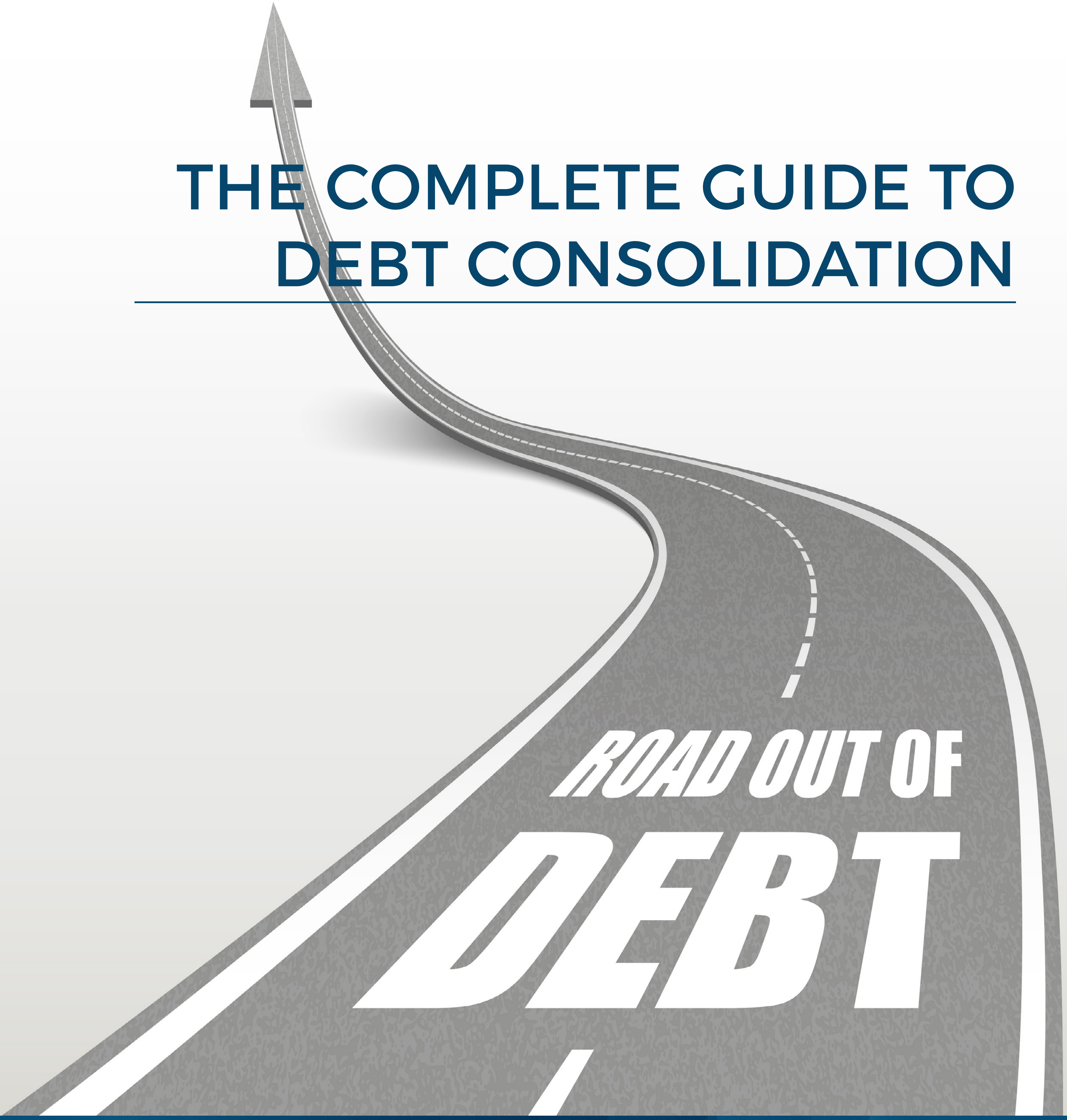
THE COMPLETE GUIDE TO DEBT CONSOLIDATION



MONEYPROBLEMS
MONEYSOLUTIONS

Contents

www.moneyproblems.ca

An Introduction To Debt Consolidation

One size does not fit all.

Debt consolidation is a way of managing debt by combining multiple debt obligations into one.

There are many reasons to consolidate your debt:

- You save money by reducing your interest costs and possibly principal repayments.
- Managing your money becomes easier with one single monthly payment.
- You can get out of debt sooner.

With the right debt consolidation program your life becomes less stressful. The problem is there are almost as many ways to consolidate your debts in Canada as there are different types of credit. Gone are the days when debt consolidation simply meant talking to your banker about getting a new loan or a second mortgage and using the money to pay off your credit card debt. Today you have to decide if you need more than just a new loan. Do you also need some form of debt relief? Which options are safe and how will each choice affect your credit rating?

