

**PERC Testimony
Before the Oversight and Investigations Subcommittee of the
Financial Services Committee**

**By Dr. Michael A. Turner, President and Senior Scholar
Political & Economic Research Council (PERC)**

Tuesday, July 29, 2008

On the Topic:

**“What Borrowers Need to Know about Credit Scoring Models
and Credit Scores”**

Good afternoon Chairman Watt and Ranking Member Miller. Thank you both for your invitation to testify before this subcommittee on issue of great social and economic importance. My name is Michael Turner, and I am President and Senior Scholar at the Political & Economic Research Council in Chapel Hill, North Carolina. PERC is a non-profit, non-partisan policy research organization focusing upon market-based economic development in the US and globally.

Today, at your invitation and based upon guidance from your staff, I will address automated underwriting and the extensive role it has played in improving access to credit for all Americans, but particularly minorities and the poor. Then I will address how the data collected and used for credit risk assessment is evolving, and how a growing number of non-financial firms that traditionally have not provided payment information to credit bureaus have started doing so, and the extraordinarily positive effect that these developments have had to further enhance credit availability, again particularly among minorities and the poor. I will

then examine whether alternative data is accurate, and whether there are incentives of furnishers to accurately report. Finally, I will conclude with a brief discussion of the adequacy of disclosures to consumers who are purchasing their credit scores.

Co-Evolution of National Credit and Credit Reporting Markets

The growth, development, and performance of the national consumer credit marketplace is integrally linked to the national credit reporting system. Since the enactment of the Fair Credit Reporting Act in 1970, as highlighted in an earlier PERC study that was presented to Congress in 2003, the evolution of regional and national consumer credit markets in the United States have been enabled by the increased use of sophisticated credit decisioning tools that rely upon credit file data.¹ In fact, the pervasive use of automated underwriting solutions by mainstream lenders has yielded considerable social and economic benefits, including:

- Between 1970 and 2001, the overall share of families with general-purpose credit cards increased from 16 to 73 percent (Federal Reserve);
- The percentage of households in the lowest income quintile with a credit card has increased from 2 percent in 1970 to 28 percent in 2001 (Federal Reserve);

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¹ Turner, Michael A. *The Fair Credit Reporting Act: Access, Efficiency & Opportunity—The Economic Importance of Fair Credit Reauthorization*. Washington, DC: The National Chamber Foundation of the U.S. Chamber of Commerce, 2003. Publication #0320.

- During the same period, the percentage of African American households with credit cards has more than doubled, from 23.6 percent to 55.8 percent (Federal Reserve); and,
- Competition, credit scoring, and technology have reduced the consumer's price for credit card credit. Assuming constant prices for credit card credit since 1997, PERC estimated the consumer savings from increased competition in the credit card industry to be about \$30 billion per year from 1998 to 2002.²

However, the system is not perfect. Specifically, as we all know, it is often difficult for consumers to enter the credit market. To start down that path - you can't get credit because you don't already have credit, and you don't have credit because you don't have any credit history. This is the "credit catch-22" confronting many potential first time borrowers.

However, several developments over the last 10 years, pioneered by cutting edge research by PERC, the Brookings Institution's Urban Markets Initiative and others, has started to ease that transition for millions of Americans. Specifically, because of the increasing availability and acceptance of so-called "alternative data," millions of Americans are now facing a shortened path to entering the credit "mainstream."

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² Ibid. Pg. 98. Calculated from figures in Revenue figure derived from *Credit Card Management*. "A Little Help from UNCLE SAM." Published by Thomson Financial. Article shows 2001 revenues of \$92.47 billion and charge-offs of \$29.87 billion. Thus, revenues net of charge-offs are \$62.6 billion.

What is alternative data?

