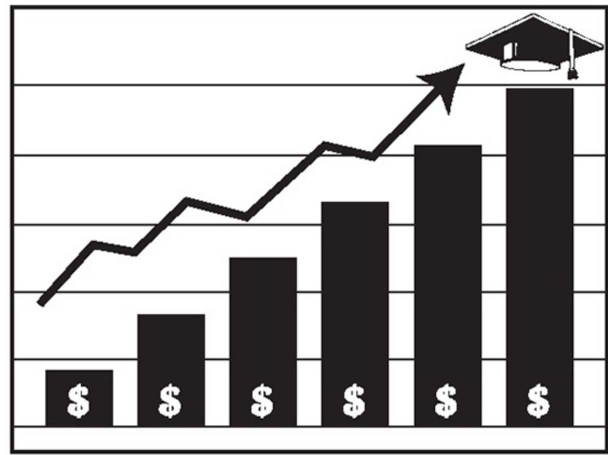
A CRASH COURSE IN DEBT MANAGEMENT

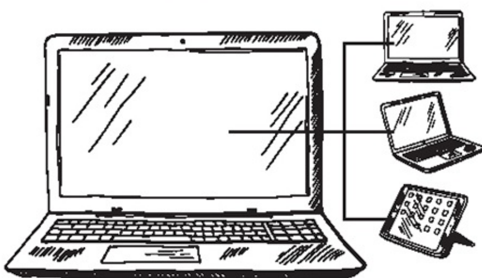


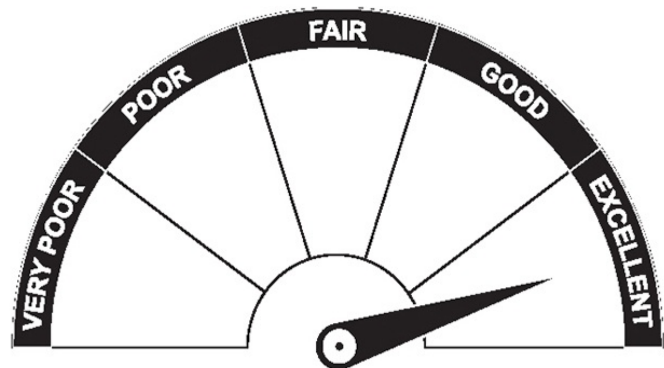
INTEREST ON SOME STUDENT LOANS STARTS ACCRUING IMMEDIATELY, EVEN IF YOU'RE STILL IN SCHOOL AND NOT YET REQUIRED TO MAKE PAYMENTS.

DEBT 101

FROM **INTEREST RATES** AND **CREDIT SCORES** TO **STUDENT LOANS** AND **DEBT PAYOFF STRATEGIES**, AN ESSENTIAL PRIMER ON **MANAGING DEBT**

PEER-TO-PEER LENDING USES ONLINE PLATFORMS TO DIRECTLY MATCH LENDERS WITH BORROWERS.





USING LESS THAN YOUR AVAILABLE CREDIT INCREASES YOUR CREDIT SCORE.

CUSTOMERS WITH THE HIGHEST CREDIT SCORES CAN OFTEN NEGOTIATE LOWER RATES WITH THEIR CREDITORS.

MICHELE CAGAN, CPA

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DEBT 101

FROM **INTEREST RATES** AND **CREDIT SCORES** TO **STUDENT LOANS** AND **DEBT PAYOFF STRATEGIES**, AN ESSENTIAL PRIMER ON **MANAGING DEBT**

MICHELE CAGAN, CPA

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INTRODUCTION

If you're like most people, the word "debt" can sound scary—but it doesn't have to. The truth is that debt will probably play an important part in your life, and as you'll discover, there are ways to use debt to your advantage. In this book, you'll find information about:

- The difference between "good debt" and "bad debt" and why, in some circumstances, it makes financial sense to borrow money and invest in your future (mortgages, student loans, and business loans, for example)
- What secured debt is and why it generally has lower interest rates than unsecured debt
- The best ways to make payments on different types of debt

Once you know more about debt, it will be easier for you to evaluate your own finances and figure out what to do about them. The information in this book will help you as you create a road map to financial security. *Debt 101* shows you how to design a personal path leading to that goal; along the way, you'll learn how to form a plan for dealing with different kinds of debt. Sometimes that plan includes cutting back on expenses and getting rid of drains on your finances. Other times, it means finding new income streams, such as side gigs; investing in rental properties; or other ways of bringing more money into your household. You'll be able to achieve financial security and freedom by understanding the best ways to borrow money, matching your expenses to your income, and saving for the future.

