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Credit After Foreclosure, Bankruptcy, or Short Sale

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One of the concerns a consumer has after experiencing a bankruptcy, foreclosure, or short sale (referred to as a "preforeclosure sale" by Fannie Mae when the owner is in default) is the ability to obtain credit to purchase another home. Fannie Mae has updated its credit guidelines in the FNMA Selling Guide, June 30, 2010. [Note: This is a 1,234 page PDF document that takes a long time to download.] This legal article summarizes those guidelines in Part I. In addition, since lenders use FICO scores in order to determine the creditworthiness of a borrower, this article covers the impact of a bankruptcy, foreclosure or short sale on FICO scores in Part II.

I. Fannie Mae Credit Guidelines

A. Credit after Foreclosure

Q 1. ***How long is the time period after a foreclosure before a consumer can be eligible to obtain credit to purchase a home?***

A **Seven years** from the date the foreclosure sale was completed as reported on the credit report or other foreclosure documents provided by the borrower. See Question 2 below for exceptions.

(*Source*: FNMA Selling Guide, 6-30-10 at 426)

Q 2. ***Does a shorter time period apply if the borrower has "extenuating circumstances" that led to the foreclosure?***

A Yes. The borrower may again be eligible for a loan t**hree years** from the date the foreclosure sale was completed if the borrower has "extenutating circumstances" as defined in Question 3.

Additional requirements that apply after 3 years and up to 7 years following the completion date are as follows:

- The purchase must be of a principal residence. Purchase of a second home or investment property is not permitted until the seven-year waiting period has elapsed.
- The consumer is limited to a maximum loan to value ratio of 90 percent. If the Eligibility Matrix (https://www.efanniemae.com/sf/refmaterials/eligibility/pdf/eligibilitymatrix.pdf) sets forth a lower maximum loan-to-value ratio for the transaction at hand, then the consumer is limited to the lower maximum loan-to-value ratio.

- Limited cash-out refinances are permitted for all occupancy types. (Cash-out refinances are not permitted until a seven-year waiting period has elapsed.)

(*Source*: FNMA Selling Guide, 6-30-10 at 426-7.)

Q 3. ***What are"extenuating circumstances"?***

A Fannie Mae describes "extenuating circumstances" as follows:

> Extenuating circumstances are 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.
>
> If a borrower claims that derogatory information is the result of extenuating circumstances, the lender must substantiate the borrower's claim. Examples of documentation that can be used to support extenuating circumstances include documents that confirm the event (such as a copy of a divorce decree, medical bills, notice of job layoff, job severance papers, etc.) and documents that illustrate factors that contributed to the borrower's inability to resolve the problems that resulted from the event (such as a copy of insurance papers or claim settlements, listing agreements, lease agreements, tax returns (e.g., covering the periods prior to, during, and after a loss of employment).
>
> The lender must obtain a letter from the borrower explaining the relevance of the documentation. The letter must support the claims of extenuating circumstances, confirm the nature of the event that led to the bankruptcy or foreclosure-related action, and illustrate the borrower had no reasonable options other than to default on his or her financial obligations.

(*Source*: FNMA Selling Guide, 6-30-10, 6-30-10 at 429.)

Q 4. ***What are the requirements to re-establish a credit history after a foreclosure?***

A After a foreclosure, a credit history must meet the following requirements to be considered re-established:

- The elapsed time and the related requirements are met (as discussed in this article).
- The loan receives a recommendation from Desktop Underwriter (an automated underwriting system) that is acceptable for delivery to Fannie Mae. If manually underwritten, then the loan must meet the minimum credit score requirements based on the parameters of the loan and the established eligibility requirements.
- The borrower has traditional credit as outlined in the Selling Guide, B3-5.3, Traditional Credit History (https://www.efanniemae.com/sf/guides/ssg/sg/pdf/sel043010.pdf). Nontraditional credit or “thin files” are not acceptable. A “thin file” exists where the borrower does not have a sufficient number of credit references to develop a traditional credit report.

(*Source*: FNMA Selling Guide, 6-30-10, 6-30-10 at 428).

B. Credit after Deed-in-Lieu (DIL) of Foreclosure

Q 5. ***How long is the time period after a deed-in-lieu of foreclosure before a consumer can be eligible to obtain credit to purchase a property?***

A After **two years** from the date the deed in lieu was executed, but the consumer is limited to a maximum loan-to-value ratio of 80 percent. If the Eligibility Matrix (https://www.efanniemae.com/sf/refmaterials/eligibility/pdf/eligibilitymatrix.pdf) sets forth a lower maximum loan-to-value ratio for the transaction at hand, then the consumer is limited to the lower maximum loan-to-value ratio.

