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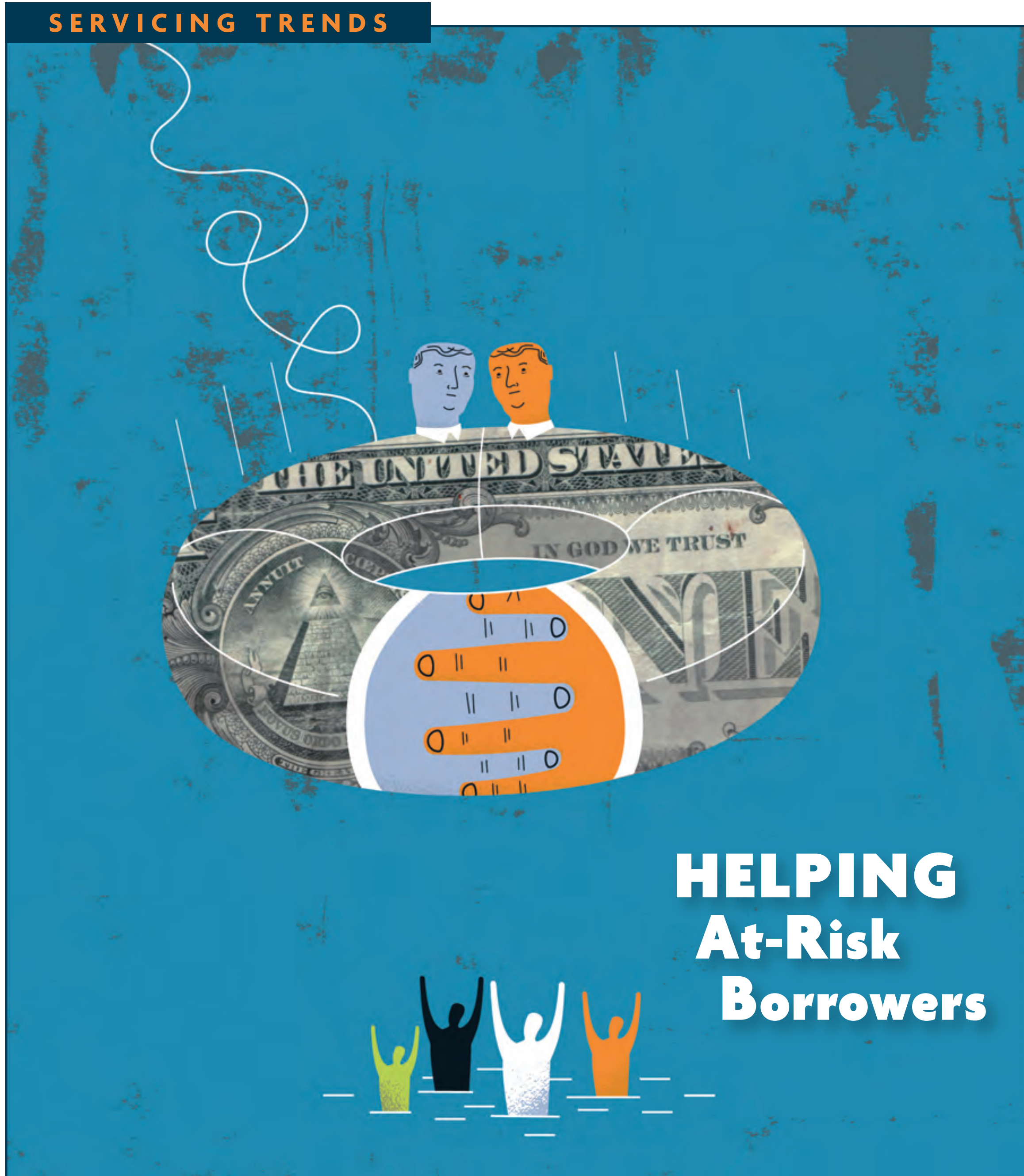
Mortgage Banking



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Doing the Least

Which loss-mitigation options do the most harm to a borrower's credit score?

PHOTOILLUSTRATION BY LE CLUB SYMPHONIE / IAN NOLAN

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Damage

Bankruptcies, a new study finds, do the most damage for the longest period of time.

