Why Your Credit Rating Matters

Before a lending institution will give you a mortgage to purchase a new home, it wants to estimate how much risk you present as a borrower. If the bank perceives you as having a high default risk, it will protect itself by charging you a higher interest rate for a loan or if the perceived risk is high enough, by denying you altogether.

So how do banks determine how risky of a proposition it is to loan you money? The most valuable tool they have is your credit report.

What is a Credit Report?

Your credit report is a summary of the credit you have been extended in the past and how you have handled it.

Are most or all of your payments made on time? Have you had a repossession or foreclosure due to nonpayment? Any accounts in collections? How close are your balances to your credit limits?

This is the kind of information that is visible to prospective lenders in your credit report.

"Maybe we'd better airbrush this credit report before applying for a loan."

What's the Difference?

It is important to differentiate between a credit report and a credit score, both of which are used by most lenders to make credit decisions.

Your credit report features the summary of information on your credit history as described above.

There are three major bureaus that issue credit reports:

- Experian
- Equifax
- Transunion

The information from the three bureaus is very similar; however, there are occasionally slight discrepancies, as some creditors do not report to all three bureaus.

In addition to providing credit reports, each bureau has a formula for taking the information within the report and using it to generate a numerical credit score, also known as your FICO score.

FICO scores range from 350 to 850. Most lenders consider borrowers with 720 FICOs and above to be "A" borrowers.

Borrowers with FICOs between 620 and 720 can generally still get a mortgage but with less favorable rates and terms.

With a FICO below 620, it can be difficult to get a mortgage at all; however, there are some niche programs such as FHA loans which offer mortgages to people with very low FICO scores in certain circumstances.

How are Credit Scores Calculated?

To better understand your FICO score and the steps you can take to improve it, it is important to know how it is calculated.

Each bureau uses a slightly different formula, but for the most part, here are the components of your credit report that affect your score and what percentage of your score they account for:

- 35 percent is your payment history. How many of your monthly payments have been 30, 60, or 90 days late?
- 30 percent is your debt to credit limit ratio. The closer your debt is to your total credit available, the higher default risk you are perceived to be.
- 15 percent is based on your length of credit history. The longer your credit history, the more of a track record is established for lenders to make an educated judgment on your creditworthiness.
- 10 percent involves the types of credit used. Lenders like to see a diversity in type of credit used, but too much revolving (credit card) debt is a red flag. A track record of taking out mortgages and paying them on time will help you here.
- 10 percent is based on new credit. Applying for new credit cards or car loans immediately before trying to get a mortgage sends up a red flag and therefore is not advised.

How to Improve Your Score

If a bad credit report or low FICO is holding you back from getting a mortgage, there are steps you can take to clean up your report and improve your score.

The first step is to fix erroneous information on your credit report by disputing it directly with the credit bureaus. This can be done online through their respective web sites.

When you file a dispute, the creditor who reported the information must respond within 30 days; otherwise, the information in question is automatically deleted.

Next, you should try to pay down any credit card balances that are close to your credit limit. This will lower the ratio of your debt to available credit and make you a more attractive borrower.

Also, don’t apply for any new credit. Not only will this lower your score by decreasing your average length of open accounts, but new hard inquiries make it look like you’re “credit shopping,” a no-no when trying to get a mortgage.

Finally, see to it that you make all your payments by their due dates each month. This means paying at least the minimum payment on your credit cards. On-time payments establish you as a responsible borrower who pays his bills.