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Six Steps to Eliminating Debt & Repairing Credit: An Ultimate Guide

Scott Trench

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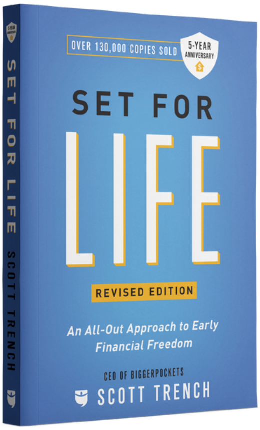
The *Six Steps to Eliminating Debt & Repairing Credit: An Ultimate Guide* (originally a $19.99 value, but this is yours free for becoming a BiggerPockets Pro Member!) is a companion to the book [*Set for Life: Dominate Life, Money, and the American Dream*] b. In his book, Scott lays out actionable advice to improve your personal finances in order to live the life you aim to live.

Scott Trench is the President and CEO of BiggerPockets. Through a solid understanding of money management, calculated risks, and a lot of hard work, he has created financial freedom for himself as well as a successful real estate business in just three years after graduating college.

He hopes to now share the knowledge he has acquired so that others will have the tools they need to repeat his results in just 3-5 years, giving them the option to go anywhere they want in the world, work any job, start any business, or finish out the journey to financial independence and retire young.

Six Steps to Eliminating Debt & Repairing Credit: An Ultimate Guide is an A to Z guide on tackling debt and uplifting your financial situation—the more bank-friendly you are, the more doors open for you!



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SIX STEPS

TO ELIMINATING DEBT & REPAIRING CREDIT: AN ULTIMATE GUIDE

A companion eBook to
Set for Life

By Scott Trench

BiggerPockets® PUBLISHING

Introduction

This short eBook is a companion work to *Set For Life*, which discusses the pursuit of Early Financial Freedom for the ambitious full-time employee. In chapter 3 of *Set For Life*, the topics of debt elimination and credit are briefly discussed and this companion eBook will expand upon that discussion in much greater detail. Most readers will fall into one of several categories with respect to debts:

1) Debt is a major part of one's financial position and must be tackled prior to making headway in other areas of personal finance. Someone like this would have a poor credit score, many different kinds of debt, and/or a large credit card balance.

2) Debt is a major part of one's financial position, but that debt is rather large and simply needs to be repaid with hustle by creatively finding ways to increase income over a long period of time. Someone like this could have six figures in student loan debt, but as they might be current on their debts, they simply need to hustle to pay it off or build wealth elsewhere.

3) Debt is mostly irrelevant to one's financial position. Someone like this would have no debt whatsoever, or their only debt is on their primary residence, and they are ready to begin working aggressively to hasten early financial freedom.

People with one or several current large ticket loans that are not impacting their credit score have a clear path before them; make sure the debt is financed at the best interest rates available and pay it down and/or build or invest in other assets while making the minimum payments through hustle and creativity on the income front. Those with no debt need only avoid acquiring bad or unnecessary debt in the future. However, those in the first category, categorized by many outstanding debts and a poor credit score, may find a great deal of value out of the following discussion.

If you are someone that struggles with debt and poor credit and would like to eliminate it from your life, this discussion is for you. You are right to tackle those issues prior to focusing on investing or other means of wealth creation. Best of luck on your journey back to positive net worth, and then on to *Early Financial Freedom*.

This eBook will help walk you through a six-step process to eliminating debt so that you can set yourself up to begin preparing for early financial freedom. The six steps are as follows:

- **Step 1** explains how to view, analyze, and understand personal debts so that you learn how to correct errors, protect yourself from fraud, and understand the position from which you are starting.
- **Step 2** discusses the difference between "good" debt and "bad" debt. You will learn to recognize that debts fall across a spectrum, where some are emergencies that need to be paid down immediately, others aren't great but can be paid off slowly over time with little consequence, while still other types of debt can actually help you *build* wealth.
- **Step 3** dives deep into the "bad" debt category. It discusses common types of bad debts and specific strategies for how you should be dealing with them.
- **Step 4** shows how a credit score is calculated and how to improve it. Tips to maximize your credit score in the short-term (useful when applying for a loan) and the systems and personal financial position needed to track scores consistently and improve over the long run are discussed. Plus, you'll get some tips to maximize your access to credit.
- **Step 5** examines some of the nuances of debt and will help those of you aspiring to early financial freedom decide which debts to repay and which debts to keep.
- **Step 6** discusses common financial decisions surrounding "good" debt that smart, everyday people are confronted with, and how to understand the impact of those decisions.

Step 1: Gather Information and Assess Your Situation

Frankly, one of the primary reasons that folks find themselves in a position in which they have a lot of bad debt and disastrous credit scores is that they aren't *paying attention*. The fact of the matter is that a poor credit score is usually (but not always) a result of a lack of attention and poor decision-making that has compounded for *years*.

If you are in this situation, the first step to correcting it is to admit that you are ignorant of this important part of your life and to take responsibility for yourself and your finances going forward. It won't be easy, but it has to be done to start your journey to early financial freedom.

Once you've done that, it's time to check your credit reports. There are multiple ways to get your credit information for free, but however you do it, understand the goal. The goal is to have a complete understanding of how much you owe on each of your debts, the interest rate incurred, whether a debt is delinquent, and what's needed to get current on each of your debts.

How to View Your Credit Profile

Just a few years ago (I'm writing this in 2017), checking one's credit report involved contacting one of the three nationwide credit reporting companies—Equifax, Experian, and TransUnion—and asking them for a free copy of your credit report. If you'd like, that option is still available to you, and you can request your report for free once per year at www.annualcreditreport.com.

