CHAPTER 1

How Did We Get Here? And Where Are We?

We haven't ever been here before. The debt landscape has changed dramatically and irrevocably, and the ways in which we borrowed, spent, and repaid debts before are relics of the past.

The cash-back credit card offers that used to crowd our mailboxes have dried up.

There's no such thing as a ''No down payment? No problem!'' mortgage.

Those tempting teaser rates are long gone, replaced by ''gotcha'' interest costs so high you'd think the Mob was involved.

It's sometimes impossible to borrow money at any price—for college, a car, or a home renovation. And you need to submit a credit card at the front desk before a doctor will even see you now.

It may seem like credit has dried up altogether, just when you need it the most.

What hasn't disappeared is the debt. American consumers are on the hook for close to $3 trillion, not counting their mortgages, according to the Federal Reserve. The average credit card holder is juggling almost $11,000 in debt on close to 13 cards. Roughly one of every three homeowners is underwater, meaning that they owe more on their homes than the homes are worth.

And paybacks are rough. As banks and other lenders began pulling back on credit, they tightened terms and squeezed indebted consumers. Interest rates skyrocketed, and so did minimum monthly payments on everything from credit cards to mortgages.

Middle-class people who were barely making it aren't making it anymore. Those in the worst situations are trapped in houses they can't afford to pay for and are unable to sell. Others are selling homes at bargain-basement prices and downsizing. Or sending their kids to community colleges instead of the private colleges they were aiming for. Or working nights and weekends and skipping lunch to make the payments on their MasterCard and Visa bills.

And yet, all is far from lost. If there were no good news, there would be no reason for this book. I'd just crawl back into bed and call it a day—or a decade.

But there *is* good news. In the first place, the dialing back of debt in the United States was necessary. As a society, we got overextended. Now, there's a renewed feeling of responsibility in the air as banks and consumers ratchet back to a more sustainable and stable way of doing business. The federal government has stepped in, over and over again, to tighten standards of behavior for creditors and to protect the borrowing public. There are more ways to protect your home, your family, and your credit score than there were a year or two ago.

And, as has always happened in U.S. economic history, the marketplace is adapting to the new era with new products and services for consumers. Some of them are shoddy, or worse. But many offer new and innovative ways to manage debt.

That's why we're here. With the right information and the right techniques, you can take charge of your debts, blow them away, and prosper. You can negotiate with your credit card issuer, rework your mortgage, and improve your credit score so you qualify for the lowest-cost, best deals out there.

You can pay off your mortgage years—and thousands of dollars—early. You can still find credit card issuers that pay you back. You can get more cash out of your child's first-choice school that you don't have to pay back.

I will show you how.

But first, it's instructive to see how we got here.

A Long Time Coming

Americans have had a long love affair with debt, but it really rose to prominence in the 1980s and 1990s. The deregulation of financial institutions meant that there were many more lenders competing for borrowers and that they faced fewer rules about their interest rates and practices.

More debt became securitized—bundled up and resold to investors. Mortgage-backed securities were the most common of these arrangements, and they resulted in mortgage-backed mutual funds for investors and a big, steady stream of cash for mortgage lenders. As everything from auto loans to credit cards got securitized, that meant more money coming back to banks and other issuers so they could quickly turn around and lend it to new borrowers. This also served to separate the lenders from the ultimate holders of the debt: Banks that issued mortgages weren't holding on to them; they were selling them off as fast as they could issue them.

At the same time, the credit scoring business was growing up. This gave lenders quick numerical answers to their questions about the creditworthiness of customers. Instead of poring over credit reports for hours, they could get a score in moments that would qualify a borrower as a good prospect.

Here's what happened when all of that came together: Lenders that issued mortgages, car loans, student loans, and even credit card accounts were able to make money fast by qualifying a borrower, collecting a fee (or, more typically, a lot of fees), and then selling the loan off to someone else. The lenders didn't even really care whether the borrower made good on the loan; they only cared about the borrower looking good enough to qualify in the first place.

As interest rates fell in the 1990s, refinancing became another popular way for lenders to make money, over and over again, from the same homeowners. They encouraged people to do cash-out refinance deals—borrow against the swelling equity in their homes to pay off other debts, improve their homes, send their kids to college, and do anything else that struck their fancy.

By 2005, the country was in the midst of a housing bubble, and would-be homeowners were told they should do whatever it took to buy a house before it was too late and they couldn't afford it any more. Some lenders simply allowed themselves to be pressured by brokers, real estate agents, homeowners, and their own bosses to make more and more loans. But some particularly unethical predatory lenders went out of their way to push cash-out refinance deals on unqualified, unsuspecting, and naive (often elderly) homeowners who gave up good, small, inexpensive loans for subprime deals that turned out to be disasters.

