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Community Development

The Private Sector Is a Cornerstone in Community Development

Juan C. Sanchez
Community Affairs Officer

Lately I've been thinking about the evolution of community development, especially about how affordable housing has changed. Over time affordable housing has become a significant line of business for many financial institutions. While deep subsidies and other effective products have been huge factors in the success of affordable housing, community development could not have advanced to its current level of accomplishment without the confidence and commitment of financial institutions.

Not long ago most bankers looked at affordable housing loans with great skepticism. Conventional wisdom told bankers that these deals were unsafe, unsound and unprofitable. Developers building in low-income areas couldn't expect to attract sufficient demand to charge market rates. They were typically plagued by cash flow shortages and upside-down property values.

Even though products such as HUD Section 8 vouchers became a primary subsidy for low-income developments, traditional bank loan underwriting usually discounted rent supplements when calculating cash flows. This action limited loan amounts, and developers were forced to use starkly utilitarian construction to control costs. Developments tended to be plain brick or concrete block buildings with no amenities.

Today we have many powerful tools that did not exist years ago, including low income housing tax credits, mortgage revenue bonds, special needs programs, Federal Home Loan Bank awards, philanthropic grants, subsidized second mortgages and plenty of local government housing assistance products. We all know that funding from sources such as these is directly related to the successful transformation of affordable housing.

Now additional funds are often available to provide pools, community centers, childcare facilities, exercise rooms, additional parking, attractive landscaping and bonus green space — amenities that weren't possible before. It is now difficult to distinguish a market-rate complex from those designated to include low- and moderate-income families.

Most will agree that innovative programs have radically changed affordable housing. But what's still often overlooked or under-appreciated is the importance of the private sector in this transformation. It is the commitment and support of the private sector that have ultimately smoothed the way to success through product enhancement, flexible underwriting and relationship building. Without the help of the private sector, affordable housing facilities might not be as well-made and safe as they are today.

Looking at the rapid rate of change over the last couple of decades, I can only imagine what community development will be like in the years to come. As we explore opportunities to develop new products and more efficient programs, one thing is clear to me: bankers will always be an integral part of a successful community development plan.

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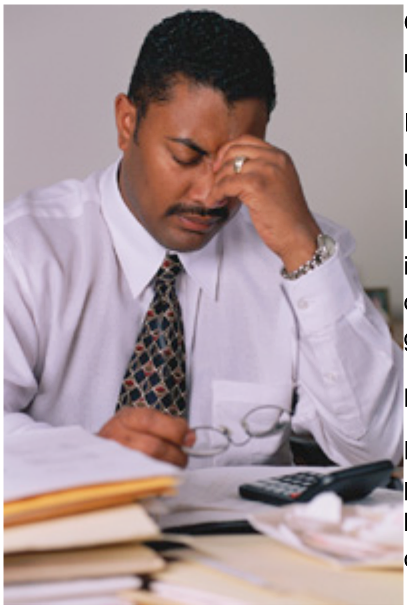
Community Development

Bounce Protection: Awareness Is the Key



Overdraft protection for checking accounts has long been available. So how is bounce protection different and why is it a new issue for consumers?

In recent years, many financial institutions have introduced bounce protection as a unique overdraft product for their deposit customers. Unlike traditional overdraft products, bounce protection is usually informal in nature and can be initiated by the bank without a pre-arranged, written agreement between the customer and financial institution. The potential impact of this product on low- and moderate- income depositors has spurred debate between the financial industry and consumer advocacy groups.

How bounce protection works

Deposit accounts (noninterest checking and NOW accounts) are assigned a bounce protection limit, typically from $100 to $1,000, depending on the type of account. The bounce protection amount is added to the account holder's actual balance, and customers are permitted to write checks on the total.

Unlike traditional overdraft protection, this product includes the bounce protection amount in the customer's available balance. However, when a customer writes a check that exceeds the amount of the actual funds in the account, he or she is charged the normal NSF ("Not Sufficient Funds") fee, despite the indication of an adequate "available balance."

NSF fees typically range from $15 to $35 for each check that dips into the bounce protection amount. The NSF fee is subtracted from the customer's available funds, and the customer receives notification that an overdraft item has been paid, along with a notice requesting a deposit to replenish the bounce protection portion of their account.

