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Zeroing In on Your Debt

On the path to a great financial life, it's easy to get sidetracked by debt. This chapter gives you strategies to improve your creditworthiness and cut your debt.

The first part of the chapter focuses on ways to pay off those darn credit cards and other loans. The last part tackles the credit score that lenders use to measure your credit risk.

Your credit score is a statistic that is considered by an increasing array of financial service providers when they issue you credit. Your credit score also could have a dramatic impact on the price you pay for credit.

In this chapter, we give you the straight scoop on dealing with debt, and tell you how to get your credit score as high as possible. A high credit score means you have a great track record in paying off debt. Complete the tasks given in this chapter and you'll be that much closer to reaching your financial goals!

IN THIS CHAPTER:

- Quickly cut your debt
- Know your rights with debt
- Improve your credit score

TO DO LIST

- ❑ Determine whether you have a debt problem
- ❑ Choose an option for dealing with your debt
- ❑ Understand your credit score
- ❑ Take steps to get your credit score as high as possible

Over Your Head in Debt? Try These Fixes

The first step is to nail down whether you already have a debt problem. Take this short test to determine whether you're in financial hot water:

1. Is more than 20% of your take-home pay used for credit card payments, excluding the mortgage?
2. Is the balance in your savings account shrinking?
3. Are your credit card balances growing even though you're making monthly payments?
4. Are you close to hitting your credit card borrowing limits?
5. Are you making just minimum payments on your credit cards?
6. Do you have a hard time paying your rent or mortgage?
7. Have you gotten calls because you're late paying the bills?
8. Are you using a cash advance on one credit card to pay off another?

If you answered yes to any of these questions, your financial life may be headed for trouble. Exactly how serious is your problem? That depends. But, if you're having difficulty meeting your monthly obligations, you have some options, as discussed in the next section.

> **TIP** Already being hounded by debt collectors? You have some rights under the Fair Debt Collection Practices Act, which you can read more about at www.ftc.gov. For personal, family, and household debts, you can stop debt collectors from contacting you simply by writing letters and asking them to stop. Upon receiving your letter, a collector may only contact you again to say that there will be no further contact, or that the creditor intends to take a specific action. Even if calls stop, however, you still could be sued for the debt.

TO DO LIST

- ❑ Control your debt
- ❑ Understand the pros and cons of credit counseling
- ❑ Consolidate your debt
- ❑ Learn about the bankruptcy option

Controlling Debt Yourself

If your debt problem is not totally out of control, why not handle it yourself?

It never hurts to ask lenders to lower your interest rates. Interest rates typically are not reported to credit bureaus. Some lenders may lower the rate to keep your business.

Many lenders also may agree to modify other terms of your loan agreement, such as the monthly payment, if you're having serious problems and contact them. But beware that a modified payment could be noted on your credit report. This could lower your credit score quite a bit.

> **CAUTION** Standard on many credit card agreements now is a "universal default clause." This means that a lower credit score due to a single loan or credit card problem could automatically trigger higher rates on your other credit cards. Also, when lenders modify your payment, you actually may owe more interest. This could happen if you're paying your balance off over a longer period.

If you have a lot of debt but believe you ultimately can repay it, we urge you to revisit your income and expense worksheet in Chapter 1, "Examining Your Financial Condition." Be sure to set monthly targets for your income and expenses. Each month, review how close you are to meeting the amounts you have targeted in each category. Then figure out what more you can do to cut expenses or increase income enough to get there. In addition, you must stop using those credit cards.

To self-control your debt, take this action:

1. Cut up your credit cards, or put them in a drawer and stop using them.
2. Free up as much money as possible through some of the tactics we told you about in Chapter 1. Take at least $50 to $100 per month—more, if possible—and route it toward increasing your monthly credit card or loan

payments. Pay off your highest interest rate credit card or loan first. Or, if it seems easier, start on the card with the lowest balance. Once you've paid off one card, double up on your monthly payments on another card or loan.

Here's a simple example of how this tactic works. Assume you have a credit card balance of $5,000 at 12% interest. Cut your expenses enough to pay $200 monthly toward that balance. You'd pay off your credit card in two years and five months.

3. Once you're debt-free, you're all set to start saving toward your financial goals. Assume you reroute that $200 monthly payment toward savings at a 6% annual rate. In 10 years, you will have saved $32,776 toward your financial goals.

CAUTION Don't close unused credit card accounts and, if possible, avoid shifting balances to another account. Having fewer open accounts may lower your credit score.

