# A No-Nonsense Guide to Understanding Credit Scores

Veterans United
*Home Loans*

# Introduction

Credit and credit scores are more important than ever before.

More restrictive credit and underwriting standards have kept thousands of military members from purchasing or refinancing a home in the past two years.

VA-approved lenders nationwide have ratcheted up their requirements in the wake of the subprime meltdown. Qualified borrowers can still purchase a home with no money down, but veterans and active duty service members without a solid credit score are finding it tough to secure financing.

Lenders might start to loosen up a bit in the coming years, but in most cases a more conservative approach to home lending will continue to define the industry and govern the path to homeownership.

For America's service members, the reality is both stark and simple: Building a solid credit profile is more crucial than ever before.

This guide aims to help borrowers do exactly that.

# Credit Scores and Homeownership

There was a time when obtaining a home loan involved little more than a handshake with your local banker. After all, he was probably your aunt's neighbor and served on the PTA with your brother-in-law. He knew if you were a good credit risk, just like you knew that he mowed his lawn every Saturday.

Those days are long gone.

Today, lenders scrutinize a prospective borrower's credit score and overall financial profile. Your three-digit credit score helps determine your interest rate, your monthly mortgage payment and whether you can qualify for a home loan in the first place.

Credit requirements and standards are getting tighter by the day. VA lenders avoided the kind of risky lending that helped trigger the nation's economic collapse. But all borrowers are paying the price.

# What is a credit score?

**A credit score is essentially a measurement of a borrower's willingness and ability to repay debt.**

**Borrowers build up their credit profile by selectively using credit and repaying it on time each month, along with other key factors we'll discuss shortly.**

**But when people talk about their "credit score," they're most likely talking about one scoring model in particular, the FICO score. This mathematical algorithm comes from the Fair Issac Corporation, or FICO, a California-based company that also created the first-ever credit score.**

**FICO scores run from 300 to 850. They are calculated using a complex web of factors, some 20 in all, broken down into five broad categories. For consumers, that's a lot of credit scores to worry about. Scoring ranges for the different methodologies vary.**

**The companies that extend credit to borrowers report their monthly transactions to one or more of the nation's three credit reporting agencies:**

**Equifax • Experian • TransUnion**

**Each of the three credit agencies has its own scoring method, and there's a fourth — the VantageScore — that the trio created together.**

# What is a Good Credit Score?

There's no national cutoff or score range that lenders are required to use. One lender might offer a lower interest rate to borrowers with a score of at least 690. Another lender might require a 710 score in order to qualify for a better rate.

"Good," much like "Beauty," is in the eye of the beholder. Or, in this case, the eye of the lender.

But there are some general trends borrowers should consider. To get the best rates and have the most favorable conditions for financing, your score should be well above 700. Those with scores in the upper 600s will still have plenty of options, but there are very few products for borrowers with credit below 620.

Veterans and active duty service members will likely need a credit score of at least 620 to secure a VA loan. These flexible, low-cost loans have helped more than 18 million veterans become homeowners since 1944. Qualified borrowers can buy a home with no money down, no private mortgage insurance and with consistently better rates than conventional loans.

But why stop at 620? The higher your credit score, the more money you will save as you qualify for great rates and terms on all kinds of financing. There's also no guarantee that requirements will loosen. In fact, they could easily get even more restrictive.

VA loans also provide military borrowers with greater flexibility than other loan types. A prospective borrower with a 620 score will almost always get considerably better rates on a VA loan than on a conventional loan.

**FICO slices its score range into eight categories. Here's a look at the breakdown of scores by percentage of consumers:**

| Credit Score | Percentage |
|---|---|
| 499 and below | 1 percent |
| 500-549 | 5 percent |
| 550-599 | 7 percent |
| 600-649 | 11 percent |
| 650-699 | 16 percent |
| 700-749 | 20 percent |
| 749-799 | 29 percent |
| 800 and above | 11 percent |

# Credit Scores and Securing a VA Loan

The Department of Veterans Affairs doesn't have a hard and fast credit score requirement for service members to participate in the program. Instead, the VA looks at a host of factors to determine whether a veteran is a satisfactory credit risk. Flexibility is a cornerstone of the program.

