DEBT FREE

HOW TO PAY OFF YOUR DEBTS FOR GOOD

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Contents

Please note the usual disclaimers: This information is general in nature and not tailored to your specific situation. It is not financial advice. Your personal situation will dictate the best debt reduction strategies for you. If you're debt situation is critical, seek the assistance of a professional financial counselling service ASAP. If you're in Australia, you can go to this government website to find a free financial counsellor near you, or the Salvation Army also offer free financial counselling services, you can find their contact details here.

Introduction

According to a leading data survey company, four out of five Australians worry about not being able to pay off their debts and one in five Australians are already struggling to pay off their credit cards.[1]

Being deep in debt is the antithesis to being frugal and thriving. It's hard to thrive when you are awake at night worrying about making ends meet. And while you are paying off yesterday's purchases, plus interest, it's hard to meet today's and tomorrow's expenses (and have money for the fun stuff).

This eBook is all about how to tackle your debt once and for all. The strategies outlined below will help you pay off your existing debt (without too much pain) and set up an easy system to cover your living expenses that helps you avoid future debt. It also addresses spending habits. Without examining and changing spending habits, debt and the worry that accompanies it will travel with you through life.

Read through the eBook once so you get an idea of the strategies involved, then go back and do each action step. It won't take very long, and once the system is in place, you can get on with doing all the other stuff in life. It will take the worry out of reducing your debts.

There is one debt reduction strategy that this eBook does *not* cover and that is debt consolidation. While debt consolidation certainly has its place, particularly if you are struggling to make minimum repayments, the problem with consolidation is that you can end up paying a lot more interest in the long run *and* you are not addressing the underlying causes for debt in the first place. Instead, the strategies in this eBook are about clearing debt quickly and avoiding unnecessary debt in the future.

[1] From the Sydney Morning Herald, Dec 19, 2011

First things first

Getting out of debt starts with a decision. And for that decision to become a reality, it needs to be backed up by action. All the resolutions and strategies in the world will come to nothing if you don't take action.

You have made the decision to pay off your debt, that's why you are reading this eBook. I encourage you to do each action step within this eBook in order to see results.

The first step to take today to paying off your debts is to take your credit cards out of your wallet.

Let me tell you a little bit about willpower. It's a myth. Or at least, you have a very limited capacity for it. Don't take it personally; it's just the way the prefrontal cortex area of our brain works. While your prefrontal cortex is busy trying to concentrate on negotiating your trolley with the bung wheel, remembering what you have to do at work tomorrow and thinking about what you're going to eat for dinner, resisting that impulse buy is just one too many tasks for your prefrontal cortex to do.

So don't rely on willpower. It doesn't work. Instead, set yourself up for success no matter how you feel or what your situation. That means not carrying around your little plastic temptations because it will be impossible to pay off your debt if you keep piling it on.

But what if you don't have enough cash to pay for the petrol? Or the groceries? It can be reassuring to have credit cards as a backup: no money? no worries – just put it on the plastic. But when you leave the credit cards at home, you are forced to manage your money and *plan your spending*, which is one way of addressing spending habits.

By not having easy access to credit you will have to ask yourself the questions *'can I afford this purchase? Will I be able to afford everything else if I buy this?'*

Do you know what your debt represents? Is it a new fridge, furniture, more clothes, food, entertainment, holidays, books, electronics? Or have the purchases been long forgotten?

Your existing debts are most likely the result of many, many purchases made over time. Is the pain of today worth the pleasures of yesterday?

Action Step 1: Take your credit cards out of your wallet and put them in a safe place so that you avoid incurring more debt.

Introducing...your debts. Facing your debt head on

Do you ignore the balance on your credit card statement when it comes in the mail and just pay the minimum monthly repayment? Have you ever calculated the amount you owe on *all* your debts together? Have you worked out how much of your paycheque is eaten up by debt repayments?

If you have repressed your debt, then now is the time to bring it out into the light. Grab your latest credit card and loan statements, some scrap paper, pen and calculator (or a spreadsheet if you prefer) and let's crunch the numbers.

By the way, if you are in a relationship, then it's important to do these exercises together with your partner. Financial management is a team effort. If your partner is in debt denial, then actually seeing how debt is affecting your capacity to pay future bills or achieve future goals (go on that holiday, buy that house) can be just the motivation they need.

So what you need to do is simple: list each of your debts, the balance owing, the interest rate applicable and the minimum monthly repayments and tally the total. Here's an example of what I mean. I'll be using this example throughout the eBook.

