Chapter 1

Introducing Credit Management Essentials in a Tightened Credit Market

In This Chapter

- Discovering how to manage your credit
- Knowing ways to protect your credit
- Keeping your credit solid in each stage of life
- Handling credit problems
- Rebuilding your credit after a crisis

Managing your credit in today's tight credit environment is more important than ever. Why? Because of the huge excesses and losses of the last several years, credit is tight and unforgiving. If that's not enough, credit reports play a larger role than they used to in your noncredit life, affecting more decisions than ever before. This combination of scarcity and value make managing your credit one of the most important things you can do to be successful in achieving your life goals and personal happiness.

In this launchpad chapter, I start with the basics of credit management, which include how credit works, how you can apply that knowledge to get what you want, how to deal with life's inevitable setbacks, and how to recover from those setbacks as quickly as possible. Subsequent chapters build on this information and go into much more detail, helping to make your credit the best it can be and keep it that way. Why? Because life's too short to put up with bad credit, to be taken advantage of by unscrupulous financial companies, and to waste years recovering from credit problems that you can avoid or minimize with the proper actions on your part.

Managing Credit in Today's Unforgiving Economy

The concept of *credit* is easy to understand. It goes like this: You receive something *now* in return for your believable promise to pay for it *later.* That's it. Mortgages, credit cards, auto loans, and other types of credit all fit this definition.

Some people think that credit is a way to increase their income. It's not, although credit can help you manage your income. Others see credit as a way to enhance status — I have a platinum card and you don't! These distinctions are just ways to wrap additional products, features, and profits into the same credit instrument. Credit allows you to conveniently spend money that you've already earned or saved or to spend the money today that you'll earn tomorrow.

But spending tomorrow's money today gets more people in more trouble than they ever dreamed of — trouble that, at a minimum, can cost them some huge interest payments and fees and shut them out of future opportunities. For those with a combination of poor credit management and bad luck, the trouble can take the form of collectors, lawyers, and the loss of peace of mind that comes with financial stability. But not for you! Managing your credit and finances is easy if you know the rules of the game, do some basic painless planning, and know where you stand.

Planning for success

Behind every successful person or venture is a plan. Whether detailed or general, a plan for your money and credit is one of the basic criteria for success. Why? Because others have a plan for your money, and if you don't have one, their plan will win.

Your financial plan begins with envisioning your future as you'd like it to be. Do you desire a home, an education, vacations, a family? The basis of your plan consists of your personal dreams and vision expressed as goals. Long- and short-term goals form a firm base on which to build a plan, and they give you the incentive to fund your plan with savings and targeted spending. Counting up all your income and making decisions on how much you spend and how much you put toward your goals comes next. Called a *budget* or *spending plan,* this becomes your road map to financial success. In Chapter 4 I provide you with step-by-step instructions on how to set up your goals and plans.

After deciding on your goals and setting up your spending plan, you want to consider how credit can help. Using credit cards for convenience and auto and home loans for big-ticket items helps accomplish your goals. Each has differing criteria to qualify you for the best, lowest priced products. That criteria is found in your credit report and credit score.

Reviewing your credit report

Your credit is increasingly used to predict your future value as a customer, employee, and insurance risk. Why? Because there's a strong and proven link showing that if you have bad credit, you're more likely to have insurance claims and a diminished job performance. Research shows that employees with credit problems are less productive and have more absences than those with good credit. The result is that employers use credit reports during the hiring process to complete their assessment of candidates. In a competitive job market, a bad credit report can make the difference between an offer and the employer moving on to the next candidate.

Your *credit report* is a financial snapshot of your life so far. In most cases, every time you use credit, it gets reported to a data storehouse known as a *credit bureau.* This information ends up on a credit report for at least the next seven years. The good, the bad, and the ugly are all there for anyone you do business with to see and for FICO and VantageScore to summarize in a three-digit number (known as your *credit score,* which I discuss in the next section).

