GUY CARPENTER

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Federal Housing Finance Agency
Constitution Center
400 7th Street, SW
Washington, D.C. 20219

To Whom It May Concern,

Guy Carpenter is pleased to provide its perspective in response to FHFA's Request for Input on Credit Scores. As an intermediary for the Enterprises on the Credit Risk Transfer (CRT) reinsurance programs, Guy Carpenter is uniquely positioned to comment on both how potential changes to credit scores may impact the reinsurers that support the CRT programs as well as how these changes may impact the Enterprises' execution of their respective CRT programs.

Guy Carpenter has an inherent bias for innovation and competition. While the new credit scoring models offer the promise of improved accuracy which is welcomed by the reinsurance market, they also add additional cost and complexity in their use and implementation. Guy Carpenter supports the option of including these new credit scoring models while maintaining backwards compatibility with the existing Classic FICO scores.

Over the course of the last four years, the Enterprises have established a tremendously successful and programmatic CRT program that has thrived under the consistent support of the reinsurance market at competitive terms. During this period, reinsurers have grown comfortable with the predictability of the Classic FICO score. As credit scores are a key risk driver of borrower default, Guy Carpenter, reinsurers and third party models have all relied on the Classic FICO score to calibrate their credit default loss distributions and pricing models.

Guy Carpenter believes that any new credit scoring adopted by the Enterprises must be backwards compatible with Classic FICO to allow for the consistent evaluation of credit risk across time and across transactions. Not providing the translation into Classic FICO risks continuity of reinsurer support, and potentially jeopardizes market pricing for future CRT transactions. It is our understanding that FICO Score 9 is the only credit score that is backwards compatible with Classic FICO, and allows the reinsurance market to have a consistent view of credit risk.

To this end, Guy Carpenter supports Option 2 (Multiple Scores) on the condition that FICO Score 9 is required for every loan (and not provided as an option as is currently stated in the FHFA RFI). This approach allows the reinsurer consistency in their view of credit risk as well as gives them the option to incorporate additional credit scores if they so choose. With Option 1 (Single Score), reinsurers will be provided a single credit score, but it could be a new form of credit scoring where a FICO Score 9 does not exist. This would force reinsurers to evaluate and implement a new scoring system that will add time and expense to their operations. Options 3 (Lender Choice) and Option 4 (Waterfall) appear fundamentally flawed and introduce adverse selection into the system. With these two options reinsurers may unknowingly bear the cost of anti-selection.

We applaud the FHFA for its transparency and for extending the period for comment. Guy Carpenter appreciates the opportunity to share our perspective, and we look forward to continued collaboration with the FHFA and the Enterprises in the future.

Regards,

Jeffrey N. Krohn
Global Mortgage Credit Practice Leader

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RESPONSE TO FHFA CREDIT SCORE REQUEST FOR INPUT

MARCH 30, 2018

MARSH & McLENNAN COMPANIES

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General Questions on Credit Scores

A1.1: When and how do you use credit scores during the mortgage life cycle to support your business?

Guy Carpenter acts as an intermediary for the Enterprises on their Credit Risk Transfer (CRT) reinsurance programs. In that role we analyze loan level data for each transaction, including credit scores, at the time of CRT issuance as part of our work in advising the Enterprises on structuring and marketing the transaction to reinsurers. Credit scores are among the most important variables and predictors of default risk. Once CRT transactions are issued, updated FICO scores are reported on an ongoing basis allowing reinsurers to monitor the overall credit worthiness of the mortgage pool.

A1.2: Do you use the same credit score version for all of your lending business lines, whether it is mortgage lending or non-mortgage lending (e.g., credit card and / or auto loans)? If so, why? If you use multiple credit scores (e.g., FICO and VantageScore) in making credit decisions for any one line of business, please identify which credit score you use for the type of lending and why? Are you considering updating credit scores that you use in your non-mortgage lending business lines?

Not applicable to Guy Carpenter.

A1.3: Is it necessary for any new credit score policy from the Enterprises on credit score models to be applicable in all aspects of the loan life cycle, or could there be differences, such as in servicing?

Guy Carpenter believes that any new credit score policy should be applicable to all aspects of the loan life cycle. Our view is based on the importance of consistency and comparability of credit scores across time and across transactions for reinsurers to provide the most competitive prices to the Enterprises for their CRT programs.

