

Unit 7: Debt, Debt Reduction, & Bankruptcy

Read Chapter 7 in the text.

Read this unit including websites. You may want to take notes on the key points.

You can't borrow your way to wealth. That sounds like an obvious statement, but some people try to do it. When things start getting tough, they take out a loan, or rather, another loan.

Don't rely on lenders to tell you when you have enough debt. A problem with the lending situation in this country is that lenders are giving credit to people who often should not be receiving any more credit. They are going lower and lower on the creditor ladder. It is up to you to set your own limits and stick to them. The ratio worksheet from The Financial Checkup can help you determine safe limits.

Read the information on the following website:

[Setting Reasonable Debt Limits \(http://ianrwww.unl.edu/pubs/homemgt/nf3.htm\)](http://ianrwww.unl.edu/pubs/homemgt/nf3.htm)

The government has set up laws that help protect the consumer when obtaining credit. Read the sections "What laws Apply?", "The Finance Charge and Annual Percentage Rate", "A Comparison", and "Cost of Open-end Credit" on the following website:

[The Cost of Credit \(http://www.federalreserve.gov/pubs/consumerhdbk/cost.htm\)](http://www.federalreserve.gov/pubs/consumerhdbk/cost.htm)

Be careful with companies that will pay your bills for you. There are some that are reputable companies and provide a good service, but others are fraudulent or close to it. The good ones will work with your credit card companies to get your interest rates reduced and educate you about money management. You pay them a set amount a month and they pay all your creditors. There are others that have taken the payment from the clients and not paid the creditors. Some of these companies charge large fees for the service and still others have you sign a contract stating that you will pay them a large fee if you decide to discontinue the service. You may want to check with the Better Business Bureau before you sign up with any of these companies.

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Types of Loans Part I: Consolidation Loans

A debt consolidation loan involves taking out a new loan and paying off existing debt. I am asked frequently if these loans are good or bad. It depends on a lot of different factors. A debt consolidation loan can be good if:

- ✓ It has an overall cost less than the original loans. Some people end up paying more overall with a consolidation loan than they would if they paid off the original loans. This is often because the consolidation loan may be for a longer period of time.
- ✓ It has a lower interest rate. You wouldn't want to put a debt with a low interest rate on a consolidation loan with a higher interest rate. Some people do this because they put all their debt on a consolidation loan and don't consider the interest rate for each individual debt.
- ✓ It reduces the total debt payment to a manageable level. Some people get to the point where they can't make all their debt payments. This may be a good time to consolidate the debt into one loan if they can then make the payment. A word of caution with this - often people continue to buy on credit and get their total debt payment back up to where it was before they took out the consolidation loan!

A consolidation loan can be bad if:

- ✓ It switches unsecured debt to secured debt. This often happens when consolidating credit card debt with a home equity loan. Credit card debt is not secured with collateral. A home equity loan is secured with your home. Or in other words, if you don't pay your home equity loan payment, they can take your home.
- ✓ It takes longer to get out of debt. As mentioned earlier, you may be able to pay off the original loans quicker than you could the consolidation loan.
- ✓ The borrowers don't change their spending habits. Many people consolidate their loans, feel a little less burdened, and think they can start spending again. They start charging on their credit cards again and this puts them right back where they were before the consolidation loan.

You may have heard advertisements for companies that say they can get you completely out of debt in 5 to 10 years, including a mortgage. Have you wondered what that was all about? Let me explain them to you. What they usually do is have you get a new mortgage loan with a little lower interest rate if possible and consolidate all your other loans onto the mortgage loan. You get a mortgage loan that is enough to pay off all the previous debt, including the previous mortgage. They often can get you out of debt in less than 10 years. Sounds good, right? Look at the following example.

| <u>Debt</u> | <u>Balance</u> | <u>Interest Rate</u> | <u>Time to Pay Off</u> | <u>Monthly Payment</u> |
|-------------|----------------|----------------------|------------------------|------------------------|
| Home | \$110,000 | 8.0 | 25 | \$849.00 |
| Car | 9,500 | 6.5 | 3 | 291.00 |
| Credit Card | 3,250 | 21.0 | 5 | 88.00 |
| Credit Card | 6,100 | 18.0 | 5 | 155.00 |
| Credit Card | <u>2,900</u> | 19.0 | 4 | <u>87.00</u> |
| Total | \$131,750 | | | \$1,470.00 |

If this person took out a new mortgage loan for \$131,750 at 7% interest and paid off all of the above debt, their monthly payment would still only be \$1,470 a month and they would get out of debt in 10.67 years. That is a lot better than 25 years. But do you see any drawbacks with this program? Consider the following points. In 5 years this person would have had all of their debt paid off except their home (if they didn't get any new debt). At that time their total monthly debt payment would only be the home mortgage (\$849.00). With the consolidation loan they are locked into a huge payment of \$1,470 for almost 11 years. It is a little scary to commit to that large of a payment for that long of a period of time. Emergencies, lay-offs, medical problems, etc. can and often do arise. These things would make the larger payment even harder to pay. Also, they have taken unsecured debt and turned it into secured debt.