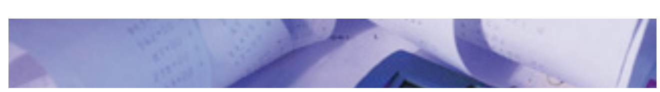
Deposit customers can also activate bounce protection by using ATMs or debit cards. In some cases ATM terminals show only the customer's available balance, which includes the bounce protection amount and therefore overstates the customer's actual balance. Thus customers who use ATMs and debit cards must be especially vigilant about maintaining accurate account records to avoid overdraft charges.

Bounce protection disclosure

Bounce protection disclosure to retail depositors usually states that approval of overdraft items is at the discretion of the bank, even if overdrafts have been paid for the depositor in the past. Because the financial institution offering the program is not legally obligated to pay the overdraft, bounce protection programs typically have not been subject to Regulation Z — Truth in Lending Act disclosures.

Account holders can often opt out of the bounce protection feature by contacting staff at the financial institution. Customers who already have an overdraft protection line of credit must sometimes choose between the bounce protection feature and the overdraft protection line of credit.

Industry and advocacy groups square off



To what extent is bounce protection a benefit to customers? The banking industry and consumer advocacy groups hold diametrically opposing views.

The banking industry claims that bounce protection a) eliminates the aggravation and embarrassment of a returned check by a retailer; b) saves the cost of additional charges from some retailers for returned checks; and c) adds convenience and flexibility in managing funds.

Most consumer advocacy groups argue that financial institutions offer this product to raise profits. Some vendors who market bounce protection to banks claim it can increase a bank's fee income by as much as 300 percent.

Advocacy groups further contend that banks' marketing practices essentially target and exploit vulnerable customers who are less informed and lack financial sophistication. Pointing out that depositors are in essence encouraged to overdraw their accounts, they note that bounce protection is no better than a payday loan since accounts have to be brought to a positive actual balance every 30 to 45 days.

Watchdogs stress that, when calculated on an annualized basis, NSF fees can translate into annual percentage rates of between 100 to 1,000 percent, depending on the protection limit.

Federal Reserve System response

The debate on this issue prompted the Federal Reserve Board to solicit information and comments from the public regarding bounce protection services in its 2002 proposal to revise the official staff commentary to Regulation Z, which implements the Truth in Lending Act. About 300 comments came from financial institutions, vendors and consumer advocates. The Board continues to gather information with the goal of better understanding the nuances of programs offered by different institutions before determining what action, if any, needs to be taken.

Whether or not additional regulation is created to address this issue, the best defense for consumers is stronger awareness about how to handle a checking account or NOW account properly. As Fed Chairman Alan Greenspan recently noted, financial education can play a critical role in improving the financial status of families by equipping consumers with the knowledge required to choose from the myriad of financial products and providers. Today's consumers must be able to differentiate between a wide range of products, services and providers to manage their personal finances successfully.

By Gary Clayton, senior consumer affairs examiner in the Atlanta Fed's Department of Supervision and Regulation.

Coalitions Tackle the Challenges of Financial Education

Financial aptitude is a critical skill for all members of our society. Throughout the Sixth Federal Reserve District, public and private organizations have formed statewide coalitions to promote the importance of financial education for both adults and children. Working in partnership they are helping to make education and training programs more effective.

Coalitions are creative and effective

Creative partnerships that engage the strengths of individual organizations and optimize limited resources make financial education programs more successful. Financial institutions, nonprofit organizations, faith-based organizations, educators, government officials and other public and private agencies can join together to realize their shared goal of improving the financial health of their individual constituencies and their communities as a whole.

Although each statewide coalition on financial education has a unique set of partners, public agencies, financial institutions, and community organizations usually play a leading role. Convinced that a coalition can raise public awareness more effectively than an individual organization, coalition partners often provide training and resources for delivering financial education in addition to collaborating on promotion and outreach. They can also share research and data collection responsibilities.

