Understanding the Growing Gap Between Traditional Credit Data and Consumer Risk

Identifying gaps in traditional credit reporting and helping lenders anticipate market instability

EBOOK

LexisNexis® RISK SOLUTIONS

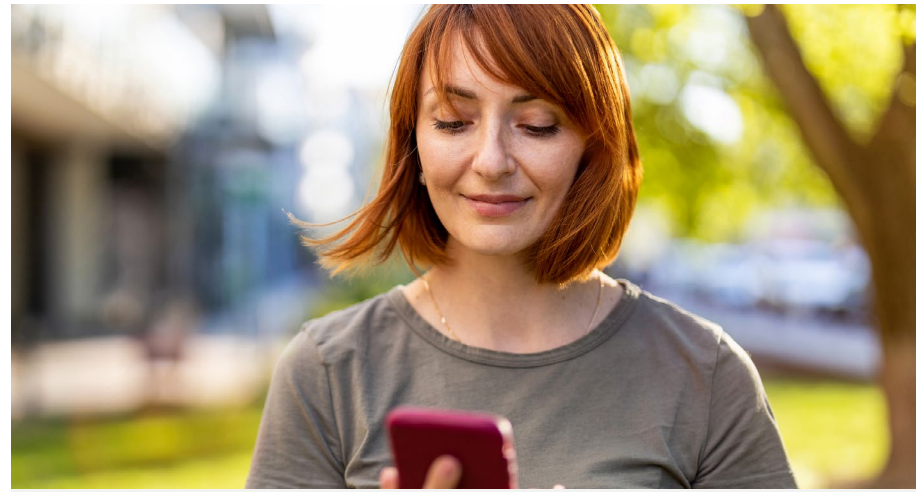
The challenges of operating in an evolving credit landscape

When consumers face economic uncertainty, changes in financial behavior can be expected. However, the speed and magnitude of those changes can sometimes catch lenders by surprise.

Today, lenders primarily rely on traditional credit data to reflect these shifts:

- *Regulatory changes*
- *Increased use of non-reported financial products*
- *Shifts in credit reporting practices*

These shifts have degraded the visibility of these foundational credit data signals to true consumer credit health. As a result, insights gleaned from traditional credit scores might not be sufficient to help lenders and service providers stay competitive in a rapidly changing marketplace — causing them to either decline credit worthy applicants, approve high risk consumers leading to higher losses, or extend approved customers sub-optimal offers (credit lines, APRS, etc.). This makes it important to incorporate a broader collection of alternative data — generally defined as FCRA credit data sources not captured in traditional credit scores and reports — into the risk assessment process.



Are you looking for better ways to evaluate, segment and prioritize the right consumers to help drive your business forward?

A growing number of data solutions can help you gain a better understanding of prospect, applicant and customer credit quality, allowing risk managers to engage more individuals with strategies fit to their true risk levels, while building proactive strategies to mitigate loss exposure.

The difficulty of navigating visibility gaps in traditional credit data

There seems to be a misalignment between reported credit quality and observed consumer behavior.

For example, consumer credit quality remains high according to traditional data; the average FICO score was 717 as of Q3 2023, up 12 points from 5 years prior.[1] And yet, household debt is moving beyond pre-pandemic levels, growing by $184 billion in Q1 of 2024, to a total of $17.69 trillion.[2]

Today's financial institutions who rely strictly on traditional credit data to drive their risk management strategies have a diminishing view of consumers' true credit quality. It remains essential that lenders acquire a more holistic and timely understanding of consumers' current financial health, particularly since credit stress continues to shift in unprecedented ways.

Increasing household debt balances in Q1 2024[2]

$14B	$190B	$9B
credit cards	*mortgages*	*auto loans*
($1.12T total)	*($12.44T total)*	*($1.62T, upward trajectory since 2020)*

This rising debt load, as you might expect, is resulting in a significant spike in delinquencies, as evidenced by both credit card and automotive load delinquencies hitting their highest mark in a decade.[3] So that natural question is — if consumers are increasingly struggling to meet their credit obligations…why are their credit scores so high?

