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TEN YEARS OF CONSERVATORSHIP: THE STATUS OF THE HOUSING FINANCE SYSTEM

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIFTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE STATUS OF THE HOUSING FINANCE SYSTEM, INCLUDING THE STATUS OF FANNIE MAE, FREDDIE MAC, AND THE FEDERAL HOUSING FINANCE AGENCY IN ITS ROLE AS CONSERVATOR AND REGULATOR OF THE ENTERPRISES

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TEN YEARS OF CONSERVATORSHIP: THE STATUS OF THE HOUSING FINANCE SYSTEM

WEDNESDAY, MAY 23, 2018

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. The Committee will come to order.

Today we will receive testimony from Federal Housing Finance Agency Director Mel Watt on the status of Fannie Mae, Freddie Mac, and the broader housing finance system.

The Banking Committee has been busy over the past year-and-a-half.

Yesterday the Committee reported favorably a bipartisan bill to update the rules governing CFIUS and the export control regime.

Earlier this year, the Senate passed S. 2155, bipartisan legislation focused on rightsizing regulations for community banks and credit unions, which was passed by the House yesterday and will hopefully soon be signed into law.

But we have not forgotten about housing finance reform, which remains one of my top priorities as Chairman.

Fannie Mae and Freddie Mac have now been in conservatorship for close to 10 years. You appeared before this Committee a year ago, Director Watt, and we talked about the importance of finding a permanent solution for our housing finance system.

The status quo is not a viable option. The Government plays too big a role in the mortgage market today.

You stated last year, as you have many times in the past, that "unequivocally . . . it is the role of Congress, not FHFA, to make the decisions that chart the path out of conservatorship and to the future housing finance system."

I agree with this sentiment, and I look forward to continuing to work with you and your staff as we delineate a way forward.

Meanwhile, over the past couple years, FHFA, Fannie Mae, and Freddie Mac have all been busy. The underwriting requirements on conforming mortgages have progressively weakened over time. The enterprises began purchasing loans with less than 5 percent down in 2014. Since then, Fannie's and Freddie's 97 LTV loans have become increasingly popular.

Freddie recently announced a new program called HomeOne, separate from its existing low downpayment program, which will allow low downpayment loans without any income or geographic restrictions.

According to one report, Freddie "is about to supercharge its 3 percent down program" as it "takes aim at FHA."

Meanwhile, both enterprises have also experimented with pilot programs that allow certain lenders to sell loans with 1 percent or even 0 percent down.

Last summer, Fannie Mae raised its maximum debt-to-income ratio from 40 to 50 percent, and according to reports, both GSEs saw a surge in high DTI loans in the second half of last year.

Additionally, Fannie and Freddie have continued to expand into other markets, such as single-family rentals. Freddie Mac has also begun providing lines of credit to nonbank mortgage servicers, presumably at cheaper rates than available in the market.

I understand your role, Mr. Watt, requires juggling multiple mandates as both conservator and regulator. I also appreciate that Fannie's and Freddie's underwriting standards remain tighter than they were at the peak of the housing boom.

However, the overall trends I am seeing toward greater taxpayer risk and greater Government presence in the mortgage market are concerning to me and further demonstrate the need for Congress to turn to housing finance reform expeditiously.

I appreciate you being here with us today and look forward to our discussion.

Senator Brown.

OPENING STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. Director Watt, welcome back. Nice to see you again.

I want to thank the Chairman for calling this hearing to continue the Committee's discussion of the current status and future of housing finance. At the center of our discussion today, of course, are millions of American families, homeowners, aspiring homeowners, and renters, each one with a different income, each one with different needs. All of them want one specific thing: a safe, affordable place to call home.

The secondary mortgage market was developed to give borrowers in each of our States access to that opportunity, but leading up to the crisis, as new private entities entered the secondary market, the secondary market tail started wagging the dog. Lenders churned out loans to meet the demands of risk-seeking investors, and homeowners suffered the consequences. Communities in Ohio and across the country are still dealing with the foreclosures and blight that resulted from the housing crisis.

There have been significant changes in GSEs' activity since the crisis. They have reduced their portfolios. They have ended investments in the high-risk private label securities that drove losses to taxpayers. The GSEs have also undergone additional changes since you last appeared before this Committee.

Last year I expressed my concerns that under the terms of an agreement with Treasury, GSEs' capital cushion could soon go to zero, putting taxpayers and GSEs at unnecessary risk. I applaud

your work with the Treasury Secretary to allow each enterprise to retain a small capital buffer to absorb quarterly accounting fluctuations. This small but meaningful change provided certainty to mortgage investors and the enterprises and ultimately to homeowners. And in January, GSEs began implementing plans to meet their duty to serve underserved markets. These steps are important to so many American families.

But we need to take a close look at what has not changed. Far too many creditworthy borrowers still struggle to access sustainable credit in the mortgage market, particularly in communities of color. In February, the Center for Investigative Reporting released data showing that people of color were far more likely, in some cases five times more likely to be denied a conventional mortgage in the 61 metropolitan areas they surveyed.

Yesterday, a really good day for the banking industry, was the day that the FDIC announced in its quarterly report that bank profits were up 13 percent from this quarter over a year ago, continuing the string of almost every year a double-digit increase in bank profits. That does not count the tax cut, which would mean their profits would have been 27 percent. Community bankers did quite well also. But yesterday the reason it was such a good day for bankers was that the House of Representatives passed legislation to weaken rules and regulations on banks in an overreach, especially as it moves to help Wall Street, which the collective amnesia that this body seems to enjoy continues to stun us. Yesterday the House of Representatives' bill that it passed makes it harder to detect and protect against violations of fair housing laws, particularly reverse redlining, which devastated borrowers in communities during the crisis. It just begs the question of why we have not learned or do not care to learn.

Meanwhile, borrowers in Ohio are still unable to access low-balance loans to revitalize properties and neighborhoods throughout the State. As you know, more than one-quarter of all renters pay more than half their income in rent. And it is just important that all of us—many of us in this crowd, on this panel, many of you watching this do not know people that spend half their income on rent and what can happen to them if one thing goes wrong in their lives. It is important we continue to think about that.

Today's discussion of the secondary market is at its core a discussion about access. Going forward, decisions made in this Committee will determine whether borrowers across each of our States will continue to have access to a 30-year fixed-rate mortgage and whether community bankers will still be able to compete with large lenders to serve their customers.

Today I hope we explore the elements of the secondary market that are essential to facilitate affordable home ownership and should be preserved and explore new ways to address remaining problems and unmet housing needs. I look forward to working with Director Watt and to hearing from him about the work that FHFA and the GSEs are doing.

Thank you.

Chairman CRAPO. Thank you very much, and I will resist the temptation to reengage in the debate over S. 2155.

Senator BROWN. You guys did win, right?

Chairman CRAPO. And definitely, Director Watt, I will not bring you into it.

Thank you again for being here with us today, and you now have the opportunity to make your presentation.

STATEMENT OF MELVIN L. WATT, DIRECTOR, FEDERAL HOUSING FINANCE AGENCY

Mr. WATT. Chairman Crapo, Ranking Member Brown, and Members of the Committee, thank you for inviting me to testify this morning.

When I last appeared before this Committee, I spent much of my time describing some of the important reforms FHFA has made to Fannie Mae and Freddie Mac while they have been in conservatorship. Today, because I suspect this could be my last time before this Committee, I would like to highlight some of the challenges that lie ahead.

One obvious challenge that has clearly been exacerbated by conservatorship is the difficulty of managing and planning in the face of uncertainty about the future. As I said in a speech I gave at the Bipartisan Policy Center in 2016, "Here, I am not talking about plans for housing finance reform but plans for everyday operations, including strategic planning that every well-run business does, and project planning that is necessary to continue key initiatives. Without looking somewhat down the road, FHFA and the enterprises would both lose their momentum and jeopardize day-to-day success. The key dilemma when you have an uncertain future, however, is how far down the road to look and how to retain the necessary talent to implement either short-term or longer-term plans."

In my written statement, I outline two specific examples of this challenge: one related to enterprise board turnover, and one related to our decision to transition Fannie Mae from a property owner to a tenant.

A second challenge that I think is also exacerbated by being in conservatorship has been how to ensure market discipline for the enterprises in the absence of the market forces that normally inform operating and business decisions. In the absence of market forces that normally enforce market discipline, FHFA has had to develop its own regime for market discipline. FHFA developed a conservatorship capital framework and requires both enterprises to use this aligned capital framework when making business decisions.

FHFA also uses this framework in its role as conservator to assess guarantee fees, the economic reasonableness of risk transfers and other business decisions, and to guard against the enterprises making competitive decisions adverse to safety and soundness.

FHFA will soon be building on the conservatorship capital framework we developed to propose a risk-based capital and minimum leverage capital rule to replace the old capital standards that OFHEO had in place that have been suspended during conservatorship.

While any final rule adopted by FHFA would also be suspended during conservatorship, we believe it is important for our agency as a regulator to use the experience we have gained during this long conservatorship period to articulate a view on prudential cap-

ital requirements for the enterprises. We also believe our proposed rule will provide valuable transparency to the public and will be a catalyst for thoughtful discussions about capital requirements that would be appropriate for the enterprises or other entities playing similar roles going forward in a reformed housing finance system. The input we receive will also help us refine the capital framework we continue to use during conservatorship.

Another serious challenge I think we must all confront is the affordability of home ownership and rental housing. This challenge is not unique to conservatorship and, unfortunately, is a significant challenge facing the market as a whole. We have taken a number of different approaches to try to respond, especially encouraging the enterprises to test and learn through pilots that can be replicated and implemented safely and soundly.

We are also engaging collaboratively with other industry stakeholders, all of whom acknowledge this as an urgent and growing concern that may prove to be our most intractable problem in the present and in the future.

Thank you again for inviting me to testify, and I look forward to answering your questions.

Chairman CRAPO. Thank you very much, Director Watt.

Just a couple of quick ones. In January, the FHFA released its Perspectives on Housing Finance Reform, which, by the way, I appreciated. I thought it was a very good document. The FHFA explained that the guarantors in the future system should be subject to comprehensive capital and liquidity requirements so that they could survive a severe housing stress like the recent financial crisis and continue to write new business.

At a hearing last year, I stated the need to have substantial, robust, loss-absorbing private capital at guarantors comparable to the capital at G–SIBs to protect taxpayers from losses as needed.

Considering the size and the role that guarantors would play in our financial system, do you agree that substantial, robust capital standards must be imposed on such institutions?

Mr. WATT. I do, and I think that is one of the reasons we are undertaking this proposed capital rule to get the public, Members of this Committee and the House Committee, and other stakeholders involved in this discussion so that those appropriate capital standards can be set not only for Fannie and Freddie in the present but for guarantors going forward.

Chairman CRAPO. Well, thank you. And another question on this in general: In your written testimony for the hearing today, you again wrote that it is your firm belief that these conservatorships are unsustainable, and you wrote that it is the responsibility of Congress, not the FHFA, to decide on housing finance reform and that you hope we will do so expeditiously.

Could you explain a little more fully the consequences for consumers and taxpayers and the economy if Congress does not act to reform the housing finance system?

Mr. WATT. Well, I think one of the things I referred to is the uncertainty that is associated with continuing conservatorship and the inability to look forward and plan for the future. So that is certainly a problem.

I think having a capital regime would be necessary to move forward into the future and would help inform good business decisions that are both compatible with the mission of the enterprises and compatible with safety and soundness. I just think having this much of our economy in conservatorship is just not a sustainable idea and is not a good idea under any circumstances.

Chairman CRAPO. Well, I appreciate your perspective on that and your advocacy with regard to it.

On a different topic, the FHFA recently announced that the enterprises will begin issuing a single security, the UMBS, on June 3, 2019. FHFA has said that one of the key goals of the initiative is to reduce cost to taxpayers caused by the difference in liquidity among Fannie Mae and Freddie Mac securities.

At the same time, in a recent 10–Q filing, Fannie Mae listed the transition to the uniform MBS as a risk factor, citing both financial and operational risks.

Could you provide the Committee with an update on the progress on this single security and a description of the benefits and costs of moving to the MBS?

Mr. WATT. Well, you know, in securities filings, both Fannie and Freddie have to be very forward-leaning on identifying potential risk, and we have been very transparent in saying that you cannot build a platform for issuance of securities without incurring risk, and you cannot make a transition to a single security without incurring risk. So I do not think they are unduly emphasizing the risk associated with it. They are just being transparent and honest, as we have.

The benefit, of course, is that it is going to provide additional liquidity in the marketplace and additional standardization so that everybody knows what the rules of the road are when it comes to operating in the space. And it will, of course, close the pricing differential between Freddie Mac and Fannie Mae stock—or Fannie Mae securities, not stock but their securities.

Chairman CRAPO. And you are on target to hit the June 3, 2019——

Mr. WATT. We are definitely on target to hit the June 2019 implementation date of the second phase of it. The first phase went swimmingly well. The best indication of that, of course, is that nobody even read anything about it in the paper. But Freddie is actually operating on the platform now to issue their securities without any problems whatsoever, and when we get to the June 2019 timeframe, both enterprises will be operating, and they will be issuing a single unified security.

Chairman CRAPO. Well, thank you very much.

Senator Brown.

Senator BROWN. Thanks, Mr. Chairman. Thank you, Director Watt.

In 2008, when you were a Member of the House, Congress reaffirmed the GSEs' duty to serve lower-income families in underserved markets. FHFA's rulemaking and Fannie and Freddie's duty-to-serve plans discuss parts of the housing system that have not been well served by the market. Talk about that, if you would. Where did FHFA find gaps in mortgage credit access as you final-

ize the duty-to-serve rule? And why have these markets been left behind?

Mr. WATT. Well, three of those gaps are identified in the duty-to-serve legislation, that is, manufactured housing preservation, and rural housing. And there are substantial challenges in rural communities, different challenges in rural communities than in metropolitan communities. And the recovery in rural communities has clearly not been as robust as the recovery in metropolitan areas.

Senator BROWN. Although very uneven in metropolitan areas.

Mr. WATT. Very uneven in terms of—so you have got a different set of problems in metropolitan areas. The affordability is just off the charts in metropolitan areas. Availability of houses in rural communities is a problem. So the duty-to-serve rule is designed to meet that unavailability of housing in three areas: manufactured housing, which is prominent in rural areas; rural housing that is not manufactured, which is a serious challenge; and the preservation of affordable housing in all areas. So duty-to-serve, when it is fully implemented, as it is now in the process of being geared up, should help to solve that problem. But there will continue to be problems as I identified in my opening statement.

Senator BROWN. Thank you. I would differ on one point. In metropolitan areas, I know you said it was uneven, but you also said the increased cost of housing is off the charts. In many areas that were hit the hardest in 2006, 2007, and 2008 in my State, in Cleveland and Dayton and Cincinnati and Youngstown, especially, that is not always the case by a long shot, as you know.

Mr. WATT. That is correct.

Senator BROWN. Let me talk about the national market. Congress set out five purposes for Fannie and Freddie in their charters. One of these was "promote access to mortgage credit throughout the Nation, including central cities, rural areas, underserved areas." A recent report released by Brookings showed that by purchasing and guaranteeing loans, particularly loans from community financial institutions, the GSEs are the single largest source of mortgage credit in rural areas.

So as we consider housing financing reform proposals in this Congress or the next, discuss the importance of a national market and discuss, if you would, which borrowers lose access to affordable mortgage credit without a national market.

Mr. WATT. Well, our opinion is that a national market is critically important in any housing finance system because right now we have national pricing. A person in Florida gets the same rates as a person in New York, California, or Ohio. And without a national market, guarantors could go in, lenders could go in and cherrypick just the best credit risk. So a national market is absolutely critical, we think, to preserving access to credit and providing liquidity across the board to everybody. So we think that is one of the most critical aspects of a housing finance reform proposal.

Senator BROWN. Thank you. One last question. In my State, homebuyers, and especially in the cities where property values took the hardest hit during the foreclosure crisis, are still struggling to finance small purchases. In many cases this means that first-time

homebuyers looking to stay in their communities are pushed out of the market by cash buyers, often investors who will never live there, who do not need mortgage financing.

What has FHFA and what have the GSEs done to work with lenders in communities to help creditworthy families like those in need of small-balance loans to move toward home ownership?

Mr. WATT. Well, we tried to make it easier for them to transfer those loans—make it easier for lenders to transfer those loans to the GSEs so that they can be securitized and the risk spread around the world. So that is an important ingredient. Reducing downpayments when you can do it responsibly and with compensating factors is important. We have got pilots related to student debt that we are testing out to see if they can be implemented responsibly.

There are all kinds of things that we are trying to solve this problem. You know, access is just an intractable problem, and some of the things as I described in my written testimony—I did not have time to do it in my oral testimony. Some of these things are things that we just do not as a regulatory or conservator agency have leverage over. Incomes are uneven. Education is uneven. I mean, there are things that we cannot control in our lane. So we try to collaborate with other stakeholders to get them working on that also.

Senator BROWN. Thank you.

Thank you, Mr. Chairman.

Chairman CRAPO. Senator Shelby.

Senator SHELBY. Director Watt, you bring a lot of experience to your job as Director. We have worked together in conferences, sometimes on the same side, dealing with these issues.

Mr. WATT. I always try to be on the same side as you.

Senator SHELBY. I know. Thank you. Me, too.

You brought up several things that I think are very relevant and very interesting. The conservatorship, I never thought that would last this long. I never thought that we, Congress, and several Administrations would let that happen. But it is what it is right now.

But what have you learned as the Director—and maybe you can impart this to us, too—of the failures and the mistakes that were made in dealing with Freddie and Fannie? And if we ever reform them—and God knows we hope and pray. We have a lot of plans out there, but none of them have been implemented yet. I believe, one, as you say, we have got to have more than adequate capital because people believe in that—I do, too—and liquidity. And this national market and the GSEs do bring some liquidity to the market. The GSEs have brought national housing, you know, like you have referenced, if it is my State of Alabama or if it is Michigan or Pennsylvania, you have got the same opportunity in a sense with the mortgages. But is all of that basically based, or a lot of it, on the express or implied guarantee of the taxpayer? And how important is that?

Mr. WATT. Well, you have asked several different questions. Let me try to go back and——

Senator SHELBY. You are up to the task, though.

Mr. WATT. ——try to address them as I remember them. I thought the first question you asked was——

Senator SHELBY. What have you learned?

Mr. WATT. What did we learn about the problems that caused the meltdown? I think what we learned, first and foremost, is that having one foot in the public sector and one foot in the private sector does not work because when you have a foot in the public sector, taxpayers take the risk, and a foot in the private sector, shareholders take the benefit. So I think the first thing I would try to solve is getting one foot out of the public sector and one foot in the private sector. And then the second——

Senator SHELBY. How do you do that?

Mr. WATT. Well, I think, first of all, you have got to build capital from the private sector that you put at risk ahead of taxpayers. That does not necessarily mean that there is not taxpayer remote backing of the mortgage sector, because I think most people agree that without remote backing of the taxpayers for the mortgage sector, you will not have necessarily a 30-year fixed-rate mortgage. So if you want to have a 30-year fixed-rate mortgage, I think you can have remote backing of the Federal Government. That will also lower rates because that allows access to capital from all around the world. People do not understand that people all over the world are financing our housing in this country because we were able to securitize and spread the responsibility of the capital and money responsibility around the world.

But the real problem was that I think because there was this competition to make money for the private sector, there developed a race to the bottom, and the competition was to get more and more and more business rather than a competition to provide responsible lending and backing of responsible loans. And both the private sector lenders and the GSEs were guilty of that. And so I always harken back to one thing that I said to Senator Corker in my confirmation hearing. What was needed in this industry was somebody to make responsible decisions and not let access overburden safety and soundness. Both of those are important responsibilities, and the most important responsibility we walked as FHFA and we have walked through our conservatorship and the enterprises should continue to walk going forward is balancing those two things, not a race to make more money, not a race to only provide access, but a balance of safety and soundness and access to credit. And it is a difficult balance to walk, and it has to be walked responsibly. It cannot be walked politically. It cannot be walked—I mean, you know, these are tough decisions, and they require good judgment.

Senator SHELBY. I agree with you.

Thank you, Mr. Chairman.

Chairman CRAPO. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Director Watt, thank you for your service and your leadership.

I want to ask about a few of the postconservatorship priorities highlighted in the perspectives document you sent to this Committee in January. Do you have concerns that a system with too many guarantors could result in a race to the bottom where guarantors chase volume by eroding underwriting standards and pricing?

Mr. WATT. Yes, I do have that concern.

Senator MENENDEZ. Do you believe that a mandate on guarantors to serve a national market is necessary to promote affordable and sustainable home ownership opportunities for creditworthy borrowers, including those in urban and rural underserved areas of the country?

Mr. WATT. I believe that, yes.

Senator MENENDEZ. And do you agree that guarantors should be prohibited from offering pricing discounts to lenders based on their higher volumes because it disadvantages smaller community lenders?

Mr. WATT. I do believe that, yes.

Senator MENENDEZ. All right. I deduced that from the document, but I just wanted to put it on the record.

Data released last week by the Federal Reserve Bank of New York shows housing wealth is becoming increasingly concentrated among older Americans, a marked change from before the crisis when younger and older Americans had similar shares of home equity. Moreover, home ownership rates continue to be down overall from their peaks, but this is particularly true for millennials. With mounting student loan debt, a limited supply of affordable housing, the difficulties of assembling a downpayment, I am concerned that too many of those who are coming of age during the financial crisis and recession are missing out on their opportunity to have a piece of the American Dream.

So under your leadership at FHFA, what steps have the GSEs taken to expand home ownership opportunities for younger Americans? And, looking ahead—second part of the question—what do we in Congress need to do to ensure millennials are not precluded from assessing affordable home ownership opportunities?

Mr. WATT. Well, we have taken some serious looks at the burden that student loan debt is placing on millennials, and we are looking at pilots that would address that. We have got to do it responsibly because student loan debt is a debt that gets taken into account in debt-to-income ratios. The question is: Are there ways that we could mitigate that by perhaps having parents be backers to millennials?

The biggest problem is millennials do not have downpayments. They have exorbitant debt because of student loans. Nobody takes into account rental payments in assessing creditworthiness, or at least the credit rating score do not do that.

So there is this cascade of things that make it disadvantageous for millennials, and, in addition, our studies indicate that millennials are waiting later and later to get married, which has historically been a true indicator of when somebody wants to buy a home. So, you know, there are all kinds of things that go into this, and we try to take all of those things into account as we structure programs that will at least try to address, if not completely eliminate, these problems.

Senator MENENDEZ. Looking at what Congress could do, if we—for example, there is legislation that calls for allowing $1 trillion in student loan debt collectively nationwide to be ultimately refinanced at historical lows. We would significant cut the debt, and that might create an opportunity for those millennials who want to purchase a home to be in a better position to do so.

