



THE FINANCIAL PLANNING ASSOCIATION

of San Diego

HOME

PLANNER RESOURCES

BE CAREFUL OF PITFALLS OF CONSOLIDATING LOANS

With interest rates at rock bottom, many consumers are consolidating their higher-interest loans, especially credit cards. Consolidation can be a good strategy, but it also can cost far more in interest charges and even bad credit if you're not careful, caution CERTIFIED FINANCIAL PLANNER™ professionals.

Consumers typically consolidate loans for several reasons: to bundle multiple loans under a single lender, to lower their overall interest rates, or to dig their way out of debt. But before rushing out to consolidate, weigh whether it is your best option, and if it is, be careful how you consolidate.

First, don't confuse loan consolidation with debt consolidation. Debt consolidation programs, whose offers frequently appear in the mail or through e-mails, are designed for people with severe debt problems. The debt consolidation service renegotiates loan terms with your creditors and consolidates the loans into a single payment through the debt service. The use of a debt consolidation program can hurt your credit rating.

Loan consolidations, on the other hand, are generally available only to those people with good credit ratings. Loan consolidations take many forms: among the most common are home equity loans, home equity lines of credit, "cash out" home refinancing, student loan consolidation programs, and personal loans through financial institutions.

Let's assume you want to consolidate multiple higher-rate loans into a single lower-rate loan. To do this cost-effectively, keep the following points in mind.

Are you disciplined enough to take advantage of consolidation? This may sound like a silly question, but it's not uncommon for people to consolidate multiple loans, lower their overall interest rates and payments, and then go out and rack up new debt. This defeats the entire purpose of consolidation.

Don't confuse lower payments with lower rates. Just because the monthly payments for a consolidated loan are lower doesn't mean you're actually paying lower interest rates. This is especially true with plans offered by some debt consolidation programs. The lower monthly payments occur because the consolidation stretches out the life of the loan.

A similar mistake is transferring lower-interest-rate loans into a higher-interest-rate consolidation loan. For ease of bill paying, and because most of their loans can benefit from consolidation, a person may consolidate all of their loans. Yet, one or more of the original loans may actually have lower rates.

But undoubtedly the biggest mistake occurs when consumers confuse lower monthly consolidation

payments with saving overall finance charges. The college loan consolidation program, offering its lowest interest rates in its history, illustrates this point. Graduating students typically end up with multiple loans from multiple lenders, so consolidation makes paying easier. And the consolidation rates typically are lower than the rates for the original loans.

But here's the catch. Say you have \$20,000 in student loans. In one example from a commercial lender, a consolidation loan would cost the student \$222 a month for ten years. Total interest payments would be \$6,644. The student could lower that monthly payment to \$143 a month by paying off the loan over 20 years—tempting considering the tight budgets of students just out of school. Yet, the total interest payments over the life of the loan would run \$14,389!

Another example occurs when someone consolidates a five-year car loan into a 15-year refinanced mortgage or 10-year home equity loan. Even at lower rates, you probably will end up paying more in interest for the car than if you'd stuck with the original loan, or refinanced the car loan itself for a five-year period. Be sure you consolidate a loan for no longer than the period of the original loan.

Another drawback in the above example is that you're transferring more loan risk to your home. Home bankruptcies right now are among the highest in history. Do you want to risk the loss of your home for a car? A worse situation occurs when people consolidate their credit cards into a home equity loan. They're transferring unsecured debt to secured debt.

Hence, sometimes the best strategy is to live with the higher rates and pay the loans off faster with money saved either from earning extra income or by cutting household expenses.

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