Dealing with Debt

1. How do you negotiate with a credit card company? What happens when you settle your debts for less than you owe?

A: I've been seeing this question more with every passing week. You fall a bit behind on a credit card bill, your interest rate soars, your minimum payment rises, and you start falling more and more behind every month. You don't see an end. But you don't want to file bankruptcy either. What you can do — and should do — is negotiate. Here are the steps.

• **Prepare your case**. Why are you in this situation? You need a clear, legitimate excuse for why you're behind, such as a layoff, divorce, or medical emergency. Be prepared to back up the circumstances with supporting documents. Anything you have to substantiate your story — including proof that you have, for instance, been actively looking for a new job — will help.

•**Call your creditor directly**. In most cases, if you've gotten to this point, you've already received a letter or phone message from your creditor with the name and extension of a representative. If you haven't, you can call the toll-free number on your bill, but keep in mind that the person who answers may not have the power to negotiate a settlement. Ask to speak to someone who is either a supervisor or in the settlement department, if the creditor has one (as many do).

• **Make an offer**. After explaining why you're in trouble, ask the creditor if the company would be willing to accept a smaller amount. Start negotiations at about 30% of the total amount due, with the end goal of paying 50%.

• **Ask the creditor to report to all three major credit bureaus — TransUnion, Experian, and Equifax — that the debt has been paid in full.** Sometimes a creditor is willingto do this as a bargaining point — you give the creditor cash in hand, it gives you a positive listing on your credit report — even though you haven't paid the full amount. Get this agreement in writing.

• **Write the check**. The creditor will want to see the money immediately.
One thing I want to make clear: You never want to hide from your debts. It doesn't work. You'll get much better results by being upfront, answering their calls, and responding to their letters. Delaying the inevitable only digs a deeper hole.

I also need to know ...

Q: Does negotiating a settlement hurt my credit score?

A: It will. Once the settlement is completed, the credit card company will report it to the credit bureaus, which will then make a notation on your credit report that that account was paid by settlement. That's going to signal to future lenders that you left the last guy hanging. That's why, as with bankruptcy, debt settlement is an extreme option, one you shouldn't take lightly. It's not just an easy, cheap way to eliminate debt.

Q: Are there tax liabilities?

A: In many cases, yes. Most people don't know this, but if you settle a debt for less than the amount you owed, you are potentially responsible for taxes on the forgiven debt. Look at it this way: You received goods and services for the full amount of debt, but you're only paying for a portion of it — sometimes less than 50%. Anything more than $600 is generally considered taxable, but the IRS will sometimes waive the tax if you can prove that your assets were less than your liabilities when the debt was settled.

2. Should I consolidate my debts?

A: Rolling all of your debts into a single loan is a good idea — in theory. In fact, it can be a great idea. But before you move forward, you need to be certain of two things: (1) that this consolidation makes sense financially and (2) that it makes sense for you personally.

A consolidation makes sense only if you can lower your overall interest rate. Many people consolidate by taking out a home equity line loan or home equity line of credit (HELOC), refinancing a mortgage, or taking out a personal loan. They then use this cheaper debt to pay off more expensive debt, most frequently credit card loans, but also auto loans, private student loans, or other debt.

You also need to understand that when you consolidate credit card debt into mortgage debt — like a home equity loan or a HELOC — you're taking an unsecured debt and turning it into a secured debt. If you default on an unsecured debt, you won't lose anything (except points on your credit score). When you default on a secured debt, the creditor takes the asset that backs up that debt. When you convert credit card debt to mortgage debt, you are securing that credit card debt with your home. That's a risky proposition.

Personally, can you handle it? In about one-third of credit card consolidations, within a short period of time, the cards come back out of the wallet, and in no time at all, they're charged back up. Then you're in an even worse position, because you have the credit card debt and the consolidation loan to worry about. You're in a hole that's twice as deep — and twice as steep.

Debt If you have even a smidgen of doubt that you'll be able to stay away from racking up additional debt, don't do it. You must be sure — and I mean absolutely positive — that you have the willpower to pay off those credit cards and not use them again. If you are, consolidating at a lower interest rate can help you pay off your debt faster. But if there's even a small chance that you'll spiral back into debt, it's not for you.

The math If you have $20,000 on a card with an 18% interest rate and you put $300 toward paying it off each month, it will be more than 24 years before you're debt free. If, however, you transfer the debt to a $30,000 HELOC at an interest rate of 5.37%,* you'll be able to pay your debt off in a little more than six years.

I also need to know ...

Q: In this tighter credit market, what sort of a credit score do I need to qualify?

A: Even in the days of the tightest credit in 2008, HELOCs and home equity loans were being made. The interest rate you receive, however, is contingent on your credit score. For example, according to myFICO .com, the consumer Web site of Fair Isaac Corporation, the primary creator of credit scores in the United States, the monthly payments on a 15-year, $50,000 home equity loan vary widely, depending on credit score. As you can see, borrowers with the best credit score pay 28% less each month than borrowers with the worst — and $23,940 less over the life of the loan.
* Bankrate.com: national overnight average on October 19, 2008.

Q: Do you have any tips for staying out of debt once I've consolidated?

A: I do, and in fact, even if you're sure you have the strength to keep from backsliding, it will help to put some of these safeguards in place:
• Turn down offers for new cards or credit line increases on your current cards. Credit's tight, and chances are, you're not getting many offers anyway. But if you do, remember that the less credit you have available, the less trouble you can get into.
• Take the cards out of your wallet. A debit card is accepted just

about everywhere that credit cards are, and you'll be spending money you have — always a good thing.

- **Pay cash.** For some reason, it's harder for people psychologically to part with their cash than it is to swipe a card. Maybe it's the act of physically seeing the money change hands, or maybe it's because you don't want to break a $20 for a $2 cup of coffee. In fact, the bigger the bill, the less likely you are to spend it. If you want to really save money, spend only cash and carry only fifty-dollar bills.
- Save for your goals. Take note of what's coming your way — vacations, the holidays, what ever is going to cost you money — and start saving ahead of time so that you have a stash when the time comes. That way, you won't be caught off guard and you won't feel guilty, because you'll be spending money that you've allocated for the occasion.
- Develop and live by a written financial plan (aka. Budget).
- Get your friends involved. Let your shopping buddies know that you're on a tight budget, and they can help you out when your willpower starts to weaken at the mall.