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Your guide to debt consolidation

With debt consolidation you combine a number of individual debts into a single debt. So, for example, instead of having lots of little debts; such as store cards, credit cards, short-term loans and overdrafts, debt consolidation wraps all of those smaller debts into one bigger loan. This usually means increasing your home loan and using the extra cash to pay off all your loans.

Why consolidate your debts?

Having lots of smaller debts can be expensive and it can also be difficult to keep track of all the repayments. Typically, store cards and credit cards have interest rates ranging from 17% to 30%, whereas a short-term loan could have an interest rate of almost 40% in a calendar year, depending on your credit history. So this form of borrowing is far more expensive than a home loan, which will usually have an interest rate of around 10%. However, it is important to note that the interest rate charged on credit will be influenced by changes in the repo rate.

It's important to keep track of all your debt repayment due dates because if you are late with a repayment, or you miss a repayment completely, you will probably be charged a penalty fee that will just add to the amount of money you already owe.

So by having lots of little debts you will probably end up with lots of smaller, but expensive monthly repayments. If you consolidate all your debts into your home loan, on the other hand, you will have just one monthly repayment to make that will usually be less than all of your old monthly repayments combined.

The impact of NCA

The introduction of the National Credit Act (NCA) has also made a big difference to the way people get credit and how much credit they are allowed to have. Now credit providers have to work extra hard and ask for more paperwork from customers before they grant loans to ensure they are not lending out money recklessly.

If money is leant out recklessly there is a danger that the consumer may not be able to meet their loan obligations and may not be able to make their monthly repayments.

It also means that consumers have to prove they can afford any new credit agreement by declaring how many loans or debts they currently have, supported by evidence, as well as how much disposable income they have left after paying off their debts and other expenses.

Previously all a consumer had to do was show a provider a current pay slip to prove they earned enough to pay for the individual credit agreement they were applying for. This did not take into account the total amount of debts a person had, which sometimes could add up to more in repayments than they actually earned. This caused a lot of problems and so the NCA was introduced.

What this means is that consumers struggling with smaller debts are now finding it harder to take another small loan to fill the gap because they fail the new NCA criteria and are deemed to have too much debt already.

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If they have a property, however, debt consolidation could get them out of difficulties, clear their debts and give them time to get their finances straight.

How does it work?

Usually you combine all your debts into your home loan so that you are paying off just one loan that is more affordable. This is because a home loan usually has a lower interest rate and is spread out over a longer period of time, typically 20 years.

Equity in your property

To be able to consolidate your debts into your home loan you need have equity in your property. This means that the current market value of your property must be higher than the size of the home loan you have on it. If your property is worth R750,000 and you have a mortgage of R500,000, then your equity is the difference between these two figures – R250,000.

So if you currently have a home loan of R500,000 and you wish to consolidate R100,000 worth of smaller debts into a new mortgage, then your property needs to be worth more than the new home loan amount of R600,000. How much more will depend on the provider and what percentage the total home loan is of the value of the property.

The smaller the percentage of the value of the property – and therefore the greater the amount of equity – then the more likely the lender is to give you a debt consolidation loan. If you have a lot of equity then your lender might even be willing to lend you money in addition to the debts you are paying off.

If you have very little equity in your property then you might struggle to get a debt consolidation loan. Lenders will also need to take into account other factors, such as your income and your credit history. As with any credit agreement you will have to prove that you can afford to meet the repayments on your new debt consolidation loan. If you have a poor credit history because of missed payments or judgements against you, this may also count against you.

A fresh start

Debt consolidation can help people make a fresh start. By rolling all their debts into a single, affordable loan, they can remove the stress of managing several loans and debts, can save themselves money on their monthly repayments, and take time to get their finances straight.

To make certain that customers use their newly consolidated home loan to pay off all their outstanding smaller debts, many lenders actually insist on the consumer giving power of attorney to a lawyer whose job it will be to pay off those debts on the consumer's behalf. This ensures that the original debts are cleared and that you are not able to incur new debts by keeping the cards and loans open.

Under the rules of the NCA, it also means that once you have taken out your consolidation loan, you will find it harder to get new credit anywhere else – such as store cards or credit agreements – because you might not meet the NCA's criteria.

It is also important to take responsibility for your own debts and ensure that you do not start

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spending more than you earn and begin building up debts again. You should also be aware that because your new debt consolidation loan is a home loan, and therefore secured against your property, if you do not keep up repayments you will be at risk of losing your home.

If, as a result of your consolidation loan and new lower monthly repayment, you find you have money left over at the end of the month, it would be a wise move to pay more into your home loan. This will help to bring down the length of your mortgage and could also save you tens or even hundreds of thousands of Rands in mortgage repayments.

Fees and charges

Increasing your home loan to consolidate all your other debts will incur additional fees and charges. You will need to check with your lender or broker to establish how much these will be.

When is debt consolidation not suitable?

Debt consolidation is most suitable for people with a significant amount of debt. If you are purchasing something like a piece of furniture or electrical item, rather than taking out a loan from the retailer, it might be more cost-effective to purchase it on a credit card, and then pay it off over a few months or a year.

But as always, before considering any credit agreement or loan, it is vital to make sure you can meet your monthly repayments and will be able to pay off you debts. Failing to do so could leave you in big trouble.

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