The creative folks in the mortgage and real estate industries did what they could to invent new mortgages that would allow more and more borrowers to qualify. There were new mortgages that required no down payment and no demonstrable income from borrowers. They started with teaser rates, tiny monthly payments and a feeling of euphoria. But they held deadly traps, like interest rates that reset at levels that doubled and tripled monthly payments, and amortization schedules calculated so that the balance of the loans grew over time instead of shrinking.

While that was happening, everything from college to cars was becoming less and less affordable. College costs were rising precipitously, and neither household income nor government aid programs were growing quite as fast. Lenders rushed into that void, too—creating a student loan industry that was predatory in its own way. At its worst, it was found to be kicking money back to schools that were recommending costly private loans to students who had been told that no price was too high for a good education. Those loans carried an implicit college seal of approval that made students and their parents think they were good deals.

As cars became unaffordable, dealers and manufacturers cooked up auto loans that stretched longer than the useful lives of the sport utility vehicles they were paying for. It became possible to get a seven-year car loan, and it was not unusual for car owners to trade in their cars before their loans were paid off. They were adding the balances of their old loans to their new car loans.

Credit cards became as common as head colds, and issuers who could now qualify borrowers and process payments for pennies went crazy promoting the cards. Every store and affinity group, from sports clubs to hamburger joints, had its own card. To encourage consumers to use the cards for even the tiniest pack-of-gum type purchases, issuers started promoting the cards with big cash-back bonuses for money charged at gas stations, convenience stores, and groceries. Then they started piling on the fees. Issuers that used to depend on interest income and fees from merchants discovered they could really cash in if they charged consumers for being late, for going over their credit limits, for getting cash advances, and for anything else they could think of.

Borrowers did their part, buying into more and more debt for any and every reason, and thinking it was all okay. By 2006, the United States had a negative savings rate for the entire year. That means—and it bears repeating—that as a nation, on average, all Americans were spending more than they made, borrowing to make up the difference. Consumer debt quintupled between 1980 and 2001, and then practically doubled again to $2.6 trillion in 2008.

Pop! It had to happen. The credit spree that had taken decades to build came to a crashing halt in 2007. It started when the lowest tier of mortgage borrowers—those folks who'd been talked into crazy mortgages—stopped being able to keep up with the rising monthly payments. The investors who held big portfolios of weak loans didn't have the cash to float new loans. The bankers stopped making money. Housing prices started to fall, and people weren't able to refinance, pull money out of their homes, or even get new loans for new homes. Prices fell further. The banks, worried about where the next shoe was going to drop, started pulling back on consumer debt. They cut credit lines on home equity lines and on credit cards. Consumers lost their borrowing ability and their breathing room. Stocks got slammed, and it all started spiraling downward. Joblessness, bankruptcies, delinquencies, and interest rates were on the rise, and spirits, paychecks, and economic activity dropped.

The government stepped in, on almost a dozen different occasions. In the fall of 2007, President George W. Bush created the Hope Now Alliance, a union of mortgage investors (including giants Fannie Mae and Freddie Mac), the Federal Housing Administration, mortgage lenders, and trade groups. The group was to provide free counseling and voluntary workout assistance to troubled borrowers. In September 2007, Congress passed, and President Bush signed, the College Cost Reduction and Access Act, which cut interest rates on federal college loans and eased repayment options for struggling graduates.

Early in 2008, Congress enacted the Economic Stimulus Act of 2008, legislation that put an additional $600 into the hands of most taxpayers quickly. That wasn't enough, though, to address the systemic problems that worsened throughout the year. In July 2008, under President Bush, Congress passed the Housing and Economic Recovery Act of 2008, designed to ease credit in the mortgage markets and make more cash available to support refinance loans for subprime borrowers. The Higher Education Opportunity Act was passed by Congress and signed by President Bush in the summer of 2008. In February 2009, President Barack Obama and Congress approved the

American Recovery and Reinvestment Act of 2009. This was a grab bag of provisions, including money for students, car buyers, and homeowners. In March 2009, the Obama administration unveiled a comprehensive mortgage relief plan called ''Making Home Affordable.'' In subsequent months, it refined and amended that program. Later in 2009, Congress passed, and President Obama signed, a comprehensive credit card reform bill.

A New Era

Now we are digesting all of this. As a nation, we are moving out of recession and into a new economic era. We are adjusting to the new benefits, rules, and programs that came out of that mountain of legislation. As consumers, we are learning to take advantage of the new programs while learning to live without the easy money that used to be all around us. That's not so bad—the money really wasn't that easy after all.

In the following pages, I'll take you through all that is new about managing debt in the United States, circa 2010 and beyond. We'll discuss every unique type of debt, from credit cards to mortgages, in great detail. I'll show you where the traps are hidden and where the great new opportunities lie.

For starters, here is a quick overview of the major types of debts that most Americans deal with, along with the recent changes and trends in each area.

- **Mortgages.** The biggest and most important debt for most Americans, mortgages have changed dramatically, and changed again. Now we are in an era when mortgages are moving back to more traditional forms—plain-vanilla, 30-year fixed-rate mortgages dominate the marketplace. There are still some variable-rate mortgages.

