The Five Most Important Concepts to Understand About Borrowing and Payment Products

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THE UNIVERSITY OF ARIZONA®

Take Charge Today (FEFE), Empowering Future Generations
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Topics for Today

- Present self/future self orientation as a way of assessing a spending/borrowing decision
- Payment methods at the point of sale have different costs and benefits
- Interest and the cost of dragging out loan repayment
- Financial reputation shapes your future opportunities
- Credit score: What is it? How is it used? Do I have more than one? How can I manage it?

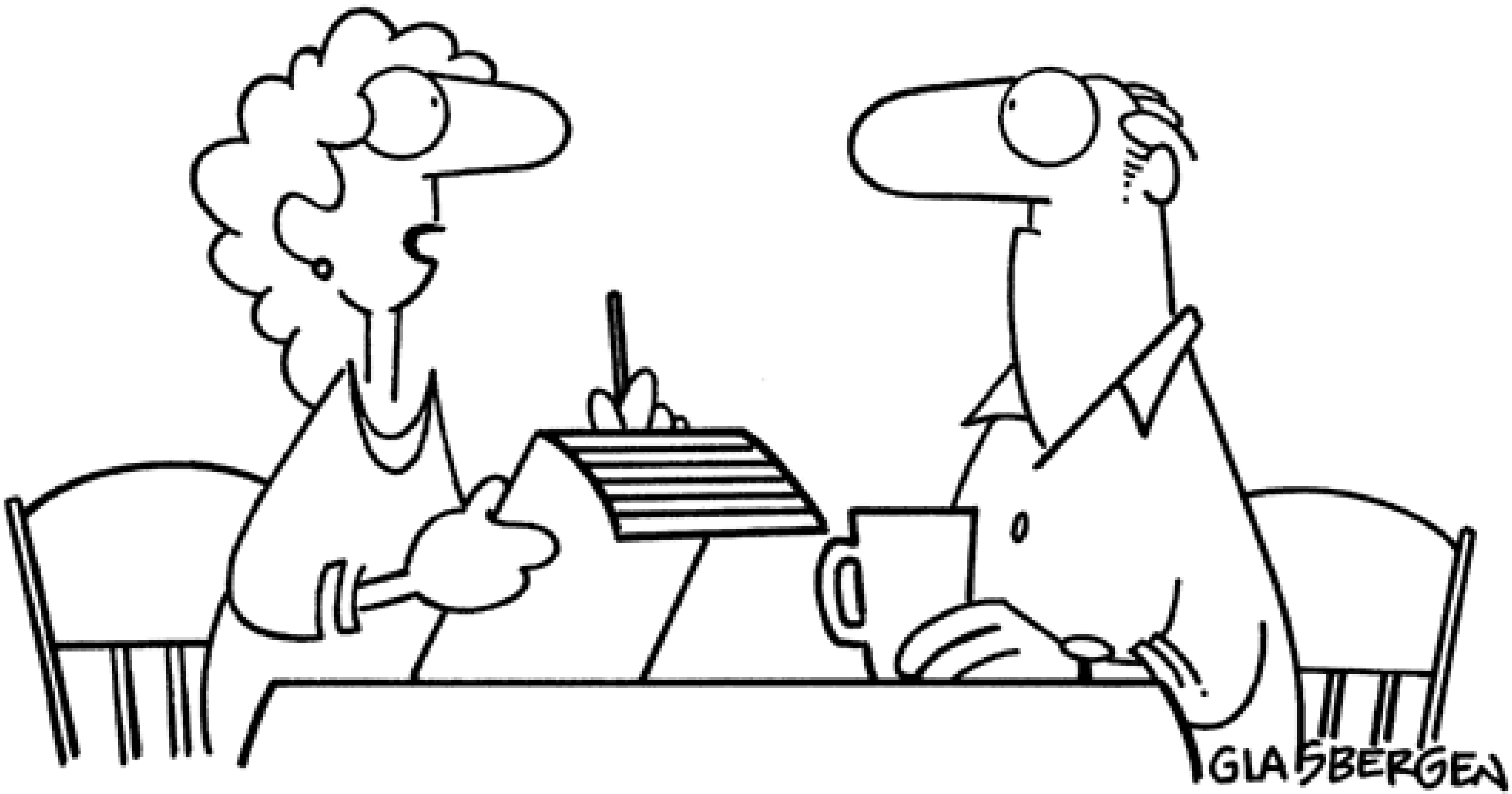
Lesson #1

Borrowing => Obligating Your Future Income to Support Today's Spending

Debt Sits Heavily on the Monthly Budget

- **Example: $2,250 monthly take home pay, and where it goes**
  - $750 rent and utilities
  - $400 food
  - $350 car payment
  - $200 gasoline
  - $100 cell phone/internet
  - $150 student loan payment
  - $300 for everything else
- Now, add $300 for a credit card payment (to pay off $8,000 in 3 years)

  => **goodbye to flexibility inside the budget, buildup of emergency savings, and any "fun" money**



"We can afford to retire in 20 years, but only if our credit cards retire in 10 years."

