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FINANCIAL TECHNOLOGY

Agencies Should Provide Clarification on Lenders' Use of Alternative Data

Statement of Lawrance L. Evans, Jr., Managing Director, Financial Markets and Community Investment

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GAO Highlights

Highlights of GAO-19-694T, a testimony before the Task Force on Financial Technology, Committee on Financial Services, House of Representatives

Why GAO Did This Study

Fintech refers to the use of technology and innovation to provide financial products and services. Fintech lenders are nonbank firms that operate online and may use alternative data to make loan decisions. In December 2018, GAO issued a report that examined fintech lenders' use of alternative data. The three fintech lending segments that GAO reviewed are personal, small business, and student loans.

This statement—based on GAO's December 2018 report (GAO-19-111)—discusses (1) fintech lenders' use of alternative data, (2) potential benefits and risks of alternative data, and (3) the extent to which federal agencies monitor lenders' use of these data. For that report, GAO reviewed literature and agency documents; analyzed relevant federal guidance; conducted interviews with agency officials and industry stakeholders; and interviewed a sample of 11 fintech lenders (selected based on size, products offered, and other factors).

What GAO Recommends

In its December 2018 report, GAO recommended that CFPB and the federal banking regulators communicate in writing to fintech lenders and banks that partner with fintech lenders on the appropriate use of alternative data in the underwriting process. The agencies concurred and stated that they plan to take action to address GAO's recommendations.

View GAO-19-694T. For more information, contact Lawrance L. Evans, Jr., at (202) 512-8678 or evansl@gao.gov

What GAO Found

Some of the financial technology (fintech) lenders GAO interviewed said they use nontraditional data—also referred to as alternative data—to supplement the traditional data used to make credit decisions or to detect potential fraud. Federal agencies and stakeholders generally define alternative data as information not traditionally used by the national consumer reporting agencies to calculate a credit score. Examples of alternative data include utility payments, cash flow statements, education information, social media activity, and internet browser history.

Using alternative data in credit decisions presents both potential benefits and risks. According to industry stakeholders and literature GAO reviewed, potential benefits include expansion of credit availability and faster credit decisions. For example, alternative data could be used to allow fintech lenders to offer loans to borrowers whose traditional credit history may have been insufficient for banks to extend them credit. Potential risks include disparate impact and other fair lending issues and cybersecurity concerns.

The Consumer Financial Protection Bureau (CFPB) and federal banking regulators have monitored fintech lenders' use of alternative data by collecting information and developing reports on alternative data, but they have not provided lenders and banks with specific guidance on using the data in underwriting. For example, CFPB's fair lending examination procedures and the banking regulators' third-party guidance on risk do not clearly communicate the agencies' views on the appropriate use of alternative data. Nine of the 11 fintech lenders GAO interviewed said additional guidance would be helpful to clarify regulatory uncertainty, which some lenders identified as a barrier to further financial innovation in expanding access to credit. Federally regulated banks that partnered with fintech lenders also told GAO that clarification on appropriate use of alternative data would help them manage their relationships with those lenders. Clear communication from CFPB and the federal banking regulators on appropriate use of alternative data in the underwriting process would bring fintech lenders greater certainty about their compliance with fair lending and other consumer protection laws, and help federally regulated banks better manage the risks associated with partnering with fintech lenders that use these data. Additionally, this communication might allow fintech lenders and their bank partners to innovate and expand access to credit through the responsible use of alternative data.

Chairman Lynch, Ranking Member Hill, and Members of the Task Force:

Thank you for the opportunity to testify today about the use of alternative data in underwriting by financial technology (fintech) lenders. Fintech refers to the use of technology and innovation to provide financial products and services, and fintech lenders are online, nonbank lenders that leverage this technology to provide consumers and small businesses with loans. Fintech lenders typically rely on the internet to offer their loan products and use different sources of funds than traditional banks. These lenders may use traditional means to assess borrowers' creditworthiness, such as credit scores. But their credit models also may analyze large amounts of data from nontraditional sources such as bank accounts—also referred to as alternative data—to determine creditworthiness. Using alternative data in credit decisions could expand responsible access to credit, particularly for some borrowers who lack traditional credit scores because they lack or have insufficient credit history. However, potential risks remain that using alternative data could lead to disparate impacts in credit decisions or pricing and that consumers' data will not be adequately secured.

