Issue Briefs

2011-5 Family Financial Education

Getting Back on Your Feet: Approaching Personal Financial Recovery

Wisconsin has not been spared from the "great recession" that has rippled across the country since 2007. As of March 2011, Wisconsin's unemployment rate is 7.4%, up from 4.7% in 2006[i]. Annual bankruptcies in the state have increased from 11,478 filings in 2006 to 30,422 in 2010[ii]. More than 12,000 Wisconsin foreclosure proceedings have been initiated during just the first quarter of 2011[iii]. While these are difficult life events to endure, families are resilient and most will recover to some extent — at least financially — over the next few years. But exiting from a spell of unemployment, losing a home or bankruptcy is fraught with challenges. The purpose of this brief is to help educators, professionals, and counselors guide people in their community who are recovering from a financial setback.

Setting Goals

The first priority for most families is making sure to have a stable source of income. This might include public assistance for a short period, but eventually a return to full time work — or the most work feasible given life circumstances — is often a driving goal. That income may not be at the level prior to the setback, or may require more hours or multiple earners (for example a spouse also working) to make ends meet. The second priority is managing unpaid bills and any debts that put the family at risk of losing a home or car that is vital for their financial security. As part of these tasks, a number of other activities are important, including (1) setting a budget (2) re-building credit and, (3) re-starting savings. Meanwhile it is important to protect families from financial scams or other pitfalls that might impede progress.

1) Setting a Budget

A budget, spending plan or other tool is generally important for all households to develop and maintain. It serves as a family financial dashboard to provide guidance on spending and earning decisions. Families facing a set back may have been forced to develop an austerity budget, with few expenditures outside of food, shelter and transportation. After a period of sacrifice it is normal to want to splurge or enjoy a few 'extras' again. Spending on such items might bring families great happiness and can be viewed positively, if approached with intentionality and grounded in an overall spending plan. It is important that the budget be realistic and include the pay down of any debt or bills, as well as some room for rainy day savings. To the extent these items were not part of the budget before this set back, the new spending plan, even if the family's income overall has recovered to prior levels, will result in lowered spending. This might be a hard adjustment for some families to make.

2) Effects of Financial Shocks on Credit

Fair Isaacs, one of the main companies that offers credit score calculations based on credit bureau data, suggests that FICO credit scores fall by 85 points for a hypothetical subprime borrower (with a FICO score of <680) and about 160 points for a prime borrower (with a FICO score of >780) when a borrower has a foreclosure in their record (Christie, 2010). According to Fair Isaac, FICO

[i] U.S. Department of Labor, Bureau of Labor Statistics, http://www.bls.gov/eag/eag.wi.htm

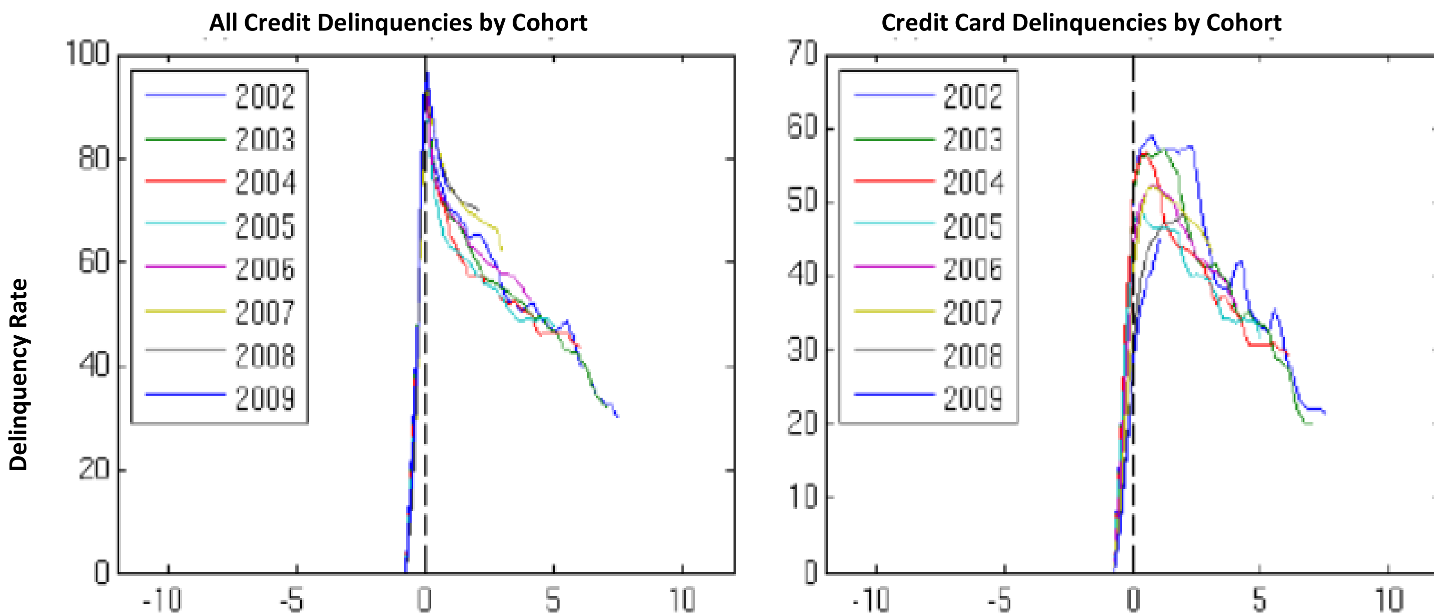
[ii] American Bankruptcy Institute by-state statistics, http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=63196&TEMPLATE=/CM/ContentDisplay.cfm

