CREDIT SCORES

HOW TO IMPROVE CREDIT SCORES FOR YOU AND YOUR BUYER

The three digit number known as one's credit score is probably the most important financial piece of information about any individual in their lifetime, as it often determines the interest rates and terms on their automobile and homes. In many States, the credit score also determines the rates on auto insurance and homeowner's insurance. Yet credit scoring is one of the least understood concepts by the public at large. This is largely due to the secrecy surrounding credit scores.

The Fair Isaacs Company is largely credited with developing the credit score system used by most lenders today, to determine the creditworthiness of potential borrowers. They developed a mathematical formula to determine whether a borrower would default and convinced lenders that their system was more accurate than experienced loan officers. However, they strived to keep their system secret to protect their investment and keep people from manipulating their credit scores. From the 1970's through the 1990's, they where very successful in keeping the information that determined one's credit score from the public, until congress was pressured to make credit scores available to individuals, as it is an important part of one's credit report. Once people found out their credit score, they wanted to know how the score was derived. This led to more information being released, as the credit scoring companies came under more pressure from the public.

Here is what we know today about credit scoring: **35% of the score is based on timely payments on loans, 30%of the score is based on the amount and type of debts outstanding, 15% is based on the length of credit history, 10% is based on the mix of credit accounts-credit cards, department store cards, finance companies and bank loans, and 10% is based on the number of accounts opened recently.**

By understanding each of the elements that make up the credit score thoroughly, one can improve one's credit score dramatically within a short period of time. On the other hand, if one makes the wrong moves he can lower his credit score dramatically in a short period of time. **This is due to the fact that credit scores are not set in stone, as many people believe, they go up and down with the individual's daily activity, and the individual retailers have the ability to report the activity daily to the credit agencies via computer links. While no one checks his credit scores daily, if he did, he may find a 60 point swing during the course of a year.**

When it comes to mortgage loans there are three really important credit score numbers that we should strive to attain for our home buying customers. First, **660**, which is considered an "A" loan and would entitle the borrower to conventional mortgage loans at the best rate. **620** which is the minimum score most lenders would allow the borrower to finance 100% of the mortgage loan, or obtain sub-prime financing at an" A-" rate. **720** and above, which would allow borrowers to finance 100%, 103% or 107% of the home loan at superior interest rates, which would free up the money for down payment and closing costs to re-invest elsewhere. This may allow them to buy an investment property in addition to the occupied home and allow you to earn another commission.

Let's examine each category of the credit score and see what we can do to improve the buyer's credit score before he tries to obtain home financing. The most important category is paying timely, as 35% of one's credit score is determined in this area. **Warn your buyer's that one late payment of 30 days or more before closing on the loan can drop his score 70-80 points. This is actually a greater decrease than if the buyer's had a bankruptcy or foreclosure 5 or more years ago.** This phenomenon is largely due to the weighting given the most recent time frame; that is, this year is far more important than last year and so on. Things that happened in your credit history in years past carry far less weight than things that have happened recently. This is why someone can dramatically improve his credit score, by doing positive things currently, to make up for past errors.

Since paying on time carries so much weight on credit scores, it is a good idea to pay over the internet or by check draft, so you have a record that you paid timely. As you know the mail service is not what it used to be and the postmark really means nothing when it comes to credit scoring, as the retailer does not care when you mailed the payment, they only care when they receive it. Lost payments can have a big negative impact on one's credit score, so it is better to be safe than sorry. It is much easier to maintain a good credit score than try to improve a bad one. This is one important lesson that many young people have not discovered and the penalty is far greater than a small late payment charge. Low credit scores can cost people thousands of dollars in higher payments.

The next most important category in credit scoring is the amount and type of debt that one carries, as it accounts for 30% of the credit score. **This is an area that one can dramatically improve their credit score, once they understand how the system works.** Since credit reports do not show one's income, the credit agencies can not do an income to debt ratio, which has been traditionally very important to mortgage lenders. What the credit score

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does is compare the available line of credit to the balance carried on that account. For example, if the buyer's MasterCard account had an available line of credit of $10,000 and their current balance was $3,000, the account would show that the customer had used 30% of his available line of credit. **Anytime the available line of credit reaches 30%, the credit score goes down. If the same individual owed $7500 on his $10,000 available line of credit, the credit score would be dramatically reduced. This was based on studying hundreds of thousands of credit reports over many years, when people get over-extended on their debts, they tend to be more prone to defaulting on their other obligations.**

If each buyer was aware of the above information he could improve his credit score substantially. If for example, the person that owed $3,000 on the $10,000 MasterCard, sent an additional check in before the next month's statement, it would bring the percentage of available line of credit down to 25%, increasing the credit score. He could also ask MasterCard to increase his available line of credit. If MasterCard increased the available line of credit to $12,000, the debt of $3,000, is reduced to 25% of available line of credit, improving the credit score.