BY BARRETT BURNS

The most recent figures from the Mortgage Bankers Association (MBA) show a record 14.41 percent of loans either in foreclosure or at least one payment past due as of third-quarter 2009. And according to TransUnion LLC, Chicago, 6.25 percent of U.S. mortgage loans were 60 or more days past due in third-quarter 2009—a 58 percent increase compared with a year earlier. ■ What these numbers aren't revealing is the shift we're seeing in where that default risk exists. A recent analysis undertaken by VantageScore Solutions LLC, Stamford, Connecticut, demonstrates that credit risk is rising faster at the prime and super-prime credit quality levels than at the subprime-borrower level. ■ In fact, the prime and super-prime credit tiers within the mortgage sector experienced an average 100 percent increase in risk for the 24-month period from June 2007 to June 2009 compared with the 24-month period from June 2006 to June 2008. (This shift in credit-risk metrics is reflected by the top line in Figure 1.) ■ Two contributing factors to increased delinquency and foreclosures among prime and super-prime consumers are rising unemployment and the diverse set of mortgage products introduced earlier this decade. ■

Despite some success, *many* **questions remain** *about these loss-mitigation programs.*

To keep people in their homes and stem foreclosures, various government- and lender-sponsored programs have been launched. Among them are forbearance and refinance solutions—the Making Home Affordable Program (MHA), HOPE for Homeowners program, and the Fannie Mae and Freddie Mac streamlined loan-modification programs, among others, including servicers' loss-prevention programs.

The general intent of almost every program is to lower the homeowner's monthly payment by reducing interest rates or extending the term (from a 30-year loan to a 40-year loan, for example) or both, thus making the monthly mortgage payment more affordable and sustainable.

And some of these loss-mitigation programs are gaining momentum. Reports from the Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS) show rate reductions were applied to 81.1 percent of all modifications in the third quarter of 2009. OCC/OTS statistics also reveal that modifications made during the third quarter lowered monthly principal and interest payments in 80.1 percent of all modified loans, compared with 78.3 percent in the second quarter of 2009.

Despite some success, many questions remain about these loss-mitigation programs. Consumers, lenders and regulators alike are wondering how mortgage-related actions such as modifications, short sales, foreclosures or bankruptcies will impact consumers' credit profiles and, especially, their credit scores going forward.

To get the answers, VantageScore Solutions recently examined the impact to consumers' credit scores (based on the VantageScore® range of 501–990) from mortgage restructuring programs or events.

The study yielded several key insights:

- Consumers and lenders should proactively seek out loan modifications before consumers experience severe delinquency in their credit file. Late payments have a far greater impact on a credit score than loan modifications.
- Certain loan modifications can positively impact the score, based on the recapitalization structure of the loan and whether the loan retains its original open date.
- Bankruptcy filing has the greatest negative impact on a consumer score, and will continue to affect the consumer score for a minimum of seven years due to the presence of a public record on the consumer file.
- In order to rehabilitate the consumer's score as quickly as possible, the consumer and lender working toward mortgage restructuring should allow sufficient cash availability to remain with the consumer so that all other delinquent debts can be paid to current status.

How the study was constructed

Given the relative newness of some of the loan-restructuring programs, long-term consumer performance in response to these modifications remains to be seen. However, the initial impact to a consumer's credit score can be effectively modeled by analyzing restructured mortgage scenarios on consumers' credit profiles.

To calculate this impact, four representative samples of homeowners were extracted from a national database and their consumer credit profiles changed to reflect a given mortgage restructuring program or event.

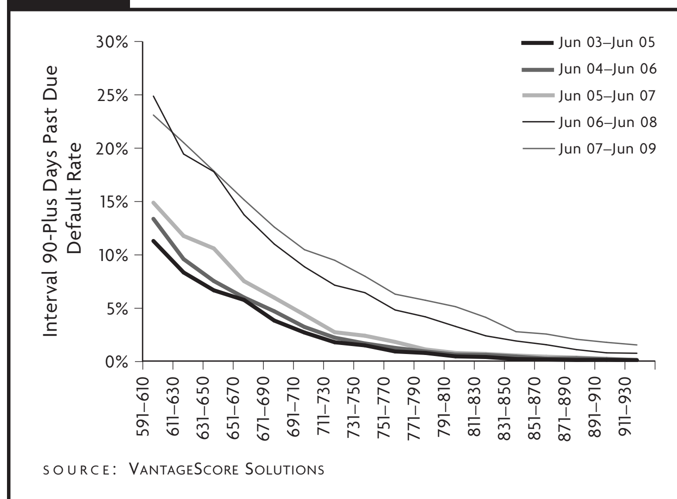
Consumer profiles

All mortgage scenarios are evaluated on four consumer behavioral profiles:

- *Population One*—Consumers with clean credit files (presently current and no delinquency that has ever been greater than 30 days on any trade in the past);
- *Population Two*—Consumers with first mortgages in clean status, yet other delinquencies are present;
- *Population Three*—Consumers with delinquencies on the first mortgage, but no other delinquencies are present; and
- *Population Four*—Consumers with delinquencies on the first mortgage and a delinquency on at least one other account.

Approximately 100,000 consumers were randomly selected for each population according to these four criteria. (Personally identifiable information was removed from the consumer data prior to the data being furnished

Figure **1** **New Accounts—90-Plus Days Past Due Rates: Real Estate**



SOURCE: VANTAGESCORE SOLUTIONS

> Mortgage-modification programs *generally drive toward* **one of two results**–*principal forgiveness or recapitalization.*

to VantageScore Solutions. VantageScore Solutions does not have or maintain consumer credit files with personally identifiable information.)

For every mortgage scenario, the following was conducted: The average credit score was calculated for each population before any changes were made, which is noted as the starting score shown at the top of the results table (see Figure 2). Relevant account fields in the credit file were edited to reflect the scenario designs, and the credit score was recalculated after the changes were made. The resulting scores were compared with the starting score, and the differences between the starting score and the new score were reported.

Scenario Design

The VantageScore study examined the impact from forbearance and mortgage modification programs on consumers' VantageScore scores, along with three other events homeowners potentially face if unable to make timely mortgage payments—short sale, foreclosure or bankruptcy.

Forbearance programs: Under forbearance programs, the borrower is permitted to make either substantially reduced monthly payments or postpone making monthly payments altogether during the forbearance period. There are generally three types of forbearance programs—interest-only, reduced payment and deferred payment. Therefore, three scenarios were created that reflect these three forbearance types.

For the purposes of this study, the interest-only scenario was evaluated by reducing the monthly payment amount to 25 percent of the original monthly payment amount. The reduced payment scenario was structured as 50 percent of the original monthly payment. No payment is made under a deferral program.

Loan-modification programs: Despite diverse eligibility requirements, mortgage-modification programs generally drive toward one of two results—principal forgiveness or recapitalization.

In principal forgiveness, lenders agree to forgive part of the original principal, thus alleviating consumers' debt burden by reducing the balance and resulting in a lower monthly payment. To reflect a case of principal forgiveness in the study, the current balance was reduced by 10 percent from the original current balance and the resulting monthly payment and term length were adjusted. For purposes of the study, forgiven principal is not recorded as a partial charge-off by the lender; rather, it was recorded as a derogatory event and the score impact was similar to that of a short sale or foreclosure.

Figure **2** **Impact to a Credit Score from Various Mortgage Restructuring Events**

		All Trades Clean	First Mortgage Clean, Other Trades Delinquent	First Mortgage Delinquent, Other Trades Clean	All Trades Delinquent
VantageScore® Starting Score		**862**	**830**	**722**	**625**
Forbearance	Interest-only	0	0	0	0
	Reduced principal plus interest	0	0	0	0
	Deferral	-40 to -30	-35 to -25	-10 to 0	0 to 10
Loan Modification	Forgive, no partial charge-off, overwrite	10	10	5	0
	Forgive, no partial charge-off, new loan	-14	-10	-9	-2
	Recapitalization, overwrite	3	2	2	0
	Recap., new loan	2	1	1	0
	Recap. and forgive subordinate loans	3	3	5	12
Short Sale		-130 to -120	-110 to -100	-50 to -40	-25 to -15
Foreclosure	Foreclosure initiated	-140 to -130	-130 to -120	-55 to -45	-20 to -10
	Foreclosure initiated, payment made	-125 to -115	-115 to -105	-40 to -30	-10 to -5
Bankruptcy	Filing only for mortgage trade line	-175 to -165	-160 to -150	-70 to -60	-30 to -20
	All trade lines included in filing	-365 to -355	-330 to -320	-220 to -210	-120 to -110

