4 C's of Lending

Version 2.1

- Credit - Cash - Capacity - Collateral

Online Recordings - Part 1 / Part 2 - Main Site 4 C's -

Credit

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The biggest reason why borrowers do not qualify for a mortgage is due to their credit or lack of credit. There is a huge misunderstanding about credit and credit scores. Credit has a dramatic effect on your ability to qualify for a mortgage and your interest rate.

There are 3 major credit bureaus in the United States. Equifax, Experian and TransUnion. Your mortgage lender will pull a merged credit report which will combine the information from all three credit bureaus into one report. Each bureau will give you a credit score or rating on your credit.

Credit is only obtained and reported to the credit bureaus when the company you make payments to reports the payment history to one or even better all three of the credit reporting agencies. So items like rent, insurance, cell phones, and most utilities, doctor, or dentist bills are not reported to the credit bureaus. Items that are reported to credit bureaus are student loans, car loans, credit cards, mortgages and other installment loans and some utility bills.

NO CREDIT

Some young borrowers coming out of high school or college and have no credit score. There are very few lenders that will offer loans to borrowers with no credit and even the ones that do charge a higher rate.

If you do not have a credit score, you can not get a conventional loan which is less expensive than an FHA loan. In order to get an FHA mortgage, the borrower still has to have at least three lines of alternate credit. Alternate credit consists of a minimum of 12 months of payments that are not reported to the credit bureaus such as rent, utilities, cell phone, car insurance, doctor, and dentist bills. These type of FHA loans with alternate credit have a higher default rate so the qualifications are more difficult.

We normally recommend and educate people to start obtaining credit at age 18 or shortly after if they want to purchase a home in the next few years. It normally takes about 12 months of making payments to creditors that report to the credit bureaus to establish a good credit score. The credit reports are normally about a month behind in reporting payments.

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ESTABLISHING CREDIT

Everyone is allowed to get one free credit report per year and you can go to www.annualcreditreport.com to request a copy of your credit report from Equifax, Experian and TransUnion. Although these free reports do not give credit scores, they will show you what is being reported by the creditors to the credit reporting agencies. Please be aware that credit reports may contain errors. A recent study shows that 25% of credit reports contain errors serious enough to deny or affect the rate of a mortgage. It is important to check your credit report every year for errors such as accounts that have actually closed, accounts that do not belong to you, and accounts (usually collections) that are listed more than once.

Another good site is www.creditkarma.com. This site is free and will provide you with your TransUnion Score and another scoring system and will continue to monitor your credit and give you advice on how to continue to increase your credit score. It is best to have 3 payments reporting each month. I don't encourage people to borrow, but I do encourage them to establish a credit record to obtain the best mortgage at the lowest interest rate by following these 3 steps.

1. Open up a sharebuilder account at a local credit union or bank. This is a special account that many credit unions and some banks offer. This account is a 12 month certificate of deposit. For an example, a person can open up a savings account and have the credit union draft $45 each month out of this account and put it into a certificate of deposit.

   The credit union reports this deposit or payment to all three credit bureaus each month and at the end of the year you get back your $540 ($45 x 12 months) plus interest. This is an option available in my lending area. You can check in your area to see which banks and credit unions offer a similar program to establish credit without borrowing money.

2. Open up a joint credit card with your parents or someone else with a positive established credit history. Just charge one tank of gas instead of paying for it by cash once a month and pay your bill on time in full each month. MAKE SURE TO NEVER CHARGE MORE THAN 25% OF THE LIMIT ON YOUR CREDIT CARD DURING ANY MONTH.

3. Open a credit card in your name alone or even a secured credit card. A secured credit card requires you to deposit the limit of your credit card in the bank as security. Again only use your credit card for 1 item a month and pay it off in full each month so you pay no interest. Make sure to ask if the credit card reports to the three major credit bureaus and look for a card with no annual fee. The interest rate is not important if you always pay the card off each month.

I did this with 2 of my children and they both own a home now and have credit scores in the upper 700's. My third child just turned 19 and will be opening up these accounts soon.

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CREDIT SCORES

Starting in the 1960's, the credit bureaus assign a credit score to each borrower. The credit scoring model is used to establish a risk factor in determining the likelihood of a consumer to pay off debt. There are many different scoring models but most use the FICO (Fair, Isaac and Company) which produce scores that range from 300 to 850.

I like to use the analogy of a grade point average, the higher your grade point average the better your chance of getting into the best college. The higher your credit score the better the chance of getting approval for a mortgage with the best interest rate. About 11% of the US population is between 600 and 649, 13% between 650 and 699, 14% between 700-749 and 25% between 750-799 and 16% above 800.

Every mortgage lender will use the middle of the three credit scores from Equifax, Experian and TransUnion and the lowest score of all borrowers will be used on each application to determine qualification and the rate of the mortgage.

What makes up the score?

1. 35% of the score is based on payment history. Did you make your payments on time (not 30, 60 or 90 days late)?

2. 30% of the score is based on the ratio of your balance to your credit limit. Many people say it is based on amount owed but this is really not right. The credit scoring model looks at available credit. It is best if you never let your balance go over 25% of your limit. Each credit card reports at different times during the month so if your limit on your credit card is $1000 you never at any time during the month want to use more than $250. Keeping your balance to credit limit ratio below 25% is the fastest way to raise your credit score.

