REDACTED

Federal Housing Finance Agency
Office of Inspector General

# FHFA's Analysis of Credit Score Models Was Consistent with Applicable Requirements but the Agency Could Improve Its Process and Enhance the Level of Detail in Its Decision Record

This report contains redactions of information that is privileged or otherwise protected from disclosure under applicable law.

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## Executive Summary

We conducted this evaluation to assess FHFA's implementation of the requirements in the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act that apply to the validation and approval of credit score models used by the Enterprises. Specifically, we assessed how FHFA addressed the statutory requirement that the Agency ensure any credit score model validated and approved by an Enterprise is consistent with the Enterprises' safe and sound operations. Our assessment also included a review of the related regulatory requirements and the support for the FHFA Director's October 2022 decision to require the Enterprises to approve multiple credit score models. FHFA instructed the Enterprises to approve two credit score models and to jointly develop a plan to implement FHFA's decision. Implementation currently is underway and is scheduled to be completed in 2025.

We take no position on FHFA's final decision. Our evaluation focused on the policies, procedures, and practices that govern FHFA's review of the Enterprises' proposed determinations on applications received from credit score model developers. We based our conclusions on the decision record maintained by FHFA, supplemented by interviews with relevant FHFA staff, and by information we collected during the evaluation that was not part of the decision record.

We found that FHFA analyzed the factors established in the relevant Agency regulation and documented its independent analysis of potential impacts of changes to the Enterprises' credit score models in the decision record. In our view, the decision record reflects that FHFA was aware of and acknowledged the significant impact on the Enterprises' operations that would result from its decision.

That said, the staff's analysis did not document an explicit conclusion that the approved credit score models were consistent with the Enterprises' safe and sound operations. In our view, including such documentation would serve multiple purposes. It would enhance the level of detail in FHFA's decision record; memorialize that the Agency expressly considered and addressed [redacted] concerns over the operational complexities and potential operational obstacles associated with transitioning to multiple credit scores; more clearly demonstrate that FHFA fulfilled its responsibility to ensure that any approved credit score model is consistent with safe and sound operations; and promote the principles contained in FHFA's Official Documents Policy. Based on our review of the decision record and the supplemental information we obtained through interviews and follow-up questions with relevant FHFA personnel, we conclude that the Agency held the view that the operational

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impact of the credit score models would not jeopardize the Enterprises' safe and sound operations.

We recognize that this was FHFA's first experience reviewing applications for multiple credit score models, and the Agency did not have written policies and procedures in place to provide guidance to FHFA staff on the details of the review and approval process. In addition, although the Agency states that its Division of Enterprise Regulation (DER) "is responsible for the supervision of Fannie Mae and Freddie Mac and for the evaluation of the safety and soundness of their operations," the decision record does not contain a DER evaluation of the operational impact of using multiple credit score models on the Enterprises' operational safety and soundness.

We offer recommendations that we believe would enhance the level of detail in the decision record and improve the effectiveness of the Agency's review process. In a written management response, FHFA agreed with our recommendations.

This report was prepared by Jacob Kennedy, Senior Investigative Evaluator, with assistance from Philip Noyovitz, Investigative Evaluator. We appreciate the cooperation of FHFA staff, Enterprise personnel, and the assistance of all those who contributed to the preparation of this report.

This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, www.fhfaoig.gov, and www.oversight.gov.

/s/

Kyle D. Roberts
Deputy Inspector General for Evaluations

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# ABBREVIATIONS

| | |
|---|---|
| C.F.R. | Code of Federal Regulations |
| DER | Division of Enterprise Regulation |
| Economic Growth Act | 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act |
| Enterprises | Fannie Mae and Freddie Mac |
| FHFA or Agency | Federal Housing Finance Agency |
| FICO | Fair Isaac Corporation |
| Regulation | 12 C.F.R. Part 1254 – Validation and Approval of Credit Models |
| Safety and Soundness Act | Federal Housing Enterprises Financial Safety and Soundness Act of 1992 |

# BACKGROUND

## FHFA's Supervisory and Conservatorship Authority

The Federal Housing Finance Agency (FHFA or Agency) is responsible for supervising and regulating Fannie Mae and Freddie Mac (collectively, the Enterprises).[1] The FHFA Director has a duty to ensure that each Enterprise operates in a safe and sound manner and complies with applicable law, FHFA regulations, and with their respective charter acts.[2]

In September 2008, the FHFA Director exercised authorities under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Safety and Soundness Act) to place each Enterprise into conservatorship. The Safety and Soundness Act grants the FHFA Director sweeping powers when acting as conservator. For example, as conservator, FHFA has authority to operate the Enterprises "with all the powers of the shareholders, the directors, and the officers."[3] However, FHFA delegated authority for general corporate governance and day-to-day matters to the Enterprises' boards of directors and executive management.[4]

## FHFA's Efforts Between 2015 and 2018 to Update the Enterprises' Credit Score Requirements

FHFA defines "credit score model" to mean a statistical tool or algorithm created by a third party used to produce a numerical value or categorization to predict the likelihood of certain credit behaviors.[5] Credit score models are primarily used to inform management for decision making and to provide predictive information on the potential for delinquency or default that may be used in the loan approval process and risk pricing. The Enterprises use credit score models to help assess borrower creditworthiness and credit scores for mortgage product eligibility, loan pricing, and financial disclosures. For nearly 30 years, lenders delivered credit scores to the Enterprises based on Classic FICO, a model owned by credit score model developer Fair Isaac Corporation (FICO).

