March 21, 2019

Submitted electronically

Federal Housing Finance Agency
400 7th St SW
Washington, DC 20024

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

To whom it may concern,

SIFMA[1] writes in response to the above-captioned consultation regarding the validation and approval of credit score models. We are pleased to provide further input to this discussion which has been ongoing for a number of years.

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 and default modeling which forms the core analysis in the To-Be-Announced (TBA) and credit risk transfer markets. The current generation of credit scores and how they relate to prepayments and defaults is well understood, but the new generation is less well understood. If modeling is rendered less predictive, it is likely that there will be negative consequences to liquidity in these markets. Accordingly, change must be managed thoughtfully and carefully.

SIFMA's Principles for the Use of Credit Scores

This letter and these principles are focused on how scores are used by the GSEs – not so much the process by which they are analyzed by the GSEs – whereas much of the proposal is focused on process. We think a primary focus should be on the end result and how that works in the markets. It is in the usage of scores that MBS markets will, or will not be, affected by change. It is somewhat concerning that while there were eight references to investors in the rule, there were no references to the TBA market. Protecting the ability of the TBA market to continue to

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

provide funding for the majority of mortgage loans originated in the country should be a top priority of this exercise. Our core views include:

1. **The credit scores that are used by the GSEs need to be consistent and stable across lenders and pools.** The TBA market is premised on homogeneity. Pools that contain a mix of loans with *either* one *or* another credit score as the sole score are significantly less preferred than issuance of pools that will always have one score as a baseline. This is primarily because it is more complex to build models to accommodate multiple scoring models 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 one score or another, as opposed to dealing with two or more at the same time. Further, 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 that could result in pools that do not have consistency in scoring models. This does not mean that multiple scoring models could not be used – rather it means that there needs to be a consistent baseline score that market participants can compare across pools, given that scores produced by different models are not always comparable.

2. **A regime that promotes consistency and allows secondary market participants to build models around one score is the most advisable path assuming a decision is made by the GSEs to pursue an alternative to the score used today.**

3. **Before any changes are made the GSEs must disclose comprehensive data to the market.** This is likely the most critical aspect of implementation - the market needs to understand the new scores and what they mean. This would involve a large sample of loans across a sufficient period of time. If there are contractual restrictions in the way of such disclosure, they need to be resolved.

4. **If a change to the current regime is made, FHFA (or GSEs) 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.

   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.[2] Changing models is not a simple flip-the-switch operation. Related to this, we note that not all

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

lenders are subject to this type of regulation. FHFA must take care to ensure that weaknesses in new credit scoring models are not exploited resulting in the GSEs being adversely selected.

Interaction with UMBS – GSE Usage and Disclosure of Scores Should be Aligned

The proposed rule notes: *"FHFA may determine that alignment is necessary to facilitate the Enterprise credit risk transfer (CRT) programs or the development and implementation of the Uniform Mortgage-Backed Security (UMBS)."*[3]

We believe it is entirely necessary and appropriate for FHFA to align GSE usage of credit scores. With trading of UMBS in a single contract, Fannie Mae and Freddie Mac securities need to be as homogeneous as possible. The credit scores are used and disclosed with pools needs to be aligned.

Data Disclosure and Narrative of GSE Analysis

One of our most important requests, dating back to our first discussion with FHFA in the summer of 2015, is for the GSEs to disclose significant amounts of data and analysis so that the market can understand how any new scores proposed to be used relate to the old scores, and how they relate to loan performance. 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.

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 or similar document.

Other Questions Remain

There are additional issues to be addressed:

- How do the GSEs plan to manage pricing grids in a multi-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

[3] Proposal at 65578.

unchanged, could there be shifts within the box? It's hard to visualize that without historical data or some analyses that they have run.

These are important questions to answer.

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
Securitization and Credit Markets