When the buyer has used 75% or more of the available line of credit, his credit score is dramatically reduced, as they are perceived as being over-indebted. Conversely, if the balance is paid down below 75% or the line of credit is increased, the buyer would have a substantial increase in his credit score! Knowing this information can easily improve a credit score 20-50 points.

Many people are being advised to close some credit accounts, because they have too much available credit. This is just the opposite of the truth; doing so will probably lower their credit score, not raise it. This is due to the fact that the credit scores are a function of the debt to available line of credit on individual accounts and on the buyer's total debt. That is, the scoring model adds up all the debts and compares it to the total of available lines of credit.

Let's say that that your buyer has six credit cards with $60,000 in available lines credit and his total credit used is $15,000, or 25% used. This amount would not aversely affect his credit score. If he closed three $10,000 accounts, it would drop his total line of credit to $30,000, but his debt of $15,000 becomes 50% of his credit line being used. This move lowered his score! Another factor, not considered, what if the buyer closed the three accounts he had the longest, this would further lower his score, because the length of credit history is also a factor to determine the credit score.

It is almost impossible to have too much credit; it is very easy to have too much debt. In order to raise your or your buyer's credit scores, request increases in the available lines of credit, as this reduces the percentage of available credit used, thus increasing your credit score. Do not close accounts because someone tells you it will look better to the lender. The lender generally only looks at the credit score to determine if they will make the loan, they rarely try to make assumptions about buyers because they carry less weight than the credit score.

In order to establish good credit scores, it is important that one demonstrates that he can successfully borrow money and repay it. The more that you borrow, and the more that you repay, the higher the credit score. However, many conservative people will never use more than a few hundred dollars of their $10,000 MasterCard limit. This is a mistake, if they want a really high credit score. The person that used $6-7000 of the available line and repaid it, would have a higher score than the person only using $300. This is because it demonstrates that you the person with the larger payback is more creditworthy.

Another important area of credit scoring is length of credit history, which accounts for 15% of the total score. It is important that young people understand that they should begin developing credit as soon as they possibly can, as their credit scores are generally lower than the people that are older than them, because older people generally have longer credit histories. It is even wise to get a credit card or two while in high school or college and begin developing credit, by paying timely. If you run into a potential homebuyer who has a low credit score due to lack of credit history, ask him to gather letters from the telephone company, gas company, electric company, landlords or gasoline companies and take this letters to their credit bureau, as they have begun accepting alternative documentation. Incidentally, almost none of the aforementioned creditors report to the credit bureaus.

If the buyer has already destroyed his credit score and creditors refuse to extend credit to him, have him get secured credit cards to reestablish credit.

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Many banks offer secured credit cards, where the creditor gives them $500 in cash and they issue a credit card with an available line of credit equal to the $500. The payments are reported to the credit bureau and the consumer begins reestablishing credit. After 6 months to a year of timely payments the balance is increased and the card is no longer secured.

Another credit enhancing technique that can be employed for people with impaired credit, is to have a relative put them on one of their accounts and see that the account is paid timely. The party with impaired credit must have their social security number on the account with the relative, so that both parties credit will increase. Caution: the responsible party should control the account and the payments to insure his credit does not go down.

Another area where credit scores can be increased is the mix of credit accounts, as this counts 10% of the credit score. If the borrower demonstrates that he can handle numerous different types of accounts he is considered more credit worthy than someone that only has one or two accounts. Therefore, in order to have a high credit score, it is imperative that the consumer have as many good paying accounts in three different categories as possible. The first category, department store cards are perhaps the easiest to obtain. Wal-Mart, Target, Sears and others offer credit lines. It is a good idea to use the maximum credit line at some stage and repay it, establishing credit worthiness.

The second category is installment loans such as automobiles, motorcycles, homes etc. In this category, the balance carried is not a factor, only, timely payments is important. Never be late and having more than one history is helpful here, but not required. Young people should buy their first automobile from a reputable dealer and pay on time religiously, to develop a good credit score. Remember parents can co-borrower on the auto and help establish their children's credit, as long as both social security numbers appear on the loan.

