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Office of the Comptroller of the Currency
E-mail: regs.comments@occ.treas.gov
12 CFR Part 43 [Docket No. OCC–2013–0010]

Federal Reserve System
E-mail:regs.comments@federalreserve.gov
12 CFR Part 244 [Docket No. R-1411]

Federal Deposit Insurance Corporation
E-mail: Comments@FDIC.gov
12 CFR Part 373 RIN 3064–AD74

Federal Housing Finance Agency
Attention: Alfred M. Pollard, General Counsel,
RIN 2590–AA43
E-mail: *RegComments@fhfa.gov*
12 CFR Part 1234

Securities and Exchange Commission
E-mail: *rule-comments@sec.gov*
File Number S7-14-11
17 CFR Part 246 [Release No. 34–7077] RIN 3235–AK96

Department of Housing and Urban Development
E-mail: www.regulations.gov
24 CFR Part 267 RIN 2501–AD53

Re: Credit Risk Retention; Proposed Rule

Fair Isaac Corporation (FICO) respectfully submits these comments in response to a joint proposed rule published in the *Federal Register* / Vol. 78, No. 183/ Friday, September 20, 2013, pp. 57928-58048, which would revise the proposed rule the Agencies published in the *Federal Register* on April 29, 2011.

About FICO

FICO is a leading provider of analytics and decision management technology. The company offers a wide range of market leading products and services including the FICO® score that was first introduced in 1989. With over 10 billion FICO® Scores used annually worldwide to empower lenders to make credit decisions, the FICO Score is the standard measure of credit risk. FICO Scores are used today in more than 20 countries on five continents, by all of the top 50 U.S. financial institutions, and by both the 25 largest U.S. credit card issuers and auto lenders. FICO is also committed to assisting in consumer education about credit matters. For more than 12 years, FICO has supported its popular consumer education site, myFICO.com, and recently launched a non-commercial website called ScoreInfo.org, specifically designed to help consumers understand and benefit from the risk-based pricing and credit score disclosure notices they receive in the mail from U.S. lenders in accordance with federal regulations.

Summary of Comments

As previously stated in our Comment letter in response to the original risk retention rule proposal (*Federal Register* / Vol. 76, No. 83 / Friday, April 29, 2011), FICO believes that the current proposed credit history standards within the Qualified Auto Loan (QAL) definition are fundamentally flawed. FICO research reveals that the proposed QAL credit history standards are not sufficiently predictive of the risk of delinquency or default. Also, inclusion of the proposed QAL credit history standards will lead to distorted outcomes of consumers' credit risk profiles which could prove harmful to the creditor, the consumer as well as the overall securitization market. In addition, the proposed rule takes a similar approach in defining the credit history standards that are part of the Alternative Qualified Residential Mortgage proposal, "QM-plus." If the Agencies are to adopt credit history standards as part of the QAL or "QM-plus" definitions, it should leverage the most accurate and predictive measurement of credit risk - credit scores. This can be achieved in a vendor neutral way, using an approach that is similar to one recently adopted by the Federal Deposit Insurance Corporation (FDIC) as part of its final rule, Assessment, Large Bank Pricing (*Federal Register* / Vol. 77, No. 211 / Wednesday, October 31, 2012).

FICO Comments

1. The proposed QAL credit history standards will produce distorted outcomes and are not a substitute or proxy for an empirically derived, demonstrably and statistically sound credit scoring system.

Proposed Rule. "In the original proposal, an originator would have been required to verify, within 30 days of originating a QAL, that the borrower was not 30 days or more past due; was not more than 60 days past due over the past two years; and was not a judgment debtor or in bankruptcy in the past three years.

***   *   ***

The agencies believe that a QAL should meet conservative underwriting criteria, including that the borrower not be more than 30 days late." *[Proposed Rule, p. 57985]*

FICO Response. FICO's research reveals that the proposed QAL credit history standards exclude too many borrowers who are good credit risks, while at the same time failing to identify too many borrowers who are bad credit risks – that is, low risks fail to meet the QAL credit history standards while high risks satisfy the QAL. As outlined in a swap set analysis of FICO's research in **Appendix 1,** the proposed QAL credit history standards would actually result in some of the riskiest borrowers (i.e., very low credit scores) being included in the QAL, while excluding many of the least risky borrowers (i.e., very high credit scores) from the same exemption. These same low risk and high risk consumers could be easily identified by allowing the use of empirically derived, demonstrably and statistically sound credit scoring models that have been used in the market for decades to manage credit risk and avoid unfair or illegal discrimination.

The proposed credit history standards will also mark an unwelcome return to manual underwriting while also proving to be difficult to implement. Requiring originators to conduct a manual review of the proposed credit history standards, i.e., the "derogatory factors", in the credit file will signal a shift away from automated underwriting, and will likely be accompanied by added costs passed along to consumers in addition to delays and a process prone to error.