A1.4: How would mortgage lenders and investors manage different credit score requirements from primary and secondary mortgage market participants? Is it important for your business processes that government guarantee programs in the primary mortgage market (e.g., FHA, VA, USDA-Rural Development) have the same credit score requirements as the Enterprises?

Our view is that different credit score requirements for primary and secondary mortgage market participants would create unnecessary complexity (and potentially cause confusion) among market participants. Currently, Guy Carpenter is only involved in the Enterprises' CRT programs, but if CRT expanded to include the FHA, VA or USDA-Rural Development programs, it would be critical for all government guarantee programs to be evaluated on the same basis of credit score requirements. Consistency of credit score requirements allows reinsurers and investors to benchmark and price for performance differences across their portfolios. The more complex the credit score landscape, the higher the cost of acquiring protection and the higher the barrier to expanding CRT investor and reinsurer participation.

A1.5: How would updating credit score requirements impact other industry-wide initiatives that affect your organization? What is the relative priority of this initiative compared to other industry-wide initiatives?

Guy Carpenter has no meaningful comments to offer.

A1.6: Do you have a recommendation on which option the FHFA should adopt?

Guy Carpenter understands and appreciates the aspirations and potential benefits of the various options under consideration. However, the promise of innovation and increased competition must be balanced with the continuity and soundness of not only the CRT market but the broader objectives of the Enterprises and the housing finance market.

Guy Carpenter believes that it is essential to maintain backwards capability to Classic FICO scores and supports Option 2 on the condition that FICO Score 9 is a required field and not just an optional field. Our recommendation is based on the reinsurance market's strong bias for the consistency of credit scores across transactions and across time. Since the advent of the CRT market, Guy Carpenter, reinsurers and third party credit default models have all used Classic FICO scores to calibrate their models and assess credit default risk of every new CRT transaction that comes to market. The Enterprises risk losing reinsurer support, either temporarily or permanently, if reinsurers cannot tie the FICO scores of new CRT issuances to the FICO scores of historical vintages. Any disruption to the consistency of reinsurers' support potentially jeopardizes efficient pricing and the long term continuity of the CRT reinsurance programs.

Guy Carpenter believes there may be only limited benefits to introducing VantageScore 3.0 in Option 2. Those benefits may not be worth the additional frictional costs, but at least it gives reinsurers the option to use a new score or not. Forcing reinsurers to rely on VantageScore 3.0, in our view, would not be well-received by the market.

Option 1 would deliver a single score – either FICO 9 or VantageScore 3.0. This option forces the reinsurance market to use VantageScore 3.0 where FICO 9 is not available. In Guy Carpenter's view, this option is problematic because VantageScore 3.0 is not backwards compatible with Classic FICO and does not allow a consistent view across time and transactions. Furthermore, we believe the reinsurance market would not welcome the additional time and cost required to develop multiple rating systems – one for each credit scoring system. Option 3 (lender choice with constraints) and Option 4 (waterfall) introduce adverse selection into the system and the reinsurance market will, at a minimum, respond with a heightened sense of trepidation. Adverse selection is the basis for many textbooks in the risk management and insurance sector and may cause many reinsurers to withdraw from the CRT market. In Guy Carpenter's view, Options 3 and 4 would be viewed more negatively by several orders of magnitude than the requirement to being forced to incorporate a new credit scoring system as in Option 1.

A1.7: Do you have additional concerns with or insights to share on the Enterprises updating their credit score requirements?

Guy Carpenter's role as an intermediary for the Enterprises on their Credit Risk Transfer (CRT) reinsurance programs means that our primary objectives are (a) to increase the universe of reinsurers who participate in CRT reinsurance and (b) to achieve the best execution (i.e., price and terms) for CRT reinsurance transactions on behalf of the Enterprises.

All else equal we support competition and innovation, but the benefits of any new requirements must outweigh the costs. It is our understanding that the new credit scoring models, whether FICO Score 9 or VantageScore 3.0, do indeed have greater accuracy and that would benefit the CRT reinsurance market. However, those benefits appear to be only marginal. On the other hand, the system costs to these new credit scoring models are largely unknown. We applaud the FHFA for extending the period to comment on the proposals and encourage a deeper examination of the system impacts to lenders, mortgage insurers, third party providers and the TBA and CRT markets. We suspect, however, the cost and risks of introducing these new proposals outweighs the marginal benefits.

