How credit scores affect your mortgage

By Ameen Kamadia, author of How To Make Your Credit Sparkle, available at

www.creditsparkle.com

Buying a house can be a fun yet daunting task. Most of the anxiety is caused by the loan application process. Most people today can't afford to pay cash for their houses so the loan process is one we can't avoid. And the loan process itself has become a very complicated and drawn out process.

The two major unknowns of the loan process are whether you will get approved, and at what percentage rate. Both of these depend primarily on your credit. The better your credit, the better your chances of approval at a low rate. But what exactly is good credit? What's the difference between A credit and A- credit or even B credit? Good question. Every bank has its own rules and definitions. That's where credit scores come in.

The reasoning behind credit scores.

Lenders needed a way to simplify the loan approval process. They wanted to make it more streamlined, (to reduce costs) and more impersonal (to avoid lawsuits). To solve this problem a company called Fair Isaac developed a credit risk model based on thousands of credit histories. The Fair Isaac Model called FICO was the first credit scoring system to hit the mortgage industry.

The FICO score is a number between 350 and 850 that tries to determine how much of a credit risk a consumer is. The higher the score, the less risky.

In the early 1990's, Fannie Mae, (FNMA) started requiring credit scores on all loans submitted to it for purchase. FNMA is the company that buys mortgage loans from lenders and banks. Therefore, most banks and mortgage companies need you to qualify for a FNMA loan so that they can sell your loan to FNMA. Ask your loan officer for more information about how the primary and secondary mortgage markets work.

FNMA decided that 620 was the cutoff credit score. They would not buy the loan of anyone with a score below 620. They consider that loan too risky. That loan then becomes harder to sell on the secondary market and this causes the rate for the borrower to go up.

What are your credit scores? Ask your mortgage broker what they are, or get your own reports and find out your own scores. More information on how to do this is at www.creditsparkle.com

How the score is calculated

There are three major credit bureaus. Equifax, Experian, and Trans Union. Each of them have a file on you, meaning they each have a credit report available on you. Each of them also has different information on their reports about you. And each of them has their own credit score based on their information.

That means that you have 3 credit reports and 3 credit scores. Equifax uses a score called Beacon, TransUnion's is called Empirica, and Experian uses FICO.

Depending on what information is being reported by which bureau, your score could vary drastically from bureau to bureau. I have seen clients of mine have a score of 700 in one bureau and 595 in another bureau.

Lenders have gotten around this by saying that your middle score must be at least 620 to qualify for FNMA financing. For example, if your scores are 650, 635, and 619, you would qualify because your middle score of 635 is above 620.

How they come up with scores

The process of determining the scores is a very difficult mathematical calculation. They take dozen of items into account. For a detailed list of the items affecting your credit score you can find it in my book, How To Make Your Credit Sparkle, available at www.creditsparkle.com. In fact, the bureaus do not even reveal the equation they use. They keep it very secret. Until very recently, no one except the bureaus themselves was even allowed to tell you what your score was. You could be sitting across the table from your mortgage broker and he was not allowed to tell you what your score was even if he had it in his hand! This has since changed, but the bureaus still want you to come to them first.

Basically, every piece of bad information on your report lowers your score. Major bad listings are collections, bankruptcies, consumer counseling, and foreclosure. Pretty bad listings are late payments. Bad listings are inquires, too high balances, and too many accounts.

I can't go into detail about how much each item affects your score in this report because it would just be too long, but you can get all the information you need in my book at www.creditsparkle.com. Including how many points your credit scores suffers for each inquiry, how many accounts you should have, and how long these items stay on your report.

The computer then takes all this information and calculates a score to determine how risky you might be.

How to improve your score

Improving your credit score is the same as improving your credit. While I can't give you my secret methods for free (my publisher would kill me), here are several ways you can improve your credit score in a short amount of time.

- stop applying for credit – no more inquires
- pay down or payoff your credit card balances
- consolidate student loans

- consolidate as many other loans as you can
- have any incorrect information on your credit reports removed
- close accounts you do not use
- lower your payments on fixed payment loans like your house or car by refinancing.

If you have negative information on your report that you cannot remove, the bureaus say the best way to improve your score is to let some time go by. The older the negative information gets, the less important it becomes in the credit score mathematical equations.

But while you are waiting, do the things I suggest above to boost your score.

The future of credit scoring

Credit scores are now being used in many more places then just the mortgage approval department. Credit card companies, banks, and even insurance companies accept or reject applications based on credit scores. Some people are starting to protest the use of credit scores in certain industries like insurance. But the benefits of credit scores outweigh the negatives, at least as far as lenders are concerned. So I see credit scores becoming more mainstream. It will get to the point, if it is not already where applications will be accepted or rejected solely based on the credit score. And that is why it is so important that you make sure yours is as high as it can be.