six-steps 123456

take control

Feature article: Manage your debt

Manage your debt and you're on the way to controlling your finances.

The temptation to borrow – whether it's via credit/store cards, loans, hire purchase agreements or mortgages – is all around us. But although credit can be useful, it ain't money for nothing.

The bottom line? When we buy something this way, we typically pay more for it.

How borrowing works

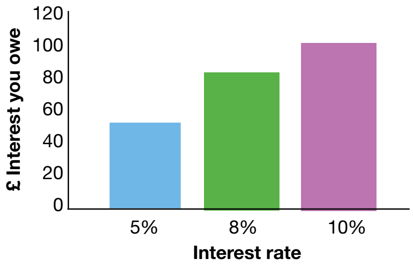
The four things that affect how much you actually pay are:

- how much you've borrowed
- the interest rate you're paying
- how much you are repaying at a time
- how long you're taking to pay it back

The first of these is pretty obvious – if you take out a loan, what you borrow is going to affect the total amount you repay. Where things get more complicated is the interest on the loan.

The interest – the amount the lender charges on what you owe – is expressed as a percentage. If you're looking to borrow, it makes sense to shop around for the lowest interest rate possible. (But be on your guard! Always check for any extra charges and think about how they will affect what you pay. And remember that if you take out a loan secured against your home, you could lose your home if you don't keep up the repayments).

This chart shows how the interest rate on your loan affects how much you owe over a year. The bigger the rate, the more interest you'll owe. (This example assumes that you've borrowed £1,000 and that you haven't made any repayments in that time.)



How much you repay at a time and how long you take to pay the loan back go together – if you repay a loan or credit card bill in small instalments it will take you longer. And here you have to take interest into the equation again.

Loans normally have fixed repayments and a fixed rate of interest. Credit cards work a little differently. Interest is worked out every month and added to your debt. That means that, by month two, you won't just be paying interest on the balance (what you borrowed minus your initial payment). It will be calculated on that amount PLUS the interest you've been charged. You're being charged interest on top of interest – and this will keep mounting up, month by month.

Think of it this way. Say you buy a pair of shoes for £50. You put it on your credit card and don't make any payments for a couple of months. If your credit card has an interest rate of 2% a month (remember, they will quote an annual rate), your bill will rise to £51 in the first month. That's £1 in interest. And the next month, it will be £52.02. The interest the second month is £1.02 – more than the month before. You're paying interest on the interest.

These sums may seem too small to worry about, but think how they could build up over time – and with a bigger debt.

This is compound interest in action. If you're saving, it works in your favour as you'll receive interest on top of the interest you've already earned. However, when you're borrowing, it's out there against you and increasing your debt.

The best way to tackle it is to pay off what you owe as quickly as possible by making larger monthly repayments – but check the small print to see if you'll be penalised for paying off your loan early. Credit card companies won't charge you interest if you pay off your balance in full each month but they will if you just make the minimum payment.

Compound interest on credit card debt is one of the main reasons borrowing can get out of control. The key is to manage your debts so they don't manage you. So what can you do?

Make a budget

The theory's simple: spend less than you earn.

To get an overview of where everything is going, keep a spending diary. This will allow you to see how much you've been spending on impulse buys and treats – and so where you can cut back.

You can then draw up a budget, making sure that you prioritise essentials and credit repayments.

Beware of credit cards

Credit cards can be expensive. If you feel you can't trust yourself, it's best to steer clear.

If you don't pay off the whole balance every month, interest will keep being added to it. That's why, if you find that you've got some spare cash at the end of the month, it's a good idea to use it to reduce your credit card balance.

You should also try and pay it off before you think about saving.

Although you can borrow money on a credit card (up to your credit limit), the high interest rates mean this is a bad idea – it would probably be cheaper to get a loan. However, loans can lock you in for a while and you may be penalised if you pay them off early. This means they may not be suitable for short-term borrowing. So, as usual, always check the terms of the agreement.

If you do want to get a credit card, check out the ratings tables in newspapers' financial pages to compare interest rates. A zero rate offer can be tempting but you should only go for it if you're confident that you'll be able to pay off your bill in full before the introduction period ends – otherwise you could end up paying interest on the whole amount.

Think about what you buy on credit

It's wisest to borrow for things that are likely to increase in value – for instance, a mortgage so that you can buy a home – rather than things which will fall in value over time. When you buy a new car, it drops in value as soon as it's driven off the forecourt. You'll be paying all that extra in interest for something that will soon be worth less – perhaps you should save up instead.
You should also avoid relying on credit for everyday purchases and essentials such as food.

Tackling your debt

But what do you do if you feel that your debt is out of control?

The most important thing is not to ignore it – that will only make the situation worse. There are organisations which can help, like the Citizens Advice Bureau (CAB). Avoid places that charge a fee; there are plenty that don't. You'll find some of them listed in our info centre on www.six-steps.org.

If you contact your creditors, you may be able to arrange to pay them back nominal amounts each month. Again, this is something CAB can help you with.

You also need to prioritise which creditors you should pay off first. The essentials are mortgage/rent arrears, tax and utilities as otherwise you could be evicted or be cut off.

You may see ads for loans which offer to consolidate all your different debts into one. Be wary and check the interest rate – it could be very high. Lower interest options are around, so talk to an expert and listen to their advice.

True or False

Credit is always bad

False

Credit is expensive but it can be a useful tool.

Just make sure you pay off your credit card bill each month to prevent compound interest working against you.