

Reduce Debt, the Systematic Way

As the holidays approach, you may be planning a gift list for those special people in your life. You may also be worrying about adding to your already sizeable credit card balances. In America today, carrying some debt is unavoidable, and even desirable, for most households. But between mortgages, car payments and credit cards, many Americans find themselves over their heads -- unable to dig out from under a debt burden that consumes an ever-growing portion of their resources.

The median U.S. household owes \$3,000 in credit card debt.¹ Credit card companies have made running up that balance deceptively easy. But what's lost when you are racking up big credit card balances is the realization that paying off your debt can be costly, in terms of its impact on your cash flow as well as your overall financial health.

Assessing Your Debt

How much debt is too much? The figure varies from person to person, but in general, experts agree that your debt-to-income ratio should be no more than 43%.¹ A debt-to-income ratio is commonly used by lenders to assess an individual's ability to repay the money he or she has borrowed.

To calculate your debt-to-income ratio, add up all your monthly debt payments (including mortgage, car and other non-housing debts) and divide that sum by your gross monthly income -- i.e., income before taxes and other deductions are taken out. Mortgage lenders, in particular, use the 43% debt-to-income ratio as a benchmark to determine whether or not an individual is a good candidate for a mortgage.¹

Other signs that you may be carrying too much debt include not knowing how much you owe, constantly paying the minimum balance due on credit cards (or worse, being unable to make the minimum payments), and borrowing from one lender to pay another.

If you find that you are overextended, don't panic. There are a number of steps you can follow to eliminate that debt and get yourself back on track. Working your way out of debt will, of course, require you to adjust your spending habits and perhaps be more judicious in your spending.

Begin With a Budget

The first step in eliminating debt is to figure out where your money goes. This will allow you to see where your debt is coming from and, perhaps, help you to free up some cash to put toward lowering that debt.

Track your expenses for one month by writing down what you spend. At the end of the month, total up your expenses and break them down into two categories: "Essential," including fixed expenses such as mortgage/rent, food and utilities, and "Nonessential," including entertainment and dining out. Analyze your expenses to see where your spending can be reduced. Perhaps you can cut back on food expenses by bringing lunch to work instead of eating out each day. You might be able to reduce commuting costs by taking public transportation instead of parking your car at a pricey downtown garage. Even utility costs can be reduced by turning lights off, making fewer long-distance calls or turning the thermostat down a few degrees in winter.

Three Steps to Reduce Debt

Once you have a handle on your budget, you can begin to attack existing debt with the following steps.

Pay off high-rate debt first. The higher your interest rate, the more you wind up paying. Begin with your highest-rate credit cards and eliminate the balance as aggressively as possible. For example, assume you have two separate \$2,000 balances, one charging 20% interest, the other 8%, on which you can pay a total of 6% per month. If you were to pay 4% per month on the higher-rate card and 2% on the lower-rate card (which is typically the minimum monthly payment), you would save \$961 in interest and 18 months of payments over allocating 3% to each balance.²

Transfer high-rate debt to lower-rate cards.

Consolidating credit card debts to a single, lower-rate card saves in interest costs over the life of the loan. Comparison shop for the best rates, and beware of “teaser” rates that start low, say, at 6%, then jump to much higher rates after the introductory period ends. You can find lists of low-rate cards online from sites such as [CardTrak](#) and [Bankrate](#).

If you can only find a card with a low introductory rate, maximize the value of that low-interest period. By paying off your balance aggressively, you will reduce the balance more quickly than you will when the rate goes up.

You can also contact your current credit card companies to inquire about consolidation and lower rates. Competition in the industry is fierce, and many companies are willing to lower their rates to keep their customers. Even a percentage point or two can make a difference with a sizable balance.

Borrow only for the long term. The best use of debt is to finance things that will gain in value, such as a home, an education, or big-ticket necessities, like a washing machine or a computer that will still be around when the debt is paid off. Avoid using your credit card for concert tickets, vacation expenses or meals out. By the time the balance is gone, you will have paid far more than the cost of these items and have nothing but memories to show for it.

By analyzing your spending, controlling expenses and establishing a plan, you can reduce -- and perhaps eliminate -- your debt, leaving you with more money to save today and a better outlook for your financial future.

¹Source: Consumer Financial Protection Bureau, “What is a debt-to-income ratio? Why is the 43% debt-to-income ratio important?” December 30, 2013.

²This example is hypothetical and for illustrative purposes only.

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