However, I suggest that you simply sign up for CreditKarma.com (no, at the time of this writing, neither the author nor BiggerPockets.com receives financial benefit from promoting Credit Karma, it's just a great service for folks looking to improve their credit scores).

Credit Karma will give you access (for free at the time of writing) to your credit scores and reports in a convenient manner from TransUnion and Equifax, and update your scores weekly so that you can easily track your progress. This is far better than tracking your scores annually, or paying for your reports if you want to view them more frequently. Checking your own scores does not hurt your credit.

However you decide to do it, simply by getting access to your credit reports, you will discover a wealth of information, including the specific accounts you have outstanding, the balance due, and some information on the owner of your debts.

First Things to Look for on Your Credit Report:

Once you get a copy of your credit report, the first thing you want to look for is any errors or debts that you don't recognize. The three credit reporting agencies are not perfect, and mistakes are not uncommon. CNN reported in 2013 that as many as 10 million Americans are being denied loans or getting stuck with higher interest rates due to errors on their reports.

Why do these errors persist? There are many reasons. Sometimes, folks with common names can have debts or other credit-damaging information on their reports. For example, there are many John Smiths, and it's possible that credit reporting agencies confuse their names or addresses. It's possible that you've been the victim of identity theft and someone fraudulently took out a balance in your name. There are many reasons why an error might be present on your credit report, and you suffer needlessly by remaining ignorant.

If you do find a significant error on your credit report, you'll need to contact both the information provider and the credit reporting agency to dispute the error. Explain to them why the account, charge, or information is incorrect and request that they investigate it. This may not be a very fun endeavor, however understand that it is important for you to clear your credit report of any debts that are fraudulently or erroneously placed. This is an activity that will have a high dollar-per-hour reward if you are able to clear the error and improve your score or clear a debt.

Analyzing Your Position:

If you don't have any errors on your credit report, it's time to analyze your position and assess where you stand. You want to gather the following information in a convenient format:

- The amount or size of each of your debts
- Which debts are current vs delinquent
- Contact information for each of your creditors
- Interest rates for your various debts
- The age of your delinquent or non-current debts

Note that all of this information may not be conveniently present on your credit report. For example, a debt may not have its interest rate listed, and a creditor might not have their contact information listed. Collect this information through whatever means necessary. You *need* to understand the interest rates on each one of your debts, and how to pay them. Many people with poor credit scores are not even aware of who they need to pay! Gathering all that information is the first step of the process toward eliminating debt.

In most cases it shouldn't be too hard to do some online research to find the contact information for each of your creditors, and, once contacted, they should be able to provide you with information on your interest rates, penalties, and instructions for payment.

Step 2: Understand the Difference Between Good and Bad Debts

Bad debts include debts financed at high (10 percent or more) interest rates, debts incurring or accruing late fees, or debts that impact your credit score. These types of debts are actively draining your wallet and preventing you from reaping the advantages of a strong credit score. These debts are an emergency, and must be tackled prior to developing a long-term approach to achieve early financial freedom. Save up just enough cash to make sure that you don't take on additional bad debt due to bad luck, and then begin paying down your bad debts as aggressively as you can.

Some examples of bad debts include:

- Credit card debt (often charge high interest)
- Fines and parking tickets (often incur late fees)
- Any delinquent or high interest consumer debts
- Payday loans (ugh)

These types of debts are actively killing your financial position and damaging your credit. It's likely that if you have these kinds of debts and haven't taken action to begin paying them off promptly, you have collections agencies after you. This is where finances begin to spiral out of control for many people as their debt coverage and fees accompanying their debt consumes their disposable income, and creates new and larger amounts of debt.

If you have bad debt, don't buy luxuries. Don't go out for dinner. Instead, stop wasting money and pay off those debts as quickly as possible. It's foolish and dangerous to pursue investments, consider buying property, or otherwise make large financial decisions with bad debts looming overhead.

"Good" Debts

In addition to bad debts, there are so-called "good" debts. These debts can include things like:

- Home mortgages
- Student loans
- Car loans
- Personal Loans
- Any other debt financed at low interest rates that is current

While these debts are often called "good" debts, that's misleading. These debts slow progress toward early financial freedom because they are not backed by real assets—assets that are appreciating in value or generating significant cash flow. If you aspire to early financial freedom, you will not accrue this bad debt needlessly.

The Gray Zone

Like everything else in finance, it is not black and white when it comes to classifying debts as "good" or "bad." Everything is on a spectrum. While a payday loan might be clearly in the "bad" debt realm, many debts can hover frustratingly in the middle.

Jim has the following debts to his name:

- *$10,000 in student loans at 6.5 percent interest*
- *$4,000 in a car loan at 1.9 percent interest*
- *$8,000 in credit card debt at 15 percent interest.*
- *$150 in unpaid parking tickets, which will double to $300 in two months*

In Jim's case, it's clear that he has some really bad debts. Those parking tickets are set to double in just a few months and that credit card debt is at an insane 15 percent interest rate. It's easy for Jim to classify his credit card debt and parking tickets as bad debts that need to be repaid immediately.

But how about his other debts? The car loan is at 1.9 percent interest and since he is current on his payments, that debt is clearly not as bad a debt as some of the other ones on this list. It's probably safe to call his car loan a "good" debt that does not need to be repaid early before Jim can begin investing and pursuing early financial freedom. But what about that student loan debt?

This is where things get tricky. That student loan debt is in the gray zone. It carries a fairly high interest rate at 6.5 percent, but not an insane rate approaching double digits. Jim has a tough choice to make, and smart people will argue on both sides of this about whether Jim should pay off his student debt early, or begin building wealth while making the minimum payments on it.

