

How to Get Out of Debt



The relative ease of getting credit lets consumers get goods and services when cash is not readily available. It also lets them buy things on sale or when prices are low. It lets them pay for items at the same time they are using and enjoying them.

Unfortunately, problems and financial risks occur, because consumers and creditors abuse credit. Careless use of credit by consumers can lead to financial difficulty, family problems, repossession of property, garnishment of wages, and even bankruptcy.

Options are available to help you manage financial difficulties when bills stack up and you cannot pay them. This publication discusses how to spot potential debt problems, how to set up a debt-payment plan, and court provisions for handling credit obligations.

Danger Signals of Too Much Debt

Fortunately, you can spot potential debt problems before they become serious. By knowing what danger signals to look for, you can take steps to prevent a problem before it occurs.

Look over the checklist below. If any of these danger signals look familiar, you may be headed for financial trouble.

- You think of credit as cash, not debt.
- Your debts are greater than your assets.
- You owe more than seven creditors.
- You are an impulsive or compulsive shopper.
- You and your spouse are dishonest with each other about your use of credit.
- You don't know how much your monthly living expenses are or the amount of your total debt.
- Your expected increase in income is already committed to paying off debts.
- You depend on extra income, such as earnings by a second person or overtime by the breadwinner, to help you make ends meet.
- You have less than 2 months' take-home pay in cash or savings where you can get to it quickly.

- You have to pay back several installment payments that will take more than 12 months to pay off.
- You have more than 20 percent of your take-home pay committed to credit payments other than your home mortgage.
- You get behind in utility or rent payments.
- You have to consolidate several loans into one or reduce monthly payments by extending current loans to pay your debts.
- You cannot afford to pay for regular living expenses or credit payments; therefore, you:
 - take out a loan.
 - withdraw savings.
 - skip payments.
 - pay only the minimum amount due on your charge accounts.

If you checked at least four of the above statements, examine your budget and look for ways to tighten your belt. If you checked five or more, you are probably headed for financial trouble. If you checked seven or more, you are in financial danger.

Develop a Debt-Management Plan

If you find yourself with more bills than your monthly income can cover, one alternative is to develop a debt-management plan. Completing this plan takes patience, but it works if you really want to get out of debt.

To set up a debt-management plan, follow these steps:

- Find out whom you owe and how much you owe.
- Decide how much you can pay back and when you can pay it back.
- Create a written debt payment plan.
- Discuss your plan with your creditors.
- Control spending by sticking with your debt-payment plan until debts are repaid.
- Occasionally look over your plan to see if you are keeping up with your debts and your daily living expenses. If there is a change in your income, you may need to raise or lower your monthly payments accordingly.

Find Out Whom You Owe

The first step in getting out of debt is to find out whom you owe and how much you owe. Using your credit statements as a reference, list the following information about each debt.

- Name of creditor.
- Creditor's address.
- Creditor's telephone number.
- Your account number.
- Collateral (property or other asset that secures a debt).
- Balance owed.
- Remaining number of payments.
- Monthly payment.
- Payment due date.
- Amount last paid.
- Date last paid.
- Type of legal action taken (such as garnishment or repossession).
- Collection agency or attorney.

Decide How Much You Can Pay

Once you have listed everyone you owe, determine how much you can pay each creditor and how long it will take to pay back each debt. Generally, it is good to limit the amount of credit you owe (excluding your home mortgage) to no more than 20 percent of your monthly take-home pay.

If your family earns \$1,200 a month, try to keep your credit payments under \$240 per month ($\$1,200 \times 0.20 = \240). But if you already have numerous debts, figure out a way to use 25 percent of your monthly take-home pay for paying back your monthly debts. You usually need 75 percent of your income to maintain your necessary daily living expenses.

A family earning \$1,200 a month probably needs to keep \$900 ($\$1,200 \times 0.75 = \900) for basic living expenses. That leaves \$300 ($\$1,200 \times 0.25 = \300) for debt repayment. If the minimum monthly payments add up to \$396, for example, you must find ways to increase the money available for debt repayment.

These options may help you repay debts on a monthly basis:

Option 1. Keep a record of your current living expenses for a month. Look for ways to reduce your expenses so you can use the extra money to clear up debts.

Option 2. Consider selling assets. What assets do you own? Do you have a savings account or stocks and bonds you could cash in to help pay off your debts? Do you have a television, furniture, stereo, car, jewelry, or antiques? Could you cash in or borrow against the cash value of your insurance policy?

Option 3. Increase your family income. An extra paycheck will help maintain your present lifestyle while you pay back your debts. However, additional money does not cure poor management habits.

Option 4. Borrow money. Loan consolidation, home equity loans, or refinancing your home are ways to avoid repossession or loss of income through wage garnishment.

These options may reduce the amount of your monthly payment. But the cost for borrowing is usually increased, because the borrowing time is extended and you may be borrowing at a higher interest rate. If you can manage to pay your debts without loan consolidation, home equity loans, or refinancing, you probably will save yourself extra expense.

These options generally do not improve poor money management habits, and the reduced monthly payment may encourage you to get more debts.

Create a Written Plan

By now you should have a clear picture of how much money you can manage to pay back and when you will be able to pay it back. The next step is to decide how much you will pay each creditor and how long it will take to pay each creditor. Try to set up your plan so you pay your creditors back within 3 years.

The debt payment plan can be done in several ways: 1) You may choose to give each creditor an equal amount. 2) You may choose to pay more to the creditors you owe the most money and a smaller amount to those you owe the least. 3) You may pay back a percentage of the total monthly obligation based on the amount of money available for debt payments.

On the next page are examples using each of the three methods of debt repayment. Each is based on a situation in which the consumer has a monthly take-home pay of \$1,200 and a total debt of \$3,380.69. Using 25 percent of income to pay back monthly bills, the consumer will be paying back \$300 per month ($\$1,200 \times 0.25 = \300).

Method 1. Pay creditors equal amounts.			
Debts	Amount owed	Amount required	Amount you can pay
Car loan	\$1,145.39	\$180	\$60
Bank card	680.30	35	60
Bank loan	525.00	70	60
Bank loan	755.00	190	60
Department store	275.00	25	60
Totals	\$3,380.69	\$600	\$300

The amount available from monthly income for debt repayment is \$300. The consumer pays each creditor an equal amount: $\$300 / 5 = \60 per month to pay each creditor.

Method 2. Pay the percentage of total debt represented by each individual debt.				
Debts	Amount owed	Percentage of total debt owed	Amount required	Amount you can pay
Car loan	\$1,145.39	34	\$180	\$102
Bank card	680.30	20	35	60
Bank loan	525.00	16	170	48
Bank loan	755.00	22	190	66
Department store	275.00	8	25	24
Totals	\$3,380.69	100	\$600	\$300

To determine the percentage of debt owed, make the following calculation:

$$\frac{\text{amount owed}}{\text{total debt}} = \text{percentage of total debt owed}$$

Example: car loan – total debt = \$1,145.39 / \$3,380.69 = 0.34 or 34 percent

To determine the amount you can pay on each debt, make this calculation:

total amount can pay X percentage of total debt owed = amount can pay on that debt

Example: \$300 X .34 = \$102

Method 3. Pay a percentage of the total monthly obligation based on the amount of money available for debt payments.			
Debts	Amount owed	Amount required	Prorated payment
Car loan	\$1,145.39	\$180 X .50	\$90.00
Bank card	680.30	35 X .50	17.50
Bank loan	525.00	170 X .50	85.00
Bank loan	755.00	190 X .50	95.00
Department store	275.00	25 X .50	12.50
Totals	\$3,380.69	\$600	\$300.00

You have \$300 per month available for debt payments. This is 50 percent of the amount required. Each creditor is offered a prorated payment of 50 percent of the regular monthly payment.

It is important to pay back all of the debts you owe. If there is not enough money to make payments on all of your loans, consider prioritizing your debts. Debts you may want to pay first include mortgage or rent, utilities, secured loans, and insurance. Second priorities may include credit cards and unsecured debts to finance companies. Some examples of third priorities are doctor,

dentist, and hospital bills. Family members and friends usually are willing to wait.

Use the worksheet on page 7 to set up your debt-payment plan. Write the creditor's name in the first column. Figure the percentage of total debt you owe each creditor and write it in the second column. Write the amount of the original monthly payment in the next column. Decide if you will pay the debtors in equal amounts (Method 1), by proportions (Method 2 or 3), or according to what action the creditor might take (such as garnishment or repossession). Write the dollar amount you can pay each creditor each month in the fourth column.

Discuss the Plan with Your Creditors

Now that you have worked out a plan, destroy all of your credit cards. Do not take out any more loans except in extreme emergencies, and contact each creditor and explain your plan. Creditors generally are more responsive to your proposal if you take the initiative to contact them first and express a sincere desire to pay your obligations.

