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Solving the Credit Conundrum: Helping Consumers' Credit Records Impaired by the Foreclosure Crisis and Great Recession

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— F. Scott Fitzgerald

"Forgiveness is the attribute of the strong."
— Mahatma Gandhi

I. INTRODUCTION

The foreclosure crisis of the late 2000s left an enormous trail of economic destruction in its wake. Most Americans are familiar with the obvious damage -- the crisis cost nearly $200 billion in lost wealth,[1] resulted in over 4.5 million Americans losing their homes,[2] and triggered the worst recession since the Great Depression. One long-term result of the foreclosure crisis, however, is less familiar to many Americans – the impact on the credit reports of millions of consumers.

The most obvious credit reporting impact to consumers was the damage caused by foreclosure entries on millions of credit reports. These black marks can cause a decrease of 100 to 150 points to a consumer's credit score. The impact also includes the damage wrought by adverse mortgage-related events other than foreclosure, such as short sales or loan modifications. As discussed in Section II.A on page 3, many of these foreclosures and other adverse mortgage events were not caused by bad decisions made by the borrowers, but both economic forces out of their control and fraud or abuse by servicers/lenders.

Damaged credit reports and plunging credit scores means, of course, reduced access to credit. Even if the consumer can obtain credit, it will be at a much higher cost – a practice called "risk-based pricing" which ironically can cause defaults because the high cost of the credit makes it harder to repay. However, the credit reporting damage from the foreclosure crisis extends beyond the immediate impact on the availability and price of credit. Impaired credit reports also affect the ability of consumers to obtain employment, rental housing, and insurance. On a broader macro-level, the credit reporting harm from the crisis slowed the nation's economic recovery and created a class of consumers shut out of mainstream financial services.

Some of these consumers could be good borrowers after their foreclosure, and would certainly be good workers. They are not bad or irresponsible people, but simply unlucky. Helping these consumers rectify the credit reporting harms caused by the foreclosure crisis would enable them

[1] Ben Henry, Jill Reese, and Angel Torres, Alliance for a Just Society, Wasted Wealth: How the Wall Street Crash Continues to Stall Recovery and Deepened Racial Inequity in America, May 2013, p.8.
[2] CoreLogic, CoreLogic National Foreclosure Report, May 2013, p.2, *available at* www.corelogic.com/research/foreclosure-report/national-foreclosure-report-may-2013.pdf (visited Dec. 2013).

to move on economically. Their recovery, in turn, would help with the nation's economic recovery from the Great Recession.

This white paper explores the scope of the credit reporting harms caused by the foreclosure crisis and the Great Recession. It reviews both the harm to individual consumers and the wider impact on economic recovery. It also documents the credit reporting problems caused by inaccuracies and anomalies in the system. This paper discusses the broader problem of relying on past credit history to judge future performance, arguing that such a broad-brush approach fails to distinguish between consumers who are simply unlucky and those who are truly irresponsible. Finally, it suggests a number of solutions to assist consumers whose credit reports have been damaged by the foreclosure crisis and Great Recession.

II. SCOPE OF THE PROBLEM

A. Credit Harms from the Foreclosure Crisis and Great Recession

Credit reporting has become the determining factor for many essentials in a consumer's financial life – not only credit (mortgages, auto loans, credit cards) but insurance, employment and rental housing. It is no exaggeration to say that a credit history can make or break a family's finances. The Big Three credit bureaus (Equifax, Experian, and TransUnion) stand as gatekeepers – and solely profit-motivated ones at that – to many economic essentials in the lives of Americans.

The foreclosure crisis and the massive unemployment caused by the Great Recession saddled millions of consumers with poor credit histories. These include the over 8 million workers who lost their jobs,[3] as well as the 4.5 million families whose homes were foreclosed upon. Many of these 4.5 million foreclosures were not due to irresponsible borrowing, but phenomena such as:

- Abusive and predatory lending, such as mortgage brokers and lenders who targeted low-income and minority consumers for expensive subprime loans that they could not afford.
- The combination of exploding Adjustable Rate Mortgages (ARMs), negatively amortizing mortgage loans, and the collapse of the housing market, which left many mortgages "underwater," with the homeowner owing more than the home was worth.
- Inability to pay mortgage payments due to unemployment or underemployment caused by the Great Recession.
- Abusive servicing practices, including cramming accounts with illegal fees, failing to process loan modification requests, and gross accounting errors.

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[3] Economic Policy Institute, The Great Recession – Job Loss, at http://stateofworkingamerica.org/great-recession/ (visited Dec. 2013).

Millions of other families did not have a foreclosure completed, but still have undergone adverse mortgage-related events, such as:

- **A short sale**, which is when a mortgage servicer or lender agrees to let the homeowner sell the home and release the mortgage lien, even if the proceeds of the sale will not cover the amount due on the mortgage.

