Whalen Global Advisors LLC

January 29, 2018

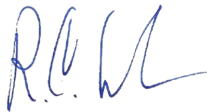
Federal Housing Finance Agency
Office of Housing and Regulatory Policy
400 7th Street SW, 9th floor
Washington, D.C., 20219.

Re: Credit Score Request For Input

Dear Sirs,

In response to the FHFA's request for input regarding the Enterprises' credit score requirements, please see my response below together with two attachments that are responsive to the request.

Yours sincerely,



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Credit Score Request For Input
FHFA

Questions

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

In assessing the valuation of residential mortgage loans, residential mortgage backed securities (RMBS) and related assets such as mortgage servicing rights (MSRs) on behalf of lenders, servicers and institutional investors.

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?

Yes. Virtually all residential whole loans, RMBS and MSRs in the market today currently rely upon FICO Classic scores. There is no significant market acceptance for alternative scores. FICO is essentially a government sponsored monopoly by virtue of the current FHFA requirement. This is an important point because all of the possible changes suggested by FHFA to its loan underwriting process imply a significant change for investors and other end users of consumer and institutional credit ratings.

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?

Yes. As a practical matter, having more than one measure of default probability at any part of the mortgage life cycle creates a discontinuity and a myriad of risks for all participants. To be blunt, having two different ways to measure *an estimate of default probability* is not particularly helpful to any of the constituencies in the mortgage market. The notion of "benefits" as a result of "competition" in credit scoring methodologies seems illogical from the perspective of the consumers of credit scores (lenders, credit analysts, guarantors, investors). These consumers of credit ratings simply want a single reliable, stable benchmark for estimating credit risk in residential mortgages.

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?

Managing different credit scores for primary and secondary market participants is problematic. Lenders want a highly optimized credit review process that avoids varriation. Investors, who are really the most important members of the consumption chain for credit scores, rely on the consistent underwriting of loans to assess credit and prepayment risk. Having two different measures of default risk, one for primary markets and another for the secondary markets, is a recipe for operational and compliance chaos and could seriously impair the function of the secondary markets for residential loans, RMBS and MSRs. At a minimum, as discussed below, having two scores would create possible dispersion in the pricing for loans and/or securities issued by the Enterprises as investors made a value judgment about using one credit score vs. the other.

Question 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?

From an industry perspective, no change is required in credit score requirements. Mandating any change (for example, moving to FICO 9 from FICO classic), would create considerable disruption in the primary and secondary market for residential mortgages. For example, one constituency that is largely absent from the FHFA background discussion is rating agencies.

In the event of a change by FHFA, all of the major rating agencies might well be forced to discard legacy models and revamp default probability models for RMBS to accommodate multiple credit scores. The agencies then would need to have these models reviewed by regulators around the world, including the Securities and Exchange Commission in the US and ESMA in Europe, etc. This is not a trivial undertaking and would cost each of the agencies involved many millions of dollars in development, project management and compliance costs.

In addition, the major investors in RMBS including private mortgage insurers, central banks, commercial banks, pensions and insurance companies would be forced to retool their internal capital models for calculating default probabilities for their RMBS portfolios. Banks in particular would be forced to restructure existing internal default models and then would need to have these models reviewed under the Basel III/IV framework by prudential regulators around the world – a process that could take years and cost tens if not hundreds of millions of dollars to complete.

The FHFA need be mindful of the fact that its decision regarding a mandate of a given credit score in any of the scenarios proposed in this RFI carries large, real world financial implications for many members of the mortgage finance food chain. In view of the enormous primary and secondary impact of any change by FHFA, it would be preferable for the FHFA not to mandate any specific credit score at all. Leave the choice up to end investors, who will ultimately make the determination based upon execution for loans and RMBS in the secondary market. The notion that lenders can "choose" what score to use independent of the preferences of global fixed income investors is absurd. The investors will tell the lenders what score to employ, period.

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

As above, FHFA should cease recommending or requiring any specific credit score as part of the Enterprises underwriting process. Once lenders, servicers and investors understand that the FHFA is not mandating any specific score, they will make a judgement as to the efficacy of the respective scores and make a choice. We do not have sufficient data to judge the resolution of the alternative scores through the credit cycle, but the more liberal attributes of the VantageScore suggest that loans originated using this methodology would trade at a discount in the secondary market.

