National Taxpayers Union

March 9, 2018

The Honorable Mel Watt
Director
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20219

Dear Director Watt,

On behalf of our organizations and our supporters across the nation, we write to submit the following comments in response to the Federal Housing Finance Agency (FHFA) Request for Information (RFI) on "operational and competition considerations of changing Fannie Mae and Freddie Mac's current credit score requirements." To best protect America's taxpayers, our organizations believe FHFA should observe the following considerations described in greater detail below.

National Taxpayers Union (NTU), Taxpayers Protection Alliance (TPA), and Institute for Liberty (IFL) are non-partisan non-profit organizations dedicated to defending the interests of taxpayers. For decades we have promoted the interests of taxpayers at the federal, state and local level. Our organizations are a prominent voice regarding financial services issues ranging from banking regulation to flood insurance reform. Important for this conversation, we all follow the same housing policy principles: maintaining a housing finance system that promotes broad access to credit for qualified borrowers, while also promoting competitive markets and protecting taxpayers.

In the years preceding the 2008 financial crisis, we warned that certain government policies put the economy and taxpayer's at risk. NTU specifically had the privilege of testifying before Congress regarding the dangers the Government-Sponsored Enterprises (GSEs) pose to the nation's economy. In one hearing, NTU testified in favor of legislation that would have added modest curbs on the risks these GSEs would be permitted to take. We specifically warned Congress then that many of the conditions that triggered the Savings & Loan crisis were developing around the GSEs which could threaten the national housing system and require unprecedented action to restore balance to the market. However as a result of Congressional inaction and other underlying causes of the 2008 financial crisis, the housing market deteriorated and nearly $200 billion of taxpayer funds were used to bail out Fannie and Freddie, which were then placed into conservatorship. To this day, our organizations call for major changes to the GSEs to mitigate the future threat these institutions pose to our housing market, economy, and taxpayers.

Such changes can be highly complex, involving seemingly minor details that actually have major implications. For example, a bill in the previous Congress (H.R. 574 sponsored by Congressman Royce) to included changes to strengthen rules suspending payments from Fannie Mae and Freddie Mac into the Housing Trust Fund if they would "cause the GSEs to be undercapitalized." Ensuring prudent levels of capitalization of the GSEs is a major cornerstone of a strong housing finance system. On the other hand, there are taxpayer concerns over certain provisions in legislation for the current Congress (H.R. 4560 sponsored by Congressman Hill) that would essentially deter FHFA from retaining GSE profits to build sensible capital reserves, through suspending Housing Trust Fund payments under some circumstances.

To the casual observer, these bills would appear to have similar aims, but beneath the surface, their policy outcomes would be very different. So it is with proposals regarding GSE credit score requirements. While often portrayed as enhancing the competition and therefore the quality of information, such plans could impede the function of markets and imperil taxpayers.

Throughout the economic recovery, lenders have changed qualifications for home buyers and required higher credit scores to make it more difficult for prospective borrowers with subpar credit to qualify for a mortgage. With positive reforms already enacted in the private market, as well as at the Agency itself, and with legislative reforms under contemplation, we would caution against further potential changes to the credit score requirements that are currently being considered by the FHFA. While fostering additional competition would normally increase innovation and lead to better outcomes, we are concerned that allowing certain scores with lower standards to enter this marketplace and compete against FICO would lead to "rate shopping," precipitate moral hazard, and cause serious financial harm to Fannie and Freddie. Further, given these potential disadvantages, any major changes to credit scoring for GSE purposes should not move forward outside a much larger framework of reforms to other areas of housing finance.

Credit scoring is an essential piece of our housing market. Its purpose is to indicate the likelihood a potential borrower is to default on their mortgage. The exact score helps FHFA determine who is qualified for a mortgage and helps set conditions for repayment depending on risk. Credit Reporting Bureau scores are used as an initial screen for mortgage applicants and, in many cases, become the foundation of the mortgage decision. Credit Reporting Bureaus played a major role in the 2008 financial crisis as lenders lowered their credit-scoring requirements to fuel the housing demand for subprime borrowers. Led by a policy of "rate shopping," lenders drove all rating agencies to lower their standards, which created a "race to the bottom" where firms devalued the actual risk of the score to secure revenue from their competitors. Should such a course of events take place again, we could reenter a situation where firms have an incentive to make the most loans instead of striving to provide the highest reliability. Simply, lower standards produce outcomes that are much harder to predict, which means higher risks are borne for the lender. However, for Fannie and Freddie, the "lender" is ultimately the taxpayers.

