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Alfred M. Pollard
General Counsel
Attention: Comments/RIN 2590–AA98
Federal Housing Finance Agency
Eighth Floor
400 Seventh Street, S.W.
Washington, DC 20219

Re: Validation and Approval of Credit Score Models (RIN 2590–AA98)

Dear Mr. Pollard,

I am writing today to comment on the Federal Housing Finance Agency's ("FHFA's") proposed rule to implement the "Credit Score Competition" provisions contained in Sec. 310 of the "Economic Growth, Regulatory Relief, and Consumer Protection Act" (S. 2155 / Public Law 115-174). I am writing in my capacity as the retired chief economist of the Mortgage Bankers Association, and as an interested observer who has followed the GSEs for decades. These comments are entirely my own, and I do not in any way represent any of the parties involved.

I do not believe the proposed rule meets either the spirit or the letter of Section 310. I see the intent of the statute as expanding competition in the area of credit scoring for mortgages. The proposed rule, however, actually appears to make the current situation worse by erecting a number of barriers to the adoption of alternative scoring models. Rather than fostering competition, it sets out in regulation any number of excuses the GSEs can fall back on to maintain the status quo. I am not a lawyer, so I will leave it to others to argue legislative intent versus regulatory implementation. I will confine my comments to a few of the most significant problems and concerns with the proposed rule.

The first problem is the proposed prohibition on the use of a credit score model produced by a company in any way affiliated with a credit reporting agency. FHFA makes the assertion, with zero evidence, that such arrangements would represent an uncompetitive advantage for the affiliated firm. In worrying about a hypothesized unfair competitive advantage, FHFA is further solidifying the actual monopoly position that the Fair Issac Corporation appears to have enjoyed for decades as a tool in credit evaluation for GSE-eligible mortgages. FICO is a fine company, and, over the years, has helped streamline lending and reduce the costs of consumer credit analysis, but no

company should be immune from competition. In our Schumpeterian world of progress through creative destruction, a world in which most everyone not working in a GSE must learn to survive, protecting FICO from meaningful competition results in the long-term harm to society that sclerotic structures and business systems cause. Simply put, everyone benefits from competition.

Given the costs of building and verifying a credit scoring modelling system, it is unlikely that any disinterested party would invest the large amounts of capital required to build such a model on spec, that is, build it with the hopes that someone might buy it. As I understand the VantageScore structure, it is a joint venture of three highly competitive credit reporting agencies. Perhaps FHFA should look at why these firms put aside their differences to fund this effort. If it was just to gain some sort of unfair competitive advantage as FHFA appears to believe, would not each firm attempt to build its own credit scoring system to exploit its competitive advantage over not just FICO but its CRA competitors? Or is it the case that the three firms acted jointly because each faced the pricing and licensing arrangements of FICO? While I have no personal knowledge of FICO's pricing practices, history has many examples of pricing and other requirements that thrive under a monopoly structure. Rather than injecting itself into restricting ownership structures based solely on suppositions, FHFA should concentrate instead on the outsized role of FICO in the mortgage industry, particularly when compared to other forms of credit outside the world of the GSEs where there is growing competition in credit scores. Again, a government regulatory agency should be encouraging competition and innovation, not protecting the status quo due to some unproven supposition of an unfair competitive advantage by one of the major players.

A second issue is that the proposed rule appears to require that a any new credit score should achieve essentially the same results as the current FICO system. Certainly there are statistical tests for comparing distributions, and the commentary for the proposed rule cites a few, including the Kolmogorov–Smirnov statistic. My concern with this approach is that it begins with the assumption that the FICO distribution is correct, and that the distribution of outcomes for another credit scoring model should match the distribution of the FICO outcomes. The problem with a test of this formulation is that it deals with the current or historic population of borrowers and their default history. One major complaint some have raised regarding the current credit score system is that it discourages some individuals from even applying. They self-select out of the pool of loan applicants because they understand they would not qualify for a mortgage, or are financed through an FHA-backed loan rather than through the GSEs. These individuals would not make it into the test sample. Together with the usual statistical tests for Type 1 and Type 2 errors for default prediction, FHFA should insist that one additional criterion be the potential expansion of the borrower pool by use of an alternative score.

A third issue with the proposed rule is the requirement that any potential benefits of a different credit score provider should be measured against the implementation costs to the GSEs. One example cited is that it would cause problems for generating LVT/FICO loan level pricing adjustment grids. Historically there have been those in the lending community who have questioned whether the LLPAs were justified by default

and loss experience. However, any additional technology and other implementation costs should be measured against what it would take private sector lenders to implement such changes, rather than the costs claimed by the GSEs. Regardless, any such costs should be weighed against the potential market expansion benefits discussed above.

Finally, even if FHFA completely reversed its current position and decided instead to mandate the use of different credit scoring models, a stumbling block would be investors in GSE securities. FICO scores are an input for pricing models due to their impact on prepayment speeds and defaults. Given the long-held opposition to the common security for TBA delivery among Wall Street firms, it is likely that similar opposition could arise for TBA delivery eligibility for securities with something other than a FICO score. Were the SIFMA TBA committee to deem that non-FICO scored GSE securities did not meet the TBA delivery guidelines, the resulting liquidity hit to pricing would dwarf the benefits from credit score competition. At the same time, however, the private label market is showing some resurgence and analysts should be getting some background in dealing with alternative scores.

In summary, it is not FHFA's job to protect apparent monopolies, or to minimize operational headaches for the GSEs. Instead, its responsibility is to maximize the availability of mortgage credit to deserving borrowers as long as the current structure of the GSEs remains in place. Congress has not yet seen fit to alter that structure, but it has spoken on the issue of expanding the universe of credit scores used by the GSEs. FHFA should act to encourage the change Congress wants, and not establish a system of roadblocks that keep the status quo in place.

Sincerely,

Emile J. Brinkmann