Today debt consolidation is offered by many different providers including traditional financial institutions; finance companies and specialty lenders; not-for-profit and for-profit credit counselling agencies; as well as bankruptcy trustees. Deciding who to talk to can be a daunting task.

A good starting point is to understand the pros and cons of each debt consolidation approach and how it can help you.

In this guide, we will explain:

- How debt consolidation works in Canada.
- What you should look for in a debt consolidation program.

- The difference between debt consolidation and debt settlement.
- How a debt management plan or consumer proposal can consolidate your debts and provide debt relief at the same time.

We will "run the numbers" for each debt consolidation option through a simple case study to show you how each solution can benefit your finances.

Once you understand how these alternatives differ you will be in a better position to choose the right option for your situation. After all, no one person's financial problems are the same, and no one program will work for everyone.

Five Goals For Restructuring Debt

Chapter 1

What do you need to accomplish?

Debt consolidation is one of the best ways to reduce your debt. But making the choice about how to consolidate debt should be based on meeting your financial needs. Are you running out of money at the end of the month? Are you looking at 15 years to pay off your debts? Are you juggling too many payments that you miss some? Your first step in choosing the right approach is to determine exactly what you need to accomplish.

Let's look at **five core debt consolidation goals** you might want to accomplish by restructuring your debt. No matter what debt consolidation approach you choose, these goals are relevant to you.

5 Debt Consolidation Goals

1. Lower Interest Rates
2. One Single Payment
3. Lower Monthly Payments
4. Debt Settlement
5. Creditor Protection

Every debt consolidation alternative should be judged against its ability to meet your needs. Keep in mind you can certainly accomplish more than one of these goals, but you might not be able to achieve all of them with every debt consolidation option.

Goal 1. Lower Interest Rates

This should be on everyone's list. Whether you are suffering under the burden of high credit card rates or have an expensive car loan or bank loan, you should pay close attention to the interest rate that you will be paying on any debt consolidation option. If you're being charged 19-percent interest on four credit cards, does it make sense to consolidate them into a high-cost finance company loan at 25-percent? Probably not, but you can get yourself into this situation if you don't read the fine print.

Here's our first red flag: Don't forget to include application fees and processing fees into the calculation. When you sign on the dotted line, make sure you are paying a lower rate "all in," than you were before you consolidated your debt.

Goal 2. One Single Payment

Having to make one payment toward all of your debts is one of the most appealing features of almost any consolidation option. You're probably creating your own personal accounting nightmare if you are making the minimum payment on one credit card with cash advances from another. The end result can often be missed payments, even if you have the cash flow to keep afloat.

Goal 3. Lower Monthly Payments

If you are struggling to make ends meet, one of your goals might be to reduce how much you have to pay each month. There are two ways to accomplish this goal through debt consolidation:

1. Lower the interest rate charged on the debt you owe — and / or
2. Extend the term of your loan so that you take longer to pay off your debt.

Red flag: Be aware that the second option will cost you more in the long run.

Goal 4. Debt Settlement

Any option you choose should mean that your debt is eliminated within a reasonable period of time. If your situation is so severe that you are looking at years of debt repayment, you need to do more than simply refinance your current debts. Instead, you should be considering debt relief options. This might take many different forms, including simple interest relief through a debt management plan or some form of principle reduction with a consumer proposal, two alternatives we will discuss in later chapters.

Goal 5. Creditor Protection

If all else fails and you've missed so many payments that your creditors are calling you at home or you're facing the specter of your wages being garnished, creditor protection is an option. We will talk more about how a consumer proposal can provide you with legal protection from your creditors and help you protect your assets in a later chapter.

The remainder of this book will explain different debt consolidation options and analyze them against these five goals or objectives. We'll explain each option and let you know about things you should be aware of along the way.

Different Debt Consolidation Services

Chapter 2

Know what you are signing up for.

If you Google debt consolidation, you'll come up with a variety of possibilities:

- Banks and credit unions offering debt consolidation loans.
- Finance companies offering debt consolidation loans for high-risk customers – at a higher interest rate, of course.
- Credit counselling agencies offering credit consolidation through a debt management plan.
- Companies that offer debt consolidation, debt negotiation or debt settlement services.
- Bankruptcy trustees who can help you consolidate and settle your debts using a consumer proposal.

That's a lot of confusing terminology. So how do you know who is offering what and which is the best option for your unique situation? To begin, we will start with a basic definition of each type of debt consolidation service available in Canada.

Debt Consolidation Loan

A traditional debt consolidation loan means you are taking out one loan and using the proceeds to pay off several smaller loans. They are usually offered by a bank or other financial institution. You pay off 100 percent of your debt, plus interest on the new loan, and sometimes you are also charged a loan application fee. A good example would be taking out a second mortgage on your home to pay off your credit card debts.

Debt Management Plan

This is a repayment arrangement made between you and your creditors with the help of a credit counselling agency. You pay back 100 percent of what you owe but often avoid having to pay interest.

