What to do if you're Drowning in Debt

A Beginner's Guide to Debt and Debt Relief

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INTRODUCTION

Are you drowning in debt? Do you feel like no matter what you do, you'll never be debt-free?

You're not alone. According to Veda's bi-annual Australian Debt Study (released in December 2011), four out of five Australians are worried about being able to make all of their future debt repayments.

The good thing is that getting your debt under control is largely in your own hands. You can get out of debt. You just have to figure out a plan of action you can stick with.

In this guide, we're going to introduce you to some of the basics of debt management. For example, you'll discover:

- The difference between "good debt" and "bad debt"
- Easy budgeting tips so you can save money and pay down debt faster
- Five debt reduction strategies you can start using today!

Do you want to start saving money and reduce your debt? Yes?

Then let's get started!

TYPES OF DEBT

The first step in getting your debt under control is understanding the kind of debt you're in.

Not all debt is bad. Some debt payments should be priorities over others when it comes to routine monthly payments eg your mortgage payments have to be met so you don't lose your home. However, these debts might not be priorities when it comes to paying off your debts in full.

Let's start by looking at the difference between good and bad debt, examples of both, and how you might prioritise the debts you currently have.

Good Debt vs Bad Debt

Here is the basic difference between good debt and bad debt:

Good Debt - Is when you borrow money in a way that is beneficial to you. With good debt you'll get a return on your money in some form rather than paying more than it is ultimately worth once you factor in interest charges.

Bad Debt - Is when you finance things you probably shouldn't and things that can be consumed. It costs you more in the long run and can hurt your financial future. For example, if you put groceries on your credit card every week and don't pay them off in full, you ultimately end up paying much more than that food is worth. Plus, you'll eventually reach your credit limit and still be paying for that old food while you have to come up with money to pay for new food for your family.

Another way to define what sort of debt you have is:

If you go into debt over something that will be fully consumed before you pay it off or is losing value (ie depreciating), this is **bad debt**.

VERSUS

If what you're financing will last long beyond the debt and will provide some kind of return or is going up in value (ie appreciating), this is **good debt**.

TYPES OF DEBT

GOOD DEBT vs BAD DEBT

DEBT	GOOD OR BAD?	WHY?
Home loan i.e. mortgage	Good	A home's value will grow (i.e. appreciate) over the long run.
New car loan	Good/ Bad	A new car's value depreciates dramatically the moment you drive it, and loses over 50% of its value within 5 yrs. The exclusion to this general rule is vintage or high end luxury cars e.g. Corvette. In this case, the car tends to maintain its value and the purchase is predominantly a lifestyle choice.
Used car loan	Good	Used cars don't experi.e..nce a rapid drop in value post-purchase (unlike a new car). It's also good debt if it helps you earn income by providing you transport to/from work.
Credit cards	Bad	Credit cards are a great financial tool when used responsibly. But when you don't pay your balance in full and carry it over, you pay interest. This means you're paying more for goods (usually consumables) than they're worth.

TYPES OF DEBT

GOOD DEBT vs BAD DEBT

DEBT	GOOD OR BAD?	WHY?
Student loan	Good	A student loan, used to acquire a better education produces better job prospects and higher income levels over the long term.
Vacation loans	Bad	Vacation loans will leave you paying more than the original cost of the vacation ie paying more for an item already consumed.
Groceries, clothes	Bad	Creating debt to pay for consumer goods or consumables leaves you paying more for them than their value. Combined with credit card debt, this could see spiralling bad debt.

So the question becomes: what kinds of debt do you have?

Make a list of all of your debts and lump them into either the "**good debt**" or "**bad debt**" category. Write down how much you owe, what interest rate each loan account has, and what each debt you have was for.

Once this is done, you'll be able to prioritise your debts in a way that helps you get out of debt faster.

BUDGETING TIPS: STARTING SIMPLE

Once you have a list of all of your debts and know which ones are good and bad, you need to prioritise them.

We're going to focus on prioritising your debts in a way that helps you get out of bad debt. You can often tackle bad debt from two sides -- paying off existing debt and preventing future debt.

Let's start by talking about prevention and how basic changes to your budget can help you avoid future debt problems.

BUDGETING TIPS: STARTING SIMPLE

Budgeting Tips: Starting Simple

Budgeting is all about spending within your means. For some consumers budgeting is almost like a game - they challenge themselves to save more and more money as times goes on. But you don't have to take budgeting to the extreme in order to prevent unnecessary debt.

