Solving Your Debt Problem

When paying off debt is one of the best uses of your money you can find. Invest in yourself by paying off expensive debt. By paying off such debt, you would earn the equivalent of a whopping 25 percent annual interest if you are in the middle 28 percent tax bracket. This return exceeds any safe investment today.

How can you reduce your personal debt? There are several methods that work. Regardless of the method you choose, start by tracking your spending and setting up a monthly spending plan or budget. Once you have determined how much money you can pay towards the total debt each month, keep that amount fixed in the budget. You may reduce expenses and increase the payment, but do not reduce the total payment until all the debts are paid.

Method 1

List each debt from smallest to largest balance. Begin with the one that has the smallest balance. Write the minimum payment beside each. If your balance after expenses is not sufficient to meet all the minimum payments, you should get help with your finances immediately. Hopefully, you will be able to meet expenses and minimum payments with some money left over. If so, add this extra amount to the payment going to the first (smallest) balance listed. Each month, pay the extra money to this account until it is paid in full. When the first account is paid in full, keep the budget amount for credit payments as is and apply extra money to the next account on the list. Do this until all accounts are paid in full.

The Best Method For Reducing Debt

The best method for reducing debt is the one that works for you. Regardless of the method you select, it must be part of an overall spending plan. One method may save a little more than another. You may get a needed boost of confidence by paying off an account sooner than expected. Whatever the reason, the important thing is to take action to achieve your financial goals.

Where Can You Get Help?

For additional information, contact your county Extension office, or call Fred Waddell, Extension Family Resource Management Specialist, at 334-844-3244, or e-mail: fwaddell@hmsci.auburn.edu

How Much Debt Can You Afford?

It is important to know how much credit you can afford. Just because you receive credit offers does not mean you can make the payments. To figure out how much money you have available for credit payments, you need to know:

- Your total monthly take-home pay (net income).
- Your total monthly expenses, not counting any non-mortgage credit payments.

Your total monthly expenses fall in two groups: fixed expenses and flexible expenses. Fixed expenses, such as rent, utilities, and credit card payments, are the same each month. Flexible expenses, such as recreation or food, change throughout the month or seasonally. Total monthly expenses also include any money put aside each month for annual events, such as Christmas or a vacation.

Once you determine your total monthly take-home pay and your total monthly expenses, you can figure out how much money you have available for credit payments. Simply subtract the monthly fixed and flexible expenses from the monthly net pay. If there is some money left over, consider this amount as a maximum for credit payments for personal debt, not including mortgage payments.

Credit is an easy trap. Unplanned decisions about how we spend our limited cash resources and careless use of credit can limit our financial freedom. Credit advertisements would have us believe that with credit we can “have it all, right away!” But depending on credit can slowly rob us of our financial freedom.

Have you taken a close look at your spending lately? Do you find yourself charging items that used to be cash purchases? Do you make only minimum payments to creditors or skip payments when allowed? Have you requested increases in credit lines or been turned down on recent credit applications? Have you considered making a consolidation loan? Have you considered filing for bankruptcy?

Anyone can be caught in the credit trap. Almost one in every five Americans presently has a level of personal debt that is overwhelming. How much is too much?
Table 1. The Time-Is-Money Calculator.

<table>
<thead>
<tr>
<th>Time in Months</th>
<th>Monthly Payment</th>
<th>Total Credit Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>$400</td>
<td>$4,800</td>
</tr>
<tr>
<td>24</td>
<td>$200</td>
<td>$9,600</td>
</tr>
<tr>
<td>36</td>
<td>$133.33</td>
<td>$14,400</td>
</tr>
<tr>
<td>48</td>
<td>$111.11</td>
<td>$19,200</td>
</tr>
<tr>
<td>60</td>
<td>$95.24</td>
<td>$24,000</td>
</tr>
</tbody>
</table>

Calculating current debt load with mortgage payment:

1. Add your monthly mortgage payment to your required monthly payments (figured in step 1 above).
2. Divide the required monthly payment amount by net monthly income (figured in step 2 above). Move the decimal two places to the right. This figure is the percentage of your monthly income that you are using to pay off your total monthly debt (with mortgage payment).
3. Use the Debt-Signals chart (right column) to determine the credit risk of your current debt load including your mortgage.

Table 2. Comparing Net Income To Credit Payments.

<table>
<thead>
<tr>
<th>Total Monthly Income</th>
<th>Total Credit Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0,000</td>
<td>$0.00</td>
</tr>
<tr>
<td>$5,000</td>
<td>$0.00</td>
</tr>
<tr>
<td>$10,000</td>
<td>$0.00</td>
</tr>
<tr>
<td>$15,000</td>
<td>$0.00</td>
</tr>
<tr>
<td>$20,000</td>
<td>$0.00</td>
</tr>
</tbody>
</table>

Checking Your Debt Limit:

Are you concerned that you may have more debt than you can handle? To see if your debt is within safe limits, check your debt rate. There are several ways to see if your monthly credit payments are taking too much of your income.

Method 1:

One way to check your debt rate is to compare your average weekly and monthly income with your total credit payments. To do this, divide your total credit payment by your total income. The result should be 5% or less.

Method 2:

Here's another way to check your debt rate. Use Table 2 to see if your monthly credit payments are taking too much of your income.

First, find and circle the amount in the income column that is closest to your total monthly debt. That is the amount you are using to pay off your total monthly debt (with mortgage payment).

Next, find and circle the amount in the debt payment column that is closest to the amount you are using to pay off your total monthly debt. That is the amount your monthly income is going to pay off your total monthly debt (with mortgage payment).

Finally, divide the amount in the debt payment column by the amount in the income column. The result should be 5% or less.

Only if the interest on the debt, then you have a 10% debt rate. Each additional 5% adds 10% to the rate. For example, a total debt load of $7,000 and an hourly wage of $7, shows 150 work hours are needed to just pay the interest on the debt.

It means that about 30% of your income can handle a level line. That is about as much debt as you can safely manage. If the line you drew from the income column to the debt payment column is going up, then more than 30% of all the money you take home is going to pay off credit debt. Think of this as a dangerous amount of debt. The steeper the line, the greater the danger to your financial safety and security. You may be getting by from month to month right now, but a loss of income due to illness, job loss, divorce, medical expenses, or repairs for the car or house could mean real financial trouble.

Method 3:

You can determine the risk of your current debt load with or without mortgage payments—by following a few simple steps.

Calculating current debt load without mortgage payment:

1. List and total the required monthly payments against all credit cards, including education and automobile loans. DO NOT include monthly mortgage payments.
2. List and total all of your net monthly income (take-home pay).
3. Add your required monthly mortgage payment to your required monthly payments (figured in step 1 above).
4. Divide the required monthly payment amount by net monthly income (figured in step 2 above). Move the decimal two places to the right. This figure is the percentage of your monthly income that you are using to pay off your total monthly debt (with mortgage payment).
5. Use the Debt-Signals chart (right column) to determine the credit risk of your current debt load including your mortgage.