Closing the "Lender Information Gap" with Alternative Data and Account Connectivity

Abstract

FICO scores are often the primary (and sometimes only) criterion used by lenders to determine if a loan applicant should be approved for a loan. But this three-digit score provides an incomplete picture of both lender risk and consumer loan-worthiness, preventing millions of Americans from receiving the funds that they need to achieve life's most defining financial goals. Alternative data and account connectivity technology give lenders comprehensive insight into the financial health of each applicant, making the underwriting and securitization processes easier and more insightful and effective for lenders, and the odds of consumers receiving the loan they need to achieve their life and financial goals all the more likely.

Introduction

The US consumer lending industry generates approximately $35 billion in annual revenue.[1] The most common reasons for borrowing money include leasing a vehicle, buying a new home, and acquiring small business capital, and most consumers will seek a loan for one or more of these during their lifetime. While lenders assess an applicant's loan worthiness according to their own specific industry and credit risk models, FICO scores are used by 90 percent of lenders in the US [2] As a result, this score, which ranges from 300 to 850, heavily determines whether or not someone is approved for a loan. But the amount of weight that lenders assign to this score overlooks many key data points that are more meaningful and robust indicators of a loan applicant's ability to successfully repay a loan.

In addition, millions of applicants are excluded from getting a loan because of their low or no score status. Likewise, traditional credit decision-making methodology often overlooks financial indicators that could prevent late payments, loan defaults, and missed lending opportunities. Worse, many consumers are confused and even misinformed about what their real score is and what it actually means for their financial health and ability to qualify for a loan.

Addressing these problems gives lenders a complete picture of each applicant's financial story, allowing them to better assess risk, reduce late payment and default

[1] Source: *retrieved 18 February 2018 from http://www.firstresearch.com/industry-research/Consumer-Lending.html.*

[2] Source: Nick Clements, "5 Reasons Lenders Are Ignoring FICO Credit Scores", Forbes, April 21, 2015.

incidents, streamline the lending workflow, and even offer more competitive interest rates.

Consumers also benefit by receiving a more accurate picture of their loan approval chances (reducing hard inquiries, which can lower credit scores). They're also less likely to incur an overdraft or late fee because lenders know when to withdraw loan payments based on a data-driven estimation of what the borrower's account balance is on a given day. Applicants can also save money in the form of lower interest rates, as their true credit risk is measured on a case-by-case basis, instead of as part of a risk pool determined by FICO scores, which often penalizes groups based on a small number of default risks.

By connecting to applicants' financial accounts and accessing insightful alternative data points, lenders can effectively bridge the "lender information gap" and provide much-needed funding to deserving consumers.

The FICO Score

FICO scores first appeared in 1989, becoming available to all three of the major credit reporting bureaus (Equifax, Experian, and TransUnion) in 1991. Today, this three-digit score ranges from 300 to 850 and consists of five components: payment history, amount of debt, length of credit history, new credit, and credit composition. Amount of debt and payment history make up 65 percent of each score.[3] Despite the ubiquity of the FICO score in traditional lending models, FICO itself refers to it as a metric that "summarizes your credit risk, based on a snapshot of your credit report at a particular point in time."[4] Likewise, neither income nor job status is factored into the calculation of this score. Despite the inherent limitations of the FICO score, it still weighs heavily for consumers applying for a credit card, auto loan, mortgage, or personal loan.

A study conducted by Oliver Wyman on alternative data found that credit scores, including FICO, work well on a macro level but relatively poorly at a micro level. In short, the scores are good at sorting groups of individuals into measurable risk pools, but bad at predicting individual default rates. For example, if a lender uses a score of 670 as their risk cut-off point, of those with scores ranging from 651 to 670 (the group being rejected because their scores are lower than 670), statistical analysis predicted that 4.9 percent would be likely to default on a loan, but 95 percent would be unlikely to default.[5] A more comprehensive metric of creditworthiness would be able to better separate those who are likely to default from those who are not.

[3] Source: *retrieved February 18, 2018 from http://www.fico.com/25years/.*
[4] Source: *retrieved February 18, 2018 from http://www.fico.com/25years/.*
[5] Source: Oliver Wyman (*Alternative Data and the Unbanked*, 2017).

Who Pays the Price?

