Overburdened by holiday debt? Pay down loans with highest interest rates first

January 4 2012, By Neil Schoenherr

(PhysOrg.com) -- The presents have been opened. The tree has been put away. Now come the bills. What is the best way to tackle holiday debt? Pay down the loan with the highest interest rate first.

But consumers often take a slightly different approach, according to a consumer behavior expert at Olin Business School at Washington University in St. Louis.

“Our research finds that people really like closing accounts,” says Cynthia Cryder, PhD, assistant professor of marketing. “They will close a small debt account with a low interest rate at the expense of paying down a larger loan with a higher interest rate.”

Cryder, along with co-authors Shahar Ayal, Moty Amar and Dan Ariely of Duke University and Scott Rick of the University of Michigan, designed several studies to examine how consumers manage debt portfolios.

The article describing this research, titled “Winning the Battle But Losing the War: The Psychology of Debt Management” is forthcoming in the *Journal of Marketing Research*.

Drawing on prior work about the psychology of decisions and goal pursuit, the researchers hypothesized that consumers saddled with multiple debts will primarily be motivated to reduce their total number of outstanding loans, rather than to reduce their total debt across loans, a phenomenon they refer to as debt account aversion.

Throughout a series of debt-management experiments, the researchers found that participants consistently paid off small debts first, even though the larger debts in the study had higher interest rates. In fact, no participant in their sample consistently used their cash to pay off the loan with the highest interest rate.

Because small losses impose a disproportionately heavy psychological burden, the authors argue, eliminating a small debt may offer greater relief than making an equivalent reduction to a larger debt.

Still, “while it is attractive to close an account, that’s not necessarily the best approach to minimizing your debt burden,” Cryder says.

The researchers found a few strategies that help encourage optimal debt management decisions. Debt consolidation schemes that combine several small debt pools into fewer larger ones eliminate tempting small accounts and encourage people to focus on interest rates.

Also, explicitly focusing people’s attention on the actual dollars spent on interest payments encouraged people to prioritize interest rates, and helped them reduce overall debt more quickly.

To optimally reduce overall debt, Cryder says, always put extra money toward loans with high interest rates. When behavior is debt account-averse, consumers are winning the battle, but ultimately losing the war against debt repayment.

Provided by Washington University in St. Louis

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