Debt – Get Out and Stay Out!

Most of us have debt – perhaps the mortgage on a home, car payments, the balance on a credit card – or several cards – education loans, home equity loans, and many other kinds of debt.

Debt can make a lot of sense, as one part of a person's or family's overall financial situation. It allows us to enjoy things now that we could not have if we had to pay for them all at once. For many people, however, debt has grown larger than they ever intended, and has created a problem. Repaying what is owed seems to take more of the budget than they can manage. American households now spend an average of 14% of their disposable income just to pay the *interest* on their debt. At the same time, it is easy to go deeper into debt, as credit card offers keep arriving in the mail.

If debt is a problem for you now, how can you get out? If there is no problem now, how can you make sure there won't be a problem later?

Knowledge is power. The information here can help you gain the knowledge you need to get out – and stay out – of debt. Access to this information is one of the services The CIMA Companies, Inc. provides its insurance customers.

We have included some basic information – not as professional advice, but as guidance for you. We have included links to a variety of other Web sites you might want to visit, if you need additional help.

We hope the information is useful.

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Budget basics

Spend only what you can afford. Sounds simple, but it’s really not. How do you know what you can “afford,” if you have a billfold full of credit cards and debit cards? There’s no one to stop you at the checkout counter and say, “You’d better put that back.” That’s a job you’ll have to do for yourself. You can do it, if you’ll be honest about your financial situation. Here’s how:

For one month, write down everything you spend, and what you spent it for. (If there is more than one earner in the family, everyone gets to join in this exercise.) What you write down will include all the checks you write, all the purchases or cash withdrawals you make with your debit card, all the purchases you put on any of your credit cards, all the cash you spend. It will be annoying to keep track of it, but you can do it for a month. (One way to make it easier will be not to carry your credit cards all the time. You can’t use them if you don’t have them!)

After a month, take two sheets of paper and put them side by side. On one sheet write down how much you spent, and what you spent it for. On the other sheet, write down your total income for the month.

Which figure is larger? If your expenses were greater than your income, was that because of an unusual purchase? If the answer is no – if those expenses were pretty much a typical month – start looking at the expense list and decide where you can cut.

One more thing – Keep cutting until you are able to add one more item on the expense list – a little savings. (See **Saving and investing**, coming up next, for more information.)

By the way, did you ever notice how much more expensive it is to eat out for lunch, instead of bringing yours from home?

Saving and investing – pay yourself first!

A number of studies show that most people are not saving enough to be able to retire at the age they plan to retire. The rate of savings for the typical American household falls short of what will be necessary to build enough wealth to maintain a desirable standard of living. Even those who have set a goal for the financial resources they expect to have at a particular age, and are saving enough to reach that goal, sometimes underestimate the amount of money it will take to live on, once the paychecks stop. Those who are in the

early part of their careers, when budgets usually are very tight, sometimes assume that there will be plenty of time later, for saving. Yet, you might be surprised how much more you have at retirement if you start saving early.

"Pay yourself first." If you remember that, saving becomes easier. Pay yourself -- the "you" of the future, who wants to retire -- first. Pay yourself before you buy something you don't really have to have.

How much should you "pay yourself," to get ready for retirement? If you go to the Web site of the FinanCenter, in the "consumer" section you will find a number of calculators that will show you how your savings and investments can be expected to grow, based on how much you save and when you start saving. The site is at http://www.financenter.com/consumer.

If your employer has a 401(k) or similar tax-favored retirement program, you can have several thousand dollars a year deducted from your income on a pre-tax basis, and placed in a number of investment accounts of your choice, so the money will grow for you. The advantage of the pre-tax deduction is that each dollar is worth a whole dollar -- no tax has been taken out. Also, the money you put into a 401(k) is not taxed while it grows. You pay tax only when you withdraw the money, at retirement. (NOTE: Most 401(k) plans allow loans, with certain restrictions. Usually, the loan must be repaid with interest. It's true that you actually are paying the interest to yourself rather than another lender. But remember, when you take money out of your 401(k), that money cannot grow tax-free. So, it isn't really a "free" loan to yourself.)

Individual Retirement Accounts -- both the traditional type and the "Roth" type -- also provide opportunities to save and invest, and have your money grow without being taxed. With the "Roth" IRA, you do not even pay taxes when you withdraw the money at retirement.

