**Retirees and Surviving Spouses:**

**The following article on consumer debt may be of interest. While the article is a bit long, there are many good ideas provided on the management and reduction of debt. The article has been edited to reduce the size of the document.**

# Consumer Debt - The Enemy Of Saving And Investing

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***IN THIS ISSUE:***



**Introduction**

In this week's E-Letter, I'm going to address the subject of what I call **"non-essential debt,"** which includes much of the credit card and installment debt out there today. If you or your adult children are struggling with credit card debt, this information should be invaluable. As always, feel free to forward this E-Letter to anyone you feel may benefit from it.

According to one source, there were only about five million bank cards in existence in 1965. **Yet the September 2006 Nilson Report says that there are now over 800 million MasterCard and Visa cards alone, not counting American Express, Discover or any of the cards issued by individual retailers.** It's probably safe to say that there are now well over a billion credit, debit and charge cards in existence in the US today.

**Debt Statistics**

I'm sure all of us are aware of the statistics of how much debt the average family carries, as the financial media loves to paint a picture of an overburdened consumer base. Their reports imply that the "average" American household is awash in debt. An August 2006 Newsweek article estimates that **the average American family now owes more than $9,000 in credit card debt**. This number is based on the total credit card debt of over $800 billion divided by the 87+ million households estimated to have at least one credit card.

Based on the Fed's 2006 update, it would appear that most American households are not as bad off as some of the financial media would have us believe. **Even so, there are still many households who are slaves to credit card debt, and things just recently got worse for them, at least as far as monthly payments go.** At the end of 2005, most bankcard issuers increased the minimum monthly payment as a result of pressure from federal regulators. In most cases, minimum payments increased from 2% of the outstanding balance to 4%, a 100% increase.

The effect of this change can be seen by assuming a $10,000 credit card debt at

18% interest (all too common today). At only a 2% minimum payment, it would take over **57 years** to pay off the debt, and total interest paid would be almost **$29,000.** Under the new rules, minimum payments are now in the 4% range, so the same $10,000 would take just under **15 years** to pay off, and total interest paid would be only **$5,915**.

**Transferring Debt -- Not Always A Good Idea**

Over the past few years, many individuals have chosen to consolidate credit card debts by refinancing their homes or taking out a home equity loan or line of credit. This usually results in lower interest rates, and thus lower payments. However, this really amounts to debtors transferring unsecured debt to debt secured by their homes. If payments are not made on this type of debt, foreclosure could result.

**By eliminating the deductibility of interest payments on most loans other than those on primary and secondary residences, the Tax Reform Act of 1986 created an incentive for homeowners with a need for additional liquid funds to borrow against their home equity.**

Couple the tax incentives with rapidly appreciating home values, low mortgage rates, and an aggressive mortgage loan industry, and you have a massive amount of home equity going to pay off credit card bills. Of course, this may be OK as long as households cut up their cards and do not charge them back up again. However, it remains to be seen whether this will happen.

**How Did We Get In This Predicament?**

What follows are my own personal observations about why some households struggle with excessive credit card debt.

First of all, it is important to note that there are some people who get into a credit crunch because of external factors beyond their control. Some have unexpected legal or health costs that cannot be met from current income or savings, and have no choice but to incur credit card debt. Others may be laid off of their job, or have children or elderly parents with pressing needs that cannot be ignored. It is definitely a mistake to assume that anyone with a credit card balance is a failure at budgeting. However, there are many others who carry credit card balances for reasons that are totally within their own discretion. My list of observations is as follows, in no particular order:

**Living Beyond Your Means --** I have found that the most common reason for people incurring credit card debt has been the decision to spend more than they make.  Some people are "impulse buyers" while others try to keep up with the Joneses. Some must have the "best of everything" and a lower-cost alternative just won't do. Whatever the motivation, the net effect is the same -- living beyond your means will likely result in credit card debt.

**Parents' Failure to Teach Financial Responsibility --** This is one of my pet peeves. It amazes me how some parents feel it is not necessary to teach their children to be financially responsible. I know of parents who set up a checking account for their teenage children, and then just deposit whatever is necessary to cover checks written by their child. In some cases, they never even teach the child to reconcile their bank account, so the child has no idea what his/her actual balance is. However, since good ol' mom and dad will pony up whatever is necessary, it's literally a situation where *"I have money because I still have some checks left."*

Fast forward to when these kids graduate from college and are out on their own. Mom and Dad are now enjoying the empty nest and their child is supposed to suddenly become financially astute. In some cases, credit cards take the place of Mom and Dad, providing a source of money with only a small minimum monthly payment.

**Succumbing to Countless Credit Card Promotions --** If you're like me, you receive a ton of credit card solicitations in the mail every month. Some of these make it sound *so easy* to get a credit card, and offer such low initial interest rates, that they are hard to pass up. In fact, some promotions make it sound like it would be financially unwise if you didn't take them up on their offer.