The proposed credit history standards are not a reasonable proxy for empirically derived, demonstrably and statistically sound credit scoring models that have been used in the market for decades to manage credit risk and avoid unfair or illegal discrimination. The proposed rule would consider only a small subset of a consumer's credit history, and the proposed factors could only be considered in a binary fashion – the consumer's credit history would meet these factors or not. This approach is unfair to consumers whose actual credit history can often be distorted by this simplistic analysis. The proposed credit history standards do not capture many aspects considered by credit scoring models such as positive payment history, amounts owed, length of credit history, new credit, types of credit, utilization of current credit, recent credit-seeking or credit mix. FICO believes that a thorough, predictive analysis of a borrower's credit history must include far more varied factors than those proposed by the Agencies, and those factors must be considered in an empirically derived, multivariate analysis.

Below are some of the characteristics which demonstrate the lack of sufficient predictive nature in the proposed QAL credit history standards.

Characteristics of a consumer that would fail QAL and have a high FICO 8 Auto score include:

- Most recent delinquency a 60 dpd from ~23 months ago
- Nothing worse than 60 dpd on file, no collections, no adverse public records
- Never missed a payment on an auto loan
- Demonstrated history of successfully repaying a variety of different types of credit obligations (revolving, auto, mortgage, etc…)
- Low revolving balances, very low revolving utilization ratio
- Long credit history (25+ years)
- Few recently opened accounts

Characteristics of a consumer that would pass QAL and have a low FICO 8 Auto Score include:

- Very recently (but not currently) 30 days past due on auto loan
- No 60+ delinquency in last 2 years, but 90-180 dpd just over 2 years ago
- Numerous 3rd party collection accounts
- Current balance close to original loan amount on existing installment loans
- Maxed out or close to it on revolving accounts
- Relatively short credit history (< 10 years)
- Large number of recent new account openings/applications for credit

If credit history standards are to be incorporated into the proposed QAL definition, they should include the same transparent and easily understood credit scores that have over the past two decades become widely accepted by lenders, investors, regulators and consumers alike as the market standard for measuring credit risk. As will be discussed below, this can be achieved in a vendor-neutral way.

2. Incorporating credit scores as part of the QAL credit history standards provides the most accurate measurement of credit risk as well as other market and consumer benefits.

Proposed Rule. "Moreover, securitizers from the automobile sector explicitly disavowed any interest in using any underwriting-based exemptive approach unless the agencies incorporated the industry's current model, which relies almost exclusively on matrices of credit scores (like FICO) and LTV. As is discussed in the agencies' original proposal, the agencies are not persuaded that it would be appropriate for the underwriting-based exemptions under the rule to incorporate a credit score metric." *[p. 57979]*

FICO Response. The securitization market must have credit history standards that instill confidence in investors of the credit risk of the auto loans that comprise the assets backing. If the credit history standards adopted are not highly effective predictors of credit risk, investors will remain on the sidelines or be required to accept loans where the actual credit risk is unknown. The purpose of the Dodd-Frank risk retention provisions is to protect the securitization and credit markets. As a result, if credit history standards are included in the QAL definition then the Agencies should require the use of empirically derived and demonstrable sound credit scoring models to accurately predict the credit risk that is being assumed by securitizers.

Twenty years ago, prior to the earliest credit risk scoring analytics to be widely used for this purpose, lenders relied on judgmental systems that were observation-based, unreliable, and inefficient, and often led to inconsistent and unfair treatment of consumers. By 1995, these assumptions were replaced at the GSEs and FHA by predictive scoring analytics in the form of *Desktop Underwriter* and *Loan Prospector*. These credit risk scoring models were developed using empirically derived, demonstrably and statistically sound mathematical algorithms. Today the two GSEs and the FHA have automated underwriting systems that include the use of credit scores as a qualifying factor for accepting or endorsing mortgage loans. The benefits derived by the credit markets from using credit scoring were well articulated by the Federal Reserve Board in its landmark 2007 Report to Congress on *Credit Scoring and Its Effects on the Availability and Affordability of Credit*:

> Increased accuracy, access to credit, and market efficiency
> Finally, credit scoring is accurate; that is, individuals with lower (worse) credit scores are more likely to default on their loans than individuals with higher (better) scores. Credit scoring increases the efficiency of consumer credit markets by helping creditors establish prices that are more consistent with the risks and costs inherent in extending credit. Risk-based pricing reduces cross-subsidization among borrowers posing different credit risks and sends a more accurate price signal to each consumer. Reducing cross-subsidization can discourage excessive borrowing by risky customers while helping to ensure that less-risky customers are not discouraged from borrowing as much as their circumstances warrant. Finally, risk-based pricing expands access to credit for previously credit-constrained populations, as creditors are better able to evaluate credit risk and, by pricing it appropriately, offer credit to higher-risk individuals. [p. O-5]
>
> Decreased possibility of bias
> Credit scoring also increases the consistency and objectivity of credit evaluation and thus may diminish the possibility that credit decisions will be influenced by personal characteristics or other factors prohibited by law, including race or ethnicity. [p. O-5]

With respect to the question of bias, the FRB followed up its 2007 Report to Congress with a 2010 Staff Report titled “Does Credit Scoring Produce a Disparate Impact?” [2010-58, Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, October 12, 2010], which answered the title question in the negative:

> The widespread use of credit scoring in the underwriting and pricing of mortgage and consumer credit has raised concerns that the use of these scores may unfairly disadvantage minority populations. A specific concern has been that the independent variables that comprise

> these models may have a disparate impact on these demographic groups. By “disparate impact” we mean that a variable’s predictive power might arise not from its ability to predict future performance within any demographic group, but rather from acting as a surrogate for group membership. Using a unique source of data that combines a nationally representative sample of credit bureau records with demographic information from the Social Security Administration and a demographic information company, we examine the extent to which credit history scores may have such a disparate impact. Our examination yields no evidence of disparate impact by race (or ethnicity) or gender.

In short, more than two decades of research, analysis, and commercial use have demonstrated that analytically-derived and statistically-sound credit scoring systems are the most accurate, efficient and fair way to reliably predict mortgage credit risk.

3. A vendor-neutral approach, similar to the one recently adopted by the FDIC in its Assessment, Large Bank Pricing rule, should be utilized to include credit scores as part of the QAL credit history standards.

Proposed Rule: “Finally, the agencies are not proposing requirements that would rely on proprietary credit scoring systems or underwriting systems. The agencies recognize that much of the current automobile lending industry relies heavily or solely on a FICO score to approve automobile loans. However, the agencies do not believe that a credit score alone is sufficient underwriting for a conservative automobile loan with a low risk of default. Furthermore, the agencies do not believe it is appropriate to establish regulatory requirements that use a specific credit scoring product from a private company, especially one not subject to any government oversight or investor review of its scoring model. The agencies believe that the risks to investors of trusting in such proprietary systems and models weighs against this alternative, and does not provide the transparency of the bright line underwriting standards proposed by the agencies.” *[p. 57985]*

FICO response. In their proposed rule, the Agencies express their reluctance to adopt QAL credit history standards which rely on a credit scoring system from a single vendor. However, FICO believes, as outlined in its August 1, 2011 Comment Letter, see **Appendix 2**, there is a viable, vendor- neutral alternative which supports the use of credit scores as part of the QAL. The vendor-neutral approach uses credit scoring models to more accurately determine which auto loans qualify for the QAL exemption from the 5% skin-in-the-game retention requirements. The approach offers two options for the Agencies to consider: (1) whether the QAL exemption should apply to all auto borrowers whose credit risk profile represents a predetermined *level of credit risk* (i.e., probability of default rate), irrespective of how many borrowers qualify under that test; or (2) whether the QAL exemption should apply to a predetermined *percentage* of all auto borrowers whose credit risk profiles are the least risky of all such borrowers, irrespective of the actual level of credit risk presented by those who qualify for the acceptable percentage. The use of either approach would result in a considerably more accurate assessment of the borrower’s credit risk.

In addition, incorporating credit scores as part of the QAL credit history standards allows for simple compliance and regulatory oversight. Credit scores are the product of credit scoring models, which are built with depersonalized data pursuant to the rigorous requirements of Regulation B, which implements the Equal Credit Opportunity Act. Credit scores are already validated, revalidated and subject to comprehensive regulatory oversight, as evidenced by the recently published Federal Reserve/OCC Supervisory Guidance on Credit Risk Management, to ensure that they are fully predictive, and do not result in impermissible discrimination or exposure to unwarranted credit risk. Credit scoring models that meet these regulatory requirements can easily be calibrated to a standard set by regulators based on a probability of default threshold, set by the regulator.

The proposed vendor-neutral solution discussed above is guided by five principles:

- *Reliable analytics* – the model must accurately rank order credit risk;
- *Vendor neutral* – the solution cannot prefer one credit scoring model builder;
- *Regulatory oversight* – regulators should have the power to assure compliance, but they should not need to frequently calibrate the compliance process;
- *Simple way to comply* – creditors should be able to comply with minimal burden; and
- *Minimize market disruption* – the credit model approach works today.

The proposed solution requires the use of a credit risk model that is "empirically derived, demonstrably and statistically sound" ("EDDSS"), as that phrase is defined in Regulation B, which implements the Equal Credit Opportunity Act. This approach assures quality, consistency, and objective standards by which to judge the effectiveness of the model. EDDSS requirements are well-established, so there would be no need to invent a new test or determine how the regulatory oversight would work. EDDSS requires model validation at inception and "within a reasonable period of time" thereafter.

Such credit scoring models are already subject to Supervisory Guidance on Model Risk Management, OCC 2011-12 and SR Letter 11-7 ("Guidance"), published by Federal Reserve Board and the Office of the Comptroller of the Currency on April 4, 2011. The Agencies could incorporate the Guidance by reference into its rule, or propose a variation of it. The Guidance explains the role of risk models and sets compliance standards; prescribes the need for banks that rely on quantitative analysis and models to demonstrate expertise in model development, implementation, use, and validation; and requires banks to establish a process of governance, policies, and controls over its own models, and those it uses from third party vendors and contractors. The Guidance, which is a compilation and update of past statements by the OCC on model risk management, would not impose new burdens on banks or require a new regulatory structure by the bank regulators, including the Consumer Financial Protection Bureau (CFPB), to administer and audit for compliance.