SOURCE: VANTAGESCORE SOLUTIONS

A **consumer credit score** *was reduced by as much as* 115 to 140 points *for short sales and foreclosures.*

In recapitalization, fees and/or past-due amounts can be recapitalized, resulting in an increase in the principal after refinance or loan modifications. As a component of the recapitalization, the loan terms are often extended and/or interest rates are reduced, thereby lowering the monthly payment. Under recapitalization in the study, the original loan amount was increased by 10 percent to reflect the recapitalizations of fees and past-due amount.

Both scenarios were modeled under two configurations—where the new loan details overwrote the existing account so that the original age of the loan was maintained, and where the original loan was closed and a new loan was created with the new terms.

Analysis of historic mortgage loan size and monthly payment profile show that the 10-percent principal forgiveness and the 10-percent recapitalization scenarios aligned with consumers whose mortgage payments have not been made for six months. Therefore, the 10-percent scenario is a reasonable assessment of today's environment.

Short sale, foreclosure and bankruptcy: In some cases, consumers face extreme financial situations (job loss or severe income reduction) and simply cannot afford to continue paying their mortgage. This can lead to a short sale, foreclosure (including all variations, such as deed-in-lieu of foreclosure) or bankruptcy, and these events have significant impact on consumers' credit scores. This study also considered these events and their implications for a borrower's credit score.

Study results

The results shown in Figure 2 are best viewed with an understanding of three aspects of the VantageScore credit score formula.

- "Utilization" and "available credit" are variables in the algorithm. Given the same outstanding balance, a higher credit limit results in lower utilization, which indicates the consumer has greater access to credit. Generally speaking, lower utilization and higher available credit combine to positively impact a consumer's score.
- VantageScore will reward consumers who have maintained an active account in good standing for a long period of time.
- A positive impact also occurs when the greater proportion of outstanding debt in a consumer file is a large, stable debt—such as a real estate loan.

Finally, as these results are reviewed, it's also important to remember that the final design of any mortgage restructuring, including whether or not the lender reports a partial charge-off, is a function of the negotiation between the lender and the consumer.

As seen in Figure 2, the first two forbearance cases had no impact on scores because the consumer still had an open/active mortgage loan and was still paying on time (just with reduced monthly payment amount). In the third forbearance case, where no payment was made during the forbearance period, the account was considered "paused" and therefore excluded from open account calculations that would normally be used in generating a score, lowering the score by 30 to 40 points.

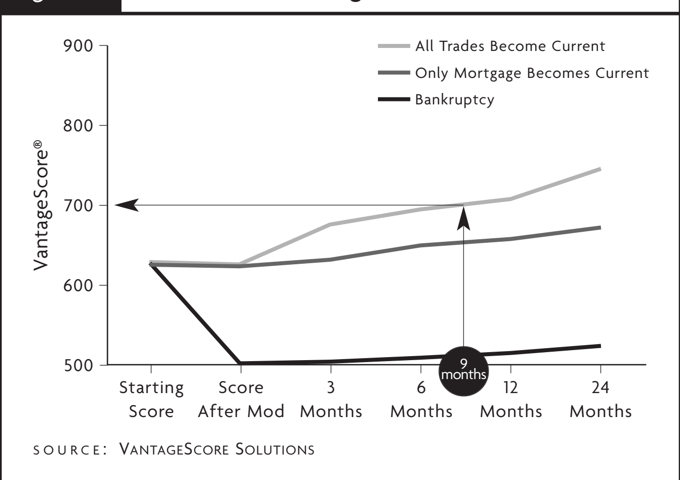
For loan modifications that involved principal forgiveness, the partial forgiveness of principal will reduce the consumer's overall utilization level, helping the score. This remains true as long the existing loan remains intact and is not replaced with a new loan, preserving the "age" of the account—whereas the creation of a new account will reduce the average age of accounts on file and have a negative impact on a consumer's VantageScore score.