Lending decisions used to be based on who you were. For example, a local banker would typically know you personally and could approve or deny your application based on your reputation and his prior experience with you. Today, few borrowers have a personal relationship with their lenders. Even if they did, most loans go before a committee that requires more than a personal reference to approve your loan. Using the information in a credit report enables a group of strangers to objectively assess your payback record. Lenders still like to see evidence of character, capacity, and collateral, known as the three Cs of lending. Credit reports show your character (whether you keep your promises) and help to measure your capacity (how much credit you've handled before).

WARNING!

The information in your credit report is essential to good credit management, but what if your file contains mistakes? Credit-reporting errors are more common than you may think. Research has shown that 25 percent of all credit reports have errors in them that are significant enough to affect your credit score!

Your credit report contains personal information, account information, and public legal records about you. After you know what information is in your report, you can take simple steps to delete out-of-date or erroneous negative information and add positive data that polishes your credit image to get you what you want and need.

TIP

Under the Fair and Accurate Credit Transactions Act (the FACT Act or FACTA), you're entitled to a free copy of each of your reports every 12 months. Your state law may entitle you to many more free credit reports. In Chapter 7 I tell you how to get your free reports from each of the three major credit-reporting bureaus, how to get additional free reports, and how to get reports from specialty reporting bureaus, such as those that collect information on your medical history. I also tell you how to clean up your reports so you get the highest score you deserve.

Knowing your credit score

Your *credit score* is a numerical analysis of the years of credit data contained in your credit report. The organizations that calculate your credit score use a proven algorithm (formula) that can predict the likelihood of you defaulting on your next loan over the next two years. Your score doesn't take into account characteristics like gender, race, nationality, or marital status. The result is a discrimination- and prejudice-free assessment of you as a credit risk. Further, by boiling down the decision-making process to a three-digit score, you get the speed and convenience of a quick approval or denial of your application.

Two main scoring models are in use today: FICO and VantageScore. Your FICO score ranges from 300 to 850. Your VantageScore ranges from 501 to 990. Several weighted factors make up your score. By understanding these factors, you can avoid any surprises when you apply for that car or other loan.

I give you detailed definitions of each of these factors in Chapter 6 and tell you how you can get the maximum boost to your score with some simple credit-management techniques, like keeping your card balances under 50 percent of your maximum limit and using your savings account to help secure a low-interest-rate loan. The differences in interest payments over a number of years can run from hundreds of dollars on a credit card to tens of thousands more for a home mortgage.

TIP

All the information used to determine your credit score is contained in only one place: your credit report. You have at least three credit reports (from TransUnion, Equifax, and Experian), and the result is that you probably have at least three different credit scores! How can you be sure the information in each of your credit reports is accurate and as positive as possible? Great credit begins by knowing what's in your report and what's not. Check out the "Protecting Your Credit" section later in this chapter as well as Chapters 6, 7, and 8 for more information about monitoring your credit reports and scores.

Considering credit a renewable resource

Some people have a block when it comes to math, and that block can carry over into credit, which is based on seemingly confusing and endless numbers. I've helped some of my clients understand credit by relating it to something everyone understands: the environment. Everyone knows that pollution is bad for the environment. Everyone knows that resources in the environment can either be overused and diminished or managed well and renewed. And finally, everyone knows that a balance among all the environment's parts is necessary for the environment to be healthy and sustainable. The same principles apply to credit; I call this credit environment your *credit ecosystem.*

Credit ecosystem

You may find understanding your credit easier if you view it as its own ecosystem. Each of the credit-scoring components affects the others, and pollution in the form of negative reported behavior hurts your ecosystem. Like the real-world ecosystem, pollution takes time to clean up. If the damage is bad enough, it causes severe systemic damage for years before the environment can recover.

Balancing components

You manage your credit environment by limiting overuse of credit and monitoring your credit's health by being aware of your credit score and the information flowing into your reports. Doing so keeps everything in harmony, and the resulting balance strengthens your credit ecosystem. Overspending and overusing credit depletes your resources faster than you can replace them, much like overfishing or overlogging. An ever-increasing accumulation of debt from using more credit than you have income to support strains your credit ecosystem, perhaps to the point of collapse.

