COMMUNITY HOME LENDERS of AMERICA

January 2024

CHLA White Paper on Mortgage Credit Score Markets and Pricing

How to Ensure the Market Remains Fair to All Borrowers

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Introduction

In the home mortgage space, policymakers have a generally good grasp of how the origination process works between lenders and consumers, in large part due to extensive reforms of Dodd-Frank and the resultant oversight of this area by the Consumer Finance Protection Bureau (CFPB).

And policymakers have a general working sense of how the mortgage secondary market works by virtue of the ongoing reforms of Fannie Mae and Freddie Mac by their regulator/ conservator, the Federal Housing Finance Agency (FHFA), as well as the public profile of Ginnie Mae. The heads of these agencies appear before Congress on a regular basis as part of the legislative branch's oversight authority.

But parts of the mortgage-making process that are "behind the scenes" are less well understood today – one area being the credit-scoring process. This integral part of how, and whether, Americans access mortgage credit is poorly understood in Washington D.C. Indeed, few policymakers are exposed to the plumbing and policy here, and when asked how it all works, they admit they don't follow this space closely. When asked if they understand how the pricing works, which market participants decide the pricing, and how these decisions affect consumers, they admit they have very little foundational knowledge at all.

The Community Home Lenders of America decided to explore this area in detail to foster better dialogue among policymakers and stakeholders.

Section 1: What is the Credit-Scoring Process, and Why Does it Play a Central Role?

Whether Americans apply for a credit card, a personal loan, or a home mortgage, their credit score plays an important role in determining whether a financial institution will say “yes” to their application. A person or couple’s credit score and that all-important three-digit credit score number can also make a big difference in how much interest they’ll have to pay on loans as well as the types of loans or credit cards for which they qualify.

Credit reports and credit scores as we know them today are a part of a long history of merchants and lenders collecting information and using it to evaluate whether a potential borrower would be able to pay their loans back in full and on time.

Before there was credit scoring, there was commercial credit reporting. Unlike consumer credit reporting today, where individuals are evaluated for their credit risk level in the context of accessing financing, commercial credit reporting was originally used by merchants to evaluate the creditworthiness of potential business customers. This was not a scientific process in any way, and potential borrowers often were judged by obviously biased and unfair factors such as race, religion, ethnicity, gender, and marital status.

It wasn’t until the late 19th century, when department stores and mass retailers gained popularity, that consumer credit reporting became more common.

Some mass retailers were installment houses, which would sell items such as furniture and drugs to customers via installment loans. The retailers needed a way to attract consumers and ensure they would be paid back, so they collected information about their customers and submitted it to a local credit bureau.

While there are three major consumer credit bureaus today — Equifax, Experian and TransUnion — it would in fact take hundreds of years to develop a national, centralized set of credit bureaus, as opposed to regional or local ones.

Computers Change the Game (Of Course)

It wasn’t until credit reporting became computerized in the 1960s that the industry would become consolidated.

In the 1960s, there were more than 2,000 credit bureaus across the U.S. Over the course of the next 20 years, that number would shrink to five and, eventually, to the three major credit bureaus that exist today.

It would take longer for credit scoring to gain dominant popularity in the U.S., however, as lenders hesitated to give up their use of so-called “character judgments” in the evaluation of someone’s creditworthiness.

In 1989, Fair Isaac (FICO) worked with the national credit bureaus to create a credit scoring model that could be used to evaluate all consumers — the company literally invented a national metric that would condense multiple variables into a simple index number.

FICO scores then became a key, national metric for home lending when Fannie Mae and Freddie Mac started requiring mortgage applicants to submit them via lenders in the mid-1990s.

Yes—this is a young industry, and one that continues to evolve, but also continues to concentrate.

Section 2: Credit Scores Today

Today, there are different types of credit scoring models used by a variety of lenders. FICO, however, remains far and away the market leader — the company claims its scores are used by 90% of top lenders. ***The combination of this extremely high market share, and the fact that Washington agencies require lenders to use this company's product, means that FICO has unilateral, solid-gold market power, the type rarely seen in any US industry short of highly regulated utilities, whereby rates are set by public-utility boards or commissions.***

What Exactly Is a Mortgage Credit Score?

An American borrower's FICO number is a modeled "propensity to repay" scores that ranges from 300-850, with 850 being the highest score. A relatively new market entrant, VantageScore, also uses this 300-850 range.

What's Behind This FICO Index Number? How are Mortgage Credit Scores Calculated?

Mortgage credit scores put a lot of emphasis on payment history and credit utilization with other factors playing a role too.

- **35% payment history:** A borrower's payment history tracks how well a person or couple make their payments. Any payment made 30 days or more past the due date hurts their credit score, whereas a timely payment history can greatly improve their credit score.
- **30% credit utilization:** A borrower's credit utilization is a comparison of the person or couple's total outstanding debt compared to their credit lines. For example, if a borrower has a $1,000 credit line and $500 outstanding, this is a 50% credit utilization rate. Ideally, borrowers should keep credit utilization rates lower than 30% for the best results.
- **15% credit length:** The age of a borrower's credit affects their credit score too. The 'older' the borrower's credit, the better it is for their credit score. (Borrowers should not close old accounts unless it's absolutely necessary, as this is an easy way to decrease their credit score.)
- **10% credit mix:** Credit-score models like to see that borrowers can handle a variety of debt including credit cards (revolving debt) and installment debt (mortgage loans, personal loans, car loans, etc.)

