CREDIT SCORES ARE IMPORTANT ON MORTGAGE LOANS

Until l993, mortgage lenders had traditionally relied on underwriters to determine if a borrower was worthy of a mortgage loan. The underwriter would mail out employment and bank verifications, order a credit report and review each piece of information when it was received. The underwriter or loan committee would meet to determine if the borrower met the guidelines established for the type of loan he was applying for. This process would often take weeks or even months to gather the information and make an underwriting decision. **In today's fast paced market, lenders want to be able to make decisions within 24 hours, if possible. So lenders have had to change the way mortgage loans are underwritten.**

One of the first changes made to speed up the underwriting process was to accept verifications of employment through pay stubs, rather than written verifications through the U.S. mail. Likewise, bank statements have replaced the need for written bank verifications. Court papers and canceled checks are often used as proof of additional income sources such as child support or alimony. Next, credit reports started coming with credit scores.

Credit scoring is an numeric way of weighing various financial factors, like income, debts, job history, credit history, and other factors, which can help predict the likelihood of the borrower defaulting on the mortgage. While there are a number of credit scoring models used, most lenders seem to use the Fair, Isaac & Co. (FICO) score that ranges from 450 to 900. The lower the score the higher the risk. Credit scoring is now part of the credit report that the lender gets when a borrower applies for a mortgage.

The formula for the Fair Isaac creditworthiness score deals only with financial information about a borrower and doesn't consider such factors as place of residence, age, race, sex or nationality. The score is developed by giving weight to the following areas: **Record of timely payments on loans-35%, the amount and type of outstanding debt-30%, length of credit history-15%, the mix of credit accounts-credit cards, department stores, finance companies, bank loans-10%, number and types of accounts opened recently-10%.**

While the credit scores have some merit, there are different systems of scoring and the borrower may actually have three different credit scores at the three major credit bureaus. This is why FNMA recommends that lenders obtain credit scores from two of the three major credit bureaus and compare the scores. The lower score is used when only two scores are obtained. The middle score is used if all three credit bureaus are used.

While the credit score is only a tool to help lenders determine their risk, FNMA conducted tests on one million loans and found that one in eight borrowers with a FICO score below 600 were either severely delinquent or in default. On the other hand, borrowers who had a FICO score of 800, only one in 1300 borrowers were severely delinquent or in default.

While individual lenders are allowed to set up their own requirements for credit scores and there are no established guidelines, most lenders seem to generally agree on the following grading system:

CREDIT SCORE	RATING	
750-850	A+	Excellent: entitles the borrower to the best interest rates and terms.
740-749	A	Very good: entitles the borrower to lower interest rates and terms than B.
680-739	B	Good: The borrower pays higher interest rates than A or A+.
620-679	B-	Fair: Borrower would pay higher rates and be required to put more money down.
340-619	F	Poor: Borrower would not be eligible for conventional mortgages in most cases.

It should be noted that conventional lenders began requiring more down payment on conventional loans in 2008 when the credit score was under 680. If the credit score is between 620-679, 10%-20% down may be required.

Conventional lenders experienced very high foreclosures by the end of the year 2006. Subprime loan foreclosures reached epidemic proportions and consequently they were discontinued. Loans where the borrower's income was not verified, posted very high foreclosures, as did conventional loans disregarding income to debt ratios. As a result of the high rate of foreclosures on conventional loans, conventional lenders became very conservative and required higher credit scores, went back to using income to debt ratios and eliminated loans where the borrower's income could not be documented. When the value of the property started to fall in 2006-2007, many adjustable rate and fixed rate conventional loans went into default, so lenders required larger down payments to stave off future foreclosures.

Conventional borrowers now have to have high credit scores, meet income and debt tests and make a down payment, just like is was prior to the lending boom of 2001-2006.

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Once the underwriter has obtained the proof of employment, proof of assets and the credit report to include the credit scores and all other required documents, he may seek loan approval through Automated Underwriting Systems (AUS) which are available through FNMA and FHLMC. The computers (using models) can approve a buyer for a mortgage loan and the purchase of that loan in two minutes or less. This not only speeds the qualifying process for the borrower, it assures the lender that they have a source to sell t eh mortgage to in the secondary mortgage market. Today's real estate purchase transaction can actually go from loan application to loan closing in 3-10 days, if everything goes without hitches! However, the average time frame to close is much longer, usually 30-45 days.

Many borrowers want to know how credit scoring works and how to improve their credit scores. Credit scoring takes into account numerous components. **<u>For example, the longer that you have had credit without late payments the higher the score. The more sources of good credit references that you have the higher the score.</u>** **On the negative side, slow payments lower the credit score, as do high loan balances.** Credit scoring also weighs how much available credit the borrower has used. For example, **if account balances are 75% or more of the credit limit, it may signal high financial leverage and a higher risk to the lender.** Since the lender compares the amount of debt the borrower carries compared to the amount of income he earns, it is important to keep available credit reasonably low. **Credit balances should not exceed 30% of the credit limit.** Therefore, a borrower can improve his credit score by paying off or paying down outstanding loans. Some borrowers could improve their credit scores 60 points or more by paying off all of their credit balances. (Tip – It is legal to receive gifts to pay off a borrower's debts to improve their credit score and lower their debt ratios, although few are aware of this credit enhancing technique.)

Borrowers should avoid opening too many new accounts if they desire high credit scores; on the other hand some borrowers actually need to open some additional accounts to establish a good mix of credit accounts. But this should be done six months to a year before applying for mortgage loans.

Borrowers may shop their financing at numerous lenders within a 45-day period, as they will only count as one inquiry.

The single most important thing that one can do to improve his credit score is pay timely. A payment that is more than 30 days late in the past year may harm a credit score more than a bankruptcy that occurred more than five years ago! (This late payment may reduce their credit score 20-80 points!)

Never use on credit care to pay off another credit card, when you want a high credit score, as this may lower the credit score, as this is an indication of substantial borrowing activity. It may also increase the total debt. Therefore, the borrower should abstain from this practice, if he desires high credit scores. The borrower needs adequate time to change a credit score, as it takes time to get accounts paid off or closed and posted to the borrower's credit report. **Another tip - borrowers should avoid using consumer finance companies, as credit scores are lowered for those using this type of credit.**

In general, a borrower is considered to have good credit and would be eligible for 'A' quality loans and interest rates as long as his credit report shows nothing more detrimental than the following and he could adequately explain why any payments were past due.

- **Revolving credit (credit cards): No more than two payments 30 days past due, and no payments 60 days past due. (One payment that is 30 days late reported to the credit bureaus can lower the buyer's credit score by 20-80 points, which can prevent some buyer's from obtaining the mortgage loan.)**
- **Installment credit (car loans): No more than one payment 30 days past due and no payments 60 days or more past due. (A payment that is 30 days late can lower a buyer's credit score 20-80 points)**
- **Housing Debt (first second mortgages or rent): No payments past due.**

If the borrower's credit does not fit the above guidelines, he would not be eligible for "prime" secondary mortgage market loans and interest rates. However, a "sub-prime" lender could still make him a mortgage loan at higher interest rates. In the period from 2000-2008 many lenders made sub-prime loans and charged the borrower an additional .5% to 5% more than standard rates. **NOTE: As of 2008 few lenders were willing to make sub-prime loans, due to the high foreclosure rate on them and a lack of investors willing to buy the loans.**

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