UNDERSTANDING
DEBT CONSOLIDATION

When Money Becomes Mayhem

MHV
MID-HUDSON VALLEY FEDERAL CREDIT UNION

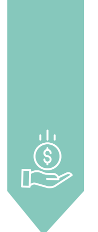
DON'T LET *your* MONEY MASTER YOU

No matter how well you think you've managed your money, there can come a point when debt feels overwhelming. This guide will walk you through financial warning signs, how a debt consolidation loan works, and how to manage your finances after you consolidate your debt.

As you work your way through this guide, it's important to keep in mind two key points.

1. Never feel too embarrassed or scared to ask your financial institution for help. It's easy to feel like you're the only one facing financial insecurity but you aren't. Financial institutions help hundreds of people each year and are ready and willing to work with you.

2. If you consolidate your debt, it's critical to understand that you must adjust your financial habits to avoid falling into a financially-compromised position again.



WARNING SIGNS

There are a few telltale signs that you may be stretched too financially thin. If, of course, you're struggling to make your payments each month it may be time to consider consolidating your debt. Another major sign is relying on credit. Yes, we occasionally have to charge items such as unexpected emergency expenses. If you find yourself charging everyday purchases like your groceries or gas, though, it may be a sign of a serious shortage of cash.

Using a credit card for everyday purchases to earn rewards points or cash back is fine – as long as you can pay your balance in full each month.

Credit is not an extension of your checking account, and if you're using it like it is you're setting yourself up for financial failure.

Banking on grace periods is another sign that your finances may be spinning out of control. Most lenders provide grace periods – periods of time that extend beyond your due date but which won't reflect on your credit report – to protect you from an occasional late payment. If you're shuffling your bills to maximize grace periods, though, it's indicative of a disruption in your cash flow.

Financial Warning Signs

- ☐ Struggling to make payments
- ☐ Relying on credit
- ☐ Consistently using grace periods

Act Before It's Too Late

Don't wait until you're making late payments. Doing so jeopardizes your credit score and makes it harder for lenders to work with you. If you do opt for a debt consolidation loan, you're going to want your credit to be as healthy as possible to help secure a favorable rate.

If you're experiencing any financial warning signs, it's critical to reach out to your financial institution for guidance on possible solutions. Debt consolidation loans are only one possible remedy: your bank or credit union may be able to offer you deferred payments, a longer term to lower payments, a forbearance, or other options.

A **deferment** is a period of time during which you don't need to make payments. Interest may or may not accrue during a deferment, so it's important to clarify that with your lender. The length of a deferment varies by financial institution and individual need. A **forbearance** typically applies to a mortgage and is an agreement with your lender to delay foreclosure or other collection efforts.

CASH FLOW refers to the movement of money. If you're spending more money than you're receiving, your cash flow will be disrupted and you won't have funds on hand to make payments.

How Debt Consolidation Works

When you consolidate things, you're essentially making them easier for you to handle, right? Consolidating your weekend errands, for example, means you're going to group errands by location, so you're not ping-ponging around town to get things done.

The same principle applies to debt consolidation.

When you're trying to balance multiple credit card payments, it can be hard to keep track of what is due when and how the multiple due dates impact your cash flow. For example, if you get paid on the first of the month and have one credit card that's due on the seventh, one due on the twelfth, and one due on the twenty-second, managing those payments along with your utility bills, groceries, and rent or mortgage can get exhausting and lead to missed payments.

When you consolidate your debt, you are taking all of those payments and combining them into a single one. A debt consolidation loan is a personal loan that provides funds for paying off your credit cards or other debts, leaving you with one monthly loan payment. In other words, the proceeds from your debt consolidation loan are paid directly to your credit card companies or other lenders to pay those balances off. You then make a monthly payment towards the debt consolidation loan. There are multiple benefits to consolidating your debt. Making your budget much easier to manage is chief among them.

BEFORE *you* APPLY

Like any loan, your financial institution will look at your credit and your debt-to-income ratio, among other factors, to determine your eligibility. This is why it's so important to take action before late payments start hurting your score. You can check your credit using annualcreditreport.com. Look over your reports from each bureau to make sure there aren't any inaccuracies. If you find any, contact the lender or the credit bureau directly to start the correction process.

The three main credit bureaus – Experian, Equifax, and Transunion – very often reflect slightly different information on their reports. It can be possible for two of the three to have accurate data while the third still shows a delinquency that you've paid off. This makes it critically important to read through the reports of all three bureaus.

Your debt-to-income (DTI) ratio looks at the amount of debt you have relative to your income. You should have a sense of your DTI before applying for any kind of loan because, even if your credit is good, a DTI that's too high could make you ineligible for the loan. To estimate your DTI, add up all of your monthly debt payments: housing, car loan, personal loan, credit card, student loan, etc. Then, divide that number by your gross monthly income, or, the income you receive before your deductions. The answer will be a fraction, so multiply it by 100 to get your percentage. That percentage is your DTI ratio.

