

# 3rd CREDIT REPORTING AND RISK MANAGEMENT TRAINING



## The Promise of Alternative Data: Financial Inclusion and Its Challenges

# Policy and Economic Research Council

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- ◎ PERC is a non-profit 501(c)3 organization dedicated to **information solutions for development challenges**
  - > **Information sharing policy reform**
  - > **Moving markets--education and outreach**
  - > **Development of applications**
- ◎ **Not just a think tank** – we work with policy makers at all levels to bring about the change we seek
  - > Foundations
  - > Private sector actors
  - > Central Banks, banking commissions, development agencies
- ◎ Committed to **market-based economic development**
- ◎ Established in **April 2002**

# Introduction

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## Credit Reporting

- ◉ Works on the premise that reputation (based on behavior and other information) can substitute for collateral.
- ◉ Helps overcome basic asymmetries of lending.

## What is “Traditional” Data?:

- > Bank loans
  - Mortgages
  - Automobiles
  - Revolving credit
  - Installment loans
  - Personal loans
- > Retail credit

# Benefits of Reporting Full-File Payment Data

## Borrowers

- Reduced probability of over-extension
- Greater and fairer access
- Credit offers reflect credit risk and credit capacity

## Lenders

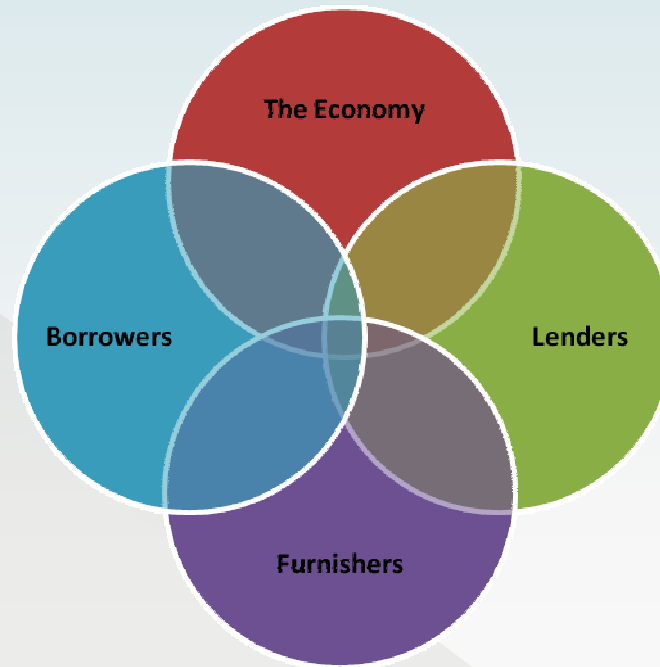
- Improved loan portfolio performance
- Basel 2 compliance
- Sustainable growth into new markets

## Furnishers

- Improved cash flow, fewer delinquencies
- Improved relation with customers

## The Economy

- Better financial services efficiencies
- Affordable growth in domestic consumption



# The Limits of Financial Data

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## **Limitations of traditional approach**

- **Works for borrowers already in the system**
- **Creates a credit catch-22**
- **Problem of:**
  - **How to extend credit to those without collateral (or valued collateral)?**
  - **How to provide access to those in the informal sector (often large share of the population)**

**In USA, this population is high as 30% of adult population (70 million)**

**In emerging markets, this population is a larger share of population**

# Alternative Data: A Solution

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**What is “Alternative” or “Non-Traditional” Data?: non-financial information that also helps assess reputation**

- > **Many forms of post payment**
  - Energy and Water Utility Payments
  - Landline and wireless phone bills
  - Auto liability insurance payments
  - Rental payments (especially apartments)
- > **But also**
  - Remittance payments and stored value cards
  - Prepayment
    - Cell phones
    - Education expenses

**What is Alternative Data Being Used to Predict?**










- > **The probability of a serious delinquency on a loan (above 60 or above 90 days beyond term)**
- > **Creditworthiness, credit capacity, and credit risk (e.g., income stability)**

# Methodology for Identification

Our qualitative study was designed to assess usefulness along 3 key dimensions

- > “Cash-like” vs. “Credit-like” (incentive to furnish)
- > Coverage (reach of data in population)
- > Concentration (resources needed to reach furnishers)

-  Traditional “credit-like” data
-  Non-traditional “cash-like” data

		Service Providers / Data Furnisher	
		Few	Many
Consumers Utilizing Services	Many	 Rental Payments	 Energy  Water  Cable  Auto liability insurance
	Few	 Child care  Payment cards  Payday loans	 Tuition

# Hurdles to Reporting

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## Technological barriers to reporting:

- Complex billing cycles (footprint dependent)
- Legacy IT systems

## Economic barriers:

- Compliance costs—FCRA data furnisher obligations
- Customer service costs from lenders scaring customers substantial

## Regulatory barriers:

- Some states have statutory prohibitions (CA, NJ, OH)
- Federal prohibitions: Section 22 of the 1996 Telecommunications Act
- Regulatory uncertainty at the state level

