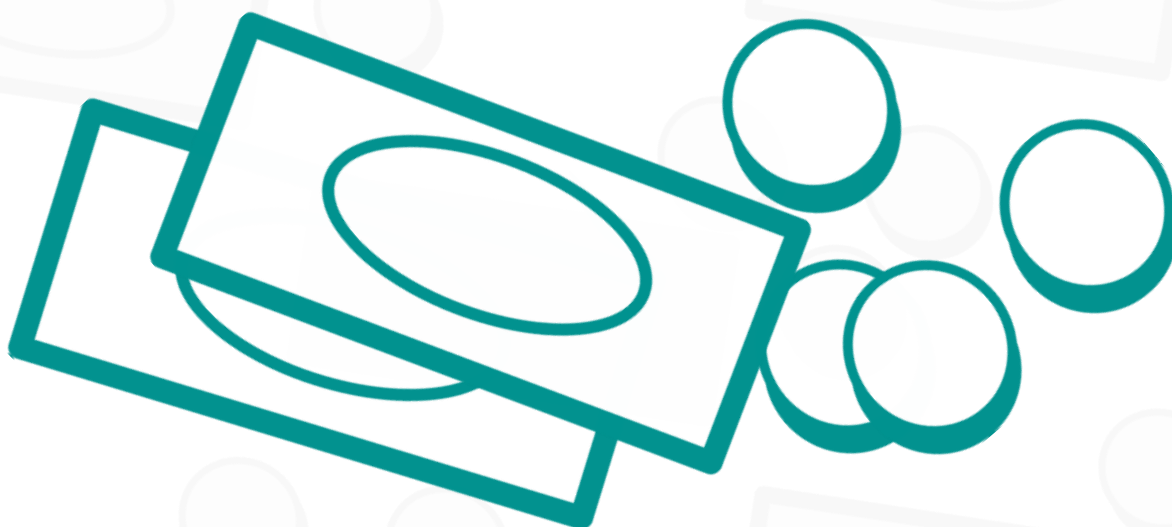




# MONEY \$MART *in Head Start*



## Credit and Debt: Make it work for you!



Extension  
UNIVERSITY OF WISCONSIN-MADISON



# Credit Scores



*"If winning isn't everything, why do they keep score?" – Vince Lombardi*

## ■ FICO® Credit Score Range is 300-850:

- 850 - 780 - Low Risk
- 780 - 740 - Medium - Low Risk
- 740 - 690 - Medium Risk
- 690 - 620 - Medium - High Risk
- Below 620 - High Risk (sub-prime)

These are general guidelines since there's no one "score cutoff" used by all lenders. Be aware that in the last year most lenders have RAISED their minimum score. Also know that your score can change from month to month and can be different at each of the credit bureaus.



## How do poor credit scores hurt?

Typical rates for a 4-year loan on a \$15,000 vehicle:

FICO score	APR	Monthly payment
850-720	3.119%	\$333
719-690	4.533%	\$342
689-660	6.396%	\$355
659-620	10.129%	\$381
619-590	15.387%	\$420
589-500	17.304%	\$435
499 and below	People with these scores aren't usually accepted for a loan through a financial institution.	