Consumer Proposal

This is a formal debt settlement program under the *Bankruptcy And Insolvency Act* offered through a licensed bankruptcy trustee. You pay back less than the full amount that you owe. While settlements of 30 percent are common, the exact settlement rate depends on your income and what you own.

Debt Settlement

While a debt management plan and a consumer proposal are technically debt settlements because you negotiate an agreement with your creditors, debt settlement can also refer to services provided by unregistered debt consultants.

> **Red flag: Beware of this option, which sometimes is offered by companies that use high-pressure sales tactics and charge large up-front fees before reaching an agreement with your creditors.**

In many cases, these companies charge you high up-front fees, pressure you to sign difficult-to-understand contracts, provide misleading information about how your credit rating will be affected and claim that they are somehow connected to the Canadian government.

In other instances, they charge an up-front fee to discuss your situation with you, only to refer you to a bankruptcy trustee to file a consumer proposal.

According to the Credit Counselling Society, the success rate for these for-profit debt settlement companies is under 10 percent, and 65 percent of the people who pay fees to them leave their programs without settling their debt.

Because we generally do not recommend non-accredited debt settlement programs due to their inherent danger, our next chapters will focus on the three most common forms of debt consolidation: debt consolidation loans, debt management plans and consumer proposals. We will look at how each option works, run some numbers to help you see how each solution could affect you financially and take a look at the pros and cons of each alternative.

Debt Consolidation Loans

Chapter 3

Read the fine print before you apply.

A traditional debt consolidation loan is pretty simple.
A bank, mortgage company, credit union or finance company grants you a new loan, and you use the proceeds of the loan to pay off your current debts and "consolidate" them into one new, larger loan.

By doing so, you swap several debt payments each month with one single payment on your new loan.

With a debt consolidation loan, you eventually will pay off all of your debt, plus interest. However, because you can generally negotiate a lower interest rate than you were paying before, you can actually get out of debt sooner.

Not all debt can be consolidated. Credit card debt, utility bills, car loans and other personal loans can but mortgages and tax debts can't. You'll need fairly decent credit to qualify for a debt consolidation loan, and you'll have to make enough money to repay the loan.

You might also need someone to co-sign your loan, and the bank might require collateral, such as your car or house. You probably will be able to obtain a better interest rate and extend your payments over a longer time period if you use the equity in your home to refinance with a second mortgage.

Know What Your Total Costs Will Be

Loans come with different interest rates, fees, payment schedules and flexibility. You should consider all of these factors before choosing the product that fits your situation the best.

Interest and Fees

The exact rate you will pay on a debt consolidation loan will depend on many factors, including your credit score, your debt level relative to your income and assets and whether or not you are willing to offer collateral for your loan. Banks and credit unions tend to offer the lowest rates. Finance companies tend to charge a higher rate because they are often loaning to individuals who have been turned down by a traditional lender. Lenders who specialize in low-credit or no-credit loans are, of course, the most expensive option.

In addition to the actual interest rate, you also need to carefully understand all possible fees and charges. Your interest rate might seem reasonable, but life insurance or disability insurance fees and other seemingly unnecessary service charges or penalties might run up the cost of your loan. Make sure you understand the costs for missed or late payments and ask if there are any up-front application fees.

The Length of Your Loan

How long are you going to take to pay off your loan? It's certainly true that $200 a month looks a whole lot more affordable than $250 a month. However, that $50 a month savings means you might be paying off the loan for six or seven years instead of five, which also means you will be paying more interest in the long run.

> **Our advice: You should choose the shortest term that you can afford. If your payment still looks like more than you can afford, you should consider other options, such as a debt management plan or a consumer proposal.**

Flexibility

You decided to consolidate your debts because you were having trouble keeping up with your monthly payments. In looking at your new loan, be sure to consider the following:

- If you are taking out a second mortgage, are you permitted to prepay or make additional payments without penalties?
- Can you skip a payment if you hit a temporary financial bump in the road; and if you do, will you have to pay a penalty or add to the long-term cost of the loan by

rolling that month's interest into your mortgage?

- Beware of interest-only loans. While your monthly payment might be lower than with other options, you may be paying off the debt for the rest of your life.
- Be wary of variable rate loans. They may look attractive today, but you might be in serious trouble later when the interest rate increases.

The Bottom Line

Your monthly payments should be as high as you can afford without taking on too much risk. The best way to figure out which loan works best for you is to look at the total amount you will have to pay over the life of the loan, including interest and fees. If you can afford the monthly payments, you should choose the loan with the lowest total payback amount.

Read the fine print, ask questions and learn as much as you can about debt consolidation loans before you apply for one.

Should You Use Your Home Equity?

Depending on your credit history and what assets you have to offer as collateral, you can choose to consolidate your debts with either a secured or an unsecured loan.