The third category is credit cards. This is one area that raises or lowers one's credit score more than any other single factor. As mentioned previously, one late payment over 30 days can destroy a credit score. If the balance used exceeds 30% or 75%, the score will be much lower than it would normally be. Either pay down the balances below these percentages or raise the limits, to effectively lower the ratio of debt. It is also legal to obtain gifts from relatives or other entities of up to $12,000 per year per person, which could be used to pay down or pay off the debts. One couple is allowed to give another couple up to $48,000 per year tax-free, which is a form of estate planning for the donor (think: parents, grandparents, brothers and sisters) which could be used to pay off all debts. If the party had a low credit score because of too much debt, his score would rise dramatically if he no longer had any debt, wouldn't it?

While credit scores should be updated daily, as payments are made, the human factor often gets in the way. That is, when Sears, MasterCard or any other retailer receives a payment, they are supposed to notify the credit bureaus the same day by computer. In practice many people receiving those payments send them to be cashed but do not report the payment immediately. That is why it is a good idea to pay down these balances and expect that it may not be reflected for a week or two after receiving the payment. Of course there are ways to expedite the process by attaching a letter requesting immediate notification of the credit bureaus, as you are applying for a home loan and you want the best credit score possible. The letter should be sent with a cashier's check in an overnight envelope, such as UPS or Fed Ex, so the consumer has a way to check up on the payment.

The last category of credit scoring that is important is opening new accounts or making inquiries for credit, which counts 10% of the total. You should be aware that additional inquires or opening new accounts may lower a buyer's credit score 4-5 points for each entry. If they make 4 or 5 such inquires, it could knock them out of "A" financing (scores below 660). It could also cause them not to be able to finance 100% of the purchase price. Tell buyers not to make any inquiries or open any new accounts, until after they close on their home loan. Once this accomplished, feel free to make some inquiries, as their credit score will not matte as much.

There is a major exception to the above rule, the consumer is allowed to shop for their financing without penalty. The rule states that if a consumer gets numerous quotes from lenders within a 30 day period, they will only count as one entry as long as they are similar type lenders (mortgage, auto, etc.). This is opposite of what many lenders would tell the consumer, because they do not want the consumer to shop around, as they may find a lender with lower rates or lower closing costs or higher loan qualifications. (I believe it is the real estate agent's job to point this out, so the buyers can locate the best mortgage deals.

TIPS ON HELPING PEOPLE IMPROVE THEIR CREDIT SCORES

Purchasing a home is the largest investment that most people undertake in their lifetimes. Since credit scores are a very important factor in determining what terms the buyer would receive on the financing in the purchase of a home, buyers should know what they can do to improve their credit scores.

The first thing one must do is get his credit scores from the three major credit bureaus, Experian, Equifax and Trans Union, as there are three different scores. Each of these bureaus has slightly different information on each individual, since they sort of compete for the information. Hopefully, the scores are similar or grouped. Scores of 650, 660 and 640 are similar and would indicate no major discrepancies. However, scores of 650, 660 and 570 would indicate that the credit bureau reporting the 570 score has incorrect information that needs to be corrected, as this low score could lower the consumer's average credit score. It could also be the one used by an automobile dealer or other creditor, dramatically affecting the consumer's terms.

- **The homebuyer should locate any error or errors contained in the credit file and immediately challenge the incorrect information in writing by filling out a dispute form located in the back of the credit report.** This written challenge or dispute should be sent via fax or e-mail directly to the credit bureau, with a request for a receipt that they have received the written challenge. Once the credit bureau has received the written challenge, they must notify the retailer of the challenge. Once notified, the retailer has 30 days to respond in writing. If they fail to respond within the 30 day time limit, the consumer is to be given the benefit of any doubt. Once the error has been corrected the credit score would reflect the correction. The fallacy with this system is, it often takes 30-45 days to get a problem corrected and reflected in the credit score. That is why we recommend that the consumer/homebuyer get his credit scores 45-60 before closing on a home loan. That way he will have adequate time to correct errors and have adequate time to improve his credit scores.

- **Do not make inquiries for additional credit such as department stores, automobile dealers, furniture, jewelry stores or apply for additional credit cards.** You do not want a lot of recent inquiries on your credit report as they lower your score. Each inquiry can lower your score 3-5 points. It is OK to shop lenders, as long as they are similar entries within a 30-day time frame, they are to be treated as only one inquiry. (This category is 10% of your credit score.)

