Module 4: How to Escape Debt

How to Escape Debt

Understanding compound interest, common debt traps, and a clear path to financial freedom

Debt is not a moral failing. It is a financial condition — one that millions of people find themselves in, often through circumstances beyond their control. But debt does have rules, and understanding those rules is what separates people who escape it from those who carry it for decades. This lesson gives you those rules.

What You Will Learn in This Lesson

- ✓ How compound interest grows what you owe — and what minimum payments actually cost you
- ✓ Why payday loans, rent-to-own, and buy-here-pay-here deals trap people in debt cycles
- ✓ Two proven debt payoff strategies and how to choose the right one for you
- ✓ Your legal rights when dealing with debt collectors under the FDCPA
- ✓ How long a debt can be legally pursued — and what happens when that window closes
- ✓ When bankruptcy is actually the right choice — and the difference between Chapter 7 and Chapter 13
- ✓ Debt consolidation vs. debt settlement: what they mean and what they cost

Section 1: The Invisible Force Working Against You — Compound Interest

📖 **Interest:** The fee a lender charges you for borrowing money. Expressed as a percentage of what you owe per year.

📖 **Compound Interest:** Interest that is calculated not just on the original amount you borrowed, but also on the interest that has already been added to your balance. You pay interest on your interest.

Your credit card charges interest every single month. On a $3,000 balance at 22% APR: the lender divides 22% by 12 months = 1.83% per month. The monthly interest charge = $3,000 x 1.83% = $54.90. Your $60 minimum payment covers that $54.90 in interest, leaving only $5.10 to actually reduce your balance. This is why minimum payments feel like running on a treadmill — the balance barely moves.

The True Cost of a Minimum Payment

Credit card: $3,000 balance at 22% APR. Minimum payment: $60/month.

- Paying only the minimum: 20 years to pay off, roughly $5,100 in interest, total cost over $8,000.
- Paying $150/month instead: paid off in about 2 years, roughly $600 in interest — saving $4,500 and 18 years.
- The difference between $60 and $150 per month is $90. That $90 saves you $4,500.

The Key Insight

Paying more than the minimum is not just helpful — it is the only way to actually escape. Even an extra $20–$30 per month per debt makes a dramatic difference. The math is on your side the moment you start paying more than required.

Section 2: Debt Traps — What They Really Cost

Payday Loans

Payday Loan: A short-term, high-cost loan typically due on your next payday. You borrow a small amount ($100–$500) and pay it back with fees when your next paycheck arrives.

The Real Cost of a Payday Loan

You borrow $300. The lender charges $45 (at $15 per $100). In two weeks, you owe $345. That $45 fee on a 2-week loan = an APR of approximately 391%. For comparison, a typical credit card APR is 18–29%. Most borrowers cannot repay the full amount on payday and "roll over" the loan, paying another fee. One $300 loan can cost $300 or more in fees alone over just a few months.

Rent-to-Own Stores

Rent-to-own stores let you take home furniture, electronics, or appliances and make weekly or monthly payments until you own them. The true cost is staggering: a television that costs $400 at a regular store might be available at a rent-to-own store for $25 per week over 78 weeks — meaning you pay $1,950 total for a $400 TV. That is nearly 5 times the retail price. The effective interest rate can exceed 100–200% APR.

Buy-Here-Pay-Here Auto Dealers

Buy-here-pay-here car lots allow people with poor credit to purchase a vehicle and make payments directly to the dealer — no bank involved. Interest rates commonly range from 20% to 30% APR — sometimes higher. Many vehicles sold are high-mileage with mechanical problems. Missing even one payment can trigger repossession in many states. You may end up paying $8,000 for a car worth $3,000.

> **Alternatives Worth Exploring First**
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> Credit unions often offer small emergency loans at far lower rates to members
> Many employers offer paycheck advances — ask your HR department
> Community organizations and nonprofits sometimes provide emergency financial assistance
> A secured credit card used responsibly builds credit and costs far less than payday products
> A used car purchased through a credit union loan typically costs far less than BHPH financing

Section 3: The Two Debt Payoff Methods

Method 1: The Debt Avalanche (Highest Interest First)

List your debts from highest interest rate to lowest. Pay the minimums on all of them — then put every extra dollar toward the debt with the highest interest rate. When that debt is paid off, you roll that payment to the next highest-rate debt.

> **Why It Works Mathematically**
>
> The avalanche method minimizes the total amount of interest you pay over time. It is mathematically the fastest and cheapest way out of debt. Best for: people who are motivated by data and long-term savings, and who can stay consistent even if early progress feels slow.

Method 2: The Debt Snowball (Smallest Balance First)

List your debts from smallest total balance to largest — ignoring interest rates. Pay the minimums on all debts, then put every extra dollar toward the smallest balance until it is gone. Then roll that payment to the next smallest, and so on.

> **Why It Works Psychologically**
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> The snowball method creates quick wins. Eliminating a debt entirely — even a small one — builds momentum and motivation. Research shows people are more likely to stay on track when they can see visible progress, even if it costs slightly more in interest. Best for: people who need emotional momentum.