The FHFA and the Enterprises would need to adjust credit overlays to compensate for the inferior secondary mortgage valuation that would likely be assigned for loans underwritten using alternative scores. Investors too would differentiate between a loan pool originated using FICO vs VantageScore, both in terms of the value of the MSR and any non-performing loans that resulted. Rather than seeking to impose a decision on the markets, the FHFA should let the lenders and investors decide and then adjust its own credit overlays accordingly to protect the Enterprises and taxpayers from any incremental risk that may come from allowing lenders to select the score. Let the markets tell FHFA what the pricing differential should be between FICO Classic or FICO 9 or VantageScore.

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

FHFA needs to recognize as part of its fact finding with respect to the way the Enterprises use credit scores that government regulation of housing finance has inadvertently encouraged the evolution of tripartite monopoly in the world of consumer data. Equifax, Experian and Transunion have a shared monopoly on consumer credit data in mortgages because the FHFA makes every consumer buy all three reports from the CRAs. Thanks to the FHFA mandate for three credit reports in the tri-merge file, the data repositories do not compete in the mortgage market. FHFA notes that the data repositories have now jointly created a company that publishes a less rigorous credit score to displace the incumbent agency FICO. Indeed, as FHFA notes, the three data repositories set the pricing for FICO scores!

There is little utility for investors or analysts in creating multiple measures of consumer default risk, and doing so certainly encourages a "race to the bottom" in terms of the aggressiveness of the credit tests. Endorsing multiple measures of default risk may create risk for the Enterprises and the taxpayer, as FHFA states. Yet should FHFA decide to endorse specific scores, the one fact that seems clear is that the data repositories stand to enhance their considerable market power and financial influence in the world of consumer credit, including influence over lenders, analysts, industry associations and policy outlets, and the media. As a result, as stated above, FHFA should cease requiring any particular credit score rather than implicitly recognizing multiple scores. FHFA ought to put the onus on the lenders to ensure the files are complete and ready for underwriting.

Regarding the FHFA's concerns about the market power of the three data repositories, please see the attached articles which confirm many of the FHFA's findings.

- "Experian, Equifax & TransUnion want to sell you new mortgage credit scores," *The Institutional Risk Analyst*, September 18, 2017 and

- "Equifax's Grip on Mortgage Data Squeezes Smaller Rivals," Gretchen Morgenson, *The New York Times*, October 13, 2017.

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

Having multiple models for default risk on consumer mortgages is not a bad thing in and off itself, but the possibility of introducing variance in such an important part of the mortgage lending process immediately raises red flags for risk, compliance and finance.

The markets are accustomed to a stable, predictable monopoly benchmark built around the FICO Classic score. If you are a lender in today's market, do you want to spend the time and money to accommodate multiple scores in your credit underwriting process? I suspect that the answer to that question is no in many but not all cases.

Right off the bat, lenders and the Enterprises must still pick one score that is a definitive benchmark for approving credit decisions to avoid claims of bias or discrimination. Then there are compliance and financial aspects of using multiple indicators of default risk that could cost significant time and expense for many market participants. Changing from a stable monopoly benchmark to supposed "competition" in credit ratings is potentially an enormously disruptive operational risk event for the Enterprises and market participants.

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).

The single score update of FICO Classic to FICO 9 seems to be the simplest (and long overdue) approach, but will still entail significant expense for ratings agencies, financial institutions and end investors that acquire agency securities. That said, the industry badly need to update these models – this despite FHFA's findings that there will be little benefit to be gained from the update. Many of the model assumptions in the credit community still reflect a pre-2008 design and data bias that does not reflect the dramatic qualitative improvement in loan asset quality that has occurred since then. If the single model updated solution were taken, FHFA should reach out to the SEC and jointly "encourage" the ratings community to do a model update to the most recent version of FICO 9. But even this modest change will require considerable time and expense from all parts of the financial industry, including rating agencies, investors and financial institutions.

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?

The basic issue that will be commonly experienced by lenders or investors is how you integrate two default scores into a highly regulated business process. From the start, you are forced to make a judgement as to the relative value or weighting of each score. Such judgments and comparisons are imprecise and the models themselves have a significant error rate, so having *two* different measures of *estimated* default risk seems to add complexity to the credit underwriting task without adding clarity.

Ultimately, most of the down stream consumers of credit ratings use them indirectly, as with investors in RMBS be they a bank or a fund or a central bank. They want to have one stable indicator upon which to base an investment decision. So even if you have two or three or four consumer credit scores available to provide estimates of an obligor's propensity to default, at the end of the process the lender or investor wants <u>a single metric upon which to base a decision</u>.