- **10% inquiries:** Each time a borrower applies for new credit or takes out new credit, it influences their credit score.

Under current mortgage market rules set by Fannie Mae and Freddie Mac, mortgage lenders typically pull credit histories from the three of the main credit reporting Bureaus — Equifax, Experian and TransUnion — to calculate an applicant's score. Then, they use the middle score to quote a rate and approve the mortgage.

Credit Scores and Major Mortgage Channels

It's worth reviewing how credit scores affect the various U.S. mortgage channels, given that some differences do exist today. As of today, all of the agencies below require a tri-merge credit report (pulling data from all 3 Bureaus). The middle score of these three is the one used for the qualification.

Conventional mortgage (Fannie and Freddie): This popular loan program is a good fit for American families with a credit score of at least 620 that can make a 20% down payment. For those making a lower down payment, Private Mortgage Insurance premiums kick in, and the lower your credit score, the higher your mortgage premium and monthly payment will be.

FHA mortgage: A home loan backed by the Federal Housing Administration (FHA) is often the only choice for borrowers with a credit score between 500 and 679. Here, borrowers pay FHA mortgage insurance that includes an upfront premium of 1.75% of the loan amount and annual mortgage insurance premiums ranging between 0.15% and 0.75%. (Most actual premiums paid here are 0.55%.) However, unlike Private Mortgage Insurance as noted above, the premium percentage here is the same regardless of your credit score—in essence, this program cross-subsidizes between relatively less-risky and more-risky (judged by the credit score) borrowers.

VA mortgage: This loan type can only be made to eligible veterans, active-duty service members, reservists and surviving spouses. Lenders don't require mortgage insurance or a down payment. Although the VA has no minimum score requirement (this is not well understood, but true), most lenders set their minimum between 580 and 620. VA does, however, require lenders to pull a three-file merged credit report ("tri-merge").

USDA mortgage: The U.S. Department of Agriculture (USDA) backs this loan type to help low- and moderate-income buyers finance rural homes. No down payment is required, but borrowers pay upfront and annual guarantee fees that work like FHA mortgage insurance. Like the VA program above, the USDA doesn't set a minimum credit score, but most lenders require at least 580. The upfront insurance fee here is 1.00% and the monthly fee is 0.35%.

Jumbo mortgage: This is the only choice for those borrowing above the conforming loan limits, and these loans are more common in expensive cities throughout the country. Most jumbo mortgage programs require a credit score of at least 700, although there may be programs with lower score limits if the borrower(s) can afford a higher interest rate and payment.

The Credit Scoring Infrastructure, Reviewed in Brief

As discussed above, FICO has over 90% of the credit score marketplace, but what other kind of "plumbing" exists in this world? Let's review some of what has been stated already, but also provide more details in this world:

FICO: A publicly-traded company with a proprietary credit scoring model and index, and over 90% of this market.

National Consumer Reporting Agencies (NCRAs): The "Big Three" are Transunion, Equifax, and Experian, with 100% market share among the three. These organizations gather actual data from lenders and, using the FICO model, generate the credit score, though each of them may, and do, use different data (sometimes with different timing) - which is why scores are different across the Bureaus.

Reseller Consumer Reporting Agencies (RCRAs): These organizations are where most mortgage companies and lenders go to buy a credit report for a consumer. They are consumer reporting agencies, but do not maintain their own databases. They submit requests to the National Consumer Reporting Agencies (NCRAs) to get information regarding a consumer on behalf of an end-user that has contracted with them to gather information on a consumer. Resellers act as conduits just passing on information. Today 28 exist in the U.S., though industry officials expect consolidation due to tight margins and a mortgage industry slowdown. (By comparison, 30 years ago this segment of the industry had 2,000 members.)

RCRAs have legal agreements with lenders that prevent lenders from sharing credit reports with consumers or anyone else.

VantageScore: Launched in 2006, VantageScore is an independently managed joint venture owned by the nation's three NCRAs (TransUnion, Equifax, and Experien). It claims to have developed a far better model for capturing the "propensity to repay" odds by taking a different approach to how the consumer uses their credit and placing different weights on specific pieces of information in a credit profile. Some examples include credit utilization - considering whether you usually only make minimum credit card payments or pay your bill in full monthly, collection accounts - ignoring paid collection accounts and ignoring unpaid medical collection accounts, regardless of balance, and credit inquiries - combining hard inquiries into one inquiry in certain situations, therefore not negatively impacting the score to such a degree as the previous models did.

Credit Scores and Costs of Credit Reports

Mortgage lenders contract with an RCRA to pull credit reports. There are many different types of credit reports that can be ordered – single bureau, tri-merge, or RMCR (residential mortgage credit report). Typically, mortgage companies will order one single bureau first to determine if a borrower qualifies for a loan program; if the borrower score is over a certain benchmark, the report can be either automatically or manually converted to a tri-merge. (The single credit bureau is pulled to reduce costs because a tri-merge typically costs more.) If the score of the borrower is below the mortgage companies benchmark, the borrower is typically counseled to improve their credit, and they are turned down for the mortgage loan. In some cases, some mortgage lenders will even pull an expensive product that is also sold by the RCRA to show the borrower what can be done to their credit to improve their credit score. (Not all lenders offer this service, but this service is offered by all RCRAs. This fee is not ever recouped by the lender.) The reason mortgage lenders ultimately upgrade to a tri-merge is that every investor that mortgage companies sell loans to requires the tri-merge credit report.

