MBA

MORTGAGE BANKERS ASSOCIATION

March 30, 2018

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

RE: Credit Score Request for Input

Dear Director Watt:

The Mortgage Bankers Association (MBA)[1] thanks the Federal Housing Finance Agency (FHFA) for the opportunity to comment on potential changes to the credit score requirements at Fannie Mae and Freddie Mac (the Enterprises). In its Request for Input (RFI),[2] FHFA correctly notes that such changes "would generate industry-wide effects…including impacts on mortgage applicants, mortgage lenders, mortgage insurance companies, consumer reporting agencies (CRAs), consumer credit reporting resellers, mortgage-backed security (MBS) investors, credit risk transfer (CRT) investors, and other market participants."[3] And while credit scores play only a limited role in the underwriting process for loans acquired by the Enterprises, their impact on borrower eligibility and loan pricing warrants periodic review.

MBA believes that changes to existing credit score requirements should be evaluated across the following dimensions:

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, DC, the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,300 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies, and others in the mortgage lending field. For additional information, visit MBA's website: www.mba.org.

[2] FHFA, "Credit Score Request for Input," December 20, 2017. Available at: https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/CreditScore_RFI-2017.pdf.

[3] Id., page 4.

1) Consumer access to mortgage credit;
2) Costs to industry participants;
3) Liquidity in the secondary market; and
4) Safety and soundness of the Enterprises.

The various options considered within the RFI will offer differing advantages and disadvantages across these dimensions; no option is without costs or drawbacks. The key to a positive outcome will be for FHFA and the Enterprises to choose an option that maximizes the benefits across these dimensions while taking active steps to address any concerns prior to its implementation.

Principles for Credit Scores

MBA believes that, much like with other aspects of mortgage lending, regulations governing the use of credit scores at the Enterprises should foster a fair and competitive market that supports innovation and access to affordable credit. As such, MBA urges FHFA and the Enterprises to adhere to the following principles with respect to the Enterprise credit score requirements:

1) Any decisions regarding existing credit score requirements should be data-driven and analyzed thoroughly;
2) Any accepted credit scoring models—regardless of provider—should be subject to frequent, rigorous testing of their predictive capacity by FHFA and/or the Enterprises;
3) Competitive forces typically produce better results in the market by stimulating innovation and lowering costs; therefore changes to the existing requirements, as well as the review process for future changes, should extract the benefits of competition in credit score modeling;
4) The regulatory system governing credit scoring models should be structured to incentivize ongoing efforts to improve predictive capacity and reliability throughout the credit cycle; other objectives, such as expanded consumer access to credit, should also be pursued so long as they do not compromise predictive capacity and reliability;
5) Current efforts that are focused on data provided by the national CRAs (Equifax, Experian, and TransUnion) should not displace or otherwise discourage efforts focused on the use of additional data sources, such as telecommunications, rent, or utility payments; and
6) FHFA and the Enterprises should abide by transparent processes for maintaining and/or changing the Enterprise credit score requirements; such processes should include regular communication with a wide variety of mortgage market participants.

Credit Score Options

For the purposes of these comments, MBA will use the same naming conventions as the RFI when referring to the credit score options being considered:

Option 1: Single Score

- Require either FICO 9 or VantageScore 3.0 on every loan (if available)

Option 2: Require Both

- Require both FICO 9 and VantageScore 3.0 on every loan (if available)

Option 3: Lender Choice with Constraints

- Require either FICO 9 or VantageScore 3.0, with the lender maintaining discretion as to which score to deliver, while prohibiting the lender from switching models for a defined period of time

Option 4: Waterfall

- Require delivery of either FICO 9 or VantageScore 3.0 as the primary score, with the lender maintaining the option to provide the other score if the primary score is unavailable

Why Consider Changes to the Existing Requirements?

Given that any changes to the existing Enterprise requirements would entail operational challenges that bring with them additional costs, it is important to understand what can be gained from such changes.

