

**[START OF TRANSCRIPT]**

**Marvin:**

Welcome and thank you for joining today's Validation and Approval of Credit Score Models Proposed Rule webinar. Please note that all participant lines will be muted for the duration of the call. You are welcome to submit written questions during the presentation, and these will be addressed during Q and A. To send a note, select "all panelists" on the "send to" drop down menu of the chat panel located on the lower right hand side of your screen. If you require technical assistance, send a note to the event producer or call our help desk at 888-796-6118. With that, I'll turn the call over to Danielle Walton, stakeholder relations officer. Please go ahead.

**Danielle:**

Thank you Marvin, and good afternoon to everyone. This is Danielle with the Federal Housing Finance Agency. I want to welcome you all and thank you for taking the time to join us for this webinar. On December 13<sup>th</sup>, FHFA issued a proposed rule on validation and approval of a credit score model by Fannie Mae and Freddie Mac. Joining me for today's webinar is Beth Spring, senior policy analyst in FHFA's Office of Housing and Regulatory Policy, and Robert Dunskey, principal economist in FHFA's Office of Policy Analysis and Research. They will provide an overview of the proposed rule and answer questions you may have. As the operator mentioned, throughout this presentation, you can type your questions into the "submit a question" box at the bottom of your screen. Be sure to send to all presenters. Once the Webinar has concluded, we will make a recording available on **FHFA.gov**, where you can also find a full proposal and submit your written question. I'll now turn over things to Beth to begin.

**Beth:**

Thank you all for joining us today for the Validation and Approval of Enterprise credit score models webinar. As background, FHFA began researching possible changes to the Enterprise credit score requirements as part of the work related to the 2015 conservatorship scorecard. In May of 2018 when section 310 of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 was enacted, FHFA announced it was shifting its focus from the work related to the scorecard to the development of notice and comment rulemaking. As Danielle mentioned, the validation and approval of credit score models proposed rule was issued on December 13<sup>th</sup> of last year. Consistent with section 310, the proposed rule focuses on standards and criteria that Fannie Mae and Freddie Mac must follow to validate and approve third party credit score models. In drafting the proposed rule, FHFA took into

account the multiple years of research and outreach conducted by the agency and the Enterprise.

The proposed rule reflects the requirements of section 310, as well as input received from multiple years of outreach on the costs and benefits of possible updates to the Enterprise credit score requirements. Today's presentation will provide you with an overview of the main features of the proposed rule. We encourage everyone, if they haven't done so already, to read the proposed rule and the additional materials that we have available on our website. FHFA will carefully consider all of the comments that are received on the proposed rule, so we encourage everyone to submit comments through the FHFA website, even if you've previously provided information to FHFA on this topic. I will now turn it over to Robert Dunsky, a principal economist here at FHFA to introduce himself.

**Robert:**

Thank you Beth. Good afternoon and good morning to those on the west coast. I'm Robert Dunsky, an economist with the FHFA and I've been involved in the credit score discussion from the very beginning. I would encourage everyone to read the notice of proposed rule. In addition, if you seek background information on credit scores in the mortgage marketplace, I would also encourage you to read last year's Request for Input. Many of you on the phone penned letters in response to last year's RFI. We are grateful for your contributions, and where appropriate your input was used in the proposed rule we're discussing today. As Beth said, please comment on the current proposed rule, we need your input. Now, back to Beth to discuss the structure of the NPR.

**Beth:**

Section 310 of the Economic Growth, Regulatory Relief, and Consumer Protection Act of [2018] amended the Fannie Mae and Freddie Mac charter acts as well as the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. The charter acts were amended to establish requirements for the validation and approval of third party credit score models by Fannie Mae and Freddie Mac. Section 310 imposes separate requirements on FHFA and the Enterprises. FHFA must first issue regulations establishing standards and criteria for the validation and approval of credit score models by the Enterprises. Each Enterprise must then publish a description of the validation and approval process that it will use to evaluate applications from credit score model developers consistent with the standards and criteria established by FHFA regulation. Section 310 sets forth several factors that must be considered in the validation and approval process, including the credit score model's integrity, reliability, and accuracy, and its historical record of predicting borrower credit behaviors and consistency of any model with

Enterprise safety and soundness. FHFA's proposed rule includes these criteria in the validation and approval process.

