Poyner Spruill LLP

January 29, 2018

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

Re: FHFA Credit Score Request for Input
Issued December 20, 2017

Dear Sir or Madame:

This letter is in response to the Request for Input (RFI) referred to above. I am submitting it as counsel to Fair Isaac Corporation (FICO), however it is based on my independent review of the regulatory, supervisory, and policy issues that, in my opinion, are fundamental to FHFA's determination as to "alternative" credit scoring. It is also based on my experience as a regional bank general counsel, North Carolina Commissioner of Banks, Chairman of the Conference of State Bank Supervisors, founding Member of Regulatory Registry LLC (operator of the National Mortgage Licensing System) and Monitor of the consent judgments commonly referred to as the National Mortgage Settlement. A more complete statement of my conclusions with regard to this matter are contained in a paper that I have recently delivered, a copy of which is attached to this letter as Appendix A.

Responses to Request for Input

Question 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?

With all due respect, to ask the question is to answer it. Authorizing a credit scoring regime that includes as an option a provider owned and controlled by the three entities that are the only providers of both the credit data necessary to generate credit scores and the means to distribute them virtually guarantees a reduction in or elimination of competition.

Question 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?

By all accounts, competition in the credit scoring market is robust and the number of entrants is growing, particularly in consumer and small business lending. This growth is in less regulated areas than mortgage finance, where there is no direct or indirect federal government credit backstop and where rates, fees and charges reflect the risk of lending. Resolution of the issue presented by the RFI will have no impact on these developments.

With regard to home mortgage lending, it is interesting to note that there is no legal or regulatory inhibition (except, perhaps, state high cost loan statutes) on the making of home mortgage loans without a government backstop on the basis of alternative credit scoring protocols. As Exhibit A notes, the absence of market activity in this regard speaks volumes.

Finally, it is important to note what the RFI itself points out: the Enterprises have themselves developed credit scoring protocols for loan applicants who do not qualify for traditional credit scores.

Question 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?

As Exhibit A and the research papers on which it relies point out, there would in fact be little or no change in the number of qualified borrowers from lender choice. There would be a watering down of credit standards that could result in confusion in the marketplace and probably would result in an increase in defaulted loans. The best alternative credit scoring choice to cover potential borrowers at the margin would be adoption of FICO® Score 9, which incorporates economic changes since the financial crisis (*e.g.,* medical collections) on a basis consistent with Classic FICO.

Question 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?

As more fully discussed in Appendix A and the authority on which it relies, multiple alternative credit scores would not result in superior credit scoring to the current regime and would result in a watering down of credit standards. The information on which credit scores would be based remains essentially the same; as noted above, the proposed alternatives would analyze some information differently. In the case of FICO® Score 9, the change would be on a basis consistent with Classic FICO and would be comparable; in the case of VantageScore 3.0 this would not be the case.

As noted in my response to Question A3.3, the RFI itself points out that the Enterprises have developed automated scoring systems for potential borrowers who do not have credit scores. Use of such protocols is the best resolution for borrowers with "thin" credit files.

Question 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?

For the reasons fully discussed in Appendix A, the answer to this question is yes. If there were no opportunity for arbitrage, there is no reason to have alternatives and if alternatives are available there is no reason to assume that market participants would not use the least rigorous one. The only way to mitigate moral hazard is to allow only one credit scoring system, rather than alternatives.

