OBJECTIVE:

To learn a debt-reduction technique that reduces the burden and stress caused by debt.

Tackling your debt will not only reduce stress in your life, it will increase the amount of money you have for savings and other planned expenses.

Many people feel as if they will never be out of debt, and are tempted by credit card offers with low introductory rates or an ad urging debt consolidation into one easy payment. If you feel like you're on the debt treadmill with no way of getting off, you should know there is a better way. The solution to too much debt is not more debt.

Consider the following... You may be too deep in debt if:

- Your mortgage purchasing power is limited because of debt
- You use more than 20% of your take-home pay, excluding housing costs, to pay off your loans
- You need to take out loans or use credit cards to pay for regular living expenses
- You can't keep up with your monthly utility payments and other bills
- You have to rely on co-signers for loan approvals
- You often borrow from one lender to pay another

Understand the costs of credit card debt :

If you had three credit cards with an average interest rate of 16% and balance totaling $7,700.

What would happen if you made only minimum monthly payments?
It would take you 32 years to pay it off!

On $7,700 you would pay $14,059 in interest for a total of $21,759!

Here's another way to look at it. How much will that new cell phone really cost you?

Method of Purchase	Terms	Ending Total
Cash	Save up and pay now	$650
Financed	Paid off over 12 months with 24% interest	$60.52/month = $737 total

Debt Consolidation

Perhaps you've received information encouraging you to consolidate all of your debts into one easy payment, telling you this is the way to get rid of your debt. Before you take that road, there are some important questions you should ask:

- What's the rate of a debt consolidation loan? It may only be one rate, but if it is higher than your other rates, that's no bargain.
- Is the interest rate adjustable? Perhaps it's a good rate now, but where will it be in a year? or two from now?
- What is the term of the loan? How long will it take you to pay it off? Will it take longer to pay off than if you paid the individual debts on your own? If so, you'll be paying more interest over the long term.
- Are there prepayment penalties? If you'd like to pay off the loan early to save yourself some of the interest, will you have to pay a fee?
- What are the terms and cost of the loan? Study them carefully, do they really benefit you?
- Does it fix the problem or extend it? Often times individuals who use debt consolidation have done nothing to change the habits and behaviors that created the debt in the first place and now have both old and new debt, making the problem worse than it was before.

FITNESS TIP

A good rule of thumb is to never borrow money for something that doesn't provide lasting value. Mortgages and student loans can boost your earning power or your net worth. Loans for items like vacations, clothes, and furniture just cost you a lot of money.

Power Pay

There is a better way! **Power Pay** is a no-nonsense way to reduce your debt and your stress along with it.

When you power pay your debt away, you focus on paying down one debt at a time while making minimum payments on all the others.

1. First, for maximum success, incur no new debt and stop using your credit cards.
2. Free up whatever additional money you can from your budget. This is your initial power pay amount. Perhaps you combine all extra money you are currently adding onto your monthly payments or simply cut back on extra spending over the next few months.
3. Focus on paying down one debt at a time. What works for you: shortest term, highest interest rate, or the debts identified by the home purchase advisor that would help you increase your purchasing power? Use that additional power pay amount to pay down that debt even faster.
4. Don't forget to continue making minimum payments on your other obligations!
5. When your first debt is paid off, celebrate the fact that you paid off one debt—you deserve it (but don't go overboard)!
6. Now focus on the next debt. Use your initial power pay amount plus the minimum amount you were paying on the first debt as your new power pay amount.
7. When your next debt is paid off, reward yourself, and again focus on the next debt, using not only your initial power pay amount, but also the minimum amount you were paying toward the debts you have already paid off as your new power pay amount.
   - Remembering your goals along the way will help keep you motivated.
   - Life happens! While emergencies may arise, be cautious about adding new debt as it will extend the time it will take you to pay off all debts.

Let's work through an example on the next page to see how this works.

Reduce Your Debts and Your Stress

1. Gather the following information about each of your debts: the total balance due, the interest rate and the bill's minimum monthly payment and write them in the corresponding column.
2. Divide the total balance by the monthly minimum payment and put the answer in column 5. Example: 4,800 / 200 = 24. This may represent the months it will take you to pay off the debt. The division answer is necessary to help you prioritize which debts have the shorter term for paying them off.
3. Prioritize your debts in column 6. Perhaps you want to use column 5 to focus on the quickest payoff or you might want to refer to column 3 to start with the highest interest rate. Where you begin is up to you.
4. Column 7 shows your power pay amount (minimum amount + power pay amount).
5. Column 8 is to calculate how many months it will take to pay each debt off using the power pay amount + the monthly minimum payment.

