White Paper

Additional Uses of Alternative Data for Credit Risk Decisioning

Add a new dimension to traditional credit history.

Explore the inside track on alternatives for expansion into emerging markets.

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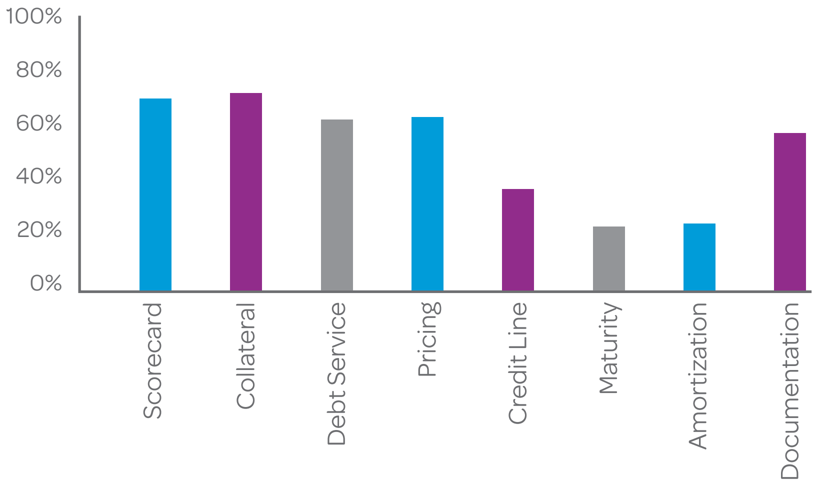
Risk Solutions

Alternative data–More valuable than ever

In the recent troubled economic environment, consumer lending has become more challenging as both consumers and lenders adjusted their behavior and their economic priorities. Competitive dynamics in all industries have changed as companies chase declining consumer spending and changing consumption patterns in an environment of increased delinquency rates. Now, more than ever, understanding one's customers and prospective customers, and accurately assessing their credit worthiness, is of critical importance.

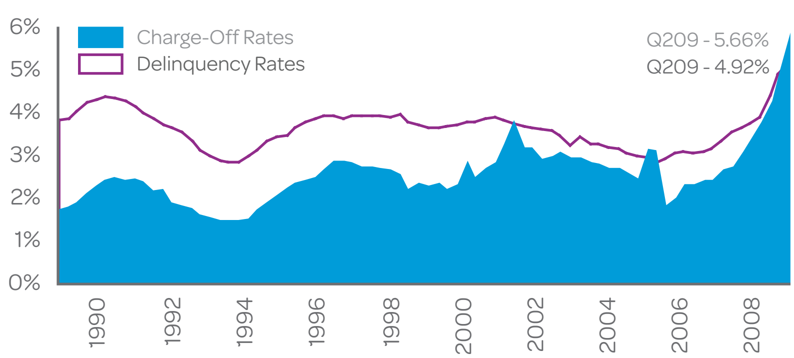
Methods Used to Tighten Retail Underwriting Standards: 2009



Source: Survey of Credit Underwriting processes 2009,
Office of the Comptroller of Currency

The traditional credit score, calculated based upon data provided to credit bureaus, has long been one of the most useful tools to assess credit risk and predict customer behavior. In today's environment, credit scores are changing for many consumers. While certain attributes, such as the number of credit card inquiries, have become more predictive during the crisis, other changes are not necessarily indicative of a consumer's underlying ability and willingness to pay. For example, if a consumer becomes increasingly prudent by closing some credit card accounts and using debit cards instead of credit cards, the individual's credit score may decrease. Additionally, a consumer's

Consumer Loan Charge-Off and Delinquency Rates



Source: Federal Reserve

bank may cut his credit line, which also negatively impacts his credit score without necessarily reflecting a change in his underlying financial health or financial behavior.

As consumers' personal financial situations and needs change more rapidly than ever before, having the clearest and most complete picture of a consumer's economic situation has never been more important. Lenders benefit by having more information on their customers and their applicants, and two very valuable sources that supplement credit bureau data are public records data and data derived from private sources, such as prepaid card issuers and payday lenders. "Alternative" data, defined in this paper as data that does not come from a traditional credit bureau, a credit application or a customer's master file with a lender, can shed additional insight on a consumer's economic health, ultimately enhancing a lender's credit assessment by providing a view of the consumer that credit bureau data alone cannot capture.

