Enterprising Rural Families™

An Online Newsletter September, 2005 Volume 1, Issue 9

Chat This Month

Reminder: The chat this month is scheduled for North America: Pacific Time- 6 p.m., Mountain Time- 7 p.m.; Queensland, Australia: Eastern Time-12 Noon. The topic is "*Understanding Credit Reports"*

Suggested Progress by Group: In order to stay current, by the end of this month you should be completed to:

Antarctic –

Arctic –

Atlantic –

Baltic – End of Module 7

Bering – 2nd Week of "Project" in Module 6

Black – End of Module 5

Caribbean - 2nd Week of Module 4

Coral – End of Module 2

Indian – End of Module 1

Mediterranean -

Pacific -

Red -

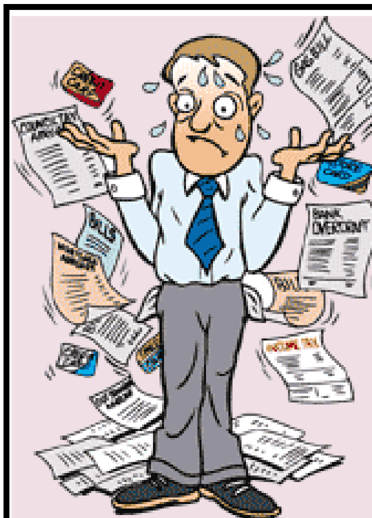
Contact e-mail for further course information:

information@eRuralFamilies.org

Consumer Debt: Understanding Your Credit Reports

(Part One)

Many Americans are spending more than they earn and according to Cambridge Consumer Credit Index, for the first time in history more people (28 percent) made a New Year's resolution in 2004 not to lose weight or exercise more, but to reduce their debt (Laurier, 2004). Most, if not all, individuals are faced with the overwhelming challenge of reducing and/or eliminating their debt burden. Accumulated debt may stem from poverty , unemployment, underemployment or reduced wages, divorce, medical expenses, frivolous spending, being a victim of identity theft or an unexpected expense. As a result, consumer debt can lead to negative economic consequences; such as loss of a home, not being able to provide basic needs, having utilities shut off, not being able to find a job, may cause stress related illnesses, or worse, bankruptcy. Furthermore, debt also can have negative effects on consumers' overall well-being.



...Credit constraints should play a role in keeping household debt down.

Increased consumer purchasing power has been made more easily available by the credit industry; individuals and families alike are one paycheck away from the brink of financial ruin. People are now paying for things such as groceries, tuition bills, fast food, movies, rent, medical care, prescriptions, gas, and home repairs with their credit cards. Moreover, if fixed expenses are high, food and other categories of variable living expenses must fall to compensate. But do they, or do consumers, continue to compensate via more credit? Ultimately, credit constraints should play a role in keeping household debt down.

Consumer Debt Studies

Consumer financial debt levels and soaring bankruptcies have encouraged many researchers and organizations to study the magnitude and effects of debt both on individual and household levels, looking at consumption and investment patterns. Many organizations such as Demos, Argus Research, MyVesta, CardWeb, Economic Research Service, AARP, U.S. Department of Agriculture, U.S. Department of Health and Human Services, CNNMoney, and CBS News all have their own surveys and studies regarding consumer debt.

Most studies, though, have only focused on consumer (personal) debt in terms of credit cards and mortgages. However, personal debt also may include medical expenses, school loans, insurance (car, life, etc.), alimony and back child support, car loans, personal loans, legal bills, old utility bills, unpaid property/income taxes and other bank lines of credit. Other causes contributing to greater household expenditure ultimately leading to increased debt that are not as obvious are gambling debt, daycare costs, drug addictions or recurring payments such as gym memberships (billed on a regular basis). All the sources of debt, consumers are willing to incur, has led to a rapid increase in outstanding consumer credit .

Determining Creditworthiness

Years ago it would have been impossible to walk into a credit institution and apply for credit without first having an established credit history or having collateral to back up the loan request. However, over the past few years it has been

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been easier to obtain credit with the interest rates set at historic lows and the lax borrowing requirements, such as a low or no down payment, extended maturities, and credit approval for the riskiest consumers. Consequently, with the average debt load per household estimated at $18,700 in 2003 – this figure only represents credit card debt and car loan debt - (Laurier, 2004), lenders are now looking at several factors to determine a person's creditworthiness before extending credit. Once a person has established credit, their credit history may be recorded with the three different credit bureau institutions; Experian, TransUnion and Equifax, which is just one factor credit institutions will contemplate when deciding to extend credit.

