Chapter 1

The Basics of Managing Too Much Debt

In This Chapter

- Figuring out where you stand financially
- Knowing what to do when you owe too much
- Dealing with debt collectors
- Handling your most important debts
- Building your financial future

Going into debt is as American as Mom's apple pie and fireworks on the Fourth of July. It's the American way! Unfortunately, if it's also *your* way, you may be so deep in debt that you live paycheck to paycheck, using credit cards and home equity loans to make ends meet and pay for unexpected expenses. Maybe you despair of ever being able to buy a home, have a comfortable retirement, or take a vacation with your kids. (Are we hitting a nerve?) You've probably just about given up on the American Dream.

Many creditors claim that consumers owe too much because they're irresponsible spenders, but recent studies tell a different story. For example, a 2006 study based on information from the Federal Reserve Board reveals that U.S. wages have been flat (after adjustments for inflation) since 2001, while the costs of such basics as housing, medical care, food, and other household essentials have increased. In other words, not all U.S. consumers are in debt because they're spendthrifts; instead, we've all taken a national pay cut.

Okay, so consumers at all income levels are being stretched to their limits — including you, which is undoubtedly why you picked up this book. But chances are that you haven't yet taken decisive action to improve your financial situation. Maybe you haven't even acknowledged the state of your finances, much less changed your lifestyle and become more careful about your spending. Even if you're well aware that you're in financial jeopardy, chances are you don't know what to do about your situation. You may be frozen by fear and confusion.

If you're trying to keep up with your financial obligations but you feel like poor Sisyphus, struggling to keep the boulder he's pushing uphill from rolling over him, you're in the right chapter. Starting here, we give you the information you need to take control of your finances and turn them around.

Taking Stock of Your Finances

You need a clear idea of the current state of your finances in order to figure out the best way to deal with your debts. Here's how you can begin to take stock of your finances (a topic we discuss in detail in Chapter 2):

- **Compare your monthly spending to your monthly income.** Prepare yourself for a shock. Most people underestimate the amount that they actually spend relative to what they earn. By doing this comparison, you may quickly realize that you're using credit to finance a lifestyle you can't afford, and you're spending your way to the poorhouse. If that's the case, you must reduce your spending to meet your financial obligations, and you may need to do a lot more than that depending on the seriousness of your financial situation.
- **Order copies of your credit histories from the three national credit-reporting agencies: Equifax, Experian, and TransUnion.** We provide the contact information in Chapter 2. Your credit history is a warts-and-all portrait of how you manage your money: to whom you owe money, how much you owe, whether you pay your debts on time, whether you are over your credit limits, and so on. Being charged higher interest rates on credit cards and loans is a direct consequence of having a lot of negative information in your credit history.
- **Find out your FICO score.** Your FICO score, which is derived from your credit history information, is another measure of your financial health. These days, many creditors make decisions about you based on this score rather than on the actual information in your credit history. See Chapter 2 for instructions on ordering this score.

We understand that things beyond your control — like bad luck and rising prices — may be partly to blame for your debt. We also know that chances are you're at least partly responsible as well. For example, you may

- Pay too little attention to your finances. You forget to pay your bills on time; you don't pay attention to the balance in your checking account so you bounce checks a lot; and/or you have a lot of credit accounts.
- Maintain high balances on your credit cards. As a consequence, you can afford to pay only the minimum due on the cards, you pay a lot in interest on your credit card debts, and all that debt has lowered your FICO score.
- Have little (or nothing) in savings so you have to use credit to pay for every unexpected expense.
- Mismanage your finances because you don't know how to manage them correctly.

The National Foundation for Credit Counseling surveyed its member credit counseling agencies in early 2006 to determine the key reasons consumers were filing for bankruptcy. The survey showed that 41 percent of consumers blamed their bankruptcy on poor money management skills; 34 percent attributed it to lost income; and 14 percent cited an increase in medical costs.