Debts Backed by REAL Assets:

To reiterate what we've learned so far:

- Bad debts are debts with high interest, fees, or those that are actively damaging your credit score.
- "Good" debts are debts with low interest, few fees, and that are current and not actively damaging your credit score.

While neither of these debts actually help those that are interested in pursuing early financial freedom, it's important to remember that only bad debts are an emergency.

However, there is a third category of debt that sophisticated investors use to their great advantage. Those are **debts backed by real assets**. Let's explain this with an example:

> *Mike buys a rental property worth $100,000 by bringing $20,000 of his own money to the table. He gets an $80,000 loan in the process. This loan has a payment of $400 per month. The gross rents are $1,000 and the monthly upkeep averages to about $300 per month.*

In this example, Mike is using debt to purchase a real asset that generates cash flow far in excess of the financing costs. If Mike is a well-educated real estate investor and willing to work hard to make sure that his asset performs as he expects, he stands a good chance at building wealth quickly.

While real estate is a classic example of a way to use debt to enhance returns, many folks use debts to buy other types of assets and businesses. This can allow them to buy far larger businesses than they might otherwise be financially capable of purchasing and produce correspondingly faster and larger increases in wealth.

Note, however, that the trap that many people fall into is that they misjudge the potential of their investments and get stuck with an asset that performs poorly and they are thus unable to cover the monthly financing costs. Using debt to purchase businesses and assets can exponentially speed early financial freedom, but it can also lead to financial ruin.

The point is that there is really only one type of debt that is "good" and that is debt that is used to purchase income producing assets. While even this type of debt can be dangerous if the assets don't produce the expected cash flow, at least those who take out debt to purchase income-generating assets are taking a shot at building wealth. This in contrast to using debt to purchase a new car, which will almost certainly depreciate quickly.

If you have to take out debt to buy a "false" asset (an asset that does not generate income or is not expected to appreciate at a faster rate than inflation, such as a car, degree, or other luxury) because there really is no other viable option, make sure that you are taking out as little as possible.

Those that can start out with no debt at all, or only debt that is backed by income generating assets (like rental properties or businesses) are in a highly advantageous position to begin pursuing early financial freedom.

Home Mortgages:

While many readers of *Set For Life* will try to seek out a house-hack as their primary investment, many folks will already have a home with a mortgage. A home mortgage loan is definitely a barrier to early financial freedom, but it is going too far to call it a bad debt that needs to be paid off as soon as possible. Home mortgages typically allow the homeowner to receive certain tax breaks and come with low interest rates. A smart homeowner can get far ahead financially relative to peers that are renting.

Instead of paying off the mortgage as soon as possible, it's often wise to make the regular mortgage payments consistently, and then to move aggressively into saving and investing in assets that have a good shot at appreciating or generating cash flow in excess of the appreciation typically seen in housing markets.

Step 3: Strategy, Tricks, and Tips for Dealing with Bad Debts:

In step one, you gathered your credit information in one place to develop a clear understanding of your debts. To recap, here is the information that you should have access to prior to beginning this step:

- The amount or size of each of your debts.
- Which debts are current vs delinquent
- Contact information for each of your creditors
- Interest rates for your various debts
- The age of your delinquent or non-current debts

Let's examine why we collected this information in reverse order:

The Age of Your Various Delinquent Debts:

If you have bad debts that are more than seven years old, or very large debts that are approaching seven years old, you want to stop and think carefully about your approach to improving your credit score.

Many bad debts roll off your credit report and no longer count against your score after seven years. This does NOT mean that the debts go away, only that creditors may, in certain cases, simply be unable to sue you for the amount that you owe and win due to the statute of limitations on that debt.

> *Janice racked up $8,000 in credit card debt. After six months, her credit card company "charged off" her bad debt (assumed they'd never get repaid) and sold her balance to a collection agency. The collection agency bought the $8,000 in debt for just $2,000, as they estimate that less than 1/3rd of folks like Janice ever end up paying off their debts.*
>
> *Years go by, and Janice appears less and less likely to repair her debt. The first collection agency sells the debt to a second agency—one that specializes in debts that are over a few years old. Then the second agency sells it again. The process is repeated, and six years later, Janice finds that the debt has been sold seven times total.*
>
> *After seven years and six months, the calls finally stop. Janice has endured almost a decade of letters and calls from collections agencies, and the debt has finally passed beyond the statute of limitations. While creditors may still attempt to collect from Janice, or she may feel ethically obligated to repay anyways, creditors can no longer sue her for the debt.*

This is *not* a win for Janice. Janice borrowed too much money and was unable to pay it off. She wrecked her credit for the better part of a decade, and likely racked up other debts as well.

However, if, six years into this ordeal, Janice finally wakes up and decides to tackle her holistic personal financial situation, then she might decide (with expert guidance from a specialist in this area of the law and personal finance) that ignoring this particular old, large debt is worthwhile for 18 months (remember, the statute of limitations can start the first time a debt is missed, but often that time period can be fuzzy, so it's wise to do further research and clearly understand exactly when a specific debt is past the statute of limitations). If that's the case, then this debt might not need to be paid off prior to tackling her other debts. In fact, she won't want to make ANY payments on this debt before consulting a specialist, as that might bring the debt current, in this specific scenario.

There are some debts that do not have a statute of limitations. Notable among these debts are federal student loans. Student loans that are more than seven years old still need to be repaid, even if the loan is twenty-five years old or older. The federal government can still sue for payment. Another example of debt that may have no statute of limitations or a statute that can be renewed or extended for longer than seven to ten years, is a court judgment.