Annual Free Credit Reports

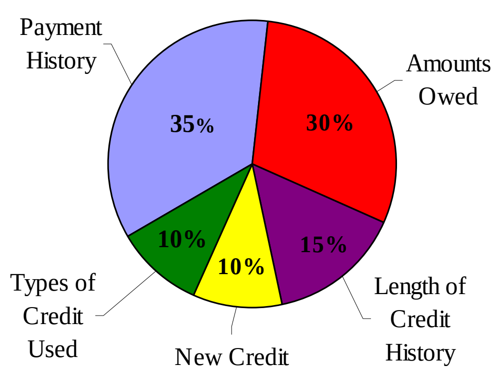
It is important for an individual to look over his credit reports at least once a year, because any flaw can seriously damage a person's credit rating. For instance, information may have been mistakenly reported or someone may have stolen a person's identity and opened accounts under their name; both of which can have serious consequences. Eligibility for an annual free credit report is determined by the state of residence based on the rollout schedule set by federal law, as follows: Western States – December 1, 2004; Midwestern States – March 1, 2005; Southern States – June 1, 2005; and Eastern States and all U.S. Territories – September 1, 2005. This was made possible by the new federal law, known as the Fair and Accurate Credit Transactions Act (FACTA), adopted by Congress last year. Before this act a person had to purchase their credit reports from each of the credit bureaus (some states like Colorado offered their residents free credit reports annually).

Consumers may obtain their free annual credit report via the website at *www.annualcreditreport.com, by calling the toll-free telephone number 877-322-8228, or by completing the Annual Credit Report Request Form found at www.ftc.gov/credit and mailing it to Annual Credit Report Request Service, P.O. Box 105281, Atlanta, GA 30348-5281. Since this is a central website for all three credit bureaus do not contact each one individually. Furthermore, reports may be ordered at the same time or a consumer can order just one or two.*

FICO Score Based on Five Types of Data

There are two things to look for in a credit report: 1) the overall validity of it and 2) the FICO score. However, the old saying "nothing is ever free" is fitting; even though the credit report is free, a person is still charged a fee to obtain their FICO score which is what all lenders consider before deciding to extend credit. The FICO score was developed by Fair Isaac & Company and is a general person's credit rating that is calculated using a mathematical calculation from the five types of data obtained in a credit report as figure 2 illustrates.

Figure 2: The Importance of Five Different Types of Data Reported in Credit Reports to Determine FICO Score



Source: MyFico; January, 2005

FICO scores usually range from 500-850 (can go as low as 150 and as high as 950), the higher the FICO score the lower the interest rate and thus payments. Take for example, a $150,000, 30 year fixed-rate mortgage; Table 1 compares the FICO score, interest rate for a particular FICO score and the average monthly payment. Over the life of the loan an individual with the lowest FICO score will have monthly payments of $363 higher than an individual with the highest FICO score. More notably, that same individual will pay a whopping $130,680 more (FICO score 720-850 = $315,000 and FICO score 500-559 = $445,680) for the same loan scenario! Furthermore, a FICO score of 620 or less is categorized in the riskiest category, known as subprime, in which a person will incur the highest borrowing rates.

Table 1: Comparisons of a $150,000 30 year, fixed-rate mortgage *(Source: MyFico; January, 2005)*

FICO Score	Interest Rate	Monthly Payment
720-850	5.75%	$875
700-719	5.87%	$887
675-699	6.41%	$939
620-674	7.56%	$1,055
560-619	8.53%	$1,157
500-599	9.29%	$1,238

Overall, FICO scores determine how risky an individual will be in repaying a credit obligation. Obtaining FICO scores to determine creditworthiness is not just limited to the mortgage industry; they apply to all aspects of the credit industry. For instance, credit card companies look at FICO scores to determine how high to set interest rates; the same is true when applying for a car loan or personal loan. Furthermore, employers are now pulling credit reports to help determine a person's character. In addition, insurance companies also are obtaining FICO scores to determine rates on their policies. One can assume, then, that a person's FICO score is probably the most vital statistic to Americans.

The Three C's of Credit and the Debt-to-Income Ratio

In addition to obtaining FICO scores there are two other factors credit institutions may use to help determine a person's creditworthiness; the three C's of credit and the debt-to-income ratio (DTI). The three C's of credit are: *capacity* – the ability to repay; *collateral* – what forms of assets and if any late payments have been made; and *character* – what is the length of stay at current and past jobs (Killian, 2005).

Financial institutions will also look at a person's DTI; another key indicator of an individual's financial picture. A DTI of 10 percent or less is considered great; this however does not include mortgage/rent, utilities, etc. When including mortgages and all other loans/debt (revolving unsecured debt) obligations, a DTI should not exceed 36 percent of gross monthly income. If a person's debt does exceed 36 percent, just one financial strain such as a medical emergency, an unexpected illness, or divorce could topple the consumer.

A person's FICO score, the three C's of credit and the DTI all illustrate to credit institutions and individuals the consequences that having no debt, some debt or too much debt can affect every aspect of a person's life.

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

This topic will be continued in the next newsletter in which the complexities of reading your credit report and understanding your credit scores will be addressed.

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Killian, M.T. "Keys to Establishing and Then Maintaining a Good Credit File." <http://credit.about.com/cs/creditrepair/a/060403_p.htm> (13 January 2005).
Laurier, J. "US Consumer Debt Reaches Record Levels." (2004). <http://www.wsws.org/articles/jan2004/debt-j15/shtml> (19 January 2005).
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Desiree Olson, Assistant Research Scientist, University of Wyoming Department of Agriculture and Applied Economics, March 23, 2005.

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