- **A deed-in-lieu of foreclosure**, which is when the mortgage servicer or lender accepts a voluntary surrender of the property by the homeowner as an alternative to foreclosure.

- **A loan modification**, which is an agreement between the servicer or lender and the homeowner to change the terms of the mortgage so that it is easier for the homeowner to make timely mortgage payments. Changes may include reducing the interest rate or principal amount, changing the mortgage product (for example, from an adjustable to a fixed rate mortgage), extending the loan term, or adding delinquent payments to the loan principal.

- **A Chapter 13 bankruptcy** to prevent or slow a foreclosure.

Foreclosures, short sales, loan modifications, and other mortgage-related events cause significant damage to the credit reports of consumers. The impact varies based upon what credit score the consumer originally had prior to the event. According to FICO, the developer of most-often used credit scoring model, the following events lower a credit score by these amounts:

Starting FICO Score	680	720	780
30 days late on mortgage	600-620	630-650	670-690
90 days late on mortgage	600-620	610-630	650-670
Short sale/deed-in-lieu/settlement (no deficiency)	610-630	605-625	655-675
Short sale (with deficiency balance)	575-595	570-590	620-640
Foreclosure	575-595	570-590	620-640
Bankruptcy	530-550	525-545	540-560

Source: FICO (r) Banking Analtyics Blog. (c) 2011 Fair Isaac Corp.

VantageScore, which is a joint venture of the Big Three credit bureaus that sells a competing credit scoring model, provides similar information:

	All accounts in good standing	1st Mortgage in good standing; other accounts delinquent	1st Mortgage delinquent; other accounts in good standing	1st Mortgage delinquent; other accounts delinquent
VantageScore Starting Score	**862**	**830**	**722**	**625**
Loan Modification (various circumstances)	842-892	815-860	710-742	620-643
Short Sale	732-742	720-730	672-682	600-610
Foreclosure	722-732	710-720	667-677	605-615
Foreclosure initiated, payment made	737-747	715-725	682-692	615-620
Bankruptcy – mortgage only	687-697	670-680	652-662	595-605
Bankruptcy – all accounts	497-507	500-510	502-512	505-515

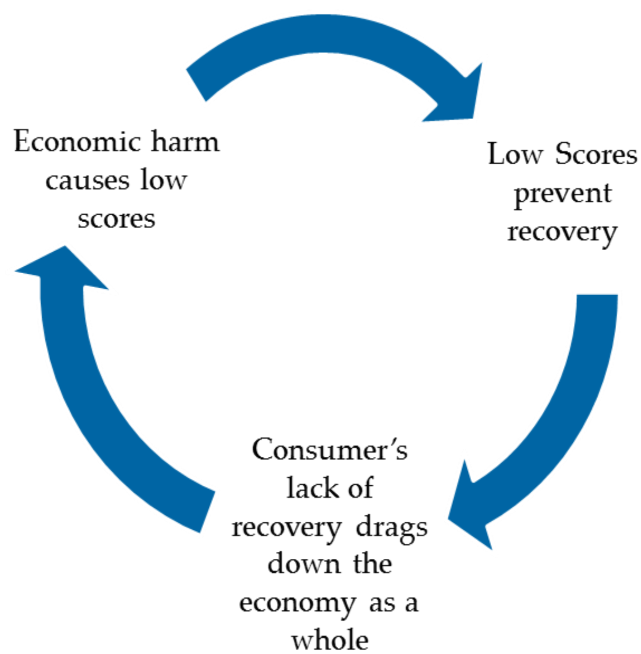
Source: VantageScore, Impact on Consumer VantageScore Credit Scores Due To Various Mortgage Loan Restructuring Options, January 2010, at p. 9 (Note that this chart was based on the prior VantageScore scoring range of 501 to 990. VantageScore has since revised its scoring range to match that of FICO, from 300 to 850).

These negative impacts of a foreclosure or other mortgage-related event will last for seven years, or ten years in the case of bankruptcies, as these are the time limits under the Fair Credit Reporting Act for adverse information to remain on a credit report. Thus, consumers who have gone through a foreclosure or other adverse mortgage event are shut out of affordable credit markets for seven years (or ten years, in the case of bankruptcies), unable to obtain reasonably priced auto loans or credit cards. They may end up paying exorbitant amounts for fringe credit, such as payday loans with APRs of 400% or more, or "buy here, pay here" subprime auto loans.

More disturbingly, credit reports are used for other purposes, such as employment, rental housing, and insurance. Thus, the damage from a foreclosure or other adverse mortgage-related event could cause a consumer to be denied a job, lose out on a rental apartment after losing his or her home, and pay hundreds of dollars more in auto insurance premiums. The cumulative impact of these financial calamities could strand a consumer economically for years after the foreclosure itself. It could create a self-fulfilling downward spiral in a consumer's economic life.