These provisions of the statute are discussed on the next few slides. This slide quotes the statutory provision on use of credit scores. The statute provides that if an Enterprise uses a credit score, the [credit] scoring model must be validated and approved. However, neither the statute nor the proposed rule requires an Enterprise to use a third party credit score. For example, an Enterprise may decide at some point in the future that it will not use a credit score in any of its purchase-related systems and procedures. In that case, the Enterprise would not be subject to the requirements in the proposed rule. The proposed rule would also not create any right or expectation of continued use of a credit score. Section 310 does not require an Enterprise to continue to use previously validated and approved credit score models, and nothing in the proposed rule would create such a requirement.

These five statutory requirements on the slide are the foundation for the four phase validation and approval process. These requirements are built into the four phase process. FHFA has proposed standards and criteria for evaluating integrity, reliability, and accuracy. Credit score models will have to meet these standards and criteria in the credit score assessment phase. Additional standards and criteria are included in the Enterprise's business assessment phase. Roman numeral five is referenced throughout the proposed rule in terms of the Enterprises adding additional requirements to those requirements in the proposed rule. Any additional Enterprise requirements would be subject to FHFA review and approval, and those requirements would be made available in the credit score solicitation, which is discussed later on.

So, let's start with an overview of the entire process and a description of what is expected as part of each phase. Phase one, solicitation phase. As part of the solicitation phase, each Enterprise would publish a credit score solicitation that would include the opening and closing dates of the solicitation time period, during which the Enterprise would accept applications from credit score model developers. The solicitation would include a description of the information that must be submitted with the application, instructions for submitting the application, a description of the Enterprise process for obtaining data for testing, a description of the Enterprise's process and criteria for conducting a credit score assessment, and an Enterprise business assessment.

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Phase two, application review phase. As part of the application review phase, an Enterprise would determine whether each application submitted is complete. An Enterprise may request additional information if necessary. An application would only be complete after an Enterprise has received all the required fees and information including any data needed from a third party. All of the information is needed by the required timeframes outlined in the proposed rule in order to move the application to the credit score assessment phase.

Phase three, credit score assessment phase. During the credit score assessment phase, each credit score model would be assessed for accuracy, reliability, and integrity. These tests would be conducted independent of the credit score in the Enterprise's systems and AUS. A credit score model must pass the credit score assessment phase to be reviewed by an Enterprise during the business assessment phase.

Phase four, Enterprise business assessment phase. During the Enterprise business assessment phase, which is the final phase of the process, an Enterprise would assess the credit score model in conjunction with the Enterprise's business systems and processes. An Enterprise must consider accuracy and reliability where used within the Enterprise system, possible impacts on fair lending, possible impacts on the Enterprise's operations and risk management. An Enterprise must also consider impacts on the mortgage finance industry, assess competitive effects (positive and negative), conduct a third party vendor review, and any other evaluations established by an Enterprise. Now that we've gone over, at a high level, the proposed requirements of each phase, let's go more specifically through each phase, one by one.

The first phase is the solicitation of applications from credit score model developers. The proposed rule would permit FHFA to require periodically the Enterprises to solicit applications from credit score model developers. FHFA would establish the need for solicitation by notice to an Enterprise. FHFA is proposing, based on years of outreach and feedback from the mortgage finance industry, that solicitation for new applications occur at least every seven years, or as determined necessary by FHFA. The proposed rule would require the process for solicitation to begin within 60 days of the effective date of the final rule. Now, as described on the previous slide, an Enterprise would submit their credit score solicitation for FHFA review and approval. FHFA will have 45 days to review and approve each credit score solicitation. Then, an Enterprise would make publicly available their credit score solicitation for at least 90 days prior to the start of the solicitation period.