2

Operational Questions on Credit Scores

A2.1: What benefits and disadvantages would you envision for your business, your business partners, and/or borrowers under each of the options?

Should the Enterprises require the reporting of the backward compatible FICO Score 9 under Option 2 as Guy Carpenter suggests in A1.6, we believe it offers the CRT reinsurance market (key suppliers of risk capital) the least disruption and presents the Enterprises with the best market execution and greatest consistency of reinsurer support.

Option 1 forces reinsurers to adopt a new credit scoring methodology (VantageScore 3.0) that is not backwards compatible to Classic FICO and will incur additional time and effort to implement. Options 3 and 4 are even more problematic introducing potential adverse selection allowing lenders to choose which credit score to use. This misalignment of interest will not go unnoticed by the reinsurance market and may lead to lack of future CRT support and suboptimal execution for the Enterprises.

A2.2: How significant are the operational considerations for a single score update? Please discuss any comparison of operational considerations between a single score (Option 1) and multiple score options (Options 2-4).

Moving from Classic FICO to FICO Score 9 will be less disruptive to the reinsurance market than it would be to VantageScore 3.0 which is not backwards compatible to Classic FICO. Reinsurers have a need for consistency across CRT transactions and across time. FICO Score 9 offers a bridge to past vintages and performance which allows reinsurers to evaluate new mortgage pools and recast historical experience based on the current mix of FICO scores (and other variables). Forcing reinsurers to rely on VantageScore 3.0 where FICO scores are not available will not likely be welcomed by the reinsurance market.

A2.3: What operational considerations are there for preferring one of the multiple credit score options (Options 2-4) over the others? For industry participants, are there unique operational considerations for your segment of the industry that FHFA should consider? If so, what are they? Are there unique operational considerations in a wholesale environment with mortgage brokers or correspondents under each of the multiple score options? If so, what are they?

Guy Carpenter has no meaningful comments to offer.

A2.4: Please provide an estimate of how much it would cost your organization to implement each option and how much time it would take to implement each option.

It's really difficult to estimate the cost to our organization for each option, but needless to say it is significant for us and the reinsurance market. We transact with over 30 reinsurers on CRT transactions and will need to brief and educate each one. This kind of effort would take time to get reinsurers comfortable with the changes. Reinsurance underwriters in turn will have to educate their management and make them comfortable that the credit scoring changes do not present any adverse consequences that would impact price or alignment of interest. The consistency of reinsurance support will be greatest with fewer changes. Any temporary lack of support while reinsurers evaluate changes could lead to CRT reinsurance placements that are not fully subscribed. Additionally, the Enterprises' price execution in the CRT reinsurance market could suffer if reinsurers temporarily withhold support. The totality of these costs are difficult to estimate.

A2.5: Could using any of the multiple credit score options affect the way investors view, and therefore price, Enterprise securities? Could any of the multiple credit score options reduce liquidity in the TBA market and/or increase the volume to the specified market? Are there any unique considerations among the multiple score options (Options 2-4) in evaluating their impact on MBS liquidity and/or demand for credit risk transfer transactions?

Comparability of data is critical for reinsurers who participate in CRT transactions. Reinsurers must feel comfortable with the comparability of the new credit score to historical Classic FICO data in order to participate in, and accurately price, CRT transactions. In addition, reinsurers will want the comparability of credit scores across transactions to be as consistent as possible so they can properly evaluate each transaction on a relative as well as an absolute basis. As noted earlier, Guy Carpenter understands that FICO has committed to providing backward compatibility with FICO Score 9 to simplify the process of adopting the new score. Mandating FICO Score 9 under Option 1 and 2 greatly improves any transition to new scores.

A2.6: Under the multiple score options (Options 2-4), if other mortgage market participants have different credit score requirements, such as requiring dual credit scores, what operational and resource issues would that present for you?

Introducing credit scores beyond Classic FICO requires creating new frameworks and re-parameterizing models. In addition, it is incumbent upon Guy Carpenter to educate the 30 plus reinsurers of the changes and potential impacts. Conversations and meetings with reinsurers take time. Reinsurers not comfortable with changes tend to withhold support until they become content.

A2.7: What impact would any of the credit score options have on a need for consumer education? What impact would the multiple credit score options (Options 2-4) have on consumers? Are there steps that FHFA, the Enterprises, or stakeholders could take that would mitigate any confusion about multiple credit score options?