Alternative data has never been more powerful or more important than it is in today's environment. It is one of the best ways to enhance a company's understanding of its customers throughout the account life cycle stretching from applications to collections, an understanding that has a direct impact on the bottom line, especially as margins are being squeezed by challenging business conditions and regulatory changes.

This paper attempts to provide a more complete picture of alternative data and how it can be used to get a better understanding of a consumer's risk profile by discussing the following topics:

- Explanation of alternative data
- Uses of alternative data
- Areas of improvement
- Future of alternative data

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Explanation of alternative data

Traditionally, companies have relied on information from three sources to analyze and monitor the credit risk of their customers: the customer's credit application, the credit bureaus and the customer's master file with the lender. This data can be limited, however, if the customer is new to the lender or has little information on file at the credit bureaus. Furthermore, while it provides a view of a customer's trade line health, it offers a non-holistic and sometimes self-reported insight into where that person is in his financial, or economic, life. For a more complete look, lenders are increasingly turning to alternative data to help round out this view.

These data elements are not new but what is new is the fact that this information is now easier for companies to utilize in their credit analytics process than ever before. A credit card company now has the ability to view a consumer's asset ownership history to understand more about that person's overall financial position. An auto lender can now search eviction records to see if an applicant has had problems paying rent. A mobile phone service provider can analyze utility bill payments to identify creditworthy consumers who may have a lower credit score or who has become credit inactive.

Two main types of data elements exist:

Public Records Data	Private Source Information
Data that is submitted to or captured by national, state and local governments	Information compiled from other non-traditional sources not in the public domain; may be proprietary to the provider
• Property deed records: Purchase date and amount, dwelling type and more. • Property tax values • Bankruptcy filings • Criminal conviction history • Change of address: Most recent and prior changes • Evictions • Occupational and business records • Phone and utility records: Connects and disconnects • Professional licenses • Asset ownership (automobiles, watercraft and aircraft)	• Bill payment history: Utilities, mortgage, insurance, phone, rent and more. • AVM market value of property • Prepaid card data • Employment information • Sources confirming an individual's identity and current address • Bounced check and deposit account information • Repayment of payday loans

In essence, this data captures how an individual has been living; helping to illuminate financial stresses that may fall outside the credit bureau data and, often more importantly, identifying good consumers whose credit bureau scores may not reflect their financial health. Thus, the alternative data provides further insight into an individual's willingness to pay, ability to pay and financial stability.

There are many providers of alternative data who have been investing in the market, consolidating and building up databases that cover multiple data attributes and developing predictive models around alternative data. Additionally, the providers approach the data with different methodologies—some combine alternative data with conventional credit bureau data to provide an enhanced score, while other companies focus more on gathering disparate sources of data and presenting them to their clients in report form.

The ability to utilize these public record and non-traditional data elements has given companies additional tools that can be used in conjunction with trade line data to predict an individual's creditworthiness.

Uses of alternative data

Over the past few years, the power of alternative data has become evident, particularly for companies that serve No-File and Thin-File customers about whom credit bureaus have little or no data. There is, however, a growing recognition that alternative data can be used in ways beyond merely substituting for missing traditional data. Indeed, it can supplement credit bureau data and give companies the ability to get a more complete view of a consumer's economic life.

Companies are reporting increased usage of alternative data as a result of the current economic, regulatory and legislative environment. Driven by the CARD Act and other marketing changes, credit card companies are requiring greater upfront precision regarding pricing, size of credit line and other credit terms because they will soon be much more constrained in changing a card's terms once it has been issued. Thus, having a more complete profile of potential customers is a significant benefit. Alternative data provides a view of a consumer's financial life beyond trade line behavior. As a result, companies can use this to generate a more thorough risk profile that identifies additional financial stress or reveals better financial behavior than shown by trade line history alone. Examples of these findings include the ability to maintain employment, a history of evictions, the holding of professional certifications or a string of recent utility disconnects. As financial situations change quickly in today's economic environment, companies are working harder than ever to understand the creditworthiness of their customers in order to better serve their needs and anticipate problems.

Alternative data can improve segmentation of customer creditworthiness.

For example, a LexisNexis® analysis found using alternative data combined with credit bureau data drove a significant improvement in customer segmentation; a 55 % lift in K-S (Kolmogorov-Smirnov statistic) over the credit bureau data alone for bank card applicants and a 74 % increase in K-S for retail card applicants.