Traditional consumer credit files most commonly include, among other information, records of credit and payment obligations between individuals and creditors, typically financial organizations or retailers. Mortgage loans, student loans, auto loans, and credit cards are the most common examples of traditional credit data contained in a personal credit report. “Alternative” or “non-traditional” data are other payment obligations from non-financial institutions that are generally either not reported at all to credit bureaus, or are under-reported. While there are many potential data sets contained in the universe of “alternative” data, some of the more prominent ones include energy utility, telecoms, rental, remittance, and insurance payment data.³

In the Federal Trade Commission’s Report to Congress as per Section 319 of the 2003 Fair and Accurate Credit Transactions Act (FACT Act), the FTC noted a variety of different alternative data sets being tested in the market.⁴ In a follow on study to the FTC’s report, PERC’s Information Policy Institute released a report that identified energy utility and telecoms payment data as the most promising alternative data sets given the objective of increasing financial

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³ Afshar, Anna. “Use of Alternative Credit Data Offers Promise, Raises Questions,” *New England Community Developments: Emerging Issues in Community Development and Consumer Affairs*. Federal Reserve Bank of Boston: Issue 1, Third Quarter 2005.

⁴ *Report to Congress Under Sections 318 and 319 of the Fair and Accurate Credit Transactions Act of 2003*. Washington, DC: Federal Trade Commission.

inclusion in America.⁵ Energy utility and telecoms payment data are the most promising data sets, given the objective of increased financial inclusions, as they:

- (1) have broad coverage among the thin-file and no-file population so that if the data is predictive then the greatest number of thin-file and no-file persons will benefit;
- (2) they are derived from relatively concentrated industries so collection will be less of a challenge; and,
- (3) they reflect credit-like transactions in that a good or service is provided before payment is required.⁶

The report also examined technological, economic, and regulatory barriers to having these two alternative data sets reported to credit bureaus and consumer reporting agencies. While there were few technological or economic barriers of note, there were varying prohibitions in four states—CA, NJ, OH, and TX—that preclude the onward transfer of customer payment data to third parties. In addition, there exists considerable “regulatory uncertainty” in the states. Many state regulatory commissions are unwilling to grant permission to regulated utilities and telephone companies to report without direction from the statehouse—despite the absence of any statutory prohibition.⁷

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⁵ Turner, Michael A. *Giving Underserved Consumers Better Access to the Credit System: The Promise of Non-traditional Data*. New York: The Information Policy Institute at PERC. 2005. Downloaded from www.infopolicy.org/pdf/nontrad.pdf

⁶ Ibid. Pg. 14.

⁷ Ibid. Pg. 21.

Based upon its initial research, PERC hypothesized that the most effective means to help the greatest number of thin-file and no-file persons develop a credit history in order to access affordable sources of mainstream credit was to have energy utility and telecoms customer payment data fully reported to traditional credit reports, and to promote scoring models that are better able to incorporate alternative data into a credit score. Currently, 91 percent of energy utility and telecoms firms surveyed by PERC report only negative data to credit bureaus, either directly or indirectly through collections agencies. By contrast, PERC advocates that energy utility and telecoms firms report both late and timely payment information. We want people to benefit from their good payment history, not just be penalized for late payments.

PERC then proceeded to empirically test this hypothesis. This is an important point—whether or not various sets of alternative data are predictive of credit risk, credit capacity, and credit worthiness are empirical and objectively measurable questions and not merely theoretical and speculative.

The Social and Economic Value of Fully Reporting Alternative Data

As discussed above, tremendous strides have been made in making credit access both fairer and more affordable, but there are still an estimated 35 to 54 million Americans who remain outside of the credit mainstream owing to

insufficient credit information about them.⁸ Because of this information gap, millions of Americans still cannot be scored. In such cases, the default position of mainstream lenders that heavily rely on automated underwriting solutions is to reject an unscorable credit applicant as being too high of a risk to provide credit

This rejection is consequential. The two primary means by which Americans build assets and create wealth are homeownership and small business ownership. And both of these typically require access to credit, and decisions about credit are based upon the borrower's risk profile (e.g. the business owner, and not the business). In this context, the lack of sufficient data in a credit file acts as a barrier to wealth creation, opportunity, and social and economic advancement.