After **four years**, the consumer is limited to a maximum loan to value ratio of 90 percent. If the Eligibility Matrix (https://www.efanniemae.com/sf/refmaterials/eligibility/pdf/eligibilitymatrix.pdf) sets forth a lower maximum loan-to-value ratio for the transaction at hand, then the consumer is limited to the lower maximum loan-to-value ratio.

After **seven years**, the consumer is limited to the loan-to-value ratios set forth in the Eligibility Matrix. (https://www.efanniemae.com/sf/refmaterials/eligibility/pdf/eligibilitymatrix.pdf)

(*Source*: FNMA Selling Guide, 6-30-10, 6-30-10 at 427.)

Q 6. ***Does a shorter time period apply if the borrower has "extenuating circumstances" that led to the deed-in-lieu of foreclosure?***

A Yes. **Two years** from the date the deed-in-lieu was executed, but the consumer is limited to a maximum loan-to-value ratio of 90 percent. If the Eligibility Matrix (https://www.efanniemae.com/sf/refmaterials/eligibility/pdf/eligibilitymatrix.pdf) sets forth a lower maximum loan-to-value ratio for the transaction at hand, then the consumer is limited to the lower maximum loan-to-value ratio.

(*Source*: FNMA Selling Guide, 6-30-10, 6-30-10 at 427.)

See Question 3 for the definition of "extenuating circumstances."

Q 7. ***Are deed-in-lieu of foreclosure actions identified on a credit report?***

A A deed-in-lieu of foreclosure may be reported by a remarks code indicating a deed-in-lieu.

(*Source*: FNMA Announcement 08-16 Q&A, 8-13-08.)

Q 8. ***What are the requirements to re-establish a credit history after a deed-in-lieu of foreclosure?***

A After a deed-in-lieu of foreclosure, a credit history must meet the following requirements to be considered re-established:

- The elapsed time and the related requirements are met (as discussed in this article).

- The loan receives a recommendation from Desktop Underwriter (an automated underwriting system) that is acceptable for delivery to Fannie Mae. If manually underwritten, then the loan must meet the minimum credit score requirements based on the parameters of the loan and the established eligibility requirements.

- The borrower has traditional credit as outlined in the Selling Guide, B3-5.3, Traditional Credit History (https://www.efanniemae.com/sf/guides/ssg/sg/pdf/sel043010.pdf). Nontraditional credit or “thin files” are not acceptable. A “thin file” exists where the borrower does not have a sufficient number of credit references to develop a traditional credit report.

(*Source*: FNMA Selling Guide, 6-30-10 at 428).

C. Credit after a Short Sale (Preforeclosure Sale)

Q 9. ***How long is the time period after a " preforeclosure sale" before a consumer can be eligible to obtain credit to purchase a property?***

A After **two years** from the date the preforeclosure sale was completed, but the consumer is limited to a maximum loan-to-value ratio of 80 percent. If the Eligibility Matrix (https://www.efanniemae.com/sf/refmaterials/eligibility/pdf/eligibilitymatrix.pdf) sets forth a lower maximum loan-to-value ratio for the transaction at hand, then the consumer is limited to the lower maximum loan-to-value ratio.

After **four years**, the consumer is limited to a maximum loan to value ratio of 90 percent. If the Eligibility Matrix (https://www.efanniemae.com/sf/refmaterials/eligibility/pdf/eligibilitymatrix.pdf) sets forth a lower maximum loan-to-value ratio for the transaction at hand, then the consumer is limited to the lower maximum loan-to-value ratio.

After **seven years**, the consumer is limited to the loan-to-value ratios set forth in the Eligibility Matrix (https://www.efanniemae.com/sf/refmaterials/eligibility/pdf/eligibilitymatrix.pdf).

(*Source*: FNMA Selling Guide, 6-30-10, 6-30-10 at 427.)