Dealing with debt head-on will help take anxiety out of your money management. You can get rid of the stress that comes with facing your monthly bills and build up savings to cover emergencies, goals (like buying a house or going on vacation), and retirement. The financial confidence that comes with understanding debt will help you overcome challenges that have been keeping you from getting ahead and accumulating a healthy nest egg.

To know when it's smart to take on good debt and how to rid yourself of bad debt—whether it's an excessively high mortgage payment, personal

or payday loans, or credit cards—you need to set a clear course. *Debt 101* will help you get wherever you want to go.

Chapter 1

How Loans Work

A loan, at its most basic, is borrowed money that's expected to be paid back in the future with interest (extra money). Loans usually come with more rules and features than this simplified version, but at heart, they're just promises to return something.

Every loan has two sides: a lender and a borrower. The lender gives something, usually money, to the borrower. The borrower agrees to give back what she or he borrowed plus a bonus (whether that's extra money, an extra goat, or five days of labor) for the lender.

A BRIEF HISTORY OF DEBT

Ancient IOUs

Back before humans created money, they bartered to get everything they needed. Every trade was completed at once, and no one owed anything. As soon as the idea of currency came on the scene (long before actual currency appeared), all of that changed. The concepts of debt and credit began more than five thousand years ago, and they've continued to dominate the way people manage their money.

SHEEP AND SHELLS AND SHEAVES OF WHEAT

The idea of money showed up long before coins and paper currency. As far back as 9000 B.C.E., people all over the world used sheep and cows as cash. Some societies used cowrie shells, others used beads or feathers. People weren't out shopping with this "money," though. They were using it to settle disputes and arrange marriages.

Copper Coins

Metal coins first appeared between 600 and 500 B.C.E. when Chinese craftsmen created "cowrie shells" out of copper and bronze. Those shells soon evolved into coins, normally threaded on strings so they'd be easy to carry.

As societies solidified, merchants began to emerge. People began to purchase goods and services, with most purchases related in some way to farming. Very soon, customers fell into a buy now–pay later pattern, and the concepts of credit and debt were born.

Enter Debt

The first sign of debt appeared in 3500 B.C.E. in Mesopotamia. Various merchants recorded debts on clay tablets, confirmed by borrowers' personal seals. Merchants often used those debts as a form of currency to buy what they needed. Whoever ended up holding the ancient IOU got to collect the debt.

In about 1754 B.C.E., the Code of Hammurabi spelled out the rules regarding credit and debt. Instead of casual clay tablets, loans now required witnessed, written contracts. Loans now carried interest, and the code set strict interest rate caps (for example, interest on grain could not be more than 33 percent). Borrowers could pledge property to assure lenders that their debts would be paid. These early forms of collateral included:

- Land
- Houses
- Livestock
- Family members

When borrowers could not pay their debts, such as a farmer whose crops were wiped out in a flood, they often fled their homes. That became so common that kings sometimes offered general amnesty for debtors, giving land back to those borrowers who couldn't pay.

Ancient Credit Scores

By the time of ancient Rome, large amounts of money began to change hands and loans became part of everyday finances. That's partly because carting around several tons of coins was impractical, and it was easier to transfer ownership of the coins and buy on credit. People borrowed funds to bankroll trade, finance farms, buy properties, and invest. The loans were carefully tallied and tracked in account books held by both debtors and creditors; each entry was called a *nomen*, basically a name attached to an amount borrowed.

Those books also kept track of delinquent borrowers, protecting lenders from those likely to default. A farmer who was considered "untrustworthy," for example, would have a hard time finding a lender to finance his next crop. This practice was the forerunner of modern credit scores, which rate a borrower's ability and likelihood to pay off debt.