My testimony today addresses (1) fintech lenders' use of alternative data, (2) potential benefits and risks of alternative data, and (3) the extent to which federal agencies monitor lenders' use of these data. This statement is based on our December 2018 report on fintech lending.[1] For that report, we reviewed reports by industry stakeholders and federal agencies (identified through a literature search) and responses to the Consumer Financial Protection Bureau's (CFPB) request for information on alternative data.[2] We also interviewed a sample of 11 fintech lenders, which we primarily selected based on size ($1 billion or more in loans originated or facilitated since the formation of the firm) and products offered, and five fintech lending trade associations. To assess the extent to which federal regulators have monitored the use of alternative data by fintech lenders, we reviewed federal regulators' examination policies, guidance on third-party risk management, and other documents. We

[1]GAO, *Financial Technology: Agencies Should Provide Clarification on Lenders' Use of Alternative Data,* GAO-19-111 (Washington, D.C.: Dec. 19, 2018).

[2]On February 21, 2017, CFPB requested information from all interested members of the public on the use or potential use of alternative data and modeling techniques in the credit process. Through this request, CFPB sought to learn more about current and future market developments, including existing and emerging consumer benefits and risks, and how these developments could alter the marketplace and the consumer experience.

interviewed officials from CFPB, the Department of the Treasury (Treasury), Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System (Federal Reserve), Federal Trade Commission, National Credit Union Administration, Office of the Comptroller of the Currency, Securities and Exchange Commission, and the Small Business Administration. Further, we interviewed representatives from federally regulated banks and other industry stakeholders. A complete description of our scope and methodology can be found in our December 2018 report.

We conducted the work upon which this statement is based in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Fintech Lenders Use Alternative Data to Supplement Traditional Underwriting and for Other Purposes

Five of the 11 fintech lenders we interviewed for our December 2018 report said they used alternative data to supplement traditional data when making a credit decision. In addition, one fintech lender used alternative data exclusively in its underwriting decisions.[3] As defined by federal agencies and industry stakeholders, alternative data includes any information not traditionally used by the three national consumer reporting agencies when calculating a credit score.[4] Some of the information defined as alternative data is financial in nature and has characteristics similar to traditional data used by consumer reporting agencies. For example, on-time mortgage payments factor into credit scores, but on-time rental payments do not and are therefore considered alternative data. Other alternative data are nonfinancial. For example, two fintech lenders we interviewed consider the applicant's educational institution

[3]At least one lender in each of the three fintech lending segments (personal, small business, and student loans) we reviewed in GAO-19-111 stated that they use alternative data when making credit decisions.

[4]Consumer reporting agencies, also known as credit reporting companies and credit bureaus, collect information on consumers that is commonly used to determine eligibility for credit, employment, and insurance, including credit scores. Credit scores are typically calculated using information such as on-time mortgage payments, unpaid debt, number and type of loans, debt collection history, and bankruptcy. The three national consumer reporting agencies are Equifax, Experian, and TransUnion.

and degree when underwriting or pricing a loan. Other examples of alternative data include utility payments, cash flow statements, social media activity, and internet browser history.

According to the fintech lenders we interviewed that use alternative data in making underwriting decisions, the data may be obtained from the borrower, data aggregators, national databases, or other sources. For example, one lender stated that it makes credit decisions using information from multiple credit bureaus in conjunction with alternative data provided by the borrower on educational background, work history, occupation, and employer. Four lenders said that the addition of alternative data helps them better determine a potential borrower's credit risk.

Other lenders we interviewed used alternative data to detect potential fraud. For example, two of these lenders told us they verify a borrower's identity using information collected from the borrower's internet browser. One lender also discussed checking the email address provided by a borrower against a list of email addresses that a third party has identified as fraudulent.

All 11 of the fintech lenders we interviewed stated that they take steps to test their underwriting model for compliance with fair lending laws.[5] For example, two lenders said they use CFPB's report on fair lending analysis to test for potential discriminatory impacts of their models, and one used model risk management guidance from the federal banking regulators to review its model. In addition, four lenders said they use third parties, including consulting and law firms specializing in fair lending issues, to test their model for compliance with fair lending laws.