Debt	Balance Owing	Interest Rate %	Minimum monthly repayment
Store Card	$2,000	24.5%	$63
Credit Card 1	$1,340	18.6%	$34
Credit Card 2	$4,600	16.5%	$138
Car Loan	$8,800	14.23%	$265
Personal Loan	$3,300	13.05%	$100
Total	**$20,040**		**$600**

A reality check – what paying the minimum is costing you

Here is an exercise that should help you and your partner get motivated to pay off your debt as soon as possible. Using this online calculator, enter each of your credit card balances, interest rates and minimum monthly repayments to find out just how long it will take you to pay off your cards if you only pay the minimum monthly repayment, and how much interest you will end up paying in total (assuming you never use the card again, of course! It will be worse if you continue to incur debt). The results will surprise you!

With our example above, the store card will take *20 years* to pay off and it will cost $3,788 in interest (plus fees!). Credit card 1 will take 16 years to pay off and will cost $1,767 in interest and Credit Card 2 will take 24 years to pay off and will cost $8,271 in interest.

You have to ask yourself: are you going to be happy paying off today's purchases 20 years from now? Are they worth all that extra interest? How old will you be when today's debts are paid off?

Action Step 2: Gather all recent loan and credit card statements and jot down in a table the outstanding balance, the interest rate and the minimum monthly repayments. For the very game, look at how long it will take you to pay off your debts if you continue paying the minimum repayments.

Your debt repayment strategy step one – how it works

As you can see, it is vital to pay *more than the minimum monthly repayment* when paying off your debts.

But of course, this is often easier said than done. After all, you still have to pay for the roof over your head, the food on the table and the upcoming bills.

So here is a simple yet effective strategy for paying off your debt:

Pay more than the minimum monthly repayment on one debt and then when that debt is paid off, apply that repayment amount to your next debt.

Let's look again at the example to see how this works.

Debt	Balance Owing	Interest Rate %	Minimum monthly repayment
Store Card	$2,000	24.5%	$63
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Just say in this example we decided to tackle the Store Card first. The minimum monthly repayment is $63 but we work out we can afford to pay $100 towards that debt (more on calculating how much you can afford to pay later). For the other debts, we continue to pay only the minimum monthly repayment.

Once the Store Card is paid off, we then apply that $100 to our second debt, in this case Credit Card 1 – the total monthly repayment on Credit Card 1 now becomes $134 ($34 minimum + $100 from the Store Card).

When this card is paid off we apply the repayment amount to Credit Card 2 – the total monthly repayment now becomes $272 ($138 minimum + $134), and so on until all our debts have been paid off.

This strategy for eliminating debt is referred to as 'snowballing'; your debt elimination gains momentum each time you apply the previous repayment amount to your next debt just like a snowball rolling down a hill. Obviously, the more you can pay off that first debt, the quicker your snowball will roll down the hill to debt free land!

How do I know which debt to tackle first?

When it comes to choosing which debt to pay off first there are two main strategies, pick the one that works best for you.

The first strategy is to choose the debt with the highest interest rate. This means that you end up paying the least amount of interest in the long run. While this snowballing strategy makes mathematical sense, it doesn't necessarily make psychological sense.

The other strategy is to choose the smallest debt to pay off first. While this may mean you pay more interest in the long run, seeing that debt dwindle quickly and then actually paying it off can be a huge motivational boost. Gaining a psychological advantage over your debt can be the difference between sticking to your repayment strategy and blowing it.

Action step 3: Decide which debt that you will tackle first by paying more than the minimum monthly repayment.

Your debt repayment strategy step two – get out of debt and stay out of debt

I'm not going to tell you to draw up a budget or spend a month tracking every cent you spend. The aim here is to get to it and pay off your debt, so you are going to work with your current circumstances *not* wishful thinking like 'if' you save money on the groceries or 'if' you reduce your bills. This strategy is about results, so let's get straight into it!

You will however, need a good idea of your current income and expenses, so before you start, grab your payslips, bills and receipts, some more scrap paper and we'll crunch some more numbers. I promise this exercise will only take an hour or two at the *very* most, but it will give you control over your money and save you many, many hours of stress and worry.

- Calculate your total net income and write this amount down (note whether you get paid monthly, fortnightly or weekly). Your net income is what you end up with in the bank after tax is taken out *not* your annual salary. E.g.:

Income	Fortnightly Amount
Wage	$620
Partner's Wage	$1,580
Government payments etc	$180
Total	**$2,380**

- Take your total minimum monthly debt repayment amount and divide it by 2 (for fortnights) or 4 (for weeks) depending on whether you get paid fortnightly or weekly (you don't need to do this step if you get paid monthly).

