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Beyond the Rate – Chapter 6

Is anyone telling the TRUTH in the mortgage business??

Hello and welcome to Beyond the Rate, a series of podcasts that are designed to educate the listener on the world of finance and in particular, the mortgage business. This is Chapter 6 and we'll be looking at credit and credit scoring. We'll identify the three primary credit repositories here in the United States and discuss what elements become part of your credit score.

My name is Patrick and I'm a Mortgage Banker here in the San Francisco Bay Area. I'm your host and I really encourage you to subscribe to this series for an informative and detailed account of how the mortgage industry operates and how to navigate through all the confusing programs and deceptive marketing techniques being used by some of today's Mortgage Brokers.

Please note that the text versions of these podcasts are now available for free download at my website at www.beyondtherate.com.

When it comes to your mortgage, or even a car loan or your credit cards, the interest you pay is directly tied to your credit score. Back in Chapter 3, we discussed the 3 pillars of underwriting: credit, income and assets. Well, credit is probably the most important yet few of us truly understand where these scores come from and how they're calculated. That's what we'll be discussing in this Chapter.

Credit scores are calculated and provided by three primary credit repositories: Experian, Equifax and Trans Union. These are basically huge databases that house credit information on almost everybody in the country. And how do they get all this information about us? Well, creditors (like car companies, credit card companies and mortgage companies) are always looking for information about potential clients; people like you and me. They get that information from these repositories but in exchange, they agree to provide data about all their customers back into the same databases. Almost all of your credit providers report your payment history into these databases and every time you obtain a new credit account, that account is reported under your Social Security Number.

Credit reporting in its current form is still relatively new and a lot of people, particularly in the older generations, are still unaware of all this information being held about them and their credit histories. My own parents, for example, were shocked when I told them such databases exist and the extent of information available. And it's amazing the number of things in our lives that are affected by our credit scores, so an understanding of the things they look for when calculating our scores can be incredibly beneficial for those who want to manage and optimize their scores.

Let's start with a definition. What is a credit score actually trying to reflect? Well, the exact thing a credit score intends to predict is this: the probability you'll have a 90-day late on a trade account within the next 24 months. That's what they're actually trying to predict. And as you can imagine, there are a number of things that increase the probability you'll have such a late payment and those are the variables that make up your credit score. Now, the formulas and algorithms being used these days are incredibly complicated and they change periodically as well, so it's impossible to lay out the exact components and their respective weights. But the basic structure is well documented and we'll take a look here in just a minute or two.

First, you should know that the median credit score in this country is right around 720. That means half the population has a higher credit score and half the population has a lower score. It's actually just a bit higher than 720 – about 722 is the latest I've heard. Pretty high, huh? It's true. So the average person in this country has pretty darn good credit. In fact, only about 1% of the population has a score below 500. So, that means at least half the population should be in A-paper mortgage programs. It's true that income and assets also play a major role in mortgage underwriting but at least from a credit perspective, most people should be in A-paper mortgage programs. Sadly, that's not the case.

As mentioned in Chapter 2, many Mortgage Brokers gently nudge their clients DOWN the ladder of loan programs because it makes their lives easier. The guidelines are looser in Alt-A and Subprime programs so you don't have to get as much documentation and it's easier to get an approval. Listen to Chapter 2 for more detail on this. Well, what you want is someone who'll instinctively push you UP the ladder and try to get you into the best possible program you qualify for. And with a 720 credit score, you're off to a great start.

We should also mention that there are actually 10 different score cards that calculate credit scores. They're each designed to evaluate a different set of circumstances. Are you young with only very recent credit history? If so, that's one of the score cards and it focuses on different metrics than the score card for someone who's had a 30-year credit history. Do you own a house and have mortgage debt? That's reflected in different score cards as well. Have you ever declared bankruptcy? That's an entirely separate score card also – and the strictest one of the bunch, by the way. There's no question that you should avoid bankruptcy however possible, because it'll put you on the bankruptcy score card for

seven to ten years – and that’s not a good place to be. Bankruptcy should be the absolute last option.

