New England Community Developments

Emerging Issues in Community Development and Consumer Affairs

Use of Alternative Credit Data Offers Promise, Raises Issues

by Anna Afshar

Lenders rely heavily on credit scores to make credit decisions. An estimated 32 million Americans, however, have credit files that do not have sufficient information to calculate standard credit scores. An additional 22 million have no files at all.[1] These consumers, sometimes referred to as "thin file" or "no file" (TFNF) individuals, are largely

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minorities, low-income individuals, the elderly, the recently widowed or divorced, and new immigrants.[2]

Previously, many lenders denied these customers credit or charged them high interest rates. More recently, some lenders are learning to use alternative sources of credit data to assess the risk of TFNF consumers. These lenders are thus able to provide some individuals with access to consumer loans and mortgages for the first time or to offer them more favorably priced credit than would otherwise be the case.

This expanded access to credit may, in turn, help some TFNF persons obtain the benefits of homeownership, including the ability to build up assets through home-price appreciation – the primary way individuals in the U.S. increase their wealth.

Consumer advocates point out, however, that the use of alternative credit data must be monitored to ensure that it benefits and does not harm TFNF individuals. They are concerned, for example, that credit scores calculated from alternative data could be used to unfairly lock consumers into high cost credit or hurt them in other areas, such as employment. They are also concerned about the privacy implications of increased information-sharing and the adequacy of reporting standards for data providers under current law.

This article looks briefly at some novel initiatives using alternative credit data and prospective benefits of using the new data. It then examines the potential usefulness of various sources of alternative data and some considerations for lenders, consumers, and policymakers when these data are used.

New Market, New Initiatives

The majority of TFNF individuals make regular payments that are not traditionally reported to credit bureaus but that may prove useful for calculating credit scores. This presents a potentially sizable market of new borrowers. Figure 1 lists some types of alternative payment data that have been identified as potentially useful for calculating credit scores. Say, for

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example, a family makes monthly payments for cell phone service, a land line, cable TV, gas/oil, and rent. This represents five regular monthly payments not currently reported to credit bureaus that could be used to calculate credit scores.

The use of alternative data potentially benefits borrowers, lenders, and data providers alike. TFNF customers may be able to borrow at standard rates, rather than not at all or at higher rates to compensate for their lack of a traditional credit score. From the lender's standpoint, supplementing credit files with alternative data may improve the precision of existing credit risk models, allowing creditors to

more accurately assess risk and distribute credit costs among borrowers. Firms that furnish the alternative data may find that reporting customers' payments encourages these customers to make fewer delinquent payments, thereby reducing costs for the company.

Companies are using alternative credit data in a variety of ways for the purposes of making credit decisions. These initiatives supplement the standard scoring of Experian, TransUnion, and Equifax—the three national credit bureaus that currently compile credit reports for individuals and calculate credit scores based on the information in consumers' files.[3] Even these companies are beginning to investigate ways of expanding their credit scoring models to include alternative data. Figure 2 depicts the various providers and users of alternative credit data and their relationships with one another.

Some companies have recently begun utilizing or investigating credit scoring models relying on alternative credit data:

• In April, MassHousing, the housing finance agency for the state of Massachusetts, became the first nationwide lender to qualify borrowers using a credit scoring system based on alternative sources of credit data. The scoring system, *Anthem*, was created by First American CREDCO.

• Pay Rent, Build Credit (PRBC), considered an alternative credit bureau, also calculates a credit score based on alternative data. Consumers can have third parties (lenders or service/product providers) report payment data to PRBC, or consumers can report their data directly and have a third party verify the information. PRBC has obtained letters from the Federal Reserve and other government entities stating that lending institutions may receive credit under the CRA when they serve as a conduit for rental payment information.[4]

• In 2004, the Fair Isaac Corporation launched its *Expansion Score*, combining alternative data such as payday loan payments and product purchase-payment plans with traditional payment data.

• TransUnion has announced that it is also looking into creating an ancillary score that makes use of alternative data.

Several companies are using alternative credit data in other ways:

• Fannie Mae, Freddie Mac, and CitiMortgage are jointly testing the usefulness of the alternative data collected by PRBC for use in their own credit models.