If you have delinquent debts that are approaching the seven-year mark, do not take action without self-educating yourself, and possibly seeking professional guidance. But, understand that you may not need to pay these off to begin rebuilding your financial position in certain circumstances.

The Interest Rates of Your Various Debts:

While there are a couple of schools of thought on how best to pay down debts, the fact of the matter is that you will want to make an informed decision in developing your plan and interest rates will need to be considered.

While we'll talk about two viable approaches to paying down debt in a moment, understand that if you have a few debts that are significantly higher interest than the rest, that it's probably wise to pay down those ones first.

Greg has debt in the amount of $8,000 spread across the following accounts:

- *$300 at 8 percent interest*
- *$700 at 9 percent interest*
- *$2,000 at 5 percent interest*
- *$5,000 at 19 percent interest*

Assuming that Greg can't refinance this debt, Greg will not want to worry about the first three debts, and will want to focus all of his efforts on paying down the super high interest debt at $5,000 first. That debt is significantly more detrimental than the other debts. While they are *all* bad debts, the most important thing is to eliminate the really bad one first.

Of course, when it comes to his $300 and $700 debts, while it is technically more efficient to pay off the $700 debt at the slightly higher interest rate first, Greg might feel more of a sense of accomplishment by paying off the $300 debt and crossing another debt off his list. Because the interest rates on those two debts are so similar, Greg is not making a large financial sacrifice, and if it proves more motivating to cross a debt off the list, no problem—paying off the smaller balance first makes sense and will keep him focused on his goal.

However, Greg is really taking a huge hit every month while he has that $5,000 balance on his books. He needs to do whatever is in his power to refinance or pay off that high interest debt.

Clearly, debt falls on a spectrum, and there is no one right way to handle it across the entire spectrum. That is why you must gather as much information as you possibly can about your debts and research them extensively.

Contact Information for Each of Your Creditors:

There are two main reasons why you need to gather the contact information for your creditors.

The first reason is so that you understand exactly how to go about making payments and to make sure that you are not being defrauded. This can be harder than you'd think. Some of these collections agencies can be astonishingly tough to pay, and there are occasionally folks out there that are seeking to fraudulently trick you into making payments. Make sure that you are able to get on the phone with a representative from the company, and that you can double and triple check the information presented so that you are sure that your payments are actually going to your creditors and not some fraudster.

The second reason you collect the contact information for your creditors is because you will likely want to call them and *negotiate your debt*.

Believe it or not, you may find yourself in a strong negotiating position when it comes to negotiating your debt down with some of these collections agencies. The reason you have negotiating power is because of the very thing that got you into this financial mess in the first place:

You have bad credit and a history of failing to make payments on your debts. The folks that own your debts, including the collections agencies, don't expect you to pay that debt off! That's why they were able to buy your debt for pennies on the dollar! Only a fraction of the people in your situation end up actually paying off their debts. So, the collections agencies will often make money even if you pay just half, or even less, of your debt!

This is an incredibly powerful position to negotiate from! Imagine that you and some of your buddies lend some money to a friend. That friend moves away, and you hear that he hasn't paid any of your friends back. A few years go by and you almost forget that your friend owes you money. Imagine getting a call after a few *years* from this guy telling you that he wants to pay you back. You weren't expecting to ever hear from him again! I'd bet you'd be delighted if he called you up out of the blue offering to pay back half of what he owes you.

Regardless of how you personally feel, countless individuals with poor credit scores that decide to get their act together financially have been able to reduce the amount they owe on large delinquent debts by *50 percent* or more through the age old tactic of simple negotiation. If you have significant debts that are fairly old and a poor credit score, then you can't afford to pass up the opportunity to potentially save yourself thousands of dollars.

Here are some tips for that negotiation:

- Understand many delinquent debts are *never* paid, so the collector wins when you agree to pay even a fraction of the total amount owed.
- Keep in mind that a long call might be necessary—but even two straight hours is worth it if you can negotiate the bill down by hundreds or thousands of dollars.
- Be polite, but make it clear that you're willing to take as long as it takes on the phone to bring down your debt amount.
- Your creditor has every right to refuse to reduce what you owe, so don't count on getting it lowered.

This is perhaps the highest dollar per hour activity that you can undertake if you have significant bad debts. You may find that you can negotiate certain debts down significantly. This kind of negotiation can work best with debts like credit card debt, hospital debt, and other personal loans.

Andy was in bad shape. He had the following debts to his name:

- *$40,000 in student loans*
- *$7,000 in hospital debt*
- *$1,800 in credit card debt*
- *$500 in unpaid parking tickets and fines*

Andy had a terrible credit score in the 400s and was tired of hearing from his creditors day in and day out. He was tired of never having any money, having to mooch off friends and family in order to rent apartments, buy his car, and otherwise make basic life decisions. Andy decided to tackle his debts.

Andy was delinquent on ALL of his debts, and some of them were accumulating interest and fees at an alarming rate. After careful analysis of his situation, Andy took the following actions:

- *Andy knew that there isn't too much he could do about the student loans. So he made sure that they were financed at the best rate available and kept his eyes out for opportunities to take advantage of debt forgiveness programs—it's always possible he might be able to put himself in position to eliminate a large chunk of debt. However, as he couldn't count on that, he made sure to get current on them and resolved to stay consistent in repaying them until they were totally repaid.*
- *Andy called the creditor that owned his delinquent hospital debt. He made it clear that he could not pay the full amount and asked what they could do to help him out if he promised to make timely payments on the reduced amount of debt. After some back and forth and haggling, Andy was able to get the debt down to less than $3,000. Not bad for a day's work! Andy made sure to keep his end of the bargain and never missed a single payment—the debt was eliminated entirely in less than six months.*
- *Andy called the credit card company and repeated his negotiation tactics. This time around, things didn't go quite as well, and he was only able to negotiate $300 off his debt. Still, $300 for a two-hour phone call is serious money. As with the hospital debt, Andy made sure to make regular payments and wipe his debt out as soon as possible to hold up his end of the bargain.*

- *Andy knew he had no leg to stand on with his parking tickets—the city was not going to negotiate with him on those, and might simply impound his car if he ever got hit with another violation. He sucked it up and paid them off.*

After a year of hard work, frugal living, negotiation, and smart money management, Andy upped his credit score by nearly 200 points and is solidly in the 600s. He wiped out all of his bad debt, and is working consistently on his student debts. Andy is thinking about buying his first house-hack and is on the right track to begin moving aggressively toward early financial freedom. Almost half of his progress came from just two phone calls and the ensuing negotiation of his debt.

