How Traditional Credit Scoring Models

Negatively Impact Small Dollar Lending

QCASH®

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EXECUTIVE SUMMARY

"WHEN FACED WITH A HYPOTHETICAL EXPENSE OF $400, 64 PERCENT OF ALL ADULTS IN NOVEMBER 2020 SAID THEY WOULD HAVE COVERED IT EXCLUSIVELY USING CASH, SAVINGS, OR A CREDIT CARD PAID OFF AT THE NEXT STATEMENT."

From credit card issuers and insurance companies, to mortgage lenders and property managers, the leading benchmark for lenders is a person's credit score — and most often it's one of their many FICO scores. This three-digit number represents the amount of risk a prospective borrower poses to a lender. Scores ranging from 300 to 850-plus are intended to quickly evaluate a consumer's creditworthiness. And whereas a lender may also access a borrower's Vantage Score, a Community Empower (CE) score or findings from Experian, Equifax and TransUnion, these aggregated metrics don't accurately represent a consumer's ability to repay a debt.

According to the Federal Reserve's "Report on the Economic Well-Being of U.S. Households in 2020 to May 2021," small, unexpected expenses, such as a car repair or a modest medical bill, can be a hardship for many hard-working American families, especially in the wake of COVID-19 and the discontinuance of government bailout packages.

"When faced with a hypothetical expense of $400, 64 percent of all adults in November 2020 said they would have covered it exclusively using cash, savings, or a credit card paid off at the next statement," the report stated. And for many credit-challenged consumers, "using cash" can mean being forced to accept predatory small dollar loans with interest rates exceeding 300 percent.

Merits to traditional credit scoring include analyzing certain payment history, credit utilization ratio, credit mix, new credit and credit history length. These scoring models, however, fail to incorporate other critical data points. A borrower, for example, may have had financial troubles in the past but demonstrates the ability to repay current debts, such as utility bills and rent. These variables aren't factored when determining real-time credit worthiness. To this end, this same individual with a FICO score below 600 would most likely not receive a reasonable line of credit, whereas a person with a credit score over 750 who recently paid off their credit card and closed the account would receive a credit line, but his or her FICO score would lose points. The system is broken.

The intention of this white paper is to educate on antiquated credit scoring models that disadvantage borrowers who are in need of a loan but don't qualify when measured against legacy lending criteria. The white paper will also make the case as to why credit unions should use alternative lending criteria when considering a member's ability to repay a debt. This reimagined approach to lending benefits members who are making a concerted effort to improve their financial portfolio, while attracting new, younger members to a credit union.

THE HISTORY OF TRADITIONAL CREDIT SCORING MODELS

A $1.29 billion business as of 2020, the San Jose, Calif. –based data analytics company Fair Isaac Company (FICO) was founded in 1956. The goal was to measure consumer credit risk. By 2013, National Mortgage News reported that lenders purchased more than 10 billion FICO scores and roughly 30 million American consumers personally accessed their credit scores. Over the last nine-plus years, these user statistics have increased, as have user rates from other leading credit scoring companies and curious consumers.

What makes traditional credit reporting models perplexing to many lenders and consumers alike is that each scoring company has multiple credit scores, which is essentially just a snap shot in time that doesn't provide a comprehensive understanding of a consumer's complete credit history. FICO, for example, is estimated to have more than 50 versions of a credit score accessed by third parties for credit card, mortgage and lending decisions.

"Although these traditional scoring models are an important tool, they can lack the insights needed to ensure a complete consumer picture within the consumer credit assessment process. It can be quite predictive of whether a consumer will repay a debt, but there are other relevant behaviors the score doesn't take into consideration," said Kevin King, vice president, Credit Risk and Marketing Strategy at LexisNexis Risk Solutions. The Alpharetta, Ga. –based company provides customers with solutions and decisioning tools that combine public and industry specific content with advanced technology and analytics to assist in evaluating and predicting risk and enhancing operational efficiency. "The credit responsibilities managed by U.S. consumers have changed a great deal in the past 30 years and the core scoring models haven't kept pace," King added.