Refinancing their mortgage to 7% interest may be a good idea for this person. However, they may want to keep their other debt separate and use the power pay principle to pay off their debt sooner than 25 years. Power pay is explained in the debt reduction section.

The following website has a worksheet that may help you decide if a consolidation loan would be good for you. Look at the calculator and read the information at the following site:

[Should You Consolidate Your Loans?
\(www.smartmoney.com/debt/calculator/index.cfm?story=intro\)](http://www.smartmoney.com/debt/calculator/index.cfm?story=intro)

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Types of Loans Part II: Home Equity, Rent-to-Own, & Pay-Day Loans

Home Equity Loans

If you own a home you probably get a lot of offers for home equity loans. It's hard to know if this is a good idea or not. The lenders will tell you that their loan may have a lower interest rate or be tax deductible. They may not remind you that if you don't make the payments you could lose your home. Read the information on the following website to be more knowledgeable about home equity loans: [When Your Home is on the Line: What You Should Know About Home Equity Lines of Credit](http://www.federalreserve.gov/pubs/homeline/) (<http://www.federalreserve.gov/pubs/homeline/>)

Rent-to-Own

Although this is not really a loan, I put it in this section because some people use them like loans. Some individuals rent an item and keep it until they have paid the amount needed to own the item. In doing this, they have paid a lot more than they would have if they had bought it on credit elsewhere or especially if they had paid cash for it. Also, you often start out with a used item and still pay much more than it would have cost new. An article in the Cleveland Plain Dealer, April 3, 2000 stated that for \$974.35 you rent-to-own a 27 inch Samsung TV set (\$14.99 per week for 65 weeks). If you paid retail you could get that 27 inch TV (\$299) and also a 4-head VCR, and an oak entertainment center, and an oversized recliner, and one video rental a week for a year! The rent-to-own TV may have even been a used TV.

Rent-to-own has its place. If you only needed something temporarily (such as someone had surgery and wanted a TV in their bedroom during recovery), it might work out well. Sometimes people don't have credit histories good enough to get credit and buy a new item. Rent-to-own is one of the few ways they can make payments instead of paying full price (another good reason to keep your credit history clean).

Pay-Day Loans

"Pay-day loans", also called "cash advance loans", "check advance loans", "post-dated check loans", or "delayed deposit check loans", are popping up everywhere. These types of loans are another example of the services some

people must use because they can't get traditional credit. These loans have extremely high interest rates. However, most people don't take the time to figure out a yearly APR. Read the information at the following website:

[Payday Loans](http://www.urbanext.uiuc.edu/thriftyliving/tl-payday_loans.html) (http://www.urbanext.uiuc.edu/thriftyliving/tl-payday_loans.html)

Once started, many people have a hard time getting out of these types of loans.

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Types of Loans Part III: Student Loans

This section is applicable to many of you. The main thing I hope you all think about before getting a student loan is how you will pay it back. Student loans have rules that regular consumer loans don't have. For example, if you don't pay your student loans they can take your tax refund. Usually student loans can't be discharged in a bankruptcy either. Because they are backed by the government they have these special privileges.

I had a neighbor once that came to my house one day and she was very mad. She said that they had taken her tax refund because she didn't pay her student loan. She was mad because she got the loan for one class and never took any more classes. Because she didn't get anything out of the school experience (like a degree), she felt she shouldn't have to pay it back. It doesn't work that way.

It is a good idea to find out what entry positions in your field are paying. If you are in a field that has potential to make a great income, it may be beneficial to get a loan and get through school as soon as possible. If you are likely to make a more modest income, it may be better to extend the time it takes you to graduate and work your way through. Make sure you can pay back a loan before you get one.

If you have financial hardships you can apply for a deferment for your student loan. The following website is not required, but you can find information on deferment at:

<http://www.uheaa.org/uslphome.htm>

Another site just for your information has a budget calculator you can use to work out school expenses:

<http://www.uheaa.org/budget.htm>

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Debt Reduction

The Federal Reserve Board has said that the average consumer owes more than 20% of their income to consumer debt. Remember that consumer debt does not include a mortgage payment. Twenty percent is a large amount to be going to consumer debt.

There are many problems that can come from too much debt. Some of them are:

Repossessions - lenders may seize and sell property that you use as collateral for a loan if you default on a loan.

Sued - if you don't make your payments the lenders may sue you and you may have to pay the lender's legal expenses (it probably says that on the contract you signed).

Wage garnishment - lenders can garnish up to 25% of your income if you don't make your payments.

Loss of work productivity - employees with financial stress are less productive. One article said 20% less effective (The Negative Impact of Employee Poor Personal Financial Behaviors on employers, Financial Counseling and Planning, Vol, 157-168).

