

FHFA CREDIT SCORE REQUEST FOR INPUT

The FHFA recently submitted a *Request for Input* that seeks feedback on how it should go about updating the Fannie Mae and Freddie Mac underwriting guidelines that only allows for the Classic FICO credit score.¹ We very much support the effort to update the credit score used/required by the GSEs and explore how more than one score could be considered or permitted.

The Need to Update Credit Scores

Some have reacted to this effort by suggesting that this could result in “reduced underwriting standards.”² This is a surprising response, since among the currently required credit scores is one introduced in 1998 and developed on data from 1995 to 1997. Consequently, this would have included a good share of data in the credit histories of the sample population from the 1980s—a period with markedly different patterns of credit access and credit usage than today. While it is true that the enactment of the Equal Credit Opportunity Act (ECOA) in 1974, and the deregulation of the financial services industry in the 1980s broadened access to credit for women and members of minority communities, it often did so on terms that were relatively disadvantageous (lower credit limit, higher cost of credit, crippling debt service burden).³ While not suggesting that existing scoring models are discriminatory, models based upon data from a time when access to credit weren’t universally on the same terms for all groups may not be the best we can do.

Credit scores from FICO, VantageScore, and other developers are routinely updated with newer versions for a number of reasons including that described above. Another is that the underlying “realities” of consumer behavior and credit data relationships may change over time. For instance, having a credit card in the 1970s or early 1980s may be associated with a different risk level than having a credit card in the 2000s, when subprime credit cards were more common. Rates of home ownership have changed over time, the average number of credit cards has changed, the average number of credit obligations, and so on. And, of course, if scoring models utilize actual dollar amounts, inflation will change the real meaning of this over time.

¹ FHFA. *Credit Score Request for Input*. December 20, 2017. Available at: https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/CreditScore_RFI-2017.pdf

² Smith Jr., Joseph A. “Bank Think: FHFA Should Resist Calls to Weaken Mortgage Underwriting Standards.” *The American Banker*. January 8, 2018. Downloaded at <https://www.americanbanker.com/opinion/fhfa-should-resist-calls-to-weaken-mortgage-standards>. Note, that since its publication this article has been removed from American Banker.

³ Demos. “The Color of Debt: Credit Card Debt by Race and Ethnicity.” DEMOS Fact Sheet. Downloaded at http://www.demos.org/sites/default/files/publications/FACTSHEET_TheColorofDebt_Demos.pdf and Eveleth, Rose. “Forty Years Ago Women Had a Hard Time Getting Credit Cards.” January 8, 2014. Smithsonian.com. Downloaded at <https://www.smithsonianmag.com/smart-news/forty-years-ago-women-had-a-hard-time-getting-credit-cards-180949289/>

An additional key reason that credit scores are regularly updated (for instance, FICO 9 and VantageScore 4, which leverages recently released time series balance and payment fields, are the most recent versions among the flagship generic models) is that the data *collected and reported* by the CRAs changes over time. Some common reasons for changes in the data collected and use include:

- more entities can and do report to CRAs;
- data quality improves due to increasing industry standards and general IT improvements;
- additional, more refined ways of classifying data are introduced;
- new data fields are collected and/or the rate of furnishing changes;
- data is removed from credit reports due to regulations or agreements with courts and the like (or to avoid litigation);
- consumers have improved access to their credit reports and can more easily dispute items;
- consumers have learned what behaviors will improve their credit scores and so act in ways to try to improve them; and/or,
- CRAs make available more data to score developers, such as allowing score to be developed using more longitudinal data.

Some real world context may be helpful. What happens when, due to a consent decree (National Consumer Assistance Plan or “NCAP”), a good share of the public record data in the CRAs is suddenly removed but the required credit scores are expecting to see that data? What happens when consumers are told that their paid collections will no longer hurt their credit scores, and see this in a credit score made available to them, only to find out that the scores used to approve and price their mortgage (by lenders) are much older credit scores that *do* take paid collations into account?

Not updating credit scores in a changing data and consumer behavior environment would, in fact, seem to guarantee a slow reduction in underwriting quality over time as well as act to confuse consumers.

It is worthwhile to note that FHFA acknowledges in the *Request for Input* that the use of updated credit scores “provides a slight increase in accuracy, which would ultimately benefit borrowers and investors,” and “in building the models for FICO 9 and VantageScore3.0, both companies have incorporated economic changes since the financial crisis.” In both models paid third-party collections no longer negatively impact applicants, medical collections are treated differently from other collections in FICO 9, and rental data (when reported to the CRAs) can now be incorporated in both credit scores. Each change individually may not seem much, but the totality of these changes is lost when lenders use older scores.

