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Back to previous page

Short sellers may take a big hit on their credit scores, fairly or not

By Kenneth R. Harney, Published: September 7

With generous new guidelines from Fannie Mae and Freddie Mac likely to stimulate large numbers of short sales by underwater homeowners, what impact can these sellers expect to see on their credit scores?

It’s a crucial question because short sales typically cause FICO scores to plummet, sometimes by 150 points or more. This complicates sellers’ credit capabilities for years and makes additional borrowings — whether for auto loans, credit cards or new mortgages — tougher and more expensive.

The issue arises now because Fannie Mae and Freddie Mac, the dominant sources of home loan funds, recently outlined plans to approve short sales for underwater borrowers who are current on their loan payments, provided they face an imminent “hardship.” Though the numbers of participants in the plan won’t be known for months, the two companies combined have approximately 3.7 million underwater mortgages in their portfolios on which borrowers are making their payments on time, according to federal regulators.

Short sales traditionally have been associated with extended periods of delinquency by borrowers. The technique itself — where the lender agrees to accept less than what’s owed and the property is sold — usually has been employed as an alternative to foreclosure.

As a result, FICO credit scores — the major risk-predictive tool used in the mortgage industry — have severely penalized borrowers who opt for short sales. VantageScore, the FICO rival created by the three national credit bureaus, also hits short sellers with triple-digit-point losses.

In a recent blog post, Frederic Huynh, FICO’s senior scientist, said statistical reviews of short sellers by the company concluded that they “represent a high degree of risk” to lenders. More than 55 percent of short sellers in a sample of borrowers between 2007 and 2009 went on to later default on other credit accounts after completing the sale transaction. This ranks them in “the same heavyweight [risk] class” as people who have been foreclosed upon, who have filed for bankruptcyoe who had a tax lien or collection account.

But hold on. Won’t underwater homeowners who qualify for the upcoming short sale program be fundamentally different? Won't they have solid mortgage-payment histories despite being underwater? Why should they have to take the same heavy hits to their scores earned by people who didn't pay their mortgage for months on end?

Good questions, but it appears that these sellers won't get the break they deserve. The current scoring system, credit experts say, isn't set up to recognize -- or properly report -- short sales by on-time mortgage customers to the national credit bureaus. And the credit score companies aren't currently planning to make any changes to the penalties their models assign to people who participate in short sales.

Anthony Sprauve, a spokesman for Fair Isaac Corp., developer of the FICO score, says that "in general," when a "loan [is] paid off for less than the full balance," it is "classified as a severe negative item" by the FICO scoring model. And "there are currently no plans to change," Sprauve added.

Sarah Davies, senior vice president for research and analytics for VantageScore Solutions, said in an interview that her company won't likely modify its scoring algorithms either, even if the seller was not delinquent and came to a mutually satisfactory resolution with the lender.

Terry Clemans, executive director of the National Credit Reporting Association, an industry trade group, says this is all inherently "unfair" for borrowers who have continued to make timely payments on their loans. Crushing them with deep credit score penalties "doesn't reflect the fact that these people are actually excellent credit risks. They simply encountered an extraordinary situation" — namely, the national home-value bust — that put them underwater.

A Fannie Mae spokesman, Andrew Wilson, said his company has no control over how short sales — whether of people who paid on time or those who didn't — are scored. However, when borrowers do a short sale rather than force the lender to foreclose, Fannie rewards them: They are potentially eligible for a new mortgage again within two years after a short sale. People who go to foreclosure, by contrast, may not be able to get a new Fannie loan for up to seven years.

Bottom line: At the moment, if you're underwater and plan to use the new Fannie-Freddie short sale program later this year, don't bank on any special favors when it comes to your credit score. It looks as though you're going to have to take a big hit, despite all your on-time payments.

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