Underwriting the American Dream

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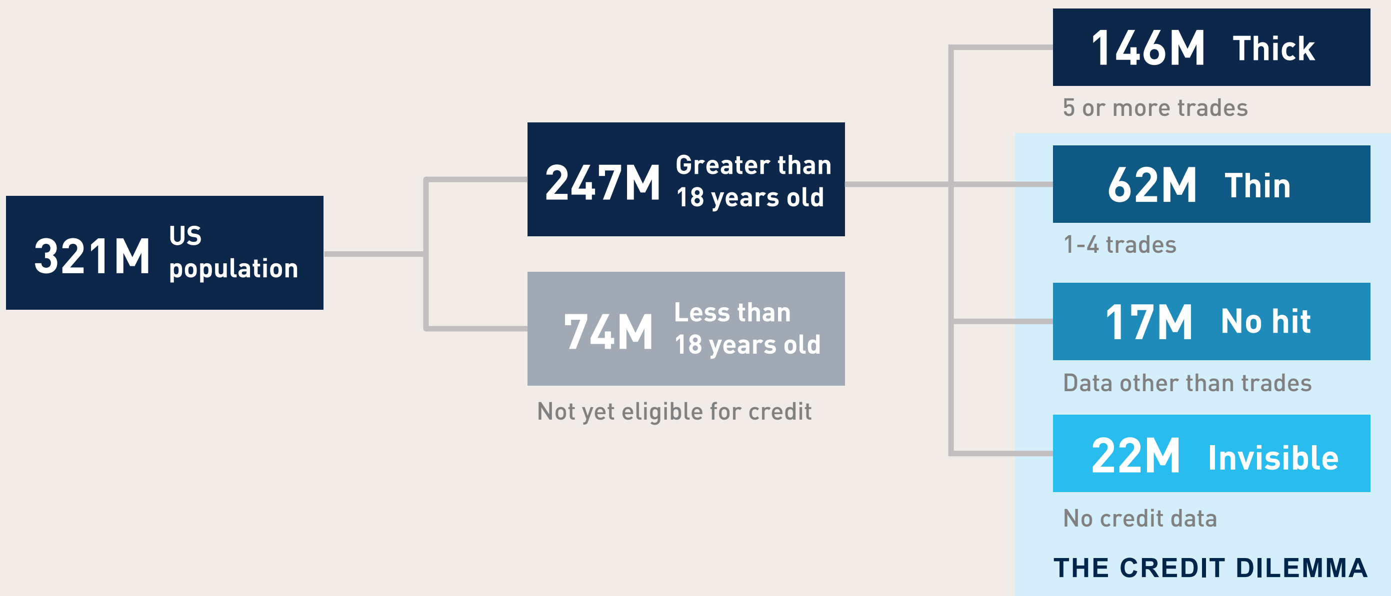
Summary

Fintech and alternative credit scoring are helping underserved consumers achieve the American Dream. It is estimated that over one hundred million Americans have a credit dilemma due to limited or lack of traditional credit history. Through innovation and technology, consumers can be given expanded access to credit. The Consumer Financial Protection Bureau (CFPB) highlights that artificial intelligence (AI)–based lending decisions are aiding this expanded credit. According to the CFPB, a prominent fintech platform is lending to 27 percent more approved borrowers and with lower interest rates.[1] This creates large market opportunities for fintech innovators. Other agencies believe the prospects could reach much more.

The Credit Dilemma - Thick and Thin

The American Dream is often characterized as the opportunity for prosperity and success for a family and its children, achieved through hard work in a society with few barriers. Traditionally, a FICO score is the key to underwriting credit and a strong score helps with upward mobility. According to Kelly Cochran, deputy director of FinRegLab, "about 20 percent of US adults can't be scored using traditional credit reporting because of insufficient information."[2] Of the remaining US consumers, 16 percent have poor ratings (579 or below).[3] The lack of a FICO score can happen due to many factors but is caused primarily by a lack of engagement by certain borrowers in the formalized credit markets and a level of underreporting of these people to the credit bureaus. Many of these people have never used credit, having relied on cash for major purchases, either due to a conscious avoidance of debt or because credit has never been made available to them. As a result, they have not built up a FICO score, which disadvantages them from future credit and underwriting decisions. According to Experian, it is estimated that over sixty-two million Americans have thin credit files, seventeen million have no hits, and twenty-two million are considered "credit invisibles"—collectively, the Credit Dilemma.[4]