And in a partial test of the impact of using new score, the *Request for Input* notes that in an internal test utilizing already submitted applications, the new scores resulted in a “marginal improvement” in the number of applications that would be accepted for

purchase (approved). This is unsurprising, since the minimum credit score is just one of many factors (such as debt-to-income, employment, etc.) taken into account in the residential mortgage origination process. The GSEs also use their own automated underwriting. As a result, the Classic FICO score is just one part of a much more involved underwriting procedure. Further, based on their description, the FHFA's own analysis seemed to have been conducted on only *actually* submitted applications. This would not include an application that was not submitted because a consumer or originator thought their Classic FICO was too low. Thus, that there was even a "marginal improvement" identified is potentially important. And it may also be the case that the overall marginal impact could loom larger among lower income households. And it also may be the case that other aspects of the overall origination process, such as Fannie's DU and Freddie's LPA, could be improved.

The notion that using newer credit scores might reduce underwriting standards makes little sense and runs counter to the FHFA's own research findings. The GSEs (Fannie and Freddie) and lenders should implement procedures that allow for credit scores to be updated on a more regular basis than has been the case.

The details of *how* they enable this, is, of course, crucial to improving underwriting. For instance, since credit scores will vary for any particular consumer, originators should not be allowed to cherry-pick a score so to have an applicant approved. Although the important implementation details are not provided, the *Request for Input* offers four options of how two credit scores could be incorporated into GSE guidelines. The first would be to simply choose one credit score as the sole standard. This would seem to be the least satisfying option. The second would be to require two credit scores (for instance, FICO 9 and VantageScore 4) and then have rules that account for two credit scores, such as choosing the minimum after each is converted to a comparable value (such as probability of default). Third, lenders could choose their score (under some commonsense guidelines to prevent cherry-picking). And fourth, a waterfall approach in which, presumably, each lender could choose their own primary credit score (such as VantageScore or FICO) and then have an option of providing a secondary credit score if the consumer was unscorable with the primary score. This would seem to offer the greatest flexibility. This is also not a radical departure from the way credit scoring occurs within models. For instance, consumers with thick credit files, thin credit files, clean credit histories and ones with bankruptcies may have FICO or VantageScore credit scores but each of these particular scores may have been produced by different score cards within the models that take account of differing data elements or elements weighted or utilized differently. So, having a separate credit score (or score card) that utilizes utility, telecom, rental or other well tested data for consumers with little to no credit history is not that great a departure. (But since the FHFA restricts consideration to just two credit scoring models, the only choices for the primary and secondary model are the FICO 9 and the VantageScore 3.0).

Finally, concerns that anyone might have regarding the reliability of producing credit scores for consumers who are traditionally unscorable by having different scoring

criteria are easily addressed by requiring a minimum level of score accuracy and or other score performance characteristics overall and/or for segments of concern. For instance, FICO in a blog compares the predictive power of a segment of consumers who are (1) new to credit, with a traditional FICO credit score to (2) a research credit score used on consumers with no credit history (with only non-credit credit bureau data) to (3) the FICO XD on consumers with no credit history (with only non-credit credit bureau data plus alternative data).⁴ FICO, VantageScore, and other credit score developers can easily produce such analysis to demonstrate how well different credit scores are able to assess risk, using different types of data, on different segments (new to credit, thin-file consumers, etc.). Credit scores are statistical constructs and their performance overall and in different segments is both highly and easily measurable. FHFA, can then set minimum thresholds for credit scoring models in key segments, such as new to credit, thin file, no file, and the like. This will require common, standard and transparent ways to define performance (such as appropriate measures of performance, samples, definitions of goods and bads). This could be easily accomplished with consultations between the relevant stakeholders (such as FHFA, Freddie, Fannie, lenders, and credit score developers).

Where the GSEs are Not Going Far Enough

It is unfortunate the *Request for Input* is excluding credit scores other than FICO 9 or VantageScore 3.0 (the newer VS 4.0 was apparently released too late to be considered in this round of credit score updates). It specifically excludes the FICO XD, noting: “Because the FICO XD score is derived solely from alternative data that is generally not reported to the CRAs (such as utility, cable and cell phone bills), this score may not be suitable for use by mortgage applicants.” On this point, the FHFA is incorrect. The FICO XD scorecard combines CRA data (from Equifax), non-financial bill payment data from the National Consumer Telecommunications and Utility Exchange (“NCTUE” includes payment data from energy utility and media firms, however most that is available for FICO XD is cable and wireless phone bill payment data), with expanded public record data from LexisNexis Risk Solutions. So, the FICO XD score is based upon CRA credit data *plus* additional useful data. The CRAs also offer other credit scores that combine CRA data with additional data. It is unclear why the FHFA would not seek ways to incorporate more robust scores incorporating more predictive data into the underwriting process.