### Compare highest score

&

### lowest score:

FICO score 850-720 = 3.119%

\$333/month X 12 months = \$3,996

\$3,996 X 4 years = **\$15,984 total paid**

FICO score 589-500 = 17.304%

\$435/month X 12 months = \$5,220

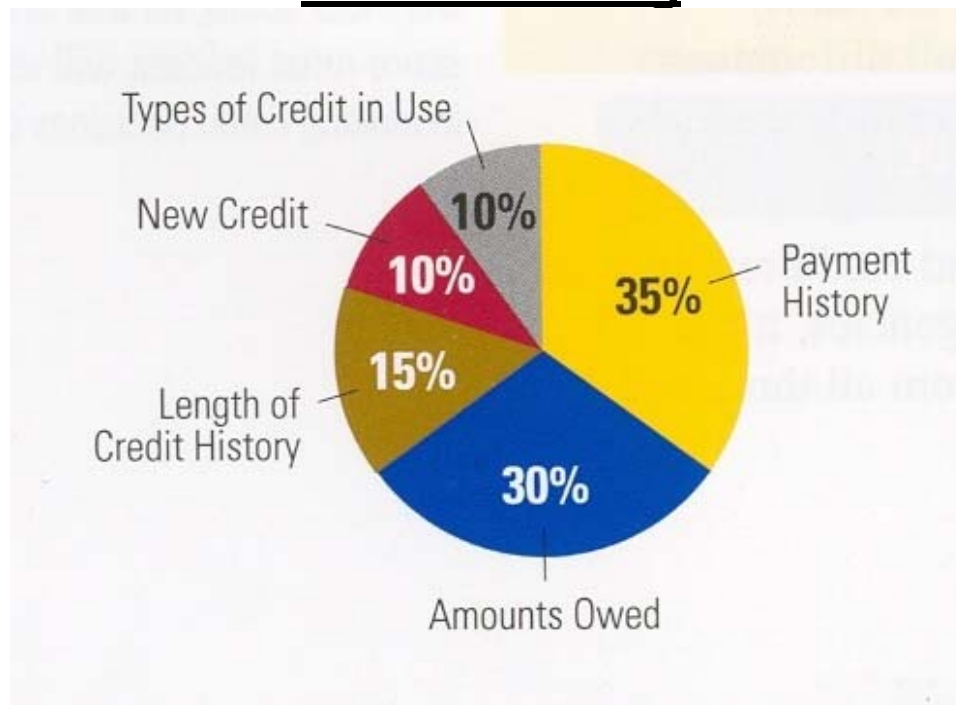
\$5,220 X 4 years = **\$20,880 total paid**

**Difference = \$4,896**

Person with a **high score** saves **\$4,896** in interest payments alone.

*(Plus a **higher credit score** can save you thousands of dollars on interest in home loans, credit cards, insurance rates, & more)*

# Credit Scoring



Source: Fair Isaac Corporation, [www.myfico.com](http://www.myfico.com), retrieved 2006

## Factors used to make up the credit score:

*(The introduction of FICO®2008 may slightly change the following factors)*

- 1) **35% - Payment History:** This is the single most important factor in a credit score. The longer you have paid your bills on time, the better your score. Payment history includes:
  - Payment information on each type of account (mortgages, installment loans, credit cards, etc.). Active positive information can remain on your credit report indefinitely, while a closed account with positive information may remain on your report for 10 years from the date of closing.
  - Late loan/credit payments and collection accounts remain on report for 7 years from the initial late payment – Score reflects when late payment occurred, how many payments were late, and length of time of delinquency.
  - Public Records on your credit report:
    - Foreclosures, liens, lawsuits, garnishments, paid judgments – 7 years
    - Bankruptcies - 7-10 years on report
    - Unpaid child support - 20 years after the youngest child reaches age 18
    - Unpaid judgments – up to 20 years on report
    - Student loans and certain taxes - unpaid can stay forever on report

### **↑ Score:**

- Pay all bills on time
  - Pay attention to due dates and due times
  - A recent 30 days late payment can lower your score more than a paid judgment from 6 years ago
- If you carry a credit card balance, pay more than the minimum every month. Paying only the minimum can lower your score.
- Schedule automatic monthly payments if that helps you pay on time.

2) **30% - Amounts Owed:** This is the second most important factor of your credit score:

- This is how much you've borrowed compared to the total amount of credit available to you. **The more of your available balances you have borrowed, the lower the score.**
- Balances on accounts: Even if you pay off your credit card monthly, your balance is reported to the credit bureau based on the date/time the record is pulled. The creditor may not know if you pay off the balance.
- The number of accounts that have balances.
- The amounts owed on the different types of accounts are scored differently. As an example, a mortgage loan would be scored differently than a credit card or a "big box" store loan.
- Installment loan balances are compared to the original loan amounts. As the loan balance goes down, it shows you're able and willing to manage and repay debt.

↑ **Score:**

- Pay off your credit card balances in full every month.
- Don't use more than one-third of your available credit limit on credit cards and other revolving loans – even if you pay it off every month.
- Pay attention to credit card limits – card companies can lower your credit limit triggering over the limit fees.
- Pay off debt instead of moving it around to different credit cards or lenders.

3) **15% - Length of Credit History:** In general, the longer your credit history, the better your credit score. Length of credit history factors include:

- How long credit accounts have been established. In order to have a credit score, your credit report must list at least one account that has been open for six months or more.
- The age of the oldest account, the age of your newest account, and the average age of all your accounts combined.
- How long it has been since you used your credit accounts.

↑ **Score:**

- If you're young or don't have a very long credit history, don't open a lot of new accounts too quickly. That can lower your average account age and your credit score.
- If you pay off a credit card, don't close the account if it is an account you have had for a while. If you only recently opened it, closing the account may not have much effect.
- Ask a family member with good credit if you could be an authorized user on their credit card – that's if their creditor reports authorized user data to the credit bureaus. You could also ask to be added as a joint account holder. Note there are risks with attaching your credit report to another person.
- Secured credit cards can help build up a credit history but **only** if the creditor reports to a Credit Reporting Bureau.
- The better your financial track record, the better you can weather the occasional late payment without greatly impacting your score.

