

Debt Repayment Strategy - the Debt Snowball

the Debt Snowball Game

The main object of the debt snowball game is to build momentum, like a snowball rolling down a hill. Each turn of the ball picks up new snow and the ball gets larger, overcoming larger and larger objects as it grows. Money is like that too. Savings will build momentum as your money earns interest, and your debts will grow faster and faster as the interest compounds against you.

In this game, we want to build momentum through a series of quick wins that happen simply by paying off the smallest debt first and applying the savings to the next largest debt. Don't worry about interest rates, we've run the numbers and it is far more important to pay off the small debts to generate the "quick wins" and allow your debt snowball to grow. Making immediate progress reinforces the success you are having paying off your debts, and brings more focus and energy to the task at hand... becoming debt free. Once your debt snowball gets rolling, it becomes a powerful force to eliminate debt and build future wealth.

Winning the Game: Pay off your current debt as quickly as possible using current cash flow.

You'll get a bonus if you are creative and find new ways to free up cash flow or small lump sum payments (more on this later). If you play exceptionally well, there is an avalanche of savings ahead.

Playing the Game:

Step 1 – Write down all your current debts:

Month 1			
Creditor	Balance	Rate	Payment
Credit Card #1	4,400	12.00%	50
Auto Loan #1	4,800	8.00%	300
Auto Loan #2	15,000	7.00%	400
Credit Card #2	6,600	13.50%	100
Student Loan	500	4.00%	50
Mortgage	200,000	7.00%	1,330
Totals:	231,300		2,230

Debt Repayment Strategy - Steps 2 - 4

Step 2 – Organize the debts from smallest balance to highest balance:

Month 2			
Creditor	Balance	Rate	Payment
Student Loan	500	4.00%	50
Credit Card #1	4,400	12.00%	50
Auto Loan #1	4,800	8.00%	300
Credit Card #2	6,600	13.50%	100
Auto Loan #2	15,000	7.00%	400
Mortgage	200,000	7.00%	1,330
Totals:	231,300		2,230

Step 3 – Make a list of any extra resources you have to generate some cash today.

Example: Have a yard sale to generate \$250, sell outgrown kids clothes on Ebay to generate \$500, check old bank accounts, change jars, convert credit card miles to cash. If you can come up with \$1,000, use that with your next payment toward the smallest balance to get the ball rolling.

Step 4 – Apply any extra savings you find toward your smallest debt to jump start your debt snowball.

Let's assume you find \$250 from your search. Your next payment to the lowest balance Student Loan #1 would be \$300, the \$250 you found from your Step 3 and the \$50 payment you would normally make. You'd make all your others payments as you would normally, but any extra cash you find along the way will always go to the smallest debt first.

Let's fast forward a few months to month 5. After making a payment of \$300 on the smallest balance Student Loan, you needed only 4 more payment of \$50 each to pay off the remaining \$200 in debt, your debt now looks like this.

Month 5			
Creditor	Balance	Rate	Payment
Student Loan	0	4.00%	0
Credit Card #1	4,369	12.00%	50
Auto Loan #1	3,442	8.00%	300
Credit Card #2	6,468	13.50%	100
Auto Loan #2	13,149	7.00%	400
Mortgage	199,163	7.00%	1,330
Total:	226,591		2,180

Debt Repayment Strategy - Step 5

You paid down a little principal on the other debts, but the Student Loan is now paid off, and your new monthly payment for debt is \$2,180, exactly \$50 less than the prior month of \$2,230. This is how the debt snowball really works, you are going to keep paying \$2,230 that you are paying today until all the debts are paid off. Normally the \$50 would just flow to your checking account and become new spending.

Step 5 – Apply the free cash flow from the paid off debt to the next smallest debt.

Your extra \$50 in cash flow from paying off the Student Loan now gets applied toward your Credit Card #1. That means you'll pay \$100 toward Credit Card #1, your Month 5 should look like this:

Month 5			
Creditor	Balance	Rate	Payment
Credit Card #1	4,369	12.00%	100
Auto Loan #1	3,442	8.00%	300
Credit Card #2	6,468	13.50%	100
Auto Loan #2	13,149	7.00%	400
Mortgage	199,163	7.00%	1,330
Total:	226,591		2,230

That's it. Once you get into the habit of it, things start to get exciting. The Credit Card #1 would have taken 214 months to pay off, but with the addition of the \$50 from the payoff of the Student Loan things happen much faster. The Auto Loan #1 had only 17 months remaining. Assuming you don't need a new car right now, that \$300 a month will be added to your Credit Card #1 so you'll be making a \$400 a month payment to the Credit Card #1 in Month 18. Let's take a look:

Month 18			
Creditor	Balance	Rate	Payment
Credit Card #1	3,397	12.00%	400
Auto Loan #1	0	8.00%	0
Credit Card #2	5,993	13.50%	100
Auto Loan #2	7,743	7.00%	400
Mortgage	196,350	7.00%	1,330
Total:	213,483		2,230

Essentially the Auto Loan #1 created \$300 in savings that are added to the \$100 that was being paid to the Credit Card #1. Now a \$400 monthly snowball payment rolls over the remaining credit card balance in just 9 months. This frees up \$400 per month that can be added to the payment for Credit Card #2.

Debt Repayment Strategy - Consider a Snowball Coach

So how are things looking after just 27 months?

Month 27			
Creditor	Balance	Rate	Payment
Credit Card #2	5,721	13.50%	500
Auto Loan #2	4,845	7.00%	400
Mortgage	194,842	7.00%	1,330
Total:	226,591		2,230

Things continue to pick up steam. The Credit Card #2 is paid off in just 13 months and the Auto Loan #2 is paid off just one month later... freeing \$900 a month that could repay the remaining mortgage in less than 14 years.

Does it pay to snowball? In this example, there's over \$164,000 in interest saved – and you'd be debt free in 14 years. There are many other things to consider that could have a big impact on the amount you save. You'll need a new car or two along the way, you might be able to refinance and consolidate your debt first, then make the old payment toward the new debt to further increase your interest savings. There's also wealth to consider... as you might be better off paying off the higher interest rate debt and then snow plow the cash flow savings into a savings account that provides you greater future liquidity and interest earnings... this is where an expert can help, if you can find a coach for the first year to get you on the right track.

Inertia works against you until it works for you. In the debt snowball game, the cash flow and interest cost that work against you can work for you, and you'll go from a debt snowball to a wealth snowball.

If you paid off all your debt in 14 years by committing to the \$2,230 per month payment, then why not allow the \$2,230 per month to earn interest for you in a savings account for the remaining 16 years you'd have continued making mortgage payments. That \$2,230 earning a net after tax rate of 6% over the remaining 16 years would grow to over \$700,000.

So, while debt snowballing pays, you might also use it to build a wealth snowball and really lets the power of compounding work for you.

Debt Snowball Tips:

1. Order your debts from lowest balance to highest balance.
2. Find any savings you can to really attack the first debt.
3. Pay the minimum payment on all debts except the one with the lowest balance.
4. Any extra cash flow goes to the smallest balance.
5. When a debt is gone, **do not** alter the monthly amount used to pay debts, simply apply the savings to the next-lowest balance.
6. For an additional savings, refinance any debt to lower interest rates as you snowball. Lower credit card rates, lower auto rates, lower mortgage rates help the debt snowball roll faster!
7. Don't let math get in the way of momentum. You can pay off your highest interest rates first for a better financial gain, but consider doing this after you've really gotten the snowball rolling.

While the process is simple, having a Financial Coach can really help to maximize the savings.