

## The importance of debt prioritization: *How to take control and pay off debt the right way*

Almost all of us look to various forms of borrowing to get what we need and want. Not all debt is created equal, however—it's how that credit is treated, prioritized, and paid off that matters.

### Long-term strategy

The goal is to pay the least amount over time, rather than worrying about monthly costs. For example, using the calculators at [www.pioneerservices.com/calculators](http://www.pioneerservices.com/calculators), you can see the danger of minimum credit card payments:

- » If you had \$1,000 of credit card debt at 17 percent interest, it would take you seven years to pay off, costing nearly \$500 in interest.
- » If you had \$2,500 at 17 percent interest, it would take nearly 10 years and cost \$1,300 in interest.
- » If you owed \$5,000 at 17 percent interest, it would take 12 years and cost \$2,665 in interest.

It's clear that making minimum payments on your credit cards costs an enormous amount. For this reason, any long-term strategy should focus on getting these debts paid first.

The next step is to order your debts by the longest term, or length. Take one loan with an interest rate of 15 percent and six months remaining, and another with an interest rate of 10 percent and 24 months left. In this case, it's a better

long-term decision to pay the 10 percent loan first because, over time, it will cost you more in interest.

### The month-to-month, or cash flow, strategy

This strategy focuses on reducing monthly payments and is a short-term fix for what are likely long-term financial problems.

The first step is to list bills by ease of payoff, perhaps the smallest amount you owe, or the debt with the shortest term. To use the two loans in the long-term plan above, you would pay off the 15 percent loan due to end in six months first, then move on to the next.

The advantage is that you can see progress relatively quickly, motivating you to stick with the plan. The disadvantage is that if you have a lot of credit card debt, it usually puts that debt lower in priority, meaning you will pay more interest over time.

### The interest-rate strategy

Take all your bills and order them by their interest rate, and then start by paying the highest-rate one first. Remember to use the effective interest rate (EIR), which takes into account any tax deductions you may receive, such as the deduction on mortgage and student loan interest. Since interest payments on these debts can be tax deductible, the EIR is often lower than whatever is stated on the paperwork.

Prioritizing your debt can be difficult, and figuring out which strategy to use in doing so can be complicated. But it's an essential step in any financial plan and can actually make you feel much better about your finances.

### Other tips

- » **The "snowball" technique** — Use this to pay debt faster. For example, say you have one payment of \$50 a month, and another at \$75. Once you pay the \$50 bill in full, you roll that \$50 into paying off the second bill. Once that second bill is paid off, take that \$125 and put it toward another debt. And so on and so on.
- » **Watch for the fees** — Check your paperwork or call the creditor to find out if there is a prepayment penalty or other fees.
- » **Watch for rate changes** — Credit cards may have an introductory rate that changes, while your mortgage may be adjustable. Consider this and be prepared for the change.
- » **Control spending** — Prioritizing and paying off your debt will mean little if you continue to add more, so also develop a spending plan.
- » **Make phone calls** — Call a creditor before you start having payment problems because it shows you care about paying your debt responsibly and can buy you some time.

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