If you cannot visit your creditor, call or write a letter. A sample letter you can use for writing your letter is included in this publication. Obviously, you need to change some statements to fit your situation. In your letter, be sure to include the following:

- Why you fell behind in your payments (such as loss of job, illness, divorce, death in the family, or poor money-management skills).
- Your current income.
- Your other obligations.
- How you plan to bring this debt up-to-date and keep it current.
- The exact amount you will be able to pay back each month.

Once the creditor has agreed to your repayment plan, make every effort to uphold your end of the bargain. If you fail to follow the plan you and your creditors have agreed upon, you harm your chances of getting future credit. Tell your creditor about any changes that may affect your payment agreement.

Consumer Credit Counseling Services

For very serious debt problems, a nonprofit credit counseling agency may be able to further negotiate lower monthly payments or interest. Find a counselor who serves your area at the National Foundation for Credit Counseling website, www.nfcc.org. Consumer Credit Counseling Services (CCCS) agencies in Mississippi include Money Management International (statewide), Family Service Agency (Southaven), and CredAbility (Jackson and statewide).

Court Provision in Handling Debt

Bankruptcy may be the last resort in handling debt. The Federal Bankruptcy Code provides two forms of debtor relief. Chapter 7 of the code is the straight bankruptcy provision and provides for liquidation (convert into cash) of the debtor's assets. Under Chapter 7, the secured creditors may have the security turned over to them unless the debtor reaffirms the debt with the court's approval.

Mississippi law lets the debtor keep certain property, and all other debts are discharged in bankruptcy. With bankruptcy under Chapter 7, you give up the property you put up for collateral when using credit unless the debts are reaffirmed by court permission and you continue to pay the creditor.

Chapter 13 is the wage-earner's plan. With Chapter 13, you promise to pay existing debts with part of the income you will earn in the next few years. While paying the debts, you will be able to keep the things you bought on credit if the courts approve your plan.

Changes in bankruptcy laws went into effect in October 2005. The changes give more incentive to seek bankruptcy relief under Chapter 13 instead of Chapter 7. If you have a steady income, Chapter 13 lets you keep property you might otherwise lose. The court lets you use future income to pay off your debts in 3 to 5 years. After you have made all the payments under the plan, you receive a discharge of your debts.

With limited exceptions, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 requires people who plan to file for bankruptcy protection to get credit counseling from a government-approved organization within 180 days before they file. They must complete a debtor education course after filing to have their debts discharged.

Chapter 7: Bankruptcy

Chapter 7 allows a person overburdened with debts to make a fresh start by discharging most of the claims against him or her.

The granting of a discharge after the filing of a bankruptcy petition in federal court releases or discharges you from the legal responsibility of your debts once the petition is approved. Once the petition is filed, garnishments and lawsuits can be stopped if proper papers are filed with the court; you are protected by the automatic stay provision of the bankruptcy code.

Your attorney will file the petition with the clerk of the United States Bankruptcy Court in the area in which you have been living for the past 6 months. You must pay

a filing fee. This fee is in addition to fees your attorney charges for his or her services. You must file a list of all your debts and creditors.

You must also file a detailed list of all property you own, money owed you, insurance policies owned, and property you may inherit within 6 months. You must list property for which you are claiming a homestead exemption. You must also file a detailed statement of your financial affairs.

Once the bankruptcy petition has been filed, the court will appoint a trustee. The trustee presides over the first meeting of creditors in the bankruptcy proceeding. The trustee liquidates certain assets that are not exempted or the debts reaffirmed, and these proceeds are distributed to your creditors.

All your listed creditors are notified and given the option to attend a meeting, at which you will be present, to file claims on the debts you owe them. The court-appointed trustee takes administrative control of your property to be sold and delivers property to the secured creditors. Once property has been sold, administrative costs are paid, and the remaining cash is paid proportionately to all creditors.

The bankruptcy court holds a hearing to inform you that your debts have been discharged or gives you a reason they were not discharged. You may reaffirm certain debts with the court's approval if you desire to keep the collateral and if it is in your best interest. For instance, if you wish to keep your car, you can reaffirm the debt and continue to make payments. You do not have to reaffirm the debt, but if you do, you become legally liable for the reaffirmed debt. The bankruptcy process takes a number of months from date of filing until date of discharge.

Bankruptcy claims may be voluntary or involuntary. Most are voluntary.

These debts cannot be eliminated in bankruptcy:

- State and federal taxes owed within the past 2 years before filing bankruptcy.
- Money or items received by fraud or false pretenses.
- Unlisted debts, unless creditor had knowledge of bankruptcy filing.
- Child support or alimony.
- Debts incurred by embezzlement, fraud, or larceny.
- Willful or malicious injury to another person or person's property by the debtor.
- Government-imposed fines or penalties, such as tax penalties.
- Student loans guaranteed by the government or a nonprofit educational institution.

