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debt consolidation – pros and cons

The Reserve Bank's latest official rate hike signals the end of what proved to be a mild economic downturn, and a return to more normal conditions. This is good news for our economy but the March rate rise will add to the financial burden of many families.

Housing debt – your mortgage, is generally seen as 'good debt' because it's debt backed by an asset that should rise in value over time. The trouble is, you need to be able to pay off the loan while living a comfortable life, and rising interest rates can make this challenging.

Higher rates don't just impact home loans. It's a fair bet that rates on credit cards will go up too. For people facing multiple debts like a mortgage, personal loan and perhaps one or more credit cards, debt consolidation may appear to be a low cost solution to the problem of unmanageable repayments.

Debt consolidation involves combining all your outstanding debts into one lower interest loan, typically your mortgage.

Extending your home loan or taking out a single personal loan to cover all your debts can reduce the overall monthly repayments, however it's not an instant cure-all.

Unless you stick to a tight spending budget you could end up accumulating other debts again.

Moreover, debt consolidation can have a nasty habit of turning short-term debts like a personal loan, into longer-term ones. This often means paying far more in long-term interest than would be the case if you simply knuckle down to repay each debt separately.

That's why debt consolidation works best if you focus on paying off the newly consolidated debt as fast as possible. It's the only way to minimise the total interest cost.

When you approach a lender to consolidate your debts into one loan, the first thing you need to show is that you can comfortably meet the new repayments. As a rule of thumb your monthly debt repayments (comprised of interest plus principal) shouldn't exceed 30% to 35% of your gross monthly income.

The second thing a lender will look for is security, which is why most debts are consolidated into a home loan. There is a catch here. If consolidation pushes the balance of your mortgage above 80% of the value of your property, you could get slugged for lenders mortgage

insurance. It's an expense that can run into hundreds, even thousands, of dollars, and it offers no benefit to borrowers as it protects the lender, not you, in the event that you fall behind with the loan in the future.

You may also be asked to pay early-exit charges when you pay out existing debts like a car or personal loan.

The important thing is to work out the cost of consolidating your debts, and weigh this up against any benefits. There's every possibility that you could be in front simply by focusing on paying off your current debts as fast as possible.

Paul Clitheroe's 'Making Money' for the week beginning 15 March 2010



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