Line of credit? Mortgage refinance? Experts rank the best and worst options for debt consolidation

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The idea behind debt consolidation is simple: You take on a single, big loan to pay off all or most of your other, smaller liabilities.

Usually, there are three big reasons to do it. First, focusing on a single monthly debt payment is much easier than chasing due dates for a multitude of creditors. Second, you might be able to get a lower interest rate on your debt consolidation loan than you were paying on several of your smaller loans. Third, especially if you were able to get a lower rate, the monthly debt payment on your consolidated loan may be smaller than the sum of what you were paying before to your many creditors.

How to consolidate debt, though, is anything but straightforward. Some options involve low interest rates but the repayment period is so long that you may end up paying more interest on your debt overall. But math isn't the only consideration. Psychology matters, too. Sometimes, a smaller payment and a flexible repayment schedule just enable borrowers to run up their credit cards all over again.

So what's the best way to untangle your debts? Global News asked Scott Hannah, head of the B.C.-based Credit Counselling Society and Sheila Walkington, co-founded and CFO of Money Coaches Canada, to order debt consolidation options from best to worst. Their ranking was identical:

1. Term loans

The nice thing about term or personal loans is that they have an end date that isn't too far off and, if you chose a fixed interest rate, predictable and generally mandatory monthly payments.

"That is why we recommend them," Hannah said.

Term loans may come with interest rates slightly higher than those available through a line of credit or a mortgage. And because you have to extinguish the loan within a set amount of time, your debt repayments are also quite a bit higher than what you'd usually get away with using a line of credit.

But the more structured nature of term loans generally helps people stay on track, Hannah said. And a term loan from a bank or other mainstream lender still comes with lower interest rates than the 20 per cent charge you'd typically get on a credit card.

Another advantage of term loans is that there are usually no prepayment penalties, Walkington noted.

If you qualify for a loan with a payment you can manage and have a fairly stable financial situation, this is the way to go, Hannah said.

2. Unsecured lines of credit

These days, unsecured lines of credit come with relatively low interest rates of 5-8 per cent, and you can keep the payments as small as the interest charge alone.

They are "a good way to consolidate debt without locking yourself into a high monthly payment," Walkington said via email. At the same time, "the flexibility to pay more than the minimum makes it easy to adjust your payments to your cash flow.'

But those traits also make lines of credit a potential slippery slope that leads many borrowers into deeper debt, both Hannah and Walkington told Global News.

"Without discipline, a line of credit may be difficult to pay down and easy to run up again," Walkington said.

Also, the interest rate on a line of credit is variable. This means that both your minimum payment amounts and overall interest costs may rise if interest rates increase, as they have since July 2017.

3. Secured lines of credit (HELOCs)

Home Equity Lines of Credit, or HELOCs, are secured by your house and come with even lower rates (think 4.5 per cent). Another perk is that your ability to borrow is linked to your home equity, so that your credit limit goes up as you pay down the mortgage, potentially freeing up room to consolidate higher-rate debt.

Other than that, HELOCs have all the pros and cons of their unsecured cousins, including variable interest rates.

Still, when it comes to psychological debt traps, HELOCs can be even more treacherous, according to Walkington and Hannah.

That's because making only minimum payments on your HELOC comes with "the double whammy of not only not paying off the line of credit, but negating any progress on paying down your mortgage if one keeps running up the HELOC," Walkington said.

4. Mortgage refinancing

By folding your high-interest debt into a mortgage you may be able to lock in an interest rate as low as 3.39 per cent, according to financial product comparison site RateHub.ca.

With a fixed rate and a low monthly payment, this can be a "'get out of jail free' opportunity to consolidate debt," Walkington said.

But the math may not be favourable as the low interest rate suggests, both Walkington and Hannah noted.

If you have, say, $80,000 in credit card debt and are spreading it out over 20 or 25 years, Hannah said, you have to ask yourself, "how much interest am I going to have to pay on that debt over that amount of time?"

The answer may be: More than if you had not consolidated your liabilities.

Mortgage refinancing also comes with fees and potential penalties for pre-paying the debt before the end of the term.

5. Second mortgage

A second mortgage is a loan backed by a home that is already mortgaged. You'll be paying a higher interest rate on a second mortgage because your lender is second in line on your property's title. If you default, it's the lender on your first mortgage that will get first dibs on your property.

Second mortgages, though, can still be a way to turn multiple debt charges into a single, lower payment. They are "a last resort," Walkington said.

But taking out a second mortgage means committing to additional fixed costs for the long term, Hannah said. And even if you choose a fixed interest rate, those costs are likely to rise at renewal if interest rates keep going up.

And if you run into a snag, a second mortgage may be difficult to refinance, Walkington said.

6. Getting a co-signer on a debt loan or line of credit

Adding a friend or relative to your debt-consolidation loan can help you access credit or a lower interest rate if you have a bruised credit record or little credit history. This, though, puts your family and friends at risk if you default on your payment, which can put a significant strain on relationships, both Hannah and Walkington noted.

And co-signers often don’t realize that adding themselves to your loan will limit their own ability to borrow, Hannah said. Lenders will count your debt as their debt when they apply for credit.

In most cases, Hannah said, “it’s best to keep friends and family out of it.”