CREDIT SCORES AND LOANS: STUDENT HANDOUT

Note to Students: In order to understand the factors that led to the 2008 economic meltdown, it is helpful to learn about credit scores and how they affect the type of loan that a consumer can obtain.

A credit score is "a number, roughly between 300 and 800, that measures an individual's credit worthiness. The most well-known type of credit score is the FICO® score. This score represents the answer from a mathematical formula that assigns numerical values to various pieces of information in your credit report." (Source: www.helpwithmybank.gov/dictionary/index.html)

Your credit score is used to determine whether or not you can qualify to receive credit. Credit providers such as banks look at your FICO score to make a quick judgment about how risky it is for them to make a loan to you. The score is also used by loan providers to determine whether they will give you their best or worst loan rates and terms. The three major credit report bureaus that keep a score on consumers in the U.S. are Experian, Equifax and TransUnion. You can buy your FICO scores by going to www.myfico.com.

Prime vs. Subprime Loans

When consumers seek a mortgage, the mortgage lender or bank looks at their credit scores to determine whether to give them their lowest (prime) or highest (subprime) interest rates and the best or worst terms. If you have a high credit score and the amount of your down payment is at least 10 percent of the home's value, you are likely to qualify for a prime loan rate, which has lower interest rates and better terms. A subprime loan is a loan made to a person who has a lower credit score and/or who is borrowing a larger amount relative to the value of the home price. Here are two examples:

- Danielle saved $20,000 for a down payment on a house valued at $300,000. She had a high credit score, but her lender only offered her a subprime loan, with higher interest rates and potentially worse terms. Why? Her loan of $280,000 is higher than 90 percent of the value of the home. (If she bought a home of lesser value, she would likely qualify for a prime loan with lower interest rates and better terms.)
- Teddy had a low credit score because he had not paid his credit cards on time. His family gave him $100,000 to use as a down payment for buying a home worth $300,000. Even though his loan is for far less than 80 percent of the value of the house, his bad credit score would still make most lenders offer him subprime rates and terms.

Leverage is defined as "using credit or borrowed money to increase the rate of return for an investment. For example, by purchasing a $100,000 house with 10 percent down, you are using just $10,000 to control the investment." (Source: www.harrynorman.com/Content/Content.aspx)

Leverage can help an investor make money. Say the house goes up in value over four years to $120,000, and the investor sells it: There is a $20,000 gain, or 200 percent return, on your original investment. Your $10,000 investment was used to leverage a $20,000 gain.

Leverage magnifies gains and can magnify losses. During the 2008 economic crisis, there were banks that held investments with high leverage (i.e., the amount that was invested was used to borrow up to 30 times of its value). Because the value of stocks fell more than 40 percent, and home values, on average, fell more than 20 percent, the high leverage investments caused both individuals and businesses to lose fortunes.