Debt Avalanche	Debt Snowball
Pay highest interest rate first	Pay smallest balance first
Saves the most money overall	Creates fastest emotional wins
May take longer to see first payoff	First payoff can happen quickly
Best if you are disciplined and data-driven	Best if you need motivation to stay going
Total interest paid: lower	Total interest paid: slightly higher

The truth is: the best method is the one you will actually stick with. If the avalanche feels demotivating and you quit, the snowball that you follow through on wins every time. Choose based on how you are wired.

Section 4: Your Rights When Dealing with Debt Collectors

> 📖 **Debt Collector:** A person or company that collects money owed to another business. Debt collectors are different from the original lender — they often purchase old debts or are hired to collect on behalf of lenders.

> 📖 **FDCPA:** The Fair Debt Collection Practices Act — a federal law that limits what debt collectors can say and do when trying to collect a debt from you.

What Debt Collectors CANNOT Do

- Call you before 8 a.m. or after 9 p.m. in your local time zone
- Call you at work if you tell them your employer does not allow such calls
- Use threatening, abusive, or obscene language
- Threaten to take action they cannot legally take or do not intend to take
- Falsely claim to be a lawyer, law enforcement, or government representative
- Tell anyone else about your debt (except your attorney or a co-signer)
- Contact you at all after you send a written request to stop — a cease and desist letter

What You Can Do

- Request verification in writing: Within 30 days of first contact, you can request written proof that the debt is valid. They must stop collection activity until they provide this.

- Send a cease and desist letter: Once you send a written letter requesting that a collector stop contacting you, they are legally required to stop — except to inform you that collection efforts are ending or they intend to sue.
- File a complaint: Report violations to the CFPB at consumerfinance.gov or to your state Attorney General.
- Sue for violations: If a collector violates the FDCPA, you can sue them in court. If you win, you may be entitled to damages up to $1,000 plus attorney fees.

> ⚠ **Know What You Owe Before You Pay**
> Before paying any debt collector, verify that the debt is actually yours, that the amount is correct, and that the collector has the legal right to collect it. Scammers sometimes pose as collectors for debts that do not exist or have already been paid. Always get any payment agreement in writing before sending money.

The Statute of Limitations on Debt

> 📖 **Statute of Limitations:** A legal time limit. For debt, it is the window of time during which a creditor or collector can successfully sue you in court to force repayment. After this period expires, the debt becomes "time-barred" — they can still try to collect, but they cannot win a lawsuit against you.

Debt Type	Typical SOL Range	Notes
Credit card debt	3–6 years (most states)	Starts from date of last payment
Medical debt	3–6 years	Varies significantly by state
Auto loans	3–6 years	Secured debt may have longer period
Personal loans	3–6 years	Depends on written vs. oral agreement
Student loans (federal)	No SOL for collection	Federal loans never expire
Student loans (private)	3–10 years	Treated more like private contracts

> ⚠ **CRITICAL WARNING: Making a Payment Restarts the Clock**
> If a debt is near or past its statute of limitations, making even a small payment — or in some states, simply acknowledging the debt in writing — can restart the clock entirely. Before making any payment on an old or unfamiliar debt, find out when your last payment was, what your state's SOL is for that debt type, and whether the debt may already be time-barred.

Section 5: Debt Consolidation vs. Debt Settlement

Debt Consolidation

> 🕮 **Debt Consolidation:** Combining multiple debts into a single new loan, ideally at a lower interest rate. You now have one payment instead of several. Consolidation does not reduce what you owe — it reorganizes it.

Common consolidation options: Personal loan (a bank or credit union lends you enough to pay off your other debts), Balance transfer credit card (some cards offer 0% interest for 12–21 months on transferred balances — powerful if you pay off the balance before the promotional period ends), Home equity loan (low rates but puts your home at risk if you cannot repay).

> **When Consolidation Makes Sense**
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> You have multiple high-interest debts and qualify for a lower-rate loan • You will not continue adding new debt while paying off the consolidated loan • The total interest over the new loan's life is genuinely less than what you would pay separately | Warning: Consolidation does not solve a spending problem — it just reorganizes debt.

Debt Settlement

> 🕮 **Debt Settlement:** Negotiating with a creditor to accept less than the full amount you owe as payment in full. For example, settling a $5,000 debt for $2,500.

> ⚠ **What Debt Settlement Companies Often Do Not Tell You**
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> 1. They typically instruct you to STOP paying your debts entirely. During this time, your credit score drops significantly. 2. They charge fees of 15–25% of the total enrolled debt. 3. The IRS generally treats forgiven debt as taxable income. 4. There is no guarantee creditors will settle — some will sue you instead. 5. Settled debts appear on your credit report for up to 7 years.

You can negotiate directly with creditors yourself — you do not need to pay a settlement company. Creditors often prefer receiving some payment over none, especially on very old debts. Call the original creditor, explain your situation honestly, and ask if they have a hardship program or would consider a lump-sum settlement.