# Alternative Data Initiative

# The Roadmap USA: ADI Phase 1

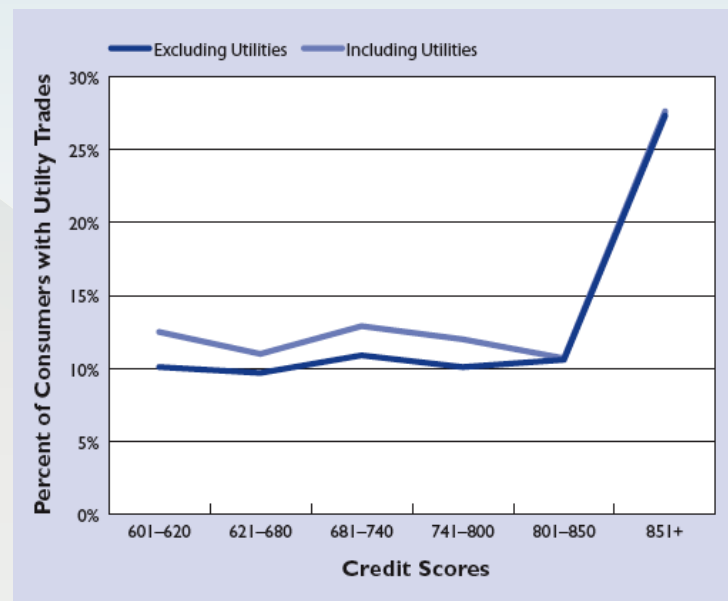
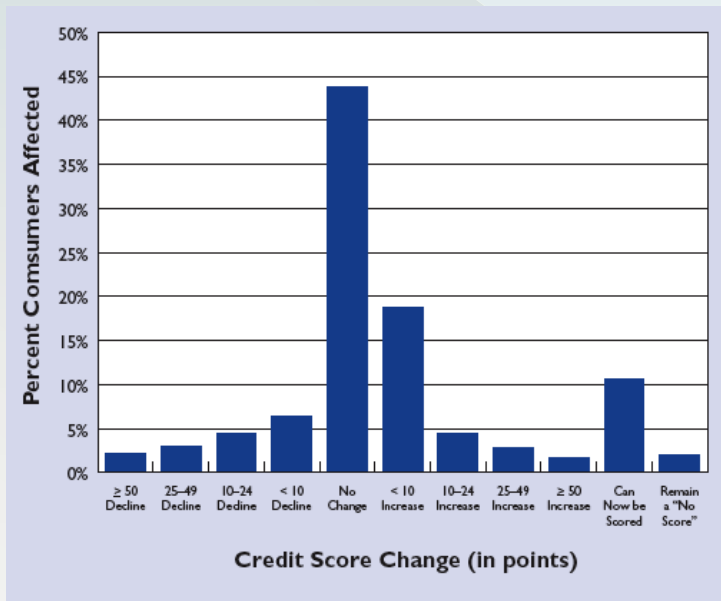
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## Phase 1 Key Findings and Results

- ⊙ **Reporting of utility and telecom payments hold most near term promise**
- ⊙ **Technological and economic barriers are surmountable**
- ⊙ **Legislative barriers and “regulatory uncertainty” need to be addressed**

# Addition of Utility Data Has Small Impact on Score Distribution

Total sample 7.5M



# Phase 2 Key Findings--Greater Access for All

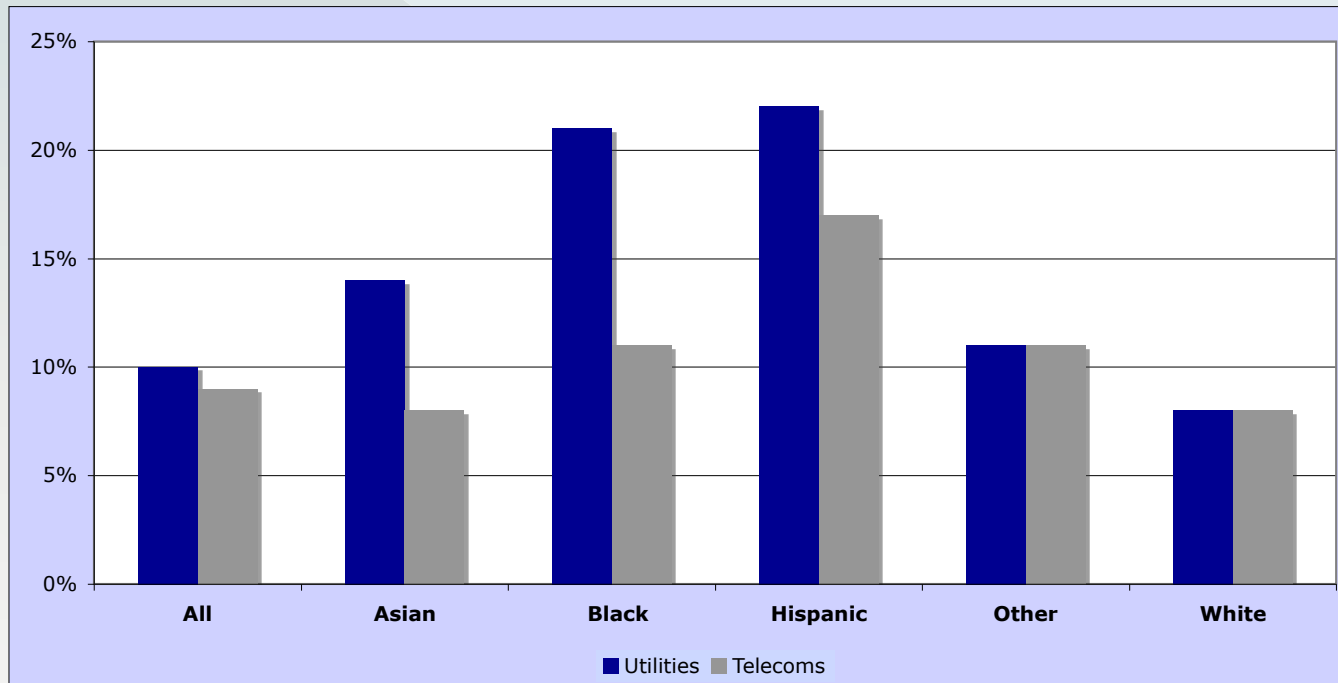
Considerable increases in acceptance rates for a given performance level. For utilities, an increase of 6 percentage points for a 6% delinquency level.

