Enterprising Rural Families™

An Online Newsletter November, 2005 Volume 1, Issue 11

This newsletter is an instrument of the Enterprising Rural Families: Making It Work program of the University of Wyoming Cooperative Extension Service. For further information concerning the Enterprising Rural Families program or on-line course contact *information@eRuralFamilies.org* or go to *http://eRuralFamilies.org/*.

TIP OF THE MONTH

When setting goals for you as an individual, your family, the business, or even the community be sure to use the **SMART** goal format.

Specific—goals need to be specific to issues and needs, not general enough to be a catch-all.

Measurable—you need to be able to measure whether you are making progress toward or have attained a goal.

Attainable—be willing to dream, but if goals are impossible to achieve they will only breed frustration and hopelessness.

Related—goals need to be related to the issues you and your family business face.

Trackable—you should be able to keep track of how you are proceeding toward a goal and how much you have left to complete it.

Consumer Debt: Understanding Your Credit Reports
(Part Three)

In part one of *Consumer Debt: Understanding Your Credit Reports*, Desiree Olson explored the issues of determining a person's creditworthiness before being extended credit, including the importance of the FICO score in determining how risky an individual will be in repaying a credit liability. Part two provided background information about credit reports and addresses the credit report process. **Part three unravels some of the mystery surrounding the credit score.**

A Nation of Unaware Consumers

Evan Hendricks, author of Credit Scores and Credit Reports, addresses the reality that defines our consumer economy: *The worse your credit score, the more you pay in mortgages, insurance, loans, and credit cards. The better your credit score, the more favorable terms you will get on interest rates and premiums.* A survey commissioned by the Consumer Federation of America (CFA) in 2003 emphasized the need for greater awareness about the credit scoring system. The survey interviewed more than 1,000 adult Americans on their knowledge related to credit reports and scores. Among other things, the survey tested knowledge about which service providers often use credit scores to decide whether consumers can purchase a service or at what price. The CFA found that 60 percent of those surveyed were not aware that electric utilities use credit scores, 41 percent were unaware that home insurance companies use credit scores, 41 percent were unaware that landlords use credit scores, and 38 percent were unaware that cell phone companies used them.

A Secret until 2003

Although there are various credit scoring systems in use today, the standard measure of credit risk used in the United states and Canada is the FICO score, developed by Fair Isaac & Co. (commonly referred to as Fair Isaac) in the late 1950s. Fair Isaac provides decision management solutions for business.

It wasn't until the late 1980s that credit scores started being used more extensively by financial institutions in issuing credit cards. By the late 1990s, when the mortgage lenders started to make use of credit scores in their loan underwriting, consumers started to become aware that credit scores could have a direct and pressing impact on their financial well-being.

It is not surprising that so many Americans are unclear about how credit scores are calculated or who uses them. It is only recently that we, as consumers, have been allowed to know our own credit scores. According to Beth Givens, Director of Privacy Clearinghouse, a nonprofit consumer information and advocacy program, "… even as recently as 1996, Congress amended the Fair Credit Reporting Act (FCRA) through the Consumer Credit Reporting Reform Act of 1996, consumers were specifically blocked from knowing their score and component factors." Public criticism of this policy escalated as consumers began to demand free access to information about their credit scores before they applied for credit or loans. After years of secrecy, California took the lead in forcing Congress to provide consumers with their scores. Finally in 2003, Congress amended the FCRA with the Fair and Accurate Credit Reporting Act of 2003, giving consumers the right to view their score as well as get an explanation of the factors that went into the score. (Givens, 2005) For more information about this, visit the Privacy Clearinghouse site at http://www.privacyrights.org.