The good news, however, is that that world is changing, and changing rapidly. The tens of millions who might otherwise have been left outside the mainstream credit fold, because there is insufficient or no information about them in their credit files, are finding that payment data reported by non-financial organizations is thickening their files and increasing their attractiveness to lenders.

We believe that the market has responded with an emerging solution. By fully reporting so-called "alternative data"—that is, reporting timely and positive payments on gas, electric, heating oil, water, wireline and wireless telecoms,

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⁸ Burr, Sara and Virginia Carlson. "Utility Payments as Alternative Credit Data: A Reality Check." Milwaukee: Asset Builders of America, 2007. Downloaded from www.assetbuilders.org/pdf/PAID-casefor_final.pdf

cable TV, and rent—to credit bureaus and consumer reporting agencies, lenders are better able to see and understand this “thin file” population, increasing their ability to obtain competitive loans and offers.

Alternative data as a predictor of credit risk, credit capacity, and credit worthiness:

For many alternative data sets, the jury is still out on this question. For energy utility and telecoms payment data, however, rigorous empirical testing by PERC and the Urban Markets Initiative at the Brookings Institution yielded irrefutable evidence that these “alternative data” data sets are predictive of an individual’s credit risk and credit worthiness.⁹

As discussed above, much of this data is already finding its way into traditional credit reports, and it has tremendous potential. PERC and Brookings UMI examined a sample of over 8 million TransUnion credit files that contained one or more fully reported energy utility or telecoms (wireline and wireless) payment tradelines. A validation sample of a further 4 million randomly selected credit files was used for benchmarking.

The report had a strong focus on the impacts of fully reporting energy utility and telecoms payment data upon credit access for consumers outside of the credit

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⁹ Turner, Michael A. Alyssa Lee, Ann Schnare, Robin Varghese, Patrick Walker. *Give Credit Where Credit Is Due: Increasing Access to Affordable Mainstream Credit Using Alternative Data*. Washington, DC: Brookings Institution Urban Markets Initiative and, Chapel Hill: Political and Economic Research Council, December 2006.

mainstream. In addition, the report examined impacts upon scoring model performance—10 commercial scoring models were used in the simulations, including four generic scoring models (VantageScore and TransRisk), three credit card models (thin-file, new account, bankruptcy), and three mortgage scoring models that rely on credit bureau data for internal routing decisions such as “needs more information.” The key findings of the PERC/Brookings UMI report are compelling:

- ***Those with thin files have similar risk profiles as those in the mainstream when including alternative data in credit assessments.***

The evidence from the report suggests that most borrowers in the thin-file and no-file segments are not high risk in terms of lending. For example, by including fully reported utility payment data in credit files, 40% of African Americans who were previously unscorable were found to have prime credit scores.

- ***Fully reporting alternative data dramatically increases credit access for thin-file borrowers:*** : Given that credit scoring models now exist that can generate a score based upon two and sometimes one credit tradeline, fully reporting alternative data such as energy utility and telecoms payment data virtually eliminates the phenomenon of unscorability. Two-thirds of both the thin-file utility sample (60.3%) and the thin-file telecommunications sample (67.7%) become scoreable when alternative data are included in their credit files.

- **Fully reporting alternative data broadens and deepens access to affordable mainstream sources of credit.** Including energy utility data in all consumer credit files increases the acceptance rate by 10%, and including telecommunications data increases the acceptance rate by 9%, given a 3% target default rate using a VantageScore generic model.
- **Minorities, the poor, the young, and the elderly are the greatest beneficiaries of fully reported alternative data:** For instance, Hispanics saw a 22% increase in acceptance rates. The rate of increase was 21% for Blacks; 14% for Asians; 14% for those under 25 years of age or younger; 14% for those 66 years of age or older; 21% for those who earn \$20,000 or less annually. In addition, renters saw a 13% increase in their acceptance rates, and those who prefer Spanish as their primary language (a proxy measure for recent immigrants) saw a 27% increase.
- **Fully reporting energy utility and telecoms payment data can reduce bad loans.** By integrating fully reported energy utility data, a lender's default rate (percentage of outstanding loans 90 days or more past due) declines 29%, given a 60% target acceptance rate. These reductions allow lenders to make more capital available and improves their margins, capital adequacy, and provisioning requirements. Such improvements have further positive economy-wide effects.
- **More comprehensive data can improve scoring models.** In the PERC/Brookings UMI report, we assume that creditors interpret little or no data as the highest credit risk. As a result, when fully reported utility or