In some instances, financial education is the primary mission of a coalition, but it may also be offered in conjunction with other asset building strategies. For instance, a coalition focused on administering Individual Development Accounts (IDAs), promoting the Earned Income Tax Credit (EITC) or offering Volunteer Income Tax Assistance (VITA) may find that financial education is crucial for the success of their primary mission. Statewide coalitions also serve as advocates for financial education in the schools and promote policies that have a positive impact on an individual's asset-building capacity.

The Atlanta Fed lends a hand

The Federal Reserve System is committed to developing greater public awareness about personal finance and helping consumers make informed financial decisions. In the Sixth District's branch offices, the Fed's Regional Community Development Managers work with financial institutions, schools and nonprofit organizations to build or enhance personal finance programs. These are often designed for youth and low- and moderate-income consumers.

Each of our regional managers conducts "train-the-trainer" sessions using the Federal Deposit Insurance Corporation's "MoneySmart" curriculum. These workshops instruct bankers, teachers and community development representatives to become personal finance educators. Participants who successfully complete the course can then teach their constituents about basic bank products and services, consumer rights, credit issues, taxation and other personal finance issues.

Regional Community Development Managers have also facilitated the development of several state-level coalitions by convening the partners, determining program goals and identifying potential financial resources. They provide ongoing assistance by ensuring that members of the statewide coalitions are represented on financial education committees and by offering one-on-one technical assistance with curriculum design and program evaluation. Community Affairs and other Federal Reserve staff are currently working on local programs with Jump$tart Coalition, Junior Achievement, America Saves and the National Academy Foundation.

Coalitions vary but share the same goals

Though affiliates of coalitions vary from state to state, all include financial education for youth, adults and families as a critical component of their asset building strategies. Each southeastern state has a branch of Jump$tart, a national organization that focuses on financial education in schools and the financial aptitude of youth.

In Tennessee and Georgia, statewide coalitions are affiliated with America Saves. Tennessee Saves and Georgia Saves emphasize building wealth and encouraging savings through adult financial education and cultural marketing. In Louisiana and Florida statewide IDA coalitions include financial education in their promotion of the IDA concept and technical assistance programs.

Jump$tart coalitions are relatively new in the Sixth District. In the first year of activity, they are focusing primarily on developing partnerships, conducting outreach and raising public awareness. Several coalitions are currently organizing training workshops for educators and other service providers interested in delivering financial education.

Incorporating financial education in the schools is a primary goal for Jump$tart. Louisiana recently passed legislation to make financial education a requirement in K-12 schools. In Tennessee, the State Board of Education is considering revision of its curriculum to include financial education.

Georgia Saves and Tennessee Saves are also new coalitions in their first year of operation. In addition to identifying partners, they are training wealth-building coaches and developing marketing strategies for a savings campaign. Georgia Saves has the ambitious goal of attracting 3,000 savers across the state.

One of the most established coalitions in the Sixth District, The IDA Collaborative of Louisiana (IDACOLA) originated in New Orleans and grew to become a statewide program. IDACOLA, in partnership with Louisiana Jump$tart, has established adult financial education standards and developed an appropriate curriculum using FDIC's "MoneySmart" program. The coalition has thus far trained 30 individuals using the new curriculum.

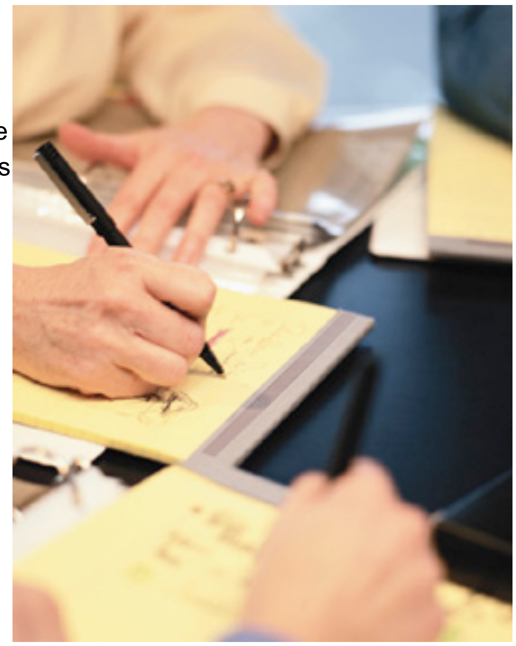
In Florida and Mississippi, active statewide IDA coalitions serve as networking and advocacy groups for local providers. Both coalitions include financial education subcommittees that are identifying best practices in financial education to guide IDA providers as they develop their programs.

