

In too deep? Consumer guide to debt consolidation

Sometimes it is the unexpected – job loss or illness - that catches up with us and forces us to make some tough financial decisions. At other times poor budgeting and financial mismanagement can lead us to get into too much debt.

It is common for people in financial strife to attempt to refinance their home loans in order to “consolidate” all their debts – credit cards, car and personal loans, etc – into the one 25-year mortgage. But is debt consolidation always a sound strategy?

The recent economic downturn was one of the worst we’ve seen in a generation, making job losses a harsh reality. In its midst, the Federal Government urged the banks to take it easy on people at risk of losing their homes. So what steps should you take if you find yourself in financial difficulty?

Work with your lender

Talk to your lender as soon as possible if you think you are going to have difficulty meeting repayments. This applies to your home loan but also to other smaller debts such as your credit cards, personal loans and even household electricity and phone bills. Don’t wait until you fall behind. With a home loan, for example, if you delay the lender can take action to repossess and sell your home. This can happen very quickly and can be difficult to stop.

The lender may be prepared to work with you to come up with a new repayment plan that you can afford. This may involve extending the life of the loan to lower your monthly repayments. Another possibility is to switch to interest-only repayments until you get back on your feet.

Hardship variations

Another option before resorting to a debt consolidation loan might be a formal hardship variation under the Consumer Credit code. To qualify the loan must be for a home (not an investment property) or used to raise money for “other household, personal or domestic purposes”. You must be unable to pay because of illness, unemployment or another reasonable cause and you have to be able to demonstrate that you will be able to repay the loan if you get the variation.

Better off selling?

Selling your home can be a better option than falling behind to a point where the lender takes steps to foreclose and sell. If it is left to the lender there’s a chance they will take a quick sale rather than hold out for the highest price.

If the amount the home is sold for falls short of what you owe, you will still need to repay the difference.

Avoid lenders of last resort

According to Legal Aid NSW, refinancing can be the wrong decision, particularly if you’re forced to turn to lenders of last resort, those who advertise using slogans such as “Bad debt? No problem”.

Legal Aid NSW says you can identify a lender of last resort because: "... the loan term will usually be 12 months (definitely less than five years); you will have to borrow a lot more to cover all the fees; you will be told you have to sign a declaration that the loan is for a business/investment purpose even if it is not ...".

Prevention is better

The best strategy is to take steps to ensure you don't get into a situation where you have to think about a consolidation loan.

Pay more than the minimum repayments required by your lender. Pay as much off your mortgage as possible while you are healthy and employed. This teaches you to be disciplined with your cash flow and discretionary expenditure and gives you a buffer if you need to reduce your payments back to the minimum due to your circumstances changing.

If you do become unemployed the first thing to get on top of is your entitlements and how to use them. If you get a chunk of money the big questions are should I pay off my mortgage, put it into super or keep it in a savings account to live off. You don't know how long you will be without a job. The worst thing in the world is having a pile of debt, underperforming investments and little or no income. So if you lose your job consider paying a three or six-month block off your mortgage if you can afford it.

Kick card habits

If credit cards are your problem you may be better off doing the hard slog and paying each credit card off. You will need to make a budget to determine how much you make each month, how much you spend and what money you have left over to start paying down your debts.

If you have multiple cards and you are a disciplined person start by paying off the card with the highest interest debt. By making regular payments and not putting new purchases on a card you can eventually reduce the balance to zero and then you can chop that card up and move on to the card with the next highest level of interest debt.

As you reduce each credit cards carry-over balance you should call the credit card provider and ask them to lower your credit limit so you don't get tempted to fill it up again.

Rich says Consumer Action is "wary" of balance transfer offers: "It's human nature to be over-confident on your ability to pay off the debt within the 0% interest period," she explains.

Give yourself wriggle room

Craig and Gina are only 18 months into their hefty Sydney mortgage. They still owe \$625,000 on their 30 year loan, which has a current variable rate of 5.25%. They are currently making monthly repayments of \$3451.00 and that is the minimum repayment required under their loan agreement.

The couple's combined annual taxable income is \$250,000 so they are already using almost 17% of their income for mortgage repayments and they want to have their second child within the next couple of years.

After tax and mortgage repayments Gina and Craig still have around \$100,000 to live on each year. They're not struggling but they also have a \$20,000 credit card balance and a \$45,000 car loan and they pay \$100 per day in childcare fees.

What would happen if interest rates went up 1%? Would they still have "room to move"? Their monthly repayments would go up to \$3848. Their repayments start edging up towards 20% of gross income and the amount of disposable income they have to cover other debts, rates, insurance and day-to-day living is reduced.

And because they haven't paid more than the required minimum they have no 'buffer' that can be drawn on to cope with a period of maternity or paternity leave or if one of them was to lose their job.

Consider the worst case scenario

How would this couple cope if they were reduced to one income? For the sake of this exercise, let's say they both earn \$125,000. If their taxable income was suddenly reduced to \$125,000, their disposable income, after tax and mortgage repayments would be reduced to \$33,588.

They would have to substantially change their lifestyle and cut back their living costs in order to meet their other repayments, childcare costs and hold on to their house. They may have to review their desire to have a second baby, at least in the short-term.

If they were down to one income and rates increased another whole 1%, their disposable income after tax and mortgage repayments is down to around \$24,000 and this young family would be finding it difficult to keep their home.

How would you cope in a similar situation? It's worth using a budget planner and your current lender's online calculator to find out exactly what impact higher mortgage rates would have on your personal finances. How long would it take before you found yourself in mortgage stress?

Then be positive

Sometimes you may not be able to find an alternative to a debt consolidation loan. If you're in that situation, do your homework to find the best available deal. Lenders prepared to refinance mortgages to include unsecured debts such as credit cards usually require a higher interest rate than for a 'normal' mortgage. That's why you're better off taking steps to prevent getting into too much debt. Here are some simple strategies you can use to get ahead of the game:

1. Put together a household budget and identify areas where you can cut discretionary expenses (entertainment, alcohol, clothing, etc).

2. Use money saved from your budgeting to pay more off your mortgage. By paying more than the minimum required by your lender you will reduce the loan period, save interest and create a buffer that you can use to adjust your repayments during tough times.

3. Pay more frequently. Paying fortnightly or monthly does mean you are chipping away at the principal amount you owe (and therefore the interest) more rapidly than if you pay only the minimum once a month.
4. Pay attention to your statements. Keep track of how much interest you're paying, understand how your lender calculates interest and watch your buffer grow while rates remain low.
5. Don't borrow more than you can afford. Figure out how much you can realistically repay, consider lifestyle choices such as having a family and don't over-commit.