A2.5 Could using any of the multiple credit score options affect the way investors view, and therefore price, Enterprises 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?

Yes. As noted above, the question of execution 1) in the secondary loan market and 2) into agency RMBS is crucial, both for FHFA, investors and the CRAs themselves. If, for example, FHFA decides to not require any particular credit score, lenders and aggregators of loans into the market for mortgage securities would demand to know which score was utilized in making the credit decision for each loan. As issuance into the ABS market grew, actual experience would help us to understand the performance differences in the different models.

Initially lenders likely will be conservative as will the aggregators who issue securities for the Enterprises and GNMA, and usage of FICO would continue to predominate with or without a requirement from the FHFA. There seems to be very little upside to using the alternative credit score and a good bit of risk from the perspective of a lender operating in an extremely tight market today.

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?

See above. Requiring both FICO and VantageScore would be absurd, effectively a tax on the industry and, indirectly, on all consumers. Why should FHFA tax consumers to pay Equifax, Experian and TransUnion for VantageScore? There appears to be no public benefit for requiring both credit ratings. Also, there seems to be no evidence in the public record of analytical benefits of two ratings. As noted above, ultimately the loan underwriting process must distill down into one credit default risk indicator.

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 Enterprisess, or stakeholders could take that would mitigate any confusion about multiple credit score options?

Education should be left to the lenders as part of their underwriting, compliance and business process. The FHFA should not be in the business of endorsing one credit score or another, or explaining it to the public. Engaging in a public "educational" dialog regarding the different score of necessity forces FHFA to make a qualitative judgment about each score.

For example, would FHFA talk about the relative merits of each score? How precisely? What would FHFA say to a consumer who could get a VantageScore but did not qualify for a FICO score? Would FHFA view VantageScore, for example, as a step up for consumers to achieve better access to credit or a potential source of negative stigma for a borrower population that cannot get a FICO score?

Better to leave this communication task to a lender who must address the issue as part of the loan underwriting, compliance and disclosure process.

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?

Again, the FHFA faces the same operational problems from multiple credit score as do lenders and investors. If, for example, you decide to mandate multiple scores for all GSE loans, the Enterprises and FHFA would need to make a qualitative judgment about the relative efficacy of different scores. As noted above, the markets would also make a judgment about the relative quality of loans underwritten with one score or the other. This judgment would be manifested in secondary market prices for loans and RMBS, and would also be reflected in the stressed loan default simulations of the various rating agencies for RMBS. If you actually had significant uptake of a second, inferior consumer credit score, there would probably emerge over time some segmentation of pricing for loan pools and MSRs based upon the proportion of each score in a given pool.

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?

See above. How would FHFA propose to publicly "weight" the different scores for underwriting purposes? Also, the public affairs aspect of communicating with the public regarding the choice of multiple credit scores strongly mitigates in favor of FHFA not mandating any specific score.

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?

There does not seem to be any groundswell of demand from lenders or investors for new credit scores. The chief benefit of "competition" in credit scores seems to be generating business for the CRAs, but in analytical terms having multiple credit score potentially creates instability in how credit analysts and investors view these loans and securities. As a result, it seems difficult to make the case that upgrading to FICO 9, for example, would produce a clear benefit to the public interest.

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?

The lack of competition in the world of credit scores is well-documented by FHFA. Like Frankenstein's monster, the CRAs have consolidated the once thousands of independent credit bureaus down to a three-company cartel that is encouraged by the FHFA requirement for the tri-merge report. FHFA should make the CRAs compete in the world of residential mortgage finance as they do in all other sectors of consumer finance.

The lender should make the decision about how many reports to pull in the context of the underwriting process and their duties and responsibilities under their seller/servicer agreements with the Enterprises. The lenders are already on the hook in terms of loan quality, so FHFA should address this concern via surveillance of the production of seller/servicers.

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?

Yes. Multiple credit scores could easily proliferate if FICO were no longer required by FHFA. Be careful what you wish for, you may get it! Keeping the existing FHFA mandate for FICO or an updated version eliminates the need for other credit scores.

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?

There does not seem to be a significant benefit in prospect in terms of increasing the number of qualified borrowers. My fear is that using other scores that are less rigid than FICO could create a ghetto of inferior borrowers, individuals who could not qualify for a FICO score. Loans from these borrowers could potentially trade at a discount to loans with obligors that did have FICO scores, raising significant risk, financial as well as compliance and fair lending issues.