Indeed, there are indications that the negative impact of a foreclosure or other adverse mortgage event has a ripple effect even after the black mark is removed after seven years, continuing to weigh down the consumer. One study found that only 30% of foreclosed homeowners return to mortgage market within 10 years.[4] Furthermore, some studies show that it takes even longer for African Americans and Latinos to recover homeownership after a foreclosure.[5]

Another study found that, for many previously-prime homeowners, their scores did not return to pre-foreclosure levels even after seven years had passed.[6] In the years after a foreclosure, these consumers had persistently higher levels of delinquency on auto, credit card, and other loans. The authors speculate that this phenomenon could be caused by several reasons, including lingering effects of the economic difficulties that caused the foreclosure or a change in the consumer's behaviors toward delinquency due to reduced stigma associated with default. A third potential reason would be subsequent difficulties attributable to having a poor credit record, such as inability to access jobs, apartments, credit, or insurance, or being required to pay exorbitant prices for the latter two.



Finally, it appears the depressed credit scores from the foreclosure crisis and the Great Recession have impeded the country's economic recovery. According to some analysts, the Federal Reserve's effort to stimulate the economy with low interest rates has been less than effective because many of the consumers who could most benefit from these rates do not qualify for loans due to low credit scores.[7] In turn, the lack of ability to access low rates means these consumers have less ability to open small businesses or engage in household spending, the very steps needed to jump start the economy. In an ironic way, credit scoring and reporting have created a vicious cycle – economic harm causes low scores, low scores prevent recovery by shutting out

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[4] William Hedberg and John Krainer, Credit Access Following a Mortgage Default, FRBSF Economic Letter 2012-32, Oct. 29, 2012.

[5] Donald R. Haurin and Stuart S. Rosenthal, Dept. of Housing and Urban Development, Sustainability of Homeownership: Factors Affecting the Duration of Homeownership and Rental Spells, Dec. 2004.

[6] Kenneth P. Brevoort and Cheryl R. Cooper, Federal Reserve Board and Urban Institute, Foreclosure's Wake: The Credit Experiences of Individuals Following Foreclosure," Nov. 18, 2010, *available at* www.federalreserve.gov/pubs/feds/2010/201059/201059abs.html.

[7] Jon Hilsenrath, Fed Wrestles with How Best to Bridge U.S. Credit Divide, Wall St. J., June 19, 2012.

the consumer from benefits that require a high score, and the consumer's lack of recovery drags down the economy as a whole.

The drag on recovery by consumers' low scores is exacerbated by lenders that currently require even higher credit scores to qualify for mortgage loans. The average credit scores required for Fannie Mae/Freddie Mac/Federal Housing Administration (FHA) home-purchase mortgages appears to be 50 points higher than it was before the foreclosure crisis and Great Recession,[8] putting affordable credit even more out of the reach of consumers who were most harmed by these events.

B. Errors, Problems, and Anomalies

The credit reporting damage from the foreclosure crisis was bad enough, creating an economic blacklist affecting millions of consumers. This damage is exacerbated and compounded by the errors, problems, and anomalies caused by servicers and lenders and the credit reporting industry. Examples of errors and anomalies include:

1. Reporting short sales as foreclosures

This error is caused because there is no specific code in the standardized format for credit reporting (called the "Metro 2 format") for a short sale. Instead, a short sale is reported under the Metro 2 format as a loan that is "settled for less than full amount," and in many cases also as "foreclosure started." The courts have differed as to whether such reporting is inaccurate because it is misleading or incomplete.[9] While reporting a short sale as a foreclosure might not make a significant difference in terms of a credit score,[10] it can cause problems when a user views the full credit report. For example, until recently, Fannie Mae guidelines prevented consumers who had an incorrect foreclosure notation from obtaining another Fannie-backed mortgage for seven years (versus two to four years for a short sale).[11]

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[8] Jim Parrott and Mark Zandi, Moody's Analytics and Urban Institute, Opening the Credit Box, Sept. 30, 2013, *available at* www.urban.org/UploadedPDF/412910-Opening-the-Credit-Box.pdf (visited Dec. 2013).
[9] *Compare* Williams v. Wells Fargo Bank, 2012 WL 5510747 (N.D. Tex. Nov. 14, 2012) *with* Co v. JP Morgan Chase Bank, 2013 WL 1788061 (N.D. Cal. Apr. 26, 2013).
[10] Frederic Huynh, Are Short Sales Really That Bad? FICO Banking Analytics Blog, August 28, 2012, at http://bankinganalyticsblog.fico.com/2012/08/are-short-sales-really-that-bad.html (visited Dec. 2013).
[11] Fannie Mae Selling Guide, B3-5.3-07, Significant Derogatory Credit Events — Waiting Periods and Re-establishing Credit, October 22, 2013, p. 485, *available at* www.fanniemae.com/content/guide/sel102213.pdf (visited Dec, 2013).