telecoms trade lines are added to credit files, we see a significant rise in the KS statistic—an industry gauge to measure model performance. Specifically, we see a 300% rise for a sample of thin-file consumers, and a nearly 10% rise for the general sample. In the most conservative case, in which the general sample is used but unscorable credit files are excluded from the calculations, we still find a 2% improvement in model performance with the addition of alternative data.

There is further *prima facie* evidence from the market that suggests that other alternative data sets may also be predictive of credit risk, credit capacity, and credit worthiness. Rental payment information has been used by Freddie Mac's and Fannie Mae's models as deployed by Loan Prospector and Desktop Underwriter with success. Mortgage insurers including Genworth Financial have been using rental payment data, energy utility and telephone payment data, and other alternative data for underwriting purposes for affordable housing loan insurance for almost two decades. FirstAmerican Credco's Anthem score similarly uses rental payment data to successfully assess risk.

To be sure, a growing number of mainstream lenders are adopting scoring models to account for alternative data reported directly to credit bureaus or CRAs. But this data is not yet widely reported. As a result, innovative new firms like PRBC, Link2Credit, RentBureau and VantageScore are offering solutions. Larger and established players like Experian, Fair Isaac, Lexis-Nexis, SAS, and

TransUnion are also introducing new products that are predicated upon using alternative data in credit risk assessment. On a larger level, these data, like financial data, will prove to be more predictive in some models and less so in others. Ultimately, scoring is an empirical not explanatory enterprise.

Why alternative data furnishers provide bureaus with accurate data.

On the face of it, there appears to be good reasons to be skeptical that non-traditional data providers have less of an incentive to provide accurate data compared to traditional data providers. But our understanding that credit providers have an incentive to provide accurate data because they are also users of this data obscures the complexities of the structure of incentives in the traditional and non-traditional sectors, the history of reporting, and the institutions that promote accuracy in reporting.

Energy utility and telecoms firms have both direct and indirect incentives to report accurate data to credit bureaus and consumer reporting agencies. The first direct incentive pertains to operating costs. As the rate of inaccuracy rises, it is almost certainly the case that the customer service and administrative costs for the furnisher providing the inaccurate data will also rise. Given the data furnisher obligations under the Fair Credit Reporting Act, highly inaccurate data will result in a large number of disputes, the resolution of which requires resources. Firms have a compelling market incentive to control costs, making it unlikely that any

firm with a high error rate in the payment data reported to a credit bureau would continue to report without dramatically improving the accuracy of its data.

The second direct incentive concerns improved cash flow. According to PERC's recent survey, every firm energy utility and telecoms fully reporting to a credit bureau witnessed a decline in delinquencies and charge-offs. This reduction had a positive cash-flow impact. Respondents to the forthcoming PERC survey also indicated that the perceived benefits from reporting outweighed the perceived costs. Reporting inaccurate data would fundamentally alter this cost/benefit equation, and affect firm level decisionmaking about whether to report.

And the logic behind the provision of data by these utility and other non-traditional data providers for them rests in the promise and observed fact that they can reduce charge-offs and late payments by reporting because consumers would have stronger incentives to pay on time. Relatively high levels of inaccuracy would destroy the incentive on the part of the consumer to pay on time. That is, if what gets reported on a consumer may or may not be true, and if a consumer can be sanctioned when paying on time and rewarded when paying late in unpredictable ways, consumers will have no incentive to pay on time as a result of reporting. In short, as the rate of inaccuracy grows for data furnished by a utility or telecom firm, the lower the value of reporting becomes to the furnisher.