Present Self and Future Self

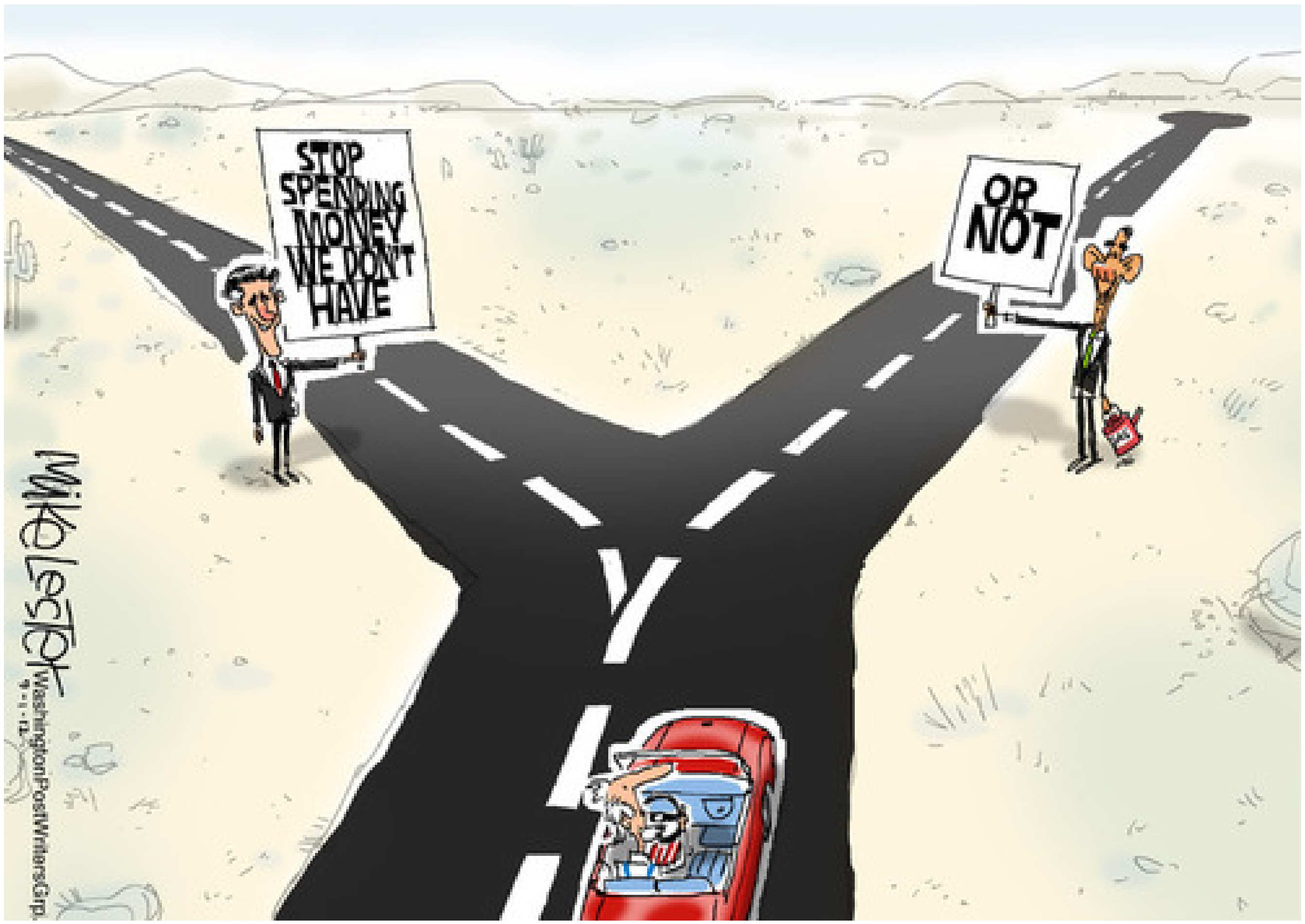
"To abstain from the enjoyment which is in our power, or to seek distant rather than immediate results, are among the most painful exertions of the human will."

Nassau W. Senior, 1836

But, today's decisions affect your options and resources in the future

– http://www.youtube.com/watch?v=W-Cz-LK16g4

Present Self vs. Future Self



Good Debt vs. Bad Debt

Type of Debt	Purpose of Financing	Expected Impact
Mortgage	Housing/shelter	•Stream of services over time •Build equity
Auto loan	Transportation	•Stream of services over time
Student loan	Education	•Higher future income
Credit Cards	•Convenience •Bridge over rough patch	• Tax on future income to pay for current consumption