[5]Lending practices that result in unequal treatment based on race and sex, among other borrower characteristics, would be a violation of the Equal Credit Opportunity Act. See 15 U.S.C. § 1691.

Stakeholders and Literature Identified Both Benefits and Risks of Alternative Data

Industry stakeholders and literature we reviewed identified several potential benefits associated with fintech lenders' use of alternative data, including expansion of credit availability and faster credit decisions.

- **Expansion of credit.** Several industry stakeholders and literature we reviewed noted that alternative data could be used to allow fintech lenders to offer loans to borrowers whose traditional credit history may have been insufficient for banks to extend them credit. As we reported in March 2018, CFPB officials stated that using alternative data could expand responsible access to credit, particularly for some borrowers who are among the estimated 45 million people who lack traditional credit scores due to the lack of a credit history or an insufficient credit history, including borrowers with a "thin" credit file.[6]
- **Improved pricing of products.** Two industry stakeholders and literature we reviewed discussed how using alternative data may enhance the assessment of a borrower's creditworthiness. As a result, the borrower may be placed in a better credit classification and receive lower-priced credit than would be available using traditional data alone.
- **Faster credit decision.** Two industry stakeholders and literature discussed how using alternative data may allow fintech lenders to reach credit decisions more quickly than traditional banks and improve convenience for borrowers. For example, lenders can utilize alternative data sources to verify application information, including borrower identity, almost immediately.
- **Fraud prevention.** As identified by five industry stakeholders and as discussed earlier, fintech lenders can use alternative data to verify borrowers' identities, which helps prevent fraud.

Using alternative data in credit decisions also presents potential risks, including for disparate impact and relating to cybersecurity.

[6]GAO, *Financial Technology: Additional Steps by Regulators Could Better Protect Consumers and Aid Regulatory Oversight*, GAO-18-254 (Washington, D.C.: Mar. 22, 2018); and Consumer Financial Protection Bureau, *Data Point: Credit Invisibles* (Washington, D.C.: May 2015). According to this publication, there are an estimated 26 million consumers who do not have a credit history with one of the national credit reporting companies. An additional 19 million consumers were estimated to have "unscorable" credit files, which means either that their file is thin and they have insufficient credit history (9.9 million) or that they have stale files and lack any recent credit history (9.6 million).

- **Disparate impact and other fair lending issues.** Five industry stakeholders and literature we reviewed discussed the potential for certain types of alternative data to be correlated with characteristics protected by fair lending laws. Accordingly, the use of alternative data in credit decisions raises concerns that borrowers who are part of protected classes may be adversely affected by the data's use.[7] However, as previously discussed, all 11 of the fintech lenders we interviewed stated that they take steps to test their underwriting model for compliance with fair lending laws.
- **Transparency of use.** Seven industry stakeholders and literature expressed concerns that there may be a lack of transparency about what alternative data are being used and how they are used in the credit decision. Furthermore, it may be unclear whether the borrower has the ability to dispute the information used.
- **Reliability of data.** Six industry stakeholders stated that it is difficult to ensure that many forms of alternative data are accurate without validation of the reliability of the data sources.[8]
- **Performance during credit cycle.** Fintech lending, including the use of alternative data in underwriting decisions, has not been tested in an economic downturn.
- **Cybersecurity.** As identified by Treasury, recent cybersecurity breaches illustrate the potential for security risks, which may become

[7]For example, according to a Federal Reserve newsletter, it has been reported that some lenders consider whether a consumer's online social network includes people with poor credit histories, which can raise concerns about discrimination against those living in disadvantaged areas. The newsletter noted that instead of expanding access to responsible credit, the use of data correlated with race or national origin could serve to entrench or even worsen existing inequities in financial access. Federal Reserve System, *Consumer Compliance Outlook,* 2nd issue, 2017.