Conclusion

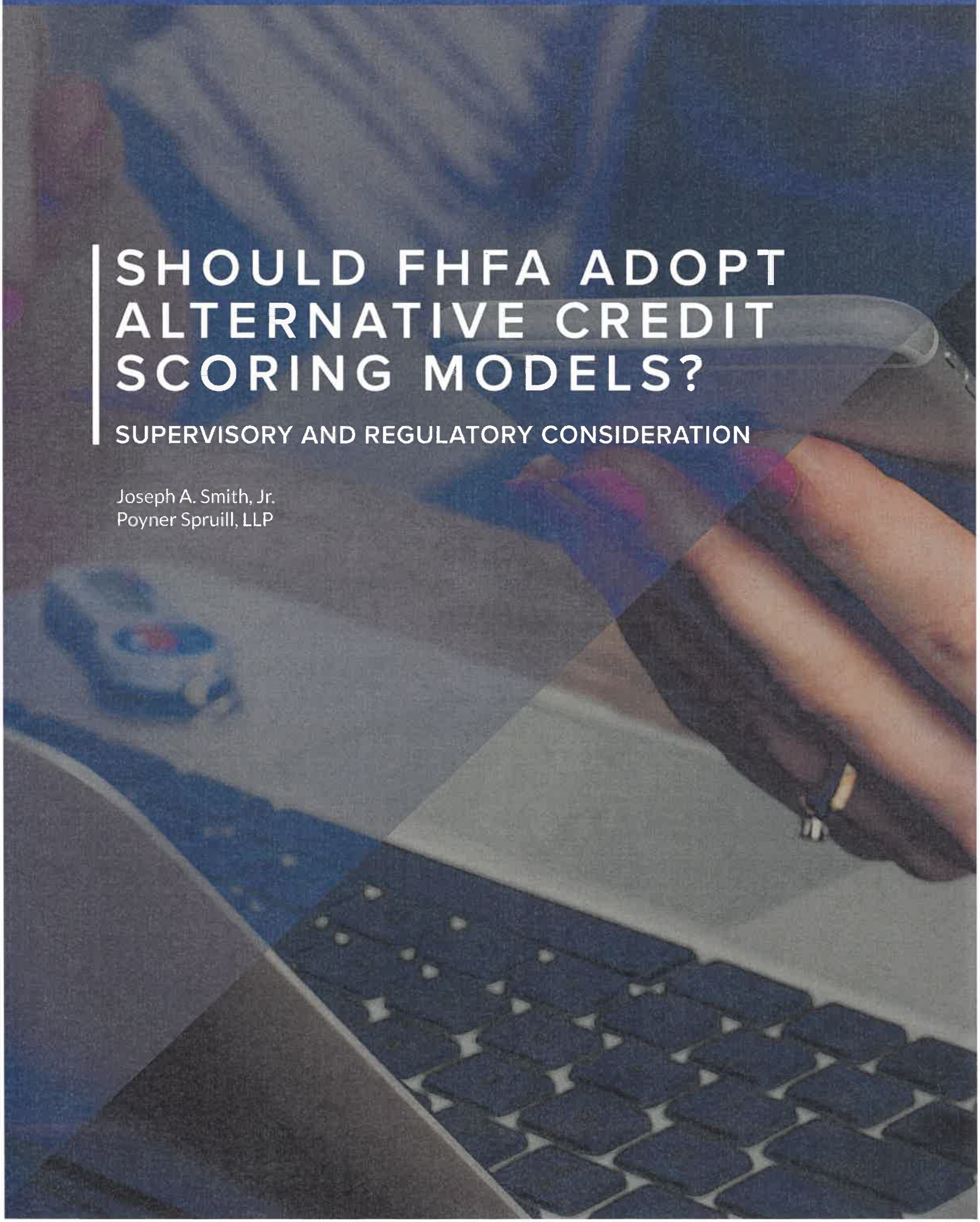
While the desire to extend home mortgage credit to worthy borrowers is laudable, it must be tempered by concern for the well-being not only of borrowers, but of communities, the credit markets, the Enterprises and the agencies of government who will be influenced by the choices made by FHFA and the Enterprises. In that regard, I applaud FHFA and Director Watt's care in making the decision regarding alternative credit scoring. As someone who attempted to reign in the worst excesses of the mortgage market before the financial crisis and who has had a role in repairing the damage afterward, I urge you to make a determination of this issue that protects all stakeholders: no change or a replacement of FICO Classic with FICO® Score 9.

