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# Why Debt Consolidation is a Good Choice and How to Go About It

## Topics Covered:

Credit and Debt Consolidation

Is Debt Consolidation A Good Choice?

Should You Use a Credit Counseling Service or A Debt Management Program?

What Does a Debt Management Program Do?

How Your Credit Score Can Affect Your Consolidation

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What to Do If You Can't Get a Loan

Advantages of Debt Consolidation

Disadvantages of Debt Consolidation

# Why Debt Consolidation is a Good Choice and How to Go About It

## Credit and Debt Consolidation

If you are in debt, and having trouble paying your bills, you may be able to lower the cost of getting a loan, or decrease the amount of interest you are paying, by consolidating your debt. This can be done through a bank loan, a home equity line of credit, or by going through a credit counseling service.

Consolidating your debt is something that you can do fairly easily the first time, but it may be difficult if you have a low credit score – for example, if you have made late payments, defaulted on a loan, or have a charge off on your credit report. If you own your own home and have equity in it, you may be able to consolidate your debt through a home equity line of credit. Or you may be able to consolidate through a bank consolidation loan to pay off all of your creditors.

Debt consolidation may also have a negative effect on your credit report if you get a loan, because more loans do not look good on your report. This should be a temporary effect, as your credit score should improve once you have paid off your existing debt and have more available credit, but you want to make sure to be making on time payments on all of your bills.

Credit counseling services abound, and many can help you to navigate the tricky task of dealing with and negotiating with your creditors. They can also help you by paying your bills for you – you send them one monthly payment, and they pay your bills. If you often make late payments, this can help tremendously in avoiding late payments. It can help you if you are finding your debt payments stressful.

Choosing a credit counseling service can be difficult, as some companies can be more effective than others in negotiating with creditors, and some companies can ruin your credit score by not paying your bills for several months. Many companies will be able to do a good job without having any effect on your credit score. Otherwise, you can do your own consolidation, by getting a loan to pay off all of your creditors and then paying off that loan.

You can also do your own negotiating with companies once you have the loan – a company may be willing to cancel some of their charges or interest if you are going to pay off their bill in one lump sum. A consolidation loan can give you negotiating power. Many people often find that they can do their own credit counseling, but this can be a difficult task for people whom have already had trouble with making on time payments or whom have creditors calling them.

Once you have paid off all of your creditors, it is important not to charge up all of your credit cards again, if your debt came from credit cards.

## **Is Debt Consolidation A Good Choice?**

For many people, consolidating their debts seems like an obvious choice. You get one loan, and then you only have to pay one loan off each month rather than many creditors. It eliminates or reduces many creditor calls and letters, which can greatly lower your stress.

But credit consolidation is not for everyone. Not everyone needs to consolidate their debts, and not everyone should consolidate, either by borrowing money to pay off the debts, or by using a debt consolidation service.

Some people are simply not in enough debt to justify going to a debt consolidation or credit counseling service, as while a debt consolidation service would ensure all of your debts got paid off, it is sometimes possible to do this faster by yourself. This, of course, is only true if your debt occurred through an emergency such as medical expenses. For those who have spending problems, a credit counseling service may be necessary to get out of debt.

Don't consolidate your debt until you have made certain you are aware of all of your options. Consolidating debt can actually end up being disadvantageous for some families, and being sure that it is the right choice for you before you commit to it is important.

For some people, whether or not they consolidate their debt may depend on whether or not they qualify for a second mortgage or other bank loan. But watch what interest rate you are offered on that loan, as it may be higher than the interest you pay on student loans. The interest rate on the loan is actually very important, because if it is higher than what you are paying on most of your loans, you may end up in the end paying more than you would if you continued paying all of your creditors separately.

Use an online calculator, or just sit down with a lot of paper, and determine how long it will take you to pay off your debt as it is now, and how long it will take if you consolidate. Balance this information against your own personal factors, such as your credit score, whether you will be looking at selling your house in the near future, and your own level of comfort with debt.