You can start by taking some simple steps which will help you reduce your spending, leaving you with more money to help pay your existing debt quicker.

Below are some simple budgeting tips to help get you started:

- Choose one or two luxuries you can cut back on. You don't have to cut back on everything, especially in the beginning. Cutting back on too much too quickly will leave you feeling disheartened by the budgeting process and can encourage failure –so remember, small steps towards success. You might be surprised to see much you can save with modest budget cuts such as the following:
    - A coffee a day: swapping the daily morning coffee you buy with one you make at home or work yourself can see you save hundreds a year:
    - Lengthen the lifespan of your technology: there's nothing wrong with staying on top of technology however you should try to get more life out of them before spending more money to replace them every few months to a year.
    - Movie time at home. Rather than attend the cinema a few times per month, get together with friends at one of your homes to watch a favourite movie over some home-made dinner. Everyone can bring a dish and you have dinner and movies at a fraction of the cost of heading out.

BUDGETING BASICS

BUDGETING TIPS: STARTING SIMPLE

As you can see from the table below, it just takes some simple steps to get on the right track to saving more:

ITEM	PER DAY	PER WEEK	PER MONTH	$$ SAVED PER YEAR
Coffee	$3.50	$17.50	$70.00	**$840.00**
Train/bus	$10.20	$51.00	$204.00	**$2,448.00**
Takeaway lunch	$10.00	$50.00	$200.00	**$2,400.00**
Newspaper	$1.00	$5.00	$20.00	**$240.00**
Friday beers	-	$25.00	$100.00	**$1,200.00**
Total	$24.70	$148.50	$594.00	**$7,128.00**

BUDGETING TIPS: STARTING SIMPLE

- Pay your bills whenever you get paid. Don't wait for the due dates. This lets you spread out payments so they don't all come due at once, and you can't spend that money elsewhere if you use it to make a debt payment first.
- Switch to cash for everyday shopping. Take only what you've budgeted for and you'll stop yourself making impulse buys you can't afford and don't need. If you can't give up the convenience of buying with a card, consider loading your budgeted amount onto debit cards instead.
- Consider automatic savings. Your bank might let you make automatic weekly or monthly transfers from your transaction account into your savings account. Start with a small amount and increase it as you cut back on other expenses. Then use that "extra" money you effortlessly save to make lump sum debt payments (or first establish an emergency fund so you don't rely on credit cards for that).
    - For example: You might tell your bank to automatically transfer $50 from your transaction account to your savings account every week. As soon as your salary is deposited, that amount goes right into savings before you have a chance to spend it. By the end of the month, you've saved around $200 that can go towards your debts.
- Look for simple ways to save. It's not always about cutting back; it's also about making changes which still give you the things you enjoy, but at a lower cost. For example, do you like a certain restaurant that is pricey? Learn to make your favourite meal they offer and enjoy it at home. Enjoy certain brands or products? Then look out for catalogue offers so you can still enjoy them but at a lower price.
- Start bartering. Do you have a neighbour who is great with cars? Are you a great gardener? Maybe they can help you save money on big car repairs if you barter services and help them out with landscaping in exchange.

BUDGETING BASICS

BUDGETING TIPS: STARTING SIMPLE

Avoiding new debt doesn't have to involve giving up all of the bigger things you love. It's about making small changes and letting them add up to big savings – like the old adage says: if you take care of the pennies the pounds will take care of themselves.

You certainly can do more if you want to, or even cut costs more over time but just remember to take it slow in the beginning so you don't feel overwhelmed by too much change.

What should do with all of the money you save? Well, you can put some towards an emergency fund to cover unexpected expenses. Keep some of it to cover things you used to buy on credit (if you can pay cash, there's no need to go into debt over it). And put the rest towards paying down existing debt.

DEBT REDUCTION PLANS

So far we've looked at different kinds of debt, prioritising your debt and budgeting basics.

Now it's time to look at how to start reducing your debt..

Before you can prioritise your bad debts (deciding which to pay off more aggressively first), you should pick a debt reduction plan that will suit you and your financial situation. But first you need to remember:

- Your debt reduction plan is about eliminating bad debt first. Any plan mentioned here assumes you're still making your required payments on all of your good debts (like your home loan).
- When you prioritise your bad debts and decide which to focus on first it just means you'll attack that debt more assertively and it will be the first debt account eliminated in full. It does not mean you'll ignore other bad debts in the meantime. You would still need to make at least your minimum payments each month on the rest of them.
- To prioritise a debt, you must pay more than the minimum on at least that one each month. Paying only the minimum due on all debts will not help you become debt-free any time soon.

