④ Take Control of Debt

Remember the definition of net worth (wealth)?

Assets – Liabilities = Net Worth

I owe, I owe, so it's off to work I go.

Bumper sticker on a 1972 Chevy

Liabilities are your debts. Debt reduces net worth. Plus, the interest you pay on debt, including credit card debt, is money that cannot be saved or invested—it's just gone. Debt is a tool to be used wisely for such things as buying a house. If not used wisely, debt can easily get out of hand. For example, putting day-to-day expenses—like groceries or utility bills—on a credit card and not paying off the balance monthly can lead to debt overload.

WHY PEOPLE GET INTO TROUBLE WITH DEBT

More than 1.4 million individuals filed for bankruptcy in 2001, a significant increase from the 316,000 individuals who filed in 1981. That means lots of people are mired in debt. In some cases, they could not control the causes of their debt. However, in some instances they could have.

Many people get into serious debt because they:

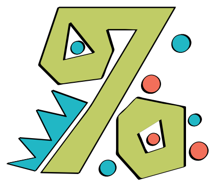
- Experienced financial stresses caused by unemployment, medical bills or divorce.
- Could not control spending, did not plan for the future and did not save money.
- Lacked knowledge of financial and credit matters.

WEALTH-BUILDING TIPS

- Develop a budget and stick to it.
- Save money so you're prepared for unforeseen circumstances. You should have at least three to six months of living expenses stashed in your rainy day savings account, because as the poet Longfellow put it, "Into each life some rain must fall."
- When faced with a choice of financing a purchase, it may be a better financial decision to choose a less expensive model of the same product and save or invest the difference.
- Pay off credit card balances monthly.
- If you must borrow, learn everything about the loan, including interest rate, fees and penalties for late payments or early repayment.

SPEAKING OF INTEREST

When you take out a loan, you repay the ***principal***, which is the amount borrowed, plus ***interest***, the amount charged for lending you the money.



Remember the discussion about earning compound interest in Chapter 3? The interest on your monthly balance is a good example of compound interest that you pay. The interest is added to your bill, and the next month interest is charged on that amount *and* on the outstanding balance. For example, if you have a $1,000 balance that you do not pay off at the end of the monthly billing period and the annual interest rate is 20 percent, your bill next month will be $1,016.67, even though you made no additional purchases. In a year's time you will have paid more than $219 in interest.

The bottom line on interest is that those who know about interest earn it; those who don't, pay it.

AVOID CREDIT CARD DEBT

Planners, like Betty, rarely use credit cards. When they do, they pay off their balances every month. When a credit card balance is not paid off monthly, it means paying interest—often 20 percent or more a year—on everything purchased. So think of credit card debt as a high-interest loan.

Do you need to reduce your credit card debt? Here are some suggestions.

- Pay cash.
- Set a monthly limit on charging, and keep a written record so you don't exceed that amount. (Remember your daily expense sheet from Chapter 2? Use it to keep track.)
- Limit the number of credit cards you have. Cut up all but one of your cards. Stash that one out of sight, and use it only in emergencies.
- Choose the card with the lowest interest rate and no (or very low) annual fee. But beware of low introductory interest rates offered by mail. These rates often skyrocket after the first few months.
- Don't apply for credit cards to get a free gift or a discount on a purchase.
- Steer clear of blank checks that financial services companies send you. These checks are cash advances that may carry a higher interest rate than typical charges.
- Pay bills on time to avoid late charges.

The Tale of Two Spenders and the Big-Screen TV

Remember Betty, the planner? She saved up for the "extras." When she had enough money in her savings account, she bought a big-screen TV for $1,500. She paid cash.

Her friend Tim is an impulsive spender. He seeks immediate gratification using his credit cards, not realizing how much extra it costs. Tim bought the same TV for $1,500 but financed it for one year using a store credit card with an annual interest rate of 18 percent. His monthly payments were $137.52.

At the end of the year, Tim discovered that he had paid $150.24 in interest. He paid $1,650.24 for the big-screen TV—the cost of the TV plus interest—and Betty paid only $1,500. Tim not only paid an extra $150.24, he lost the opportunity to invest the $150.24 in building his wealth.

BEWARE THE PERILS OF PAYDAY LOANS AND PREDATORY LENDERS

People can get deep in debt when they take out a loan against their paycheck. They write a postdated check in exchange for money. When they get paid again, they repay the loan, thus the name ***payday loan***. These loans generally come with very high, double-digit interest rates. Borrowers who can't repay the money are charged additional fees for an extension, which puts them even deeper in debt. Borrowers can continue to pay fees to extend the loan's due date indefinitely, only to find they are getting deeper in debt because of the steep interest payments and fees.

Pauline

Predatory lenders often target elderly and low-income people they contact by phone, mail or in person. After her husband died, 73-year-old Pauline got plenty of solicitations from finance companies. She was struggling to make ends meet on her fixed income. To pay off her bills, she took out a $5,000 home equity loan that carried a high interest rate and excessive fees. Soon she found she was even deeper in debt, so she refinanced the loan once, then again, and again, paying fees each time.

Pauline's children discovered her situation and paid off the loan. The lessons here are:

- Don't borrow from Peter to pay Paul.
- Never respond to a solicitation that makes borrowing sound easy and cheap.
- Always read the fine print on any loan application.

Seek assistance from family members, local credit counseling services or others to make sure a loan is right for you.

KNOW WHAT CREDITORS SAY ABOUT YOU

Those who have used credit will have a credit report that shows everything about their payment history, including late payments.

