EXECUTIVE SUMMARY

Despite the vast accomplishments of the American credit system, approximately 35 million to 54 million Americans remain outside the credit system. For a variety of reasons, mainstream lenders have too little information on them to evaluate risk and thereby extend credit. As a result, those in most need of credit often turn to check cashing services and payday loan providers, with effective interest rates as high as 500 percent. The lack of reliable credit places them at a great disadvantage in building assets (such as homes, small businesses, or loans for education) and thereby improving their lives.

This study offers a feasible market solution to bring those outside the mainstream credit fold within it. Mainstream lenders can use "alternative" or "nontraditional" data, including payment obligations such as rent, gas, electric, insurance, and other recurring obligations, to evaluate the risk profile of a potential borrower.[1] Our findings indicate that alternative data, if widely incorporated into credit reporting, can bridge the information gap on financial risk for millions of Americans. More concretely, considering that many of these millions outside the credit mainstream are poorer, less advantaged Americans, the information can direct markets toward a faster alleviation of poverty in this country.

We examined a sample of approximately 8 million TransUnion credit files with a strong focus on consumers outside of the credit mainstream. The consumers include populations with thin credit files (fewer than three sources of payment information, or trade lines) on payment timeliness, as well as "unscoreable" segments whose risk cannot be determined owing to insufficient information. The credit report files, which contained alternative or nontraditional utility and telecommunications payment information, were applied to models used by lenders to

make a variety of credit decisions. The scores, or predictions, of these models were then compared with payment/bankruptcy outcomes observed during the following year.

Key findings include:

• *Those outside the credit mainstream have similar risk profiles as those in the mainstream when including nontraditional data in credit assessments.* The evidence suggests that most individuals in this segment are not at high risk in terms of lending. Using nontraditional data lowered the rate of serious default by more than 20 percent among previously unscoreable populations. The risk profile of the thin-file/unscoreable population—after energy utility and telecommunications data sets are included in their credit files—is similar to that of the general population (as measured by credit score distribution).

• *Nontraditional data make extending credit easier.* Including energy utility data in all consumer credit reports increases the acceptance rate by 10 percent, and including telecommunications data increases the acceptance rate by 9 percent, given a 3 percent target default rate.

• *Minorities and the poor benefit more than expected from nontraditional data.*

Including alternative data was especially beneficial for members of ethnic communities and other borrower subgroups. For instance, Hispanics saw a 22 percent increase in acceptance rates. The rate of increase was 21 percent for Blacks; 14 percent for Asians; 14 percent for those aged 25 or younger; 14 percent for those aged 66 older; 21 percent for those who earn $20,000 or less annually; and 15 percent for those earning between $20,000 and $29,999. In addition, renters (as opposed to homeowners) saw a 13 percent increase in their acceptance rate, and those who prefer Spanish as their primary language saw a 27 percent increase in their acceptance rate.

• *Nontraditional data decrease credit risk and increase access.*

The addition of the alternative data moves 10 percent of the analysis sample from being unscoreable to scoreable. Sizable segments would see their credit scores improve—22.4 percent in the utility sample and 11 percent in the telecommunications sample. Most remarkable is that two-thirds of both the thin-file utility sample (60.3 percent) and the thin-file telecommunications sample (67.7 percent) become scoreable when alternative data are included in their credit files. Preliminary evidence strongly suggests that the inclusion of alternative trade lines in conventional credit reports improves access to mainstream sources of consumer credit. In a one-year observation period, 16 percent of thin-file borrowers whose credit report included nontraditional data opened a new credit account compared with only 4.6 percent of thin-file borrowers with only traditional data in their credit reports.

• *Nontraditional data have little effect on the credit mainstream.*

One worry is that including nontraditional data will be counterproductive, harming more in the mainstream that helping those now excluded. The results of simulations reported here suggest that little will change for the mainstream population.[2]

• *More comprehensive data can improve scoring models.*

This migration greatly affects the performance of examined scoring models. For example, in our study, in one set of calculations we assume that creditors interpret little or no credit information as the highest risk. As a result, when fully reported utility or telecommunications trade lines are added to credit reports, we see a significant rise in the KS statistic—an industry gauge to measure the model performance. Specifically, we see a 300 percent rise for a sample of thin-file consumers, and a nearly 10 percent rise for the general sample. In the most conservative case, in which the general sample is used but unscoreable credit files are excluded from the calculations, we still find a modest 2 percent improvement in model performance with the addition of alternative data.

• *More data can reduce bad loans.*

Including fully reported energy utility and telecommunications trade lines (i.e., different accounts) in traditional consumer credit reports measurably improves the performance of loans for a target acceptance rate. For example, by integrating fully reported energy utility data, a lender's default rate (percentage of outstanding loans 90 days or more past due) declines 29 percent, given a 60 percent target acceptance rate. Similarly, adding telecommunications data reduces the default rate by 27 percent. These reductions allow lenders to make more capital available and improves their margins, capital adequacy, and provisioning requirements. Such improvements could have further positive economywide effects.

In summary, nontraditional data promise to bring millions into the credit mainstream and improve their chances of building assets. Although using alternative data in consumer credit reports affects how the data appear in a host of credit scoring models, nothing about the data subjects has changed. What has changed is the availability of information. Whenever an information gap exists, markets fail to thrive. The use of alternative data in consumer (and commercial) credit reports can close an information gap that has negatively affected the lives of millions of thin-file and unscoreable Americans who reside in urban areas and elsewhere.

The benefits of using nontraditional data will not be instantaneous. Information must first be gathered and implemented, new models optimized for such data must be built and old models modified. Some models must be altered to not treat utilities and telecommunications accounts as a financial trade. The steps, while few, are important. Simply bringing the information online will spur many of the steps; without it, there is no incentive to take them. Public officials can play a positive role by removing barriers to reporting where they exist. ■