With that in mind, here are some types of debt reduction plans you might want to consider.

DEBT REDUCTION PLANS
THE SNOWBALL METHOD

The snowball debt reduction method involves making your smallest debt the priority. You start with the smallest debt because you can pay it off the fastest.

To make it work for you, you need to decide how much more than the minimum payment you can pay every month for your smallest loan.

Meanwhile, continue to pay the minimums on your other debts. Then put the extra payment towards your lowest balance debt.

When the first debt is paid off, take the payment that previously went to the old debt and add it to your minimum payment on your next smallest debt.

Benefit of this method: Some consumers might find it motivational to see results sooner helping you to stick with your debt repayment plan for the long haul.

DEBT REDUCTION PLANS
THE SNOWBALL METHOD

Example: Judy has **three loans** she would like to eliminate:

Personal Loan	Credit Card A	Credit Card B
Balance: $1000 Monthly minimum: $20	Balance: $500 Monthly minimum repayment: $15	Balance: $300 Monthly minimum repayment: $10

Thanks to some basic budgeting Judy can afford to pay a total of $100 a month towards her debt. This means she has an additional $55 to contribute over the minimum repayments.

Using the snowball method, this means Judy would contribute the following amounts per month:

- $20 to the personal loan
- $15 to Credit Card A
- $65 to Credit Card B ($10 + $55)

By doing this, in approximately five months, Credit Card B will be paid in full.

DEBT REDUCTION PLANS
THE SNOWBALL METHOD

Continuing to use the snowball method and still having $100 in total to contribute to the debt, Judy will now contribute the following amounts per month:

- $20 to the personal loan
- $80 to Credit Card A ($15 minimum + $65 originally allocated to Credit Card B)

Finally, once Credit Card A is paid off, the full amount of $100 will be contributed to the Personal Loan until it is completely paid off.

DEBT REDUCTION PLANS
THE HIGH INTEREST PRIORITY PLAN

Technically you'll save the most money if you pay off your highest interest debts first. Again, decide how much extra you can pay each month. But this time put the extra payment towards your highest interest debt. When that one is paid off, you keep paying the same amount but you assign the former debt's payment towards the next one you prioritise.

Benefit of this method: You'll save more money on interest / finance charges, and that saved money can go towards paying down your total debts.

DEBT REDUCTION PLANS

THE HIGH INTEREST PRIORITY PLAN

Example: When constructing your high interest priority debt reduction plan, first you need to create a list of your debts.

Let's say for this example, Judy has the following debts:

DEBT	INTEREST RATE	AMOUNT OWING	MIN. MONTHLY PAYMENT
Store Credit Card	22%	$1756	$38
Visa Card	18%	$3300	$68
Car Loan	10.5%	$7000	$151
Home Loan	6.5%	$110,000	$744
Total Debt:		$123,580	$1001

Using this debt reduction plan, Judy would need to select the debt with the highest interest rate and target this one first. This means that you only make the minimum repayments on all your other debts until this one is paid in full.

In this case Judy needs to target the Store Credit Card.

DEBT REDUCTION PLANS
THE HIGH INTEREST PRIORITY PLAN

Step 1: Thanks to Judy's budgeting success, she has an extra $200 per month (in addition to the $38 minimum repayment) to put towards her store Credit Card. As can be seen in the table below, within 8 months, Judy has eliminated this debt.

MONTH	START BALANCE	22% INTEREST ADDED	ACCUMULATED BALANCE	REPAYMENT	END MONTH BALANCE
Jul 2012	$1,756.00	$32.19	$1,788.19	$238.00	$1,550.19
Aug 2012	$1,550.19	$28.42	$1,578.61	$238.00	$1,340.61
Sep 2012	$1,340.61	$24.58	$1,365.19	$238.00	$1,127.19
Oct 2012	$1,127.19	$20.67	$1,147.86	$238.00	$909.86
Nov 2012	$909.86	$16.68	$926.54	$238.00	$688.54
Dec 2012	$688.54	$12.62	$701.16	$238.00	$463.16
Jan 2013	$463.16	$8.49	$471.65	$238.00	$233.65
Feb 2013	$233.65	$4.28	$237.94	$238.00	-$0.06

THE HIGH INTEREST PRIORITY PLAN

Step 2: In line with this debt reduction method, Judy would target the Visa Card next. Now she would have an extra $238 to contribute towards this debt, in addition to the original $68 minimum repayment amount.

