The Honorable Melvin Watt, Director FHFA

Comment on Credit Score Options from Richard Koss 3/28/2018

This note is in response to the Request for Information regarding credit score options by FHFA. FHFA lists four options through which lenders can access credit information in the mortgage application process in the future. On the basis of the information currently available, I don’t believe that a compelling case is made that the benefits of any of the four options outweigh the costs. I raise three major points in this regard that should be considered before changes in the current system are made. Should it be deemed that a change is necessary, I believe that the best option is to choose Option 1, a switch in the single score delivery to FICO 9.

1. Transactions Costs

The RFI states “FHFA concluded that the Enterprises’ empirical findings revealed only marginal benefits to requiring a different credit score than Classic FICO”. As a result, any change should be implemented only if the transaction costs are modest. While consideration needs to be given to costs across the entire mortgage value chain, FHFA should give primary consideration to the costs imposed on the Enterprises in its role of Conservator. The RFI goes on to say that “Implementation of a new score(s) will take the Enterprises 12-18 months and would begin only after the Common Securitization Platform and Single Security Initiative are fully implemented in 2019.” Beyond the timeline, it is important that the public be made aware of the estimated dollar costs of this transition. Are taxpayer resources being well-used for a result that promises “only marginal benefits?”

I am very concerned about the statement in the RFI in Section III Credit Score Options: “However, FHFA recognizes that there are compelling reasons for the Enterprises to update their credit score requirement from Classic FICO. First, while Classic FICO adequately predicts risk, the new models provide a slight increase in accuracy, which would ultimately benefit borrowers and investors.” How does a “slight increase in accuracy” amount to a “compelling reason” to change? The other stated reasons for change such as models being reestimated with additional economic data mean little if forecast accuracy is not meaningfully improved. Such a statement implies that change will occur no matter the cost which does not inspire confidence that the prudent use of taxpayer resources is being adequately taken into account in the decision-making processes at FHFA. Before proceeding, FHFA needs to clearly state what the benefits in terms of forecast accuracy and social welfare, while providing a clear estimate of the dollar cost of implementation. Experienced model consumers never assume the model is correct. However, the use of a consistent model provides users with the opportunity to gain experience with its workings on a day to day basis, which is proven helpful in decision making. The implementation of marginal or un-convincing improvements does not justify the loss of consistency and stability.

1. Benefits from Increased Competition

Of course, more competition always has the potential for enhanced efficiencies and cost savings. For competition to work appropriately, a market structure needs to be in place that allows for free and fair competition between market participants. It is far from clear that such a structure exists for the options in which FICO would be pitted against VantageScore. First, VantageScore is itself a consortium formed by the three CRA’s. The formation of a cartel on the part of the three bureaus smacks of anticompetitive behavior on its face. Second, as market participants obtain credit information through the CRA’s, what is to stop them from pricing the various options in a way to advantage themselves in the market, or taking other measures to the same effect? Finally, gaining market share by tweaking models to broaden the base of eligible borrowers is also a concern. Ownership structure and “race to the bottom” issues are discussed by FHFA, but no suggestion is made for resolving them. Before proceeding in this direction, a clear independent regulatory structure needs to be put in place to ensure that free and fair access to the available choices is implemented and maintained. In addition, this body would have to approve any model changes before they are implemented by any data provider. The formation of such a structure would be expensive, and its budget should be clearly stated on the cost side of the cost-benefit analysis used to govern the decision-making process.

1. Safety and Soundness

Finally, there is the key issue of the safety and soundness of the Enterprises and concerns about systemic risk stemming from the system of housing finance. There are many aspects to this, but I will focus on the potential of adverse fallout from using the VantageScore model. In the RFI, FHFA points out conditions under which consumers would receive a credit score under VantageScore but not from FICO, namely that there is no minimum aging of an account, or, that any tradeline exist at all. The RFI goes on to say that “Because of its less restrictive minimum requirements, VantageScore will score more consumers in the U.S. population than FICO.” What it doesn’t say is whether that is a good idea or not. Almost certainly, it’s not.

As there is no history of mortgage performance for borrowers with de minimis or no credit history, it is impossible to say how these borrowers will hold up in the next downturn. Certainly, loan performance will be worse than for borrowers with more experience managing their finances. Moreover, this loosening of standards comes at a time when home prices are surging. In the fourth quarter of 2017, the FHFA all-transactions house price index stood over 8% above the bubble peak attained in early 2007. Total mortgage debt outstanding is a mere few tenths of a percentage point below the prior peak. There is a large and growing literature that demonstrates the effectiveness of countercyclical macroprudential policies in dampening boom and bust cycles.[[1]](#footnote-1) Relaxing standards at this state of the cycle follows other troubling moves like raising DTI and LTV limits and widening allowable income standards. These moves are the opposite of prudential policy-making and will likely contribute to a near-term surge in activity, followed by a bigger bust down the road.

