Credit Score Catch-22: Mortgage Shopping Can Raise Your Rate

| By Ann Brenoff | Posted May 19th 2011 1:05PM
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Getty Images It's a Catch-22 if ever there was one. The very process of shopping around for a low interest rate on a mortgage can adversely impact your credit score and cost you your eligibility for the cheaper loan you're seeking.

Each time a lender does what is known as a "hard pull" on your credit report, their action actually shaves a few points off your score. A lower credit score means a higher mortgage rate. (You can check your own score 500 times a day and it won't matter. A hard pull is when a third party checks your score with the intent of extending you credit.)

With lenders tightening the noose, credit scores have become a matter of great concern for home buyers struggling to qualify for loans. Getting a favorable loan rate can mean saving hundreds of thousands of dollars over the course of the loan, so the idea that just in the course of loan-shopping you are doing yourself financial damage is logic-defying. But it's true.

The one break you can get is to do all your loan shopping within a two-week window. All checks done within this period will count as one -- and drop your credit score by just two to five points. But step outside that window, and each hard pull of your credit will cost you two to five points. Shop among eight lenders and you could see your scores drop by 40 points -- a drop that takes at least six months to recover from.

Tracy Becker, a national credit-score specialist located in New York's Hudson Valley and founder of the 20-year-old North Shore Advisory, offers these tips:

1. Don't open or close any credit accounts for three months prior to applying for a loan.

Yes, you read that right: *Closing* a credit account hurts just as much as opening a new one. Even the act of ending your car lease will cost you up to 60 points on your credit score.

Somewhere, some place, some analyst determined that one of the symptoms of a person about to go into default was that they began to close credit accounts. Well, duh. Isn't that what you're supposed to do when

you find yourself overextended? Apparently the credit scorekeepers lump the financially solvent in with the defaulters' profile. So if your car lease is about to expire, extend it for three months while you loan shop, says Becker. And don't apply to increase your credit limits on any cards or take out any new ones.

2. Don't apply for a loan until you have a signed contract to buy a house and then do an intense day of loan-shopping.

The idea is to have all your hard pulls done within the 14-day window. One obvious problem is that not all home deals come to fruition. Estimates are that about 35 percent of open escrows fall apart. That means that those 35 percent of buyers will likely be back out there looking for another home and another home loan. And when they find it, their earlier efforts could work against them. The one glimmer of reasonableness here is that if you return within 90 days to the initial lender you approached, they will consider the credit score they pulled on that first go-round.

Becker had a client about a year ago who wanted to refinance his Long Island home. Not knowing the rules, he shopped for a loan about 30 times over a five-month period. He also went shopping for a car loan, got a credit card limit increase and was looking for a student loan for his daughter. The result: His credit score dropped 40 points and he couldn't get the mortgage loan he wanted, at a cost to him of an extra $600 a month.

Another of her clients had a credit score of 722 when he started looking to refinance his home. But he went out and bought a car, dropping his score by four points. Once under the credit threshold of 720, the refi application was denied. "Ultimately he paid down some balances and got back the extra points, but it was a lot of stress, a lot of paperwork and two-and-a-half months to get the loan he wanted," says Becker.

3. Don't let your balances exceed more than 10 percent of your available credit for at least three months, and pay your bills on time.

Getting a home loan these days is hard for everyone, and near impossible for those who have bad credit. Becker says to keep your balances below 10 percent of your available credit for at least three months prior to applying. That means if you have a credit card with a ceiling of $10,000, don't let the balance exceed $1,000. And since the credit reporting bureaus don't update their sites daily, you need to allow for a three-month delay.

FICO last month released information about how easily even a single unpaid bill can wreak havoc with your credit score. If you have a score of 780 and are 30 days late on your mortgage, your score will drop to 670 and it will take you three years to recover it. (Obviously, the F in FICO doesn't stand for Forgiveness.)

Credit consultant and head of New Start Financial Corp. Wayne Sanford -- a.k.a. "Wayne the Credit Guy" -- says that credit scores are just part of the equation.

He recently worked with a Texas family trying to buy a $330,000 home in Plano. The couple was ready to put $150,000 on the purchase and had scores of 690 and 740 between them. Yet the loan was flagged because a well-known national furniture store had marked their account as having a "consumer dispute." It was a computer error; the account had never been disputed and had in fact been paid in full on time and was closed. Nevertheless, it held up their loan and they almost lost their house deal.

Sanford advises running regular checks on your credit--which, by the way, won't impact your scores.