

S T E P **1**

UNDERSTANDING DEBT AND CREDIT

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CHAPTER 1

What Is Debt?

My problem lies in reconciling my gross habits with my net income.
—Errol Flynn

D*ebt* . . . talk about a dirty four-letter word. Unfortunately, though, in our current culture, debt has become an all too common way of life. Merriam-Webster defines *debt* as “something owed.” Yet today, I believe that the current use of debt greatly transcends this definition. Just look at our economy. The Federal Reserve reports consumer debt has reached nearly \$14 trillion¹ (yeah—that’s a *t*). That’s a lot of “something owed.”

Consider my definition of debt:

Debt is the commitment of future, non-guaranteed, yet-to-be-earned income for past or present purchases.

Our society has taken debt and given it a complete face-lift. Debt isn’t just something you owe; it has become a staple in our culture. And it’s a staple that carries with it a financially dangerous assumption. You’re hoping that those future dollars will be there to make the necessary payments. The creditor knows these dollars aren’t guaranteed, which is why interest is being charged. And the

amount of interest being charged is a reflection of the creditor's faith in the borrower. The lower the interest charged by the creditor, the higher the faith in the borrower—and vice versa.

Good Debt/Bad Debt?

There are those who try to teach that there are two kinds of debt. *They teach that there's good debt and there's bad debt.* A mortgage is considered by some to be good debt. Credit card debt, in contrast, is considered to be bad debt. The argument is that since a mortgage is paying for what should be an appreciating commodity (real estate), it should be considered good debt. Conversely, credit card debt usually carries higher interest rates and is used to purchase items that will most likely depreciate in value; that's why it's considered bad debt.

I remember a while ago being interviewed by a journalist who asked me about the good debt/bad debt thing. I just laughed and told her there is no such thing as good debt.

It's never a good thing to commit future, non-guaranteed, yet-to-be-earned dollars for past purchases. Of course I understand that not many people can open up their checkbooks and write a check to cover the cost of a car or a house. No, that's just plainly unrealistic. But *good debt*? Bah!

However, there is something I refer to as *necessary* debt. Necessary debt is what you need when you can't pay cash for that house or car. And instead of renting a home or an apartment, or buying a used car that you may be able to pay cash for, you choose to utilize necessary debt in order to acquire your own house or a brand-new car. So-called necessary debt is something that—for the most part—*could* be avoided. But most people choose not to avoid it because they'd rather have what they want *now*.

Debt has gone *way* beyond "Hey, can you lend me 20 bucks?" to a point where we, as a nation, owe trillions of dollars of future, yet-to-be-earned income for stuff we've purchased in the past. When it comes to a mortgage or car loan, it stands to reason that debt can be necessary. But when you understand what's happening with credit card debt today, *insanity* is too kind a term. According to the Federal Reserve, our nation's current total credit card debt

is nearly \$900 billion² (that's almost \$1 trillion in revolving credit card debt!).

Think about this for a second. Have you ever looked at the balance on your credit card statement and asked yourself, "What the heck did I buy that totals this amount?" Maybe you can remember a few things, but as you reflect on your current balance owed, you're scratching your head wondering what list of stuff was worth this amount. To make matters worse, you see how much you're getting charged in interest for all of this stuff, and it's all you can do to keep from breaking down in tears (we'll get into the interest part in a little bit). This is what I call the "credit hangover," which is commonly experienced by millions of people in the months of January and February after the spending frenzy that took place during the preceding holiday season.

But let's get back to the point of understanding debt. There are many—and I do mean *many*—kinds of debt, like normal first or second mortgages, car loans, home equity lines of credit (HELOCs), adjustable-rate mortgages (ARMs), simple interest or installment debt, revolving debt, and the list goes on. Regardless of the new types of loans that may be advertised, each can typically be placed in either of two categories—secured or unsecured debt.

What are Secured Debt and Unsecured Debt?

Secured debt is debt that is backed by some kind of collateral. Most people understand secured debt as a home or car loan where the loan itself carries a lien against the property that the proceeds from the loan purchased. But in the case of a second mortgage where the proceeds from the loan are used to pay off unsecured credit card debt, your home is now the security or collateral against that loan.