Behavioral Time Machine Tools

Lesson #2

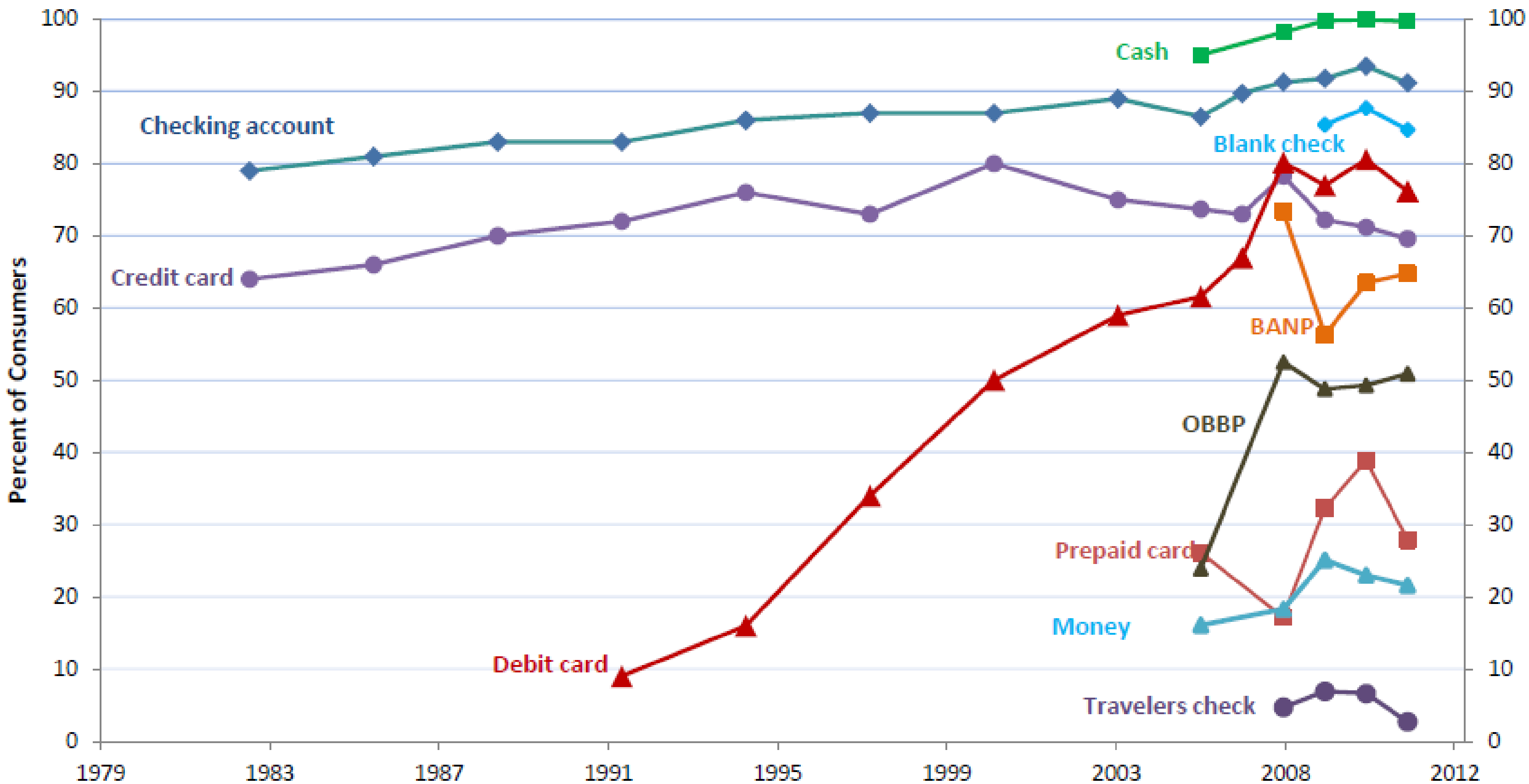
Methods of Payment at the Point of Sale Have Different Costs and Implications

Not all methods of payment at the point of sale are equal

- **It is not obvious to young consumers how payment cards work.**
  - **Credit**
  - **Debit**
  - **Prepaid cards**
- **Plastic payment cards elevate the importance of budgeting**
  - **Spending with plastic hurts less than when cash flies out of the wallet**
- **Increased reliance on digital payment tools (e.g., smartphones) will further separate the pleasure of purchase from the pain of payment**