In the example above, the total minimum monthly repayment amount on all debts is $600. If I get paid fortnightly then the fortnightly amount is $300.

- Draw up a table of your bills and payments for the year and then divide these by either by 12 months, 26 fortnights or 52 weeks, depending on your pay cycle (if you pay bills regularly already by direct debit, write down the payment amount in the *next step* – this step is for bills you need to save for). Here's an example of what I mean (rounded up to whole numbers):

	Yearly Total	**Fortnightly Amount**
Emergency Money	$1,500	$56
Electricity	$1,600	$60
Phone	$1,440	$53
Mobile Phones	$520	$20
Internet	$720	$26
Contents Insurance	$312	$14
Car Insurance	$520	$20
Car Registration	$480	$18
Car Maint. & Repair	$1000	$37
Christmas	$600	$22
Birthdays	$400	$15
Holidays / Travel	$1,500	$56
Clothing	$800	$30
etc...		
Total		**$427**

[You will probably have bills due in less than 12 months. If so, calculate how many weeks / fortnights / months until due and divide the yearly amount by that number. For example, if the car insurance above is due in six months, I will need to save $40 a fortnight to ensure I have enough saved. Once that bill is paid, I can adjust the amount to $20 to save enough for next year. To be on the safe side, I would also add a little inflation amount to this year's bill.]

- Once you have worked out the year's bills and payments your income has to cover, the next step is to take into account regular expenses like the rent or mortgage, groceries, petrol, regular direct debits, sundry expenses, splurge money. Use some recent receipts if you can or give a good estimate (over estimating is best).

General Recurring Expenses	Fortnightly Amount
Rent (or mortgage)	$840
Groceries	$350
Petrol	$150
Sundries / splurge money	$200
Total	**$1,540**

- The final step is to calculate what's left over – this is how much you can currently afford to put towards repaying your debt.

Fortnightly Income	$2,380
(minimum debt repayments)	($300)
(Bills and Payments)	($427)
(General recurring expenses)	($1,540)
Remaining	**$113**

The amount remaining is what you can add to the minimum repayment of debt one in your snowball strategy, in this case $113.

Tip: *If you and your partner get paid in different intervals (one weekly and one fortnightly for instance), divide the amounts proportionately between the two incomes so that you can easily do the next step.*

Action Step 4: Calculate the following according to whether you get paid weekly, fortnightly or monthly:

* Your net income

* Your minimum monthly repayments

* Your yearly bills and other expenses

* Your regular expenses

And then deduct the value of your minimum monthly repayments, your bills and your regular expenses from your income to work out how much extra money you can afford to pay off your debt.

Your debt repayment strategy step three – don't think, automate

The final but important step is to log onto your online banking account(s) and automate your payments so that they are automatically deducted each pay period, the day after pay day. This should take you less than 10 minutes.

Set up each of your credit card payments so that you are automatically paying them each pay period. You won't have to worry about missing a payment or getting a late fee. Your debts will be paid *when you have the money*, i.e. as soon as you get paid, while you're getting on with life. Each time you pay off a debt, don't forget to change your automatic deductions to 'snowball' your repayments!

If you have debts that are direct debited, ask your bank to change the payment day so that they too come out the day after pay day and you don't have to worry about whether you have the money in your account to cover them. Paying them according to your pay cycle rather than the default 'monthly' makes cash flow management easier. Same too goes for rent, mortgage and direct debit payments.

This next step is important too – in order to stay out of debt, set up an automatic deduction for the fortnightly (or weekly or monthly) amount needed to cover your future bills and expenses as calculated above, again to be transferred into a separate online savings account (no instant access – you don't want to blow that money on impulse buys) the day after pay day. That way, you will have the cash to cover these expenses when they occur rather than relying on credit, and you'll be *earning* interest *not* paying it! (You can find more information on managing bill payments on the website in these articles: Creating a Bill payment System and Managing Electronic Bills.)

What you have left in your account after all of these payments have been automatically deducted is the money to spend on everyday expenses like groceries, petrol and sundries for the week, fortnight or month. Make this amount last and avoid dipping into your savings (or splurging on credit) and you will be out of debt in no time.