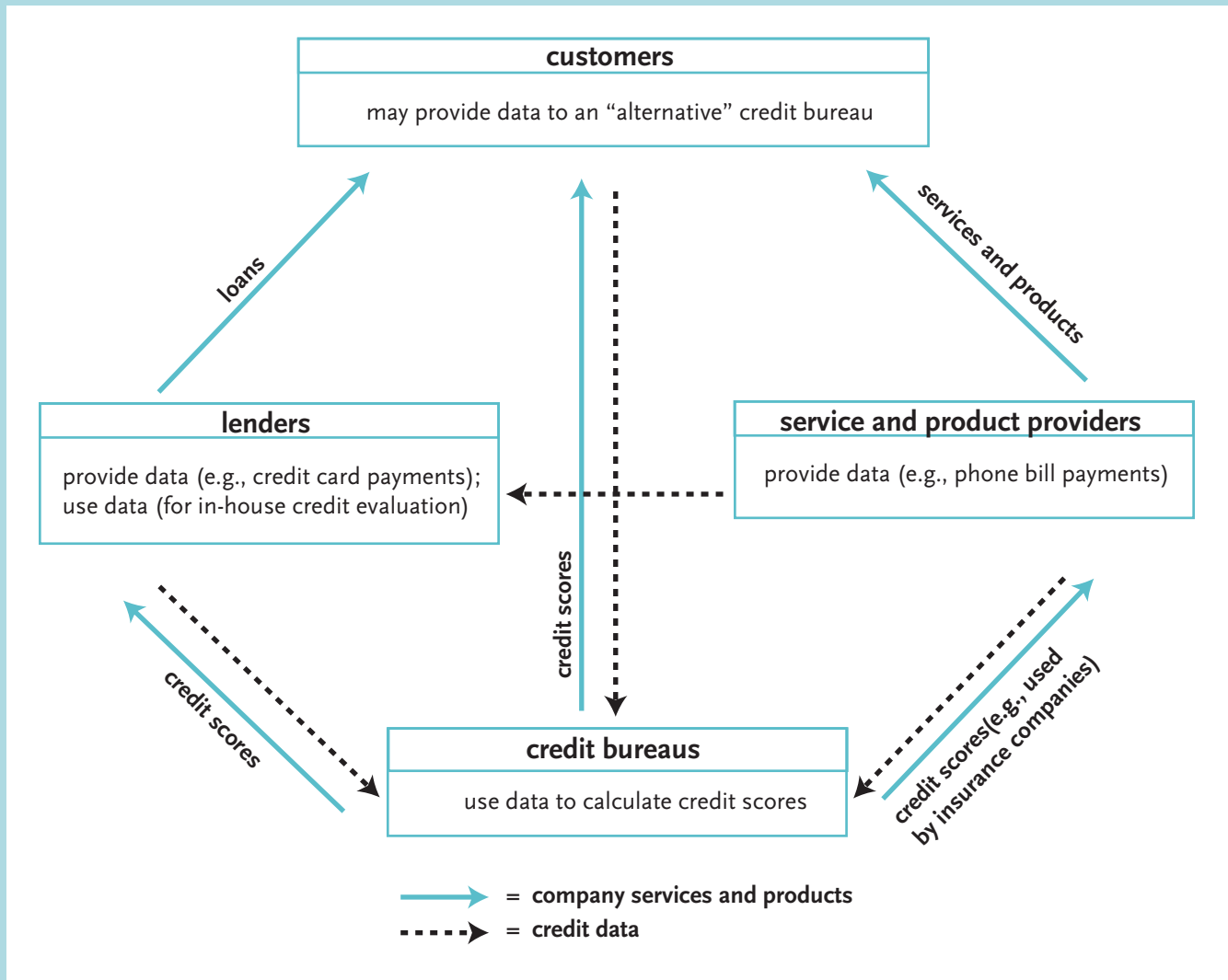• Bank of America incorporates alternative data into

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Figure 1

Alternative Sources of Payment Data

- Energy accounts
- Telecommunications accounts
- Auto liability insurance
- Homeowner's insurance
- Housing rentals
- Child care
- Payday loans
- Health insurance
- Certain retail accounts
  (e.g., furniture rentals)

Source: Information Policy Institute.

Figure 2 | **Providers and Users of Credit Data**

customers

may provide data to an "alternative" credit bureau

loans

services and products

lenders

provide data (e.g., credit card payments);
use data (for in-house credit evaluation)

service and product providers

provide data (e.g., phone bill payments)

credit scores

credit scores

credit scores(e.g., used
by insurance companies)

credit bureaus

use data to calculate credit scores

⟶ = **company services and products**

┄┄⟶ = **credit data**

its existing credit evaluation processes for some customers.

• Advance America and Check Into Cash, both payday loan lenders, have launched a three-month pilot project in several Chicago branches to report loan payments to PRBC. PRBC includes this information in credit reports but not credit scores, in order to minimize concerns that the reporting of payday loan information will encourage consumers to use payday loans, a costly loan product.

• In August, Experian announced that it has begun incorporating phone bill payment data into its scoring models.