DEBT GETS BIGGER

International trade—meaning trade among nations rather than the earlier practice of trade within states—gained momentum during the 1500s. Individual countries developed more complicated financial systems to deal with the complexities of their economies and foreign trade.

National governments now needed to raise funds to finance expansion, trade, and wars. They turned to banks and then to the public to borrow money. Consumer borrowing began to expand as well, mainly through merchants extending credit to customers.

The First Modern Banks

Though technically banks have existed since the Roman Empire, the modern banks we're familiar with today appeared along with economic development. Giovanni de' Medici established the first bank in Italy in 1397. Other Italian banks cropped up, including the oldest bank still in existence today, Banca Monte dei Paschi di Siena, which has operated since 1472.

Banking systems spread slowly throughout Europe. In 1694, the British government formed the Bank of England to raise capital for its war with France. Nearly one hundred years later, in 1791, prompted by Alexander Hamilton, the Bank of the United States was established. That short-lived bank lost its charter in 1811 (it wasn't renewed by Congress), leaving the country without a central bank. The Second Bank of the United States had a similarly short run. It wasn't until 1913 that the nation would get a long-standing central bank, when President Hoover signed the Federal Reserve Act into law.

Consumer Debt Grows Like a Weed

For generations, people borrowed money to buy homes and bought goods from local merchants on credit. For many years, consumer debt was nothing to write about. But once the first universal credit card (Diners' Club) was introduced in 1950, consumer debt began to take on a different character. The first credit cards were actually charge cards, where any balance due had to be paid back immediately; you couldn't run a balance. By 1958, that changed when Bank of America introduced the first revolving credit cards (BankAmericard) in California. In less than ten years, that card went national, and people throughout the country began to build up credit card balances.

TERMS & CONDITIONS

Read the Fine Print

Because they're primarily written by big banks and lending institutions, loan agreements can be hard for borrowers to digest. They're full of terms and conditions that may be unfamiliar, especially for first-time borrowers. They're often very long and written in formal legal language (sort of like user agreements that most of us just scroll to the bottom of). Since these contracts affect your current and future finances, it's important to read and understand every word before you initial and sign them.

LOAN AGREEMENTS

Loan agreements are contracts that exist to protect both parties (the borrower and the lender) when someone borrows money. The contracts spell out exactly what the parties have agreed to and detail each party's responsibilities. They also detail what will happen if either party doesn't fulfill their obligations and how any disputes will be settled.

People are used to dealing with loan agreements when they borrow money from banks or mortgage companies, but not so much when loans get personal. In those cases, though, putting something in writing can protect both your finances and your relationships.

Different Kinds of Loan Agreements

There are many different kinds of loan agreements, and they range from super simple to dizzyingly complex. The simplest of these can be written in just a few words describing the arrangement between the borrower and lender ("I owe Joe $50," for example). The most complicated look like booklets, with dozens of pages detailing every facet of the loan.

Formal loan agreements are legally binding contracts between two (or more) parties. They typically cover fixed-payment loans, meaning the borrower has to pay the money back according to a schedule based on the terms specified in the agreement. They're normally added into public

records, especially when the lender has the ability to seize the borrower's property (called collateral) if they don't pay the money back as spelled out in the contract.

The simplest loan agreements are called promissory notes. They include everything from an IOU tossed into a poker pot to a one-page fill-in-the-blank form with simple payment terms. Promissory notes serve as proof that one person owes another money and promises to repay the money. They may or may not contain specific time limits or payment amounts, but they do create a paper trail for the loan, though they don't offer the same legal protections as a formal agreement. These are often on-demand loans, which means that the lender can call for repayment whenever they want as long as they provide reasonable notice.

Put It in Writing

Loan agreements don't have to be written, but it's better when they are. That's especially true of loans made between friends (who want to stay friendly) or family members. Written agreements can prevent arguments down the line (such as disputes over how much was borrowed in the first place). They can serve as proof that the money was loaned rather than gifted. If there's interest involved, the agreement can include how the interest is calculated and what portion of each payment goes toward interest. Bottom line: Whenever you borrow or lend money, put something in writing to protect both sides.

