

Alternative Data is Here to Stay



The Big Five Regulatory Agencies Recently Issued a Joint Statement on the Use of Alternative Data in Underwriting.



Are you maximizing the number of borrowers for your lending products who can afford to pay you back, or are you (and they) being stymied by thin or non-existent credit files? Do FICO and other scores provide the most accurate indicator of ability to repay for the particular kind of credit you are offering?

Expanding the use of alternative data is a strong step in the right direction to address these concerns. Fortunately, in December 2019 the “big five” federal financial regulatory agencies issued a joint statement on the use of alternative data in underwriting. This action cements the reality that alternative data is here to stay, and lenders who do not have a strategy in place to utilize this powerful tool will be left behind.

From the agencies’ perspective, the “use of alternative data may improve the speed and accuracy of credit decisions and may help firms evaluate the creditworthiness of consumers who currently may not obtain credit in the mainstream credit system.”

What is “alternative data”? The interagency statement defines it as “information not typically found in the consumer’s credit files of the nationwide consumer reporting agencies or customarily provided by consumers as part of applications for credit.” The data can include anything from checking account transaction history to a business’s Yelp reviews to whether a consumer uses proper capitalization in completing a web form. Believe it or not, some lenders believe this is important, with one lender stating that people who fill in their names in all capital letters are much riskier.²

While perhaps startling that completing a web form without proper capitalization could get you turned down for credit, the reality is that alternative data actually opens credit avenues for most consumers that otherwise might have been closed to them. The interagency statement points out that “alternative

data may enable consumers to obtain additional products and/or more favorable pricing/terms based on enhanced assessments of repayment capacity.

These innovations reflect the continuing evolution of automated underwriting and credit score modeling, offering the potential to lower the cost of credit and increase access to credit.”

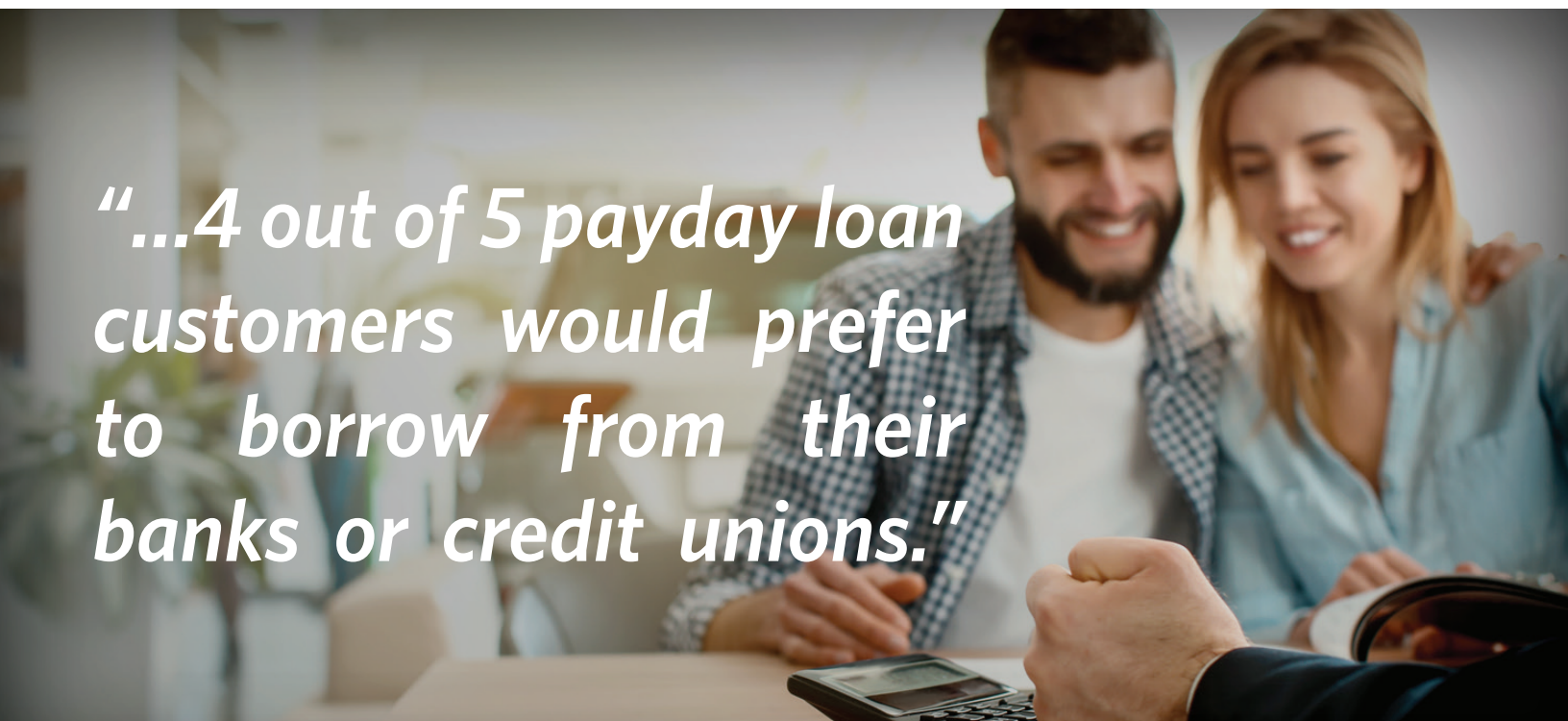
So how does this work in practice? Let’s take short-term, small-dollar loans as an example – loans that banks and credit unions often don’t make because of the complexity of underwriting them along with the resources required to do so.