In a regulation promulgated last year, the FDIC adopted the *probability-of-default* option. Their solution is already being successfully used by creditors in compliance the Assessment, Large Bank Pricing rule. The agency incorporated the use of credit scores, in a vendor-neutral manner, to assist in identifying higher risk assets as part of its Assessment, Large Bank Pricing (LBP) final rule (*Federal Register* / Vol. 77, No. 211 / Wednesday, October 31, 2012). Specifically, the FDIC's final rule amended the FDIC assessment system for large and highly complex institutions by, in part, revising the definition of subprime consumer loans, called "higher-risk" consumer loans. In defining this class of higher-risk consumer loans, the FDIC revised its original final rule in response to industry feedback. In doing so, the revised rule defines a higher-risk consumer loan as having a probability of default greater than 20 percent (p. 66004). The FDIC adopted a process for identifying these loans by mapping credit scores produced by empirically derived, demonstrably statistically sound credit scoring models to probability of default rates. Regardless of the credit score used, whether it was produced by a third party or the creditor's own credit scoring system, the borrower's score can be mapped to probability of default rate to determine whether the loan is a "higher-risk consumer loan."

The Agencies could choose to predetermine a specific credit risk *default rate*, in a manner similar to the FDIC in its Assessment, Large Bank Pricing rule, that would qualify an auto loan for QAL status. The default rate would be a permissible ratio that indicated the borrower's *odds-of-default* on the auto. The auto lender would be required to use an EDDSS credit scoring model that, when the auto borrower's credit profile is an input to the model, is capable of rank ordering the credit risk presented by each auto borrower over the spectrum of all auto borrowers. In order for a certain auto loan to qualify for the QAL exemption, a securitizer would be required to demonstrate that the credit risk score on that auto borrower produced by the model indicated an odds-of-default ratio that was less than or equal to the Agencies' predetermined odds-of-default ratio.

4. The QRM Alternative Approach ("QM Plus") contains the same flawed set of credit history standards as the QAL.

Proposed Rule. "*Credit history.* To be eligible for QRM status, the originator would be required to determine the borrower was not currently 30 or more days past due on any debt obligation, and the borrower had not been 60 or more days past due on any debt obligations within preceding 24 months. Further, the borrower must not have, within the preceding 36 months, been a debtor in a bankruptcy proceeding or been subject to a judgment for collection of an unpaid debt; had personal property repossessed; had any one-to-four family property foreclosed upon; or engaged in a short sale or deed in lieu of foreclosure." *[p. 57979]*

FICO Response. The "QM Plus" proposal contains the same credit history standards as found in the original QRM proposal (Federal Register / Vol. 76, No. 83 / Friday, April 29, 2011). For the reasons stated in our discussion of the QAL credit history standards, FICO believes that the proposed " Plus" credit history standards are not adequately predictive of credit risk and will result in distorted outcomes. As a result, if credit history standards are to be used they should leverage credit scores in a vendor-neutral way as proposed above and in the FDIC Assessment, Large Bank Pricing rule.

Conclusion

Proposed Rule. Request for Comment - QAL: "83(a). Are the revisions to the qualifying automobile loan exemption appropriate? 83(b). If not, how can they be modified to more appropriately reflect industry standards? 84. Are all the proposed underwriting criteria appropriate?" *[p. 57985]*

QRM Alternative Approach: "97(a). Does the QM-plus approach have benefits that exceed the benefits of the approach discussed above that aligns QRM with QM? For example, would the QM-plus approach favorably alter the balance of incentives for extending credit that may not be met by the QM definition approach or the QRM approach previously proposed? 97(b). Would the QM-plus approach have benefits for financial stability?" *[p. 57994]*

FICO response. The proposed QAL credit history standards will not adequately predict credit risk, and adopting these standards will undermine the legislative intent of Dodd Frank. FICO's position is that in order to instill confidence in the private securitization market, the credit risk rules must not only be proven to be highly predictive over market cycles, but also must be transparent. To this end, if credit history standards are to be part of the QAL definition then FICO urges the Agencies to adopt a vendor-neutral, credit score approach that allows auto originators to use credit scoring models that comply with the requirements of Regulation B and the Guidance set forth in OCC 2011-12. A similar approach already exists as part of the FDIC Assessment, Large Bank Pricing rule. In addition, FICO's comments related to the QAL credit history standards are equally applicable to the proposed QRM Alternative approach, "QM Plus."

Finally, we refer the Agencies to FICO's comments with respect to the original proposed rule, delivered on August 1, 2011.

