ASIAN BANKING SCHOOL

Let's Talk Digital Series #10

Alternative Data and Credit Scoring for the Unbanked

Credit score, the numerical representation of an individual's creditworthiness, didn't exist until the 1950s. Then, loan officers at banks decided - purely based on their own judgement - whether an individual qualifies for a loan or not. The approval process was biased and subjected to racial discrimination and favouritism.

With the introduction of credit scoring in 1956, the entire loan exercise was standardised. Based on data points such as the individual's payment history, amount of debt, credit age, and credit types, the credit score is calculated. This score helps lenders evaluate the candidate's credit risk and their ability to repay a loan.

Recently, credit scoring saw the introduction of alternative data as an additional category of information. This data further refines the eligibility of a candidate for loans by assessing factors outside the traditional credit scoring datasets. Incorporating alternative data into credit scoring can increase the overall accuracy in evaluating a person's financial standing.

WHAT IS ALTERNATIVE DATA IN CREDIT SCORING?

Alternative data is information collected from non-traditional sources that helps financial service providers gain a complete view of an individual's creditworthiness. While traditional credit data includes an individual's credit history and debt amount, alternative credit data includes information such as rental and utility payment history, asset ownership, alternative financial data, and shopping history.

WHY IS ALTERNATIVE DATA IMPORTANT IN CREDIT SCORING?

Alternative credit data helps lenders expand their services to "credit-invisibles"; people who were previously unqualified for loans based on the conventional credit scoring system. As traditional credit data reports uphold a person's credit history as a decisive factor for scoring, an individual without credit history will have a tough time qualifying for new credit. With alternative data, credit-invisible consumers have improved chances of obtaining a loan.

ALTERNATIVE DATA CAN INCREASE CREDIT SCORING ACCURACY

A primary concern for lenders is the risks associated with each candidate. Even if an individual has a perfect credit score, there is a chance that he or she poses a threat. For example, if an individual maintains a decent credit score but defaults on insurance payments, this person is considered high risk. Yet traditional credit data fails to assess this.

Taking advantage of alternative data, lenders can gain crucial insights into candidates even if they are eligible under conventional credit scores. Lending decisions become more precise.

For consumers who are already eligible for loans under the traditional credit scoring system, alternative data can further improve their credit scores, qualifying them for more attractive interest rates.

Consumers cannot easily influence conventional credit data. With alternative credit data, however, an individual is empowered to contribute their rental or insurance payment history to shape their credit score.

Having said that, financial institutions would do well by combining both traditional and alternative credit data sources to create more accurate credit risk models. They would then be able to better predict the risk of an individual or business defaulting on a loan.

EXAMPLES OF ALTERNATIVE DATA THAT CAN BE USED

To incorporate alternative data into credit scoring, it must be accessible for analysis. The data must also be a good predictor of credit behaviour and comply with all laws associated with consumer credit evaluation.

Data analytics company FICO uses a six-point-test to determine whether any new form of data is worthy of inclusion into the credit scoring system. The test covers the following key dimensions:

- **Regulatory Compliance**- Data must comply with all regulations associated with consumer credit evaluation.
- **Depth of Information**- The more in-depth and broader a set of data, the higher its consideration will be.
- **Accuracy**- Data collected must be accurate; otherwise, it compromises predictiveness.
- **Predictiveness**- Data should be capable of predicting a consumer's future repayment behaviour.
- **Consistency**- Data must be consistent and did not undergo significant changes.
- **Additive Value**- Data must supplement or complement the information already used in credit bureau reports.

Here are some examples of alternative data for credit scoring:

- Full-file **public records** of an individual.
- **Utility bill payment** history for services including water, electricity and gas.
- **Rental payment** history.
- **Insurance payment** history.
- Information on **alternative financial services** used such as micro loans, point-of-sale financing and title loans.
- **Financial account aggregation**, which contains combined information from different books, such as bank and investment accounts.

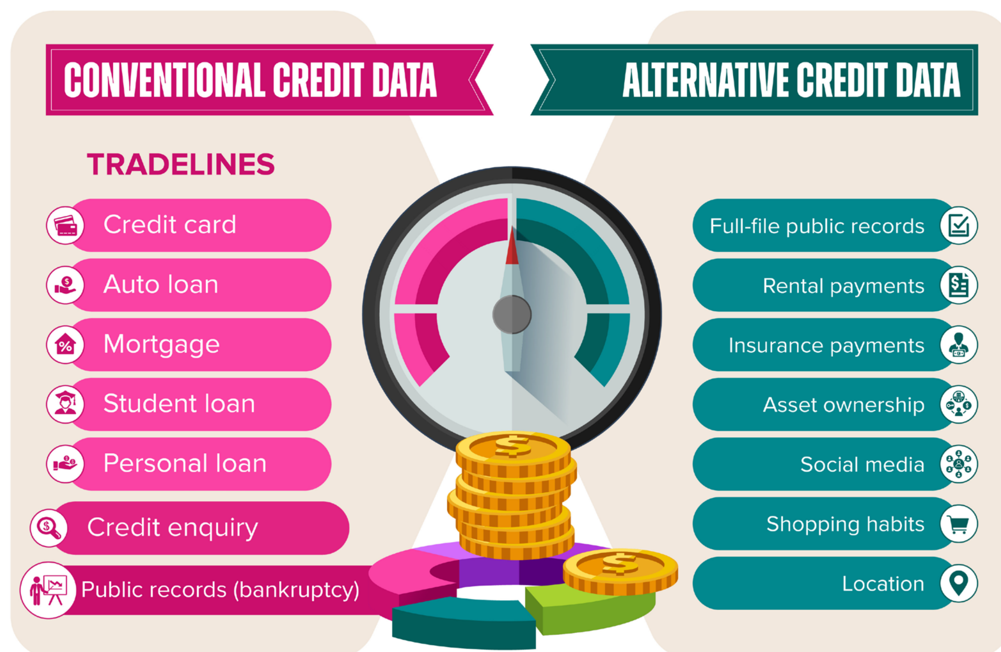
For commercial loans, a business' location, amenities and accessibility can be used as alternative credit data. Lenders can also consider social media and online information. If a retailer has excellent ratings online and social networking platforms wax lyrical about their products, then they are likely to have good ROI. Such a business should be reliable in terms of loan repayments

FINAL THOUGHTS

Employing alternative credit data to generate credit scores has remarkable benefits for both consumers and lenders.

Alternative credit data offers consumers with scant credit histories hope for obtaining loans. This data also allows people to add more value to their existing credit scores by including additional financial information not covered by traditional credit data.

For financial institutions, alternative credit data brings more accuracy to the lending system and can help them better understand the repayment capacity of an individual or business.



This article is part of the Digital Banking Learning Series, 'Let's Talk Digital', an initiative by the ABS Center for Digital Banking. It is written by industry practitioners and are aimed at educating the general public on the intricacies of digital applications in banking and other related industries, including the latest insights and trends of Digital Banking.

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