Mr. WATT. That would be one of the things that would be outside our lane, but, you know, that would be a legislative decision, so I try to stay out of those.

Senator MENENDEZ. I liked it better when you were in the legislative area.

[Laughter.]

Senator MENENDEZ. Finally, FHFA recently closed a request for input in updating Fannie and Freddie Mac's credit scoring model. S. 2155, which passed the House yesterday, requires the GSEs to establish a new process for approving the user of other credit scoring models, and I have concerns that this provision, which will soon become law, will delay your ability to update the credit scoring model, ultimately harming those consumers that could benefit from increased access. On top of that, I think this provision raises questions about competition and consolidation of power by the consumer reporting agencies.

Now that the input period is closed, do you have concerns about competition in the credit scoring marketplace?

Mr. WATT. Well, we had concerns about it initially because credit scoring is one of those things where, you know, competition is good if you are competing on the right things. But if you are competing just to get more business in the credit scoring arena, that is not a good thing. So we were very concerned about that and put a bunch of questions in our request for input so that we could get feedback, and we remain concerned about it. And people who commented were concerned about it.

Regarding the provision in Senator Crapo's bill on credit scoring, it could have come at a better time for us. I would have to say that. And we are trying to see whether we can proceed with what we had started by making the request for input on credit scoring and get to a conclusion that will now have to be an interim conclusion because the bill, as I read it, would require us now to go back and make an assessment and set up a set of rules about how to assess credit scoring agencies. So we do not want to delay—and that is, what a 2-, 2½-year buildout under the statute. It probably will take even longer than that, depending on how you define assessing credit scoring models. So it could have some impact on our ability to move forward on this, and so—but, you know, we will comply with the statute if it is signed by the President.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman CRAPO. Senator Corker.

Senator CORKER. Mr. Chairman, thank you. Director Watt, thank you for being here. You will be heading to North Carolina and I will be heading to Tennessee about the same time, it looks like. But I have enjoyed very much working with you. Mel, you and Bob have been very accessible to us. We have not always agreed, but I appreciate the way we have tried to talk through differences and tried to strengthen agreements that we have had. So, again, thank you for being here and for your service.

Mr. WATT. I have enjoyed working with you, too.

Senator CORKER. Thank you.

Mr. WATT. Sometimes.

[Laughter.]

Senator CORKER. The capital issues that you are talking about, I know that you are getting ready to put some papers out. I appreciate some of the conversations our staffs have had about that. Do you agree, though, that capital for these institutions should be fairly close at least to some of the larger banking institutions that we have in our Nation?

Mr. WATT. Well, I think you will see when we put the proposed rule out that we are following a format that is similar to banking capital. But these enterprises are not banks, and capital is about protecting against risk. So you have to really assess the risks that are being undertaken, compare them to what risk banks have, and there are some differences. And one of the reasons we think it is good to put this proposed rule out is to start those very kinds of discussions because you do not want a cookie-cutter approach to building this capital rule.

Senator CORKER. Yes. They are monolines. In many ways the risk is concentrated, so some people might say that they would be riskier than banks. But I know that——

Mr. WATT. Some people would say that, and then some people would say that by risk-transfer transactions, they might be less. But, you know, I think those are discussions that really need to be had, and they need to be transparent discussions, not behind-the-scenes decisions.

Senator CORKER. Well, I appreciate you getting ready to send those out, and there will be discussions.

My sense is that the institutions may well stay in conservatorship for some time, and I think your discussion about having one foot in one camp and one foot in another is true. And I think for some people—not everyone—them being 100 percent in the Government footprint where, you know, the Government obviously is putting up all the risk by guaranteeing the mortgages, and there are some people that kind of like it that way. Seriously, they like the fact that then the Government benefits from whatever surpluses, if any, exist.

I know that likely there will be some executive decisions that are made that hopefully can be complemented over time with some legislative action. I do not think there is any way there is going to be legislative action that takes place, at least not in the near future. But what I hope is going to happen——

Mr. WATT. I am sorry to hear you say that.

Senator CORKER. Well, I am just acknowledging the realities of it. I think you know I began—my first bill, I wound down both institutions. I did not have any cosponsors. And we have evolved to a place where we have tried to seek a balance, working with you and Bob and other members of this Committee. But, you know, it is evidently not going to happen. We may leave a bill behind that others may pick up at some point.

One of the things that—I know we have gotten our hedge fund activity in both operations down to about $250 billion each, which was the Treasury directive, the portfolio business that occurred within the institutions, and I appreciate the——

Mr. WATT. We are actually ahead of schedule on that, yes.

Senator CORKER. I appreciate you doing that. You know, the footprint had been reducing to a degree. There are some areas where

it has expanded, and I wondered if you might respond. We have a situation now where Freddie Mac is now lending, they have become a lender to their servicers. Some of the pilot programs over the last 5 years have actually expanded the role of the two GSEs. The multifamily business, which is operated in a great way—I mean, they have done an outstanding job. But at Freddie, it is up about 30 percent over last year. Fannie recently raised debt-to-income from 45 to 50 percent, which is, again, an expansion. The GSEs have pushed to 3 percent downpayments, again, an expansion. And now we have Fannie that is financing Airbnb, again, an expansion. And then one last one, we have—I know this is one of the bad guys that our Ranking Member would not appreciate, but Invitation Homes just did a dramatic expansion by having a huge investor-owned acquisition. Again, I am not criticizing what they are doing in any way. I am talking about the investor-owned enterprises. But, in essence, that was loaned to by one of the GSEs.

So there has actually been an expansion of mission, and so while we have gotten the portfolios down, it appears that instead of trying to decrease the footprint over time, over the last 5 years, we are beginning to, especially in the last couple years, expand the mission.

Mr. WATT. I think if you look at every single one of those things that you talked about—except Airbnb, which I want to come back to and correct what you said. We are not financing Airbnb. Be clear on that. All we have said is that income that people make from renting their houses through Airbnb or their apartments through Airbnb can be considered as income. We are not financing Airbnb. So let us be clear on that. But everything else that you talked about, including multifamily, Invitation Homes, all of that is in the space dealing with affordable—backing of affordable loans so that people can get access to affordable housing. And that is where the challenge comes in because when you do that, there is the perception that you are doing it by increasing risk. As the Chairman said in his opening statement, we have lowered the credit standards. I did not agree with that. What we have done is tried to responsibly make lending available to other people. So this 30-percent expansion you are talking about in Freddie's multifamily space is only in the affordable area. And if we were not doing that, the private sector would not be doing it. And there would not be affordable rental housing taking place.

So you have to put—I think all of the things that you have talked about there, the whole list, except for Airbnb, which, you know, I just have to take issue with your characterization, but everything else that you described is designed to make housing more affordable to people who cannot now afford to have either affordable home ownership or affordable rental. And if we do not do that, I do not know who does it in this country when the mandate of these enterprises is to provide liquidity for the housing market. I just do not know how else we do that.

Senator CORKER. I understand, and, again, it is an observation, though, that the mission continues to expand.

Mr. WATT. I do not think that is—the mission has been there all along.

Senator CORKER. But the footprint continues to expand, and I think where we were headed at one point was toward trying to reduce the footprint and the reliance. And instead, over the last couple years, it has expanded, and taking Airbnb income into account when making a loan is what I was referring to, and that is what is happening.

I am sorry it went over so long, and——

Mr. WATT. Can I just make one comment?

Senator CORKER. ——filibustering, and I tried to do a good job of cutting through.

Chairman CRAPO. All right. Senator Warner.

Senator WARNER. Director Watt, it is great to see you.

Mr. WATT. Good to see you.

Senator WARNER. I want to thank you for all your service. I also, as someone who, as Senator Corker and others, have spent years trying to learn the housing finance business, it is extraordinarily complicated and complex. I support a lot of the things you have done around affordability and access. I think it is very important. I support particularly—and one of the things we think we have learned, particularly on the multifamily side, how successful the program has been on multifamily, did not cause the crisis in the first place, and we need to continue that good work.

But one of the things we have granted you as Congress, because we failed to put in place a legislative solution, we have granted you as FHFA Director during conservatorship enormous, enormous power. And I think you have generally done a very good job.

What I wonder, though—and I just have some questions I would like to run through, and hopefully we can get brief answers because I have got a couple of follow-ups. Your tenure ends in January of 2019, and I would argue editorially that the Trump administration has not been necessarily favorable toward a lot of the expanded access and other issues. But the Trump administration—elections have consequences—they are going to appoint a new Director in 2019, and some of those forces who say they are for progressive causes, who have been advocates of the status quo, I really do wonder what they will say come January when a new Director is put in place.

Let me just go through, I believe, some of the powers that your replacement will have, particularly if these entities remain in conservatorship. Wouldn't the next FHFA Director have the authority to lower loan limits?

Mr. WATT. Within statutory limits. There are statutory requirements related to loan limits.

Senator WARNER. They would be able to——

Mr. WATT. Yes.

Senator WARNER. Would he or she have the authority——

Mr. WATT. And some argue that as conservator we could disregard the loan limits.

Senator WARNER. Some of these could even be——

Mr. WATT. But I do not agree with that.

Senator WARNER. But a future Director might.

Mr. WATT. A future Director might.

Senator WARNER. Would he or she have the authority to tighten minimum credit requirements?

Mr. WATT. Yes.

Senator WARNER. Would he or she have the authority to raise the overall G-fee and increase the loan level price adjustments?

Mr. WATT. Yes.

Senator WARNER. Would he or she have the authority to reduce GSEs' offerings of certain loan types?

Mr. WATT. Yes.

Senator WARNER. And in an area that you have leaned in, I think appropriately, would he or she have the authority to move GSEs to fully based risk pricing while at the same time rolling back affordability goals and duty-to-serve goals?

Mr. WATT. Yes.

Senator WARNER. So all of the work that you have been able to move forward by leaving these entities in conservatorship, a new Director, particularly appointed by this Administration, could roll back all that progress and do it administratively without any input from Congress. Is that not correct?

Mr. WATT. I think that is right. Obviously, some of those decisions could have consequences for the economy, and I would assume that those consequences would be taken into account because this is a substantial part of the economy. So whatever decisions get made, I hope they get made in a——

Senator WARNER. We are hoping, based upon maybe a new enlightened Presidential appointee. I am not sure I would make a large wager on an appointee that would follow your direction in the agency.

Also, some of the more recent actions that some of us have been talking about had actually—I think some of the proposals we have been talking about would have dramatically increased the amount of resources going to low- and moderate-income homeowners and I think hopefully will be a guidepost on a going-forward basis. I just do not understand some of the folks who seem to be caught up with status quo, thinking that status quo is going to be maintained, and that your progressive leadership is going to be replaced by this Administration's appointee come January when that person will be put forward.

In the last couple of seconds here, wouldn't the new Director also have the ability to put the entities through receivership? And what would be the effects of putting these entities through receivership?

Mr. WATT. The authority is there. The impact of doing that would be to erase—without some legislation that did otherwise, would be to erase the Government backing. And so that would certainly be a consequence of that.

Senator WARNER. I just believe, Mr. Chairman, that there are a lot of folks who have been reluctant to fully engage—and you have fully engaged, and I appreciate your work with our office, but a lot of folks who have been reluctant to fully engage on what a legislative solution would be that would still make sure we have that kind of access and affordability. And my great fear is having indicated all the powers that a Director has under conservatorship, that come next year at this point in time there may be a lot of folks saying, "Gosh, we missed a really great opportunity."

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman. Director Watt, thanks for returning to the Committee. Good to see you again.

Mr. WATT. Good to see you.

Senator TOOMEY. The first thing, just quickly. As you are very well aware, under the Preferred Stock Purchase Agreement, the Treasury made funds available to the GSEs, and over the course of several years, there were drawdowns on this availability. My understanding is the cumulative total of the draws is about $191 billion. Does that sound about right to you?

Mr. WATT. That sounds about right, yes.

Senator TOOMEY. And then there was an obligation to pay 10 percent on that initially, and then the Government came along and abrogated that agreement and basically forced a new agreement whereby it just confiscates everything that is earned. And so instead of a 10-percent dividend payment, which was the original contractual agreement, there is just a sweep, so all retained earnings go to the Government.

The cumulative total of what started as dividend payments and then became the sweeps is about $279 billion. That is according to FHFA's data. Does that sound about right to you?

Mr. WATT. I do not—I have the figures somewhere, but I think that is probably in the neighborhood, yes.

Senator TOOMEY. So, anyway, I do not have the precise dates on which the drawdowns occurred, and I do not have the precise dates on which the payments were made, so you cannot make precise interest accrual calculations. But you can back-of-the-envelope that, and if the third amendment had never occurred and instead the 10-percent payments were made—and, by the way, the third amendment was justified at the time, and it is still on the website, as being a favor to Fannie and Freddie because they would never be able to pay the 10-percent dividends. In fact, it occurred just as they were turning the corner and starting to make money.

My point is if you were crediting amounts above a 10-percent interest payment to a principal repayment, it looks to me on the basis of a back-of-an-envelope that the total obligation that the GSEs would owe is somewhere between 0 and $50 billion. Does that sound about right to you?

Mr. WATT. I honestly do not know, Senator Toomey, because I was not involved in any of those discussions about the third amendment, the PSPA, and I just—I mean——

Senator TOOMEY. Yeah, OK.

Mr. WATT. Our agency is a party to the agreement, but that is all——

Senator TOOMEY. I got it.

Mr. WATT. ——the involvement I had with it.

Senator TOOMEY. So I would like to move on to actually a follow-up to the line of questioning that Senator Corker was pursuing, because some of the new practices and pilot programs caught some of my constituents and some Members of Congress a little bit by surprise. Are you familiar with Freddie's pilot program called "IMAGIN"?

Mr. WATT. Yes, I am.

Senator TOOMEY. OK. So my understanding is that is a new practice whereby rather than having the mortgage insurance provided at the point of sale, the point of origination, instead Freddie essentially assigns one of several prearranged insurers to be providing the mortgage insurance. They are usually Bermuda-based, and that is a departure from the historical practice of Fannie and Freddie. And so my question is a simple one: Why the change? What is the purpose of this pilot program? And why is it needed now?

Mr. WATT. Well, I think we are constantly trying to make the market more efficient, and this is one of the things that we are testing to see if it will make it more efficient. It is absolutely consistent with the statute.

Senator TOOMEY. I do not dispute the legal authority to do it. I am just—you know, as I say, it caught us by surprise. It caught the industry by surprise. It is somewhat disruptive to the private mortgage insurance industry. And I am just wondering why there was not maybe even a traditional rulemaking process or a period of public comment to consider this. And there are other areas. Senator Corker went through a list that included the financing of the mortgage service companies that, again, this looks like new kinds of activities, new practices, where we have not seen an explanation, an opportunity to comment and to get public input on.

Mr. WATT. You know, if I took public comment on every pilot that we did, we would never do any. You know, there is—and we have information that determines how we move forward. We approved that transaction. So Freddie just did not jump up and do it on their own. We had some discussions with the industry about it in advance, but, you know, we cannot allow any particular interest in the housing finance system to protect their turf by saying you cannot innovate. This is a risk transfer, a front-end risk-transfer transaction that everybody has been begging for.

Senator TOOMEY. It is a change in the mechanism by which the risk transfer occurs, right? The risk transfer occurred in the scenario where the mortgage insurance is originated at the point of origination. You have changed the mechanism of applying it. We are pretty much out of time, but I would appreciate it if you could send us an explanation for what is the rationale behind this program.

Mr. WATT. I would be happy to do that.

Senator TOOMEY. What does it hope to achieve? Why has it been implemented? And what about doing it now as opposed to the decades during which my understanding is there was a different practice?

Mr. WATT. I would be happy to do that.

Senator TOOMEY. Thank you.

Chairman CRAPO. Senator Schatz.

Senator SCHATZ. Thank you, Mr. Chairman. Mr. Watt, I want to thank you for your years of service. You and I got a chance for the first time to sit down and talk at length, and I was able to understand why you are so highly regarded on both sides of the aisle, on both sides of the Capitol. So thank you for your many years of service.

Last year Fannie Mae announced a pilot to allow homeowners to overcome downpayment hurdles by using income from home-sharing, Airbnb in particular. But at the same time, several cities have conducted studies that indicate that there is at least a marginal decrease in housing supply where these home-sharing platforms are prevalent. And so my question for you is: Both at the policy level and in terms of analysis, how do you balance those two things? They seem to be in tension. But I also think there is just a lack of credible data because a lot of the data is done by individual cities, and some of the data is either provided by Airbnb or their adversaries. So it seems to me an appropriate role for FHFA to analyze the impact of these platforms on the availability of housing.

Mr. WATT. We have actually done work in that area. In fact, I have been to California and met with the folks at Airbnb. We had very serious concerns about the impact of these kind of house-sharing rent arrangements on the availability of housing. There is really nothing we could do about it, but we wanted to understand the impact. And I do not think we have a credible answer about what impact this is having yet, but we are still gathering information. In the meantime, the income that comes from it, I mean——

Senator SCHATZ. You feel like you have got to count it——

Mr. WATT. ——to not count that would be, I think, unfair to the people who are doing it.

Senator SCHATZ. Fair enough, but, obviously, these things are in tension in terms of your goals. But I will also offer that we really do need some objective information here, because nobody who is providing me any information regarding the impact of these platforms is disinterested. They are not bad people, but we need some objective analysis. And so although I am sure you have a number of staff people kind of ruminating on this, I think it is about time for a proper study that policymakers can analyze, both at the Federal level but maybe even more importantly at the municipal level.

Yesterday, as you know, Congress passed a law requiring you to consider alternative credit scoring models, which actually sounds pretty good to me. Senator Kennedy and I and others have been working on reforming what I think is an absolutely broken system with these credit bureaus. And the problem is essentially they operate in the dark. They are unaccountable. We are characterized as customers, but we never enter into a customer-business relationship. They are monetizing our data without our permission, and as you know, there are significant error rates. Nontrivial numbers of people are unable to get a house, a job, a car as a result of the errors that these credit bureaus make. And so the idea of an alternative scoring model makes a lot of sense to me.

Here is the catch: VantageScore is really what we are kind of considering at this moment, and VantageScore is owned by the three credit bureaus that we are all so angry at.

And so my question for you is: How concerned are you that moving to a VantageScore model will give too much power to the existing infrastructure and do nothing to reform it?

Mr. WATT. Well, we expressed that as one of our concerns in the request for input that we put out, and not surprisingly, we got some feedback from responders to that request for input that expressed the same level of concern. This is an opaque area. It is

hard to get good information. And I have said repeatedly that of all of the challenges that I faced at FHFA during the period I have been the Director, this is clearly the most difficult issue that I have had to deal with, because it is hard to get information, people protect their vested interests. The theory is that competition is good regardless of—you know, competition is good as long as you are competing for the right objectives.

Senator SCHATZ. And if it is real competition.

Mr. WATT. And if it is real competition.

Senator SCHATZ. If these three credit bureaus own the new alternative, this is worse than the status quo. This is doubling down on the status quo. And just one final point about this. In terms of the data sets that they currently use, they actually exclude certain data sets because they cannot rely upon it. But now their theory of the case is if you take all the data that they are in possession of, which they currently do not use because they should not use it, if you put it in one big pile, that creates some reliable algorithm that smoothes out all the admitted errors in their data sets that they have excluded. It is totally preposterous, and only in Congress do we consider taking the three incumbents and allowing them to create a new entity, only in Congress do we consider that an alternative and competition. This is not competition. This is doubling down on the status quo. And I certainly hope that as you abide by the statute, you think very carefully about whether or not this is going to make the situation worse.

Thank you.

Chairman CRAPO. Senator Cortez Masto.

Senator CORTEZ MASTO. Thank you. Director Watt, it is good to see you again. I also want to echo the comments of my colleagues. Thank you for your service.

Mr. WATT. Thank you.

Senator CORTEZ MASTO. And thank you to your staff who are here as well. I appreciate the conversation this morning.

Last year when you testified, I urged you to prohibit contract for deed mortgages. As you well know, these are installment contracts where borrowers build no equity. They lose all of their monthly payments and downpayments if they miss a single month's payment.

What is the status of contract for deed mortgages?

Mr. WATT. Well, we basically prohibit them, but we are doing some looking into shared equity arrangements, which could be a means of getting people from rental into home ownership. "Contracts for lease" is a bad term, but, you know, one way of getting from rental to home ownership is to start off in rental and go through the process of proving that you are able to pay the rent and have that applied.

I am not as categorical about saying that——

Senator CORTEZ MASTO. No, and I appreciate you prohibit them, which is fantastic. But you are still trying to figure out a way——

Mr. WATT. Yes, yes.

Senator CORTEZ MASTO. ——to move from rental to home ownership.

Mr. WATT. Absolutely.

Senator CORTEZ MASTO. And that is something that we should be working with you on trying to achieve.

Mr. WATT. Yes.

Senator CORTEZ MASTO. So thank you for that.

Let me jump to affordable housing, because in Nevada this is the number one issue that I hear in the northern part of the State and the southern part of the State. We do not have enough affordable housing, both in our urban and rural areas. We have a lack of housing, a lack of inventory. And so one of the things I wanted to talk to you about, you know Nevada was ground zero for the foreclosure crisis, and last year we discussed my concern about FHFA allowing Fannie Mae to guarantee a billion dollar loan for a single-family rental landlord that owns nearly 1,000 properties in Nevada. And let me just couch this. We do not have enough housing, rents are too high. I have just seen a statistic that is horrific. This is March of this year. Nevada ranks last among all States for providing affordable rental housing for its poorest families.

And so the challenge we have, high rents, not enough inventory, there is this $1 billion loan that you engaged in with a company. I am concerned that FHFA subsidy for this single-family landlord is putting home ownership out of reach for many Nevadans. What's more, I am more concerned that the deal did not come with any affordable housing conditions or tenant protections for those rental properties.

So last time we talked, you were studying this. It had been relatively new. You wanted to study the impacts. What research have you done about the impacts of this deal on home ownership in communities like Nevada?

Mr. WATT. So we have done several things. First of all, we are not doing any more that do not have affordability requirements in them. We are gathering information which is the reason that we approved the Invitation Homes transaction it's called so that we could gather information about whether we could raise the standards in this area. And we are trying to figure out whether this is really reducing home ownership or whether it is paving the way for more people to get into home ownership. I mean, I think you can argue both sides of that.

A lot of people do not want to rent in high-rises. They would rather rent a single-family home. And a lot of these are people who could afford to buy a home. So we are still trying to evaluate that. That is one of the things we are trying to do.

The second thing is Freddie Mac is undertaking similar things with private sector entities that are doing almost exclusively middle- and lower-income affordable kinds of projects. This is one of these areas where we are just—we are testing and learning.