Financial institutions still use models such as FICO, King explained, because despite arguments that these scoring criteria are antiquated, the data still provides a predictive credit assessment. He noted, however, that there are "plenty of other factors that have little to do with the integrity" of the credit score.

"The traditional credit score is a common language understood by every area of a financial institution, consumers and government agencies," King said. "Because of that, moving away from the traditional scoring models

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can present several challenges to a lender, which, when totaled up, typically leads them to look for ways to add additional credit information on top of the score versus replacing it altogether."

CEO and Founder of Neener Analytics, Jeff LoCastro said FICO has "outlived" its useful life — a market reality he experiences daily. "The benefits to FICO were clear when there was nothing else. Even stale bread is delicious to a starving man," he said. The Sunnyvale, Calif. –based technology company takes an "individual approach" by using cognitive-artificial intelligence (AI) to accurately evaluate financial risk via the borrower's one-click opt-in to their social media accounts. This methodology provides specific individual credit risk outcomes.

As a way to make the case against traditional scoring models, LoCastro points out that "the thin-file, no-file and the credit challenged" represent 56 percent of the U.S. market. And while he added that financial education for the underbanked is always beneficial, helping a consumer secure a checking account won't necessarily result in his or her ability to qualify for an automobile loan.

"The problem is simple: If a risk-based business cannot determine the risk of the engagement, you are invisible. Period," LoCastro said. "It's lack of access that keeps people poor."

Referencing a recent Bankrate study, LoCastro further explained that 66 percent of millennials are opting not to build a traditional credit score. This trend, he said, is not due to a lack of "financial education," but rather because this demographic doesn't want "to play" the FICO game.

"Millennials are tired of being rejected," LoCastro continued. "And when you consider that Gen Z's are already 27 percent of the global population and growing and [generally] don't even know what a 'credit score' is, this problem is going to only get worse, not better."

MAKING THE CASE FOR CHANGE

Since traditional scoring models are still often the gatekeepers of credit access in the U.S., King said having "no or poor standing puts consumers at a major disadvantage to accessing credit tools." For consumers in these situations, he said the challenge is to "amass enough new evidence of responsible credit management to generate a positive" traditional credit score.

"Because traditional credit scores have incomplete insight into many important credit behaviors – think seeking online loans, managing a cell phone or pay-tv relationship, owning property, for example – they limit the ways underbanked or credit-recovering consumers can improve their scores," King said. "The result is it becomes quite challenging for many consumers to improve their scores, particularly without financial wellness education, keeping important financial tools out of reach and often perpetuating a cycle of debt."

Combatting this cycle of debt is the mission of the Olympia, Wash. – based QCash Financial and its loan decision engine, a proven, proprietary platform built on credit union member relationships and behavior data, explained CEO Seth Brickman. Prior to launch in 2016, QCash successfully used Washington State Employees Credit Union as an incubator for its small dollar loan alternative technology.

"As a whole, a FICO score judges you on your ability to repay without taking into account the circumstances that occurred to cause the debt," Brickman said. And while he added that a person's willingness to take on a loan requires the responsibly to adhere to the agreed upon terms, there are many unknown variables responsible for a delayed payment that could derail an otherwise well-intended borrower.

"What if a person has an emergency illness and went to the doctor and couldn't pay the medical bills because they didn't have good insurance? They didn't make a choice to be sick and yet by not paying these medical bills, their credit score will be hurt, which makes them unable to obtain traditional credit," Brickman said. "It's not that they are a bad risk or chose not to repay a debt, rather a life event happened that was unexpected and they weren't in a financially stable position."

In King's estimation, fewer things are more important than financial education, including the topics LoCastro and Brickman underscored.