Section 6: When Bankruptcy Might Be the Right Tool

> 🕮 **Bankruptcy:** A legal process that allows individuals or businesses to seek relief from debts they cannot repay. It is governed by federal law and overseen by federal courts.

Bankruptcy carries a significant social stigma, but it exists in the law precisely because sometimes debt becomes genuinely unmanageable — through job loss, medical crisis, divorce, or a combination of life events. Understanding bankruptcy as a legal tool, not a moral failure, helps you make a clear-eyed decision.

Chapter 7: Liquidation Bankruptcy

Chapter 7 wipes out ("discharges") most unsecured debts — credit cards, medical bills, personal loans — relatively quickly, usually within 3 to 6 months. To qualify, you must pass a "means test" showing your income is below your state's median.

Chapter 13: Reorganization Bankruptcy

Chapter 13 allows you to keep your assets (including a home or car) while repaying some or all of your debt through a 3 to 5 year court-approved repayment plan. It is sometimes called the "wage earner's plan."

Chapter 7	Chapter 13
Wipes out most unsecured debt	Creates a repayment plan (3–5 years)
Process takes 3–6 months	Process takes 3–5 years
Must pass income means test	Available at higher income levels
Some assets may be liquidated	You keep your assets
Good for: overwhelming unsecured debt	Good for: saving a home, protecting assets
On credit report: 10 years	On credit report: 7 years

> **Get Legal Help**
> Bankruptcy requires an attorney for most people. Legal aid organizations in many areas offer free or reduced-cost bankruptcy assistance to low-income individuals. Search for "legal aid" plus your city or county name to find local resources.

Section 7: Your Debt Freedom Worksheet

Use this worksheet to build your complete debt picture, choose a payoff strategy, and calculate your freedom date. Take your time — the more accurate and complete this is, the more powerful your plan will be.

Module 4: How to Escape Debt

My Debt Freedom Worksheet

Step 1 — Complete Debt Inventory

List every debt you owe: credit cards, medical bills, car loans, personal loans, payday loans, money owed to family, everything.

Creditor / Debt Name	Total Balance	Interest Rate	Min. Payment
	$	%	$
	$	%	$
	$	%	$
	$	%	$
	$	%	$
	$	%	$
TOTAL	$	—	$

Step 2 — Choose My Payoff Method

- ☐ AVALANCHE — Pay highest-interest debt first (saves the most money overall)
- ☐ SNOWBALL — Pay smallest balance first (creates fastest visible wins and motivation)

Re-list debts in chosen payoff order:

Priority	Creditor / Debt	Balance	Rate	Min. Payment
#1		$	%	$
#2		$	%	$
#3		$	%	$
#4		$	%	$
#5		$	%	$

Step 3 — Find My Extra Monthly Payment

	Amount
Total minimum payments (Step 1)	$
Amount I can pay toward debt each month total	$
My EXTRA monthly payment (total minus minimums)	$

Step 4 — Calculate My Debt Freedom Date

Debt #	Balance	Monthly Payment	Estimated Payoff Date
#1	$	$	
#2	$	$	
#3	$	$	
MY DEBT FREEDOM DATE			

Step 5 — Collector Rights Checklist

- ☐ I know the original date of my last payment on each collection account
- ☐ I have looked up my state's statute of limitations for my debt type
- ☐ I have verified the debt is legitimate before making any payment
- ☐ I know I can request written verification within 30 days of first collector contact
- ☐ I know I can send a written cease-and-desist to stop collector contact
- ☐ I understand any payment on a time-barred debt may restart the statute of limitations

Lesson Summary

- Compound interest means debt grows much faster than you expect — minimum payments mostly pay interest, not principal.
- Payday loans, rent-to-own stores, and BHPH dealers can cost 100–400% APR — always seek alternatives first.
- The Debt Avalanche (highest interest first) saves the most money. The Debt Snowball (smallest balance first) builds the most motivation. Both work.
- Under the FDCPA, debt collectors have strict rules about when and how they can contact you. You have rights.
- Statutes of limitations mean old debts may not be legally enforceable — but making a payment can restart the clock.
- Consolidation reorganizes debt; settlement negotiates it down. Both have trade-offs. You can negotiate directly without paying a company.
- Bankruptcy is a legal tool, not a moral failure. Chapter 7 discharges most debt in months; Chapter 13 creates a repayment plan.

Next Steps and Action Items

Complete these steps to build your debt freedom plan.

1. Complete Step 1 of the worksheet: list every single debt you owe with the balance, interest rate, minimum payment, and date of last payment.
2. Choose your payoff method — Avalanche or Snowball — and re-list your debts in the chosen order.
3. Look at your monthly budget (from Module 3) and find the extra monthly payment you can put toward Debt #1.
4. Calculate your estimated payoff date for Debt #1 and write it down. This is your first milestone.
5. For any debts currently in collections, look up your state's statute of limitations and verify the date of your last payment before making any payment.
6. If your debt feels genuinely unmanageable, research nonprofit credit counseling (NFCC.org) or free legal aid bankruptcy assistance in your area.

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