The most common form of unsecured debt is the money you owe on your credit card. You can opt to consolidate several credit cards into one, combine them into one unsecured line of credit, or you may qualify for an unsecured bank loan.

With a secured debt, you would be offering an asset as collateral like your home. A second mortgage or home equity loan are the most common types of secured debt consolidation loans.

Financially speaking, if you are certain you can repay the debt, a secured loan can work out better for you. You generally can get a lower interest rate on a secured debt. You'll certainly be able to repay the loan quicker and with lower payments if you convert

19-percent interest on a credit card to, for example, 6-percent interest on a second mortgage on your home.

> **A word of caution: Using your home or car as collateral can be risky. If you are unable to keep up with your new loan payments, you run the risk of losing your house or car. Once you default on payments, your lender probably will take action to claim the asset you pledged as collateral.**

Qualifying for a Debt Consolidation Loan

Three basic factors will determine whether you will be able to obtain a debt consolidation loan: your credit rating, how much money you take in and collateral you might be able to provide.

To assess your application, the bank will want some information about you including:

- Your monthly budget;
- Your latest tax returns and pay stubs that show how much money you are earning each month;
- Your latest loan statements, indicating exactly how much money you owe;
- Your most recent credit report and possibly other information about your credit history.

Provide some proof.

The bank or credit union that is considering loaning you money will want proof that you are capable of paying the money back. Your lender will want to be able to determine your monthly debt-to-income ratio – the percentage of your salary you use to pay your mortgage costs or rent plus your other monthly expenses. A normal ratio is in the 36-percent range. To make this calculation, your banker will need proof of your income, past tax returns and possibly a detailed budget that shows your income and expenses.

Turned Down? Find Out Why.

Don't pout, walk out, slam the door and vow never to return to your bank if you don't get the loan. Find out why you came up short. Maybe you can come back in six months or so and try again if you can find a way to reduce your debt or bolster your credit rating.

Limit Your Applications.

It's not a good idea to apply for a debt consolidation loan at every financial institution in town, especially if you've already been rejected a few times. Your credit rating could suffer if several denied applications show up on your credit report.

RUNNING THE NUMBERS

Let's look at a case study.

John owes $20,000 in credit card debt, and he is managing to pay $500 each month but would like to know if consolidating his debts through a bank loan is a good choice. John's debts today look like the following:

	Debt	Interest Rate	Minimum Payments	Monthly Payment
Store card A	$3,600	25%	$75	$100
Credit card B	$6,500	19%	$130	$200
Credit card C	$9,900	19%	$198	$200
TOTAL	$20,000	20.1%	$403*	$500

*based on minimum payments, which decline over time.

Let's assume John can qualify for a $20,000 debt consolidation loan from his bank at 10 percent interest for five years. Here's how John's payments would compare:

	Credit Cards	Debt Consolidation
Interest rate	20.1%	10%
Monthly payment(s)	$500	$425
Payout period	5 years 7 months	5 years
Total paid	$33,344	$25,496
Interest paid	$13,344	$5,496

Now let's look at how that option stacks up against John's possible debt consolidation goals:

John's Debt Consolidation Goals

1. Lower Interest Rates - yes, John saved $7,848 in interest
2. One Single Payment - yes
3. Lower Monthly Payments - yes
4. Debt Settlement - no but his debt is paid in full within five years
5. Creditor Protection - not necessary

As you can see, in this scenario, John has achieved all of the debt consolidation goals we outlined earlier. That would make a debt consolidation loan in this case a great option.

But what if John was only making the minimum payments each month? If that were the case, John's new consolidated monthly payments would increase from $403 today to $425 after consolidation. So why would he consolidate? Because the abililty to pay off his debts within 5 years would significantly overweigh any small increase in his monthly payment.

If you are making only the minimum payments on your credit card debt, you will not get out of debt in your lifetime.

Summarizing the Pros and Cons

Debt Consolidation Loans – The Advantages:

- You make only one payment each month.
- You will be paying less in interest to a financial institution than you were to a credit card company.
- You might be able to shop around for the best possible interest rate.
- If you make your payments on time, your credit rating probably won't be negatively affected and might even improve.

Debt Consolidation Loans – The Disadvantages:

- Financial institutions might be less flexible than credit card companies in terms of your monthly payments.
- Your financial institution may require you to close your accounts with stores and credit card companies to make sure you don't increase your debts while you're paying off your debt consolidation loan.
- You might have to provide collateral, which means that if you don't make your payment promptly, you stand to lose your home or car.
- Your lender may ask for a co-signer, someone who will guarantee to repay the loan if you are unable to.
- If you don't have good credit or collateral, you may not qualify for a low-cost loan.

Should You Take Out A Debt Consolidation Loan?

When looking at the numbers for any debt consolidation loan, consider how the loan will meet your debt consolidation goals.

Did you save money by lowering your interest rate?

Are your payments now easier to manage – both in terms of how many you have to make and whether or not you can afford them?