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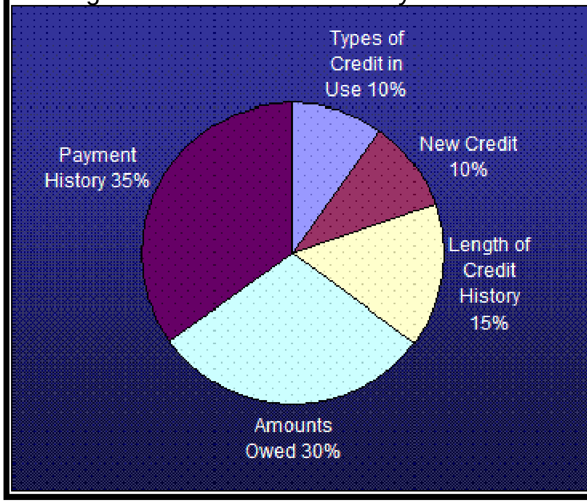
Generally, your FICO score uses the five categories below to determine your score:



More Than One FICO Score

To make things more complicated, you have <u>three</u> current FICO scores – one for each of the three national CRAs. Fair Isaac develops FICO scores based solely on information on consumer credit reports maintained at the agencies. For this reason, it is important that you obtain credit reports from the CRAs so that you can verify that your credit history is correct. The way lenders and businesses report information to the CRAs often results in different information in your credit reports so you most likely will not have the same score from all three. In fact, Fair Isaac states that 30% of people in the United State have FICO scores that vary by as much as 50 points across their three scores.

Research was conducted in 2002 by the Consumer Federation of America and the National Credit Reporting Association to determine if there were significant differences between the three national agencies in the credit scores for 1,500 consumers. The study found that there were wide disparities between credit scores reported by Equifax, Experian, and Trans Union mainly due to major difference in the underlying data colleted by each of the three agencies. Many of the concerns produced by the study dealt with structural issues regarding the system of reporting and evaluating credit and were outside of the scope of the consumers' influence, but there were several recommendations for consumers to reduce the likelihood of errors occurring in their credit reports. Primarily, the suggestions had to do with the importance for an individual to review his three credit reports at least once a year. Often times, the differences in the three FICO scores occurred because information had been mistakenly reported or someone had stolen a person's identity and opened accounts under their name. Any error can seriously damage a person's credit rating.

Calculating a Credit Score

Credit scores are three–digit numbers based on a FICO formula. The scores, ranging from about 300 (worst) to 850, analyze your credit history based on five categories: payment history, amount owed length of credit history, new credit, and types of credit in use. According to Fair Isaac, the median FICO score in the United States is 723. A FICO score can be calculated if your credit file contains at least one account that has been open at least six months and the report contains at least one account that has been updated in the past six months. Since your score is a result of your credit bureau data, it will change each time your credit report changes; a score is a snapshot of your credit risk at a particular point in time.

No single piece of information alone will determine your score. Fair Isaac provides the following information about how FICO scores are calculated:

• *Payment History.* This category is approximately 35% of your score. This takes into account payment information on many types of accounts (credit cards, retail accounts, installment loans, finance company accounts, and mortgage loans). It also evaluates public records and collection items, delinquencies, and how many accounts show no late payments. One of the most important factors in the credit score is whether you have paid past credit accounts on time.

√The longer you pay your bills on time, the better your score.

√If you are having trouble making ends meet, contact your creditors or see a legitimate credit counselor to begin to manage your credit and pay on time. You won't lose points for seeing a credit counselor.

• *Amounts Owed.* This category makes up approximately 30% of your score. This includes the amount owed on all accounts and on different types of accounts. It also includes whether you are showing a balance on certain types of accounts. The formula also considers how many accounts have balances, how much of the total credit line is being used on credit cards and other revolving credit accounts, and how much of installment loan accounts is still owed compared with the original loan.

√Keep balances low on credit cards and other revolving debt.

√Pay off debt rather than moving it around from account to account.

• *Length of Credit History.* This accounts for approximately 15% of your score. How long have your credit accounts, in general and specifically, been established? How long has it been since you used certain accounts?

√If you are a new credit user, don't open a lot of new accounts too rapidly. Rapid account buildup can look risky if you are a new credit user.

• *New Credit.* This category accounts for approximately 10% of your score. This area of the scoring process looks at how many new accounts you have and how long each has been opened. It also looks at how many recent requests for credit you have made as indicated by inquiries to the credit reporting agencies. Although inquiries remain on your credit report for two years, FICO scores only consider inquiries from the last 12 months. FICO also considers the length of time since credit report inquiries were made by lenders. Multiple credit requests can represent greater credit risk, but FICO is designed to count only those inquiries that truly impact credit risk.

