May 15, 2023

FINANCIAL INSIGHTS BLOG

BUDGETING | SAVING & INVESTING | THE ECONOMY

# 7 Steps to Increase Your Financial Freedom By Reducing Debt

Are you stressed out over your finances? Are you overburdened by debt? Are creditors contacting you due to missed loan payments? Having high levels of debt increases your financial burden and affects your ability to pay for regular expenses. By reducing debt, you will improve your financial flexibility and your ability to save towards your emergency fund, financial goals, and retirement.

As a country, we have high debt levels not only from a national debt standpoint, but also a consumer standpoint. According to the Central Bank's Quarterly Statistical Digest, as at December 31, 2022, total loans and overdrafts outstanding at domestic banks stood at $6.423 billion with about $1.937 billion being consumer loans. Because of these high consumer debt levels, a large portion of the Bahamian population tend to live paycheck to paycheck with over 90% of individual bank accounts having $10,000 or less.

The following are seven steps to manage and reduce your debt:

**1. Know your net worth.**

Knowing your net worth is the first step to organizing your finances and building your wealth. Your net worth is the value of all of your assets minus the value of all of your liabilities. This is what you own (savings, property, investments) minus what you owe (mortgages, personal loans, and other debts). If you owe more than you own you have a negative net worth and if you own more than you owe you will have a positive net worth.

When listing your liabilities, make a note of the terms of all your outstanding debt including:

- Creditor's name
- Total amount owed
- Minimum monthly payments
- Interest rates
- Payment & maturity dates

Many persons have multiple loans, but do not know the terms of the loans and how much time they have remaining on their loans. List your loans from highest interest rates to lowest. Typically credit cards carry the highest interest rate of about 18%, followed by consumer loans, and then mortgages. Making a list of your liabilities will assist with making your plan to reduce your debt and achieve a positive net worth.

**2. Analyze if the majority of your loans are "good debt" or "bad debt".**

Good debt: borrowing funds in order to generate long-term income and increase your net worth. Examples: real estate, business ownership, education. These loans typically carry a low interest rate.

Bad debt: borrowing funds to purchase items that quickly depreciate in value and do not generate long-term income. Examples: credit cards, car loans, vacation loans, cash advances. These loans typically carry a high interest rate.

**3. Determine what your debt-service ratio is.**

Your debt service ratio is the portion of your income that goes towards servicing your debts. Lenders usually use this ratio when someone applies for a mortgage to determine if the borrower can manage the monthly payments. Add up all of your monthly debt payments and divide them by your monthly gross income. This number should ideally be no more than 30 – 35%, maximum 40%. If your number is higher than this, you are probably delaying paying debts to cover your living expenses. Make a plan to reduce your debt-service ratio so that you can have more financial freedom.

**4. Create a budget.**

A budget allows you to track your income and expenses to understand your money habits and take control of your spending and saving. Forms of income include salary, investment income, pension etc. Expenses include rent, car, utilities, insurance, debt payments, entertainment etc. Determine where you are overspending and make adjustments so that you can manage your debt payments.

Here are some budgeting tips that can help you get your debt under control:

- Find ways to reduce your expenses such as downgrading your cable or phone package or burning less electricity. Cut back on your entertainment expenses or purchasing food at restaurants. Reducing your expenses will allow you to increase your debt payments.

- Plan for large trips or big purchases at the beginning of the year and make a plan to save for these large purchases. This will lower the likelihood that you will borrow for a large purchase or vacation.

**5. Pay off your high interest rate loans first.**

Credit cards typically have the highest rates at 18 – 22%. If you have multiple credit cards, try to reduce this to one by paying off the cards with the highest interest rates first. Once you have reduced your credit card debt, pay more than the minimum balance every month. Consumer loans also have high rates. Make a plan to pay these off as soon as possible.

*Tip: Credit cards should not be used for items you cannot afford or to pay other bills. When paying for items with a credit card, you should aim to pay off these items within the same month to avoid high interest charges. Where possible, use cash or debit cards for purchases rather than credit cards.*

**6. Make extra principal payments where possible.**

Holding loans to maturity causes you to pay almost double or even triple the amount borrowed due to the interest. Inquire with your financial institution on whether prepayments are permitted, and the maximum principal payment allowed without penalty. If your financial institution permits extra payments and you have some wiggle room in your budget, put extra funds towards your loan. A good strategy is to put a portion of your bonus or a portion of a salary increase towards principal repayments.

**7. Build an emergency fund.**

Save three to six months worth of living expenses in the event of a medical emergency, job loss, natural disaster, pandemic, or other emergency. This will provide you with a safety net that you can use should an emergency arise rather than taking out a loan or charging items to your credit card and accumulating more debt. The COVID-19 pandemic highlighted the need for an emergency fund as we experienced unprecedented levels of unemployment. Some say three to six months of living expenses is not enough, as some persons were unemployed for over a year during the pandemic. The more you save the better, but it is better to have something set aside than nothing at all.

Reducing your debt may seem like a daunting task. If you need further assistance, contact a financial planner that can go through your finances and help you make a plan to reduce your debt. Paying off a loan is always a great feeling. Imagine all the things you could be doing with the money you're using to pay your current debts. For example, you could save for retirement, save for a down payment on a home, or save for your children's education. Having less money going towards debt means there is more available to go towards the things that matter most.

**CFAL is here to help.**

If you need additional help, feel free to reach out to us for a Financial Planning Session. Our Certified Financial Planners are here to assist you with your budgeting, saving and investing needs.

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