A professional investment counselor, financial planner or the human-resources department where you work can help you learn more about these and other ways to save and invest. To choose a qualified investment counselor, you might want to visit the Web site of the National Association of Securities Dealers (www.nasd.org). To choose a qualified financial planner, you might want to visit the site of the Certified Financial Planner Board of Standards (www.cfp.net/learn.)

Don't pay too much tax

Make sure you are taking advantage of all the savings limits, deductions and credits you are entitled to, under the federal and state tax laws. Beginning in the 2002 tax year, the federal law was changed to increase the limits that can be contributed to an Individual Retirement Account and a Coverdell Education Savings Account, to add three new

deductions for educational expenses, and to adjust the Earned Income Tax Credit in favor of lower-income taxpayers.

The tax law changes every year, and you want to make sure you take advantage of any provisions that would allow you to reduce the amount of tax you owe. Tax-preparation software can help you determine whether you qualify for certain deductions or credits. If you have a personal computer, the $40 or so you spend on the software each year is well worth it. You might save money, and you definitely will save time, using the software instead of filling out your returns by hand.

If you get a refund, here are two suggestions:

1) Save it, don't spend it.
2) Ask your employer to reduce the amount of taxes that are withheld from your pay, by an amount equal to your refund. It's better *not* to have a tax refund. Getting a refund just means you have given the federal government an interest-free loan – which you'd probably rather not do.

Credit cards – handle with care

How many credit cards do you have? It isn't unusual to have a dozen or more. They're very easy to get, as you might know, and they allow you to spend several thousand dollars that you can pay back later. They are very convenient. You can get cash advances. You even can pay rent with them, in some places. Plus, using your credit card can earn you frequent-flyer miles or other benefits. So, the temptation is there to use your credit cards early and often.

Merchants like credit cards because they allow customers to spend more than they could if they had to pay cash all at once, and allow purchases to be made by phone or on the Internet. The banks and other companies that issue credit cards like them because the merchants pay a fee to the issuer, every time a customer uses the card. The issuers also like them because most consumers don't pay off their entire credit card bill each month. You know what that means -- they have to pay interest...interest that ranges from "low introductory rates" of a few percent to as much as 15%, 20% or even more. (It's in the fine print, when you apply for your card.)

The average household now has credit card debt of over $8,000, and pays about $1,100 in annual interest. Think about the interest...that's money you spend for which you get absolutely nothing in return! It's like taking the same amount of money, piling it up in your driveway and setting it on fire. Interest is the penalty you pay so you can have something before you have the money to pay for it.

One mistake people sometimes make is to think, "If I qualify for this card, that must mean I can afford it." That isn't true. Credit card issuers are well-financed enough to

withstand some losses from cardholders who can't pay off their credit balances. It's a numbers game, and the numbers are on the credit card issuer's side.

How do you keep from getting in over your head with credit cards? Consider having only two -- or at the most, three -- cards. One would be a versatile card such as Visa, Mastercard or Discover; the other would be gasoline credit card. Each month, pay off the entire balance on each card. If you find that you cannot pay the entire balance, adjust your spending the next month so you can finish paying the balance.

TIP: How does the interest rate on your credit card compare with other cards? Go to www.bankrate.com, or www.cardweb.com, to find out.

Credit counseling

There are a great many qualified professionals who, for a fee, can help people organize their finances in a way that helps them get out of debt. Unfortunately, there also are others in the business who are not as qualified, and are more interested in taking people's money than in helping them. Often, it is very hard to tell the difference, until it is too late. A study by the National Consumer Law Foundation and the Consumer Federation of America found that a growing number of credit counselors are offering unrealistically simple "debt management plans" (DMP) and misleading customers about fees. Also, most counselors can claim "nonprofit" status, which might make them seem more attractive to you, but many have close relationships with for-profit operations and, for all intents and purposes, operate on a for-profit basis. "Voluntary" fees sometimes are mandatory, if any services are to be provided.