Senator CORTEZ MASTO. Well, and that is why—my time is running out, but this is why I inquire, because I have had roundtable discussions in the northern part of the State and the southern part of the State with our key stakeholders, including Government entities, about how we address affordable housing. If you have data, if you have information that can help us as we go down this path and figure out an answer, a solution to more affordable housing, not just in Nevada but across the country, I would be open to working

with you. So I would love to see the data, what you have learned from it, and how we put protections in place.

Mr. WATT. We will give you the information we have on this transaction and on Freddie's transactions as they develop the information. It takes a while to get the information so that we can analyze it. But it is clear that supply of housing is a problem. I identified that as one of the issues in my written statement. I did not specifically deal with it in my oral statement because the oral statement has to be shorter. But prices are a function of demand and supply. Just like everything else, housing prices are a function. And there is just not enough supply being generated now. Nobody is building new housing. And when they do build new housing, it is at the very top of the market.

So it is just a very difficult problem that has multiple aspects to it, some of which we cannot control. But to the extent we can gather information and use that information to help impact that, we are trying to do it.

Senator CORTEZ MASTO. Well, thank you. And I know my time is up, but I appreciate your comments earlier, because this is something your agency is working on. And if you are not doing it, nobody else is.

Mr. WATT. That is correct.

Senator CORTEZ MASTO. And so that is our challenge. So thank you for everything you do. I appreciate it.

Mr. WATT. Thank you.

Chairman CRAPO. Thank you.

Senator Heitkamp.

Senator HEITKAMP. Director Watt, thank you so much for your commitment to the country and commitment to affordable housing. I think we all look upon your tenure and think about what you brought to this discussion, and I think you have brought not only an incredible capacity to understand this issue, but also a sense of your community back home and what you need to do to make things better in this country for people who go to work every day who cannot afford housing.

You know, I find it remarkable that we can talk about prescription drugs and we can talk about tax reform and we can talk about all these things that hit the pocketbook. But the single greatest challenge American families have right now is finding affordable housing, and we do not seem to—it never seems to rise above kind of the political rancor or the prioritization that we need to advance in this body if we truly represent working people.

You know, I have watched steadily as the percentage of disposable income that is utilized for housing actually increases year over year, causing huge amounts of disruption in the community. And as you said, it is a function of supply and demand. So I want to talk about a couple things.

Number one, I think Senator Menendez asked you about your comments regarding too many market entities. You kind of talked a little bit about that. Right now we have two. There are some proposals to go to five. You think five might be too many. As we look at advancing any kind of legislation right now, do you have a number in mind where it would not be too many?

Mr. WATT. I do not. But regardless of how many there are, we need to control what they are competing for, which is why in our perspectives document we thought of this, of the service that the enterprises play, Fannie and Freddie now, and future guarantors would play, as utilities.

Senator HEITKAMP. I think this is going to be very, very hard to kind of quantify and work through as we look at this, understanding that there are people who, if they were here right now, they do not think there should be any level of guarantee, any level of Federal participation, which I think would lead to a collapse of the 30-year fixed-rate mortgage. No one would take on that credit risk, that interest rate risk.

And so, you know, when we talk about—one of the issues that I would like to just kind of put on your radar, because there is always a lot of focus on urban and suburban housing, one of the greatest challenges that we have in North Dakota is affordable housing and quality housing in rural areas as well. In fact, we used to in economic development think if you build it, they will come. But a lot of people are not moving to those areas because they cannot find affordable housing. And so what are your thoughts on the challenges of increasing the supply of affordable housing? I just want to build on your discussion with Senator Cortez Masto. If, in fact, we build more supply and we have a demand, that is going to drive up prices. You see this right now in Seattle, houses that maybe 10 years ago would have sold for $150,000, $200,000, now being $1 million houses. So that house that would have been affordable 10 years ago is no longer affordable because of the lack of supply.

How do we, without some kind of Federal program guaranteeing access to affordable housing—even if we build a supply of housing, it is going to be gobbled up at the top end. So how do we tackle this problem of affordable housing, making sure that working families can get into a house and save for retirement?

Mr. WATT. What we have tried to do is support the market at the affordable level, at the entry level, because right now——

Senator HEITKAMP. But do you think it is working?

Mr. WATT. Well, it is certainly not working effectively.

Senator HEITKAMP. That would be my point.

Mr. WATT. And efficiently, right.

Senator HEITKAMP. There is no indication that what we are currently doing is solving this problem. And I think it is the sleeper issue for this body, economic issue in this Congress and the next Congress. And so it cannot be just about GSE reform. It cannot be just about providing that 30-year fixed-rate mortgage. We have got to look at the supply of housing, how we can—without disrupting the market too dramatically, how we can get people into homes. And I have seen projects in San Francisco where, you know, developers will build and there is a set-aside for policemen who want to live in the city, who do not want to drive, you know, 45 minutes into the city to serve their community but cannot afford to live in the city that they put on, you know, armor every day to protect. There is something wrong with that in this country.

And so I want to applaud you because I know you have been a champion for affordable housing. I know that you have looked at

it from every angle. I hope that you use the remaining time that you have to really drill down on this issue of affordability, and do not just look at it as building supply. We cannot get affordability by simply building more houses, because those houses may be houses that, you know, are $200,000, $300,000 houses that will sell in certain markets for $500,000 or $600,000 because of the lack of supply.

So single-family housing, ownership, and affordability are key components to what built this country. I hope that you will use your time remaining well and try and help us figure out how we are going to get more Americans into that dream of home ownership.

Mr. WATT. Thank you.

Senator HEITKAMP. Thank you.

Chairman CRAPO. Senator Jones.

Senator JONES. Thank you, Mr. Chairman. Thank you, Director Watt, for being here, and thank you for your service. I will go through all of that as well. But I also want to thank my colleagues, Senators Cortez Masto and Heitkamp. I am also inclined to just say, "Ditto," and call this hearing a day.

[Laughter.]

Senator JONES. But I really appreciate——

Mr. WATT. The Chairman might appreciate that.

Senator JONES. Yes, I understand that.

Chairman CRAPO. Should we do that?

[Laughter.]

Senator JONES. I am sorry. There is no such luck in the U.S. Senate, OK?

Mr. WATT. I might even appreciate it.

Senator JONES. This will be easy, though, but I appreciate having that dialogue about affordable housing. And I want to talk just a moment, though, about the other leg, the 30-year fixed-rate mortgage. Everyone seems to say that that is such a staple, we have got to do something about the 30-year fixed-rate mortgage for creditworthy borrowers across a wide range of incomes. And we talk about that a lot, but yet we are still struggling with how to do that.

I want to ask you from maybe a little bit different angle, and the answer is probably going to seem obvious, but in my short time here, I realize that sometimes even the obvious—we need to be reminded of the obvious. So let us talk about the fact that suppose Congress—we do a very poorly designed attempt to create a system that did not prominently feature the 30-year mortgage. What kind of effect is that going to have on our markets? What would happen to us?

Mr WATT. Well, I think if you reduced the term of a mortgage to 15 years, for example, the monthly payment on that mortgage is going to be substantially higher. It is going to price more people out of the market. If you move toward adjustable rate mortgages, people do not have certainty that allows them to plan for their future, so you could easily lose the certainty that comes with a fixed-rate mortgage.

So these decisions have real impacts, and imagine paying what would be 30 years of payments, compressing those payments into

15 years. It does not double the payment, but it would substantially increase.

Senator JONES. And it would just knock a lot of people out of the market.

Mr. WATT. Yes, it would knock a lot of people out of the ability——

Senator JONES. And I am also assuming—I have seen so many people in terms of the adjustable rate mortgage, it is great when you can first get hold of it and it is a low thing, but all of a sudden, you do not plan on whatever might come down the road, and the next thing you know we are back in a foreclosure problem. Is that right?

Mr. WATT. That is correct.

Senator JONES. All right. I want to mention briefly in the time remaining—and I applaud you for your work in expanding the Neighborhood Stabilization Initiative, which is a really innovative program, I think, to tackle the lingering effects of the foreclosure crisis. This program was expanded to Birmingham, Alabama, in December of 2017. The number of properties in Birmingham is fairly modest, but it is also persistent, and I am hopeful that that Neighborhood Stabilization Initiative can help our communities and groups and local governments turn a corner and foster economic development.

So I would like for you to just talk about that program just a little bit and the lessons learned since you started that program in 2014, how they have been applied to cities as you expand, like Birmingham, and what you see as the future of that particular program.

Mr. WATT. Well, we hope that a time comes where you do not need that program anymore, but that time is not coming anytime soon. So the theory of the program was you had all of these houses that were in foreclosure, in distressed neighborhoods, and you could sell them off to investors who could make money, or you could incentivize neighborhood groups to be involved with purchasing them and stabilizing the neighborhood—neighborhood stabilization. So if these houses sat there empty, they were going to depress the value of houses down the street or right next to them. So we did not want that to happen. We wanted people who had a vested interest in the neighborhood to be involved with either owning these properties so they could rent them to people so that they could convert them to homeowners, and the Wall Street interests were gobbling these things up initially, so the Neighborhood Stabilization Initiative has played just a very critical role. And we started it in the places where housing had taken the hardest hit as a result of the economic downturn. And then we expanded it to places that—but all of it was scientifically based. It was based on the numbers, who got hit the hardest and what neighborhoods were getting hit the worst and were most vulnerable, which is why we called it "Neighborhood Stabilization Initiative". And it has been a great success in places. It does not solve all the problems. Nothing we do solves all problems.

Senator JONES. Well, it does not solve all the problems, but it is a step in the right direction.

Mr. WATT. It is definitely a step in the right direction.

Senator JONES. I certainly applaud your efforts and innovative programs, because I think we do not see enough of that in Government sometimes with innovative programs, stepping out of your comfort zone to do something a little bit different. So thank you very much, and I hope that before your tenure is over that you will come down to Birmingham and see firsthand what we are trying to do with your programs. Thank you very much.

Thank you, Mr. Chairman.

Mr. WATT. I have got some good friends down there, so I would love to do that.

Chairman CRAPO. Senator Van Hollen.

Senator VAN HOLLEN. Thank you, Mr. Chairman. Director Watt, thank you for your service. It was great to serve with you in the House, and we have been proud of your efforts in your current job.

I also want to applaud you for making sure that the Housing Trust Fund remains stable. I know after the passage of the tax bill there were some unanticipated consequences with respect to the valuation of the enterprises' deferred assets, which, as I understand, required you to take a draw from the Treasury.

Mr. WATT. That is correct.

Senator VAN HOLLEN. Is that right?

Mr. WATT. Yes.

Senator VAN HOLLEN. And that did put the Housing Trust Fund potentially in jeopardy, so thank you for taking action to save that.

My question does relate to the Housing Trust Fund. In your experience, what has been the role of the Housing Trust Fund in providing more affordable housing in the country?

Mr. WATT. Well, we think the Housing Trust Fund has been administered in a way that provides more housing. We do not administer the funds. Part of the funds go to Treasury to administer; part of the funds go to HUD to administer. So we do not necessarily track what happens with the funds after they go into the Housing Trust Fund. We can get that information and provide you more information on it, and we meet with interest groups around the country that say that the Housing Trust Fund is critical to the provision of affordable housing.

It does not solve the whole problem. Nothing we do solves the whole problem. But it is another ingredient and the problem would be worse without it, is I guess the way to characterize it.

Senator VAN HOLLEN. Look, I appreciate that. As you said, there is no one thing to address this issue, and even with the measures that have been taken, including your provision of funds to the Housing Trust Fund, we have actually seen an increase in—let me put it this way: a reduction in the supply of affordable housing around the country.

Mr. WATT. Right.

Senator VAN HOLLEN. Just stories in the last couple days about the reduction in supplies around the country of new housing starts and affordable housing.

What are the levers, other than that fund, what are the other key levers within your authority that relate to the provision of affordable housing? I know there are many moving parts within the enterprises, but what would you say are the key levers?

Mr. WATT. Well, a big key is there is not enough supply, and we are trying to attack it from that perspective. But on the borrower side, the big challenge for getting to affordable housing, there are two things: downpayment and debt-to-income ratios. And if you put those two things together and kind of stack them on top of each other, they do increase the level of risk. If the debt-to-income ratio is high and the value ratios are out of whack, you could have problems.

So we have tried to structure programs that do not increase the risk but take into account that debt-to-income is not necessarily a one-to-one correlation with defaults. In fact, there is a lot less correlation between debt-to-income ratios and defaults than people would postulate. There is a lot less correlation between downpayment, the amount of downpayment that people put into a home and defaults than people would postulate. You just have to control and have compensating factors when you do these programs.

So those are the things that we have tried to do, and we try to do it—and we have been successful, interestingly enough, because the default rates and the delinquency rates on those 97 percent product loans, low downpayment, and the higher DTI loans, debt-to-income ratio loans, those defaults rates are consistent with the default rates and the delinquency rates of people who are paying a lot more down. Now, we have not gone through a downturn in the economy that would test that longer term, but we think we have done this in a responsible way that is both safe and sound.

Senator VAN HOLLEN. I appreciate that. A last question, and I will be brief. And Senator Warner raised some concerns that I have with respect to who might succeed you and the enormous authorities that they have and what could be done with them. But one issue he did raise was the duty to serve. Now, as you know, that duty to serve has now been put into statute as part of the 2008 Housing and Economic Recovery Act, HERA. So can you just talk about that issue? Because it is a statutory requirement. How much does the management oversight provided impact that duty to serve?

Mr. WATT. Well, we have to do it responsibly. I think the point that Senator Warner was making was don't you have the authority not to do duty to serve? Well, yes, the prior Director of this agency did not do a duty-to-serve rule. We did a duty-to-serve rule.

Senator VAN HOLLEN. Even though it is a statutory requirement?

Mr. WATT. Even though it was a statutory requirement. We did a duty-to-serve rule. There was no duty-to-serve rule before I became the Director of this agency, so we went through the process, and we are controlling it in a way to make sure that it can be implemented safely and soundly. And, you know, the people who wanted it, interestingly enough, are people who are now sometimes the most vocally opposed to it. Duty to serve is really about serving rural and manufactured housing interests. Think about who uses those programs more than anybody else. Right? So duty to serve is an important ingredient to the provision of housing in this country, because in rural areas people use manufactured housing. In North Carolina, in Alabama, in Nevada, you know, in Kentucky, Tennessee, you know, manufactured housing, there is a lot of man-

ufactured housing, and it is more higher quality now so it can be done more safely and soundly.

So we have had to put controls around it, but having a rule and having the enterprises go through the process of making proposals that get commented on and monitoring how it is done is critically important to the success of this program.

Senator VAN HOLLEN. Thank you, Mr. Director.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator. And that concludes the questioning and the hearing. Before I give the final wrap-up instructions, I want to again thank you, as I think every Senator has, for your service, Director Watt. I have appreciated working with you, and as I said in my opening remarks, I intend to keep working with you until the very last day, and thereafter.

Would you like to say something?

Senator BROWN. Yes, I would add I hope this is not your last hearing, Director Watt.

Chairman CRAPO. That is right. We are all kind of——

Senator BROWN. It is with great sincerity and genuineness that I say that.

Chairman CRAPO. It is very possible this will not be your last hearing. Who knows?

[Laughter.]

Mr. WATT. I was feeling pretty good until both of you all said that.

[Laughter.]

Chairman CRAPO. Well, keep that smile on your face, and we will keep working with you. We are going to work aggressively on housing finance reform, and I think that there is an opportunity for us to make great progress. I do not count anything out, even in this Congress. But no matter what happens, we will be moving the ball down the field and appreciate your help and your assistance in doing so.

For Senators who wish to submit questions for the record, those questions are due on Tuesday, May 30th, and I encourage you, Director Watt, to respond to questions, if you receive them, promptly.

And with that, this hearing is adjourned.

[Whereupon, at 11:38 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF MELVIN L. WATT

DIRECTOR, FEDERAL HOUSING FINANCE AGENCY

MAY 23, 2018

Chairman Crapo, Ranking Member Brown, and Members of the Committee, thank you for inviting me to testify this morning.

At my last appearance before this Committee, I described at some length some of the many ways FHFA has worked to reform Fannie Mae and Freddie Mac (the Enterprises) while they have been in conservatorship. I am pleased to report that the work and reforms in all the areas I outlined in my prior testimony have continued. Detailed updates on recent developments in some of these areas are included in the 2017 Scorecard Progress Report, Credit Risk Transfer Progress Report, and An Update on the Single Security Initiative and the Common Securitization Platform. For the convenience of the Committee, we have also provided to each member a copy of FHFA's Annual Report to Congress which includes a recap of FHFA's conservatorship of the Enterprises and its supervision of the Enterprises and the Federal Home Loan Banks during 2017.

At your last oversight hearing I also focused some of my remarks on my concern that the capital buffers for the Enterprises were scheduled to reduce to zero as of January 1 of this year. I expressed my concern that zero capital buffers would almost certainly lead the Enterprises to have to make additional draws of taxpayer support that could potentially result in negative consequences for liquidity and market stability. I am pleased to report that the Secretary of the Treasury and I were able to reinstate a $3 billion capital reserve buffer for each Enterprise through a letter agreement that modified the terms of the Senior Preferred Stock Purchase Agreements (PSPAs) to address those concerns. While both Enterprises were required to make small draws of taxpayer support in the last quarter of 2017 as a result of revaluations of their deferred tax assets following the passage of the tax legislation last year, I am confident that the modest buffer adjustments agreed to with Secretary Mnuchin will avert the need for the Enterprises to make additional draws of taxpayer support in the future in the absence of exigent circumstances.

When I was last before this Committee, several Members of the Committee also asked me to provide FHFA's views on the critically important topic of housing finance reform. In response to those requests, on January 16, 2018, I provided to Chairman Crapo and Ranking Member Brown a document entitled "Federal Housing Finance Agency Perspectives on Housing Finance Reform" (the Perspectives Document). As I indicated in our Perspectives Document, we consider the perspectives we expressed to be "responsible, balanced, viable and important to consider," and I am happy to answer any questions Members of the Committee may have about them. However, I think it is also extremely important for me to emphasize points that I made when I sent the Perspectives Document to the Chairman and Ranking Member to ensure that Members of this Committee understand that FHFA continues to be clear about the role we expect to play in the housing reform process. In my letter to the Chairman and Ranking Member, I said:

> We seek to provide our views independently and transparently to those who have requested them while continuing to provide technical assistance to the Committee and its members on other proposals that may be introduced. Consequently, to the extent that any proposal gains support from members of Congress, whether it includes the perspectives contained in the enclosure or not, we look forward to continuing to provide technical assistance to facilitate your work. This is consistent with my strongly held view that it is the prerogative and responsibility of Congress, not FHFA, to decide on housing finance reform.

To be clear, despite having expressed views in our Perspectives Document as some Members of this Committee requested, I want to reaffirm my strongly held view that it is the responsibility of Congress, not FHFA, to decide on housing finance reform and I hope you will do so expeditiously. On September 6 of this year, we all will mark an occasion that I believe I can confidently say no one expected or foresaw back in 2008. That will be the 10-year anniversary of the Enterprises' conservatorships. As I first said publicly in a speech at the Bipartisan Policy Center on February 18, 2016:

> FHFA's role as conservator of Fannie Mae and Freddie Mac has been unprecedented in its scope, complexity, and duration—especially when you consider Fannie Mae and Freddie Mac's role in supporting over $5 trillion in mortgage loans and guarantees. This is an extraordinary role for a regu-

> latory agency also because we are obligated to fulfill both the role of supervisor and conservator at the same time.

I have expressed this opinion, perhaps using different words, on numerous occasions since then. I have also expressed repeatedly my firm belief that these conservatorships are unsustainable.

I spent the bulk of my time before the Committee last year describing some of the important reforms FHFA has made to the Enterprises while they have been in conservatorship, things I referred to as "GSE reform." However, this could well be the last time I appear before this Committee as Director of FHFA, and I believe it is important for me to identify and focus today on some of the serious challenges that remain ahead. Some of these challenges are obviously exacerbated and made more difficult to deal with because we have been operating Enterprises of this size in conservatorship for such a protracted period of time. From my perspective, as I have said before, the challenges in this category will become more and more difficult the longer the conservatorships continue. However, there are also challenges that will continue regardless of whether the Enterprises are being operated in conservatorship. Throughout my term as Director of FHFA, we have made concerted efforts to address and minimize the adverse impact of all housing challenges, regardless of whether they fit into the former or the latter category.

One challenge that is clearly exacerbated by conservatorship is the ability to plan and manage in the face of uncertainty about the future. Our experience as conservator confirms that it is extremely difficult to manage the Enterprises in the present without establishing some kind of plans for the future. I doubt that I can express this concern any more coherently than I did in my speech at the Bipartisan Policy Center back in 2016. I expressed it this way:

> Here, I'm not talking about plans for housing finance reform, but plans for everyday operations, including strategic planning that every well-run business does, and project planning that's necessary to continue key initiatives. Without looking somewhat down the road, FHFA and the Enterprises would both lose their momentum and jeopardize day-to-day success. The key dilemma when you have an uncertain future, however, is how far down the road to look and how to retain the necessary talent to implement either short-term or longer-term plans.

Two concrete examples help illustrate this challenge:

1. When the Enterprises were placed into conservatorships almost 10 years ago, most members of their boards and many members of their management teams were replaced with new boards and management teams. While no one anticipated at that time that the conservatorships would last more than a few years at most, a maximum tenure of 10 years was established for service on the Enterprises' boards. While some Enterprise board members have left and been replaced over almost 10 years of conservatorship, a number of the members appointed 10 years ago continue to serve and have provided experienced oversight and valuable continuity to the Enterprises. No doubt, when the history of this conservatorship period is written it will fail to give the credit these board members deserve for the heroic roles they played in the transformation of these Enterprises. Replacing the experience and transformative spirit of these board members who will soon cycle off the boards as their 10-year service periods end will be a significant challenge.

2. A second example relates to the decision to sell Fannie Mae's buildings and relocate them to rental space. Without going into detail about the many factors FHFA and the Enterprises considered over the last several years in the process of making these decisions, I'm certain that it will be obvious to everyone that these decisions would have been much easier to make had we been sure about Fannie Mae's future and had Fannie Mae not been in conservatorship.

A second challenge associated with operating these Enterprises in conservatorship has been how to ensure market discipline. Because the Enterprises have been insulated while operating in conservatorship from normal market forces that would otherwise inform their operations and business decisions, FHFA has had the responsibility for creating its own regime for market discipline. FHFA has taken several steps to address this ongoing challenge. One of the most important steps has been to require the Enterprises to use an aligned capital framework when evaluating business decisions even though they are not able to build capital beyond the limited buffer agreed to in the PSPAs.