## Acceptance Rates by Targeted Delinquency Rates

Delinquency Rate %	Consumers with Utility Trades	
	Including	Excluding
	Utilities (#1)	Utilities (#2)
2	52.4	47.2
3	60.4	54.9
4	65.4	59.6
5	69.1	63.1
6	72.0	65.7

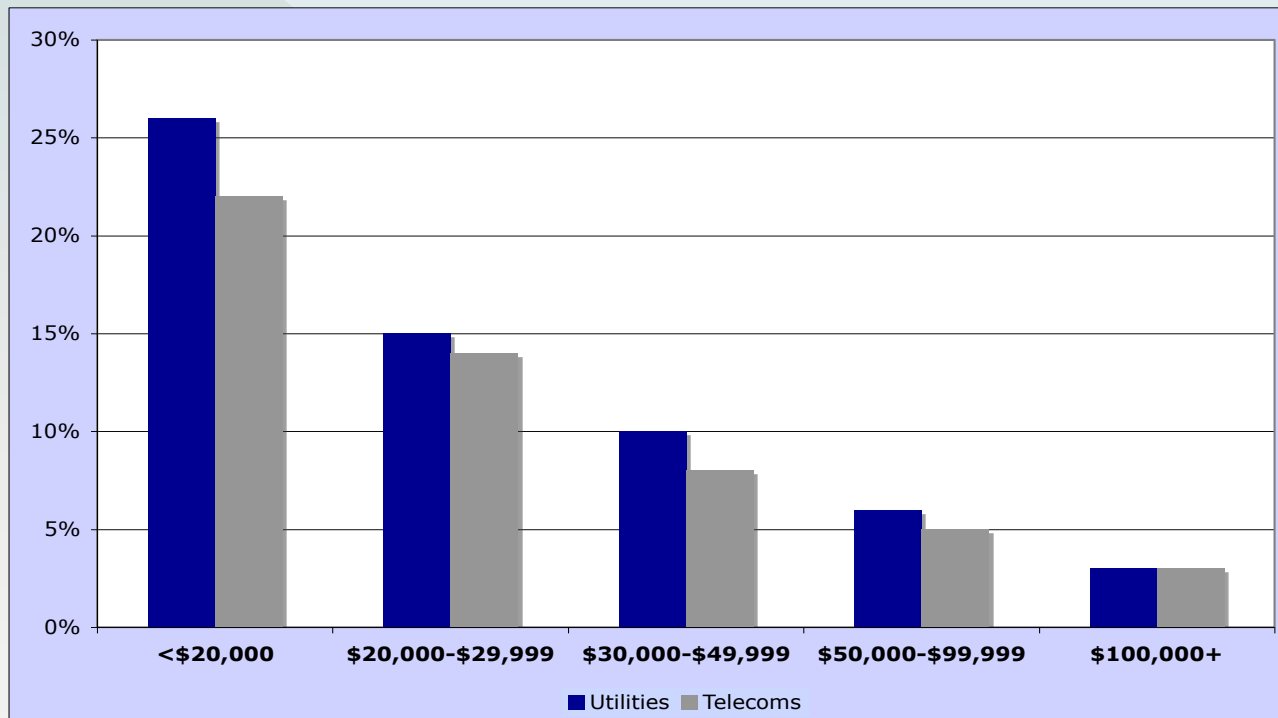
# Phase 2 Key Findings

## Change in Acceptance Rates by Race/Ethnicity at 3% Delinquency Target



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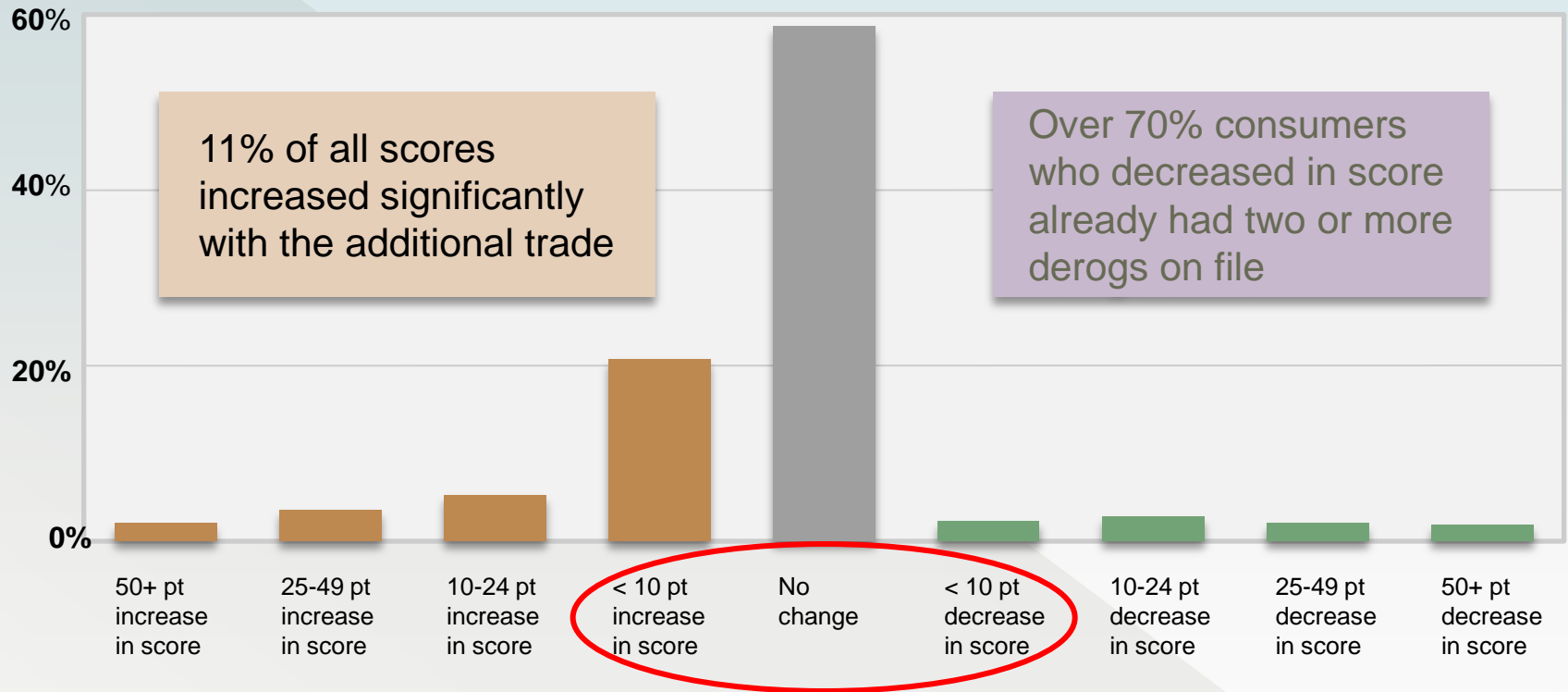