Respectfully submitted,

s/ Vance Gudmundsen

Vice President
FICO

APPENDIX 1
FICO QAL Credit History Standards Research

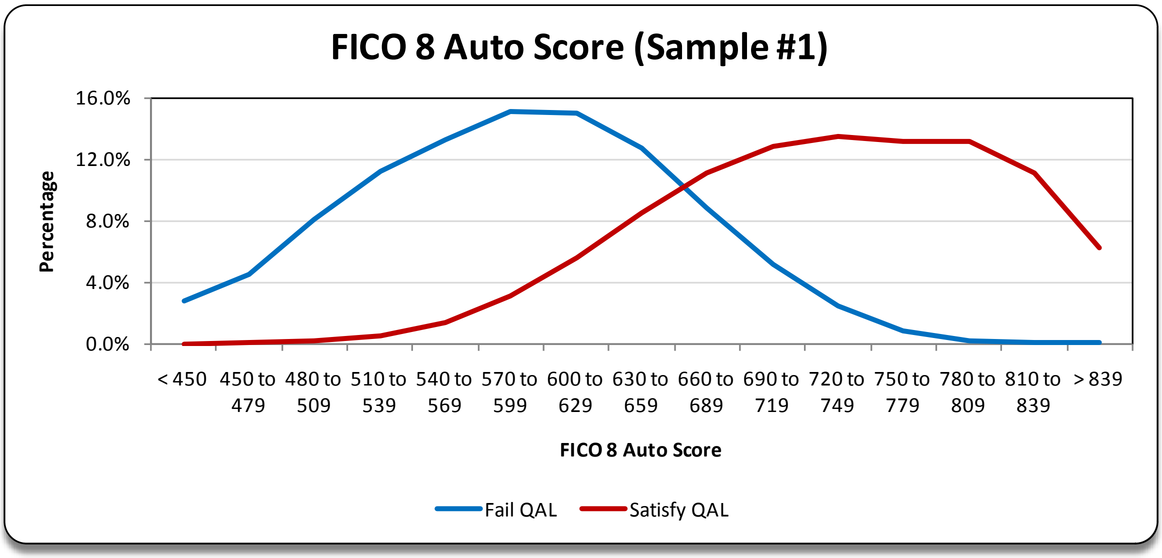
Who Qualifies under QAL?

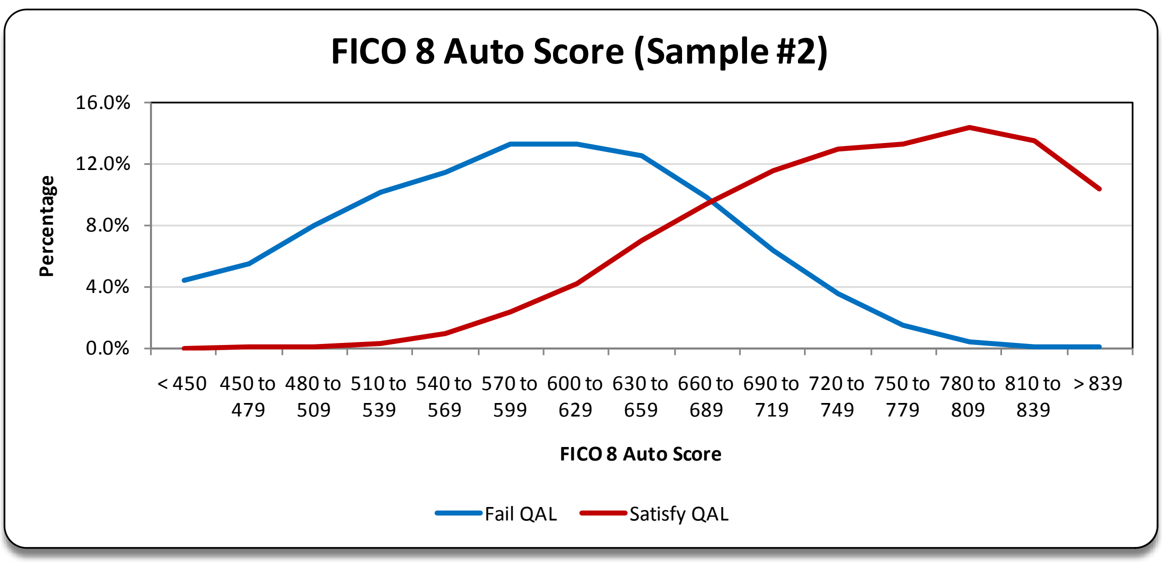
FICO examined the proposed credit history standards for Qualified Auto Loans (QAL) for two time periods, 2005 and 2008, to understand the predictive nature of the proposed QAL credit delinquency rules. FICO research included consumers who obtained an auto loan during the first three months of the specified years, and analyzed their performance over the next 24 months. The proposed QAL credit history standards were benchmarked against the FICO 8 Auto Score, which is the industry standard and is designed to specifically rank order the risk of the consumer paying their auto trade line. Note that the FICO® 8 Auto Score has a range of 250 to 900. The results below highlight that if the proposed QAL criteria had been in place, there would have been significantly higher delinquency rates (67% and 28% respectively) for those that qualified for the safe harbor during each time period while allowing for the same percentage of consumers to qualify.

- Using a 2005 data sample, the proposed QAL credit history criteria allow for 70% of the population of consumers who obtained an auto loan between Nov 2005 and Jan 2006 to qualify under the proposed QAL credit history criteria, which equates to a FICO® 8 Auto Score of 635. The corresponding 90+ day bad rate for the consumers who qualified for the QAL is 2.5% versus 1.5% using the FICO® 8 Auto Score.

