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Season 1. Taking more control of your money

Episode 4.

How to tackle expensive debt

Hi there, Jason here. So far in this series we've looked at why you'd want to take more control of your money, how to take more control of your spending, and how starting to build an emergency fund will put you on the road to financial success. In this Insight we'll explore how you could tackle expensive debts, if you have any. Here, you'll learn: the difference between good and bad types of debt; how to choose which debt to tackle first; and we'll touch on the options available to you to minimise the cost of your debts too.

But before we get into all that I just want to repeat a message from our previous money insight about your priority bills. These are things like your council tax, utility bills and your mortgage or rent. Any hire purchase payments you make on essential items and any child maintenance payments you might owe as well. If you're currently unable to find enough money to pay all of those bills, please stop this video now and click the help tab on this page and get the guidance you need. This Insight is not about paying those priority debts. This is about paying down any other debts you might have. Such as overdrafts and personal loans, credit cards and store cards, catalogue shopping debts and payday loans too.

Now if you're following the guidance we're giving in these money insight videos and you have a solid budget and your spending is under control, but you've fallen behind with debt repayments or think you might do so soon, then again - stop this video now and click the help tab on the Salary Finance website and find the guidance you need. There are ways to deal with problem debts and taking guidance on your options must be your first step to getting your financial life back onto solid ground. So, please just click the help tab if any of that applies to you

Otherwise, let's explore what could work well for you if you're looking to pay down any debts that you have. Let's start by explaining the difference between good and bad debt. After all, our focus in this insight is on paying down expensive debt and we'll leave the less urgent task of paying down good debt to another day.

So, what is the difference between good and bad debt? Well, good debt funds good investments and bad debt doesn't. Good debt funds things that could earn you more money or save you money in the future. Like student finance to fund further education and earn more at work. Or a mortgage to buy a house in which you'll (eventually) be able to live rent free or on which the payments are less than the rent you'd otherwise pay.

And, just to be clear I'm not saying that all debt is good just because the purpose is good. Good debt is where you've thought carefully about the wisdom of your investment, whether it's an education, a business or a home. It's where you understand all the terms of the debt, including all the upfront and ongoing charges and any penalties you'd be charged for repaying it early. And good debt gets you the best terms for your personal situation and has affordable repayments, even if interest rates rise in the future. So, if you've borrowed to fund investment in your future self, and you've covered the points here, you might well consider that this is good debt.

For example, student financing is normally considered to be a good debt for two reasons. Firstly, because the skills you gain from your studies should enhance your future earnings potential. And secondly, because you don't have to make any repayments at all if your earnings are below a certain amount.

So now that we know what good debt looks like it's easy to define bad debt, because bad debts are simply everything else. And very bad debts do nothing to help with your future. They simply fund consumption in the present and restrict your future freedoms. Bad debts are the ones we run up when we impulse buy stuff that we really don't need. Like an expensive foreign holiday or a brand-new car or some new furnishings for the house when what we've got already is really just fine. Or we have to pay for an unforeseen bill like the boiler breaking down and we have no emergency fund.

And the really bad news about bad debt is that it typically costs us a lot more in charges and interest, when compared to what we pay on our good debt. So, it makes sense to pay these bad debts down and keep them down whenever we can, to avoid those nasty charges. And that's what we should do as soon as we have our got our initial emergency fund in place. The big question is if you have more than one of these bad types of debt, which should you pay down first? Well, as ever in financial planning the answer depends on a great many factors, including your patience and resilience when taking on a longer-term goal. But let’s look at an example to demonstrate one idea that might surprise you.

Let’s say that you’re currently wrestling with two ‘bad’ types of debt that you want to pay down. And let’s assume that both debts are on credit cards and that you owe £10,000 and pay 20% p.a. interest on the first and you owe £3,000 and pay 15% p.a. interest on the second. Which bad debt would you pay down first? Well, the logical thing to do would be to attack the more expensive debt first, right? After all, if you pay £1,000 off that bigger debt your interest savings will be £200 a year. Whilst if you pay £1,000 off the smaller debt (the one that’s charging 15% p.a.) you’ll only save £150 a year in interest.

However, as we learned in the previous Insight the logical thing to do doesn’t always work best for most people. Our natural human behaviour can cause us to give up on our goals when they feel too difficult at the start. You could say, if we’re going to eat an elephant we need to do it one bite at a time! So, coming back to our credit card example, if you decided to attack the larger debt first and let’s say you paid down £3,000 over 3 years. There’s a chance of you seeing that as only a small dent in your loans. After all, 70% of the big debt or £7,000 would still be owed. On the other hand, if you’d attacked the smaller loan first and paid down the same £3,000 over 3 years. You’d have paid that one off altogether. Leaving you with one less credit card to worry about. And the chances are that this would make you ‘feel’ a whole lot better about the progress you’d made.

Now I know this sounds irrational, but we can all be that way sometimes and it helps to be aware of this when we deal with money issues. Of course, if you are a super resilient type and can cope well with slow progress on your bigger life goals, then by all means take the lowest cost /logical approach and attack your more expensive debts first. Just be aware, that for a great many people, the ‘smaller debts first’ approach can work better.

Now, I’ve assumed so far that you’re going to stick with the debt products you have. And start paying these down in an order that works best for you. But you may have other options available and it’s worth reviewing those over time, even if you’re sure that you got the best possible terms at the start. The market for loan products is a big one and is changing all the time. And, if your credit rating has improved since you took on your debt then a replacement loan could be a lot cheaper now. There are tools available online to get an idea if you’ll qualify to transfer expensive credit card debt to another provider and enjoy no interest charges at all for a period of time. But remember most of these 0% cards often charge an initial fee so, they're not actually free! They're also not available to all and the credit limit might not be enough for your needs. So, you may not end up repaying the debt as quickly as you might.

Now, you might be eligible for a Salary Finance low cost loan, with the convenience of having your repayments deducted directly from your pay. And you can find out about what loan you might qualify for and how much you could borrow by clicking on the Loans button on the Salary Finance website. Okay, so that's all for now on paying down debts. Next time we'll look again at finishing off your emergency fund and why we need to build that up further before we start on our longer-term investments. See you back here then, when you're ready for that.

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