[iii] Realty Trac, http://www.realtytrac.com/states/wisconsin.html

scores can recover — defined as when credit scores return to pre-crisis levels — in as little as two years.[1] But these estimates assume people only stop paying their mortgage and all accounts are current. Few households in crisis have just one unpaid account.

A recent study by the Federal Reserve Board sheds more light on the recovery from foreclosure specifically, but the lessons are useful regardless.

This analysis shows even after seven years after the foreclosure period, credit scores are 50 to 75 points below pre-foreclosure levels. Why do families struggle to regain their prior credit status? Put simply, because they continue to not manage credit well. The figure below shows all credit and credit card delinquency rates by the year (or 'cohort') the individual experienced foreclosure. Delinquencies exceed 20% even several years later. Not paying other bills limits recovery.



Source: "Foreclosure's Wake: The Credit Experiences of Individuals Following Foreclosure" by Kenneth P. Brevoort and Cheryl R. Cooper, 2010. http://ssrn.com/abstract=1696103

After a financial shock, it will take time to rebuild credit. It is important to first understand the consequences of key financial setbacks.

Unemployment itself will not show up on a credit report. However, the effects of unemployment often include late payments and delinquent accounts due to temporary inability to pay. These items, depending on their severity, may affect credit. Defaults may stay on a credit report for up to seven years. Not paying any form of debt reported to the credit bureaus will continue to drag down credit scores.

Bankruptcy can remain on one's credit report for ten years. Someone who uses bankruptcy as a strategy to restructure a "fresh start" could potentially catch up on bills and boost credit ratings. But often people in bankruptcy have had serious delinquencies recently, and continuing patterns of missed payments after the bankruptcy will further erode credit scores.

Foreclosures, like bankruptcies, are a matter of public record and are on the credit report. The foreclosure is derogatory, but will not by itself doom a consumer to a life of poor credit scores. If other debts are well managed and no payments are missed, scores will return to pre-foreclosure levels long before the 7 year period in which the foreclosure remains on the credit record (the 7 year "clock" starts the month of the first delinquency, not the date of the foreclosure).

[1]See http://www.myfico.com/crediteducation/questions/Foreclosure-FICO-Score-Affect.aspx

Credit wounds can all be healed in the passing of time and taking of positive actions. Ultimately, a credit score is based on five things: payment history, amount of outstanding debt, length of credit history, recent applications for credit, and number/types of credit accounts. Of these, paying bills on time is most important. A recent 30 days late payment can lower a credit score more than a paid judgment from 6 years ago. One strategy is to help clients emerging from a crisis to schedule automatic monthly payments if that helps them pay on time.

It is also important to pay down outstanding balances. Start with essentials--for example have the client focus first on back utility bills or high cost loans such as payday loans. Next, focus on credit cards. Try and develop a plan to pay more than the minimum credit card balance every month. While sometimes higher cost debt can be refinanced, the pattern of opening new cards to pay off older cards does not help a client's credit history, especially if these moves slow down repayments.

Closing some credit cards might a good strategy, especially for clients who have problems with self control over using their cards. However, if all else is equal it is better to close newer accounts than older ones; having longstanding accounts helps credit scores, although only slightly. Closing accounts does not remove them from credit reports.

Applying for new credit triggers a "hard inquiry" on a credit report. This suggests to other lenders that a borrower is seeking new credit and a record with a pattern of looking for credit of various kinds on a continuous basis can negatively affect credit scores. It is always good advice to decline any check-out line offers at retail stores to open a new credit card to receive an instant discount.