Credit pollution

Defaulting on payments introduces pollution into your credit report and score. Like an oil spill, this pollution can't be covered up and hidden; you have to clean it up properly and put safeguards in place so it doesn't happen again. Credit pollution, like its environmental counterpart, has effects beyond your credit report. A polluted report can hurt your job prospects, require larger payments (and a larger stain on your finances) for insurance and loan products, and more.

Green credit

I call using credit wisely, in accordance with your plan to build a positive credit history and score, *green credit.* In Chapter 3 I give you more insight into this way of understanding your credit and managing it like a renewable resource. Green credit is part of a balanced spending and income system that's reflected in your spending plan. By using credit judiciously, like you would organic fertilizer, you increase the buying power of your present income in a responsible way and replenish the resources you're using before they run out.

Protecting Your Credit

Credit is increasingly used for more than just getting a good rate on your credit card. It affects your ability to compete for a job or a promotion; get affordable insurance; qualify for some licenses, military service, and security clearances; and even find a decent place to live. At the same time, data breaches have exposed the credit and personal information of millions of people to identity thieves. These thieves can use stolen identities to establish credit in your name without your knowledge and then overuse and default on that credit.

Getting familiar with credit laws

Over the last several years, Congress has passed new laws to give you, the consumer, more protections. Knowing about and taking advantage of these safeguards can help you keep your credit safe. If your identity is ever stolen, knowing your rights is essential to a quick resolution. Among the laws I discuss in Chapter 5 are the

- **Dodd-Frank Wall Street Reform and Consumer Protection Act,** which created a single consumer watchdog agency and allows consumers free access to their credit scores under certain conditions.
- **CARD Act,** which restricts lenders from raising your rates on existing balances and more.
- **FACT Act,** which gives you access to free credit reports and ID theft protection and remedies.
- **Fair Debt Collection Practices Act (FDCPA),** which spells out your rights and the rules that collectors must follow in debt collection.

Knowing your rights: Collection protection

Collectors have a reputation for being demanding and sometimes abusive. If your plan hits a snag and a collector comes calling, knowing the rules and your rights makes all the difference between successfully resolving the problem and being terrified of the unknown.

TIP

One little-known solution to a debt-collection problem is the statute of limitations. Each state has a time period after which a debt can't legally be collected in court. Knowing your state's rules can take the teeth out of a collection attempt.

In Chapter 18 I go into detail about other ways to handle collectors, and I offer solutions that work. From how to handle calls and threatening letters to how to craft repayment proposals, I walk you through how to keep a small collection annoyance from becoming a major and upsetting life event.

Receiving free reports and filing disputes

I mention earlier in this chapter that you can get free copies of your credit reports annually to check for errors. I strongly recommend that you get these reports every chance you can. Besides the one annual free report from each of the three credit-reporting bureaus allowed by the FACT Act, your state may require the bureaus to give you more — sometimes many more! In addition, you're entitled to free extra reports, and sometimes even free credit scores, if you've been turned down for credit, didn't get the top rate offered, or had any adverse action (like a limit cut) to your credit card. All these situations are opportunities to check, dispute, and clean your credit reports for free and help make credit management a breeze.

Signing up for credit monitoring

Every time I turn around, someone is offering to monitor my credit for me. Do you need this service, and are you willing to pay for it? In Chapter 8 I get into the details of credit monitoring, and with a few exceptions, I find that it's an unnecessary expense. With all the opportunities you have for free reports (see the preceding section), paying for more may be overkill. As for score monitoring, expect it to change frequently as new data comes into and leaves your credit report. Unless you're planning a big purchase like a house in the near future that requires new credit, knowing your score every day is like knowing the value of your home when you don't intend to sell it — relatively interesting but useless information.

In addition, if you have a credit card, you may already have good fraud-monitoring in place without your knowing it. Most cards monitor spending patterns to sniff out fraud and identity theft before they cost a fortune. The result is one less reason to pay to monitor your credit.