As noted above and in the RFI, credit scores play only a minimal role in the underwriting process for loans that the Enterprises acquire. Freddie Mac's automated underwriting system, Loan Product Advisor, uses a Classic FICO score[4] as one of many attributes considered when making a credit assessment, while Fannie Mae's automated underwriting system, Desktop Underwriter, does not use any third-party scores in its credit assessment. Both systems now have the capability to evaluate applicants who do not have Classic FICO scores, as well.

Credit scores can, however, play an important role in determining borrower access to certain mortgage products through two channels—their use as eligibility criteria for products that feature minimum credit scores and their use in loan pricing. New models may result in more borrowers qualifying for scores, or higher scores for

[4] A Classic FICO score is defined in the RFI as the collective use of Equifax's FICO 5, Experian's FICO 2, and TransUnion's FICO 4.

certain borrowers who already have scores. In either case, it is possible that these borrowers will be able to access more products or obtain credit at a lower cost. MBA recommends that FHFA and the Enterprises undertake further analysis to better quantify any improvements to access to credit that new models would produce. As is discussed below, such analysis would need to go beyond the current scope of the Enterprises' empirical evaluations of Classic FICO, FICO 9, and VantageScore 3.0.

New models also hold the potential to improve the predictive capacity of credit scores. Increased predictive capacity translates into better risk management tools available to a wide variety of market participants, including the Enterprises. Where minimum credit scores serve as eligibility criteria, improved models could lower default rates. In many cases, pricing could also be more accurately aligned with the corresponding default risk of the loan. These outcomes would be unambiguously positive for the broader mortgage finance system.

Finally, the existence of a periodic review process should itself spur innovation in credit score modeling. Providers of credit scoring models will face greater incentives to update and improve the predictive capacity of their models in an environment in which FHFA and the Enterprises regularly evaluate the suitability of these models. Without such reviews, there would be diminished motivation to innovate, particularly for new providers that would otherwise seek Enterprise eligibility for their models. Therefore, even if the Enterprise requirements are not changed at present, the understanding that reviews will continue to occur (preferably on a regular and predictable timetable) should drive competitive forces in this sector.

Evaluating the Benefits and Costs of Various Options

<u>Consumer Access to Mortgage Credit</u>

Question A1.1 of the RFI asks about the use of credit scores in the mortgage lifecycle. As is discussed above, even in scenarios in which credit scores are not a major factor in the underwriting process, minimum required scores do often serve as eligibility criteria for access to certain products. This feature is not unique to the Enterprises, but also exists in the context of the loans insured or guaranteed by the Federal Housing Administration and the U.S. Department of Agriculture, as well as loans held in portfolio by many depository institutions.

Similarly, credit scores are a factor in the determination of pricing overlays for the Enterprises. Fannie Mae loan-level price adjustments and Freddie Mac delivery fees are influenced by the credit score (or lack thereof) attached to the loan. This risk-based pricing system directly impacts the cost of credit for consumers, with lower credit scores corresponding to higher costs. Those applicants without a Classic FICO score are charged higher prices (via higher guarantee fees imposed on their lenders) to compensate the Enterprises for what is assumed to be a higher risk of default.

New credit scoring models, whether produced by FICO, VantageScore, or other providers, would therefore likely enable greater access to mortgage credit if they: 1) scored more borrowers above the various minimum required scores for loan products; or 2) raised scores such that pricing was reduced for borrowers at or near the margin of affording a loan.

Based on information that is publicly available, it appears that FICO 9 would not have a material impact on the aggregate number of consumers who could be scored, relative to Classic FICO, though the distribution or level of scores for those consumers who receive scores could change materially. It appears that VantageScore 3.0 would be able to provide scores for a significant number of borrowers that currently do not qualify for a Classic FICO score, largely due to differing requirements regarding the age and number of open tradelines. Two important questions relate to the number of these newly-scored consumers who are interested in seeking mortgage loans and whether these potential borrowers will receive scores that either improve their eligibility for loan products or make their pricing for these products more favorable. Again, while recognizing the challenges in doing so, MBA urges FHFA and the Enterprises to undertake the necessary analysis to quantify the answers to these questions.