3) Building an Emergency Fund

Establishing a cushion is important to minimize the impact of future financial hardships. Building a rainy day fund is a process. But while resources are likely scarce, even $20 a week will add up to $250 in less than 3 months and could pay an unexpected bill. The key is starting someplace and starting small is ok.

The best strategy is to make savings automatic and with direct deposit and a segregated (no fee) savings account. The goal might be to have enough to cover a car repair (say $500) or one month's rent.

A good rule of thumb is to put aside several months' worth of your basic monthly living expenses in an emergency fund. It takes most people several years to build up this kind of an emergency fund> However, people coming out of a financial crisis often see the importance of these funds.

It is also important to consider long-term savings. In a crisis many families stop contributing to retirement accounts, or even borrow against these accounts. Others will cash out accounts, incurring significant penalties. While getting back on good financial footing, clients should consider trying to replenish any retirement savings, as well as developing better plans for long-term retirement savings. Neglecting savings for retirement too long will create a mounting financial insecurity as retirement approaches — and the earlier clients start the more their savings will compound.

Dealing with Deficiencies

Deficiency judgments can provide lenders the right to garnish wages or confiscate other assets in order to collect unpaid debts. These may be used on various kinds of debts, especially when the collateral supporting a loan does not cover the balance owed. For example, after a foreclosure where a home goes back to the bank for less than the debt that is owed, the lender may be granted a deficiency judgment for the balance of that debt. Judgments are the result of a court action and the borrower can try can contest the judgment. In addition to deficiencies, people can face court actions for spousal support, back taxes, child support or other debts.

Garnishments are issued after a judgment has been made and the court has ruled in favor of the creditor/collector. Most common is the process of deducting some portion of a person's earnings for the payment of a debt ("wage garnishment"). Other forms of garnishment include the seizure of assets in bank accounts or other financial accounts. State or federal agencies can garnish a

tax refund. An example of a state or federal agency doing this would be for back taxes or child support. Legal advice is often required for families facing these situations.

Protecting Against Further Setbacks

Consumers recovering from a financial shock are often targeted as the victims of scams and abuses. Help your clients understand the risks of these three dangers.

Credit Repair Agencies

Steer clear of companies that claim they can fix your credit record for a fee. They may claim "We can erase bad credit," however no one can erase information from a credit report if that information is accurate. And if the information on a credit report is inaccurate, your client can fix it themselves for free. Refer your client to the FTC for more information on how to fix errors in their credit reports: http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre21.shtm

Credit Offers by Mail

After filing for bankruptcy or dealing with other credit issues, consumers' names may be added to predatory marketing lists, leading to a flood of pre-approved credit card and insurance offers by mail. Consumers may opt out of a list used by creditors to make uninitiated offers of credit or insurance at https://www.optoutprescreen.com or by calling **1-888-5 OPT OUT** (1-888-567-8688).

Collections Abuses

The Fair Debt Collection Practices Act prevents credit collectors from using practices that are abusive, unfair and deceptive (see 15 U.S.C. 1692). Collectors cannot use inappropriate or demeaning language. Calls are usually restricted to 8:00 a.m. to 9:00 p.m., and the frequency of calls cannot be excessive. Collection agents cannot misrepresent themselves, contact you at work or threaten imprisonment. The collector must give written notice to the debtor that includes all the details of the debt and includes information about how the debtor can dispute it. Advise clients to keep a record with the time and date of any harassment and then file a complaint at www.ftc.gov or call 877-FTC-HELP (382-4357). Also file a complaint with the Wisconsin Department of Financial Institutions at www.wdfi.org or (800) 452-3328.

Conclusion

Foreclosure, bankruptcy and other financial setbacks are a significant challenge for families. Disruptions in housing, school and activities are hard for kids and adults. But families are also remarkably resilient, especially with help from relatives and the community. But financially rebuilding after a negative economic incident is possible, and perhaps faster than some people may assume. But recovery — defined as returning to pre-crisis credit scores and savings levels — is possible in as little as 3 years. But this requires a systematic and focused effort, with no further problems paying bills. In reality many families continue to struggle to juggle financial commitments. Without a workable budget, unstable income and even occasional missed payments can conspire to depress credit ratings and savings even beyond the statutory seven years negative items remain in credit records. A critical step is being informed, setting goals and sticking to a strategy. With the education, advice and ongoing support of community-based educators, families can make a fresh start and get back on solid financial footing.

The University of Wisconsin-Extension (UWEX) Cooperative Extension's mission extends the knowledge and resources of the University of Wisconsin to people where they live and work. Issue Briefs are an ongoing series of the Family Financial Education Team. This brief was drafted by J. Michael Collins, Assistant Professor in Consumer Finance and Extension State Specialist.

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