What is the best debt repayment strategy for you?

In the pursuit of financial independence, debt is indeed a four letter word. Debt is public enemy number one. However, if you have debt, the faster you pay it off, the better. Two of the most common debt repayment strategies are the Debt Snowball and the Debt Avalanche approaches. Each method has benefits and drawbacks. Let’s look at both methods and see which makes more sense for your situation.

The Debt Snowball is easy to understand. First, you list all of your debts, with the smallest balance on top and work down to the largest debt on the bottom of the list. Continue to make the minimum payments on all your debt. Take all the extra cash you can scrape up, and put the extra money towards the smallest debt until it is payed off. Once the debt has been payed, take the extra money and add it to the minimum payment you were making on the smallest debt and apply it to the next smallest debt. This will build momentum, like a snowball picking up size as it rolls downhill. Repeat this process until your debts are paid off. For people with a lot of debt, it will take time to pay off. The Snowball method will give you an emotional win each time you pay off a debt. The good feeling you get when a debt is paid, can help motivate to stay the course. The drawback is the Snowball method doesn’t look at interest rates and may not be the most efficient.

The Debt Avalanche method is based on paying off the debt with the highest interest rate first. This can save you money over time. Much like the Snowball method, you list your debts, this time putting the debt with the highest interest rate on the top of your list. While making minimum payments on your other debts, take all the extra money you can find and put it toward the debt with the highest interest rate. Repeat until debt free. People like this method because you pay less in interest while paying down your debt. If you want to save money, and don’t require a lot of positive reinforcement to stay on track, this method may be for you.

If you would like to compare how each method would work for you, the folks at Vertex42.com have built a debt reduction calculator you can use free of charge, lets check it out. Suppose that I have 3 loans to be paid off. The first is a car loan of $10,000.00, there is a student loan of $25,000.00, and finally a credit card debt of 5,000.00. Using the Snowball method we have a list that looks like this:

Creditor Balance Interest Rate Payment per month

Credit card $5000.00 15% $75.00

Car Loan $10,000.00 3% $200.00

Student Loan $25,000.00 4% $150.00

Total $40,000.00 $425.00

Let’s say I can get another $75.00 per month towards debt reduction so our monthly payments are $500.00. We will use the extra $75.00 to pay down the credit card first. Our new chart will look like this:

Creditor Original Balance Interest paid Months to pay off

Credit card $5000.00 $1508.51 44

Car loan $10,000.00 $684.97 50

Student Loan $25,000.00 $5552.71 96

 Total interest paid $7746.19 Debt Free in 8 years

Using the Avalanche Method our chart will look quite similar:

Creditor Balance Interest Rate Payment

Credit card $5000.00 15% $75.00

Student loan $25,000.00 4% $150.00

Car Loan $10,000.00 3% $200.00

Total $40,000.00 $425.00

Again, let’s say we have an extra $75.00 to pay on the debt, so our monthly payments will total $500.00.

The Avalanche chart will look like this:

Creditor Original balance Interest paid Months to pay off

Credit card $5000.00 $1508.51 44

Student loan $25,000.00 $5537.47 96

Car loan $10,000.00 $695.93 54

 Total interest paid $7741.91 Debt free in 8 years

In this example there really isn’t much of a difference which method you use. Obviously, if you have a lot of high interest debt the Avalanche method would save you more money over time. Whatever method you prefer, the important thing is to get started and stick with it.