NUTTER NOTES

The Benefits (and Risks) of Using Alternative Data in Credit Underwriting

By Thomas J. Curry, Jason J. Cabral and Daniel W. Hartman | Special to Banker & Tradesman | Jan 26, 2020
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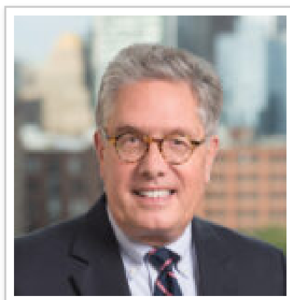


Tom Curry

In December 2019, the Board of Governors of the Federal Reserve System, Consumer Financial Protection Bureau, Federal Deposit Insurance Corp., Office of the Comptroller of the Currency and National Credit Union Administration (collectively known as "the agencies") issued an interagency statement that is generally supportive of the use of alternative data in credit underwriting by banks, credit unions, non-bank financial firms and fintechs.

Alternative data includes information not typically found in consumers' traditional credit reports or customarily provided by consumers when applying for credit. It often includes cashflow data derived from consumers' bank account records that examines categories of income and expenses (e.g., wages, rent, utility, cell phone and other regular debits and credits), as well as educational and occupational information, social media use and other online or mobile activities.

1 in 5 Are 'Credit Invisible'

The interagency statement highlights the potential financial inclusion benefits of using alternative data in credit underwriting by expanding access to credit and capital to consumers and small businesses.

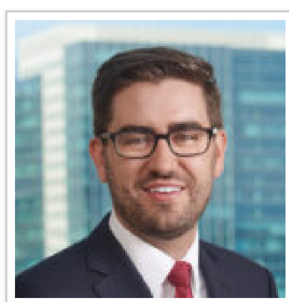
Jason J. Cabral

According to the CFPB, more than 45 million U.S. adults (approximately 1 in 5) lack traditional credit scores and more than half of those 45 million are "credit invisible," meaning they have no credit file with a nationwide consumer reporting agency. Without a sufficient credit history, consumers face significant barriers to accessing credit, or they pay drastically more for credit over time.

The use of alternative data may enable millions of U.S. adults a way to gain access to credit, more cheaply and efficiently, and build a more robust credit history. According to the agencies, alternative data may "improve the speed and accuracy of credit decisions and may help firms evaluate the creditworthiness of consumers" and "enable consumers to obtain additional products and/or more favorable pricing/terms based on enhanced assessments of repayment capacity."

> **When compared to traditional credit scores and attributes, cashflow–based metrics appear to predict creditworthiness within the subpopulations at least as well as the traditional metrics.**

Indeed, a July 2019 research report by FinRegLab, a nonprofit research organization, provides an empirical foundation for greater use of cashflow data in alternative data underwriting. The report indicates that cashflow data are already being used to underwrite credit for a range of unsecured consumer and small business credit products.



Dan Hartman

The report found that cashflow data frequently improved the ability to predict credit risk among borrowers that are scored by traditional systems as presenting similar risks of default. Moreover, when compared to traditional credit scores and attributes, cashflow–based metrics appear to predict creditworthiness within the subpopulations at least as well as the traditional metrics, and better in selected cases. Importantly, the report states, these results suggest that cashflow variables and scores do not create a disparate impact among protected populations.

Practice Raises Consumer Protection Issues

The interagency statement does caution that the use of alternative data and analytical methods raises questions about how to effectively leverage new technological developments that are consistent with applicable consumer protection laws such as fair lending laws, prohibitions against unfair, deceptive or abusive acts or practices, and the Fair Credit Reporting Act. Banks, credit unions, non-bank financial firms and fintechs are also advised to apply the federal banking agencies' model risk management guidance, which contains principles for managing risk related to models, including those that may leverage alternative data. Finally, the interagency statement describes the components of a well-designed compliance management program which should include, among others, appropriate testing, monitoring and controls to ensure consumer protections risks are understood and addressed.

Although the interagency statement highlights the potential consumer protection issues from a lending standpoint, it does not, however, highlight the potential data protection and related privacy issues that arise with the aggregation, use, and sharing of alternative data across platforms. It is a safe bet that many consumers will not know that this data has been collected and shared or how it will be used in the credit process.

As detailed in the Treasury Department's July 2019 report on financial technology and financial innovation, the agencies should support the Treasury Department's recommendation that consumers should have the right to freely access and use their financial account and transaction data and to permission their own financial account and transaction data for third-party use. Additionally, the CFPB should follow the Treasury Department's recommendation that the CFPB work with the private sector to simplify disclosures and terms and conditions so that consumers can give "informed and affirmative consent" concerning access to and sharing their data, to whom access is being granted and for what purposes.

Thomas J. Curry and Jason J. Cabral are partners in Nutter's corporate and transactions department. Daniel W. Hartman is an associate in Nutter's litigation department. Curry is the former U.S. comptroller of the currency and all are members of the firm's banking and financial services group.