While credit tools such as loans and credit cards "provide significant advantages" to consumers in reaching financial stability, King said consumers who haven't been "educated on those advantages are attempting to achieve financial health with one hand behind their backs." Financial wellness education, including learning about alternative lending scoring models, should be taught to not just the underbanked, King implored, but to all consumers.

"The credit offerings underbanked/underserved consumers have access to (particularly those with scores under 650) offer both less benefit and less margin for error than the products available to consumers with more established and positive credit histories," King said. "Education can help these consumers identify the best credit options to meet their goals, manage those obligations effectively and ultimately access increasingly strong tools that maximize their chances at financial health."

WHY ALTERNATIVE SCORING SOLUTIONS ARE BEING EMBRACED

When attempting to obtain credit either for a car loan, mortgage or short-term “emergency” loan, the underbanked and consumers with traditionally low credit scores are continually faced with systemic financial roadblocks. This deserving and often overlooked demographic can greatly benefit from credit unions taking calculated chances on lending by employing other financial metrics that can be utilized in the decision making process. After all, credit unions understand their membership better than a FICO score does, Brickman said.

“The reality is that credit unions recognize that as the financial institution [of choice], it is the place of community and security for its members,” Brickman noted, adding that since 2016, QCash Financial has funded over 700,000 loans — ranging from $50 to $4,000 — to credit union members. The platform is not limited to traditional small-dollar loans, and can also be used to automate other unsecured loans, such as personal loans, pre-approved loans and lines of credit.

> “AT THE END OF THE DAY, CREDIT UNIONS ARE MORE FOCUSED ON THEIR MEMBERS THEN ON THEIR MARGINS”

Brickman continued. “A solution like ours allows credit unions to say ‘yes’ more often to loans without increasing their risk.”

While credit unions have a long, celebrated reputation of placing members’ needs first, the days of members being granted loans based on personal relationships is the exception rather than the rule. So for many lenders, the idea of changing lending criteria is daunting. And this is for good reason — these institutions don’t want to be left holding a bag of bad debt. But in recent years, the use of “new data” and “alternative” data has become instrumental in aiding lenders and the concept is not necessarily foreign.

“Alternative data reference insights that adhere to all the regulatory guidelines needed in a consumer credit assessment, but which are not considered in core traditional credit scores, such as property or asset ownership, possession of financial licenses, lack of negative court events like bankruptcy or landlord/tenant disputes, managing telecommunications relationships,” King said. “These are all types of alternative data signals.”

In many cases, alternative data is available in a score that “looks and feels like FICO but is simply based on different information or in attribute form,” King explained. “This flexibility allows lenders to build strategies that compare FICO to alternative scores, to build rule-based approaches or to have their own analytics teams incorporate alternative data into in-house custom models,” he continued. “Maybe the most important thing

to take away is that the complexity of alternative data is often overstated – any lender can easily enhance their strategies with these insights."

As the "wealthiest country in the history of mankind" with the highest standard of living distributed to the largest population, LoCastro said while America invented the modern credit scoring system, it only serves roughly half the population represented in that structure. To this end, alternatives are desperately needed.

"America is a credit-based society with massive populations that cannot obtain credit as a method to pull themselves up or improve their standard of living, or just move to a better, safer place to live," LoCastro reflected. "That's a super-nova problem."

And while the term "alternative data" is widely used in the industry, LoCastro said at Neener Analytics, "Human Data" is the preferred expression because the model uses data that all people have access to by virtue of simply being, well, human.

"Having new, better and more equitable methods to determine risk that are in fact more predictable are absolutely critical to not only economic growth, but also social development," LoCastro said. "Having other sources of more predictive data is central to that change."

Whether or not alternative or human data should be used is a matter of opinion within every lender's risk team, LoCastro conceded. But can it be used? "The answer is 'yes'," he said. "Alternative approaches do not require that lenders scrap their current systems or engines. But alternative approaches are the only way to grow their market."