Conclusion

Since state-level coalitions in the Sixth District are newly established, the measurable results of the programs are limited. However, the public increasingly recognizes the importance of financial education, and the coalitions are successfully attracting the support of a wide range of partners. Working together, with the Federal Reserve's active support, these partners are building the foundation for better financial health among the region's youth, individual consumers and families.

By Jessica LeVeen, regional community development manager in the Atlanta Fed?s Nashville Branch.

Adult Financial Education Programs Can Yield Big Rewards



Concern about growth in consumer debt and nonbusiness bankruptcy filings is prompting many nonprofit organizations and community development professionals to think about adult financial education training. The rationale is that a more informed consumer can avoid unscrupulous lenders and make better financial decisions. Given the many resources and curricula, how does a group create an effective program?

Critical components of an adult financial education program

Although one group, Jump$tart Coalition, has made significant strides in establishing nationally recognized standards for the financial education of children, such guidelines have yet to be determined for adults.

In a 2000 study, "Personal Finance and the Rush to Competence," Dr. Lois Vitt weighs in on the topic with a definition of adult financial literacy:

"A financially literate individual understands his or her relationship to money — and can read about, discuss and communicate regarding personal financial issues. She possesses knowledge of banking and credit, practices money management, understands the need for protection against unforeseen emergencies, plans for major life events, and saves and invests for the future."

Based on this definition, Vitt has outlined the key elements of an effective financial education program. The following discussion of Vitt's approach may help organizations develop or enhance their own financial education programs.

Defining goals and targeting audience

A mission statement can help define a financial education program's goals and establish realistic expectations. The mission statement becomes the basis for the curriculum. Determining the target population is important in developing an appropriate curriculum as well. Focus on a particular audience can also help in recruiting class participants.

Although word of mouth seems to be the most successful method of recruiting once classes are established, partnering with other organizations for referrals and co-delivery of classes is another effective recruitment method.

For example, Individual Development Account (IDA) Collaborative of Louisiana receives referrals for financial education from a coalition of over 50 organizations. Consumer Credit Counseling Services and Neighborhood Housing Services of New Orleans increase the program's flexibility by offering classes on different schedules to ensure reaching the target market.

Optimizing staffing and administration

Finding adequate staffing and resources is a common and difficult challenge for many organizations teaching financial education. Even well-established groups struggle with this issue. One option is to employ existing staff to teach classes using free instructional materials. Another is to seek help from volunteers or local financial professionals.

Use of the FDIC's MoneySmart training materials, for example, supports the financial education programs established by the Neighborhood Reinvestment Corporation, the Mississippi Housing Initiative, and the U.S. Department of Housing and Neighborhood Development.

Recently grants have been available to help groups cover the cost of teaching financial education. Bank of America and the National Endowment for Financial Education are among the organizations that help with funding.

Developing a relevant curriculum

The next challenge is deciding what topics should be covered first. In Vitt's study, the top three topics among 12 areas surveyed were budgeting and money management; saving and investing; and credit and debt management.

Over half the programs surveyed included topics such as retirement planning, financially managing major life events, housing and mortgage financing, consumer education and protection, insurance and life planning. Ultimately, the program should be tailored to include topics that best fit the needs of the target audience.

Immigrant populations, for example, present special challenges. The success of the program will depend on how well cultural values are incorporated in the curriculum. Some of the programs surveyed specifically address cultural perceptions about money. Others convey the fundamentals of the U.S. banking system to address distrust of banking systems based on negative prior experience. Still others deal with culturally sensitive issues such as reticence to discuss financial matters with strangers or the tendency to use an informal banking network among community members.

In any effective financial education program, attitudes must shift before behavior can change. The good news is that almost all participants across a number of studies report that financial education has helped them change their thinking about money.

Learning theory states that adults look for personal relevance in course topics — they learn better by "doing." Therefore effective financial education must provide examples that refer to "real-life" experiences. Also, the type of teaching media affects the way individuals learn. In-class discussions and different modes of presentation such as vocal, visual or graphic can help make material relevant to the target population's life experience and value system.

