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Lower credit scores slow housing recovery by thwarting sales

Many Americans' credit scores have fallen because of economic distress in the last few years. It's probably affecting their ability to get a new mortgage or buy a house.

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How big a whack did your credit scores take during the grim years of economic distress after the housing bust? Was it 20 points, 50 points, 100 points — or maybe no drop at all?

These are key questions for millions of potential home buyers who hope to qualify for mortgages and current owners looking to refinance. New research from a major credit-risk evaluation company suggests that the drop in huge numbers of Americans' scores was dramatic.

FICO (formerly known as Fair Isaac Corp.), which developed and markets the eponymous score that dominates the home mortgage field, found that in 2008-09, about 50 million consumers in this country saw their FICO scores plunge more than 20 points. Nearly 21 million of these lost more than 50 points. Many lost 100 points or more because of severe delinquencies.

During the same period, lenders and investors began ratcheting up their standards for acceptable scores and to extend special preferences in fees and interest rates to loan applicants who rank among the highest scorers. Among these developments:

•Loans originated for purchase or guarantee by the two dominant home loan investors — government-run Fannie Mae and Freddie Mac — now carry average FICO credit scores in the 760 range and above, record highs for both companies. That's good for them, but not necessarily for you if you need a loan. (FICO scores range from 300 to 850; higher scores indicate lower risk of default.)

•Even new mortgages being insured by the Federal Housing Administration — traditionally the fail-safe financing refuge for first-time buyers with modest incomes and less-than-perfect credit histories — now have average credit scores slightly above 700.

•During the housing boom years of 2004-06, by contrast, a score of 620-640 was adequate to earn you a good mortgage rate and terms at Fannie Mae and Freddie Mac. The FHA often approved loans in which the FICO scores were in the mid-500s.

Earlier FICO studies found that the deepest score declines — creating the toughest challenges for obtaining new credit on affordable terms — have been among borrowers who ranked among the credit elite. Homeowners with scores in the high 700s may have lost as much as 130 points when they fell three months behind or more on loan payments. They might have lost as much as 160 points when they negotiated a short sale with their bank and as a result had unpaid deficiency balances left over.

Score bruises and wounds from past years are probably affecting the ability of consumers to get a new mortgage or buy a house. In a survey released before Thanksgiving, the National Assn. of Realtors reported that large numbers of sales contracts are falling apart because of financing issues — would-be buyers having difficulties meeting lenders' increasingly stringent requirements, including credit — among other factors.

Contract failures were reported by 33% of realty agents in the study, according to the association, a big spike over the year before when just 8% of agents reported cancellations. Although other factors may also be at work, credit problems stemming from 2008, 2009 and 2010, combined with lenders' higher FICO requirements, clearly are retarding the housing recovery by thwarting sales.

Part of the reason: Although FICO scores are dynamic and constantly changing, they can take extended periods to recover, much like a body that has suffered severe trauma.

In research released this year, FICO estimated that a homeowner with a 720 score who falls 30 days late on mortgage payments can take as much as 30 months to recover the 70 to 90 points that were lost in the process. And this assumes the owner gets current on all debts, keeps balances relatively low on credit cards and generally becomes a model user of credit. For homeowners with higher scores in the 780 range to start, the same 30-day delinquency — with a loss of 90 to 110 points — can take 36 months to cure fully.

What does this all mean to you if you're one of the 50 million who lost significant credit score points during the last several years? You should be in rebuilding mode if you seriously want another mortgage. As a more immediate alternative, though, keep the FHA in mind. Though the average FICO scores of its customers have never been higher, the FHA still accepts scores in the upper 500s and is more open than other financing sources to hearing about "extenuating circumstances" — unexpected job loss, medical problems, divorce and other issues — that caused your credit score to plunge in the first place.

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