Thank you very much for this opportunity to assist you in this important work.

Very truly yours,

Joseph A. Smith, Jr.

APPENDIX A



SHOULD FHFA ADOPT ALTERNATIVE CREDIT SCORING MODELS?

SUPERVISORY AND REGULATORY CONSIDERATION

Joseph A. Smith, Jr.
Poyner Spruill, LLP

INTRODUCTION

The Federal Housing Finance Agency (FHFA) is the supervisor, regulator and conservator of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac and, together with Fannie Mae, the Enterprises). FHFA is contemplating a potential change in the credit scoring models approved for use by the Enterprises.

The Enterprises use FHFA approved credit scoring models to underwrite the home mortgage loans that the FHFA guarantees. The credit scores are issued by three credit rating agencies (CRAs). The currently approved credit scoring model used by each CRA is the Fair Isaac Corporation (FICO) model. In furtherance of the goal set forth in its 2017 Scorecard for the Enterprises to "increase access to single-family mortgage credit for creditworthy borrowers, including underserved segments of the market," FHFA is exploring authorization of the use alternative credit scoring models.[1] This laudable goal is part of an overall goal to, "Maintain, in a safe and sound manner, credit availability and foreclosure prevention activities for new and refinanced mortgages to foster liquid, efficient, competitive, and resilient national housing finance markets."[2]

FHFA Director Melvin L. Watt has discussed the alternative credit scoring model issue in two recent addresses.[3] In discussing the possible adoption of alternative credit scoring models," Director Watt said that in spite of the surface attraction of allowing "choice" with regard to such models, the decision as to whether to allow them "is turning out to be among the most complicated decisions I have faced during my tenure at FHFA."[4] He went on to mention a number of questions that need to be addressed to make a determination on this issue and said that a request for information with regard to such questions would be published in the near future.

At the request of Fair Isaac Corporation (FICO), I have analyzed the regulatory, supervisory, and policy issues that will confront FHFA in the course of its alternative credit scoring model project. This analysis is based on a review of the legal and regulatory authority under which FHFA exercises supervisory, regulatory, and conservatorship powers with respect to the Enterprises. It also draws on my experience as a regional bank general counsel, North Carolina Commissioner of Banks, Chairman of the Conference of State Bank Supervisors, founding Member of Regulatory Registry LLC (operator of the National Mortgage Licensing System) and Monitor of the consent judgments commonly referred to as the National Mortgage Settlement. In addition, I have relied on the work of experts in housing finance and economics.[5]

On the basis of the foregoing, I have concluded and submit that the adoption by FHFA of alternative credit scoring models would not meaningfully increase the availability of home mortgage credit and could result in unnecessary losses to taxpayers and to borrowers who take on more mortgage debt than they can afford. During my time both as a state financial regulator and as Monitor of the National Mortgage Settlement, I have seen first-hand the damage that improvident lending has done to families, communities and financial institutions and markets. While expanding opportunity for home ownership is a laudable goal, it cannot be achieved by watering down credit standards.

A discussion of FHFA's alternative credit score project and the regulatory, supervisory and conservatorship issues relating to it is set forth below.

I. BACKGROUND

FHFA was established by the Housing and Economic Recovery Act of 2008 (HERA).[6] It came into existence as the result of years of struggle to establish a regulatory regime with sufficient authority and capacity to supervise two "too big to fail" firms that had a dominant position in the home mortgage finance market and, accordingly, were crucial to American families and to the economy.

In its supervisory role with respect to the Enterprises, FHFA is charged with ensuring that they operate in a safe and sound manner and that their operations "foster liquid, efficient, competitive, and resilient national housing finance markets."[7] Put another way, the agency's mandate is to facilitate the expansion of credit – with the significant caveat that this expansion extend only to consumers who are likely to be able to repay their loans.