Program logistics that accommodate the specific needs of the population being served help ensure a course's success. Scheduling class times and locations that are convenient for participants, providing child care and transportation, and appropriate refreshments are all issues that need to be addressed with potential participants in mind.

Dynamic partnering

"Dynamic partnering" is another hallmark of successful programs. Partners who share similar goals, constituents or geographic territory can help each other support their respective missions. Partnering can be especially beneficial to IDA programs. A recent report prepared for the U.S. Department of Health and Human Services notes that "developing and delivering a financial literacy curriculum for accountholders were among the most challenging aspects of establishing an IDA project." A good partnership can help meet this challenge.

For instance, Consumer Credit Counseling Service chapters of Greater New Orleans and Baton Rouge, as well as Louisiana State University's cooperative extension service have both partnered with the Jump$tart Coalition and the IDA Collaborative to promote financial education. The organizations work closely together using many different delivery systems to ensure that quality financial education is available to adults and children throughout the state.

Successful evaluation and follow-up

Almost all organizations use some form of follow-up to evaluate the effectiveness of their programs. The extent of the evaluation, however, varies greatly. Common evaluation tools include pre- and post-class surveys and tracking participants to determine if they have opened or expanded banking services, increased savings, reduced debt, repaired credit, or purchased a major asset. In addition, formal focus groups or recordings of informal conversations with class participants can yield important information.

Evaluation methods and measurement tools may be specified by funding sources or researchers. A financial evaluation format produced by the University of Illinois' School of Social Work is posted on the National Center on Poverty Law's website at http://www. povertylaw.org/advocacy/fllip/evaluation_report.cfm.

Many national advocacy groups and philanthropic organizations are pushing for more concrete research on what constitutes effective financial education. They are also monitoring the impact of financial education and working with nonprofits, faith-based groups and community development corporations to establish effective financial education programs. The momentum for establishing solid financial education programs will clearly continue to build.

By Nancy Montoya, regional community development manager in the Atlanta Fed's New Orleans Branch.

For more information on the subject, visit the following websites:

Institute for Socio-Financial Studies:
www.ISFS.org

Corporation for Enterprise Development:
www.cfed.org

Federal Reserve Bank of Cleveland:
www.clevelandfed.org/CommAffairs/CR_Reports/CRreport.pdf

Federal Reserve System:
www.federalreserveeducation.org

Sources:

Vitt, Lois A., et al. *Personal Finance and the Rush to Competence: Financial Literacy in the U.S. Virginia Institute for Socio-Financial Studies*, 2000.

Brookfield, Stephen. *International Encyclopedia of Education*. Pergamon Press, 1995.

Abt Associates, Inc. *Assets for Independence Act Evaluation: Second Annual Site Visit Report*. U.S. Department of Health and Human Services, 2002.

Braunstein, Sandra and Welch, Carolyn. *Financial Literacy: An Overview of Practice, Research and Policy*. Federal Reserve Bulletin, 2002.

Anderson, Steve et al. *Financial Links for Low-Income People (FLLIP): An Evaluation of Implementation and Initial Training Activity*. University of Illinois, 2002.

Curbing the Cost of the Dual Economy

At the same time banks are becoming more technologically sophisticated and the demand for paperless, electronic transactions is expanding, a parallel “cash economy” that relies on alternative financial services is also growing, especially in low- and moderate-income neighborhoods.

Increasingly fringe financial services providers such as check cashing outlets, pawn shops, car title and payday loan companies act as alternatives for traditional banking relationships. This trend is a cause for concern among community development advocates, who recognize that recourse to these services can limit an individual’s or family’s financial potential and even hamper the community as a whole.

The hidden costs of the cash economy

According to a 2001 Federal Reserve Survey of Consumer Finances, 12.7 percent of all families do not have a checking account. Among those without checking accounts, 59.3 percent have incomes in the lowest 20 percent of those surveyed, 55.8 percent are headed by persons younger than 45, and 57.4 percent are nonwhite or Hispanic.

