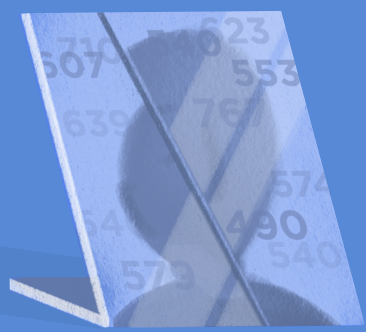
A FLAW IN THE SYSTEM

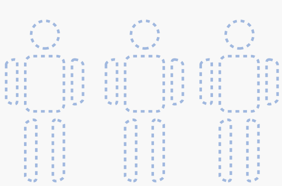
Are Credit Scores Undermining the American Dream?



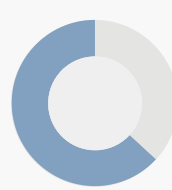
Household debt is at an all-time record in the U.S., yet millions of deserving Americans struggle to get credit on reasonable terms — if they can get it at all. Some 26 million Americans are considered "credit-invisible" by the federal Consumer Financial Protection Bureau because they have no history on file with one of the three credit bureaus. Another 19 million people don't have enough data on file to be considered scorable by the lending system. Millions more have significant errors in some stage of being corrected on their credit files.

These 45 million-plus Americans face real consequences: higher rejection rates, higher loan expenses, inferior financial products — even though many of them may, in fact, be highly creditworthy. Black and Hispanic populations are disproportionately affected. A 2015 CFPB report found that about 28% of blacks and Hispanics are either invisible or unscorable, compared to 16% of whites and Asians.

New research from the Harris Poll reveals deep disaffection by Americans for the traditional credit scoring system. Forty percent of Americans say their score has prevented them from attaining a key financial milestone: buying a home or car, taking care of their family, going on a dream vacation, or remodeling their



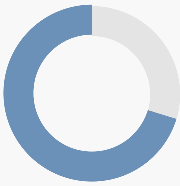
45 Million
Americans are either credit invisible or otherwise unscorable



63%
of Americans believe people with no credit history are at risk for unfair lending practices

Sources: Harris Poll; CFPB

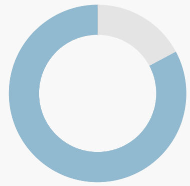
Americans Want More Ways to be Scored



70%
of Americans would be willing to give up more personal data if it resulted in a fairer credit decision

77%
of Americans think that more information sources should be used to evaluare their creditworthiness

70%
of Americans wish there was another way to prove themselves to lenders outside of the standard credit score



82%
of Americans say that more data is better when evaluating potential borrowers' credit

Sources: Harris Poll; CFPB

home. For Hispanics (57%), African-Americans (55%), and younger Americans (59%), those figures are even higher. This inability to access affordable credit leads to wider economic disparities and is cutting people off from a primary source of wealth creation.

The credit score, one of the great economic catalysts of the 20th century, has not kept up with today's consumers. The proliferation of data sources available to score people more accurately and fairly cannot be consumed easily or readily by the legacy scoring techniques. Based on a recent Harris Poll, six in ten Americans overall say they don't believe their credit score paints an accurate picture of who they are as a borrower. More than half of Americans think the credit scoring system is set up for consumers to fail.

The majority of Americans (70%) wish there was another way to prove themselves to lenders outside of the standard credit score — and it's difficult finding lenders who will look at them as something other than their credit score. Consumers want lenders to use more data and newer technology to evaluate their credit and would be willing to give up more personal data if it resulted in a fairer credit decision. This sentiment cuts across all races and ages. People want privacy, yes, but not at the expense of affordable access to financial independence.

How We Got Here

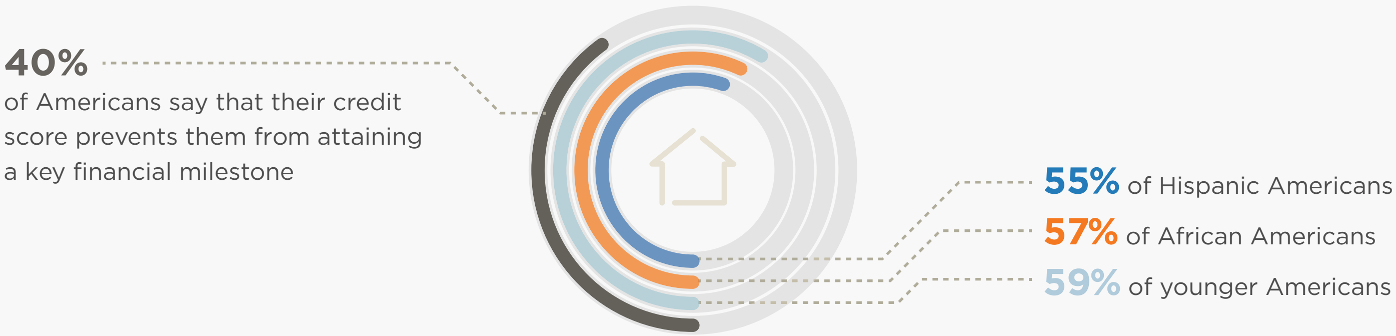
The formula-based credit score was a striking innovation when it emerged, substituting a mathematical formula for the personal judgment of a (historically white and male) banker deciding whether a fellow citizen should get a loan. The first widespread data collection efforts and scoring algorithms for business credit decisions appeared in the late 1800s. For consumers, it began in earnest in the late 1960s.