Individual stores have also jumped on the bandwagon, often offering 10% or more off of purchases at the checkout counter if you will just apply for one of their store credit cards. Of course, to qualify for the discount, you have to put the remaining 90% of the purchase price on the card. Like casinos, the stores play the percentages, knowing that many individuals will not pay off the balance the next month.

**Failure To See Debt As Debt --** This one goes beyond the realm of credit card offers, but home equity loan promotions are sometimes just as alluring as those from credit card companies. While home equity loans can have advantages as I discussed above, some mortgage loan promotions talk about how homeowners can "unlock" the value of their homes for use to buy something they want or consolidate other debts. As strange as it may sound, some homeowners borrow against their home equity, convinced that they are simply using their own money.

I recall a television commercial from a well-known home equity lender that featured a voice-over testimonial from a satisfied customer who said something along the line of being grateful to be able to consolidate her credit card bills and ***be out of debt***. Sadly, she's not out of debt, she just transferred the debt from one type of loan to another. I noticed that the lender quickly pulled the ad with this testimonial, but I wondered how many people responded to this ad while it ran so they could "get out of debt."

## How To Erase Credit Card Debt

The Internet, TV and radio have many promotions from organizations promising to help you gain control over your debt, with some even promising to have your interest rates and payments reduced to a more reasonable level. If you or any of your family are thinking about going to one of these firms, my advice to you is BE CAREFUL -- they are not all what they appear to be.

Some credit counseling agencies advertise that they are non-profit, leaving the impression that they are merely good Samaritans trying to help you out. However, a May 16, 2006 article in the *Wall Street Journal* reported that the IRS is auditing many so-called non-profit credit-counseling companies, seeking to revoke their tax-exempt status. The IRS alleges that many of these agencies do not provide meaningful education or objective advice, and some don't even try to get consumers out of debt. Instead, they generate leads for related for-profit debt management firms that charge high up-front fees.

Thus, I believe it is always best to try to gain control of your debt yourself, rather than relying on someone else to do it for you. After all, if you rely on a third-party and don't learn how to manage your finances effectively, you may end up back in the same situation later on. There is no easy way out, financial management takes discipline, and there are no shortcuts.

The Internet and bookstores are full of information about how to get out of debt. There are also a number of programs and packages that you can buy that will provide written material, computer software and even telephone counseling to help people pay off their debts. However, the key to all of the programs I have reviewed revolves around gaining control of spending, and then having the discipline to pay off credit card balances. From my research on the subject of debt management, I have come up with the following steps to help you or an adult child to get out of debt:

1. **Track your expenses.** This is different from budgeting, and I will discuss this in more detail below. Tracking expenses relates to knowing exactly where all of your money goes. This doesn't mean just checks or online bill paying, but also the cash in your pocket. How much do you spend in cash for the many miscellaneous items you purchase? Keep a journal and keep track of *all* of your expenditures. The information will be important in the next steps.

2. **Identify Non-essential Expenses.** Can you live without coffee from Starbucks? How about regular gas rather than premium (assuming your car doesn't require premium)? Do you buy things at the store that you don't really need? Must you see a movie in the theater, or can you wait until it comes out on DVD? Document *all* of these unnecessary expenditures, and add them up.

3. **Budget, Budget, Budget.** I know, I know, budgeting is one of the world's worst financial exercises. It's tedious and boring, but absolutely necessary for you to gain control of your spending. As you budget, keep in mind which expenses are fixed and which are discretionary, such as the ones discussed in #2 above. For now, list credit card expenses at the minimum required payments. I'll discuss later on how to go over and above these amounts.

   The most important rule in budgeting is to be realistic. Budgeting an expense too low just to have a better bottom-line outcome does you no good, since your actual results will always exceed your budget. It's also important to factor in seasonal fluctuations, such as the electric bill which will likely be greater in the summer and lower in the winter (depending on where you live).

   Also be sure to budget for quarterly or annual expenses, such as property taxes, insurance premiums, etc. Set aside money for these large expenses on a monthly basis so you'll have it available when it's time to pay. And it should go without saying that you should eliminate *all* credit card spending, unless you have the discipline to pay the full balance each month.

   If you decide to cancel some credit card accounts, wait until your account is paid in full before cancelling. Some credit card companies reportedly penalize cardholders who close their accounts by raising their interest rate on the outstanding balance. As a general rule, it's not good to cancel all credit card accounts, as this might negatively impact your credit rating. However, you can cut up the card and blank checks even though the account stays open, preventing you from building up another debt burden.

