What Students (and You!) Should Know

By Jeffrey E. Hanson

As a financial aid administrator, you know your students need to understand their student loans and manage their spending well. Understanding how credit works is an essential part of that, especially for students who must supplement their federal loans with private, credit-based loans. But do your students—and you—really know enough to be truly "credit-wise"?

Students may know the basics, such as having the highest credit score possible will help them get credit at an affordable price. But do they know what it *takes* to get a high credit score (say 800 or more)? And that most students probably score far below this number? Do they know that their credit score can impact the cost of credit, their ability to obtain other financial products such as auto insurance, or their employability? And what happens when they miss a payment or start accumulating credit card debt—how much can this lower their score?

Students should never underestimate the value of good credit. Those who need private education loans, as increasing numbers of students do, will find that their credit history is likely to affect their ability to obtain the needed funds, and can even affect the cost of their loans. The better the student's credit, the greater the probability that he or she will get the loan, and the lower the cost of that loan. Good credit does count! Building up a good credit history comes from understanding how credit reporting and credit scoring work, *and* from practicing sound financial habits.

Credit Reports

A credit report is a summary of the information contained in an individual's credit history, which creditors use to evaluate the likelihood that the individual will repay future loans. A credit history is generated from credit account information and payment records that creditors have reported to authorized credit reporting agencies, so anyone who has at least one credit card, a consumer loan (such as a car loan), student loans, or any other form of personal credit should have a credit history with an authorized credit reporting agency (see the list on page 17). In essence, credit reports provide a sense of an individual's *willingness* to repay a loan, based on his or her past credit performance. Students can think of their credit report as their "credit transcript."

Whether students think they have credit problems or not, it's a good practice for them to review their credit reports from each of the three national credit reporting agencies at least once a year to be certain that all reported information is accurate. In fact, the Fair and Accurate Credit Transactions Act of 2003, Pub. L. 108-159, 117 Stat. 1952 (FACT Act) entitles all consumers to obtain a free copy of their credit report upon request from each of the three agencies once every 12 months. More information about obtaining these free reports is available from the Annual Credit Report Request Service at *www.annualcreditreport.com* or by calling 887-322-8228.

Credit Scores

If the credit report is the credit transcript, the credit score is the "credit GPA," and just as with grades, the higher the better. The credit score is a numerical value based on credit account information in a person's credit report that focuses on individual borrower behavior. Unlike the credit history, which consists of raw data, credit scores are measures of future credit risk based on an assessment of that raw data. Credit scoring is a quick, accurate, consistent, and objective method that helps lenders quantify how well individuals have managed their credit. The higher the credit score, the greater the statistical likelihood that an individual will repay a future loan on time.

Credit scoring was first developed by Fair Isaac Corporation, which created the credit scores used most widely by the credit industry and are often referred to as FICO® scores. Credit scores are calculated using a statistically derived mathematical formula that provides a numeric prediction of credit risk. The formula itself, which is proprietary, was developed by examining the credit reports of millions of people at two points in time (typically 24 months apart).

Factors Affecting Credit Scores

Paying your credit card bills on time each month has the greatest affect on your credit score. However, contrary to popular belief, a flawless payment history is not sufficient for good credit. A number of factors impact your credit score, including:

- promptness in paying bills;
- total debt;
- amount owed on all credit card accounts;
- age of credit accounts;
- number of credit card accounts including number of credit inquiries;
- the proportion of credit card balances to total available credit card limit;
- number of credit card accounts opened in past 12 months;
- number of finance accounts; and
- occurrence of negative factors such as serious delinquency, derogatory public records, past due accounts that

have been turned over to collection agencies, bankruptcies, student loan defaults, and foreclosures. FICO® scores assess all such negative factors in three ways by evaluating: 1) how recently they occurred, 2) their severity, and 3) their frequency. The more recent the occurrence, the farther the score will drop. The larger the balance affected (severity), the farther the score will drop. And the more frequently such negatives appear on one's credit history, the farther the score will drop.

Two factors that warrant further review are credit inquiries and student loan debt:

- **Credit Inquiries.** Requests for your credit record can also affect your credit score. Only "hard" inquiries made during the past 12 months, however, have a potential negative affect on your score. Hard inquiries are those made by creditors when you apply for a loan or a new credit card. In such cases, you must give permission for your report to be "pulled" (provided to the creditor). All other credit inquiries are "soft" inquiries and are not a factor in scoring. Soft inquiries include:
  - Self inquiries—your requests for a copy of your own credit report or credit score;
  - Promotional inquiries—those made by companies wanting to offer you an opportunity to apply for credit;
  - Administrative inquiries — inquiries made by your current creditors who want to monitor your credit activities, as well as inquiries from the credit-reporting agency that's maintaining your credit history (this typically occurs when you have disputed an item that's contained on your credit report); and
  - Inquiries from prospective employers—although they have the right to obtain your credit report with your permission, these inquiries are not for the purpose of obtaining new credit and so do not impact your score.