There’s real market demand for these loans. According to OCC Comptroller Otting, between 25 million and 50 million consumers currently get payday loans.³ There are approximately 157 million working Americans,⁴ and working is a requirement

to get a payday loan. This means that potentially almost as many as 1 in 3 Americans use payday lenders – a huge market!

The Pew Charitable Trusts conducted extensive consumer surveys and found that 4 out of 5 payday customers would prefer to borrow from their banks or credit unions. Given the high cost of payday loans and the consumer demand for these loans from traditional financial institutions, it’s no surprise that the OCC now is encouraging its banks “to offer responsible short-term, small-dollar installment lending to help meet the credit needs of their customers.”⁶

At Velocity Solutions, we pioneered a new form of short-term, small-dollar lending to provide a vastly less expensive alternative to payday loans and automate the underwriting, documentation and funding of these loans. Payday loan customers are



“...4 out of 5 payday loan customers would prefer to borrow from their banks or credit unions.”

generally required to have a checking account, and of course the bank or credit union providing this account has rich data on the consumer's transactional activity.

We use that checking account data obtained daily from banks and credit unions to underwrite a loan amount for each account. This data is likely to be far more reliable than information that is reported by consumers on a loan application because the bank has direct proof that the transactions occurred. Our approach is in line with the interagency statement, which says that the agencies "are aware that some firms are automating the use of cash flow data to better evaluate borrowers' ability to repay loans" and that the "evaluation of a borrower's income and expenses to help determine repayment capacity is a well-established part of the underwriting process."

Once the data is in our system, it applies algorithms that take into account the dollar amount of deposits, the frequency of deposits, overdraft repayment history, and many more factors, and then tweaks these intelligently to account for time-based trending and other proprietary adjustments to enhance determination of ability to repay. For example, if a consumer historically deposits \$1,000 per month and then in March deposits \$3,000, our system isn't going to be fooled into thinking this consumer went from making \$12,000 a year to \$36,000 – the likelihood instead is that the consumer received an income tax refund in March.

"...if a consumer historically deposits \$1,000 per month and then in March deposits \$3,000, our system isn't going to be fooled into thinking this consumer went from making \$12,000 a year to \$36,000."