Setting alarms, alerts, and freezes

If you're still worried about too much access to your credit data, you have the right to limit access to only those you approve. Chapter 8 covers how to limit access, along with the pluses and minuses of doing so. Among your options:

- You can set up alerts with your creditors to spot new activity on your account.
- You can place an alert on your credit file so that lenders use more caution before approving any changes.
- If you're a member of the military, you can place an active-duty alert on your files.
- You can freeze access to your account so that no new creditors can access your information without your express permission (except if you owe the government money).

Identifying identity theft

Still the number one reported crime at the Federal Trade Commission, identity theft isn't going away. The number of cases reported is small in relation to the huge amount of identity information that hackers get every time you hear of a database compromise. This leads me to believe that your identity may be in jeopardy for years to come as thieves warehouse your data for a future time. Some simple vigilance can help you stop a theft in its early stages before serious damage is done. Follow these tips from Chapter 12:

- Protect your information at home. Most identity theft is low-tech and committed by people that you invite into your home.
- Shred financial documents with account and Social Security numbers.
- Use electronic bill paying to avoid bill theft from your mailbox.
- Check your credit report at least once a year to look for unfamiliar credit lines. If you see accounts you don't recognize, take the actions I suggest in Chapter 12.

If the unthinkable happens and you become an ID theft victim, you need to take fast, effective steps as soon as you find out you've been victimized. Chapter 20 walks you through what you need to do and who you need to contact. It also helps you reestablish your credit afterward.

Maintaining Good Credit throughout Life

I say earlier in this chapter that your credit report presents a financial snapshot of your life . . . so far. So as your life changes, your credit report changes, too. If your life is filled with positive news like a steady job, a good income, a promotion, controlled expenses, and maybe even a partner, then your credit report should reflect that stability. If, however, you have a reversal of fortune with a job loss, income interruption, illness, or divorce, expect your perfect credit to show the stress of your life.

Establishing credit for the first time

Getting credit doesn't need to be scary. You have easy ways to establish credit for the first time or, in some cases, the second time around as a single person. Knowing what to do and what to avoid makes this process simple and foolproof. In Chapter 9 I cover the essentials of getting your new credit up and running. Using simple techniques like borrowing your own money and using retail store cards and authorized user accounts, you can establish good credit in no time. Your credit score can be figured on the history of just a month or two, and then you're on your way.

Here are a few ways to build credit for the first time:

- Open a savings account at a bank that reports to all three bureaus. Then take out a loan using the account as security and make monthly payments on time.
- Have a relative add you as an authorized user on her credit card. Her history will flow into your credit report.
- Apply for a secured credit card with a bank that reports monthly to all three bureaus.

Credit changes at life's stages

As you move through life, you find new needs for credit and new challenges in keeping your credit strong when life gets bumpy. Chapters 10 and 11 give you detailed help in negotiating life's often turbulent credit waters without capsizing your boat. Credit plays a strong role in every aspect of your life, including getting a job, buying a home or renting an apartment, purchasing a car, getting insurance on your home and car, getting married, getting divorced, paying medical bills, planning for retirement and end-of-life expenses, and more!

Many people know that because a prospective employer may check your credit in the hiring process, having good credit during your job hunt is important. But how can you keep your credit in good shape when you've been laid off and don't have enough income to handle all your bills while job hunting? Chapter 11 tells you how. It also gives you practical tips for safeguarding your credit before, during, and after a divorce.

Avoiding pitfalls

Whether you're new to credit or you're a credit veteran, you need to be careful of counterproductive actions and scams. Some examples of things I advise you to avoid, if at all possible, are payday lenders, refund-anticipation loans, check cashers, and credit-repair companies.

You won't go blind from using a payday lender once for an emergency, but the very concept of this type of high-interest loan is flawed. If you have no savings and you're living paycheck to paycheck and an emergency expense comes up, does getting a payday loan make sense? You have to pay back a short-term (two weeks or so) loan on your next payday. But all that money is already committed, so how can you pay it back? Chances are you'll need more than one loan and owe lots of money in interest charges.

