

Debt Trap

Nothing is more depressing or stressful than being in financial trouble. The real truth is few Americans have been educated or prepared to properly manage their finances. There are many reasons debt may get out of control from lost jobs to poor fiscal management. The good news? It is not too late to get out of the debt trap!

To get out of the debt trap, start with a financial plan including an evaluation of your current situation. You must evaluate your current debt one item at a time and make decisions on how you can attack each situation. Here are some guidelines to follow:

1. Which credit cards and loans are carrying the highest interest rates? These are the credit cards and loans that hurt the most. There may be a huge difference in monthly payments between a 12% credit card and an 18% credit card. Solution: Transfer balances to a lower interest rate loan or card. You may also be able to negotiate a lower rate with the credit card company. One important note; as you pay down your credit cards another factor to consider is getting balances below 50% of the maximum credit limit on each card. Cards above the 50% level affect your credit score the most.
2. If you are behind on payments to creditors, the worst thing you can do is “hide.” Solution: Proactively call and talk with your creditors. There is a possibility you may be able to work out a compromise on payments. The best time to call is before you are behind. Try to have your plan prepared when you call and the representative may be more willing to work with you.
3. Write down what you have spent for the past three months and put the expenditures into categories such as food, clothing, utilities, entertainment and dining out. You will be able to quickly see which areas are your biggest financial drains. This list will be the first step in creating a monthly budget that you must learn to stick by if you are to ever escape the debt trap. It is amazing how much monthly expense you can eliminate just by reviewing the “non-essentials” such as the daily newspaper, health club membership, baby sitters, stops at the coffee shop on the corner, excessive long distance charges and eating out. Also do not be an “energy hog” in your own home. Turn off lights, move the thermostat to reduce air conditioning and heat and substitute light bulbs with newer energy efficient ones.

Once you have made these important evaluations it is time to set an actual budget. If you have a family, it is important to get everyone involved in the budgeting process since everyone should be willing to do their share in reducing debt. A budget is simple to put together, just follow these steps:

1. Start backwards! Start with your total monthly take home pay after all taxes, insurance and automatic withdrawals. Any automatic withdrawals that are non-essential should be eliminated.
2. Next go back to your three-month expenditure list that you compiled in the beginning of your plan. Go over the “have to’s” such as health insurance,

- utilities, auto insurance, house payment, car payments and groceries. Come up with a total amount and decide if any “have to” expenditures can be reduced. An example might be to start using coupons and eliminating luxury foods when you grocery shop. Once you have done this, come up with a final monthly budget on the essential expenditures.
3. Any amount you have left over should be assigned to debt reduction. If you only pay the minimum on each debt it will take years to pay each one off. Remember from part one of this plan that you may have been able to negotiate a reduced interest rate or payment but try to stay on track in eliminating the debt.
 4. Look at what is termed optional spending. Entertainment would be in this category. It is great to do fun things but many of them can be low cost. Going to the movies for a family of four can easily run eighty dollars or more while a high school basketball game can be less than twenty dollars! This is another reason an entire family should be involved.
 5. When all categories are reviewed, make sure you have a cushion for unexpected expenses of around 10%
 6. Approach your budget with excitement and commitment! Every week, review your expenses and make adjustments if necessary. You will find that sticking to a budget, although not easy can be very rewarding when your debt starts to disappear and it becomes a little easier to sleep at night. As you begin to pay off your debt and reduce monthly expenses it is very easy to get back into the “spending trap” Once you pay off one credit card, apply the extra payments to your remaining debt not a dinner at an expensive restaurant or a new stereo

There are other tips regarding getting out of the debt trap of which you should be aware. Let's look at each one.

1. Be careful if you decide to use a credit counseling service. There are both private, non-profit and government sponsored credit counseling services. This should not be your first step. Take the initiative to create your own plan. If you still struggle then credit counseling may be an alternative. Do not choose a service based on a television commercial! Do your homework! The National Foundation for Credit Counseling “NFCC” is an association for qualified, mostly non-profit credit counseling agencies and is a good place to start your search if you choose this option. Most of these members are termed “CCCS” or Consumer Credit Counseling Service. The services can range from free to just a nominal fee each month assist you in managing your debt. Each NFCC member has to be accredited every four years through an independent agency and receives the “COA” approval which comes from the “Council on Accreditation”.
2. As mentioned earlier, put aside a contingency for unexpected expenses. If it means paying a little less on your debt, it is better than an unexpected expense that sets you back.
3. If all else fails, you may want to consider “Debtors Anonymous,” a free organization dedicated to individuals who need a support group and feel they cannot get out of debt on their own.

4. Do attempt to get interest rates on loans lowered by the creditors but be careful regarding payoffs. If a creditor reduces the payoff, in most cases it will be detrimental to your credit.
5. Do consider a second job, a garage sale to raise cash, and even working odd jobs or overtime. Every little bit helps and making the sacrifice will be a lesson well learned to avoid the debt trap again.
6. Remember the earlier advice, pay off the highest interest rate debt first and try to get below the 50% maximum level on credit cards and credit lines. There is one psychological “trick” that can help you see the light at the end of the debt tunnel. If you have cards with very low balances, make an extra effort to pay them off. Why? There is a psychological boost to totally eliminating a debt.
7. Remember you can check your credit report once a year for free with the three main reporting agencies.
8. Check the fine print on any “transfer credit cards” that offer to consolidate your credit card into one card with a low monthly interest rate. Although the rate is low, many have default rates and penalties that are extremely high if you are late on a single payment!

Finally, one alternative is to refinance your home provided you have enough equity to pay off higher interest debt. Put a lot of thought into this option because you want to be sure you can handle the higher monthly payment of a cash out refinance since your principal balance will increase. A qualified loan consultant can assist you with making the right choice for you. In many cases you can reduce your debt by several hundred dollars a month while increasing your monthly house payment by a lesser amount. When you replace short term high interest rate debt with longer term lower interest rate debt, you may end up paying the same amount in interest and finance charges over the life of the longer term debt. You should also be aware that by consolidating unsecured personal debt with a cash out refinance, you pledging your home as collateral for the repayment of the debt. If you are unable to repay the debt, you may lose your home.

Good luck as you focus on creating a financial future. Having solid credit, great spending and saving habits as well as peace of mind will be more than worth the price you have to pay to get out of the debt trap and into a secure financial future.