Unfortunately, FHFA did not get to exercise its regulatory and supervisory powers on an arms-length basis for long. HERA was enacted precisely at the point in time when the consequences of "competition" and deference to unhindered "choice" in the home mortgage market led to near insolvency for the Enterprises and to chaos and destruction in the financial system. During the four years preceding enactment of the statute, the Enterprises' share of MBS issuance volume had gone from over two-thirds of the market to less than half, the decline being accounted for by a significant increase in market share of "private label" securities.[8]

As a state regulator during this period, I worked with colleagues around the country to regulate the non-depository origination channel and to reduce or eliminate the volume of loans made on predatory and unsustainable terms. Our efforts were commonly and constantly criticized for, among other things, preventing the extension of credit to low- and moderate-income people, thus denying them their chance at achievement of "the American Dream." Excesses in the market were exacerbated by the fact that the securities rating agencies, who were paid by the issuers and thus subject to obvious moral hazard, rated substantial tranches of subprime securitizations as investment grade.[9]

During the run-up to the Financial Crisis, the Enterprises guaranteed and purchased an increased amount of nontraditional and higher risk mortgages.[10] The rest, as the saying goes, is history. The deterioration of the housing market generally and the Enterprises' non-conforming loan books in particular led to a determination that their capital was unable to support continued operations and, accordingly, that their safe and sound operation was at risk.[11] On September 6, 2008, because of the financial distress of the Enterprises, FHFA invoked its statutory authority and placed them into conservatorship.[12] As conservator, FHFA has broad management and supervisory powers, authorizing the agency to take such actions as may be:

> (i) necessary to put [the Enterprises] in a sound and solvent condition; and
>
> (ii) appropriate to carry on the business of the [Enterprises] and preserve and conserve the assets and property of the [Enterprises].[13]

Since the institution of the conservatorship, the Treasury Department has provided essential financial commitments of taxpayer funding under Preferred Stock Purchase Agreements (PSPAs).[14] In their current iterations, the PSPAs authorize Treasury to sweep the net worth of each of the Enterprises that exceeds a Capital Reserve Amount.[15] As of January 1, 2018, the Capital Reserve amount for each of the Enterprises will be zero.[16] Treasury support of the Enterprises of just over $200 billion remains available so taxpayers are still at risk.

In exercising FHFA's conservatorship powers, Director Watt has decision-making power with regard to two financially and economically vital firms that are operating with little or no capital and a limited and shrinking Treasury backstop. The caution and care he is taking with regard to the alternative credit scoring project is both understandable and laudable.

Caution and care is particularly appropriate because of the impact that the Enterprises have on the health and operational standards of the entire housing finance industry. This is particularly so, given the fact that non-bank mortgage originators account for roughly half the GSE origination market and over half the market in total.[17] Although they are regulated at the state level and by some federal agencies, these firms are not subject to the same level of supervision as banks, particularly as regards capital adequacy. As these firms are originating loans at lower median FICO scores and higher median debt to income (DTI) ratios than bank competitors,[18] it is important as a matter of system soundness that the GSEs insure the maintenance of reliable and comparable measures of credit.

A second impact of the decision by FHFA to adopt alternative credit scoring models on system safety and soundness would extend beyond the conventional market because FHA would probably follow suit. Such a change would come at a time when FHA has seen a decrease in the Economic Net Worth of the MMIF and has noted a number of concerns in its lending programs. The just-released HUD Annual Report to Congress on the FHA Mutual Mortgage Insurance Fund[19] lists a number of "potential credit risk factors which bear monitoring" beyond the low down payments that characterize FHA loans:

- The average debt-to-income (DTI) ratio for FHA-insured purchase mortgages was 41.9 percent, and has generally trended upward since FY 2000.
    - 49.1 percent of FHA purchase mortgages had DTI ratios greater than 43 percent.
- The share of new purchase mortgages with some form of down payment assistance was 38.4 percent.
- $28.6 billion of new endorsements went to borrowers taking "cash out", representing 38.9 percent of FHA refinance volume.
    - $16.8 billions of cash-out refinance UPB served borrowers that previously had conventional financing and refinanced into a new mortgage with FHA insurance.[20]

Borrower profiles that have multiple additional risk factors such as those listed above underscore the importance of predictable risk tools to appropriately evaluate the individual loan. In this context, reliable and comparable credit scores are an essential aspect of FHA's being able to appropriately evaluate risk so that it can perform its mission, including meeting the needs of first-time home buyers, and remain solvent while doing so.

