



Chapter 1

The All-Important Credit Score

During my real estate and finance seminars, I spend a lot of time on credit as part of the mortgage qualification. This is the part where the people who were sleeping perk up and become involved in the conversation. More people than not have bad credit, whether from true financial hardship or sheer sloppiness. When the economy is in trouble, it is usually because consumer spending and savings are down. Consumers stop both saving and spending when the prices of consumer goods and the cost of living go out of whack, when they lose jobs, or when they are just plain scared to part with money. Bad credit is becoming an epidemic in the United States and has far-reaching effects on many long-term needs such as homeownership, renting, borrowing, opening checking accounts, getting a job, and even insurance.

Mortgage lenders do not necessarily look at the content of your credit report, but focus on the FICO score when approving and pricing your mortgage. For the purpose of this chapter, I want you to think of the person reading and analyzing your credit report as a computer. It reads and registers but does not think. (Think of Rosie the maid in the TV show *The Jetsons*. Am I dating myself?) Thus, many of the things we talk about would not make sense if a “real” person were involved and thinking. Sorry, but this is the way it is.

The FICO Score Range

FICO scores range from 300 to 850, with 850 being the best. I have *heard* that the average FICO score in America is currently in the 670 range, the 720 range, and the 770 range depending on the source. I am not sure what the average is, but I bet it is much lower! I used to say that anybody could get a loan if his score was over 500, but times have changed. I also used to discuss compensating factors, which no longer mean as much, but I will still touch on them later. Now, under the new guidelines, FICO score will affect everything from type of mortgage, to your LTV, to your interest rate.

Co-Borrowers

If there are two co-borrowers, one with terrible credit and one with good credit, the person with a high FICO score will not be able to compensate for the person with the lower score. Banks base their decision on the lower score. In this case, it is best to take the person with the lower score off the deal.

What Makes Up My FICO Score?

Five factors make up your credit score:

1. *Payment history* takes into account whether or not you've paid all your bills on time and for how long. It accounts for 35 percent of your score. If you have paid one or more bills 30 days, 60 days, or 90 days late, your credit score will drop. The longer your credit history and your history of on-time payments, the better your score will be. Remember, the computer is reading this, and it likes to see at least 24 months of credit history and at least four tradelines—mortgage, car loans, and major credit cards respectively count most. Store and gas cards don't have as much pull.

Close Store Cards

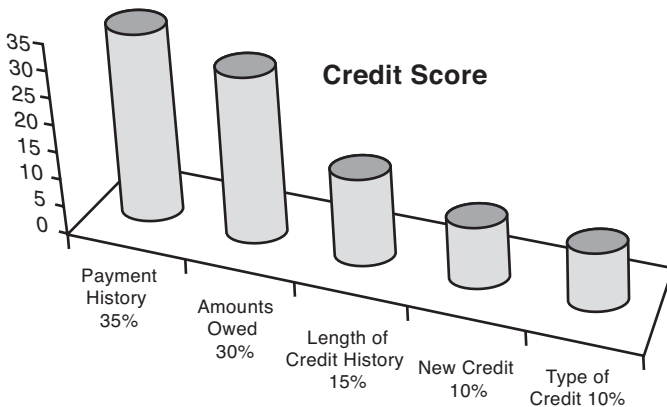
Might I suggest closing all those miscellaneous store cards? You probably only got them to get the store discount on the initial purchase. You should not rack up a bunch of cards all over the place, and besides, everybody takes Visa and Mastercard now. They can adversely affect your score by being too new and having too much credit available. (The more credit you have available, the more debt you can incur.)

2. *Amounts owed* accounts for 30 percent of your score. Debt-to-credit ratio is determined by adding up all of your current outstanding balances and dividing that by available credit. Note that the computer does not like you being maxed out; it wants you owing less than 50 percent of your available credit—on each card.

My best advice would be to have a few major credit cards and keep all of them under that 50 percent mark. I never suggest paying off your debt before you apply for a loan, because it will not make a difference. I do say make sure you know what you have, what you owe, and keep it under the 50 percent limit. I swear this can make a huge difference!