But that's not the whole story. Lenders use their own credit standards and guidelines to evaluate loan applicants. That's a fair practice, considering VA lenders assume most of the risk when they finance a home purchase or a refinance.

## Here's a look at the basic standards you'll have to meet for a VA loan:

- You must have a credit score of 620 or higher. Several years ago, the requirement was 580. Then it was 600. Now it is 620, with some lenders even using a 640 benchmark.

- No foreclosures or Chapter 7 bankruptcies in the last two years. Lenders follow the VA's guidelines here. Prospective borrowers must wait two years after foreclosure or bankruptcy. Some exceptions may be made for Chapter 13 bankruptcies, but they are rare and on a case-by-case basis.

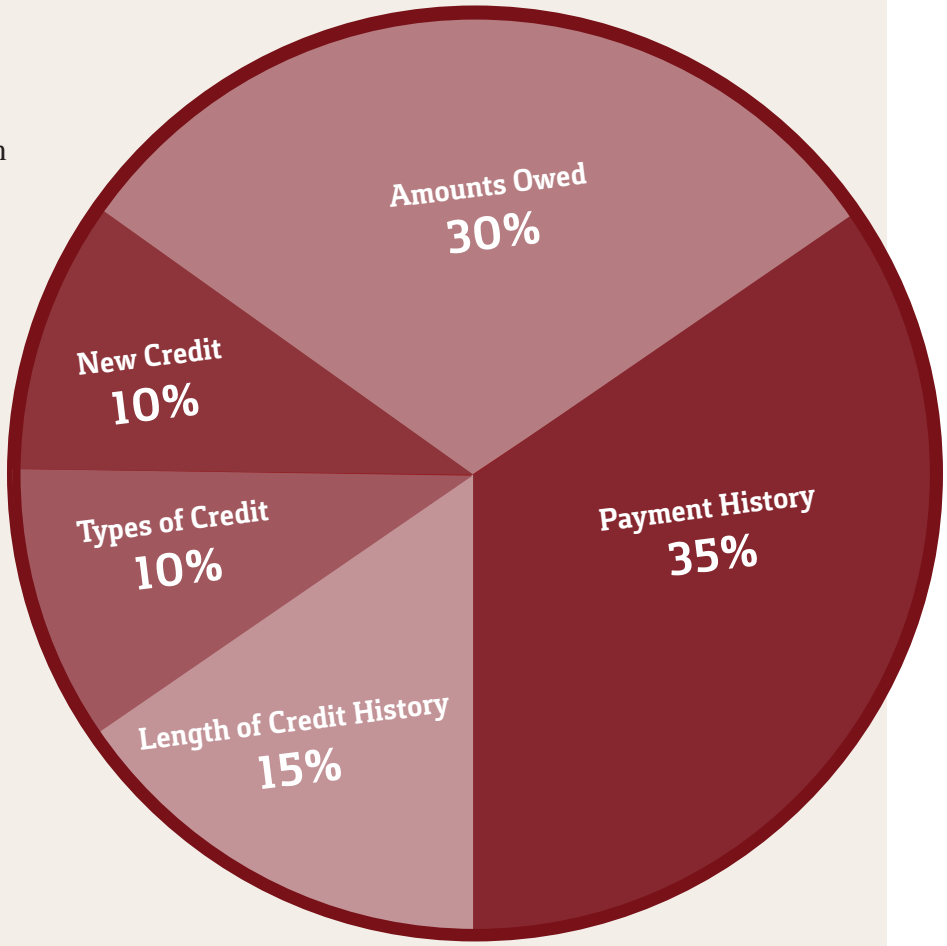
- You must be able to document a sound credit history. Borrowers can do this through a credit report or through alternate credit sources. If you do not have three open and active accounts on your credit report, a lender will most likely require you to show some other forms of credit. These may include utility bills, monthly subscriptions or pretty much any account requiring monthly payments.

