Getting Out of Debt

It is difficult to enjoy life without building some kind of debt. For most people, it would be impossible to have a home, automobile and education without taking out loans. However, it is important to know how to use credit responsibly and to have a plan for eliminating your debts within a reasonable time.

A Debt-Ridden Society

The average consumer has two or three credit cards and an average of $7,950 in credit card debt, according to the Federal Reserve.

Lack of immediate disposable income requires many of us to charge purchases on credit cards. Experts recommend not owing more than 20% of your gross income on credit cards and not exceeding 50% of your gross income for your total card-credit lines, yet many Americans exceed these recommended limits.

Today it has become too easy to pull out a plastic card or sign up for long-term financing and thus put off our worries until the bills arrive in the mail. With many credit card companies charging an annual percentage rate of 18% or higher, it would be nearly impossible to get out of debt if you only paid the minimum balance on your charge accounts.

Breaking the cycle of perpetual debt requires a change in habits and a disciplined, committed approach. Here are three proven ways you can eliminate your debt:

1. Focus on saving overspending. Saving involves not only belt-tightening measures like cutting back on expenses but also investing wisely in vehicles with dependable and high returns, such as mutual funds, stocks, money market accounts and bonds.
2. Work on increasing your income.
3. Eliminate your consumer debt as soon as possible. Don't cut into emergency funds or take out loans to pay off other loans, however. Experts recommend spending no more than 20% of your monthly take-home pay on consumer debt (i.e., installment loans such as credit card balances and car loans).

Tips for Reducing Debt

- Develop a budget savings plan.
- Keep track of all expenses. Monitor where your money goes to become a more disciplined saver.
- Make adjustments to your lifestyle. Bring lunches from home to work. Cut back on eating out. Work on quitting a smoking habit.
- Pay off the balance on the loan with the highest rate first. Do not make equal payments on all cards or try paying off the biggest balance first. Aim initially to pay the card with the highest rate in full while concurrently paying the minimum on all other cards. Then, tackle the balance on the card with the next highest rate, and so on.

- Stop using your charge cards. Until you have paid off your entire debt, use plastic only in an emergency. Never use a card that does not offer a grace period.
- Always pay a portion. Ignoring your monthly minimums can ruin your credit history and subject you to penalty fees, harassing phone calls from collection agencies and possible lawsuits. However, avoid paying only the minimum on charge-card balances.
- Lower your credit card rates. Ask the card issuer to lower the fee. Tell them you are considering switching cards unless they give you a better rate. Otherwise, open a new lower-rate charge card that allows you to transfer your higher-interest card balances without incurring a fee. Also, consider opening up a card with a credit union, which typically offers the lowest rates.
- Eliminate all unnecessary credit cards. Do not just cut them up; be sure to call or write the creditors to cancel them properly. Frequently switching cards and having too many cards, open lines of credit and outstanding balances may negatively affect your credit report and limit your ability to qualify for better rates.
- Consider a secured or debit card. If your credit record is poor, apply for a secured card, which is linked to collateral money in your bank account that is used as a line of credit. Debit cards take money directly out of your checking account to make you a more responsible spender.
- Review your property tax assessment. If you feel it is too high, you have the right to appeal the assessment.
- Consider refinancing your mortgage loan if rates drop and you know you will be in your dwelling for at least two years.
- Consider filing for bankruptcy. If you are in dire financial straits, talk to a lawyer about filing for Chapter 7 or Chapter 13. Once you do so, an automatic stay legally prevents all creditors from bothering you with collections.
- Get help. Enlist the services of a lawyer or financial counselor. Try contacting the National Foundation for Credit Counseling (NFCC), a nonprofit group that can negotiate lower monthly payments with your creditors, at www.nfcc.org.

Erasing Bad Credit

Getting out of debt may be the biggest step you take toward financial freedom, but it is not always the last step. You may also need to improve your credit rating. Follow these steps:

1. Request a copy of your credit report from one of the big three American credit-reporting companies (Equifax, Experian and TransUnion). The Fair Credit Reporting Act requires that each of the three provide you with a free copy of your credit report, at your request, once every 12 months. Do not contact the three nationwide consumer reporting companies individually. They are providing free annual credit reports only through www.annualcreditreport.com.
2. Review the reports carefully for errors. Be aware that items indicating poor credit and bankruptcy filings can legally remain on your report for seven and 10 years, respectively.
3. Dispute any inaccuracies. Send a short letter to the credit agency. The law allows you to attach a 100-word statement to your credit report explaining any special circumstances affecting a delinquent or unpaid account.
4. Establish a new, healthy credit history. Open up a savings account and a secured credit card. Make a few reasonable purchases, and pay off the entire balance immediately. A proven track record of consistent employment also can help repair your credit.

By eliminating your debt and repairing your credit history you will have the freedom to control your financial affairs. Make saving money a fun game, and try to avoid making impulse purchases and not keeping track of how you spend your money.

Consolidating Your Debt

It is often difficult to keep track of monthly payments owed to mortgage lenders, credit-card firms and other creditors. Consolidating these debts into one monthly payment can make life a lot easier and less stressful and helps save money.

Though it is unlikely, you may be able to reduce the actual amount owed by calling the NFCC. They may be able to negotiate lower monthly payments with your creditors. However, it may be possible to originate one new loan and pay off all other existing debt. The best option is typically to refinance your home mortgage or take out a home equity line of credit. The interest rate on this type of debt is generally a lot lower than that on credit cards or car loans.

In addition, the interest paid is a tax-deductible expense. If your residence has appreciated in value, it may be possible to obtain a larger loan, thus allowing you to pay off other debts. You must exercise great care, however, to not undertake a mortgage loan that your income cannot support, as failure to repay it could result in foreclosure and loss of your home.

Other possible sources of funds to pay off a wide array of debts include 401(k) plan loans, life-insurance cash values, or loans from company credit unions or local banks.

Resources

- Financial Literacy Education Commission: http://MyMoney.gov
- Federal Reserve Board: www.federalreserve.gov
- Federal Trade Commission: www.ftc.gov
- Federal Deposit Insurance Corporation: www.fdic.gov

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