If compulsive spending is the cause of your financial problems, get help from an organization like Debtors Anonymous (`www.debtorsanonymous.org`) or from a mental health therapist. Compulsive spending is an addiction just like alcoholism, and you can't beat it on your own. You'll always have debt problems if you can't control your spending.

Using a Budget to Get Out of Debt

After you assess the seriousness of your financial situation, you need to prepare a plan for handling your debt, including keeping up with your creditor payments — or at least keeping up with payments to your most important creditors. One of the first things you should do is prepare a household budget (or *spending plan*, as some financial experts euphemistically call it). Whether your annual household income is $20,000 or $100,000, living on a budget is probably the single most important thing you can do to get out of debt and to avoid debt problems down the road.

A *budget* is nothing more than a written plan for how you intend to spend your money each month. It helps you

- Make sure that your limited dollars go toward paying your most important debts and expenses first.
- Avoid spending more than you make.

- Pay off your debts as quickly as you can.
- Build up your savings.
- Achieve your financial goals.

In Chapter 4, we walk you through the budget-building process from start to finish.

Reducing your spending and making more money often go hand in hand with creating a budget. We provide lots of practical suggestions for doing both in Chapter 5.

TIP

Getting out of debt usually requires that you change your spending habits. Because those changes may affect everyone in your family, if you have children (especially preteens or teens), you and your spouse or partner should invite them to help you create your household budget. They can suggest expenses to cut and things they can do to improve your family's financial situation. By involving them, your kids will be less apt to resent the effects of budget cuts on their lives. Also, you'll be giving your kids the education they need to become responsible money managers as adults.

Taking the Right Steps When You Have Too Much Debt

If you don't owe a ton of money to your creditors, living on a budget may be all that it takes for you to whittle down your debts and hold on to your assets. If you owe a lot, living on a budget is only the first step in the get-out-of-debt process. You may also need to do some or all of the following:

- **Cut deals with your creditors.** Ask your creditors to help you keep up with your debts by lowering your monthly payments on a temporary or permanent basis, reducing the interest rate on your debts, or letting you make interest-only payments for a limited period of time. Before you approach any of your creditors, you've got homework to do. For example, you need to
  - Create a list of all your debts and the relevant information pertaining to each debt. In Chapter 6, we explain the specific information to include on your list.
  - Review your budget to figure out how much you can afford to pay on your debts every month, starting with the ones that are the most important. Don't allow a creditor to pressure you into agreeing to pay more than you think you can afford.

Whenever you talk with a creditor, explain why you're calling and exactly what you're asking for. If the first person you speak with says *no* to your request, politely end the conversation and ask to speak with a manager or supervisor.

- **Borrow money to pay off debt.** When you get new debt in order to pay off existing debt, the process is called *consolidating debt.* We realize that going into debt to get out of debt may not sound sensible, but if it's done right, it can be a smart debt-management strategy. To do it right, however, all the following should apply when you consolidate:

  - The interest rate on the new debt is lower than the rates on the debts you pay off.
  - The monthly amount of the new debt is lower than the combined monthly total for all the debts you consolidate.
  - The new debt has a fixed interest rate.
  - You commit to not using credit again until you've paid off the new debt.

  In Chapter 7, we explain the various ways to consolidate debt, including transferring credit card debt to a lower rate card and getting a bank loan. We also discuss debt consolidation offers that will do you more harm than good.

- **Get help from a credit counseling agency.** The advice and assistance of a credit counseling agency can be a godsend when you have a lot of debt and are struggling to take control of it. This kind of agency can especially help when you are confused about what to do or lack confidence about your ability to improve your finances on your own. As you find out in Chapter 8, a credit counseling agency can

  - Help you set up a household budget.
  - Evaluate a budget you have already created to suggest changes that will help you get out of debt faster, avoid the loss of assets, and so on.
  - Negotiate lower payments with your creditors and put you into a debt management plan.
  - Improve your money management skills.