TIP Did you find a lot more cash while evaluating your income and expenses? Consider routing one-half of your newfound money toward paying off the highest-rate credit card or loan. Put the other half toward saving for your financial goals. This way, you'll also have some savings to tap in an emergency, and can keep those credit cards filed away!

Credit Counseling

If you're uncertain about how serious your debt situation is, consider obtaining credit counseling from a nonprofit agency.

Following are the primary national networks of agencies that provide counseling:

- The National Foundation for Credit Counseling, Silver Spring, Maryland, www.nfcc.org. Phone: 800-388-2227.
- The Association of Independent Consumer Credit Counseling Agencies (AICCCA), Fairfax, Virginia, www.aiccca.org. Phone: 800-450-1794.

CAUTION Lenders warn that a contact with a credit counseling service could result in a notation on your credit report, even though it is not factored into your credit score. Down the road, this notation could hurt your chances of qualifying for a loan. So before meeting with any debt counselor, try to confirm that your initial counseling session won't be reported to a consumer reporting agency or credit bureau.

Often, credit counseling agencies, which are funded, at least in part, by lenders, will help you develop a debt repayment plan. They'll likely require you to make your monthly payments to them and may charge a fee up front and/or in the payment. If you sign onto a debt management plan, always get a written agreement that includes the price, services to be performed, how long it will take to complete the plan, and the company's business name and address. Call your creditors and confirm the counseling organization is making payments on time. For more information on selecting a debt counselor, see Appendix B, "Finding the Right Help."

> **NOTE** Be aware that you must see a government-approved credit counseling agency within six months before you file bankruptcy. To make sure the agency you see is government approved, view that list at www.usdoj.gov/ust.

Consolidating Your Debts

Should you consolidate all your debts—roll everything you owe into one big loan? There are pluses and minuses to loan consolidation.

You might be able to save money by consolidating your debts and lowering your loan payments. For example, say you owe $5,000 at 18% interest and want to pay off the debt in three years. Refinance that debt at 9% over the same period, and you'll save $783 in interest and cut your monthly payments $22, from $181 to $159.

There are other ways to consolidate your loans. One example is to get a lower-rate credit card, which many banks are aggressively promoting. So if you qualify, you might consider rolling the high-rate debt to a lower-rate card. The drawbacks:

- Credit card loan interest isn't tax-deductible.
- Many credit cards charge variable rates, so if interest rates rise, your low-rate credit card soon could become high-rate.
- Shifting balances from one credit card to another could cause a dip in your credit score.
- Many of the low-rate offers are teaser rates, riddled with fees and/or high rates for any missteps, such as a late payment or carrying the debt beyond a specified period. So it's very easy to miss something in these deals that could derail your efforts.

We'll explain more about this in Chapter 9, "Save by Choosing the Right Loans."

Another option is to consolidate your debts by taking out a home equity loan or home equity line of credit, which we also discuss in more detail in Chapter 9. Interest on home equity loans or lines may be deductible on your income taxes, but using them to consolidate debt could present these problems:

- If you can't make your payments, the lender can take your house!
- If you're already debt-ridden and you're not careful, having yet another loan to tap could add to your debt.
- These loans, too, may come with hidden fees and/or higher rates, under certain conditions. Watch for upfront, annual, and/or termination fees.
- Expect to pay a higher interest rate if you've already had problems paying bills.

All this, if you're not careful, could delay efforts to reach your financial goals.

> **CAUTION** Home equity loan programs that offer to lend you more than 100% of the value of your home often aren't worth it. You can't deduct loan interest on your income taxes for more than 100% of a home's value.

Bankruptcy

If your debt problems are serious and you have little or no income, it could be in your best interest to check whether you're a candidate for personal bankruptcy. By qualifying for Chapter 7 bankruptcy, which involves the sale of most of your assets, you might be able to wipe out all or most of your debts, and get a fresh start. To qualify, you have to meet a "means test" to prove your income is within certain state limits. Plus, it's possible you still might have to pay child support, alimony, fines, taxes, and/or certain student loans. But once you're clear of most debt, you can proceed to reach the goals you set for yourself and your family in Chapter 2, "Identifying Your Financial Goals."