And lastly, before we look at how the scores are calculated, we need to discuss the fact that each of the three credit repositories has its own score. We’re all familiar with the FICO score – everybody refers to the credit score as the FICO score, but that’s only Experian’s version of the credit score. Equifax has the Beacon score and Trans Union has the Classic score. Although they’re all quite similar, they’re each calculated slightly differently. It’s also important to understand that our creditors don’t necessarily give our credit information to all three repositories so they may each have slight variations of our credit histories, resulting in different scores. In the mortgage business, we always have to use the middle score – not the highest, not the lowest, but the middle credit score.

Okay. So for your credit score, the single biggest component is your Payment History. It accounts for a full 35% of your total score. That’s more than a third. It’s a huge component so making your payments on time is the best thing you can do to keep your credit score healthy. Within Payment History, the repositories look at (1) recency, (2) frequency and (3) severity. If you’ve had two 30-day lates in the past six months, that’s a lot worse than two 30-day lates a year or two ago. In fact, they consider the most recent six months the most, followed by the past two years and then anything more than two years old. The more recent, the bigger the effect on your score. Obviously, a 60-day late is worse than a 30. And if you’ve had a 90-day late, that’s the worst there is. Remember that THAT is exactly what they’re trying to predict. So if you’ve had a 90-day late in the past six months, you can rest assured your credit score took a beating as a result.

The second biggest component of your credit score is your Revolving Balances; that’s the outstanding balances on your revolving tradelines. Your “revolving” tradelines include all your credit cards as well as your lines of credit. Yip, it’s true. Your line of credit is considered a revolving tradeline. Now, the repositories have adjusted their algorithms such that any “revolving” tradeline greater than a certain size is automatically considered an installment debt. The actual threshold varies periodically, but I believe it’s currently around \$32K. But indeed, a line of credit below that threshold is considered a revolving tradeline.

Anyway, your Revolving Balances account for 30% of your total score. So, between your Payment History and your Revolving Balances, we’ve already covered 65% of your total score. These are the pillars of your score – by far, the most important.

Obviously, the higher your balances, the lower your score. It makes sense if you think about it. If your balances are really high, there’s a higher probability you’ll have a 90-day late in the next 24 months. It makes sense. And the repositories calculate your balances both on individual accounts as well as aggregated across all your accounts. So while there may be some small benefit spreading your balances around on different credit cards, it won’t make a big difference overall. The best thing you can do is pay your balances down.

It's worthwhile noting your credit score has absolutely NO memory. So if you've got a high balance today and you pay it off tomorrow, your credit score could be substantially higher tomorrow. It's also worth noting your creditors do NOT report your balances every day or even every week. Most report once each month and the day they pick may OR may NOT coincide with your statement date. So the balance reflected on your credit report may NOT match the balance reflected on your most recent statement. Anyway, your score is calculated at the time it's requested so it'll reflect the information in the database at that moment in time. If your balances are high, your score will be lower. If your balances are low, your score will be better as a result.

The next biggest component is your Credit History. It accounts for 15% of your score. So between your Payment History, Revolving Balances and your Credit History, we've not accounted for a full 80% of your total score. Your Credit History looks at the age of your oldest account and the number of new accounts opened recently. Again, the logic makes sense. If someone's opening a ton of new accounts, there's no history to see how he or she will deal with all these new accounts. So with these new unknowns, the risk level goes up and the credit score goes down. It's never a good idea to open a bunch of new accounts. From the perspective of your credit score, it's good to have between five and seven accounts but if you don't have that now, don't try opening them all up at once – especially if you plan on buying a car or a house in the near future.

Next on the list is the Type of Credit. It accounts for 10% of your credit score. Type of Credit looks at both open AND closed accounts. It looks at the type of credit you use and how many accounts of each you have, or have had. The three major types of credit are (1) revolving, (2) installment and (3) mortgages or real estate loans. But there is one subcategory under the label of revolving that hits your score harder than the rest, and that's the finance company installment accounts. These accounts are the "no payments 'til 2007" type of accounts. You know the ones. Buy now, pay later. The credit repositories know what they are as well, and they know the risk of a 90-day late increases when someone goes out and buys all kinds of furniture and flat-screen TVs without having to pay anything for it. Avoid these types of promotions whenever possible.