2. Servicers and lenders that seek to collect deficiencies after a short sale or a foreclosure.

Some servicers and lenders attempt to collect the "deficiency," which is the difference between the amount realized at the short sale or foreclosure sale and the balance due on the mortgage. This tactic is arguably an unfair practice in a short sale where the lender has agreed to accept the sale proceeds knowing they are less than the mortgage, or in the many jurisdictions that prohibit a lender from recovering a deficiency after a foreclosure. Collection activities include reporting the deficiency as a collection item on the consumer's credit report, with the resulting harm to the consumer's credit score.[12] These deficiencies are also often sold to third-party debt buyers, which are notorious for abuses they commit against consumers.[13]

3. Reporting the entire balance of a mortgage as unpaid after foreclosure.

When a home is foreclosed upon, it is usually sold at auction. Some servicers and lenders apparently have failed to credit the proceeds of the auction against the amount owed. Instead, they have reported the entire balance of the mortgage as unpaid, even though a portion of it was satisfied from the auction sale proceeds.[14]

4. Credit reports not reflecting the terms of a loan modification.

This problem occurs after a servicer or lender has agreed to a loan modification with the homeowner. The servicer or lender continues to report the mortgage as delinquent, per the original terms, even though the consumer is paying in compliance with the terms of the new modified loan terms.[15]

5. Issues regarding loan modification reporting.

Loan modifications are reported under the Metro 2 format using the code AC, which stands for "Paying under a partial payment agreement."[16] The AC code will result in a

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[12] *See, e.g.*, Rex v. Chase Home Fin. LLC, 905 F. Supp. 2d 1111 (C.D. Cal. 2012) (class action against lenders that attempted to collect short sale deficiency and reported plaintiffs' failure to pay to credit reporting agencies).

[13] *See* National Consumer Law Center, Fair Debt Collection § 1.5.4 (7th ed. 2011 and Supp.).

[14] *See, e.g.*, Abdelfattah v. Carrington Mortgage Servs. L.L.C., 2013 WL 495358 (N.D. Cal. Feb. 7, 2013).

[15] *See, e.g.*, Henderson v. Chase Home Finance, LLC, 2012 WL 4006686 (D. Ariz. Sept. 12, 2012)(servicer promised no negative reporting); Bourdelais v. JPMorgan Chase Bank, N.A., 2012 WL 5404084 (E.D. Va. Nov. 5, 2012); Bradshaw v. BAC Home Loans Servicing, Ltd. P'ship, 816 F. Supp. 2d 1066 (D. Or. 2011); Darrin v. Bank of America, N.A., 2013 WL 877087 (E.D.Cal. Mar. 7, 2013); Pundt v. Select Portfolio Service, Inc., 2012 WL 2312074 (N.D. Iowa June 18, 2012).

[16] Consumer Data Industry Association, Credit Reporting Resources Guide (2012), at 5-21 (a.k.a. the Metro 2 Manual).

lowering of the consumer's credit score.[17] In at least one case, even asking about a loan modification resulted in a drop to the homeowner's credit score of 125 points.[18] The practice of using the AC code for loan modifications has been criticized as unfairly burdening consumers.

Under pressure, the credit reporting industry did change this coding for modifications of mortgages under the federal government's Home Affordable Modification Program (HAMP) by adding a new Metro 2 code.[19] It is unclear whether the FICO algorithms were adjusted to treat this "HAMP" code as a negative factor. Furthermore, while HAMP involves two stages-–temporary or trial modifications and permanent modifications--only permanent modifications are reported using the special HAMP modification code.[20] This is especially problematic given that some HAMP trial modifications have lasted more than a year, even though they are only supposed to last three to four months.

C. The Trembles

"Character - From your credit history, the lender attempts to determine if you possess the honesty and reliability to repay the debt." [21]

— Visa's website

"When wealth is passed off as merit, bad luck is seen as bad character. This is how ideologues justify punishing the sick and the poor."[22]

— Sarah Kendzior

One of the most pernicious aspects of the use of credit reporting is its use as a proxy for "character." There is a popular conception, not just in the credit industry, but also among employers and the average layperson, that a poor credit score means that the consumer is irresponsible, a deadbeat, lazy, dishonest, or just plain sloppy. However, this stereotype is far from the truth. A bad credit record is often the result of circumstances beyond a consumer's control, such as a job loss, illness, divorce, or death of a spouse, or a local or nationwide economic collapse.

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[17] Experian, *Ask Max Credit Advice--Negotiating Reduced Payments Can Hurt Credit Scores*, Oct. 28, 2009, *available at* www.experian.com/ask_max/max102809a.html (visited Dec. 2013).

[18] Loomis v. U.S. Bank Home Mortgage, 912 F. Supp. 2d 848 (D. Ariz. 2012).