# How is My Credit Score Determined?

**The credit agencies and FICO have not publicly revealed their entire formula for creating a credit score. But they do provide consumers with a clear explanation of those five broad categories that shape your score.**

## Payment History
**(35 percent of your score)**

Late payments are penalized in tiers by 30- 60- and 90-day increments. They can reduce your score significantly, which may tip the scales between qualification and rejection for financing. Depending on your FICO score, a 30-day late payment can cut your score by as many as 110 points.




## Amounts Owed
**(30 percent of your score)**

This section looks at your debt and weighs it against your available credit. In order to get full points here, you'll want to keep your revolving debt balances (like credit cards) below 25-30 percent of their limits.

## Length of Credit History
**(15 percent of your score)**

This factor tends to penalize young borrowers who have only recently established credit. A lengthy history agives credit bureaus a good feel for your usage and responsibility, so keep your old accounts open.

## New Credit
**(10 percent of your score)**

This looks at the number of recent credit accounts and inquiries that are on your report. If you've just opened seven new credit cards, your score will go down for a while until your payment patterns are established and documented. New credit can help your scores, too, as it makes a big difference to show healthy credit after past derogatory activity.

## Types of Credit Used
**(10 percent of your score)**

If you've only ever used department store credit cards, you'll get a lower score here than someone who can show a credit card, a student loan, an auto loan and a mortgage that were all paid on time. The scoring models cater to credit users with a diverse range of accounts to document responsible use and repayment.

# Know Your Credit Report

The first step is to get a copy of your credit report and scores so you know what you're working with. You can obtain a free copy of your credit report once a year by visiting www.annualcreditreport.com. But you'll have to shell out some cash in order to see your FICO score and other credit scores. Visit www.myfico.com for more details.

Choose a "tri-merged" credit report that shows all three bureaus, or check individual reports with each of the three credit bureaus. Be assured that any potential lender will check with all three bureaus, so you don't want to risk any surprises that might show with just one of them.

## Once you have your report, look it over for the following key elements:

### • Errors

These can be as simple as a misspelled name or as significant as an account that isn't yours. Errors most frequently happen to individuals with common names, or to those who have family members with the same name (Juniors, Seniors, etc.). Not all errors are harmful to your score, but they often lead to inaccurate information on your report. This can be damaging and difficult to rectify quickly, so it's best to get these taken care of. About 1 in 4 credit reports has errors serious enough to derail a loan, according to the U.S. Public Interest Research Group.

### • Open Accounts

Check the open accounts showing on your report. Are they accurate? Most loan programs require you to have three active and open accounts showing on-time payments. You won't find debit cards and utility bills here. We're talking about credit cards and loans.

### • Negatives

Does your report show any late payments, bankruptcies, tax liens, judgments, collections, repossessions or other negative information? Make sure the information is accurate.

Review your credit report and credit score in light of that 620 score you'll likely need to secure a VA loan. If things look good, it's time to contact a lender you trust and start the loan prequalification process.

But here's an important note to remember: Lenders run a unique credit inquiry that scores applicants based on mortgage-related risks. That means your credit score might actually be a little lower to a lender. Given this and other potential bumps in the road, it's a good idea to get pre-approved for financing at least six months before you want to buy a home.

What if things don't look good on your report? If you checked it and your scores are below a 620, or if a lender checked it and denied you for financing, it's time to get to work.

# How to Repair Your Credit

The good news is that credit is fluid. Just because you have a poor score at one time does not mean it has to stay that way. All you need to fix your credit is dedication, time and a little knowledge.

Here are four simple ways to boost your credit score:

## • Be Sure to Use Credit

Many people choose not to use credit because they don't want to incur debt. Others don't use credit because they cannot do it responsibly. But without any credit history, there's no way to tell what kind of borrower you will be. You are an unknown risk. Don't want the temptation of a high-limit credit card? You can use pre-paid cards to build your credit as well. Once the pre-paid amount is used, you cannot spend more, eliminating the risk. For a list of pre-paid credit cards or other cards to fit your needs, check out Bankrate's List. As we discussed earlier, it's best to have three open and active accounts if possible.