## New Questions

- ◎ **Do non-financial obligations lose their predictive value in crisis times v normal times?**
  - > The predictive value of data and scoring models must be regularly be revalidated
  - > ‘It does require maturity to realize that models are to be used, but not to be believed’ – Henri Theil
- ◎ **Would reporting increase burdens?**
  - > Question of consumer protection *against* overindebtedness
  - > Lenders assume worst especially in worse economic climates

# 2009 Verification

## All Customers



81% scores had little or no change in score

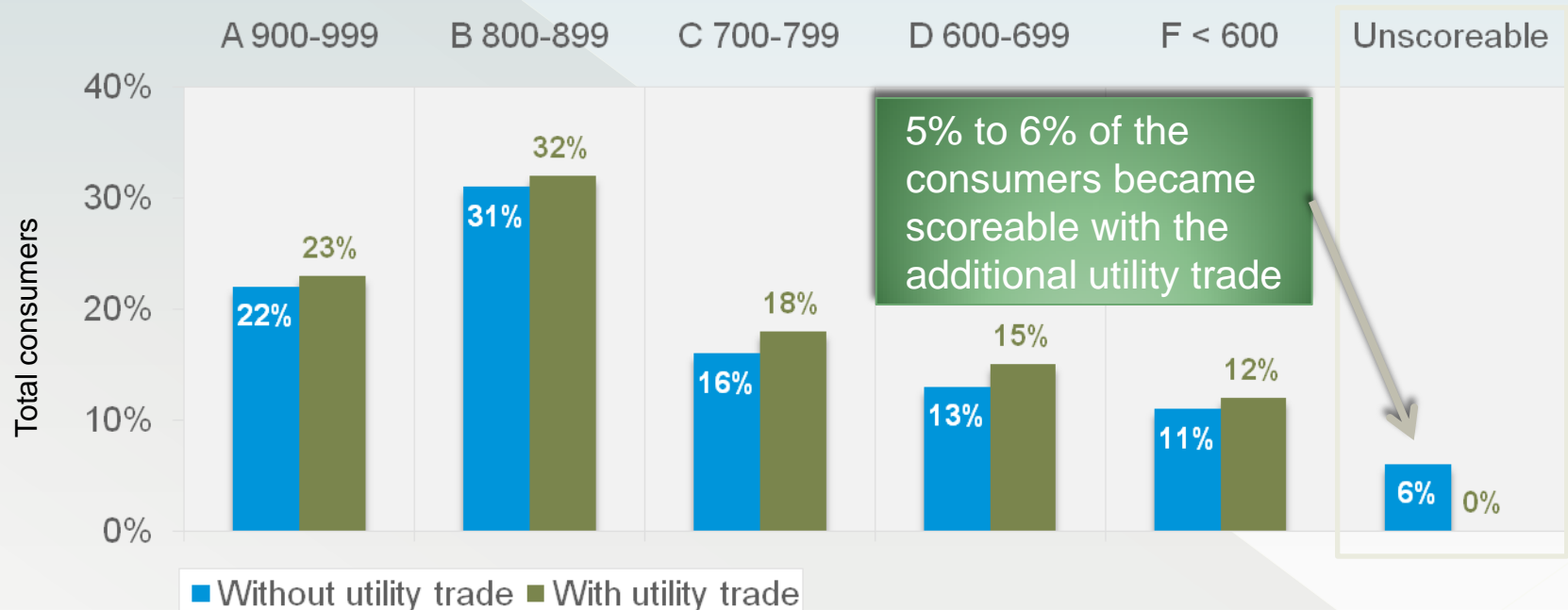
Source: Experian 2010

# 2009 Verification

## Thin Files

“Many consumers have thin or no credit files, making them unscorable.”