Other forms of property, like certificates of deposit (CDs) and even jewelry, can be used to collateralize a loan. Secured loans typically carry lower interest rates because the institution issuing the loan recognizes this type of loan as less risky. The "less risky" designation comes from the fact that if payments toward the loan aren't made as agreed, then the institution that funded the loan can lay claim to the property that collateralized it. The lender knows that typically the borrower will make every effort to make the necessary payments to

avoid surrendering the property. This is why secured loans can carry a “less risky” label. If a loan is collateralized (secured), then the other components of your financial snapshot (such as your credit report and the resulting credit score) can determine the actual interest rate on the loan.

Conversely, *unsecured debt* is debt that has no collateral (security) for the institution to place a lien against. As such, it is considered a higher risk, and as a result the interest rates charged for these types of loans are also higher. This is the category that just about every credit card falls into.

But perhaps the most striking difference between the two categories of debt isn’t whether it’s secured, but how the interest is calculated. Usually, interest on a secured debt is calculated as *simple interest*, whereas interest on an unsecured debt like a credit card is calculated as *compound interest*. Simple interest loans calculate interest on the original principal only; compound interest calculates interest on the original principal *plus* any accumulated interest from previous periods.

While the math for both can be sophisticated, the math for simple interest loans is a bit, well, simpler. Let’s take a car loan for example (maybe you remember this experience). You decide on a car and a price; now all you have to do is determine the payment. You walk into the loan officer’s office with the salesperson, who tells you, “Wait here. Jenny, our finance manager, will be right with you to help you figure out the payment plan.”

What needs to be determined is the interest rate you’ll be charged to use tomorrow’s money to drive home in that car today. To cut to the chase, Jenny sees that your credit rating is above average and the finance department’s underwriting guidelines determine the interest rates that are available to you. The interest rate you’ll be charged will depend on your credit history, the amount of money you’re putting down toward the loan (if any), and the length of the loan (typically 36, 48, or 60 months). Once you agree on how much you’re putting down and the term of the loan, Jenny can tell you the payment. And that payment will be consistent throughout the entire term of the loan until the loan has been satisfied.

Let’s say you’re purchasing a new car and using the “cash back” incentive offered by the dealership (since you don’t have \$3,500 to put down on those new wheels). You pick out your new car, which

carries a \$28,500 price tag. After Jenny applies the cash back, she winds up financing \$25,000. Consider the following examples:

Principal amount borrowed	\$25,000
Term of the loan	5 years (60 months)
Interest rate	8%
Monthly payment	\$506.91

The \$506.91 monthly payment will remain consistent each and every month until the 60th and final payment is made even though the principal amount owed declines with each payment. Maybe you've had the opportunity to trade in one vehicle (that you're still making payments on) during the purchase of another, and you had to call the bank to get the current payoff amount for that day for the car you're trading in. Let's say you're trading in a car that you borrowed \$25,000 to purchase. You signed on the dotted line for a five-year loan, and you're trading it in during month 35. When you call the bank for the payoff amount, they'll tell you it's \$11,637.38 (see the amortization table for a \$25,000 car loan in Appendix C). But even though the principal amount remaining is less than half of what it was when you first inked the deal, you're still making a payment equal to the amount of the first month's payment (\$506.91). Payments made on simple interest loans are static.

In contrast, revolving interest or compound interest loans calculate the payment each payment period based on the principal balance remaining at that time. They do this because you're extended a line of credit that you may or may not use completely. For example, if you have a credit card that allows you to borrow up to \$5,000 but you've charged only \$1,500, you can still add to that amount and charge more if you choose. So, each new month also brings with it a new calculation. As a result, the payment on a compound interest type of debt is dynamic.

For instance, let's say you have that \$5,000 available line of credit, but you've charged only \$1,500 and your annual interest rate is 18 percent. This is where compound interest type loans also compound the complexity with which payments are made. Each credit card company calculates its minimum payments a bit differently, but the one thing they all have in common is that they base each

monthly payment on the outstanding balance during that payment period. Typically, the payment is based on a percentage of the current outstanding balance (somewhere between 2 and 4 percent).