Q 10. ***What is a "preforeclosure sale" mentioned in Question 9 and is that the same as a short sale?***

A "A preforeclosure sale involves the sale of the property by the borrower to a third party for less than the amount owed to satify the delinquent mortgage, as agreed to by the lender, investor, and mortgage insurer"

Although the terms preforeclosure sale and short sale have been used interchangeably, there is a significant difference for purposes of obtaining credit. For Fannie Mae purposes, a preforeclosure assumes that the borrower has been delinquent in paying his or her mortgage and the lender agrees to accept a lesser amount to avoid the time and expense of a foreclousre action. A short-sale, however, can also refer to situations in which the lender of the mortgage agrees to a payoff of a lesser amount than is actually owed, even on a current mortgage, to facilitate the sale of the property to a third party.

(*Source*: FNMA Announcement 08-16 Q&A, 8-13-08.)

Q 11. ***Does a shorter time period apply if the borrower has "extenuating circumstances" that led to the preforeclosure (short) sale?***

A Yes. Two years from the date the preforeclosure sale was completed, but the consumer is limited to a maximum loan-to-value ratio of 90 percent. If the Eligibility Matrix (https://www.efanniemae.com/sf/refmaterials/eligibility/pdf/eligibilitymatrix.pdf) sets forth a lower maximum loan-to-value ratio for the transaction at hand, then the consumer is limited to the lower maximum loan-to-value ratio.

(*Source*: FNMA Selling Guide, 6-30-10 at 427 .)

Q 12. ***If a borrower sold his or her property as a short sale but was never delinquent on that mortgage and is now attempting to purchase a new primary residence, will Fannie Mae purchase the loan?***

A The loan will be eligible for delivery to Fannie Mae provided that the borrower's previous mortgage history complies with Fannie Mae's excessive prior mortgage delinquency policy--that is the borrower does not have one or more 60-, 90-, 120-, or 150-day delinquencies reported within the 12 months prior to the credit report date--and the borrower has not entered into any agreement with the short sale lender to repay any amounts associated with the short sale, including a deficiency judgment.

(*Source*: FNMA Announcement 08-16 Q&A, 8-13-08; FNMA Selling Guide, Part X, Chapter 3, Section 302.09.)

Q 13. ***Are preforeclosure sales (short sales) identified on a credit report?***

A Preforeclosure sales may be reported as "paid in full" with a "settled for less than owed" remarks code, and the mortgage tradeline would indicate any recent delinquency.

(*Source*: FNMA Announcement 08-16 Q&A, 8-13-08.)

D. Credit after a Bankruptcy

Q 14. ***How long is the time period after a Chapter 7 or Chapter 11 bankruptcy before a consumer can be eligible to obtain credit to purchase a property?***

A **Four years** from the discharge or dismissal date of the bankruptcy action.

(*Source*: FNMA Selling Guide, 6-30-10 at 425.)

Q 15. ***How long is the time period after a Chapter 13 bankruptcy before a consumer can be eligible to obtain credit to purchase a property?***

A **Two years** from the discharge date and **four years** from the dismissal date. The shorter waiting period based on the discharge date recognizes that borrowers have already met a portion of the waiting period within the time needed for the successful completion of a Chapter 13 plan and subsequent discharge.

(*Source*: FNMA Selling Guide, 6-30-10 at 425.)

Q 16. ***Does a shorter time period apply if the borrower has "extenuating circumstances" that led to the bankruptcy (all actions)?***

A Yes. **Two years** from the discharge or dismissal; however, no exceptions are permitted to the 2-year time period after a Chapter 13 discharge.

(*Source*: FNMA Selling Guide, 6-30-10 at 425-6.)

See Question 3 for the definition of "extenuating circumstances."

Q 17. ***How long is the time period after <u>multiple bankruptcy filings</u> before a consumer can be eligible to obtain credit to purchase a property?***

A **Five years** from the most recent dismissal or discharge date for borrowers with more than one bankruptcy filing within the past 7 years.

(*Source*: FNMA Selling Guide, 6-30-10 at 426.)

Q 18. ***What are "multiple bankruptcy filings"?***

A This means an individual borrower has filed for bankruptcy more than one time. Two or more borrowers with individual bankruptcies are not cumulative, and do not constitute multiple bankruptcies. For example, if the borrower has one bankruptcy and the co-borrower has one bankruptcy, this is not considered a multiple bankruptcy.

(*Source*: FNMA Selling Guide, 6-30-10 at 426.)

Q 19. ***Does a shorter time period apply if the borrower has "extenuating circumstances" that led to the multiple bankruptcies?***

A Yes. **Three years** from the most recent discharge or dismissal date. The most recent bankruptcy filing must have been the result of extenuating circumstances.

