



Credit Scoring and Mortgage Modifications

What Lenders Need To Know



With concern growing about the impact of mortgage loan modifications on credit scores, VantageScore Solutions conducted a web seminar in conjunction with American Banker to explore the issue. Sarah Davies, Senior Vice President of Analytics and Product Management at VantageScore Solutions, led attendees through a variety of mortgage restructuring options and discussed their impact on consumer credit scores within a variety of different credit quality tiers. The seminar also covered the primary drivers behind score changes and how consumers can rehabilitate their scores.

VantageScore Solutions, a company launched by the three major national credit bureaus—Equifax, Experian and TransUnion—to provide credit grantors a highly predictive credit-scoring model, developed the insights around this growing issue.

What follows is a brief synopsis of the web seminar. The full seminar is available online at www.vantagescore.com/research.

Davies' webinar detailed the results of a recently completed study conducted by VantageScore Solutions to illuminate the effect of various mortgage restructuring programs on consumers' VantageScore® credit scores, along with other consequences homeowners potentially face if unable to make timely mortgage payments: short sale, foreclosure, or bankruptcy. A final section of the study focused on how a consumer may rehabilitate their score in order to gain access to reasonably priced credit.

Because some mortgage modification programs were introduced only within the last year, long-term consumer performance in response to a modified mortgage remains to be seen. However, the immediate impact to a consumer's credit score can be represented by modeling the restructured mortgage on consumer credit profiles.

To calculate this effect, an analysis database was created by extracting a representative sample of homeowners from a national database. [Personally identifiable information was removed from the consumer data prior to the data being furnished to VantageScore Solutions.] All consumer credit files selected contained accounts representing primary trade lines: bank card, auto and mortgage.

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Four different consumer profiles were designed within the analysis database and populated with approximately 100,000 randomly selected consumer credit files. The starting credit score was then calculated for each consumer and the average was reported for each of the four profiles (See Figure 1).

Figure 1

	CLEAN CREDIT	FIRST MORTGAGE CLEAN	COUNTERCULTURE	OVERWHELMED
Average trade status	All trades clean	First mortgage clean, other trades delinquent	First mortgage delinquent, other trades clean	First mortgage delinquent, other trades delinquent
Total # of Open Trades	10.72	10.89	9.54	6.67
# of Open Trades 30+dpd*	0.03	0.15	0.66	1.16
# of Open Trades 90+dpd	0.00	0.02	0.14	0.34
VantageScore Starting Score	862	830	772	625

*dpd — Days Past Due

- **Clean Credit.** These consumers maintain all their debts in good standing, although they may have previously had an occasional 30-day delinquency. Consumers in the Clean Credit group have an extremely high quality VantageScore credit score of 862 (based on the VantageScore range of 501-990)—see Figure 1. This score level clearly falls within the prime field if not higher than prime, indicating high quality debt management.
- **First Mortgage Clean.** This group recognizes that their mortgage is their largest and most important loan and they keep it in good standing. This group experiences delinquency on some of their other trade lines (accounts), if financial circumstances necessitate. Culturally this is the approach that most homeowners have historically taken when finances became tight. This group experiences only a small hit to their score relative to the first group, about 30 points, with their average VantageScore credit score at 830. The score remains relatively high because the presence of a clean mortgage loan in the credit file has a positive effect in two ways, despite some other delinquencies:

1. Typically a consumer's mortgage is the largest single debt in their credit file. Therefore, maintaining the largest portion of total debt in good standing adds positive value to a credit score while treating smaller delinquencies in a less severe manner. For example, as a total percentage of debt in delinquency status, a \$5000 credit card balance or a \$10,000 auto loan is far less significant than when a \$200,000 mortgage becomes delinquent.

2. Mortgages have historically been viewed as the most stable loan type because homeowners were traditionally careful to pay their mortgage. With this in mind, credit scores generally assign positive value to consumers when mortgage loans are present in a credit file. History has shown that a consumer may occasionally become delinquent on a credit card or auto loan, but often returns to a current status, reflecting the need to maintain the utilization of the card and auto. High monthly payments make it much harder for homeowners to bring mortgage delinquencies current. Therefore, occasional delinquencies on trades other than mortgages have a less severe impact to the score than when a mortgage becomes delinquent.