Center for Financial Services Innovation

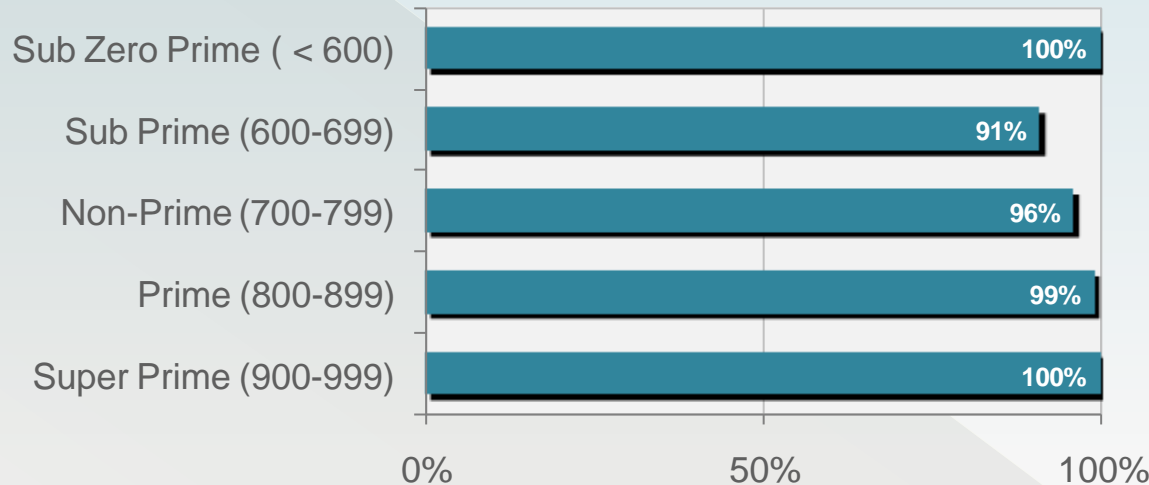


4% of the portfolios were new consumers

Source: Experian 2010

# Verification of Scoreband Changes

## All Consumers



Very little change due to the addition of a utility trade

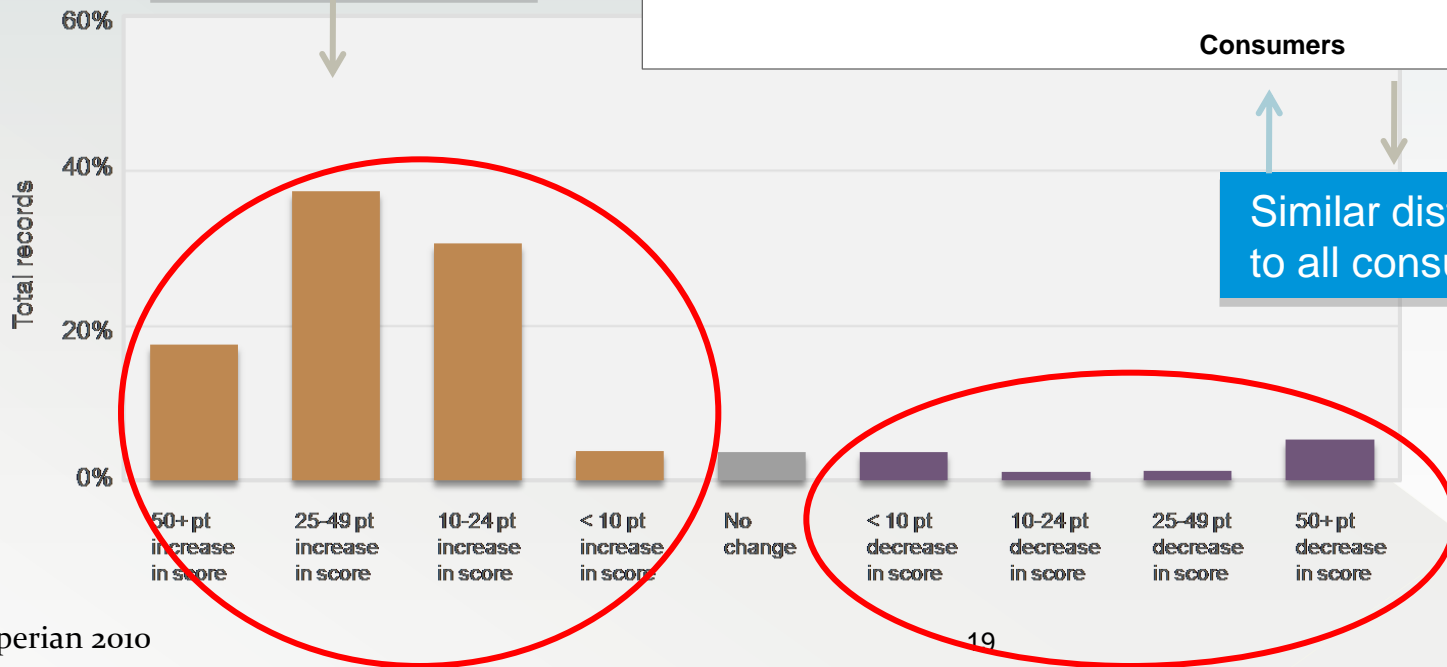
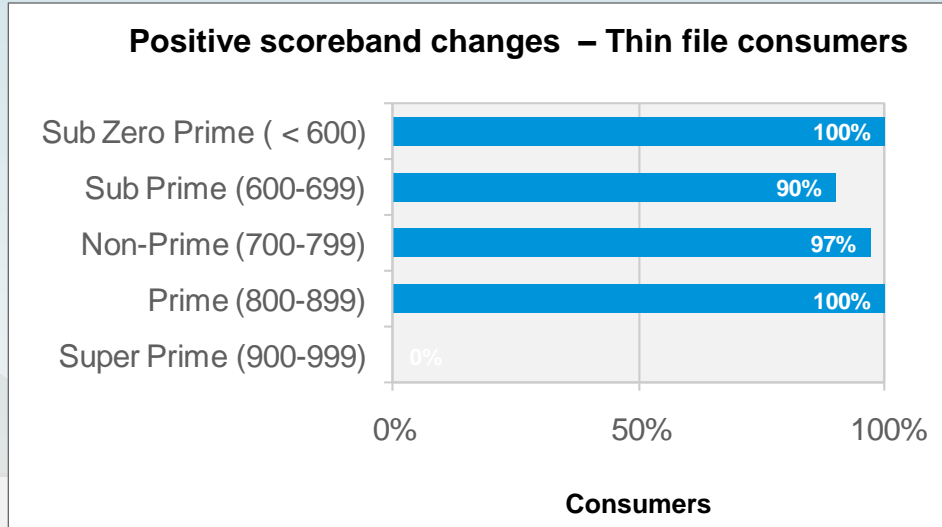
## Key findings

- ▶ **Over 91% either stay within the same band or move to a higher band**
- ▶ **84% of the scores that declined were already in a negative scoreband**

# Verification of Scoreband Changes

## Thin File Consumers

Generally positive impact to thin file consumers with the additional utility trade