UNDERSTANDING LOAN LINGO

Loan agreements contain a mix of financial and legal terms, and that combo can be confusing when you don't speak either language. Even some terms you might be familiar with, such as interest and principal, can come with unexpected twists in this setting. Lenders will throw these terms around during the loan process and expect that you understand them. Before you sign any loan agreement, get familiar with at least the most commonly used terms.

The Basics

Every loan agreement comes with four main features:

1. **Original loan balance:** the total dollar amount borrowed
2. **Interest:** a fee charged for the privilege of borrowing money, usually described as a percentage of the outstanding balance
3. **Loan term:** the length of time that the loan will be outstanding
4. **Payment:** the amount of money you'll return to the borrower periodically (usually monthly), calculated based on the loan balance, interest rate, and loan term

These four pillars form the foundation of the vast majority of loan agreements, but they don't look the same from one agreement to the next. Even if you're borrowing the same amount of money, the other terms may vary widely at different times and among different lenders.

Next-Level Lingo

Once you've conquered basic loan terminology, it's time for next-level language. You'll find these terms somewhere in most formal loan agreements, and it's important to know what they mean before you agree to them.

- **Annual percentage rate (APR):** the total charges you would pay (the cost of your loan) if you borrowed the full loan balance for an entire year, converted to a percentage and often used for comparative purposes
- **ACH payments:** letting your lender pull your monthly payments directly from your bank account
- **Collateral:** property that the lender can take and sell if the borrower doesn't pay the money back as required
- **Mandatory arbitration:** forces parties to resolve disputes privately through an arbitrator (a neutral judge) rather than through the court system; the arbitrator's ruling is final
- **Cosigner:** a person who promises to pay the loan if the primary borrower doesn't make the required payments
- **Amortization:** a series of fixed principal and interest payments used to pay down a loan over a stated period of time
- **Closing:** the meeting where money (and possibly property) legally changes hands
- **Prepayment penalties:** fees charged to discourage borrowers from paying off their debt early
- **Delinquency:** missing a single payment due date

- **Default:** not making a specific number (varies by lender) of consecutive payments, which can lead to serious financial consequences for the borrower, such as seized collateral and legal proceedings

You may come across other unfamiliar terms (or terms that don't mean quite what you thought they did) in your loan agreements. Before you sign, ask the lender to explain them to you so you know exactly what you're agreeing to.

The Difference Between APR and Interest Rate

APR and interest rate may look the same, but they're not. APR includes the total borrowing costs—interest *and* fees—that you'd pay over one year on the original loan amount, converted to an annual percentage. Interest rate includes just the percentage you'll pay periodically based on the outstanding loan balance.

AMORTIZATION

“Kill” Your Debt

Amortize, based in Latin, technically means “to kill.” In loan lingo, it refers to “killing off” a loan by paying it down. Amortization is used for installment loans, where you make a specified payment (rather than choosing your payment like you can with credit cards, for example) every month. Over time, a portion of each payment reduces the principal balance of the loan, right on schedule.

HOW AMORTIZATION WORKS

Amortization is an accounting process that gradually reduces a loan over time with installment payments. Those payments are calculated using an amortization formula based on the loan balance, rate, and loan term. Each installment payment is split into principal and interest portions. While the total payments stay the same, the interest and principal portions change every time.

The balance of the loan decreases by the principal portion every month (or other payment period), though it may not seem like that at first. That’s because with amortizing loans, the lion’s share of early payments goes toward interest, with very little applied to principal. Over the life of the loan, that balance will shift, and toward the end, the interest portion will shrink to nothing.

Amortizing Loans

The big three loans—car loans, student loans, and mortgages—are amortizing loans. They all share specific characteristics, including:

- Equal installment payments
- Fixed interest rates
- Fixed payment schedule
- Fixed maturity (pay-off) date

- Consistently declining balance (not revolving)

Because of these fixed characteristics, you can see exactly how every payment will affect your debt as well as the total interest you'll pay over the life of the loan. That can be a useful tool for comparing loan options, such as loan terms (how long you'll borrow the money) and different interest rates. You may be surprised by how much more interest you'll pay over twenty or thirty years just because of a 0.25 percent rate difference.