Does it take care of all of your debts and allow you to pay them off in a reasonable period of time?

Do the collection calls and other creditor actions stop?

If the answer is no to any of these questions, or if your credit rating is not good enough to qualify for a debt consolidation loan, your next option is to consider a debt management plan. We take a look at these plans in Chapter 4.

Debt Management Plans

Chapter 4

Debt consolidation plus interest relief.

A debt management plan is not a new loan. Instead, a credit counsellor negotiates a repayment plan with your creditors on your behalf.

It is a form of debt consolidation because you still convert several outstanding unsecured debts (such as credit cards, cell phone bills and bank loans) into one single payment plan.

Financially a debt management program has two significant advantages over a traditional debt consolidation loan:

- It works for individuals who have bad credit.
- It can provide savings in the form of interest relief.

Building a Repayment Plan

After meeting with a credit counsellor, they will put together a payment plan for you that, if you stick to it, will eliminate your debt within five years. This usually includes an interest freeze or reduction.

> **Keep in mind that you do have to be able to repay your debts in full within five years.**

Once the agreement is in place, you begin to make monthly payments to your credit counsellor, who will in turn, remit agreed upon payments to your creditors. Once you are done, you have paid all your debts in full.

Your credit counsellor will also provide advice about personal finances and help you budget your money while you are participating in a debt management plan; giving you the tools to manage your money wisely for the rest of your life.

Debt management plans don't necessarily include all of your creditors. If you are having trouble with three or four debts but want to exclude others, working with a credit counsellor to come up with a repayment plan for the troublesome debts can be a good idea.

Be careful that you don't leave so many debts out that you really are not solving your financial situation permanently.

It's also important to note that creditors don't have to participate and that not all debts are eligible. In particular, a debt management plan does not apply to tax debts and not all payday loan companies or private lenders (family and friends) will participate.

RUNNING THE NUMBERS

Let's look at our case study again.

Jasmine owes $20,000 in credit card debt, but she is only managing to pay $420 each month, and even this is a struggle.

	Debt	Interest Rate	Minimum Payments	Monthly Payment
Store card A	$3,600	25%	$75	
Credit card B	$6,500	19%	$130	
Credit card C	$9,900	19%	$198	
TOTAL	$20,000	20.1%	$403	$420*

*For simplicity, we will apply a blended payment each month to each card.

Using a debt management plan, the credit counsellor might be able to arrange a monthly payment of $333. This would allow Jasmine to repay her debts within the limit of five years.

	Credit Cards	Debt Consolidation
Interest rate	20.1%	0%
Monthly payment(s)	$420 blended	$333.33
Payout period	8 years 1 month	5 years
Total paid	$40,335	$20,000
Interest paid	$20,335	$0

Now let's look at how that option stacks up against Jasmine's possible debt consolidation goals:

Jasmine's Debt Consolidation Goals

1. Lower Interest Rates - yes, Jasmine saved $20,334 in interest
2. One Single Payment - yes
3. Lower Monthly Payments - yes, her monthly cash flow savings is $87
4. Debt Settlement - her debt is paid in full within five years
5. Creditor Protection - not necessary

We can see that in this scenario, all of Jasmine's debt consolidation options have been met. She saved interest, has only one monthly payment, and is paying less than she was before – and less than required with a debt consolidation loan – and her debt is paid in full within five years.

Summarizing the Pros and Cons

Debt Management Plans – The Advantages:

- In many cases, your creditors will agree to waive at least some interest and sometimes all of the interest.

- You'll be making only one payment a month, which will help you budget your finances.
- A debt management plan lends itself to credit card debt, some payday loans and loans from banks and finance companies.
- You won't have to deal directly with your creditors. Instead, whoever you choose as your credit counsellor will negotiate for you.

Debt Management Plans – The Disadvantages:

- Debt management plans aren't legally binding, which means your creditors can opt out of the plan at any time.
- Your wages can still be garnished.
- Collection agencies can continue to bother you for debts not included in your program.
- It will affect your credit report. A notice will appear on your credit report that you have entered into a debt management program, and it will remain for two to three years after your payments are completed.
- You must be able to repay your debts in full within five years.

Should You Choose A Debt Management Plan?

A debt management plan might be the right option for you if:

- your credit rating keeps you from qualifying for a debt consolidation loan;
- you owe $10,000 or less;
- you have only a few unsecured creditors; and
- you can afford to pay your debts but need some time to do so without the financial burden of additional interest costs.

Assuming you can keep up with the payments and it deals with all your debts, a debt management plan might be your best option. However, if you can pay only a part of the money you owe or your creditors are threatening legal action you may want to consider a consumer proposal instead. We'll discuss this plan in Chapter 5.

Consumer Proposals

Chapter 5

Debt consolidation plus debt settlement.

While a debt management plan is a negotiated plan to repay all of your debts, a consumer proposal is a negotiated agreement to pay back less than the full amount you owe.