Score migration and inflation — the consequences of recent shifts in credit reporting

Multiple factors have led to the removal or suppression of significant amounts of data from credit reports. This has contributed to the contracting view of consumers provided by traditional credit files. While more high-risk signals have been removed than low-risk signals, resulting in a net rise in average consumer credit scores, all data removed from traditional credit reports represents a loss in critical visibility needed to accurately assess consumer credit health.

SHIFT 1

Changing regulations have removed data from credit reports

Evolving regulatory guidelines have reduced the amount of consumer information that can be included in traditional credit files. The most significant changes occurred in the reporting of medical debt and collections. Between 2018 and 2022, due to litigation and compliance concerns, medical debt reporting declined 37%.[4]

In April 2023, the Consumer Financial Protection Bureau (CFPB) reported that an estimated 22.8 million people would have at least one medical collection removed from their credit reports when all medical collections less than $500 are removed, experiencing an average boost of 25 points to their credit scores in the first quarter following. For medical debt surpassing $500, the boost was 32 points.[5] There is a chance that all medical bills could be removed from most traditional credit reports if a proposal from the CFPB in June 2024 passes.[6]

Other relevant data points have also been removed from credit reports, including civil court judgments (2017), tax liens (2018) and student loan defaults for 7.5 million borrowers (2022).

While valid arguments exist for the removal of this information from credit reports, in most cases these signals represent real debt that consumers must still repay.

This is making it more difficult for lenders to accurately assess the debt load consumers are truly carrying.

32% of U.S. adults have used BNPL at least once as of the end of 2023.[7]

SHIFT 2

Changing consumer behavior has removed data from credit reports

New alternative payment methods like Buy Now, Pay Later (BNPL) allow consumers to take out multiple loans that are frequently not reported to credit reporting agencies. Sometimes referred to as “phantom debt,” BNPL account balances and other unreported credit products make it harder to assess debt-to-income ratios. As a result, lenders often find it more difficult to determine a customer’s ability to pay.

Another consumer trend involves carrying higher balances on their traditional financial products. Even amidst growing interest in alternative products, customers entering collections for the first time are highly leveraged, using an average of more than 75% of their approved credit limits.[7] It’s a particularly poor time for degradation in traditional credit reports with consumers under increasing financial stress.