> **NOTE** If bankruptcy prospects are attractive, you'll likely need a bankruptcy attorney. Search the backgrounds of bankruptcy attorneys at www.martindale.com and find one in your area. Can't go online? Get the *Martindale-Hubbell Law Directory* at your local public library. Can't afford a bankruptcy attorney? Contact some attorneys in your area and ask if they know of any lawyers who might offer "pro bono" or volunteer services. Other prospects to contact for potentially low-cost or free legal help are local legal aid societies and area university legal departments.

Visit the website of the U.S. Department of Justice U.S. Trustee Program at www.usdoj.gov/ust and, under Bankruptcy Reform, click on Means Testing Information to see if there's a chance you might qualify for Chapter 7 bankruptcy.

If you can't qualify for Chapter 7 bankruptcy, you might find some relief from creditors, foreclosures, repossessions, garnishments, and utility shutdowns under Chapter 13 of the bankruptcy code. With Chapter 13, the court approves a repayment plan, but you still have to pay off your debts within three to five years.

Again, remember to see a government-approved credit counseling agency within six months before filing bankruptcy.

> **CAUTION** Unless you follow all the rules and meet required income quotas, you could be ordered to pay back a good chunk of your debt. Furthermore, a bankruptcy remains on your credit record for 10 years, with certain exceptions. It can be reported longer in connection with credit transactions of at least $150,000, insurance transactions of at least $150,000, or employment involving an annual salary of at least $75,000.

Understanding Your Credit Score

We've told you how to get out of debt. But even if you have no debt, your credit score is an important number in your financial life. The reason: Lenders are no longer the only ones who look at it. Many insurance companies now examine credit scores. They may use this number, along with other factors, to determine your rates or even whether to insure you.

> **TIP** Debtors Anonymous is a self-help group set up like Alcoholics Anonymous. People with financial problems meet weekly in a group setting. The goal: to help people cope with and solve their debt problems. For more information, visit www.debtorsanonymous.org.

Believe it or not, your credit score could even affect your effort to get a job, rent an apartment, or sign up for a cell phone. Plus, more municipalities are turning over unpaid parking tickets, library fees, and other municipal bills that go unpaid to collection agencies. This can cause credit scores to drop.

By knowing your credit score and raising it as much as possible, you have a tool to obtain better credit terms, including lower interest rates, and perhaps better prices on insurance. It's also possible that a good credit score might save you from needing to shell out a security deposit for your utilities.

A credit score measures a number of factors on your credit report, including

- Your ability to pay your bills on time
- The number and type of loans
- Late payments

- Collection actions
- Total debts
- How long you have owed money

Credit scores generally range from about 300 to as high as 999, depending upon the company that issues the score and the specific type of score. A new type of credit score, known as the VantageScore, issues a credit score comprised of lettered grades.

TO DO LIST

- ❑ Find out your credit score
- ❑ Check your credit report
- ❑ Correct inaccuracies on your report
- ❑ Minimize credit blemishes

Getting Your Score

Nationwide consumer reporting agencies or credit bureaus are required to issue you, upon request, a copy of your credit score. The major consumer reporting agencies are

- Equifax: 800-685-1111; www.equifax.com
- Experian: 888-397-3742; www.experian.com
- TransUnion: 800-888-4213; www.transunion.com

The problems: There's more than one type of credit score, and you might not know which credit score your lender is using. Different credit scoring systems have different ranges and meanings. Some lenders and insurers may use their own internally devised credit score. If you want your credit score, you'll likely have to pay a fee, which can vary, depending upon your state laws and what else the credit bureaus insert in the package that includes your credit score.

Perhaps you've already heard of a credit score referred to as a *FICO score*. That stands for Fair Isaac Corp. (www.fairisaac.com) of Minneapolis, Minnesota—the most well-known nationwide provider of credit scores. Fair Isaac's most popular credit score ranges from 300 to 850. Fair Isaac's median credit score on that model is 723. In general, a bad credit score runs below 620. You also can purchase a credit score from Fair Isaac at www.myfico.com. Its cheapest price was $15.95, which includes not only your score but also a credit report. A number of other vendors may also offer credit scores, but they might not be the same scores used by lenders.

Always keep in mind that your credit score likely is subject to change daily and may not be the sole reason for approval or denial of the financial service you seek.

You have some added protection if the lender uses a credit score to issue a mortgage or to refinance a home. In that case, the lender usually is required to disclose a credit score. Exceptions: if the loan is used for business, or if the lender buys a credit report that happens to have a credit score but doesn't use it. Although the lender is permitted to charge you for that score, the Real Estate Settlement Procedures Act—the federal law governing real estate settlement charges—prohibits the fee from being more than the lender paid for it. Lenders typically get credit scores in a package along with your credit reports.