In the case of loan modifications that resulted in recapitalization, the scores are slightly higher due to a higher credit amount on open real estate accounts. If a new account is created, this positive effect was partially offset by the loss of the existing account age, and similar observations can be seen for recapitalization as with forgiveness of subordinated loans.

Derogatory events (short sale, all forms of foreclosure, and bankruptcy) have a much more serious impact on credit scores.

A consumer credit score was reduced by as much as 115 to 140 points for short sales and foreclosures. In the

Figure 3 **Consumer VantageScore® Rehabilitation**



SOURCE: VANTAGESCORE SOLUTIONS

A **derogatory event** such as **bankruptcy** *significantly reduced the consumer's score.*

case of foreclosures, a driving factor was whether payments had been made even as foreclosure was initiated. Bankruptcy has the most severe impact by far. A consumer can experience a drop of as many as 365 points when all accounts are included.

The study showed derogatory events have less impact on credit scores for consumers already experiencing delinquent accounts on their files than on credit scores for consumers with all clean accounts (Population One). Because delinquent populations already have negative reporting in their credit profile, adding an additional delinquent event will not be as serious as changing from a clean profile to a delinquent profile.

For example, as reflected in Figure 2, the short-sale scenario reduced the credit score of the "all trades clean" population by 130 to 120 points, but only by 25 to 15 points for the population with delinquency on all accounts (first mortgage delinquent, other accounts delinquent).

Consumer score rehabilitation

A final analysis was run to demonstrate a score-rehabilitation process after implementation of one of the mortgage-restructuring events (such as loan modification). The intent of this analysis was to provide a general guideline for the time required for a consumer to restore his or her score to a reasonable credit tier after having become significantly delinquent. Three scenarios were evaluated:

- A loan-modification agreement (reduced monthly mortgage payment) that provides enough monthly cash remaining on hand to enable the consumer to pay all debts on time and to continue paying all debts on time for an extended timeframe;
- A loan-modification agreement (reduced monthly mortgage payment) whereby the consumer is able to pay only the mortgage on a timely basis and continue paying the mortgage debt on time for an extended time frame, but where the consumer remains delinquent with other debts; and
- The consumer files bankruptcy.

The consumers' credit scores were calculated at three-, six-, 12- and 24-month intervals after the event (see Figure 3).

If the consumer is able to bring all debts current after the loan modification and maintain current status for approximately nine months, his or her VantageScore credit score can rise to over 700.

Post-loan modification, if the consumer brought only his or her mortgage debt current and maintained that status, but other debts remained delinquent, the VantageScore credit score could rise to 660—or near-prime quality—after 24 months.

Finally, a derogatory event such as bankruptcy significantly reduced the consumer's score (see Figure 3). Raising the score is extremely challenging until the public record identifying the bankruptcy filing is removed from the credit file. This currently takes a minimum of seven years for Chapter 12 and Chapter 13 bankruptcy, and 10 years for Chapter 7.

The bottom line

As consumer behavior reflected greater default levels, the VantageScore scores dropped significantly. The difference between a consumer with no delinquencies and a consumer with delinquency and defaults on all primary accounts (mortgage, auto and credit card) represented an average of 243 points. Comparing the impact of mortgage delinquency with all other delinquencies showed the importance of maintaining the mortgage in current status.

Consumers with delinquency on accounts other than their mortgage had an average VantageScore of 830, but consumers with their mortgage in delinquent status yet who maintained the current status on their auto and credit card accounts had an average VantageScore of 722.

The study showed that the negative impact on credit scores increased as programs reflected more severe restructuring. Loan-modification programs had a relatively small impact on consumers' credit scores, whereas derogatory events such as short sale, foreclosure and bankruptcy had a much more significant negative impact.

The recent economic downturn and credit market crisis continue to put immense pressures on American consumers and the mortgage industry, but with these findings we have a clearer picture of how mortgage modifications will affect credit scores.

For the near future, rising unemployment, continuing decline in property values and tighter credit requirements will likely result in increasing numbers of seriously delinquent mortgages and foreclosure actions. The good news is that when armed with enough information, consumers and lenders are better equipped to make decisions that will have the least negative impact on a credit score. **MB**

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