As with any other organizational decision, determining whether to adopt alternative credit scoring standards depends on whether the benefits of such a change outweigh the costs and risks. Given the fragility of the Enterprises, and their importance to the housing market, the economy and taxpayers, the standard for change should be rigorous and high. A discussion of two of Director Watt's questions regarding this decision are, to me, dispositive of the issue.

II. WHAT IMPACT WOULD AUTHORIZATION OF ALTERNATIVE CREDIT SCORING MODELS HAVE ON CREDIT AVAILABILITY AND THE ACCURACY OF LOAN PURCHASE DECISIONS BY THE ENTERPRISES?

In determining whether to permit alternative scoring models, FHFA should first ascertain that (i) such models are able to derive new or significant information from the data currently available to FHFA, FICO and the Enterprises; or (ii) if such models are based on new data, the new data is valid for purposes of credit analysis and consistent with FHFA mandates. Changes to credit scoring models must expand credit to creditworthy buyers while protecting the taxpayers and the Enterprises. In other words, the question is whether the introduction of additional credit scoring would "expand the credit box" in a financially responsible way.

There is a general consensus that the use of more sophisticated scoring systems would add to the number of qualified buyers. After all, almost by definition, the use of additional underwriting criteria expands the availability of credit to those specific individuals who measure well against that criterion. The question is how large the increase would be, and the impact of that increase. For instance, a currently proposed alternative model claims to be able to score 30-35 million additional customers.[21] But even if that claim is correct, an analysis of such change has found that the number of new purchase loans originated under the altered credit standards would be slightly less than 48,000.[22]

Should FHFA permit the use of alternative systems, it would run into one of two problems. First, the new system could rely on virtually the same data as the FICO method. In that case, it would be a needless and expensive redundancy, replicating what already exists. Use of the same data in a different system would have a marginal impact on increasing credit, unless standards were weakened.

Alternatively, the new system could rely on different criteria. Proponents posit that these criteria would be extensions of current financial factors. They point to the use of additional data points such as the time at current address. But this overlooks three key problems. First, FICO already offers models that utilize such features, but validated only for use in credit card lending.[23] Secondly, scores will not always distinguish between the various kinds of input data. Scores will not always distinguish between the various kinds of input data. For instance, a currently proposed alternative system does not indicate whether the score is generated from limited or old data.[24] In any event, the result is a degradation in the score's ability to distinguish between good and bad credit risks and undermine the industry's ability to manage and price mortgage risk.[25]

Third, it is true that alternative scoring systems have indeed been used in other credit contexts such as credit cards or payday lending. But they have a sparse record in the mortgage industry, where the complexity of the decision, and the scale of the corresponding risk, is orders of magnitude higher.[26] If alternative credit scoring systems indeed identify additional creditworthy borrowers, private label mortgage originators would rush to adopt them. They have not. This is instructive. Private label mortgage originators have strong business incentives to use every available tool to identify additional worth customers. Their failure to embrace alternative scoring systems is powerful testament that the promise of alternative credit scoring is a hollow one.

In sum, there is no evidence that using alternative models will lead to the expansion of credit. Alternative models have been available for over a decade. If they represented an accurate barometer of credit risk, the market would have adopted them with or without federal mandates. The market's inertia is a strong indicator that alternative credit systems cannot deliver on the promise to reach a large hitherto untapped creditworthy borrowers market. The mortgage industry reflects economic reality. To the extent an expansion in credit is inflated by artificially grafted credit scoring systems, it will be temporary, and it will come at a long-term cost in terms of additional bad loans.