Also keep in mind that many people consolidate with a bank loan or second mortgage, and then end up charging again because they cannot meet expenses. If your debt occurs because your income does not cover your bills, consolidation will not help, as it will not increase your income or decrease your bills. Also, if you use your house as collateral for the loan and then default on the loan, you could lose your home.

## **Should You Use a Credit Counseling Service or A Debt Management Program?**

For many people, using a credit counseling service or debt management program may be the best choice. If you are having trouble paying your bills on time, have creditors calling you, or are simply finding paying the bills too stressful, it may be in your best interests to get help from a credit counselor, or have a debt consolidation company deal with your creditors. A credit counseling company can tell you if you are a good candidate for a debt consolidation program.

Another person managing your debt may be a great stress relief, as well as saving you money in the long run by negotiating lower interest rates with your creditors, and avoiding future late payment charges. This would also consolidate all of your payments into one payment per month, which for many people and families, is a lot easier to handle and budget for.

Choosing a credit counseling service requires a lot of research. There are many message boards and websites where you can ask people their opinions of their experiences with a particular company – a money based message board can be a good place to get people's experiences, although you can also check with the company's local Better Business Bureau to see if there have been any complaints against them, as well as checking with their local courthouse to see if they have been sued. The advantages and disadvantages of many different companies and their programs can be found by searching on the internet for information that doesn't just come from the particular company's website or TV commercials.

Credit counseling services and debt consolidation companies offer a wide variety of debt management services. Some are government sponsored, while some are not-for-profit or even for-profit agencies. Be sure and find out how they are paying their employees – you don't want to end up with another huge debt to pay just to get out of your current debt. A small donation is often acceptable to many companies, while others may have a sliding scale for payments.

Credit counseling services can help you to form a budget and offer financial advice for you to consolidate your debt and pay off your bills yourself. Or you can have a debt consolidation company pay your bills, by sending the company a monthly payment and having them negotiate with your creditors. Some credit agencies will not deal with debt consolidation companies, and you will not be able to consolidate whatever loan or credit you have with that company.

You might not be able to use a credit counseling service if you cannot pay your minimum payments each month. In that case, you may need to get a bank loan and consolidate your loans yourself, or you may need to find another way to deal with your debt, such as a family loan, getting another job, or even, if all else fails, declaring bankruptcy.

### **What Does a Debt Management Program Do?**

With the many advertisements out there, promising one easy payment and an improved credit report and credit score, it can be difficult to figure out what service it is that a debt management program actually provides. A debt management program can work to your benefit in a variety of ways. Always ask before you sign on the dotted line.

Many debt management programs begin by calling your various creditors and trying to get them to settle for smaller amounts or at least to lower your interest rates or reduce fees. Remember that any amount that is deducted from a debt owed is reported on your taxes as income: for example, if your credit card company forgives \$5000 of a loan, that 5K is reported to the IRS as income and you will need to pay taxes on it.

Some debt management companies try to get companies to settle by withholding your payments to them, in the hope that the creditor will then be willing to settle for less. Consumers using their services have been surprised to find that even though they are sending off the checks each month, their balances are not going down and creditors continue to call. This method can also be detrimental to a person's credit score, as a 60 days past due note would definitely appear on the credit report.

Many debt management and credit counseling services do not do this, instead focusing on slowly paying off your debt and trying to get your creditors to work with them to lower interest rates and to perhaps settle for a lump sum payment if you have the money.

Once you are signed up with a debt consolidation company, there will be rules. You might not be allowed to open any new credit accounts. You might not be able to prepay your bills. Check with your credit counselor before you sign to ensure you understand what is happening with your money and when you will be finished the program.

Once you have signed up, and the debt consolidation company has contacted your creditors with offers stating how much you will pay each month and for how long you will pay, if all of your creditors agree, you simply send your check to the debt consolidation company once each month, occasionally checking your credit report to make sure everything is going well. Some of your creditors may refuse to work with the credit counseling or debt consolidation company and may require you to pay them separately.