Relatedly, Question A3.3 asks about the benefits of Option 3 if the number of qualified borrowers remains unchanged or little changed relative to the use of Classic FICO. Consumer access to credit is not the only dimension along which credit scoring models should be evaluated, as predictive capacity and reliability also represent important objectives. Improved access is one important benefit of using new models—particularly those such as VantageScore 3.0 that can produce scores for a greater number of consumers. If this benefit is not realized, the utility of Option 3 would rely more heavily on its ability to add value along these other dimensions.

Question A2.9 notes that, because credit scores derived from Classic FICO, FICO 9, and VantageScore 3.0 are not interchangeable, it is possible that the Enterprises could institute different eligibility or pricing standards based on the model used. MBA strongly recommends that, in a scenario in which multiple models are accepted, the Enterprises make every effort to align eligibility and pricing based on default risk. While this outcome will likely result in different minimum scores or pricing grids associated with different models, this outcome is also the fairest with respect to consumer access to credit. Consumers should not be penalized because of the credit scoring model used by their lender, particularly given that this information is likely to be unavailable to the consumer.

Question A2.7 inquires about the need for additional consumer education under the various options being considered. As a general matter, MBA supports improved consumer education with respect to the mortgage process. For most consumers, many aspects of the process can be somewhat opaque and difficult to understand. The use and meaning of credit scores is no exception. Given the low levels of comprehension (and rampant misconceptions) regarding how credit scores are calculated, structured, and incorporated into the underwriting process, there will be significant educational challenges regardless of the option chosen. As such, MBA does not believe that potential borrower confusion should be a major factor in the decision regarding Enterprise credit score requirements.

Costs to Industry Participants

Questions A2.2, A2.3, and A2.4 ask about the operational considerations or challenges of the various options being evaluated, including implementation costs and timing. In general, any change in the existing Enterprise requirements would require non-trivial resources and expenditures, though the scale of these resources and expenditures would vary based on the size and profile of the institution. For example, many banks would need to ensure that their systems and processes adhere to the model risk management guidance issued by the Federal Reserve and the Office of the Comptroller of the Currency. To do so, these banks—and particularly larger banks—would need to engage in thorough back-testing and documentation during a transition period. Other regulators, including state regulators that supervise independent mortgage bankers, have differing sets of requirements with respect to model risk management. FHFA should evaluate the varying compliance costs associated with these regulatory requirements when determining the overall costs of a change to existing Enterprise credit score requirements.

Among the options under consideration, Option 1 appears to feature the lowest implementation costs and the shortest implementation timing. This is because there would be no structural changes to the current credit score framework, aside from the change in model itself. Industry participants would need to adjust models of default risk to accommodate the change, as well as meet any back-testing, documentation, or other requirements as noted above.

Option 2 would entail the costs described under Option 1, but such costs would be higher because of the need to achieve compliance with two separate models. There would also be more significant changes to systems and databases required under Option 2, as current systems and databases are not (in most cases) designed to accommodate credit scores from multiple providers.

Options 3 and 4 require only one score for each loan originated, though industry participants may incur the costs associated with accommodating credit scores from multiple providers. In these cases, however, lenders are not obligated to use scores provided by both FICO and VantageScore. Under Option 3, for example, a particular lender could simply decide not to invest in the infrastructure needed to switch between FICO 9 and VantageScore 3.0, effectively choosing to forego the benefits of any future switching if it determines that the implementation costs are too steep. Similarly, under Option 4, lenders could simply choose to never provide a secondary score when the primary score is unavailable. This choice could impact their competitiveness, but each lender would make its own decision regarding the costs and benefits of such a strategy.

FHFA should also ensure that any new credit score requirements at the Enterprises do not expose lenders and other industry participants to additional litigation risk with respect to various relevant laws governing consumer lending and credit availability.

Because of the important operational challenges associated with any of the options being considered, MBA recommends that FHFA not implement any new requirements until at least 12 months—and preferably 18 months—following an announcement of these requirements.