  Mortgages are secured loans—they are backed by the property on which they are written.

  There are two new government-backed programs for mortgage holders who are in trouble. One allows homeowners to refinance their homes, even if the homes are worth less than their loans. A second one encourages mortgage lenders to modify mortgages for troubled borrowers by lowering interest rates and payments.

- **Home equity lines of credit (HELOCs).** These lines of credit are backed by your home, and give you a lot of control over your money. You can use them to fund renovations, buy cars, pay bills, and more, and repay them on your own schedule, as long as you are making monthly minimum payments as big as your monthly interest costs. Disciplined homeowners can really make their HELOCs work for them by using the equity accelerator technique described later in this book. You can use a HELOC to burn your mortgage faster than you ever thought possible.

  Bankers tend to like home equity lines, too; they don't typically resell them, so the loans stay in bank portfolios, producing cash flow. There are still many HELOCs on the market, and competition from lenders wanting to place HELOCs with homeowners.
- **Reverse mortgages.** These products put money in the hands of elderly homeowners in exchange for repayment when the home is sold. They used to be prohibitively expensive, and they still can carry some high fees, but they have been improving. They work best in very specialized situations. An older person who is not well and doesn't want to leave home can use a reverse mortgage to pay for care. A reverse mortgage typically reduces the amount of equity that heirs inherit.
- **Credit cards.** It's almost impossible to live without credit cards now, but they have gotten more complicated than ever. Consumers who carry credit card debt balances—about half of all cardholders—are at the mercy of card issuers that have been jacking up rates and fees as aggressively and unconscionably as I've seen in my decades-long career.

  New government rules slated to go into effect in 2010 will limit issuers' ability to retroactively raise rates and trap consumers into late payment charges. Many in the industry say issuers will stop offering generous cash-back deals and start charging annual fees. Those moves may make it harder for the half of consumers who pay off their bills every month to really profit from credit card use, but there is still enough competition in that space to make me think you'll have some good choices for a while.
- **Car loans.** The typical car loan has gotten longer and costlier over the years, but troubled automakers are making amends

with price cuts that may outweigh the zero percent financing offers that used to rule. Washington has been offering its own incentives; in 2009 it offered a sales tax credit to car buyers. Congress also enacted a ''cash for clunkers'' incentive for car buyers who turn in old, gas-guzzling cars. Lease deals, which used to be prohibitively expensive, now sometimes rival car loans as a less expensive way to buy a car.

- **Installment loans.** When stores offer no-interest-for-a-year deals, or agree to finance your TV, computer, or new living room furniture, that's an installment loan. They can be pretty pricey, and rarely are the best way to pay for a purchase. The no-interest promotions have largely dried up; those that remain usually are carefully constructed to trap the borrower into paying interest. You have to monitor them very carefully. Some medical offices are now offering their own installment loans, usually for high-priced procedures that insurance doesn't cover, such as LASIK eye surgery or cosmetic surgery.
- **Student loans.** The way in which families pay for college is shifting dramatically. That's a good thing. In the late 1990s and early 2000s, increased dependence on costly private loans put some graduates into so much debt they had to give up on favored careers and grad school. Now the federal government is the direct, primary lender for a much larger share of student loans, and rates have come down. There's a host of new repayment plans that offer great leniency to students who graduate and enter low-paying public service careers.
- **Retirement plan and life insurance loans.** You can borrow money from yourself. Many companies allow workers to borrow against their own 401(k) accounts; in those cases the interest you pay back is paid into your own account. Most advisers do not recommend this strategy; it removes money from an account you should allow to grow until you retire. But this can actually be a reasonable place to borrow money in an emergency; it costs less than some other forms of debt.

  Cash-value life insurance policies also allow account holders to borrow their own money back. This, too, can be a reasonable way to meet emergency expenses or even pay for college or other big costs, especially if you no longer need the full life insurance death benefit.

Other Kinds of Loans

There are a couple of other categories not discussed in this book—payday loans and tax refund anticipation loans, for example. I do not consider either legitimate enough to include in a book about debt mastery; you can't be the master of a sleazy product that preys on the poorest in society and charges fees and rates that can approach 500 percent on an annual basis. Just avoid them both; that's all there is to say about them.

I also haven't discussed margin loans in this book. Those are funds that investors borrow to pay for bets they make on stocks, bonds, and commodities. They are very risky indeed, and best left for an investment book and not a debt book.

But except for those examples, the earlier list includes all of the types of loans and debt that most Americans contend with. Each has its advantages and disadvantages, its own pitfalls and rewards.

You may use them all at different times of your life. To truly master them, to take the greatest advantage of each type of loan, to snag the lowest rates, to keep your payments manageable, and to get yourself completely free of debt when you need to be, you'll have to be both disciplined and determined. But first, you'll have to start at the beginning, by figuring out exactly where you stand.