- **Counterculture.** Often due to hardships, these consumers recognize that perhaps they can no longer handle their mortgage. Aware of restructuring options, they may be willing to let mortgage payments slip. They also recognize the need to keep their other trade lines, such as bankcard and auto loans, in very good standing in order to maintain the utility of their cars and credit cards. When a mortgage becomes delinquent, consumers experience a severe negative hit to their credit score due to the size of the outstanding balance that has been put at risk and the low likelihood that the consumer will recover. Therefore, with an average VantageScore credit score of 722, these consumers see a starting score approximately 140 points lower than the "Clean Credit" group.
- **Overwhelmed.** These consumers are probably underwater on many of their trade lines. They are experiencing severe challenges managing their finances, resulting in all their primary trades being delinquent. This group has an average score of 625.

Assuming consumers generally want to stay in their homes, the first challenge for most homeowners and lenders is to reduce the monthly payment. This is accomplished through many different programs, described at the top of Figure 2 under the "Least Severe" heading. In other cases, homeowners and/or lenders determine that retaining homeownership is not likely going to be successful long term and therefore more derogatory options are pursued, sometimes involuntarily. These are described in the bottom of the table in Figure 2 under the "More Severe" heading.

Figure 2

Least Severe: Monthly payments modified

PROGRAM	DESCRIPTION
FOREBEARANCE	Monthly Payment reduced or deferred for a short period; 3-6 months.
LOAN MODIFICATION	Various ways of reducing payment through rate reduction, term extension, which leads to either principal forgiveness or recapitalization.

More Severe: Monthly payments eliminated through derogatory events

PROGRAM	DESCRIPTION
SHORT SALE	Home is sold for less than principal still owed; bank agrees to accept this payment.
FORECLOSURE	Home sold at auction or bank takes possession.
BANKRUPTCY	Home very likely surrendered or sold.

VantageScore edited the mortgage trade line for the consumers in each credit profile to reflect these mortgage restructuring programs. The result is reported as the difference between the starting score (before restructuring) and the score after restructuring. VantageScore arrived at these results by rerunning the credit score algorithm on the entire credit file, including the edited trade lines (See Figure 3).

Figure 3

		CLEAN CREDIT	FIRST MORTGAGE CLEAN	COUNTERCULTURE	OVERWHELMED
		All trades clean	First mortgage clean, other trades delinquent	First mortgage delinquent, other trades clean	First mortgage delinquent, other trades delinquent
VantageScore Starting Score		862	830	722	625
FOREBEARANCE	Interest Only	0	0	0	0
	Reduced Principal Plus Interest	0	0	0	0
	Deferral	-40	-35	-10	0
LOAN MODIFICATION	Forgive, no Partial c/o, Overwrite	10	10	5	0
	Forgive, no partial c/o, New Loan	-14	-10	-9	-2
	Recapitalization, Overwrite Recap., New Loan	3	2	2	0
SHORT SALE	Recap., and Forgive Subord. Loans	2	1	1	0
	Recap., and Forgive Subord. Loans	3	3	5	12
FORECLOSURE	Foreclosure Initiated	-130	-110	-50	-25
	Foreclosure Initiated, Payment Made	-140	-130	-55	-20
BANKRUPTCY	Foreclosure Initiated, Payment Made	-125	-115	-40	-10
	Filing Only for Mortgage Trade Line	-175	-160	-70	-30
	All Trade Lines Included in Filing	-365	-330	-220	-120

Assuming all other credit file aspects remain equal (apart from the variances described earlier in the four credit profiles), the results in the table above are best viewed with an understanding of three aspects of the VantageScore credit score formula:

1. '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. Therefore, when a loan restructuring program produces these results in the consumer's credit file, the consumer's credit score can actually benefit or see very little change, despite the loan restructuring.
2. VantageScore will reward consumers who have maintained an active account in good standing for a long period of time. When a loan restructuring leaves account history intact in the consumer file, there is a positive net effect—or very little change occurs—with the consumer's credit score.
3. A positive impact also occurs when the greater proportion of outstanding debt in a consumer file is a large, stable debt coming from a real estate loan.