III. CAN FHFA ENSURE THAT COMPETITION IN THE CREDIT SCORE MARKET LEADS TO IMPROVED ACCURACY AND NOT A RACE TO THE BOTTOM?

Authorization of multiple credit scoring systems will inexorably lead to arbitrage between or among them. Indeed, if competition doesn't lead to arbitrage of some kind it is not clear why competition is needed at all. The issue is whether arbitrage would lead to more quality originations or to a dilution of credit quality and resultant damage to borrowers, investors and taxpayers. History suggests that the assumption of increased quality is at best optimistic and at worst naïve.

As mentioned above, arbitrage in the pre-Financial Crisis mortgage market led to disaster. When subprime mortgages were securitized, the sales of the securities hinged on their ability to obtain AAA ratings. Sellers rebuffed by one rating agency simply took their business to another one. Over time, the economic incentives of attracting and maintaining seller business incrementally but inexorably drove all rating agencies to lower their standards. In this ratings variant of Gresham's law, readily accessible AAA ratings drove credible AAA ratings from the market. FICO analysis has already determined that loosening standards to generate a credit score resulted in unacceptable model fits.[27]

It is hard to see why FHFA would allow multiple credit scoring systems if it was not prepared to countenance the same result that the ratings markets suffered. To some extent, the process has already started: the currently proposed alternative credit scoring system drops FICO's minimum scoring requirements regarding both the length and currency of a borrower's history.[28] This circumstance is particularly concerning, as the purveyor of the system is jointly owned by the CRAs.

Experience and economic logic indicate that market participants will use the tools available to them to increase volumes and maintain profit margins. Adverse selection would be inevitable. Since the mortgages would be sold, the accuracy or validity of specific models would not be a factor in market participants' behavior. Nor would the participants be driven by the desire to expand credit, the desire tempered by the need to ensure the expansion was prudent. In this regard, it is important to reiterate that non-depository originators are a significant portion of the current home mortgage origination market, as they were prior to the Financial Crisis.

The FHFA mandate requires any increase in credit to be offset by no change in risk. But there is no evidence that alternative credit scoring models can slice and dice the same data that FICO does and identify promising new borrowers without a commensurate increase in risk. If an alternative credit scoring system had this ability, it would have been the prevailing standard in the private mortgage industry. It is not. That is revealing.

Should the FHFA approve alternative credit scoring systems, a race to the bottom and watering down of underwriting standards via the same processes that played out in the ratings markets is inevitable. At the end of the day, the result will not be expanded or sounder credit practices, but watered-down credit scoring standards.

CONCLUSION

As North Carolina Commissioner of Banks, I worked with others in government and industry to target the worst excesses in the pre-Financial Crisis mortgage market, to less effect than any of us would have hoped. As noted above, these excesses were often couched in language extolling expansion of access to credit.

As Monitor of the National Mortgage Settlement, I have overseen attempts to redress at least some of the attendant damage and to nurse the market back to health. While I am sympathetic to the desire of Director Watt and his FHFA colleagues to address the needs of deserving borrowers who want to own a home, my sympathy is tempered by my experience in cleaning up after a poorly done credit expansion.

If the Financial Crisis has taught us anything, it is that a mortgage origination process that churns out loans to borrowers without factoring in their ability to repay them is no favor to the borrower, the housing market or taxpayers. The main impediment to further expansion of credit is not a particular credit scoring system. It is the hard reality that credit cannot offset the absence of wealth or income. An alternative credit scoring system that approves otherwise ineligible applicants is simply postponing the inevitable reckoning. And when the moment of reckoning arrives, it will undermine FHFA's mission. It will shrivel credit and the housing market. And the taxpayer will, once again, be left holding the bag.