[19] Consumer Data Industry Association, *Mortgage & Home Equity Reporting Guidelines In Response to Current Financial Conditions*, June 2010.

[20] *Id.*

[21] Visa, *Credit Reports - The 3 C's of credit: character, capital, and capacity*, undated, at http://usa.visa.com/personal/using_visa/personal_finance/credit_reports.html (visited Dec. 2013)

[22] Sarah Kendzior, A government shutdown, a social breakdown, Al Jazeera English, Oct. 4, 2103, at www.aljazeera.com/indepth/opinion/2013/10/a-government-shutdown-a-social-breakdown-201310491015764779.html (visited Dec. 2013).

The current credit reporting and scoring system is fundamentally flawed because it is an overly blunt instrument that lumps together defaults and negative events that are caused by very different triggers. Credit scores assume that a foreclosure due to illness resulting in job loss and crippling medical bills should be treated the same, and has the same predictive value, as a foreclosure because the borrower was a real estate investor who abandoned the property. Yet these are two fundamentally different phenomena, and likely two very different consumers.

Indeed, many foreclosures were not caused by bad decisions that borrowers made. Going back more than a decade, origination fraud and abuse by the mortgage industry was endemic – mortgages brokers falsified applications, obtained inflated appraisals, and sold unaffordable products to unsuspecting homeowners, such as adjustable rate mortgages in which the interest rate skyrocketed after the initial "teaser" period. When a loan is abusive, the failure to repay it tells nothing about the borrower's creditworthiness. Another problem is that during the foreclosure crisis, many homeowners who should have been processed for a loan modification were not provided with one. If two homeowners are identically situated, and one gets a loan modification but the other does not, it's hardly fair or useful to reflect that arbitrary result in credit scores.

The overly crude lumping together of very different consumers makes credit scores less than optimally predictive. This is reflected in, and probably responsible, for the fact that scores are actually quite inaccurate and unpredictive on an individual level. While they can predict the probability that as a group, low-scoring consumers will have a certain percentage of defaults, they cannot predict if any particular person will actually engage in the behavior. *In fact, often the probability is greater that a particular low-scoring person will not engage in the negative behavior.*

For example, a score of between 500 and 600 is generally considered to be a poor score.[23] Yet at the beginning of the foreclosure crisis in 2007, only about 20% of mortgage borrowers with a credit score in that range were seriously delinquent.[24] Thus, if a score of 600 is used as a cut-off in determining whether to grant a loan, the vast majority of applicants who are denied credit would probably *not* have become seriously delinquent.

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[23] FICO, myFICO Insider's Guide to 2010 Credit Card Reform and New FHA Mortgage Rules (2010), (noting that under the Federal Housing Administration rules, "it may be difficult for a borrower to even begin the process [of getting a mortgage] with FICO scores below 600."), *available at* www.myfico.com/Downloads/Files/myFICO_Guide_CCFHA.pdf (visited Sept. 29, 2013).

[24] Yuliya Demyanyk, *Did Credit Scores Predict the Subprime Crisis*, The Regional Economist (Federal Reserve Bank of St. Louis Oct. 2008), *available at* www.stlouisfed.org/publications/re/articles/?id=963. *See also* VantageScore Solutions, L.L.C., VantageScore 2.0: A New Version for a New World, 2011 (consumers with VantageScore of 690 - 710, or borderline between "C" and "D" grade, have about a 9% risk of default).

A study by a Federal Reserve researcher and a Swedish scientist, based on consumers in Sweden, similarly found that most consumers with impaired credit did not engage in negative behavior again.[25] The study found that, from the population of consumers with negative information in their credit reports who received credit after the mark was removed, only 27% defaulted again within two years.[26] The researchers reached a conclusion very similar to our thesis, which is that the reason for this low level of default is that many of the consumers with impaired credit ended up with negative marks due to circumstances outside of their control. The researchers noted that their results suggested:

> the possibility that for some proportion of the borrowers, the credit arrear may have been due to some temporary factor or tremble – illness, accident, or mistake – that was not reflective of their underlying type, and that [a] fresh start may improve the accuracy with which these borrower types are reflected. It is possible that, in this case, lenders punish trembles that they cannot easily differentiate from the behavior of bad types.[27]

An earlier Federal Reserve study similarly found that local economic factors, such as unemployment rates, have a significant impact on the ability of credit scores to predict risk. The researchers pointed to the omission of these factors in credit scoring as a possible flaw, stating:

> failure to consider situational circumstances raises important statistical issues that may affect the ability of scoring systems to accurately quantify an individual's credit risk. Evidence from a national sample of credit reporting agency records suggests that failure to consider measures of local economic circumstances and individual trigger events when developing credit history scores can diminish the potential effectiveness of such models.[28]

Thus, it is such situational circumstances or "trembles" within a consumer's life that are often responsible for the delinquencies, defaults, and foreclosures – *not* bad character, but bad luck. The problem with scoring and reporting is that it exacerbates and entrenches the harm from such circumstances, perpetuating the consumer's decline for at least another seven years. Not only might a consumer lose her home due to these events, but the foreclosure notation will hinder her recovery by denying her future credit, an

Situational circumstances or "trembles" within a consumer's life that are often responsible for the delinquencies, defaults, and foreclosures – not bad character, but bad luck.