<u>Liquidity in the Secondary Market</u>

Question A2.5 asks about the possibility of multiple-score options affecting investors' view (and pricing) of MBS issued by the Enterprises. Potential concerns noted in the RFI include reduced liquidity in the to-be-announced (TBA) market or reduced demand for CRT transactions. MBA believes that all options under consideration will have effects on the MBS market, and that FHFA and the Enterprises should take proactive steps to minimize any associated risks.

Under Option 1, investors will need to adjust their prepayment models and MBS/CRT valuations to account for any differences between Classic FICO and the new model that is chosen. The relationship between the credit score and the default probability for FICO 9 was developed to mirror that of Classic FICO, which may prove helpful for investors, though regardless of the model chosen, this relationship will inevitably continue to drift over time and will necessitate new prepayment modeling by investors. The same outcome is true under Option 2, though investors will have two models upon which they can base their valuations. While there is a cost associated with making adjustments for two new models, investors are effectively provided with the choice as to whether undertaking analysis of a second model is worthwhile. Because all loans would contain scores from both models, it would not be a necessity for all investors to develop valuations based on both models. Each investor could determine whether analysis of a second model provided sufficient additional information to justify the associated costs.

Under Options 3 and 4, each loan would contain one score, but the model used to generate that score would differ across loans. These scenarios present greater challenges for investors, as there would be reduced uniformity across loans. All investors would essentially be required to adjust their prepayment models and MBS/CRT valuations for both FICO 9 and VantageScore 3.0, which is costlier than adjusting to only one new model. Further, investors would need to develop mechanisms for evaluating MBS/CRTs that contain underlying loans with scores derived from different models. The Enterprises' MBS/CRT disclosures, including historical disclosures, would likely need to be amended to provide greater information regarding the distribution of FICO 9 and VantageScore 3.0 scores. Another approach to accommodate this outcome would be to explicitly segment MBS/CRTs based on credit scoring models. MBA strongly recommends that the Enterprises avoid this approach, as it would greatly harm secondary market liquidity by effectively creating two separate classes of securities.

Regardless of the option chosen, there are steps that FHFA and the Enterprises can take to reduce the transition costs for investors in MBS/CRTs. Foremost among these steps is the publication of historical Enterprise loan-level data, updated to include scores derived from the new model(s) chosen. This process is simplified somewhat by the recent publication of similar historical data for investors in Fannie Mae's Connecticut Avenue Securities (CAS) and Freddie Mac's Structured Agency Credit Risk (STACR) debt notes. If those datasets are updated with FICO 9 or VantageScore 3.0 scores (or both), investors can more easily develop prepayment models and MBS/CRT valuations, thereby alleviating much of the concern about reduced investor demand.

Similarly, MBA supports ongoing updates to the CAS and STACR datasets so that investors can observe loan-level changes in credit scores over time. These updates would counter concerns about potential drift between default probability and credit scores, as well as adverse selection by entities seeking more favorable pricing. As the Enterprises already publish updates to the CAS and STACR datasets on a monthly basis, we believe the additional cost associated with providing FICO 9 or VantageScore 3.0 scores (or both) in these updates is not likely to be significant.

<u>Safety and Soundness of the Enterprises</u>

Question A3.4 asks about incentives to incorporate more data for consumers with sparse credit history, and how FHFA should balance this outcome with the desire for greater accuracy and better management of mortgage credit risk. Because the Enterprises are exposed to much of the mortgage credit risk on the loans they acquire, FHFA is correct to consider any outcome that could potentially increase this risk. Prudent risk management is particularly important given the conservatorship of the Enterprises, the taxpayer exposure to risks that are borne by the Enterprises, and the critical role that the two institutions continue to play in the mortgage finance system.

MBA firmly believes that, regardless of any other factors that will influence the choice of an option, FHFA should only allow the Enterprises to accept new models if those models are found to be more predictive than existing models that have previously been accepted. Any such finding should be the result of thorough, rigorous testing by the Enterprises that is validated by FHFA. Efforts to incorporate more data, which in turn allows more potential borrowers to be scored, should be encouraged but should never be used to reduce the predictive capacity of a model that is accepted by the Enterprises.