There are also powerful indirect incentives to ensure that data reported by energy utility and telecoms to credit bureaus is accurate. Both for non-traditional and traditional data, data repositories have an incentive to monitor and promote data accuracy. Inaccuracy hurts the consumer to be sure, but it also hurts the lender. Less accurate data is less predictive. Poor data can adversely affect the performance of models and thereby portfolios. For bureaus, providing poor information is to provide a substandard product to your consumer (here the bank), and is bad for business. The industry's investments in reporting and dispute verification systems were born out of this incentive structure. That is, the repositories have a strong incentive to not accept, and to subsequently reject, poor quality data.

Alternative data: Current reporting practices and emerging trends

It should be noted that the vast majority of utilities (at least as indicated by results from PERC's forthcoming national survey of utility companies) do already report negatives to bureaus directly or indirectly through collections. 90 days past due (and sometimes 60 days past dues) reach consumer files. (30 days past dues is treated as an indeterminate, neither a good nor a bad payment, by most.) Consumers are already punished for late utility payments. Unfortunately, they often just aren't generally rewarded for timely ones. PERC, and its applied study center MAIN—the Markets and Information Nexus—are committed to changing the status quo and exhorting energy utility and telecoms companies to fully report customer payment data to consumer reporting agencies.

Concerns associated with fully reporting alternative data.

In concept, alternative data can improve access to credit for individuals who pay their utility and telephone bills on time. It can generate systemic benefits by reducing errors due to omission, thereby decreasing the probability of default to lenders. And fully reporting alternative data provides increased protection for borrowers who are not well positioned to undertake debt. However, the use of alternative data in credit risk assessment and loan underwriting is in its infancy in some ways, though it should be noted that alternative data collected manually (e.g., rental histories) have been used for a long time by some lenders and mortgage companies, notably Fannie and Freddie.

Since the public release of the PERC/Brookings UMI study, PERC has given over 50 public presentations on the report's key findings to lawmakers, regulators, industry executives, and consumer advocates both domestically and internationally. During this time, PERC staff have heard expressed several concerns about potential harms from having energy utility and telecoms payment data fully reported to credit bureaus and consumer reporting agencies. The following three primary concerns were most frequently voiced:

- New borrowers who receive credit as a result of having alternative data reported will quickly find themselves over-extended;

- Reporting alternative data will result in lower credit scores for most; and,
- Chronic late payers will be harmed as a result of having a subprime score.

Just yesterday, PERC, in conjunction with its applied study center the Markets and Information Nexus (MAIN), released an empirical study titled “You Score, You Win” at the National Press Club that specifically addresses each of these questions.¹⁰ The key findings from the report are:

- No evidence in our data that those who open new accounts after having only non-financial accounts become over-extended and witness declines in credit scores;
- No evidence in our data of deteriorations of credit score over time for those with non-financial payment data in the credit files and little or no traditional payment data;
- No empirical or theoretical evidence to support the notion that chronic late payers would be harmed by fully reporting energy utility and other payment data to credit bureaus; and,
- All evidence suggests that reporting payment data serves both as a consumer protection and as a system wide protection.

Another concern expressed is the tension that exists between an individual’s desire to maintain their good credit, on the one hand, and a requirement that they provide a disconnection notice to be eligible for state assistance grants to pay

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¹⁰ Lee, Alyssa, Michael Turner, Robin Varghese and Patrick Walker. *You Score, You Win: The Consequences of Giving Credit Where Credit is Due*. Chapel Hill: Markets and Information Nexus (MAIN) at the Political and Economic Council (PERC). July 2008.

their utility bills on the other.¹¹ No one should be forced to choose between protecting their credit score and keeping the heat on. We initially were concerned by this practice, but since we have had discussions with many utility providers in the course of conducting research for our forthcoming study of potential data furnishers, we've come to suspect that this problem is very rare as very few locales (none we could actually identify) require a turn-off notice.

To the extent that the problem does exist, states and municipalities must change the eligibility criteria. There are ample other criteria—for example, that an individual receives other forms of government assistance—that demonstrate financial need and that do not require someone to avoid paying their bills on time.

