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Does Debt Consolidation Hurt Your Credit?

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Debt consolidation can initially hurt your credit, but the impact is temporary. Over the long run, consolidating can improve your credit and help you get out of debt more quickly

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Our Research Process

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Debt consolidation allows you to pay off multiple debts by combining them into one monthly payment with a loan or a balance transfer credit card. But can debt consolidation hurt your credit? If handled wisely and deliberately, it's a personal finance strategy that can improve your credit in the long term on your path to becoming debt-free. But if you don't pay off your loan on time, it can hurt your credit. And applying for debt consolidation may result in an initial drop of your credit score. We'll walk you through the process and how to mitigate any concerns you might have about your credit score while consolidating your debt.

Key Takeaways

- Debt consolidation typically involves taking out a new loan or credit card to pay off existing debts, which impacts your credit score.
- Initially, applying for debt consolidation can drop your credit score. Over time, the impact can be positive, especially if you use debt consolidation to pay off your debts and make on-time monthly payments.
- Alternatives to debt consolidation, like bankruptcy and debt settlement/management plans, reduce how much you owe but can have a harsher impact on your credit score.

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How Does Debt Consolidation Work?

"Debt consolidation works by taking multiple debts, like credit cards, personal loans or other bills, and rolling them into one single loan," said Joe Camberato, CEO of National Business Capital, an online marketplace for loans. There are several ways to consolidate debt, including:

- **Personal loans**: A personal loan gives you cash upfront, which you can spend however you want, including paying off your debts. You then pay off the fixed-rate loan over time. In a recent MarketWatch Guides survey, more than 20% of respondents said they used personal loans for debt consolidation, making it the top reason for a personal loan.
- **Home equity loans/Home equity line of credit (HELOC)**: If you own your home, you can borrow against its equity using a home equity loan or a home equity line of credit (HELOC). You can then use this money to pay off your other debts before paying it back along with your current mortgage payments. This is a secured loan and uses your home as collateral — be aware of this risk before deciding if it's right for you.
- **Balance transfer credit cards**: Balance transfer credit cards offer a promotional annual percentage rate (APR) to new customers. During the first year or so, you owe little to no interest. While the interest rate is low for a certain time, you typically have to pay a transfer fee.

How Debt Consolidation Affects Credit

Debt consolidation can affect your credit score in a few different ways, both positive and negative.

Positive Impact

Reduced credit utilization ratio: The credit utilization ratio shows the percentage of your credit limit you have used. The lower, the better. If you use debt consolidation to pay off credit cards, your score will improve. This can be a long-term boost, provided you don't fall into credit card debt again.

Payment history:On-time payments improve your credit score. While this is true of any loan or credit card, debt consolidation can make it more achievable. "If managing multiple payments has been tough and you've missed some, consolidating into a single payment can make it easier to stay on top of things," Camberato said.

Credit mix: One part of measuring your credit score is the diversity of accounts you have. For example, if you have loans and you open a credit card account — or vice versa — that is credit diversity.

Negative Impact

Hard credit inquiry: Whether applying for a loan or opening a new card, hard credit inquiries temporarily lower your credit score for about a year, though most of the impact disappears after a few months. "Debt consolidation can have an immediate negative impact on your credit score as it often entails applying for new credit, which involves a hard inquiry on your credit report," said Mark Pierce, founding partner of Wyoming Trust and LLC Attorney.

New credit account:Lenders check whether you've recently opened any new credit accounts. Your score will dip after you qualify for a new loan or credit card for debt consolidation. However, the impact is temporary, and your score should recover within a few months.

Lower average age of credit:Your credit score considers the age of each of your loans and credit accounts. The older, the better. Adding a new account lowers the average age, leading to another temporary dip in your credit score.

Pros and Cons of Debt Consolidation

Pros

Simplifies payments: Debt consolidation combines multiple bills into one payment, making tracking easier.

Possible long-term boost to your credit score: If you use debt consolidation to pay off your credit cards and make the ongoing loan payments on time, it can steadily improve your credit score.

Could lower your interest rate: You may qualify for a lower interest rate on your debt consolidation loan, reducing how much you owe each month and how much interest you pay over the life of the loan.

A chance to get out of debt more quickly: You could set up a debt consolidation loan that pays off all your bills faster than your current repayment schedule, especially if you receive a lower interest rate.

Cons

Immediate drop to credit score: Your credit score likely will drop after applying for a debt consolidation loan or credit card because of the hard inquiry.

Fees: A debt consolidation loan could charge origination fees or balance transfer fees when you sign up, as well as annual fees.

Qualifying depends on your credit score: If you have a bad credit score, you might not qualify for debt consolidation, or the interest rate could be too high to be worth using.

Can create more debt trouble: If you use debt consolidation to pay off credit cards, you might be tempted to spend on them again and possibly get into an even worse financial situation.

How To Consolidate Debt Without Hurting Your Credit

Now that you understand how debt consolidation can hurt your credit, there are ways to use this approach while protecting your score.

Keep Making Payments During Consolidation

Once you decide to consolidate, you might feel like you're finished with your existing loans and credit cards. However, you must keep up with your monthly bills until you qualify for the new loan and pay everything off. Missed payments right before the consolidation would still hurt your credit score.

Don't Close Old Credit Accounts

If you use debt consolidation to pay off credit cards and don't plan on using them anymore, don't rush to shut them down.

"Avoid closing old, consolidated accounts, as length of credit history contributes to the credit score," Pierce said.

Most credit card companies will let you keep the accounts open, even if you don't spend or only make a single purchase a year. It's likely worth keeping any free accounts open. Unless forced to, only close unused cards charging an annual fee.

Avoid Taking on More Debt

Consolidating is a way to get out of debt, but only if you use it wisely. Maxing out your credit limit again would hurt your score. Don't be tempted to spend on the newly available credit after consolidating.

Focus on the Long Term

The debt consolidation process likely will lead to an initial dip in your credit score, but it can help significantly over time. "As long as you manage the new loan responsibly and make your payments on time, your credit score will bounce back and likely improve. Discipline is key, " Camberato said.

Consider Alternatives

If you're worried about your financial ability to pay off the existing debt, even with consolidation, there are alternatives.

You could use a debt management plan or a debt settlement plan. With these approaches, you work with a nonprofit or a debt agency to negotiate a lower bill with your creditors. They agree to a lower payment to get at least some money back. However, these options typically hurt your credit score or restrict your ability to take out loans while in the program.

You could also declare bankruptcy to renegotiate the debts or wipe them clean. Bankruptcy is a serious, negative mark on your credit history lasting up to 10 years.

Is Debt Consolidation a Good Idea?

"Debt consolidation can be a smart move if you have several debts and want to lower your interest rates or make your payments more manageable. But it's only a good idea if you can get better terms on the new loan," Camberato said.

Camberato recommends getting quotes from multiple lenders and comparing the cost against your current bills. Someone with good credit or excellent credit will likely see interest savings.

Factor in that you will likely take a small credit hit upfront in exchange for long-term improvement as you repay the debt consolidation loan. You should also avoid getting into further trouble by spending or making late payments. If you stay disciplined and understand the various credit impacts, debt consolidation can be a good idea.

"if the underlying issues causing the debt aren't addressed, it could potentially exacerbate the situation and cause further financial strain," Pierce said.

FAQ: Does Debt Consolidation Hurt Your Credit?

Can debt consolidation improve your credit score?

What is the best way to consolidate debt?

How long does it take for credit to recover after debt consolidation?

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