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?

No. Simply allowing multiple reports or FHFA having no mandate for a given credit score does <u>not</u> mean superior credit scores necessarily will proliferate. The monopoly power of the CRAs is a strong disincentive to new market entrants.

A3.5 Could competing credit scores in the mortgage underwriting process lead to a race to the bottom with different vendors competing for more and more customers? What steps could FHFA take to mitigate any race to the bottom?

There is the possibility of a degradation in credit scores as a result of competition, but the markets will be pretty efficient in terms of identifying inferior analytical indicators. FHFA really cannot "do" anything about this risk, but needs to monitor how the markets and investors and other regulators perceive and use the respective scores.

As noted above, the big challenge for the three CRAs is getting lenders to use a score that is clearly inferior to FICO. With all of the potential risks in terms of secondary market pricing for loans and market execution for RMBS, why should any lender take the risk? Just as a consumer who cannot get a FICO score may be stigmatized, lenders that use alternative scores will face a significant market challenge.

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.

Pulling two reports makes sense for a residential mortgage. Most consumer finance decisions are based upon a single report. But as noted above, the FHFA requirement for three CRA reports in the tri-merge file is excessive and does not reduce risk to the Enterprises. The area where the world of credit reports badly needs competition is among the three CRAs operating in the agency mortgage underwriting market!

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?

No. The best course for FHFA is to leave the decision about the number of credit files obtained to the lender. The lender has the risk in terms of defaulted loans and must comply with the relevant requirements from the Enterprises and FHFA as a seller/servicer. Also, the lender must sell its loans into the secondary market. If the market execution of using one or two credit files is inferior to a loan price with two or three credit reports, then the lender's choice is obvious.

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?

Again, how will the lender or investor or FHFA assess and/or equate the various CRAs? It would be best to have FHFA monitor seller/servicer production and loss mitigation. If the lender underwrites bad loans by using one credit file from a single CRA, that fact will become apparent pretty quickly. FHFA should focus attention on oversight of seller/servicers and get out of the practice of endorsing any credit score or CRA. Let the market decide and the actual performance of seller/servicers will help to monitor the issue for the FHFA.

Appendix

Experian, Equifax & TransUnion want to sell you new mortgage credit scores

September 18, 2017 | By: R. Christopher Whalen

Washington | Some of the housing industry's largest trade groups reportedly want housing finance agencies Fannie Mae and Freddie Mac to look at using new types of credit scores for assessing default risk on residential mortgages. These groups argue that existing scores are "unfair" to low income borrowers.

Housing Wire reported last month that the groups sent a letter to Federal Housing Finance Agency Director Mel Watt, the Mortgage Bankers Association, National Association of Realtors, the National Association of Home Builders, and other groups pressing Watt on the issue.

Watt, a former congressman from North Carolina and long-time member of the House Financial Services Committee, threw cold water on the idea that Fannie and Freddie would begin using alternative credit scoring models at any point in the next two years.

"Watt said that making any changes to the government-sponsored enterprises' credit scoring models before 2019 would be a "serious mistake," reports *HW*. Ditto.

FHFA chief Mel Watt is nobody's fool and in particular understands the state of pay to play in Washington. The push for new credit scores is not really about competition or access to credit for low income households, but rather the corporate ambitions of the major consumer credit bureaus.

"In 2006, VantageScore Solutions was introduced as a joint venture between three national credit bureaus – **Experian plc**, **Equifax Inc.** and **TransUnion** – aimed at providing an alternative solution to the widely used FICO score through the introduction of the VantageScore," writes DBRS in a June 2017 report. "Recently, evidence points at VantageScore gaining traction in consumer lending and, by extension, in structured finance."

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The three national credit bureaus or data "repositories" share a monopoly on individual credit reporting in the US. Yet as we've learned recently with Equifax (NYSE:EFX), the repositories take no responsibility for protecting consumer data or even telling consumers when they have been compromised. Nor do the repositories take any responsibility for the accuracy of data gathered or how it is used, as with identity theft and credit fraud.

Because the GSEs require three credit reports for conventional and government mortgages, the repositories apparently decided to come together in an anti-competitive alliance to promote the new VantageScore as a way of displacing **Fair Isaac Corp (NASDAQ:FICO)**, publisher of the FICO score traditionally used to assess consumer credit.

