



FINANCE

Manage Your Clients to Good Credit Health

by Craig Lemoine, CFP®

> Explore the tangible and intangible benefits of a good credit rating

Credit worthiness is an important asset to any consumer. The ability to borrow, interest rates charged and debt conditions born by a client carry potentially more magnitude than decisions of portfolio allocation, retirement plan funding and choosing between fixed income products. Credit management is crucial for all clients. However, as clients grow in age and wealth, the potential negative impacts of poorly managing credit take on a more serious and lasting significance.

Credit management has tangible and intangible benefits to consumers. Tangible benefits such as interest rates directly impact cash flow. Assume two clients, Credit Cary and Sally Spender, apply for a 30-year mortgage on a \$360,000 home. Both have saved \$60,000 down. Credit Cary receives a \$300,000 note at a 4.0 percent interest rate while Sally Spender is assessed a slightly higher 5.5 percent interest rate. The following table outlines differences in their repayment structures. (See Table 1)

In Sally's case, the cost of her credit decisions is tangible and immediate. She will

Credit bureaus pool consumer information collected from lenders, collection agencies and court records into credit files called credit reports.

pay \$4,495 more in interest than Credit Cary in the first year of the note alone. That \$4,495 could have been used to fund a Roth IRA or pay insurance premiums. Most staggeringly, Sally Spender paid additional interest of \$97,603 and incurred a 45.3 percent higher interest expense over the term of the note than Credit Cary. That \$97,603 could have been used to fund risk management, investment or retirement goals.



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Table 1

	Credit Cary	Sally Spender	Difference
Interest Rate on Note	4.0%	5.5%	37.5%
First Year Payment	\$ 1,432	\$ 1,703	18.9%
First Year Interest	\$ 11,904	\$ 16,399	37.8%
Interest on Life of Note	\$215,609	\$313,212	45.3%

Credit management also carries intangible benefits magnified in the affluent marketplace. Exclusive credit cards only available to affluent consumers with impeccable credit scores stretch well beyond frequent flier miles and hotel point accumulations (according to *Forbes*). Private concierge services, complimentary first class and hotel suite upgrades, skipping traditional airport security lines, Formula 1™ car rentals and personal shoppers are some benefits that accompany exclusive lines of credit—but only to those clients with strong credit scores.

Borrowing money, either on a revolving basis (such as a credit card) or on an installment basis (such as a mortgage or car loan) requires the lender to assess the likelihood the borrower will repay the loan in full and on time. This assessment process assesses risk to the lender and is the basis for extending and pricing credit offers to consumers, incorporating reviewing capacity and character. Capacity is measured by income and assets available to pay back a loan and answers the question, “Can the borrower pay back the loan on time?” Consumer financial statements and ratios, such as the debt service ratio (total debt payments/net income), and front ratio (total housing payments/gross income) help lending institutions gauge capacity.

Character is traditionally more difficult to measure. Character answers the question, “Will the borrower pay back the loan on time?” Fifty years ago, character was gauged in small town America, where a loan officer called references before a lending decision was made. In today’s banking climate, efficiency has replaced a phone call. According to the Federal Trade Commission (FTC), approximately 80 percent of lending institutions depend on consumer credit scores to make approval and consumer risk decisions. The most widely utilized credit score is a consumer’s Fair Issac Corporation (FICO) score. FICO scores are a function of information contained in credit reports housed by three major credit bureaus (Experian, TransUnion and Equifax).

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(commonly called credit reports). Credit reports contain information identifying consumers, including residential addresses, employment histories and a social security number. Consumer credit lines (called trade lines) also are found on a report. Trade lines include debt outstanding, payment history, credit limit and the date the account was opened or closed. Accounts with missed payments or delinquent accounts are clearly noted. Credit inquiries are included on a credit report; those initiated by the consumer are voluntary inquiries (such as applying for a mortgage or car loan), while those initiated by third parties are involuntary inquiries (such as a pre-approved credit card offer). Lastly, a credit report contains information reported from credit agencies including liens and judgments.

Information from credit reports is synthesized into one number, a credit score. FICO scores range between 820 and 300, with strong scores typically being over 700, according to myfico.com. Consumers with higher credit scores are considered a lower repayment risk, while those with lower credit scores are viewed as a higher repayment risk to lenders. Credit scores are often used, with consumer permission, in nonlending-based decisions such as employment, rental agreements and underwriting considerations. Low credit scores can have detrimental effects on employment, housing and lending decisions for any consumer.



FICO scores are calculated using the following weighting:

- 1. Payment history (35 percent):** Does the consumer make regular on-time payments? The proportion of late to on-time payments, as well as accounts currently in collection or default, is utilized in this category. Both revolving and installment debt are reviewed when considering payment history. Closed account payment history may impact consumer credit scores for up to seven years after the account closes.
- 2. Amount owed (30 percent):** Credit scores evaluate the relationship between revolving credit available and credit utilized. Consumers with low balances on credit cards, but high card limits, will achieve higher scores than those with high balances and little free credit remaining. Amounts owed on accounts turned over to collection agencies will negatively impact scores.
- 3. Length of credit history (15 percent):** Younger consumers and college graduates are at a disadvantage with this category. Length and strength of credit history adds to overall credit scores.
- 4. Short-term debt (10 percent):** Debt acquired over the past 12 months will lower credit scores. Paying down existing debt is preferential to opening new lines of credit and transferring balances. A flurry of opening and applying for credit will lead to a marked decrease in overall credit score.
- 5. What kind of debt (10 percent):** Revolving and installment debt from traditional lending and credit institutions will help raise credit scores, while payday loan lending and high-risk loans will jeopardize credit ratings.

Understanding the credit score calculation helps financial professionals work with their clients to improve credit worthi-

ness and financial health. The following techniques are important to help financial advisors and clients tackle credit issues.

- Repairing credit takes time. Closed accounts, debts in the collection process and bankruptcies remain on a credit report for up to a decade. As years pass, they are weighted less heavily in the credit score calculation. Two years of on-time payments to creditors and limited credit inquiries will have a dramatic positive impact on any credit score. Avoid any quick fix to repairing consumer credit.
- There are very small profit margins in helping consumers make on-time payments. A quick Google search for the words “Credit Repair” generates more than 10,000 organizations that claim to help. Be wary of any online-only or for-profit credit repair company. Accredited Financial Counselors (such as those certified through the Association for Financial Counseling, Planning, Education) are formally trained and skilled in helping clients from a wide variety of backgrounds with credit issues, and will often sit down with financial advisors and their clients to work towards credit solutions. Visit afcpe.org for a list of accredited financial counselors in your area.
- Encourage your clients to check their credit reports annually at annualcreditreport.com. AnnualCreditReport.com is the only website authorized by the FTC to access consumer credit reports. Other websites may have pirates and catchy jingles, but often result in subscriptions, fees and identity theft.

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