Question A3.5 notes the possibility of competition in credit score modeling leading to a "race to the bottom," presumably due to score providers relaxing standards so as to gain market share. As with many aspects of the mortgage finance system, a critical line of defense in terms of safety and soundness is the presence of a strong regulator. In a scenario in which multiple score providers are competing, FHFA must remain vigilant that the Enterprises are consistently and adequately testing the accepted models. The results of this testing should be reported to, and validated by, FHFA on a regular basis. If FHFA or an Enterprise determines that a model's predictive capacity is deteriorating, it should exercise authority to ensure that the provider of the model takes corrective actions to address the problem.

Question A2.8 raises another safety and soundness concern which is specific to Option 3, asking how the Enterprises could protect against adverse selection in which lenders choose their preferred model at the loan level to ensure favorable product eligibility and/or pricing. The RFI notes one potential approach to address this concern—the idea of a "lock-in" period. Under this approach, each lender would continue to exercise its choice between FICO 9 and VantageScore 3.0, but it would be required to use only one model for all loans that it sells to the Enterprises for a given period of time.

The aforementioned requirements (new models only accepted if they improve upon existing predictive capacity; rigorous and frequent testing of accepted models) should ease concerns about adverse selection. Nonetheless, if Option 3 were chosen, MBA would support policies that further reduce the ability of lenders to make decisions about the credit scoring model simply to achieve more favorable terms. Other approaches include segmenting the lender's originations by some other loan-level variable (e.g., by geography or by property type). However, MBA feels that the lock-in period is superior to approaches that segment originations by a single lender. The lock-in period, which would entail its own operational and supervisory challenges, would nonetheless be easier to enforce and provides fewer opportunities for lenders to engage in adverse selection.

MBA also believes that any policies that address adverse selection should be enforced at the point of origination, rather than through aggregators that purchase loans from correspondent lenders. Enforcement when the loan is originated will allow for a more consistent application of the rules across the industry, whereas enforcement at the aggregator level would create more burdensome compliance while potentially disrupting the correspondent channel for many institutions.

Tri-Merge Credit Reports

Questions B1 through B7 inquire about the effects of removing the Enterprise requirement that mortgage lenders seek credit reports from all three national CRAs (collectively, the “tri-merge” credit report). In the RFI, FHFA correctly notes that in other consumer lending markets, it is far more common for lenders to use one or two CRA credit reports rather than three reports.

Question B2 asks about the benefits to both borrowers and industry participants of allowing lenders the flexibility to obtain fewer than three CRA credit reports. In such a scenario, mortgage production costs would be reduced, as lenders currently pay a separate fee for each report. And as is again noted in the RFI, evidence suggests that the cost of the tri-merge credit report for mortgage lenders is typically greater than three times the cost of individual reports obtained by lenders in other consumer markets.

This outcome may be at least partially explained by the fact that the three CRAs do not face competitive pricing pressure in an environment in which all three reports are required by the Enterprises. Removing the tri-merge requirement could therefore lower production costs, which would likely lower borrowing costs for consumers, both by directly decreasing the number of reports that must be acquired and by indirectly lowering the per-report cost.

Question B2 also asks about the disadvantages associated with removal of the Enterprises’ tri-merge requirement. The two potential disadvantages that MBA has identified would be: 1) adverse impacts on access to credit if fewer borrowers meet the Enterprises’ minimum credit scores; and 2) safety and soundness concerns if there is wide variation among the information provided by the three separate CRA credit reports.

These potential disadvantages relate to Question B5, which poses a scenario in which lenders use only those CRA credit reports that result in preferential loan-level pricing and eligibility, as well as Question B1, which asks about incremental information provided by the use of multiple reports. Similarly, Question B7 notes that the Enterprises could increase their pricing if the use of fewer reports results in greater risk.

Our understanding of the reports offered by the three CRAs indicates that variation in the information provided on the borrower's credit history is quite limited. As such, our concerns regarding material impacts to borrower access to credit or Enterprise safety and soundness are muted. We therefore do not believe these concerns warrant the continuation of the tri-merge requirement. However, we recommend that FHFA and the Enterprises undertake more thorough analysis of the variation among CRA reports prior to removing the tri-merge requirement. In particular, we recommend that this analysis cover not only variation in delinquencies reported, but also variation in credit inquiries.