While credit bureau data will always be a primary source of information, lenders are finding that some credit attributes have gotten more predictive of future behavior (such as the number of credit file inquiries), the data ultimately only goes so far. As one credit card executive said, "There are only so many ways that a company can model existing data to gain an advantage in underwriting." Rather, companies must look at what data can be added to the current data set to gain an advantage.

Currently, alternative data is being used or investigated primarily for the solicitation and acquisition of new customers. Companies can use this additional data to create a more robust credit risk score for potential new customers, thereby allowing better and more targeted solicitation via pre-approved offers to creditworthy candidates. Not only will this help companies extend their marketing dollars, but it can also cut down back-end losses by weeding out risky individuals before they come through the door.

According to one executive, alternative data is particularly powerful because it adds further insight into the customers on the margin—those customers whose traditional credit bureau data is insufficient or could go in either direction (in terms of creditworthiness). While this has traditionally been the Thin- and No-File customers, the additional insight can be used to supplement the underwriting analysis on Full-File customers as well. Any data that can provide a company with a better understanding of an applicant's income stream, cash flow, net income and balance sheet provides value to the underwriting process—and alternative data can provide some pieces of this picture.

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As a result of the current economic environment, lenders have a renewed focus on a customer's capacity to pay—and any data that can give further insight and clarity on that capacity can provide those companies with a positive economic return. In fact, for certain sub-segments of customers, alternative data may provide enhanced predictive abilities in terms of credit risk and customer behavior over credit bureau data use alone. One example is underserved consumers, on whom credit bureaus do not have sufficient data to run through traditional credit scoring algorithms to generate a credit score. Another potential use is for creditors in trying to detect first-person fraud, such as bust out or never paid; if banks can identify certain suspicious patterns, such as address instability or mismatch of bureaus' depth versus public record file depth, they may be able to better identify and mitigate fraud.

Currently, alternative data is being used in the underwriting process and not by all companies. Many companies are still testing out various elements from different providers, while others are waiting for internal systems consolidation or clarification of industry regulations before proceeding. It is important to note that there is a consistent feeling among industry executives that internal data is more powerful than any external source of information. As a result, companies consider using alternative data only if it can provide a positive economic return, since there are costs associated with implementation (both in terms of time and money) as well as access to the databases. Alternative data providers must continually look at their offerings from this perspective and as a result, must strive to make their data sets economically attractive.

Areas of improvement

Despite the benefits of using alternative data to inform credit decisions and customer relationship management, many companies are still hesitant to fully incorporate alternative data into their decisioning processes because they have difficulty realizing a positive economic return from the data. That is, the benefits do not yet fully justify the costs they would incur. While alternative data has made much progress in recent years, there are a few aspects that could be improved to make the business case more compelling:

- **Data attributes:** Industry executives are most interested in information regarding the payment of telecom and utility bills, since that is information that credit bureaus currently do not capture. Other areas of interest include mortgage and housing information (in light of the current trouble in mortgage lending) and income and employment information (due to the increasing unemployment rate).
- **Data coverage:** Currently, hit rates on alternative data are not as high as those on credit bureau data, meaning that not all searches return results. Some companies, particularly smaller lenders, find that hit rates on alternative data are often below 10 percent, meaning that they do not receive any information on the bulk of applicants that they screen. While hit rates have been slowly increasing, as additional sources of alternative data become searchable and the existing sources become more robust, coverage is still limited enough to jeopardize the economic return in using alternative data, particularly for those smaller lenders.
- **Ease of use:** Given the high level of automation in the credit card and other lending industries, companies want to be able to incorporate new data sets into their current systems with as little disruption and additional cost as possible. Some data providers currently provide data that is not compatible with all systems. Furthermore, some companies are hesitant to use stand-alone systems due to the additional step that such a system would require. To mitigate these concerns, alternative data providers should look into ways to make accessing their data as easy as possible. In addition to making their data sources more easily accessible through current systems, providers could explore working with the big processors (such as TSYS and First Data) so that lenders do not need to each have a stand-alone system or data connection. Another possible solution would be for the providers to work with the credit bureaus to tie their databases into the credit bureaus so that one query could hit both credit bureau and alternative data attributes.