The “lender information gap” caused by the inadequacies of FICO scoring has serious and even life-defining consequences for many consumers. Those with low or no score status are most significantly impacted. In 2015, the Consumer Financial Protection Bureau (CFPB) found that 1 in 10 adults in the US is considered “credit invisible”, which means that they have no credit record at all, while about 19 million Americans are classified as “unscored” because of they either have an insufficient credit history or lack a enough recent credit activity to generate a credit score.[6]

The most common reasons why a consumer may be considered “credit invisible” include:

- Never having used credit (e.g., students, immigrants)
- No longer using credit (e.g,. older consumers who have paid off debts)
- Avoiding the use of credit (i.e., cash-rich)
- Losing access to credit due to previous financial difficulties
- Having a very limited use of credit

However, a closer look at these numbers reveals that some consumers are a lot more likely than others to belong to these categories. Nearly 30 percent of low-income consumers are “credit invisible,” with an additional 15 percent being unscored by traditional credit scoring models. By comparison, only 4 percent of those living in upper-income neighborhoods are classified as “credit invisible,” and about 5 percent are unscored.[7]

According to former CFPB Director Richard Cordray, “A limited credit history can create real barriers for consumers looking to access the credit that is often so essential to meaningful opportunity—to get an education, start a business, or buy a house. Further, some of the most economically vulnerable consumers are more likely to be credit invisible.”

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[6] Source: “CFPB Report Finds 26 Million Consumers Are Credit Invisible”, Consumer Financial Protection Bureau, May 5, 2015.
[7] Ibid.

Risk Assessment and Missed Lending Opportunities

When lenders don't have a complete picture of who they are or are not lending to, risk assessment is likely to be inaccurate, and missed lending opportunities are common.

Housing

After the housing crisis, banks faced tougher federal regulations under the 2010 Dodd-Frank Wall Street Reform Act and Consumer Protection Act, which significantly curtailed risky investing (and in turn, subprime lending practices) and enforced stricter financial oversight of banks and financial markets, making many banks reluctant to underwrite loans for all but the most stellar of applicants. Today, banks are issuing 21 percent fewer mortgages[8], which means that borrowers need to have higher incomes *and* higher credit scores to qualify for a home loan.

As of 2017, the median FICO score for an originated mortgage was 754, compared to 707 in late 2006 (pre-subprime crisis).[9] Nonetheless, the number of homeowners who were late with their mortgage payments (defined as being 90+ days behind) in January 2017 was 5.3 percent, higher than the pre-crisis figure of 4.6 percent. If even the most qualified are capable of being late on their mortgage, there must be more to assessing a person's loan worthiness than income and a FICO score. Without a comprehensive understanding of a loan applicant's financial profile, a lender is less likely to be able to successfully predict who will be late with a payment or default on a loan.

Car Loans

The precise number of missed lending opportunities due to FICO score-based lending is likely in the many millions, and possibly even the billions. In 2015, the value of U.S.-originated auto loans given to those with credit scores of 760+ was $38.3 billion.[10] This group encompasses those with the highest possible scores. Likewise, of all auto loans originated between 2004 and 2016, those that went to applicants with scores of 760 or higher accounted for 45.7 billion. The next lower group of consumers, who had scores in the 720 to 759 ranges, were only awarded loans totaling 19.5 billion. But does the small difference in FICO scores really justify the billions in lost lending opportunities?

Small Business Lending

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[8] Soucer: Hannah Rounds, "U.S. Mortgage Market Statistics: 2017", MagnifyMoney, October 5, 2017.
[9] Ibid.
[10] Source: Statista (Value of auto loans originated in the United States from 2004 to 2016, by risk score (in billion U.S. dollars) 2017).

FICO also provides scores for small businesses, often referred to as an SBSS score (Small Business Scoring Service score). Such scores are widely used by banks when making lending decisions. However, a 2015 survey by Nav found that small business owners face many of the same struggles as other borrowers when they try to access capital, and the growing number of financing options could be making the situation worse. Nav's analyses showed that 45 percent of business owners had been turned down for a loan more than once, and 23 percent of those in the segment were unaware of why their application was rejected. But many businesses simply can't get by without outside funding, as the study reported that 53 percent of small businesses had applied for a loan or credit in the last five years. The numbers were similar for those looking to expand their operations in the next 1-2 years, with 40 percent of respondents stating that their primary resource for capital would be a bank loan.