As a side note, a Residential Mortgage Credit Report when ordered is typically more expensive than a tri-merge, because the RCRA verifies all the information on the report to confirm accuracy. These RMCRs used to be very common in the 1990s, but demand for them has waned over the years as tri-merge credit information has become more accurate.

So far, we have covered the various types of credit reports: single bureau, tri-merge, an RMCR, and credit score improvement services. What do these various services cost? Typical fees for each (as of Dec 31, 2023) would be:

Single bureau: $18-30 for an individual report, $24-40 for a joint report.

Tri-merge: $40–60

RMCR: $95

Credit score improvement: $8-$10 per score, per tradeline reviewed. A tradeline is one line of credit – like a credit card or an installment loan. The credit simulator would show the impact of paying down a debt or paying off a debt. An example of the cost for lowering the balance of two revolving accounts showing how all three scores would be impacted would be $48 to $60 dollars.

There are also more ancillary charges passed through to mortgage lenders. One of these is a credit tradeline update. Many times, a borrower needs to update a credit line to a current date or to show the credit is paid off. In these cases, the cost of that manual tradeline update is passed through to the mortgage lender. The typical cost is around $17 per tradeline that needs updating. Typically, the one tradeline always updated is the current mortgage payment to ensure it is still current.

More costs passed on from the RCRA to the mortgage lender are “repulls.” A “repull” is when a credit is pulled and the lender has that credit report, but that report needs to be reissued to read in the automated underwriting systems that are mandated by all agencies. Desktop underwriter (DU) is Fannie Mae’s system and Loan Product Advisor (LPA) is Freddie Mac’s system. Guaranteed Underwriting System (GUS) is the USDA system. VA and FHA loan applications get run through DU or LP. An estimated cost for this reissue is $2 each. Another cost is assessed by the Loan Origination System to run DU or LP through their proprietary software. This cost is also typically $2. Another cost is involved if the mortgage lender wants to swap the borrowers on a loan – that is $5. (Swapping is done when the borrower that applied first wants to be the co-borrower and vice versa.) Another related cost is if a borrower wants to drop off the loan and the mortgage lender needs to unmerge the credit with a spouse which costs an estimated $1.

These costs vary with all RCRAs and typically mortgage companies will review their options annually or based on the contract they have with the RCRA to try to improve their pricing.

The three main credit Bureaus (Equifax, Experian, and TransUnion) charge the RCRA for each score and credit provided to the RCRA. Whatever the main credit Bureaus charge would be marked up by the RCRA and passed on to the mortgage lender. *These costs are a mystery to mortgage companies and are never passed on as exact expenses.* Costs borne by the lenders are typically passed on to the consumer, either through a line-item charge in their closing costs, or the lender will charge an underwriting, administrative or processing fee that includes the average cost of credit and other costs associated with a mortgage loan. Costs are absorbed (lost) by the lender for a borrower that does not end up closing with the lender. Remember that borrowers are encouraged to apply to multiple lenders and compare costs by the CFPB, so many mortgage lenders will pull the exact same credit and pay different prices depending on their contract with the RCRA. It has been noted lately that larger mortgage lenders pay less than smaller mortgage lenders. This is a common practice in the United States – more volume, lower costs – but it hurts the smaller independent mortgage lenders as their expenses for credit cost more than the larger mortgage companies. Smaller independent mortgage companies are the ones that specialize in government lending for lower income, minority borrowers and are hurt the worst by this pricing model.

Section 3: What is Changing in the Credit Scoring Process Today?

FHFA, the regulator and conservator of both Fannie Mae and Freddie Mac (GSEs), has proposed for comment an updated credit scoring regimen for use by Fannie and Freddie, saying that it is committed to regularly assessing and modernizing the credit score models used by mortgage lenders and other stakeholders in the housing finance system. FHFA notes that the process is governed by the 2018 enactment of the Economic Growth, Regulatory Relief and Consumer Protection Act (Section 310) and the Validation and Approval of Credit Score Models Rule (12 CFR Part 1254) and is consistent with FHFA's commitment to accuracy and inclusivity in credit scoring, as well as the safety and soundness of the GSEs. FHFA and the GSEs are currently implementing key updates to the GSEs' credit score model requirements. FHFA expects that implementation will be a multiyear effort.

In October 2022, FHFA announced the validation and approval of two new credit score models, FICO™ 10T and VantageScore® 4.0, for use by the GSEs. Once implemented, lenders will be required to deliver both FICO™ 10T and VantageScore 4.0 credit scores, when available, with each loan sold to the GSEs. FHFA also announced that the GSEs will change the requirement that lenders provide credit reports from all three nationwide consumer reporting agencies (CRAs). Instead, the GSEs are giving lenders the option to provide credit reports from two, at minimum, of the three nationwide CRAs. But if the lender chooses to pull three, they can continue working with all three NCRAs.

On March 23, 2023, FHFA provided an update on the GSEs' implementation plans and opportunities for stakeholder engagement, saying that it and Fannie Mae and Freddie Mac are committed to working with stakeholders to ensure a smooth transition to the new credit scores and the new credit report requirements, in a manner that avoids unnecessary costs and complexity.