In March 2015, PERC published *Research Consensus Confirms Benefits of Alternative Data* that highlighted what was an explosion in new credit scoring solutions, many of which utilized nontraditional data sources.⁵ This paper presented publicly available findings from a number of firms, including FICO, VantageScore, TransUnion, Equifax,

⁴ Dornhelm, Ethan. *Can Alternative Data Score More Consumers?* FICO. December 1, 2015. Available at: <http://www.fico.com/en/blogs/risk-compliance/can-alternative-data-score-more-consumers/>

⁵ Turner, Michael A., Robin Varghese and Patrick Walker. *Research Consensus Confirms Benefits of Alternative Data*. Durham, NC. PERC Press. March, 2015. Downloaded at <http://www.perc.net/wp-content/uploads/2015/03/ResearchConsensus.pdf>

Experian, and LexisNexis. The findings showed clear benefits from the newer solutions in terms of improving underwriting *and* reaching more consumers (inclusion). In addition to those large market players, there are also a number of smaller players and startups with innovative solutions. Some solutions may even focus on particular market segments, such as immigrants with little credit history in the US. Since that paper was published the explosion in newer solutions has continued with the release of the FICO XD model and the growing segment of so-called “consumer permission” data solutions, where, for instance, consumers authorize a third-party to access their bank account or telecom statement data.

In May 2015, PERC released *Predicting Financial Account Delinquencies with Utility and Telecom Payment Data*.⁶ This paper specially examined whether adding utility and telecom payment data to credit scores could improve risk assessment with mortgages. It found the added data was, indeed, useful. For instance, among consumers with a 800-899 VantageScore, the delinquency rate for the following 12 months on an otherwise clean, well performing mortgage was 3.0% for consumers with no past utility or telecom delinquencies. However, among consumers with a preceding severe delinquency on their utility/telecom accounts, the future mortgage delinquency rate was 11.3%. This clearly suggests that adding utility and telecom payment data to credit file data can improve mortgage underwriting and benefit account maintenance and investors.

Another finding was that among consumers with no 90+ days past due (DPD) on any financial (traditional credit bureau data) or non-financial data (utility/telecom data), the 12-month mortgage delinquency rate was 4.5%. However for consumers with a 90+ DPD on a non-financial account during the previous 12-months but no similar 90+ DPD from the traditional credit bureau data, the rate was 20.3%! Surprisingly, about one-third of consumers with a past 90+ DPD *only* had it on a non-financial account (utility/telecom data) not typically reported to the credit bureaus. As the paper speculates, this may point to a bill payment polarization in which a consumer undergoing or beginning to experience financial stress would first exhibit this by becoming delinquent on some accounts (and not all at once). As such, this important signal would not be seen if only *some* obligations are taken into account, such as only the traditional financial accounts. So, considering a broader array of accounts and data not only helps consumers with no traditional credit who may *only* have utility/telecom accounts and rent or consumers on the margin with a minimal credit history in which a thicker credit file could be useful, but also may help underwriting among a larger segment of consumers.

⁶ Turner, Michael A. and Patrick Walker. *Predicting Financial Account Delinquencies with Utility and Telecom Payment Data*. Durham, NC. PERC Press. May, 2015. Available at: <http://www.perc.net/wp-content/uploads/2015/05/Alt-Data-and-Traditional-Accounts.pdf>

Conclusion

PERC is encouraged that the FHFA is moving to update the GSE required credit score. We hope that this is just the beginning of a larger process of updating the entire mortgage space, from originators/lenders (initial underwriting and risk-management) to the GSEs (minimum score and overall application evaluation) to investors. It is important that the FHFA and the GSEs do not simply update a credit score and leave the process as inflexible as it has been. It is far more important to update their systems, guidelines, and procedures to be more flexible so they can more easily make future updates and incorporate other scores and new data.