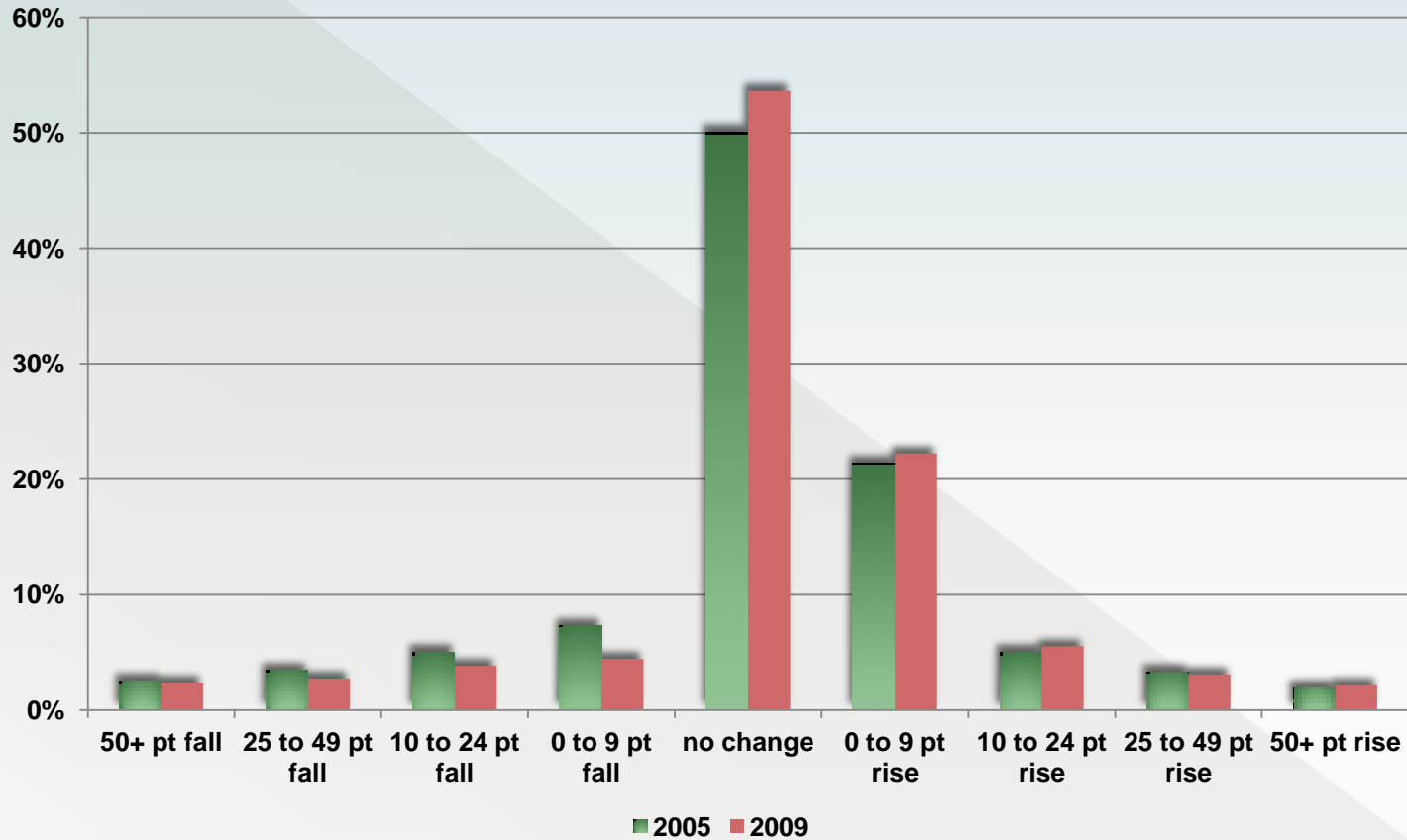


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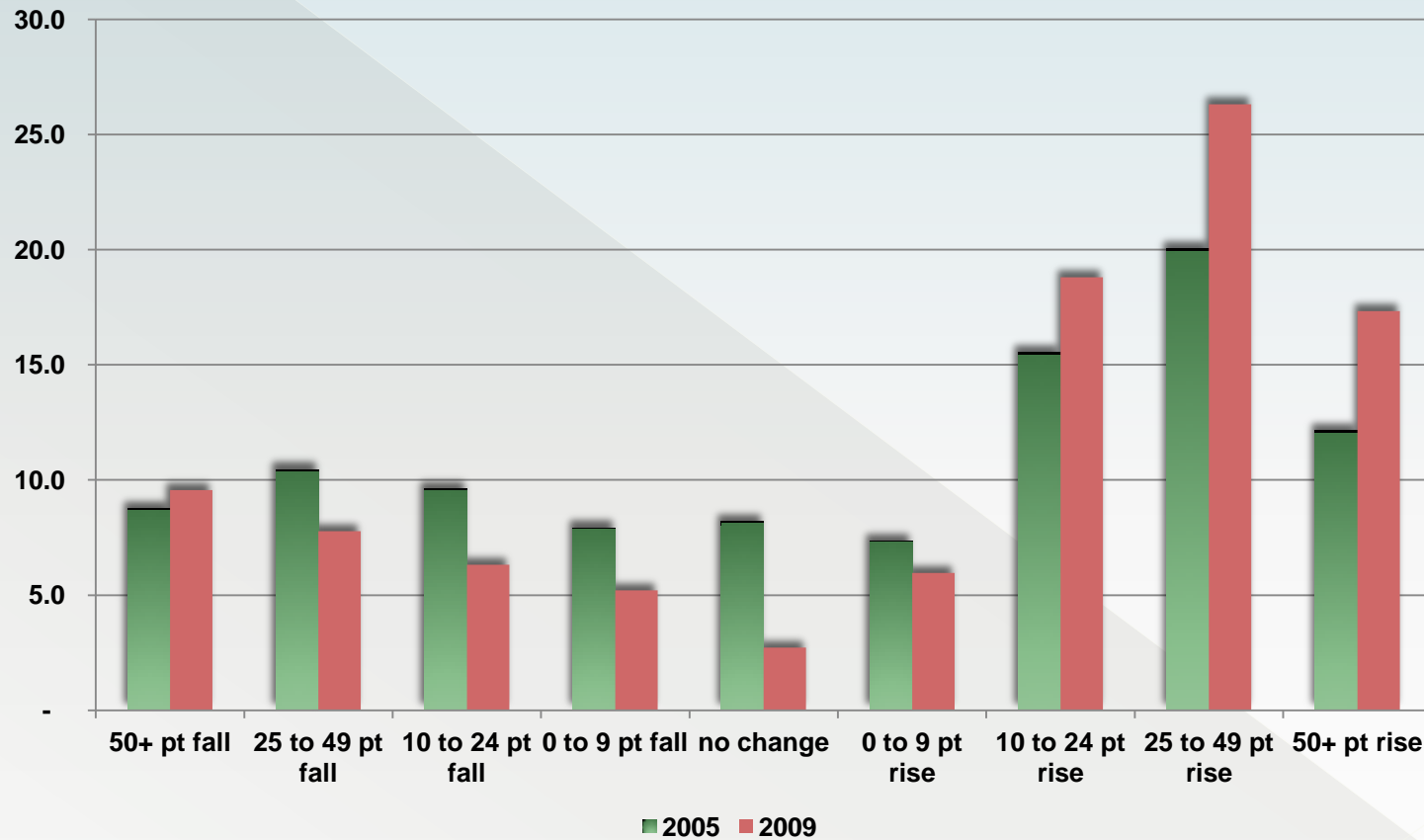
# 2005 and 2009 Comparison (Utilities)