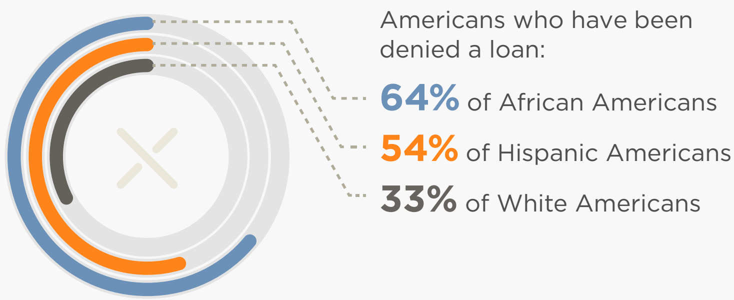
The formulas used widely today are not that dissimilar from those used 30 years ago. They include roughly the same five predictive factors and a few dozen variables. This limits a model's ability to deal with messy, missing, or erroneous data, and credit records are rife with errors. Working with such a small number of variables, when the world is swarming with all kinds of useful credit data, limits a model's ability to make better predictions. Below a score of 600, traditional scoring techniques are frequently not much better than a coin flip at predicting risk. And, because traditional credit scores are heavily reliant on income and debt-to-income ratios, they tend to embed racial disparity into overall lending decisions. In some prime credit lending models, the traditional credit score can drive up to 30% of the disparity in approval rates between whites and minorities.

Lenders are starting to switch to AI and machine learning underwriting, which processes more data through sophisticated algorithms and can handle messy or flawed data. Machine learning credit models draw conclusions from millions of interactions and use 10 to 100 times more variables than traditional techniques. Banks and lenders that have used machine learning report higher approval rates or lower default rates, sometimes both, by finding good borrowers missed by traditional techniques (and rejected bad borrowers who might have gotten approved before).

As the Harris Poll data shows, consumers want banks and lenders to use more data and new techniques to score them. The biggest players in credit data are heeding the call. Each of the three major credit bureaus (TransUnion, Experian, and Equifax) are adding new measures of financial responsibility such as utility payments and rent to consumers' profiles. This will improve scores for disciplined people, but may not help those seriously underwater. Soon consumers will be able to boost their credit score by enhancing it with checking and savings account data to prove their discipline and income.

Disparity in the American Dream





Sources: Harris Poll; Federal Reserve

What We All Can Do To Improve Accuracy and Fairness In Lending

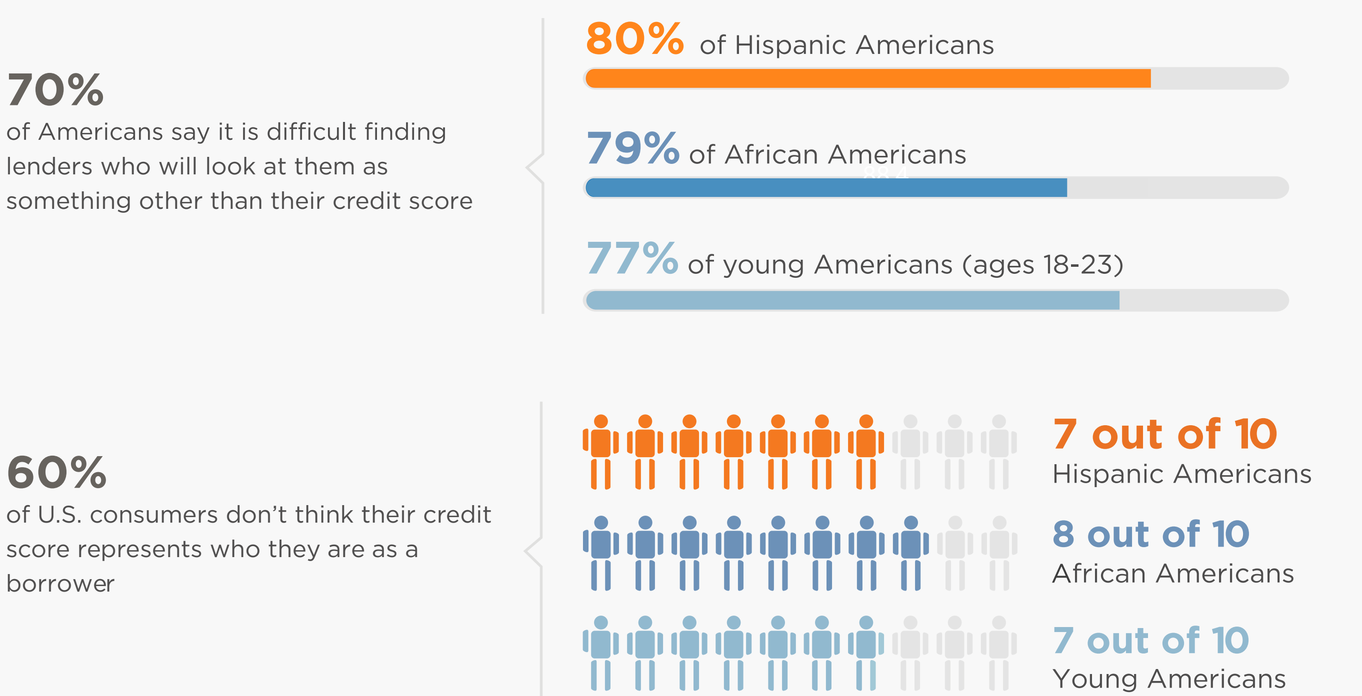
The consumer economy has changed vastly in the last 30 years. Consumers don't feel that the credit scoring system has kept up, and they want an assessment that reflects them accurately. It's going to take efforts on several fronts to improve the status quo.