SHIFT 3

Changes in reporting practices have removed data from traditional credit reports

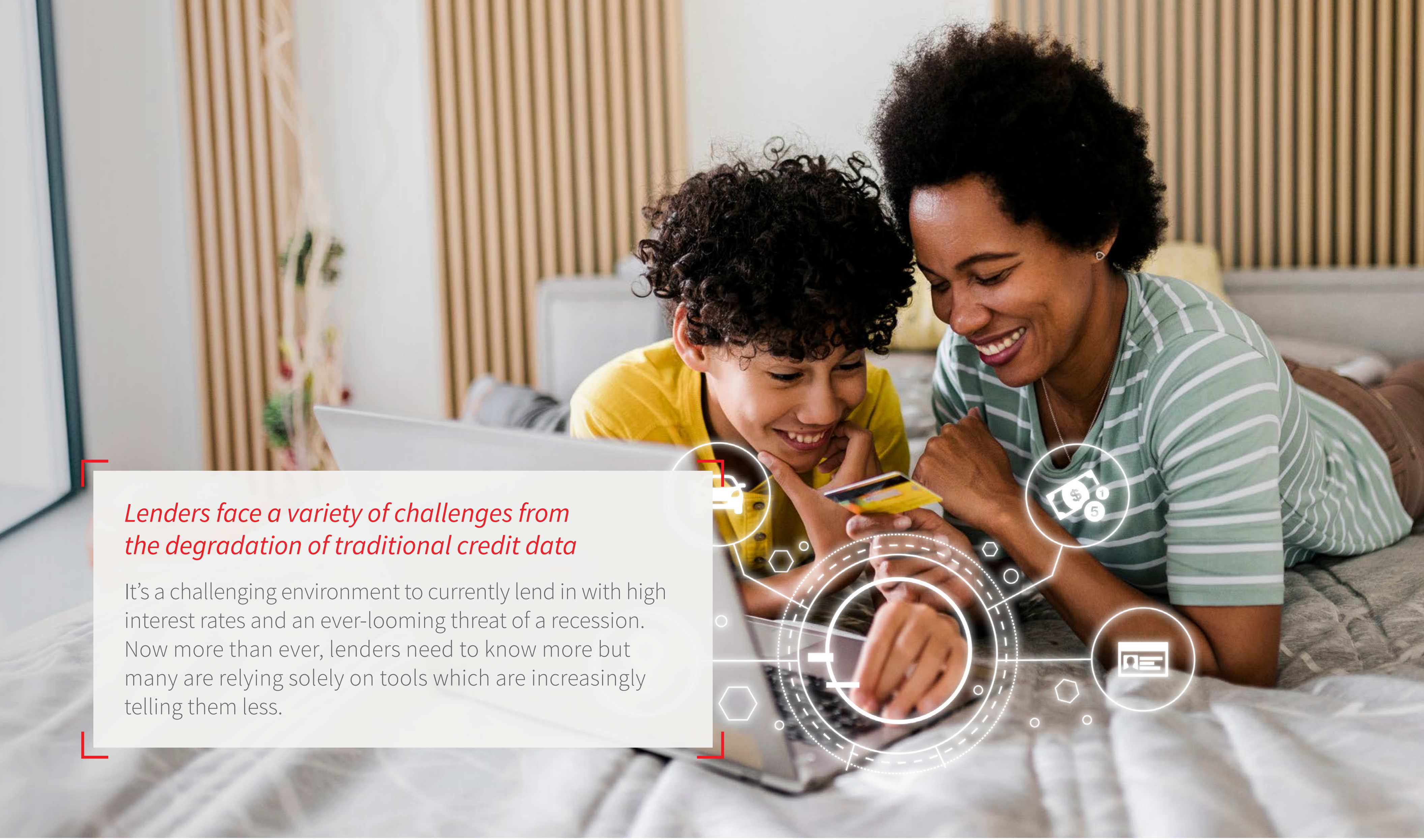
Changes in reporting detail across the industry have further impacted lender visibility to positive and negative signals. Since 2020, actual payment data reporting by credit card companies has significantly declined.

Lack of positive payment insights leaves a gap that could help many consumers receive better financial offers.[8] And lack of delinquency reporting leaves lenders in the dark on increasing credit risk.

In the collections space, changes to Regulation F have limited when a debt collector may furnish information to consumer reporting agencies. And some collections agencies no longer report paid delinquencies to consumer credit agencies once the debt has been paid or settled, erasing insight into past negative payment behaviors.

A combination of these changes has meaningfully reduced the visibility of traditional consumer credit data, ultimately resulting in the diminished predictive ability of traditional scoring and risk assessment methods:

- *Shifting regulations*
- *Consumer behaviors*
- *Reporting practices*



Lenders face a variety of challenges from the degradation of traditional credit data

It's a challenging environment to currently lend in with high interest rates and an ever-looming threat of a recession. Now more than ever, lenders need to know more but many are relying solely on tools which are increasingly telling them less.

CHALLENGE 1

Assessing risk with reduced visibility

Consumer interest in credit and financial products remains strong:

20%

increase in credit card application volume since Q1 2020

8x

increase in BNPL application volume since 2019

However, assessment of credit risk is changing. Risk managers in today's market are facing a daunting task — meeting consumer demand, portfolio growth and profitability goals by approving more consumers at more competitive pricing terms. What many don't realize is that if they're attempting to meet this challenge with traditional data alone, they're relying on an increasingly limited view into consumer credit health.

To maintain portfolio growth and drive profitability, lenders will want to find a more holistic way of assessing risk.

Access to actionable alternative data will remain a high priority.

Figure 1

Percent of new collections entrants by generation — excludes invisibles

	2019	2023	% change
GEN-Z	1.67%	4.57%	2.90%
MILLENNIAL	22.50%	24.10%	1.60%
GEN-X	39.40%	38.10%	-1.30%
BABY BOOMER	29.70%	27.10%	-2.60%
SILENT GEN+	6.70%	6.14%	-0.56%

CHALLENGE 2

Building personalized strategies

More young consumers are experiencing their first serious struggles with debt. While older consumers (Baby Boomers, Gen-X) still make up most of the first-time third-party collections, younger generations (Gen-Z, Millennial) are making up a growing percentage of new collections entrants since 2019.[7] (Figure 1)

With traditional credit data weakening and risk rising for youngest consumers, lenders need to better understand who is making up collections to influence their engagement strategies at customer acquisition and loan origination. In servicing and recovery, more insight into collections entrants by generation can inform opportunities for tailored financial education for younger consumers and default prevention and contact strategies to recover consumers and get them back on track. Many factors already discussed, such as the rise in BNPL usage reducing visibility into consumer debt, are particularly acute for younger consumers, increasing the need to obtain additional insight to effectively serve this demographic.