## All Consumers (preliminary)



# 2005 and 2009 Comparison (Utilities)

## Thin-file Consumers (preliminary)



# Alternative Data Initiative

# US Firms: Impact of Reporting

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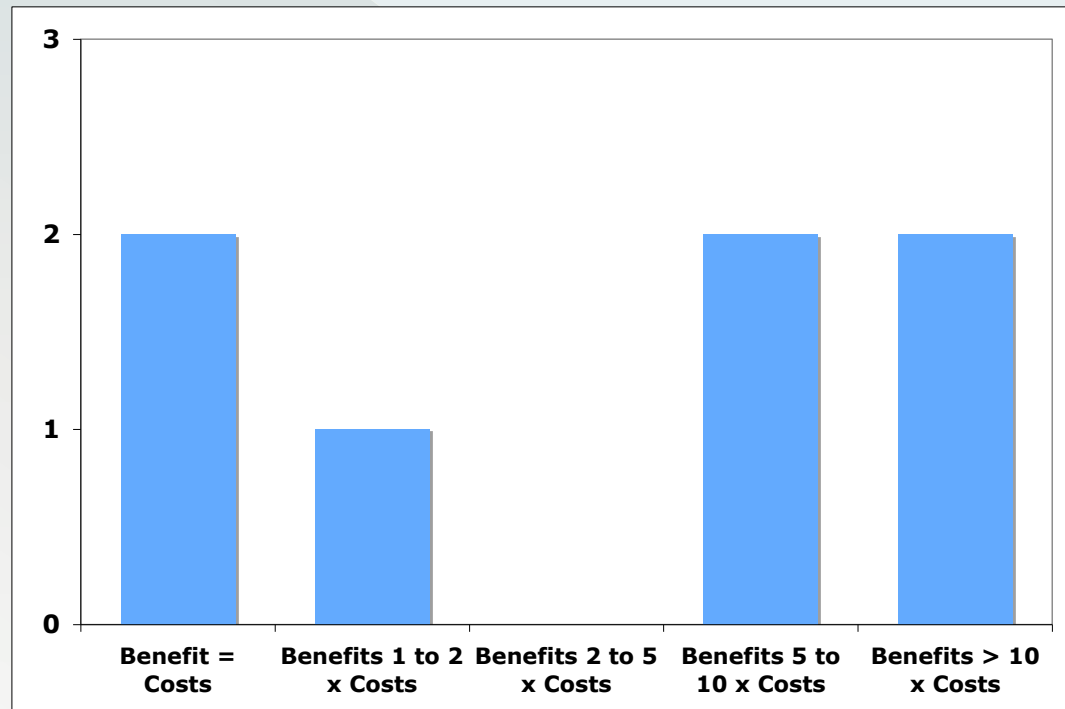
## Utility and Telecom survey

- **Average firm benefits of fully reporting are several times the costs**
  - Benefits include fewer delinquencies, decline in accounts in arrears, and improved cash-flow
  - Costs include IT upgrades, conducting new processes, compliance procedures and new customer service demands
- **10% of firms in survey currently fully report to a bureau**
- **89% currently refer delinquencies to a collections agency**

# US Firms: Impact of Reporting

**Utility and Telecom survey:** Benefits/Costs of reporting to a Credit Bureau

All firms reported **benefits  $\geq$  costs, including compliance costs**

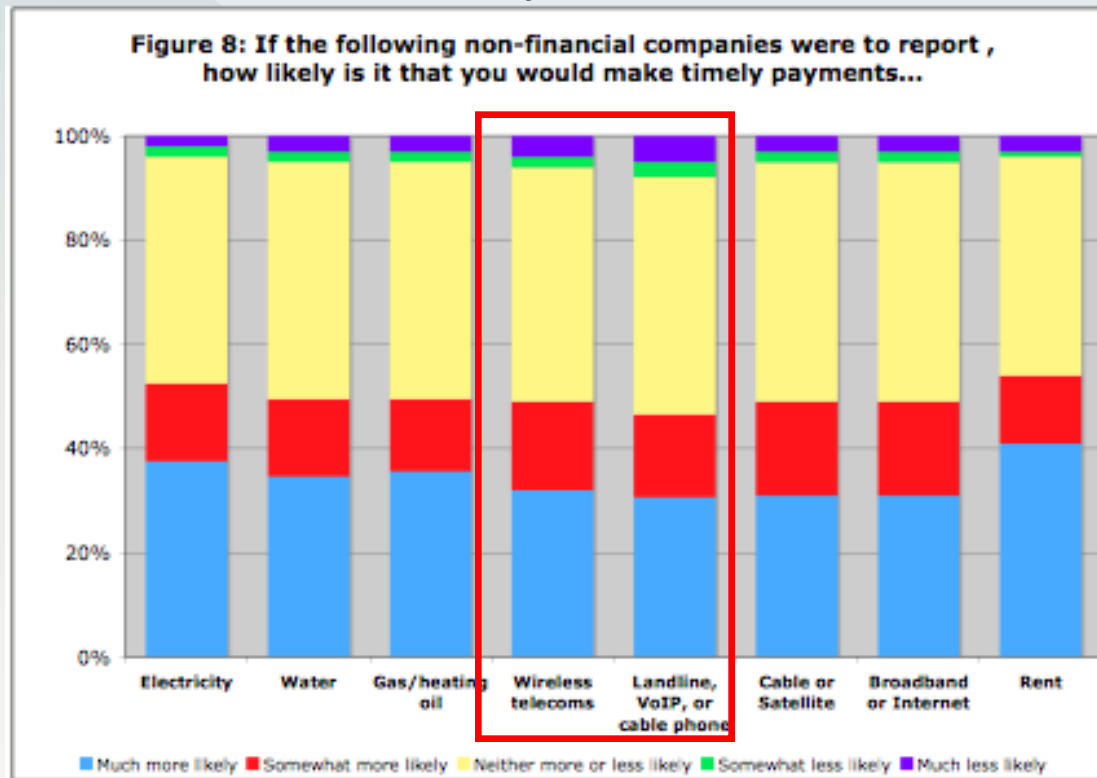


# US Customers: Response to Reporting

## Customer survey

About half of customers more likely to pay on time if payment reported was reported to a credit bureau and impact their credit files and credit scores