Figure 1. Defining the Population



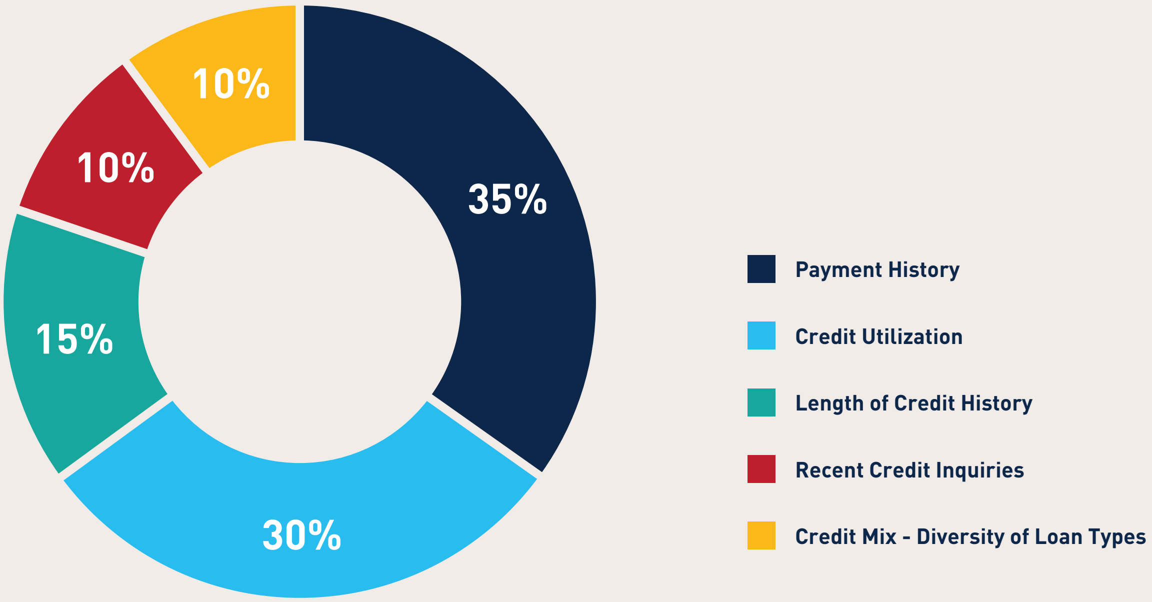
Note: trades defined as a record of activity for any type of credit extended to a borrower and reported to a credit reporting agency

In assessing creditworthiness and to reach credit decisions, lenders should consider all aspects of payment history, not just selected data points that are being reported. By considering alternative data points, fintech companies can better assess the true risk associated with a borrower and price loans accordingly. They can offer loans to borrowers that would otherwise be considered not creditworthy when considering only traditional FICO scores and underwriting metrics. Using financial transaction data also can provide a close to real-time view of a customer's credit performance, versus traditional credit reports that can lag several months. Combining both traditional credit scores and financial transaction data can enhance underwriting decisioning and allow lenders to reach creditworthy borrowers with thin or no credit history.

FICO and Its Shortcomings

FICO scores, created by Fair Isaac Corporation, are one of the most important factors considered in loan underwriting decisions. The score is based on five factors (see Figure 2). These five criteria are weighted to determine FICO scoring, typically on the scale of 300 to 850. For example, "Payment History" has a 35 percent weighting.

***Figure 2. FICO Weighting by Five Key Criteria*[5]**



Creating FICO scores requires that lenders and other credit providers willingly report information to the credit bureaus. Companies typically are willing to report this information voluntarily, as customers who know that their payment history is being tracked and shared are more willing to pay obligations on time and in full.