By spending money on marketing and Washington lobbying activities, the three credit repositories have orchestrated a seeming groundswell of support for the VantageScore. But to us, the combination of the three data monopolies in the world of housing finance sure looks like anti-competitive behavior.

Of course there are instances where an anti-competitive business combination constructed as an ancillary restraint will survive antitrust tests, but this situation with the three incumbent consumer credit repositories looks like an illegal attempt to stifle competition – namely FICO -- and create a vertical monopoly atop the existing horizontal data franchise shared by the three firms.

In the rest of the world of consumer credit, there is competition between the three credit rating bureaus. By maintaining an accurate profile of a consumer's credit, auto lenders, employers and other parties can quickly assess a subject's basic credit standing with one report. Only because the GSEs require credit reports from *all three agencies* is a competitive market transformed into a murky, monopolistic alliance between the three incumbent credit data repositories.

Some consumer advocates and Washington policy organs, including many that receive direct financial support from the owners of VantageScore, argue that the new score is more fair than the multiple versions of FICO scores, which are tuned for different industries and can vary by as much as 10% either way depending on the credit type. They also argue that the inclusion of limited rental payment data gives lower income borrowers a better chance of approval.

Both private research and internal assessments reportedly conducted (but not published) by the GSEs, however, raise significant doubts as to the numbers of additional low income borrowers that might be approved using VantageScore vs FICO for mortgage lending. Some policy advocates have claimed that seven million new borrowers might be added to the mortgage rolls by wide adoption of VantageScore.

"The credit score model used by the GSEs needs to be updated," writes Laurie Goodman at Urban Institute. "The credit score model the GSEs essentially require mortgage originators to use for mortgage lending— FICO 4—is outdated, based on models estimated in the late 1990s. Both FICO and VantageScore have much more recent models, including FICO 9 and VantageScore 3. VantageScore is also rolling out VantageScore 4.0 this fall."

Goodman and other market participants note that the GSEs and the rating agencies are still using antiquated versions of the FICO model in their own models, versions that ignore advancements in new data and how events such as medical expenses are weighted in credit models.

Credit professionals operating in the ABS market also wonder whether either the GSEs, the rating agencies or bond investors are ready to make a change, especially if it results in any expense to make the transition. Many policy advocates in Washington are innocently unaware of the magnitude of change that shifting to, say, FICO 9 would entail for the housing agencies, the credit rating firms and for major bond investors.

In tactical terms, the GSEs are the source of the problem when it comes to antiquated credit scores in the world of housing finance. By mandating universal usage of raw credit reports from all of the three repositories, on the

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one hand, and then dragging their feet on adoption of new credit scoring models – from either FICO or Vantage – the GSEs have created an intellectual and operational bottleneck in the US mortgage industry.

But ultimately this Washington conversation is ignoring the most important constituency, namely global bond investors in the US and around the world. One of the dirty secrets of the pro-VantageScore, access-to-credit crowd in Washington is that not all consumers have enough of a credit history to get a FICO score.

If you can fog a mirror, you can pretty much get a VantageScore. In fact, VantageScore 3.0 can generate a score for up to 35 million more people than conventional models, according to company claims. And the VantageScore model is about to get even more forgiving, according to *The Washingtton Post*.

The basic credit models used by FICO and VantageScore are similar, but not comparable. An 800 FICO is not the same as an 800 VantageScore. The rental and utility payment data included in Vantage is limited and, to the earlier point on FICO, really does not tell you about the obligor's ability to pay a 30-year mortgage and take care of the house.

These differences between FICO and VantageScore make the credit rating agencies, lenders and servicers, and end investors in residential mortgage backed securities (RMBS) nervous about depending upon newer scores to judge default risk. Think about the folks at the Bank of Japan, for example, who are traditional and size buyers of GNMA securities.

Goodman notes that the newer version of FICO and VantageScore are more closely aligned, but the fact remains that you cannot compare a FICO and VantageScore because of differences in the data and methodology. Yet the GSEs could do a great deal to help illuminate and clarify these issues. She writes:

> "In their 2017 Scorecard, the FHFA directed the GSEs to 'Conclude assessment of updated credit score models for underwriting, pricing, and investor disclosures, and, as appropriate, plan for implementation.' In addition, 'The Credit Score Competition Act of 2017,' HR 898 in the House and an expected companion bill in the Senate, would encourage the GSEs to consider alternative credit risk scoring models when making mortgage purchasing decisions. In particular, the GSEs would be required to establish and make public their procedures for validating and approving credit scoring models."

