What is Debt Trap? How to Avoid It?

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5 Ways to Avoid Debt Trap

Don’t Fall Into a Debt Trap. Here’s How.

Taking out loans for different purposes is a good way to build a favorable credit score. They stretch over for a long period with monthly installments to help with immediate needs. The most common loans people take; include education, home, car, and personal loans.

However, life can be uncertain, and one is forced to face unexpected problems from time to time. As a result, repaying multiple loans at a time becomes impossible if the person loses their job or faces other challenges. Hence, the person is likely to fall into a debt trap.

What is Debt Trap?

When a person has taken multiple loans and is unable to pay them, taking out another loan to repay the previous ones is known as a debt trap. In a way, the person’s capacity to repay their loans changes due to unforeseen events. Therefore, they feel trapped in a situation where taking out another loan seems like a better idea.

A debt trap situation occurs when the person’s income becomes inadequate to repay the loans they have taken. Moreover, not repaying monthly installments on time causes the interest to accumulate over time due to late payment penalties. Hence, the borrower’s overall debt keeps on increasing.

It is important to note that a debt trap happens unexpectedly. It could result from a sudden health issue, losing a source of income, unemployment, overusing credit cards, and other reasons. However, a debt trap causes a huge dent in the credit score and leads to psychological stress.

Causes of Debt Trap

As mentioned earlier, a debt trap can happen unexpectedly or due to mismanagement of finances. You should never take out multiple loans if you don’t have the necessary income to repay them. Some of the common causes of debt traps include the following:

- Low income or loss of income
- Total monthly installments exceeding 50% of income
- Inability to accumulate savings
- Financial or related emergencies
- Expenses more than 60% of income
- Exceeding credit card limits
- Trying to maintain an expensive lifestyle
- Unexpected medical or health emergencies
- Improper or poor budgeting

How to Avoid Debt Trap?

Having excess debt can be stressful and can negatively affect mental health. Therefore, it becomes important to know how to avoid falling into a debt trap. The following advice will help you to manage your debts and secure your financial needs in the future. The primary advice will always be to avoid taking on multiple loans you cannot repay.

Making monthly payments on time is also important to avoid higher interest on pending EMIs. Here are a few other tips to help avoid being in a debt trap:

1. Prepare and Follow a Budget

Becoming responsible with money becomes an important task when it comes to managing debts. You cannot overspend on things that you do not need if you have important bills to pay. Hence, preparing a budget helps to develop a habit of becoming wise with money.

The budget will help you to track various expenditures and let you know how the money is being spent. Setting a threshold for these expenses will help you to be mindful of not spending more on them unless deemed necessary. Therefore, following a set budget will help in efficient money management.

2. Debt Management

Once you’ve prepared a sound budget plan, it is time to manage your existing debt. The best way to do so is by prioritizing the different debts according to the amount of EMI and interest rate. Therefore, higher-interest loans and EMIs will be ranked first. Subsequently, it will be followed by other EMIs based on their amount.

While doing so, do not forget to check if a certain loan invites a penalty for failing to pay them timely. Once you’ve prioritized your debts, ensure to pay them on or before their due dates.

3. Overall Debt Servicing

As a good rule, always ensure that your overall debts and their EMIs do not exceed 30-40% of your monthly net income. It will help you stay safe and prevent default in payments. The percentage can increase to 40-50% if you have taken big loans such as a home loan.

Here, net income does not refer to your cash in hand. It is the amount of money left after deducting provident funds, income taxes, and other outgoing charges. Calculating the percentage will help you to understand whether you’re taking loans you cannot repay.

4. Create an Emergency Fund

An emergency fund helps to prepare for unforeseen events such as accidents, medical emergencies, and job loss. Ensure that your emergency fund has at least three months’ salary equivalent. Having such an amount becomes important when dealing with any kind of emergency.

As a result, an emergency fund helps to ensure that your EMIs are paid on time, even if you lose your job. Therefore, you can circumvent any temporary crisis and prevent falling into a debt trap.

5. Debt Consolidation

Keeping track of different loans with different interests and EMIs can be stressful. The best way to manage their payments is by taking a loan to service all the other loans. It is known as debt consolidation, and it helps to repay other loans effectively. Hence, all your debt obligations are put under one roof.

The best reason to go for debt consolidation is that you can tackle higher-interest loan repayments in exchange for a lower interest. Hence, the burden of paying your EMIs reduces to a great degree. Moreover, you can set auto payments with your bank, so you won’t have to worry about missing any deadlines.

Conclusion

To summarize, falling into a debt trap harms your credit score and future finances. Managing your debts and money effectively becomes instrumental in protecting yourself from such a fate. Never try to take loans that you cannot repay. It will affect your credit score, resulting in higher interest or rejections of future loan applications. Therefore, pay your EMIs on time, start saving immediately and don’t go overboard with your spending habits.

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