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[1] 12 U.S.C. § 4511(b)(1). FHFA is also responsible for supervising and regulating the Federal Home Loan Bank System.

[2] 12 U.S.C. § 4513(a)(1)(B)(iii).

[3] 12 U.S.C. § 4617(b)(2)(B)(i), (D)(ii).

[4] FHFA may revoke those delegations at its discretion. FHFA retained authority for certain significant decisions and requires prior notice of others. For further discussion of the conservatorships, see OIG, *FHFA's Conservatorships of Fannie Mae and Freddie Mac: A Long and Complicated Journey*, at 11–12 (Mar. 25, 2015) (WPR-2015-002).

[5] 12 C.F.R. § 1254.2.

According to FHFA, from 2015 to mid-2018, the Agency engaged with the Enterprises, market participants, and other interested parties on possible changes to the Enterprises' credit score requirements. FHFA instructed the Enterprises through its 2015 and 2016 Conservatorship Scorecards to study the feasibility of implementing alternative credit score models (i.e., models other than Classic FICO).[6] In response, FHFA and the Enterprises conducted in-depth reviews of various credit score models. They met with market participants and other interested parties to assess the potential impact of a change on Enterprise operations and systems, and whether updating the requirements would generate additional access to mortgage credit for creditworthy borrowers while maintaining consistency with Enterprise credit requirements and risk management practices.

In 2017, FHFA issued a "Request for Input" on four possible credit score model options. The purpose of the request was to gather feedback on those options from parties that could be impacted by a change in the Enterprises' credit score requirements. The options under consideration included whether to use a single credit score model or two credit score models, whether to permit lenders to choose the credit scores, or whether to adopt a waterfall approach to credit scores.[7] Commenters provided FHFA with feedback on the credit score model options presented. FHFA planned to make a decision to update the Enterprises' credit score requirements in 2018.

## New Statutory Requirements for Validating and Approving Third-Party Credit Score Models and FHFA's Implementing Regulation

### *New Statutory Requirements for Credit Score Model Validation and Approval Went into Effect in 2018*

In May 2018, before FHFA made a decision, Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act (Economic Growth Act).[8] This law, among

[6] Each year since 2012, FHFA has published a conservatorship scorecard that is tied to the Agency's overall strategic plan and conservatorship strategic plan in place at the time. The Agency describes the scorecards as "an essential tool in holding the Enterprises accountable for the Strategic Plan's effective implementation" and its "mechanism for communicating its priorities and expectations for the Enterprises and providing transparency to the public about these expectations." For further discussion of the conservatorship scorecards, see OIG, *FHFA's Public Reporting of the Enterprises' Progress Toward the Objectives FHFA Set in the 2020 Conservatorship Scorecard Lacked the Detail and Transparency of Past Reporting*, at 8–9 (Mar. 17, 2022) (EVL-2022-002).

[7] In this context, waterfall refers to an approach that would establish a primary credit score and secondary credit score. If a borrower did not have a credit score under the primary credit score, a lender would have the option to provide a secondary credit score. Using this approach, FHFA and the Enterprises would need to determine how a secondary credit score option would work in various scenarios.

[8] Pub. L. 115-174, 132 Stat. 1296 (2018). In July 2018, FHFA issued a press release announcing that it would not make a decision about updating the credit score model requirements in 2018 and instead was shifting its attention to promulgating the regulations the Enterprises will follow to validate the credit score models, as

other things, established new requirements for the validation and approval of credit score models used by the Enterprises in the purchase of mortgages.[9] Some of those requirements apply to the Enterprises, and some apply to FHFA. The statute requires the Enterprises to establish a validation and approval process under which they may not validate and approve a credit score model unless the model:

(i) Satisfies minimum requirements of integrity, reliability, and accuracy;

(ii) Has a historical record of measuring and predicting default rates and other credit behaviors;

(iii) Is consistent with the safe and sound operation of the corporation; and

(iv) Complies with any applicable standards established by the FHFA Director.

FHFA establishes (by regulation) the standards and criteria for the Enterprises' credit score model validation and approval processes, and the Enterprises must apply those standards and criteria.[10] FHFA must then ensure that any model approved by an Enterprise complies with FHFA's standards and criteria.

