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How Loan Modifications *Affect Credit Scores*

by Prabal Chakrabarti, Federal Reserve Bank of Boston

Homeowners who receive loan modifications and successfully avoid foreclosure may face another issue, one that is not well understood. It turns out that participation in loan-modification programs may adversely affect credit scores.[1] The magnitude of the impact is unclear because many factors affect what lenders will report about borrowers who seek modifications, and other factors affect how much the credit-reporting agencies, credit-score providers, and lenders will penalize borrowers who have loan modifications on their credit reports. Although both the U.S. Treasury and credit-scoring agencies have tried to clarify the issue, the outcome is still murky.

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The negative impact of loan modifications first received attention in summer 2009, several months after the start of a Making Home Affordable initiative called the Home Affordable Modification Program (HAMP). Some borrowers who received three-month trial modifications subsequently reported decreases in their credit card limit and increases in credit card interest rates. Others reported being denied car loans. The borrowers speculated that their credit history and credit scores had been negatively affected by participation in the HAMP program.

Borrowers need not be late in their loan payments to qualify for a modification but are eligible if default is reasonably foreseeable. If they have been making mortgage payments on time but are approved for a HAMP modification based on evidence of future distress, they may see an impact on their credit score. In fact, borrowers with credit scores of 720 or above with no history of late payments could see a substantial drop in their credit score—a drop of roughly 70 points.

A Borrower Gets a Shock

One borrower reported that after being unemployed for six months, he took a new job at about one-third less pay. As a result, he and his wife were in poor financial shape. Moreover, they had been struggling since taking out a second mortgage to pay off

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debt and medical bills. Late in 2009, he went searching for a used vehicle and was approved for 30 days for a $2,000 loan if he found something. The 30-day period ran out before he found a suitable car. When he went to reapply, he was stunned to learn that he was denied as a result of the new information reported about his participation in the HAMP.[2] What happened?

Prior to November 2009, most lenders were telling the credit-reporting agencies (Equifax, Experian, and TransUnion) that borrowers in the HAMP were being coded as "making partial payment," a standard set by the Consumer Data Industry Association. According to the U.S. Treasury Department, the credit-score penalties for those who sought loan modifications varied, ranging from 30 points to 100 points.

According to Fair Isaac Corporation (FICO), the company behind the FICO credit score, the penalty varied depending on the borrower's previous credit history.[3] The main purpose of scoring agencies' and lenders' credit modeling is to predict an applicant's repayment behavior. Lenders use credit scores to gauge the risk of lending to a borrower and to price that risk appropriately.

Surprisingly, the penalty tended to be *larger* for a borrower who had never been delinquent with a payment. If the borrower was delinquent prior to receiving a trial modification, the credit score would already have dropped considerably (for example, if the borrower was being reported as "pays more than 60 days late"), and the additional effect of making partial payment would be moderate.

A New Code

After the U.S. Treasury recommended that the industry address the issue, the Consumer Data Industry Association created a new code designed to signify participation in the Making Home Affordable program. It is too soon to know whether the code "making payments under government modification plan" causes a negative prediction of repayment in the scoring models. It is meant to be retroactive and replace partial-payment codes for borrowers in loan-modification programs. The change should keep borrowers in good standing from being penalized for entering the modification program, but there is no guarantee. As of this writing, the FICO scoring model ignores the new code, so the overall effect of participating in the program is neutral.

Moreover, although it may be the most well known, the Fair Isaac model is not the sole credit-scoring model. Other models exist, including the VantageScore by VantageScore Solutions LLC, a joint venture of the three credit-reporting agencies. The loan-modification program may have different impacts on different models.[4]

Lenders such as credit card companies and auto finance companies also may have their own scoring models and may use the FICO-derived score only as one input into their process. Hence no one should assume that the new code solves the issue. Entrants into a modification program may still see their credit limits lowered or confront a rise in their short-term rates. And although several banks have agreed to use the new code, it is not known whether all servicers are complying.

HAMP revisions issued in March 2010 included two significant new elements: first, a principal-forgiveness option, and second, a temporary payment reduction for the unemployed. The former may be treated differently from the "making payments under government modification plan" code because it represents a true and permanent debt forgiveness. The latter, according to some commentators, is likely to trigger a credit-report penalty.[5]

Other Debts

The treatment of other debts is of special importance. Loan modifications under the HAMP use a formula to compute desirable debt-to-income ratios for mortgage payments. Monthly debt payments are brought down to 31 percent of monthly income. But so called "back-end" debt (monthly payments for car loans, credit cards, and the like) is excluded from the computation. That is true even though there is a requirement to see a housing counselor certified by the Department of Housing and Urban Development if back-end debt exceeds 55 percent of debt-to-income. This means that borrowers under the HAMP plan may still have many other payments that are not adjusted or modified. Second liens are also not modified except under certain limited circumstances. The value of this element of the plan is debatable, as one could view it as a requirement falling upon senior mortgage-lien holders that is not falling upon second-lien holders, car loan finance companies, or credit card companies. But from a practical perspective, the borrower must maintain all payments or face consequences from lenders.

Borrower Beware

The possibility of credit score problems should not deter most borrowers from participating in the HAMP program if they face financial distress. According to the Vantage model, a foreclosure can result in a 140-point decline for a borrower with good credit. Bankruptcy can result in a decline of more than 300 points.

But given the prominence that credit scores have taken on, including with employers conducting credit checks or landlords evaluating a tenant, borrowers should be aware that in the future, even if they make every payment on time and follow all the rules of the program, they may be punished by lenders for their participation.

It is understandable that lenders use credit histories and relevant information to assess a borrower's ability to repay and that a change in financial circumstances that manifests itself through modified payments may be taken into account. But one can also argue that the public policy goals of the HAMP should not be compromised by an industry practice if it can be reasonably avoided when borrowers act in good faith in a government-sponsored program. Lender compliance with standard industry reporting must be monitored to ensure that proper reporting is being done.

Prabal Chakrabarti, *an officer at the Federal Reserve Bank of Boston, is the director of community development.*

Endnotes

1 As of February 2010, more than 1 million borrowers had lowered their payments (168,000 permanently) through the Making Home Affordable modification program. Some, especially those with job losses and significantly reduced incomes, were not eligible according to the initial criteria, and as of this writing, it was unclear how many more would qualify after the March 2010 program changes. See www.makinghomeaffordable.gov for program details and eligibility.

2 Alan Zibel, "Credit Scores Can Drop After Getting Loan Help," Associated Press, March 19, 2010, abcnews.go.com/Business/wireStory?id=10147330.

3 The FICO score is on a 300 to 850 scale.

4 According to the Vantage Scoring Model, a charge-off of principal can reduce the score by 100 points (on a 501 to 990 scale). See Ken Harney, "Loan Modifications Can Be Gained without Ruining Your Credit Score," *Daily Herald*, April 16, 2010, http://www.dailyherald.com/story/?id=373263&src=118.

5 See Ron Lieber and Jennifer Saranow Schultz, "Answers to Questions about New Mortgage Modification Program," *New York Times*, March 5, 2009; and Jennifer Schultz, "Mortgage Modifications Affect Credit Scores," *New York Times*, January 5, 2010.