CHALLENGE 3

Understanding the true credit quality of consumers with prime traditional credit scores

Traditionally stable segments face increasing economic instability. For the first time in recent years, more consumers with prime credit scores are unexpectedly entering third-party collections. The same is true with homeowners. These qualities have long been associated with credit stability, so this current situation is posing new challenges for lenders, who could end up inadvertently extending credit to riskier consumers.

Below are the percentage increases in the rates of consumers entering third-party collections for the first time between 2019 and 2022:

15% *prime consumers*

20% *prime consumers who own homes*

The overall trend is clear — from 2019–2022, prime consumers were increasingly likely to become first-time collections entrants.[7] This runs counter to many longstanding assumptions about credit stability.

If third-party collections growth continues to be driven by prime consumers, origination and collections strategies will need to evolve in response.

Consumers with high traditional credit scores have long been dependable customers for lenders, but as the visibility of traditional scores into consumer credit health continues to recede, it is becoming increasingly challenging to lend to even this previously reliable demographic.

Close the visibility gap

Helping lenders obtain a better view of credit risk

The predictive power of traditional credit reports is waning, causing challenges not only at loan origination but across the customer journey. To remain competitive, lenders should be aware of these growing limitations and explore ways to augment traditional credit data with insights provided by alternative data.

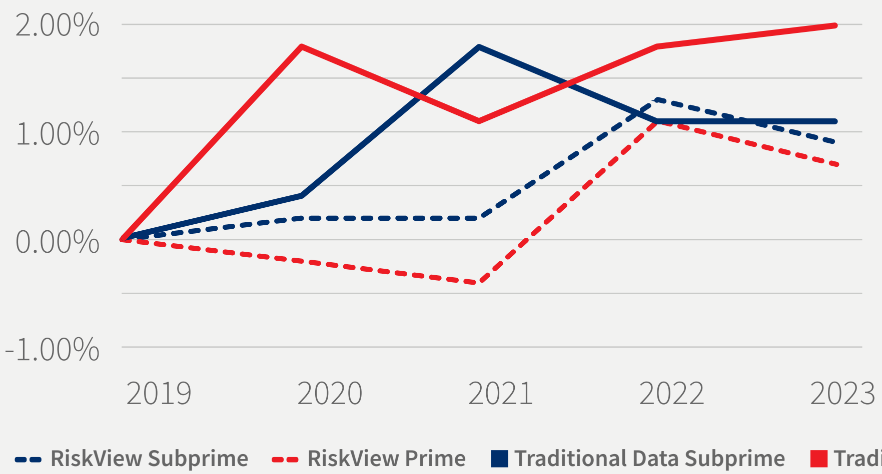
These insights can help you regain visibility into consumer credit risk, enabling you to improve outcomes across the customer lifecycle.

By leveraging alternative data, you can build a more comprehensive understanding of consumer behavior. This permits you to more effectively match credit risk to your risk tolerance.

Alternative credit insights can be used to reveal shifting portfolio risk, enhance account service and improve recovery workflows.