If you are considering using a credit counselor, visit more than one. Compare their fees (get it in writing, and read the fine print.) One resource that might help you is the National Foundation For Credit Counseling, based in Silver Spring, MD. Credit counseling agencies that are members of the NFCC are accredited by an independent organization called the Council on Accreditation of Services For Families and Children, after an extensive qualification process. You can locate an NFCC member agency near you either through the Web site (www.nfcc.org), or by calling 800.388.2227. You might also want to visit NFCC's consumer Web site, www.debtadvice.org, to learn more about money management, home financing, and other topics.

Instead of going to a credit counselor, consider doing the hard work yourself -- get on a budget and stick to it, and negotiate with your creditors yourself, to work out a payment schedule you can meet.

NOTE: Sometimes, a "low introductory rate" on a new credit card offer can help you get out of debt. Does the offer allow you to transfer your existing balance from another card, to the new card, and pay that balance at the introductory rate? If so, check the fine print to see how long the introductory rate lasts. If you are *sure* you will be able to pay the old

card balance within that time, you might save a bundle in interest by transferring the balance to the new card. Just be aware that the interest rate on the new card will be substantially higher once the introductory period is over -- and don't let yourself get into the interest trap again.

If it sounds too good to be true…

You've probably heard advertisements like this: "We will pay off your debts, and combine all your bills into one easy payment that is LESS than you pay now!" And at the end of the advertisement the announcer mumbles something like, "Negative equity applies to new loan balance." You need to understand that you will pay MORE, in the long run, in an arrangement like that. That is because your payments will be extended for a longer period, plus you will pay an additional fee to the consolidator. Rule of thumb: If it sounds too easy and painless, too good to be true -- run the other way. There are enough good professionals out there, if you need credit counseling, that you don't need to do business with the carnival barkers.

Credit scoring and insurance scoring – don't let mistakes hurt you

Credit scoring -- There are three major credit bureaus -- Equifax, Experian and TransUnion -- that have a record of your credit history, and that have assigned you a "score" indicating how risky they believe it is to provide credit to you. That score is a three-digit number, usually ranging from 350 (high risk) to 850 (low risk). It takes into account your history of making payments on time, the amount you owe currently, how long you have had credit, how much new credit you have, and the types of credit you have. Whenever you apply for credit, the lender checks with one or more of the bureaus, and an "inquiry" is noted on your report. If you are late on credit payments, you can expect that the lender will notify one or more of the bureaus, and the information will be added to your report.

Note that we said "one or more." That means the information that Equifax has for you might be different from what Experian has. Any or all three bureaus might have incomplete or inaccurate information. They should all be the same, and, unfortunately, it is up to you to make sure that's the case. How do you do it? Once a year, you should pay a few dollars to obtain a credit report from each of the three bureaus, and check it for accuracy. You might be shocked by the mistakes you find -- including credit information on other people with similar-sounding names or similar addresses, that accidentally was put into your report!

There also will be inaccurate information in your credit report if someone has "stolen" your identity in order to get money – a growing problem. (See **Are you the only *you*?** below.)

When you find mistakes, the credit bureau is required to check it out, to correct it if you are right, and send you a corrected report at no charge.

The Consumer Federation of America and the National Credit Reporting Association conducted a study in 2002 that found huge differences in the three bureaus' reports on many of the same individuals. It pays to check, because the credit scores are used by lenders not only to determine whether or not to issue credit to you, but also what interest rate will be charged. If you are considered a high risk, you will pay a higher interest rate. Over the life of the loan, that higher rate could be many thousands of dollars -- and it might be based on false information, if you don't correct your credit report.

There is more information about credit scoring, and the models that are used to develop credit scores, at the Web site of a company that develops those models, Fair, Isaac & Co. After you have obtained your credit scores from the three bureaus, go to www.myfico.com . You can see what your own score might mean in terms of the availability, and cost, of credit.

The Freddie Mac Web site also has a good explanation of credit scoring, and how to maintain a good score, at http://www.freddiemac.com/knowyourscore/.

Here are the names, addresses and phone numbers of the three credit bureaus:

Equifax -- Report fraud at 800.525.6285, or Box 740250, Atlanta GA 30374. Obtain a copy of your credit report at 800.685.1111, or Box 740241, Atlanta GA 30374 or www.equifax.com ($8 for most states).

