

CFPB Insights On Alternative Data Use In Credit Scoring

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The growing utilization of alternative data in credit decisions and scoring models continues to attract the attention of regulators. Although clear and practical guidance from regulators remains elusive, regulator pronouncements provide some clues and takeaways for market participants. Recently, for example, the Consumer Financial Protection Bureau issued a request for information (RFI) regarding the use of alternative data and modeling techniques in the consumer credit marketplace. [1]

The RFI describes “alternative data” as encompassing an array of nontraditional sources lenders might consider when assessing consumers. The CFPB seeks not only to understand the potential benefits and risks of alternative data and modeling techniques, but “also to begin to consider future activity to encourage their responsible use and lower unnecessary barriers, including any unnecessary regulatory burden or uncertainty that impedes such use.”[2] While expanded access to alternative data could help lenders make better credit decisions, future bureau activity in this area could alter the regulatory landscape for many stakeholders.

Background

Alternative data sources include payment data related to nonloan products requiring regular payments, such as rent, insurance, utilities or cell phone bills. Such data sources can also include information related to a consumer’s checking account cash flow, residential stability, educational attainment, occupational status, shopping habits, and social network. The RFI cites various machine-learning processes as examples of alternative modeling techniques, including decision trees, random forests and artificial neural networks.

Historically, many lenders have assumed that consumers with limited or nonexistent credit histories are bad credit risks. However, a LexisNexis study found that nearly two-thirds of these consumers are low-risk and “likely to be good and profitable customers for lenders and credit card issuers” [3] If alternative sources of data can help correctly gauge these consumers’ risk, traditional lenders may be able to generate credit scores that more accurately reflect default rates and therefore expand credit access to this broader population. Consumer reporting agencies already collect alternative data such as rent and utility payments that are not part of the typical credit score. Many lenders have begun to realize the potential of alternative data to illuminate the creditworthiness of borrowers where traditional credit information is scarce. [4]

Highlights

The CFPB is seeking information on the various types of alternative data and modeling techniques, their uses and impact, and the extent to which these data and techniques have been adopted. The bureau also requests information concerning the policies and procedures in place to ensure responsible use of alternative data and comparisons to traditional data. Not surprisingly, the CFPB is focused on potential benefits and risks to consumers as well as potential compliance challenges.

The bureau also cites five topics about which it is seeking more information:

- **Access to Credit:** The CFPB seeks information about whether using alternative data to augment a credit score could increase access to credit by helping lenders better assess creditworthiness.
- **Complexity of the Process:** The bureau is exploring whether the use of this information could make credit decisions more complex for both consumers and industry.
- **Impact on Costs and Services:** The CFPB is considering the impact of the use of alternative data on costs and services in credit decisions, and particularly whether new technologies may produce a faster application process and lower operating costs for lenders.



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- **Implications for Privacy and Security:** The CFPB is concerned about consumers' knowledge that sensitive personal information has been collected, shared and used to formulate credit decisions.
- **Impact on Specific Groups:** The CFPB is studying whether the use of alternative data could create unintended consequences for certain groups, including members of the military who frequently change residential addresses.

At a field hearing on alternative data, CFPB Director Richard Cordray stated that alternative data and modeling techniques could help expand access to financial products to the 26 million Americans the agency estimates have no credit history and an additional 19 million people who have credit histories too limited to generate a credit score.[5] The RFI also cites enhanced creditworthiness predictions and lower costs of credit as the potential benefits of alternative data and modeling techniques.

In the RFI, the bureau also highlights potential challenges consumers may face in a credit system reliant on alternative sources of data. These include concerns about data quality and difficulty correcting inaccuracies, including consumers' potential inability to understand complex modeling techniques. The bureau is also concerned that unlike traditional credit factors, which are heavily influenced by the consumer's own conduct, alternative data that relate to peers or broader consumer segments may limit consumers' ability to improve their credit rating. Without specifying its next steps, the bureau notes that it is considering taking future action in this area to encourage the responsible use of data and lower unnecessary regulatory barriers.

Key Takeaways and Implications

The expanded use of alternative data and modeling presents both opportunities and challenges for stakeholders, including consumers, lenders, credit reporting agencies and a new wave of data furnishers. Moreover, while the CFPB's involvement could potentially complicate an evolving area, agency guidance could also reduce regulatory uncertainty. There are several possible implications of greater use of alternative data and modeling:

- **Default Rates:** While incorporating alternative data into the underwriting process could improve risk assessments, it may be difficult, at least initially, for lenders to evaluate the predictive power of new sources of data or new credit scores based on such data
- **Credit Reporting:** Credit reporting agencies (CRAs) may face difficulties incorporating alternative data into their scoring models. For example, expanding the data sources for credit scoring systems from credit card payments to fast-changing data like social media usage and GPS location information could present accuracy problems. [6]
- **New Legal Expectations:** The expanded use of alternative data means that entities who have never faced credit-related obligations may fall within the scope of a variety of consumer protection statutes. It is not clear whether regulators would subject a new class of data furnishers such as Comcast, AT&T, or apartment management companies to the same compliance expectations as traditional furnishers.
- **Fair Lending and Discrimination:** Using alternative data presents both opportunities and challenges from a fair lending perspective. Alternative data sources could assist lenders in making credit available to a wider array of customers, a goal embraced by regulators. The CFPB in particular has been focused in recent years on studying the characteristics of "credit invisible" individuals [7] and to enhancing their ability to access credit. Alternative data could be a key tool to enable lenders to expand such access. At the same time, however, alternative data sources that include protected characteristics under fair lending laws (such as race, age, sex and source of income) may heighten fair lending risks. Moreover, other data variables such as geography, language or other personal characteristics could be considered proxies for groups protected by anti-discrimination laws. Managing this risk might entail the use of novel approaches to compliance management and testing.
- **Privacy:** Alternative data will often include sensitive, nonpublic personal information, and consumers may not know the data were collected or could be used in credit decisions.

Stakeholders should continue monitoring developments in this area, including additional CFPB activity. Comments on the RFI are due May 19, 2017.

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[1] Request for Information Regarding Use of Alternative Data and Modeling Techniques in the Credit Process, 82 Fed. Reg. 11183 (Feb. 21, 2017), available at http://files.consumerfinance.gov/f/documents/20170214_cfpb_Alt-Data-RFI.pdf.

[2] *Id.* at 3.

[3] Jeffrey Feinstein, *Alternative Data and Fair Lending* (August 2013), available at http://www.lexisnexis.com/risk/downloads/whitepaper/fair_lending.pdf.

[4] Brian Bowdye, *Can Alternative Data Determine a Borrower's Ability to Repay?*, *American Banker* (Feb. 24, 2015), available at <https://www.americanbanker.com/news/can-alternative-data-determine-a-borrowers-ability-to-repay>.

[5] See Richard Cordray, *Prepared Remarks of CFPB Director Richard Cordray at the Alternative Data Field Hearing* (Feb. 16, 2017), available at <https://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-cfpb-director-richard-cordray-alternative-data-field-hearing/>.

[6] See Executive Office of the President, *Big Data: A Report on Algorithmic Systems, Opportunity, and Civil Rights* (May 2016), available at https://obamawhitehouse.archives.gov/sites/default/files/microsites/ostp/2016_0504_data_discrimination.pdf.

[7] Consumer Financial Protection Bureau Report, *Data Point: Credit Invisibles*, May 2015, available at http://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf