Alternative Data Reporting Helps Families Build Credit & Wealth

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45 Million Americans Face Severe Consequences for Having No or Low Credit Scores

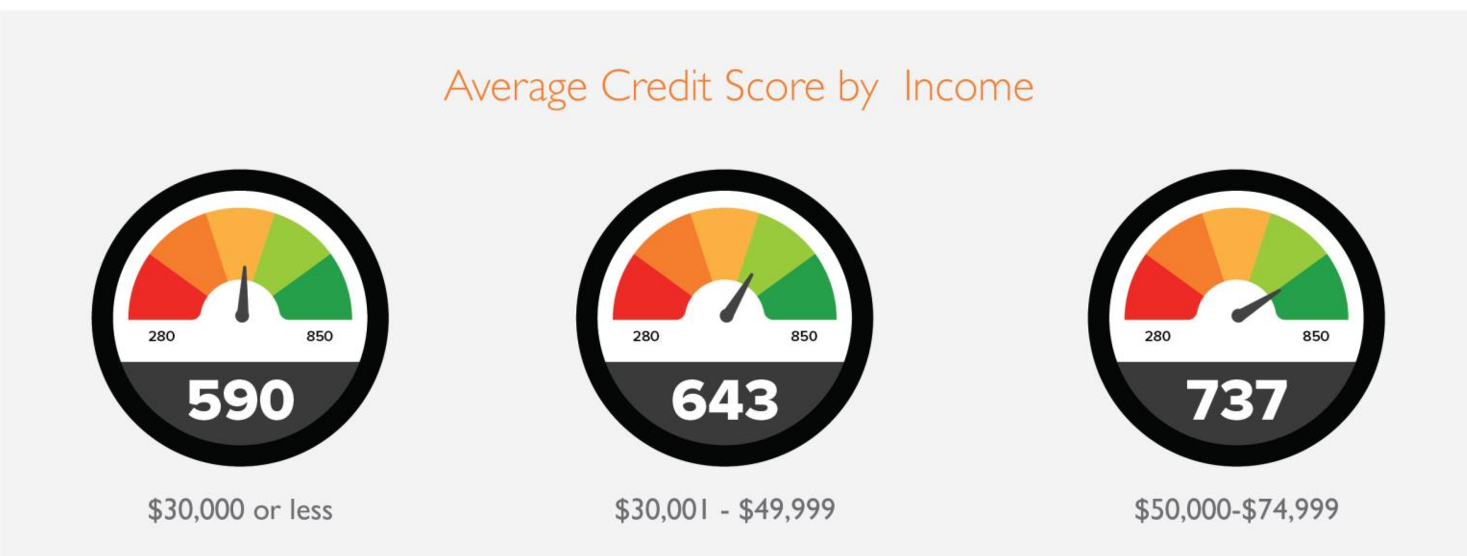
Access to credit is a cornerstone of financial security and an important wealth-building tool. Being able to take out a loan with low costs and affordable terms and conditions (e.g., fees, interest rates, etc.) supports long-term household savings and facilitates purchases that contribute to wealth building and prosperity. In that sense, access to credit is, in itself, an asset.

But millions of Americans are "credit invisible." According to the Consumer Financial Protection Bureau (CFPB), approximately 45 million Americans are outside the credit mainstream because they have a thin credit file or no credit file at all.[1] The consumer credit bureaus lack sufficient loan repayment records to generate these individuals' credit scores. Additionally, Prosperity Now's 2017 *Scorecard* reports that 49% of Americans with credit scores have "subprime" scores, meaning their access to credit doesn't necessarily prevent them from avoiding more expensive borrowing options.[2]

The issue is particularly pronounced for households of color and low-income families. Black and Hispanic households are nearly twice as likely to be credit invisible or unscoreable than White families,[3] and while the median FICO score for those who live in majority-White communities is around 720, the median score for neighborhoods whose populations are primarily people of color is about 650.[4] Similar patterns emerge when looking at income levels: lower-income households are five times likelier to be credit invisible or unscored than high-income households,[5] and according to TransUnion, the average credit score for those making $30,000 or less annually is 590, compared to 737 for households making $50,000-75,000 annually.[6]

People with low or nonexistent credit scores could pay **$200,000** more for lending products and services