Experian -- Report fraud at 888.EXPERIAN (888.397.3742), or Box 1017, Allen TX 75013. Obtain a copy of your credit report at 888.EXPERIAN or Box 2104, Allen TX 75013 or www.experian.com/consumer ($8 for most states).

Transunion -- Report fraud at 800.680.7289, or 888.4213, or Box 6790, Fullerton CA 92634. Obtain a copy of your credit report at 800.888.4213 or Box 390, Springfield PA 19064 or www.tuc.com ($8 for most states).

Insurance scoring -- This has become a controversial subject in the past several years. Insurance companies have been obtaining applicants' credit scores, and using those scores in a formula that determines an "insurance score." The insurance score is supposed to determine the likelihood that the applicant will have claims, and how severe those claims might be. One of the major factors considered is how regularly the applicant has paid his or her bills in the past.

Some consumer organizations oppose credit scores because, they say, the insurance companies have not shown why it is that someone who is late paying bills is more likely to have an insurance claim. Opponents say the insurance scoring system has an adverse impact on minorities, and those who live in poorer neighborhoods. Still, a number of independent studies have shown that there is a relationship between insurance scores and actual claims experience. Insurance companies refuse to show just how their formulas work, because those formulas are trade secrets they do not want to share with competitors.

In 2002, Maryland passed a law that prohibits insurers from using credit information when considering whether to accept or reject applications for homeowner's insurance or car insurance. The information *can* be used to determine the rate that will be charged for car insurance, however. The Virginia General Assembly recently passed a law that prohibits insurers from using credit information as the *only* reason not to renew homeowner's and private-passenger automobile insurance. If credit information is part of the reason not to renew the insurance, the law requires that the insurer provide an explanation.

State legislatures are considering a number of other bills that would change the way credit reports and insurance reports can be used. As long as the reports are used by lenders or insurance companies, however, the moral of the story is plain -- keep your credit history clean. Especially, pay your bills on time.

Your mortgage

There's a lot of satisfaction that goes with owning your own home, a lot of responsibility to maintain it and make the mortgage payments, and a nice tax deduction for the interest you pay on your mortgage.

The mortgage is the largest debt most homeowners will ever have. If you calculate the amount of interest you pay over the life of your 30-year or 15-year loan, you might be surprised at the amount. It can be more than the principal! That's why it is important to make sure the interest rate you are paying is in line with the market. Many newspapers publish the mortgage interest rates for various lenders once a week. Check those once in a while. If your interest rate is more than a couple of percentage points higher than what's available in the current market, it probably is worthwhile to refinance your mortgage. You will save more in interest costs than you will spend in "closing costs" (paying the lender, the title company, and dozens more).

Your present lender might be your best bet for the new loan. They don't want to lose you to a competitor. Plus, because they have the information from your original application, the process might be less time-consuming for you than it would be if you went to a new lender.

Back to those total interest costs over the life of the loan...many lenders' Web sites now have calculators that will show you how you could reduce those costs, by paying additional principal amounts each month...$50 extra, $100 extra...whatever you can manage. If you refinance your mortgage and have a lower monthly payment, why not continue to pay the same amount each month that you paid before? If you could pay off your loan a few years sooner, and save several thousand dollars in interest, would it be worth it?

The Fannie Mae and Freddie Mac Web sites have some useful resources for those who are trying to determine what they can afford in the housing market. Go to http://www.fanniemae.com/homebuyers/resources/index.jhtml?p=Resources, and http://www.freddiemac.com/homeownership/, and try some of the calculators.

Home equity loans

When you own a home (even if the real owner is your mortgage company), it's possible to use your home as a kind of piggy bank. You can obtain a loan, by using your home as "collateral," to secure the loan. With automated application systems, it usually is very simple and quick to obtain approval for the loan.

Here is a good rule to live by, to help stay out of debt: when credit approval is easy, ask yourself why, and try to figure out if there's some danger involved. The main reason home equity loans are easy to get is that the lender is not taking much of a risk. Why? Because if you don't pay the loan, the lender can take your house. There's another danger, too: interest rates on home equity loans usually are not locked. They can go up. If you are considering a home equity loan, read the loan agreement carefully to see what the maximum interest is that can be charged, and what would allow the lender to raise the interest rate that much.