## The First 3 Factors = 80% of your Credit Score

4) **10% - New Credit:** Red flags go up when several accounts are opened in a short period of time. New credit factors include:

- Multiple credit requests/inquiries. However, credit inquiries that were made on your credit within the prior 30 days don't count towards your score. Also, inquiries older than 30 days that occur within a "typical shopping period" for the same type of transaction (home loans, car loans) will only count as one inquiry.
- How long it has been since a new account was opened and the type of account that was opened.
- Hard inquiries: Length of time since lenders made credit report inquiries.

### ↑ Score:

- Shop for a home or car loan within a 30-day period.
- Think twice about store offers to open a new credit card to receive an instant discount on your purchase. The new account could lower your credit score and cost you more in interest and insurance rates than you will have saved with a 10% discount on your purchase. Plus you should take time to review the details of the offer—hard to do in the checkout line.
- When you apply for new credit, a "*hard inquiry*" shows up on your credit report and can affect your credit score for 12 months. Too many hard inquiries can send the message to creditors that you are desperate for new credit. ("*Soft inquiries*" don't affect your score so don't worry about ordering your free annual credit reports or a free report if you've been turned down for credit.)

5) **10% - Types of Credit Used:** The types of credit includes the following factors:

- The mix of accounts including mortgage loans, credit cards, installment loans, finance company accounts, etc.
- This is usually not a major factor in the credit score unless the credit report does not have a lot of other information to base the score.

### ↑ Score:

- It's good to have at least one major credit card in addition to retail store credit cards.
- Don't open new accounts just to have a better credit mix. That could lower your score more in the short term.
- "Payday" and title loans may not report to Credit Reporting Bureaus unless you miss a payment. Even if the lenders do report regular payments to the Bureaus – be careful using these higher cost forms of debt since other lenders may view them negatively.

# How do these factors affect my credit score?

That depends. These five factors have different effects on lower credit scores than they do on higher ones. Plus there are several different credit score models being used by the three credit reporting bureaus and Fair Isaac Corporation (FICO) that may weigh these various credit events differently.

Credit Karma Credit Simulator Score Chart						
Credit Event	Jane	Change	Points	John	Change	Points
Add a New Credit Card with a Credit Limit of \$15,000	793	791	-2	576	557	-19
Increase Credit Limit of Credit Cards by \$10,000	793	793	0	576	612	+36
Closing Oldest Account	793	793	0	576	558	-18
Increase Credit Card Debt by \$10,000	793	769	-24	576	556	-20
Paying Off All Credit Card Debt	793	793	0	576	615	+39
Allow 1 Monthly Account to Become 30 Days Past Due	793	759	-34	576	558	-18
Have On Time Credit History for 24 Months	793	793	0	576	595	+19

Source: CreditKarma.com Credit Simulator, Retrieved June 2009

- For your **free annual credit report**: [www.annualcreditreport.com](http://www.annualcreditreport.com)
- To **purchase** your credit score: [www.myfico.com](http://www.myfico.com)
- To **estimate** your FICO score: [www.bankrate.com](http://www.bankrate.com) – under calculators
- For a **free credit score** service: [www.creditkarma.com](http://www.creditkarma.com)  
[www.quizzle.com](http://www.quizzle.com)  
[www.credit.com](http://www.credit.com)

(Reference to websites is provided for educational information only and does not imply an endorsement.)

Prepared by: Peggy Olive, Richland County UW-Extension, June 2009. Revised January 2013.

Reviewed by: J. Michael Collins, Assistant Professor, Extension Specialist Family Financial Management, UW-Madison.

Sources: Credit Scores & Credit Reports: How the System Really Works, What You Can Do, Evan Hendricks. Privacy Times, 2005.

Understanding Your FICO® Score, [www.myfico.com/crediteducation](http://www.myfico.com/crediteducation), May 2009.

Your Credit Score: How to Fix, Improve, and Protect the 3-Digit Number that Shapes Your Financial Future, Liz Pulliam Weston. Prentice Hall, 2004.

# Credit Repair Options

When you're ready to tackle repairing your credit, there are a range of options for getting caught up on current debt and starting to pay back past debt. While doing nothing is always an option, there are consequences to not acting to repair your credit. And the sooner you start to address debt, the faster your credit rating will start to go back up.