Assessing the Usefulness of Alternative Data

Alternative credit information is useful if (1) it is predictive, (2) it is reliable, (3) data providers are willing to report it, and (4) it covers a large number of TFNF individuals. Currently, utility, auto liability insurance, and housing rental payments offer the most promise of being useful.

Predictive value refers to how well the data measure the likelihood that a borrower will make timely loan repayments. This is the primary measurement of the usefulness of any credit data. To assess the predictive power of alternative payment information, the data must be collected, models con-

structed, and the performance of loans assessed. Lenders, data providers, credit bureaus, academics, and others are currently doing empirical research in this area. That said, there is reason to believe that data from *credit-like* services are likely to be predictive. This is because credit-like services and credit products share the same payment structure. Both report information on the provision of a service or good in advance of a series of periodic payments and involve formal agreements between the company and customer about penalties in the event of non-payment.

The reliability of alternative data is also important in assessing its usefulness. Lenders need to know that their calculations are based on accurate information, and all parties involved have an interest in reducing the costs associated with disputes over data accuracy and completeness.

The *reliability* of alternative data is also important in assessing its usefulness. Lenders need to know that their calculations are based on accurate information, and all parties involved have an interest in reducing the costs associated with disputes over data accuracy and completeness. The Information Policy Institute, a center for research on the regulation of information, suggests that reliable credit data

(1) are accurate, a quality resulting from good recordkeeping, (2) provide a stream of information sizable enough to make calculations, and (3) are easily standardized, a quality helping to reduce reporting costs and errors.

Data providers must also be *willing* to report their customers' payment information. Providers of credit-like data often have an incentive to report because customers who know that their payment history is being reported are more likely to make timely payments. But the value of this incentive to the data provider must surpass the cost of implementing a reporting system. Some data providers would have to undertake extensive efforts to consolidate their reporting systems into a central system that adheres to the standards established by the Consumer Data Industry Association. Most of the costs of implementing a reporting system are fixed, and the average cost of reporting data and handling disputes is therefore larger for smaller companies.

The fourth consideration in assessing the usefulness of alternative credit data is *how many* TFNF individuals are covered by a particular data source. Of the sources listed in Figure 1, utility, auto liability insurance, and housing rental payments have the potential to cover the most TFNF customers.

Next, this article examines briefly how well these three sources meet the previously mentioned considerations of predictability, reliability, and whether data providers are willing to report payment information. This analysis provides insight into some of

Figure 3 | **Indicators of Potential Coverage of TFNF Individuals by Various Data Sources**

Utilities
The vast majority of households make monthly electricity, gas/oil, and water payments

Automobile Insurance (2000 data)
86% of households own at least one car
63% of the lowest income quintile of households own a car
85% of the second lowest income quintile of households own a car

Housing Rentals (2004 data)
31% of all households rent their primary residence
54% of the unbanked/underbanked population rent their primary residence

Sources: Fair Isaac Corporation; U.S. Census Bureau.

the barriers to reporting that must be overcome in order for these data sources to be truly useful.

Utility payments. The use of utilities is widespread and the associated payment data would probably cover more TFNF individuals than any other alternative data source. Figure 3 provides an indication of how widespread the coverage of TFNF individuals may be for utility payment data, as well as for automobile insurance and housing rental data. Utility payment data are credit-like as customers pay for services after their use. Moreover, there is evidence that the practice of reporting utility payments to credit bureaus can lead to a reduction in delinquent bill payments.[5] Because these services are provided by a small number of companies, economies of scale would minimize the cost of implementing reliable reporting systems.

There are, however, regulatory barriers that make utility providers reluctant to report data. California and New Jersey have public commission rulings forbidding the reporting of certain payment data to credit bureaus. A bill pending in Texas would similarly restrict the ability of state utilities to report. Moreover, because utilities are regulated by a complex web of statutes and jurisdictional authorities, the absence of clear statements giving utilities permission to report payment data is arguably the most significant barrier to reliance on this source of alternative credit data.

Auto liability insurance payments. Because auto insurance usage is widespread and is required in many states, payment data likely cover many TFNF individuals. The data are not credit-like, because customers pay for insurance ahead of its use. But because customers do make regular payments in return for a service, this data source may yet prove predictive. Like utilities, the auto insurance industry comprises a small number of companies, making it possible to have economies of scale in developing reliable reporting systems. However, there may be minimal incentive for these companies to report the data. Insurance carriers are able to discipline customers who make late payments by canceling their coverage; thus, they may not view the reporting of payment history as valuable in motivating customers to make their payments. Notwithstanding, insurance companies may yet find they want to report because they would benefit from other providers' data for their eligibility and pricing models.