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The initial solicitation period, which is the period of time applicants have to submit their application, is open for 120 days. For solicitations after the initial one, FHFA will determine the appropriate length of time for the next solicitation period.

The second phase is the initial review of submitted applications. The proposed rule would establish the criteria an application must meet in order to be considered complete. Each applicant would be required to submit: one, an application fee, two, a fair lending certification, three, information on demonstrated use of the model by industry, four, conflicts of interest certification, and other information on the credit score model developer's qualifications, and five, any other information required by an Enterprise credit score solicitation. The last component of the application is the data needed to perform the credit score assessment. Such data would not be provided by the applicant. Instead, an Enterprise would obtain the data from the data provider on behalf of the applicant. As mentioned earlier, the application would only be complete once an Enterprise is in receipt of all the information from the applicant as well as the necessary data from a third party.

The third phase is the credit score assessment phase. The proposed rule would require Fannie Mae and Freddie Mac to undertake a credit score assessment of each credit score model for which it has received a complete application. The credit score assessment consists of the evaluation of accuracy and reliability of credit scores on a standalone basis (so outside of the Enterprise's systems and processes). The credit score assessment would also evaluate the integrity of the credit score model. The proposed rule would permit an Enterprise to conduct its own testing for the credit score assessment or allow a third party to test each credit score model. The proposed rule also permits an Enterprise to jointly conduct testing for a single credit score assessment for each application. The credit score assessment must be completed within 180 days. However, FHFA may grant up to two possible 30-day extensions. The NPR outlines a few options for evaluating testing results. Robert will cover those on the next slide.

**Robert:**

Thank you, Beth. Statistical tests to measure credit score accuracy are well known and understood. The proposed rule permits the Enterprises to select the test statistics used in the credit score assessment. The proposed framework is to test the applicant's credit scores on the same set of Enterprise mortgage loans. Please note, Enterprise mortgages are not reflective of the general population of all consumer loans. They have already met the Enterprise underwriting standards and requirements.

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FHFA is considering four approaches for the Enterprises to evaluate the testing results and to select which credit score models will move forward to the business assessment [phase]. I will summarize the four approaches. However, the rule text only covers the first approach. The preamble discusses all four approaches. As such, I would encourage you to read the NPR for the full discussion.

The first approach is the comparison based approach. Under the comparison based approach, the proposed rule would not establish a bright line requiring the applicant's credit score to be more accurate than the existing credit score in use by the Enterprises. This approach would be more subjective and indicates reasonableness of the [credit] score's accuracy.

The second approach is the championship challenger approach. Under the championship challenger approach, the proposed rule would require that the applicant's credit score be more accurate than the existing credit score in use by the Enterprises. This approach would favor newer credit scores since newer credit scores will likely be more accurate than the existing credit score in use by the Enterprise. The championship challenger approach would be a bright line test.

The third approach is the benchmark approach. Under the benchmark approach, an absolute statistical standard would be established and all scores would have to surpass the standard. For example, FHFA could establish through rulemaking a test statistic (for example, a K-S or a Gini) and establish through rulemaking or notice the specific numerical threshold that all scores must surpass.

Lastly, the fourth approach is the transitional approach. This approach would allow one of the above described approaches to be applied for the initial credit score assessment and a possible different approach for subsequent credit score evaluations. FHFA is seeking feedback on the four approaches and FHFA may adopt any of these options in the final rule or revise any of the options based on public comments. Now, back to Beth to discuss the credit score business assessment.

**Beth:**

The fourth and final phase of the validation and approval process is the Enterprise business assessment phase. The proposed rule would require Fannie Mae and Freddie Mac to undertake an Enterprise business assessment of each credit score model that the Enterprise determines has met or passed the credit score assessment. The Enterprise business assessment is proposed to be broader than the credit score assessment and is unique to each Enterprise. The business assessment is proposed to include an evaluation of at least

five areas: one, the assessment of accuracy and reliability, two, possible fair lending impact, three, impact on Enterprise risk management and impact on the mortgage finance industry, four, positive and negative competitive effects, five, the third party vendor review, and six, any other criteria established by an Enterprise. Now, most of these criteria are part of the Enterprises' current course of business. The maximum timeframe to complete the Enterprise business assessment would be 240 days.