Each lender has different credit and DTI requirements, but knowing what your numbers are helps you understand your financial picture a little better as well as anticipate concerns lenders may have. Talk to your bank or credit union. While they may not be able to provide specifics about their lending guidelines you should be able to get a feel for your eligibility.

How Debt Consolidation Helps

It may seem counterintuitive to take out a loan as a form of debt relief, but there are two primary benefits to consolidating your debt:

1. Consolidating makes your payments more manageable, and

2. Consolidating may help you save money.

By consolidating several credit cards or other debts, you are eliminating the hassle of having to spread your money across several bills and, let's face it, remembering to pay them all. Building and managing a budget becomes much easier when dealing with a single payment, helping you to improve your cash flow throughout the month.

Savings Comparison

Credit Card Balance: $15,000	Debt Consolidation Loan Balance: $15,000
Interest: 17%	Interest: 6.75%
Months to pay off: 60 (5 years)	Months to pay off: 60 (5 years)
Monthly Payment: $356	Monthly Payment: $93.88
Total interest paid: $6,410	Total interest paid: $1,810

Because a debt consolidation loan is a personal loan, it will very often have a lower interest rate than a credit card. Consolidating higher-rate debt to lower-rate debt saves you money on both your monthly payments and the total amount of interest you'll pay, potentially injecting your budget with much-needed cash.

Aside from the obvious savings, it's important to remember that a debt consolidation loan also has a definitive term. In other words, you know exactly when you'll pay it off. This "light at the end of the tunnel" feeling can help you stay motivated and focused on your journey to rebuilding a solid financial foundation. A credit card, on the other hand, is what's known as revolving debt. There is no definitive pay off date. In addition, making minimum monthly payments on a card extends that debt for years and years and coud cost you thousands of dollars in interest payments.

If you plan on consolidating more debt than you can cover with a debt consolidation loan, and you own your home, you may be able to use your home's equity to consolidate your debt. CLICK HERE or scan the code to the right to read more about using your home's equity for debt consolidation.

Consolidating your debt can also help improve your credit. While your score may take an initial hit because of the inquiry your lender will do when you apply, by paying off your credit cards with the loan you are freeing up your available credit, also known as improving your credit usage.

> **Your credit usage reflects how much of your credit you have available to use. If you've maxed out your credit cards, your usage is high and your score is adversely impacted. Your credit usage accounts for roughly 30% of your credit score.**

Demonstrating that you have credit available to use improves your score, especially if you had previously maxed out your cards.

Applying for a Debt Consolidation Loan

Once you've got a feel for your credit and DTI, you can apply for a debt consolidation loan. To determine how much you should apply for, add up all of the debts you plan on paying off with the loan. You'll need documentation; very often lenders will want the names of your credit card companies or lenders, the account numbers, and the balances.

Once you are approved, the funds are typically disbursed directly to the credit card companies and lenders that you included in your debt consolidation. Check your outstanding balance after the funds are received by those lenders; there may be accrued interest that wasn't captured by the debt consolidation. Even if it's just a few dollars you'll want to be sure you pay that to avoid delinquency.

AFTER *you* CONSOLIDATE

There's an undeniable sense of relief after you consolidate your debt, particularly if you had been struggling with credit card debt for some time. Hold onto that feeling and let it prevent you from racking that debt back up.

After you consolidate debt, it will eventually become very hard to resist using your credit cards. And since debt consolidation often improves your score, you may begin to receive tempting card offers. You must recognize that debt consolidation is only effective if it breaks the cycle of debt. To keep your credit healthy, you can charge a few items per month, but no more than you can afford to pay in full each month. This demonstrates responsible credit card usage, helping your score without racking up debt.

> Debt consolidation may be your ticket out of financial stress. Couple that with more effective money management and your financial journey can feel a whole lot smoother.

You can stop yourself from slipping back into credit card debt by:

1. Tracking your credit score. Consolidating your debt, and then managing your credit wisely, should help your score improve. Tracking that improvement over time enables you to see concrete proof of your efforts.

2. Set up special savings accounts. Rather than reaching for your credit card for vacations or purchases, set up a savings account to empower you to pay cash for those items. Automate transfers into those savings to help you reach your goal.

3. Remind yourself of how financial stress feels. You don't want to make yourself feel bad about your spending, but remembering how stressed you felt when struggling with debt can prevent you from getting back into it.

4. Build the budget habit. You should build a budget after you consolidate debt so you can manage your loan payment, and any newly-found cash flow, effectively. If you can, give yourself a "fun bucket" so that you don't feel constrained by your budget. Getting in the habit of spending according to your budget can help stop the debt cycle.

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