Here it should be noted that the practice of using energy utility, telecoms, and other non-financial payment data for credit risk assessment purposes is neither new, nor unique to the United States. This practice has been ongoing in several emerging markets characterized by large credit-underserved populations. PERC was able to conduct quantitative analysis using 5 million Colombian credit files containing alternative data to verify the predictive value of fully reported non-financial payment data in Colombia.¹²

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¹¹ Saunders, Margot. Testimony regarding “Helping Consumers Receive the Credit They Deserve,” before the United States House Subcommittee on Financial Institutions and Consumer Credit. 12 May 2005.

¹² Turner, Michael A. and Robin Varghese. *Economic Impact of Payment Reporting Participation in Latin America*. Chapel Hill: Center for Competitive Credit (CCC) at the Political and Economic Research Council (PERC), May 2007.

This approach to extending credit access to the financial excluded in emerging markets has attracted considerable attention from the World Bank, the International Finance Corporation (IFC), the Consultative Group to Assist the Poor (CGAP), and the Inter-American Development Bank, all of which have requested consultations with PERC on this topic. In addition, a growing number of consumer advocacy groups, lawmakers, and regulators are endorsing PERC's Alternative Data Initiative to promote the full reporting of energy utility and telecoms payment data and to have all statutory and regulatory barriers to alternative data reporting removed.

The adequacy of disclosures to consumers purchasing credit scores.

There are literally thousands of different proprietary scoring models that perform dozens of different functions ranging from simple account maintenance to predicting the likelihood that someone will respond to a firm offer of credit. Scores can be developed in-house or by third party vendors. To suggest to consumers that there is a single score or scoring model with which they should be concerned is inaccurate and misleading because there is no way for a consumer to know what score a particular lender has chosen to use. For borrowers, far more important than a single score attached to a single model, is having a clear understanding of their broad risk tier or risk band—are they subprime, non-prime, near-prime, prime, or super-prime—and what measures they can take to either preserve their good credit or improve their credit standing

if it needs improving. Knowing their band will allow consumers to best negotiate the interest rate they deserve.

On this front, there is no great mystery to be solved. In so far as consumers pay their bills on time, and keep their debt levels manageable, they should always find themselves contained within a prime score band. Other factors such as inquiries don't affect one's overall credit profile except on the margins.

In the context of the adequacy of disclosures when an individual is purchasing a credit score, those sites may lead an individual to believe that there is only a single score of consequence, or that represent one score to be superior to another score, or that misrepresent the nature and use of scores are clearly inadequate and should be modified.

Conclusion

The research conducted by PERC, the Brookings Institution's Urban Markets Initiative, and now the Markets and Information Nexus at PERC has provided irrefutable evidence of the predictiveness of energy utility and telecoms payment data of credit risk and credit worthiness. Similarly, the research has shown the tremendous measurable social and economic benefits from fully reporting these alternative data sets, while demonstrating a lack of any apparent harm from their inclusion in credit files and use in credit scoring models. The same research also demonstrates that the method by which the greatest number of thin-file and no-

file persons can be brought into the credit mainstream in order to build assets and create wealth to improve their lives and life's chances is by promoting the pervasive full reporting of energy utility and telecoms payment data to credit bureaus and consumer reporting agencies.

Congress can play a role in helping achieve this socially and economically optimal outcome. They can work to help remove statutory barriers—including the perceived prohibition on sharing positive data contained in Section 222 of the Telecommunications Act of 1996 that some telecoms firms have unfortunately interpreted as permitting the reporting of only negative payment data but not positive payment data. Congress could also pass a law permitting energy utility and telecoms companies to choose to report their customer payment data to credit bureaus and consumer reporting agencies. This would remove the most significant barrier identified by NARUC in the states—that of regulatory uncertainty. Finally, Congress could act to exhort or incentivize energy utility and telecoms companies to fully report.

Thank you Chairman Watt and Ranking Member Miller for the opportunity to share PERC's perspective on fully reporting alternative data to credit bureaus and consumer reporting agencies.