Consumer adoption of payments

Consumers are adopting new instruments but not discarding old ones…



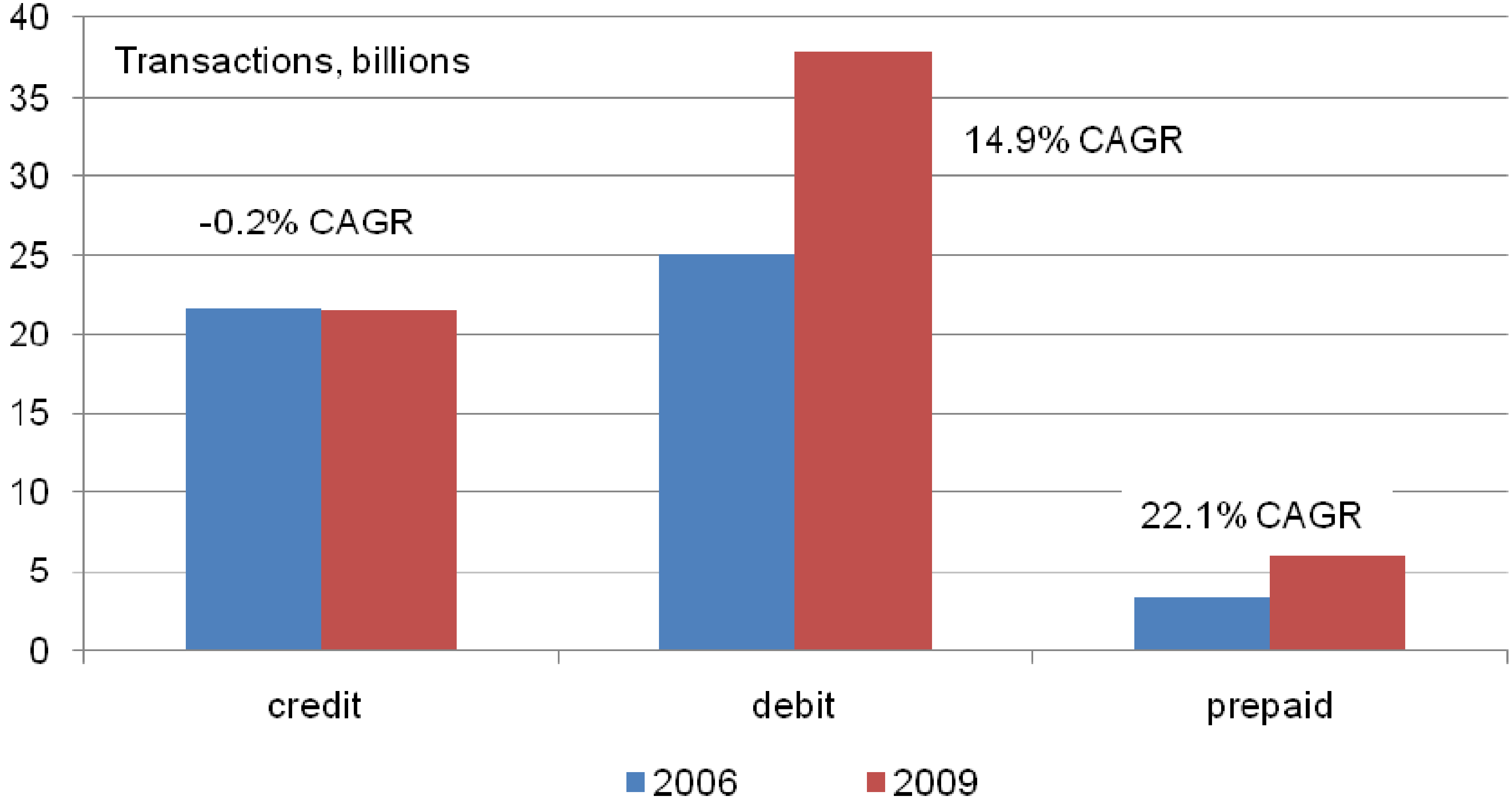
Source: 2011 Survey of Consumer Payment Choice.
Note: The 2011 SCPC data are preliminary and subject to changes.

CONSUMER PAYMENTS Research Center

FEDERAL RESERVE BANK OF BOSTON™

Debit and Prepaid Growth Far Exceeds Credit Cards since 2006

Figure 1.1 Aggregate Statistics on Credit, Debit, and Prepaid Card Transactions*



Source: The 2010 Federal Reserve Payments Study.

* Compound annual growth rates (CAGR) are calculated for the years 2006-2009.

Not all methods of payment at the point of sale are equal

- It is not obvious to young consumers how payment cards work.
  - Credit
  - Debit
  - Prepaid cards
- Plastic payment cards elevate the importance of budgeting
  - Spending with plastic hurts less than when cash flies out of the wallet
- Increased reliance on digital payment tools (e.g., smartphones) will further separate the pleasure of purchase from the pain of payment

- **The response of the financial educator <u>can't</u> be to tell young people "just say no" to credit cards, or Iphone payment, or the next cool tool.**

Today's Youth Have a Different View

For today's consumers under the age of 25 – the landscape is different from a generation ago

- The financial services industry is fragmented: Far more complex array of financial products and channels
- A bank is not necessarily top-of-mind when young adults think of financial services
  - Growth of non-bank providers and channels
- They have less exposure to traditional financial institution branches because their parents use them less
- Much more comfortable with alternate technologies for delivery

Money services offerings at mainstream retailers

"Which location do you prefer most for making financial transactions?" --(CFSI Underbanked Survey)

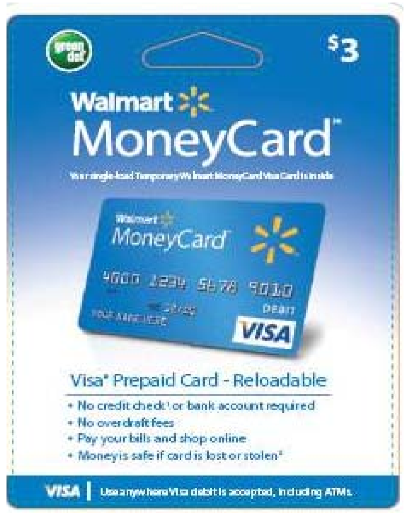
	18 – 24	25+ years
• Bank or credit union branch*	**27.1%**	**36.6%**
• Supermarket, Club, or Superstore	**43.3**	**19.8**

Source: CFSI Underbanked Consumer Survey, 2008

***Combined answers for stand-alone and in-store branches**

Walmart Money Management Products

(Check Cashing)



(Money Cards)

(Bill Payments)

(Gift Cards)

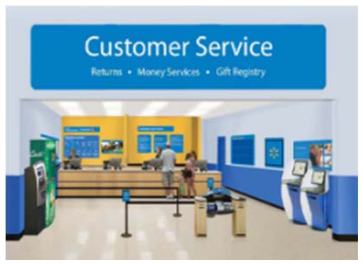
(Money Transfers)

(Product Care Plans)

(Credit Cards)

(Money Orders)

Walmart MoneyCenter

Walmart MoneyCenter	Walmart MoneyCenter At Customer Service	Customer Service Desk	Walmart MoneyCenter Express
			
1,055	771	1,936	1,979

Unit Locations

1,936
Traditional Service Desks

5,741
Locations

3,805
Walmart MoneyCenters

Today's Circumstances: Conclusion

Young people expect less and get less from retail financial institutions

They have far more products and channels to pick from and they choose them *a la carte*

- They expect to have multiple relationships for payments, cash management, credit, savings… and not necessarily with banks

Their relationships have become more transient, technology-driven and more dependent on where they..