### *FHFA's Regulation on Credit Score Model Validation and Approval Went into Effect in October 2019 and Established Standards and Criteria for the Enterprises*

FHFA published its regulation on the validation and approval of third-party credit score models (the Regulation) on August 16, 2019.[11] The Regulation sets forth standards and criteria for the process an Enterprise must establish to validate and approve any credit score model. The process consists of several steps—some of which are taken by the Enterprises, and others by FHFA. With respect to the Enterprises:

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required by the Economic Growth Act. In December 2018, FHFA announced that it was seeking public comment on the proposed rule that would establish the standards and requirements for the validation and approval of third-party credit score models that will be used by the Enterprises.

[9] Section 310 of the Economic Growth Act is relevant to our evaluation. Sections 310(a) and (b) amended the Fannie Mae and Freddie Mac charter acts, respectively, and the Safety and Soundness Act to establish requirements for the validation and approval of third-party credit score models by Fannie Mae and Freddie Mac.

[10] Section 310(c) requires FHFA to establish standards and criteria for the Enterprises' validation and approval processes of credit score models. Sections 310(a) and 310(b), among other things, require compliance with FHFA's standards and criteria.

[11] *See* the Regulation on Validation and Approval of Credit Score Models, 84 Fed. Reg. 41886 (August 16, 2019). The Regulation became effective on October 15, 2019.

- The Enterprises solicit applications from credit score model developers;[12]
- Each Enterprise reviews the applications that it received in response to the solicitation;[13]
- Each Enterprise performs a "Credit Score Assessment" of each complete application it received and must determine whether the application passes;[14]
- Each Enterprise performs an "Enterprise Business Assessment" of each application that passes the Credit Score Assessment and must determine whether the application passes;[15] and
- Each Enterprise submits to FHFA "proposed determinations" of approval or disapproval for each application.

### *The Regulation Assigned Specific Responsibilities to FHFA with Regard to the Validation and Approval of the Credit Score Models*

#### FHFA Must Perform an Independent Evaluation of the Potential Impacts of Changes in Credit Score Models

The Regulation requires FHFA to conduct an "independent analysis" of the potential impacts of any change to an Enterprise's credit score model.[16] According to FHFA, its review and independent analysis provides an opportunity for FHFA to determine the feasibility of implementing multiple credit score models and "will provide a mechanism to make determinations in its capacity as safety and soundness regulator of the Enterprises with respect

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[12] The Joint Credit Score Solicitation (dated Feb. 18, 2020) established the application requirements for credit score model developers seeking the Enterprises' approval of their models. The solicitation, among other things, describes application requirements, provides instructions for submitting applications, identifies information that must be submitted by the applicant, and describes the process and criteria for conducting a Credit Score Assessment and an Enterprise Business Assessment.

[13] At this step, the Enterprises determine whether the application is complete (i.e., it satisfies the requirements set forth in the solicitation) and the application fee has been paid. *See generally* 12 C.F.R. § 1254.6 (submission and initial review of applications).

[14] 12 C.F.R. § 1254.7(a). The Credit Score Assessment evaluates a model's accuracy, reliability, and integrity on a standalone basis, that is, independent of the Enterprise's business, systems, and operational processes. 12 C.F.R. § 1254.7 established the regulatory requirements for the credit score assessment.

[15] 12 C.F.R. § 1254.8(a). The Enterprise Business Assessment evaluates the potential impact of each model within the Enterprise's proprietary business systems and processes. FHFA established the criteria for Enterprise Business Assessments in the Regulation at section 1254.8(b).

[16] The Regulation requires FHFA to initiate its independent analysis "no later than the beginning of the Enterprise Business Assessment." Whereas the Regulation requires the Enterprises to complete their business assessments within 240 days, it does not specify a timeframe within which FHFA must complete its independent analysis under section 1254.8(d).

to the Enterprises' use of credit scores."[17] Based on this independent analysis, FHFA may, among other things, require an Enterprise to undertake additional analysis; require the Enterprises to permit the use of multiple models; or require "any other change to an Enterprise program, policy, or practice related to the Enterprise's use of credit scores."[18]

#### FHFA Must Review the Enterprises' Proposed Determinations and Must Approve or Disapprove Those Proposals

Upon completion of the Enterprise Business Assessment, the Enterprises must submit to FHFA "a proposed determination of approval or disapproval of each application."[19] FHFA is then required to approve or disapprove the Enterprise's proposed determination within 45 days of the Enterprise's submission (FHFA may extend the timeline indefinitely). The Regulation also gives FHFA the authority to impose conditions on any such approval and to approve more than one credit score model.[20]

## The Enterprises' Credit Score Model Validation and Approval Process

### *Credit Score Assessment*

As noted above, the Regulation sets forth criteria and standards that the Enterprises must apply to test each model application.[21] The Enterprises must first determine whether each application passed the Credit Score Assessment. To do this, an Enterprise tests for accuracy and reliability using one or more industry standard statistical tests to demonstrate divergence among borrowers' propensity to repay using the industry standard definition of default, applied to mortgages purchased by an Enterprise. An Enterprise also tests for credit score integrity by evaluating whether the model uses relevant data that reasonably encompasses the borrower's credit history and financial performance. The Enterprises must determine whether the application passed the Credit Score Assessment and notify the applicant if it passed within 30 days of that determination.