What can consumers do? Check your credit report regularly for errors. Responsible borrowers struggling to get credit may want to ask their bank or lender if they offer other ways to let them prove they can manage their obligations. A good example is Experian's new Boost product, which gives consumers the ability to share utility and telephone payment information to their credit files to improve their scores. You can also ask your lender if it uses trended data, a multi-month snapshot of credit account activity, to augment its models. An analysis a few years ago found that lenders using trended data increased their mortgage lending by 4% for consumers who may have previously been ineligible.

What can banks do? Financial institutions have every incentive to want data that accurately reflects their customers. With more accurate, fair credit scores, lenders are less likely to overlook worthwhile customers just because they lack enough data or perfect data to assess their risk accurately. Newer techniques such as machine learning can let banks use more of their internal customer data, or tolerate some missing data, that traditional models cannot handle.

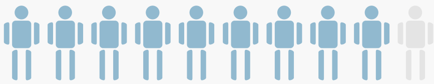
What can legislators and regulators do? Policymakers have introduced bills to reform the credit reporting and scoring system by encouraging more inclusion of rent, utility, and cellphone bill payments, as well as changing the rules so that credit files don't include only notifications of default but also good behavior

My Score Isn't Who I Am, So Why Is It Getting In My Way?



Source: Harris Poll

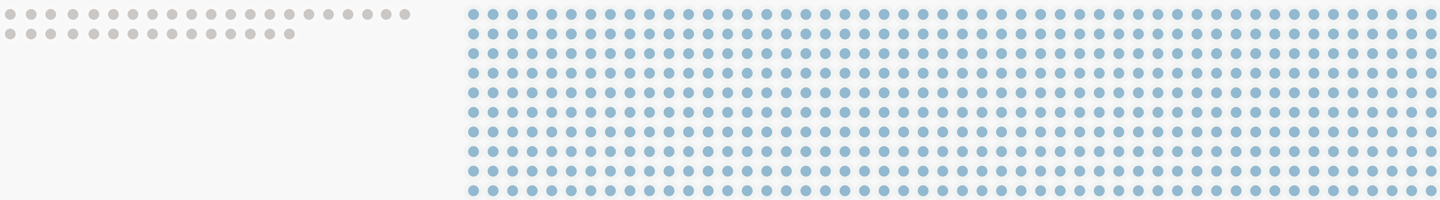
Big Data:
Consumers Believe Machine Learning Produces More Accurate Credit Scores



9 in 10
Americans say that their ideal lender would use machine learning

Traditional credit scoring model:
36 variables

Machine learning credit scoring model:
500+ variables



Sources: Harris Poll; ZestFinance

milestones such as when a consumer later pays off a defaulted loan. Other proposals encourage competition among credit scoring techniques by creating pilot programs with regulatory safe harbors or limited guarantees to lenders who extend credit using additional forms of credit variables and data.

What can technology companies do? Makers of newer machine learning scoring algorithms have to ensure that their models do not carry over the bias that exists in the current lending system. Some developers of AI software such as Microsoft, IBM, and ZestFinance have released tools that can “de-bias” models in credit and other regulated industries.

Restoring faith in the credit system will require collaboration among all stakeholders across the financial landscape. We’ll have to balance the needs for privacy and data integrity with the desire of consumers to see more data used to assess their creditworthiness. The more that we can get worthy and overlooked borrowers access to credit, the sooner we can close the wealth and opportunity gap in America.

Harris Poll Methodology:
The survey was conducted online by The Harris Poll on behalf of ZestFinance from January 17-22, 2019 among 2,015 adults ages 18 and older in the United States. Results were weighted as needed for age by gender, education, race/ethnicity, region, household income, marital status, employment, household size, and propensity to be online to bring them into line with their actual proportions in the population.

Resources:
Center for Financial Services Innovation
FinReg
National Community Reinvestment Coalition
U.S. House Committee On Financial Services’ Comprehensive Credit Reporting Reform
Experian Boost
ZestFinance