This means Judy would be contributing a total of $306 per month towards the Visa Card debt and would pay it off within 12 months, even though the total amount owed was nearly twice the Store Card.

Step 3: Next Judy would target her $7000 car loan. Now she would have an extra $306 to contribute towards this debt, in addition to the original $151 minimum repayment amount.

This means she would contribute a total of $457 per month at the car loan, paying it off in less than 17 months.

Step 4: Judy's final loan to target is her home loan of $110,000. Now she would have an extra $407 to contribute towards this debt, in addition to the original $744 minimum repayment amount.

This means she would contribute a total of $1201 per month, paying it off in just over 10 years.

DEBT REDUCTION PLANS
THE FLAT RATE PAYMENT PLAN

With a flat rate debt payment plan, you assign a set dollar amount (higher than the minimum due) to every debt you're trying to pay off. For example, let's say you have three credit cards with balances due. Your minimum payments range from $25 to $50 each month.

With this plan, you might choose to make a $100 payment on each of those debts every month. Or you can choose different flat rate payments for each debt (such as $50, $100, and $150, moving from your lowest to highest balance cards).

> **Benefit of this method**: You always know how much you'll need to pay every month (as opposed to adding something to a variable minimum payment that's due). When you pay one debt off, you can reallocate those funds to higher payments on other debts if you want to get out of debt faster.

DEBT REDUCTION PLANS

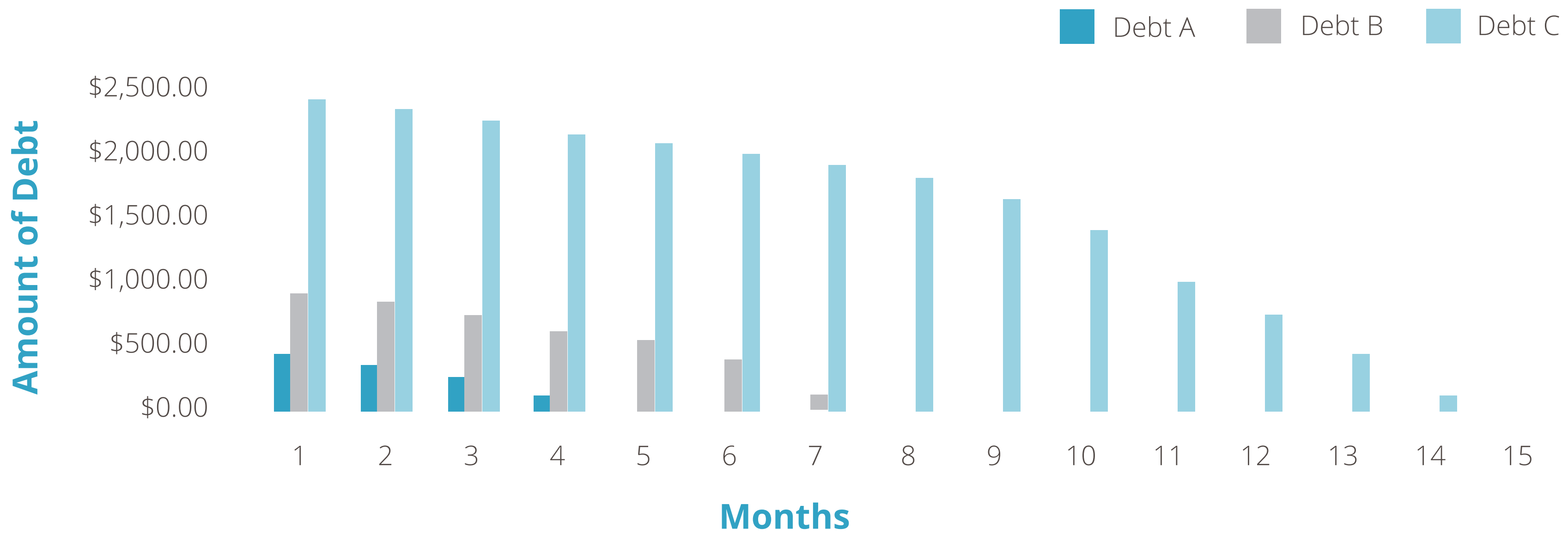
THE FLAT RATE PAYMENT PLAN

Example: In this example, Judy has three debts: $500, $1000 and $2500. Thanks to Judy's budgeting, she has extra $300 per month she can contribute towards her debts (in addition to their monthly minimum repayments).

In this case, Judy would allocate $100 to each of her debts. This means she would be splitting the extra money she has evenly between her debts.