Incorporating capital requirements into the analytics of day-to-day business is essential to making rational business decisions about when to conduct different transactions or pursue certain ideas. FHFA has worked with the Enterprises to develop a Conservatorship Capital Framework that establishes aligned capital guidelines for

both Enterprises across different mortgage loan and asset categories. Both Enterprises now use this aligned framework to make their regular business decisions. FHFA also uses this framework in its role as conservator to assess Enterprise guarantee fees, activities, and operations and to guard against the Enterprises making competitive decisions that could adversely impact safety and soundness.

FHFA has found the Conservatorship Capital Framework to be a useful tool because it reflects a refined approach to assessing the relative risks of different mortgage loan categories. To build on this work, we are planning in the very near future to propose a risk-based capital and minimum leverage capital rule that would replace the OFHEO capital standards that were in place prior to conservatorship and that are now suspended while the Enterprises are in conservatorship.

While the new capital rule would also be suspended while the Enterprises remain in conservatorship, we believe it is important for our Agency, as a regulator, to articulate a view on prudential capital requirements for the Enterprises based on their current operations. We also believe our proposed rule will provide valuable transparency to the public about capital and will be a catalyst for serious and thoughtful discussions and opinions about the capital requirements that would be appropriate for the Enterprises and/or other entities playing similar roles in the housing finance system going forward, regardless of the form these entities are required to take as a result of housing finance reform legislation. Public input on our proposed rule will also provide valuable feedback to FHFA about refinements that may be appropriate to our Conservatorship Capital Framework, which we will continue to apply to the Enterprises while they remain in conservatorship.

I emphasize that this rulemaking is not connected in any way to any efforts or ideas others may have about recapitalizing and releasing the Enterprises from conservatorship. The rule may need to be further revised to take into account the provisions of housing finance reform legislation and FHFA will suspend any final capital rule adopted while the Enterprises remain in conservatorship, just as the OFHEO rule that is currently on the books has been suspended.

Another challenge that FHFA and the Enterprises continue to try to address is affordability of both home ownership and rental housing. This challenge is not unique to conservatorship and will, unfortunately, persist after the conservatorships end. While FHFA and the Enterprises have taken a number of different approaches to try to responsibly improve access to credit and the availability of affordable rental housing, many of the challenges associated with affordability are beyond the control of FHFA or the Enterprises. They are significant challenges facing the market as a whole.

One problem that does not get as much attention as it probably should is that the supply of affordable single-family and multifamily housing is simply not keeping up with demand, especially in most cities and metropolitan areas. Following the foreclosure crisis, single-family new construction has lagged behind historical norms. With new household formation showing signs of increasing, the limited availability of housing on the market—both single-family homes and affordable rental units—presents a challenge that will not go away any time soon. Multiple approaches are needed to address the different facets of this low supply.

We have encouraged the Enterprises to launch pilots that can test new approaches to affordability, access and supply on a small scale to ensure that they work to help address these problems and to ensure that they can be replicated and implemented safely and soundly. The Enterprises' Duty to Serve Plans also incorporate a number of pilots and initiatives that will help address these challenges by better serving the manufactured housing, affordable housing preservation, and rural housing markets. We will continue to work with the Enterprises on pilots and initiatives to make progress where we think it is possible. We are also engaged in broader discussions and efforts with other industry participants—lenders, builders, Realtors, housing counselors and others—all of whom acknowledge these serious and growing challenges that require concerted efforts across all market sectors.

There are, of course, a number of other challenges that FHFA continues to work on and try to address, each of which would merit extensive discussion. Some of these include assisting borrowers who have limited English proficiency, evaluating and improving mortgage loan servicing, assessing updated credit score models, implementing the REMIC structure for some credit-risk transfer transactions, and implementing the Uniform Mortgage-Backed Security on the Common Securitization Platform on June 3, 2019. Suffice it to say that we have attempted to be collaborative with stakeholders and thoughtful in our approach to each challenge we face, and I expect to continue to do so throughout the remainder of my term as Director. I, of course, would be happy to respond to questions about any of these challenges, as well as any other aspect of our work.

I thank you again for the opportunity to be here and for the opportunity I have had to serve in this position. I look forward to answering your questions.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM MELVIN L. WATT

Q.1. In your testimony, you discussed the work that the Federal Housing Finance Agency (FHFA) and the Enterprises have done to expand access to credit among borrowers who might not fit today's tighter credit box. But I am also concerned about access to credit for borrowers who qualify for a loan but are struggling to find a mortgage lender who will serve distressed markets where property values have still not recovered. A recent report from the Urban Institute shows that homes up to $70,000 make up almost 14 percent of home sales but just 5.5 percent of mortgage loans.[1] While the GSEs provide access to credit for 53 percent of all mortgages, they provide access to credit on just 45 percent of these smaller balance loans. These smaller balance loans are more than three times as likely to be held in portfolio. With limited secondary market access, creditors may be constrained in their ability to make lower balance mortgages, giving cash buyers and investors a leg up in the sale process. In the time since you appeared before the Committee, I have been contacted by another Ohioan who lives in a community where many property values remain below $50,000 and that has limited access to loans. This lack of access to credit has constrained revitalization of a residential district and access to housing that could help address the affordability issues we see in our community.

What are FHFA and the GSEs doing to facilitate access to smaller balance loans?

A.1. The 2018 Scorecard requires Fannie Mae and Freddie Mac (the Enterprises) to assess the availability of low-balance loan financing and develop recommendations as appropriate. FHFA, with the Enterprises, has engaged with lenders, community organizations, and State and Local housing finance agencies to examine challenges to financing small balance loans and to explore possible solutions to address the issues associated with low value properties. The Enterprises have identified several barriers to financing low value properties, including high costs for originating small balance loans, lack of products for property rehabilitation, and challenges for smaller lenders to participate with the Enterprises in their programs. In response, the Enterprises are exploring various potential solutions, including pricing initiatives, partnerships with local housing financing agencies, lender education and training, and REO marketing.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SCOTT FROM MELVIN L. WATT

Q.1. I'm concerned that the Agency's proposed rule on the FHLBs' Affordable Housing Program is going to hinder the Banks' ability to finance affordable housing.

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[1] McCargo, et al., "Small Dollar Mortgages for Single-Family Residential Properties", Urban Institute, April 2018, available at *https://www.urban.org/sites/default/files/publication/98261/small_dollar_mortgages_for_single_family_residential_properties_0.pdf.*

Each FHLB addresses regional needs in its own way. What works in the Southeast might differ from what works in the Northeast.

The proposed rule is going to make those tailored approaches difficult to pull off.

Please answer the following with specificity:

Do you share these concerns?

A.1. FHFA's objective for proposing amendments to the regulations governing the FHLBank System's Affordable Housing Program (AHP) was to enhance each FHLBank's ability to address the affordable housing needs in its district. In fact, our intention was to improve each FHLBank's ability to develop the tailored approaches you refer to in your question. FHFA is currently reviewing and analyzing the public comments we have received in response to the proposed rule, many of which have also expressed concerns about the FHLBanks' ability to address district-specific affordable housing needs under the existing regulation. As we move forward, FHFA will carefully consider these concerns to ensure that the final regulation does not restrict or hinder a FHLBank's ability to respond effectively to these needs.

Q.2. What is your rationale for pursuing such a rule?

A.2. The current rule that governs administration of the FHLBank's Affordable Housing Programs has been in effect with only minor alterations since 2006. It has been regularly criticized by the FHLBanks as too restrictive on their ability to address the affordable housing needs in their districts. FHFA developed the proposed rule in an effort to provide the FHLBanks with more authority to address the specific affordable housing needs within their districts. FHFA also designed the amendments to reduce the regulatory requirements that are redundant with other Federal programs and to make the program easier to use. Under the proposed amendments, the FHLBanks would have more authority to allocate their affordable housing program funds. For example, the proposal would provide the FHLBanks additional flexibility to allocate their total annual affordable housing program funds in order to address the specific home ownership and rental housing needs in their districts. The proposed amendments would also allow the FHLBanks to establish special competitive funds that target specific affordable housing needs in their districts that are unmet, have proven difficult to address in the past, or align with objectives identified in the FHLBanks' strategic plans.

The proposed rule would require that each FHLBank award a minimum percentage of its annual total AHP subsidies to projects that address statutory and regulatory priorities. The proposed regulatory priorities include preserving affordable housing, the affordable housing needs of underserved communities and populations, and the creation of economic opportunities in conjunction with affordable housing. These priorities encompass a broad range of affordable housing initiatives the FHLBanks routinely address through their affordable housing programs.

The proposed rule would also authorize the FHLBanks to design and implement their own project selection scoring criteria. These proposed amendments would enable the FHLBanks to tailor and

customize their affordable housing programs in a manner that effectively and efficiently addresses the affordable housing needs within each district and regions throughout the country.

Q.3. *GSE Charter Creep*—The GSEs' charters strictly prohibit them from "originating mortgages." They also state that the Enterprises should "respond appropriately to the private capital market."

I fear the potential for giving certain market actors an unfair competitive advantage while crossing the charters' boundaries with pilot programs like IMAGIN and Day One Certainty.

Please answer the following with specificity:

How do you interpret these provisions, both the definition of "mortgage origination" and "responding appropriately to the private capital market?"

A.3. The Enterprises' purposes where responding to the private capital markets is discussed make clear that both Enterprises serve an important role in supporting the secondary mortgage market. While the term "mortgage origination" does not appear in either Enterprise charter, both charters include a prohibition on the Enterprises using their lending authority to originate mortgage loans. With respect to Day One Certainty and IMAGIN, both pilots deal with mortgages that have been originated by bank and nonbank lenders, not by the Enterprises. Day One Certainty provides lenders with the ability to more efficiently confirm they have met Fannie Mae data verification requirements and thus mitigate representation and warranty risk. With respect to IMAGIN, the pilot provides traditional lenders an additional new option to obtain charter-compliant mortgage insurance for the mortgages they originate.

Q.4. How are you guarding against creating uneven playing fields with these pilot programs? How do you choose the market participants?

A.4. In conservatorship, Fannie Mae and Freddie Mac have taken a number of ongoing steps to help level the playing field for market participants, including eliminating volume-based discounts on guarantee fee pricing, so that lenders of all sizes can better maintain competitive access to the secondary market. Additionally, the Enterprises are currently engaged in a large number pilot programs covering a range of activities from income and asset verification to front-end credit risk transfers. These pilot programs vary in size, scope, and activity and are focused on improving credit risk assessment, improving access to credit, efficiency and innovation, reducing cost, reducing inefficiencies and redundancies in the mortgage process, and credit risk transfer. We are always mindful of the potential impact participation in pilots can have on lenders and other market participants of varying sizes. While we do not select Enterprise pilot market participants, we encourage the Enterprises to offer pilots to a variety of potential participants when doing so is feasible. For example, Freddie Mac's IMAGIN pilot and Fannie Mae's similar EPMI pilot feature a number of lender participants of various types. Because pilots are utilized to "test and learn," it is not always possible for the Enterprises to engage a variety of partners in a given pilot program. When pilots engage only a limited number of counterparties, the Enterprises work

to determine whether the pilot should be terminated or approved for broad rollout and, if approved, expand access to programs as soon as practicable.

Q.5. *Restoring Insurance Captives to FHLB*—In 2016, you stated, "Congress has amended the Federal Home Loan Bank Act in the past to allow additional entities to become members of a Federal Home Loan Bank and it can certainly do so again."

I agree with you. Which is why there's a bipartisan group of us trying to do that with the insurance captives the FHFA expelled.

These captives were a critical source of private capital for the development of affordable housing, something sorely needed in South Carolina. They should be restored.

A.5. On January 20, 2016, the Federal Housing Finance Agency (FHFA) issued a final membership rule prohibiting captive insurance companies from membership in a Federal Home Loan Bank (FHLBank). This rule was issued because certain captive insurance companies were being created primarily as vehicles for "back door" FHLBank membership by entities that are not themselves eligible for FHLBank membership. The final rule addressed the circumvention of the statute by ineligible entities by defining "insurance company" to exclude captive insurers, thereby making them ineligible for Bank membership. Should Congress advance Senate bill 2361, the Housing Opportunity Mortgage Expansion Act, FHFA would like to remain engaged with your staff and other Congressional staff and provide further technical assistance.

Q.6. *Credit Score Competition*—The Senate and House have passed my legislation, the Credit Score Competition Act, to create a transparent validation process for which credit scoring models can be accepted by the GSEs.

I think doing so will ultimately benefit creditworthy Americans that are trying to achieve home ownership.

The legislation has the word "competition" in its title, and that's the key: It was my intent that multiple, statistically sound credit scoring models could be used by the GSEs.

I look forward to you enacting this provision without delay.

A.6. While FHFA is proceeding as expeditiously as possible with efforts to meet the requirements of the Act, we have concluded that we will not be able to meet the first critical deadline set in the Act (the time for accepting applications for validation) and, despite reasonable efforts, may find it difficult to meet other subsequent timetables. FHFA will, of course, work to propose a rule and to complete the final rule as expeditiously as possible. Once the final rule is complete, FHFA and the Enterprises will make every effort to complete the credit score validation and approval process with the timeframes envisioned in the law. However, meeting these timeframes will also be extremely challenging. FHFA is in the process of developing a preliminary rulemaking timeline for the proposed and final rule. Additionally, based on the input received from FHFA's recent Request for Information on credit scores, almost every industry respondent agreed that the industry would need 18 to 24 months to implement a new credit score model or models.

Q.7. *Tri-Merge Credit Reports*—The Agency's December 2017 Request for Information on credit scoring models stated it was " . . . evaluating whether to change from the current requirement of obtaining a credit report and credit score from all three of the CRAs to a requirement to obtain only two or one report and score from the CRAs for each mortgage applicant."

Of the 115 respondents to the RFI, just 34 respondents addressed the "tri-merge" credit report requirement issue.

Please answer the following with specificity:

Has the FHFA conducted an independent study on the impact on "credit accuracy" of a change from the tri-merge requirement to a bi-merge or single report requirement? If so, what did the FHFA conclude from this study?

A.7. The Enterprises, at the request of FHFA, did conduct a preliminary analysis in 2017 comparing the requirement of two versus three CRA credit reports. This preliminary analysis suggested minimal impact on "credit accuracy." Additional analysis is needed prior to FHFA making a determination. However, feedback from the FHFA RFI suggests that moving to a duel-merge from the tri-merge would increase competition among the CRAs and reduce costs for consumers.

Since Section 310 of the Economic Growth, Regulatory Relief, and Consumer Protection Act was enacted, FHFA has been evaluating the impact the law will have on the existing credit score project and related credit score activities. As described in the Director's letter to Congress, FHFA will be shifting its focus from these activities in order to expeditiously issue a proposed and final rule to comply with the provisions in Section 310.

Q.8. If no study was performed, how does the Agency justify not studying this issue on its own before making a decision?

A.8. FHFA believes that eliminating the tri-merge requirement may improve the level of competition among the CRAs and reduce costs for consumers. The questions related to the tri-merge report in the RFI were designed to measure industry response to such a change, and the Economic Growth, Regulatory Relief, and Consumer Protection Act does not address tri-merge. Overall, the feedback from the industry was supportive of a change to the current tri-merge requirement. However, significantly more work would be required by FHFA and the Enterprises to support the Enterprises' 2017 preliminary analysis and FHFA's belief that eliminating the tri-merge could be beneficial before the implementation of any change. FHFA plans to further investigate the costs and benefits of changing the tri-merge requirement after FHFA issues a final rule in accordance with the provisions in Section 310 of the Economic Growth, Regulatory Relief, and Consumer Protection Act.

Q.9. If the Agency believes further analysis is required before making a decision, what kind of analysis needs to be done?

A.9. As stated above, further analysis is needed prior to FHFA making a determination on reducing the number of credit reports for mortgage applicants. However, FHFA has not determined what additional analysis is needed because the agency is focused on expeditiously issuing a proposed and final rule on the validation and approval of credit score models in accordance with Section 310 of

the Economic Growth, Regulatory Relief, and Consumer Protection Act.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR COTTON FROM MELVIN L. WATT

Q.1. If the GSEs stated purpose is the help achieve the dream of home ownership, what justification is there for the GSEs to have about 30 percent of their business activity involved in cash-out refis, investor mortgages and 2nd homes?

A.1. Supporting sustainable home ownership is one of several stated purposes of the Enterprises, which include:

Providing stability in the secondary market for residential mortgages;

Responding appropriately to the private capital market;

Providing ongoing assistance to the secondary market for residential mortgages by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing, and;

Promoting access to mortgage credit nationwide by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

By securitizing different mortgage products that serve a variety of financial needs, the Enterprises broadly support liquidity in the housing finance market and facilitate access to mortgage credit that allows not just families to buy a home, but also allows investors to provide rental housing, homeowners to utilize the equity in their homes to maintain and make improvements to them and help pay off other debts such as student loans, and for older couples or individuals preparing for retirement to buy a second home where they want to retire.

Q.2. Why are the taxpayers being asked to back these loans?

A.2. FHFA is sensitive to the obligations and risks that taxpayers have taken on since the Enterprises were placed in conservatorship. To that end, FHFA published its Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac, and one of the goals of the plan is to reduce taxpayer risk through increasing the role of private capital in the mortgage market. For the single family credit guarantee business, FHFA directed the Enterprises to establish risk transfer programs in which the private sector assumes a significant proportion of the credit risk in exchange for receiving a portion of the Enterprises' guarantee fee. In the these transactions, the Enterprises retain a small first loss position in the underlying loans, sell a significant portion of the risk beyond the initial loss and then retain the catastrophic risk in the event losses exceeded the private capital support. The Enterprises' credit risk transfer (CRT) programs have become a core part of the Enterprises' single-family credit guarantee business and include all loans meeting the target criteria, including cash-out refinances and mortgages for investor-owned properties and second homes. The programs have expanded to transfer credit risk to private capital via debt issuances, insurance/reinsurance transactions, senior-subordi-

nate securitizations, front-end collateralized lender recourse transactions, and other pilot transactions. More information on CRT programs is contained in FHFA's CRT Progress Report, available on FHFA's website at: *https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Progress-Report-O42017.pdf.*

Q.3. Please list what steps have you taken to:

Reduce the GSEs involvement in cash-out refis, investor mortgages and those for 2nd homes?

A.3. As discussed above, the Enterprises are helping reduce the risks to taxpayers in guaranteeing the credit risk of loans that include traditional first mortgages and the types of loans you are referencing through the expansion of their CRT programs. Also, as a result of the Agency's analysis of guarantee fees, in 2015 FHFA announced small guarantee fee increases for certain Enterprise loans that had risk layering attributes, including cash-out refinances and investment properties.

Q.4. Reduce the GSEs overall footprint on the U.S. housing market? Please include metrics.

A.4. As I have said on numerous occasions, FHFA has no statutory mandate to reduce the Enterprises' footprint, and FHFA and the Enterprises continue to have the same statutory obligations which can only be changed by statute and not by regulators. As conservator, FHFA has an obligation to reduce risk to taxpayers and we have done so by shifting risk to private market participants and away from the Enterprises in a responsible way that does not reduce liquidity or adversely impact the availability of mortgage credit. FHFA and the Enterprises have pursued this objective through several means, including reducing the Enterprises' retained portfolios and engaging in credit risk transfer transactions. Through the PSPAs, FHFA and Treasury agreed that each Enterprise must reduce its retained portfolio to $250 billion by December 31, 2018. In addition, FHFA imposed a requirement that each Enterprise reduce their respective retained portfolios by an additional 10 percent to hedge against market disruptions. FHFA expects each Enterprise to be al or below $225 billion as of December 31, 2018. Both Enterprises are on track to meet that specific FHFA target of $225 billion by December 31, 2018.

In addition, from the beginning of the Enterprises' single-family CRT program in 2013 through the end of 2017, Fannie Mae and Freddie Mac have transferred a portion of credit risk on $2.1 trillion of unpaid principal balance (UPB), with a combined risk in force of about $69 billion or 3.2 percent of UPB. Successful implementation of CRT has introduced a significant layer of private capital to absorb losses and, thus, protect taxpayers.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM MELVIN L. WATT

Q.1. When do you anticipate you will make an announcement as to the results of the ongoing review of credit scoring models used by the GSEs? Do you anticipate it will be before the end of the year?

A.1. FHFA will not reach a decision about updating the credit model used by Fannie Mae and Freddie Mac later this year as planned. Instead, FHFA is shifting its focus to implementation of Section 310 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) enacted in May.

Q.2. In your testimony before the Committee last week, you indicated that you would like to reach a conclusion on the review of credit scoring models, but you cautioned that conclusion would now have to be an "interim conclusion."

Would you please clarify what you meant by "interim?"

A.2. In response to a question asked during the May 23, 2018, hearing, I testified that I thought that FHFA could reasonably proceed with the work we had started under the Conservatorship Scorecard Initiative despite the provisions in the Economic Growth, Regulatory Relief, and Consumer Protection Act that has recently been adopted by Congress and was expected to be signed into law by the President within days following my testimony. However, further review and consultation with my staff has confirmed that proceeding with efforts to reach a decision based on our Conservatorship Scorecard Initiative process and timetable would be duplicative of, and in some aspects inconsistent with, the work we are mandated to do under Section 310 of the Act.

If we had proceeded with our work to reach a conclusion on the review of credit score models, it would have been an "interim conclusion" at best because of the 18–24 month period we would have given the industry to implement our conclusion.

Q.3. In your view, does Section 310 of S. 2155, now P.L. No. 115-174, prevent you from making a final decision in the near future on the review of credit scoring models?

A.3. Yes, FHFA will not make a final decision in 2018 and instead will shift focus to implementation of the Act.

Q.4. Section 310 requires FHFA to issue regulations before accepting applications for new credit scoring models.

How long do you anticipate it will take FHFA to issue final regulations?

A.4. While FHFA is proceeding as expeditiously as possible with efforts to meet the requirements of the Act, we have concluded that we will not be able to meet the first critical deadline set in the Act (the time for accepting applications for validation) and, despite reasonable efforts, may find it difficult to meet other subsequent timetables. FHFA will, of course, work to complete the final rule as expeditiously as possible. Once the final rule is complete, FHFA and the Enterprises will make every effort to complete the credit score validation and approval process with the timeframes envisioned in the law. However, meeting these timeframes will also be extremely challenging. FHFA is in the process of developing a preliminary rulemaking timeline for the proposed and final rule.

Q.5. Now that Section 310 has been signed into law, what is your time estimate for completion of the entire process, including issuance of regulations, evaluation, approval, and implementation of a new updated credit scoring model?