[25] Marieke Bos and Leonard Nakamura, Federal Reserve Bank of Philadelphia, Working Paper No. 12-19/R, Should Defaults Be Forgotten? Evidence from Quasi-Experimental Variation in Removal of Negative Consumer Credit Information, Apr. 2013, at 1, *available at* www.philadelphiafed.org/research-and-data/publications/working-papers/2012/wp12-29R.pdf (visited Dec. 2013).

[26] *Id.* at 1.

[27] *Id.* at 4.

[28] Robert B Avery, Paul S Calem, and Glenn B Canner, Consumer Credit Scoring: Do Situational Circumstances Matter? BIS Working Papers No 146 (Jan. 2004).

apartment, and perhaps even a job. Even if the consumer gets a new job, the black marks from the foreclosure will follow her and result in higher prices for credit and insurance, costing hundreds or thousands more. This will, in turn, make it harder for her to pay those insurance or credit bills, and strain her economic recovery.

Furthermore, the credit reporting system, especially foreclosure and adverse mortgage-related information, perpetuate and exacerbate the income and wealth gaps between whites and minority groups.[29] For one thing, African American and Latinos are disproportionately targeted for predatory credit practices, such as the marketing of subprime mortgages and overpriced auto loans targeted at these populations.[30] As a result, these groups have suffered higher foreclosure rates.[31] In addition, numerous studies have documented how, as a group, African Americans and Latinos have lower credit scores than whites.[32]

We need a better way to judge consumers. We need a system that can distinguish between consumers who are truly irresponsible and those who simply fell on hard times. We need a system that can take into account both economic factors and extraordinary life circumstances particular to an individual consumer. And, we need a system that does not further widen the huge economic chasm between whites and minorities.

III. POLICY RECOMMENDATIONS

The solutions to the issues discussed are not easy or simple. They require a fundamental rethinking about how credit reports are structured and how we judge creditworthiness in the United States. The following are ideas about how to help consumers impacted by the foreclosure crisis and the Great Recession, as well as helping the nation's economy recovery.

These ideas vary in terms of their developmental stage and how much they have been fleshed out. Some of these ideas were previously proposed, extensively discussed, advocated for, and even implemented on the state level (such as banning the use of credit reports/scores for employment and insurance). Others may benefit from more exploration and refinement.

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[29] *See* Chi Chi Wu & Birny Birnbaum, National Consumer Law Center & Center for Economic Justice, Credit Scoring and Insurance: Costing Consumers Billions and Perpetuating the Economic Racial Divide (June 2007).

[30] *See* National Consumer Law Center, Credit Discrimination §§ 1.1.1 and 8.4 (6th ed. 2013) (summarizing studies).

[31] Debbie Gruenstein Bocian, Wei Li, and Keith S. Ernst, Center for Responsible Lending, Foreclosures by Race and Ethnicity: The Demographics of a Crisis, June 18, 2010, *available at* www.responsiblelending.org/mortgage-lending/research-analysis/foreclosures-by-race-and-ethnicity.pdf.

[32] *See* National Consumer Law Center, Credit Discrimination § 6.4.1 (6th ed. 2013).

A. Recommendations to Lessen the Negative Impact of Foreclosures and Other Adverse Mortgage Events

1. Remove adverse mortgage information earlier than seven years.

The FCRA should be amended to shorten the time periods for adverse mortgage-related events – and other negative information -- to three years. There is nothing special about the current seven-year time limit for negative information under the FCRA. It is certainly not universal. For example, the time limits in Sweden and Germany – countries that are as economically vibrant and prosperous as the United States – are three and four years, respectively.[33]

Negative mortgage-related information should be removed even before a three-year period if the consumer has taken steps to mitigate the loss to the lender, such as a short sale, a deed-in-lieu of foreclosure, or a loan modification. Negative information should also be removed if the mortgage is eligible for relief under settlements negotiated by government agencies with mortgage servicers or lenders, such as the National Mortgage Settlement[34] and the Independent Foreclosure Review (IFR) Payment Agreement. These settlements address abuses by servicers and lenders that resulted in foreclosures, and the borrowers who are entitled to relief should not have their credit reports marred by negative information caused by the servicer or lender.

2. Prohibit insurers, employers, and landlords from considering credit reports at all, and particularly a foreclosure or other adverse mortgage event.