Front-Loaded Interest

Every month (or alternate payment period), the interest portion of the payment is calculated by multiplying the current loan balance by one-twelfth of the interest rate. Since the balance decreases every month, the interest charge decreases as well. In the earlier years of the loan, interest will take up a much larger portion of the monthly payment. That's why amortizing loans are considered front-loaded: The vast majority of interest is paid in the beginning.

Mortgage Loans Didn't Always Amortize

Before the Great Depression, people borrowed only half the cost of their house, paid interest on the loan for five or ten years, and then paid back the loan in one lump when it came due, usually by refinancing. Once the Depression hit, housing values dropped and banks stopped refinancing, leading to a profound change in the mortgage loan industry: amortization.

AMORTIZATION SCHEDULES

With fixed-rate amortizing loans, you can see from day one the effect every payment (each one an amortizing payment) will have on your loan balance. An amortization schedule is a report of every payment to be made over the entire loan term and how that payment affects the loan balance. Many loan agreements include an amortization schedule among their exhibits, but you can figure it out even if you didn't get one from the lender.

Create Your Schedule

It's easy to create an amortization schedule for a fixed-rate, fixed-payment loan. There are dozens of online calculators available. If you prefer to DIY, you can use the template in Microsoft Excel, which has an extra column for (consistent) early payments. Basic amortization schedules include four columns (plus a date column):

- **Payments:** your regular monthly payment that includes principal and interest but not taxes and insurance
- **Interest expense:** the portion of the current payment going toward interest, calculated by multiplying last month's ending loan balance by the monthly interest rate (annual rate divided by twelve)
- **Principal:** the principal portion of the payment, calculated by subtracting the current interest from the full payment
- **Balance:** the remaining loan balance (ending balance) after subtracting this month's principal payment

Your amortization schedule may also include cumulative interest, which is a running total of the interest paid each month so you can see how much interest you're paying over time. Some schedules include a column for extra payments, which get applied directly to principal.

For Variable-Rate or Revolving Loans

Creating an amortization schedule for a loan with a variable interest rate or for a revolving loan (like a line of credit or a credit card) is much tougher, as these don't fit neatly into the amortizing loan category. Since you can't accurately predict how rates and payments will change with variable-rate loans, you won't be able to create a true amortization schedule for your loan. What you can do is come up with different assumptions to see how they might affect your repayment schedule.

With revolving loans, the principal amount goes up (with more borrowing) and down (with payments), which also makes it harder to create an accurate amortization schedule. It is possible with a home equity line of credit where you borrow more money only occasionally, but virtually impossible with an active credit card. (Don't even bother trying with a revolving, variable-rate loan; you'll just end up frustrated for no reason.) You can find revolving loan amortization calculators and variable-rate amortization calculators online at www.bankrate.com or www.mortgagecalculator.org. Remember, these will be best guesses and may be way off from your actual future amortization schedule.

DIFFERENT TYPES OF DEBT

Name That Debt

Debt comes in many different forms, but most of those fit neatly into big-picture categories. The main categories involve security and totality. Security here refers to the lender's security and how they can get their money back if you don't pay. Totality speaks to whether the amount you borrow remains fixed or changes (meaning you can borrow more money on the same loan). Both factors impact the interest rate attached to the loan.

SECURED VERSUS UNSECURED

One key to categorizing debt is based on what's behind the debt, backing it up. Debt can be either secured or unsecured depending on whether or not the lender has a claim on some sort of property. That distinction can have a great effect on interest rates, as it speaks to the lender's overall risk in lending the money.

From a borrower's perspective, paying secured debts takes top priority when there's not enough money to pay every bill. Though these payments often take up more of the available budget, you stand to lose crucial assets (like your home or your car) if these debts are not paid regularly.

Secured Debt

Secured loans are backed by some form of collateral, which is property (like a car or a house) pledged to satisfy the debt if the loan is not paid. With this kind of loan, the lender will place a lien (a claim on an asset) on the collateral that allows them to take it if the borrower doesn't pay. For example, the lender could repossess a car or foreclose on a house.

