

Know Thy Credit Score

by Dave Muti

Benjamin Franklin once said “credit is money”. Although he was referring to actually having credit with a store to purchase things, his quote still rings true today. Almost all decisions today whether applying for a credit card, a new apartment to rent, a mortgage or even homeowners insurance (yes homeowner’s insurance) look at your credit score before quoting you a particular interest rate or premium. In essence it has become the filter for many industries in making the determination “do they want to do business with you and at what price”. This article explains “what” a credit score is, what it is based on and how you should maintain it.

The most common credit score we hear about is the FICO score. This is a score that was created by the Fair Isaac Corporation and it is the standard for the mortgage industry as well as many others as indicated above. Your score can range from a low of 350 to a high of 850. The higher the score the lower the interest rate you’ll be offered saving you hundreds if not thousands of dollars a year. The magic number you want to remain above is 720. About half of the country maintains a score above this magic number. Begin to move below this number and interest rates may begin to rise. Fall below 500 and you may not be able to take out a mortgage even if you currently have one. “How is my score determined” is one of the most common questions I get from clients that are trying to improve their credit score. While we do not know the exact formulas used by the three biggest credit agencies (they are beyond the scope of this article) that use Fair Isaac Corporation’s standard of scoring here is what we do know.

There are five key elements that make



up your score. How you pay your bills (your payment history) makes up about 35% of your score. How much you owe is 30% and how long you have had credit is another 15%. The type of credit you have and new credit issued make up 10% each.

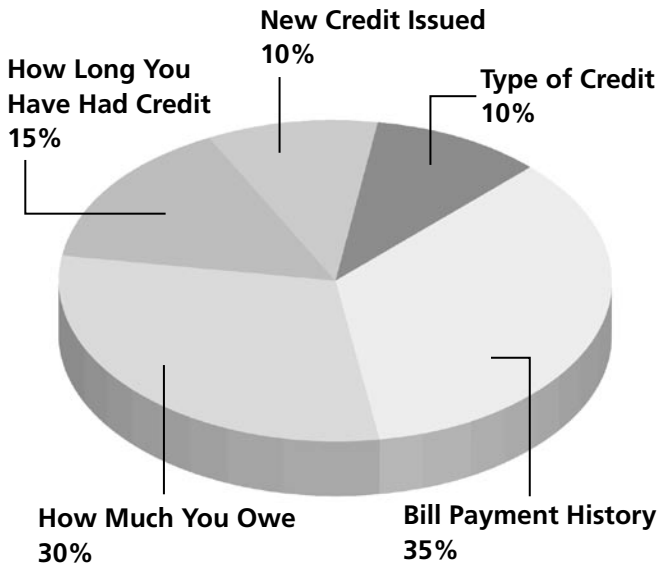
Factors that are NOT considered in this formula are your income, savings, age, race, geographic location or marital status. Basically the score indicates your track record of making payments to companies you owe money to including your utility bills. Although it appears like an exact formula it is more of an art form in knowing what affects each component.

The largest factor is “do you pay your bills on time”. Of course it is best to always pay your bills on or before the date that they are due. While you may pay a bill a couple of days late and incur a late charge, having a “late” on your credit report means that it is 30 days or more past the due date. The more lates you have the lower your score will go. Have a bill that is 60, 90 or even 120 days late and your score will rapidly decrease. Even if you have a “late” on your report, the more time you gain between

that date and the current date your score will improve. The mortgage industry has two major thresholds in looking at any late payments on your report. Are they older than 12 months and 24 months? Each milestone will provide you with better financing solutions as your late payments fade with time. Also, a mortgage late is much more serious than a credit card late. So if it comes down to a choice “what bill should you pay” always make your mortgage payment and never miss this one. The consequences are far too great.

How much you owe is the next biggest and this combined with types of credit you have available make up the “art” side of the calculation. You might be thinking if I owe less I will have a better score. Unfortunately that is not always true. This portion of your score is determined by a delicate 3-way dance between the types (mortgage, car loans and credit cards) partnered with how much do you owe and how much do you have available to you. Having too many credit cards can be a negative and so can only having one. Also, having a credit card with a large limit can be a good thing if you

How Your Credit Score is Determined



are not near that limit. Same with a second mortgage or a home equity line of credit. When you have lots of credit available you want to make sure you “use” that credit but do not maintain a high balance. The closer your balance is to the maximum credit available to you, the lower your score will go. The last two components are the length of your history and new accounts. Of course the longer you have a credit history the longer your track record will be but another important factor is how long you have had a particular account. The longer an account is open and active the better your score will be. Open up a bunch of new accounts and/or playing the credit card switching balances game does not bode well. So now you know what a FICO score is and how it is calculated. The big question is now; how do you maintain it?

Most people don't plan to fail, they simply fail to plan and as the saying goes, by failing to plan you plan to fail. It happens all too often in our business and if clients regularly monitored their credit scores we would be able to save them thousands of dollars on their mortgages. What this means is if you are planning to buy a home don't just look at houses, make an offer and then get a mortgage because you may not like what you are offered as a result of your FICO score. My suggestion is to plan this event. The same holds true if you are thinking about refinancing.

Improving your credit score is kind of like getting ready to run a marathon. You can't just sign up today and expect to run tomorrow. If you have a poor credit history or if there is inaccurate information on your report it can take months to repair and/or correct this information. I have a saying that I have been using for over 15 years and that is “Make Life Happen!” Don't sit back and let it happen to you. Being proactive with your credit scores (like

many other areas of your life) will improve the results and your experiences. Now some of you reading this will be thinking; I don't have to worry about this because I have never missed a payment and I have excellent credit. Yeah well so did a client of mine when we were in the process of obtaining a loan for him.

This client, we will call Mark, was referred to us by an attorney and Mark was only 30 days away from his purchase closing date. Mark advised that his credit was perfect however when we ran it as part of his application it turned out that it was not. One of the student loans that Mark co-signed on behalf of his daughter indicated several missed payments despite the fact she was still in school and the first payment was not due for 2 more years. We still got the mortgage approved at a rate and payment Mark could live with but had Mark proactively monitored his credit scores he would have had a better interest rate. Mark did in fact contact the student loan provider and they agreed that it was a mistake but the damage was done. They corrected the information with the credit agencies but they did not reflect this until two months after the closing so it was too late to affect that mortgage.

In that example “life happened to Mark” and if he was proactive about his credit score he would have been better off. This is not a hard thing to do – it is just like going to the gym, you have to be regular about it. While I am not suggesting that you monitor your scores daily or even weekly, I am suggesting that you institute a bi-annual credit review to ensure your credit is the best it can be so you are not caught off guard like Mark.

If you would like to read more in-depth information about what you need to know so you can take control of your finances simply go to www.MyFICO.com and download a FREE 20-page booklet entitled: Understanding Your FICO Score. They also have a paid service that you can sign up for to be alerted anytime there is a change to your score and/or credit history. In today's world of stolen identity this could prove to be a prudent investment. Not only will you save money by ensuring you have good credit but you may be able to prevent any fraudulent charges against your name as well as accruing interest and legal fees should you be an unfortunate victim. You can also obtain free credit report by visiting www.annualcreditreport.com. At the very least monitor your credit twice a year and you will be happy you did; Make Life Happen!



David Muti, JD, RMA, a Senior Mortgage Planner with Millenium Home Mortgage, LLC, is a founding member and President of Forgotten Equity, Inc.

He can be reached at 973.402.9112, via email at dave@TeamMuti.com, or visit www.TeamMuti.com.