When the first debt account is eliminated, Judy would then split the $300 evenly between the two remaining debts.
Once the second debt is eliminated, the full $300 would be allocated to the final debt account until it is paid in full.

You can see the method and results in the graph below:



DEBT REDUCTION PLANS

DEBT CONSOLIDATION

If you're struggling to manage several different due dates or some debts have extremely high interest, you might consider debt consolidation. You can consolidate some or all of your current bad debts into a new one (using a personal loan or balance transfer credit card). The idea is to find a new loan or card with a lower interest rate so more of your payments go towards your principal debt.

Benefit of this method: You can simplify things so you only have a single payment to make every month (or at least fewer payments), and you can save money on interest.

Example: In this example Judy again had three debts: $500, $2000 and $4500. She also has an extra $300 per month she can contribute to her debts.

But Judy is busy and doesn't have the time or inclination to manage the different accounts, interest rates and payment cycles, so she wants to consolidate all her debt into one account.

Judy wants to get a debt consolidation loan with an interest rate that is at least equal, or preferably lower, than the lowest rate she is currently paying.

Right now Judy's loans attract rates of 13%, 16% and 19%. So the debt consolidation or balance transfer credit card she will choose will have an interest rate of 13% or lower.

This way, Judy will be required to pay less in monthly repayments each month and can allocate the $300 extra monthly payment towards her new single debt account instead of figuring out how to split it or prioritise it among three different payments.

However it's important to note that you must not get caught in the trap of continuing to create debt at a lower rate. This tends to happen as people think they are getting a better deal on their money because they're paying less, but this is not true. Acquiring debt at any rate will end up costing you more money in the long-term if you don't eliminate it.

DEBT SETTLEMENT / NEGOTIATING WITH CREDITORS

Debt settlement is when you negotiate a lower payoff amount than is technically owed. This can be a good option if you're seriously delinquent on your debt payments and paying in full is completely unrealistic (such as due to a permanent job loss as a result of a serious injury or illness). The idea is to get the lender to "forgive" some of the balance - usually interest or penalties that have accrued over time.

You can either work with debt settlement companies (which can charge you) or you can try to negotiate with creditors yourself. If you choose a debt settlement company, do your research first. Some are more reliable and successful than others.

Benefit of this method: If other debt repayment methods would still be impossible for you to work with, this can be a last resort option that will lower the total amount of money you have to repay.

Example: Debt settlement is something that needs to be negotiated with creditors on an individual basis. Some will be willing to work with you while others won't. So let's focus on a single debt in this example - $2500. The interest rate doesn't even matter, because your goal is to get the lender to agree to a lower total balance due.

You would contact them and propose an offer in settlement. You would explain your circumstances and why it's unlikely you could ever realistically pay off the full amount you owe. And you would let them know how much you can pay them. They might ask for personal and financial information to verify your situation.

The idea is to settle on a lower balance amount. For example, you might negotiate it down to $1500. The settlement would be that you pay $1500 and the lender will consider the full $2500 debt paid in full. Basically, you clear your delinquent account status and you save $1000 in the process.

WHICH DEBT REDUCTION PLAN IS RIGHT FOR YOU?

Only you know your current financial situation. Start with your budget first and see if you can come up with extra money to put towards your debts. Then consider other elements of your situation, such as your current income and what debt repayment style would most likely motivate you to stick with it.

Remember. It's okay to start small. The key is starting to address the problem at all. Choose something you won't give up on quickly, and celebrate even the small victories. Before you know it, you'll be celebrating the fact that your hard work has left you debt-free!

LEARN MORE ABOUT PERSONAL FINANCE & DEBT REDUCTION

Here at creditworld.com.au, we do more than try to help you get out of debt. We help you get a better handle on all of the important aspects of your financial life. From choosing the right bank accounts to understanding loans and insurance options, we want to be your partner as you build or repair your financial future.

What We Have To Offer

Here are some of the things we can assist you with:

- Compare credit cards.
- Find a new transaction account.
- Earn higher interest by choosing the right savings account.
- Shop for any kind of loan - from home loans to car loans.
- Find debt consolidation loans to save on interest while you pay off debt.
- Get easy online life insurance quotes.

Want to learn even more about personal finance? Then check out our personal finance articles at any time! There you can learn the basics about credit, debt, insurance, tax accounting and more before you apply for any financial product.

Our goal is to help you become a better educated consumer so you can take the reigns when it comes to managing your finances. Save more money. Buy a home. Get out of debt. No matter what *your* financial goals are, we're here for you today, tomorrow and always.