

Get Ready Series #2

Understanding credit

Credit is a powerful tool, but used unwisely, it can negatively affect your financial standing, jeopardize your ability to qualify for a mortgage loan and result in you being charged higher interest rates. Your credit standing is key to becoming a homeowner, so take action to review and improve your credit when getting ready to buy a house.

Credit lets you obtain something now for little or no money and pay for it over a specific time period. In today's world, it's just about impossible to live without credit. There are two types of credit:

Open-end credit, like credit cards, is extended on an ongoing basis with a limit on how much you can borrow. It's also known as "revolving credit" because, as you pay the balance down, you free up credit to re-use (up to a specified limit).

Closed-end credit is extended on a one-time, limited basis, such as a car or personal loan. After paying off the loan, you need to requalify every time you want another loan.

Get credit

Those who extend credit, such as credit card companies, finance companies, stores and commercial banks, are called creditors. Creditors look at 2 things when deciding whether to extend credit to you:

You as a credit risk. Most creditors review these factors to evaluate the likelihood you'll repay the amount you borrowed:

- Length of employment
- How long you've lived at one residence
- Previous credit history
- Amount of outstanding debts
- Stability of checking and savings accounts

Your collateral purchase. The bigger the purchase, the greater the scrutiny on your credit history and ability to repay. If you don't make payments, it's easier for a creditor to repossess purchases like furniture and appliances than to foreclose on a home.

Lenders evaluate you and your credit history more carefully when you're trying to buy a house because they're assuming greater risk at a lower interest rate.

Unfortunately, this is when some people learn their first real lesson about credit – when it really matters – because they are shocked to find their credit history has prevented them from getting a home loan.

Establish a good credit history

Open a checking and a savings account. Keep enough money in your checking account to cover all regular expenses. Make regular deposits to your savings account to establish a history of saving.

Apply for credit gradually. Once your checking and savings accounts are set, apply for credit through a major bank or retail store. Use retail store credit cards wisely – they're easier to acquire than a credit card from a bank if you have low or no credit, but they often come with higher interest rates and fees.

Don't apply for more credit than you can manage. Start by using credit for small purchases only – just enough to start building a credit history. Pay off your balance in full each month.

Make regular payments. Every time you make a payment, you're building a favorable credit history.

Protect your good credit standing

Late payments affect your credit history. It doesn't matter if your balance is only \$5, if your payment is only 1 day late, or if you pay the late fee. Failure to pay on time compromises your credit history for a year or more.

Avoid making minimum payments. Paying the bare minimum does little to reduce your outstanding debt. Meanwhile, interest and annual fees add up. It's best to pay your credit card balance in full every month.

Use credit effectively. Develop a budget so you know how much you can comfortably purchase on credit and still be able to pay off the balance at the end of the month. For larger purchases, create a payment schedule to make sure the debt is paid off quickly.

Check your credit regularly. Experts recommend checking your credit reports once a year to look for errors and monitor your standing. The 3 main credit reporting agencies, Experian, TransUnion and Equifax, are required by law to give you a free copy of your credit report each year if you ask for it. Request those reports at AnnualCreditReport.com.

Repair your credit

If you experience unexpected financial difficulty or need to clean up your credit, don't be afraid to ask for help.

If you fall behind on payments, contact your creditors right away – they may be willing to work with you on a reduced payment plan. Be sure to get all agreements in writing. The worst thing you can do is wait until you're so far behind that your creditors resort to collection agencies.

If you need help developing a budget/debt reduction plan, contact a professional financial counselor or a credit- and budget-counseling agency.

It may take some time, but bad credit can be fixed. Once you start making regular, on-time payments and building that positive history, your credit standing will improve and look more attractive to future creditors.

Talk to a lender

If you're interested in buying a home and want to know how your credit will affect your ability to get a mortgage, a lender can help you understand your individual situation.

Notes:



Find helpful tools, information and stories about the homebuying process, including more on credit, at readyne.com by MGIC.