Understanding Credit Scoring

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Why is Credit Important?

Credit scores are an instrument used by any mortgage company to evaluate risk. Credit scores may lead to lower interest rates when borrowing money for a - automobiles, mortgages, installment loans, revolving credit cards/ lines of credit, and any type of insurance. Credit scores are a critical (but not the only) element in getting a mortgage. Scores have recently become even more important in attaining affordable Mortgage Insurance. Credit scores and responsible borrowing may even have an effect on successful job searching. Credit scoring, although seems difficult to understand, follows a fairly common sense approach.

Fair Isaac Credit Scoring:

Payment History- Will account for 35% of your credit score. The most obvious way to control your score is to make payments on time. Mortgage and Installment loans will rely heavily on consistent payment history. These loans are usually larger and will reward points every 6, 12, 18, and 24 months if payments are paid on time. The further in the past your late payments are, the less they impact your score.

How much you owe- Will account for 30% of your credit score. Maxed out revolving debt (credit cards) will result in loss of points. Popular belief is that as long as you pay balance in full your score will remain positive. This is not an accurate. Maxing out revolving debt will subtract points however surprisingly having zero balances on a card can also hurt. The suggested method is to keep small balances under 30% of YOUR HIGHEST BALANCE to maximize credit points. CREDIT SCORING COMPARES YOUR CURRENT BALANCE TO THE HIGHEST BALANCE YOU HAVE EVER HAD ON THE CARD NOT THE LIMIT OF THE CARD. This is a common misunderstanding.

New Credit- Will account for 10% of your credit score. Too many cards reflect poorly on scores as it gives borrower more opportunity to create trouble. Opening many new accounts in a short period of time will result in an immediate loss in points. Normally creditors will pull credit score before allowing a line of credit. This will also slightly decrease scores. If your score is poor, you may have no option but to open new credit. This may lower your score in the short term but help in the long term.

Credit History- Credit history accounts for 15% of your overall credit score. Installment (loans) and mortgages with positive payment history will accrue credit points over time. The older the account and the larger the account, the more value you get in terms of credit points. Closing old installment and mortgage loans (paying in full) will reward positive points as common sense applies. Closing old credit card debt will result in loss of credit points. The older the credit account, the more it helps you.

Good Mixture- Accounts for the final 10% of your credit score. Ideally an individual will want a mortgage, an installment loan of some sort (student loan /automobile), and revolving credit card or line of credit. The idea is to have a mixture of each type of loan available to give your credit report a well rounded consistency. This goes along with the belief that a strong variety of credit will be able to absorb minor scuffs and blemishes which are common.

Summary- An ideal credit report will contain all of these factors: payment history, amount of debt, good history to allow new debt, along with a healthy mixture of loans, results in premium A+ credit scores.

UNDERSTANDING THE ACTUAL SCORE:

A+	740-850
A	700-739
B+	680-699
B	660-679
B-	640-659
C	600-639
D	560-599
D-	520-559
F	below-520

A perfect score is rewarded with such advantages in interest rates and financing because of the difficulty necessary to accomplish such scores. Pristine credit scores will drop dramatically with its first delinquency. A new delinquency added to a previously perfect credit report may result in a score drop of 70-220 points. A foreclosure/bankruptcy may result in a drop of 160-220 in points. Mortgage late 40-100, Judgment 10-70, Collection 10-70, late payment 10-70.

The science behind predicting score loss is all about the prior history of the individual. If the credit report was unscathed and a small collection shows up for $300 the A+ borrower may lose 50 points where the B- borrower may lose 10. If the late "fits" the report then the "punishment" is not so severe.

A+ borrowers lose points just as fast as D borrowers may be able to gain them. Borrowers with poor history will gain more points by repairing an item than borrowers with mediocre history. The borrower with poor credit will be able to increase scores into the B+ by making payments on time, paying down revolving debt and clearing collection balances and judgments. This may only take a year. In order to move from B+ to A will take the same steps but it may take two years or more to find yourself back in A paper land.

NEGATIVE ITEMS ON THE REPORT

- Bankruptcy-7-10 years to fall off report
- Judgment-7-10 years to fall off report
- Collections- 5-7 years to fall off report

Collections: Collections should be paid off based upon how recent the collection is. Newer collections should be paid off right away. Paying off older collections may actually hurt the score as the payoff reminds the credit bureaus that an older collection was outstanding. If a old collection is not reporting currently, you may not want to pay it off. If you do pay off a collection, DO NOT SETTLE FOR LESS. Insist on paying off the collection in full. Paying off a lesser amount will result in a "charge off" which may continue to hurt your score in the future.

Judgments: paying off judgments will not help your score dramatically however you cannot get a mortgage with an outstanding judgment. You must pay off all judgments. You will need to get a letter of satisfaction from the courthouse and be sure to send it directly to all 3 credit bureaus as the courthouses often do not report settled judgments to the bureaus. Assume that if you don't tell the credit bureau about a settled judgment, then the court has not either.

Collections, Judgments and Charge Offs are all measured by their age. Depending on the original score and credit history, when a delinquency of this nature hits a report the effect will be different by measure but negative nonetheless. Points will be lost initially and then the line will remain idle most of the time. If this Collection, Judgment or Charge Off is paid off within two years than most, not all, of the points originally lost will be regained. If the item is paid off between 2-5 years no points will be regained and some points will be lost depending on how old. If the item is paid off after five years then it is almost as bad as the Collection, Judgment or Charge Off just appearing as if it were new. The credit report is going to concentrate on the date filed vs. the date last updated. The delinquent item will become diluted with time, don't wake it up.

If the credit report at stake is one of B rating or better and the delinquency is older than two years then it is better to pay off at closing instead of trying to remove beforehand. If credit rating is below B rating then the losses will be minimal when waking up that sleeping giant for reasons that we discussed before.

IMPORTANT FOR CLIENTS WITH FORECLOSURE, SHORT SALE AND BANKRUPTCY IN PAST:

You can get a mortgage following any of these events. However, in general, you have to:

Be PERFECT on your payment history after these events with no lates on any items

Have REESTABLISHED credit by opening up new credit, and paying it on time for 1-2 years. You will need to have 2-3 credit lines.

Keeping a low balance and showing super responsible use of credit

After a BK or foreclosure I find that many clients avoid/stay away from credit because of their past experience. Do not fall into this trap! GET BACK INTO THE CREDIT GAME!

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