Figure 2

Diverging trends in Bureau Score and Alternative Data RiskView score for Prime and Subprime collections entrants



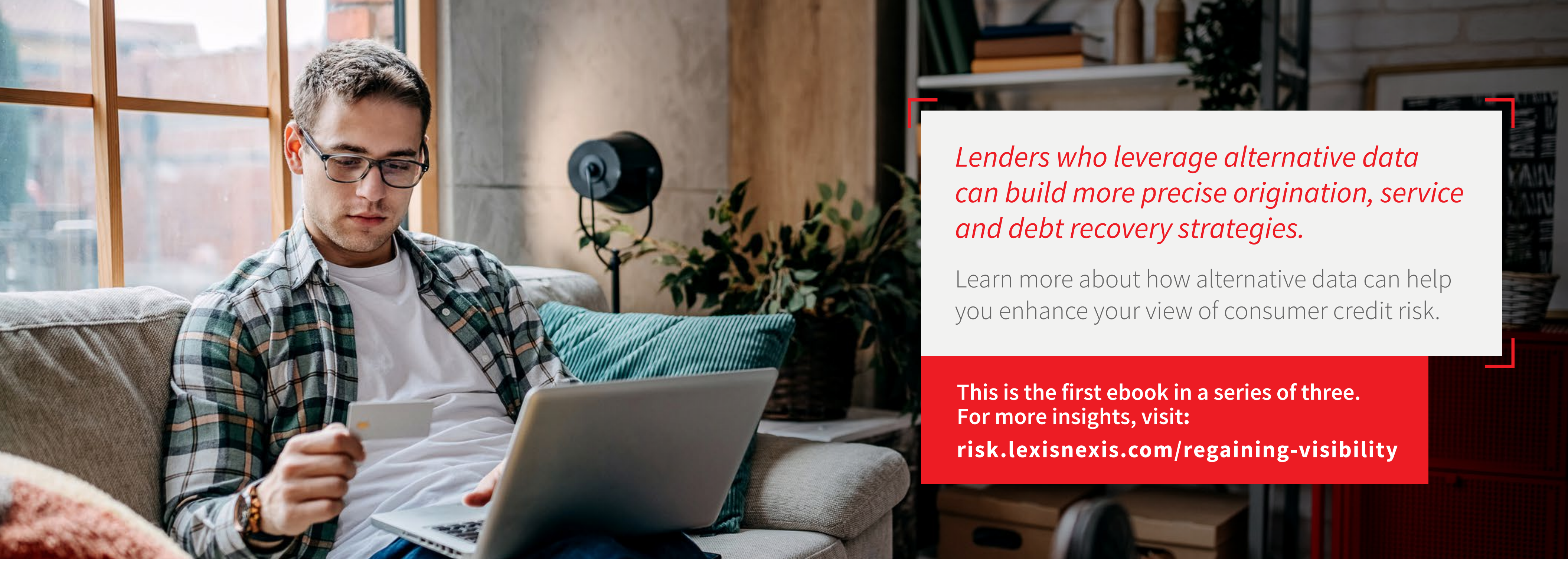
The RiskView scores of **Prime** entrants are not increasing at the same rate as Bureau Proxy scores.

Similar trend with **Subprime** consumers, but not as strong.

Improving evaluation of real-world consumer risk with alternative data

From 2019–2023, among those referred to third-party collection for the first time, both prime and subprime consumers showed rising credit scores, based on traditional scoring methods (labeled “Traditional Data Prime” and “Traditional Data Subprime” in Figure 2). However, when those same consumers were analyzed using the alternative data-driven LexisNexis® RiskView™ scores methods (labeled “RiskView Prime” and “RiskView Subprime” in Figure 2), their credit did not rise at the same rate, especially among prime consumers.

The slower overall rate of increases for the RiskView™ scores seems to more accurately reflect actual shifts in consumer risk among those entering collections for the first time. This suggests that incorporating alternative data into scoring processes can help lenders capture a more accurate and up-to-date view of consumers’ financial well-being.



Lenders who leverage alternative data can build more precise origination, service and debt recovery strategies.

Learn more about how alternative data can help you enhance your view of consumer credit risk.

This is the first ebook in a series of three.
For more insights, visit:
risk.lexisnexis.com/regaining-visibility

Sources:

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About LexisNexis Risk Solutions

LexisNexis® Risk Solutions includes seven brands that span multiple industries and sectors. We harness the power of data, sophisticated analytics platforms and technology solutions to provide insights that help businesses and governmental entities reduce risk and improve decisions to benefit people around the globe. Headquartered in metro Atlanta, Georgia, we have offices throughout the world and are part of RELX (LSE: REL/NYSE: RELX), a global provider of information-based analytics and decision tools for professional and business customers. For more information, please visit LexisNexis Risk Solutions and RELX.

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