A.5. FHFA will work as expeditiously as possible to complete the final rule. Once the final rule is complete, FHFA and the Enterprises will make every effort to complete the credit score validation and approval process within the timeframes envisioned in the law. However, meeting these timeframes will also be challenging. Section 310 allows the Enterprises to continue to use a credit score model that has not been validated and approved under the Act until November 20, 2020, but not does not address implementation by the broader industry. Based on the input received from our Request for Input, implementation was one of the most significant issues addressed by respondents and almost every industry respondent agreed that the industry would need 18 to 24 months to implement a new credit score model or models. Therefore, even with FHFA proceeding expeditiously with the rulemaking process, and the Enterprises' application, validation an approval process, the subsequent implementation of any new credit model(s) by the industry cannot be completed by November 20, 2020. We will have to evaluate options to address how the Enterprises should proceed in that period

Q.6. I was pleased last fall to see FHFA agree to include a question on the uniform mortgage application for borrowers to indicate their preferred language, something for which I have advocated. Another key element of FHFA's language access plan is development of a clearinghouse that will be a central source of translated materials and educational documents to ensure lenders and housing counselors have the tools necessary to serve limited English proficient borrowers.

When do you expect this part of the process to be completed?

A.6. As part of the 2018 Conservators hip Scorecard, the Enterprises are tasked with finalizing the multiyear borrower language access plan and beginning to implement it. The plan was finalized May 10, 2018, and posted on FHFA's website. It includes development of a language access clearinghouse that will host translated mortgage documents. Specifically during 2018, FHFA and the Enterprises are establishing a clearinghouse on the FHFA.gov website that will primarily contain existing translated mortgage-related documents and materials produced by Fannie Mae and Freddie Mac and Government agencies (primarily in Spanish). This first stage of the clearinghouse is designed to assist lenders, servicers, document vendors, and housing counselors in serving limited English proficiency (LEP) borrowers and will contain links to pertinent Government resources such as housing counseling services offered by HUD and CFPB. FHFA, the Enterprises, and CFPB working with the Library of Congress are translating into Spanish a glossary of key mortgage terms, such as interest rate, origination charges, grace period, and loan modification which will also be included in the public clearinghouse.

During 2019 and 2020, the multiyear plan is to migrate the clearinghouse to a standalone ".gov" website with an added focus towards borrowers and other market participants. During this time, additional mortgage documents and materials produced by other Federal agencies will be added to the clearinghouse, and the documents already in the clearinghouse will be translated in the

four remaining languages identified by the U.S. Census as the most common non-English languages (in addition to Spanish) spoken in LEP households (Korean, Chinese, Vietnamese, and Tagalog). FHFA and the Enterprises intend to add glossaries of key mortgage terms in these languages as well.

Q.7. What steps have you taken to ensure that the language access multiyear plan will continue beyond your tenure at FHFA?

A.7. In May, the FHFA published the multiyear borrower language access plan[1] with milestones for 2019 and 2020, and has engaged with industry stakeholders to assist in meeting those milestones. By publishing the plan our anticipation/expectation is that future FHFA leadership will continue the work in process.

Q.8. In your testimony before the Committee last week, you referenced a number of pilots intended to expand access to home ownership for creditworthy borrowers. For instance, you mentioned a pilot related to student debt.

Could you provide a comprehensive list and descriptions of currently existing pilot programs?

A.8. The Enterprises are currently engaged in a large number pilot programs covering a range of activities from income and asset verification to front-end credit risk transfers. These pilot programs vary in size, scope, and activity and are focused on improving access to credit, efficiency and innovation, reducing cost, reducing inefficiencies and redundancies in the mortgage process, and improving credit risk assessment and credit risk transfer. The goal of each Enterprise pilot program is to test a particular approach and learn from those results whether the pilot would benefit the housing finance market. By necessity, this entails smaller scale efforts that are conducted with prior due diligence and implemented in a limited and time-bound manner, after which careful analysis of the benefits and drawbacks can be considered. Because even general information about some of these pilot programs amounts to confidential commercial information and can lead to disruptive market speculation, FHFA cannot publish such a list, but will respond to requests from Congress for more information with the understanding that such information will not be publicly disclosed.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM MELVIN L. WATT

Q.1. In the absence of housing finance reform legislation, FHFA has the authority to take some key steps administratively to continue to reduce the risk that a guarantor on the brink of failure requires another taxpayer bailout. While prescribing higher risk-based capital and minimum leverage requirements, and requiring programmatic credit-risk-transfers (CRT) are both positive steps that reduce the risk that an enterprise (or guarantor in a fully reformed system) may fail in the future, these steps do little to improve the ability to resolve an enterprise (or guarantor) in the event that they do wind up taking excessive risks in the future.

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[1] Available at: *https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/LEP-Multi-Year-Plan.pdf.*

Can you please describe what steps, if any, FHFA is undertaking to put the GSEs into a more resolvable condition and institute a credible resolution regime? In particular, what steps are you taking to separate the credit risk-taking functions of the enterprises from the critical secondary market infrastructure and underwriting systems such that a GSE (or guarantor in a fully reformed system) can credibly be allowed to fail without that failure and resolution threatening to take down the primary market with it?

A.1. Since the beginning of the conservatorships, FHFA has been taking actions to reform the Enterprises in order to make them more stable institutions and to reduce the risks they posed to taxpayers. In particular, FHFA has supported derisking the Enterprises through reduction of their retained portfolios and engaging in credit risk transfer (CRT) transactions. Under the PSPAs, FHFA, and Treasury agreed that each Enterprise must reduce its retained portfolio to $250 billion by December 31, 2018. In addition, FHFA imposed a requirement that each Enterprise reduce its respective retained portfolio by an additional 10 percent. FHFA expects each Enterprise to be at or below $225 billion as of December 31, 2018. Both Enterprises are on track to meet this requirement. These reductions have significantly reduced the Enterprises' exposure to credit risk, while allowing them to continue to support their core credit guarantee business.

For the single-family credit guarantee business, FHFA instructed the Enterprises to establish credit risk transfer programs in which the private sector assumes a significant proportion of the credit risk in exchange for receiving a portion of the Enterprises' guarantee fee. These CRT transactions have become a core part of the Enterprises' single-family credit guarantee business. Through CRT, in combination with mortgage insurance, the majority of the underlying credit risk on mortgages targeted for CRT has been transferred to private investors. The Enterprises continue to innovate in the CRT space to identify new ways of reducing risk.

Another reform, outlined in FHFA's 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac, is the development of a new securitization infrastructure for the Enterprises for mortgage loans backed by single-family properties. Common Securitization Solutions, LLC (CSS) is a joint venture formed by the Enterprises under FHFA's direction and guidance to achieve that strategic goal. CSS is developing and operating the Common Securitization Platform (CSP) that supports the Enterprises' single-family mortgage securitization activities, including the issuance by both Enterprises of a new common mortgage-backed security, the Uniform Mortgage-Backed Security (UMBS). UMBS will finance the same types of fixed-rate mortgages that currently back Enterprise-guaranteed securities eligible for delivery into the "To-Be-Announced" (TBA) market, a forward market for certain mortgage-backed securities, including those issued by Fannie Mae and Freddie Mac. FHFA has mandated that CSS develop the CSP to allow for possible future adoption and use by other market participants.

CSS and Freddie Mac implemented Release 1 of the CSP on November 21, 2016. With that implementation, Freddie Mac transferred to CSS operational responsibilities for the monthly issuance

and settlement of single-class mortgage-backed securities backed by 15-, 20-, and 30-year fixed-rate loans and for the computation of the monthly pool and bond factors for Freddie Mac's PCs and Giants. CSS, Fannie Mae, and Freddie Mac are testing systems and operational readiness for the implementation of Release 2 in June 2019. Upon successful implementation of Release 2, both Fannie Mae and Freddie Mac will be using the CSP and CSS operations to perform the key security issuance, settlement, bond administration, and disclosure activities for both single-class securities and multiclass securities. Such functionality is a major milestone in the separation of the credit risk-taking functions of the Enterprises from the secondary market infrastructure.

In addition to the development of the CSP, other changes during the conservatorships that could facilitate entry of other market participants include the standardization of mortgage data and the ongoing development of standards related to electronic mortgage origination and documentation.

FHFA and the Enterprises have taken all of the above steps and others to ensure that a credible resolution regime is never needed. However, we continue to believe that ensuring and instituting a credible resolution regime is the responsibility of Congress, not FHFA.

Q.2. During the financial crisis, we saw the pitfalls of overreliance on credit rating agencies, and Congress discouraged reliance on ratings to assess counterparty risk in Dodd–Frank. Do you have any concern that the Freddie is overrelying on ratings to measure the capital strength of offshore reinsurers involved in the IMAGIN pilot program?

A.2. Public credit ratings are only one of a number of inputs into Freddie Mac's counterparty risk assessment of reinsurers. Participating insurers in the IMAGIN pilot are subject to Freddie Mac's traditional counterparty approval process and framework, which include due diligence on the following: pro forma financials, balance sheets, capital plans, business line mix and diversification, risk management frameworks, concentration limits, excess capital levels, management, and track records. Participating insurers are also subject to regular quarterly monitoring and credit review as part of Freddie Mac's counterparty risk framework. In addition to the financial strength provided by the participating insurers' balance sheets, the participating insurers also post significant collateral to Freddie Mac. In light of the above, FHFA does not have concerns that Freddie Mac is over relying on credit ratings.

Q.3. At the end of March, the FHFA released a progress update on the 2017 Scorecard. Among the items identified was the ongoing evaluation of update credit scoring models which has spanned more than 3 years. You indicated that after reviewing the responses from the recently issued RFI you plan to make a decision in 2018.

When can we expect a decision?

A.3. FHFA will not reach a decision about updating the credit model used by Fannie Mae and Freddie Mac later this year as planned. Instead, FHFA is shifting its focus to implementation of Section 310 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) enacted in May.

Q.4. What impact, if any, will section 310 in S. 2155 have on your decision?

A.4. FHFA will not be able to reach a decision about updating the credit model used by Fannie Mae and Freddie Mac later this year as planned. Instead, FHFA is shifting its focus to implementation of Section 310 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) enacted in May.

Q.5. FHFA's proposed FHLBank Affordable Housing Program (AHP) rulemaking could be the most significant change in the program's history. Currently, each FHLBank must award at least 10 percent of its annual required AHP contribution to low- or moderate-income households and 20 percent of multifamily units for homeless households.

How would adding on a new requirement to award 55 percent of multifamily units in rental projects receiving AHP awards to very low income households and increasing the current regulatory requirement for the homeless allocation to 50 percent affect mixed income project opportunities?

A.5. The FHLBanks are required by law to establish an affordable housing program (AHP) to enable FHLBank members to provide subsidies for long-term, low- and moderate-income, owner-occupied and affordable rental housing. The FHLBanks may provide AHP subsidies to finance home ownership by families with incomes at or below 80 percent of area median income (AMI) and the purchase, construction, or rehabilitation of rental housing, at least 20 percent of the units of which will be occupied by and affordable for very low-income households. The current regulations authorize the FHLBanks to establish and administer a mandatory competitive application program and an optional home ownership set-aside program to meet these statutory requirements.

FHFA specifically requested comments on the appropriateness of the proposals in the proposed rule, including alternative ways of meeting the statutory requirements while providing additional flexibility to the FHLBanks in the design of their programs. To date, numerous commenters have addressed the implications for mixed income project opportunities. FHFA will carefully consider the commenters' concerns and will strive to ensure that the final regulation does not have negative implications for mixed income projects or the FHLBanks' ability to address these projects and their underlying objectives.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM MELVIN L. WATT

Q.1. I appreciate the letter you send to the Banking Committee in January that lays out your priorities for reforming the housing finance system. It's an important contribution to the discussion this Committee has been having about this issue for years. I want to focus on your recommendations on access and affordability. You write that our current tools like affordable housing goals, duty to serve, the Housing Trust Fund, and the Capital Magnet Fund should be preserved, or if they are replaced, they should be replaced by new tools that, quote, "provide benefits at least com-

parable to these existing requirements." The home ownership rate today stands at 64 percent. In the early 2000s—well before the housing bubble—the home ownership rate was over 68 percent. That 4 percentage point decline represents millions of families denied the benefits of home ownership. It also means there is substantially more pressure on the rental market, raising rental costs.

Why are you satisfied with maintaining the current level of emphasis on access and affordability when the home ownership rate is so far below historic levels?

A.1. In responding to the Committee's questions about the future of the housing finance system, the Housing Finance Reform Perspectives document deliberately highlighted that any reformed housing finance system should not reduce support for affordable rental housing and home ownership—as per your citation, the support should be "at least" comparable. One of the objectives of our Perspectives document was to make it clear that responsible access to credit and a lack of housing affordability remain important, pressing issues for millions of households across the country. Another objective of our Perspectives document was to make clear our continuing belief that as part of housing finance reform legislation, it is the responsibility of Congress, not FHFA, to decide what role a future housing finance system should play in addressing these needs.

Q.2. The home ownership problem is particularly severe for black families. According to the Urban Institute, in 2001, the black home ownership rate was 46 percent. As of 2016, it was 41 percent. That's a 5 percentage point decline—compared to a 1 percentage point decline among white families over that same time period.

Do you think our current access and affordability approach is doing enough for black families?

A.2. FHFA shares your concern about the home ownership gap. It is a multifaceted problem that requires many responses, only some of which are within FHFA's statutory responsibilities. We have aggressively tried to provide responses within FHFA's statutory authorities in a safe and sound manner.

FHFA's efforts related to addressing this gap focus on mortgage credit in various ways. They include: encouraging the Enterprises to test new approaches to affordability, access to credit, and housing supply; monitoring the Enterprises' Duty to Serve Underserved Market Plans, which incorporate a number of initiatives that will help address these housing affordability challenges; monitoring and enforcing the affordable housing goals, which provide quantified and measurable directions to the Enterprises to reach all segments of the home mortgage market; and implementing the Neighborhood Stabilization Initiative, which aims to create more and better opportunities for home ownership in communities impacted by the financial crisis.

FHFA will continue these efforts to improve access and affordability for minority and other underserved populations.

Q.3. In addition to the declining home ownership rate, average credit scores on the GSEs' books have increased sharply. In the early 2000s, the average credit score for a home loan on Fannie and Freddie's books was about 710. Now it's close to 750. That in-

crease means that millions of borrowers with solid credit scores are not being served.

Why should we be satisfied with maintaining our current access and affordability approach when the GSEs are not serving nearly as many creditworthy borrowers as they used to?

A.3. Both Enterprises are carefully seeking ways to expand affordable home ownership opportunities through access to credit pilots and initiatives with oversight from FHFA as regulator and conservator. These efforts include the activities referenced in my response to your previous question above.

As secondary market entities, the Enterprises attempt to broaden access to home ownership through establishing a credit box that can accommodate a diversity of borrowers, with a variety of credit scores, consistent with safe and sound underwriting practices. Lending decisions, however, are ultimately made by originators and are not within the Enterprises control.

Expanding access to home ownership is an ongoing process. Based on the demonstrated need for both affordable home ownership and rental housing, FHFA will continue efforts to expand access and affordability consistent with safe and sustainable underwriting.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM MELVIN L. WATT

Q.1. I believe that shared-equity, deed-restricted mortgages can be very useful in helping families find affordable homes that provide stability and a possibility for some wealth creation.

During your testimony, you mentioned shared-equity models provided by nonprofits. Could you please provide me with details on these types of products? Could you also include models that are Sharia-compliant, that is, models that do not charge interest which might work for some Muslim Americans who do not wish to pay interest?

A.1. Shared equity models refer to an array of programs that create long-term, affordable home ownership opportunities by imposing restrictions on the resale of subsidized housing units. When a nonprofit or Government entity is involved in such a program, it provides a subsidy to lower the purchase price of a housing unit, making it affordable to a low-income buyer. In return for the subsidy, the buyer agrees to share any home price appreciation at the time of resale with the entity providing the subsidy. This helps preserve affordability for subsequent homebuyers.

Although several types of shared equity programs exist, they fall into two basic categories: shared appreciation loans and subsidy retention programs. Shared appreciation loans are second mortgages provided by the public or nonprofit agency that buyers repay in full at the time of resale along with a percentage of home value appreciation. These funds are then reinvested to make home ownership affordable to another low-income buyer. Most nonprofits, however, typically opt for the subsidy retention programs where the resale price restrictions ensure that the subsidy remains with the home. The most widely implemented subsidy retention programs include deed-restricted housing programs and community land trusts

(CLTs). According to the National Community Land Trust Network, there are 330 CLT programs in the country. However, no such programs operate in the State of Nevada. As part of their Underserved Markets Plans under the Duty to Serve Program, both Enterprises have included outreach, loan product development, and Loan purchase activities to support the development of shared equity loans.

Grounded Solutions Network, the leading trade organization for nonprofit shared equity, recently released two reports, one sponsored by Freddie Mac and one by Fannie Mae as part of their Duty to Serve plans. Freddie Mac sponsored a paper on shared appreciation lending (*https://groundedsolutions.org/new-report-explores-shared-equity-homeownership-funding-model/*), and Fannie Mae sponsored a paper on inclusionary zoning (*https://gsn.maps.arcgis.com/apps/webappviewer/index.html?id=c4c8ebef970b43f597de7bfd2fd1b954*).

As for potentially Sharia-compliant programs, often these may be contract for deed or land installment contracts, where, instead of purchasing a home with a mortgage, the buyer agrees to directly pay the seller in monthly installments. The buyer is able to occupy the home after the closing of the sale, but the seller still retains legal title to the property and ownership passes to the buyer only after the final payment is made. While there may be some nonprofit housing organizations that use contract for deed programs to help low-income families purchase a home, it is a financing vehicle most typically offered by private entities or individuals. The State of Minnesota operated a contract for deed program, called "Bridge to Success", at one time. However, the program has ended. Because of the spotty history of contract for deed arrangements, neither Enterprise permits contract for deed arrangements.

Q.2. The private equity fund Blackstone's single-family home business, known as Invitation Homes, was founded in 2012 and had an initial public offering (IPO) in February 2017. As part of the IPO, Invitation Homes needed to refinance existing debt and sought a lower-cost funding structure. Fannie Mae agreed to step-in, guaranteeing $1 billion in debt issued by Invitation Homes. This guarantee marked the first time that a GSE has facilitated financing for a large institutional operator in single-family rental properties. According to Invitation Homes' SEC filing related to the IPO, the company owns 940 single-family rental homes in Las Vegas. This deal has been questioned on a number of grounds. First, critics have questioned why the GSEs are providing financing support for single-family rental properties given that single-family home purchase inventory is at a historic low in many parts of the country. Second, many are critical of hedge funds' maintenance and eviction policies towards homeowners and question whether it is sensible for a quasi-government entity to facilitate this business model. Third, many question the fact that Fannie Mae has imposed no rental affordability restrictions on the properties underlying the transaction. Fourth, many note that Invitation Homes did not necessarily need this financing; instead the Fannie-backed loan was used to pay down other debt and secure cheaper funding rates. Fifth, many question Fannie Mae's exposure to such a huge deal with a single counterparty.

What is FHFA's response to the criticism of this deal? Has FHFA staff learned so far from this investment? Are these single-family home rentals affordable? Do they have tenant protections? Has FHFA made any large scale single family purchases to a private investor? If so, please describe.

A.2. The Enterprises have historically engaged in the single-family rental market by financing loans to smaller investors, for Fannie Mae owners often properties to a single borrower and/or Freddie Mac owners of six properties to a single borrower. Since the financial crisis, single-family rentals have become an increasingly larger component of the rental market. Single-family rental units provide affordable housing alternatives to families in need of more space than traditional apartments. These families may not be able to or may choose not to own a home in light of their existing family or financial position.

FHFA approved the Enterprises to do pilot programs in the single-family rental market beyond the existing Enterprise products available in response to the substantial growth in the number of detached single-family homes being rented. These pilots provide the Enterprises with opportunities to gather data about this market, and this will assist FHFA in making a more informed decision on the Enterprises' future participation in the single-family rental market. Fannie Mae's pilot investment was with Invitation Homes, which is an institutional investor in single-family rental. Invitation Homes uses standard leases and follows all tenant protection laws required by the State or locality in which the asset is located, including all eviction standards. In addition, Invitation Homes does not have a contract-for-deed or rent-to-own program. Freddie Mac's pilot transactions have been smaller and focused on affordable single-family rental properties. Both pilot programs will provide helpful data to better understand the market and help inform the role the Enterprises should play in it going forward.

On June 28, 2017, FHFA hosted more than 60 housing industry professionals—including advocacy groups, investors, lenders, nonprofits, service providers, and researchers—for a day-long discussion to better understand the single-family rental market and gather feedback as part of our ongoing stakeholder outreach. In addition, FHFA directed the Enterprises to further explore this segment of the housing market in the 2017 Conservatorship Scorecard. The Enterprises submitted revised single-family rental strategies to FHFA and the FHFA is currently reviewing those strategies. Informed by the strategies, transactional learnings, and stakeholder outreach, FHFA will determine the Enterprises' future role, if any, in serving the single-family rental market beyond the current guidelines summarized earlier.

Q.3. How will the new sub-goal for small multifamily properties specifically help renters?

A.3. The Safety and Soundness Act requires FHFA to establish annual housing goals for mortgages purchased by the Enterprises. Included in their housing goals is a small multifamily Low-income sub-goal for rental units in multifamily properties with 5–50 units that are affordable to families with incomes no greater than 80 percent of area median income. The sub-goal encourages the Enter-

prises to provide efficient financing for a sector of the rental market that particularly serves lower-income renters. Small multifamily properties house approximately 22 percent of the population, yet they contain more than 55 percent of subsidized units nationwide. [1]

Access to reliable financing helps preserve these properties and maintain housing quality.

Owners of small properties tend to be individuals or small companies that need financing when making the major capital repairs needed from time to time. Keeping up with capital repairs is essential to maintain housing quality for residents and lo ensure this source of affordable housing remains an enduring community asset.

Making loans to small multifamily properties requires essentially the same amount of resources by the lender as do loans to larger properties, but because the returns are smaller due to the smaller loan size, lending activity for these properties can be uneven. The small multifamily sub-goal encourages the Enterprises' participation in this market and ensures the Enterprises have the expertise necessary to serve this market should private sources of financing become unable or unwilling to retain small multifamily property loans on their balance sheets. Based on Enterprise performance since 2015 when the sub-goal was put in place, the sub-goal is achievable and encourages a meaningful Enterprise presence in this sector.

Q.4. I'm concerned about the ever-growing home ownership gap between whites and African Americans and Latinos. What can FHFA do to help more Latinos and African Americans buy a home?

A.4. FHFA shares your concern about the home ownership gap. It is a multifaceted problem that requires many responses, only some of which are in FHFA's purview.