Current Vs. Delinquent Debts

In the next step, we will discuss the importance of building credit and some tips and tricks to help you improve your score in addition to and in conjunction with paying down your debts. Understand for now, however, that one of the first priorities in debt reduction is getting current on your debts, so that you stop accruing penalties and late fees. These fees can add up quick and continue to push your ability to repay your debt out of reach.

Make sure that you are current on all of your debts before you focus heavily on paying any individual debt down.

The Amount or Size of Your Debts

A popular method of debt repayment, championed by anti-debt guru Dave Ramsey, is called the *Debt Snowball*. This approach advocates paying down the debt with the smallest balance first, then moving to the next smallest, and proceeding so on and so forth. The reason you might want to do this is that you can get some easy wins by paying down small debts entirely. This can prove very motivational for some people, as those that pay off a debt entirely are able to quickly check an accomplishment off their list, and then tackle a manageable next debt. Depending on how you are motivated and your personal style, you may want to employ this method.

However, as we mentioned earlier, keep in mind the relative interest rates of your debts. While the debt snowball can make a lot of sense if you have many debts of different sizes at similar interest rates, it can be needlessly expensive if you have a few debts that have significantly higher interest rates than the rest of your debts.

Joey has the following debts:

- *A $5,000 debt at 15 percent interest*
- *A $1,000 debt at 10 percent interest*
- *A $500 debt at 5 percent interest*

Kelly has the following debts:

- *A $5,000 debt at 7 percent interest*
- *A $1,000 debt at 6.5 percent interest*
- *A $500 debt at 6 percent interest*

In this scenario, Kelly might reasonably apply the debt snowball approach and come out just fine. She might pay a little bit more interest in total than if she started with her $5,000 7 percent interest debt, but she may also be far more motivated. What's a few dollars compared to keeping a strong motivation to keep working hard to reduce her debt?

Joey, on the other hand, probably needs to focus all his energies on repaying or refinancing his $5,000 and $1,000 debts first, starting with the $5,000 debt. The difference in interest rate on his debts is very large, and he will needlessly pay far too much in interest if he uses the debt snowball approach.

While these examples are very different, readers may find that their debts fall across a spectrum. When to apply the debt snowball approach, and when to pay off the highest interest debt first will come down to an analysis of one's personal situation, the interest rates and amounts owed, and self-awareness to know how one is motivated.

Step 4: Improving Credit

Improving one's credit goes hand in hand with improving one's overall financial position and will naturally improve as a part of debt reduction. While we'll talk about some tips to improve credit in the short-term, it's important to understand that the credit score is a reflection of your long-term financial behavior. The score would be of no use to anyone if you were able to wipe out a lifetime of financial misbehavior in just a few months.

However, it *is* possible to go from terrible credit to a score in the mid 600s in just a year or so. That kind of progress can reopen many doors in the world of financing, and can once again allow you to live where you want, get access to car loans and home mortgages, and open up credit cards. Many employers also check credit scores as part of the job application. A score in the 600s is unlikely to disqualify workers from job opportunities, especially relative to someone with a score in 400s.

Folks are often bewildered about just why this vague number—the credit score—affects so many things in life. Why on earth should landlords, lenders, and even employers care about this seemingly random number?

Some folks go through life never worrying about their credit score, as they never miss payments and never struggle to repay their debts. Many middle-class Americans that live relatively frugal lives are in this situation. If your score is good to excellent, you never even notice the negative ramifications of a bad score. You are generally accepted when you apply to rent an apartment or get a reasonable mortgage, you probably have a credit card or two, and it's likely that you also have a steady job. In fact, the entire reason that this eBook mini was written as a separate companion work with *Set for Life* is because improving credit is likely to be an irrelevant discussion to many readers. On the other hand, this might be the most important thing to focus on for readers with lots of debt and lousy scores.

On the other hand, if you *don't* have those things going for you, your credit score can have a big impact on your life, perhaps shockingly so. If you have a bad score the following things can happen to you:

- Landlords won't rent to you
- You can't get a loan on a vehicle
- Many employers won't hire you
- You can't get a credit card
- You can't get a loan to buy a house

Quite literally, your score impacts the very basic fundamentals of your life down to the very core. If you don't have a good enough credit score, you won't be able to live where you want, transport yourself in your preferred manner, work at many jobs, and enjoy the leisure activities of your preference.

Improving this number is more important than just helping to set yourself up to pursue early financial freedom. If you have a bad score, it is most likely negatively impacting your quality of life right now.

Going from a bad score to an okay/good one is something that can be achieved fairly rapidly (less than eighteen months for many, less than six months for some) and of paramount importance—in fact it's an emergency!

Of course, your journey doesn't stop once you have a "good" score if you are serious about accelerating toward early financial freedom and want to employ some of the advanced strategies in *Set for Life*—such as house-hacking. It will continue to be important if you ever want to apply for a business loan or purchase investment real estate with leverage.

So What Is a Credit Score?

A credit score at its core is used to help potential lenders determine *how likely you are to pay off your debts*. Think about it this way—suppose one of your friends or a family member asked you to lend them $100 because they were strapped for cash. Who would you help? It's likely that you'd have no problem lending that money to some friends, and a great deal of reservation about lending to others. Can you think of some of the traits that these friends share?

Suppose you have the following friends:

Honest John always pays back his friends on time. He occasionally will ask his buddies for money as he doesn't always carry cash, but when he does need to borrow, he makes a meticulous note about the amount owed and pays the money back as soon as he has the opportunity to do so. Lending to Honest John is easy and automatic—you know that John is not only a guy with high integrity that will never go back on his word, but also a man of reserve and competence. He has enough self-control to never bite off more than he can chew and is an excellent judge of his financial position.

While you have many friends that mean well and have great character, Honest John stands apart because he not only means well, he acts well. He is punctual, organized, intelligent, and on an excellent career track. Honest John is the first guy you want to lend to. Honest John has an Excellent credit score, and will have few problems in life when attempting to borrow money.

Normal Nancy is a pretty, nice, and kind girl that you are friends with. She has a decent job, is just as honest and well-meaning as John, but isn't quite as organized. She would never borrow money and intentionally fail to repay you, but you could see her borrowing a couple of bucks and totally forgetting about it. She's also not too concerned with money management. While she normally has no problem making rent, every once in a while she forgets to set aside money for the rent and needs a bit of money to make it through the next month.

Normal Nancy is probably a pretty reasonable bet to get your money back. She's not going to skip town on you, but you might have to remind her a few times, and it might be a little awkward for a few weeks while she gets her financial house in order to repay you.

Sleazy Sam is always a bit of a pain. You're never sure if he's really your friend, and he never seems to have quite enough money to cover whatever activity you are up to. He's always asking for $10 here and $5 there, and you always seem to "spot" him the money. You have no idea how much he owes you, but it's a lot. One of your friends recently had a big fight with him because he owed $75 for tickets to the ball game. Sam refused to pay, saying, "that game was garbage, I could only make the second half, and I bought you a beer at the game anyway!" He finally caved in and paid off your buddy, but it wasn't until months later with pressure from many friends.

You are going to have some serious reservations about lending a significant amount to Sam. Sam is unorganized, annoying, quick to borrow and mysteriously absent when you ask for your money or a favor in return.

Who would you rather lend money to? John, Nancy, or Sam? The answer is rather obvious.

Credit Score Ranges:

Your credit score is an attempt to classify you into one of these categories. Credit scores are often in the following ranges:

Excellent: 750 or higher

Good: 700-749

Fair: 650-699

Poor: 600-649

Bad: lower than 600

Sleazy Sam is likely to have bad or poor credit, Normal Nancy is likely to have fair credit, and Honest John will have good or excellent credit. Understand, however, that these ranges aren't exact, and that individual lenders will have different classifications.

Where do you fall on this spectrum? If you've read this much, it's likely that you have fair credit or worse. Why is that? Do you mysteriously disappear when your creditors call to collect? Do you borrow too much and hope that the debts will just go away? Or, are you more like Nancy, and just a tad unorganized? Do you have trouble making ends meet every month?

You'll have to answer those questions honestly for yourself. Remember, while the credit score is not perfect, it's a pretty darn good indicator of folks's likelihood to repay their debts over time. There is a reason that it is so widely used by landlords, creditors, and even employers. Those with poor credit have a tendency to not manage their money, and by extension their personal lives, very well. Dismiss the credit score's importance at your own peril.

How the Credit Score Is Calculated:

The credit score, while far from perfect, is actually *remarkably* effective at determining whether you behave financially more like Honest John or Sleazy Sam. It does this by mathematically measuring several things:

- How consistently you pay back your debts
- How much you owe and your credit utilization rate
- Derogatory marks
- The length of your credit history
- New lines of credit
- Credit inquiries

Let's dive into each one of these and talk about why they are important to the lender.

How Consistently You Pay Back Your Debts:

Your payment history is an important criteria to many prospective lenders. If you have never missed or been late on a payment, then you should have no trouble scoring well in this category. It's as simple as that. Make sure that your payments are made on time, and do so consistently to stabilize this largest component of your credit score.

If you do have late payments, or have a less than perfect payment history, then you have your work cut out for you. You should resolve to *never* miss another payment. We'll talk about how to do that in the next step.

How Much You Owe and Your Credit Utilization Rate:

Would you rather lend to someone that makes $75,000 per year that has $5,000 in other debts, or someone at the same salary with $500,000 in other debts? Of course the fellow that owes less is a less risky proposition and is more likely to pay you back! This is especially true with high interest debts like credit cards. If you have a large amount of debt outstanding, a new lender is going to see that and will likely make the determination that you are super risky.

The best way to improve this part of your score is to simply pay off your debts consistently over time and reduce the overall amount that you owe. This synergizes very well with making on-time payments.

Your credit utilization rate is the percentage of your maximum credit card balance that you are using. For example, if Tim has a $5,000 credit card maximum, and typically carries a balance of about $2,500, then he averages around 50 percent credit card utilization. If he wants to improve his score in this category he will have to do one or both of two things:

- He can pay off his credit card balance—for example, if he carried just $500, he'd only be utilizing 10 percent of his maximum.
- He can apply for a larger credit line—for example, if he is able to increase his credit line to $25,000, he'd utilize just 10 percent of his maximum with his current balance of $2,500

Those who are responsible and able to consistently pay off their credit card debt in full each month might be wise to continue to increase their available credit lines, so as to improve their score in this category. Remember that you are not applying for a larger credit line so that you can go out and spend more money on trinkets and luxuries. A larger credit line should not change your financial behavior, but it can help you improve your credit score.