- Using a 2008 data sample, the proposed QAL credit history criteria allow for 77% of the population of consumers who obtained an auto loan between Nov 2008 and Jan 2009 to qualify under the proposed QAL credit history criteria, which equates to a FICO® 8 Auto Score of 635. The corresponding 90+ day bad rate for the consumers who qualified for the QAL is 2.3% versus 1.8% using the FICO® 8 Auto Score.

The graphics below illustrate the percentage of population that both fail and satisfy the QAL credit history criteria for loans originated in 2005 (Sample 1) and 2008 (Sample 2) plotted against FICO® 8 Auto Score on the x axis and percentage of population on the y axis. There is a significant percentage of the higher FICO 8 Auto Score consumers that do not qualify for QAL, and a significant percentage of the lower FICO 8 Auto Score consumers that do qualify. The most prominent overlap occurs in the score range of 600 to 720. Using a case study example, two consumers who have the same FICO 8 Auto Score and have always paid their auto loan on time could have a different result; when assessed by the proposed QAL standard, one consumer might pass while the other could fail.





To provide keener insight, FICO also studied the minimum and maximum FICO 8 Auto Score that that would either pass or fail the proposed credit history standards of QAL. The minimum FICO 8 Auto Score that qualifies for QAL is a 406, while the maximum FICO 8 Auto Score that would fail the QAL standards is 863. So, similar to the QRM research, consumers with excellent credit history failed the proposed QAL credit history test and likely incurred higher financing costs as a result.

FICO Auto Scores on Loans Originated November 2005 – January 2006

	Files that Satisfy QAL "Credit" Criteria							
					Percentiles			
Score Version	Min	Max	Mean	Median	1^{st}	5^{th}	95^{th}	99^{th}
FICO 8 Auto	406	900	731	735	551	599	845	864
Prior FICO Auto	421	843	730	734	556	607	827	834

	Files that Fail QAL "Credit" Criteria							
					Percentiles			
Score Version	Min	Max	Mean	Median	1^{st}	5^{th}	95^{th}	99^{th}
FICO 8 Auto	341	863	589	590	425	468	708	749
Prior FICO Auto	321	806	586	588	421	466	698	733

Swap Set Analyses

The tables below highlight by FICO 8 Score bands the percentage of the population that obtained auto loans in 2005 and 2008 respectively that would either fail or satisfy the proposed QAL credit history rules. For example, in 2005 30% of the population would satisfy the proposed QAL standards and score below 690 (the apparent FICO score benchmark within the proposed rules); conversely 8% of the population would score above 690 and fail the QAL criteria. In 2008 the results are fairly similar: 24% of the population scored below 690 and qualified for QAL, and 12% of the population scored above 690 but failed QRM. Given there were approximately 20M auto loans originated in an average year, there would have been approximately 2.4M consumers who had FICO 8 Auto Scores above 690, but who would not have qualified for QAL.

	Sample #1 (October 2005)							
	Fail QAL & score greater than				Satisfy QAL & score less than			
	660	690	710	720	660	690	710	720
FICO 8 Auto	17%	8%	5%	3%	19%	30%	39%	43%
Prior FICO Auto	15%	7%	3%	2%	18%	30%	39%	43%

	Sample #2 (October 2008)							
	Fail QAL & score greater than				*Satisfy QAL & score less than*			
	660	*690*	*710*	*720*	*660*	*690*	*710*	*720*
FICO 8 Auto	21%	12%	7%	5%	15%	24%	32%	36%
Prior FICO Auto	20%	9%	5%	3%	14%	24%	32%	37%

APPENDIX 2

Proposal: Include the use of credit scoring models in the QAL Definition in place of the proposed "derogatory factors" to assess credit risk

On April 29, 2011, the OCC, Board, FDIC, Commission, FHFA, and HUD (the "Agencies") proposed rules to implement the credit risk retention requirements of section 15G of the Securities Exchange Act of 1934, as added by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Proposed Rule"). In response to the Agencies' request for comments on the Proposed Rule, Fair Isaac Corporation (FICO) respectfully submitted comments, which presented comprehensive research that demonstrated the Agencies' "derogatory factors", included in the definition of Qualified Residential Mortgage (QRM) and Qualified Auto Loan (QAL), are not sufficiently predictive to accurately assess an auto and mortgage borrower's credit risk for purposes of qualifying for the QRM and QAL exemption. The research revealed that the derogatory factors are not an adequate substitute for the use of a credit risk score, which is the method used currently by all auto lenders to assess credit risk in the auto underwriting process.

In its comment letter, FICO proposed a different approach: mandate the use of credit scoring models on a vendor-neutral basis, within the existing regulatory structure. We recommended that regulators require the use of credit risk models to make the critical credit risk analysis of mortgage and auto applicants, subject to certain constraints. In response to our comment letter, FICO was asked by several of the Agencies to suggest practical ways to implement this approach.

Below are four potential credit history rule solutions, each with its own advantages, that could be adopted as part of the QAL credit history standards. Any one of the four solutions would be considerably more predictive than the "derogatory factors" QAL credit history approach in the Proposed Rule, and would therefore be fairer to consumers and lenders alike. By assuring that the QAL exemption applies only to those auto originations that present the least credit risk, each of these solutions helps achieve Congress's goal of protecting the securitization market and its investors.