Watt told an industry group last month that the FHFA is supposed to issue a request for information this fall addressing the impact of alternative credit scoring models on access to credit, costs and operational considerations. We agree with Goodman and others that it would be helpful to understand the rationale behind how the GSEs assess different consumer credit agency models for the purpose of default probability.

But we also think that the GSEs moving from FICO to VantageScore is probably not practical either. There is not enough of a significant positive difference between the two models to make a change worth the time and money. We also think the idea of the lender selecting the credit score to be used in the underwriting process is a non-starter with investors – and prudential regulators. Real simple: the answer is no.

More, there are some far bigger analytical issues that must be settled before the industry moves forward to new credit scores. Last week, Jack Kahan and Steve McCarthy of KBRA wrote an important research note on this issue of default risk estimates in residential RMBS:

> "Investors and originators alike tend to use the 2001-2003 mortgage origination vintages to establish underwriting standards and to benchmark base case default expectations on newly originated loans. Many industry participants have expressed the view that the market struck the perfect balance between credit availability and prudent underwriting during this period, pointing to pristine mortgage performance for those loans as evidence. Indeed, depending on the metric chosen, defaults for crisis vintage loans were 5.9x that of loans originated between 2001 and 2003. However, our research suggests that credit standards seem to explain only a fraction of this increase when judged through the lens of expected default rates. Based on the Urban

> Institute's HFPC Credit Availability Index, average GSE default risk due to borrower attributes was five percent between 2001 and 2003 and six percent between 2005 and 2007, a 20 percent increase."

More that just a request for information, we'd like to see a public, head-to-head comparison of the different scores supervised by the GSEs and their respective regulators, and with input from the credit community. The last word on this topic is not going to come from Mel Watt or anybody in Washington, but from the bond investors who hold $9 trillion in RMBS.

Remember, if the GSEs were to mandate VantageScores, the entire analytical infrastructure of the credit, ratings and regulatory community would need to be revamped. And then the SEC would need to evaluate and validate the new models, especially given the new rules governing RMBS in Dodd-Frank. But of course this all implies that the three monopoly credit repositories would allow their "private" data on millions of consumers to be exposed to the public. Stay tuned.

Tags: Experian Equifax TransUnion VantageScore credit score FHFA Mel Watt Fannie Mae Freddie Mac Fair Issaac

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BUSINESS DAY

Equifax's Grip on Mortgage Data Squeezes Smaller Rivals

Fair Game

By GRETCHEN MORGENSON OCT. 13, 2017

Like it or not, when you apply for a home mortgage or to refinance an existing loan, Equifax will be a part of the process.

That's because, of the three major credit reporting agencies, only Equifax has a division, Equifax Mortgage Solutions, that supplies lenders with what is known as a merged credit report. These reports, which borrowers pay for, compile information provided by Equifax and the other two major credit reporting agencies, Experian and TransUnion.

As with much else about the credit-reporting industry, you don't have a choice about who provides your information. Mortgage lenders need to know your credit standing when they consider whether to give you a loan, and while other credit-reporting companies can provide a merged report, Equifax is a major go-to source for that information.

This is a very big business for Equifax. The mortgage solutions unit generated $142 million in operating revenue last year, up 15 percent from 2015. The unit accounted for 11.5 percent of Equifax's operating revenue last year.

Given that the company's lapses recently allowed hackers to steal personal information belonging to as many as 145.5 million consumers, Equifax's dominance

in this arena is unfortunate.

Even more troubling is a deal between Freddie Mac, the huge mortgage-finance company, and Equifax that gave the troubled credit reporting agency an even tighter grip on the business of providing credit information.

Here's the background. Both Freddie Mac and the other government-sponsored mortgage finance company, Fannie Mae, have automated underwriting systems that are meant to make their loan guarantee or purchasing processes work smoothly and quickly. Mortgage lenders rely on them heavily.

A borrower's credit standing is a crucial piece of the information that flows into these systems. While Equifax and the other big credit-reporting agencies dominate, a group of about 40 other firms also provide lenders with credit information. In addition to supplying merged credit reports as Equifax does, these firms often provide more detailed information, including verification of a borrower's employment, and past payments to utilities, phone companies and landlords.