Take our \$1,500 balance on a credit card with an 18 percent annual interest rate. That \$1,500 balance is a current balance for the current billing period. Next month it could be higher or lower, depending on the payment you make for the current billing period and whether you use your credit card and add to that balance the next month. Let's say the bank issuing this card determines your monthly payment based on 2.75 percent of the current balance. If you have a \$1,500 balance, your payment for that month would be \$41.25 (2.75 percent \$1,500).

And since compound interest loans (also known as revolving interest loans) have a dynamic payment as well as a potentially dynamic balance, there's no amortization schedule to refer to regarding how much of that payment is applied toward principal and how much is applied toward interest. That's done differently, also on a monthly basis.

To determine how much of your payment is being applied toward principal and interest, first you must take the annual percentage rate you're being charged and divide that by 12 (the number of months in the year). In our example, the card has an 18 percent annual interest rate. Dividing 18 percent by 12 gives us 1.5 percent. The math would look something like this:

Current balance	\$1,500
Annual interest rate ($18\% \div 12$)	1.5%
Current month's interest charges ($1.5\% \times \$1,500$)	\$22.50
Monthly payment ($2.75\% \times \$1,500$)	\$41.25
Total applied toward principal ($\$41.25 - \22.50)	\$18.75

This is a somewhat oversimplified version regarding how credit card (compound or revolving interest) loans work. Here, of the \$41.25 you pay, a little more than 54 percent of your payment is being applied toward interest. The next month, if you haven't charged any more purchases on that card, the remaining balance would be \$1,481.25 ($\$1,500 - \18.75), and the math would start all over with that new balance as the starting point.

In recent years there has been talk about how some credit card companies were issuing monthly statements that stipulated minimum payments that were barely enough to cover that month's interest charges (and in some cases even less than the current month's interest charges). A quick way to determine if you are making payments that exceed interest charges is to compare the percentages we just reviewed. There are two steps:

1. Divide the annual interest rate your card is charging you (in our example $18\% \div 12 = 1.5\%$).
2. Multiply the division answer (1.5 percent in our example) by the current balance and see whether the resulting amount is less than the company is requiring you to pay.

If 1.5 percent of the current balance is less than your minimum payment, then you're covering the interest for that month as well as knocking down some of that principal.

If it is not less, then the difference (the amount of interest you're not covering) will carry over as additional principal on the next month's statement and you'll be charged interest on an increased amount, even if you don't use the card at all. Of course, you can also cross reference your minimum payment with the interest charges for that month on your statement to be sure your payment exceeds interest charges incurred during that period . . . if the appropriate information on your statement is easy to find.

The talk about this slippery little trick being employed by credit card companies has forced consumer advocate groups to clamor for change. And change is supposed to have taken place. *But* I would make sure of the math on my own if I were you. And if your required minimum payment on any card seemingly is less than that month's interest charges, make sure you add more to that minimum payment to protect yourself from an escalating balance. You can visit www.TheDebtFreeMillionaire.com for information on how you can do this if you wish.

Okay. After all that, here's some good news. If you find this brief introduction on debt a bit intimidating and your head is kind of spinning, don't worry. The process behind your Debt-FREE Millionaire Plan is quite a bit less complex. As a matter of fact, it's a whole heck of a lot simpler. You don't have to become an expert

on debt, because as you progress through your personal plan you'll have less and less of it. The only expertise you'll need is how to avoid debt altogether. And that will be a heck of a lot easier when you see how your cash flow will improve all throughout your plan.

What Debt *Really* Is

Now that I've spent some time explaining debt in very basic terms, let's take another look at the definition of debt I proposed in the beginning of this chapter.

Debt is the commitment of future, non-guaranteed, yet-to-be-earned income for past or present purchases.

But what does this truly mean? Consider our earlier \$25,000 car example. Let's say 35 months ago you purchased a fairly loaded Ford Escape and you've kept it in mint condition. According to the Kelley Blue Book, a 2005 mint-condition Ford Escape would have a trade-in value of about \$10,200.³

You've made 35 payments of \$506.91 (a grand total of \$17,741.85) and your return on that investment is \$10,200. No need to work any more math here—that's the kind of investment that sent Freddie Mac and Fannie Mae into a frenzy. You committed future income toward a losing proposition. And if you think a house is a better example, let's take a gander there, too.