Also check for any "application fees," annual fees or other fees the lender might be charging. Get an explanation of what those are for (an explanation you can understand...there's no such thing as a dumb question, when you are protecting your money.)

What do you want the home equity loan for? If you are thinking about taking the loan as a way to pay your credit-card debt, be careful. Unless you correct the spending habits that caused you to go into debt in the first place, you have put your home ownership in danger, without addressing the real problem. As *Newsweek* economics columnist Jane Bryant Quinn once said, you don't get out of debt by borrowing more.

"Cash out" refinancing

This is another way of using your home as a piggy bank. You take out some of the equity you have in your home, as cash, and you add the same amount to your mortgage loan. ("Equity" just means the difference between what your home is worth and the total amount you still owe on your mortgage.) As with home equity loans, there's some danger with "cash out" refinancing. The main danger: if you need to sell your home (for example, if you lose your job), and the market for homes in your area is down (perhaps because of the same recession that caused you to lose your job), you might not be able to sell your home for the amount that you now owe on it.

Loan modifications

Sometimes, when a borrower is behind on payments, the lender will offer to "modify" the loan -- cutting the monthly payments to whatever the borrower can afford to pay. In a pinch, this can be a sensible strategy -- especially if the alternative is losing your home. But it does have a downside.

In a loan modification, the lender doesn't just forget about the payments you missed. Those payments are added to your loan. The payment schedule for your modified loan will be longer than the schedule for your original loan. The interest rate might also be higher. In any event, the modified loan will cost you more in the long run, even if it makes it easier to make payments in the short run. Look at the numbers. How much will the total payments -- principal and interest -- be in the modified loan compared to the original loan? If your financial situation gets better in a year or two, can you change back to the terms of the original loan with no penalty? Negotiate everything you can in your favor.

If you have no choice but to go with the loan modification, it generally means you are overextended, financially. Look for other areas where you can cut back, so you aren't in danger of defaulting on the modified loan.

Debt collection – know your rights

Creditors often hire collection agencies to pursue overdue debts by contacting the debtor and asking for payment. In 1977, Congress passed the Fair Debt Collection Practices Act, which gives debtors certain rights, by restricting how the collection agency may contact them. A debt collector may contact you by mail, in person or by other methods, but not at times that are unusual or inconvenient, such as early morning and late evening. If your employer disapproves, the collector may not contact you at work.

You may stop the collector from contacting you at all, by instructing the collection agency in writing. After you write to them, the agency may not contact you again except

to acknowledge your instructions, or notify you of some specific action the agency or your creditor intends to take.

Generally speaking, the collector may contact other people you know, but only to find out where you live or work. If you have an attorney and have notified the collection agency, the collector may not contact anyone but the attorney. If you believe you do not owe the money, and you notify the collector within 30 days after they first contact you, the collector must either provide proof of your debt, or stop contacting you.

"Subprime" loans

"Subprime" lenders are companies that will lend money to people whose credit history is not good – people who might be turned down if they applied for a loan at a bank. Interest rates are higher with subprime loans, and it is legal to charge these higher rates. In recent years, however, the federal government and a number of states have been cracking down on what they see as abuses. Examples are excessive fees that are charged, "balloon payments" that amount to a huge final payment on the loan, penalties for paying off the loan early, and frequent refinancing of the loan (with new fees for each refinancing). Still, some abuses still are legal, and some continue even if they are against the law.

Studies by Fannie Mae and Freddie Mac have shown that at least one-third of borrowers who take out subprime loans would have qualified for loans in the regular market, at much lower interest rates, if they had tried. So visit your bank first, and another bank, or savings and loan, or credit union if you have one, first. If it turns out that you do not qualify for a regular loan, and you decide to visit a subprime lender, be sure to visit more than one, and read all the terms and conditions carefully before accepting the loan.

You can learn more about "subprime" loans, how they can turn into predatory lending practices, and what laws exist to protect borrowers, at the Web site of the Association of Community Organizations For Reform Now (ACORN), www.acorn.org, and the Web sites of Fannie Mae (www.fanniemae.com) and Freddie Mac (www.freddiemac.com.)

"Payday" loans – do you really want a 458% interest rate?

