Insight

FHFA Credit Scoring Evaluation – Credit Risk Assessment Should be the Guide

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- Currently, Fair Isaac Corporation (FICO) credit scores are required for most mortgages purchased or securitized by the GSEs, Fannie Mae and Freddie Mac.
- Fannie and Freddie's overseer, the Federal Housing Finance Agency (FHFA) is in the process of reviewing alternative scoring models to potentially overhaul the GSEs' credit scoring process.
- Advocates for alternative scoring models argue that scoring currently "credit invisible" consumers will result in an increase of tens of millions of new homebuyers.
- Opponents of new or alternative scoring models suggest that scoring the "credit invisible" relies on mistakenly-enhanced credit information which will result in an increase in defaults.

Introduction

Credit scoring has become a part of almost everyone's lives. Whether it's buying a house, obtaining a student loan, or opening a new credit card, just about everyone has a credit score as a result of their past credit history. But what if, for whatever reason, someone doesn't have a traditional credit score? How should the bank, university, or credit card company evaluate their ability to repay a loan? These people are considered the "credit invisible" and, more often than not, have difficulty in accessing everyday credit products. Some people think that alternative credit scoring models should be used to capture those credit invisible, while other argue that scoring these "credit invisible" creates an artificial credit score that will just result in their eventual default.

Fannie Mae's Selling Guide states that: "Credit scores are required for most mortgages purchased or securitized by Fannie Mae." Both Fannie Mae and Freddie Mac currently call for specific versions of a score developed by FICO to be provided through their respective automated underwriting systems. However, with the recent introduction of new credit scoring models, including FICO Score 9 and VantageScore 3, policymakers have been urging the GSE's overseer, FHFA, to consider updating the GSE's selling guides to reflect the new credit scoring models.

In advocating for changes, some have called on the FHFA to implement a competitive decision-making process when deciding which credit scoring model(s) will be used by the GSEs. This notion is widely supported as competition should exist in every sector of the economy, and in fact, a competitive process was initiated by the FHFA more than a year ago as the GSEs have reportedly been testing and reviewing multiple credit scoring models to determine which is the most effective for their program models.

An ongoing concern is that some are arguing that competition will only be achieved if the FHFA adopts multiple credit scoring models giving competing credit score providers an opportunity for their scores to be included in the GSE guidelines. While true competition can only be achieved when multiple credit score alternatives are considered, competition should not mandate the adoption of all new scoring models eliminating the ability of credit risk experts to choose what credit risk tools are best to address their portfolio.

Credit Score Adoption Should Be Made with Safety and Soundness in Mind

The adoption of new credit scoring models has been discussed by some in the context of expanding access to credit. This is an important goal, but allowing more borrowers to gain access to homeownership is something that should only be achieved if FHFA and the GSEs can provide long-term sustainability with an emphasis on ensuring reasonable levels of credit risk as well as maintaining the safety and soundness of the overall financial system.

One such approach that appears to have promise is a recent announcement by Fannie Mae that lenders will now be required to acquire "trended data" – that is, data on consumers' monthly payments, not just outstanding debt and delinquencies. TransUnion has said that the use of trended data would increase the percentage of the population that qualifies "Super Prime" mortgage group from 12 percent to around 20 percent. However, it is important to note that this initiative does not rely on updated credit scoring models.

Last year, the CFPB released a report which found that 26 million Americans were "credit invisible." The CFPB identified another 19 million had credit reports that were limited and/or incomplete and, as a result, were unable to produce a credit score. Of these 19 million, about half were unscorable because of insufficient credit history, with the other half were unscorable because of a lack of *recent* credit history.

Some proponents of the GSEs adopting updated credit scoring models argue that there are new models that will capture a large percentage of these "credit invisible" consumers and allow them to obtain a mortgage whereas they previously would not have qualified due to a lack of credit. These claims may prove problematic.

Scoring tens of millions of previously "credit invisible" borrowers may not necessarily be a good thing. In order to score these additional borrowers, these credit scoring models relax their credit scoring standards across the board. As a result, consumers who have insufficient or outdated information in their credit files would receive a score (e.g., scoring a consumer based solely on the presence of a collection item or a few payments on a recently opened account). This "relaxed" approach directly conflicts with the CFPB's analysis in its report which relies on an accepted minimum scoring methodology that is "consistent with most credit scores today." Lowering the scoring standards may prove to be an unsound method and result in an inaccurate prediction of future payment behavior.

Expanding access to credit at the potential expense of safety and soundness is simply bad policy. We know what happened the last time lending standards were relaxed. It was the early 2000s, and "lending standards were lax enough that lenders could remain within the law but still generate huge volumes of bad mortgages. It is likely that the housing bubble and the crisis would have occurred even if there had been no mortgage fraud," as the Financial Crisis Inquiry Commission's report explained. If the GSEs undertake a new credit scoring model that fails to produce accurate credit scores, it is akin to lowering lending standards across the board. And as we saw in the financial crisis, relaxed lending standards cause significant problems for the economy and, eventually, the taxpayers.

Managing the risk of the GSEs' portfolios must be the first priority, and quality, reasoned decisions regarding credit risk tools should not be compromised.

Experts Needs to Make the Call

Ultimately FHFA will decide which credit scoring model will be used by the GSEs. While FHFA and the GSEs' policies receive their fair share of criticism, in this case it is important to note that the subject matter experts at FHFA and the GSEs are in the best position to make the decision on any new credit scoring policies– they are the ones who have tested and reviewed competing credit scoring models over the past year and can determine what tool or tools are best to assess the credit risk in the GSEs' portfolio. The recent history of the GSEs should be enough to remind us not to take any steps that might diminish the quality of the portfolio.

Conclusion

As detailed in its FY 2015 and now FY 2016 Scorecard, FHFA says it is committed to concluding its evaluation and is expected to make a decision on any shift in credit scoring model policy within the next several months. In the meantime, it is important to allow for the competitive review process to conclude. No one will benefit if safety and soundness and other credit risk considerations are tossed aside in pursuit of riskier objectives.