The collateral doesn't have to have any relation to the loan, though it usually does. For example, a car loan usually comes with a lien on that car. Collateral can be pledged to secure loans not tied to any particular asset (for example, some personal loans may require collateral). Because of the

built-in safety net, secured loans (from reputable lenders) typically come with lower interest rates.

Creative Collateral

"Collateral" usually refers to things like cars, houses, and investment securities, but they're not limited to these assets. As long as the lender agrees, anything of value can work. Some more creative choices include designer handbags, wheels of Parmesan cheese, thoroughbred horses, and star soccer players (on Real Madrid).

Unsecured Debt

Unsecured debt doesn't come with the security of collateral. Here, the lender is banking on your ability and willingness to make all of the scheduled payments.

Examples of unsecured debt include:

- Student loans
- Credit card debt
- Personal loans
- Medical bills

Technically, payday loans fall into the unsecured debt category, but this isn't exactly correct. While there's no physical collateral (like a car or a house) pledged to the payday lender, borrowers do have to provide direct access (through a post-dated check or an ACH withdrawal, for example) to their paychecks when they arrive.

REVOLVING VERSUS NONREVOLVING

Revolving and nonrevolving describe the way money is borrowed. Revolving debt allows you to borrow money at will, up to a preset limit, and then borrow that money again as often as you like. Nonrevolving debt refers to a one-time loan for a fixed dollar amount, and once it's repaid, you can only borrow again by applying for a new loan.

Revolving debt makes up about 25 percent of the total outstanding US consumer debt in dollars (as of May 2019, according to the Federal Reserve). That's because individual nonrevolving loans tend to be bigger, covering big-ticket items like mortgages, student loans, and car loans.

Revolving Debt

With revolving loans, such as home equity lines of credit (HELOCs) and credit cards, your balance due goes up and down depending on your financial activity. You can borrow more at will, up to your limit, and your monthly payment amount can vary based on the current outstanding debt.

Revolving debt is sometimes referred to as open-ended debt, because you can borrow the same money repeatedly. As you make payments, your available credit increases; as you borrow more, your available credit decreases. Even though you can only borrow up to the maximum credit limit at any given time, you can borrow much more than that over time. Revolving debt can be secured, such as a HELOC secured by your home, or unsecured, such as credit card debt.

Nonrevolving Debt

With a nonrevolving loan, you borrow a set amount of money in one shot, and the lender expects to be paid back according to a schedule. These loans are predictable, come with planned payments, and have predetermined payoff dates. Both parties know from the start when the loan will be paid in full. If you need more money, you have to start the process again from the top and take out another loan. Examples of nonrevolving debt include car loans and mortgages.

In most circumstances, the outstanding balance of a nonrevolving loan will only decline over time. (The exception is a loan with negative amortization, when unpaid interest gets added to the balance of the loan.) Nonrevolving debt can be either secured or unsecured.

PREDATORY LENDING

Legal Loan Sharks

Predatory lenders take advantage of desperate or uninformed borrowers. While these lenders often pretend that they're helping you, their only goal is maximizing their profits by lending you as much money as possible at the highest interest rate possible. They don't care if the debt is too much for you to manage based on your current financial situation. In fact, they often specifically target people who can't really afford the loans. Those borrowers often end up trapped in a dangerous debt cycle with thoroughly trashed credit. Many end up losing their homes.

While it seems like predatory lending should be illegal, it isn't always. The federal government offers some protections, and twenty-five states have specific anti–predatory lending laws. But many lenders work through loopholes, and others just flat-out break the law. You have to protect yourself and your finances by knowing the signs and walking away, even if you're desperate for a loan. Your situation will certainly get even worse if you borrow from a predatory lender.

SIGNS OF A PREDATORY LENDER

There's no standard definition for predatory lending, so learning what to watch out for can help you avoid these unscrupulous practices. Some of these are harder to spot than others, so you have to be very cautious. If you notice any of these red flags, you are dealing with a predatory lending practice, and you should stop the process immediately.

- **Surprisingly good offer.** Predatory lenders reel you in with the promise of plenty of quick cash, lower-than-market interest rates, and instant money regardless of how bad your credit score is (and sometimes even if you're unemployed). If a deal sounds too good to be true, read every single word of the fine print, and you'll see that it's not.