the full amount, and it probably won't be willing to work with you on a settlement again.

Look into refinancing options

If your student, auto, or mortgage loan has a high interest rate, consider refinancing to save money. When you *refinance* a loan, you take out a newer loan with better terms and conditions to pay off an old loan. By refinancing a loan, you can have smaller monthly payments while paying less money overall with a better interest rate. This option is great if you have a good credit score.

TIP

If you don't have a high credit score, look to see what you can do to improve your rating. Make sure you pay your debt on time and work hard to lower your *credit utilization rate* (how much of your available credit you're using).

As you improve your credit score, more financial products become available. Eventually, you'll be able to find a loan with better terms than what you're currently paying.

Save an emergency fund

Emergency funds are crucial to keeping you out of debt. When people don't have the money to cover a financial emergency, they often charge it to a credit card or take out a loan. This scenario can turn into a nasty cycle of endless debt repayment that keeps you from achieving your financial goals. Having an emergency fund allows you to have the money available to keep emergencies from derailing your budget.

You can also avoid some emergencies if you plan ahead in your budget and take time for regular maintenance and screenings.

Say no to credit card offers

REMEMBER

If you're trying to pay off debt, stay away from store credit cards and other in-house financing options. This type of consumer financing can keep you stuck in the cycle of charging for an item you don't need because you're "saving" money. If saving money is what you're after, look up discount codes on the internet. You can find a coupon for just about everything out there if you search hard enough.

Another great way to stay away from credit when working on debt repayment is to pay in cash from your bank account. Instead of using your credit card, pay with your debit card, which is deducted from your account. Go through any online retailers you use and update your payment information. This step ensures you're using your budget to pay for your purchases and not relying on credit.

WARNING

Please keep in mind that there is a higher fraud risk when using your debit card. Banks can only offer so much in terms of fraud protection, unlike credit card companies.

Invest in the right insurance

One way to keep yourself out of debt is to have adequate insurance for your health, car, and home. Insurance is an important tool for protecting both you and your finances. Instead of your having to take care of a financial emergency all on your own, an insurance policy can help you weather the cost (after you pay a deductible or co-pay). Insurance doesn't have to be expensive, either. Both online and in-person insurance brokers can offer you great deals and rates.

Health insurance is expensive, but going without insurance can cost more. Medical bills are one of the main reasons people declare bankruptcy. If you don't have health insurance and need major surgery, you can be hundreds of thousands of dollars in debt before you even know it. A lack of health insurance can also cost you your quality of life. Without health insurance, you may not have adequate preventive care — care that can help you avoid having serious medical issues in the future — or be able to fill the prescriptions you need.

REMEMBER

You should also consider life insurance, short-term and long-term disability insurance, and long-term care if you're close to or in retirement.