Start by looking at your monthly spending plan to help find the best solution for your specific situation. If you find yourself burdened by debt, however, and you want to get back on track towards healthy credit, you have several options to address the situation:

1. ***Talk with your creditor.*** As a consumer, you always have the option to contact your creditors and negotiate with them directly. Depending on your financial situation, you could request a lower monthly payment amount, a reduction in interest rate or late fees, or the option to skip a few months of payments without being reported as late to the credit bureaus. Not all creditors will be willing to work with you, but if you've been a good customer and call before you miss a payment, you'll be in a better position to bargain.

## **Pitfalls and Traps**

- ❖ **Talk to the right person:** When you call your creditor about your bill, you usually speak with a customer service representative who may be more interested in getting your monthly payment than in problem-solving with you. Ask to speak with supervisor or "loss mitigation" specialist who has the authority to adjust your account.
- ❖ **Get it in writing:** Before you send in your new agreed upon payment amount, ask your creditor to send you the agreement in writing. You'll then have a written record in case there's any question about the arrangement in the future.
- ❖ **Don't give up:** It could take an hour or longer on hold and you might get "no's" from several creditors before you find one who's willing to work with you. But if you don't even ask, the answer is already "no."

2. ***Transferring balances.*** Transferring balances from one credit card to a lower interest credit card can save money on interest or lower the monthly minimum payment due, but be careful.

## **Pitfalls and Traps**

- ❖ **Recycling debt.** When people who are having trouble managing their money consolidate their debt, they often recycle their debt by continuing to create new debt. That's because they haven't changed any spending behaviors. People may intend to change, but once the pressure and stress of the debt is reduced through the consolidation, the motivation to change is gone.
- ❖ **Increase risk or cost of credit.** Often people want to use equity on their home to repay debt. They do this because they have no other collateral for a consolidation loan. They have increased their risk of losing their home by converting unsecured debt (credit card debt not secured by any property) into a secured debt. They also have increased the amount of interest they will be paying and perhaps the length of time it will take to pay off their debt.



3. **Consolidation loans.** These loans take several debts and roll them into one loan. Ideally, a consolidation loan offers a lower interest rate, but this isn't always the case. An acceptable loan can lower your monthly payment and often reduce the overall amount of interest you are paying. A consolidation loan can be a good idea for people who already can pay their monthly bills and just want to be more efficient with debt repayment. However, you need to have good credit and collateral in order to get a consolidation loan without paying excessive interest.

**Pitfalls and Traps**

- ❖ **Cost to transfer debt:** Some creditors are charging balance transfers at the same high rate as cash advances.
- ❖ **Read the fine print:** Read the contract. It often is the case that if you slip up, such as being one day late on a payment, the interest rate goes way up and you're back where you started.
- ❖ **Fees:** Be aware of the cost of extra charges on "low interest" credit cards: late fees, over limit fees, cash advance fees, yearly fees.
- ❖ **More interest:** If you switch balances, you may be stretching out the time it will take to pay off your debt and end up paying more in interest in the long run.

4. **Use a credit counselor to negotiate debt.** A non-profit consumer credit counseling agency may be able to negotiate a debt management plan (**DMP**) with your creditors. **DMPs** are voluntary agreements between borrower and lenders that are designed to help organize debts. This often includes reduced interest rates, lower monthly payments, and consolidates them into one monthly payment. Costs are usually based on your ability to pay. For more information on DMPs and dealing with debt, check out the Federal Trade Commission's Website:

- ❖ <http://www.consumer.ftc.gov/topics/dealing-debt>

**Pitfalls and Traps**

- ❖ **Type of Debt:** While DMPs might be a good fit for some consumers, this type of plan may or may not be right for you. A DMP is most helpful if your debt is unsecured and you have money to put towards debt repayment every month.
- ❖ **Timeline:** If a repayment plan cannot be accomplished in three to five years, usually this is not an option.
- ❖ **Credit Report:** Debt repayment plans that decrease interest or monthly payments will show up on credit reports as late or reduced payments.
- ❖ **Total Cost:** It can be expensive, especially if you have several creditors and the fee is based on the number of accounts in your debt management plan.
- ❖ **Check out the agency:** There are dishonest companies claiming to do credit counseling, so choose carefully. They could overcharge for their services. Others may take your money and not pay your creditors, or they may not even have called your creditors. Many states, including Wisconsin, require licensure of credit counseling agencies that do business in the state.