TIP An analysis by Fair Isaac showed that if you applied for a $216,000 30-year fixed-rate mortgage, a great credit score of 760 to 850 could get you a low, 5.8% interest rate. By contrast, if your score ranged from 620 to 639, your interest rate would be 7.39%. The good credit score could save you $226 monthly on that mortgage! All that extra cash sure could go a long way toward reaching your financial goals.

CAUTION If you're looking to qualify for a loan, make certain that the lender you select actually seeks business from people whose credit history is similar to yours. Ditto if you're seeking insurance. Some lenders, known as "sub-prime lenders," actually want to do business with people who have poor credit ratings. The reason: They can charge higher rates and make more profits on these loans. Other lenders may not want to have anything to do with any borrowers except those with the absolute best credit.

TIP Even if the lender isn't required to disclose a credit score used in a loan you're seeking, it never hurts to ask what it is. Some lenders don't mind telling you.

Once you have an idea of your credit score and what it means, you can compare your interest rate with going interest rates, based on similar credit scores. One place to do it is www.myfico.com. Determine whether you're getting a fair deal. If not, tell your lender and ask for a lower rate, or shop around.

> **CAUTION** Not all credit scores come from Fair Isaac, so be certain to note who issued your score, and understand its true meaning, based on whatever system is used.

LENDERS CONSIDER OTHER THINGS

Your credit score often is not the only factor considered by a lender in its decision of whether to grant you a loan or other financial service. So don't give up the ship if your credit score is down in the dumps. If you've had a family medical emergency that derailed your credit, your lenders might consider this fact. Notify them in writing of your plight. In fact, as we wrote this book, some credit bureaus were adding notations on credit reports of borrowers who were victims of Hurricane Katrina. It was not yet known how this information ultimately would affect the borrowers' chances of qualifying for a loan.

What if you don't have a credit score?

Increasingly, lenders will consider you if you can document other regular business relationships and the fact that you've honored your obligations. Some, for example, might consider documentation of rent or utility payments, a checking account, or regular payments to a book club or record club. So shop around if you need a loan. We'll offer more tips on getting new credit and rebuilding credit in Chapter 9.

> **CAUTION** If you've only had credit for a short time, don't open lots of new credit card accounts. This can lower your credit score.

Check Your Credit Report to Raise Your Credit Score

Now that you understand credit scores and know certain factors that can lower yours, it's important to make every effort to raise it. Be sure to act way before you apply for any loan or financial service so that you're sure to get the best possible terms. The rules are simple:

- Get your credit reports from the three major credit bureaus and correct any errors.
- Get outdated information on your credit report removed.

Again, the following are the three major credit bureaus or consumer reporting agencies that issue credit reports:

- Equifax: 800-685-1111; www.equifax.com
- Experian: 888-397-3742; www.experian.com
- TransUnion: 800-888-4213; www.transunion.com

CAUTION Never respond to emails offering free credit reports. Also, double-check that you've typed in the correct official website address—www.annualcreditreport.com—if you do get your free report online. The website already has been mimicked by "phishers" or imposters seeking your personal information.

GET YOUR CREDIT REPORT FREE!

There are several circumstances in which you may be entitled to free credit reports. Otherwise, you may have to write to the three consumer reporting agencies and pay as much as $9.50 for each copy of your credit file.

First, everyone is entitled to one free copy of a credit report annually from each of the three major credit bureaus. But don't call the credit bureaus for it or it likely won't be free. To qualify for a free report, you must visit www.annualcreditreport.com, call 877-322-8228, or send your request to Annual Credit Report Request Service, P.O. Box 105281, Atlanta, GA, 30348-5281.

Other circumstances under which you're entitled to a free credit report include the following:

- **You've been denied a loan. Just ask your lender for the name and phone number of the consumer reporting agency that provided your credit report.**
- **You've been a victim of identity theft.**
- **You successfully dispute an item in your credit report that results in a change.**
- **You're on public assistance.**

Get more details on your credit rights, including your rights to free credit reports, at www.ftc.gov. This website also has the most comprehensive information on dealing with identity theft.

Correcting Mistakes on Your Credit Report

Review your credit report for mistakes. If you find any, you'll need to write to the consumer reporting agency or credit bureau immediately. Include your full name and address, and clearly identify each wrong item.