Source: Credit Builders Alliance, 2015



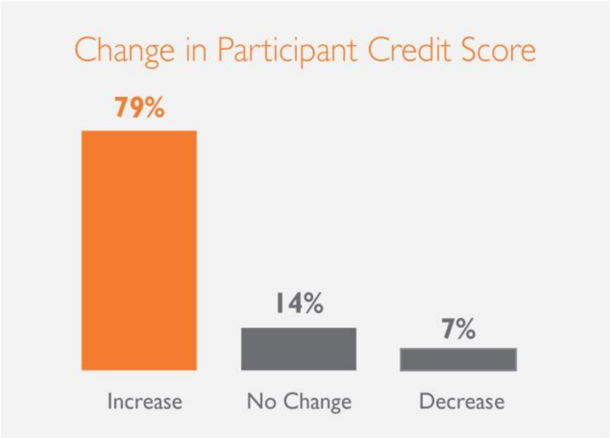
Source: WalletHub, 2017

It's tough to build wealth with poor or nonexistent credit. Individuals caught in this situation face challenges that those with prime credit don't encounter, including being eligible for only high-cost home mortgages, small business loans or car loans, if they are extended credit at all. Moreover, an increasing number of landlords and employers use credit reports to help them decide who to rent to or hire, making it harder to land a job or find a place to live for those with compromised or nonexistent credit. These households are also more vulnerable to relying on predatory products like payday loans to make ends meet. Indeed, the Credit Builders Alliance (CBA) estimates that people with low or nonexistent credit scores could pay $200,000 more for lending products and services over the course of a lifetime than those with strong scores.[7] Moreover, these challenges are especially pronounced for consumers of color. During a period of credit tightening in 2013, lower scores among households of color resulted in 50% fewer loans made to Black borrowers and 38% fewer loans made to Hispanic borrowers; meanwhile, loans made to White borrowers declined by only 31%.[8]

The Proper Use of Alternative Data Can Increase Household Financial Security Without Sacrificing Consumer Safety

The way credit scores are traditionally calculated does not necessarily capture a person's creditworthiness. The major scoring models in use today consider payments for some expenses, while not factoring in regular, on-time payment of others. For example, expenses like mortgages and credit cards are routinely taken into account, while recurring payments like rent are often not reported to the agencies. Unfortunately, the type of expenses that are usually reported do not accurately gauge the credit risk of many consumers, particularly low-income borrowers and borrowers of color (e.g., wealthier households are more likely to have mortgages, while less wealthy households tend to rent). These traditionally unreported routine payments are considered "alternative" sources of data and, along with rent, can include nonfinancial information such as public records, residence information and social media data.

The reporting of rent, utility and telecommunications payments has the potential to create a much more inclusive credit market. Research shows the inclusion of rent, utility and phone payments (whether landline or mobile) can boost scores or create scores for previously "invisible" consumers without weakening the predictive power of the score and without compromising consumer safety. For example, through the "Power of Rent Reporting Pilot," CBA and Experian, in collaboration with Prosperity Now and other partners, demonstrated that regular reporting of rental payments boosted credit scores for close to 80% of participants[9] and contributed to an average credit score increase of 57 points in a subsequent case study.[10] Additionally, since 2005, the Policy & Economic Research Council (PERC) has examined the impact of alternative data on credit scores and has found the positive effect of reporting uility and phone payments, including one study which showed incorporating utility payments could lift the number of scorable borrowers by more than 60%, while the inclusion of phone payment data could result in an increase in the number of scoreable borrowers by more than 67%.[11]



Source: Credit Builders Alliance, 2015

Research has found that alternative data are particularly beneficial for vulnerable groups. A 2012 PERC study showed that low-income families and households of color benefit from the inclusion of utility and telecommunications payment data to an even greater extent than their wealthier and White counterparts. For those making $20,000 or less annually, including utility and phone payments raises the number of those who are extended a loan by over 20%, while the boost for the highest earners is only five percent. Looking at the numbers for Black and Hispanic borrowers reveals a similar pattern. With the incorporation of utility and phone payments, loan acceptance rates increase by just over six percent for White consumers, while that number jumps to 14% for Black borrowers and 10% for Hispanic borrowers.[12]

Despite Opportunities, Alternative Data Credit Reporting Comes with Some Challenges