Under the current structure, GSEs use the FICO model for their automated underwriting system, because FICO employs the highest standards in determining a consumer's credit score. Permitting firms such as VantageScore, which accept lower scoring standards, increases the risk of the government lending based on subprime scores. Competition is normally a desirable goal in providing evaluative services, but in this case VantageScore offers no such edge. The entity is controlled by the very credit bureaus that utilize FICO currently, a direct conflict of interest. More worrisome, the VantageScore approach to lower scoring standards increases the risk exposure of anyone lending based on the scores, meaning a 620 VantageScore does not equal a 620 FICO Score (which is considered a strong score in the industry). In addition to different but not necessarily equal scores, FICO requires at least six months of credit history and at least one credit account active within the last six months. VantageScore, on the other hand, only requires one month of history and one account active within the past two years.

Special interests oppose stringent requirements because they claim they are outdated and exclude millions of Americans from the homebuying market, thus impacting the bottom line of many firms. Estimates from industry experts and the government's Consumer Financial Protection Bureau indicate 30 to 45 million people do not have a regular credit score - a portion of the population called "credit invisible." Despite claiming to reliably score an additional 7.6 million borrowers, as VantageScore suggests, a recent analysis found that only a fraction of their estimates would result in a mortgage for these "credit invisible" Americans. VantageScore claims to score more Americans by plainly dropping the minimum information scoring requirements as used by FICO. Simply, VantageScore is just loosening their standards and providing the government with a lower quality product. Such a scheme is not an analytical or technological innovation but raises the risk of exposure for taxpayers.

Director Watt, our organizations believe you are correct when you stated "the notion that there would be substantially more people credit scored and that would increase access if we had competition is probably exaggerated." The risk to taxpayers is far too high to implement the considered changes at FHFA for far too little reward.

When borrowers are approved for mortgages that they cannot feasibly pay back, the consequences fall not just on the lender and borrower, but on parties not directly included in the transaction, such as homeowners in the community and the overall economic health of the country. Such was the scene a decade ago when the housing bubble burst. Failing to heed the lessons of ten years ago by approving subprime applicants could lead us once again down a road that could ruin the US economy and undermine the vision of the FHFA to provide "a reliable, stable, and liquid housing finance system." Ultimately, if there is another government manufactured housing crisis similar to 2008, the taxpayer will, once again, be stuck with the bill.

Furthermore, we would be remiss if we did not mention the "ripple effect" that a decision to prematurely embrace VantageScore models could have on other taxpayer-backed lending programs. The Federal Housing Administration (FHA), for example, relies on FICO scores for its own loan programs, which currently constitute a contingent taxpayer liability of $1.2 trillion. If FHFA moves to allow VantageScore's methods to permeate its own procedures, it is a near-certainty that FHA will follow. Other loans in turn, such as VA programs, could be affected as well, leading to a wave of financial risk throughout the entire federal government.

FICO Scores help primary mortgage lenders accurately and consistently evaluate each potential borrowers' credit risk. Reliability is critical for lenders as they disperse trillions of dollars annually to help millions purchase a home. It is for these reasons 90 percent of top mortgage lenders trust FICO as the main score for risk assessment. The current system, which has been in effect for over three decades has performed well and is a reliable indicator of loan performance.

We also strongly believe that introducing competition into this complex space has the potential to create a "race to the bottom" effect on our nation's housing finance system. While it is a noble goal to encourage homeownership, reducing standards to achieve that outcome is reckless and perverse. In our view, taking on an alternative system with lower credit scoring standards would move in the opposite direction of these noble goals. Therefore, it is our strong belief that FHFA should follow the guidance which we have laid out to protect the interests of taxpayers.

Director Watt, you and your staff are to be commended for your thoughtful and prudent approach to maintaining the financial resilience of the GSEs. We applauded your announcement in December that FHFA had reached agreement with the Treasury "to reinstate a $3 billion capital reserve amount under the Senior Preferred Stock Purchase Agreements for each Enterprise beginning in the fourth quarter of 2017." While we would support a variety of reforms that would comprehensively restructure and reduce the federal government's role in housing finance, the intermediate steps you have taken at FHFA, including timely assessments to Congress about the health of Fannie Mae and Freddie Mac, have helped to foster an ongoing discussion over the need for long-term solutions. Experts disagree on what those solutions should entail, but your commitment to providing candid evaluations of GSEs' condition has proven vital.

Our organizations appreciate FHFA's consideration of our comments regarding this RFI. We look forward to our continued work with FHFA in promoting a housing finance system that is more equitable for our nation's taxpayers. Should you have questions or wish to discuss these comments, please contact Thomas Aiello, Policy and Government Affairs Associate, at (703) 683-5700 or Thomas.aiello@ntu.org

Sincerely,

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David Williams, President

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