The initial proposed timeline includes a staged implementation to ease the transition complexity for stakeholders. The first stage includes the credit report update ("optional" change from tri-merge to bi-merge), and the second stage encompasses the credit score model implementation. Additionally, the way scores are calculated will change: Currently the mid-score of a tri-merge is used, whereas in the future, the various scores (bi-merge + VantageScore® 4.0) will be averaged. FHFA and the GSEs have been conducting outreach to stakeholders to ensure a smooth transition to the newer credit score models and the bi-merge credit report requirement. The public engagement process has solicited input from stakeholders to inform and further refine the proposed implementation plans. CHLA signed an industry letter asking that the proposed timeline be lengthened to allow for existing data to be fully shared before the new systems go live, which also will allow for more comprehensive and accurate feedback from stakeholders, including lenders.

(It's also noteworthy that at this point in, the proposed changes by FHFA will affect Fannie Mae and Freddie Mac mortgages only; FHA, VA and the Department of Agriculture's Rural Housing Services (RHS) have not yet announced any conforming measures or plans to move in a similar direction. *See more on this on page 12 of this white paper*.)

These announced FHFA changes are big news for the mortgage industry, as it's the first significant change in credit scoring calculations in many years. This reformed scoring system has several key additions from the old model. Here are five of the changes found in the new credit scoring models, and how they will affect borrowers.

a. Includes Trended Data

The most impactful change in the new scoring models is that trended data is now being figured into the credit score. While trended data, which is the consumer's past 24 months of balance, payment, and credit utilization history behaviors, has been recorded on credit reports for several years now, the data wasn't calculated into the credit score until now.

Both FICO™ 10T and VantageScore® 4.0 are adding trended data into their credit scoring calculations; the credit scoring models are banking on adding trended data to scoring calculations will significantly increase the accuracy and predictability of determining whether the consumer will pay their loans on time. The overall result will be better decision making and fewer defaults.

b. Improved Scorecard Segmentation and Performance

The credit scoring model knows it can't get accurate results from comparing everyone. Consumers must be segmented. Otherwise, the scoring model would perform well for one set of customers and badly for everyone else.

For example, young consumers with short credit histories can't be measured against older consumers with decades' worth of positive credit. That's why the scoring formulas segment consumers into groups.

FICO™ 10T and VantageScore® 4.0 made changes to their scorecard segmentation metrics.

FICO™ 10T put additional segments of populations into the scoring formula, which has outperformed previous versions by better-measuring risk assessment.

VantageScore® 4.0 leverages machine learning to score consumers with thin files and short credit histories. Many of these (Vantage estimates 37 million) consumers couldn't be scored with previous models.

In theory, the better scoring formulas are at segmenting populations, the more accurate and predictive they can perform. This change means lenders will most likely see fewer borrowers without credit scores, which is a common hindrance in being able to extend credit. More people with credit scores results in more borrowers being approved for loans.

In addition, this change made more minorities credit scorable, enabling lenders to be more inclusive and build a more diverse customer base.

c. Removes Most Medical Debt From the Credit Scoring Calculation

Medical collections tanking otherwise high credit scores have been frustrating for borrowers for a long time. A forgotten medical bill, often under $100, could tank a person's credit score and cause them to get turned down for mortgage loans.

The credit scoring model builders analyzed these small medical collection accounts and found they have little predictive bearing on a consumer paying their debt obligations on time. This finding is the reason for removing them from the credit scoring calculation.

FICO™ 10T has made this change.

If borrowers have paid their bills on time, managed their credit card debt wisely, and practiced good credit behavior, medical bill issues won't influence credit scores like before. Removing medical collections from the credit scoring calculation will allow lenders to approve more borrowers for loans.

d. Adds Rental Payment History

In the past, consumers with few or no lines of credit haven't been able to generate a credit score. This issue stems from the scoring model needing some type of behavior to analyze, so it can predict future actions. New credit scoring models have begun factoring in rental payment history into the credit scoring calculation (provided rental history is reported on the credit report - which anecdotally, it often is not).

FICO™ 10T has made this change.

FICO™ 10T Predicts:

- Mortgage approval rates can be expanded by 5%
- Delinquency rates can be reduced by 17% (for borrowers with 680 or above credit scores)
- Gain up to a 10% predictive lift over previous scoring models

VantageScore® 4.0 ® Predicts:

- 33 million more consumers can be scored with the new formula
- 8 million minorities can be scored with a credit score of 620 or above
- As a result, lenders using VantageScore® 4.0 can extend credit to those who have been historically marginalized, including minority and lower-to-middle income Americans.

e. Inquiries Over a 14-day Period Count as a Single Inquiry

Applying for new credit has in the past always had a negative impact on credit score. Consumers are, however, encouraged to apply to a variety of lenders in order to get the best option for them. So, what is encouraged can come back to hurt consumers as every new credit pulled has a lower credit score as each inquiry hits their credit. The new VantageScore® 4.0 and FICO™ 10T count multiple inquiries with a 14-day period as a single inquiry, even when the credit being applied for is different.

When Will These Changes Take Effect?