Some of the home ownership gap is about housing affordability. Many communities in the United States have a mismatch between housing supply and demand, and local zoning and land use policies are a significant contributing/actor that restrict greater supply. In communities with strong job growth and high incomes, lack of supply can make home ownership unaffordable for many potential buyers. In communities with flat or declining incomes, even housing that appears affordable from afar can remain out of reach.

Some of the home ownership gap is tied to the wealth gap, which reflects that minority communities have been limited in their ability to build wealth. The recent financial crisis and housing price collapse erased about $7 trillion in household wealth nationally, but that impact was more extreme for poorer households and for African American and Latino households. Because the median net worth of minority households historically has been low, building the necessary wealth to meet downpayment and closing costs will likely also continue to be a challenge for many of these new households.

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[1] "Understanding the Small and Medium Multifamily Housing Stock", Enterprise Community Partners/University of Southern California, March 2017, available at *http://www.enterprisecommunity.org/resources/understanding-small-and-medium-multifamily-housing-stock-19423.*

Some of the home ownership gap is also tied to income differences that continue to persist, as well as outright discrimination in spite of decades of work to eliminate housing discrimination and promote economic opportunity.

FHFA's efforts related to closing the home ownership gap focus on mortgage credit in various ways. Encouraging the Enterprises to better reach underserved African American, Latino, and other minority communities requires the same focus that FHFA applies across its activities on balancing housing finance market liquidity with ensuring safety and soundness. Among the steps FHFA is taking are:

Encouraging the Enterprises to test new approaches to affordability, access, and supply on a small scale through pilots. This approach helps to ensure that the approaches work and that they can be replicated and implemented safely and soundly.

Monitoring the Enterprises' Duty to Serve Underserved Market Plans, which incorporate a number of initiatives that will help address housing affordability challenges by better serving the manufactured housing, affordable housing preservation, and rural housing markets. Residential economic diversity is one element of the Duty to Serve plans that can help focus more specifically on the home ownership gap.

Assessing the potential impact of the Enterprise's 2017 update of debt to income ratio (DTI) limits from 45 percent to 50 percent based on the automated underwriting systems' comprehensive risk assessment, which helps people get a mortgage who are good credit risks but may have higher DTI percentages. African Americans and Latinos are more likely to have DTIs above 45 percent than other potential borrowers.

Monitoring and enforcing the affordable housing goals, which provide a quantified and measurable direction to the Enterprises to reach all segments of the home mortgage market, specifically areas with many low-income or minority residents.

Implementing the Neighborhood Stabilization Initiative, which aims to create more and better opportunities for home ownership in communities impacted by the financial crisis, many of which are already home to many minority households. Sustainable home ownership can be about improving existing neighborhoods as well as about empowering households to seek home ownership elsewhere.

These steps are part of efforts to address the home ownership gap, but are not sufficient by themselves. Closing the home ownership gap will require steps beyond the housing finance market and FHFA's oversight of the regulated entities. FHFA will have to work with other agencies, stakeholders, and partners at the Federal, State, and local levels to promote fair and equitable access to affordable housing.

Q.5. In the run-up to the Financial Crisis, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks bought residential mortgage backed securities. The sellers lied about the quality of these securities. In recent years, the Federal Home Loan Banks have settled lawsuits with dealers who concealed information and lied to them. The Federal Home Loan Bank of San Francisco received more than $450 million in settlement funds and then set-aside $100 million of the settlement funds it received to establish vol-

untary programs including a Quality Jobs Fund. This Fund will help people obtain higher-paid employment.

How much total compensation did the 11 Federal Home Loan Banks receive from settlements from fraudulent dealers? What did the FHLBanks do with these settlement dollars?

A.5. The FHLBanks were successful in numerous lawsuits against parties that were involved in the private label mortgage backed security (PLMBS) securitization process. Litigation settlement proceeds totaled $2.1 billion as of March 31, 2018. Few, if any, further significant litigation settlements are expected.

The settlement amounts from these lawsuits have been used in several ways. Because FHLBanks allocate 10 percent of their net income to the Affordable Housing Program (AHP), any litigation settlements that accrue to earnings increase the dollar amounts to AHP. The FHLBanks have also used the proceeds from litigation settlements to strengthen the capital position of the FHLBanks and provide value to their members and communities. Retained earnings have grown substantially across the FHLBank System, strengthening the FHLBanks' capital position and dividend rates have increased, partially as a result of the settlements, increasing the value of FHLBank membership. Some FHLBanks have also declared special dividends that coincided with some of the more significant settlements. The FHLBank of San Francisco, for example, voluntarily decided to make a $100 million charitable contribution to the Quality Jobs Fund as a result of the settlements received.

Q.6. Hundreds of employees of banks, mortgage lenders and brokers have been indicted for submitting fraudulent loan applications, forging signatures, and embezzling in cases that affected the loans purchased by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

In March, the Office of Inspector General urged the FHFA to improve how Fannie Mae and Freddie Mac are told to report fraud. The OIG found a disparity between the statutory requirement and the criteria set by FHFA. The OIG says by statute an Enterprise must "timely report possible fraud" but FHFA requires the GSEs to report only those they have investigated and have a "reasonable belief" is fraud. The OIG asserts that these investigations result in a delay and is inconsistent with Congressional intent.

What is your view of the OIG report? When will FHFA align the reporting requirement to Congressional intent?

A.6. As noted in the FHFA OIG Report, FHFA's Office of the General Counsel does not agree with the OIG's conclusion that FHFA's interpretation and application since 2010 of the "timely report" requirement in the Housing and Economic Recovery Act regarding possible fraud is inconsistent with the statute.

At the time of the statutory enactment, which codified FHFA practices and avoided Enterprise liability for reporting suspected fraud, FHFA had a robust reporting regime and it continues to do so. The regulated entities make a reasonable determination of possible fraud to avoid reporting a large number of "false positives." A concern about "false positives" had been raised by law enforcement officials with FHFA in the past. FHFA makes a responsible inquiry following a "tip" or of other information, which we believe

is appropriate. This inquiry does not create a higher reporting threshold or delay a timely notification. It provides a mechanism by which the regulated entities implement statutory and regulatory requirements so FHFA has robust information that is timely and will assist both FHFA and law enforcement in preventing fraudulent activity.

The General Counsel agreed to consider any possible disparity raised by the FHFA OIG report during the Agency's 5 year review of its regulations, which is now underway.

Q.7. Employees who submit fraudulent reimbursement requests for personal travel that they identify as business-related are engaged in theft. The FHFA Office of the Inspector General reported that the leadership of the Federal Home Loan Bank of Dallas was indicted for stealing more than a million of dollars in expenses and uncharged vacation time.

When did the FHFA become aware of this embezzlement charge?

A.7. FHFA learned from the FHLBank of Dallas (the Bank) in September 2013 that issues had arisen with members of its senior management. As is usual in these situations, the Bank conducted an inquiry using outside counsel. The FHFA OIG subsequently was informed of this matter as well. FHFA was kept informed of the progress of the investigation and informed that the Bank was terminating the employees. FHFA OIG also looked into this matter. FHFA reviewed the Bank activities regarding the employees and reformed its policies on submission of claims and review of billing by senior executives. FHFA then undertook an additional effort to secure repayment to the Bank by the executives of the estimated benefits to the executives.

During this period, FHFA remained in touch with the Dallas United States Attorney's Office (USAO) as they reviewed potential civil or criminal actions. FHFA responded to all inquiries and provided all information that it had to the satisfaction of the USAO. There were two separate contacts: one preceded the actual filing of charges by approximately a year, and then another as the USAO approached filing charges.

Q.8. What is the status of the indictment against the former Federal Home Loan Bank of Dallas President and Chief Executive Officer Terrence Smith, Nancy Parker, and Michael Sims?

A.8. FHFA is aware that the Dallas USAO is preparing/or a criminal trial in this matter.

Q.9. What technical assistance has FHFA provided to the Federal Home Loan Bank of Dallas board of directors to prevent these types of frauds in the future?

A.9. FHFA regularly conducts examinations and ongoing supervision, which includes meetings with the full board of directors and targeted reviews. Supervision staff met with the FHLBank of Dallas board of directors to recommend and/or require the implementation of controls related to expense reimbursement approval, improved inventory controls, and improved fraud reporting.

Q.10. Native Americans face acute housing challenges, spanning from affordability concerns to the need for investments to improve housing quality.

I was pleased to see that the Duty to Serve plans from Fannie Mae and Freddie Mac include commitments to engage with tribal governments, and ensure that the GSEs are serving the needs of Native American renters and homeowners. Can you discuss why the inclusion of tribal areas was important, and will you commit to having the GSEs engage with Nevada tribal leaders to understand their housing concerns?

A.10. The Duty to Serve statute encourages the Enterprises to improve capital distribution available for mortgage financing for underserved markets. The Duty to Serve regulation specifically identified serving members of Federally recognized Indian Tribes located in Tribal areas as a challenging segment of the rural underserved market. This conclusion was reached after taking public input through a notice and comment process, which identified this population as one that struggles with a high concentration of poverty and substandard housing conditions. The challenges of lending to tribal populations is exacerbated because the land and improvements involved in a transaction may not have the same transfer rights and may function more like a leasehold estate. This could deter traditional lenders from financing mortgages for home purchase because they cannot perfect the lien on the collateral.

Both Enterprises have committed to engaging with Tribal leaders in their 3-year Duty To Serve Plans (Fannie Mae Duty To Serve Plan p. RH 25-31; and Freddie Mac Duty To Serve Plan p. RH 34-46).[2] FHFA is committed to ensuring that the Enterprises fulfill the commitments they made in their public plans and will encourage them to look for opportunities to work with Nevada Tribal leaders to better understand their housing concerns.

Q.11. Director Watt, when you served in the House of Representatives, you led the way to ensure people received quality mortgages they could afford to repay. The current leadership of the Consumer Financial Protection Bureau is undermining enforcement and reducing oversight of the mortgage market.

If President Trump's appointed director, Mick Mulvaney, stops policing the mortgage market, how might that affect Fannie Mae, Freddie Mac, and the Federal Home Loan Banks? Do you have any concerns that mortgage lenders might go back to steering customers to subprime, costly, and unsustainable loans?

A.11. The Consumer Financial Protection Bureau and FHFA are separate agencies and play different roles in overseeing parts of the mortgage market and housing finance system. FHFA, as both regulator and conservator of Fannie Mae and Freddie Mac, continues to have the responsibility and authority to establish strong underwriting criteria for any loans that the Enterprises purchase and to ensure that taxpayers are not again put at risk/or possible losses. FHFA will also be working closely with the CFPB as ii reviews and updates the qualified mortgage standards.

Q.12. Fannie and Freddie have not only repaid the Treasury and taxpayers for the investment during the financial crisis. It continues to send its profits directly back to the Treasury.

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[2] Available at: *https://www.fhfa.gov/PolicyProgramsResearch/Programs/Documents/Fannie-Mae_Final-UMP.pdf; https://www.fhfa.gov/PolicyProgramsResearch/Programs/Documents/Freddie-Mac_Final-UMP.pdf.*

How much beyond the initial $185 billion have Fannie Mae and Freddie Mac sent to the Treasury?

A.12. Through March 31, 2018, the Enterprises have paid combined dividends to the Treasury of $278.8 billion as outlined under the terms of the Preferred Stock Purchase Agreements (PSPAs); Fannie Mae has paid dividends totaling $166.4 billion, and Freddie Mac has paid $112.4 billion. The draws from the Treasury, also through March 31, 2018, have been in the combined amount of $191.5 billion—$119.8 billion/or Fannie Mae, and $71.6 billion/or Freddie Mac. The PSPAs, which specify the terms of this financial agreement, do not count dividends paid toward the reduction of the principal amounts invested by the Treasury. Therefore, the Treasury continues to own senior preferred stock with a liquidation preference in the amount of $191.5 billion.

Q.13. While much of this repayment stems from an increase in the value of both GSEs' portfolios, a sizeable amount also comes from the guarantee fees assessed on the loans in their mortgage-backed securities. These fees, which are intended to offset the credit risks borne by the GSEs (and Treasury), have increased in recent years from levels that were clearly set too low. However, as these fees have increased, so too have the credit scores of the average borrowers whose loans comprise those securities.

Are you concerned that the guarantee fees may be higher than is needed to cover the risks of the GSEs' current portfolio?

A.13. Establishing appropriate guarantee fee levels entails balancing the costs of covering projected credit losses over the life of each loan, and the Enterprises' cost of holding capital to cover these potential losses and administrative costs with important considerations related to housing affordability. Achieving this balance requires constant monitoring of G-fee levels and considering various adjustments that might be made.

FHFA's most recent full-scale review of guarantee fee levels was completed in early 2015. Since that time, FHFA has been monitoring pricing in light of developments in the primary and secondary mortgage markets. FHFA will continue to evaluate and reevaluate the level of G-fees as we strive to meet all of our statutory responsibilities and will make adjustments deemed appropriate.

Q.14. How might a decrease in the guarantee fee level affect housing affordability, particularly for first-time homebuyers, low-wealth borrowers and borrowers in typically underserved areas, such as area with large minority populations?

A.14. G-fees are one of a number of factors that can affect housing affordability; however, reductions in G-fees would likely have a relatively limited impact on improving affordability overall. Increases in home values over the last several years, combined with the rise in mortgage rates in' more recent periods, have resulted in lessening affordability.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTERS SUBMITTED BY SENATOR TIM SCOTT

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March 30, 2018

VIA EMAIL

The Honorable Mel Watt
Director
Federal Housing Finance Agency
Office of Housing and Regulatory Policy
400 7th Street Southwest, 9th Floor
Washington, DC 20219

Re: Credit Score Request for Input

Dear Director Watt:

This letter responds to the Credit Score Request for Input ("RFI") issued by the Federal Housing Finance Agency ("FHFA"), and specifically to arguments raised by various parties regarding the allegedly anticompetitive impact that would occur if FHFA were to adopt Option 3 ("Lender Choice on which Score to Deliver, with Constraints").

I represent VantageScore® Solutions, LLC ("VantageScore Solutions"),[1] and have done so since 2006, when I defended the company in a lawsuit FICO brought against it and its owners, TransUnion LLC ("TransUnion"), Experian Information Solutions, Inc. ("Experian"), and Equifax, Inc. ("Equifax"), the three national credit reporting agencies ("CRAs").[2]

VantageScore Solutions was formed in part to introduce some viable competition

[1] I am with the law firm of Berens & Miller, P.A. in Minneapolis, Minnesota.
[2] *Fair Isaac Corp. v. Experian Information Solutions Inc.*, Civ. No. 06-4112 ADM/JSM (D. Minn.).

to FICO's dominance[3] in the relevant market of generic credit scores.[4] FICO sued VantageScore Solutions within months of its formation, asserting several claims, including antitrust claims, and asking the court to put VantageScore Solutions out of business entirely.[5]

FICO readily acknowledged in that litigation that its Classic score was "the dominant credit score,"[6] which at that point in time represented, for example, "more than 94% of the business-to-business segment" of the market.[7]

The introduction of VantageScore, however, did not impede FICO's dominance.[8] And more than twelve years later, the competitive landscape, according to FICO, remains largely unchanged. Today, FICO claims, as it has for years, that its credit scores are used

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[3] *See Fair Isaac Corp. v. Experian Information Solutions Inc.*, 650 F.3d 1139, 1144 (8th Cir. 2011)(the credit bureaus joined to develop a "credit score algorithm that could compete with FICO and reduce the amount the credit bureaus paid as royalty for using FICO's algorithms"). Market participants had also expressed a desire for a legitimate alternative to FICO.

[4] Several RFI responses have focused on the CRAs' alleged dominance in the market for consumer credit data. *See, e.g.*, William Stallings, *Competition Considerations in Changing Mortgage Finance Credit Score Requirements* at 3 ("the CRAs control the data on which credit scores are based")(hereinafter "*Competitive Considerations*"). That, however, is not the relevant market for purposes of analyzing antitrust threats in the mortgage sector, as was determined in FICO's litigation against VantageScore.

[5] FICO'S Third Amended Complaint, in the Prayer for Relief, asked among other things that "The Defendants be ordered to dissolve VantageScore…." (Nov. 10, 2008)(Dkt. No. 436). FICO also claimed that its trade secrets had been copied in the development of VantageScore's algorithm, but FICO dropped that claim after one of its experts found no evidence to support that theory and the court also ordered FICO to produce all of the trade secrets it alleged had been copied.

[6] *Fair Isaac Corp. v. Experian Information Solutions Inc.*, 645 F. Supp. 2d 734, 764 n.2 (D. Minn. 2009)(FICO is the "dominant credit score")(citing FICO 3d Am. Compl. ¶¶ 22, 40).

[7] *Id.* at 738.

[8] *Id.* at 754-55 (detailing FICO's continued dominance in the credit scoring market despite the introduction of the first VantageScore credit score three years earlier).

in 90% of all of the lending decisions in the United States.[9] FICO has no evidence to support any notion that the CRAs have harmed FICO in the last twelve years.

Public statements confirm that FICO's business has continued to boom. For example, in FICO's November 9, 2017 10-K, FICO reported that:

> Scores segment revenues increased $25.3 million in fiscal 2017 from 2016 due to a $14.2 million increase in our business-to-business scores revenues and an $11.1 million increase in our business-to-consumer services revenue.[10]

Barclays made the following statement regarding FICO's January 25, 2018 earnings release:

> We saw more positives than negatives from FICO's 1Q18, and update our PT to $175 (from $150). Three key takeaways: 1) Scores showing no signs of slowing down: B2B (+13% y/y) continues to benefit from healthy consumer credit trends, and **better-than-historical pricing escalations**. B2C displayed well-rounded growth (albeit +27% in 1Q benefitted from easiest comp), supported by continued ramp with EXPN.... (emphasis added).[11]

The strength of FICO's current earnings; its recent, unilateral, and "historical" price increases;[12] its claimed dominant position in the marketplace, coupled with FICO's

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[9] *See Credit Where Credit is Due*, *DSNews* (Feb. 1, 2018)(interview with FICO's Joanne Gaskins), available at http:/dsnews.com/daily-dose/02-01-2018/future-fico-gses; *see also* Mercator Press Release, *FICO® Scores Used in Over 90% of Lending Decisions According to New Study* (Feb. 27, 2018)("New research from Mercator Advisory Group has found that in the United States, FICO® Scores were in 2016 used in more than 90% of lending decisions, including credit cards, mortgages, and automobile financing."), available at https://www.mercatoradvisorygroup.com/.

[10] This represents business that, by FICO's own admission, is sold through the three CRAs.

[11] Another Barclays' investor communication, dated December 22, 2017, noted that: "Scores business is most profitable segment (50% of profitability) and [is] all in the U.S."

[12] FICO's recent price increases put the lie to the notion, *see infra*, that the CRAs somehow control the pricing of an entity that has monopoly power.

joint, well-publicized initiatives with Experian (one of VantageScore Solution's owners); its joint development and sale of the FICO XD credit score with Equifax (another one of VantageScore Solution's owners); and all three CRAs' substantial sale of FICO scoring products underscore FICO's continued ability to compete successfully in all of those industries in which VantageScore is also accepted.[13]

Despite the foregoing and other factors, several responses to the RFI speculate that if Option 3 were to be adopted, VantageScore Solutions and/or its owners would gain some type of anticompetitive advantage and misuse that advantage to drive FICO from the mortgage space. These responses, often proffered by persons associated with FICO, argue that the maintenance of FICO's monopolistic position is the sole remedy to protect FICO from alleged extinction.

Two of FICO's outside attorneys, William Stallings, of Mayer Brown LLP,[14] and Joseph A. Smith, of Poyner Spruill,[15] have submitted responses opposing a change in the status quo, as have Tom Parrent and Ann Schnare, two consultants whose papers submitted to FHFA were funded by FICO.[16]

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[13] Indeed, Equifax's new CEO, Mark Begor, is currently on FICO's board of directors, although it is reported that Begor will be resigning from that directorship before starting with Equifax on April 16, 2018. *See, e.g.*, Jenny Surane, *Equifax Names Warburg Pincus's Begor CEO After Data Breach* (Bloomberg Mar. 28, 2018).

[14] Although Stallings asserts that his submission "is based on my independent review of the competition issues raised by the RFI," *see Competitive Considerations* at 1, Stallings represents FICO, the credit scoring company which benefits the most from the maintenance of the status quo. As Stallings acknowledges: "The Enterprises have long required the use of FICO® Scores in connection with mortgage finance credit applications." *Id.*

[15] Joseph Smith similarly states that his submission "is based on my independent review of the regulatory, supervisory, and policy issues that, in my opinion, are fundamental to FHFA's determination as to 'alternative' credit scoring," but he too concedes that he is submitting his response to the RFI "as counsel to Fair Isaac Corporation (FICO)." Joseph A. Smith, Jr. RFI Response at 1 (Jan. 29, 2018) (hereinafter "Smith").

[16] Ann B. Schnare, *Alternative Credit Scores and the Mortgage Market: Opportunities and Limitations* at 1 (Dec. 4, 2017)(FICO "provided funding for this paper)(hereinafter "Schnare's Paper"); Tom Parrent & George Haman, *Risks & Opportunities in Expanding*

Those submissions all threaten dire competitive consequences if FICO were unable to maintain its exclusive position in the mortgage space. For example, Stallings claims that "[t]he principal competitive concern . . . is that allowing the use of VantageScore would provide the CRAs both the *incentive* and the *ability* to foreclose FICO as a mortgage credit score provider."[17] "In credit information markets, mortgage or otherwise," Stallings writes, "the CRAs already control the data used to generate credit scores, set the downstream price for credit scores offered by both FICO and VantageScore, and own VantageScore itself."[18] He then goes on to imply (erroneously) that the CRAs' joint ownership of VantageScore Solutions somehow runs afoul of "the antitrust laws," a theory that was resoundingly rejected in FICO's 2006 lawsuit against VantageScore Solutions and the CRAs.[19]

Based on the foregoing, Stallings theorizes that "should FHFA authorize the use of" VantageScore credit scoring models, that "undoubtedly would harm FICO as a competitor as it would drive FICO from the mortgage market, leaving VantageScore as the only provider."[20]

Smith's submission similarly threatens dire anticompetitive consequences if VantageScore were to be offered as a choice, contending that by "[a]uthorizing a credit

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Mortgage Credit Availability through New Credit Scores (cover page indicating that "Research sponsored by FICO").

[17] *Competitive Considerations* at 1 (italics in original). Stallings claims that the competition issues that would arise if VantageScore were a permitted alternative would be "similar to those that frequently arise in connection with vertical mergers or vertical integrations," and then contends that although "many" instances "of vertical integration or vertical transactions" are admittedly "procompetitive," allowing VantageScore as an alternative would "harm" the competitive process. *Id.* at 2-3. This is ironic given that this arena is currently bereft of any competition.

[18] *Id.*

[19] *Fair Isaac Corp.*, 645 F. Supp. 2d at 747.

