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Consolidate To Get Ahead

Debt consolidation is often portrayed as a way out of trouble.

But for many it's actually a smart way to get debt-free more quickly by reducing the interest being paid.

Many of us have several loans and debts. For example we may have a home loan, a line of credit, car financing, a personal loan, a few credit cards, and some store finance for furniture or renovations. These commitments will all be charged at different interest rates, perhaps with account fees and other charges.

Whilst it may have been logical to set-up and keep these commitments separate, it can mean that you are paying more interest than you have to.

Credit Cards

For example, the Australian Consumers' Association monitors 250 credit cards on a weekly basis. They currently list cards with interest rates varying from 8.99% to 18.99%, with annual fees ranging from $0 to $395, and interest-free days from nil to 25.

Whilst some of the more expensive cards will have rewards and loyalty programs, these may not make up for the differences in interest charges, fees and interest-free days.

Personal loans, car loans and store finance also show wide variations, with some very high interest rates. For example, interest-free finance through a store is an attractive option provided that the debt is cleared within the term. If not, these loans often revert to extremely high interest rates – 20% and higher are not uncommon.

Balance Transfers

The smart way to reduce this debt more quickly is to minimise the interest rate and fees being charged, whilst maintaining the same monthly payment as before.

A good example is to watch out for low interest or even interest-free balance transfers that are regularly offered by credit card providers. You can apply for a new card and then transfer the balances from other credit cards, which will then be charged interest at a very low

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rate or even interest free, at least for a period of six months and occasionally for the lifetime of the balance transferred.

This can be a good short term solution, but often the interest rate then reverts back to a (comparatively) high rate. So then the whole process of application and balance transfer has to start again. Also, this doesn't help to reduce the interest rates on some store finance, personal loans and car financing.

Smart Debt Consolidation

A more comprehensive solution is to consolidate all of the debts into a relatively low-interest product such as a home loan. This can be done by either using an existing capacity, for example using available redraw or an unused line of credit, or by refinancing the entire home loan.

This can often result in halving your average interest rates. For example you could refinance a credit card at 18.75% to the standard variable mortgage rate of 7.8%. On a debt of $10,000 this represents a reduction in interest of nearly $1,100 per annum.

Similarly, by refinancing a car loan of $25,000 at 12.75% you could see interest savings of approximately $1,200 per annum.

Of course in both of these examples the amount of saving would reduce over time as some of the debt principal is paid off, but it would still be substantial.

Now here is the important point. By keeping the new consolidated payment **the same** as the sum of the various payments being made previously, then the debt will reduce much quicker as less interest is being paid.

Words of Caution

This strategy does work, but you should watch out for the following:

- **Cancel The Old Debts or Cards.** If you transfer the debts (e.g. from credit cards) then you are at risk of building up new debt in its place, which isn't the idea. By cancelling the old credit cards and loans this won't happen.

- **Early Repayment Costs.** Some loans may incur a penalty if paid out early, which can negate some of the benefit of refinancing the debt.

- **Establishment Costs.** Organising a top up on your home loan, or refinancing altogether, will incur some costs. Again you should check what these costs are and factor them into your calculations.

Conclusion

If used correctly and by keeping the new payment at the same level as the sum of the old payments, then using your home loan to consolidate your debts is a good way of reducing interest and clearing debts more quickly.

Sources

1. Australian Consumers' Association

2. ASIC – FIDO web-site www.asic.gov.au/fido, August 2006

3. Defence Tactics – Sydney Morning Herald October 10th 2001

4. Various lender web-sites and brochures.

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