3. *Length of credit history*, the amount of time you have held each of your credit cards, counts for 15 percent of your score. Lenders want to know you can pay off debt over time. Again, the computer likes to read at least 24 months of credit history. You will not even get a score unless you have at least 6 months of active credit. However, it is better to have a few credit vehicles for 12 months than many credit vehicles for 6 months. Length of credit is more important than quantity of credit vehicles. That is why it is so important to establish credit and a good payment history early in life.

4. *New credit* counts for 10 percent of your score. Any attempts to acquire new credit (such as recent credit or loan applications) will adversely affect your score. Opening up new accounts means “I need more credit; I spend, spend, spend” to the lender, and that makes the lender nervous. If you have applied for credit and decided not to take the card, the computer will read it as if you were rejected by the creditor! Remember, you’re not exactly asking the mortgage lender to fork over chump change.
5. *Type of credit* you use (credit cards, installment loans, etc.) also is a factor in determining your FICO score, although it is unclear which types hold what weight. This category counts for 10 percent of your score. A good mix is important to establish credit, but once you have a history it will be fine to close some the less-important cards (sorry Mr. Bloomingtondale’s). However, closed accounts may still play into your credit score.



What makes up your FICO score.

Unsuited for Loan

I had a client who was borderline in obtaining a particular mortgage program with a 680 FICO score. Then, there were problems with the house she was purchasing, which took a long time to resolve, so the closing was delayed for so long that the lender had to run a new credit check. In the meantime, my client treated herself to a new Armani suit at Barney's. The salesperson enticed her with a new Barney's credit card, offering 10 percent off the suit. Of course, she took her up on it. It would save her \$200. Nevertheless, in the end it cost her 12 points of her FICO. Her score dropped below what was required for this loan, and the bank rejected her. If she had put the suit on her American Express card, it would not have affected her FICO score. Why? Because she had the Amex card for years, but the Barney's card was brand-new credit and more opportunity to spend from the lender's view. Just say no to new credit!

Credit Boosters

Here are some obvious and not-so-obvious ways to improve your score:

Pay on time: Duh. One of the best ways to increase your FICO score is to start making your payments on time on a consistent basis. Remember, payment history makes up 35 percent of your score. If you have fallen behind on payments in the past, put it in the past and start fresh today. If you have large credit card debt, just pay the minimum balance on time each month, and this will boost your credit score.

Control your debt: Your debt-to-credit ratio makes up 30 percent of your FICO score. If you have a lot of debt, start paying it down and don't add to it. Keep the plastic home for a while until you get back on track. If you're having trouble paying down a credit card, think about transferring the balance to a 0 percent interest card. That way your payments will be applied to the principle balance rather than the

interest. This will help you pay the credit card off faster. Before taking out a new credit card to make a transfer, call your credit company first and see if they will lower your interest rate.

Do not cancel your cards: I had a lot to say on this in the previous section. Remember, credit length makes up 15 percent of your FICO score. The older, the better.

Do not apply for more credit: If you want to improve your FICO score, do not apply for new credit cards and never apply for retail store cards. Each new application is a new inquiry that might not result in a tradeline. Each new tradeline is too new to show a history, so it is a negative rating. New credit applications make up 10 percent of your score and that is a negative effect.

Create a mix: Your credit mix makes up 10 percent of your score, so it is not a big deal. The computer likes to see that you can handle different types of credit. However, if you do not need a car, do not go out and lease one!

Credit Killers

As you can probably guess, the credit killers I'm going to discuss here fall into the five major categories that make up your FICO score.

High balances: If you have high balances on your credit cards and loans, your debt-to-credit ratio is going to be a lot higher than it should be, which will hurt your score dramatically. Try to keep all balances below 45 percent of available credit.

Late payments: If you don't make your payments on time, your credit score is going to take a major hit. You don't have to pay the whole balance at once, just the minimum balance each month. Fair Isaac has three categories for late payments: 30 days late, 60 days late, and 90 days late. Being 30 days late will drastically reduce your score, which, as you can guess, means that if you're 90 days late, your score will nosedive.