Second, forward copies of any information, receipts, or data you have to confirm the error. Feel free to include a copy of the report with the questioned items circled. Send your letter by certified mail, return receipt requested, so that you can document what was received. Keep copies of everything you sent.

Here is a sample dispute letter offered by the Federal Trade Commission on its website (www.ftc.gov):

Date
Your Name
Your Address, City, State, Zip Code

Complaint Department
Name of Company
Address
City, State, Zip Code

Dear Sir or Madam:

I am writing to dispute the following information in my file. I have circled the items I dispute on the attached copy of the report I received.

This item (identify item(s) disputed by name of source, such as creditors or tax court, and identify type of item, such as credit account, judgment, etc.) is (inaccurate or incomplete) because (describe what is inaccurate or incomplete and why). I am requesting that the item be deleted (or request another specific change) to correct the information.

Enclosed are copies of (use this sentence if applicable and describe any enclosed documentation, such as payment records, court documents) supporting my position. Please investigate this (these) matter(s) and (delete or correct) the disputed item(s) as soon as possible.

Sincerely,
Your name

Enclosures: (List what you are enclosing.)

The consumer reporting agency is required to investigate the questionable items—usually within 30 days, unless it considers the dispute "frivolous."

If the information provider finds that the disputed information is wrong, it must notify all three major nationwide consumer reporting companies so that the information is corrected.

If you ask, the consumer reporting company or credit bureau must notify anyone who received your report in the recent past.

NOTE If a consumer reporting agency fails to follow very specific rules and correct information on your report, call the office of your state attorney general. You can find a list of state attorneys general at www.naag.org.

HOW TO DEAL WITH CREDIT FILE ERRORS

What if you simply can't get a mistake on your credit report corrected? You can

- **Write up to 100 words stating reasons for disputing the accuracy or completeness of a credit report item. Submit it to the consumer reporting agency. It must be added to your credit report at no charge.**
- **Resubmit the dispute to the consumer reporting agency, but only if you have additional documentation.**
- **Sue under the Fair Credit Reporting Act for negligent or willful noncompliance. If successful, you can get damages, court costs, and attorney fees.**
- **When applying for a loan, request in writing that a lender consider information indicating that the credit history being considered is inaccurate. The lender is required to consider it.**

What If Your Bad Credit Score Is Accurate?

If you have a bad credit score, and it's accurate, you need to know exactly when the items that are triggering it legally must be removed. Then, it's up to you to make certain the consumer reporting agency removes them.

Accurate negative information may stay on your credit report for seven years. Bankruptcy information, as we told you earlier, may be reported for 10 years or, in certain cases, longer.

Information about an unpaid judgment against you typically can be reported for at least seven years. The following have no time limit:

- Information on criminal convictions.
- Information reported in response to an application for a job that pays more than $75,000 annually.
- Information reported because you've applied for more than $150,000 worth of credit or life insurance.

> **CAUTION** If your credit record is blemished, don't fall for scams that promise to fix your credit for an upfront fee. They're probably illegal. Also, beware of debt settlement companies that charge outrageous fees to negotiate with your lender. Often, you're better off just paying your debt or dealing with your lender yourself.

The good news is that many lenders still will grant you credit even with bad information on your credit report. So it pays to take steps to boost your credit score as much as possible.

Here are some more ways to do that, according to Fair Isaac Corp.:

- Pay bills on time.
- If you've missed payments, get current and stay current.
- Keep balances on credit cards and other revolving accounts low.
- Pay off debt rather than moving it around.
- Confine your shopping for a given loan within a focused period of time.

Once you've succeeded in getting your debt under control and removing negative information from your credit report, be sure to ask your creditors to lower their interest rates and/or fees. You'll definitely have more leverage to shop for better deals. Plus, you'll have a lot more money to earmark toward your financial goals!

Summary

In this chapter, we outlined your options for dealing with debt: handle it yourself, see a credit counseling agency, consolidate debts, or file bankruptcy. Also, we explained that today, more lenders, insurers, landlords, and utility companies are considering your "credit score," a three-digit number designed to predict your chances of paying your loan or bills. Your credit score not only can be a factor in whether to grant you a number of financial services, but also can influence the

price you pay. Generally, the higher your credit score, the lower your loan rate and the more leverage you may have on insurance prices. To raise a genuinely bad credit score, you need to correct any mistakes on your credit reports and make sure accurate bad information is removed when it legally is required to expire. Improving your credit score can help you free up even more money to put toward your financial life. Now, on to building wealth!