Basic Terminology Defined

1. FICO: An acronym that stands for "Fair Isaac Corporation." They are a research firm that has developed the credit scores that are used by most lenders in the U.S.

2. Delinquency: A term used by lenders to reflect a borrower that is late on their loan payment. Lenders report delinquency to the credit bureaus in 30-day increments (e.g. 30-day, 60-day and 90+ day delinquency, etc.)

3. Trade Line: Lender-speak for an individual loan account that shows up on your credit report.

4. Installment Trade Line: Loans on your credit report that have a specific, fixed number of payments assigned to them (e.g. a car loan, first and second mortgages and personal loans).

Basic Terminology Defined Cont.

5. Revolving Trade Line: Loans on your credit report that do not have a fixed number of payments assigned to them (e.g. credit cards, home equity line-of-credit loans and overdraft loans).

6. Underwriting: The process a lender goes through to decide on whether or not to approve a loan request. Many factors, to include your credit score, go in to underwriting a loan request.

7. A “Hard” Credit Report Inquiry: When you go to a lender or other provider of a service (e.g. an apartment complex or cell-phone company) asking for a loan or service and they pull your credit report in order to make their decision.

8. A “Soft” Credit Report Inquiry: When a current lender, potential lender or service provider does a “behind the scenes” look at your credit.

FICO Scores – The Basics

There are three national credit bureaus:

1. Equifax
2. Experian
3. Trans Union

There are many different credit scores available to lenders, but the vast majority of lenders use the following scores:

1. Equifax - Beacon
2. Experian - FICO
3. Trans Union – Empirica

FICO Scores – The Basics Cont.

This presentation teaches you about these three FICO credit scores. Interestingly, if you look at all three of your FICO scores on the same day they will usually vary between 0 and 50 points because not all lenders and collection agencies report to all three credit bureaus.

The purpose of FICO credit scores is to assist a lender in making a credit decision and to predict the likelihood of 90+ day delinquency over the next two years. FICO scores range from 300 to 850. The higher the score the better (i.e. a lender views you as lower risk).

Reasons Why You Want a Good (i.e. High) Credit Score

1. A good credit score significantly increases your chance of a lender approving your loan request. A significant number of banks and some credit unions deny loan requests when the borrower has a credit score less than 600. If you cannot get approved for a loan at a bank or credit union, your loan options get real ugly, real fast.

2. Most lenders today use a credit score to price their loans. If you have a high credit score you are statistically proven to be lower risk and so you will receive lower interest rates on your approved loans.

3. Many of the large, national credit card issuers now have a "Universal Default Clause" that will cause your interest rate to go up dramatically if your credit score falls significantly.

Reasons Why You Want a Good (i.e. High) Credit Score Cont.

4. Insurance companies use credit scores to evaluate the risk you represent and to set premium rates. They have determined that people that have high credit scores are more likely to take care of their homes and their autos.

5. Employers look at credit reports and credit scores in making hiring decisions.

Great References to Learn More About Credit Scoring

www.myfico.com www.equifax.com www.consumerfed.org/score

www.experian.com www.bankrate.com www.transunion.com

Your Credit Score. Liz Pulliam Weston, Prentice Hall Publishing, Upper Saddle River, NJ, 2005.

***Please note that information contained on these sites and from this book is used throughout this presentation.**

Great References to Learn More About Credit Scoring Cont.

- Effective September 1, 2005, all U.S. residents are able to receive one free credit report from each of the three national credit bureaus once per year. You can get your free credit reports at www.annualcreditreport.com. A smart strategy is to pull one bureau from one of the three credit bureaus every four months.

- If you would like to pay to receive your FICO credit scores, you can do so at www.myfico.com. The cost for all three FICO scores at this website is $44.50. If you would like to opt-out of the pre-approved credit offers lenders send in the mail, you may do so at www.optoutprescreen.com.

FICO Scores- General Information

National Distribution of FICO Scores

800 & Above:	13%
750 – 799:	27%
700 – 749:	18%
650 – 699:	15%
600 – 649:	12%
550 – 599:	8%
500 - 549:	5%
Up to 499:	2%

FICO Scores- General Information Cont.

Score Composition

Payment History	35%
Amount you Owe (Capacity)	30%
Length of Credit History	15%
Types of Credit	10%
New Credit	10%
Total	100%

FICO Credit Score Tidbits

- Derogatory public records that pertain to bankruptcy will remain on a credit report for ten years.
- All other negative information on a credit report will remain on the bureau for seven years.
- If you are an “authorized user” on a credit card and that account shows up on your credit report, then it is in your credit score.
- If you have co-signed for a loan and the account is on your credit report, then it is in your credit score.

What a FICO Score Ignores…

- Your race, color, religion, age, national origin, sex and marital status.
- Where you live, your salary, occupation, title, employer, date employed or employment history.
- Any interest rate being charged on any loan on your credit report.
- Whether or not you are participating in a credit counseling service of any kind.
- Certain types of inquiries. The score does not count “consumer-initiated” inquiries – requests you have made for your credit report in order to check its validity. It also does not count “soft” inquiries such as promotional inquiries made by lenders in order to make you a pre-approved credit offer; or administrative inquiries made by lenders to review your account with them. Inquiries that are marked as coming from employers are also ignored.

What a FICO Score Ignores Cont.

You may have heard that a large number of inquiries can have a negative impact on your credit score, but you are probably OK. **The vast majority of inquiries are ignored by the FICO scoring models**.