Refund-anticipation loans are another borrowing mistake. These loans accelerate an e-filed tax refund by a very short period of time for a very large fee when calculated as an annual percentage rate (APR). Plus, if your refund is held up or reduced, you owe more money on the loan than you expected.

Check cashers perform a valid but expensive function for people with no bank accounts who need to cash checks. But I suggest that you get a bank account so you have a place to begin saving and stop paying for unnecessary check cashing.

Credit-repair companies have a horrid reputation. Legislation called the Credit Repair Organizations Act has tried to limit the damage caused by fraudulent actions that some companies advise to rig the credit-reporting system. If you're thinking of credit-repair companies, think again.

Repairing Bad Credit

After you've had a rough patch and fallen behind on your credit payments, you may think that you'll never recover. Between the interest expense, the negative credit reporting, and maybe even collection actions, the situation can be overwhelming. But I assure you that you can reverse the cycle. You can not only reestablish good credit but also keep good credit forever. Forever is a long time, but if you follow my advice in this book, you'll banish the credit blues from your history permanently! It's not magic, and it won't cost you another dime. By realistically assessing your situation, using free help if you need it, setting goals, planning your spending and savings, and using credit as part of your overall plan, you'll quickly rebuild your credit.

Settling debts

You hear the ads everywhere today: "Settle your debt for pennies on the dollar!"; "You have a right to pay less than you owe!"; and more. Debt settlement is an often misunderstood option that may work for you, but only if you handle it properly. Many companies that offer debt settlement help themselves a lot more than they help you. You can avoid the huge fees and potential credit damage you incur by dealing with many debt-settlement companies if you reach a settlement agreement with your lender on your own or if you use your own attorney.

Most people don't know that they're personally responsible for the actions of the debt-settlement company they hire and that their credit will be ruined in a protracted and adversarial settlement process.

In Chapter 18 I give you the information you need about debt settlements to decide whether debt settlement is for you and, if so, what your best options are.

Resetting your goals

Just as you did when you first started establishing credit, I want you to revisit your goals from time to time as your life changes. When your life changes, your goals should reflect that new reality. Some goals that seemed so easy may now move from short-term goals to long-term ones. Others may change as you mature. That red Corvette may not be as important as it was in your 20s. Take the time to reset your sights, as I explain in Chapter 13.

Begin by envisioning your life as you'd like it to be over the short, medium, and long term. Next, update your budget/spending plan so you know your current financial resources. Then begin to see how long it will take to fund your goals and when using credit may be appropriate.

To be sure your credit is up to the job of supporting your goals for the future, check your credit report and dispute any inaccuracies or out-of-date information. To rebuild a solid credit report, you need to start on solid credit history, not errors that may hold you back. After you check your reports, look for opportunities to review them for free every time you can (see Chapter 7 for extra free opportunities).

As you build your plan to clear up any past-due loan payments, take a minute to find out which creditors report your credit history to the bureaus and which don't. You need to pay all your creditors, but you sure don't want to miss paying a bill that reports late payments to the bureaus while paying one that doesn't report. Chapter 6 has a list of who reports and who doesn't.

Rebuilding credit by using it

The best way to rebuild your credit is to exercise it! Using your goals and spending plan as a guide, start making those payments as agreed, on time and for the correct amount. Every month you do so, you build better credit while your older, bad credit either counts for less or drops off your credit report altogether.

Consider opening a *secured credit card* (backed by a bank account deposit) or a *passbook loan* to add a revolving and installment account to fatten your credit history and score.

Using cosigning and authorized users

I normally don't recommend cosigning for a loan, but in your case, the opposite is true — you aren't cosigning, someone else is! Cosigning is one way to get access to credit so it can be reported to the bureaus. But you need to keep in mind a few important rules. First, you have to make all the payments on time. Second, if you can't make a payment when it's due, you have to tell the cosigner in advance so he can make the payment and protect his credit. You can pay him back later. Third, you can't ever get mad at the cosigner while you still owe him money. He's doing you a huge favor at great personal credit risk!