√If you have had problems in the past, you can re–establish your credit history by opening new accounts responsibly and pay them off on time.

√Request and check your own credit reports and FICO scores. This won't affect your score as long as you order your credit report directly from the consumer reporting agency or through an organization authorized to provide credit reports to consumers (such as myFICO service).

√Shop for rates for an auto or mortgage loan within a focused period of time.

• *Type of Credit in Use.* Approximately 10% of your score is based on what kinds of credit accounts (a mix of credit cards, retail accounts, installment loans, finance company accounts, and mortgage loans) you have and how many of each. It's not necessary to have one of each type of credit. The credit mix usually is not a key factor in determining your score but it-could be more important if your credit report does not have a lot of other information on which to base a score. A closed account will still show up on your credit report, and may be considered in the score.

√Apply for and open new credit accounts only as needed. It is not a good idea to open credit accounts you don't intend to use.

√Have credit cards and installment loans, but make sure that you manage them responsibly.

(Source: Understanding Your Credit Score. MyFICO. Fair Isaac. November 2003.)

Factors That Are Disregarded When Calculating the FICO Score

Fair Isaac does not consider the following factors when calculating your FICO score:

- Your race, color, religion, national origin, sex, and marital status.
- Your age, salary, and location of residence.
- Any interest rate being charged on a particular credit card and other accounts.
- Any items reported as child/family support obligations and rental agreements.
- Certain type of inquiries (requests for your credit report or score) such as any requests you make, any requests from employers, and any requests lenders make without your knowledge.
- Any information not found in your credit report.
- Any information that is not proven to be predictive of future credit performance.

Expect To Be Charged for Your Credit Scores

Many people who have ordered their free annual credit file disclosures mistakenly believe that the report includes your three–digit credit score. While the credit reporting agencies are required to provide you with annual consumer credit reports free of charge, they are not required to give you your credit scores for free. You will have to specifically order your credit score(s) and pay a certain amount per score. Financial experts recommend that you request and pay for your credit scores when you request your free annual credit file disclosure. Upon request, credit reporting agencies must provide credit scores and information on up to four key factors negatively affecting your credit score.

Learn More about How Certain Actions Affect of Your Score

Fair Isaac provides online tools and educational information to help consumers learn more about how different actions can improve or hurt their FICO scores. FICOÒ Score Simulator, a free online personal credit tool located at the MyFICO online site at http://www.myfico.com, allows you to explore the following seven simulation activities: pay bills on time, pay down balances on all credit cards, pay down delinquent balances first, seek new credit, transfer credit card balances, miss payments, and max out your credit cards. Included with each of these simulation tools is a "best action" answer and detailed explanation of how the score would be affected by your action.

Take Control of Your Financial Security

You may be one of many Americans who struggle monthly to cope with your credit card payments, consumer loan payments, car payments, and perhaps a home mortgage. The growing cycle of debt contributes to the risk of higher insurance premiums, higher interest rates for credit card accounts and secured loans, higher prices for certain services including cell phone service, and electric utilities, or whether you can rent an apartment, or even get a job. The less you know about how the credit card and insurance industries and banking institutions operate as creditors, the more at risk is your financial security and well-being. You can begin to take control of your financial security by developing an awareness of your financial situation, followed by thoughtful planning and increasing your knowledge about financial-management practices. The following steps will improve your chances of having higher credit scores and good credit files, which in turn will increase your likelihood of being determined to be creditworthy before being extended credit:

- Be aware of risk-based pricing in the credit card and insurance industries, and how this trend affects your borrowing levels and debt access,
- Understand how the credit reporting process works,
- Take control of your credit files by monitoring the information regularly,
- Know how your credit scores are calculated, and
- Take steps to improve your FICO scores.

For more information on personal finance and the management of rural family enterprises, check the Enterprising Rural Families website at http://eRuralFamilies.org.

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Develop an awareness of your financial situation.

Keep an "eye" on your credit files.