  Not all credit counseling agencies are on the up and up, so take time to choose one that is reputable. First and foremost, that means working with a nonprofit, tax-exempt agency that charges you little or nothing for its services. In Chapter 8, we offer a complete rundown of all the criteria to consider when you are choosing a credit counseling agency.

  Also in Chapter 8, we warn you against mistaking a debt settlement firm for a credit counseling agency. If you're not careful, it can be an easy mistake to make because some debt settlement firms try to appear as though they are credit counseling agencies. However, there are big differences between the two. The goal of debt settlement firms is to profit off of financially stressed consumers — not help them improve their finances. They charge a lot for their services, and many of them don't deliver on their promises. Consumers who work with debt settlement firms often end up in worse financial shape than they were before.

- **File for bankruptcy.** When you owe too much relative to your income, your best option sometimes is to file for bankruptcy, especially if you're concerned that one of your creditors is about to take an asset that you own and don't want to lose. You can file a *Chapter 7 liquidation bankruptcy,* which wipes out most but not all of your debts, or a *Chapter 13 reorganization bankruptcy,* which gives you three to five years to pay what you owe and may also reduce the amounts of some of your debts. Throughout this book, we explain how bankruptcy can help you deal with various types of debts.

Handling Debt Collectors

Being contacted by debt collectors can be unnerving, especially if they try to pressure you into paying more than you think you can afford by calling you constantly, threatening you, and using other abusive tactics. Some debt collectors can be so difficult to deal with that you may promise them just about anything to make them leave you alone.

Realizing your rights

Debt collectors don't like taking *no* for an answer. Most of them are paid according to how much they collect, and they know from experience that pushiness pays off. They also know that most consumers are unaware of the federal Fair Debt Collection Practices Act (FDCPA), which gives them rights when debt collectors contact them and restricts what debt collectors can do to collect money. For example, the FDCPA says that you have the right to

- Ask a debt collector for written proof that you owe the debt he's trying to collect from you. The debt collector is obligated to comply with your request.
- Dispute a debt if you do not think that you owe it or if you disagree with the amount. You must put your dispute in writing and send it to the debt collector within 30 days of being contacted by the debt collector for the first time.

- Write a letter to a debt collector telling him not to contact you again about a particular debt. After the debt collector receives your letter, he cannot communicate with you again except to let you know that he'll comply with your request or to inform you of a specific action he's about to take in order to collect the money you owe.

The FDCPA also says that a debt collector cannot

- Call you before 8 a.m. or after 9 p.m. unless you indicate that it's okay.
- Contact you at work if you tell the collector that your employer doesn't want you to be called there.
- Call you constantly during a single day or call you day after day. That's harassment!
- Use profane or insulting language when talking to you.
- Threaten you with consequences that are not legal or that the debt collector has no intention of acting on.

Many states have their own debt collection laws. Sometimes those laws provide consumers with more protections from debt collectors than the federal law. Contact your state attorney general's office to find out if your state has such a law.

If a debt collector violates the law, get in contact with a consumer law attorney right away. The attorney will advise you of the actions you may want to take.

We're not suggesting that you should never deal with a debt collector. If you agree that you owe a debt, and if your finances allow, you may want to work out a plan with the debt collector for paying your debt over time, or the debt collector may agree to let you settle your debt for less than the full amount you owe.

Understanding why debt collectors behave like they do

The adage *know thy enemy* certainly applies to debt collectors. Understanding why debt collectors behave like they do helps take some of their power away and empowers you in return.

One of the main reasons debt collectors are so darn persistent (and can be quite aggressive at times) is money. Most of them are paid according to the amount of money they collect: The more they collect, the more they earn; if they collect nothing on your debt, they get nothing. Other debt collectors actually purchase your bad debt from the creditor you originally owed the money to. These collectors need to recoup the investment they've made by purchasing your past-due debt.