Consumer Misinformation and Reform

Many consumers have a misleading or incomplete understanding of what their FICO score is and what it means. The scores that are commonly advertised are often proprietary or even educational in nature, and often don't reflect the scores that lenders actually use to make credit decisions. If someone applies for a mortgage, the score that the lender pulls to determine whether to approve or reject the loan application may not be the same as the one that that person receives in the mail from their credit card company or even what they see when they visit MyFICO online.

There are also two primary FICO score models currently in use. FICO 9 is the most recent formula, but most lenders and credit reporting agencies are still using the older FICO 8 version, and there is no easy way for consumers to determine which version is being used. In addition, trying to understand, obtain, or correct a credit report is often a challenge, and time-consuming and costly, precisely when consumers most need it to be simple, as in the case of identity theft.

In 2017, the CFPB determined that both Equifax and TransUnion misrepresented the scores that were provided to consumers and fined them $23 million. Yet, all three credit reporting agencies still wield considerable influence over the financial opportunities afforded to Americans, and many lenders use only the scores and credit reports from these agencies when considering a loan and its interest rate.[11] Having a less-than-excellent score can cost the average consumer tens of thousands of dollars in mortgage, business loans, and credit card interest. Likewise, the lower

[11] Source: Gillian B. White, “Two Major Credit Reporting Agencies Have Been Lying to Consumers", The Atlantic, June 4, 2017.

one’s score is the less able it is to sustain the point decline that accompanies each new credit inquiry, furthering the problem of limited lending access.

Consumer advocacy groups have long argued against the misinformation and exclusionary realities of credit scores, as these narrowly focused metrics often further marginalize many individuals, making it difficult for consumers to improve their financial standing. As a result, consumer advocacy groups are among the most vocal proponents of alternative data in lending.

The Benefits of Using Alternative Data

The term ‘’alternative data” encompasses a wide variety of non-traditional financial data, including:

- Utilities
- Rent
- Bank account balance
- Savings history
- Career length and trajectory

With this type of comprehensive data, lenders get more than just a snapshot of an applicant’s financial history at a particular moment in time. They can see the complete history and transactional ledger of each consumer’s financial story, giving them the power to close the “lender information gap” and better determine each applicant’s risk and loan-worthiness.

Likewise, late payments and loan defaults are reduced, many manual processes for loan origination become more streamlined or even eliminated, and lenders can offer more competitive interest rates, something that many currently find challenging. Similarly, with ongoing account monitoring, defaults can be preempted because creditors are aware of any changes in an applicant's income, allowing them to proactively address the topic of loan modification and thereby reduce the likelihood of a borrower defaulting on a loan.

In addition, with income/cash flow data (via account connectivity), the value of loan assets on the secondary market increases as the loans themselves are deemed less "risky". In turn, lenders are able to approve loans more quickly, be repaid more quickly, and reinvest their revenue into additional lending opportunities.

Consumers receive increased access to loans to buy homes, finance a vehicle, and even fund higher education, all of which can add to the quality of a person's overall financial health. Just as important, consumers will finally have a clearer and more expansive understanding of their creditworthiness and therefore be in a better position to apply and be approved for a loan. They'll also save thousands in overdraft fees, late fees, and loan transactional costs, while financially benefiting from lower, more risk-proportionate interest rates.

Even FICO has begun to see the value in alternative data, having recently launched FICO Score XD, which allows lenders to access some alternative data, like utility, mobile, and TV payment history for loan applicants. During a pilot of the new scoring system, 35 – 50 percent of previously unscored consumers received an alternative score equivalent to 620 or better.[12]

The Power of Account Connectivity

Account connectivity technology gives lenders access to each potential borrower's financial backstory. Income verification, expense tracking, savings pattern assessment, and account balance estimation are some of the most powerful tools a lender can have at its disposal when assessing credit risk.

While mortgage lenders often look at income when determining whether or not to approve a loan, the average lender often does not. However, by connecting to an applicant's financial accounts, lenders see not only how much someone is earning but how long they've been earning it and if there are any notable increases or decreases in that income, key information that a FICO score can't divulge.

