5 Credit Myths, Busted

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When it comes to credit, sometimes the largest challenge is the most difficult to surmount: we simply don't know what we don't know, so our assumptions and inaccurate beliefs run wild and free through our mental real estate. Most of the time, there's no harm; following finance fundamentals like paying every bill on time, every time, keep us out of credit danger zones.

But when it's approaching the time to buy Angel Fire or Taos real estate, relatively small credit score differences can stop you from getting your dream home, and can cost (or save) you thousands of dollars in interest over the life of your loan.

If you're at a time in your life where it makes sense to invest some time and effort into optimizing your credit score, here are five common credit myths we'd like to help you bust without further ado:

Myth #1: Having lots of cash, a great income, or tons of equity, makes your FICO score less relevant.

Fact: No matter how much cash you have, if you want a mortgage, you must meet the lender's FICO score guidelines. Of course, if you're flush with cash, it should be relatively easy to make your monthly payments on time. But if you have come into cash relatively recently or you're coming off a rough financial patch, lenders don't not look at your credit score on the theory that your other assets diminish your credit riskiness. Most lenders want nothing more than to avoid having to foreclose on a home, even if the homeowner has other assets.

And the best predictor of whether you'll default on a loan in the future is how you've handled your credit in the past, so your credit score will drive whether you qualify for a home loan and what interest rate you're charged, no matter how much you make.

Two exceptions: if you buy a home with all cash, or take a hard money loan, which usually requires a much larger-than-average down payment and interest rate, you might be able to bypass credit score scrutiny, but you'll pay for it.

Myth #2: Having no debt or no late payments means you have great credit.

Fact: Financial responsibility and good credit are two different things. Your FICO score is meant to be a measure of your responsibility when it comes to managing debt, as proven by the fact that you have credit accounts, use them regularly and don't abuse them.

Having no credit accounts or debts doesn't give you good credit - it gives you no credit. And on the other end of the credit usage spectrum, being maxed out on various credit accounts all the time, submitting lots of credit applications and other credit moves that indicate you may abuse your credit can actually depress your score. Best practice is to have several credit accounts (student and car loans count!) that you actively and responsibly use on a monthly basis.

Tip: FICO gives a top score to accounts with balances that are 30 percent of the credit limit, so if you can keep your credit card or loan account balances at or around that mark, even better.

Myth #3: Checking your own credit score in advance prevents surprises when you apply for a mortgage.

Fact: Your mortgage originator (broker or banker) must pull their own version of your report from their own provider, and it might have a very different score, rating scale or even different line items than the free or paid report you pulled online. This is why it's imperative to start working with a mortgage professional as early as possible - a year in advance is not overkill - so you can detect any errors or issues and get their recommended fix in the works with plenty of lead time.

Myth #4: If you've had a foreclosure or short sale, your credit report will be damaged for 7 years.
Fact: Derogatory credit items, like late mortgage payments, foreclosures and short sales, appear on your credit report for 7 years, but your credit score can be rehabilitated enough to buy a home or obtain other credit in less time, depending on your circumstances. Your post-short sale or foreclosure waiting period depends on a number of things, including what type of loan you'll be seeking to buy your next home with, how much cash you'll have to put down and whether there were any extenuating circumstances involved in losing your home in the first place; some loans allow for an immediate purchase, others require a waiting period of 2, 4 5 or even 7 years after the loss of a home.

Of course, your FICO score is also a key criteria in a post-home loss "buy," but interestingly enough, the length of time it takes to get your FICO score back up depends on how high it was beforehand. Earlier this year, the New York Times reported that it would take a consumer with a 680 FICO score three years after a foreclosure to bring their score back to that level, while it might take someone with a 780 FICO score (near-perfect) seven years for full score recovery.

And keep in mind that as your foreclosure or short sale ages, its impact on your score will decrease, too.

Myth #5: Short sales have much less impact on your credit score than foreclosures.

Fact: Hear ye, hear ye - short sales and foreclosures have the same impact on your credit score, according to the FICO folks themselves. (The only exceptions are for short sales or deeds-in-lieu of foreclosure where the property was not upside down, which are few and far between, if they're not just a real estate urban legend!)

However, the number of missed payments you had before your home was lost to foreclosure or short sale might weigh on how gravely injured your FICO score is in the process. At the going rate at which banks are foreclosing on homes - clocking roughly 2 years of missed payments before a home is repossessed - your FICO score could take an even greater hit than if you were able to divest of it via a short sale in 1 year's time.