The development of an alternative financial services industry has been exacerbated by reduction in the number of mainstream bank branches in low- and moderate-income neighborhoods. In turn, concentration of alternative service providers in low- and moderate-income communities often stymies community and economic development efforts. The absence of documented income, payment records and credit history can block individuals from affordable housing and hinder business development.

Furthermore economic data for communities whose residents operate primarily in a cash economy will not be truly accurate because of undocumented income. Just as census undercounts affect decisions related to geographic and demographic allocation of public funds, inaccurate economic data may lead to inefficient use of revitalization resources.

Because the cash economy is largely unregulated, allowing an undocumented flow of money, fringe financial service providers create a fertile environment for predatory practices that strip wealth and equity from residents. The resulting destabilization of low- and moderate-income neighborhoods thwarts redevelopment efforts.

Non-banking households are on the rise

Numerous studies have addressed the reasons for the increase in non-banking households. Among the obstacles to banking cited are:

1. lack of access or proximity to mainstream financial services,
2. bank identification requirements,
3. bank fees and charges,
4. perceived benefits of alternative services and
5. lack of trust in the banking system.

Some analyses look more fundamentally to the impact of globalization on job migration and immigration patterns as an explanation for the proportional increase in the number of those who do not use traditional banking services.

In *The State of Working America 2002/2003*, authors Mishel, Bernstein and Boushey explain that global investment has led to an overall decrease in employment stability, and thus to a rise in job-related migration. They say globalization has increased reliance on part-time and temporary jobs, self-employment and other non-standard wage jobs. Such non-standard wages tend to be concentrated in low-paying industries and among minorities and individuals with a high school education or less. The analysts point out that as families attempt to manage their finances in a less structured, more volatile environment characterized by unstable jobs and wages, mainstream financial products and services may seem less functional.

Immigrant populations and dual economies

High concentrations of ethnic or immigrant populations may also contribute to the existence of dual economies. In their recent study, "The Cash Centric Behavior of the Hispanic Community," economics professors Radha Bhattacharya and Denise Stanley surveyed 217 Hispanic individuals in Orange County, California to determine money management preferences and identify possible connections to demographic and cultural profiles.

The survey showed that 35 percent of the sample did not participate in mainstream banking. Bhattacharya and Stanley determined that the main reasons Hispanics chose not to bank were banks' minimum account balance requirements and the need for documentation and identification.

The study also concluded that non-banking Hispanics were more likely to have lower levels of education, to speak little or no English, and to be non-residents. They found that many immigrants were not accustomed to having access to bank products and services in their home country. Consequently, operating in a cash economy was more familiar to them than traditional banking.

Negative impact of alternative financial services

A major complaint about alternative financial service providers in low-and moderate-income communities is the exorbitant fees they charge for their services. Although this is often the case, the proliferation of fringe businesses can sometimes make prices more competitive for certain products. For example, Western Union in Miami charges $9.99 plus tax for a next day wire to Mexico City, whereas a local bank would charge on average $40 for the same service in addition to requiring that the money be sent to a correspondent bank.

An equally serious and more immediate concern regarding fringe financial service providers is the incidence of other abusive practices, including misreporting or not reporting timely debt repayment. This practice essentially disfranchises individuals from access to conventional markets.

Community recourse to fringe financial service providers can create a self-perpetuating cycle: A bank branch's ability to serve the financial needs of its local market depends in part on its capacity to generate new business. In low- and moderate-income areas with a history of disinvestment and dependence on alternative financial services, financial institutions may find it difficult to maintain profitable branches. Growth can be particularly problematic for banks that require an established bank account as a reference for loan approval. Likewise, if individuals are not banking with a regulated institution, it may affect their access to credit.

Creating access to mainstream banking

Many financial institutions are partnering with local community development programs to provide better access to banking and improve personal financial management habits. The ultimate goal is to increase an individual's or family's net worth over time — especially those with limited incomes. Earned Income Tax Credit (EITC) and Volunteer Income Tax Assistance (VITA) outreach programs recently helped thousands of families throughout the country file their income tax returns and obtain their EITC refund, at no charge (See Partners Vol. 13, No. 1). Those who maintained bank accounts were able to file electronically and receive their refunds within 10 days.