The use of credit reports or credit scores has been a controversial practice for these purposes. Negative credit information has no clear relationship with work performance or driving history, and is often caused by economic forces outside of a consumer's control. For rental housing, denying a consumer who has lost his or her home to foreclosure from the ability to find an apartment contributes to the already appalling amount of homelessness in our country. Furthermore, as discussed in Section II.C on page 12, there are significant racial disparities in credit scores. The use of credit reports and scores for employment, insurance, and rental housing likely causes a disparate impact on minority groups.

[33] Marieke Bos and Leonard Nakamura, Federal Reserve Bank of Philadelphia, Working Paper No. 12-19/R, Should Defaults Be Forgotten? Evidence from Quasi-Experimental Variation in Removal of Negative Consumer Credit Information, Apr. 2013, at 21, *available at* www.philadelphiafed.org/research-and-data/publications/working-papers/2012/wp12-29R.pdf (visited Dec. 2013).
[34] http://www.nationalmortgagesettlement.com/

In general, employers, insurers, and lenders should not be permitted to consider credit reports or scores at all (with perhaps some very limited some exceptions). Prohibiting them from considering foreclosures or other adverse mortgage-related events is a first step toward protecting consumers from unfair harm.

3. Create exceptions or models to consider extraordinary life circumstances.

The rules for credit reporting, as well as the algorithms for credit scoring models, should be revised to lessen or eliminate the impact of situational or "extraordinary life circumstances," by minimizing or excluding negative information that can be attributed to job loss, medical causes, or other similar causes. Creditors should be required to make allowances for extraordinary life circumstances, or even prohibited from denying credit based on negative information caused by such circumstances.

There is precedent for special consideration of extraordinary life circumstances. A number of state laws governing the use of credit information for insurance require insurers to consider or grant reasonable exceptions based on the impact of extraordinary life circumstances.[35] Even Fannie Mae recognizes their presence, by acknowledging the existence of "extenuating circumstances," which it defines as "nonrecurring events that are beyond the borrower's control that result in a sudden, significant, and prolonged reduction in income or a catastrophic increase in financial obligations."[36] However, Fannie Mae primarily uses these extenuating circumstances to shorten certain waiting periods before a consumer can seek another mortgage. It does not *require* lenders to take these circumstances into account, much less mandate that the lender exclude negative information that the consumer can show was the result of extraordinary life circumstances. The FHA similarly recognizes "extenuating circumstances" but uses them mostly to shorten certain waiting periods.[37]

B. Fixing Errors, Problems, and Anomalies

There are a number of measures that the industry or regulators can take to prevent the errors, problems, and anomalies discussed in Section II.B on pages 7-9.

[35] *See, e.g.,* Conn Gen. Stat. § 38a-686; 215 Ill. Comp. Stat. § 157/22; Iowa Code § 515.103; Kan. Stat. Ann. §40-5115; Ky. Rev. Stat. Ann. § 304.20-040; La. Rev. Stat. Ann. § 22:1507; Mich. Comp. Laws § 500.2154; Minn. Stat. § 72A.20, subd. 36; Mont. Code Ann. § 33-18-605 ; Nev. Rev. Stat. § 686A.685; N.M. Stat. § 59A-17A-5.

[36] Fannie Mae Selling Guide, B3-5.3-08, Extenuating Circumstances for Derogatory Credit, October 22, 2013, p. 488, *available at* www.fanniemae.com/content/guide/sel102213.pdf (visited Dec, 2013).

[37] *See* HUD Mortgagee Letter 2013-26: Back to Work - Extenuating Circumstances, August 15, 2013, *available at* http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee (visited Dec. 2013).

1. **The credit reporting industry should revise the Metro 2 reporting format to include:**

   - A special code for short sales.
   - Requirements that borrowers who are complying with the terms of a modification be reported as "paying as agreed," and not reported using the AC code or any code that results in significant harm to their credit score.
   - More detailed reporting regarding the terms of loans, including the annual percentage rate (APR), so that users of a credit report can tell whether the terms were reasonable or were so abusive that they actually led to the default.

2. **Lenders and servicers should have better compliance and audit procedures to ensure that they are properly follow the Metro 2 format, including filling out all applicable fields and using the proper codes, to avoid erroneous reporting.**

C. Make Lending More Available

The following reforms would address the larger economic problems caused by the inability of consumers with impaired credit records to access reasonably-priced credit:

1. **Capacity should count more than credit score.**

Lenders should be required to place more emphasis on capacity, *i.e.*, residual income and debt-to-income ratio, instead of so-called "character" (credit score). The touchstone of all lending should be the consumer's ability to pay, not his or her credit score. Ironically, such a reform would constitute a return to traditional underwriting standards. It would also prevent future foreclosures and other adverse mortgage-events. For example, Veteran Administration (VA) loans have significantly lower default rates than FHA loans given the same credit scores —and FHA loans in turn are significantly better performing than other loans.[38] The big difference is underwriting, because the VA is the only one of the three that currently requires analysis of residual income.[39]

New requirements established by the Dodd-Frank Act represent an important step forward. These requirements institute a minimum ability-to-pay standard, which should result in less reliance on credit scores for *approvals* on mortgage lending. However, lenders will probably continue to *deny* applicants for too-low scores.