[8]Whereas the Fair Credit Reporting Act requires that borrowers have an opportunity to check and correct inaccuracies in credit reports, borrowers could face more challenges in checking and correcting alternative data that some fintech lenders use to make underwriting decisions because alternative data are not typically reflected in credit reports. See GAO-18-254.

a growing concern as lenders expand beyond traditional borrower data.[9]

Federal Agencies Could Provide Better Communication on the Appropriate Use of Alternative Data

In December 2018, we reported that CFPB and federal banking regulators have monitored fintech lenders' use of alternative data by collecting information and developing reports on alternative data, but they have not provided lenders and banks with specific guidance on using the data in underwriting.[10] Specifically, CFPB has developed fair lending examination procedures that discuss identifying and detecting potential fair lending violations related to credit models. However, CFPB has not issued any procedures or guidance specifically discussing what the agency considers to be appropriate use of alternative data.

Furthermore, the federal banking regulators each have provided third-party or vendor management guidance to depository institutions, which describes the risk assessment, due diligence and risk monitoring, and oversight in which banks should engage when working with third parties, including fintech lenders. However, the guidance does not specifically mention fintech lending activities or provide specific information on how bank management should monitor a third party's use of alternative data and any associated risks. The federal banking regulators also have taken some steps to supplement the existing third-party guidance with more information that may be applied to banks' relationships with fintech lenders. However, these efforts do not include clarification on the regulators' views on alternative data. For example, in July 2016, the Federal Deposit Insurance Corporation issued proposed third-party lending guidance that outlines the risks that may be associated with third-party lending, and the expectations for a risk-management program, supervisory considerations, and relevant examination procedures.[11] However, the proposed guidance does not specifically address alternative data.

[9]We discuss cybersecurity and privacy concerns generally and among fintech firms in several other reports. For example, see GAO, *Consumer Privacy: Changes to Legal Framework Needed to Address Gaps,* GAO-19-621T (Washington, D.C.: June 11, 2019); *Consumer Data Protection: Actions Needed to Strengthen Oversight of Consumer Reporting Agencies,* GAO-19-196 (Washington, D.C.: Feb. 21, 2019); *Internet Privacy: Additional Federal Authority Could Enhance Consumer Protection and Provide Flexibility,* GAO-19-52 (Washington, D.C.: Jan. 15, 2019); and GAO-18-254.

[10]GAO-19-111.

[11]Federal Deposit Insurance Corporation, *Proposed Guidance on Third-Party Lending,* Financial Institution Letters 50-2016 (Washington, D.C.: July 29, 2016).

Nine of the 11 fintech lenders we interviewed said additional guidance would be helpful to clarify regulatory uncertainty. For example, one lender stated that guidance that clarified the appropriate use of alternative data and outlined steps lenders should take to ensure compliance with fair lending laws would be helpful. Another lender said it would be helpful for federal regulators to develop additional guidance clarifying how to incorporate different types of data in lending decisions. Additionally, three fintech lenders stated that the uncertainty surrounding the use of alternative data arising from the lack of clear guidance acts as a barrier to further financial innovation and potential expansion of access to credit.

Similarly, federally regulated banks that partnered with fintech lenders told us that clarification on appropriate use of alternative data by federal regulators would help them manage their relationships with those lenders. For example, representatives of one bank said that a partner fintech lender’s use of alternative data may be attractive from an innovation and business perspective, but the bank likely would hesitate to agree to using these data due to regulatory uncertainty. Bank representatives stated that more guidance therefore would be helpful to clarify what is and is not permissible in terms of alternative data.

Thus, in our December 2018 report, we recommended that CFPB and the federal banking regulators communicate in writing to fintech lenders and banks that partner with fintech lenders on the appropriate use of alternative data in the underwriting process. The agencies concurred and stated that they plan to take action to address our recommendations. Clear, consistent communication on alternative data can help provide fintech lenders with greater assurance that they are complying with fair lending laws when using these data in their credit decisions. It also can help the banks effectively manage the risks associated with partnering with lenders that use these data. Additionally, this communication may allow fintech lenders and their bank partners to innovate and expand access to credit through the responsible use of alternative data. We will continue to monitor the agencies’ progress in addressing our recommendations.

Chairman Lynch, Ranking Member Hill, and Members of the Task Force, this concludes my prepared statement. I would be pleased to respond to any questions you may have at this time.

GAO Contact and Staff Acknowledgments

If you or your staff have any questions about this testimony, please contact Lawrance L. Evans, Jr., Managing Director, Financial Markets and Community Investment at (202) 512-8678 or evansl@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement.

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