Initially FHFA proposed a timeline that discussed having the bi-merge credit report (and averaging the scores instead of using the mid-score) implementation occurring by the first quarter of 2024, with implementation of the new credit score models expected to occur over two phases in 2024 and 2025:

- **Phase 1:** Estimated to begin in the third quarter of 2024, would include delivery and disclosure of the additional credit scores (the Dual Score Models and the updated models - FICO™ 10T and VantageScore® 4.0).
- **Phase 2:** Estimated to occur in the fourth quarter of 2025, would include incorporation of the new credit score models into pricing, capital, and other processes.

This initial timeline proposal was altered in September 2023, when FHFA announced the tri-merge to bi-merge implementation will occur later than the first quarter of 2024; the agency also announced listening sessions for interested parties this Fall. Any changes here will take substantial time to be adopted. As noted above, CHLA and a large coalition of mortgage and real estate trade groups asked for more time to implement these changes; CHLA went a step further and asked that the FICO™ 10T adoption wait until the VantageScore® 4.0 alternative is fully incorporated and functional within the conventional space; CHLA wrote then that trying to adopt both at the same time might lead to market inefficiencies or outright errors if data have not been adequately vetted and tested, and lender backend systems have not been fully tested & integrated into this new system.

However, after more study and feedback from CHLA lenders, CHLA now believes the best alternative for consumers would be to allow the lender and/or consumer to have the option to choose one of the two new models, but keep the tri-merge system in place.

The biggest concern with the implementation timeline and transition period is that these changes will likely not save homebuyers money - but rather ***increase*** their costs for pulling credit - especially for veterans, rural Americans, and low- and moderate-income borrowers. The cost increases are due to a variety of factors. This is directly counter to the cost savings intended by FHFA.

First, regarding the credit pulls themselves: today, lenders pull a classic tri-merge FICO classic for a single applicant (three scores). After the move to bi-merge during the transition period, lenders will be pulling two FICO classic scores, two FICO™ 10T scores, and two VantageScore® 4.0 (**six scores**) for a period of time, in order to properly gauge credit risk. This is double the number of credit pulls that lenders do today.

Secondly, we know that the FHA, VA Loan Guaranty Service, and USDA Loan program are not planning to transition to bi-merge or the new scores. In order to properly compare products for FHA first-time borrowers, veterans & active-duty borrowers, and others who may be eligible for these government mortgage programs, lenders will still need to pull a tri-merge. During the transition period, this means that lenders will be pulling **nine scores** - three FICO Classic, three FICO™ 10T, and three VantageScore® 4.0.

These government programs are usually ***the best product for first-time homebuyers, people of color, veterans, rural Americans, low- and moderate-income consumers, and other underserved communities and people. In order to properly serve these consumers and present them with the best loan options - <u>even after the full transition to bi-merge and VantageScore® 4.0</u> at FHFA and the GSEs - lenders will still have to pull a tri-merge score for these consumers, which will represent an increased cost for the underserved for the foreseeable future.***

It is also worth noting that all of these numbers would be doubled for a dual-applicant household. Meaning that during the transition, for an FHA, rural, or veteran family with two applicants, the lender will have to pull 18 credit scores (3 classic, 3 10 T, and 3 VantageScore® 4.0 per applicant) to properly compare products for the consumers.

Finally, once the third credit score is seen, it cannot be unseen by the lender or consumer. This raises a number of questions, not the least of which is whether the lender is still required to average the scores they have. This also presents the consumer and a potential different lender with a choice and opportunity to game the system: use the quad score (tri-merge plus VantageScore® 4.0) at the current lender or go to another lender and request that they pull the best two Bureau scores and VantageScore® 4.0, possibly resulting in better pricing.

From a pricing perspective, allowing the lender and/or consumer to choose one of the two models will ensure at least some level of competition among FICO, the Bureaus, and VantageScore® 4.0, as well as among the various CRAs that contract directly with lenders.

Competition between the two new models, both of which should be similarly beneficial to underserved communities, will help control the rate at which costs increase.

It is for these reasons that FHFA should retain tri-merge and allow a lender and consumer the choice between FICO™ 10T and VantageScore® 4.0, rather than requiring just one solution: a bi-merge plus VantageScore® 4.0.

Transition Periods Needed Within GSE Automated Underwriting Systems

While understandable that FHFA wants to drive change within the GSE world, as noted above, a challenge will remain for the foreseeable future that the other federal housing channels will not comport their credit-scoring paradigms at the same rate (or may not ever fully comport them). Given that originators of FHA, VA, and RHS products do utilize the GSE automated-underwriting systems for products ultimately destined for Ginnie Mae investors, a dual-track automated underwriting system (AUS) world will be required for some time to come.

CHLA's research here, speaking with these other housing channel policymakers, indicates that the variance will remain for possibly years to come. Thus, Fannie and Freddie must signal to the marketplace that they (1) understand this reality and (2) will commit to a lengthy period of dual-track AUS systems. Failure to do so will raise prices and depress demand for these key federal programs that serve, on average, families of more modest means.

Section 4: FICO Announcements Regarding Major Price Hikes

FICO Announcement in November '22 Regarding Major Price Hikes

In an industry where one provider has a vastly dominant market share, pricing decisions are unilateral and customers have no choice but to accept them; as mentioned above, FHFA mortgages delivered to Fannie Mae and Freddie Mac to have FICO scoring, and as detailed above, the marketplace has few real options for lenders to turn to for alternative execution.