## • Keep Credit Card Balances Low

Assuming that you are using credit, pay down the balances on your credit cards. This is important because the "Amounts Owed" factor accounts for 30 percent of your score. The ideal balance on your cards should be below 30 percent, both of the card's limit, and of your total credit limit. For example, if you have a card with a $1,000 limit, you shouldn't put more than $300 on it. Similarly, if you have a total credit limit of $10,000 among several cards, be sure to keep your cumulative balance below $3,000.

## • Fix Errors

There are two ways you can go about getting errors fixed. You can go directly to the credit bureaus and ask them to verify the misinformation and to remove or adjust it. Or you can go directly to the creditor. Either approach can be effective, but we recommend starting with the creditor. Why? They are a service-oriented agency that benefits from keeping customers happy and are usually more motivated to settle problems quickly. Whichever approach you take, make sure to get everything in writing just in case you need it later.

## • Settle and Pay Outstanding Debts

If you have any judgments, tax liens, repossessions, or collections, it's likely they will have to be paid in order for you to purchase a home. Settle judgments, tax liens and repossessions first, as these are items you usually must pay regardless of your credit scores. Collections are more of a gray area, but it's best to get these paid off as well.

# Create Healthy Habits

Working on your credit involves not only fixing past mistakes but also developing healthy habits to continue shaping and improving your credit in the future. Again, using credit responsibly is a crucial part of repairing your credit score. To that end, here are some tips to help create healthy credit habits:

## • Make a budget and stick to it

If you're not currently living within your means, or you just don't know where your money is going or how much you owe each month, this is the place to start. You can access a great free budgeting tool online at From NFCC.

## • Pay your bills on time

Don't flirt with late payments. Most creditors won't report your payment as late until it's more than 30 days overdue, but don't take that risk. It's too easy to forget something or to have cash come up tight at the last minute.

## • Don't have your credit checked unnecessarily

Turn down pre-screened mailers and department store offers and really think about your needs before applying for credit. Note: Checking your credit yourself will not affect your score.

## • Don't close old accounts

The longer you've had an account open, the more important it is to keep it open. This will help the overall "age" of your credit.

## • Contact creditors right away if you're having trouble making payments

Creditors will often help you restructure payments or avoid late fees if you take the initiative.

**Veterans United Home Loans is committed to educating military borrowers and their families about credit and its crucial role in the VA lending process.**

How committed? Well, we created an entirely new department dedicated to helping prospective homeowners repair their credit and get on the path to prequalification.

Our unique Department of Secondary Approval has helped hundreds of prospective borrowers boost their scores and secure the VA financing they deserve. At DSA, credit consultants work with veterans and active duty service members to improve their scores through a free, online check-up system. A DSA employee monitors the progress and alerts the veteran when it's time to pull credit scores again in anticipation of loan prequalification.

# Repair Isn't A Quick Fix

Embracing these healthy habits and practices is essential to improving your credit score.

But don't expect results overnight.

It can take 30 days for the bureaus to update your report. Similarly, it takes even more time for your scores to rebound entirely.

Your scores will gradually increase as you get further from derogatory activity and you begin to practice healthy credit habits. Keep in mind that individual results vary greatly, depending on your starting point and the improvements made.

Some borrowers will see their scores skyrocket 100 points in a month. Others might need six months for that kind of jump.

Keep a close eye on your credit score, spending habits and overall financial health from this point forward. Contact a trusted lender once you hit your goal — and remember that the higher your score, the lower your mortgage costs.

# Avoiding credit clinic and credit repair scams

We don't recommend credit counseling services or credit clinics. There are some reputable agencies out there that will work with your creditors to arrange more manageable payments. But there aren't a lot of guarantees with these kinds of firms, and veterans can wind up doing more harm than good. After a rash of scams in recent years, the Federal Trade Commission started issuing warnings to consumers on how to spot what officials call "credit clinics." Some of the warning signs include:

## What to watch out for

- An organization that guarantees to remove late payments, bankruptcies or similar information from a credit report

- An organization that is reluctant to give out its address or one that pushes you to make a decision immediately

- An organization that charges a lot of money to repair credit

- A company that asks the consumer to write to the credit reporting company and repeatedly seek verification of the same credit account information in the file, month after month, even though the information has been determined to be correct.