

Debt Prioritization

Credit is a fact of American life. Whether it's a credit card, mortgage, car payment, or even a business needing extra funds to make a new product, almost all of us look to various forms of borrowing to get what we need and want.

The thing to remember is that not all credit is bad. It's how that credit is treated, prioritized, and paid off that makes the difference.

It can be difficult for the average consumer to organize debt effectively—confusion about interest rates versus Annual Percentage Rates (APR), not knowing payoff amounts for certain debts, and the need to balance monthly payments with long-term financial goals can make the entire process too time consuming and hard to grasp.

There are some strategies, however, that anyone can use to prioritize debt and start conquering that mountain of bills. Which ones you use will depend on your own financial status, your goals, and other such factors. But regardless of the strategies you employ, the key is to start now and start making sense of your debt.

Also note that in this chapter, “debt” includes more than just loans or credit cards—it's any revolving, recurring bill you have each month. For this reason, utilities and even rent are classified as “debt.”

Paying off debt

If you're not having issues making your monthly payments and just want to reduce your debt load—or you see a day coming when paying bills will be difficult, such as when extra pay (combat pay, for example) ends—there are several different ways to do so.

Which one you choose will depend on your current financial situation, and mixing and matching methods from each is also effective.

Long-term strategy

This strategy looks at which bills will cost the most over time. The goal is to pay the least amount overall, over the course of years, rather than worrying about month-to-month costs. It's the most fiscally responsible way to pay off debt, since it reduces the amount of interest you pay overall.

With this strategy, you look at the total amount paid throughout the lifetime of the obligation, including interest and annual fees. For this reason, credit cards should be at the top of the list when using this strategy.

Using the examples from “Chapter 4: Smart Borrowing” to once again show how much credit cards cost over the long haul, you can see why they should be your primary focus when using this strategy:

- If you had \$1,000 of credit card debt at 17 percent interest, and only made the minimum payment of four percent of the balance, it would take you 84 payments—seven years—to pay off. During that time, you will have paid nearly \$500 in interest.
- If you had \$2,500 of credit card debt at 17 percent interest, and only made the minimum payment, it would take you 119 months (nearly 10 years) and cost you almost \$1,300 in interest.
- If you owed \$5,000 at 17 percent interest, and only made the minimum payment, it would take you 145 months (12 years) to pay in full and cost you an additional \$2,665 dollars in interest.

These numbers clearly show that making minimum payments on your credit cards costs an enormous amount over the long haul. For this reason, any long-term strategy should focus on getting these debts paid off first and foremost.

After you get your credit cards taken care of, the next step is to order your debts not necessarily by the highest interest rate, but by the longest term—or length—of the debt.

For example, say you have two loans, one with an interest rate of 15 percent and six months left to pay on it, and another with an interest rate of 10 percent and 24 months left to pay. In this case, it's a better long-term decision to concentrate on paying off the 10 percent loan first. This is because over time, that 10 percent loan will cost you more in interest charges than the 15 percent loan will in the next few months.

So organize your debts looking at which one will cost more throughout the life of the debt, and focus on paying those first.

The month-to-month, or cash flow, strategy

This strategy is best suited for those who find it impossible to meet their monthly debt obligations. Since its goal is to reduce the amount paid out in sheer dollars each month, it's a short-term fix for what are likely longer-term financial problems.

It's best to use this strategy only until you can make all of your monthly payments—after that, it's best to switch to a longer-term solution.

The first step is to list all of your monthly bills by ease of payoff. This could mean the smallest amount you owe, or the debt with the shortest time until it's paid in full. To use the two loans in the long-term plan above, you would pay off the 15 percent loan due to end in six months first, then move on to the next.

The advantage to this method is that you can see progress relatively quickly, thus motivating you to stick with the plan. After all, having just one less bill can be like having a huge weight lifted off your shoulders, no matter the size of the bill.

The major disadvantage is that if you have a lot of credit card debt, it usually puts that debt lower on the priority scale, meaning you will pay more in interest over the long run.

If you find yourself consistently using the month-to-month strategy, you may want to consider some type of debt consolidation loan. Doing so can reduce your monthly payments while also paying off longer-term debt (such as credit cards, especially if you only make the minimum payment) in a shorter amount of time.

The interest-rate strategy

This way of prioritizing debt is straightforward: just take all your bills and order them by their interest rate, with the highest as the top priority.

If you use this strategy, remember to use the effective interest rate (EIR). The EIR takes into account any tax deductions you may get on the debt, such as the deduction you receive on mortgage and student loan interest. Since interest payments on these debts are tax deductible—depending on IRS eligibility rules, such as income and the type of residence—the EIR is often lower than whatever is stated on the paperwork.

Other tips

No matter which strategy, or combination of strategies, you use, there are a few more tips you can use, and a few key points to remember:

- **The snowball technique**—Say you have two credit cards, with one bill being \$50 a month and another bill \$75 a month. Once you pay off the \$50 a month card, instead of spending the “extra” \$50 you have each month—or, worse yet, taking out another debt that costs the same amount—you instead roll that \$50 into paying off the second card. Once that second card is paid off, you then take that \$125 and put it toward yet another debt. And so on and so on.

This is a great method for paying off any type of debt because it doesn’t take additional money out of your monthly budget while greatly increasing your chances of paying off a lot of debt relatively quickly.

- **Be flexible**—The nature of military life means things can change quickly, including how much you’re paid (due to specialty pays) and the nature of your bills (moving from on-installation housing to off base can lead to a rent payment you didn’t have before). So always be ready to adjust to the circumstances, and look to use any extra money you get to pay off debt.
- **Watch for the fees**—Some debts may have a fee for paying the balance in full before the term expires. So before you decide to completely pay off any debt, either check your paperwork or call the creditor to find out if there is an early payoff fee, and what that fee entails.
- **Watch for rate changes**—Some credit cards may have an introductory rate, while your mortgage may be adjustable depending on the prime rate. Take any of these factors into account ahead of time and be prepared for when the rate changes.
- **Control spending**—Part of any plan must also be coupled with a spending plan that keeps you from getting in the same situation. After all, prioritizing and paying off your debt will mean little if you continue to add more debt or spend money unwisely.
- **Make phone calls**—One of the easiest and most effective things you can do is call a creditor before you start having payment problems. They will truly appreciate it, since it shows you care about paying your debt responsibly. It can even lead to solutions you didn’t consider, such as a rate reduction or lower payoff amount.

Prioritizing your debt can be difficult, and figuring out which strategy to use in doing so can be complicated, depending on your debt load, income, family situation, and a whole host of other factors.

But it's an essential step in any financial plan and, better yet, can actually make you feel much better about your finances—seeing all your bills and exactly what you owe gives you a sense of control over the situation. And as with any financial plan, the most important thing is follow through. Picking a strategy and organizing bills won't do much if you don't use that strategy effectively and consistently.

So pick your plan, get your debt prioritized, and start down the road toward a secure financial future today!