- **Student Loan Debt**. Student loan debt affects credit scores, but it does not necessarily result in a low credit score unless the borrower has a "thin" credit file. A "thin" file is one that contains three or fewer "trade lines" (credit cards, car loans, etc.). These files are more susceptible to lower scores because they contain less positive information to offset any negative impact of increases in student loan debt. (Note that the majority of Access Group private loan borrowers have more than three trade lines.) As installment debt, student loans typically are viewed more favorably than revolving debt (credit card debt) in credit scoring. However, although increasing installment balances (for example, because of additional student loans) *can* have a negative impact on credit score, as students advance from year to year in their program of study, payment delinquencies and increasing credit card debt appear to have the *greatest* negative impact.

Weighing the Factors

As illustrated in the figure on page 18, the factors affecting credit scores are not equally weighted in the scoring process. As Fair Isaac reports at *www.myFICO.com*, payment history has more impact—about 35% of the score—than the other factors. Thus, making payments by the due date is very important. Missed payments, one or more delinquent accounts, and serious derogatory items such as student loan defaults, bankruptcy, charge-offs of accounts, etc., can have a significant negative impact on the score.

The amount of debt, especially credit card debt, is the next most significant factor, typically accounting for about 30% of the score. Total debt is important, particularly the percentage of revolving credit (credit cards) being used. Utilization is the amount of credit card debt you have as a percentage of your total available credit card limit. The smaller a person's credit utilization rate, the less likely it is to have a negative affect on the person's FICO® score. Thus, it is important to keep credit card balances low, since lower is better. But this does not mean credit cards should not be used once in a while. In fact, some minimal use of credit cards can be beneficial to establish a positive payment history. This does not require the accumulation of credit card debt, however. Rather, simply using a credit card

HYPOTHETICAL STUDENT'S CREDIT CHARACTERISTICS	VALUES
How many credit card accounts?	2
When was first loan borrowed?	3 years ago
How many loans borrowed or credit card accounts opened in past year?	1
How recently was new account opened?	6 months
How many loans/accounts have balances?	3
How much debt (other than mortgage)?	$10,000
When did you miss payment?	Never
How many accounts are past due?	None
What percent of credit card limits are used?	0%

occasionally each month for small purchases and *paying the credit card bill in full* each time will achieve this goal.

The other three factors—length of history as measured by the age of your oldest credit account, new credit as measured by the number of new accounts opened and the number of "hard" inquiries made within the past 12 months, and account mix (relative proportion of installment accounts, revolving accounts, finance accounts, etc.) generally have a lesser impact on scoring, but cannot be ignored when managing your credit.

What's the Score?

Although there are no well-established statistics regarding the average credit scores of college students, 60% of all consumers with established credit histories have FICO® scores above 700 (using a scale of 300 to 850) according to Fair Isaac. Scores above 700 generally are considered to be "good," and scores above 775 are viewed as "very good" to "excellent" by most lenders.

It is possible to estimate what the credit score might be for a typical student. Fair Isaac Corporation and Bankrate.com have joined forces to offer an online FICO® Score Estimator, which provides a credit score range, rather than a specific score, at no cost to consumers at *Bankrate.com/brm/fico/calc.asp*. Using the basic Fair Isaac methodology, it provides an estimate based on the answers to a brief series of questions about credit use and payment behavior.

We used the FICO® Score Estimator to predict likely credit scores for a typical third-year undergraduate, who has both education loans and credit cards, using four scenarios. For the first scenario, this hypothetical student's credit characteristics are as shown in the table at left.

1. "No payments missed" scenario. The estimated FICO® credit score range for

>>>>>>>>>>>>>>>>>> Credit Resources

Credit Reporting Agencies
For more information on credit reporting or to obtain a copy of your credit report, you can contact a credit reporting agency. The three national credit reporting agencies are:

- Equifax, call 800-685-1111 or visit *www.equifax.com*
- Experian, call 888-397-3742 or visit *www.experian.com*
- TransUnion Corporation, call 800-888-4213 or visit *www.transunion.com*

Annual Credit Report Request Service
This service was established by the three national credit reporting agencies in response to the requirements of the Fair and Accurate Credit Transactions (FACT) Act of 2003, which provides consumers with the right to obtain a free copy of their credit report from each of the three national credit reporting agencies once every 12 months. Visit *www.annualcreditreport.com* for more information.

Bankrate.com
For information on all aspects of credit and personal finance, visit *www.bankrate.com.*

Fair Isaac Corporation
For more information on credit scoring or to purchase your credit score and report, visit Fair Isaac's consumer Web site at *www.myfico.com*.

Federal Trade Commission (FTC)
For help with credit reporting problems, call 877-382-4357, or visit *www.ftc.gov* for information and free publications about credit.

Consumer Credit Counseling Service (CCCS)
For help managing your budget or your debt, call 800-388-2227 for the CCCS office nearest you or visit the national Web site at *www.nfcc.org*.

Note: *Contact information for the above resources is provided for information purposes only. This does not constitute an endorsement, by the author, Access Group, or NASFAA, of these entities or the information and services they provide.*

>>>>>>>>>>>>>>>>> Tips for Maintaining Good Credit

You can use the following tips to help students develop and maintain a strong credit record; one that should allow them to borrow the funds they will need to fulfill their educational dreams and successfully achieve their other long-term goals. In fact, many of these tips probably are good ideas for everyone, not just for students.