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[17] 84 Fed. Reg. 41903-04 (preamble to the Regulation, describing the purpose of FHFA's independent analysis).

[18] 12 C.F.R. §§ 1254.8(d)(1)-(3).

[19] 12 C.F.R. § 1254.9(a). Through its Regulation, FHFA expanded the role that the text of Section 310(c) of the Economic Growth Act described for FHFA. Section 310 describes a framework whereby the Enterprises make the decision whether to approve or disapprove an application; the text of the law does not call for FHFA's prior review and approval.

[20] 12 C.F.R. § 1254.9(a).

[21] 12 C.F.R. § 1254.7(b).

### *Enterprise Business Assessment*

Once the Enterprise determines that the application passed the Credit Score Assessment, it then undertakes an Enterprise Business Assessment. The Enterprise Business Assessment is a comprehensive evaluation of the potential impacts that using each credit score model could have on an Enterprise and the mortgage finance industry.[22] The Enterprise must evaluate the impact that using the credit score model would have on Enterprise operations (including any impact on purchase eligibility criteria and loan pricing) and risk management (including counterparty risk management) and do so "in accordance with standards and requirements related to prudential management and operations and governance..."[23] The quoted language refers to FHFA's minimum safety and soundness standards and FHFA's requirements for the Enterprises' risk management programs.[24] The Enterprise is then required to determine whether a model application passes the Enterprise Business Assessment.[25]

## The Enterprises Submitted Their Respective Proposed Determinations to FHFA

[redacted] model developers responded to the Enterprises' solicitation for applications and submitted applications for a total of five credit score models. The Enterprises completed Credit Score Assessments and Enterprise Business Assessments for each credit score model and submitted their respective proposed determinations to FHFA. Fannie Mae submitted its proposed determinations on December 17, 2021, and Freddie Mac submitted its proposed determinations on January 21, 2022.

Both Enterprises recommended [redacted]. Both Enterprises [redacted].

## FHFA Reviewed the Proposed Determinations and Announced Its Decision

FHFA established an internal working group comprised of personnel from multiple offices within the Agency. Its task was to, among other things:

- Coordinate with Enterprise personnel and FHFA leadership;
- Review the Enterprises' proposed determinations;

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[22] 12 C.F.R. §§ 1254.8(b)(1)-(6).

[23] 12 C.F.R. § 1254.8(b)(3).

[24] *See* 12 C.F.R. Part 1236, Appendix A (prudential management and operations standards); and 12 C.F.R. § 1239.11 (risk management).

[25] 12 C.F.R. § 1254.8(a).

- Prepare and document FHFA's independent analysis of the potential impacts of any changes to an Enterprise's credit score models; and

- Present options for a final decision by the FHFA Director.

FHFA documented its independent analysis in a memorandum (Memorandum) and an internal presentation prepared by FHFA staff.[26]

The Regulation requires FHFA to approve or disapprove each of the Enterprise's proposed determinations. On October 24, 2022, FHFA announced the Director's decision to approve FICO's FICO 10T credit score model and VantageScore Solutions, LLC's VantageScore 4.0 credit score model for use by the Enterprises.[27] FHFA instructed the Enterprises to approve the applications for those credit score models and required them jointly, with each other and the Agency, to develop an implementation plan. FHFA conditioned its approvals on the Enterprises replacing the requirement for lenders to deliver Classic FICO scores for loans purchased by the Enterprises with FICO 10T and VantageScore 4.0 scores, as well as the "successful development of a feasible implementation plan." Implementation currently is underway and is scheduled to be completed in 2025.

## FACTS AND ANALYSIS ..........................................................

We conducted this evaluation to assess FHFA's implementation of its statutory and regulatory responsibilities related to the review and approval of credit score models used by the Enterprises. We take no position on FHFA's final decision to approve the FICO 10T and VantageScore 4.0 credit score models because the decision was outside the scope of this evaluation. In making our assessment, we reviewed the Agency's decision record in relation to the requirements established by the relevant provisions of the Economic Growth Act and FHFA's Regulation.[28] To supplement our review of the Agency's decision record, we conducted interviews with relevant FHFA staff and reviewed other information provided by FHFA that was not part of its decision record.

[26] FHFA staff delivered the presentation to the FHFA Director and Agency executives on October 20, 2022.