Housing rental payments. Housing rentals are widespread and have the potential to cover many TFNF individuals. Although payment is made ahead of the use of the service, rental payments are regularly scheduled and, as such, have the potential for being predictive. The chief barrier to using housing and apartment rental information is the diffuse nature of the sector. The top 50 landlords in the United States own only 2.5 million units, a mere 8 percent of total rental properties.[6] Moreover, these landlords are responsible for properties in approximately 12,000 locations, and they typically do not keep centralized payment records. It would therefore be difficult and expensive to develop integrated and reliable reporting systems. Moreover, it is unclear whether landlords would have any significant economic incentive to report.

Cautions

Consumer advocates are concerned that alternative credit data could turn out to be used disproportionately by high cost lenders. It is likely that some proportion of TFNF customers are low risk and should receive credit packages that reflect this. Advocates suggest that it is necessary to make certain that both low cost and high cost lenders reach out to TFNF borrowers. Some consumer advocates also argue that it is possible for lenders to take advantage of these consumers, especially while competition among lenders is sparse. Because credit scoring models are proprietary, it is not always clear what data are being used in the calculations and how

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much weight is being given to each source. It is therefore theoretically possible for a lender to unfairly lock consumers into low scores and high interest rates.

Advocates are also concerned about the potential misuse of alternative credit scoring models for non-credit purposes. Credit scores today are used for such purposes as initial employment and job retention and to determine insurance eligibility and prices. Advocates argue that the use of alternative credit scoring models for these other purposes should be limited to situations where the accuracy, relevance, and predictive value of the data have been proven.

An additional set of concerns focuses on data sharing. The potentially large number of companies that would report and process alternative credit data raises questions about privacy and the potential for identity theft. Some advocates also suggest that under current law, the *accuracy* and *completeness* reporting standards for data providers are not as clear as the standards for credit bureaus and require clarification.[7] Advocates maintain that this is of concern because alternative data providers generally do not use alternative data themselves and, therefore, have less incentive than providers of standard data to report accurate and complete information.

Policy Considerations

Congress and the Federal Trade Commission (FTC), the government body responsible for implementing several fair credit laws, believe it is too early for legislative action related to the use of alternative credit data, but both continue to investigate the issue. In May, for example, the U.S. House Subcommittee on Financial Institutions and Consumer Credit held a hearing to explore which alternative credit data may be the most useful, consumer rights concerns, and various policy issues.

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Going forward, there appears to be a role for government action to promote voluntary reporting by data providers and to protect consumer rights. Utility companies and policy advocates, for example, have suggested that the government clarify utility regulations to encourage companies to report payment data. Policy advocates have also suggested that the government encourage public housing commissions to report residents' rental payments.[8] In addition, consumer advocates have suggested that the current law may need to be revised to specify sufficient accuracy and completeness standards for data providers and adequately protect consumers from predatory lending, identity theft, and the use of credit scores to unfairly harm them in the areas of employment and insurance.

Conclusion

There is compelling reason to encourage the development of credit evaluation systems that make use of alternative transaction data. Primarily, these new models have the potential to provide millions of TFNF individuals with expanded access to credit markets. The success of this endeavor depends on the extent to which alternative data forms prove to be predictive of consumer credit risk. Also critical are data providers' incentives to supply reliable payment data, as well as the economic costs and regulatory barriers they face in so doing. New initiatives that make use of alternative credit data are largely market-driven. Notwithstanding, it may prove necessary for the public sector to act to promote voluntary reporting and ensure that the use of alternative credit data serves ultimately to benefit and not harm consumers.

Notes

[1] Estimated by the Fair Isaac Corporation using the Federal Reserve Board's definition of "unbanked" consumers as a proxy for unscorable files. Lee, *American Banker*.

[2] "The Unbanked – Who are They?" *Capital Connections*.

[3] Credit report files consist of: payment and other information about credit accounts held by the consumer (e.g. credit cards); public records including tax liens, bankruptcies, state and county court judgments, and, in some states, child support payment delinquencies; and a list of those who have obtained a consumer's credit score. *Giving Underserved Consumers Better Access to the Credit System*, 3.

[4] In these cases, tenants pay rent directly to a deposit account at the lending institution and the institution reports the payment to PRBC. See http://www.payrentbuildcredit.com/pub/Federal_Reserve_Board_CRA_letter.pdf and http:www.payrentbuildcredit.com/pub/NY_State_Banking_Dept_Letter.pdf.

[5] *TransUnion Case Study*.

[6] *Report to Congress*, 80.

[7] As covered under the Fair Credit Reporting Act (FCRA) and the Fair and Accurate Credit Transactions (FACT) Act.

[8] Many public housing residents may be TFNF customers. *Giving Underserved Consumers Better Access to the Credit System*, 30.

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