1. Develop and follow an affordable monthly budget.
Live below your means while you're a student; learn to stretch your dollars; be thrifty.

2. Pay all your bills on time.
Just one late or missed payment can have a noticeable negative impact on your credit score.

3. Notify your creditors immediately whenever your address changes.
Typically you can provide information updates by phone or via the creditor's Web site. But remember, it's your responsibility to keep them informed.

4. Minimize your credit card debt.
Keep credit card balances as low as possible. Do not exceed 30% of your available credit limit.

5. Avoid charging more on your credit cards than you can afford to repay in full each month.
Get in the habit of using cash, not credit cards, whenever possible. Credit card debt that carries over from month to month can be very costly and may lower your credit score.

6. Record every credit card purchase you charge just as you record every check you write.
Tracking your charges is important so that you always know exactly how much you must repay.

7. Limit the number of credit card accounts you maintain.
You probably don't need more than three major credit card accounts. Avoid opening new department/retail store charge accounts; they typically can only be used at the store that issued the card and they tend to have the highest interest rates of any credit cards.

8. Be careful about opening new credit card accounts and closing older ones.
It's beneficial to have the longest possible credit history to show that you've maintained your credit accounts responsibly over time.

9. Maintain accurate records of your credit accounts.
Keep copies of all documents relating to your credit accounts. These documents should include the application, promissory note, account terms and conditions, disbursement and disclosure statements (if applicable), and lender correspondence.

10. Obtain a copy of your credit report from each of the three national credit-reporting agencies at least once a year and review it for accuracy.
Promptly notify the reporting agency of any errors; it can take several months to correct those errors.

Weighting of factors that affect FICO® credit scores

Source: Understanding Your Credit Score (Fair Isaac Corporation, 2004). Available at *http://www.myfico.com/Offers/myFICO_UYCS%20booklet.pdf.*

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this individual is 715-765. Lenders would probably consider this person to have a "good" history, and although they might not offer their best interest rate, they are unlikely to deny credit based solely on this credit score. Of course, before extending credit, the lender might also require the borrower to meet a minimum income threshold or provide loan collateral.

2. "Missed payments" scenario. What happens if the hypothetical student's credit characteristics change? In this second scenario, suppose the student suddenly becomes delinquent on an account and is 30 days late in making the payment. Assuming this is the only change, the estimated score range drops to **620-670**. This would represent an average drop of 90 points, and the borrower's credit would now be considered only "fair." The individual would be more likely to have trouble getting some forms of credit, such as a private student loan, on his or her own signature. If credit were granted, it probably would be at a higher interest rate and have other restrictions and/or costs.

3. Higher credit use scenario. By contrast, suppose the record showed greater utilization of credit cards. Starting from the original "no-payments-missed" scenario, suppose in this third scenario that the amount of credit card debt was at 50% of the available credit limit. The estimated score range drops to 645-695—a "fair" credit rating. This is better than the missed payment scenario, but would still cause an average drop of 70 points in the score from the original scenario. If credit card utilization increases to 90% (credit cards are nearly "maxed out"), the estimated score range drops to 620-670—the same impact as a 30-day delinquency.

4. Both 30-day delinquency and 90% utilization scenario. If this hypothetical student had both a 30-day delinquency and was at 90% utilization of credit cards, the estimated score range falls to 565-615. This would create serious credit issues for the student and would make it very difficult to obtain most kinds of credit. Thus, two simple missteps—missing a payment and maxing out credit cards—could take our hypothetical student from having good credit to a situation where credit (particularly private education loans) might be very difficult to obtain and much more expensive.

Obtaining Your Credit Score

The easiest way to obtain your FICO® credit score is to go to the Fair Isaac consumer Web site at *www.myFICO.com*. From this site you can request your FICO® credit scores calculated by the three national credit reporting agencies—Equifax, Experian, and TransUnion—and can purchase your FICO® credit score from one, two, or all three of these agencies.

You will receive an explanation of the score, a copy of the credit report that was used to generate that score, and an explanation of the positive and negative factors that are affecting your score. Be aware that your credit score may vary from agency to agency, because the information on your credit report at each agency may differ.

More information about credit scores and the scoring process can be found at *www.myFICO.com*. In addition, the Federal Trade Commission provides consumer information about credit scoring at *www.ftc.gov*. Access Group also has developed a series of on-line educational tutorials for students, including a series on credit, in which two tutorials focus on credit scoring. They can be found at *accessgroup.org/wiseborrower* as part of the WiseBorrower℠ Curriculum.

Good Credit Really Counts!

To sum up, to get the credit needed, *when* it's needed, at an affordable cost, it is essential to understand credit reporting and credit scoring. But knowledge alone is not enough. Being credit-wise also requires practicing good habits. The credit tips listed on page 18 provide a framework for practicing those good habits and can help students avoid the types of pitfalls illustrated in the hypothetical credit score scenarios presented here. This will help them avoid the frustrations, anxieties, and fears associated with credit problems.

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