Let's go back to willpower. You don't need to worry about exercising it. Willpower does not even factor in this debt repayment system. Everything is automated so you don't need to think about repaying your debts or convincing yourself to save for your bills *('oh, I'll start saving next payday…')*. You live off what is left in your account and you stay out of debt because you took your credit cards out of your wallet (didn't you!).

Action Step 5: Jump online or make a phone call or two to your lenders and automate all of your debt repayments and savings to be scheduled to come out of your bank account the day after each pay day.

But what if I can't find extra money to pay back my debts or worse, I'm spending more than I earn?

If you've crunched the numbers and you're faced with the reality that you're spending everything that you earn *or more* it's time to make a few changes to your spending habits and reduce your expenses right away. The days of indulgence are over (at least until you've dug yourself out of debt), cost cutting is the name of the game now.

Even if you do have remaining cash to pay extra off your debts, you can supercharge your repayments and get rid of your debt that much faster by reducing your expenses and you will also be addressing the root cause of all that debt in the first place.

Before you begin:

Implement the above strategy! Automate your debt repayments, pay a little extra on one debt (even if it's just $5) and put as much as you can afford aside (automate this too) to cover future bills. Every little bit counts. Even if you can't save for *all* of your future expenses, it will make paying them off that much easier if you save for part of them.

Also, don't forget to take your credit cards out of your wallet. Impulse buys are certainly out for the time being, so remove the temptation.

Now that you've done that, it's time to look at reducing each of your expenses, one at a time.

Change your spending habits

Not all spending habits are bad; your spending habits will be different to mine and that's ok. The proverbial latte a day isn't a bad habit, unless you decide it is!

If you are spending more than you earn though, you are going to have some spending habits that you want to change. Here's how:

- Work out what you are actually spending money on (see tracking expenses below).
- Choose one habit at a time to change and stick to your new habit for at least a month.
- Understand the underlying reasons (triggers) for your habit and address those. For instance, do you shop because you're bored? Arrange fun, low cost activities to do instead.
- Set up your environment for success. For instance, avoid the shops as much as possible to avoid impulse buys.
- Replace old habits with new, positive ones. For instance, take your own gourmet coffee to work rather than buy takeaway. This way, you are not trying to go without; you are substituting means to the same pleasure.

Reduce discretionary spending

Discretionary spending is spending on stuff you don't need. There are a lot of things we *think* we need that we really don't. When our family switched to a single income, I looked at our budget and thought there was *no way* I could reduce our expenses. Now I look back and see just how much money we wasted on things we didn't need.

You need food; you don't need takeaway or restaurant dining. You need to drink; you don't need to drink alcohol. You need to breathe fresh air; you definitely don't need to smoke. You need entertainment, to laugh, to have fun; you don't need pay TV. You need to stay fit; you don't need a gym membership. You need clothes; you don't need that many. You need

to maintain personal grooming; you don't need more hair products, face products, body products. Your kids need to play; they don't need more toys.

You get the picture.

Most of what we buy is unnecessary and often wasted. To get out of debt, you need to avoid this unnecessary spending. Despite what advertising will have us believe, less spending equals more freedom and happiness!

How to reduce discretionary spending:

- Stop and think before you buy something. Ask: '*do I really need this?*' This is the most important habit for reducing unnecessary spending.

- Cancel ongoing memberships, contracts and subscriptions. If you can't cancel due to contractual reasons, then negotiate payment terms or contract suspension. At least ask first. I have cancelled contracts in the past, with no questions asked, despite a no-cancellation policy.

- Spend, but spend less often. If you eat out for lunch every day, eat out once or twice a week instead. If you go to the movies every week, go every month instead.

- Substitute rather than eliminate. For example, rather than dining out, take turns eating friend's houses or go on a picnic. Hire a DVD rather than go to the movies. Borrow clothes rather than buy new ones.

- Do it for less. Look for deals and specials. Shop second hand. Shop online. But before you buy remember to ask '*do I really need this in the first place?*'

Reduce your regular, non-discretionary expenses

Now that you have reduced your discretionary spending (it's always important to tackle wants before actual needs), you can take your savings further by reducing your everyday expenses. These include reducing your utility costs like electricity and phone bills, your grocery costs and other regular household expenses.

I'm not going to go into detail on how to reduce those expenses here, there's lots of information on the website for reducing your everyday expenses and I've written a whole eBook on reducing the cost of groceries. For more information, check out the website, particularly the categories section in the side bar.

The key to reducing any type of expenditure is to work on changing your underlying spending habits. Don't try to reduce every expense at once, you will set yourself up for failure (and fatigue); work on them one by one until you are at a comfortable spending level and you are spending less than you earn.