Question B3 seeks input as to whether industry participants would choose to obtain fewer than three CRA credit reports if given the flexibility to do so. Question B4 seeks input as to whether industry participants would prefer lenders to choose the CRA(s) from which they obtain credit reports (rather than designating the Enterprises or other stakeholders to make this choice). MBA believes that the vast majority of lenders would elect to use fewer than three reports and would prefer to choose the CRA(s) with which they do business. If lenders do not have discretion to choose among the CRAs, we fear that competitive forces between the CRAs would remain blunted.

MBA therefore recommends that FHFA and the Enterprises begin the process of eliminating the tri-merge requirement. However, any finalization of this process should be dependent upon a finding that there is sufficiently minimal variation among the delinquency and credit inquiry data provided by the three CRAs. Any updated standards, for example the decision to require one or two reports, or to tailor the number of required reports based on loan-level factors, should be calibrated to ensure the continued safety and soundness of the Enterprises.

Additional Considerations

<u>Alternative Data Sources</u>

Question A1.7 requests supplementary concerns or insights regarding potential changes to the Enterprise credit score requirements. In addition to the comments provided above, MBA urges FHFA and the Enterprises to expand their review to include models that use data not typically provided by the three national CRAs. The most commonly-cited examples of such "alternative" data are telecommunications, rent, and utility payments.

There is great potential for alternative data to improve access to credit for consumers that are historically underserved, such as low-income or minority households. Because underserved consumers generally have less experience using traditional financial products, their credit history data at the CRAs will be sparse—these are the so-called "thin file" consumers. The inclusion of telecommunications, rent, and utility payments, however, could add valuable data on many consumers' credit histories. In particular, we would expect past rental payments to show a strong positive relationship to future mortgage payments.

As we have noted elsewhere in these comments, MBA does not support any changes that will decrease the predictive capacity of models accepted by the Enterprises. Such an outcome would harm borrowers, lenders, and taxpayers. Instead, we believe that any new models—whether designed by new providers or those that already produce scores used by the Enterprises—should be held to the same rigorous testing and validation processes that currently exist. It is likely that the most successful innovations in credit score modeling will use alternative data in a way that is additive to data already collected via the CRAs, thereby improving predictive capacity, rather than by replacing CRA data.

More work is certainly needed to develop and test reliable models that make use of alternative data. FHFA and the Enterprises should, however, expand their current review as well as any future evaluations of credit scoring models to include those models that incorporate such data. Doing so has the potential to generate improved consumer access to credit without increasing default risk in the system.

<u>Enterprise Empirical Evaluations</u>

Another consideration relevant to Question A1.7 is the Enterprises' empirical evaluations of Classic FICO, FICO 9, and VantageScore 3.0. MBA reiterates our request that the results of these evaluations be released publicly. While these evaluations are limited in scope, as they do not consider the impact of potential borrowers who have chosen not to apply for mortgages or who have been served through non-Enterprise channels, we continue to believe that the results will help inform our analysis of the options presented in the RFI.

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The ongoing review of the Enterprise credit score requirements presents an opportunity to reduce default risk in the mortgage finance system while potentially improving consumer access to credit. While any transition to new requirements will entail costs and challenges, MBA believes that periodic reviews of Enterprise standards are a necessary condition to encourage innovation. We would once again emphasize the principles described above, which prioritize rigorous, data-driven approaches that foster competition, innovation, and transparency.

MBA appreciates FHFA's consideration of our comments regarding the Enterprise credit score requirements. Should you have questions or wish to discuss these comments, please contact Dan Fichtler, Director of Housing Finance Policy, at (202) 557-2780 or dfichtler@mba.org.

Sincerely,

David H. Stevens, CMB
President and Chief Executive Officer
Mortgage Bankers Association

cc: Office of Housing and Regulatory Policy