Bad credit rating - when you don't make payments on debt it adds negative items to your credit history. Hopefully from the last unit you can see how important it is to keep your credit history clean.

Collection agency contacts - collection agencies can be ruthless when they are trying to get people to pay their bills.

Strain on relationships - when individuals experience financial stress they often become impatient with family members and other close individuals. There can be a great emotional drain when finances become a problem.

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Debt Elimination Calendar

If you feel you may have a debt problem, follow these steps to reduce your debt load:

1. Determine what you owe - you may think that sounds funny, but some people do not even know how much they owe their creditors. Finding out will help you make a more accurate plan for repayment.
2. Focus your budget on debt reduction - try reducing expenses and using that money to add more to the debt payments.
3. Contact your creditors - some creditors will work with you if you tell them you are trying to get control of your debt. They may reduce your interest rate at least temporarily. If you ever can't make a payment be SURE to contact your creditors. You may be able to work out a plan with them. But if you just don't make the payment they don't like that!
4. Take on NO NEW CREDIT - if you are already in debt too much the last thing you need is more debt. Get rid of the credit cards if you need to. Some people cut them up, freeze them in a block of ice (don't microwave to thaw!), or wrap duct tape around them to keep themselves from using the cards.
5. Find good help and avoid bad help - sometimes you need help to most effectively reduce your debt load. If you live close to Utah State University you can get free help from the Family Life Center (797-7224). If you live away from USU, it is likely that you may still be able to find a non-profit organization that helps with debt reduction. Don't get caught in the trap of a company that will charge you to pay your bills. If you need to reduce your debt, every dollar should go toward debt and not to someone else's pocket.
6. Try making Power Payments - when you have one debt paid off, take the money you have been paying toward that debt and add it to another debt. It is amazing how fast debt will go away when you make power payments. Look at the following debt elimination calendar and see how the next payment increases when the first one is paid off.

| MONTH | CREDIT CARD | DEPARTMENT STORE CARD | FURNITURE LOAN | CAR |
|----------|-------------|-----------------------|----------------|-----|
| January | 80 | 50 | 100 | 250 |
| February | 80 | 50 | 100 | 250 |

| | | | | |
|-----------|--|-----|-----|-----|
| March | | 130 | 100 | 250 |
| April | | 130 | 100 | 250 |
| May | | 130 | 100 | 250 |
| June | | | 230 | 250 |
| July | | | 230 | 250 |
| August | | | | 480 |
| September | | | | 480 |
| October | | | | 480 |
| November | | | | 480 |
| December | | | | 480 |

The department store card is paid off quickly when the \$80 from the credit card is added to the \$50 payment. That is because you are paying more than double the original payment and most of the payment is going toward principle. The same is true with the furniture and car loans.

There are computer programs that will show you how much you can save by using the power payment system. There is one such program on some of the "Quicken" computer programs. Also, Utah State University Extension has created a great program called "Power Pay". You can try the Power Pay program on the following website:

[Power Pay \(http://www.powerpay.org\)](http://www.powerpay.org)

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Bankruptcy

When debt levels get high enough, some people need to consider bankruptcy. What one word can you think of that is that is the cause of bankruptcy debt. That may sound obvious, but think about how profound that is. If you never have any debt, you will never have to file for bankruptcy. That leads us to think that keeping debt under control is a major factor in reducing the chances of bankruptcy.

Samuel J. Gerdano, the director of the American Bankruptcy Institute stated two causes of the high bankruptcy rates. One is "sustained high levels of household debt." The other is "major life-changing events" such as divorce, lay-offs, and illness. Have you learned anything in this class so far that could help you avoid these two problems? How about setting your own reasonable debt levels and having an emergency fund?

Read the information at the following website:

[Banruptcy: Debtor's Last Resort \(http://ianrwww.unl.edu/pubs/homemgt/nf1.htm\)](http://ianrwww.unl.edu/pubs/homemgt/nf1.htm)

Look at the following website to see how high the rates have been lately (especially look at household per filings and see how Utah is doing):

[U.S. Bankruptcy Filing Statistics \(http://www.abiworld.org/Content/NavigationMenu/Online_Resources/Bankruptcy_Statistics/ABI_-_Bankruptcy_Statistics.htm\)](http://www.abiworld.org/Content/NavigationMenu/Online_Resources/Bankruptcy_Statistics/ABI_-_Bankruptcy_Statistics.htm)

Research has shown some trends concerning personal bankruptcies. It can hit all groups, different incomes, jobs, races, educations levels, and homeowners as well as renters. Women are the fastest growing group. Entrepreneurs and the self-employed are more vulnerable. A gap between income was often correlated to bankruptcy (being unemployed). Again, an emergency fund could help with being unemployed for a while.

Hopefully you will all learn how to manage your money well and have an emergency savings account and never have to consider bankruptcy.