We are somewhat perplexed by the FHFA's seeming dismissal of encouraging the use of scorecards optimized for predictive and proven payment data (PPD) such as energy utility payment data or rental payment data.⁷ In this case, the US is not the leader but a distinct laggard. A casual survey of the World Bank's Doing Business database reveals that more than 30 countries—countries as diverse as China, Germany, the United Kingdom, New Zealand, Colombia, and Mexico—accounting for more than one-third of humanity permit the use of fully-reported (positive and late payment) proven payment data in consumer credit reporting and scoring.⁸ In some countries, this practice has been in place for a half-century or more. It has become so widespread and accepted that the International Consumer Credit Reporting Commission (ICCRC) of the World Bank includes a recommendation that proven payment data be collected by private credit bureaus and used in credit risk assessment analytics.⁹

In addition to the fact that proven payment data has been successfully used in credit risk assessment by countries around the world for decades, it has a long history in the US—albeit on a much more limited scale. While only between 6 and 8 million Americans have credit files with one or more fully reported proven payment data tradeline, this has provided a rich pool of data for empirical research over the years. While many diverse groups have analyzed actual credit reports to assess the various credit market impacts from the use of PPD, there has emerged a consensus finding.

⁷ Proven payment data or PPD is distinguished from so-called “alternative data” that includes many forms of data that have not been used in credit underwriting. PPD includes energy utility, rent, media (wireline telecoms, wireless telecoms, broadband, cable TV, satellite TV) payment data, while excluding remittance payments, payday loan payments, unstructured “Big Data,” insurance payments, and other data not currently used by nationally regulated lenders in an advanced economy such as members of the G7 or Organization for Economic Cooperation and Development (OECD).

⁸ The methodology section of the World Bank's Doing Business Access to Credit component includes details on a variable called “Depth of Credit Information Index” that includes “Data from retailers or utility companies are distributed in addition to data from financial institutions.” See

<http://www.doingbusiness.org/Methodology/getting-credit>

⁹ *General Principles for Credit Reporting*. World Bank with support from the Bank of International Settlements (BIS). September, 2011. Downloaded at

http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/Credit_Reporting_text.pdf

Namely, that the inclusion of PPD results in fairer, more inclusive lending while enabling lenders to better distinguish between good and bad risk borrowers.¹⁰

The benefits of using PPD in credit granting are not lost on federal policymakers and regulators in the US, and both Congress and the Consumer Financial Protection Bureau (CFPB) have recognized this fact. The CFPB issued two studies on “credit invisibility” and hypothesized that the use of PPD holds great promise in facilitating access to affordable sources of mainstream credit for an estimated 43 million people in the US.¹¹ More recently, the House Financial Services Committee marked up a bill (H.R. 435 “The Credit Access and Inclusion Act of 2017”) by a vote of 60 to 0 clarifying that proven payment data may be reported to nationwide consumer reporting agencies.

While PERC and many other organizations maintain that the Federal Consumer Reporting Act (FCRA) already permits this, and the fact that some utilities and telecoms firms have been fully reporting to one or more nationwide CRAs for a very long time is prima facie evidence of this fact, because our utilities and telecoms firms face a bi-furcated regulatory system (federal and state regulators), there exists a clear need to clarify this so that state regulators are not acting to prevent the credit reporting of consumer payment data. With such a clarifying law in place, PERC and other supporters of this effort believe that much greater quantities of PPD will make their way into FCRA-regulated consumer credit databases.

In summary, given both the global and domestic precedent (widespread and long-established use of PPD in consumer credit reports and credit risk scores), the decade plus of compelling supportive empirical research, and the current policy objectives of both Congress and the CFPB, we posit that the FHFA should move forward and explore the use of newer credit scores (perhaps in a waterfall or cascade approach) that are able to rely on proven payment data (heavily and/or in part) and other well tested data to facilitate responsible and fairer access to affordable sources of mainstream credit. And movement to newer solutions that layer-in newer data sources to enable both greater inclusion *and* sounder underwriting should go beyond the credit score used in the minimum score criteria. For newer solutions to maximally benefit consumers and the economy it is important that they be used in the entire mortgage process: origination, approval, pricing, maintenance, and investing.

¹⁰ Turner, Michael A., Robin Varghese and Patrick Walker. Research Consensus Confirms Benefits of Alternative Data. Durham, NC. PERC Press. March, 2015. Downloaded at <http://www.perc.net/wp-content/uploads/2015/03/ResearchConsensus.pdf>

¹¹ Data Point: Credit Invisibles. CFPB. June 2015. Downloaded at http://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf; Scarborough, Michelle. “Who Are the Credit Invisible?: How to help people with limited credit histories.” CFPB. December 12, 2016. Downloaded at <https://www.consumerfinance.gov/about-us/blog/who-are-credit-invisible/>; CFPB Data Point: Becoming Credit Invisible. CFPB, June 7, 2017. Downloaded at <https://www.consumerfinance.gov/data-research/research-reports/cfpb-data-point-becoming-credit-visible/>