EITC filers without bank accounts are often targeted by tax preparers for tax-refund anticipation loans. Such loans can significantly reduce the eventual refund after fees and interest are deducted. On the contrary, when financial education is combined with access to bank savings accounts and Individual Development Account (IDA) programs, the EITC can become a powerful wealth accumulation tool for low-income families.

Several recent initiatives have focused on improving access to banking services and financial education by increasing the participation of mainstream banks. With varying degrees of success, Community Development Financial Institutions (CDFIs) and Community Development Credit Unions have dedicated resources specifically to promoting greater access to credit and banking services for low- and moderate-income individuals. In the public sector, the FDIC and the Federal Reserve Bank have partnered with other organizations in designing materials to support financial education and personal financial planning. Private sector companies, including Fannie Mae, Freddie Mac and individual banks, have also developed financial education and budgeting materials.

Strategic partnerships are a key component to reaching all segments of the population effectively. In one such partnership, the Department of Defense recently adopted the FDIC's Money Smart curriculum for use at more than 3,000 military installations around the world, thus reaching 1.4 million military servicemen and women.

Improving the efficiency of the economy in low-and moderate-income markets will increase the success of sustainable community and economic development in those neighborhoods. Facilitating access to mainstream banking services and identifying financial products that meet the needs of low-and moderate-income families are important challenges. The response to these challenges begins with basic financial education and comprehensive solutions that include a wide network of interested partners. The alternative financial services system discourages the wealth and asset accumulation that form the vital building blocks for stable communities and neighborhoods. Bringing more individuals back into the financial mainstream is a first step toward promoting personal financial growth and community development.

By Ana Cruz-Taura and Janet Hamer, regional community development managers in the Atlanta Fed's Miami and Jacksonville Branch, respectively.

Announcing — Partners Software Online!

In 1995, the Federal Reserve Bank of Atlanta's Community Affairs Program designed the Partners Software program as a development tool for community groups, financial institutions, government agencies and community development practitioners providing affordable mortgage programs.

We are excited to announce a new online version of this software. While similar to the original, the online program is geared more toward consumers who want to know how much house they can afford and ways to improve their financial profile to qualify for a mortgage.

For more information, please check out the beta version of Partners Software Online on our website at www.frbatlanta.org/PartnersSoftwareOnline/. The original Partners software remains available from www.frbatlanta.org/PartnersSoftware/.

Keeping Score With Your Credit

In today's increasingly complex and competitive financial market, it's essential for consumers to be aware of their credit scores. In addition to affecting the cost of borrowing money, credit scores are now consulted by auto and home insurance agencies, utility companies and potential employers in making business decisions.

Credit scoring has become a common tool for pricing loans over the last 15 years. As a composite representation of the risk associated with a particular borrower, an individual's credit score is in essence a predictor of future behavior based on past behavior. The more reliable one's payment history, the lower the risk of problems in future transactions.

Credit scores are not static. They fluctuate over time in response to changes in an individual's credit management. Negative transactions will result in a lower score; credit cleanup will generally lead to a higher score. Lower credit scores suggest greater risk, and thus lenders will charge higher interest rates, whereas higher scores indicate lower risk and attract more favorable interest rates.

Credit scores and lending decisions

The loan evaluation process varies with the lender and the type of loan. Because each lending institution evaluates credit scores and sets qualification ranges for loan applicants according to its own standards, several lenders presented with the same loan request could arrive at different decisions regarding approval and pricing.

Credit scores also determine whether a loan is considered prime or subprime credit. Those with impaired or limited credit histories or high debt relative to income typically qualify only for subprime credit. Some lenders offer both prime and subprime credit products, while others may not offer subprime credit, or offer it only through an affiliate.

Consumers should be aware of their credit score before shopping for a loan to guard against unscrupulous lenders who take advantage of those unfamiliar with the credit scoring process. Opportunistic lenders may misdirect borrowers into the highest priced loan despite a favorable credit score.

Credit scores are most often generated by Fair, Isaac and Company, Inc. Although the use of credit scores has been widely accepted and trusted by the financial industry, most lenders do not fully understand the calculation of individual credit scores. As a result different lenders address poor credit scores in different ways.