Guiding Principles

The proposed solutions are guided by five principles:

- *Reliable analytics* – the model must accurately rank order credit risk;
- *Vendor neutral* – the solution cannot prefer one credit scoring model builder;

- *Regulatory oversight* – regulators should have the power to assure compliance, but they should not need to frequently calibrate the compliance process;

- *Simple way to comply* – creditors should be able to comply with minimal burden; and

- *Minimize market disruption* – the credit model approach works today.

Each proposed solution requires the use of a credit risk model that is "empirically derived, demonstrably and statistically sound" ("EDDSS"), as that phrase is defined in Regulation B, which implements the Equal Credit Opportunity Act. This approach assures quality, consistency, and objective standards by which to judge the effectiveness of the model. EDDSS requirements are well-established, so there would be no need to invent a new test or determine how the regulatory oversight would work. EDDSS requires model validation at inception and "within a reasonable period of time" thereafter.

Such credit scoring models could be subject to standards similar to the Supervisory Guidance on Model Risk Management, OCC 2011-12 and SR Letter 11-7 ("Guidance"), published by Federal Reserve Board and the Office of the Comptroller of the Currency on April 4, 2011. The Agencies could incorporate the Guidance by reference into its rule, or propose a variation of it. The Guidance explains the role of risk models and sets compliance standards; prescribes the need for banks that rely on quantitative analysis and models to demonstrate expertise in model development, implementation, use, and validation; and requires banks to establish a process of governance, policies, and controls over its own models, and those it uses from third party vendors and contractors. The Guidance, which is a compilation and update of past statements by the OCC on model risk management, would not impose new burdens on banks or require a new regulatory structure by the bank regulators, including the Consumer Financial Protection Bureau (CFPB), to administer and audit for compliance.

Two Distinct Approaches

The Proposed Rule should use credit scoring models to more accurately determine which auto loans qualify for the QAL exemption from the 5% skin-in-the-game retention requirements. First, however, the Agencies must determine: (1) whether the QAL exemption should apply to all auto borrowers whose credit risk profile represents a predetermined **level of credit risk**, irrespective of how many borrowers qualify under that test; or (2) whether the QAL exemption should apply to a predetermined **percentage** of all auto borrowers whose credit risk profiles are the least risky of all such borrowers, irrespective of the actual level of credit risk presented by those who qualify for the acceptable percentage. The use of either approach would result in a considerably more accurate assessment of the borrower's credit risk, which would permit the QAL definition to rely less heavily on certain non-credit history criteria such as the borrower's debt-to-income [§(d)(8)], loan-to-value [§(d)(9)], and amount of downpayment [§(d)(10)].

Setting a Level of Credit Risk (Options 1-3). The Agencies would predetermine a specific credit risk *default rate* that would qualify an auto loan for QAL status. The default rate would be a permissible ratio that indicated the borrower's *odds-of-default* on the loan. The auto lender would use an EDDSS credit scoring model that, when the borrower's credit profile is an input to the model, is capable of rank ordering the credit risk presented by each borrower over the spectrum of all borrowers. In order for a certain auto loan to qualify for the QAL exemption, a securitizer would be required to demonstrate that the credit risk score on that auto borrower produced by the model indicated an odds-of-default ratio that was less than or equal to the Agencies' predetermined odds-of-default ratio.

- The creditor would be required to use a qualified third party's EDDSS model in Option #1, which would be certified annually by the third party.

- The creditor could use either a qualified third party's model or its own proprietary model in Option #2, but the creditor would have to annually validate whatever model it selected on its own book of business.

- The creditor could use either a qualified third party's model or its own proprietary model in Option #3; if the creditor selected the third party model, the creditor could rely on the annual certification by the third party, but if the creditor selected its own proprietary model, that model would have to be annually validated on the creditor's own book of business.

Setting a Percentage of Loans (Option 4). The Agencies would predetermine a specific *percentage of loans* that qualifies for QAL status—say the least credit risky 20% of all auto loan borrowers issued by creditors would be targeted for QAL status. The auto lender would be required to use a qualified third party's EDDSS credit scoring model that, when the auto borrower's credit profile is an input to the model, is capable of rank ordering the credit risk presented by each auto borrower over the spectrum of all auto borrowers. In order for a certain auto loan to qualify for the QAL exemption, a securitizer would be required to demonstrate that the borrower has a credit risk score that places the borrower in the least credit risky 20% of auto borrowers.

There is no option presented herein that would allow an auto loan originator to comply with the QAL exemption by relying on its own proprietary EDDSS model. This is because the percentage approach would result in significantly different results among creditors using their own models, even if the models were EDDSS, due to the regional and lender-by-lender variances in the quality of auto loans written by such creditors. Therefore, the only option presented under the percentage approach is to require all auto securitizers to use credit scoring models built using data from a consumer reporting agency that compiles and maintains files on consumers on a nationwide basis.