Your credit counselor can help you deal with this company, perhaps sending them a better offer or perhaps you might have to make a certain amount of on-time payments to this creditor before they will agree to go on the program. A debt management program makes certain all of your creditors are paid on time. You send them one check each month, and they send out checks to each of your creditors in the amount they got the creditor to agree to.

## **How Your Credit Score Can Affect Your Consolidation**

You might not think a credit score is important when consolidating, but this number decides whether or not you can get a loan, and what interest rate you get that loan at if you qualify for a loan. You might not be able to get a consolidation loan or a line of credit from your bank if your credit score is too low. Or you may end up with a higher interest rate due to a lower credit score, and even a small increase to the interest rate you are paying on a loan, compounded over 10 years, can add up to thousands of dollars of difference.

Your credit score is also called your FICO score, which gets its name from the Fair Isaac Corporation, the company which does the math to determine your credit score. The score is based on a very complicated algorithm, which is itself based upon a variety of factors. These factors include how much credit you have available, how much you owe, what your payment history has been like, the length of your credit relationships (longer seems to be better, so keep that credit account from when you were 20 open), and any charge-offs or bankruptcies which appear on your account. Your credit score can also be affected by recent inquiries on your

credit, and if you have recently opened a credit account. This information is compared against every other American who has a credit history of any form, and everyone gets a credit rating. This score tells lenders how likely you are to pay back a loan.

Your credit score is a number from 300 – 800. Most people's scores land between 600 and 800.

Your credit score affects you when you sign up for a cell phone plan, when you try to get a mortgage, if you are applying for a job that deals with money or sensitive information, and in any area where you might end up owing someone money, such as renting an apartment.

You can find out your credit score for free from one of the 3 credit bureaus. Equifax, being the biggest of the 3, may be where you want to start. Each bureau is required to give you one free copy of your credit report each year. The 3 bureaus are fairly similar in what they record, so you can try pulling a report from one of the 3 companies once every four months, which allows you to keep an eye on your credit report and protect yourself from identity theft without having to pay for copies.

You should know what your credit score is before you apply for a loan. This will give you some idea of what interest rate to expect, as well as giving you an opportunity to dispute any errors on your report before you try to get the loan. You might also want to work on improving your credit score before you consolidate, if you have the time.

## **What to Look For In a Credit Counselor**

Selecting the right credit counselor can make a huge difference in your debt consolidation experience. If you choose to go with a credit counseling service rather than consolidate on your own, you need to be aware of the possible problems. Many organizations exist that rather than looking out for your best interests, will be trying to make a profit.

In choosing a credit counselor, it may be best to select a credit counseling company which belongs to a nationally accredited organization, such as the National Foundation for Credit Counseling (NFCC). This will ensure that the agency must meet certain standards for quality.

When choosing a company, be sure that:

- The entirety of the money you pay to go towards your creditors is actually going towards your creditors – some companies take a \$15-20 “donation” or fee off the top of your payments, which will make your payments take longer. Some companies even take your entire first month's payment as a fee, which will damage your credit score, not to mention could be unexpected for those who haven't done their research. Successfully paying off all of your debt requires on time payments every month – if your debt management program holds on to all or part of payments, then your credit score is going to be damaged and your debt is going to take longer to pay off.

- You research the company – ask the company for referrals from people who've used them, as well as asking around on message boards and checking with the Better Business Bureau in their area.
- The company offers a full range of services. Not everyone needs a debt management plan. Sometimes, all you need is someone to help you sort out all of your creditors and make a plan. This is why a counseling service with a full range of plans may be best for you, and a full counseling session of at least an hour at the beginning is necessary. You need to be sure that this company is actually looking out for you, and doesn't just want to catch you in a program that you cannot get out of.
- The company will work with any creditors that are willing to work with it. Some creditors will not work with credit counseling services or debt consolidation companies, preferring to deal directly with you. But your credit counseling company should be willing to work with all companies. Some debt consolidation companies will not work with certain creditors, preferring only to work with creditors from whom they receive some form of profit.
- The agency is bonded or insured, so you are protected against the agency closing down.

