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Making S.M.A.R.T. Financial Decisions

Getting Out of Debt

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I interviewed a young woman named Prima a few months ago. She's got a college degree and student loans. She has credit card debt with a high interest rate. She makes and sells clothing online. So her income varies greatly from month to month. She wants to start saving for retirement. Prima asked me which I thought she should do first-- opened up an individual retirement account or IRA, pay off her credit card debt, pay off her student loans, or build up a security fund. What would you tell Prima, and why? In which order would you recommend she pay her debts and start to save?

My suggestion was that Prima first get $1,000 in her bank account. This $1,000 is the beginning of Prima's security fund, also called an emergency fund or a rainy day fund. It's there to keep her from sliding further into credit card debt when things go wrong. I suggested that Prima focus next on paying off her credit card debt while keeping current on her student loan payments and her other monthly bills. Remember, paying off debts that you're going to have to pay sooner or later is saving. Getting rid of debt with a high interest rate is better than continuing to pay high interest while earning much less in a savings account or investment account.

For most people, paying off credit card debt is one of the best investments they can make. After paying off her credit cards, Prima should open an IRA or a Roth IRA and start saving for retirement. It's important that she start saving for retirement while she's young. If she were working for a company with a 401(k) plan, I would have told her to immediately enroll in the plan. We'll talk more about IRAs and other retirement savings accounts elsewhere in the course.

Prima also needs to build up a security fund. If she can manage to save 15% of her after tax income, I'd recommend that she put 10% in her IRA and 5% in her security fund until she has about six months of must have expenses in the fund. Six months of must have expenses is a good rule of thumb for how much security fund you need. A security fund's especially important for Prima because her income is unpredictable. Her income could drop off unexpectedly, or her car could break down. Without a security fund, she'd be likely to end up back in credit card debt.

The interest rate on Prima's student loans is low. So she should start building her retirement savings and her habit of saving for retirement before trying to pay off her student loans. Of course, she needs to stay current on her student loan payments. Do you have debts? If so, should you first pay your debts and then save or start saving right away? Here are some suggestions. If you work for a company that makes matching contributions to your 401(k) plan, always contribute enough to get the entire match. Even if you have debts to pay, get that match. Credit card balances, personal loans, pawnshop loans, pay check advances, overdue child support payments, and overdue bills are all stealing from your future. If you're going to save for your retirement and your other goals, you need to get rid of these types of debt. Home mortgages, car loans, and student loans-- they're different. Your home provides shelter. And as you pay off your mortgage, an opportunity to save. You may need a car to get to work, and an education can get you a better job. Of course, you can buy a house or a car that's too expensive or go too deeply into student debt without increasing your income. Furthermore, if you lose your job, even these potentially beneficial debts can drag you down.

This video is not a comprehensive tutorial in getting out of debt. Rather, it's a list of a few things you should try to do and a few things not to do. If you're struggling with debt, I recommend that you read Elizabeth Warren and Tyagi's book, All Your Worth. The first step to gain out of death is to get $1,000 in a bank account. This gives you a cushion, and it starts your security fund. What if you already have more than $1,000 in the bank? Well, most people in debt don't. But if you do and you owe credit card or other high interest rate debt, use all but $1,000 to pay off those debts. Once you have $1,000 in the bank, step two is to set aside 20% of your after tax income each month-- or as much as you can manage-- and use it to pay off your debts. Elsewhere in the course, I say that you should be putting this 20% into savings, but paying off your debts is saving. You can't find a higher return investment than paying off high interest rate credit card debt. Pay off your credit card debt, your store debts, medical debts, overdue child support-- everything except your mortgage, your car loan, and your student loans. Of course, stay current on those. Focus on paying off one debt at a time while keeping current on the others.

Which debt should you pay off first? Advice varies. Some people recommend paying off the smallest debts first so that you can get a sense of accomplishment and confidence that you can succeed. Some people recommend paying off the debts that bother you the most first. Doing so is going to give you the most psychological relief. Most economists would recommend first paying off the debts with the highest interest rates because this is going to speed up how fast you can pay off all debts. But really, the important thing is just get started. Knock off debts one at a time. Doing so is going to give you a clearer sense of progress and accomplishment.

Do not take money out of your retirement accounts-- your IRA, your Roth IRA, or your 401(k)-- plan to pay your debts. Your retirement money is sacred. Furthermore, there are significant penalties for early withdrawal. What about taking out a home equity loan to pay off your credit card debt? Well, for most people this is a bad idea. Yeah, the home equity loan will have a lower interest rate than your credit cards, but it will also put your home at risk. Unless there's absolutely no doubt that you're going to be able to pay that loan and absolutely no doubt that you will not plunge yourself back into credit card debt, don't risk your home. You simply can't borrow your way out of debt. Transferring credit card debt to your home does not get rid of the debt, and the new zero balance on your credit card statement might even lure you into more spending, not more saving. If you have a lot of debt, it may take a long time to pay it off, and getting rid of it is going to be hard.

Once you've paid off the debts that are stealing from your future, it's time to start saving. Watch the course video on prioritizing saving. What if you can't save and you're sliding further into debt each month? Do your must-have expenses add up to more than half of your monthly paycheck? If so, you may need to look for a less expensive apartment, find a roommate, sell your car and buy a cheaper one, or search for a better job. None of these are easy, but you're never going to get out of debt if you're spending more than you make. And what if your debts are more than you can ever pay ? If you add up all of your personal debts, not including your mortgage, car loan, and student loans, are these more than a year's income? Are the minimum payments more than 20% of your monthly income? If you've got a lot of debt, read Warren and Tyagi's chapter on financial CPR and watch the course video on personal bankruptcy.