- One-third would be *much* more likely



# Alternative Data Initiative

# Why Non-Financial Data in Emerging Markets?

**Problem of lending to lower income segments, informal economy?**

- > Lenders express concern about problem of identifying risk
- > Lenders are uncertain if lower income segments have incomes too volatile for structured lending products

**Is there a data based solution to the problem of loan monitoring?**

**Can automated scoring systems help reduce origination costs, and lower costs of micro- and other small value loans?**

**Can large lenders enter underserved markets while working mostly within their existing business models?**

# Approach for Regulators and Market Actors



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- ① **Define universe of alternative data**
- ② **Assess which are most promising and useful**
- ③ **Frame the issue, identify the problem and the way forward**

# Methodology for Identification

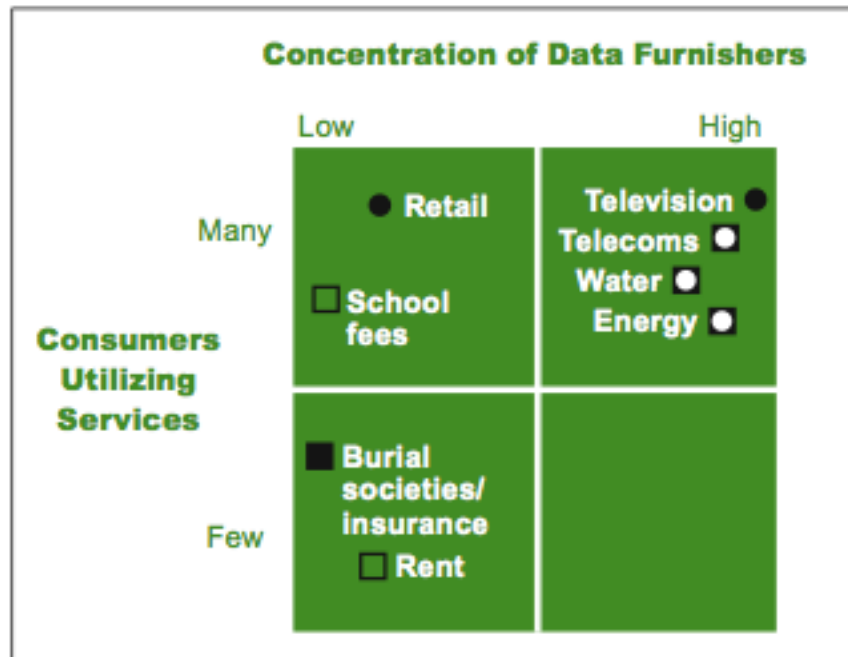
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	Few		

# Identifying Alternative Data in South Africa



**Figure 3: Select Alternative Data Sources Along Dimensions of Evaluation**

- Credit like
- Both pre and post pay
- Prepay
- Prepay but services not immediately severed upon delinquency

# Pending ADI in South Africa

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## Alternative data approach: test data identified in ADI report

- **Reorient mainstream finance to urban and rural poor**
- **Two sources indicate willingness to participate in tests**
  - Municipal services data on payment and prepayment patterns
  - Rental information
- **Next steps:**
  - collect data,
  - build models,
  - and test,
- **Phase III would involve a lending pilot to see the effects of lending on the basis of this information**

# What Can Policymakers Do?

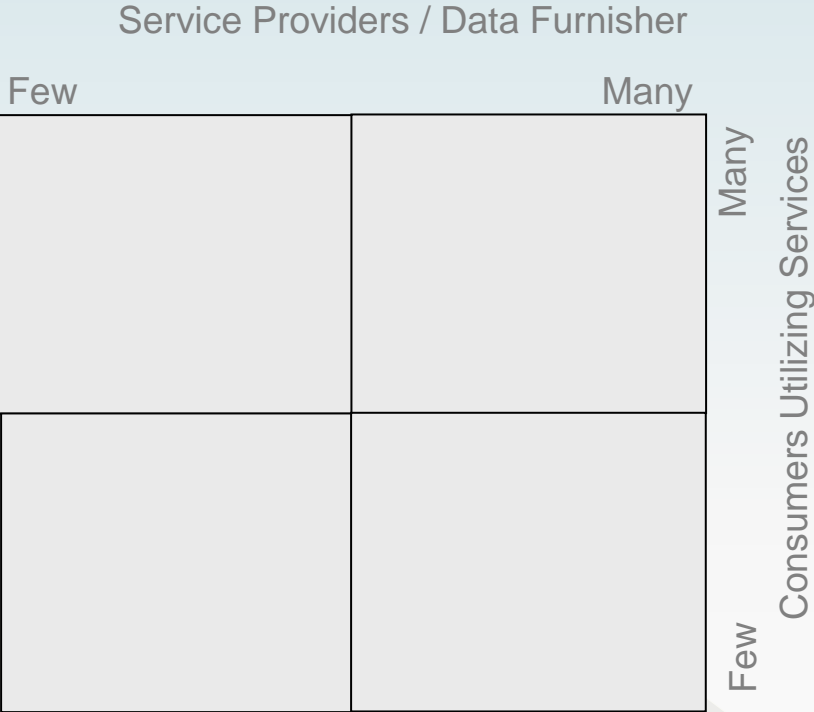
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Alternative

Data

Initiative

# Considering Alternative Data



- Traditional "credit-like" data
- Non-traditional "cash-like" data

# Identifying Policy Challenges

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FOR EACH OF THE SECTORS IDENTIFIED AS PROMISING

**Useful exercise when developing regulatory framework:**

- in addition to normal consideration in reporting (consumer protection, data quality)
- consider *all* of the hurdles in your economy

Technological barriers to reporting:

Economic barriers to reporting:

Regulatory barriers to reporting:

# PERC

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