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ACCESS TO CONSUMER CREDIT POST FORECLOSURE

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Access to Consumer Credit Post Foreclosure

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The comments in this paper are those of the author alone and do not necessarily reflect the views of the Federal Reserve Bank of Atlanta or the Federal Reserve System.

The financial implications of foreclosure are enormous, especially for lower income households. The immediate loss of the home and the corresponding decrease in household net worth are most dramatic. However, foreclosure also damages a consumer's credit, and due to the rising importance of credit and credit scores in all areas of our lives, the adverse impacts of foreclosure over time can be just as devastating. In order to begin to address this problem, we need to understand not simply its magnitude but its diverse underlying causes, for these will shape the kinds of policy interventions that might be appropriate.

The foreclosure crisis

There have been a record number of foreclosures in the past two years, and significantly more are projected in the next five years.¹ In 2008, there were over three million foreclosure filings, and over one million homeowners lost their homes to foreclosure. In 2009, the number of foreclosures is projected to more than double.² The problem shows no signs of abating, as nearly one out of every ten homeowners is currently delinquent on their mortgage.³ The causes of foreclosure have evolved over time. Initially, many of the individuals who lost their homes were victims of subprime mortgages or had exotic, adjustable rate mortgages that they could not afford. More recently falling home values and rising unemployment have increased the number foreclosures, and have compounded the difficulty of dealing with foreclosures.

What is the connection between foreclosure and credit scores?

A consumer's credit score declines significantly as a result of foreclosure.⁴ For individuals who have lost their jobs or have declared bankruptcy, the implications of foreclosure are most severe and long-lasting. Given the magnitude of the foreclosure crisis and the rising number of unemployed, it's clear that we are facing a significant problem for the foreseeable future with the number of individuals in this country with impaired credit.

¹ Center for Responsible Lending, *Snapshot of a Foreclosure Crisis-15 Fast Facts*. August 2009. www.responsiblelending.org/mortgage-lending/research-analysis/snapshot-of-a-foreclosure-crisis.html

² RealtyTrac (www.realtytrac.com)

³ Mortgage Bankers Association, National Delinquency Survey. August 2009.

⁴ According to Vantage Score Solutions a national credit scoring agency, a consumer's credit score decreases by 100 to over 300 points as a result of foreclosure. The actual impact depends on a number of factors, including but not limited to the disposition strategy for the home, the status of the consumer's other debts, the length of time the homeowner was delinquent on their mortgage, and whether the homeowner declared bankruptcy. Source: November 5, 2009 Webinar hosted by Vantage Score. Webinar archive available at www.vantagescore.com.

Why does this matter?

Credit scores matter today more than ever and their use is much more widespread than simply evaluating credit worthiness. Individuals with damaged credit pay more for any type of consumer financing, if they can even get a loan. In addition, credit scores can influence price and terms for other services, such as insurance.⁵ Landlords may evaluate an individual's credit prior to renting a home and some employers access credit scores for all new hires.⁶

Furthermore, access to credit has become increasingly important for individuals at all income levels, and credit card usage has risen dramatically in the past twenty years.⁷ Consumers now use credit for everything from major purchases to basic goods. Particularly for many lower-income households, credit cards have become a financial safety net, as they are used to cover basic needs, such as food or medical bills.⁸ Even before the current recession, an increasing number of households were financing their basic living expenses with debt. With rising unemployment and foreclosures, these households are likely to face much greater difficulty obtaining affordable credit at the same time that their need for it has increased.

Is policy intervention is needed?

Given the widespread problem of impaired consumer credit due to foreclosure, policy intervention may be needed in order to insure individuals are not entirely shut out of the mainstream credit system, exacerbating their financial hardship. One of the benefits of the recent period of financial innovation was the “democratization of credit.”⁹ More individuals were able to purchase homes and obtain credit at reasonably affordable rates, and to this day, there are still successful homeowners who benefited from these products. Policy intervention may be needed to insure reasonably priced, responsible credit products are still available, even for individuals with blemished credit histories. Most importantly, policy intervention may be required to make sure that for individuals who have gone through foreclosure have access to the means necessary to improve their weakened financial condition.

In order to design appropriate policy interventions, we need a better understanding of the different types of foreclosure victims, the factors that led to their foreclosure, and their credit needs. Victims of foreclosure range from those with subprime mortgages they cannot afford, to those who owe more on their mortgage than their home is worth, to the recently unemployed. These individuals differ significantly in terms of their ability to withstand the financial hardship of foreclosure and unique strategies, including regulation and policy interventions, will be required to help them undertake a

⁵ National Consumer Law Center. *Credit Scoring and Insurance: Costing Consumers Billions and Perpetuating the Economic Racial Divide*. June 2007.

⁶ G. Thomas Kingsley, Robin Smith, and David Price. *The Impacts of Foreclosures on Families and Communities* (Washington, DC: Urban Institute, 2009).

⁷ According to Demos, American's overall credit card debt increased by 315% between 1989 and 2006. Demos, *Borrowing to Make Ends Meet*. July 2007.

⁸ Demos, *The Plastic Safety Net*. July 2009.

⁹ Chairman Ben S. Bernanke, *Increasing Economic Opportunity: Challenges and Strategies*. Speech at the At the Fifth Regional Issues Conference of the Fifteenth Congressional District of Texas, Washington, D.C. June 13, 2006. www.federalreserve.gov/newsevents/speech/Bernanke20060613a.htm

successful process of recovery. One common need for all victims of foreclosure is access to financial counseling, to help them negotiate the complex credit system and make informed financial decisions in the future.

Research questions

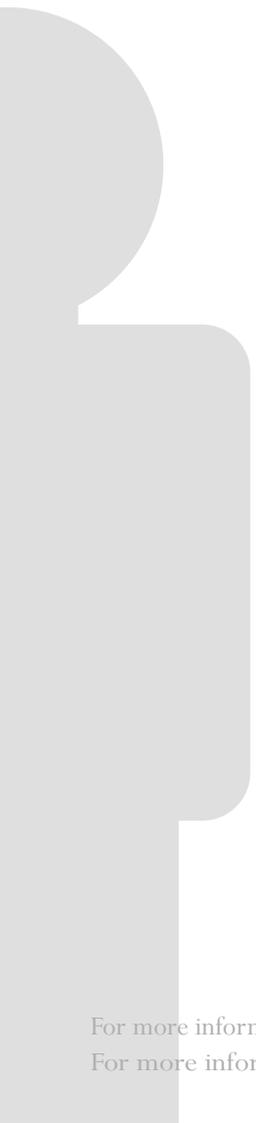
To develop effective policy interventions that address the impact of foreclosure on consumer credit, a number of research questions should be considered.

- First, what is the current credit risk profile of the different types of foreclosure victims? How does the risk profile compare with current bank lending policies? If these individuals are shut out due to existing policies, how are banks going to respond? Will other types of financial institutions such as community development financial institutions (CDFIs) or credit unions play a greater role in access to consumer credit? Can we encourage a more constructive role for banks?
- Second, beyond credit scores, what are alternate means for determining an individual's credit worthiness and/or evaluating individuals for renting a home or employment? How can we insure that individuals with low credit scores are not denied access to the means of improving those scores (i.e., affordable rental housing, employment or the ability to restructure their other debt to make it more affordable)?
- Finally, with declining access to credit, will new abusive lending practices emerge to provide credit to individuals who are denied by mainstream financial institutions? How can we prevent such practices?

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