**How Does Debt Consolidation Work: Do's and Don’ts**

Dealing with multiple debts is devastating. Just when you have settled a monthly payment of one debt, another one pops up. Most people in these situations end up getting late payments penalties or end up living in poverty as they direct all their incomes to the loans.

Luckily, loan consolidation helps in such situations. It rolls all the debts into a single loan with a fixed interest rate. The new interest rate is typically lower than the old ones, depending on the borrower's credit score.

Loan consolidation is highly beneficial, but it still has a few pitfalls. Here are also some do’s and don'ts that you must observe for it to work well for you. Keep reading our guide to learn more.

**What is debt consolidation?**

As mentioned above, debt consolidation is all about rolling different loans into one. It is therefore defined as the process of combining more than two debts to a single debt, or fewer obligations. The primary goal of consolidation is to get a lower interest which the borrower can pay with ease. Debt consolidation, therefore, allows you to repay the debts easier by simplifying and reducing the monthly payments.

For instance, assume that you owe $2000 on five different credit cards each, whose interests vary from 17% to 24%. If you want to consolidate the loans to have excellent credit, you can take out a $10,000 personal loan at a lower interest rate of around 12%. The loan would consolidate the others, and save money by paying a lesser interest.

**Understanding a debt consolidation loan**

A debt consolidation loan is the new amount of cash used to pay off the existing debts. The credit allows the borrower to focus on paying a single monthly payment, as compared to the multiple loans.

**How debts consolidation works**

Firstly, you must take out a loan application. The application generally involves a credit check which usually reduces your credit score with a few points, for two years.

Once your application goes through, you receive the lumps one to your bank account. The credited amount is supposed to be used to pay off your already existing creditors.

Once you have settled the loans, which as earlier mentioned have a high-interest rate, you are left with a single loan whose interest is lower.

The consolidation works well if you still maintain a discipline of making monthly payments for the new loan, and also paying in time.

**The types of loan that you can consolidate**

Debt consolidation simplifies many types of unsecured personal debts. These includes

* Medical bills
* Credit cards
* Payday loans
* Utility bills
* Taxes
* Student loan

Personal loans are commonly used options for debt consolidation. However, HELOC and home equity loan can also be used as well.

**The pros and cons of debt consolidation**

**Pros**

* **Single payment**- loan consolidation combines multiple debts into one. His makes it easy for the borrower to concentrate on paying one loan.
* **Stress reduction** - loan is among the leading causes of stress. By considering loan consolidation, the borrower reduces the stress associated with the loan and allows them to focus on other things.
* **Stop collection calls**- collection calls can be quite annoying, and especially if you receive them from multiple sources. With consolidation, you can get a call from one source, or even fail to receive if you pay well.
* **Lower interest rate**- this is the primary purpose of loan consolidation. It reduces the interest rate and thus allows the borrower to save substantial amounts.

**Cons**

* **Increased indebtedness-** debt consolidation institutions charge fees for the service. The fees can sometimes be too high and increase your indebtedness. There might also be some hidden fees.
* **Longer repayment period-** Consolidating a loan does not change the initial amount, but just stretching it into a shorter repayment period through a single payment.
* **Serious penalties-** Unlike in normal loans, a consolidation loan has a hefty penalty. You can quickly lose your car, house or any other collateral if you had used any.

**The dos and don'ts of debt consolidation**

**Do’s**

* **Compare to get the lowest interest rate**

There are many financial institutions which offer the debt consolidation plan. So, before you settle on a single institution, be sure to shop around and inquire about the interest rates. Generally, you will pay for a more extended period if you choose a meager interest rate. But all in all, you must look for the lowest depending on your income. After all, the primary reason as to why to seek loan consolidation was to get low-interest rates.

Some institutions welcome offers such as complimentary insurance, promotional rates, and more features which all aim at saving the borrowers money. While there are many other factors to consider in financial institutions other than the welcoming offers, the money-saving extras will help you to save some cash.

* **Change your spending habits**

A debt consolidation simplifies your loan repayment. This is however one part of the solution as you still have to change your spending methods for it to work well.

Begin by dropping the expenses purchases and start living a cheap life. You can also consider purchasing second-hand products if you are used to the brand new things. Other than the spending, you will need to look for a supplement of your income to boost savings. Remember that loan consolidation does not act as a magic bullet to drastically change your life. It is just an opportunity to simplifying your problems. If you don't change your lifestyle, you will most likely continue getting stuck in the same financial pit as before.

* **Create a repayment plan**

Remember to come up with a practical repayment plan. You can only do this by creating a budget first. How much do you earn? Start from there. Make your allocations wisely. The loan repayment for the consolidation plan should be made a priority in the new budget.

Also, try to estimate how much it will take you to settle the amount in full. Don't also to forgo the needs which are not basic, as earlier mentioned. Try also to set up money for some emergencies. Remember that anything can happen and you wouldn't need to be caught up broke. If you still find some challenges in coming up with a repayment plan, be sure to seek the help of a financial advisor.

**Don'ts**

* **Don't use credit facilities**

Once your debt consolidation loan is approved, you won't be allowed to use the already existing credit cards, unsecured credit facilities, and personal loans. The loan consolidation, however, comes with a bundle of revolving credit facility. The credit card comes with a fixed credit limit for your monthly income. This provides you with a reliable mode of payment just in case you need to recover your daily expenses.

Since the credit facility is part of your consolidation plan, it is not canceled. This means that you still have to bear with the interest rates and the fees associated with its usage.

If you continue to use the credit card, you will undo all your hard work and maybe out you into a deeper financial hole. So, what should you do? Stay out of the debt cycle by saving money continuously even when you have a credit card debt.

* **Don't miss your payments**

Use a financial calculator to know how much the monthly payments will cost you. With the calculator, you will be able to come up with a good plan so that you don't miss your payments. A late payment attracts penalties, and the financial institution can charge you interest for the missed payments.

This is similar to what happens when you can't afford credit card payments, but the consequences are more severe. No financial institution will help you out if you fail to pay or default your consolidation plan. So, maintain a payment discipline and pay your loan in time.

* **Don't take a home equity loan**

You may come across different home equity offers when looking for methods of consolidating credit. These are secured loans which allow you to use your home as collateral. When you fail to repay the loan, the lender takes your house. Never consider a home equity line of credit to settle an outstanding credit card loan. This is because the risk will be too significant even when you are confident about your ability to repay the loan.

Consider what would probably happen if you can't make the payments to a financial emergency. You may lose your loan just because of a simple card debt amount.

* **Don't rush**

Debt consolidation is not always the last financial solution to your woes. It comes with its disadvantages, and that's why you shouldn't always rush to it. Just because you keep on hearing success stories from other people or seeing TV adverts on how low the interest rates does not mean that the option is the best.

**Conclusion**

Debt consolidation is helpful, but we cannot ignore the fact that it has some severe drawbacks. When you decide to use, consult a finical advisor. Also, make sure that you understand its basics to that you don't experience surprises.

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