(*Source*: FNMA Selling Guide, 6-30-10 at 426.)

See Question 3 for the definition of "extenuating circumstances."

Q 20. ***What is the difference between a Chapter 13 bankruptcy and a Chapter 7 bankruptcy?***

A Chapter 13 permits a borrower with a regular income to propose a plan to repay some or all of his or her obligations over a period of up to five years. A borrower who files a Chapter 7 is permitted to retain exempt assets and receive a discharge of the borrower's debts. Chapter 7 is a relatively quick liquidation process that is generally completed within 120 days. Chapter 7 cases are rarely dismissed.

(*Source*: FNMA Announcement 08-16 Q&A, 8-13-08.)

Q 21. ***What is the difference between a Chapter 13 dismissal and a Chapter 13 discharge?***

A A borrower who files a Chapter 13 can dismiss the case at any time (voluntary dismissal) or the case may be dismissed by the court based on the borrower's failure to comply with the requirements of the Bankruptcy Code or to make the required payments. If the borrower who files a Chapter 13 case makes all of the payments required by the plan, the borrower receives a discharge at the end of the plan. A borrower who doesn't make all the payment required by the plan may still receive a discharge if the court finds, among other things, that the borrower made a certain amount of the payments and the borrower's failure to make all of the payments was due to circumstances beyond the borrower's control.

(*Source*: FNMA Announcement 08-16 Q&A, 8-13-08.)

Q 22. ***What are the requirements to re-establish a credit history?***

A After a bankruptcy, a credit history must meet the following requirements to be considered re-established:

- The elapsed time and the related requirements are met (as discussed in this article).

- The loan receives a recommendation from Desktop Underwriter (an automated underwriting system) that is acceptable for delivery to Fannie Mae. If manually underwritten, then the loan must meet the minimum credit score requirements based on the parameters of the loan and the established eligibility requirements.

- The borrower has traditional credit as outlined in the Selling Guide, B3-5.3, Traditional Credit History (https://www.efanniemae.com/sf/guides/ssg/sg/pdf/sel043010.pdf). Nontraditional credit or "thin files" are not acceptable. A "thin file" exists where the borrower does not have a sufficient number of credit references to develop a traditional credit report.

(*Source*: FNMA Selling Guide, 6-30-10 at 428).

II. Bankruptcy, Foreclosure, and Short Sale and the Impact on a FICO ®Score

Q **23.** ***What is a FICO® Score?***

A A FICO® score is a number representing the creditworthiness of a person or the likelihood that person will pay his or her debts. The three credit reporting agencies, Equifax, Experian, and TransUnion, collect data about consumers in order to compile credit reports. The credit agencies use FICO® software to generate FICO® scores, which are then sold to lenders. Actually FICO® is just one of the several credit scoring systems available. The Fair Isaac Corporation (known as FICO®) created the first credit scoring system in 1958. Others are NextGen, VantageScore, and the CE Score. They all evaluate the creditworthiness of a borrower. However, FICO appears to be the most -used credit scoring system. A FICO® score is between 300 and 850. The higher the better the credit.

Each consumer has three credit scores at any given time for any given scoring model because the three credit agencies have their own databases, gather reports from different creditors, and receive information from creditors at different times.

Q **24.** ***What factors go into determining a FICO® score?***

A Credit scores are designed to measure the risk of default by taking into account various factors in a person's financial history. Although the exact formulas for calculating credit scores are closely-guarded secrets, FICO® has disclosed the following components and the approximate weighted contribution of each:

35% — **Payment History** – Late payments on bills, such as a mortgage, credit card or automobile loan, can cause a consumer's FICO® score to drop. Paying bills as agreed over time will improve a consumer's FICO® score.

30% — **Credit Utilization** - The ratio of current revolving debt (such as credit card balances) to the total available revolving credit (credit limits). Consumers can improve their FICO® scores by paying off debt and lowering their utilization ratio. The closing of existing revolving accounts will typically adversely affect this ratio and therefore have a negative impact on the FICO® score.

15% — **Length of Credit History** – As a consumer's credit history ages, assuming the consumer pays his or her bills, it can have a positive impact on the FICO® score.

10% — **Types of Credit Used** (installment, revolving, consumer finance) – Consumers can benefit by having a history of managing different types of credit.