Finally, as the results above are reviewed, it's also important to remember that the final design of any mortgage restructuring, including whether or not the lender reports any adverse action, including but not limited to a charge-off (c/o), is a function of the negotiation between the lender and the consumer.

Impact to a VantageScore Credit Score from Forbearance

VantageScore modeled three configurations for the forbearance scenario:

- (1) an interest-only scenario, in which the average monthly payment was substantially reduced;
- (2) a reduced payment scenario containing interest and a portion of principle; and
- (3) a deferred payment scenario, in which the consumer notifies the lender that a payment is not possible.

The key factor in the first two scenarios was that a payment was being made on-time, which is a critical contributor in maintaining the credit score. Looking at these results for the forbearance programs with the Clean Credit group in Figure 3, we see there's no impact to a consumer's credit score provided the consumer continues to make a payment, whether it's reduced or not.

The 'deferred' scenario does impact the credit score. In this scenario, the lender puts the loan into a deferred status, documenting the mortgage trade line with a "D" to denote the loan's deferred state for a period of time. This particular scenario removes the mortgage trade line from the overall credit mix of a consumer's profile. While consumers experience no negative impact on their credit scores from not making their mortgage payments, they also lose all the positive impact associated with having a mortgage on their credit file over an extended period of time. This results in the credit score effect of as much as negative 40 for the Clean Credit population, as seen in Figure 3. When deferment is lifted from their credit file, all the positive value of the large loan returns and their credit score will again reflect this.

An examination of consumers at the other end of the spectrum, with delinquencies on all their trades, illustrates the impact of delinquency on credit scores. The impact of the forbearance options, as well as the other various mortgage restructuring scenarios on this population is relatively low, compared to the impact of the restructurings on other consumer populations.

Delinquency negatively affects credit scores much more than loan modifications. So as a result, the research shows that when a consumer is already severely delinquent, actions such as the three scenarios described have a much less dramatic impact on their score.

The other two populations, First Mortgage Clean and Counterculture also show reduced effects from the Clean Credit population. In both cases, delinquency drives the primary story about credit score impact rather than the various forms of loan restructuring.



Effect of Loan Modification Scenarios on a VantageScore Credit Score

Under the category of Loan Modification in (Figure 3), credit score impact results are provided for the principal forgiveness and recapitalization scenarios. VantageScore modeled a reduced monthly payment for both forgiveness and recapitalization, essentially equivalent to not making mortgage payments for four to six months—a significant length of time which is likely larger than a lender would allow. Additionally, when executing loan modifications, lenders will follow their own protocols about whether or not to overwrite the current loan, keeping the existing loan number, or close the existing loan and open a new loan. The process of closing a loan and opening a new one negatively impacts a consumer's score because the consumer loses the value of having a mature loan in which they've demonstrated good payment practices in their profile. This decision can have a different impact within each of the four credit profiles, as seen in (Figure 3) for Loan Modifications.

In the forgiveness category, VantageScore modeled two scenarios: forgiveness where the existing loan is overwritten, or forgiveness where the existing loan is closed and a new loan is generated.

For consumers in the Clean Credit profile who receive a loan modification resulting in principal forgiveness where the existing loan is overwritten, a positive lift of 10 points in the credit score is realized. This positive effect occurs because the total amount owed by the consumer on the accounts is lower after the lender forgives principal when compared to the sum of the original balances and credit lines before the forgiveness, decreasing utilization. Because the consumer now has fewer dollars at risk, the consumer is also a lower risk. The positive change to their credit score reflects this reduced risk.

However, when the same principal forgiveness is executed with a new loan, a drop of 14 points is seen in the credit score, underscoring the power of having mature loans in a consumer's credit file.

With the recapitalization scenario executed for a loan modification, consumers in the Clean Credit profile see a very slight improvement to the score. In this case, there is virtually no difference in the consumer credit score regardless of whether the existing loan is overwritten or a new loan is created.

These credit score changes are recognition that the mortgage loan is the most significant and typically the most stable loan in a consumer's debt profile. As that loan is increased even slightly by recapitalizing late fees and past due payments, the contribution made by the mortgage to the overall debt profile for that consumer is larger, i.e., a greater percentage of the consumer's debt is comprised of a more stable debt, and therefore the credit score changes for the positive.