Small lenders naturally fear any form of market concentration, anywhere in the mortgage-making process, that would allow a dominant player to unilaterally raise prices and squeeze out smaller credit grantors. The U.S. remains fortunate that American families have many, many choices on which lenders to approach and choose to help them secure a competitive, safe mortgage. But lenders increasingly see consolidation in "backend" products and services, which can and will result in higher consumer prices over time. This will also lead, again over time, to consolidation in other parts of the mortgage world, including within the originator space, as pricing power in "backend" products and services reduces margins for originators. *The danger here is that it could happen without regulators and agencies even being aware of it; the "slow boil of the frog" situation comes to mind.*

Thus, it's worth printing in whole the National Consumer Reporting Association (NCRA) letter to the marketplace at that time, signed by that organization's executive director Terry Clemans:

"The National Consumer Reporting Association (NCRA) is aware and can confirm that the vast majority of the mortgage lending industry will most likely incur a massive mortgage credit report price increase for 2023.

"The NCRA understands that the end users of the tri-merge mortgage credit report (the mortgage lenders) have been grouped into three pricing tiers by Fair Isaac (FICO) with a wholesale price increase of less than 10% for the top tier of approximately 46 lenders, about 200% for approximately 6 lenders in the middle tier, and more than 300% for all other mortgage lenders in the nation. This is a paradigm shift in the pricing structure for credit scores and is being dictated to the mortgage credit reporting industry from all three national credit Bureaus and/or FICO.

"The NCRA is not aware of the full origin of this change as it has not been disclosed to us by either FICO or the national credit Bureaus. It will be up to each mortgage credit reporting company to determine how to implement this change with its customers based on its individual business plans.

"NCRA feels the need to address this issue due to questions raised by the mortgage lending community and the media who are beginning to be made aware of a major pricing change coming for the new year. The industry as a whole is looking for more details which are complicated by the contractual limitations that prevent NCRA members from disclosing the reason for this price increase. Unfortunately, we can only confirm the limited information above and urge the source/sources of this dramatic pricing change to be more transparent with the reasons requiring this statement."

FICO Announcement in November '23 Regarding Price Hikes

In November, according to a HousingWire article, FICO announced another change in pricing for 2024; instead of a tiered system based on volume, it would charge one price to all lenders, but with an increase from $8 to $10. *Thus, for small lenders, the 2023 300% price increase has morphed into a 2024 400% price increase.*

In addition, this new higher price will be applied to both "soft pulls" and "hard pulls," a new practice that began in 2023.

So How Does Pricing Really Work Here?

FICO officials have stated publicly that they are not setting the price of the scores; in a strict sense they are technically correct, but in a general, policy-setting sense they are not—royalty rate cards set boundaries within which the rest of the industry must follow. Also, FICO is setting the baseline pricing, which now includes the creation of this new three-tiered wholesale pricing model based on the end user, which is something that was never before done in the mortgage space. Prior to this new model (again, decided unilaterally by FICO), the volume of the Reseller CRA is what set the price, which did not have the drastic differences that the FICO model has with these three tiers, and did not overtly put community lenders, and the families they serve, at a distinct disadvantage relative to larger lenders.

The resultant price increases set by FICO royalty rate cards came to the reseller CRA's from each of the three national CRAs (TU, Experian and Equifax). While the national CRAs blamed the price increase on FICO policy, CHLA has learned that each of them also marks up the FICO wholesale cost when they deliver that to the reseller CRA's. CHLA's research has discovered that the national CRA's mark up the FICO score fee around 100% to the resellers and in the past have even increased the cost of the FICO score to resellers more than FICO increased the cost to them. The FICO charges (both the wholesale FICO price to the national CRA's and their markup) are a major part of all the wholesale costs of the components required to create a tri-merge or bi-merge mortgage credit report by the reseller CRA's. The reseller CRA's are going to factor all this into however they price their tri-merge or bi-merge report to the mortgage lenders.

In summary, while FICO does not set specific prices to the end-user (lenders and their customers) their market power allows them to unilaterally raise boundaried wholesale prices to the national CRAs and dictate a new three-tiered pricing model at the wholesale level, forcing the national CRAs to pass it through to the reseller CRAs, and the reseller CRAs to pass it on to the lenders and American families. The national CRAs have no competition in the mortgage market due to the (FHFA- and HUD-required) tri-merge, so they get to charge whatever they want for the score and the Reseller CRA's have to pay it. ***We are told there is no negotiation allowed to the reseller CRAs on any aspect of the price or terms with the national CRAs, again a required part of the mortgage credit report due to the GSE's and HUD requirements.*** Thus, the Reseller CRAs have no choice but to pass this through to lenders as the margins these Resellers are trying to survive on remain very slim.

Unlike in the wholesale credit market described above, a relatively competitive retail credit market exists among the Resellers; while we cannot say for sure here, as we are not privy to contracts between National CRAs and Reseller CRAs, there is little evidence of any doubling of the FICO price at the retail level. Competition within the Reseller industry forces margins to remain relatively thin such that the mortgage industry has lost almost half of the Reseller CRAs in the last 5 years – many reseller CRA owners have decided it's time to exit the industry due to inadequate margins. CHLA has been told to expect more consolidation in the Reseller CRA market due to (1) the downturn in the mortgage market, historically low housing inventory, Fed tightening, illiquid MBS market and resulting rise in interest rates, and (2) this FICO™ 10T pricing model and additional price increases added by the Bureaus, which is making a tough situation even worse. Margin compression and the lack of pricing power by the Reseller CRAs very well could lead to 28 Reseller CRAs (serving the mortgage industry today) falling to only 4 or 5 within 10 years. To put this into perspective, when the Reseller trade organization (NCRA) was founded 31 years ago, more than 2,000 Reseller CRAs served the mortgage industry. This creates even less competition at the RCRA level and likely increased pricing there. CHLA has also been told there has not been a new entry into the market in that same period.