- **Pay off as many outstanding balances owed on credit cards and other month to month obligations as possible and cease using your credit cards until after loan closing**. This lowers you debt ratio and lowers the percentage of available credit used. The lower the percentage of available credit used, the better the score. It is a fact that people that are overextended on their debts do not pay as timely as those who are not overextended. Make sure that your balances do not exceed 30% of your available credit line, as your credit score will be lowered. If your balance exceeds 75% of your available line of credit, you credit score will decline substantially. (This category represents 30% of your credit score.)

- **Pay your obligations timely**. Pay before the due date or pay electronically or by check draft, to avoid late payments due to poor mail service. One late payment of more than 30 days in the past year can be more detrimental to a credit score than a bankruptcy that occurred more than 5 years ago! This is due to the weight given to the most recent time frame in credit scoring. (This category represents 35% of your credit score and it is the one that we can do the least about before loan closing.) If a consumer has a late payment of more than 30 days in the past year, he can raise his credit score by paying timely for the next six months. The score will climb substantially after one year of paying timely.

- **Do not use one credit card to pay off another during the 30-45 home closing period, as both credit card balances could show up increasing the available credit used and increasing the debt ratio. A**

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TIPS ON HELPING PEOPLE IMPROVE THEIR CREDIT SCORES

- **Do not use consumer finance companies.** Use banks and credit unions for personal loans. Your score is lowered if consumer finance companies show up on your credit report.

- **Never go to consumer counseling services when you are applying for home mortgage loans or if you wish to have a good credit score.** This action alerts the credit bureaus that you are unable to pay your bills and may have an effect on your credit score much like a bankruptcy would.

- **Demand that negative credit more than seven years old be removed from your credit report.** The only item that should be on your credit for more than 7 years is a chapter 7 bankruptcy.

- **To obtain a good credit score you must have a good mix of credit accounts, credit cards, bank loans, department stores and finance companies.** People with few accounts should open more and pay timely, but not just before applying for home loans. New accounts should be opened at least six months prior to mortgage loan applications, to avoid lowering credit scores. (This category represents 10% of the credit score.)

- **To obtain good credit scores one must have a lengthy credit history.** This explains why older people generally have higher credit scores than younger people. It is important for young people to establish credit as soon as possible and commit to paying timely. All they have to do to obtain good credit scores is pay the minimum payment as agreed. Credit bureaus are now accepting alternative credit information, such as letters from landlords, telephone companies, power companies and others, so that people who have few credit histories on their credit report can begin building good credit scores. (This category represents 15% of the credit score.)

- **Your credit score does not go down when you check your own credit or a bank does a credit scan on you to determine if they want to offer you a credit card or other loans.**

- **In cases where relatives are willing to provide gifts to help with a home purchase, a relative can give a large gift that can be used to wipe out debts and improve credit scores.** Most relatives know that they can give gifts for the down payment or closing costs to purchase homes, but few know that they can improve their relative's credit scores and ability to qualify. Present estate gift laws allow relatives to give $12,000 per year to as many people as they want. A couple can give someone $24,000 tax free and one couple could give another two individuals up to $48,000 per year. These gifts could be used to wipe out some or all of the debts. A reduction of all debts would lower the available credit used, increasing the credit scores and lowering the debt ratios. The majority of home buyers rejected for loans are rejected because they are over-indebted. Caution: If relatives wish to give gifts to reduce debts, thus improving credit scores, the debts should be paid off at least 30-45 days prior to home loan application, allowing time for posting the debt payoff and the rise in credit scores.

- **Another situation where relatives could help other relatives qualify for mortgage loans would be to provide gifts to buy down the mortgage rate, either permanently or temporarily.** That is, a gift of $5,000 to buy the interest rate down would lower the interest rate approximately 1% for the entire 30 years of the term, for each $100,000 of loan amount. It is easier to qualify for a mortgage at 5% than 6%. The same $5,000 would be enough for a 3-2-1 temporary buydown, which would lower the initial interest rate from 6% to 3%. Once again, it is easier to qualify at 3% than at 6%. Few relatives know that they can provide gifts to buy down the rates and help their relatives qualify for higher loan amounts.

- **If the homebuyer's credit score is not sufficient to obtain the home mortgage loan with the terms that they desire, relatives with better credit scores could act as co-borrower's, to insure that the owner-occupant can obtain better loan terms.** Many lenders allow non-occupant relatives to team up with occupants to obtain high ratio mortgages. CAUTION: The occupant borrowers must have decent credit and be paired up with people with very good credit for this to work.