[27] *See* FHFA News Release, *FHFA Announces Validation of FICO 10T and VantageScore 4.0 for Use by Fannie Mae and Freddie Mac* (Oct. 24, 2022). FHFA formally notified the Enterprises of its decision on October 25, 2022. FHFA also announced that "the Enterprises will work toward changing the requirement that lenders provide credit reports…from two of the three nationwide [consumer reporting agencies]" instead of requiring credit reports from all three. This change is not within the scope of our evaluation.

[28] For purposes of this report, we use the term "decision record" to mean the collection of documents that FHFA staff distributed to the FHFA Director and members of FHFA executive management for review on October 20, 2022, and provided to OIG.

## FHFA Completed the Independent Analysis of the Impact on the Enterprises of New Credit Score Models That Is Required by the Regulation

The Memorandum, which is part of the Agency's decision record, describes FHFA's consideration of the factors it used in its analysis. Our review confirmed that the Memorandum addressed each of the criteria established by the Regulation and documented the Agency's independent assessment of those criteria.[29] FHFA personnel reviewed the materials submitted by the Enterprises, including summaries of the Enterprise Business Assessments and supplemental research and analysis, and the Enterprises' respective proposed determinations.[30]

The Enterprises noted in their respective Enterprise Business Assessments that a change in the credit score model would affect their credit risk policies, automated underwriting systems, loan pricing, credit risk transfer, and other servicing and operational functions. FHFA personnel assessed [redacted] concerns over the operational risk that would accompany a transition to multiple models due to the increased complexities and expressly acknowledged in the Memorandum that there would be "significant" operational impacts to the Enterprises' systems that support acquisitions of mortgages, disclosures to investors, and their financial disclosures.

The Economic Growth Act contains a requirement that is specific to operational risk and requires FHFA to ensure that any credit score model approved by an Enterprise "is consistent with the safe and sound operation of the Enterprise."[31] The decision record reflects that FHFA was aware of the general impact FHFA's decision would have on the Enterprises' operations; however, the Memorandum and internal presentation prepared by FHFA staff did not document an explicit conclusion that the approved credit score models were consistent with the Enterprises' safe and sound operations.

Because of the statutory requirement, we made additional document and interview requests to understand the Agency's position. We asked the Agency how it assessed the safety and soundness of the Enterprises in a multiple credit score environment. FHFA responded that it

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[29] The Regulation established the criteria that must be applied: (1) the accuracy and reliability of credit scores within its systems or processes for mortgage purchases; (2) possible fair lending impacts of using the credit score within the Enterprise's systems and processes that use credit scores; (3) the impact on the Enterprise's operations and risk management, and the impact on the housing finance industry; (4) possible competitive effects from using a particular credit score model; (5) the credit score model provider as a potential third-party provider; and (6) any other criteria established by an Enterprise. 12 C.F.R. §§ 1254.8(b)(1)-(6).

[30] Our report omits certain details from the Enterprises' submissions and FHFA's internal deliberations because FHFA has not made those details public. Additionally, the Enterprises designated the materials they provided FHFA as privileged and confidential and requested exemption from disclosure under the Freedom of Information Act.

[31] Economic Growth Act, Section 310(c).

reviewed the Enterprises' analysis in their Credit Score Assessments (i.e., the accuracy, reliability, and integrity of the models outside of business systems and processes) to determine that each credit score model met the minimum accuracy standard and provided an enhanced assessment of credit risk. FHFA reasoned that credit score models that independently meet safety and soundness standards would also meet these standards when used together in a multiple credit score environment. In follow-up interviews, FHFA staff explained to us that they did not consider the operational challenges identified by [redacted] to be insurmountable.

Based on the decision record and supplemental information we obtained through interviews and follow-up questions with relevant FHFA personnel, we conclude that FHFA held the view that the operational impact of implementing multiple models would not jeopardize the Enterprises' safe and sound operations.

## OIG Analysis of FHFA's Review and Decision Process

### *Although Encouraged by FHFA's Official Documents Policy, the Agency Does Not Have Internal Procedures for FHFA's Review and Decision Under the Regulation*

FHFA's Official Documents Policy (2018) established the Agency's overarching framework for developing and clearing "high quality agency decisions and related work products." It contains a guiding principle that all "official documents" reflect strong analysis, analytical rigor, and clear writing, and states that it "facilitates Agency decision making and documentation of Agency decisions." Under this policy, "Staff analysis memoranda provided in clearance packages to recommend and/or support decisions…are considered Official Documents." The policy also encourages individual divisions and offices within FHFA to adopt their own internal procedures to supplement the Agency-level policy.

The Regulation requires FHFA to perform an independent analysis of the potential impact of a change in credit score models, and FHFA may utilize this analysis as a mechanism to make determinations with respect to the Enterprises' use of the credit score models. However, there are no procedures and therefore no guidance for FHFA staff to follow when performing and documenting the independent analysis required by the Regulation.[32]

[32] The Agency provided us with the Division of Housing Mission and Goals' general policy for overseeing certain Enterprise activities. However, that policy does not address its review under 12 C.F.R. § 1254.8(d). FHFA's Official Documents Policy establishes a process for circulating clearance packages to the Director for review, approval, and/or signature.