10% — **Recent search for credit and/or amount of credit obtained recently** - Multiple credit inquiries for a consumer seeking to open new credit, such as credit cards, retail store accounts, and personal loans, can hurt an individual's score. Applying for lots of new credit in a short period of time is also viewed as risky and can cause a drop in an individual's score. However, individuals shopping for a mortgage or auto loan over a short period will likely not experience a decrease in their scores as a result of these types of inquiries.

(*Source*: http://www.myfico.com/CreditEducation/WhatsInYourScore.aspx)

Q 25. *How does a mortgage modification affect my FICO® score?*

A FICO® credit scores are calculated from the information in consumer credit reports. Whether a loan modification affects the borrower's FICO® score depends on whether and how the lender chooses to report the event to the credit bureau, as well as on the person's overall credit profile. If a lender indicates to a credit bureau that the consumer has not made payments on a mortgage as originally agreed, that information on the consumer's credit report could cause the consumer's FICO® score to decrease or it could have little to no impact on the score.

(*Source*: http://www.myfico.com/crediteducation/questions/Mortgage_Modification.aspx)

Q 26. *How does a bankruptcy affect my FICO® score?*

A A bankruptcy is considered a very negative event regardless of the type. A bankruptcy is factored into your FICO® score until it is removed from your credit report. As long as the bankruptcy is listed on your credit report, it will be factored into your score. If you are considering bankruptcy as an alternative to foreclosure, keep in mind that it may have a greater impact on your FICO® score.

Typically, you can expect bankruptcies to impact your FICO® score, from the date filed, as follows:

(1) Chapter 11 and Chapter 7 bankruptcies up to 10 years.

(2) Completed Chapter 13 bankruptcies up to 7 years.

These time periods refer to the public record item associated with filing for bankruptcy. All of the individual accounts included in the bankruptcy should be removed from your credit report after 7 years.
(*Source*: http://www.myfico.com/crediteducation/Questions/Bankruptcy-Types.aspx)

If you plan to file a bankruptcy, here are some things you should do to make sure your creditors are accurately reporting the bankruptcy filing:

(1) Check your credit report to ensure that accounts that were not part of the bankruptcy filing are not being reported with a bankruptcy status.

(2) Make sure your bankruptcy is removed as soon as it is eligible to be "purged" from your credit report.

After a bankruptcy has been filed, the sooner you begin re-establishing credit in good standing, the sooner you can expect your FICO® score to rebound. A good practice is to obtain a secured credit card and continually make all of your payments on time. As time passes and the impact of the bankruptcy lessens, you might apply for a traditional credit card and also continually make all of your payments on time.

(*Source*: http://www.myfico.com/crediteducation/questions/Bankruptcy-Reach.aspx)

Q **27.** ***How does a short sale, deed-in-lieu-of foreclosure. or a foreclosure affect my FICO® score?***

A The alternatives to foreclosure, such as a deed-in-lieu of foreclosure or a short sale, aren't any better as far as a FICO® score is concerned.

The common alternatives to foreclosure, such as short sales, and deeds-in-lieu of foreclosure are all "not paid as agreed" accounts, and considered the same by your FICO® score. This is not to say that these may not be better options for you from a financial or tax perspective, just that they will be considered no better or worse for your FICO® score.

If you are considering bankruptcy as an alternative to foreclosure, that may have a greater impact on your FICO® score. While a foreclosure is a single account that you default on, declaring bankruptcy has the opportunity to affect multiple accounts and therefore has potential to have a greater negative impact on your FICO® score.

(*Source*: http://www.myfico.com/CreditEducation/Questions/foreclosure-alternatives-fico-score.aspx)

Q **28.** ***What won't affect my FICO® score?***

A The following information is not considered by the FICO® scoring formula:

- Your race, color, religion, national origin, sex, or marital status
- Your age
- Your salary, occupation, title, employer, date employed, or employment history
- Where you live
- Any interest rate being charged on a particular credit card or other account
- Certain types of inquiries (such as promotional, account review, insurance or employment-related inquiries)
- Credit counseling
- Any information not found in your credit report
- Any information that is not proven to be predictive of future credit performance

(*Source*: http://myfico.custhelp.com/cgi-bin/myfico.cfg/php/enduser/std_adp.php?p_faqid=55)

Q 29. ***Where can I get more information?***

A For a credit missteps comparison (i.e., affect on credit scores after certain events), go to http://www.myfico.com/crediteducation/questions/Credit_Problem_Comparison.aspx.

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