A number of credit reporting agencies work with applicants to correct credit history information and recalculate credit scores quickly. According to Alan Koch, Florida regional sales manager for CBA, his company can make corrections with the three major credit bureaus within three days. Although there is a fee for this service, Koch notes fees can be like an investment if corrections lead to a considerably lower interest rate.

However, CBA advises its customers that corrections on the credit report do not guarantee a better credit score. Koch relates the experience of one applicant who reduced his available credit by closing a few revolving accounts he no longer used. Unfortunately, one of them was his longest established credit reference, so closing the account actually lowered his credit score.

Credit scoring and insurance premiums

Insurance companies have also begun using credit scoring in pricing premiums. Insurance credit scoring predicts future insurance losses by comparing policyholder performance data with credit bureau data for the same individual. Independent tests conducted by insurance companies comparing policyholders' credit scores against their claims histories indicate that credit scores are an accurate predictor of the probability of future claims. Since individuals with lower credit scores are statistically more likely to file claims, they are charged higher premiums or denied coverage.

Opponents of the practice of basing insurance pricing on credit scores argue that it results in discrimination. Auto insurance rates, for example, were previously based on an individual's driving record: two drivers with the same car and similar driving profiles would pay the same insurance rate. By contrast, insurance credit scoring results in higher premiums for drivers with lower credit scores — even when all other factors are equal. Critics also contend that low-income individuals and senior citizens who have limited or impaired credit are more likely to be adversely affected by insurance credit scoring.

If an individual is denied coverage, the Fair Credit Reporting Act requires the insurance company to provide the consumer with an adverse action notice disclosing the specific attributes of the credit history, motor vehicle report and/or comprehensive loss underwriting report that led to denial of coverage.

Policyholders who have improved their credit scores can also request re-scoring when a policy is being renewed. Consumers should also be certain that insurance providers use the highest credit score when multiple drivers are included on the same policy.

Credit counseling services

Although most people don't address credit problems until they experience difficulty obtaining a loan or face possible bankruptcy, consumers should optimally check their personal credit reports on an annual basis. Not only does protecting one's financial profile facilitate access to competitive financial services, but it also helps to avert identity theft.

Consumer Credit Counseling Services (CCCS) provides several free services such as budget counseling, housing counseling and community outreach/workplace education. Beginning in July 2003, CCCS of Greater Atlanta will also offer debt management and repayment plans for a fee of 5.5 percent of the outstanding debt. CCCS is an affiliate of the National Foundation for Credit Counseling (NFCC) and has offices throughout the country. Branch operations may vary slightly, but they all consistently provide effective financial counseling to the full socioeconomic spectrum of the markets they serve.

Consumers should exercise care when choosing a debt management counselor. Many counselors mislead consumers into thinking initial payments are helping to reduce debt when they may in fact be counseling fees. Some debt management services are not staffed by accredited financial counselors and may actually be offered by home equity lenders eager to refinance the consumer's debt without developing a plan to lower debt or improve credit management.

Major Credit Bureaus

Experian
P.O. Box 2002 Allen, TX 75013
(888) 397-3742 — experian.com

Trans Union Corporation
P.O. Box 1000 Chester, PA 19022
(800) 888-4213 — transunion.com

Equifax, Inc.
P.O. Box 740241 Atlanta, GA 30374
(800) 685-1111 — equifax.com

For more information about credit scoring, check out Fair Issac?s website at http://www.myFICO.com

Consumers seeking quality credit counseling services should look for one of the more than 1,300 community based agencies that are members of the NFCC network. NFCC member offices nationwide can be reached by calling (800) 388-2227 or by accessing www.nfcc.org.

By Ana Cruz-Taura and Sibyl Howell, regional community development managers in the Atlanta Fed's Miami and Atlanta Branch, respectively.

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Events

Wall Street Without Walls (WSWW) Program

Federal Reserve Bank of Atlanta — October 8, 2003

For more information, contact Jennifer Grier, Federal Reserve Bank of Atlanta, (404) 498-7374 or the WSWW website at http://www.wallstreetwithoutwalls.com

EDFS (Economic Development Finance Service) Annual Loan fund "How To" Training Conference

New Orleans, LA — October 27-28, 2003

For more information about this event, contact Bill Amt at (202) 624-8467 or bamt@nado.org

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