A history of paying bills late can have a negative impact on your credit record. Banks and other lenders use credit reports when deciding whether to loan money. Insurance companies and potential landlords and employers may also check credit reports. A person's history of paying bills is a good predictor of how he or she will pay future debts. Creditors generally look for a two-year history of consistently paying bills on time to establish good credit.

A credit report that includes late payments, delinquencies or defaults could mean not getting a loan or having to pay a higher interest rate because the borrower has a greater risk of default.

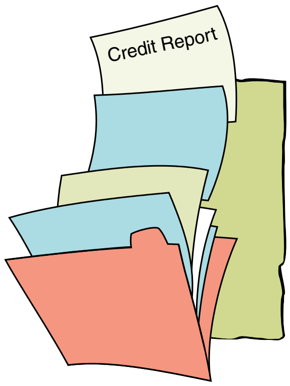
What's on YOUR Credit Report?

To learn what is on your credit report, you can order a copy for a fee from the following major credit bureaus:

Equifax
1-800-685-1111; www.equifax.com

Experian
1-888-397-3742; www.experian.com

Trans Union
1-800-888-4213; www.transunion.com



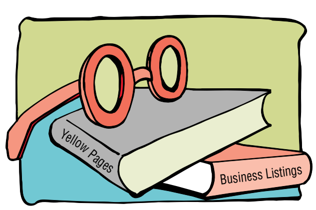
Review your credit report at least once a year to make sure all information is accurate. Correct errors on your report by:

- Alerting the credit bureau to the error.
- Sending the credit bureau copies of canceled checks or other payment information.
- Explaining the problem in a brief letter. The credit-reporting agency must investigate your complaint within 30 days and get back to you with its results.
- Contacting the creditor if the credit bureau disagrees with you. When you resolve the dispute, ask the creditor to send the credit bureau a correction.

If the issue remains unresolved, you have the right to explain in a statement that will go on your credit report. For example, if you did not pay a car repair bill because the mechanic didn't fix the problem, the unpaid bill may show up on your credit report, but so will your explanation.

KEEP YOUR GOOD NAME

Every month, go back to your budget and plan carefully to ensure your bills are paid before their due dates. Betty, the planner, makes sure she pays her bills on time. Betty gets paid twice a month. Out of her first check, she pays her mortgage, cable TV and utility bills. Out of the second check, Betty pays her car payment, telephone bill, student loan, newspaper and health insurance by their due dates. She sticks faithfully to that schedule. You, too, can keep your good name by being a planner.



If you believe you are too deep in debt:

- Discuss your options with your creditors before you miss a payment.
- Seek expert help, such as Consumer Credit Counseling Services, listed in your local telephone directory.
- Avoid "credit repair" companies that charge a fee. Many of these are scams.

SAVE MONEY BY CHOOSING THE RIGHT LOAN

If you have good credit, you may want to take out a loan for a house or to pay your children's college tuition—both are investments in the future. But regardless of how the money is spent, a loan is a liability, or debt, and decreases your wealth. So choose loans carefully.

Shop and negotiate for the lowest interest rate. The interest you save can be invested to build wealth. Take a look at the chart to the left. It is obvious that Pixley Bank and Trust would charge the lowest interest over the term of the loan.

$15,000 Car Loan for 5 Years

Lender	Interest rate	Total interest
Pixley Bank and Trust	6.5%	$2,609.53
XYZ Savings and Loan	7.5%	$3,034.15
Bank ABC	8.75%	$3,573.51

SAVE MONEY BY PAYING LOANS OFF EARLY

You can save interest expense by increasing your monthly payments or choosing a shorter payment term on your loan.

Betty, the planner, knew her new car would cost more than the sticker price because she would have to pay interest on the loan from the bank. After checking her options, she chose a shorter payment term with higher payments. Betty budgeted enough money each month to make the higher payments. By doing this, she will reduce the amount of interest she ultimately pays.

The chart on the left shows how shorter terms with higher payments would affect the total amount and interest on Betty's $15,000 car loan.

$15,000 Car Loan at 10 Percent Interest

	3-year	4-year	5-year
Number of payments	36	48	60
Payment	$ 484	$ 380	$ 318
Total paid	$17,424	$18,261	$19,122
Interest saved	$ 1,698	$ 861	—

Betty's car will be paid for in three years, and she plans on driving it for at least eight years. Once her car is paid for, she will continue to budget for the car payment but will invest the money to further build her wealth.

TAKE STEPS TO CONTROL YOUR DEBT

As you can see, a big part of building wealth is making wise choices about debt. You need to maximize assets and minimize liabilities to maximize net worth. To manage debt you need to know how much you have and develop strategies to control it. When Bob decided to reduce his credit card debt of $3,000 (see page 4), he analyzed his debt and developed a strategy to reduce it.

Credit card	Debt	Interest rate	Monthly interest*
Department Store A	$ 500	19.5%	$ 8.13
XYZ Bank	$ 1,250	17%	$ 17.71
BHA Finance Co.	$ 1,000	22%	$ 18.33
Store B	$ 250	15%	$ 3.13
Total	$ 3,000		$ 47.30

*Interest rate divided by 12 months multiplied by the amount of debt.

Credit card	Debt	Interest rate	Monthly interest
Total			

To reduce his credit card debt and the monthly interest he paid, Bob also decided to find a card with a lower interest rate and transfer the $3,000 balance to that account. Bob reviewed his budget and cut expenses. He found a card with an interest rate of 9 percent, reducing his monthly interest expense by $24.80. He cut up the old credit cards and used the $24.80 in interest savings to pay more of the debt principal each month. He only used the new card for emergencies.

What is your credit card debt situation? Using the chart to the left, do an analysis of your own.

My strategy for reducing credit card debt includes:

1. ______________________________

2. ______________________________

3. ______________________________