It is a debt consolidation alternative because you stop paying your individual creditors and make one payment to your consumer proposal administrator. However, more than that, a consumer proposal also offers debt relief:

- You pay back less than you owe;
- Interest stops accumulating.

Consumer proposals provide a way to eliminate your debt and avoid bankruptcy while still receiving the benefit of creditor protection.

Because you are settling your debts for less than you owe, consumer proposals are a low-cost debt consolidation option.

A consumer proposal must be administered by a bankruptcy trustee, who negotiates a settlement with your creditors for less than you owe. You agree to pay a certain amount of money per month for a specific time period – up to five years – to wipe out your debts. You also might be able to get rid of your debt with a lump sum payment. For the plan to work, more than 50 percent of your creditors – based on dollar value – must agree to the proposal.

There are a two important things to consider with a consumer proposal:

- First, your creditors probably won't agree to your terms if you don't offer them more money than they would be likely to receive if you filed for bankruptcy;
- In addition, you must be able to meet the payments that you agree to make. If you can only afford $500 a month, it makes little sense to agree to pay $750 a month.

It is not unusual to see consumer proposal agreements that settle your debts for 30 to 35 cents on the dollar. However, the actual payment depends on several factors, including your income and what assets you have.

For more information on how a consumer proposal works, read our Insider's Guide To Consumer Proposals.

Why Can't Everyone Do That?

A consumer proposal only works for individuals who are "insolvent." This means that they must owe more than they own and be unable to repay their debts in full. Someone who has $50,000 in equity in their home and owes $25,000 in unsecured debts cannot qualify to settle their debts through a consumer proposal. In that situation, a traditional debt consolidation loan makes more sense and is the better option.

RUNNING THE NUMBERS

Let's revisit our scenario.

Steve also owes $20,000 in credit card debt and he is struggling to pay $420 each month:

	Debt	Interest Rate	Minimum Payments	Monthly Payment
Store card A	$3,600	25%	$75	
Credit card B	$6,500	19%	$130	
Credit card C	$9,900	19%	$198	
TOTAL	$20,000	20.1%	$403	$420*

*For simplicity, we will apply a blended payment each month to each card.

If Steve files a consumer proposal, a bankruptcy trustee might be able to arrange a monthly payment of $120 over five years. This is a settlement rate of 36 cents on the dollar, which is fairly common.

	Credit Cards	Debt Consolidation
Interest rate	20.1%	0%
Monthly payment(s)	$420 blended	$120
Payout period	8 years, 1 month	5 years
Total paid	$40,335	$7,200
Interest paid	$20,335	$0

Now let's look at how that option stacks up against Steve's possible debt consolidation goals:

Steve's Debt Consolidation Goals

1. Lower Interest Rates - yes, Steve saved $20,334 in interest
2. One Single Payment - yes
3. Lower Monthly Payments - yes, his monthly cash flow savings is $300.
4. Debt Settlement - yes, Steve does not have to pay $12,800 of his debts.
5. Creditor Protection - yes

Among all our scenarios so far, a consumer proposal resulted in the lowest monthly payment and the most savings. However, it is a legal proceeding completed under the *Bankruptcy and Insolvency Act* and is only available if you are unable to repay your debts in full.

Summarizing The Pros and Cons

Consumer Proposals – The Advantages:

- You only repay a part of your debt.

- You only have one monthly payment to make.
- Once you file for a consumer proposal, the interest on what you owe is frozen.
- You won't lose your house or other assets.
- You won't have to deal with calls from collection agencies, and your wages won't be garnished.

Consumer Proposals – The Disadvantages:

- It's possible that some of your creditors won't agree to the terms of your initial proposal. In most cases, however, your trustee will help you renegotiate.
- A consumer proposal will appear on your credit report for three years after you complete your payments.
- If you miss three payments, your proposal will be annulled and you won't be able to file another consumer proposal.

Should You File A Consumer Proposal?

If you need to make a settlement with your creditors while protecting your assets, a consumer proposal provides the most cost-effective option.

However, if you do not think you can keep up with the monthly payments during the term of your proposal or you do not have assets that you would like to keep, bankruptcy may be your final option.

The Final Comparison

Chapter 6

Which option meets your needs?

Now that we have reviewed each debt consolidation option, it's time to compare the results.

Comparing Goals

Goal	Debt Consolidation Loan	Debt Management Plan	Consumer Proposal
Lower interest rate	Possibly	Interest freeze	No interest
Single payment	Yes	Yes	Yes
Lower payments	Possibly	Yes	Yes
Debt settlement	No	Interest relief	Yes
Creditor protection	No	No	Yes

As you can see, each debt consolidation option achieves different goals. Which program is best for you depends on your specific needs.