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[38] *See* National Consumer Law Center, Comments to the Department of Housing and Urban Development- Qualified Mortgage Definition for HUD Insured and Guaranteed Single Family Mortgages, Oct. 30, 2013, pp 12-14, *available at* www.nclc.org/images/pdf/foreclosure_mortgage/dodd-frank/comments-fha-oct2013.pdf (visited Dec. 2013).

[39] The FHA is in the processing of adding a residual income option for its underwriting.

Applicants with sufficient residual incomes but low credit scores should not be automatically denied or sent to a manual underwriting process that is effectively a denial.

2. While ability-to-pay requirements should be tightened, credit score requirements should be loosened.

The trend toward requiring higher credit scores for mortgages and other loans should be reversed. Some lenders, particularly auto lenders, are moving in this direction by loosening requirements for consumers who have experienced adverse mortgage events.[40] In contrast, Fannie Mae, Freddie Mac and the FHA still rely heavily on credit scores.[41] And a step in the wrong direction is the recent increase of fees by Fannie Mae and Freddie Mac for borrowers with credit scores below 780.

There may be some types of credit for which credit reports and scores should not be used at all. For example, a credit history analysis should not be used to deny seniors the ability to obtain reverse mortgages under the Home Equity Conversion Mortgage (HECM) program proposed by the Department of Housing and Urban Development (HUD).

3. Alternatives to traditional credit scores should be considered.

The credit industry should be encouraged to consider alternatives to the traditional credit score. Some potential ideas for exploration include:

- Alternative scoring systems, such as the Credit Capacity Score offered by the RDR Institute, which focuses on a net cash-flow analysis.[42]

- Some subprime lenders use alternative criteria to differentiate among low-scoring consumers to determine who is more likely to pay. While we

[40] Ruth Simon, Auto Lenders Speeding Past Mortgage Troubles, Wall St. J., Jan 5, 2012.

[41] *See* 75 Fed. Reg. 54,020 (Sept. 3, 2010) (FHA setting a minimum FICO score of 500, as well as requiring a higher loan-to-value threshold for borrowers with scores of 500 to 590). Fannie Mae generally will not buy mortgages when the borrower has a FICO scores under 620. *See* Consumer Fin. Prot. Bureau, Analysis of Differences Between Consumer- and Creditor-Purchased Credit Scores, p. 6 (Sept. 2012), *available at* http://files.consumerfinance.gov/f/201209_Analysis_Differences_Consumer_Credit.pdf (visited Dec. 2013).

[42] Press Release, Responsible Debt Relief Announces Pathbreaking Housing Counseling and Mortgage Modification Assessment System, October 31, 2011, *available* at www.prweb.com/releases/2011/10/prweb8919333.htm (visited Dec. 2013) (key features include "net cash-flow algorithm/software that calculates net, after-tax household income based on such factors as federal, state and local taxes, household structure, tax filing status, regional cost of living, home ownership status, federal approved deductions such as retirement and charitable contributions, and court-mandated payments such as child support and garnishments").

certainly believe the products offered by these lenders are bad for consumers and should be banned, the criteria that these lenders use to differentiate consumers are worth exploring, albeit with a skeptical eye.

- Requiring lenders to use information that is voluntarily submitted by consumers regarding payments that are not typically reported to the credit bureaus. Lenders should be required to do more than just "consider" this voluntarily-submitted information, which is actually already required by federal regulation.[43] Lenders should be required to treat voluntarily-submitted information in the same manner as traditional credit reporting information, if it is certified as accurate by a trusted third-party verification company.

D. More Research

Finally, we need more research on how to improve the methods we as a society use to judge who is worthy of reasonably-priced credit. Our society has made great strides in information technology in the last few decades, with the explosion of the Internet and ever-more powerful computer hardware and software. Yet our assessment of creditworthiness is still stuck in methodologies invented in the last century.

Our nation devotes billions of dollars every year for medical research. We should be willing to devote a fraction of that amount into research to ensure that consumers are treated fairly in credit decisions and to promote economic growth that is dependent on this fair treatment. It's time for a new paradigm to judge consumers so that they are not unfairly penalized by economic and life circumstances outside of their control.

[43] Under Regulation B, which implements the Equal Credit Opportunity Act, lenders are already required to consider "[o]n the applicant's request, any information the applicant may present that tends to indicate the credit history being considered by the creditor does not accurately reflect the applicant's creditworthiness." 12 C.F.R. 1002.6(b)(6)(ii).

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