### *The Division of Enterprise Regulation's Role in FHFA's Safety and Soundness Review Is Not Clearly Defined*

The Memorandum states that FHFA's Division of Enterprise Regulation (DER) "is responsible for the supervision of Fannie Mae and Freddie Mac *and for the evaluation of the safety and soundness of their operations*." (Emphasis added.) Notwithstanding this responsibility, the decision record does not contain a DER evaluation of the operational impact of using multiple credit score models on the Enterprises' operational safety and soundness. The decision record contains an assessment by DER of the impact of the change in credit score models on DER's own operations, but it does not contain a DER opinion on whether the approved models, and the Enterprises' implementation of multiple credit score models, are consistent with their safe and sound operations.[33]

### *Documentation of FHFA's Conclusion with Respect to the Enterprises' Safe and Sound Operations Would Enhance the Level of Detail in the Decision Record and More Clearly Demonstrate That FHFA Fulfilled Its Statutory Responsibility*

As noted above, FHFA's decision record does not document an explicit conclusion by the Agency that the credit score models it approved are consistent with the Enterprises' safe and sound operations. We acknowledge that neither the Economic Growth Act nor FHFA's Regulation *require* such documentation. However, in our view, including such documentation would serve multiple purposes. It would enhance the level of detail in FHFA's decision record; memorialize that the Agency expressly considered and addressed [redacted] concerns over the operational complexities and potential operational obstacles associated with transitioning to multiple credit scores; more clearly demonstrate that FHFA fulfilled its responsibility to ensure that any approved credit score model is consistent with safe and sound operations; and promote the principles contained in FHFA's Official Documents Policy. This policy applies to regulatory decisions that require the FHFA Director's approval and to the staff analysis memoranda that support those decisions and calls for FHFA to demonstrate "analytical rigor" and "strong analysis."[34] Explicit language of this nature would provide clear, objective evidence that FHFA fulfilled its obligations under the Economic Growth Act.

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[33] The minutes from the October 20, 2022, meeting do not contain such an opinion by a DER representative, and the Deputy Director was not included in the FHFA leadership group that reviewed the decision record.

[34] Federal agencies such as FHFA must be able to demonstrate that they engaged in reasonable decision-making when reaching final determinations. The Congressional Research Service report, *An Introduction to Judicial Review of Federal Agency Action* (Dec. 7, 2016), discusses, among other things, an agency's obligation to examine relevant data and to articulate a satisfactory explanation for its action, including a rational connection between the facts and the choice the agency made.

### *FHFA Could Clarify Language in the Regulation That Cites FHFA's Prudential Management and Operations Standards and Relevant Corporate Governance Regulations*

The Regulation requires an Enterprise to evaluate the impact of a new credit score model "in accordance with" FHFA's prudential management and operations standards and regulatory requirements. The Regulation, however, does not explain whether FHFA expects the Enterprise Business Assessments to explicitly reference or discuss those standards and requirements. Although the Enterprises addressed the specific sub-risks identified in the Regulation, the decision record does not reflect that the Enterprises addressed other prudential standards and FHFA's governance regulations that appear to be relevant.[35]

### *The Enterprises' Submissions Did Not Disclose Whether a Credit Score Model Passed or Did Not Pass the Enterprise Business Assessment*

As mentioned earlier, each Enterprise performs an Enterprise Business Assessment of each application and determines whether it passes. In their submissions to FHFA, the Enterprises proposed [redacted] but did not disclose whether the models had passed their Enterprise Business Assessments.[36] In our view, FHFA's review of the Enterprises' proposed determinations would be more effective when FHFA personnel know at the outset of their review that a given credit score model did or did not pass an Enterprise Business Assessment, and – in the case of a failure to pass the assessment – when those personnel are made aware of the specific criteria that the model did not pass.[37] The Regulation permits an Enterprise to disapprove a credit score model "based on any of the criteria" approved by FHFA, but it does not require the Enterprises to provide this information to FHFA. Requiring the Enterprises to furnish this information in their proposed determinations would ensure that FHFA had these relevant and meaningful details

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[35] The language in the Regulation is clear that the specific sub-risks are included among broader risk-related topics that fall within FHFA's prudential management and operations standards and governance regulations. The Enterprises did not address, for example, FHFA's prudential standard for overall risk management (Standard 8, which includes operational risk and risk measurement models) or FHFA regulations that establish requirements for risk management programs (12 C.F.R. § 1239.11).

[36] The relevant language in the preamble to the Regulation states, "The final rule requires an Enterprise to submit to FHFA a proposed determination of approval if an application passes both the Credit Score Assessment and the Enterprise Business Assessment." 84 Fed. Reg. 41904. The Regulation permits an Enterprise to establish requirements for the Enterprise Business Assessment that are in addition to the criteria established by FHFA. 12 C.F.R. § 1254.8(b)(6).

