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How Foreclosure Affects Your Credit Score

By: Jerry DeMuth

The way you approach mortgage delinquency and possible foreclosure can have an effect on your credit score. Prudent handling of the problem can limit, although not eliminate, the damages.

Payment history makes up the largest portion—35%—of your FICO score. And the higher your credit score, the harder you will be hit by a foreclosure, or by whatever alternate route you take because becoming delinquent on your debts had not been a regular occurrence. That is, if you've been good until now, one late payment has a disproportionate effect.

The biggest negative hit comes with your first late payment. If you have a credit score of 780, your first late payment could reduce your score by 90 to 110 points. And if your score is 680, it could fall by 60 to 80 points, according to Barry Paperno, consumer operations manager for myFICO. With a second late payment, your score could be hit by another 50 or so points.

If the loan goes to foreclosure, still another 50 points could be knocked off your score. If your lender doesn't immediately report your late payment to the credit bureaus, the delay could make an even greater hit when it finally is reported.

Proper management of delinquency

However, with the first late payment on your mortgage, you can consider alternatives that may prevent you from going all the way to foreclosure, an event that probably will prevent you from buying another home with a mortgage for at least three to five years because of how lenders view a foreclosure and because your score will be so low.

A loan modification commonly is reported to the credit bureaus as "partial payments being accepted," which in terms of credit damage, is scarcely different from a 30-day late home. But you have a better chance of keeping your home and limiting damage to your credit score if you can get a trial modification under the federal government's Home Affordable Modification Program (HAMP).

You should know that lenders use codes from the Consumer Data Industry Association (CDIA) when reporting loans to credit bureaus, where they ultimately influence FICO scores. At first, the loan ends up generating an AC code, which indicates that partial payments are being made—not much help.

However, when that three-month trial period is successfully completed and the trial modification is converted to a permanent modification, the loan gets the CN code, which indicates the loan was modified under a federal government plan. This new CN code, which lenders are free to use or not use, does not currently affect the score because FICO has yet to assess its strength as a risk predictor, according to myFICO's Paperno.

Other loan modifications, such as those done under a lender's own program, may be or may not be reported as partial payments without violating the Fair Credit Reporting Act. In general, get some understanding of how the bank is going to be reporting any potential resolution, advises Paperno.

And as you live up to the terms of your new permanent modification, those late payments keep moving further into the past and the size of the dings on your credit score keep shrinking. At the same time, as you make your new, reduced payments on time, your score will begin rising. And because your new monthly payment is lower, your monthly debt obligation is lower as well, again helping raise your credit score.

Other choices and implications

As an alternative, a forbearance agreement requires you to make reduced "good faith" payments for two to six months to re-establish a positive payment history, after which you may have to resume your original monthly payments or continue reduced payments under a loan modification and sometimes immediately pay off the missed amounts. A forbearance agreement, as a partial payment program, would have the same impact on your credit score as a trial modification.

Other options include a deed-in-lieu of foreclosure, under which you turn ownership of your home to your lender, or a short sale, which is a sale for less than you owe but that is accepted by your lender as full payment. There are advantages to each, but Fair Isaac, developer of the FICO score, stresses that contrary to popular belief, foreclosure, short sale and deed-in-lieu will all have a similar impact on the your FICO score.

Other factors can affect credit scores and their ability to bounce back after any event, and you should check with a financial professional for the details in your particular situation.

State law also can affect your credit status. If, with a short sale, the proceeds are less than the amount of principal still owed, it could be treated as a charge-off and, in states that allow deficiency judgments, you could be on the hook for the difference.

If you are in the Home Affordable Foreclosure Alternatives (HAFA) program, the lender must agree not to come after you for the deficiency judgment. However, even in states where lenders can't come after you, the rules can be complex, so be sure to have a lawyer review your paperwork.

If a deed-in-lieu or short sale is reported as a charge-off, a "settled" debt, a "debt satisfied for less than the full amount" or as "not paid as agreed," the impact to your score could be the same as that caused by that first late payment. Ideally, you want your debt reported as "paid in full," "paid satisfactorily" or as a "total satisfaction of debt."

Generally, a deed-in-lieu, a short sale or a foreclosure, including those that occur after walking away from your home, are all reported the same. Once reported that's the end of it, except for the steps you will have to take to start rebuilding your credit score, and finding another place to live, which will have to be a rental property: You won't be able to get another mortgage for at least two years, and then only after getting your credit score up to at least 580 for an FHA-insured mortgage and 680 for a conventional mortgage.

Meanwhile, managers of large rental properties, who use credit reports and credit scores to determine whether potential renters are credit worthy, may hesitate to rent to you. So you should explore all your options in managing a mortgage delinquency.

Jerry DeMuth has written about mortgages and other financial issues for more than two decades for trade publications, major newspapers, and consumer magazines. His writing has received four awards and has been included in eight non-fiction books.

Source: HouseLogic.com

If you or someone you know, are considering selling your home, regardless of your financial situation, please give us a call so we can talk about all of your options!

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