When choosing a credit counseling service, an important thing to beware of is companies making magical promises. It's the old saying "If it sounds too good to be true..." No company can magically increase your credit score or make things on your credit report disappear. Fixing your credit score and paying off debt is something that takes time, planning, and persistence. It can't be done overnight.

### **How to Consolidate By Yourself**

You can consolidate your debts on your own. This can be done by carefully planning out how much you will need to pay off all of your debts, then applying for a bank loan to cover those debts.

Once you have the bank loan, which should be at a lower interest rate than your other loans, you can begin. Be sure the bank loan or mortgage is at a lower interest rate than your credit cards or student loans were, or you may end up owing more in the long run.

Try calling your creditors to negotiate. They may be willing to remove some charges and fees if they know you are going to be able to pay them in full. This might save you a little bit. Remember that if you get a settlement – say, your debt is at 5K and the company accepts 3K, the \$2000 will count as income for your next income tax return. Creditors may not be willing to work with you, but you may be able to at least get some fees reduced, or perhaps some late charges removed.

Once you have called all of your creditors, you can then send out all of the payments. Be sure that you have called all of your creditors to find out the exact amount you should send them, or you will end up with another bill next month for any interest which was added on after the last

bill was sent out. It can be confusing, but take your bills one at a time and knock them out. Keep careful records of what you paid and when, and keep the cancelled checks attached to your copy of the credit card statement, so as to prove you should have a zero balance.

Once you've paid the creditors off, don't just charge up those credit cards again. You're still in the exact same amount of debt, you've just moved it around a bit, and hopefully lowered the amount you will eventually end up paying. Be sure to make your payments to this loan on time and in full, especially if you got a home equity line of credit or a second mortgage on your home – you do not want to lose your house.

If your income does not meet your bills, try to cut back on expenses or increase your income rather than charging again, or you will end up in the same position, only this time with credit cards and a second mortgage or line of credit. Take the time to make a plan so you can be sure that by consolidating, you are choosing the easiest path to get out of debt.

### **What to Do If You Can't Get a Loan**

Some people, often through unavoidable circumstances such as a medical emergency, cannot get a loan because their credit score is too low. And they might not be able to get on a debt management program, either because their loans are secured loans (house or car as collateral), or because they do not have enough debt.

Avoid continually applying to different credit counseling services until one accepts you.

This puts you at risk of being taken advantage of by a for profit company.

If your credit score is too low to get a loan that is at a lower interest rate than you have right now, or you don't have a house, or for some other reason, you cannot consolidate, you may have to wait a few months before trying again to get a loan.

First, you may need to improve your credit score. This will help you to qualify for a loan, as well as allowing you to get lower interest rates. To improve your credit score:

- Pay bills on time. 6 months of on-time bill payments can raise your credit score
- Don't automatically close accounts as you pay them off. Part of your credit score is based on how much credit you have available.
- Don't open new accounts

As well as improving your credit score, you may want to work on reducing your debt.

This will also improve your credit score and make it easier for you to consolidate. A popular method to pay off debts is to send minimum payments to all of your debts, and choose one debt (either the smallest amount or the highest interest rate) to send any extra money you get. Once that one debt you have focused on has been paid off, use the money you were sending to it, and add it to the payment on the next debt on your list. (So the next debt gets its own

minimum payment, plus the minimum payment of the other debt, as well as any extra money you can send to it. You could also decide not to decrease the amount you send to any debt – even though the minimum payment on a debt will be lower next month, keep sending this month’s minimum payment to it until you get it paid off. Credit card debt especially can be difficult to get rid of. The interest on many cards is compounded daily, so you may want to try to send your payments a bit early, if possible.

If you can’t send the whole payment early, and your credit card company allows multiple payments in one month, send some of the payment early, and the remainder on the due date. This helps cut down the amount of interest you have to pay, and in the end you will end up paying less. There are a number of small ways you can reduce your debt, and once you add them all up, your debt will go down much faster. Try reading books about debt, or joining a debt support group.