[37] The Regulation requires the Enterprises to determine whether each credit score model passes the Enterprise Business Assessment (12 C.F.R. § 1254.8(a)); however, the Regulation does not require the Enterprises to disclose to FHFA that a credit score model did or did not pass.

when it conducts its independent analysis and safety and soundness assessment under section 1254.8(d).

## FINDINGS ....................................................................................

We recognize that this was FHFA's first experience reviewing applications for multiple credit score models, and the Agency has not yet adopted internal policies or procedures. We found that:

1. FHFA did not provide guidance to staff with respect to performing and documenting the impact evaluation and independent analysis required by section 1254.8(d) of the Regulation or the review required by section 1254.9(a). Well-crafted guidance to staff is a means for FHFA to ensure that the Agency meets its legal duties and provides consistency for future reviews.

2. FHFA did not define the role and responsibilities of DER in the review of the Enterprises' proposed determinations. Although FHFA identified DER as the division responsible for supervising the Enterprises and evaluating the safety and soundness of their operations, there is no evidence in the decision record that DER personnel contributed such an opinion to the internal working group.

3. Due to the absence of a documented conclusion in the decision record regarding safe and sound operations at the Enterprises, we had to supplement the decision record with evidence from FHFA staff to infer FHFA's position.

4. Section 1254.8(b)(3) of the Regulation calls for an evaluation of a new credit score model "in accordance with" FHFA's prudential management and operations standards and regulatory requirements but does not explain whether the Enterprise Business Assessment must expressly reference or discuss such standards and requirements. The Enterprises addressed certain standards but did not address standards and requirements that appear to us to be relevant.

5. FHFA did not require the Enterprises to report whether the credit score models passed or did not pass the Enterprise Business Assessments, and the Enterprises did not disclose those results to FHFA. [redacted].

## CONCLUSION

We conclude, based on FHFA's decision record as supplemented by interviews with FHFA staff and other information we collected during follow-up inquiries, that FHFA performed the independent analysis required by section 1254.8(d) of the Regulation in general accord with applicable provisions of the Regulation and the Economic Growth Act. FHFA could take steps in the future to improve its review process through instructional guidance and enhance the level of detail and clarity in its documentation.

## RECOMMENDATIONS

When conducting future reviews of the Enterprises' proposed determinations on credit score model applications, we recommend that FHFA:

1. Define the role and responsibilities of FHFA personnel involved in the review of the proposed determinations submitted by the Enterprises, including personnel from the Division of Enterprise Regulation, with respect to performing and documenting the evaluation of the impact of a change in credit score models required by section 1254.8(d) of the Regulation and the review and Agency decision required by section 1254.9(a).

2. Clearly document in the decision record FHFA's conclusion that any credit score model the Agency approves is consistent with the safe and sound operation of the Enterprises. Such a step would better demonstrate FHFA's fulfillment of its responsibility under the Economic Growth Act and the Regulation.

3. Clarify the extent to which FHFA expects the Enterprise Business Assessments to discuss the impact of a new credit score model or models on the Enterprises' operations and risk management in terms of FHFA's prudential management and operations standards and relevant governance regulations. To ensure that the Enterprises evaluate the impact of a new credit score model relative to the Agency's prudential standards and risk management requirements, FHFA should explain what it means by "in accordance with" in this context.

4. Require the Enterprises to include in their proposed determinations: (a) explicit statements that a credit score model did or did not pass the Enterprise Business Assessment, (b) the specific criteria in section 1254.8(b) that the model did not pass, and (c) the reasons for disapproval of the application. This step would ensure that

FHFA has the benefit of relevant and meaningful details when it conducts its independent analysis under section 1254.8(d).

## FHFA COMMENTS AND OIG RESPONSE....................................

We provided FHFA an opportunity to respond to a draft of this evaluation report. FHFA management provided technical comments, which we considered in finalizing this report. FHFA management also provided a written response, which we included in the Appendix to this report. In its management response, FHFA agreed with our recommendations and committed to develop internal guidance by September 30, 2024.

# OBJECTIVE, SCOPE, AND METHODOLOGY ................................

We conducted this evaluation to assess FHFA's implementation of its statutory and regulatory responsibilities to review and approve credit score models used by the Enterprises. We focused on FHFA's policies, procedures, and practices that establish the Agency's process for approving credit score models in accordance with the Economic Growth, Regulatory Relief, and Consumer Protection Act and FHFA's implementing regulations. The review period for this evaluation was from December 2021 through October 2022 (review period). We take no position on FHFA's final decision to approve the FICO 10T and VantageScore 4.0 credit score models because the decision was outside the scope of this evaluation.