It is also true, however, that lenders cannot know the exact credit pricing system and which parts of the supply chain are charging what amounts exactly. We know

FICO increased their prices by 100-300% in 2023, and we know that overall credit charges to the lenders increased by more than that. (We will soon know more about the 2024 price hikes.) What lenders cannot know for sure, because of how opaque the multi-layered contract setup is (from FICO to the National CRAs to the Reseller CRAs to the lenders) is who else beyond FICO increased (and will increase further in 2024) their fees, and by how much. Lenders simply don't have access to this pricing world between these various industry partners, and individual lenders report that their own complicated contracts [between who and the lender?] don't shed any light on this question.

It's safe to say that there is no other part of the mortgage production marketplace where actual pricing levels and processes are so hard to determine, unfortunately.

Section 5: Credit-Scoring Issues Going Forward for the Mortgage Market

Policymakers in Washington understandably have been pushing for reformed, more fair credit pricing models to capture a larger percentage of Americans who will qualify for responsible credit and thus homeownership. These changes will take some time to be tested against existing data and be comprehensively incorporated into lenders' backend software processing systems. Lenders will also need time to measure and understand how well these reforms work in actuality; there is little margin of error for credit scoring systems to be put in play but then yield unanticipated results that unfairly penalize American families.

As noted in a National Mortgage News article dated August 15, 2023, CHLA member Matt VanFossen discussed how FHFA "had asked for feedback too soon," given that the lending community had not seen the scoring models in actual use with mortgages, and would have much more relevant feedback once they do.

On the pricing front, small lenders were caught off guard by the 300% increase in credit score fees to most of the industry, including all community lenders. CHLA weighed in with FHFA that these fees did not make sense in today's mortgage market, and asked for transparency around the reason and/or cause of these large increases, including why FICO decided to change their tier pricing based on the end user and not the reseller CRA, in effect creating an even less-level playing field between the largest mortgage banks and small community lenders.

In a July 27th National Mortgage News article, a FICO official indicated that "FICO doesn't set the price of the FICO score in the market. We provide a Royalty Rate Card that we give to the CRAs, and then they can choose to price the FICO score any way they want in the market." A "royalty rate card" refers to a recommended set of pricing range for FICO's customers, which are the credit reporting agencies. But this range is directing higher prices and sets pricing policy that other parts of the credit-granting industry MUST follow.

In 2023, FICO made the following claims to rationalize a 300% (now 400% in 2024) increase in pricing to community lenders that specialize in outreach to American families looking to get on the first rung of the economic security ladder; these community lenders, relative to the largest U.S. lenders, have books of business that focus on lower- and moderate-income households, with lower- than-average FICO scores, and that include non-white families, veterans and active-duty families, and rural families:

1. **"The price increase is only $2 to $8 total for all three scores out of (an up to) $50+ tri-merge report and out of approximately $3800 in closing costs."**

   Let's analyze this claim in more detail. First, lenders usually pull multiple credit reports per mortgage applicant in the process of the applicant finding a home and then qualifying for the mortgage. In this market today, where people might search for 1-2 years to find a home to buy, lenders could pull 3 to 6 credit reports; for applicants with credit issues, more credit pulls than 3-6 might be necessary. These fees are either (1) paid directly by the very families that Washington claims it wants to help, or (2) paid by the lender, which then must recapture the foregone fees as general overhead applied to all closed mortgages. CHLA estimates that all expenses related to credit now average $100+ per closed loan, up from $50 in 2022 (before the higher fees went into effect).

   In addition, lenders take many applications that never close successfully, and CHLA estimates that of all applications taken, only 20-30% actually close. For the other 70-80% of mortgage applications taken by lenders, the lenders must pull credit reports and pay for them, essentially leading to sunk costs that get built into overhead such as higher administration fees or increased rates. Put another way, in today's market, prospecting costs that don't generate revenue eventually get passed on to the consumers that do actually close loans, and the FICO price hikes exacerbate this condition.

   CHLA estimates that the total sunk costs average $250-300 per closed loan today, up from $150-200 in 2022.

2. **"This price jump is only the 2nd increase in 25+ years, not including inflationary price adjustments over the last few years."**

   As we now know, FICO came out late in 2023 with a 3rd increase! At a time when families already struggle to access home ownership, with home prices still rising and interest rates still elevated at 20+ year highs, it seems an overt profit grab for any segment of the mortgage production to raise prices 300%, no matter the scale. *Indeed, it is a rare event in any US industry for a supplier to quadruple and then quintuple prices in an instant*.

3. **This volume-based pricing now introduced into the mortgage market matches what has always existed in the credit card, auto, and personal loan markets.**

   The previously announced tiered pricing system, ***now discarded***, was not entirely volume based, and therefore somewhat capricious. The fact that it was so quickly discarded seems to validate our concerns that it was not a well-thought-through decision in the first place.