RUNNING THE NUMBERS

In our case studies, all our debtors owed $20,000 a month, and they were struggling to maintain their monthly payments. After reviewing each debt consolidation option, their payment plans looked like this:

	Current Debts	Debt Consolidation Loan	Debt Management Plan	Consumer Proposal
Beginning debt	$20,000	$20,000	$20,000	$20,000
Monthly payment	$500	$425	$333.33	$120
Total payments	$33,344	$25,496	$20,000	$7,200
Interest paid	$13,344	$5,496	$0	$0
Savings		$7,848	$20,334	$33,134

Debt Consolidation, Debt Management Plan or Consumer Proposal?

While numbers are part of the story, the final decision is based on balancing these numbers with the pros and cons of each alternative and your personal situation.

You should choose the solution that you can afford, both in terms of monthly payments and long-term consequences. Debt relief programs such as a debt management plan or consumer proposal may offer lower payments, but they do affect your credit. Only choose those options if you need them financially. Revisit each of the five debt consolidation goals and identify which are important to you. Choose the plan that will meet those needs.

5 Debt Consolidation Goals

1. Lower Interest Rates
2. One Single Payment
3. Lower Monthly Payments
4. Debt Settlement
5. Creditor Protection

When You Have Bad Credit

Chapter 7

Some issues with debt consolidation.

If you have bad credit, being approved for a debt consolidation loan brings a new set of challenges. There are lenders who specialize in offering debt consolidation loans to people with poor credit, but at a tremendous financial cost. Making multiple applications with the goal of finding any lender who can help can actually hurt your credit rating. In desperation, you may turn to poor alternatives to keep your bill payments afloat.

Credit Capacity Versus Credit Score

Before deciding whether or not to take out that new debt consolidation loan, it's important to distinguish between two very different concepts that can affect which option is best for you.

Credit Score

Your credit score is an assessment of how much risk your lender would be taking if they loaned you money. Based on a number of factors in your credit history, a low number means there is a high chance that you will default on your loan at some point. It doesn't mean you will; it means you are more likely to do that than someone with a better score. Even if your loan application is accepted, a low score will likely mean you have to pay a higher interest rate because you are perceived to be a higher risk.

Credit Capacity

While a credit score will determine whether or not the bank will lend you money and at what cost, credit capacity answers the question of how much money they will lend you.

First your lender will look at your income. Most lenders will want to make sure your debt payments don't use up too much of your income. They will measure something called your Total Debt Service Ratio (TDSR). This is basically calculated as:

$$\frac{\text{All annual loan payments, mortgage payments + property taxes + utilities}}{\text{Total annual income (including taxes)}}$$

Most lenders recommend that this ratio stay below 36 percent. However, if you are looking for a consolidation loan, you are probably at the higher end of this range and perhaps even higher.

Just as with a low credit score, all things being equal, a higher TDSR means a higher interest rate. Even if you have a great credit score, if your total debts push you into the 40-percent range, you are going to pay a high cost for a traditional debt consolidation loan. A higher TDSR also means a higher risk to you that you may not be able to keep up with your payments over the term of the program.

Repair Any Credit Score Issues First

If you feel you have enough credit capacity (in other words ability to keep up with your payments) but have a poor credit score because of some past history, here's what you can do to improve your credit score before applying for a debt consolidation loan. Remember, the higher your credit score the lower your interest rate will be so it's well worth the effort, and time, it takes to work on your credit score.

1. Get a copy of your credit report. Find out what is on it. You cannot start addressing the problems if you don't know what they are. In most cases you can obtain a copy of your credit report for free from both Equifax and Trans Union.
2. When you get your credit report, review it to determine if it contains any errors or negative comments. An error may include a debt that you have already repaid. A negative comment may result from a department store credit card that you stopped using ten years ago, but if it had a $10 balance owing, it may still show up on your credit report. If you find an error, contact the credit bureau and offer proof that you do not owe the money. You may need a letter from the creditor indicating the payments were made, or you may provide canceled cheques to indicate payments were received. You may also send a letter to the credit bureau explaining your side

of the story; your comments can be attached to your credit report.

3. Pay off any small unpaid bills. If a $200 debt on an old credit card shows up as a black mark on your credit report, save up $200, contact the credit card company, and arrange to make payment. Ask the creditor to remove the negative credit report from your credit record. Paying your debts is the most effective was to repair credit in the short term.
4. Don't bounce any cheques. Don't overdraw your account at the bank (even if you have overdraft protection). Show the credit system that you are a responsible money manager and that when you borrow money, it's because you want to, not because you have to.
5. Pay down your debt balances. Even if your credit report indicates that you have made all of your regular monthly payments, a potential lender may look unfavorably on high levels of debt. The solution is to pay off as much of your existing debt as possible before applying for a new loan. We recommend that you pay off your highest interest debts first, so pay the 18% interest credit card off first, and then repay the 16% interest credit card.
6. If you cannot pay off your debts in full, consider filing a debt management plan, a proposal to your creditors, or even personal bankruptcy. While each of these things has a serious impact on your credit report, they are all improvements over a number of individual bad items.