Alternative data vastly benefits consumers far more than harming them. When a bill for a debt obligation goes into collections for failure to repay, or a judgment or eviction is handed down—whether the expense is considered "alternative" or not—that negative information makes its way into credit reports and damages credit scores. At the same time, a consumer who routinely pays alternative expenses that are often not reported to the credit agencies is not receiving any benefits from their positive repayment behavior, meaning their payment histories establish bad credit but not good credit. Because of this, there is concern that the reporting of alternative data could hurt consumers who fall behind on these types of payments. Yet research finds that reporting rent, utility and phone payments lowers credit scores for a small percentage of consumers while helping millions more raise or establish credit scores for the first time. In 2016, private credit reporting agency Experian discovered reporting energy utility payments increased scores or kept scores level for 96% of the population sampled.[13] Experian conducted a rent reporting simulation two years earlier that yielded similar results.[14]

Not all alternative data are created equal. Although some evidence supports the use of rent, utility and phone payments, other forms of alternative data have not been studied enough to establish the value these payments bring to the table, at least not in a transparent fashion. But there are issues beyond evidence that also impact whether certain forms of data should be part of credit reporting. For example, some social media data tracks a consumer's spending history, their educational attainment and who they are friends with on vaious social platforms. Even if these sources have some predictive power, they raise concerns about privacy, discrimination and disparate impact that should be carefully considered. Finally, another form of alternative data comes from small-dollar lending, like payday or auto-title loans. These types of payments should not be incorporated into credit reports because even if a person faithfully pays off a payday loan obligation, the small-dollar lending industry is currently poorly regulated and highly predatory. In the absence of strong regulations, this market should be not be part of the credit reporting process.

Current law leaves firms with little guidance on how to use alternative data. The federal Fair Credit Reporting Act (FCRA) imposes certain responsiblities on those who furnish, collect and use the information contained in consumers' credit reports. Under the FCRA, utility and telecommunications companies are permitted to report consumers' timely payment behavior to credit reporting agencies. However, there is no requirement to make these reports, nor are there standards or guidance on how to do so properly. As a result, few companies report these data, and because FCRA violations can lead to hefty fines, credit reporting agencies and data providers alike are wary of expanding the use of alternative data without additional federal clarification.

How Congress and Federal Agencies Can Support Alternative Data Credit Reporting

The CFPB should clearly address how to furnish, collect and use alternative data under current law. As mentioned above, the lack of clarity about what types of expenses can be reported and under what conditions without running afoul of regulations like FCRA discourage the use of alternative data in credit scoring. The CFPB has regulatory authority over FCRA and should craft guidelines for consumer credit bureaus, landlords, utilities and other companies that spell out how these entities can furnish, collect and use alternative data legally. This should include criteria firms can use to determine whether certain types of data are acceptable to use in specific situations.

Fannie Mae and Freddie Mac should promote more progressive scoring models. Fannie Mae and Freddie Mac, the Government-Sponsored Enterprises (GSEs), guarantee more than half the mortgages originated in this country, and both have seller-service guidelines that define the types of loans GSEs prefer to purchase. For a number of these loans, the guidelines endorse the use of outdated, traditional scoring models as part of the underwriting process. Because Fannie and Freddie have such a significant impact on the mortgage market, their more active encouragement of the use of scoring models that incorporate safe and predictive alternative data would have a profound effect on the type of scoring models used by lenders.

Also, Fannie and Freddie are currently in the process of conducting an assessment of alternative scoring models, which the Federal Housing Finance Agency (FHFA) would like completed by the end of 2017. While FHFA Director Mel Watt indicated the use of alternative credit scoring models by the GSEs would not be approved until the middle of 2019 for largely operational reasons,[15] the FHFA should still hold the GSEs to the 2017 assessment deadline and make sure they leverage the knowledge gained from this examination to inform their adoption of newer and more inclusive models when the time comes.

Congress should pass legislation that creates greater inclusivity. Another avenue for change would be the enactment of legislation aimed at increasing access to credit through the careful use of alternative data. A recent example of this includes the Credit Score Competition Act (S. 1685), sponsored by Senators Tim Scott (R-SC), Mark Warner (D-VA) and Tim Kaine (D-VA). Parallel legislation in the House (H.R. 898) was sponsored by Representative Ed Royce (R-CA). This legislation would encourage the GSEs to adopt more inclusive scoring models. The Credit Access and Inclusion Act of 2017 (H.R. 435, sponsored by Representative Keith Ellison [D-MN]) is another good example of a legislative solution. H.R. 435 calls for the reporting of both negative and positive payment histories to the credit agencies for rent, utility and phone expenses.

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