1. NAME OF DEBT	2. TOTAL BALANCE	3. % RATE	4. MONTHLY MINIMUM PAYMENT	5. DIVISION ANSWER	6. PAY OFF PRIORITY	7. POWER PAY AMOUNT	8. MONTHS TO PAY OFF DEBT
CAR LOAN	$4,800	9%	$200				
STORE CREDIT CARD	$240	24%	$30				
CREDIT CARD	$540	18.9%	$45				
BANK LOAN	$1,000	13%	$100				

At **www.powerpay.org** you will find tools that will help you with the calculations and allow you to play around with different numbers and options. They will not ask you for any personal or account information. You will also find other helpful financial tools. Sign up on the website or download the mobile app.

See page 78 in chapter 6 for the answers above.

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Pay Down Debt to Increase Your Mortgage Purchasing Power

Lenders look at three factors to determine whether you qualify for a mortgage loan and how much you qualify to borrow.

1. **Capacity** – your ability to pay back the mortgage loan. It takes into account both your income and minimum monthly payment on debts.

   Your monthly debt affects how much you can borrow. Take a look at the following example.

Gross monthly family income		$3,200
Monthly debt		
(*Minimum payment*	Car loan	$300
required on monthly debt)	Credit Card 1	$ 50
	Credit Card 2	$ 50
Total monthly debt		**$400**

At 5.5% interest rate:

	MORTGAGE AMOUNT BORROWER QUALIFIES FOR
With current debt of $400 per month	**$154,000**
If car loan paid off, only $100 in minimum monthly payments on credit card debt	**$197,000**

2. **Cash** – lenders usually expect that the buyer contribute some money toward the purchase of the home. You need to have savings to cover:

   - down payment (with Homewise, typically 2-5% of the purchase price of the home)
   - closing costs (3-5% of the mortgage loan amount, typically financed with Homewise)
   - 1–2 months living expenses as emergency reserves (required sometimes)

3. **Credit History** – Your credit history shows a lender your willingness to pay past debts and is believed to show how you will repay in the future. We'll examine this in detail in the next chapter.

Differences Between a Car Loan and a Lease

Before you get your next car, evaluate the costs and benefits of leasing versus buying a car.

- **Ownership** - With a lease, you do not own the car. Leases are basically long-term rental agreements. You make monthly payments to the dealership. These agreements might last five years. If you obtained a car purchase loan, you would own the car at the end of the loan.
- **Wear and Tear** - Most leases charge for exceeding "normal" wear and tear. If you bought, you would not have any additional costs for wear and tear in your purchase agreement.
- **Monthly Payments** - You will have lower monthly payments if you lease a car rather than if you finance a car. The reason monthly lease payments would be lower than monthly loan payments is because you are not purchasing the car. The dealership owns the car. Once the lease agreement is over, you usually turn in the car. Although you have the option of purchasing the car at the end of the lease, the total cost would be more than if you had initially bought the car. On the other hand, with a car loan, you actually pay for the purchase of the vehicle. Once you finish making the payments, you own the car.
- **Mileage Limitations** - Leases usually restrict the number of miles you drive each year. You must pay the dealer for each additional mile driven, as stated in your lease contract. For example, a two-year lease might have a 24,000-mile restriction and cost you $0.15 for each mile driven over 24,000. This can add up if you drive a lot. Driving 2,000 miles over the limit would cost you $300 (2000 x $0.15 = $300). If you buy a car, there are no mileage restrictions.
- **Auto Insurance** - Auto insurance usually costs more if you lease than if you purchase a car. Most car leases require you to purchase higher levels of insurance coverage. Make sure you find out what the requirements are and get an estimate from your insurance company before you decide on a lease.

FITNESS TIP

The typical couple spends in excess of $1 million on auto purchases during their lifetime. Commit to keeping your current automobile until your loan is paid off. When you are ready to buy a new car, shop around for financing and get pre-approved for the loan before going to the dealer.