To meet this objective, we reviewed applicable statutes and FHFA regulations in effect during our review period. We obtained and reviewed FHFA's decision record, which included documents provided by the Enterprises. We interviewed FHFA personnel responsible for the preparation of the decision record. To supplement our review of the Agency's decision record, we conducted interviews with relevant FHFA staff and reviewed other information provided by FHFA that was not part of its decision record. We provided a draft of this report to FHFA for its review and comment.

This evaluation was conducted between April and July 2022 and April 2023 and February 2024 under the authority of the Inspector General Act and in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation* (December 2020).

# APPENDIX: FHFA MANAGEMENT RESPONSE............................

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# Federal Housing Finance Agency

**MEMORANDUM**

TO: Kyle Roberts, Deputy Inspector General for Evaluations

FROM: Naa Awaa Tagoe, Deputy Director, Division of Housing Mission and Goals

JAMES WYLIE

Digitally signed by JAMES WYLIE
Date: 2024.03.21 20:00:02 -04'00'

SUBJECT: OIG Draft Report: *FHFA's Analysis of Credit Score Models Was Consistent with Applicable Requirements but the Agency Could Improve Its Process and Enhance the Level of Detail in Its Decision Record*

DATE: March 21, 2024

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Thank you for the opportunity to respond to the Office of Inspector General (OIG) draft report. The objective of the OIG evaluation was to assess FHFA's implementation of the requirements in the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act that apply to the validation and approval of credit score models used by the Enterprises.

The report noted that FHFA analyzed the factors established in the relevant Agency regulation and documented its independent analysis of the potential impacts of changes to the Enterprises. OIG also acknowledged FHFA's awareness of the significant impact the credit score model revisions would have on the Enterprises' operations but found areas for improvement and made four recommendations. FHFA agrees with the recommendations and proposes the following corrective actions:

**Recommendation 1:** *Define the role and responsibilities of FHFA personnel involved in the review of the proposed determinations submitted by the Enterprises, including personnel from the Division of Enterprise Regulation, with respect to performing and documenting the evaluation of the impact of a change in credit score models required by section 1254.8(d) of the Regulation and the review and Agency decision required by section 1254.9(a).*

**Management Response**: FHFA agrees with the recommendation and will take the following actions by September 30, 2024. FHFA will develop an internal document that will provide staff with guidance for evaluating any future submissions from the Enterprises related to the Validation and Approval of Credit Score Models Rule. The internal guidance document will define the roles and responsibilities of FHFA offices and management officials involved in the evaluation process.

**Recommendation 2:** *Clearly document in the decision record FHFA's conclusion that any credit score model the Agency approves is consistent with the safe and sound operation of the Enterprises. Such a step would better demonstrate FHFA's fulfillment of its responsibility under the Economic Growth Act and the Regulation.*

**Management Response**: FHFA agrees with the recommendation and will take the following actions by September 30, 2024. The internal guidance document described in the Management Response to Recommendation 1 will establish that FHFA's decision record on credit score models must include a conclusion that any credit score model the Agency approves is consistent with the safe and sound operation of the Enterprises.

**Recommendation 3:** *Clarify the extent to which FHFA expects the Enterprise Business Assessments to discuss the impact of a new credit score model or models on the Enterprises' operations and risk management in terms of FHFA's prudential management and operations standards and relevant governance regulations. To ensure that the Enterprises evaluate the impact of a new credit score model relative to the Agency's prudential standards and risk management requirements, FHFA should explain what it means by "in accordance with" in this context.*

**Management Response**: FHFA agrees with the recommendation and will take the following actions by September 30, 2024. The internal guidance document described in the Management Response to Recommendation 1 will include guidance for FHFA staff on evaluating whether the Enterprise Business Assessments meet the standards under 12 CFR 1254.8(b). This internal guidance will provide additional context about the requirement that an Enterprise's evaluation of the impact on Enterprise operations and risk management be conducted "in accordance with standards and requirements related to prudential management and operations and governance set forth at parts 1236 and 1239 of this chapter."

**Recommendation 4**: *Require the Enterprises to include in their proposed determinations: (a) explicit statements that a credit score model did or did not pass the Enterprise Business Assessment, (b) the specific criteria in section 1254.8(b) that the model did not pass, and (c) the reasons for disapproval of the application. This step would ensure that FHFA has the benefit of relevant and meaningful details when it conducts its independent analysis under section 1254.8(d).*

**Management Response**: FHFA agrees with the recommendation and will take the following actions by September 30, 2024. The internal guidance document described in the Management Response to Recommendation 1 will include guidance for FHFA staff on requiring that any future Enterprise Business Assessment include each of the items described in Recommendation 4: (a) explicit statements that a credit score model did or did not pass the Enterprise Business

Assessment, (b) the specific criteria in section 1254.8(b) that the model did not pass, and (c) the reasons for disapproval of the application.

If you have any questions relating to our response, please contact Shelly Blackston, DHMG Audit Liaison.

cc: Edom Aweke
John Major
Mark David
Shelly Blackston

## ADDITIONAL INFORMATION AND COPIES ..............................

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