CONCLUSION

Credit reporting and scoring is a very key part of the American mortgage delivery world, but much of it remains arcane to most of the public and to Washington policymakers. The credit scoring industry has vastly improved, and become more scientific, the key question of which Americans deserve to borrow to buy a home, and at what price. The result is a wider application of credit—which in turns drives family economic opportunity and sustainable neighborhoods—without a concurrent rise in risk and ultimate defaults and economic harm (to families and neighborhoods.) Lenders appreciate and applaud this remarkable system.

But much remains to be considered today, and CHLA believes Washington needs to carefully study and contemplate changes going forward here. As discussed in this paper, the cost of accessing credit data has risen markedly; parts of the industry are already concentrated, and other parts seem to be headed there. Changes driven by FHFA need to occur but in a manner that acknowledges the complex systems and data that must integrate fully and well to have the reforms succeed for everyone.

For its part, CHLA seeks today, as it always has, markets that are competitive, fair, and work to consumers' advantage. The origination market today remains highly competitive; families have many lenders to consider, which in turn keeps consumer prices low. In the mortgage secondary market, CHLA has worked to ensure that the limited number of securitization providers remain well-regulated and outside the grasp of large financial companies, again to keep prices as low as possible for consumers.

Today the risk of market concentration and potential (monopoly) price-setting power appears more in the "backend" world of mortgages, a part not easily understood by consumers and policymakers. In the credit-granting space, CHLA remains concerned that if Washington policymakers look the other way over time, consumers will pay more and more to monopoly providers that can unilaterally charge whatever price they desire – with no market competition, nor public utility oversight, to protect consumer from outright price gouging.

CHLA applauds and agrees with FHFA's goals for these changes, key among which are qualifying more underserved communities with currently "non-traditional" credit and lowering the costs of pulling credit for consumers.

We believe the goal of serving underserved communities can be accomplished through a much less complex and disruptive implementation: simply require one of the two new scoring models to be used - at the choice of the lender and consumer - with the continued requirement of a tri-merge. This both ensures that one of the new models is serving the underserved without disrupting their ability to properly compare all mortgage products (FHA, VA, USDA), which still require a tri-merge credit review.

The second goal (lowering the cost of pulling credit) while laudable, seems highly improbable given the state of the market in the credit world. Fair Isaac, Experian, Equifax, and Transunion are publicly-traded companies that are also essentially a federally-mandated oligopoly (one could argue, given its dominant market share, that Fair Isaac is a federally-mandated *monopoly* provider). VantageScore® 4.0, while technically a separate LLC, is a joint venture of the Big Three credit Bureaus. As large publicly-traded companies, these companies and their boards owe a fiduciary duty to their shareholders to increase profits. It would be irrational to expect that any of these companies would not make up the loss of a third of their business elsewhere. It is also true that today, and in the future, there is nothing to stop these companies from pursuing more profit-maximization at the expense of consumers and lenders.

Mandating a change from tri-merge to bi-merge and mandating VantageScore® 4.0 simply encourages all these entities to increase their pricing by 33.3%. In the context of the recent massive price increases (400% for FICO in most cases, and less transparent increases by the Bureaus made possible the extremely opaque multi-layered contract system), it seems more likely that these entities will actually increase their profits throughout this transition, paid for on the backs of the very consumers FHFA and the Administration seek to help. This concern can be somewhat alleviated by ensuring some minimum competition among these entities and retaining tri-merge and allowing a choice between FICO™ 10T and VantageScore® 4.0.

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April 2024

The Community Home Lenders of America is pleased to transmit to you an addendum memo to our January 2024 White Paper based on our lenders' feedback concerning the credit-scoring industry, and particularly the dramatic rise in prices in the last 18 months.

In this addendum memo, based on 2024 transactions that have occurred after the publication date of the White Paper, we are updating the current market costs of pulling credit for home mortgages.

- As written in the White Paper, to say that the cost of a credit pull is only $3.50 is misleading because it's applied 3 times (or 6 times for joint applicants) in the current tri-merge model, and pulled multiple times in the process (because a credit pull is only valid for 120 days, and home searches and mortgage application processes can last for many months.)
- Thus, without considering the sunk costs of credit pulls for mortgage applications that did not close—the credit costs incurred to close a loan for a family has risen from roughly $50 in 2022 to $100+ in late 2023 to **$150-$250 today.**
- Add in those *sunk costs*, which have risen from $150-$200 in 2022, to $250-$300 in late 2023, to **$360-$475+ today,** and the total credit costs per closed loan has now risen from $200-$250 in 2022, to $350-$400 in 2023, and to **$510-$725+** today.
- Soft pulls were once a way to provide savings to the consumer, but FICO raised those prices 6x as well, making them equally as expensive as "hard" pulls.
- FICO prices went from around $2.00 for a tri-merge in late 2022 to $10.50 for a tri-merge today (that's the 400% increase; and the Big Three Credit Bureaus tacked on increases as well.) ***The scale of these price hikes is unusual in American industry and can only occur when a producer has monopoly or near-monopoly status.***
- FICO's mortgage revenue was up 147% percent last year and the stock price has more than tripled since the fall of 2022. By way of comparison, the S&P 500 is up just under 20% during this same time period.

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