3. 15% of the score is based on the length of your credit history. The longer your credit history the higher your score. The credit scoring model emphasizes the last 24 months.

4. 10% of the score is based on the type of credit. Your mortgage is the highest form of credit and counts the most in the scoring model, followed by installment loans like car loans or student loans and then revolving credit, such as credit cards. It is best to have all three types of credit if you want the highest score.

5. 10% of the score is based on inquiries. An inquiry is when a lender pulls your credit report because you requested a loan or opened a credit card or inquired about a loan. You don't want to be continually having lenders pull your credit report as your score will drop.

   - All inquiries for similar credit like a car loan count as 1 for 45 days.
   - The higher your score the faster it will drop with any negative credit.
   - One 30 day late can lower your score from 70 to 130.
   - One 90 day late will drop you about 100 to 130 points
   - Foreclosure will drop your score 150 to 160 points

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Credit Score Do's and Don'ts

1. Don't apply for new credit of any kind as this will actually lower your score unless you are trying to establish credit and have a number of months before you apply for a mortgage.

2. Don't close credit cards as this will reduce your available credit which is 30% of your score and your length of credit history which is 15% of your score.

3. Don't payoff collections or charge offs. Generally paying these off lowers your score because it brings the date of activity up to the current date.

4. Don't add additional charges to your credit card as again this will reduce your available credit.

5. Don't consolidate debt on your credit card unless your new debt is less than 25% of your limit.

6. Don't dispute an item with the credit bureau as most programs require disputed items to be resolved prior to closing.

7. Do join a credit watch program. Many banks, credit unions or credit cards offer a free service which will alert you to any changes on your credit report.

8. Do continue to use your credit card so each month it reports another on time payment.

9. Do stay current on your existing accounts.

10. Do call your loan officer if you have a question on your credit.

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Why is your credit score important?

1. Mortgages have a minimum credit score criteria, currently this is 580 for many lenders

2. Your interest rate and the type of mortgage will be affected by your credit score.

3. If your loan has private mortgage insurance this is also affected by your credit score.

4. Your credit score is also used for other loans and also affects the premium for most car and although many require 620 or even 640 home insurance companies and many employers also pull your credit report.

I recently saw an analysis where two borrowers had the same job and income and one had a credit score 80 points lower than the other one. They assumed each would take out an average mortgage, and keep an average balance on their credit card and use car loans over a their lifetime. The borrower with the lower credit score paid 1 MILLION more in interest.

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CREDIT SIMULATOR

Once the lender pulls a credit report we have the ability to run your credit report through a simulator. This simulator takes the information from your credit report and provides the lender with how changes to your credit will affect your credit score. Say for example if you paid a credit card down by $1,000 it might improve your credit score by 30 to 45 points. Although it will not guarantee an exact improvement in score it will give us a pretty good idea on how much your credit score will increase. Once the client pays down a credit and gets us proof we contact the credit reporting company to update the account and have the credit report rescored. This gives us the ability to look at doing different scenarios to see what will improve your score the most, which will help you either qualify for the loan or enable the lender to offer you a better rate.

This is one of the main reasons getting prequalified before you purchase a home is so important. We normally recommend you get prequalified by meeting with your lender at least 60 days or more prior to going out to look at homes. It allows the lender the necessary time to analyze and either correct errors or get your credit rescored if necessary.

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CREDIT REPAIR

There are really two ways to do credit repair the first is working on it yourself and the second is paying for a professional credit repair company to work with you to improve your credit score. The decision on how to pursue credit repair really depends on the discipline of the individual, the time frame and the extent of the repair.

Obvious errors such as unauthorized inquiries, incorrect date of last activity, paid accounts or paid judgments can be resolved by the borrower contacting the creditor to have them correct the error and report it to the credit bureaus. If information is mailed such as cancelled checks or other proof it is always best to correspond with the creditor or credit bureaus with certified mail return receipt requested and keep a copy of all correspondence for life.

Unfortunately many times the item is cleared off the credit report and then will appear again months or years later. If you contact one of the credit bureaus directly according to the fair credit reporting act they have 30 days to verify your concern or they must remove it from your credit bureau report. I recently had a borrower that contacted a creditor where they had a credit card and there were errors on the credit report. They were corrected by the credit card company and reported to all three credit bureaus and the credit score improved by 80 points.

Simple credit repairs start off will a “Goodwill Letter”, where a customer missed one or two payments but has again paid on time for at least 3 to 12 months and humbly and politely asks the creditor to remove the late payment from their creditor report.

Beyond any of the items listed above we normally request the client work with a credit repair company that we recommend. They are experts in the area and have all the right contacts and legal forms and can expedite credit corrections and or removal by referencing all the legal protections the consumer has.

Many times credit repair companies can work with creditors to get substantial discounts on debts or are even able in some instances to get items deleted in exchange for payment. They also monitor the credit score and will notify us when you have reached the minimum required score. Although they do charge a fee, this will help you stay motivated to the plan that they have established and will stay in contact and can continue to coach and encourage you.

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