- Go to school
- Work
- Shop
- Which phone they use

Thoughts on How Payment Cards Can Help Young People Start a Credit History

- Start with a debit card
  - Easy to get as a feature of a checking account
  - Will not impact credit report, but will demonstrate (to parents) responsible handling of a point-of-sale payment device
- Authorized user on parents' credit card
  - Card account is reported on student's credit report, so "good" account history transfers over to student
  - Student doesn't need to possess or use the card
- Co-signed credit card (with parents)
  - Student has opportunity to learn how to use card responsibly
  - Parents can monitor card usage through monthly statements
- Secured credit card
  - Readily available from major banks
  - Requires deposit up front equal to the limit, but builds credit history just like an unsecured credit card, even with no charge activity

Lesson #3

Lower Monthly Payments Usually Mean That You Pay More Interest Over the Life of Your Loan

Lower Monthly Payment Trap:
Borrowing Longer means Paying More

Example:	**$250,000 mortgage**	**4% interest rate**
	30 year term	**15 year term**
Monthly Payment:	$1,194	$1,849
Total Payments:	$429,673	$332,859
Total Interest Paid:	$179,673	$82,860

Common Ways We are Tempted to Lower Monthly Payments

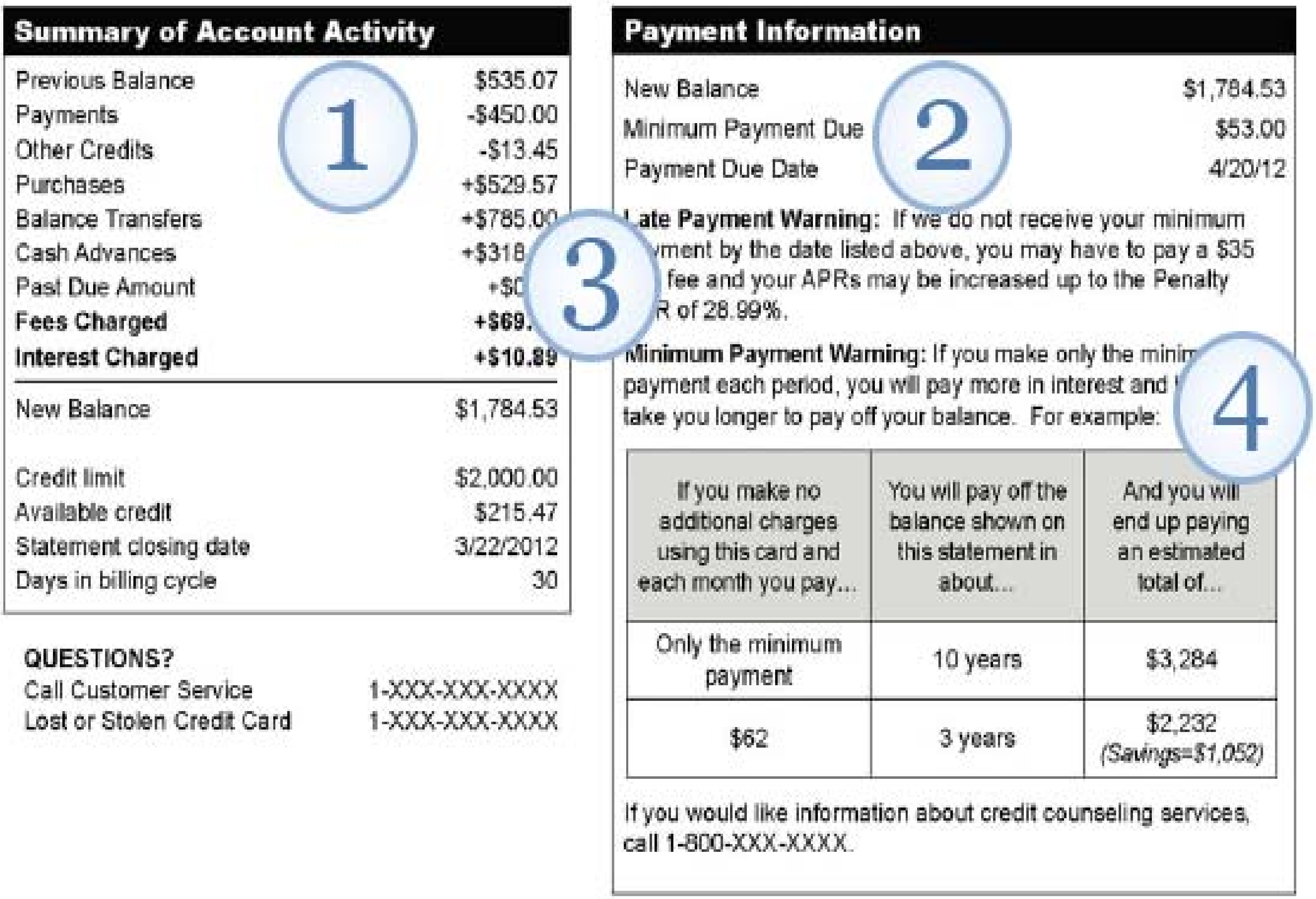
- Extend term of loan (e.g., 72 month auto loans)
- Mortgage ARM loans with low "teaser" fixed interest rates for the first 2-3 years, adjustable thereafter.
- Interest only loans
  - No interest for first few years but then rapidly amortize over rest of term
  - (Many home equity loans still do this, to the shock of borrowers 5 or 10 years after setting up the account)
- "No payment 'til July 2014" offers
- Make only the minimum payment due on credit cards

Question: How Long Does it Take to Pay Off a Credit Card Balance at 0% interest if you pay 2.5% of the original balance each month?