Should You Consider Debt Relief?

It's all well and good for your lender to look at your credit score and credit capacity to assess how much they are willing to lend you to consolidate your existing debts, but you need to assess your own situation for yourself to see if this is the right option.

Here are some circumstances under which you might want to consider a debt relief program, such as a debt management plan or consumer proposal, rather than taking out a new debt consolidation loan:

- Your TDSR is above 36 percent or you are just making minimum payments each month and even that is a struggle.
- Your only source of new credit is credit cards, finance companies, payday lenders or other high-cost providers.

- You have debts that don't qualify for debt consolidation (such as taxes) or you can't qualify for a loan large enough to cover them all.
- Your repayment plan will last too long. In general, most debt relief options will get you out of debt in five years, excluding your mortgage. Use this as a benchmark.
- You need creditor protection from potential wage garnishments or collection calls.

Now that you have some idea of what type of program can help you become debt free, you'll need some ideas on how to find a reputable financial institution or company that can help you get out of debt. We'll provide you with this information in Chapter 8.

Finding a Debt Consolidation Company

Chapter 8

Always shop around.

Debt consolidation loans are offered by most financial institutions, including banks and credit unions. Financing companies also offer debt consolidation loans, but these are usually more expensive because they are often a lender of last resort for those with poor credit. There are even companies that specialize in low-credit or no-credit debt consolidation loans. These types of loans, however, can be the most expensive option.

Always shop around and compare rates among lenders. Talk to at least three different providers, and don't hesitate to ask for a lower interest rate or better payment terms.

Even if your own bank is willing to help you out, you should shop around for the best rate and terms you can get. Your goal is to find a reputable institution that will offer you the best deal possible.

If your bank says no, ask why. You might be able to tweak your situation and, as a result, your loan might be approved a few months down the line.

What Questions To Ask

If you visit with a non-traditional lender about debt consolidation, you should ask some important questions. And don't be shy about asking friends and family members for a referral or about researching lenders online. The Better Business Bureau is a good place to start.

1. How long have you been in business and can you provide some references or testimonials?
2. Is your company regulated and, if so, where?
3. Are you listed with the Better Business Bureau? Be sure to check the lender's reputation for yourself.

4. Are you talking about a consolidation loan or a debt settlement program?
5. Do you charge up-front fees before the loan is approved?
6. What are your average interest rates?
7. How much do you charge for an application fee?

Credit Counsellors

One option is to talk with a credit counsellor, but, if you choose this route, make sure the companies or agencies you select are both reputable and accredited. Besides seeking referrals from friends and family members and checking with the Better Business Bureau, you should ask these questions.

1. Is the agency for-profit or not-for-profit? If the answer is not-for-profit, ask for its charitable registration number.

2. Find out if the agency is registered with an accredited Credit Counselling Association.

3. Ask if the person you will be working with is an accredited counsellor.

Bankruptcy Trustees

You might want to visit with a bankruptcy trustee. If so, here are some things you should keep in mind.

1. All bankruptcy trustees in Canada are licensed by the federal government and are listed at www.ic.gc.ca/app/osb/tds/list.html. Most are also listed with the Better Business Bureau.

2. You should never pay a fee to see a bankruptcy trustee. Almost all of them offer a free consultation.

Raising a Red Flag

If you run into any of the following situations while meeting with a potential debt consolidation lender, you should end the conversation and continue your search for a debt consolidation provider elsewhere.

- You are asked to pay any fees before your loan or consolidation program is in place.
- The company or agency offers you an option you weren't expecting. For instance, some companies advertise that they provide debt consolidation loans but instead they offer you a debt settlement program. There is a significant difference between the two.
- The company says you need to see the "court officer." This generally means they will collect their fee and send you on to a bankruptcy trustee. You could have gone to the trustee first, without paying the fee.
- They pressure you to sign right away.
- You feel uncomfortable with the program they are offering.

Remember Your Goals

Regardless of who you decide to do business with as you strive to solve your debt problems, you should remember the five goals you set for yourself.

Lower Interest Rates – Don't forget to include application fees and processing fees when you determine who is offering you the best deal. Read the fine print, and make certain you are paying a lower interest rate than you were before you consolidated your debt.

A Single Payment – One of the best features of any consolidation option is that you will be making one payment every month, rather than trying to decide how much you should pay to each of your creditors.

Lower Monthly Payments – There are two ways to reduce how much you have to pay your creditors each month: Lower your interest rate or extend the term of your loan so you can take longer to pay off your debt.

Debt Settlement – Regardless of which option you choose, your goal should be to eliminate your debt within a reasonable period of time.

Creditor Protection - If all else fails, you've missed so many payments that your creditors are calling you at home and you're facing the specter of your wages being garnished you may need a solution that provides legal protection from your creditors.

More information about debt consolidation, and a list of reputable debt experts, can be found on our website moneyproblems.ca.