Remember Tom and Lisa Fortunado? They borrowed \$205,000 for their home and are making monthly principal and interest payments of \$1,335. Let's say they do what many people do, which is to buy a home and then upgrade to a larger home in seven years (84 months). This would mean they'll make 84 monthly payments of \$1,335, totaling \$112,140. What do you think the balance on their home will be? According to the amortization table in Appendix C, after 84 monthly payments, they'll still owe \$186,222.58 on the home. What this means is that they've invested \$112,140 to lower their balance by \$18,777.42. I don't believe there is any real estate in the country that involves a single family home in an average neighborhood that would appreciate enough to cover this loss.

I could go on and on here and mystify you with more numbers and math. I could illustrate with charts and graphs how accumulating

personal debt will virtually be a guaranteed *loser* as an investment, but I think you get the point. After you consider all of this and recall the Debt Dollar Drain™ I explained in the Introduction, let me offer this easier-to-remember, five-word definition of debt:

Debt is a wealth consumer!

That's it, plain and simple. No matter how you slice it, debt will consume any and all of the wealth you let it. Debt is the difference between *generating* wealth and *accumulating* wealth. The more you continue to commit future income for past purchases *and pay interest on those purchases*, you will be *consuming* your wealth before you've had the chance to earn it, let alone accumulate any of it. I'd like to say that the damage debt causes stops there, but it doesn't. Debt doesn't just severely impact your *future* potential to accumulate any of the wealth you'll generate, which is something you may have a hard time grasping in the present. Debt is also having a severe impact on your *present* lifestyle. Allow me to demonstrate.

The Income Replacement Factor

For me to explain the Income Replacement Factor™ (IRF), let's flash back again to Tom and Lisa Fortunado. Remember, they have an annual household income of \$80,000 and are making total debt payments of \$2,575 each month; that's \$30,900 a year in debt payments made with after-tax dollars. Their income taxes (state and federal) are 31 percent. So how much of their gross income has to be earned, *right now*, just to cover their debt payments every year? This math is similar to the math we used when calculating their Debt Dollar Drain™ impact. It goes like this:

$$\text{IRF} = \frac{\text{Annual Debt Payments}}{1 - \text{Tax Bracket}}$$

In the Fortunados' case,

$$\text{IRF} = \frac{\$30,900}{0.69} = \$44,782.61$$

Here, Tom and Lisa Fortunado's Income Replacement Factor™ is \$44,782.61. What does this mean? Simply that of the \$80,000 in

gross income the Fortunados earn annually, almost \$45,000 goes toward making the minimum payments on their debts, leaving them with only \$35,217.39 for living expenses. Oh . . . wait, we forgot that this \$35,217.39 is *gross* income that's left over; they still have to pay their income taxes (31 percent or \$10,917.39), leaving them with \$24,300 to pay property taxes, put food on the table, pay utilities, and essentially have a life.

Tom and Lisa Fortunado are earning above-average income, but living on less than half of it. Sure, they have the stuff the debt payments allow them to have. But is it really worth it? (The www.TheDebtFreeMillionaire.com web site has information available to help you discover how much of your gross income is being wasted on debt payments.)

One last point here (possibly another Pepto-Bismol moment): Do you think there's a difference in tax brackets between an \$80,000 income and a \$35,217.39 income? You bet there is.

Fuzzy Math

So, not only is debt a wealth consumer, it's also a lifestyle consumer. Maybe you're wondering how in the world you could have been lured into such a financial quandary. Well, it's kind of hard to avoid debt in our culture, especially with the types of ads you're bombarded with each and every day. And not knowing what you're learning here makes it nearly impossible. There are the "buy now, pay later" enticements that hypnotize you into thinking that you're getting whatever it is for free. Or there are those car commercials that flash the new model luxury sedan or new and improved SUV with the "low monthly payment" that gets you thinking, "Hey, I can fit that into my monthly budget!" During a past presidential campaign, the term *fuzzy math* became famous. Well, debt ads have taken fuzzy math to new heights. Let's review a few of them.

The Fine Print

Each day we're bombarded with commercials that insult our intelligence. When I sit down to watch a ball game I'm constantly amazed at just how many times ads for different credit offers keep coming up. Then I have a very scary thought. That thought is that these ads must be working or else these companies wouldn't be spending millions of dollars to run them. *Yikes!* If there's one thing I know about

marketing, it's this: If something isn't working, the plug gets pulled *really* fast. So, the more I see these commercials, the more I realize just how uneducated our populace is.