[20] *Competitive Considerations* at 1. Stallings' arguments are based on the unfounded (and historically inaccurate) notion that VantageScore Solutions and the three CRAs are planning to violate the antitrust laws. Those antitrust laws are designed, however, to protect competition (and not competitors), to ensure that antitrust violations do not occur, and to empower those alleging antitrust injury to seek redress. Should VantageScore or any of the three CRAs commit an antitrust violation, past history reveals that FICO is both willing and able to file suit under the federal antitrust laws.

scoring regime that includes as an option a provider owned and controlled by the three entities that are the only providers of both the credit data necessary to generate credit scores and the means to distribute them virtually guarantees a reduction in or elimination of competition."[21]

Parrent's RFI response contends that "[t]he ownership structure, pricing power and control over data wielded by the CRAs and VantageScore pose a clear danger to fair competition in credit scoring."[22] Parrent hypothesizes "that VantageScore acceptance without a complete separation of ownership from the CRAs will ultimately result in an effective monopoly in the credit scoring space."[23]

Schnare's RFI response argues, among other things, that FICO "is the only logical choice given concerns over VantageScore's … problematic ownership structure."[24] She claims that if FHFA were to permit the use of competing scores, "it should take steps to ensure that the credit bureaus do not use their control over credit records . . . to steer the market to VantageScore."[25]

A submission by Anne C. Canfield, the Executive Director of the Consumer Mortgage Coalition, raises a similar concern, that "the ownership structure of VantageScore is . . . problematic."[26] She also charges that "Equifax, Experian, and Transunion have a shared monopoly in the consumer finance space because FHFA requires every consumer to purchase all three reports from the CRAs."[27]

The concerns raised by Stallings, Smith, Schnare, and Canfield, as well as other RFI responses threatening FICO's extinction, are unfounded.[28] This scenario is both

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[21] Smith at 1.
[22] Tom Parrent & George Haman RFI Response at 13 (Jan. 29, 2018).
[23] *Id.*
[24] Ann B. Schnare RFI Response at 2 (Jan. 17, 2018).
[25] Ann B. Schnare RFI Response Appendix A at 2 (Jan. 17, 2018).
[26] Anne C. Canfield RFI Response at 3 (Mar. 15, 2018).
[27] *Id.* at 4.
[28] Canfield's "shared monopoly" challenge is without legal support because such allegations cannot support a viable antitrust claim. *See, e.g.*, *Int'l Longshore & Warehouse Union v. ICTSI Oregon, Inc.*, 15 F. Supp. 3d 1075, 1096 (D. Ore. 2014) ("'[A]n allegation of conspiracy to create a shared monopoly does not plead a claim of conspiracy under section 2.'")(quotation omitted); *Oxbox Carbon & Minerals LLC v.*

unlikely (given FICO's claimed and continuing dominance in all other pertinent industries despite VantageScore's presence therein) as well as ironic (given FICO's efforts to continue to remain the only scoring model that the Enterprises are allowed to accept). The notion that FICO will somehow be driven from the mortgage market if it were to be faced with legitimate competition for the first time is nothing more than a scare tactic.

Indeed, this is not the first time that FICO has raised this specter. In its 2006 lawsuit, FICO alleged that the CRAs' goal in forming VantageScore Solutions "was not merely to compete with FICO scores but to eliminate FICO scores from the credit scoring market entirely."[29] Although that situation has never occurred, FICO echoes a similar refrain here, claiming that the CRAs are again intent on eliminating FICO from a market, in this case, the mortgage market.

A review of the last twelve years shows the improbability of the threat on which FICO and its supporters focus. The CRAs could have taken steps to hamper FICO's growth anytime over the last twelve years, but it has not happened. Instead, public statements reveal that the CRAs have facilitated FICO's growth, in terms of scores sold, over the last twelve years.

Moreover, an examination of every other industry in which the two credit scores compete demonstrates via concrete evidence, as opposed to some hypothetical notions, that VantageScore's acceptance and use in those other industries has not resulted in FICO's elimination from those markets.

On the other hand, FICO has engaged in a campaign to quash any meaningful competition since 2006. In 2006, FICO encouraged the U.S. Department of Justice to

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Union Pacific Railroad Co., 926 F. Supp. 2d 36, 45 (D.D.C. 2013)(allegations of a "shared monopoly" do not support an antitrust claim).

Indeed, in *Standfacts Credit Servs., Inc. v. Experian Info. Solutions, Inc.*, 405 F. Supp. 2d 1141 (C.D. Cal. 2005), the court expressly rejected Canfield's notion that the tri-report requirement could lead to a viable monopolization claim against the three CRAs. *Id.* at 1151-52.

In fact, it is *FICO*, not VantageScore or the three CRAs, which currently enjoys a monopoly.

[29] *Fair Isaac Corp.*, 645 F. Supp. 2d at 739. The Court rejected FICO's allegation when finding that it lacked antitrust standing. *Id.* at 753.

look into VantageScore Solutions and its formation. The Department of Justice closed its inquiry of VantageScore Solutions in January of 2007 with no further action taken.

FICO also continued to pursue its lawsuit against VantageScore Solutions and the CRAs, in part because of FICO's claimed concern that the CRAs were going "to drive [FICO] out of business."[30] The court rejected FICO's theory outright, finding instead that the CRAs' "strategy of persuading the market that one product is equal or superior to another product and that the price of the first product presents a higher value proposition than does the second is the very nature of competition."[31]

Stallings argues, however, that the FICO litigation against VantageScore Solutions is without much significance because the federal district court ruled, and the United States Court of Appeals for the Eighth Circuit affirmed, the dismissal of FICO's antitrust claims on the basis of its lack of standing.[32] That argument underplays the significance of the courts' rulings that FICO lacked "antitrust standing."[33] To find a party lacks antitrust standing, a court must conclude that the complainant did not suffer "antitrust injury."[34] Such a finding goes directly to a principal element of a viable antitrust claim, that is, that the party bringing the action must be harmed in a manner that is forbidden under the antitrust laws.[35] As a result, a finding of an absence of antitrust standing is deemed a ruling on the merits.[36]

The district court in the FICO case clearly reached the merits of FICO's antitrust claims when holding that those claims failed as a matter of law because FICO lacked antitrust standing:

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[30] *Id.* at 750.
[31] *Id.* at 751.
[32] *Competitive Considerations* at 8.
[33] *Fair Isaac Corp.*, 645 F. Supp. 2d at 753, *aff'd* 650 F.3d at 1146.
[34] "An antitrust injury is 'injury of a type that the antitrust laws were intended to prevent and that flows from that which makes defendants' acts unlawful.'" *Fair Isaac Corp.*, 650 F.3d at 1144-45 (citation omitted).
[35] *See, e.g.*, *Ethypharm S.A. France v. Abbott Laboratories*, 707 F.3d 223, 232 & n.15 (3d Cir. 2013)("antitrust standing 'is simply another element of proof for an antitrust claim, rather than a predicate for asserting a claim in the first place'")(quotation omitted).
[36] *Id.* ("failure to establish antitrust standings is a merits issue").

> Fair Isaac's antitrust claims **suffer from a fundamental, indeed fatal, flaw**. The alleged conspiracy does not employ tactics that seek to destroy or cut off competition *before it even has a chance to take hold*; rather, the alleged conspiracy is dependent on convincing the market … that greater value can be realized by switching from FICO scores to VantageScore credit scores. **This is the very essence of competition**.[37]

Permitting a choice of credit scores in the mortgage sector would also foster the "very essence of competition." A review of historical facts demonstrates that competition between FICO and VantageScore has not triggered FICO's elimination from any other industry, but has instead fostered innovation, and there is no evidence to suggest that the situation would be any different in the mortgage arena. If Option 3 were to be adopted, the antitrust laws stand ready to protect any entity that is harmed by actionable anti-competitive behavior,[38] and unfounded scare tactics should not tip the balance when all evidence regarding the value of competition supports choice rather than exclusivity.

Very truly yours,

Barbara Podlucky Berens

Barbara Podlucky Berens

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[37] *Fair Isaac Corp.*, 645 F. Supp. 2d at 752 (emphasis added; italics in the original).

[38] For example, sales of credit data or credit reports are deemed to be services subject to the protections of the Sherman Act and the Federal Trade Commission Act, as well as portions of the Clayton Act. *See, e.g.*, *Credit Bureau Reports, Inc. v. Retail Credit Co.*, 476 F.2d 989, 991 (5th Cir. 1973)(affirming injunctive relief against company selling credit reports for violations of Sections 1 and 2 of the Sherman Act and Sections 7 and 16 of the Clayton Act); *Fed. Trade Comm'n v. Credit Bureau Ctr., LLC*, 235 F. Supp. 3d 1054, 1060 (N.D. Ill. 2017)(FTC action against company that offered credit monitoring services and online credit scores which alleged violations of the Federal Trade Commission Act and other laws).

VantageScore

Friday, March 30, 2018

Federal Housing Finance Agency
Office of Housing and Regulatory Policy
400 7th Street Southwest, 9th Floor
Washington, DC 20219

Re: Credit Score Request for Input

Thank you for the opportunity to provide feedback on the important issues that have been raised in the Agency's *Credit Score Request for Input* ("RFI"). We have valued the dialog with the Agency's staff over the previous years and look forward to jointly working towards a mortgage market that fosters competition to fairly serve all creditworthy borrowers.

As you know, VantageScore Solutions, LLC, develops generic credit scoring models that deploy a consistent algorithm across each of the three national credit reporting companies: Equifax, Experian, and TransUnion (the "CRCs"). In choosing to work exclusively with credit file data, we benefit from the stringent regulations (i.e., ECOA and FCRA) and data standards (e.g., quality, accuracy, standardization, and universality) that such data are subject to. Each of our models is strenuously audited and tested prior to implementation, according to industry best practices, and validated thereafter on an annual basis. We have, for the past 9 years, shared the results of these annual validations publicly. Peak performance is the "table stakes" in our business: before implementing a new model, a lender will conduct its own series of tests and predictiveness evaluations. According to a recent study by Oliver Wyman, more than 2,200 lenders used more than 6 billion VantageScore credit scores during a 12-month period between 2016 and 2017.[1]

The strongest market is one in which credit score model developers compete to develop the most predictive models for the largest number of consumers. This can only be achieved when each mortgage lender has the freedom to choose which model is best for its business, as described in Option 3 on page 15 of the RFI. With respect to the Enterprises, the models chosen should meet industry-leading performance benchmarks; protections must be applied to prevent "score shopping"; and sufficient data must be supplied to investors. We elaborate on each of these themes throughout the response below.

[1] This does not include the more than 2 billion scores used by consumer-facing programs and other non-lenders. "2017 VantageScore Market Study." Authored by Oliver Wyman. https://bit.ly/2qW1KRz

Competition can and, outside of the mortgage industry, has led to more predictive, more consumer-friendly, and more inclusive credit scoring models. An examination of the actual impact in other industries demonstrates that credit scoring competition has not led to a "race to the bottom," but rather a race to innovate and build better-performing models. Extending this competition to the mortgage industry will benefit the entire market by ensuring better access and fairer pricing for consumers; better risk evaluation for lenders, insurers, and investors; more transparency for all participants; and continued pressure on model developers to innovate and improve their products.

Below please find our responses to a number of the specific questions that were posed in the Request for Input. As an introduction to those answers, we've also provided general commentary below in response to the *Background* and *Introduction* sections of the RFI.

On the second page of the RFI, under the section Empirical Evaluation, you note that *"the Enterprise empirical findings are only applicable to the Enterprises' testing of mortgage applications and loans and should not be extrapolated beyond this scope."* The very next paragraph in the RFI, however, makes a statement about "marginal benefits" that has been interpreted by some to suggest a broad conclusion which far exceeds the scope of the tests actually performed.

Today, prospective borrowers with limited or imperfect credit histories are often discouraged from applying for loans.[2] When they do apply, they face limited lender options; limited product options; and significantly higher prices. The evaluations performed by the Enterprises only considered those applications submitted to the Enterprises, and thus substantially ignored the population that today is unserved or underserved by the Enterprises.

In addition, by focusing on accuracy and coverage, the Enterprises' tests also did not consider questions of fairness and affordability. Page 6 of the RFI correctly notes that a borrower's FICO score is one of two factors that determines loan pricing. A loan application without a FICO score may be eligible through a nontraditional credit program, but these loans are subject to onerous price increases. Without changing the way in which these loans are underwritten today, the use of a model with a larger scoreable universe could potentially improve the terms offered for some nontraditional borrowers.

The market as a whole would be fairer if loans were priced using models that do not compromise on performance integrity but also incorporate more consumer-friendly approach to medical debt, paid collections, and the other "compelling reasons" outlined on page 15 of

[2] https://www.urban.org/urban-wire/borrowers-less-perfect-credit-are-giving-trying-get-mortgage

the RFI. VantageScore takes particular pride in having pioneered every single one of the new approaches that the RFI lists as "compelling reasons for the Enterprises to update their credit score requirement." Such innovations underscore the need for and value of competition.

Finally, please note that the term "Classic FICO" is not specific to the three different models currently required by the Enterprises. FICO uses the "classic" designation to describe several different generations of models which date back to the 1990s. The current set of models required by the Enterprises, which we refer to throughout this letter as "Legacy FICO," was built prior to the recession using data from July 1995-97, July 1998-2000, and October 1998-2000.

Question A1.2: Do you use the same credit score version for all of your lending business lines, whether it is mortgage lending or non-mortgage lending (e.g., credit card and/or auto loans)? If so, why? If you use multiple credit scores (e.g., FICO and VantageScore) in making credit decisions for any one line of business, please identify which credit score you use for the type of lending and why? Are you considering updating credit scores that you use in your non-mortgage lending business lines?

The ways in which lenders source, underwrite, and manage accounts are often viewed as proprietary competitive information and therefore many lenders are reluctant to publicly discuss details. We base the following responses on the combined experiences of VantageScore model developers and other VantageScore executives, both at and prior to joining the VantageScore team, and on public information gathered through presentations and securities disclosures.

There is often substantial variation in score usage across and within lines of business. According to a Supervisory Note from the FDIC:

> "Many lenders segment the applicant population by applicant characteristics, channels through which the application was received, or both. For example, a lender may have one [credit scoring] system for applicants with nothing worse than a 30-day late on their credit report and a different system for applicants with more serious derogatory information. Or, a lender may have one system for automobile loan applications received directly from the borrower and a different system for automobile loan applications received indirectly through an auto dealer."[3]

[3] FDIC Supervisory Notes: "Fair Lending Implications of Credit Scoring Systems." Published 2013. Available at https://bit.ly/2GkxOSF

The selection and use of models can vary, even within a business unit, across pre-screen (i.e., pre-approval or marketing), underwriting (i.e., new account opening), account management (e.g., line increase or decrease decisions), corporate risk management (e.g., stress testing, loss reserving, corporate reporting), consumer education, and investor reporting functions.

We consider the first three categories above to be "credit decisions." The pre-screening process begins by making soft inquiries to prospective borrowers' credit files in order to extend conditional offers or terms. Third-party credit scores typically play a central role in this process. Chase, the second largest card issuer in the United States, states the following:

> "For preapproved direct mail solicitations, Chase USA generally obtains from credit bureaus prospective cardholder names that meet its underwriting criteria... Chase USA then mails those prospective cardholders preapproved solicitation packages which require a limited amount of additional information from the prospective cardholder in order to open an account."[4]

Once a borrower submits an application for credit, the lender will make a hard inquiry to his or her credit file. This inquiry often includes a mix of pre-defined attributes, raw credit file data, and one or more third-party credit scores that are calculated using a model developed by FICO, VantageScore, or the credit bureau providing the data.

While some smaller lenders may make underwriting decisions using only a third-party credit score, most large lenders rely upon proprietary models. Continuing with the above example, "Chase USA primarily uses a proprietary credit scoring model to assess the credit risk of potential and existing cardholders."[5] The FDIC Advisory Note agrees, "It is rare for a bureau score to be the only criterion considered in making a credit decision."[6]

Third-party credit risk scores, also known as generic credit risk scores, have principally been developed by FICO, VantageScore, or one of the CRCs. The score delivers an estimate of consumer risk. It is typically used in one of three ways, as the sole risk indicator, in combination with additional consumer related information such as credit file composition, income and/or cash flow, or as a variable within a lender's proprietary risk model. Consumer risk assessment from any of these methods can be used in a variety of credit underwriting processes, for example, to determining credit eligibility, pricing and/or segmentation.

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[4] Prospectus for Chase Issuance Trust. Page 4. Filed with SEC November 13, 2017. https://bit.ly/2uvuQsZ
[5] Ibid, Page 56.
[6] FDIC Op. Cit.

Consider Toyota Financial, the largest auto lender in the United States. Toyota calculates a proprietary credit score based on each borrower's full credit file together with a FICO Score and a VantageScore credit score. For approved loans, the borrower is assigned into a pricing tier based on "customer risk as defined by credit bureau scores and other factors for a range of price and risk combinations."[7]

Account management decisions are made using a soft inquiry to each borrower's credit file or, if a borrower requests a credit increase, using a hard inquiry. As with underwriting decisions, the specific ways in which third-party credit scores are used vary. Alliance Data, one of the largest card issuers in the United States, notes that "In order to monitor and control the quality of the credit card portfolio, the bank uses behavioral scoring models and credit bureau scores to score each active account on its monthly billing date."[8]

Both proprietary and third-party models are routinely tested. It is not uncommon for some lenders to update their proprietary models as often as annually. These upgrades are occasionally disclosed through public asset-backed securities filings, which is common for newer "marketplace" lenders, who are building credibility with investors. Most other lenders more commonly treat this information as proprietary.

For example, Oportun—a lender that primarily makes personal loans to Hispanic borrowers with limited credit histories— reports plans to roll out its eighth-generation proprietary model since being founded in 2005. Oportun reports that it employs a "empirically derived decision tree built using the Company's credit experience" that considers free cash flow, an alternative data score, VantageScore credit score, credit file information, and, in some cases, verified references.[9]

Question A1.3: Is it necessary for any new credit score policy from the Enterprises on credit score models to be applicable in all aspects of the loan life cycle, or could there be differences, such as in servicing?

As noted above, it is very common for credit card, auto, and personal lenders to use different models or approaches in each phase of a loan's lifecycle. Servicers may wish to use different behavioral models to engage with borrowers, particularly in working through defaults. All

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[7] Prospectus for Toyota Auto Receivables 2017-D Owners Trust. Page 48. Filed with the SEC on November 9, 2017. https://bit.ly/2GhXkHZ

[8] Prospectus for World Financial Network Credit Card Master Trust. Page 30. Filed with SEC on October 31, 2016. https://bit.ly/2Gfh6YF

[9] Kroll ABS New Issue Report. Oportun Funding VII, LLC, Series 2017-B. Page 18. Published October 11, 2017 at https://bit.ly/2woJq1M

models of FICO and VantageScore are designed to rank order consumers based on their likelihood of default. As such, the utility of these models is diminished when working through delinquent accounts. Some lenders use models like these in their collections and recovery operations to prioritize workflows.

Question A1.4: How would mortgage lenders and investors manage different credit score requirements from primary and secondary mortgage market participants? Is it important for your business processes that government guarantee programs in the primary mortgage market (e.g., FHA, VA, USDA-Rural Development) have the same credit score requirements as the Enterprises?

Based on extensive conversations with investors, trade groups, and sell-side researchers, we published a short whitepaper on this topic in October, 2017.[10] That paper makes four recommendations, including the following:

> "In ABS lending, it is common for issuers to re-score a pool of loans as of a common post-delivery or 'cut-off' date. This practice creates uniformity and also provides investors with a homogeneous set of attributes. Extending this practice to MBS, either as a replacement for or supplement to "score at origination" disclosures, would provide those same benefits. In a market in which originators can choose between credit scoring models, a homogeneous "score at cutoff" field would reduce the complexity for prepayment modelers. Likewise, the ability for investors to leverage a newer and more predictive scoring model would improve their ability to forecast defaults.
>
> Any VantageScore or FICO credit score can be derived from any consumer's credit file at any point in time, including in the past.[11] If an originator chooses to use FICO Score 9, for example, Fannie Mae can still disclose to investors a VantageScore 3.0 for that loan (and vice versa)."

Of note, the Veterans Administration does not currently require the use of any credit scores in any part of its mortgage program.

It is important to note that the updated credit score provided by Fannie Mae to investors in Connecticut Avenue Securities is calculated using a different model than the one used elsewhere in the mortgage process.

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[10] New Credit Scoring Models: A Smooth Transition to More Transparent Capital Markets. VantageScore Solutions. October, 2017, p. 2. https://bit.ly/2zMO22W

[11] There may be CRA-specific limitations in "retro-scoring" due to older versions of the underlying credit file data.

Question A1.6: Do you have a recommendation on which option FHFA should adopt?

VantageScore Solutions has always supported lender choice as long as the models under consideration are empirically derived and demonstrably and statistically sound. In a well-structured market, the benefits of competition will always accrue to consumers. We are proud of the role that we have had in driving competitive innovation and transparency since our launch in 2006. The ultimate test of a model's value is its predictive power, and we are confident that, in a competitive market, many lenders would test and elect to use VantageScore.

Of the options on the table, only Option 3 ("Lender Choice on which Score to Deliver, with Constraints") would create true and lasting competition. Choice would enable lenders to opt in to the cost of switching to a new model only when such a change would make business sense. Option 3 also eliminates the potential for "score shopping" by requiring lenders to stick with their decision for a period of time. As lenders adopt VantageScore, we believe that such adoption will improve consumers' access to credit in certain segments, including traditionally underserved segments, and enable many more borrowers to obtain fairer pricing. And while change can create uncertainty for investors, that uncertainty can be entirely mitigated by sharing ample historical data; appending one or more homogeneous (i.e., calculated using a single model) sets of credit scores to all securitizations, regardless of the model chosen by any individual lender; and allowing sufficient time to transition.

The current FICO scoring models in use were developed using data from 1995 to 2000. They have been used to determine mortgage eligibility since prior to the Great Recession and to determine pricing since the first LLPAs were published. It is time to change. Given the complexity and cost of such an industrywide initiative, not to mention the time and cost of analysis in advance of that change, it is essential that this next move accommodates competing models. Option 3 would support competition and provide a platform to make future model upgrades more efficiently so that the market need not wait another two decades to benefit from the latest and most predictive tools.

No one company should have a monopoly on the analysis of consumer credit information. Looking beyond the mortgage industry, the virtues of competition are self-evident. Option 3 will ensure that FICO, VantageScore, and others (provided their scores are empirically derived, demonstrably and statistically sound, and based on current data from a consumer reporting agency) continue to compete to develop models that are the most predictive for the largest number of consumers.

