BAD WAYS TO PAY OFF DEBT

By Jacob Ansel

WE'VE ALL READ ARTICLES ON THE best ways to manage money and pay off debt, but what about the worst ways to pay off debt? If your money isn't growing and your debt is rising, well then you probably don't know what not to do. When you're behind on your debt, you might relieve your stress by leaving bills unopened or avoiding collection calls. This isn't going to make the debts go away; hiding from your debt problems is not a realistic solution. First things first, get your head out of the sand and figure out your debt by ordering a credit report. Then figure out how much money you have in all of your accounts. Compare assets and debts for the last two years. If your assets are going down and your debt's going up, congratulations, this column is for you.

One of the biggest mistakes is making minimum monthly credit cards payments. Creditors want you to do this because you're essentially just paying interest month to month and never making a dent in the principal. The key is to pay at least triple the monthly minimum and not charge anything else on that card until you hit a zero balance and then shred your cards. If you owe a balance on more than one account, don't choose an amount each month and divvy it up equally among accounts. It's smarter to pay down the highest interest rate card first and then move on to the next highest rate. You want to rid yourself of the debt that's costing you the most as soon as possible. Be sure you maintain on-time minimum payments on the other accounts.

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There's good debt and bad debt and knowing the difference between the two is key. Paying down debt is a terrific goal, but you want to make sure you do so in a way that actually improves your overall financial status.

Using balance transfers can be a smart way to pay off a debt using a lower or zero interest rate card. The danger lies in the limited promotional period. People end up using the new card for additional spending without paying off the original balance before the introductory period expires. And with every new account you open, your credit score takes a temporary hit.

Most folks remit a monthly mortgage payment. That's the single best way to have your debt last 30 years. Banks want you to finance homes for 30 years and more because they earn more interest the slower you pay it off. A better idea is take a 30-year loan but pay off at least 20% extra principal each month which takes years off the life of the loan.

If you've racked up high-rate credit card debt, you may want to tap the equity in your home to pay it down. But since your debt problem is probably a result of overspending, you'll just run up your credit cards again. Perhaps, you're out of work and you need the extra cash. A home equity loan won't fix the underlying issue and you could be putting your home at risk of foreclosure.

Another bad idea is taking a cash advance loan; it's just another very high-cost way to borrow money. The interest rate can be more than 10 percentage points higher than standard rates and there are typically fees of 3% percent per transaction. And a cash advance is another loan that must be repaid, adding to your debt. Same thing with a payday loan which carries high interest rates, often in excess of 400% annually.

A lot of people overwhelmed by debt often resort to filing bankruptcy unnecessarily. Sometimes bankruptcy is necessary, like when you have insurmountable medical bills or credit card debt you'll never be able to repay. But bankruptcy stays on your credit report ten years, making you a financial outcast, so it should be a last-ditch option. It should never be used to wipe out small obligations.

Debt settlement firms say they're a good solution for consumers in debt but they charge high fees. After you settle your debts – by paying a lot less than owed – you wind up with a terrible credit rating and a big bill from the IRS, which views forgiven debts as income and expects taxes paid on them.

Finally, don't dip into retirement savings. By tapping a 401(k), not only do you sacrifice growth in your retirement funds while you pay off the loan, but if you leave your job before the loan is paid back, you'll owe the entire balance immediately and it can't be paid back with a credit card. It's also not smart to withdraw from an IRA; the 10% early withdrawal penalty can end up costing more than any credit card interest. ❑