Now for a dirty (not so secret) secret

Budgeting. Yes, I'm going to bring it up. I love budgeting, but I realise I'm in the minority. To *really* know what you spend your money on and how you can maximise savings, you need to be able to analyse your spending. To do that, you need to track your spending (yes, every cent), tabulate it so it makes senses, crunch some numbers and then make the changes you need to.

There's no hiding from raw data, it can be an eye opener for you and a way of communicating your financial situation to a less-than-enthusiastic partner or family members.

I've put all the nitty-gritty details for setting up a budget, including tutorials on using Excel and a free printable expense tracker all in one place on the website, which you can find here.

A budget is a tool to help you manage your finances. There are other tools that will help you reduce your spending. For instance, if you are looking at reducing your electricity, then you will want to learn to analyse your electricity usage. Your budget won't help you reduce electricity; it will tell you how successful you have been. My point is that if you want to increase your savings and reduce your debt, it is wise to use the tools available to help you do that. Budgeting is one such tool.

And when you've reduced your expenses...

As you reduce your expenditure, go back and redo steps two and three of the debt repayment strategy outlined above and adjust your automated repayments to increase your debt repayments and increase the amount you are putting away into savings to cover future expenses.

You are now well on the way to paying off your debts and gaining long-term control over your finances. There's a light at the end of the tunnel and it's looking bright!

Action Step 6: Look at your spending patterns and one by one, reduce your expenses. Write a list of common expenses (yes, even the daily latte) or better yet, draw up a budget, and tackle each expense one at a time. Check out the Frugal and Thriving website for ideas on how to your expenses.

Fast tracking your debt repayments

There are two main strategies for fast tracking your debt reduction. You can use one or the other or both *on top of* the 'snowballing' strategy outlined above.

'Snow flaking' is a complimentary strategy to the 'snowballing' method of debt reduction and in it involves applying any small (or large) incidental amounts of money to your debts.

These 'snowflakes' are usually the result of:

- extra savings you have made by reducing your expenses
- windfalls and bonuses
- tax refunds
- gifts

Even small amounts make a difference, especially if applied to your debt regularly, because they immediately reduce the interest charged, reducing the time it takes to pay off your debt and therefore reducing the overall interest.

The second strategy is to earn more money and apply the extra income to your debts. You can earn more money by selling your stuff on eBay or at a garage sale, starting a side business (for instance, I did ironing at night, even after I found a job – cash in hand), turning a hobby into an income, selling your second car, asking for a raise or getting a new job.

A great way to fast track your debt repayments is to set yourself a goal of paying off a debt by a certain date and then do what you can (reducing your expenses, snow flaking, selling your clutter) to reach that goal.

To set a goal, use this online calculator to work out how much you will need to pay towards your debt each month/fortnight/week, in order to pay off the debt by your due date.

Action Step 7: Fast track your debt by applying incidental amounts of money against it. Set yourself a goal to pay your first debt off by a certain date, work out how much you need to pay each month and use the above strategies to help you meet that repayment amount.

Conclusion and a call to action

What would you do with an extra $600 a month?

As per our example, that's what the light looks like at the end of the tunnel. Extra cash in hand that you can invest, save or spend, or a combination of the three. And a whole load of stress off your shoulders. Well worth the effort in the short term.

I actually have two calls to action for you. The first is to put the strategies outlined in the eBook into practice. Try them. Take action. Eliminate your debt.

The second call to action is to drop me a line and tell me how you go.

The strategies outlined in this eBook come from my own financial experiences. They have been tweaked and adjusted over the last ten years until I've found something that works well for us.

This free eBook itself is a result of many, many hours writing and research. I would love it if you could take a couple of minutes to tell me what you think of the information that you read here. Was this information useful? Did you see results? What worked for you, what didn't?

You can drop me a line at melissa@frugalandthriving.com.au. I look forward to hearing from you.

Whether you use the information here or not, I wish you all the best with your plans to get out of debt.

About Frugal and Thriving

Frugal and Thriving is an Australian website that celebrates all things frugal. On the website you will find:

- Tips on saving money
- Money management resources (like this eBook)
- Ideas for green living
- Lots of frugal recipes – and growing every week!
- Tips on living a thriving life

If you're new to Frugal and Thriving, I recommend you start here to get an idea of what's available on the website. Also, check out the archives for all the articles on the site as well as the resources section (a growing section on the website) for further useful resources. For more information about the website and the author (that's me) check out the about page.