March 29, 2018

Federal Housing Finance Agency
Office of Housing and Regulatory Policy,
400 7th St SW, Washington, DC 20024

Re: Use of Alternative Credit Scores in GSE Underwriting

To Whom It May Concern,

The Securities Industry and Financial Markets Association ("SIFMA") writes in response to FHFA's consultation regarding the GSEs' use of a credit score other than FICO 4 in their underwriting guidelines. Our views expressed herein are largely similar to those that we conveyed in 2016.

The RFC lays out the following four options:

1. Single Score - GSEs will require the use of one of the two modern scores;
2. Require Both - GSEs will require the use of both scores;
3. Lender Choice - GSEs will allow banks to choose which score to use and require use of that score for a set period of time.
4. Waterfall - GSEs will require the use of one of the two modern scores, but in the event that the designated score is not available, will allow for the use of the other score;

Based on the discussions we've had with the GSEs and FHFA and information we have received, as explained in the discussion below, we are only able to offer a limited perspective. We underscore that the GSEs must disclose significant historical data to the market before any changes to their guidelines are made.

SIFMA members' primary concern regarding this effort is disruption of market participants' ability to model credit risk and prepayments. Credit scores are an important input into the prepayment/default modeling which forms the core analysis in the To-Be-Announced and credit risk transfer markets. Furthermore, lenders need to understand how a borrower's score relates to their propensity to default. The current generation of credit scores and how they relate to prepayments/defaults is well

understood, but the new generation is less well understood. If modeling is challenged or rendered less predictive, the activity of these participants will be disrupted.

Process

While we greatly appreciate the opportunity to provide input in 2016 and respond to this RFI, we believe FHFA should create a programmatic review process for credit score models. These will surely not be the last new models presented to the GSEs. There should be transparency around the timing of reviews and the standards for data quality and predictability that a model offers. The process should also accommodate industry and investor capacity for any updates, which are significant projects for operational and risk groups. This process should include consideration of the need for consumer education.

Data Disclosure and Narrative of GSE Analysis

Our most important request, dating back to our first discussion in the summer of 2015, is for the GSEs to disclose significant amounts of data and analysis so that the market can understand how the new scores relate to the old scores, and how they relate to loan performance. We have not aware of any new datasets or disclosures related to this request. While we understand that there may be contractual issues that stand in the way of certain disclosures, given the importance of this issue we believe it is imperative for the GSEs and FHFA to find ways to work through those issues and resolve them so that data may be provided to the market.

Any released data should include actual and observed data through the economic cycle so that modeling can be undertaken accurately using ex-post observations. Accordingly, we would suggest you consider an Option 5: Do not implement alternative credit scoring until we have passed through the current economic cycle with actual mortgage outcomes so that the market can understand how the models will perform.

In addition to raw data, as discussed, we believe the GSEs should publish a narrative including details of their historical analysis and discussion of the rationale for such analysis in the form of a whitepaper. Having data that shows historical prepayments with the alternate credit scores is necessary to evaluate the choices and to understand the choices and their expected impacts on security performance. The market needs a comparative analysis. How is the application of the new credit scores different in terms of credit outcome relative to the current credit score being used?

Furthermore, as FHFA notes in the RFI, *"While FICO and VantageScore use the same score range, their credit scores are not interchangeable because of the minimum scoring criteria described above, which leads to a different universe of "scoreable consumers" and a different credit score distribution for each model…The score difference between FICO 9 and VantageScore 3.0 cannot be addressed or corrected by simply adding or subtracting a fixed number of points from either score because each model rank orders borrowers somewhat differently."* All of this points to the need for greater disclosure to the markets so that performance, nuances, and trade-offs can be better understood.

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Other Questions Remain

There are additional issues to be addressed:

- How do the GSEs plan to manage pricing grids in a two score environment? Does their analysis show differences in customer pricing between the two models?
- To what degree and how are the GSEs coordinating with mortgage insurers and FHA/VA/RD?
- Does the shift to the new models achieve a reshaping of the credit box? We understand that the GSEs expect the impact on prepayments to be minimal, but the market needs to see some data to validate that. Additionally, while overall prepays may remain unchanged, could there be shifts within the box? It is hard to analyze this without historical data or some analyses that they have run.

What We Can Recommend At This Time

Given the lack of available data and these open questions, we are not prepared to provide a complete and specific recommendation to FHFA and the GSEs as to the specific option to choose, and indeed, whether the effort ultimately is the right avenue to pursue at this time or not. Here are SIFMA's conclusions at this time:

1. **The credit score that is used needs to be consistent and stable across all lenders and all pools; accordingly, options 3 and 4 should be rejected.** Options 3 and 4, which would make it likely that pools would contain a mix of loans with *either* FICO *or* VantageScore as the sole score, are significantly less preferred. This is primarily because it is more complex to build models to accommodate either of the scoring options being present in the same pool, as opposed to just one. It would be much easier to build or adapt an existing model around just FICO or just VantageScore, as opposed to dealing with both at the same time. Optionality may create the potential for lenders to game the scores over time. It also seems possible that mixed pools, given the increased complexity of analysis, could see lower liquidity over time.

   In our discussions, each of lenders, market makers, and most importantly investors have criticized approaches 3 and 4. We do not see a benefit to options 3 or 4 that outweigh the costs, risks, and complexities that would be involved.

2. **Options 1 or 2, which would promote consistency and allow secondary market participants to build models around one score, are the most advisable path assuming the decision is made to pursue an alternative to FICO 4 (subject to our requests for additional data, etc).** At this point we do not have a recommendation within those two options, or a recommendation on FICO vs. VantageScore. Both options would allow investors and researchers to focus on the model of their choosing, limit opportunities to game the system, and provide for a consistent path of analysis.

3. **Before any changes are made the GSEs must disclose comprehensive data to the market.** See above. This is the most critical aspect of implementation.

4. **If a change to the current regime is made, FHFA should provide details of the cost-benefit analysis.** This will help the market understand the change.

5. **FHFA and the GSEs must allow sufficient time for lenders, market makers, and investors to adapt to any changes.** Lenders and secondary market participants will need significant time to implement the needed operational and technology changes– at least six to 12 months and more like 18 months if the path forward is a mixed two score option (*which, as noted, is not a path that should be pursued*). We understand that any change is expected implemented only after single security is in place, and we believe that is a good idea.

   In addition to the actual changing of modeling engines, which may be more or less challenging depending on the path chosen, many participants must implement rigorous controls around their models. For example, banks must comply with rules such as Federal Reserve guidance on model risk management contained in SR 11-7.[1] Changing models is not a simple flip-the-switch operation. Related to this, we note that not all lenders are subject to this type of regulation. FHFA must take care to ensure that weaknesses in either of the proposed new credit scoring models are not exploited resulting in the GSEs being adversely selected.

We look forward to further discussions with FHFA and the GSEs on this topic. Please contact me at 212-313-1126 or ckillian@sifma.org with any questions or for more information.

Sincerely,

Chris Killian
Managing Director

[1] See https://www.federalreserve.gov/bankinforeg/srletters/sr1107.htm.