high interest rates or charging high fees to initiate the loan is called predatory lending.

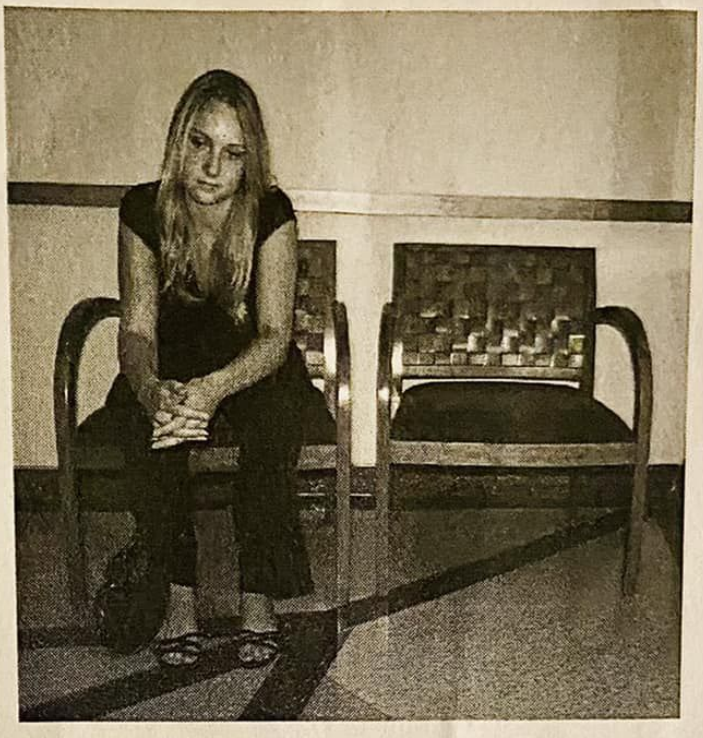
More Detailed Information

Usually a consolidation loan is used to pay off unsecured, revolving debts, especially credit card balances. Unsecured debt is any debt that is not backed up by collateral (something, such as a house or a car, that the lender can assume ownership of if the borrower becomes unable to pay back the debt). "Revolving" means that the debt is open-ended; unlike an installment loan (as for a car), where the borrower borrows a finite sum of money and then pays it back in set installments over a fixed period of months, the balance of revolving debt continues to rise and fall (within an allowed credit limit) according to how much the borrower spends and how much he or she pays off each month. Unsecured, revolving debt is considered a more dangerous kind of debt to carry, because it is easy for consumers to get in over their heads.

If you own your home, the best way to consolidate your debt is usually with a home equity loan (also called a second mortgage). With this kind of loan, you borrow against the amount of equity you have in the home. Equity is the difference between the market value of the home (the amount you could sell it for) and the outstanding balance on your original home loan. So, for example, if your house is worth $240,000 and you owe $195,000 on your mortgage, then you may be able to borrow up to $45,000 (the difference between the two numbers) with a home equity loan. Because a home equity loan is secured (the home is your collateral), the lender regards it as a lesser risk than an unsecured loan and will usually offer you a more favorable interest rate. Also, the interest you pay on a home equity loan (as with a regular home loan) is often tax deductible, meaning it can help reduce the amount of annual income tax you have to pay.

If a person does not own a home or other property that he or she can use to take out a secured loan, it is possible to obtain an unsecured debt consolidation loan. The Federal Trade Commission (a U.S. government agency) and other consumer-protection groups caution consumers to choose carefully among the private companies that offer these loans. Many do not fully disclose the fees and other terms associated with their loans, and they may make inflated or false promises about their ability to alleviate debt.

In general, many critics warn that debt consolidation loans are not the cure-all that many people think they are. The problem with debt consolidation, they say, is that it makes you feel as though you have taken care of your debt problem, when in fact you have only rearranged the problem. Debt consolidation may get you a lower interest rate and a lower monthly payment, but it does not make the debt go away. Also, many people do not realize that a lower monthly payment often just means that the term of the loan is extended; thus, even with a lower interest rate, stretching the loan out over a longer period may ultimately cause the borrower to pay more interest.



For this woman and many like her, trying to keep up with multiple payments on individual, high-interest debts can be stressful and discouraging. A debt consolidation loan, which loan folds various separate debts into one large debt, often at a lower overall interest rate, can make paying off debt feel a lot more manageable. *Photograph by Kelly A. Quin. Cengage Learning, Gale.*

Moreover, a debt consolidation loan does nothing to help someone change the spending habits that got him or her into debt in the first place. Indeed, according to one study, more than three-quarters of the people who consolidate their debt and clear their credit cards gradually build balances back up on those empty cards.

Recent Trends

By the end of 2003, U.S. consumer debt had topped $2 trillion. This unprecedented figure demonstrated that the level of debt carried by the average American household was escalating rapidly. Indeed, American consumer debt was far higher than that of any other country, and the $2 trillion figure represented a doubling of this debt in less than a decade.

As Americans with heavy debt loads have become increasingly anxious about their vulnerability to financial ruin, the debt consolidation industry has boomed. The Internet and television have become flooded with ads for "get-out-of-debt-quick" plans that promise financial miracles and peace of mind. Many honest loan companies do offer legitimate debt consolidation loans that can greatly facilitate the process of getting out of debt; but there are also many companies that make false claims and can potentially cause consumers more financial harm.