Question A2.5 Could using any of the multiple credit score options affect the way investors view, and therefore price, Enterprise securities? Could any of the multiple credit score options reduce liquidity in the TBA market and/or increase the volume to the specified market? Are there any unique considerations among the multiple score options (options 2-4) in evaluating their impact on MBS liquidity and/or demand for credit risk transfer transactions?

Both DU and LP will be largely unaffected by the decision at hand. Likewise, the parameters of the "credit box" will remain in full effect. These are the foundations on which TBA liquidity is built, while Legacy FICO remains a reporting convention. Changing that convention will require recalibrating models, which will require time, data and education. But, providing these conditions are met, there is no logical reason why it should impact market liquidity in any way.

As noted in our recent whitepaper:

> "Both Fannie and Freddie should provide enough historical data to enable investors and analytic vendors to recalibrate their prepayment models. This dataset should include a representative performance sample of single family loans including the following attributes: VantageScore 4.0 [or 3.0, if applicable], FICO Score 9, PMI, loan balance, owner or investor, originator, coupon, and servicer.
>
> The most efficient way to deliver this dataset would be to append VantageScore 3.0 and FICO Score 9 to the existing single family loan performance datasets that Fannie and Freddie maintain in connection with their Connecticut Avenue Securities ("CAS") and Structured Agency Credit Risk ("STACR") programs, respectively. Appending scores to historical loans is a straightforward process for any of the three national credit bureaus. These data should be provided to investors as soon as possible to allow time to study this change and recalibrate their models. This release should be made before those loans acquired using newer scoring models represent a meaningful percentage of any pool."[12]

For a period of time, the Enterprises might also choose to continue to disclose Legacy FICO Scores to investors alongside newer credit scores. This would provide additional time to deliver data and educate the market on the differences between scoring models.

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[12]New Credit Scoring Models: A Smooth Transition to More Transparent Capital Markets. VantageScore Solutions. October, 2017, p. 2.

Furthermore, the disclosure of VantageScore 3.0 ***and*** FICO 9 (each of which is more predictive than the Legacy FICO Scores) should have a positive impact on participants' ability to price securities. While this would have marginal benefits for rates investors, the benefits to credit investors could be more meaningful in a less benign part of the credit cycle. We strongly encourage the Enterprises to append both VantageScore 3.0 and FICO 9 to each loan in each securitization or reference pool.

Question A2.7: What impact would any of the credit score options have on a need for consumer education? What impact would the multiple credit score options (options 2-4) have on consumers? Are there steps that FHFA, the Enterprises, or stakeholders could take that would mitigate any confusion about multiple credit score options?

Outside the mortgage industry, there is no one "score that lenders use." Just as lenders use a variety of custom and third-party credit scores to make decisions, consumers have multiple credit scores available to help them manage their credit health. During the twelve months ending in July 2017, over 1.3 billion VantageScore credit scores were delivered directly to consumers by lenders like Chase and Capital One and educational websites like Credit Karma, Lending Tree, and Mint.[13] These scores are calculated using the same VantageScore model used by lenders (i.e., not an "educational" model). They are most often provided free of charge as part of educational offerings that include simulators, credit reports, educational articles, and explanations.

Almost every adult with a credit file now has the ability to freely access his or her VantageScore 3.0 and credit report. In many instances, they also have access to one or more versions of FICO Score provided by Experian or a lender. For a recurring monthly fee of $39.95, some consumers purchase access to 28 different versions of FICO Score from myFICO.com.[14]

In a 2015 survey by FTI Consulting,[15] the majority of consumers reported that they had been scored by more than one different credit scoring model during the preceding twelve months. Asked, "What impact did having multiple credit scores have on your understanding of your credit score," 95% of respondents said neutral or positive.

Credit is more complicated than any three digit number. This is as true in the mortgage industry as it is in any other. Explaining what it takes to qualify for a mortgage is an essential part of consumer education. While FHFA and the Enterprises can and should clearly state any change in

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[13] Note: The 1.4 billion VantageScore credit scores delivered to consumers represented only 16% of the total number of all VantageScore credit scores used.
[14] https://www1.myfico.com/products/fico-credit-monitoring
[15] Telephone survey of 1,000 American adults commissioned by VantageScore Solutions.

certain and accessible terms, it will be incumbent upon the industry—real estate agents, mortgage brokers and bankers, credit counselors, lenders, and servicers—to continue educating borrowers as they do today. Educational websites that help consumers build and manage their credit and finances can continue to be strong allies in that effort.

Question A2.8: Under option 3 (lender choice with constraints), how would the Enterprises protect against adverse selection and ensure that a lender is not selecting a credit score at the loan level that results in preferential pricing or eligibility? Instead of attempting to reduce adverse selection through setting certain selling requirements for lenders, should the Enterprises instead adopt underwriting and pricing policies that account for any increased risk of adverse selection between the two credit score models? Are there ways to control this risk?

There is only a potential for arbitrage if originators can pull two sets of credit scores for a given loan but deliver it only with the set that delivers the best execution. By requiring that originators choose a model and stick with it, this risk can be effectively eliminated. This requirement can and should be enforced through the re-sellers at the originator level to ensure that loan aggregators are not burdened with enforcement. This solution is incorporated in Option 3, as presented in the RFI, using a 12-month limitation as an example. In order to eliminate gaming, the Enterprises need only take away lenders' ability to score shop from one loan to the next.

An alternative approach to eliminating adverse selection would be to treat score shopping as an option and price accordingly. Opportunities to score shop are inherently limited: pricing is a grid rather than a continuous function; the "lower of two, middle of three" decision score heuristic is already conservative; and score shopping carries costs for the shopper. As such, this approach would likely result in a very small increase in delivery fees. The benefit of this approach is that it eliminates information asymmetry and with it all opportunity for adverse selection. Further, it does so in a way that does not require any policy or system changes from re-sellers or lenders. The downside of this approach is that all participants would face marginally higher fees while not all participants (and therefore not all consumers) would employ a score shopping strategy or derive its benefit.

Question A3.1: Given that the CRAs own VantageScore Solutions, LLC and set the price for both FICO and VantageScore credit scores, and own the data used to generate both scores, do you have concerns about competition? If so, please explain your [sic]

The CRAs do not have an unchecked ability to set FICO's price. It is also our understanding that FICO has the contractual flexibility to sell scores directly to end users and does in some cases do

so. According to FICO's most recent SEC Form 10-K, revenues earned through agreements with Equifax, Experian, and TransUnion represented approximately $186 million of the $266 million in total revenues earned in FICO's Scores segment.[16]

In addition, even though the CRAs own consumer credit data, FICO would have a clear remedy at its disposal if the CRAs were to take some anticompetitive act: that is, to go around the CRAs and enter into sales agreements directly with the re-sellers. In this circumstance, the FICO Score would be calculated and delivered by the CRAs but the price would be set and collected by FICO. We believe there is already a market and contractual precedent for this to happen. Given the concentration in the re-seller industry, this does not appear to represent a cost prohibitive competitive response.

Moreover, any agreement between the CRAs to set prices, of either FICO or VantageScore, would run afoul of several federal antitrust statutes. One observer has suggested that federal antitrust laws would not apply to such a situation because transactions involving either credit data or credit scores pertain only to services and are thus exempt. That is wrong. Section 1 of the Sherman Antitrust Act, several provisions of the Clayton Act, and the Federal Trade Commission Act would clearly frown upon any joint action to "price out" FICO.

As with other industries, the competition between FICO and VantageScore would instead put price pressure on the cost of credit scores to the benefit of consumers, resellers and lenders. The historical absence of competition in the mortgage industry may be the principle reason why the cost of FICO Scores in this sector has reportedly increased drastically in 2018— both in absolute terms and also in comparison with the price of FICO scores used outside of the mortgage industry— despite the fact that the models have not changed since they were first introduced in the early 2000s.

Finally, we note that similar incentives ostensibly exist in other consumer lending industries where FICO Scores are resold through the CRCs as part of bundles that include credit file data. Twelve years have passed since VantageScore's introduction in 2006, and during that time, the CRCs have not taken any action to leverage their position to displace FICO. To the contrary, both VantageScore and FICO have grown. While we do not have directly comparable data, we note that VantageScore's rise in market adoption has coincided with a compound annual growth rate of 6% in the operating income earned by FICO in its Scores business. We note further that Experian, despite its ownership interest in VantageScore, entered into a strategic partnership with FICO to compete in the direct-to-consumer market[17], Equifax has also jointly

[16] https://bit.ly/2pKaK9s
[17] That partnership, which began in 2014, was expanded in 2017. https://on.wsj.com/2E2UiWa

developed and sells with FICO a credit score launched in April 2015 despite its ownership interest in VantageScore, including yet another jointly developed model (FICO Score XD®) announced on March 29, 2018.

Question A3.2: Would allowing multiple credit scores in the mortgage underwriting process encourage new entrants into the scoring marketplace? If the requirement remains to keep a single credit score in the mortgage underwriting process what impact would this have on whether new entrants join the credit scoring marketplace?

It is our view that a decision to perpetuate a government-sanctioned monopoly will, without doubt, restrict new scoring entrants and hamper future innovation. This deadening effect will have implications both within the mortgage industry and across other areas of consumer lending.

Fair Isaac was the first company to develop a credit scoring model and, following introduction, it enjoyed nearly twenty years of uncontested market dominance. During that time, the FICO name became synonymous with credit scoring.

VantageScore Solutions launched its first competitive model in 2006 as the result of market demand. After successfully defending a lawsuit brought by FICO, we spent years working to ensure a level playing field in the ways that regulators, ratings agencies, and other participants treat credit scores. In the mortgage industry, that work is unfinished. It took several years to establish meaningful market adoption, but we are proud that more than 8.5 billion VantageScore credit scores were used last year by more than 2,700 companies. The vast majority—almost 75%-- were used by more than 2,200 lenders.[18]

Since 2006, the benefit of competition between FICO and VantageScore has accrued to both lenders and consumers. Competition has shone light into what was traditionally a black box. VantageScore has competed by increasing transparency by publishing validation results; walking end-users through attribute-level reviews for compliance and testing; and disclosing annual risk tables to ratings agencies and regulators upon request. VantageScore is the only score developer that has committed to freely publishing annual validations, a decision that has encouraged other models to "race to the top" on performance.

In addition, newer models have adopted more consumer-friendly approaches to collections and medical debt while leveraging newer analytical techniques to increase predictive lift.

[18] "2017 VantageScore Market Study Report." Authored by Oliver Wyman.

As noted above under Question A2.7, consumers now have free access to quality credit scores. This transformation began in 2008 with Credit Karma, which quickly attracted new competitors in the race to educate and serve consumers. Providing free credit scores via Credit Karma is an area of the market that VantageScore is proud to have helped pioneer.

Prior to that time, consumers had limited and mostly pay-for-play access to their own credit scores. In 2013, FICO responded with its Open Access program, followed in 2014 with a consumer-facing partnership with Experian. Today, dozens of web and mobile products compete to provide consumers with versions of FICO or VantageScore credit scores, together with credit reports, explanatory factors, educational content, and other financial information. All of these developments have accrued to the benefit of consumers and they may have never occurred without competition between the CRCs and also between credit score model developers.

In recent years, we have also seen a number of new entrants in the field of alternative data scores. We see this field as a complementary and a natural offshoot of the competition in the generic (i.e., not alternative) segment of the market in which VantageScore operates. For newer model developers, the competitive environment in card, auto, personal, and other categories of consumer lending (along with the direct-to-consumer segment) is essential to justify investments in new products. As these segments represent the vast majority of credit scores used by volume, competition has been able to take hold despite the current monopoly in the mortgage market.

That is not to say, however, that the monopoly mortgage industry does not have broader implications. The exclusive use of FICO Scores as a gateway to homeownership confers a decided competitive advantage. It ensures that FICO has an imprint in almost every depository institution and with almost every institutional investor, regulator, ratings agency, re-seller, and technology vendor. That imprint inhibits competition by raising switching costs and granting the irreplaceable brand value of utter ubiquity. It gives FICO unparalleled and highly controversial negotiating leverage with almost every participant in the industry.

The credit scoring marketplace is a difficult proposition for new entrants. Opening the walled garden that has been the mortgage industry would not wholly change that equation, but it would certainly help to level the playing field. It would signal to current and future model developers a willingness to consider and reward innovation over inertia.

Question A3.3: What would be the benefits of lender choice if the number of qualified borrowers remained unchanged or changed only modestly from the credit score you are using today to underwrite borrowers for loans sold to the Enterprises?

Our analysis demonstrates that, in aggregate, lender choice will result in more creditworthy consumers accessing the conventional mortgage market. Whatever the short term lift, the long term lift may be higher due to demographic and behavioral shifts already beginning to occur. For some lenders—in particular those who apply credit overlays to screen out borrowers with thin or near-prime credit— the volume of qualified borrowers may not change. By creating a platform for competition, however, the market as a whole will benefit and a healthier market will help all participants over the long run.

The immediate benefits would be that all consumers—from those with nontraditional credit histories to prime—would receive a price based on a newer, more consumer-friendly and accurate credit score. Many would see no change in price; others would perhaps see a smaller change associated with moving from one box on the pricing grid to the next; and a few, in particular those who qualify through nontraditional underwriting, could see enough of a difference to impact the affordability of their loans.

Over the near term, we would expect that competition would have a positive impact on the price and availability of credit scores throughout the mortgage process.[19] In the tri-merge process, the availability of a second option could put pressure on the price paid for credit scores by re-sellers, lenders, and/or end consumers.

Over the medium run, competition could also change the cost and scope of disclosures for investors. As we published in a recent whitepaper:

> "...the relationship between a credit score and its underlying probability of default changes over time. Further, borrowers' credit scores can and do change precipitously with their behaviors. As such, the credit score attached to a loan at origination grows irrelevant over time. Recognizing this limitation, Freddie and Fannie both publish routine loan-level credit score updates to support their CAS and STACR transactions. There is clearly another layer of value for the credit investors who care about the ultimate loan performance in those transactions, but score updates would also be valuable to "rates" investors seeking to forecast prepayment speeds.
>
> With FICO's de facto monopoly, however, Fannie and Freddie did not extend this benefit to all investors. In a market in which FICO and VantageScore are permitted to freely

[19] Note that VantageScore Solutions is not involved in the sale or pricing of its models or that of the credit scores calculated using its models. It offers these responses based on publicly available information and purely as an industry observer. The CRCs compete with each other in setting VantageScore pricing and the selling of those scores.

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compete, however, that competition could change the playing field so that such monthly credit score updates can be provided to all mortgage investors." [20]

Over the medium- and long-run, competition will encourage model developers to continue building better models. Since 2006, competition has led to multiple new versions of VantageScore and FICO. These new versions continue to improve in terms of consistency, predictive power, and consumer-friendliness.

One example of such an improvement is the inclusion of rental payment information. VantageScore 1.0 was the first generic model to consider positive rental payment data when available in a consumer's credit file. While the availability of rental data is limited today, this move has put positive pressure on other industry participants. It has encouraged newer entrants[21] to begin collecting and furnishing rental data to the CRCs, which has also coincided with the inclusion of rental data in FICO 9. Last year, the NYC Comptroller published an exhaustive study[22] advocating the expansion in the reporting of these data. This evolution will take time, and VantageScore has been proud to advocate for this positive change.

Question A3.5: Could competing credit scores in the mortgage underwriting process lead to a race to the bottom with different vendors competing for more and more customers? What steps could FHFA take to mitigate any race to the bottom?

Any model deployed in the mortgage process should be subjected to rigorous testing and validation to show that it is empirically derived and demonstrably and statistically sound. These tests typically include historical evaluations relative to a benchmark, which are sometimes called "champion-challenger tests." Models that do not perform at the highest standards should not be considered. It is our understanding that the Enterprises have already tested VantageScore 3.0.

This is best practice whenever a scoring model is used to make credit decisions. Consumer lenders routinely conduct these tests prior to implementation and follow them up with their own regular model validations (see, for example, OCC Model Governance Guidelines).[23] Any deterioration in standards would be revealed in these tests and preclude the model from being adopted. This should continue to be the case in the mortgage market.

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[20] VantageScore Op. Cit.
[21] See, for example, Rental Kharma.
[22] https://comptroller.nyc.gov/reports/making-rent-count/rent-and-credit-report/
[23] https://www.occ.treas.gov/news-issuances/bulletins/2011/bulletin-2011-12a.pdf

The first and foremost plane on which scoring models compete is on predictive power. A new model with inferior predictive power will not find adoption even if it scores more people. VantageScore's success in scoring more people has been subject to the overarching goal of building the most predictive model. Competition has proven the exact opposite of a "race to the bottom."

Within that framework of rigorous third-party testing and analysis, competition to score more consumers is a decided benefit for the market. There are 30 to 35 million consumers who have a credit file but are nonetheless unscoreable using FICO.[24] Within this 30 -35 million consumer group that receive a VantageScore credit score, approximately 7.6 million have a score of 620 and above with approximately 2.4 million of this population being minorities. This is significant for the mortgage sector given the rapidly changing demographics driving the composition of first time homeowners in America.[25] The vast majority of these consumers do not have a FICO Score because they have not had an update to their credit file in the last 6 months.

We estimate that 2.3 to 2.5 million of these 7.6 million consumers may have the desire, credit profile, and income to support a mortgage.[26]

As suggested by FHFA, we derived this estimate in the following way:

1. Begin with FICO-unscoreable consumers with a VantageScore 3.0 credit score of 620 of higher;
2. Remove consumers younger than 25 and older than 70;
3. Remove consumers who already own a home;
4. Remove consumers who have had an account 90+ days delinquent in the prior two years;
5. Remove consumers who have had a foreclosure; and
6. Remove consumers who cannot afford the estimated mortgage payment on the median home in their zip code.

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[24] Note: Any reduction in public records and collection trade lines in consumer files will cause a decline in the total number of consumers who would be newly-scoreable using the VantageScore credit scoring model. However, we do not expect that such changes would have a meaningful impact on the estimate of the addressable mortgage population discussed above.

[25] As well documented by respected organizations such as the Urban Institute and the National Association of Hispanic Real Estate Professionals (NAHREP).

[26] Exclusionary Credit Score Modeling Limits Access. VantageScore Solutions. 2016.

VantageScore 3.0, launched in 2013, made significant strides in using credit file information to score the millions of consumers who were without a FICO Score. VantageScore 4.0 took this effort further, using machine learning techniques to generate our most predictive model yet.

Our success in this arena has often been mischaracterized by FICO as one that has "lowered standards." FICO has maintained the same minimum scoring criteria, as outlined on page 14 of the RFI,[27] since its first generic model[28]. FICO often characterizes these criteria as decades of research, when we believe it is more aptly characterized as decades of inertia. Changing minimum scoring criteria would change FICO's population distributions and require the development of new reason codes— two factors that increase switching costs for some lenders looking to upgrade from one version of FICO to the next. Scoring more people may also inhibit the opportunity to sell secondary or "add-on" scores such as FICO XD.

Much has changed since the first FICO models were built. The CRAs went on to introduce more granular data which in turn enabled modelers to distinguish, for example, between first and second mortgages and between student and other installment loans. In tandem, increases in computing power have made newer analytical techniques and large-sample analysis possible. VantageScore 4.0 was built using 45 million credit files, including trended credit data, and applying analytical techniques that would have been impractical (if even possible) when the first FICO models were built. While both FICO and VantageScore are built using samples from the same credit reporting databases, we approach that task quite differently.

As part of its mischaracterization, FICO often relies upon a "research score" that it built to demonstrate the impossibility of using credit file data to score more consumers. FICO then uses this research score as a proxy for VantageScore throughout FICO's analysis and commentary. This research score, according to FICO,[29] demonstrated a Gini score of 14.7 and did not align with the rest of its population. VantageScore 3.0 and 4.0 both have Gini scores for the FICO-unscoreable population above 50 and show strong alignment between and across populations. FICO's "research score" is a straw man, while all VantageScore models are routinely tested for performance by VantageScore Solutions and, more importantly, by the more than 2,200 regulated financial institutions that use them.

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[27] Note, however, that the RFI incorrectly states that VantageScore does not require any minimum aging of an account or trade line.

[28] Jim Wehman at the Barclays Emerging Payments Forum, March 13 to 14: "Bill Fair and Earl Isaac...studied whether we could reliably score these types of credit files and they determined back then that we couldn't."

[29] http://www.fico.com/independent/assets/Insights_90_Can_Alternative_Data_Expand_Credit%20Access_4151WP.pdf

As always, the results of our annual validations are publicly available on our website[30]. But neither FHFA nor the Enterprises need to take our word for it: these are exactly the tests that any lender, mortgage or otherwise, should conduct on their own portfolio before adopting a new model. We understand that these are the same (or similar) tests that FHFA and the Enterprises have already undertaken as part of this study. This is one clear and time-tested best practice that we wholly endorse.

The RFI correctly establishes that third-party credit scores are not a fundamental part of the underwriting process at either Enterprise or their respective lender-sellers. We appreciate that the FHFA's assessment is not about underwriting. Underwriting is a process that includes direct analysis of credit file, income, and employment data and is subject to all federal rules and regulations, including but not limited to the CFPB's Ability-to-Repay and Qualified Mortgage rules.

Despite this well-established fact, some commentators have incorrectly equated the FHFA's evaluation of newer and competing credit scoring models with a change in underwriting standards. Some have gone so far as to analogize the evaluation at hand to pre-crisis practices that led to the last housing bust[31]. We note here that these assertions are both incorrect and irresponsible. We also note that three commentators in particular—Joseph A Smith Jr., Ann B. Schnare, and Tom Parrent— have all fomented this misconception as part of their respective engagements with FICO.[32]

In Conclusion

For all of the reasons discussed on the preceding pages, we submit that Option 3 (lender choice with constraints) is the option that best advances the public interest. Further, we respectfully suggest that it is the option most consistent with the principal duties of the conservator: "to ensure that … the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets …"[33]

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[30] https://www.vantagescore.com/resource/143/decade-validation-demonstrates-superior-performance
[31] See, for example, OpEd by Joseph A. Smith, Jr.: "FHFA should resist calls to weaken mortgage standards." American Banker. January 8th, 2018.
[32] As disclosed on their research reports published in connection with the Progressive Policy Institute.
[33] Section 1313(a)(1)(B)(ii) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4501 et seq.) as amended by the Housing and Economic Recovery Act of 2008 (HERA), Public Law 110– 289, 122 Stat. 2654

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We stand ready to aid in the transition and look forward to playing a part in a housing finance system that fairly and inclusively serves all creditworthy borrowers who aspire to achieve sustainable homeownership. While this is indeed a lofty goal, it is a worthy one; and we know that competition between model developers will be an important step in the right direction.

Yours sincerely,

Barrett Burns

Barrett Burns
President & CEO