Not all financial data is reported, though. The current FICO score calculation excludes certain datapoints that readily could be used to provide insight into underwriting decisions. Rent and utilities payment history, for example, are ignored in the calculation of the FICO score; one could argue they are as important as debt service payments for underwriting decisions. Many landlords are small owners who do not have the scale required to enable credit bureau reporting. Put simply, many potential borrowers make their largest and most important payment on time each month and are creditworthy, but still have a low FICO score.

Government and Credit Agencies Efforts to Support Prospective Borrowers

Government programs assist disadvantaged borrowers in approval for home loans and education loans. For home loans, the Federal Housing Administration will provide mortgage insurance to borrowers with a FICO score as low as 500. Federal student loans generally are available to US citizens who are making satisfactory academic progress at school, regardless of credit score.

No such programs exist for auto loans, personal loans, or credit cards, which leaves would-be borrowers with lower FICO scores less likely to have a ride to work and more susceptible to predatory lending. To compound this issue, when someone has a poor FICO score, they are unlikely to get approved for an auto loan, credit card, or personal loan, and therefore cannot repair their FICO score without buying a house or taking out an education loan.

Experian and others are making efforts to expand credit with alternative credit scores. These efforts include Experian Boost™, FICO® Score XD, and the UltraFICO™ Score. These efforts help the "credit invisibles" gain access to credit that they otherwise would not have had.

Fintech and Alternative Credit Scoring

Fintech at its core is the technology and innovation that competes with traditional lending methods. Alternative credit scoring methods challenge the traditional underwriting methods by using many datapoints not considered in the traditional FICO score. Table 1 highlights ten examples of alternative credit criteria that help determine the creditworthiness of the underserved.

TABLE 1. ALTERNATIVE CREDIT CRITERIA EXAMPLES

	Alternative Credit Criteria Examples		FICO Criteria
1	Auto loans/buy-here pay-here	1	Payment history
2	Utility payments	2	Credit utilization
3	TV/cable	3	Length of credit history
4	Internet/cell phone	4	New credit - recent credit inquiries
5	Rent	5	Credit mix - diversity of loan types
6	Property/asset records		
7	Alternative lending payments		
8	Payroll deposits		
9	Bank activity		
10	Social media		

Technological advances in predictive analytics and machine learning enable underwriters to gather and analyze more datapoints than ever before. The same efficiencies that allow the processing of more data also remove friction and resources required to process additional credit applications. Both factors increase the likelihood of loan approval for creditworthy borrowers with low FICO scores. **The CFED estimates that adding utility payment data as a credit scoring criterion would result in an additional twenty million adults having access to traditional sources of credit.[6]**

Alternative scoring methods have shown that it is possible to expand that range of qualified customers beyond FICO scores alone. Companies like Nova Credit, Zest AI, Perfios, and Applied Data Finance[7] have tapped into this underserved market and are making loans based on alternative, proprietary credit scores. These proprietary models have enabled the companies to expand their pool of customers when compared to FICO scores alone. As these borrowers qualify for and ultimately repay loans, their traditional FICO score improves, opening up access to more traditional forms of lending.

The credit invisibles and "no hits" are currently estimated at a combined thirty-nine million citizens. However, with the aid of fintech and alternative credit scoring, credit barriers could ease and eventually provide economic and social mobility for those with limited credit. With credit and hard work, many more will achieve the American Dream.

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To discuss your needs and our approach in more detail, please contact us.

References

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4 Experian, The State of Alternative Credit Data (2018), p. 11.

5 Experian, “How Is Your Credit Score Determined?” (retrieved November 10, 2021). https://www.experian.com/blogs/ask-experian/how-is-your-credit-score-determined/

6 Peter Carroll and Saba Rehmani, Alternative Data and the Unbanked, Oliver Wyman (2017), p. 12.

7 Tracxn, “Top Alternative Credit Score Provider Startups” (last updated October 18, 2021). https://tracxn.com/d/trending-themes/Startups-in-Alternative-Credit-Score-Providers

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