I urge Director Watt and the FHFA to stay with established and tested credit scoring methods, expanding them slowly and in light of market knowledge built over decades, rather than pursuing the *chimera* of "alternative" models. FHFA is the *de facto* regulator of the American home mortgage market, including the infrastructure in which it operates. Credit scoring is an essential part of that infrastructure. Resisting the temptation to increase market access by altering the scoring system is a hard decision. Nevertheless, as Director Watt recently stated, "none of the decisions we make at FHFA are easy decisions."[29]

ENDNOTES

1. FHFA, 2017 SCORECARD FOR FANNIE MAE, FREDDIE MAC, AND COMMON SECURITIZATION SOLUTIONS, p. 3, available at, https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2017-Scorecard-for-Fannie-Mae-Freddie-Mac-and-CSS.pdf
2. Ibid.
3. Prepared Remarks of Melvin L. Watt, Director of FHFA at the National Association of Real Estate Brokers 70th Annual Convention, August 1, 2017, available at https://www.fhfa.gov/Media/PublicAffairs/Pages/Prepared-Remarks-of-Melvin-L-Watt-Director-of-FHFA-at-the-NAREB-70th-Annual-Convention.aspx (hereinafter Watt NAREB Address); https://www.fhfa.gov/Media/PublicAffairs/Pages/Prepared-Remarks-of-Melvin-L-Watt-Director-of-FHFA-at-Mortgage-Bankers-Association-Annual-Convention-and-Expo-2017.aspx (Watt MBA Address).
4. Watt MBA Address.
5. Parrent and Haman, Risks and Opportunities in Expanding Mortgage Credit Availability through New Credit Scores, (November22, 2017) (Parrent); Schnare, Alternative Credit Scores and the Mortgage Market, [date and further cite to come] (Schnare).
6. Housing and Economic Recovery Act of 2008, Public Law 100-289 – July 30, 2008 (HERA).
7. 12 U.S.C. § 4513(a)(1)(B).
8. FHFA, Conservator's Report on the Enterprises' Financial Performance, Third Quarter 2010 (Conservator's Report) p.5. Available at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2010-3Q_ConservatorsRpt_508.pdf
9. See, e.g., United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, WALL STREET AND THE FINANCIAL CRISIS: Anatomy of a Financial Collapse (April 13, 2011) p. 7; Parrent, pp.22-24
10. Ibid, p.6.
11. Statement of FHFA Director James Lockhart at News Conference Announcing Conservatorship of Fannie Mae and Freddie Mac. Available at https://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-FHFA-Director-James-B--Lockhart-at-News-Conference-Annnouncing-Conservatorship-of-Fannie-Mae-and-Freddie-Mac.aspx
12. FHFA, 2016 Report to Congress (June 15, 2017) available at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2016_Report-to-Congress.pdf . p. 1. (hereinafter Report to Congress)
13. 12 U.S.C. § 4617(b)(2)(D).
14. Report to Congress, p. 4.
15. Id, p. 5.
16. Ibid.
17. Urban Institute Housing Policy Finance Center, Housing Finance at a Glance (2017), p.12; available at https://www.urban.org/sites/default/files/publication/94006/housing-finance-at-a-glance-october_0.pdf
18. Ibid, pp. 13.14.

19. US Department of Housing and Urban Development, Annual Report Regarding the Fund Status of the FHA Mutual Mortgage Insurance Fund (Fiscal Year 2017), available at: https://www.hud.gov/sites/dfiles/CFO/images/2017fhaannualreport.pdf
20. Ibid, p. 11.
21. Parrent p. 3.
22. Parrent, p. 12-14.
23. Parrent, pp. 4,5.
24. Parrent p. 5.
25. Schnare p. 10.
26. The use of less reliable risk metrics can increase access to mortgage credit in some cases, but those borrowers face higher prices and receive loans either "lower than deserved or higher than safe." Schnare p. 7.
27. Parrent pp. 5-7.
28. Schnare p. 2
29. Watt MBA speech op cit note 1.