Once an Enterprise is ready to approve or disapprove an application, the proposed rule requires an Enterprise to provide FHFA 45-day prior notice. This notice will ensure FHFA has had an opportunity to determine how to handle future changes, updates to, or replacement of any credit score model. If an Enterprise disapproves an application at any point during the process, notice must be provided to the applicant within 30 days of the determination including reasons for the disapproval. If an Enterprise approves the credit score model, it must be used in all of its systems and procedures. The process for implementing a newly approved credit score model would be established by the Enterprise and would include the necessary time the industry will need to prepare for any change in the Enterprise credit score requirements. The Enterprise would need to provide notice to the industry about the expected timing of any such change or changes.

The proposed rule would require certain notices be provided to applicants and we've already touched briefly on a few of them. First, Section 310 provides that an Enterprise must provide an applicant with a status notice no later than 60 days from the application submission date, so the proposed rule would require an Enterprise to provide an application status notice within 60 days of the applicant's submission. The proposed rule would also require an Enterprise to notify an applicant once their application has been deemed complete. Applicants are also notified once an Enterprise is prepared to begin the credit score assessment phase and once an Enterprise determines if the application has passed the credit score assessment phase. Lastly, the proposed rule would require an Enterprise to notify an applicant once an approval determination is made. Now, we will take a few questions.

**Danielle:**

Marvin, would please remind the participants how to submit questions?

**Marvin:**

Sure. To send a written question, you can select "all panelists" on the "send to" drop down menu of the chat panel located on the lower right hand side of your screen.

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**Danielle:** Thanks, Marvin. I just wanted to also note we have Kevin Sheehan from our Office of General Counsel to assist with the questions. We have our first one that just came in. Could you please comment on how you see this rule interacting with the proposed Enterprise capital rule as the risk based capital requirements are direct incentives for the introduction of a new credit score or multiple credit scores that has a material impact on the Enterprise's required capital as the scores are not perfectly aligned. Will the adoption of new credit scores require another round of rulemaking with regards to the Enterprise capital requirements.

**Kevin:** Thanks, Danielle. This is Kevin Sheehan from the Office of General Counsel. I think it's a great question and it's one of the things that we've heard in response to the Request for Input that FHFA published at the end of 2017. There's a number of different ways that the Enterprises and the industry use credit scores currently. Not just the Enterprise capital rule, but things like PMIERS and the Enterprise pricing, and one of the consistent things we heard in the input we received from the RFI is that there's a lot of complexity. This proposed rule focused on the process for validating and approving a new credit score, but we recognize that once you get to a new approved credit score, any change is going to take time to implement. We heard 18 to 24 months to implement and so what we're going to do once we get through the process and have a change, we'll be working with industry, the Enterprises and with all the stakeholders to make sure that it's rolled out in an orderly way and we've sort of addressed these concerns.

In terms of a specific question about whether there would be another round of rulemaking on the Enterprise capital rule. I don't know, and I don't want to speculate on how we might have to address that. That's going to be something that we would address when we get to the implementation of this rule, I think.

**Danielle:** Okay. Thank you. Our next question is about the current model. Will the current model need to go through the approval process and if so, what is the timing?

**Kevin:** Thanks, Danielle, this is Kevin again. The proposed rule is set up in a way that would require any credit score model that's going to be used in the future to have gone through the process. As far as the current model in use, if an application is received from the credit score model developer, then that credit score model would be reviewed just like any other credit score model for which the Enterprises receive an application. I think the short answer is

probably, yes, but it would depend on what applications come into the Enterprises.

**Danielle:** Our next question is about fair lending, which we talked about earlier. What is the fair lending certificate?

