MEMBERS 1st
Community Credit Union

Financial Wellness Series

6 Debt Consolidation Traps to Avoid

As of 2023, the Federal Reserve reports that the average American carries $6,271 in credit card debt. Combine this with a line of credit, a car loan, or student debt, and it’s easy to see why debt consolidation might seem like the best way to consolidate debt. However, if not approached carefully, debt consolidation can actually worsen your financial situation. Let’s look at six common mistakes (and some best practices on how to avoid them).

1. Overlooking the Root Cause of Debt

Debt consolidation can seem like the best way to manage debt when bills are stacking up, but it often fails to address the underlying spending habits that led to the debt. Think of it as putting a bandage on a wound without addressing the infection underneath—until you tackle the root cause of your spending habits, the problem is likely to persist.

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Example: Imagine you've accumulated $12,000 in credit card debt—a combination of essential and non-essential purchases, amplified by inflation. You decide to consolidate this debt into a single, lower-interest loan, hoping it will solve your financial problems. While the consolidation reduces your monthly payments, it doesn't address the fact that you're spending beyond your means.

Solution: Connect with a certified financial counselor who can help you understand your spending patterns and identify areas where you can revise your household budget. Replace old habits with new ones by regularly tracking your spending and clearly distinguishing between needs and wants.

2. Not Researching Your Options

There are various ways to consolidate debt, such as secured or unsecured loans, balance transfer credit cards, and debt management programs. Understanding the pros and cons of debt consolidation options can significantly impact your financial situation, so it's important to do your homework.

Example: A credit card balance transfer might offer a 0% interest rate for a promotional period, which sounds great at first. But there could be a 3-5% transfer fee and a much higher interest rate after the promotion ends. If you're not careful, you could end up paying more in the long run.

Solution: Start by listing all your outstanding debts and their interest rates. Shop around for the best interest rates and terms available for debt consolidation options and contact your creditors to see if they're willing to negotiate lower rates or offer any hardship programs.

Take your time and explore all your options before making a decision. Remember, the goal is to find a solution that truly helps you manage your debt, versus a quick fix that might create more debt (and the accompanying stress it brings.)

3. Consolidating the Wrong Debts

Consolidating all debts, including those with low interest rates, can lead to paying more in the long run. It's important to be strategic about which debts you consolidate to avoid unnecessary costs.

Example: Rolling a 4% student loan into a credit card with a temporary 0% interest rate might seem advantageous initially. However, once you factor in the balance transfer fee and the high interest rate that kicks in after the promotional period, you might end up paying more than if you had just kept the original loan.

Solution: Focus on consolidating high-interest debts while keeping low-interest debts separate. This approach can save you money in the long run by avoiding unnecessary interest payments. Prioritize paying off debts with the highest interest rates first, and consider other strategies, like the debt snowball method, to tackle your debt efficiently.

4. Choosing the Wrong Professional

The debt settlement industry can have a reputation for aggressive tactics and questionable practices, which can leave you vulnerable to debt consolidation scams and potentially harm your credit score.

Example: Some firms might withhold payments from creditors to force a deal, but this strategy can backfire and further damage your credit score.

Solution: Before working with any debt settlement organization, do your homework. Check their standing with the Better Business Bureau, read customer reviews, and steer clear of aggressive sales tactics. Look for nonprofit credit counseling agencies affiliated with reputable organizations like the National Foundation for Credit Counseling (NFCC). It's important to feel comfortable with your counselor and their approach. A trustworthy professional will provide clear, honest advice and work with you to find the best solution for your financial situation.

5. Using Your Cards Too Soon

After consolidating debt, it's tempting (and all too common) to start using your credit cards again. But this slippery slope can lead you right back to where you started.

Example: You've consolidated $15,000 in credit card debt into a personal loan with a lower interest rate. As the financial pressure eases, you start using your credit cards again for everyday expenses and small splurges, like a weekend getaway or new clothing. Initially, it feels manageable, but over time, these new charges add up. Before you know it, you've racked up $3,000 in new credit card debt.

Solution: Remember that you still have considerable debt to manage. To avoid temptation, consider closing most of your credit cards or making them less accessible by cutting them up or storing them securely. Keep just one or two low-limit cards for genuine emergencies to help prevent overspending. This will give you peace of mind while keeping you accountable.

6. Not Revisiting Financial Goals

After consolidating debt, it's crucial to update your financial goals to ensure you stay on track. Without clear, updated goals, you might struggle to maintain your financial discipline and end up falling back into old habits.

Example: After consolidating $20,000 in high-interest credit card debt into a lower-interest personal loan, you feel a sense of relief. However, without a revised budget or savings plan, you start slipping back into old spending habits which erodes the meaningful progress you've made.

Solution: Take time to review and update your financial goals with the support of a certified financial counselor who can take time to ask questions and help you create a personalized plan. Set specific, achievable targets for saving, budgeting, and debt repayment, and have patience with yourself every step of the way. Regularly revisiting these goals will help you ensure that the relief from consolidation translates into lasting financial stability.

MEMBERS1st has partnered with GreenPath to equip you with the tools you need for financial success. It's free, confidential, and no pressure!

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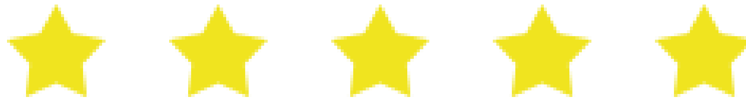

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