A second explanation for the behavior of debt collectors is one we address in the previous section: They know that most consumers don't have a clue about their legal rights related to debt collection. Debt collectors are more than willing to push the legal envelope because experience shows that a lot of consumers will pay at least a portion of what they owe if collectors harass them enough and scare them into submission.

There is a third reason for pushy collection practices as well: If the debt collector's phone calls and letters don't get you to pay your past-due debt, he has to invest additional time and money to take further action. This situation applies specifically to the collection of *unsecured* debts, like credit card debts or unpaid medical bills. When you acquire an unsecured debt, you don't have to give the creditor a *lien* on one of the assets you own (which would give the creditor an automatic right to take the asset if you didn't pay your debt). If you can't or don't pay a past-due unsecured debt, the debt collector has to sue you for the money, which costs him time and money. Then if the debt collector wins the lawsuit, he has to try to collect the money you owe by doing one of the following:

- Seizing one of your assets (assuming you have an asset that the debt collector can take)
- Having your wages garnished (if your state allows wage garnishment)
- Placing a lien on one of your assets so you can't sell it or borrow against it without paying the debt first

All three options cost the debt collector more time and money. If your debt is small, the debt collector may decide it's just not worth the effort to sue you; his time is better spent going after other consumers with debts that he thinks will be easier to collect. The same is true if you are *judgment proof,* meaning that you don't have any assets the debt collector can take or put a lien on, you are unemployed, or your state doesn't permit wage garnishment.

Paying Special Attention to High-Stake Debts

Some debts deserve special attention because the consequences of falling behind on them are especially serious. For example, depending on the type of debt, you may risk losing an important asset, being evicted, having your income tax refunds taken (or intercepted), and maybe even serving jail time. In later chapters, we give you detailed guidance regarding how to handle debts such as the following:

- A mortgage (see Chapter 10)
- A car loan (see Chapter 11)
- Rent or utility bills (see Chapter 12)
- Medical bills and court-ordered child support obligation (see Chapter 13)
- Federal income taxes (see Chapter 14)
- Federal student loans (see Chapter 15)

Talk with a consumer law attorney as soon as you become concerned about your ability to keep up with payments on a high-stake debt. The attorney can help you figure out a way to avoid a default. If you're already in arrears and being threatened with a foreclosure, repossession, lawsuit, or some other serious legal action, run — don't walk — to the attorney's office.

Getting a Financial Education

What would you do if you had no debt? Would you buy a new house? Take a great vacation? Boost your retirement savings? We've got great news: If you follow the steps we outline in this book, you'll eventually have to answer that question for yourself because your debt will disappear and you'll have money to put toward your financial goals. Getting from here to there won't be easy, but you can do it. If you're having trouble getting yourself psyched up for the challenge, take a look at Chapter 3.

To make sure you succeed, we encourage you not only to deal with your debt head-on but also to become the smartest money manager you can be. After all, when you get to the other side of your debt problems, you never want to return.

In the sections that follow, we give your financial education a quick jump-start. To get more details, see Chapters 16 and 17.

Good debt, bad debt: What's the difference?

Considering that you have serious problems with debt, you may be surprised to hear this: We eventually want you to use credit cards and get loans again. Why on earth would we steer you back into debt when getting out of it is such hard work? Because owing money to creditors is not necessarily a bad thing.

Whether debt is good or bad depends on why you took on the debt in the first place and how you manage it — whether you make your payments on time, for example. It also depends on how much debt you have relative to your income because too much debt, even if you're able to keep up with your payments, harms your credit history and brings down your credit score (see Chapter 2).

Why debt can be a good thing

Going into debt can be a good thing in many circumstances. For example, you could go to your grave trying to save up enough money to purchase a home, so a mortgage is a wonderful thing — especially if the value of your home grows over time. Also, a home equity loan is a good financial tool when you use it to improve or maintain your home (again, with the goal of increasing its value).