**Kevin:** The proposed rule addresses fair lending in two different places. Going back to the phases that Beth laid out, the first place that fair lending is addressed is in phase two, the application. And so that's the certificate that you mentioned. An applicant would have to provide a certification to the Enterprises that the credit score model is not based on or doesn't use any prohibited characteristics under fair lending laws. A credit score model couldn't use race or sex or national origin, for example, as one of the factors. I can probably hope-- hopefully it shouldn't be a hard certification for people to provide, but it would be one of the requirements at the application phase. The second place that the proposal addresses fair lending is in phase four, the Enterprise business assessment and it would be in line with what the Enterprises do currently and what they do with many different kinds of changes. If there is going to be a fair lending impact, they assess what that would be and whatever that analysis is feeds into their decision making. It would come up in two places: in the certification up front and then as part of the Enterprise business assessment for any applications that get to that phase.

**Danielle:** Okay, our next question is about the accuracy testing. Will low scoring loans be included in that review?

**Robert:** Yes, as written in the preamble, the vision is that the Enterprises are going to identify the group of loans [for accuracy testing] based on the origination date. They're going to propose that they would pick recently originated loans, but in order to do accuracy testing, the loans have to be alive for at least two years or [more specifically] you have to have a two-year performance window on them. I would suspect that a large group of loans, I'd like to say a population selected over two points in time in recent history would be included [for accuracy testing].

**Danielle:** Would pilot programs be permissible under the rule?

**Kevin:** Alright, thanks for another good question. This is Kevin again from OGC. The answer is pilot programs would be permitted under the proposed rule. I think there's some questions in there about exactly how they could be run. In our thinking about pilot programs, part of what we wanted to address or part of what we recognize is if there's

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a new credit score model out there, a pilot program may be an important way to sort of gain experience with how the credit score model actually would work used in an actual system. A pilot program is almost sort of a way of testing and learning about something that's new so we wanted to make sure that in terms of allowing for more competition, that we had a mechanism to do that.

**Danielle:** Would credit models that were developed or owned by the credit reporting agencies be excluded according to this proposed rule?

**Kevin:** Thanks, Danielle. This is getting at one of the, probably the most significant issues in this proposed rule. Similar to the fair lending, the concerns about competition are addressed in two places in the proposed rule. There's the competition concerns as you'll see discussed in the preamble to the proposed rule were really in response to a lot of the input and discussion that we had as part of the Request for Input at the end of 2017 and into 2018. It was one of the questions we asked in the Request for Input and we received a lot of input on both sides of the question in the responses. We did get a lot of comments identifying competition and in particular competition concerns raised by a credit score model that would be owned by the credit reporting agencies.

In this proposed rule the way we've addressed it is in two ways. There's an upfront certification that would be in phase two, in the application phase and the certification would be a strict rule that if a credit score model developer is owned by a credit reporting agency, the credit score model would not be able to be considered. Aside from that, there's also on the back end as part of the Enterprise business assessment, another consideration of competition concerns more generally. Even if a certification is something that could be provided, the Enterprises would still be able to look at possible competition concerns at the Enterprise business assessment phase. We put in these two things, I think largely to address the concerns that we heard in the RFI but I would also say this is a proposed rule. I expect we're going to get a fair number of comments on this topic.

We wanted to be very transparent about the issues that we thought were important and how they might be addressed. We look forward to getting comments on I expect on both sides of this issue as we move ahead.

**Danielle:** Thanks, Kevin. It looks like we're about at time and I don't see any additional questions coming in. I'm just going to thank you all again

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for joining us for this webinar. Final reminder, all comments are due by March 21st on FHFA.gov. The link right in this webinar will take you to the proposed rule and area for comments. We also have other materials there including a fact sheet if you need additional resources and if you want to ask any additional questions, contact information is available on that page as well. We'll post the recording and transcript of this webinar on this page as soon as available. I'll be sure to notify everyone via email once the recording has been posted. Thank you so much again and enjoy the rest of your afternoon.

**Marvin:**

That concludes our conference. Thank you for using AT&T Event Conferencing Enhanced. You may now disconnect.

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