For instance, the model has a buffer period that ignores inquiries within 30 days of getting a mortgage or a car loan. It also counts two or more "hard" inquiries in the same 14-day period as just one inquiry. **You could have 30 auto or mortgage inquiries in a two week period of time and it only counts as one**."

Hard inquiries are tracked on the credit report for 24 months, but only the inquiries from the most recent 12 months are included in the FICO score calculation.

Capacity is King!

Why is capacity on your revolving trade lines so important to your FICO score?

Because the FICO model **knows** that the majority of Americans who go bankrupt run up their credit cards to the limits before filing.

Capacity is King

Cont.

I will illustrate how a FICO score is affected by a person that decides to consolidate their credit cards and close out their accounts - thereby hoping to improve their credit score:

Before	After
Eight credit cards	Two credit cards
$40,000 in limits	$10,000 in limits
$10,000 in balances	$10,000 in balances
75% available capacity	0% available capacity

How Important is Capacity of Credit Cards?

In this example, the person is no further in debt, yet their credit score will drop dramatically because they have removed all of their available capacity on their credit cards.

If you reduce the available capacity on your revolving lines of credit you lower your credit score. Therefore, you should **<u>not</u>** close out revolving loan accounts. If you are closing out your credit cards for non-use, you are reducing your available capacity – and <u>your own credit score</u>!

How Lenders Use FICO Scores

FICO Credit Score	Credit Tier	Sample Auto Loan Rates				
		Up to 35 Mo	36 to 47 Mo	48 to 59 Mo	60 to 71 Mo	72 to 84 Mo
730 +	1 or A+	5.00%	5.25%	5.50%	5.75%	6.25%
680 - 729	2 or A	5.25%	5.50%	5.75%	6.00%	6.75%
640 - 679	3 or B	6.00%	6.25%	6.75%	7.25%	8.25%
600 - 639	4 or C	8.50%	8.75%	9.00%	9.25%	10.25%
550 - 599	5 or D	13.00%	13.25%	13.50%	13.75%	n/a
549 or less	6 or E	16.00%	16.25%	16.50%	16.75%	n/a

Please note: **These are sample rates and tiers only.**

Items that Hurt a FICO Score

1. Late payments and derogatory public records. When assigning points lost for payment history issues, the FICO model looks at <u>Recency</u>, <u>Frequency</u> & <u>Severity</u>.

2. A low level of “percent available” on individual revolving accounts and total revolving accounts.

3. Closing revolving accounts (especially the one that has been opened the longest).

4. Having a lender remove or lower the limit on a revolving account or if the lender does not report the limit on a revolving account.

Items that Hurt a FICO Score Cont.

5. Multiple new accounts in a short period of time.

6. Making payments on old debts.

7. Having loans at “second tier” finance companies.

Strategies that Will Improve A FICO Score

1. Ensure your credit bureau data is accurate & dispute errors.
2. Focus on bringing currently delinquent loan accounts current. Don’t allow current trade lines to go further delinquent while using cash flow to pay on old collection accounts.
3. Comparison shop for mortgage and auto loans within a 14-day period of time to minimize the impact of hard inquiries.
4. Pay off and close finance company trade lines.
5. Pay down the credit cards first that are near their limits (assuming interest rates are close to the same).

Strategies that Will Improve A FICO Score Cont.

6. Pay down total revolving balances, but do not close these accounts.

7. Move revolving balances to installment debt; but again, do not close the revolving accounts.

8. Minimize inquiries and new accounts.

The Approximate Weighting of a FICO Score Based on Time

0 to 12 Months Back:	40%
12 to 24 Months Back:	30%
24 to 36 Months Back:	20%
36 to 48 Months Back:	10%

Negative credit may stay on your credit report for 7 or 10 years, but it does not stay in your score that long! ☺

What Does all of this Mean for You?

Sample $25,000, 60-Month New Car Loan Purchase

Credit Tier	APR	Monthly Pmt	Total Interest Paid
A+	5.75%	$475	$4,327
A	6.25%	$484	$4,669
B	8.00%	$513	$5,888
C	11.25%	$547	$8,236
D	14.25%	$598	$10,498
E	17.00%	$616	$12,651

A+ to E-paper difference in payment: $139 a month.
A+ to E-paper difference in total interest paid: $8,324!

What Does all of this Mean for You?

Cont.

Sample $250,000, 30-Year First Mortgage Loan

Credit Tier	APR	Monthly Pmt	Total Interest Paid
A+	5.75%	$1459	$275,216
A	6.25%	$1539	$304,145
B	6.75%	$1622	$333,738
C	7.25%	$1705	$363,959
D	8.50%	$1922	$442,022
E	9.50%	$2102	$506,768

A+ to E-paper difference in payment: $643 a month.
A+ to E-paper difference in total interest paid: $<u>231,552</u>!

A Nickel’s Worth of Free Advice…

1. Be very careful that your level of unsecured debt (i.e. higher-rate personal loans and credit cards) does not get away from you.
2. Don’t load up on multiple new loans in a short period of time (i.e. escalating debt).
3. Don’t get in to a situation where you are “robbing Peter to pay Paul” on your credit cards. In other words, don’t “max” them out.
4. Do your absolute best to resist the temptation to “solve” your financial problems by filing for bankruptcy.

And Finally…

Those that understand interest earn it.

Those who don't, pay it!