Pivotal to the alternative data movement is the use of artificial intelligence (AI) and machine learning (ML). These tools provide the ability to determine more enhance, real-time scoring models, which paint a better picture of a person's ability to repay a debt.

"Consumers' financial lives are increasingly complex and that makes it difficult to make sound and competitive lending decisions using judgmental or rule-based underwriting," King said. "AI/ML models can absorb that increasingly large picture of consumers' financial lives – provided they've been provided with alternative data – and translate it into a straightforward and consistent assessment of consumer credit quality for which no other method really allows."

In LoCastro's view, alternative data methodologies shouldn't be equated to a "small data solution." Calling his company's cognitive AI solution unique, he said his team has cracked the code on small data.

"When you move away from historical, transactional, or even relational based risk decisioning where decisioning is happening based on a formula or calculus measuring change, risk must be parsed using at the very least ML and at most AI components," LoCastro said. "There is no other way. To say that AI is the future of risk decisioning presupposes that it is something that is going to happen. What lenders need to get their head around is it's already here, it's already happening, and that train has left the station."

As QCash Financial assesses the ever-changing market, Brickman said that the company will continue on its mission to advance financial inclusion and access for credit union members. And as the company moves closer to funding one million loans, strategic lending changes are forecasted.

One of the unique things about our offering is our relationship underwriting requires the borrower to be a member of one of our many financial institution partners, which is great in the sense that we are helping credit unions help their members. But what we are not doing is helping credit unions get new members because you can't give a loan to a new member with our current algorithm," Brickman said. "We are actively working on and looking at other alternative underwriting solutions that would allow our partners to offer loans to non-members to get them to become members."

CONCLUSION

As the nation rebounds from the pandemic, which continues to inform an uncertain economy, more and more credit-challenged consumers will need access to loans at fair percentage rates. As Brickman points out, “It’s easy getting into a bad credit spiral, but it is nearly impossible to get out of it.”

With the average age of a credit union member being 47, executives also have to consider that the way in which younger generations, such as millennials and Gen Z, view credit is not in line with the old guard. This disparity has created two economic models, LoCastro said.

“For any lender, regardless of the product vertical, the question becomes: What are you doing to serve these two economies? What are you doing to say ‘yes’ to them? If you are using a FICO score, good luck with that,” he continued. “The bottom line: If a lender uses a FICO-based system to say no to a Gen Y or Gen Z, they are gone forever. Using alternative sources of data to decision these populations is critical, because it’s the only way.”

Since credit unions have long been at the forefront of financial inclusion and are prone to “give people a fair shot at financial stability,” King said any method that “paints a more complete, and thus fairer, view of consumer credit quality” should be a perfect fit for the credit union industry.

“There have been several factors that have restricted credit unions’ adoption of alternative data – everything from limited access to the data to the misconception that its use requires a massive team of analytic experts – but those factors are quickly disappearing,” King said.

LoCastro agrees with King noting that the Neener Analytics’ business model was built on the credit union ethos of “people helping people.” And while he added that the “entire premise” of a credit union is that it “knows” its membership, the real challenge moving forward is for credit unions to stop saying to those same members “I don’t know you” when it comes to lending.

“That’s a real disconnect that credit unions need to address. By doing so, hopefully, the industry can finally lead in innovation instead of following as the third leg. That statement is not casting dispersions, but rather a statement of present realities,” LoCastro said. “And if credit unions can take the lead, there is a real opportunity here for credit unions to use their unique relationship with their members and I hope they take it.”

ABOUT THE AUTHOR

Over the past 18-plus years, W.B. "Brad" King has served as a technology writer, columnist and correspondent for Credit Union Business magazine and the Credit Union Journal. He has written on technology topics for leading industry companies and organizations, including The Credit Union National Association. Additionally, he is a co-founder of the credit union-focused technology publication, Finopotamus. Outside of the credit union industry, he has ghostwritten and authored numerous books on a wide range of subjects and is an award-winning journalist who has taught writing courses at New York University.