5. **Discharge debt (file bankruptcy).** Bankruptcy is a specialized branch of the law. It is not your responsibility to understand bankruptcy and all the laws that apply to it. It is your responsibility to become an informed consumer and know the consequences of filing bankruptcy and the long-term effect it will have on your credit.

**Pitfalls and Traps**

- ❖ **Consequences of filing bankruptcy:** It can be difficult to rent or obtain employment if a credit check is required. It can be difficult to borrow money from a financial institution. Loans that are approved will have a higher rate of interest.
- ❖ **Recycling:** Behavior must change or debt will reoccur. Sometimes people file bankruptcy and then turn around and start to incur more debt.
- ❖ **Determining if it's the best option:** A bankruptcy attorney will almost always recommend bankruptcy if a person is eligible without determining if this is the best option for a client. They also don't address spending issues that might put them at risk after the debt is discharged.
- ❖ **Embarrassment:** Often people who file bankruptcy feel ashamed and it is kept a secret. This can be a heavy burden to carry.



## **Credit repair options to approach with caution**

1. **Debt Settlement:** Debt settlement agencies are different than debt management plans. Usually debt settlement agencies collect your payments for many months instead of paying off creditors each month. When the agency has saved up a sizeable amount from your payments, then they will attempt to negotiate a lump sum settlement with your creditor for less than the full amount owed.

**Pitfalls and Traps**

- ❖ **No legal protection:** Debt settlement agencies typically take a percentage of what you save for their fee. While the agency saves up your monthly payments, your creditors can continue to come after you for payments and could pursue legal action.
- ❖ **Scams:** Any debt elimination or debt termination company that claims to be able to wipe out all your debt is most likely a scam. Some companies use fraudulent documents that claim your debt is invalid or challenge your creditors to arbitration over legitimate debt.

2. **Selling Assets:** You might consider selling something you own to help come up with some cash to put toward your debts. While selling items online or at a rummage sale can be a good one-time source of cash to pay down debt, it doesn't add to your monthly income to cover future debt payments.



**Pitfalls and Traps**

- ❖ **Lose Money:** When selling, you typically won't get as much money as you paid for an item. If you plan to replace the item when you get back on solid financial ground, this option could cost you more money in the long run.
- ❖ **Willing to sell:** You might own some family heirlooms or items with sentimental value that would be too hard to part with.
- ❖ **Do you own it:** You might not be able to sell an item that is being used as collateral for a loan. Sometimes the creditor will give you permission to sell the item, such as an auto, in order to use the money to pay off the loan.

3. **Withdrawing Retirement Savings:** The Internal Revenue Service allows "hardship withdrawals" from certain retirement plans under circumstances which present an immediate and heavy financial need, including preventing foreclosure or eviction. Your withdrawal is limited to the amount of money you paid in and does not include any employer match or interest income. A withdrawal is not considered necessary if you still have other options available to you, such as securing a bank loan or selling assets.



A hardship withdrawal is different from taking a loan out of your retirement account. Unless you're purchasing a home, a loan must be repaid within 5 years with payments beginning immediately. On the other hand, a hardship withdrawal doesn't need to be paid back. If you take out a loan and then leave the company before the loan is paid back, you must repay the loan right away or else pay taxes and penalties.

**Pitfalls and Traps**

- ❖ **Taxes:** Withdrawals are taxed as income, plus there's a 10% penalty added on, so you need to figure this amount into how much savings you plan to withdraw. It's extremely important to check with a tax professional about penalties and taxes due if you are considering cashing in a retirement policy. Find out more on the IRS website at: [www.irs.gov](http://www.irs.gov).
- ❖ **Exceptions:** A retirement plan is not required to offer hardship withdrawals. Your options for withdrawing savings also depend on the type of plan you have, such as a 401(k), 403(b), 457(b) or IRA.
- ❖ **Long-term impact:** A hardship withdrawal permanently lowers your retirement savings since the money can't be paid back once it's taken out. Also, you won't be able to contribute to any retirement account for at least 6 months following a withdrawal.
- ❖ **Bankruptcy:** Retirement savings is exempt from seizure by your creditors during a bankruptcy. Once you've spent the hardship withdrawal from your retirement savings, what other options do you have for keeping up with your bills? Borrowing from retirement savings may not be the best option if you end up filing for bankruptcy a few months later.

# Financial Services

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## University of Wisconsin-Extension

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- Provides information on establishing a spending plan, tracking spending, household record-keeping, and consumer credit.

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## National Foundation for Credit Counseling

- Find a credit counselor near you: [www.debtadvice.org](http://www.debtadvice.org) or 1-800-388-2227
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