NATIONAL ENDOWMENT FOR
FINANCIAL EDUCATION

TWELVE WAYS TO GET OUT OF SERIOUS DEBT

Follow These Tips to Pay Off Loans and Get Back on Track

ENGLEWOOD, COLORADO—By most any measure, American consumers have incurred tremendous personal debt, bringing the nationwide numbers to one of their highest levels in years. Personal bankruptcies and mortgage foreclosures are at record highs; and a 2002 survey by Western Union found that one in four Americans now pays at least one bill late every month.

Excessive debt is not limited to lower-income families, either. According to Federal Reserve Board calculations, the debt burden for households, based on a percentage of disposable income, rose faster in early 2002 for higher-income than lower-income Americans, and the burden was 20 percent higher for them in 2002 than in 1995. Retirees living on a limited income and hurt by sluggish investments also are incurring record debt.

"It's critical to get excessive debt under control as quickly as possible," says William L. Anthes, Ph.D., president and CEO of the Colorado-based National Endowment for Financial Education® (NEFE®), an independent nonprofit foundation whose mission is to educate Americans about personal finance. "It not only saps other personal financial goals, but it can damage your credit rating, which in itself can be costly. Ultimately, excessive debt can lead to financial disaster."

Following are 12 suggestions for getting yourself out of heavy debt-and making sure you don't fall back into it in the future.

1. Determine the gravity of your debt. Some families don't even realize the extent of their debt burden. Money may be tight, but many people believe they're doing okay if they manage to make their minimum payments. Unfortunately, even a minor financial setback could push them in a serious hole virtually overnight.

To determine your debt burden, add up all of your monthly consumer debt obligations and minimum required payments (not counting your mortgage). Include car loans, college loans and credit cards. If the total consumes 15 to 20 percent or more of your paycheck, you need to take measures to reduce your debt, say financial planners. Also, look for other signs of a high debt burden, such as borrowing to pay for necessities, missing payments or making late payments, being turned down for credit or neglecting to save for retirement or other

financial goals.

2. Stop spending. "One of the first steps is to stop digging the hole any deeper," says Anthes. "If you recognize that you're in serious debt, *immediately* limit spending to the bare necessities, such as food, shelter, utilities, transportation and so on. Postpone buying new gadgets or taking a family vacation, eat at home and don't buy anything on installment. Take a breather for at least a month until you have created a sound get-out-of-debt plan. Treat this month as financial triage."

3. Determine why you're in debt. If you don't understand why you got into debt in the first place, you are less likely to take the right steps to get out, and stay out.

For example, you may have held your debt load to an acceptable level—until you suddenly lost your job, suffered investment setbacks or experienced a financial crisis, such as large medical or legal expenses. This might suggest that once you get out of debt, you need to build a larger cash emergency fund, better diversify your portfolio or carry more medical and liability insurance.

On the other hand, you may have fallen into debt because of unrestrained spending, poor use of credit cards, lack of budgeting, gambling or not paying proper attention to the management of your money. In order to pay off your debts and avoid incurring more in the future, you'll need to break these habits.

4. Freeze your credit cards. "The misuse of credit cards is typically one of the biggest reasons families fall into financial difficulty," says Anthes. "They often pay the minimum required on a card, either because they can't afford to pay more or because they don't realize how costly it is to pay only the minimum."

If you've accumulated a lot of credit card debt, especially on multiple cards, try to transfer the balances from the higher-interest-rate accounts to a single, lower-rate card. (Be sure it's not a low teaser rate available for only a short time.) Cancel the cards you've paid off and don't charge any new items on the card you've kept. Try to pay more than the minimum each month in order to reduce overall finance charges.

5. Budget. Everyone should have a budget or spending plan. Not having one is a major reason people get into debt. A spending plan involves accurately tracking all of your expenses—cash, checks, credit cards, personal items and so on—and making sure they don't exceed your income. In the case of excessive debt, look for ways to trim some of the less critical expenditures, such as having lunch out every day, in order to free up extra cash to put toward decreasing your debt. Sticking to the "bare necessities" plan described earlier might help.

6. Generate new income. Take a second job or have other family members take jobs, even

part time, and direct that money to paying down debts. Sell off expendable personal assets for cash. If you have income sitting in low-interest bank and money market accounts, consider using that money for paying your debts.

7. Suspend investing. Generally, you want to continue investing, especially for retirement. But with returns so low right now on everything from stocks to certificates of deposit, consider reducing or suspending retirement plan contributions and putting that money toward eliminating high-interest-rate debt. Paying off a credit card with a 16 percent interest rate is a better use of your money than investing in a bond with a 4 percent rate of return. But before committing to this strategy, you'll probably want to talk to a qualified financial planner to be sure this is necessary. This approach many not be appropriate for all investors.