Take the following car ad:

Zero Percent Financing or \$3,500 Cash Back

Do you know what this means? It simply means that either way the car seller is going to get \$3,500 out of you . . . plain and simple. There's no mysticism here. That's why the seller can make the offer. If you take the \$3,500 cash back (usually applied as a down payment so you don't have to come up with it out of pocket), the seller will get that money back in interest. If you take the zero percent financing, you'll pay the \$3,500 in the price of the car. That's why you never see an ad that says "Zero Percent Financing *and* \$3,500 Cash Back." Just like that old spaghetti sauce ad, when it comes to the profit these companies want to make, "It's in there."

Here's another one:

No Money Down and No Payments for 12 Months

Now this sounds like a really good offer. And sometimes such offers might almost make sense. When they make sense is when you actually pay off the entire balance *before* the 12 months are up. So, if your refrigerator breaks down and you really need a new one and you're short on cash, this kind of offer might actually be acceptable. But the problem is that many people will take the new fridge home, and then wait to start making payments only when they have to.

What that means for most of these offers is that during the initial 12 months you're accumulating interest, so if you don't have the entire purchase paid off within the 12-month time frame, you're going to have to pay retroactive interest. And in these cases, you're going to be paying interest on interest accumulated during the "no payments" time frame. Yeah, I know it seems criminal, but they get away with it because it's in the fine print.

Do you remember ads for so-called smart loans or interest-only mortgages?

You don't see many of these now, because our economy is feeling the results of what these types of mortgages caused. But why did they become so prevalent? How smart were they really? Well, the

lenders were really smart in preying on the financial desperation, and to some degree ignorance, of the people who applied for the loans. You remember these commercials. You can get a \$150,000 mortgage for just \$672 a month! And while they're touting that "new lower payment" they're showing you how a regular mortgage payment would cost you about \$4,500 more a year. What a deal.

The fine print says that you can choose to pay only the interest for the first 10 years. Okay, that bears repeating. *Pay only the interest for the first 10 years!* That's 120 payments that will never be applied toward the principal. That means that for 10 years you'll make about \$80,000 in payments **and never touch the principal balance!**

And they position this as a smart choice?

You should be as insulted by these ads as I am. And they have the nerve to say that one of the misconceptions about interest-only loans is that the homeowner isn't building any equity. Then they go on to say that most homes appreciate 5 to 6 percent per year and that appreciation would build equity. Tell that to Tom and Lisa Fortunado, who paid over \$112,000 in just seven years on a normal mortgage to decrease the principal balance on that mortgage by just under \$19,000. Additionally, if you watch the news, you've heard about the bailout of Wall Street our tax dollars just paid for. Guess what was one of the causes for this crisis: the fact that many homeowners found themselves in a position where they were upside down on their homes! Any idea what might have helped facilitate that?

If you have a TiVo or digital video recorder (DVR) (one of those cable or satellite boxes that records live TV), try this. Next time you see one of these ads, press the pause button when the fine print that you almost need an electron microscope to read is on the screen. Then take the time to actually read all of that copy they give you a nanosecond in real time to read. I did this once and noticed that one of those mortgage ads promoting a 5 percent 30-year fixed-rate loan was available only to people who had a FICO® score of 731 or higher. According to MyFico.com, that's less than half of all consumers nationwide.⁴ If your FICO® score falls short of that mark, it could mean one or possibly two or more points in interest. That can have a significant impact over the term of your loan. Just one point can increase your payment by over \$100 a month. That's

\$1,200 a year. (I'll explain credit, credit reports, and credit scores in the next chapter.)

But if you're an average person, you may not know your credit score before you apply hoping for that low interest rate that was advertised. So, you fill out the application, only to find that you've fallen short of the high score the advertised rate requires. But by then, it can be hard to escape the sales machine your application has entered and a lot of effort will be put forth to try to sell you that new loan. And it can be hard to avoid the temptation if that new loan—even with the higher than advertised interest rate—offers you monthly savings. I explain more of that in Chapter 5.

Now that we've completed the boot camp on debt, let's dive into what I believe to be an even more confusing and misunderstood topic—credit.