Derogatory Marks:

Bankruptcies, judgments, foreclosures, and tax liens can negatively impact your credit score. While some of these may be unavoidable, understand that just as financial mismanagement can ruin your score, events in your personal life can have an impact as well.

The Length of Your Credit History:

Usually, a longer credit history is better and can positively influence your score. Think about it—would you rather lend to the guy that has a decades long history of handling his finances well, or a young college graduate taking out their first credit card and applying for their first loan?

While it's better to have no credit history than very bad credit history, it's important to begin working on your credit early in life and maintain strong habits throughout.

New Lines of Credit:

The guy that opens up five new lines of debt in just a few months raises red flags with creditors. This is because he all of the sudden undergoes a substantial change and introduces uncertainty. You'd rather lend to the guy that is just taking out a new line of debt with you, and not with five other folks at the same time! To keep this score high, only take out debts when they are truly advantageous to your financial position.

Credit Inquiries:

Similar to new accounts, credit inquiries can also affect your score. A credit inquiry occurs when others get your credit report, including lenders, landlords, and potential employers. If you have a large number of inquiries, your score may be negatively affected.

Sometimes inquiries can't be avoided, or offer the potential for some great advantages for you. For example, if you have just one or two credit cards, and do a great job paying them off in full every month, it might be wise to apply for a credit line increase, which could result in an inquiry on your credit report. It might be worthwhile to get access to an extra $3,000 in your credit line—which can help you improve your credit utilization rate as we discussed earlier—even if that results in an inquiry on your credit report.

It will be up to you to determine if the benefits expected from allowing a lender to pull your credit are worth the risks of potentially lowering your score. Don't pull your score needlessly, but don't be overly cautious either. This factor is not as important in determining your score as making your payments on time and keeping a low credit utilization.

Improving Your Credit Score:

Getting current on your debts, paying off outstanding balances, and reducing the overall amount of your debt are likely to be the most meaningful ways to improve your score dramatically over the course of a year. Understand that it's possible and even common for folks to go from bad to fair credit in less than a year with some hard work. But also understand that the credit score would not be useful if it was possible to wipe out years of lousy financial management in a few short months. Going from bad or poor to good/excellent can take years.

The good news is that a fair/good score will likely allow you to get decent rates at most things, and is unlikely to exclude you from many opportunities. Always continue to increase your score, however, as you will want access to the best rates and terms available to only those folks with Excellent credit.

Each individual situation is different, so the important thing to remember is that you can make huge amounts of progress by simply applying the basics of making on-time payments and reducing the overall amount that you owe. Make sure that you understand how each of the factors listed above impact your score and make tweaks to your personal financial position to make sure that you look as good as possible to the credit reporting agencies.

Step 5: Create an Emergency Fund

To this point, we have discussed how to assess and analyze your financial position and credit score, the basics of good and bad debts, how to form a debt-reduction strategy, and how your credit score is impacted by your decisions. Now, let's get to the nuts and bolts of money management during the period of time in which you are paying down your debts.

As long as you have high-interest debts, delinquent debts, or debts that are likely to significantly harm your credit score, there is little point in thinking about investing, or building up a large savings position.

Your financial focus will likely be on paying down your bad debts as soon as possible. However, there is something that is worse than your current bad debts—*new* bad debts. If you have bad debts, it's probably because you struggle financially month to month and paycheck to paycheck. You need to remedy this situation before you can begin to consistently pay down your debts. And the first step is in building out an emergency fund.

Chapters 1 and 2 of *Set for Life* discuss at length the philosophy and some practical approaches for reducing expenses. You need to read those chapters and implement some changes in your own life so that your financial position is cash flow positive.

You *must* put yourself in a position where you can accumulate $500, $1,000, or more per month however you can if you want to begin making significant progress toward getting back to zero and in position to begin rapidly pursuing early financial freedom. There is no substitute for proper financial management. Cut your spending and/or increase your income so that you can begin paying down your debts.

Assuming that you have a plan in place to begin accumulating a significant amount of money per month, you will need to devise a plan to manage this cash flow. And the first step is in building out an emergency fund of at least \$1,000 to \$2,000, in excess of what you need to fund your immediate lifestyle expenses.

This \$1,000-\$2,000 is to be used *only* in financial emergencies. A financial emergency is something that you *must* spend money on in order to maintain basic parts of your lifestyle. These kinds of expenses include hospital or health related expenses, emergency car services, critical home repairs, and other expenses that you must either purchase outright or take out additional debts to cover.

The point of the emergency fund is to prevent new bad debts from hitting your credit report or incurring late fees. Don't spend the emergency fund on anything else. If you afraid that you might spend the emergency fund, then you might consider opening the fund in a bank that is inconvenient to you, and creating a situation where you can *only* access the money if you physically visit the branch and ask to withdraw it. However, if you have more self-control, you can simply keep it in a savings account at your regular bank.

Once your emergency fund is set up and funded, it's time to get to work in earnest on your debts. Follow the plan you have developed using the information in this eBook and other research as applies to the specifics of your situation. Understand the tradeoff between paying off debts with high interest rates and paying off debts with small balances. Understand which debts are impacting your credit score currently and which debts can be dealt with at a later date with minimal consequence. Understand which debts can be negotiated down, and which debts are here to stay.

Work hard, spend as little as possible. Pay down debts intelligently, and get back to zero as fast as you can.

Step 6: Assessing Good Debts—Should You Pay Them Down or Pursue Financial Freedom?