Expense tracking reveals meaningful patterns, especially when evaluated over the course of months or years. Lenders learn if an applicant is able to pay their bills consistently and in a timely manner. Checking account data, in particular, has been shown to be a strong predictor of an applicant's ability to successfully repay, as well as how likely they are to default on it. This even holds true for small businesses.

However, a person's savings history, or lack thereof, is just as telling for a lender. Being able to answer questions like: Does this person save? How much do they save? Is it enough to make a loan payment? They are invaluable to a lender and go a long way toward better assessing whether to approve or deny a loan. A loan applicant who spends less than they earn each month presents a strong indicator of financial responsibility.

[12] Source: Nick Clements, “5 Reasons Lenders Are Ignoring FICO Credit Scores”, Forbes, April 21, 2015.

Account Connectivity and Lender Processes

Account connectivity also streamlines and improves important processes in the lending workflow via account authentication and balance estimation. Connectivity can lead to faster application processing and turnaround time by automating a lot of the paperwork. According to Fannie Mae data, the use of automated income/employment/asset validation services can reduce total underwriting cycle time by as many as 12 days on average.

In the case of mortgages, connectivity can reduce appraisal escalations by capturing investments in home renovations at the outset, and can lead to better fraud detection by essentially eliminating misrepresentations of data on applications.

By reducing complexity, lenders can also use more junior underwriters to process applications -- making for more efficient staff allocation and lower costs -- by up to as much as $2,100 per loan.[13]

Account authentication streamlines the underwriting process by instantly verifying consumer ownership of an account, which, when combined with income verification data, expense tracking and savings patterns, reduce the amount of time it takes to originate a loan, exponentially reducing processing times and ensuring a more accurate and efficient lending workflow from application to disbursement. In some cases, lenders can even automate their entire lending processes.

The ability to estimate a client's account balance on a given day enables lenders to identify the most efficient and appropriate time to collect monthly payments, thereby eliminating missed payments and costly manual processes on the lender's end, as well as overdraft fees on the consumer's end.

The Future of Alternative Data

While a handful of banks have implemented or are currently in the process of implementing alternative data into their lending strategies, it is fintech companies

[13] Source: *retrieved 2 March 2018 from https://www.bai.org/banking-strategies/article-detail/mortgage-lending-and-the-wonders-of-day-1-certainty.*

and non-traditional, free-market lenders who are leading the way towards the widespread adoption of alternative data through account connectivity.

Kabbage, a small-business and medium-sized lending platform, uses alternative data to underwrite loans for as much as $250,000. Upstart, a personal loan marketplace, makes loans based on "non-traditional variables" like education and employment history, among others. The company recently reported that it has been able to make 47 percent of its loans without the aid of human intervention.[14]

The Numbers

The Corporation for Enterprise Development (CFED) estimates that if lenders only added utility payment data to their risk assessment models, the number of unscored persons would decline by 75 percent.[15]

Mike Mondelli, Senior VP of TransUnion Alternative Data Services, found similarly profound results during the credit reporting agency's recent survey, stating "Alternative data sources (such as property, tax, deed records, checking and debit account management, payday lending information, address stability and club subscriptions) have proven to accurately score more than 90% of applicants who otherwise would be returned as no-hit or thin-file by traditional models."

The same study also found that the use of alternative data allowed 66 percent of surveyed lenders to underwrite a loan to those in their current market successfully, and 56 percent were able to lend to those in previously untapped market segments.[16]

Conclusion

FICO-based lending is ubiquitous. However, relying on this metric as a primary indicator of loan-worthiness often prevents otherwise qualified loan applicants, especially those with limited or no credit history, from being approved and prevents lenders from fully accessing their full market base. Utilizing account connectivity to access alternative data points enables lenders to obtain more meaningful and robust information, thereby closing the "lender information gap" inherent in FICO-based lending practices. It also allows consumers to have more access to and control over their financial futures.

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[14] Source: Samantha Sharf, "Forbes Fintech 50 2018: The Future Of Lending", Forbes, February, 13, 2018.
[15] Source: Oliver Wyman (*Alternative Data and the Unbanked*, 2017).
[16] Ibid.

To learn how we can help bring your business to the forefront of alternative data-based lending, please contact our sales team.