

How Credit Scores Impact Home Loans and Interest Rates

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If you have decided to buy a home, you will soon need to qualify for a home loan. Mortgage lenders will use both your credit score and credit report to determine if you qualify for financing. However, every lender will use slightly different criteria. In some cases, you can qualify for a home loan with a minimum credit score, especially when loans are underwritten or government insured. In other cases, you must meet or exceed a minimum score to qualify. Do you know your current credit score? Do you know what's on your credit report? If not, you should so that you are not caught off guard when you meet with a mortgage lender.

Understanding Your Credit Score

Your credit report reflects your history of borrowing and repaying banks, credit card companies, and other lenders. When you apply for a line of credit, the lender uses your credit report and resulting credit score to determine if you are a safe bet, or a risk, and to determine the interest rate they will offer you. If you have a good credit score, lenders will be more likely to extend you credit and offer you better interest rates.

Your credit score is like a report card. Fair Isaac & Co. (FICO) assigns you a number based on the information in your credit report. Since there are three credit-reporting bureaus, you have three FICO scores. It's a good idea to check all three on an annual basis.

5 Components of a Credit Score:

Credit scores are comprised of five pieces of information gathered from your credit report.

1. Payment history — have you paid your bills on time?
2. Amounts owed — what is your overall debt?
3. Length of credit history — how long have you been borrowing money, and how long you have used specific accounts? Lenders like to see a long credit history, but even people new to credit can have good credit scores.
4. New credit — have you applied for new credit?
5. Types of credit used — Lenders like to see all kinds of credit types: bank cards, car loans, student loans, and more.

Other information lenders consider when deciding whether or not to extend credit are any judgments against you, such as bankruptcy or evictions, and information about past disputes. Check your credit report annually so you know exactly what lenders are looking at when you apply for credit. Even if you have judgements or past disputes, you often have an opportunity to explain them.

What is a Good Credit Score?

FICO scores range from 350 to 850; 850 being the Holy Grail of credit scores. A score of 723 is the median in the U.S., so you can expect good interest rates at 720 to 760 or greater. Basically, credit scores are rated as follows:

- Excellent credit = 720 and above
- Good credit = 660 to 719
- Fair credit = 620 to 659
- Poor/bad credit = 619 and below

To give you an idea of where you need to be to secure a loan, homebuyers who pursue an FHA loan, one of the most common loan types for first-time purchasers, can usually secure a loan if their credit score is at least 620.

Get a Free Credit Report

By law, you are entitled to one free credit report each year from each of the three reporting bureaus: Equifax, Experian, and TransUnion. You can obtain your credit report within minutes online. It's a good idea to review your credit report for errors and outdated information that could be a red flag for lenders, and negatively impact your credit score.

In addition to reviewing your financial information for accuracy, you should also check your personal information, such as your name and social security number for accuracy. If, for example, you were a victim of identity theft, your social security number could have been changed. Such errors can hurt you when you need to get a mortgage.

How Credit Reports Affect Your Mortgage

Your credit score is one of the factors that will determine your mortgage loan interest rate. The better your score, the better your interest rate. The score your lender will accept for a conventional loan is determined by many factors:

- payment history
- salary history
- current wage
- available credit
- scores other lenders are accepting
- current economic climate

A score of at least 650 should meet most requirements for financing but there is no guarantee. Talk to lending companies about their minimum criteria. If you do not currently meet it, you have the opportunity to work on your credit score and maximize your chances at securing a loan with good interest rates.

Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac are government-backed mortgage lending companies. These companies set the industry standard and other lenders typically follow suit. Fannie Mae, for example, requires a credit score of 620 for a conventional loan. If your credit score is below 620, even with a down payment, you will be rejected. Fannie Mae will also reject a loan if more than 45% of your income goes toward paying debt. What Fannie Mae and Freddie Mac do other lenders are likely to do, so be prepared by checking your credit report and score, and doing what you can to present the best score possible.

Government-Backed Loans

Home loans backed or financed by the Federal Housing Administration (FHA) and the Veterans Administration (VA) look at credit scores differently than Fannie Mae and Freddie Mac. The FHA recently changed its minimum credit score to 580, which qualifies you for lending programs that require only a 3.5% down payment. VA loans are 100% financed and set aside for active and retired military, and their families. There is no minimum credit score to qualify for a VA loan, though a better credit score will get you a better interest rate.

How Credit Scores (may) affect Your Homeowners Insurance Premiums

Credit lenders aren't the only people using your credit information to make decisions. Did you know insurance companies use your credit habits to determine whether they'll provide you with insurance and how much you'll pay?

Insurance companies consider many factors in determining how likely you are to get into an accident and incur losses resulting in claims. They have found credit information to be a highly accurate predictor of these risks. However, insurance companies are more concerned with your payment history than the amount of debt you owe.

Tips to Help Homebuyers Improve Their Credit Situation

Different lending companies have different requirements, but they have all tightened their purse strings since the subprime mortgage lending crisis in 2008. Fact is, the lower your credit score, the higher your interest rate will be. This will have a dramatic effect on how much you pay for your home over the life of the loan. As mentioned before, all is not lost if your credit score is less than ideal. Here are some things you can do to ensure you get the best possible interest rate.

Check Your Credit Score

Checking your credit score well in advance of asking for a loan will give you time to correct any reporting errors and clean up your ratings if they do not meet minimum lending requirements. It can take 60 to 90 days or more to get incorrect information removed, so be sure to plan ahead.

Put More Money Down

Mortgage lenders look at more than just your credit score and report when deciding whether or not to lend you money; they also consider the amount of your down payment. Some lenders will allow you to offset a low credit score if you have a higher down payment. A bigger down payment means you will have more equity in your home, which means less risk for the lender.

Smaller banks and credit unions usually have more flexible lending guidelines, so if you have a low credit score, but a good down payment, you may consider talking to these types of institutions.

Research Non-Conventional Loans

Another option if you have a low credit score (and especially if you combine a low credit score and a small down payment) is to look into non-conventional loans, such as the aforementioned FHA loan and VA loan.

Some lending institutions offer specialized lending programs for lower-income, lower-credit homebuyers. The requirements aren't as strict, but you must still qualify.

Get Your Credit Score Up

Raising your credit score is one of the best things you can do. It's not complicated, but it does take some time and diligence. Here are a few things you can do to raise your score so that you can qualify for a mortgage:

- Obtain your free copy of your credit report. Your score is not included, so you may consider paying the small fee for your score.
- Review your report and correct any errors. If you feel financial information was reported inaccurately, especially late payments, or collection accounts weren't recorded properly, file a dispute with the credit reporting company and the creditor to get the information corrected.
- Make all bill payments on time. Late payments are the best way to ding your credit score.
- Pay down revolving debt like credit cards. A high debt-to-credit ratio is another surefire way to lower your score.
- Wait it out. As long as you're paying down debt and making payments on time, your credit score will eventually rise on its own.

Whether you are able to apply for a non-conventional loan, or you need to put more money down on your home because of a low credit score, these are good financial management practices. If your credit situation is not ideal, work with a credit counselor or financial advisor and make a plan for correcting errors, paying down debts, opening new lines of credit, and improving your credit score so you can qualify for lower interest rates.

If your credit score is good, keep up the good work! You can still take baby steps to improve your score to excellent if you want, and you will certainly want to maximize your creditworthiness by asking for refinancing options. You may be able to save thousands over the life of your loans — ask your lenders for more information.