Answer: 40 months (3 years, 4 months)

But, 2.5% is a typical minimum monthly payment, so the min-pay trap is tempting us into stringing out the payment period for several years – <u>even with a 0% interest rate!</u> And, the interest rate is almost never 0%.

Will the New Credit Card Min Pay Disclosures Speed Up Repayment?



Summary of Account Activity

Previous Balance	$535.07
Payments	-$450.00
Other Credits	-$13.45
Purchases	+$529.57
Balance Transfers	+$785.00
Cash Advances	+$318
Past Due Amount	+$0
Fees Charged	**+$69.**
Interest Charged	**+$10.89**
New Balance	$1,784.53
Credit limit	$2,000.00
Available credit	$215.47
Statement closing date	3/22/2012
Days in billing cycle	30

QUESTIONS?
Call Customer Service 1-XXX-XXX-XXXX
Lost or Stolen Credit Card 1-XXX-XXX-XXXX

Payment Information

New Balance	$1,784.53
Minimum Payment Due	$53.00
Payment Due Date	4/20/12

Late Payment Warning: If we do not receive your minimum yment by the date listed above, you may have to pay a $35 fee and your APRs may be increased up to the Penalty R of 28.99%.

Minimum Payment Warning: If you make only the minim payment each period, you will pay more in interest and take you longer to pay off your balance. For example:

If you make no additional charges using this card and each month you pay...	You will pay off the balance shown on this statement in about...	And you will end up paying an estimated total of...
Only the minimum payment	10 years	$3,284
$62	3 years	$2,232 *(Savings=$1,052)*

If you would like information about credit counseling services, call 1-800-XXX-XXXX.

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Better (Cheaper) Ways to Lower Monthly Payments …….

- Borrow less
  - Bigger down-payment
  - Pay a lower purchase price (smaller house, car, college tuition)
  - Don't run up a large credit card balance

Lesson #4

Your Past Credit and Payment History is Your Financial Reputation, and Shapes Your Future Opportunities

Credit Reports as the Basis for a Consumer's Financial Reputation

" The mission of the consumer reporting industry is to serve as an objective third-party provider of information to the companies and consumers involved in credit-related transactions. <u>Our members are libraries that make it possible for credit grantors to provide consumers with the opportunities they seek</u>."

Walter Kurth, president
Consumer Data Industry Association
1991 Congressional Testimony

Content of U.S. Credit Reports

- **Account information for current and past credit accounts**
  - Industry/account type
  - Date reported
  - Date account opened (month and year)
  - Highest balance or account limit
  - Current balance
  - Current payment status
  - Delinquency history (up to 7 years)
  - New in some bureaus: apartment and utility payment history
- **Inquiries from potential creditors**
  - Date (day, month, year)
  - Industry and company
- **Public record items (only credit-related, e.g., bankruptcy, foreclosure, tax liens, legal collection judgments)**
- **Collection items (accounts referred to collection agencies)**

Your Credit Report Establishes Your Financial Reputation.

Your Credit Score is One of the Most Important Barometers of Your Financial Health.

And, You Can Manage Both

Credit Score: What is It?

- **Statistical tool used to assess a borrower's likelihood (probability) of non-payment on a loan**

- **The numerical score that results from statistical scoring modeling ranks borrowers from lowest risk to highest risk of defaulting on a loan**
  - **Generally speaking, higher credit scores indicate lower risk**

- **A given score value translates into a specific probability of defaulting on a loan**

- **Consequently, the credit score is an important component of a consumer's reputation and exerts a powerful influence over credit-related opportunities**

Lenders Try To Reduce Loan Losses By Improving Risk Evaluation Before the Loan is Made… by Using Credit Reports and Scoring

- The Five "C"s of consumer lending: lenders gather data on the borrower to measure the following:
  - Character (Willing to repay? Demonstrated by past track record?)
  - Capacity (Income? Amount of debt already owed?)
  - Capital (Savings? Other financial assets?)
  - Collateral (Downpayment, or asset to pledge against loan?)
  - Conditions (How will economic climate influence repay risk?)
- Until the 1970s, most consumer loans were based on the personal judgment of a loan officer
  - No credit scores, just intuition and experience with the Five "C"s for every borrower they'd ever dealt with

The Loan Officer Noticed that the Past was a Guide to the Future. Statistical Scoring Models Are Built on the Same Idea

Premise: The patterns observed in the past regarding characteristics of accounts that pay as agreed ("good accounts") and accounts that pay late ("bad accounts") will be repeated in future loans.

