Tales from the Credit Card House of Horrors

Question 1: I've used up all the equity in my home to pay off credit card debt, but now my credit card debt has grown again to $40,000. I have $49,000 in a 401(k) and was thinking of using that to pay off that debt, but I'm told but that's not a good idea. Now I don't know what to do.

Answer: Cut up those cards.

Go do it right now, before you think of the million and one reasons you "need" credit. You have a serious spending problem and you'll never beat it if you continue to live beyond your means.

Draining your home equity means you've lost an important financial cushion in case of an emergency. And you've left yourself vulnerable in other ways. If you had to sell your home now, you probably would owe more than you could recoup, since your proceeds would be reduced by selling costs. And if home prices declined, which they do from time to time, you'd really be in a pickle.

You also are putting yourself behind the eight ball in terms of retirement savings. Many people use the equity in their homes to supplement Social Security, pensions and other savings – either through reverse mortgages or by selling their home and buying a less expensive one. If you keep spending all your equity, that valuable option will not be available.

Now you're thinking of making matters worse by tapping a retirement fund. Loans from a 401(k) are risky because if you lose your job you'll be forced to repay that loan quickly, or pay significant taxes and penalties on the money you withdrew.

More importantly, you need to acquire the financial discipline of paying your debts from your income. Borrowing is what got you into this mess, and you can't solve the problem by getting another loan. If you're having trouble, considered joining Debtors Anonymous. This group, based on the principles of Alcoholics Anonymous, aims to help spenders get control of their lives.

Question 2: My wife and I have two young children, a mortgage and two financed cars. We also have more than $100,000 of debt, mostly on credit cards that are in my wife's name. Our savings are gone. I have never been in this situation before. I am self-employed and bring home about $6,000 a month. My wife doesn't work. Personally, I don't think I will ever pay off this debt, and I don't know if I should call a financial advisor or a lawyer. What do you think of my situation?

Answer: You left some important information out of your letter.

For example, did you know this debt was being accrued, or did your wife accumulate it on the sly? If it was the latter, your first call should be to a marriage counselor who can help you both sort out what would be a whopping case of financial infidelity.

You need to make two other calls: one to a legitimate credit counselor affiliated with the National Foundation for Credit Counseling (www.nfcc.org), and the other to an experienced bankruptcy attorney. The credit counselor can discuss your options for repaying the credit card companies at lowered interest rates. The bankruptcy attorney can advise you about what you might face if you decide to file.

It's pretty tough to pay off consumer debt that exceeds your annual income. If your wife is able to return to work and make decent money, you might have a shot at paying this back within five years. If it would take longer, though, bankruptcy filing might make more sense.

You might be able to file for Chapter 7, which would erase most of your unsecured debts, including the credit cards. If not, you could file a Chapter 13 repayment plan that would require you to make payments for five years. Once you complete the plan, your remaining credit card debt would be erased.

"A married couple came in, and it started out normal, pleasant. I immediately got the sense that the wife was in charge. I evaluated the budget and creditors. There were only five statements. Because the husband barely said anything, I turned to him and asked if there was anything else. Up from his briefcase he pulls a bag packed with papers, all bills. The wife was in shock. If looks could kill ... He had roughly $80,000 in debt she didn't know about. The husband had been trying to support a lifestyle he couldn't afford, started gambling, lost his job and took out cash advances to pay for it all. The statements went to his post office box. He left the house each morning, pretending to go to work. I wish I could have crawled away, but tried to stick to the debt and go over possibilities. I gave them referrals for marriage counseling."

– Scott Monroe, Credit counselor, Phoenix

Question 3: I am buying a condo and have the option of rolling the purchase price of furniture into my mortgage. The furniture is high quality, which is what I want. Should I do this? I want high-end furniture, not low-end stuff that wears out in five years. But the high-end furniture store makes you pay everything up front, which I can't afford. What do you think I should do – roll the furniture cost into the condo mortgage or just wait and buy it piece by piece?

Answer: You said yourself – you can't afford this furniture. The fact that you can get it by borrowing it doesn't change that fact.

You'll keep yourself out of a lot of financial trouble by remembering this rule of thumb: Don't borrow money to buy depreciating assets. That includes your car, for which you should pay cash if possible instead of taking a loan. (See next response.)

It makes sense to borrow money to buy a home, because homes typically rise in value over time. It usually doesn't make sense to use a mortgage to buy something like furniture that will lose a significant amount of value the minute it is delivered. Find inexpensive ways to furnish your home for now, and save up for the stuff you want. You'll end up in better financial shape.

Question 4: Our old car is on its last legs and we really need to replace it. Rather than buy a new car, we were thinking of getting one that's a couple years old and using our home equity line of credit to purchase it. That way the interest is tax deductible. What do you say?

Answer: In the best of all possible worlds, you would pay cash for cars. Most people could afford to do so if they would drive their current car for four to five years after they make their last loan payment, and put an amount equal to that payment in the bank each month.

Since your car is about to die on you, though, your plan is the next best thing. A gently used car already will have suffered its worst appreciation (which typically happens the minute you drive it off the lot) and the after-tax rate you'll pay with a home equity line of credit is likely to beat your other options.

Do try to pay off the loan as soon as possible though. Lines of credit have variable rates, and the current low rates will not last forever. Also, you want to keep as much of your line clear as possible in case of emergency.

Question 5: I have $175,000 in credit card debt. Almost all of this debt was due to balance transfer offers over the years, which I managed quite well to make sure I had no balances with high interest rates. Now with credit being so tight, one of my issuers has reduced my credit limits and I can't find any balance transfer offers to extend my low rates.

Will the issuers allow me to settle this debt for less than I owe? I always get offers from credit consolidation companies that tell me banks are willing to accept 50% or less of your balance if you pay the reduced balance amount in full. Can I simply call up the credit card company and offer a reduced amount? If I cash out on my stocks and other investments, I could actually pay the debt off in full, so I do have the ability to pay. I just never did so since the interest rates were so low.

Answer: The recession has made credit card issuers more willing to accept debt-settlement offers, but your savings will come at your credit scores' expense. Card issuers really don't like it when people don't pay what they owe. When the notation of a debt settlement hits your credit reports, expect your scores to dive. Some people have little choice but to accept this price. They can't pay their debt and, for whatever reason, can't wipe it out in Bankruptcy Court. In those cases, debt settlement can be the best of bad options.

You, however, have a choice. Don't make one you'll regret.