Experian
A world of insight

All about credit in a recession

The U.S. recession is taking its toll on Americans' finances, leading to anything from simple lifestyle modifications such as eating at home more and shopping less to more serious issues such as the ability to make the car or mortgage payments. Recent reports have found that more Americans are falling into the lowest category of credit scores, while several million have fallen from the highest credit score category. Here's a look at what you need to know about your credit during a recession.

Deciding which bills to pay

If you are unemployed or have had to take a reduction in pay, you may find it difficult to pay all of your monthly bills. Not making regular payments on existing debt will have a negative impact on your credit scores, so it is important that you seek help to prioritize.

The first thing to do is get financial counseling. There are many reputable nonprofit credit counseling companies that can enroll you in a debt management plan with negotiated terms that will help you repay the debt and work with your creditors. They will help make sure that you don't miss a payment during the transition to the program. As you continue to pay your debts through such a program, your account status will be reported as current.

There are many companies making offers that make it sound easy to wipe out your debt, yet it is rarely easy. More important, some of these companies are simply making money by talking you into a consolidation loan or trying to negotiate a debt settlement with your creditors. They have been known to advise consumers to miss payments so that creditors will be more willing to negotiate rather than not being paid at all. Anytime you miss payments or settle a debt, it will have a significant negative impact on your credit history, and therefore, your credit scores. Before selecting a company, check with the Better Business Bureau, the FTC or even your state attorney general's office for information about reputable companies in your area.

Credit history can impact employment opportunities

Federal law allows potential and current employers to view a modified version of your credit report for employment purposes such as hiring or promoting. This "employment report" includes much of the information about your loans and credit cards that is listed in your credit report; however, account numbers are omitted to protect your financial security. Year of birth and spouse references are also omitted to meet equal employment opportunity laws. Credit reports are not scored when used for employment purposes; they are typically reviewed as part of the character evaluation as well as to verify identity and application information.

In order for an employer to pull your credit report, you must give written permission. If you have had trouble paying your bills, consider proactively discussing your situation with your potential employer.

Bankruptcy is not an easy way out

One of the great myths about bankruptcy is that it erases bad credit history. It doesn't. Declaring bankruptcy frees you from paying all or part of the debt you owe. Accounts will be updated in your credit report to show "included in bankruptcy." However, the accounts will not be deleted from your credit report. Chapter 13 bankruptcy remains on your credit history for seven years, while chapters 7 and 11 are reported for 10 years. Credit accounts may be deleted at different times depending on their status prior to being included in bankruptcy.

Bankruptcy makes it more difficult for you to get credit, and if you do, you are likely to get unfavorable loan or credit card terms. While bankruptcy isn't an easy way to escape a bad credit history, it does stop collectors from calling and lets you start fresh in managing your finances wisely to rebuild a good credit history over time.

Reduced credit limits can negatively impact credit scores

If your credit card company or home equity lender recently reduced your limit, it is likely having a negative impact on your credit scores. The reason that a limit decrease can hurt your scores is related to your utilization rate, or balance-to-limit ratio. The higher your utilization rate, the higher risk you represent to lenders.

To calculate your utilization rate, add up all of your credit card balances and then add up all of your total credit limits. Then, divide the balance total by the limits total. For example, if you have two credit cards, each with a $5,000 limit, you have a total of $10,000 in available credit. If one card has a $5,000 balance and the other a zero balance, your utilization rate is 50 percent. If the limit on one card is decreased by $2,500, your limit total decreases to $7,500. Your utilization rate immediately increases to 75 percent. You should try to keep your utilization rate as low as possible, ideally in the 10 to 30 percent range.

Closing accounts to reduce spending can hurt credit scores

Closing an account in an effort to reduce spending will likely have a negative impact on your credit scores. It can increase your utilization rate, as described above, making you appear to be an increased credit risk.

The standard advice is to keep unused accounts with zero balances open. However, you should use your good judgment based on your own situation. You shouldn't make credit decisions driven only by a credit score. Instead, you should make decisions based on your overall financial situation, your need for the account and your ability to repay the debt.

Voluntary vehicle surrender better than repossession

Surrendering your vehicle and repossession are fundamentally the same thing in financial terms: You are unable to make the loan payments, so the lender is taking the vehicle.

When you voluntarily return the vehicle, you are taking some responsibility for the debt you owe. Be sure you completely understand the terms when you make the voluntary surrender. If there is a balance remaining and you don't pay it, it could be turned over to a collection agency, which will add a collection account to your credit history. Your credit report will indicate a voluntary surrender for that account, and any remaining balance will continue to be reported.

If the bank has to take the vehicle, it will report the account as a repossession, and that will be reflected on your credit report.

Both voluntary surrenders and repossessions have serious impacts on your credit scores, but a voluntary surrender may hurt your credit scores slightly less than a repossession.

Impact of mortgage repayment options on credit scores

With home values falling across the country, many Americans are evaluating their mortgages to determine if loan modifications, short sales or even strategic defaults are viable options.

Loan modification

A loan modification is a permanent change in one or more of the terms of a borrower's loan, allowing the loan to be reinstated at a payment the borrower can afford. Mortgage loan modifications are intended for people struggling with serious debt problems. The modification means the mortgage lender is accepting less profitable terms.

In response to the federal government's Making Home Affordable loan modification program, the Consumer Data Industry Association has issued new guidelines for how lenders should report loan modifications to the credit bureaus. Lenders will now report loan modifications as a loan modified under a federal government plan. Under the association's guidelines, the lender is supposed to report the loan as current if a person has not missed or been late with mortgage payments before and during a trial modification period (typically three months). However, if the loan was at least 30 days past due before the trial modification, payments during the trial period will not make the loan current and the lender will still report the appropriate level of delinquency. But if the modification is approved, it will be reported as modified under a federal plan.

Because loan modifications are a relatively new option and credit scores are based on actual consumer credit usage, it is too early to know how loan modifications will impact credit scores. Once there is enough documented performance — typically a year's worth of information —for people who have gone through federal modifications, companies that develop scoring tools will determine if any changes need to be made to credit-scoring models.

Short sale

"Short sale" generally means you sell your house for less than you owe on the mortgage. The term "short sale" does not actually appear in a credit report. So, the important concept to understand before you agree to your lender's terms is how the mortgage loan will be closed and reported in your credit history.

When you pay less than originally agreed on any loan, the impact on your credit report almost always will be negative. It would be rare for a lender to report the mortgage as "paid" and forgive the remaining amount. In the vast majority of instances, a short sale is reported as "settled," which means that you reached an agreement to repay only a portion of the total amount. The remainder is written off as a loss by the creditor. Settled accounts, like charged-off accounts, have a negative impact on your credit score, particularly because a mortgage is involved.

Foreclosure and "deed in lieu" of foreclosure are other options to close out a mortgage loan, both of which also negatively impact credit scores.

Strategic default

A strategic default occurs when a borrower defaults, or stops making payments, on a mortgage because the value of the home declined well below the mortgage balance. Walking away from a mortgage using a strategic default will reduce your credit score significantly for seven years. As a borrower, you have to consider the impact such a decision will have on your ability to get credit in the years to come and determine if it is a worthwhile tradeoff compared to the financial damage of being in debt on a home that has lost substantial value in recent years.