- **In effect, the scoring model <u>automates</u> the evaluation of the first two "Cs" (character and capacity)**
  - **Better for lenders than an army of loan officers to handle millions of loan applications**
    - **Cheaper**
    - **Faster**
    - **More accurate**
    - **More consistent decisions**

Where Do Lenders Get the Information that is the Raw Material for the Scoring Model?

- Loan applications (especially mortgage loans) ask for lots of information about the borrower
  - But, most of this has to be independently documented or verified for accuracy
- Credit reports in the U.S. provide an important source of information about a borrower's past credit and payment history, and they are cheap for lenders to purchase
  - Extra valuable because the information is <u>objective</u>: provided by lenders and others with direct experience with the consumer
  - Currently (and since the early 1990s) there are three major national credit reporting agencies (CRAs) in the U.S.
    - Trans Union
    - Equifax
    - Experian

Emergence of Credit Scores as a Commercial Product

- **During the 1970s and 1980s, most large national lenders invested in developing proprietary, custom-built models to process loan applications**
  - **These models use:**
    - **data from credit reports**
    - **information that the borrower provides on the loan application**
  - **Many of these custom scoring models are <u>still being used today</u> by large lenders**
- **1980s: A new idea is born: build a model that uses only credit report data**
  - **Developers found such a model could predict default risk very accurately, using only credit report data**
  - **Any lender (of any size) could purchase a score on a borrower and use it to make credit decisions**

The FICO Score

- 1989: Fair, Isaac Corp introduces the first FICO score
  - The FICO score is often called a "generic bureau score". Translation: It uses only information in a credit report – nothing more.
- 2002: FICO began making FICO scores available to consumers through its myfico.com website
  - FICO was the first scoring company to make its product available for consumers to view
- Until 2012, consumers were required to pay a fee to see their FICO score.
- And, unless you've been turned down for credit or have been subject to "adverse action" by a creditor, you still have to pay a fee to see

Details of the FICO Score

- **Components of the FICO score:**
  - **Account information**
  - **Inquiries**
  - **Collections activity**
  - **Public records related to debt or non-payment**

- **Not included:** **age, address, income, gender or employment information; debit card or other bank account history**

- **Classic FICO score product: scale 300 – 850, where a higher number indicates lower risk**

Comprehension Check: There are <u>many</u> kinds of credit scores; Most people have more than one score

Most people have more than one score

- **Many large lenders still build their own scoring models**
  - **Custom models , built on data from just the lender's own account holders**
  - **These scores are generally not disclosed to consumers**
- **Each of the three major credit bureaus (Experian, Equifax, and Trans Union) sells their own generic bureau score built internally on their own datafiles**
  - **Example: Experian's score is called the Plus score**
- **VantageScore (introduced in 2006) is a direct competitor to FICO. It was developed as a joint venture by the three major credit bureaus to compete with FICO for creditor business.**
- **All of these scores have different scales. A "650" score on one does not mean the same thing as a "650" score on another.**

And, many (most?) consumers have <u>three</u> different FICO scores!

- **Reporting to the bureaus by creditors is voluntary => information about your past payment experience may not go to all three credit bureaus**
- **Because the data that each of the three major credit reporting agencies compiles about you may be different, your credit scores built on that data will differ, too.**
- **Implication: To get a complete picture of what lenders see about you, check credit reports AND scores from all 3 bureaus**
- **Qualifier: If the information across your 3 credit reports is very similar, so will be your scores**

Lesson #5

Higher Risk Borrowers Pay More for Credit, and are Offered Fewer Credit-Related Opportunities

A Good Credit Score is More Important Now Than Ever Before

- **Beginning in 2008, lenders backed away from higher-risk applicants, especially for mortgages**
  - **Higher downpayment and higher qualifying scores for mortgages**
  - **Tougher to get credit cards, especially for young people and others with limited credit history**

- **Risk-based pricing means a low credit score will cost you money – possibly big money**
  - **Lenders typically will not quote an interest rate on <u>your</u> loan until they've examined your credit report and credit score. Then they adjust the interest rate to your level of risk.**

Example of How Much a Low Score Can Cost You

Product: **30-year, fixed rate mortgage, $300,000 loan**

FICO Score	Interest Rate	Monthly Payment
760	5.9%	$1,787
650	7.2%	$2,047
590	9.3%	$2,500

Source: Fair Isaac Co: www.myfico.com

Interest rates as of mid 2010.

Lower Scores => Higher Interest Rates => Much More Expensive Loan Experience

Example:	$250,000 mortgage, 30 year term	4% vs. 6% interest rate
	4%	**6%**
Monthly Payment:	$1,194	$1,499
Total Payments:	$429,673	$539,595
Total Interest Paid:	$179,673	$289,595

And, the consequences of sloppy bill payment go beyond just paying a higher interest rate!
(An especially important lesson for young adults)

- Credit scores have become an important screening tool for many businesses, in addition to lenders
  - Insurance (auto; homeowners; life)
  - Apartment rentals
  - Cell phone service providers
  - Utilities (electric, gas, water, cable)
  - Employers

What Do Consumers Need to Understand About Their Credit Score(s)?