Concern surrounding the trend loosening in underwriting standards was recently raised by both Fannie Mae and the Mortgage Insurers following the release of information that Fannie Mae’s acquisition of mortgages with a DTI over 45 surged to 20% of the total in the fourth quarter of 2017 from only 5% in 2016. As a consequence of this startling jump, Fannie Mae has taken steps to reduce risk layering in its automated underwriting system, and the MI’s have taken similar moves. This is no time to be putting it back.

A look at loan-level data from securities pools provided by the mortgage analytics firm Recursion Co. also reveals some disturbing trends. In particular, while delinquencies experienced by the Enterprises remain quite low, Recursion Co. data looking at FHA loans reveals a troubling rise in delinquencies, even when regions that have been hit by natural disasters have been excluded.

Finally, there is the issue of the rising share of nonbank providers of credit in the mortgage market. In a recent article, I utilized Recursion Co. data to show that the share of non-bank servicers for newly issued Freddie Mac loans stood at 51% this past February, more than double the share experienced five years ago.[[2]](#footnote-2) With so many mortgages in the hands of these lightly regulated and capitalized financial firms, systemic risk is on the rise. A recent study conducted by researchers at the Federal Reserve and the University of California Berkeley found that “The typical nonbank has few resources with which to weather…shocks.”[[3]](#footnote-3) They conclude by asking “whether it is wise to concentrate so much risk in a sector with such little capacity to bear it, and a history, at least during the financial crisis, of going out of business.” Nonbanks are connected to the larger financial system through wholesale lines of credit and funding of servicer advances. I would imagine that nearly all of the loans for borrowers with limited or no credit histories would be underwritten by nonbanks, adding to overall systemic risk in the financial markets.

Conclusion

To conclude, I do not believe that FHFA has adequately supported its claim that there is a compelling reason to change credit models. The various options offered have been put forth with no estimate of their costs, and with the admission that the benefit as measured by forecast accuracy is slight. When a decision is made, the public should be provided with estimates of the cost of implementation, and these should be regularly updated. FHFA has not offered a satisfactory framework for ensuring that competing providers of credit scores operate on a level playing field and that proper regulatory oversight of the models is in place. The expense of creating and maintaining a regulatory apparatus to deal with these issues needs to be spelled out and included on the cost side of the decision-making process. I am very concerned about allowing mortgage credit to be extended to borrowers with little or no history of managing debt.

As I read through the RFI it is hard to escape the conclusion that this entire process is in place as a back-door method of increasing risk layering, which is particularly ill-advised near the peak of a cycle. Issues associated with the lack of housing affordability, particularly for traditionally underserved parts of the mortgage market, are important social concerns and must be taken very seriously. These are complex matters, and require policies in place that reach beyond housing, in particular with education and labor policy that allows families to build savings so they can gain status as homeowners with confidence. The one clear lesson from the global financial crisis is that the wrong way to approach this issue is to extend credit to a point where this status cannot be reasonably sustained in a downturn. Those most adversely impacted by such an outcome will likely be those who took out loans at the edges of the newly-widened credit box.

If a change is deemed necessary following a rigorous analysis, I suggest that Option 1 be chosen, with FICO 9 becoming the single delivered score. This choice minimizes the potential for increased systemic risk, while also minimizing confusion associated with procedures involving multiple scores.

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1. See, for example, Jaromir Benes, Douglas Laxton and Joannes Mongardini. “ Mitigating the Deadly Embrace in Financial Cycles: Countercyclical Buffers and Loan-to-Value Limits”, at https://www.imf.org/external/pubs/ft/wp/2016/wp1687.pdf [↑](#footnote-ref-1)
2. Richard Koss “The Mortgage Market is Moving into the Shadows” at https://www.bloomberg.com/view/articles/2018-02-23/mortgage-loans-the-market-is-moving-into-the-shadows [↑](#footnote-ref-2)
3. You Suk Kim, Steven M. Laufer, Karen Pence, Richard Stanton, Nancy Wallace, “Liquidity crises in the mortgage market” at https://www.brookings.edu/wp-content/uploads/2018/03/5\_kimetal.pdf [↑](#footnote-ref-3)