Another way to help rebuild your credit is to become an authorized user on someone else's credit card. After you're added to the person's account, her good credit history will flow on to your credit record as a positive account and payment stream, beefing up your record and score. The person needs to have good credit, though, or her bad credit will negatively affect yours. I suggest that you decline getting a card for the person's account so that only her charges appear on the account. That way, if she has a bad memory — like I do — you're spared monthly calls asking whether this charge or that charge is yours. Although you won't have access to any new credit, your score will get a boost.

Finding sources of free help

Though you can do a lot of things on your own, sometimes having a pro on your side to give you tips helps. You can find that help in three main places, and it can range from inexpensive to free. Nonprofit credit counseling, pro bono lawyers, and HUD-approved counseling agencies offer priceless insight, help, and advice. The trick is to ask for it.

Nonprofit credit counselors help by working with you to set goals, develop a spending plan, and assess your ability to repay your debts. They can set up a repayment plan in concert with your lenders to lower payments and interest rates and get positive credit back on your reports faster than you can do on your own. They're funded by creditors but work for you, and I recommend the good ones highly. You can discover where to find the good ones in Chapter 15.

Lawyers sometime offer free or pro bono help if you can't afford to pay. I have a list of resources to help you find one in your area in Chapter 15.

Mortgages are a different and dangerous type of loan. The rules for handling delinquent mortgages are different from those for regular consumer debts, and the penalty for a mistake is much more severe. So I strongly recommend that if you have a mortgage problem you get professional, HUD-certified help. You can find an agency at the HUD website: `www.hud.gov`.

WARNING!

Lastly, watch out for bad help. In a nutshell, if someone approaches you and offers to help for a fee, don't do it. The free resources work well. The costly ones too often are just ways to separate you from your money while you're under stress.

Dealing with collectors

Sometimes, you have to take the call. You know it's a collector, but you don't know what to say, do, or offer. In Chapter 16 I spell out how to take control of the collection process. Collectors have rules that they must follow, and if you know the rules, you'll feel more confident in dealing with a stressful situation. The Fair Debt Collection Practices Act (FDCPA) regulates what can and can't be done in a collection action. In general, this law protects you from abuse and threats. For example, a collector can't threaten an action that it can't or doesn't intend to take, it can't make harassing calls, and it can't use abusive language or swear at you. When you know your rights and insist that you be treated fairly, you can negotiate a payment schedule that fits your budget. If you need help, you can always ask a credit counselor (see the preceding section) for assistance.

REMEMBER

Debts are subject to your state's statute of limitations. After a debt is past the date, you can't be sued for it. Collectors won't waste their time on a debt that can't be enforced.

Weathering a Severe Mortgage Crisis

Some credit problems are worse than others. In my experience a mortgage crisis is among the most upsetting, expensive, and damaging to your credit and relationships. Your home is your castle. When you may lose it you likely feel as though your very existence is under attack. It may be difficult to think matters through and come up with the best solution for you and your family. Here I preview the major options to help guide you along the best path. Check out Chapter 17 for more mortgage information.

I've said that mortgages are different from other types of debts and credit. They're different because of a number of factors, including the size of the debt, the importance lenders attach to a debt secured by your home, the fact that the debt is probably packaged in a security that's been resold many times and is subject to inflexible collection rules, and more. Mortgage delinquency can have a very large negative effect on your credit score for a very long time. For example, just being 30 days late on your mortgage payment can cost you 100+ points on your FICO score and take three years to recover from. The upshot is that if you're in danger of falling behind on your payments or you're already behind, you're better off with some professional help.

Opting for help

In a bad mortgage situation, the sooner you get help the better. The reason is simple: The stakes are high and the help is free. Most people who have a mortgage payment due on the first of the month know they have until the 15th to pay it. Do you? If you miss that payment on the 15th, you're 45 days late. Mortgages are paid in arrears, so the bill is 30 days old when you get it. Miss the pay date and the 15-day grace period goes away until you catch up. By the 15th of the next month, you're 15 days away from a foreclosure action. Fast, isn't it! So I suggest you don't delay in contacting a HUD-approved counseling agency. These agencies are often housed in credit-counseling agencies so they can address all your debt issues at once.

