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Should you tackle your small or large debts first?

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Consumers routinely mismanage multiple debts, paying off small debts first even when larger debts have higher interest rates, study finds

When it comes to tackling debt, logic isn't always at the forefront of our decision-making. According to a new research study [http://webuser.bus.umich.edu/srick/winning%20the%20battle.pdf], consumers routinely mismanage multiple debts, paying off small debts first even when larger debts have higher interest rates.

"People want to wipe the books clean," says Scott Rick Scott of the University of Michigan. "If there's something small that can be eliminated that can be tempting, even if the larger debt is more expensive."

Mr. Rick and his colleagues devised a series of studies to track how consumers approach debt in a simulated environment. Their results showed that those facing numerous debts focus on reducing the total number of outstanding loans rather than on the total debt. This approach of paying off your smallest debt first, regardless of interest rates, is known as the debt-snowball method.

Advocates of it, like Credit Canada Executive Director Laurie Campbell, say it allows people to feel as if they are achieving some momentum in their debt reduction goals.

"If people have three credit cards, for example, with limits of $5,000, $500 and $300, they could pay off the $500 and $300 first," says Ms. Campbell. "Then if they cut up those cards, the temptation to use multiple cards is gone and it makes them feel that they're making headway."

Although Mr. Rick acknowledges the psychological benefit of the snowball strategy, his study shows that this approach can leave you saddled with debt for much longer. "There are more obscure attributes with debt, like interest rates, that make it the wrong thing to do in some cases," he says, referring to how even a slight rise in interest rates can make it much more expensive to make debt payments.

Debt levels have soared to a record high in recent years and although Canadians appear to be reining in their borrowing [http://www.theglobeandmail.com/globe-investor/personal-finance/mortgages/canadians-rein-in-debts-amid-uncertainty/article2253438] - with growth in personal loans, lines of credit and credit cards levelling off [http://www.theglobeandmail.com/globe-investor/personal-finance/home-cents/canadian-consumer-debt-loads-stabilize/article2255194] in recent months - policy makers are concerned about what will happen when interest rates inevitably rise.

One approach for Canadians who have multiple debts is to consolidate and remove the burden of prioritizing which debt to pay down first.

Banks and credit card companies could also make a few changes to help Canadians manage their debt more effectively, Mr. Rick says. They could notify consumers, in full view, of the total interest accrued over time. In his study, participants who were shown how much interest had accumulated over the course of the game (via pop-up window) had a lower total debt at the end of the game.

"That speaks to how credit card statements could be made more effective," Mr. Rick says.

Ms. Campbell agrees that creditors could do more. "The best thing creditors could do would be to show the interest cost over time - not just that month - if you only make the minimum payment," she says. "Somewhere visible in big red numbers, not buried in fine print on the last page."

But both Mr. Rick and Ms. Campbell agree that because creditors make money from interest payments, their first priority isn't to help clients wipe out their debts, which leaves the burden squarely on the shoulders of consumers.