Impact to a VantageScore Credit Score from Severe Restructuring Scenarios

The more severe methods of mortgage restructurings are involuntary scenarios that result in the consumer losing their home, either through a short sale, foreclosure, or a form of bankruptcy. It's a derogatory event for the consumer, usually initiated by the lender.

In terms of the involuntary scenarios, VantageScore modeled four types of foreclosures. Three of them—foreclosure completed, deed in lieu and foreclosure started—play out the same way in terms of credit score impact. For these three foreclosure scenarios, the impact is a decrease in 140 points to the credit score on average for the Clean Credit population.

The fourth scenario—foreclosure started, now paid—occurs when a consumer has triggered the foreclosure process, but has been able to pay that balance in full. While they put the account back into good standing, the consumer's financial difficulty still has a negative impact on a credit score and triggers a derogatory event. The result is a slightly smaller impact of reducing the credit score by an average of 125 points.

VantageScore modeled two types of bankruptcy: Chapter 7 and Chapter 13. Both types have a large impact on a credit score, immediately and long term. Since the bankruptcy filing remains in the public record for at least seven years, there is a significant long term impact. Filing for bankruptcy in all the trade lines results in an average decrease of 365 points.

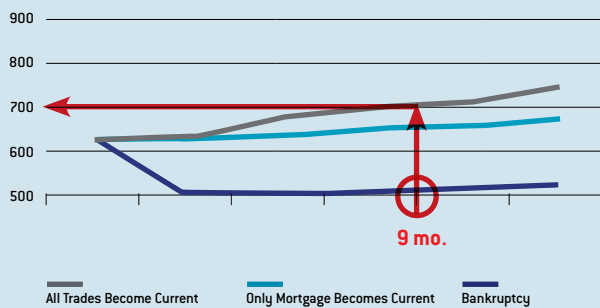
These findings show that mortgage restructurings in the form of forbearance and loan modification programs have relatively little impact on consumers' credit profiles, particularly for consumers in the Clean Credit population. A much larger impact is associated with the involuntary programs.

Rehabilitating the Consumer's Score

After a significant hit is experienced on a consumer's credit score, the natural question becomes "how long before the score improves?" The following simple analysis answers that question and shows the benefit of creating a financial plan that handles the mortgage and all other debts while examining mortgage restructuring options (See Figure 4).

Figure 4

Consumer VantageScore Rehabilitation



Using consumers with a starting score of 625, three scenarios were evaluated:

1. "All trades become current" - A loan modification agreement (reduced monthly mortgage payment) that provides the homeowner with enough remaining monthly cash flow to pay ALL debts on time and to continue paying all other debts on time for an extended timeframe;
2. "Only mortgage becomes current" - A loan modification agreement (reduced monthly mortgage payment) whereby the consumer is able to pay the mortgage on a timely basis for an extended timeframe but where the consumer remains delinquent with other debts; and
3. "Bankruptcy" - The consumer files bankruptcy.

The consumers' credit scores were calculated at 3, 6, 12 and 24 month intervals after the event.

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

Post-loan modification, if the consumer brought only their 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 consumers' score (the green line in the graph above). Raising the score is extremely challenging until the public record identifying the bankruptcy filing is removed from the credit file. This currently is a minimum of seven years for Chapter 12 and Chapter 13 bankruptcy, and ten years for Chapter 7.

There are several takeaways of this analysis for the consumer. First, consumers should work out a restructuring with a lender before serious delinquency occurs. Delinquency drives negative score impact more than loan modifications, meaning consumers should get to their lender sooner rather than later. Second, during the debt renegotiation process, consumers and lenders should take into account the consumer's entire debt picture, and create a new structure that allows the consumer to bring all debts current. Third, whenever possible, consumers should avoid bankruptcy. The long-term effects of bankruptcy are far more damaging than anything else that the consumer can do to their credit score. Finally, consumers should be reassured that the impacts of forbearance and loan modifications can be relatively insignificant. And while short sales and the other involuntary options clearly have a greater impact on credit scores, such events can be executed in a way that consumers can actually rehabilitate their scores very effectively in a reasonable time frame. ■

The entire web seminar, including many more graphs and participant questions, is available online: www.VantageScore.com/research

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