Alternative data providers should look into ways to make accessing their data as easy as possible. In addition to making their data sources more easily accessible through current systems, providers could explore working with the big processors (such as TSYS and First Data) so that lenders do not need to each have a standalone system or data connection.

- **Consolidation of data attributes:** In line with wanting the data attributes more easily accessible, one credit card executive also stated a preference for consolidation of data attributes from a wide variety of sources. In their search for a positive economic return from alternative data, companies will be more interested in providers who offer a wide range of attributes or act as aggregators of attributes from other providers, thus increasing the likelihood of a positive match, as well as facilitating the technological implementation.

By working to provide a more comprehensive selection of data attributes as well as improving the ease of accessing the data, alternative data providers will improve the economic return for their clients, and thereby attract more customers for their product.

The future of alternative data

As a result of the credit crisis of 2008-2009 and changes in both regulation and legislation, alternative data is poised to play an increasing role in credit analysis and underwriting, not only for credit cards but for also other products, such as mobile phone accounts and auto lending. Alternative data will never supplant the credit bureau, nor will it supplant customer master file data, but instead, it will serve to complement the data, adding another layer of information to help companies analyze applicants and customers.

With the new focus on tight underwriting criteria (since, due to the CARD Act, it will be difficult to change credit terms and re-price accounts) and on better analysis of an applicant's capacity to pay, credit providers are likely to turn to alternative data attributes in an effort to improve their behavioral scoring and provide additional information on those applicants in the gray area between good and bad credit. Usage of alternative data will extend beyond Thin- and No-File customers in an effort to get as much information as possible on applicants.

While some companies have been hesitant to employ alternative data due to the new regulatory and legislative framework that is being erected, this uncertainty about the impact of the CARD Act and other regulatory changes is temporary. Regulations should be clarified soon, and lenders will adjust their scoring models and their credit guidelines accordingly. When that occurs, alternative data providers should be poised to gain new customers and new uses in the credit underwriting processes of companies.

Credit providers are turning to alternative data attributes to improve their behavioral scoring and provide additional information on applicants in the gray area between good and bad credit.

Alternative data can provide additional data points that can serve as an early warning system, indicating when a customer's capacity to pay might be in risk of changing – giving companies more time to work with that customer to mitigate risk and, where necessary, even begin the collections process.

Alternative data also has uses beyond helping to screen potential applicants:

- **Account monitoring and maintenance**: Since alternative data captures changes outside the credit bureau, companies can stay better informed about changes in their customers' lives and how that might impact that customer's risk profile. Customer master file data will always remain the primary source of information regarding a credit provider's own customers, but alternative data can provide additional data points that could serve as an early warning system, indicating when a customer's capacity to pay might be in risk of changing. This could give companies more time to work with that customer to mitigate risk and, where necessary, even begin the collections process.
- **Enhanced information for collections:** Alternative data elements can provide companies with up-to-date public record information concerning a customer's address, phone number and other contact information. Again, customer master file data will remain the primary source of information, but for a particularly difficult collection situation, alternative data may be able to provide additional information to locate the customer or further clarify his financial situation. Some providers of alternative data even offer names of associates that can be used in non-FCRA environments to help track down delinquent customers. Additionally, collectors can contact customers already armed with a better understanding of where they are in their economic lives and whether they might be experiencing significant financial stress elsewhere in their lives.

Currently, companies are using their internal data for account monitoring and collections purposes and do not foresee a positive economic return in incorporating alternative data into their account management processes. Nevertheless, as alternative data sets continue to get more robust and comprehensive, they will become increasingly applicable throughout the account life cycle. Companies that are slow to take advantage of all the benefits of alternative data may find themselves at a disadvantage in a very competitive marketplace.

Indeed, alternative data may very well lose the moniker "alternative" in the next two or three years if more companies begin to use it as part of their standard, automated underwriting processes. Today's regulatory and economic environment rewards additional analysis and confirmation of an applicant's willingness and capacity to pay, so companies will be looking at many different services and data attributes that can help them make that determination. Data that is found to be particularly predictive will almost certainly get included in the underwriting process. However, it is incumbent on alternative data providers to make it as easy and straightforward as possible to access and search their databases by aggregating data attributes from disparate sources, increasing the coverage of their attributes and packaging the databases in a way that minimizes search cost and systems modification for their clients.

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