Okay—so you've crushed your bad debts, or never had them in the first place. All you have now are "good" debts. Your debts are at reasonable interest rates and you are easily able to make your regular payments on them. You understand that these debts are still slowing you down on your path toward early financial freedom, but they are not an emergency.

The question you face now is this: *Should I repay my large good debts, or should I begin investing aggressively in pursuit of early financial freedom?*

Examples of some of these good debts include the following:

- Car Loans at low interest rates
- Student loans at low interest rates
- Home mortgages at low interest rates
- Any other personal loans at low interest rates that are up to date

Car Loans:

> *Kevin has $5,000 in debt in the form of a car loan that he took out prior to getting serious about financial freedom. The car is a modest economy vehicle, and he stands to benefit little from trading it in for another make. Kevin's car loan is financed at 1.9 percent interest. Kevin has no other debts.*

Kevin, in this example, should probably consider using his surplus savings to begin investing according to the strategy that he believes is most likely to expedite early financial freedom. There is little to be gained by refinancing his vehicle, it's probably going to be a huge disruption to his life to sell the car entirely, and the debt is both small and low interest.

Student Loans:

> *Sally has $200,000 in student loans. She went to an expensive private school to get her law degree and is set to make $75,000 per year at her new job. Sally's student loans are financed at about 6 percent. She has no other debts and otherwise manages her finances pretty conservatively.*

Sally is in a poor position. She has significant debt at a fairly high interest rate. She is several years behind in the pursuit of early financial freedom compared to her peers that managed to graduate debt free. She has to make one of two bad choices in this situation.

First, she can apply any excess savings toward paying down her debts and getting back to zero. If she is able to do this, she will have years of good financial habits behind her and will be in a strong position to move rapidly toward early financial freedom with each passing month. The downside, however, is that she will not benefit from her creative potential on the investing front, and is guaranteed a measly 6 percent return on her savings. In other words, she is denied her potential.

The second option is to make the minimum payments on her debts and then use her creative energies to invest in assets that she believes offer strong potential to produce returns greater than 6 percent. For example, she could focus on building up a large down payment so that she can purchase a house-hack. This might allow her to use some extreme leverage, wipe out her rent/mortgage payment using other people's money, and achieve very high returns.

Sally should also note that a portion of her student loan payment may be tax deductible—up to $2,500 in interest in 2016, assuming she makes less than $80,000 individually and $160,000 in household income if filing jointly with her spouse. This can reduce her effective interest rate and should be factored into her calculations.

Unfortunately, Sally is simply in a worse position than her peers that managed to graduate debt free, at least from the standpoint of achieving early financial freedom. Sally's predicament should be a lesson to those considering taking only large amounts of debt for a degree. The costs of that debt and the corresponding delay to early financial freedom can be devastating.

Home Mortgages:

> *Tom has a home mortgage of $240,000 on his $350,000 home at 4.8 percent interest, fixed for 30 years. He lives in the home with his family and does not have plans to rent out any portion of the home. He is debating about whether to pay off his mortgage and live debt free, or to invest in outside assets. He knows that his home mortgage interest is tax deductible, therefore reducing his effective interest rate on the debt as he is able to claim a tax break on the interest payments.*

First off, let's note that Tom is living inefficiently, as it is possible to house-hack by living in a duplex, triplex, or fourplex and use tenant rent to pay down his mortgage. He should consider that the most efficient use of his resources is likely to sell his home and redeploy his equity in the purchase of a house-hack.

However, assuming that Tom is aware of this option, and unwilling to move because of personal reasons, he needs to think through the decision intelligently. The fundamental question Tom at play is whether Tom believes that he can invest at significantly greater returns than 4.8 percent per year. If he believes that he can sustain that level of return or greater, he should not seek to pay down his home mortgage sooner than he has to, and should instead invest excess cash flow elsewhere, and perhaps even consider refinancing his property with a cash out refinance.

If Tom believes that he cannot sustain levels of investment return higher than 4.8 percent, then he should pay down his mortgage as soon as he can.

It is popular among the financially independent to pay down their home mortgages and to live debt free. However, those that believe that they can sustain investment returns of greater than the interest rate on their home mortgage would be well served to not pay down their home mortgage, and instead invest according to the plan that they believe has the greatest odds of success.

Whether or not to pay down a home mortgage often boils down to personal choice, and many successful people make the choice to ignore the math and pay down their home to live debt free. There is nothing wrong with that, just understand that this may result in a suboptimal deployment of wealth.

Just remember that if you are gunning for early financial freedom and do not believe that you are creative enough to achieve investment returns of greater than 4-6 percent per year, you had better be prepared to go all out in your approach to frugal living and achieving large investment returns.

Conclusion:

Debt reduction strategies can be just as nuanced as the strategies employed to pursue early financial freedom, and the basics of earning as much as possible and living as cheaply as practical remain in place throughout your financial journey.

The key to success is to have a strong understanding of your current financial position, and a well-researched path mapped out for making rapid improvement. Know yourself, know your debts, and spend some time researching the options available to you.

Understand the basic information about each debt that you owe, and make a decision that is in your best financial interests when deciding how to deal with each. Some debts are an emergency, while others are financed at such great rates that it's almost silly to pay them off early. Still other debts are in the middle, and present those that are stuck with them with tough choices.

The good news is that remarkable progress can be made for most people in less than a year or eighteen months. I've personally witnessed and worked with folks that have paid off five-figures in debt in under a year, experienced a 150+ point increase in their credit scores, and move on to be in position to purchase property. You can succeed too! Just be ready to do the hard work necessary to dig out of your financial rut and get back to zero. Then, it's on toward financial freedom!

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