Also, it might be tempting to borrow money from your retirement account, such as a 401(k) plan, to pay down debt, and you may need to if it means avoiding bankruptcy. But be aware that you're shrinking the size of your future retirement nest egg. Also, you'll pay income taxes and perhaps penalties on any money you fail to pay back to the retirement plan.

8. Choose a method to pay off debt. One of two approaches is recommended.

You can pay the minimum on all of your loans and debts, and direct any extra money toward the highest-interest loan. This method saves the most money in the end because you're paying off the most expensive loan first. As soon as it's paid off, go to the next highest loan.

A second method is to earmark any extra money toward the smallest debt first and pay it off as soon as possible to give you a much-needed sense of accomplishment. Once it's paid off, use that money to pay off the next smallest debt, and so on. This method can be more psychologically rewarding than the first, though it will save you less money in the long run.

9. Consolidate loans. A popular method for dealing with debt is to consolidate multiple loans into a single, lower-interest-rate loan, such as a home equity or personal loan from a financial institution. Another option is to refinance your existing mortgage to a lower rate and to take out some additional cash based on the equity in your home. You wind up with a larger mortgage balance than you had before, but you can use the extra cash to pay off other non-mortgage debts that carry higher interest rates.

You will probably have to pay an initial charge for consolidating your loans, but the consolidation can save you money in the long run through reduced finance charges. Also, it's easier to focus on one loan rather than several. However, unless done properly, a loan consolidation can actually make matters worse.

Keep these points in mind when you're thinking of consolidating your loans:

- Be sure the loans that you combine don't have lower interest rates than the rate for the consolidation loan. Student loans, for example, usually carry some of the lowest rates around. Or if you have a zero-interest-rate auto loan, don't consolidate it; you can't beat that interest rate.
- Avoid consolidating if it will result in a longer-term loan. "People sometimes make the mistake of rolling several short-term loans, such as a four-year car loan or a two-year appliance loan, into a 10- or 15-year consolidation loan or the 30-year refinancing of a home mortgage," says Anthes. "Stretching out payments will result in an overall lower monthly payment than the combined loans—but you'll end up paying much more in interest in the long run than if you'd stuck with the original loans." If anything, you want to shorten your debt repayment period whenever possible.
- Don't consolidate if you think the lower monthly payment will tempt you to incur new debts. Otherwise you'll be right back where you started (or even deeper in debt).
- Don't forget that taking out a home equity loan or a home equity line of credit, or taking out extra cash when refinancing your home to consolidate other loans puts your home at risk in the event you fail to make the consolidation payments.
- Don't confuse a loan consolidation with debt consolidation (see tip #11). Whereas you can consolidate loans on your own, debt consolidation involves working with a debt service or consumer credit counseling agency that renegotiates your loan terms with creditors and bundles the loans into a single payment. While you may be able to lower your monthly payments, the use of such a service can hurt your credit rating.

10. Talk to your creditors. If you find you can't make even the minimum payments on your loans, talk to your creditors, including the Internal Revenue Service. They may be willing to temporarily suspend payments, let you repay your debt in smaller installments or renegotiate loan terms. They would rather receive some money from you than nothing at all.

11. See a credit counselor. A credit counseling service can help you set up a reasonable budget. They can also, if necessary, renegotiate with your creditors to devise a realistic repayment plan.

Unfortunately, the use of such a service can damage your credit rating if you renegotiate your loans. Furthermore, shady credit counseling and debt consolidation services are growing in number, so be sure the service you use is reputable.

You can obtain a list of reputable credit counseling services from the National Foundation for Credit Counseling (http://www.nfcc.org/) or the Association of Independent Consumer Credit Counseling Agencies (http://www.aiccca.org/). The Better Business Bureau

(http://www.bbb.org/) can also provide information about various firms.

Before you decide on a credit counseling service, be sure to ask about fees. Disreputable firms charge high fees ranging into the hundreds of dollars. Average fees for reputable budget counseling are around $15, with a $20 enrollment fee and a monthly service fee of perhaps $12 to $15. Also ask how the service is funded. Reputable services receive the bulk of their income from creditors, not those in debt.

12. Consider bankruptcy as a last resort. "This is where you don't want to end up," says Anthes. "While some may see this as an easy remedy, declaring bankruptcy will mean the loss of some of your assets and a major stain on your credit record for the next 7 to10 years."

Most people can avoid filing for bankruptcy if they work diligently at reducing their debts using some of the techniques suggested above. Sometimes, however, it becomes unavoidable if the debt burdens are too great. Talk with a financial planner and a bankruptcy attorney before taking this drastic step.

"Digging your way out of serious debt takes willpower, perseverance, determination and, most of all, a serious plan," says Anthes. "But the reward of financial peace of mind is well worth the effort."

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