Once your debt has gone down and your credit score has gone up, you may be a better candidate for credit consolidation. Of course, by this time, you may find you are handling the debt fine on your own.

### **Advantages of Debt Consolidation**

For many people, debt consolidation can produce a sigh of relief. By consolidating debt, you can eliminate or reduce collectors’ calls and letters, as well as just being able to feel more secure. Having one loan to pay rather than many bills to pay can be easier to handle and reduce late payments, as well as stress. With a bank loan, by paying off many of your creditors and thus having a lot more available credit, you can improve your credit score.

A bank loan also offers you some flexibility in how you will handle the debt, as well as, if the loan is timed well, giving you one month without a debt repayment. You get the loan or line of credit one month, use it that month to pay off all of your creditors, and do not have to start paying the loan until the next month. This gives you time to build up a bit of a cushion in your bank account.

If you have not gotten a consolidation loan, and instead gone with a debt consolidation company or credit counseling service and had them form a debt management plan with you, this can help you to keep your finances more under control, as well as providing you with just the one bill to pay. Often the bill you pay is lower than the sum of the bills you used to pay, because the credit counseling service has gotten your charges lowered in some way. Sometimes a creditor can even be convinced to stop charging interest while you are on the program. A debt management program may actually negatively affect your credit rating temporarily, but once all of your debts have been paid off, your credit score should go up.

A debt management program has another advantage, in that it may help you and your family to develop better spending habits, as you will not be able to use credit while you are on a debt management program. Credit counseling services usually should take the time to learn about

you and your needs, so that they can help you form a good plan for getting out of debt and staying out of debt.

Another advantage to dealing through a credit counseling service is that someone else negotiates with your creditors for you. Many people find the idea of calling their creditors intimidating, and it can be very daunting. The main advantage to either form of debt consolidation, borrowing or using a service, is peace of mind. Debt can be very stressful, but knowing you have a plan and are following it can make your finances much easier to face and handle.

### **Disadvantages of Debt Consolidation**

While there are many advantages to debt consolidation, there are a few concerns anyone should be aware of before consolidating.

You need to watch out for scams and non-profit credit counseling companies which are actually for-profit companies, as well as things which are actually a disadvantage to you – sometimes the benefits which a DMP can provide are actually benefits you could get yourself from the lender if you just ask, for example on a student loan, in some programs after a certain number of on-time payments, your interest rate is lowered a little bit. If you go with a debt management program or consolidate your student loans with a bank or other lender, you start over with the time period, so it can actually take longer for your interest rate to go down.

A disadvantage to debt consolidation through a second mortgage or a bank loan is that this is usually a secured loan. If you do not pay this bill, you can lose your home. Also, you are still in debt, and usually still in the exact same or a slightly lower amount of debt, just shifted around. Many people respond to this debt consolidation as if they have no more debt, and go out and charge up their cards again. Thus, it is easy for a person in debt to end up in even more debt after they consolidate, and there are only so many times you can consolidate.

Another disadvantage to a debt management program is that you cannot get new credit during this time. For some people, this is a good thing, as they must learn discipline, but emergencies do happen and expenses occur. As well, some debts may not qualify for the debt management program, and so you will still have to make multiple payments each month. A disadvantage in the event that you get an increase in income, through a raise or a large income tax return, is that some debt management programs do not allow you to make extra payments ahead to your debts. If you send them an extra check, they might simply hold that in an account for your next month's payment. Many consumers using a debt management program simply save any extra money in an emergency fund.

It can also be difficult to consolidate. For a bank loan to consolidate your other debts, you must qualify for a loan or mortgage. If you already have a lot of debt, your request may be turned down. On the other hand, to qualify for a debt management program, you actually need to have a minimum amount of non-house debt. (Your mortgage cannot be included in a debt management program).

While there are a number of disadvantages to consolidating, you may find it is the best choice for you and your family. Simply be aware of the need to research each company and examine any loan offer carefully.

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