Guy Carpenter does not interact with the consumer directly and has no meaningful comments to offer.

A2.8: Under option 3 (lender choice with constraints), how would the Enterprises protect against adverse selection and ensure that a lender is not selecting a credit score at the loan level that results in preferential pricing or eligibility? Instead of attempting to reduce adverse selection through setting certain selling requirements for lenders, should the Enterprises instead adopt underwriting and pricing policies that account for any increased risk of adverse selection between the two credit score models? Are there ways to control this risk?

Reinsurers who participate in the CRT program will be very sensitive to the risk of any adverse selection because they tend to bear the risk of adverse selection. Therefore, the reinsurance market will resist Options 3 and 4.

As we do not interact with the lender directly it's difficult to offer a meaningful perspective, but the FHFA should be guided by knowing that the reinsurance market prefers to see all participants in the value chain have "skin in the game" to better align interests.

A2.9: Because credit score models are not interchangeable, what issues or challenges would you face if the Enterprises were to have different eligibility or pricing based on the credit score version? What implementation hurdles might exist? How would the differences in pricing be perceived by borrowers?

Eligibility and pricing at the lender level exists more on the front-end, and therefore, Guy Carpenter has no meaningful comments to offer.

A2.10: How would you approach evaluating when the benefits of new or multiple credit scores sufficiently exceed the costs and potential risks associated with making such a change?

Evaluating the cost benefit equation is too complex for this response and Guy Carpenter has no meaningful comments to offer.

3

Questions on Credit Score Competition

A3.1: Given that the CRAs own VantageScore Solutions, LLC and set the price for both FICO and VantageScore credit scores, and own the data used to generate both scores, do you have concerns about competition? If so, please explain.

Guy Carpenter has no meaningful comments to offer.

A3.2: Would allowing multiple credit scores in the mortgage underwriting process encourage new entrants into the scoring marketplace? If the requirement remains to keep a single credit score in the mortgage underwriting process what impact would this have on whether new entrants join the credit scoring marketplace?

Guy Carpenter has no meaningful comments to offer.

A3.3: What would be the benefits of lender choice if the number of qualified borrowers remained unchanged or changed only modestly from the credit score you are using today to underwrite borrowers for loans sold to the Enterprises?

Guy Carpenter has no meaningful comments to offer.

A3.4: If FHFA allowed the Enterprises to use multiple credit score models by adopting options 2, 3, or 4, would this competition translate into far-superior credit scoring models available to the housing finance markets? Would competition in the mortgage origination process create an incentive to incorporate more credit data for consumers with “thin files” or no credit history? How should FHFA balance these considerations with accuracy and mortgage credit risk?

Not applicable to Guy Carpenter.

4

Questions on Merged Credit Reports

B1: If you have used a single credit report or two-file credit report in your business, please share any empirical information about how much incremental information/benefit is gained as a result of using a second or third credit report.

Not applicable to Guy Carpenter.

B2: If the requirement to pull data from all three credit agencies were replaced with the flexibility to pull data from just two CRAs or one CRA, what could be the benefits or disadvantages to borrowers and your business? What could be the benefits or disadvantages to the credit reporting industry and the mortgage industry in general?

Not applicable to Guy Carpenter.

B3: If presented with the flexibility to pull data from just two CRAs or one CRA, would your business likely take advantage of this flexibility? If not, why not? If so, what steps would you need to take to be comfortable with that change?

Not applicable to Guy Carpenter.

B4: If presented with the flexibility to pull data from just two CRAs or one CRA, would you want the lender to choose the credit agency or would you want the Enterprises or some other market participant to mandate the agency?

Guy Carpenter has no meaningful comments to offer.

B5: If the option of using one repository were available, how would the Enterprises ensure that the lender is not electing to use the CRA with the highest credit score (best credit profile) at the loan level that results in preferential pricing and eligibility?

Guy Carpenter has no meaningful comments to offer.

B6: What issues would this flexibility create if other mortgage participants (investors, insurers, guarantors) continued to require credit data from all three CRAs?

Guy Carpenter has no meaningful comments to offer.

B7: If the Enterprises had to increase pricing for using less credit data from fewer than three credit agencies to account for the additional risk, would the flexibility still be attractive?

Guy Carpenter has no meaningful comments to offer.

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