It might sound like a good way to get a little cash until your next payday, but it isn't. Here is how "payday" loans work: You give the lender a personal check that is post-dated (dated for a later time, usually the date of your next payday.) The lender gives you cash on the spot, for some amount less than the check is made out for. For example, you make the check out for $200 and date it for two weeks later. The lender takes his 15% "service charge" -- $30 -- and gives you $170. You can come back in two weeks, pay $200, and get your check back, or just allow the lender to cash it. But take a close look at that 15%.

On an annual basis, it's really $458%! Would you want a credit card that charged a 458% annual rate?

It gets worse, with "payday" loans. When that next payday comes, you might find that you don't have enough money to live on *and* cover that check you wrote. The lender is happy to oblige. He will simply roll that loan over until your next payday. Do you see where this is going? When the lender adds another $30 service charge, the loan amount is now $230. If you are able to pay the $230 on your next payday, you have paid an annual percentage rate of 917%! If not, well, the numbers just keep going up.

Don't get involved with payday loans.

"I want that!"

One way people get into debt is by giving in to the *impulse* to buy, rather than making a good *decision* to buy. A good decision requires some thought, weighing the pros and cons, and exercising good judgment. One way to get away from impulse buying and to decision buying is just to make yourself wait a month. How does the item you wanted to buy fit into your budget? If you buy it, will you still be able to keep your budget on track (remember savings, too.) If the item fits into your budget *and* it still looks just as good in a month, maybe you should have it. If it doesn't, you made the right choice *not* to buy it.

Another trick to stop impulse buying – don't carry your credit cards with you all the time. If you have to use cash to buy something, it feels more like real spending, which is what it is.

Identity theft -- Are you the only *you?*

"Identity theft" has grown into a huge problem. Every day, criminals pose as someone else, in order to get credit. Usually, victims never find out until their bank accounts have been tapped out, or their credit is ruined because bills never got paid. Then, it can take hundreds of hours to straighten out the mess, with the credit bureaus.

Here are a few basic ways to keep identity theft from happening to you:

- If your driver's license number is the same as your Social Security number, go to the Department of Motor Vehicles and get the number changed. Never carry anything with your Social Security number on it in your wallet. Leave your Social Security card itself in a safe place.
- Don't carry more than one or two credit cards at a time. Keep the others in a safe place.
- Don't carry receipts that have an account number on them.

Never have a Personal Identification Number (PIN) for an ATM card, debit card, phone card, etc. in your billfold. You just have to remember those numbers. Photocopy your health insurance card, black out the identification number (which often is your Social Security number), and carry the photocopy instead of the actual card. You can simply give the medical provider your ID number if the need arises.

Never give your credit card number or any other personal financial information to anyone over the phone unless *you* made the call. There are a lot of scams out there.

If you would like more information about how to prevent identity theft, the Federal Trade Commission has some helpful resources at www.consumer.gov/idtheft. If you have been a victim of identity theft, you can use the toll-free identity theft hotline number, 1.877.IDTHEFT (1.877.438.4338).

Just say no -- to telemarketers and direct marketers

One reason people sometimes get into debt is that the offer from the telemarketer, or the offer that came in the mail, is just too good to resist. You won't have to resist it, if you never receive it. The law is on your side, in this area. You can keep your name off of those call lists and mail lists. Here's how:

To opt out of "preapproved" credit card offers and other offers -- 888.5.OPTOUT (888.567.8688). All three major credit bureaus – Equifax, Experian and Transunion -- use this service. Opting out will remove your name from the lists that the major credit bureaus sell to direct marketers (but will not remove you from *other* lists that marketers might buy.)

To remove your name from mail and phone direct marketing lists, put your request in writing to:

Mail Preference Service, Direct Marketing Association, Box 9008, Farmingdale NY 11735-9008. Include your name and complete home address.

Telephone Preference Service, Direct Marketing Association, Box 9014, Farmingdale NY 11735-9014.

To remove up to three e-mail addresses from direct marketers lists, go to www.the-dma.org/consumers/optoutform_emps.shtml.

Current federal law also requires that companies who call you remove your number from their database at your request. You can make that request when the call comes in.

NOTE: You will need to go through this exercise about once a year. Telemarketers and direct mailers are not required to keep your name off their lists forever.