Client Fact Sheet

DEBT CONSOLIDATION

Debt consolidation involves bringing your existing debts together into one new loan. The objective is to reduce the number of individual payments you make and reduce the interest rate you are paying on your more expensive debts.

This may be something to consider if you are:

- Managing multiple debt repayments and struggling to keep track of what is due and when.
- Getting into a credit trap where all your spare income is used to pay interest, but you don't have enough left over to reduce your debt balances.
- You're paying a very high interest rate on your debts—perhaps you have credit card or cash advance debts, or store credit purchases.

There are several possible strategies to consolidate debts, which can include:

- Moving debts to a new credit facility (e.g. a personal loan or mortgage) with a lower rate of interest, or lower fees.
- Lengthening the term of existing loans (e.g. taking a mortgage debt back out to the 30-year loan term).
- Changing the repayment terms on an existing loan to interest only, or
- A combination of these strategies.

Usually a debt consolidation strategy is implemented to make it easier for you to pay back your debts. However, in some instances, the objective of a debt consolidation may be to improve your cash-flow.

If you implement a debt consolidation strategy, it's important to understand that it doesn't reduce your debts—it just makes your repayments more manageable. A debt consolidation strategy should be implemented in combination with a change to your spending behaviour, so you can work to reduce your overall debt level over time. This should include creating a budget to ensure the debt consolidation measures work effectively and using a budgeting template such as the one available on ASIC's MoneySmart website (www.moneysmart.gov.au).

What's good about a debt consolidation

Simplicity: One loan repayment is a lot easier to manage and more convenient than juggling several different repayments.

Savings on interest and fees: Debt consolidation could potentially reduce the amount of interest you pay on high-interest facilities like credit cards and save you money on fees for multiple credit facilities. This may make it easier to pay back your debts.

Potential cash savings: This is potentially the biggest benefit of debt consolidation. By consolidating your debt into a loan charging a lower interest rate, you have the potential to save interest on monthly repayments and reduce your overall interest.

Lower repayments: Reducing the interest rate and spreading out repayments over time could potentially reduce the monthly repayment amount due.

Stress relief: Specialist lenders are available that may lend to you if you have missed repayments on your current debts, or if you have a poor credit history

Things to consider

For example:
If you have a $30,000 personal loan over a five-year term at 15% p.a. then this will cost you $12,822 in interest.

If you add this $30,000 debt to the balance of your mortgage instead, the same $30,000 at 5% over 30 years will cost you $27,977 in interest.

Higher costs: Long-term interest costs could be higher if you extend the loan term during a debt consolidation program. While it may reduce the size of the repayments in the short term, the overall amount repaid is far greater—particularly if you are consolidating your debts into a home loan which may have a 30-year term.

Increased credit access: If you're not careful when consolidating your debts, you could make your financial situation worse. Remember to close your cleared credit facilities. For example, if you roll your credit card balances into your home loan to consolidate your debts, you might be tempted to continue using your credit cards and run up even more debt if you don't close them.

Concentration of risk: Consolidating all your debt into your mortgage means that you have a lot at stake if interest rates rise. We recommend that you take advantage of all available cash to make additional repayments to pay off the refinanced debt as quickly as possible, or to start a savings account to build up a safety net.

Using up equity: Consolidating debts into your mortgage can also mean you are using up equity gained through paying down the balance or through an increase in value of the property. This means your returns will be reduced when you sell. Furthermore, consolidating your debts into your home loan can increase your loan-to-value ratio (LVR) above 80 percent. If this occurs, you will be required to pay Lenders Mortgages Insurance (or LMI). LMI can be expensive, so this may affect the savings you receive from refinancing your home loan to consolidate your debts.