A car loan is another example of good debt because most of us need a vehicle to get to and from work, and most of us can't afford to purchase a car for cash. Debt is also good when it helps you build your wealth; for example, you borrow money to purchase your home or rental property. Some debt helps you save money in the long run, like getting a loan to make your home more energy efficient so you can reduce your energy bills.

When debt isn't so good

Debt is detrimental to your finances when you run up your credit card balances in order to live beyond your means or to purchase goods and services that don't have any lasting value for you or your family. For example, restaurant meals, happy hour drinks, clothing, jewelry, and body care services don't have any lasting value, but they sure can run up your credit card balances.

Debt is also a negative thing when you have so much that you can't afford to repay it (especially when your home is at risk), when the amount you owe lowers your credit score, or when you borrow money from shady operators (like finance companies or payday loan companies) who charge high interest rates.

Distinguishing between types of credit

You may think that all credit is created equal. Lots of people think so, which is one of many reasons they run into debt problems. In this section, we brief you about various types of credit. They definitely aren't created equal, and you should get familiar with these terms so you can become a better credit consumer.

Here are the types of credit you should be familiar with:

- **Secured:** With this kind of credit, the creditor guarantees that it will be paid back by putting a *lien* on an asset you own. The lien entitles the creditor to take the asset if you don't live up to the terms of your credit agreement. Car loans, mortgages, and home equity loans are common types of secured credit.
- **Unsecured:** When your credit is unsecured, you simply give your word to the creditor that you will repay what you borrow. Credit card, medical, and utilities bills are all examples of unsecured credit.
- **Revolving:** If your credit is revolving, the creditor has approved you for a set amount — your *credit limit* — and you can access the credit whenever you want and as often as you want. In return, you must pay the creditor at least a minimum amount on your account's outstanding balance each month. Credit cards and home equity lines of credit are examples of revolving credit.
- **Installment:** With installment credit, you borrow a certain amount of money for a set period of time and you repay the money by making a series of fixed or installment payments. Examples of installment credit include mortgages, car loans, and student loans.

We give you the complete credit rundown (not runaround!) in Chapter 16.

Seeing yourself through a creditor's eyes

To be a savvy consumer, you also need to know the criteria that creditors use to evaluate you when you apply for new or additional credit. Although creditors may take other factors into account, following are the three biggies:

- **Your character:** Does your credit history show that you've got a history of repaying your debts?
- **Your financial capacity:** Can you afford to repay the money you want to borrow?
- **Your collateral:** If you have a poor credit history, or if you are asking to borrow a lot of money, creditors want to know whether you have assets that you can use to secure your debt or guarantee payment on it.

These criteria not only determine whether a creditor will approve or deny credit; they also impact how much credit you're given, what your interest rate is, and what other terms of credit apply. See Chapter 16 for details.

Building a better credit history

Right now, when you're smothered by debt, you may not be able to think about improving your credit history — you've got too many other immediate concerns. But tuck this topic into the back of your mind because when you've had money troubles, rebuilding your credit history should be one of your first goals. Having a positive credit history is essential to getting new credit with attractive terms. (And as we explain in the section "Good debt, bad debt: What's the difference?", you do want to have access to credit again down the road.)

The credit rebuilding process, which we walk you through in Chapter 16, is quite simple: You get small amounts of new credit and repay the debt on time. For example, you get a MasterCard or Visa card, use it to purchase some goods or services you need, and pay off your card balance according to your agreement with the card issuer. You should also borrow a small amount of money from a bank and pay off the loan according to the terms of your agreement with the lender.

As you do these things, you add new positive information to your credit history. Meanwhile, the negative information in your credit history gradually begins to disappear because, with a few exceptions, most damaging credit record information can be reported for only seven years and six months. As time passes, your credit history will gradually contain more positive than negative information, assuming that you manage your finances responsibly.