Chapter 7 can only be declared every 8 years.

Chapter 13: Wage-Earner's Plan

Chapter 13, or the wage-earner's plan, is a voluntary repayment plan. When you complete the plan, you have the satisfaction of keeping your assets, paying your creditors, and discharging your debts.

When filing Chapter 13, you agree to pay approximately 25 percent of your income to the court. The court appoints a trustee to handle your money and pay your debts. The trustee also provides advice and counsel when necessary.

To file Chapter 13, contact an attorney who has experience in filing Chapter 13 petitions. Next:

1. The attorney files the petition with the federal court.
A court-appointed trustee is responsible for reviewing the petition, confirming the petition, paying the debts, and advising and counseling the debtor.
2. The court clerk sends notice of court action to creditors and the employer.
3. The employer sends a portion of your paycheck to the court trustee, who pays creditors. Secured debts are paid first, then unsecured debts.
4. The debtor cannot borrow more money without approval of the court trustee.

The actual amount of money paid creditors depends on the amount owed, the debtor's salary, and the payback timeframe. Chapter 13 payment plans may not be proposed for longer than 36 months unless you can show reason for extending the plan. The maximum time allowed is 5 years.

Administrative costs may be high. They include the court costs, filing fee, the attorney's fee, and the trustee's fee for paying off the debts. The trustee also may receive a fee for expenses such as typing equipment and supplies.

Summary

When your debts are high and your monthly income is not enough to cover the payments, there are ways to solve your debt problem. But the road to financial recovery takes a total commitment. You must decide you want to be debt-free. You have to discipline yourself to take the necessary action to pay back your debts. Only you can determine if you are willing to make the necessary sacrifices to achieve this goal.

For More Information

"Facts for Consumers: Before You File for Personal

Bankruptcy: Information about Credit Counseling and Debtor Education." November 2006, last modified April 2009. <http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre41.shtm>

"FTC Consumer Alert: Advertisements Promising Debt Relief May Be Offering Bankruptcy." May 2008, last modified September 2010. <http://www.ftc.gov/bcp/edu/pubs/consumer/alerts/alt015.shtm>

Maddux, Esther M. *How Others Can Help You Get Out of Debt*. Circular 759-3, University of Georgia Cooperative Extension Service, 1985.

Paynter, MaryAnn. *Your Money Management*. Circular 1271, University of Illinois Cooperative Extension Service, 1987.

Stephenson, Mary. *Getting Out of Debt*. Fact Sheet 436, University of Maryland Cooperative Extension Service, 1988.

Sample Letter

Street address
Your city, state, ZIP

XYZ Company
Street Address
City, state, ZIP

Attention: Delinquent account representative

Subject: Your name
Your account number

Dear Sir or Madam:

This letter is to inform you that I am experiencing financial difficulties. I am having trouble making my minimum monthly payment because of a recent divorce and job change to a lower salary. I hope we will be able to agree on an acceptable debt-repayment plan.

I have evaluated my financial situation. I have prepared a realistic, minimum budget for my living expenses and have developed a debt-repayment program. I am asking each of my creditors to accept a reduced payment. Amounts will be increased as soon as possible until debt is totally repaid.

I owe 18 creditors more than \$7,500. My asset value is less than \$3,000. My only assets are a car with a blue-book value of \$1,000, some home furnishings worth \$1,500, and my clothing. My monthly take-home pay is \$708. I have \$242 left over for debt repayment after basic living expenses. I would like you to accept a partial payment of \$50 per month for 34 months, which will repay my obligation. You may expect the first payment on (month, day, year).

Thank you.

Sincerely,

Your signature
Your name

Publication 1737 (POD-12-16)

Revised by **Dr. Rita Green**, former Assistant Extension Professor, Human Sciences.



Copyright 2016 by Mississippi State University. All rights reserved. This publication may be copied and distributed without alteration for nonprofit educational purposes provided that credit is given to the Mississippi State University Extension Service.

Produced by Agricultural Communications.

We are an equal opportunity employer, and all qualified applicants will receive consideration for employment without regard to race, color, religion, sex, national origin, disability status, protected veteran status, or any other characteristic protected by law.

Extension Service of Mississippi State University, cooperating with U.S. Department of Agriculture. Published in furtherance of Acts of Congress, May 8 and June 30, 1914. GARY B. JACKSON, Director