Proposed Credit History Rule Options 1– 3

Option #1 (Setting a Level of Credit Risk): Odds-of-default, certification on national database

A borrower's loan would qualify for the QAL exemption if the borrower's credit score indicated an acceptable odds-of-default credit risk. The auto lender would comply by using a qualified third party's EDDSS credit risk model. For QAL purposes, the creditor need not validate the model on its own database, but may rely on the third party's annual certification that the model is still EDDSS and accurately rank orders auto loan credit risk. A recent example of this approach is the Federal Reserve's Risk-Based Pricing Rule, 12 CFR Part 222, which requires credit bureaus and credit scoring model developers to provide the content for certain mandated consumer notices (providing information about the national distribution of credit scores) on an annual basis, and entitles lenders to rely on that information.

This option does not allow creditors to develop and use their own credit scoring models for QAL purposes (see Option #2), but does relieve creditors from their burden of validation and annual revalidation of the models for QAL purposes. Since all auto securitizers under this option must use credit scoring models built by third party credit score developers using data from a consumer reporting agency that compiles and maintains files on consumers on a nationwide basis, this option also adds consistency to the odds-of-default approach.

- The creditor must use a model that:
    - accurately rank orders auto credit risk
    - is built on a nationwide database of consumers
    - assigns a cut-off score that represents the predetermined odds-of-default ratio (established by the Agencies) for that model
    - is periodically revalidated to preserve its status as EDDSS and to determine if the cut-off score needs to change to meet the predetermined odds-of-default ratio
    - is subject to examination by the creditor's prudential regulator
- Agencies may reset the qualifying odds-of-default ratio

Option #2 (Setting a Level of Credit Risk): Odds-of-default, validation on creditor's own database

Like Option #1, a borrower's loan would qualify for the QAL exemption if the borrower's credit score indicated an acceptable odds-of-default credit risk. Unlike Option #1, Option #2 would allow creditors to develop and use their own credit scoring models for QAL purposes. A creditor would comply either by developing and using its own EDDSS credit risk model or by using a qualified third party's EDDSS credit risk model. In either case, however, the creditor would be required to validate and annually revalidate on its own book of business that the credit risk model selected (either a proprietary model or a model created by the third party) is EDDSS. Unlike Option #1, the creditor cannot rely on the third party's annual certification that the model is still EDDSS and accurately rank orders auto credit risk.

- The creditor must assure that the model it uses:
    - accurately rank orders auto credit risk
    - assigns a cut-off score that represents the predetermined odds-of-default ratio (established by the Agencies) for that model based on a validation on the creditor's own book of business
    - is periodically revalidated to preserve its status as EDDSS and to determine if the cut-off score needs to change to meet the predetermined odds-of-default ratio
    - is subject to examination by the creditor's prudential regulator
- Agencies may reset the qualifying odds-of-default ratio

Option #3 (Setting a Percentage of Loans): Odds-of-default, validation or certification depending on the option selected by creditor

Like Options #1 and #2, a borrower's loan would qualify for the QAL exemption if the borrower's credit score indicated an acceptable odds-of-default credit risk. Unlike Option #1, but like Option #2, Option #3 would allow creditors to develop and use their own credit scoring models for QAL purposes. A creditor would comply either by developing and using its own EDDSS credit risk model or by using a qualified third party's EDDSS credit risk model. If the creditor chose to use a qualified third party's EDDSS credit risk model, for QAL purposes, the creditor would not need to validate the model on its own database, but could rely on the third party's annual certification that the model is still EDDSS and accurately rank orders auto credit risk. If the auto lender chose to use its own credit scoring model for compliance, the creditor would be required to validate and annually revalidate on its own book of business that the credit risk model used is EDDSS.

*Option #4 (*Setting a Percentage of Loans): Percentage of least risky borrowers, certification on national database

A borrower's loan would qualify for the QAL exemption if the borrower's credit score placed the borrower in the acceptable percentage of least credit risky borrowers. The auto lender would comply by using a qualified third party's EDDSS credit risk model to determine the borrower's credit score. For QAL purposes, the creditor need not validate the model on its own book of business, but may rely on the third party's annual certification that the model is still EDDSS and accurately rank orders credit risk. A recent example of this approach is the Federal Reserve's Risk-Based Pricing Rule, 12 CFR Part 222, which requires credit bureaus and credit scoring model developers to provide the content for certain mandated consumer notices (providing information about the national distribution of credit scores) on an annual basis, and entitles lenders to rely on that information.

Like Option #1 above, this option does not allow creditors to develop and use their own credit scoring models for QAL purposes, but does relieve creditors from their burden of validation and annual revalidation of the models for QAL purposes. Since all auto securitizers under this option must rely on credit scoring models built by third party credit score developers using data from a consumer reporting agency that compiles and maintains files on consumers on a nationwide basis, this option also adds consistency to the odds-of-default approach.

- The creditor must use a model that:
  - accurately rank orders auto credit risk
  - is built on a nationwide database of consumers
  - assigns a cut-off score that represents the acceptable percentage of least credit risky borrowers (established by the Agencies) for that model
  - is periodically revalidated to preserve its status as EDDSS and to determine if the cut-off score needs to change to meet the acceptable percentage of least credit risky borrowers for that model
  - is subject to examination by the creditor's prudential regulator
- Agencies may reset the qualifying percentage of least risky borrowers