The data we're using for underwriting these short-term loans includes information as recent as the previous day, while a FICO score takes a longer-term view. When providing short-term credit, we've found that short-term data is far more important. When you think about it, is someone's car payment history over many months nearly as relevant to a short-term loan as whether she received her payroll direct deposit as scheduled every week for the past month? When I speak in front of groups, I explain it this way: "If I'm making one of these loans, I don't care about the past 7 years of history on the credit report – I care about this applicant's financial history for the past 7 weeks!"

And that focus on evaluating credit using alternative data more closely tied to recent activity has been very valuable from a risk standpoint. The interagency statement says that financial institutions "should ensure that alternative data usage comports with safe and sound operations." The ultimate proof of this is the same as how you would measure it for underwriting using traditional data – your loss/charge off experience.

"Our small-dollar loan product results in less than a 3% charge off rate."

For example, we monitor charge off rates for our small-dollar loan product and our clients are now experiencing less than a 3% charge off rate, well under the current 3.5% charge off rate for credit cards reported by the Fed.⁷ Another advantage of models like ours is that the financial institution has the ability to decide that it can tolerate higher charge offs (for example, to be more in line with the 3.5% credit card charge off rate), which then opens up this program to a larger number of borrowers.

Similarly, we use alternative data to set overdraft limits in the overdraft management software we

provide to hundreds of financial institutions. Using this approach, well over 99% of overdraft events where the system provides a positive limit will end up repaying the overdrawn balance.

Regulatory flexibility like that expressed in the interagency statement is good for borrowers. As another example, the Consumer Financial Protection Bureau has a “No Action Letter” process designed to encourage the development of innovative financial products benefiting consumers. Basically, the CFPB agrees not to bring an enforcement action against a company that has one of these letters and provides its product in accordance with the letter. The first recipient of one of these letters uses alternative data to make credit underwriting and pricing decisions. It now has data that powerfully demonstrates the value of the alternative data approach.

The alternative data model from this No Action Letter recipient demonstrates that it was able to approve 27% more applicants than a traditional model, with 16% lower average APRs for approved loans. It significantly expanded access to credit as opposed to using a traditional scoring mechanism:

**Results from
CFPB’s First
No-Action Letter
Recipient**

1. Approved 27% more applicants than a traditional credit-scoring model
2. 16% lower average APRs for approved loans
3. “Near prime” consumers (FICO scores 620 to 660) were approved about twice as often
4. Credit applicants under 25 years old were 32% more likely to be approved
5. Consumers making less than \$50,000 were 13% more likely to be approved⁸

Using alternative data also doesn’t mean you have to throw away your traditional underwriting. The interagency statement says that the “manner in which alternative data are used in relation to traditional data also can provide benefits. For example, some firms may choose to use alternative data only for those applicants who would otherwise be denied credit, often called a ‘Second Look’ program. Used in this fashion, Second Look programs may improve credit opportunities.”

In other words, maybe your first step wading into alternative data is only as an alternative to trying to approve an applicant who has a thin or non-existent file from one of the big 3 credit bureaus. Let’s take millennial generation borrowers as an example. Research shows that they may be more creditworthy than what their credit files would indicate.⁹ This generation has largely relied on debit cards instead of credit cards – more than prior generations – which means there isn’t as much history of credit utilization to build a score. And now, the millennials are the ones building businesses and need credit. You may be able to offer them a loan – and also offer it on better terms to win the business – based on your use of alternative data that provides a better indication of ability to repay.

Many non-bank fintech lenders are already well down the path of using alternative data, and pose a real threat to traditional financial institutions by being able to approve more borrowers at competitive rates. By using alternative data combined with your access to less expensive funding sources, you can win against these non-bank challengers – if you have the right technology.

Since alternative data is here to stay, now is the time to find the right technology partner with expertise in this area who is dedicated to helping traditional financial institutions better manage their charge off risks and expand their lending potential.



Christopher Leonard serves as CEO of Velocity Solutions, where he has been part of the firm's leadership since 2005. An attorney prior to his time with Velocity, he has a particular interest in the regulatory landscape and how technology can improve and modernize traditional banking within the bounds of strong standards of safety and soundness and consumer protection.

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