Why is rebuilding your credit history so crucial? First, if you have a negative credit report, you won't qualify for a credit card with a low interest rate, and you'll have trouble borrowing a significant amount of money from a bank. Here are some other potential consequences of a negative credit history:

- Potential employers who review your credit record as part of the job application process may not hire you. You could also be denied a promotion with your current employer if it checks your credit report as part of the process.
- Life insurance companies may penalize you by charging you a higher premium or not selling you as much insurance as you would like.

- Landlords may not want to rent to you.
- You may not be able to get a security clearance or certain types of professional licenses.

WARNING!

Avoid companies that promise to rebuild your credit or promise to *presto chango* make all the negatives in your credit history disappear. Not only are you wasting your money, but (depending on the tactics a credit repair firm uses) you also may violate federal law if you do what the firm tells you to do. See Chapter 16 for details.

Using other financial management basics

As you know all too well, life is full of twists and turns. You may initiate some of these changes, but others come at you with no warning. Either way, having a good handle on the basics of money management helps you keep your finances on track and cope with the inevitable bumps in the road.

Here are some of the financial basics you should have under your belt (see Chapter 16 for details):

- **Setting and achieving your financial goals.** The problem: There's a gap between what you'd like to achieve with your money and the actual money you've got available. The solution: Set (and work methodically toward) financial goals.

  Goal setting involves deciding what you want to do with your money, setting realistic time frames for achieving each goal, and deciding how you'll accomplish them. You may decide to work toward achieving several goals at the same time, or you may focus all your efforts on attaining one very important and relatively costly goal, like owning your own home.
- **Building a financial safety net.** As you start your financial recovery, one of your first goals should be growing the balance in your savings account. Having money in savings means that you can pay cash instead of going into debt for expenses such as car repairs and home maintenance. The money in your savings account can also help you weather a job loss. Financial experts advise that you stash away a minimum of 10 percent of your take-home pay every month.
- **Using a budget.** Even as your finances improve, don't throw away your budget! As we explain in Chapter 4, there is no better money management tool than a budget. Even if you're so successful at conquering your debt that you end up with

lots of disposable income, we want you to continue to use a budget to plan your spending and monitor what you actually do with your money each month.

You're far more likely to achieve the financial goals you set for yourself if you build them into your budget than if you just wing it.

- **Being a responsible money manager.** As your finances improve, don't get sloppy about the way you manage your money. If you do, you could end up right back where you are today as you're reading these words. Avoid backsliding by setting financial goals, having enough money in savings, and living on a budget. Also, make these truisms part of your daily life:
  - Whenever possible, pay with cash, not credit.
  - Pay your bills on time.
  - Don't run up your credit card balances.
  - Don't treat your home equity like it's a piggy bank.
- **Becoming a lifelong money learner.** The financial management guidance we provide in this book is really only the tip of the iceberg. There is a lot more to uncover, and fortunately, you've got access to countless resources for additional education — books, magazines, newspapers, the Web, classes at your local college, and so on. For a sampling of the possibilities, see Chapter 18.

  Being smart with your money requires a lifelong commitment because the laws that pertain to credit and debt change over time, as do laws that apply to other aspects of money management, such as taxes and investments. Also, as you age, you'll have different financial needs and a different relationship with your money. For example, even if you aren't thinking about retirement today, we promise you will someday!
- **Relying on professional advice and assistance.** No matter how much you learn about money management, you're never going to know as much as financial professionals like CPAs, financial planners, insurance agents and brokers, and estate-planning attorneys. At times, you're going to need the advice and assistance these pros can give. For example, they can help you avoid paying too much in taxes, get your retirement planning on track, save for your child's college education, purchase the appropriate types and amounts of insurance, avoid costly money mistakes, and tackle estate planning (Your *estate* is simply all the assets you own, regardless of their value.)

  In Chapter 17, we explain how each type of financial pro can help you, and we highlight various resources you can use to identify the specific advisors you need on your financial team.