Doing it on your own

I realize some of you won't take help and insist on working your mortgage problems out on your own. The process is tricky and long but it can be done. In Chapter 17 I go into details on the steps and time frames for action. Besides acting quickly, you need to keep excellent notes about who you speak with, when, and what was said. You're dealing with a bureaucracy, and bureaucracies love to forget they ever heard from you and send you all over the place to avoid responsibility for helping. So notes are essential. In Chapter 17, I list terms and things to ask for so you can sound like you know what you're talking about.

Just because a bank doesn't want to take your home doesn't mean it won't.

As in any debt-resolution process, you need to do your homework before you make a call to your mortgage servicer. Know what you really need in terms of help to take care of your missed payments and what you can offer. You may be able to make additional payments over a six-month period to catch up. Or you may not be able to make your current payment at all but need to ask for a reduced payment for a certain amount of time. Whatever you need, you have to be specific. Chapter 17 helps you understand the major options, but they change frequently, so you may have to rely on your servicer (the bureaucrat) to advise you on options.

If it looks like you can't work out a compromise, you have some ways to leave your home that result in less credit damage. Among them are a

- **Deed-in-lieu of foreclosure:** You give the house back, saving the bank foreclosure expenses.
- **Short sale:** You get the bank to agree to let you try to sell the house for less than the mortgage value.
- **Friendly foreclosure:** You cooperate with the bank and leave the house in good shape on a timely basis.

Strategic mortgage default

Strategic mortgage default isn't an option anyone likes. However, the realities of the current mortgage market have more people considering walking away from their homes as an alternative to foreclosure. What happens is that, based on what you owe, you may be very, very unlikely to ever get back the money you're putting into payments every month. According to the Federal Reserve, strategic default is particularly popular as a remedy for people who lose 50 percent or more of their property values and owe large mortgages. Say that you owe $200,000 on your mortgage but the property is only worth $100,000. Why waste $100,000 in overpayments? Following that reasoning, many people are mailing the keys back to the bank and walking away from their former homes.

Credit damage from a strategic default is significant and lasts a long time. You can expect really bad credit for seven years and a FICO score drop of 140 to 160 points. Plus, Fannie Mae won't guarantee a future loan for you for the next seven years, which means that you'll pay more for a new mortgage and you'll need expensive mortgage insurance to buy another home in the next seven years.

Filing Bankruptcy

There are times in life when you just can't cope. This is also true in credit matters. If you're unable to come to terms with the aftermath of being over-extended on credit, bankruptcy may enable you to hit the reset button and start over again. But there is no free lunch, and while you pay a price in terms of future credit, bankruptcy for the right reasons and in the right circumstances may be your best bet. In this section I give you a quick look at an often misunderstood and misused tool so you can decide if the cure for your debts is worth the damage to your credit. Chapter 19 has more information on the updated bankruptcy process, what it means to you, and what your alternatives are.

You need to pass a means test to see which type of bankruptcy you can file for. Chapter 7 bankruptcy gets rid of some of your debts but not others. Chapter 13 bankruptcy requires you to pay what you can afford to your creditors over a five-year period if you don't qualify for a Chapter 7. In a nutshell, if you earn too much money, you have to pay your bills in a Chapter 13.

Even worse, from my point of view, is that filing for bankruptcy may not solve your problem. If you're in debt trouble because you spend more than you make, or to put it another way, because your expenses exceed your income, then filing won't change that situation. Before long, you may be back in debt but without the option of refiling.

You face a waiting period between filing for bankruptcy and being able to file again. This period can range from two to eight years, depending on the type of bankruptcy you file and the type you want to file next.

In today's tight credit market, expect a long recovery time from a bankruptcy. Recent FICO research indicates that a Chapter 7 filing can lower a good credit score by up to 240 points and that it takes seven to ten years for the score to recover to its original level. Ouch! That's a long stay in the bad credit hotel. Be sure it's worth it!