The last component of your credit score is the Number of Inquiries. Inquiries account for the final 10% of your credit score. Now, there are two types of inquiries. We all get tons of credit card offers in the mail. Well, each of these companies checked our credit before sending us their offers. But don't worry; they're not considered in our credit score. They're called Soft Inquiries because we didn't request the credit. Many people worry when they get these offers that all these inquiries are reducing their credit scores but that is NOT true.

The second kind of inquiry is a Hard Inquiry. That's where you signed something authorizing a company to check your credit because you're applying for a new credit account. So every time you apply for a new credit card or try to buy a car or a house, those are all Hard Inquiries. Only these inquiries are considered in your credit score. Generally speaking, you should limit the number of inquiries to 5 to 7

per year. Yeah, that's PER YEAR. 5 to 7 per year. Your credit score will look at the most recent 12 months and each individual inquiry can affect your score by 5 to 15 points, depending on the type of credit applied for.

Now, when we're shopping for a car or a mortgage, we frequently consult with multiple places before we make our final decision. We might visit three or four different car dealerships. We might speak with two or three different Mortgage Bankers before submitting our loan application. The credit bureaus know this and they've adjusted their algorithms accordingly. For auto inquiries, you can have an infinite number of inquiries within a 14-day window and they will all count as a single inquiry. For mortgage inquiries, you can have an infinite number of inquiries within a 45-day window and they'll all count as a single inquiry. So don't worry about speaking with multiple people. That, in itself, will not reduce your credit score.

Here are a couple quick notes. First, be very careful when paying off old delinquent accounts. If you've got an account you haven't paid in months (like some old medical account, for example), the affect on your score has faded as the months passed. If you haven't paid the account in 2 years, that delinquent account is now 24 months old and is probably having a relatively small affect on your score. If you then decide to pay the account, all of a sudden, it brings that delinquent account back to the current month. Now, there's activity on a delinquent account WITHIN the LAST month. In other words, paying an old delinquent account can easily lower your credit score in the short term.

Now, that's not to say you should avoid paying these accounts but you have to do so carefully. By paying these delinquent accounts, it's like cutting the anchors off a boat. After they're paid, the boat can sail away much easier. In other words, your credit score can improve much easier if those accounts are paid. But the initial impact is that your score will probably drop. If you're applying for a mortgage, arrange to have these accounts paid through escrow at the END of the transaction. Believe me, your Mortgage Broker will understand. Pay them at the end. That way, you'll get the benefit over time and the initial drop in your credit score won't affect the underwriting approval on the loan.

Here's a second note. Everybody in this country is entitled to one free credit report each year and it's wise to order and review it for errors. But keep in mind that the scores calculated for these "consumer" reports can be quite different than those calculated for regular "credit" reports. I'm not certain of the reasons why but please be aware that the score you get on your free annual report may be different – and often higher – than the score we get as a mortgage company.

Okay, so if you like what you hear on this podcast, please tell a friend about it. My goal is to become a recognized authority in my field without having to sacrifice my freedom to tell the truth, even if it reflects poorly on my industry. Technology like podcasts can help elevate new and innovative thinkers but we all have to play our part to help spread the word for those who deserve our endorsements. If I am deserving of yours, my thanks.

If you are considering a purchase or a refinance, please call me to discuss the options. I'm a Mortgage Banker. It's what I do for a living. Interest rates change everyday but I'll promise you two things; I'll tell you the truth and I'll do the best I can. My office phone number is 925-465-1223. Again, that's 925-465-1223. You can also reach me by email at patrick@beyondtherate.com.

See you next time for Chapter 7. We'll be looking at some remaining details to consider when preparing for a refinance or purchase transaction. These details include prepayment penalties and which index would make the most sense for an adjustable rate mortgage. It's fascinating stuff. Stay tuned.

Bye for now.