Debt Consolidation

Interest rates on credit cards are up — with an average interest rate of 15.31 percent in July, according to Bankrate.com. That is almost one full percentage point higher than July of 2012 (14.5 percent). At the same time, home equity loans are going down with current rates between 5 and 5.4 percent. When does it make sense to tap that home equity to pay off those credit cards?

When you are in debt from credit cards, you have a few choices. Economize and pay the debt off slowly, consolidate your debt, do a debt settlement or declare bankruptcy. For most of us, our homes are worth more than we owe on them. The interest rate is good, so what is to stop us from doing a debt consolidation and paying off that debt?

Debt consolidation involves taking out one large loan, such as a home equity loan, to pay off unsecured loans such as credit cards. You might consider debt consolidation in order to get a lower interest rate, lower your monthly payments or just to have only one payment rather than several.

Take a look at the numbers. Let’s say you have $10,000 in credit card debt at the average rate of 15.31 percent. We’ll set a goal to pay this money off in five years. At the current rate, your payment each month will be $240. Over the course of this loan, you would pay $4,360 for interest charges. The same $10,000 on a home equity loan would have a repayment of $188 per month, with a total interest payment of $1,326. You actually save $60 per month and about $3,000 in interest charges over the five years. An added benefit is that the interest on your home equity loan is deductible on your income tax, if you itemize deductions.

It sounds like a good way to get rid of debt, but it comes at a cost. If you borrow against your house to pay off your credit cards, you have turned unsecured debt into a note secured by your home. You have put your house at risk. If you are certain that you can meet all the debt payments, it might be a good idea to take that equity and pay off your credit cards. You will certainly save more money in finance charges.
In addition, remember that the interest charges are not the only costs for a home equity loan. Depending on the amount of the loan and who you are borrowing it from, you may pay closing costs, attorney fees, title search, document preparation and insurance. Also, some banks charge an application fee for processing the loan that is equal to a certain number of points (one point is 1 percent of the loan). These fees can add up, so make sure you ask what the fees will be before you sign on the dotted line.

If you are not sure that you can make all the payments, both now and in the future, then it might not be a good idea to borrow money on your house. You might have trouble holding onto your home.

One more step should be taken in this process. Take a long look at your spending habits and see how you got in trouble with your credit cards. Make changes in your spending patterns so you don’t rack up another high balance. The worst possible scenario is when you use the equity to pay your debt and end up with credit card debt once again.

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