4. **Monitor Your Budget Regularly.** I have known a number of people who will work diligently on a family budget, only to admire it briefly, and then set it aside. A budget is useful only if you compare your actual expenses to those budgeted. That way, if one expense exceeds your budget, you know that other discretionary expenses will have to be reduced to make ends meet.
5. **Start Paying Down Debt.** Up to this point, this sounds more like a budgeting exercise than a way to pay off credit card debt. However, this step starts the ball rolling toward freedom from debt. Remember those non-essential items that you identified in Step #2 above? If you cut these out of your budget as I suggested, you should have come up with a budget that had money left over at the end of each month. That money is your key to becoming debt free. Different debt reduction programs give this money left over various cute names, but we'll just call it your "debt reduction payment" or DRP.

   You might consider rolling high-interest debt to lower-interest cards. Doing this and keeping your payment at the same level allows more money to go toward paying off the debt, and less to interest. Many credit cards now offer low promotional rates, and some periodically send you blank checks with low interest rates as an incentive to transfer balances. Some of these offers provide for a low interest rate for the life of the balance, as long as payments are made on a timely basis. However, be aware that these promotional offers often include significant transfer fees, and you may not always qualify for the special low rate. As always, read all of the fine print first.

6. **Double Up.** As you pay off a credit card bill, it is important that you take the entire amount you had been paying on the first debt, and add it to the minimum payment on the next in line to be paid off. Different sources of budgeting advice have different names for this, such as "snowballing," etc., but the idea is the same. Adding your accumulated DRP to the next minimum payment means you'll pay off the next debt even faster. Using this technique, you may be surprised at how quickly your debts can be erased.

   Another way to increase your DRP is to identify personal items that might be able to be sold and the proceeds used to reduce debt. If you have old furniture, accessories, tools, etc. in the garage or in a storage unit that you no longer use, you might be able to sell them and use the money to pay debt. That not only helps you eliminate debt, but if you sell enough stuff, you might also be able to reduce the size of your storage unit and save money, or eliminate it entirely.

   You can have a garage sale, put an ad in the paper or use e-Bay to sell just about anything. In addition, many cities have consignment shops that will sell your furniture for you, and might get a better price than in a garage sale. Just be aware that consignment shops can charge commissions of 50% or more, and may take longer to sell your items.

7. **Keep On Keeping On.** If "location, location, location" are the three most important words in real estate, then ***discipline*** has that distinction in relation

to paying off your debts. Debt reduction is a marathon, not a sprint. In some cases, it may take several years to completely pay off your debts. During that time, you are going to have to have the discipline to continue adding your DRP to the minimum payments, to not add additional charges on your credit cards (in fact, all but one of these should have already been cut up and thrown away before Step #1), and to double up your DRP as accounts are paid off.

8. **Contact Creditors.** While it may or may not do much good, it won't hurt to contact your credit card issuers and seek a reduced interest rate or a reduced payment. This is especially important if your budget reveals that you can't make ends meet with your current level of minimum payments. You may also be able to determine if an incorrect entry on your credit report is resulting in your interest rate being higher than it should.

9. **Target Other Debt** Once you have eliminated your credit card debt, you don't have to stop there. You can use your DRP to eliminate other installment debt such as for major appliances or automobiles or even your mortgage.

**If Professional Help Is Required**

I noted above my preference is for people to learn to handle debts on their own, without credit counseling organizations. However, I realize that some people simply do not have the discipline necessary to stick to a budget and pay off debts according to a schedule. For these people, a third-party counselor may be an option, but again, **be careful** when selecting such an advisor.

As a general rule, credit counselors will help you solve your debt situation by helping you develop a spending plan (budget) that includes payments to creditors. Plus, legitimate credit counseling firms often offer free educational materials and workshops, and their counselors are typically certified and trained in all areas of consumer credit, debt management and budgeting.

In many cases, a credit counseling organization can help you establish a workable solution to your debt problems. However, in some cases, they may recommend that you enroll in a "debt management" plan. In such a plan, you deposit money each month with the third-party credit counseling agency, which, in turn, makes payments to your creditors. The agency may negotiate lower interest rates and/or payments in light of using a debt management plan, but there's no guarantee they will do so.

According to the Federal Trade Commission, you should always be careful when considering a credit counseling organization. Be wary if the organization charges high up-front fees, pressures you to make "voluntary contributions" that could actually increase your debt, tries to enroll you directly into a debt management plan with a related organization without first fully reviewing your situation, or fails to provide educational materials. You should also ask if the counselors are certified by the National Foundation for Credit Counseling or any other accredited organization.

You should also be aware that if you go through a legitimate credit counseling, debt consolidation or debt negotiation firm, your creditors may still ruin your credit rating. Though creditors may allow a lower monthly payment, they might still consider anything less than their minimum payment to be overdue, thus mounting up late payments on your credit report. It is also important to find out what organizations may also have access to your confidential personal information.

You can learn more about credit counseling options by going to the following websites sponsored by AARP and the Federal Trade Commission:

http://www.ftc.gov/bcp/conline/edcams/credit/coninfo_loans.htm

http://www.aarp.org/money/credit_debt/

*Submitted by Evo Alexandre*