- **Know the factors that influence scores and understand which of your usage patterns is holding down your score**

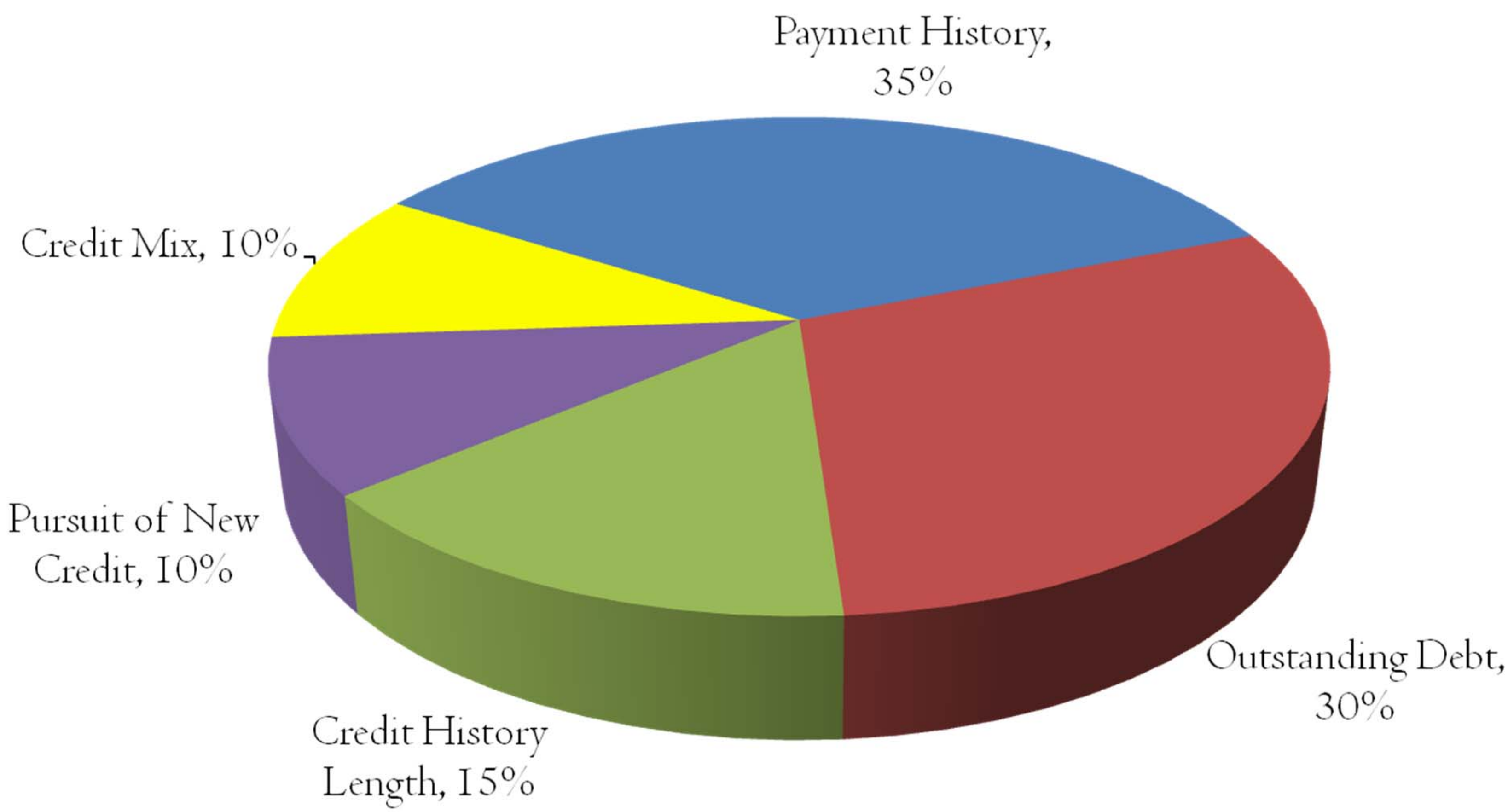
- **Know where your score stands in relation to other scores from the same model**
  - **All of these scores have different scales. A "650" score on one does not mean the same thing as a "650" score on another.**
  - **Check the score provider's website for how your score compares to other consumers**
  - **Understand where in the range of risk you fall (e.g., The best 5%; the worst 1/3, etc.)**

  - **If you are toward the top of the distribution (upper 20-25%) don't worry about trying to boost your score higher.**

Where Does Your FICO Score Fall in the National Distribution of Consumers?

(FICO Score Distribution)

Categories of predictive characteristics, Classic FICO Score (for more details go to myfico.com)



How Much Do Negative Events Hurt Your FICO Score?

Action	Decline from a 680 starting score	Decline from a 780 starting score
Maxing out a credit card	10-30 points	25-45 points
Have a 30-day delinquency	60-80 points	90-110 points
Less-than-full-balance credit card settlement	45-65 points	105-125 points
Home foreclosure	85-105 points	140-160 points
Bankruptcy	130-150 points	220-240 points

Experian's Score Planner Product

www.freecreditscore.com

Top 5 Concepts that Young Adults Should Understand About Borrowing and Payment Products

- Borrowing => obligating your future earnings to support today's spending (consumption)
- Not all means of payment at the point of sale are equal
  - Payment cards and devices have different costs and consequences
- "Lower Monthly Payment" Trap => it may be easier on the budget but leads to a larger amount of interest paid
- Your past credit and payment history is your financial reputation, and shapes your future opportunities
- Higher risk borrowers pay higher interest rates and are offered fewer credit-related opportunities

Questions?