That these independent companies can still operate in a world that Equifax dominates may be an indication that they provide superior customer service such as quickly correcting errors or outdated information in a report. Equifax can supply the same information, but its customer service is not so stellar. The internet abounds with consumer complaints about the company, and since the data breach, many consumers have said they have been unable to reach the company.

That is what comes of having little or no competition. Which is why it is troubling that Freddie Mac has decided to allow Equifax to ban dozens of rival credit-reporting companies from one part of its automated system.

Freddie Mac recently developed Loan Quality Advisor, a new part of that system. It was, according to the company's website, a "risk and eligibility assessment tool that evaluates loan data to help lenders determine if a loan is eligible for sale to Freddie Mac."

Naturally, a borrower's credit history goes into this system. But Freddie Mac assigned gatekeeper status to Equifax, essentially allowing it to bar an array of

competing firms from providing credit information during the process.

This change hurts competitors by ensuring that what could be their business goes to Equifax instead. But it may also harm certain borrowers. Because of the more efficient services the other firms often provide, preventing them from participating could make it more difficult for borrowers with errors on their credit histories to correct them in time to secure a mortgage.

(Fannie Mae has taken a different approach with its automated loan-underwriting system. Its structure is more open, allowing independent credit-information providers to participate at multiple levels)

Interestingly, an internal Freddie Mac email indicates that Equifax drove the decision to keep independent companies, known as technical affiliates, out of the system.

"Equifax chose not to make adjustments to be able to accommodate the T.A.s," wrote an official in Freddie Mac's Vendor Technology Integration unit. Because Equifax "chose not to add functionality to support," she added, "we were unable to support as a result."

I asked Equifax why it was keeping so many competitors, most of them smaller, off the Freddie Mac system. Wyatt Jefferies, a spokesman, did not respond directly, saying only that Equifax "operated within existing Fair Credit Reporting Act guidelines" with all the independent companies.

In light of the recent data breach at Equifax and deep consumer unease about the company's practices, I thought Freddie Mac might be rethinking its granting Equifax what amounts to most favored nation status.

It is not. Chad Wandler, a Freddie Mac spokesman, said that having access to a broad network of credit-report providers "has not been cited as a priority for those customers who use our quality control tools like Loan Quality Advisor." He added, "We will continue to listen to our customers to provide the functionality they need."

Naturally, this does not sit well with independent credit-reporting companies.

"What we're talking about here is to provide the consumer with a touch point of service that is different than what you get from the bureaus," said Terry Clemans, executive director of the National Consumer Reporting Association, an organization of credit-reporting agencies, employment-screening services and tenant-screening companies. "But Equifax has elected to not let these companies compete, and Freddie Mac has put them in that position to allow it."

Given that Freddie Mac is owned by taxpayers, lawmakers may be interested in its dealings with Equifax. In the past week, Senator Sherrod Brown, Democrat of Ohio, asked the Treasury Department to prohibit Equifax from eligibility for government contracts, saying the company did not deserve to earn taxpayer money. (On Thursday, the Internal Revenue Service, a unit of the Treasury, said it had suspended a $7.2 million contract it awarded to Equifax last month.)

Amid all this, it is noteworthy that Equifax imposes higher costs than competitors for some of its credit-reporting services. In an Equifax email in September 2016 about a price increase at the company, an employee said that it charged its competitors, who must buy the information, two to three times the combined costs charged by Experian and TransUnion.

Mr. Jefferies, the Equifax spokesman, declined to comment on the agency's pricing. But he said in a statement that the company's price adjustments "reflect investments we are making to ensure we are delivering market-leading innovation and technology to customers."

Unlike its competitors, Equifax also charges more for a type of credit report used by housing counselors who work with troubled consumers to get their finances back on track.

There are two types of credit reports — a "hard pull" and a "soft pull." A hard pull is requested by a lender looking to extend credit to a consumer. A soft pull, by contrast, is used by loan counselors to get a fix on a consumer's credit standing.

Most credit-reporting companies charge the same for both types of reports. Not Equifax. It charges twice as much for a soft pull as it does for a hard pull, housing counselors said.

"The role of housing counseling and assisting people getting and maintaining credit is really crucial," said Bruce Dorpalen, executive director of the National Housing Resource Center in Philadelphia, an advocacy organization for nonprofit housing counselors. "To penalize them by charging extra for a credit report is disadvantaging people when they need help the most."

Mr. Jefferies of Equifax declined to comment on this practice.

Let's have a show of hands out there. How many think Equifax should have even more control and sway in the credit reporting industry than it already has?

Noted.

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