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Here's what experts had to say about the evolution of non-QM loans and the challenges and opportunities for their growth in the near future.

SPECIAL SECTION
The 2019 COMPLIANCE Guide

Data Privacy and Unregulated Credit Scores

Experts answered a Senate Committee's questions about the impact of data brokers on financial data privacy.

The structure and practices of the data broker industry and technology companies, and the gaps that exist in federal privacy law, including the Fair Credit Reporting Act (FCRA), were the focus of discussion at a recent Senate Banking Committee hearing.

Dr. Alicia Cackley, Director of Financial Markets and Community Investment at the Government Accountability Office (GAO); and Pam Dixon, Executive Director of the World Privacy Forum answered the committee's questions at this hearing titled, "Data Brokers and the Impact on Financial Data Privacy, Credit, Insurance, Employment, and Housing."

Opening the proceedings, Sen. Mike Crapo, Chairman of the Senate Banking Committee said that more personal information was available to companies than ever before "as a result of an increasingly digital economy."

"In particular, data brokers and technology companies, including large social media platforms and search engines, play a central role in gathering vast amounts of personal information, and often without interacting with individuals, specifically in the case of data brokers," Crapo said.

Giving an example of how fintech was impacting unregulated credit scores, Cackley said, "Fintech lenders offer a variety of loans such as consumer and small business loans and operate almost exclusively online. In our 2018 report, we noted that while these lenders may still assess borrowers' creditworthiness with credit scores, they also may analyze large amounts of additional or alternative sources of data to determine creditworthiness."

Additionally, she said that the report also found some fintech firms collected more consumer data than traditional lenders. "For example, fintech lenders may have sensitive information such as consumers' educational background or utility payment information, and according to certain stakeholders, these data may contain errors that cannot be disputed by consumers under FCRA," Cackley told the committee.

Dixon offered four observations about this subject during her testimony:

1. Credit scores and predictions are being sold that are not regulated by the FCRA
2. The technology environment is facilitating more scores being used in more places in consumers' lives, and not all uses are positive
3. These scores are created without due process for consumers
4. These scores can cause consumers exceptional harm

She also offered two solutions to Congress to overcome these challenges by expanding the FCRA to regulate the "currently unregulated financial scores that affect consumers" and enacting a standards law that "will provide due process and fair standard setting in the area of privacy."

Answering a question on whether all consumer scores were covered under the FCRA so that there's a similar appeals process to resolve inaccuracies, Dixon said, "No consumer credit scores that are currently unregulated are covered under the FCRA. Unless it is a formal credit score that is articulated by the FCRA and used under an eligibility circumstance, it's not covered."

Answering a question by Sen. Crapo on how unregulated credit scores that were created for people and managed by artificial intelligence (AI) impacted consumer credit and their financial decisions, Cackley said that while these scores may not be the official credit scores taken from the credit bureaus that were regulated by FCRA, "they can be applied to decisions that companies make about the kind of products they offer to people, and the price those products are offered."

Cackley added that the products were offered "based on a score that a consumer doesn't necessarily see and can't even tell if it is correct or can't make any attempt to improve the score even if they know it exists."

Speaking about how predatory lenders tend to take advantage of these scores, Dixon, answering a question by Ranking Member Sen. Sherrod Brown, said that her organization often got calls from people who received advertisements for financial products they didn't understand "that they could have gone out in the market and affirmatively looked for the best offer."

"So these predatory marketing devices based on unregulated scores are very significant. Other significant scores are those that predict repayment of the debt," she said. "For example, the poorest of consumers are targeted the most for debt repayment by companies that use [unregulated data] like the consumer lifetime value scores that impact how well you're treated by businesses."

Similarly, she added that companies and education institutions also used a score called the "neighborhood risk scores that decide the way forward for a kid's education."

"This is a modern way of redlining because if we are going to be scored by where we live, how have we advanced, and how have all the laws that are meant to protect from such things operating if such things are still happening?" Dixon asked.

The Freedom of Fair Competition

By Tom Parrent

Fair competition in credit scoring can foster innovation and expand the population of scored consumers. However, the credit bureaus' ownership of VantageScore creates anti-competitive incentives that may ultimately harm both borrowers and lenders. With the Federal Housing Finance Agency considering comments on its Notice of Proposed Rulemaking regarding the Validation and Approval of Credit Score Models, this issue should interest anyone concerned about the safety and soundness of the $6.7 trillion conforming mortgage market.

The Status Quo

Three credit bureaus—Experian, TransUnion, and Equifax—collectively control nearly all consumer credit data available in the U.S. This balance has existed for decades and led to continuing improvements in data and services from each firm. However, in March 2006, the three bureaus jointly created VantageScore, a new entrant in the credit scoring market. While competition generally leads to better pricing and innovation, the creation of VantageScore represented a potential anti-competitive effect in the provision of both data and analytics.

FICO's flagship product, the consumer credit score, uses data from the bureaus to build its models. FICO does not sell its scores directly to lenders, instead providing a distinct algorithm to each of the bureaus, who then sell the resulting score to lenders and other customers. Thus, the bureaus ultimately control the price lenders pay to receive a FICO Score.

Anti-Competitive Effects

By forming VantageScore, the bureaus intend to jointly control both data and analytics, upsetting a beneficial balance that has existed for decades. In other words, the bureaus now have a financial stake in the outcome of competition between FICO and VantageScore and the ability to influence that competition through their control of the data and the role they play in providing FICO Scores to customers.

In fair competition, the superior product should eventually win. However, "competition" in the presence of supplier power over both input and output is not fair. The three bureaus can subtly engineer the success of VantageScore against FICO even if FICO's products are objectively superior.

While the direct result of VantageScore's displacement of FICO as the primary supplier of consumer credit scores—higher prices to end customers—is itself concerning, the secondary impacts are far more serious.

Stifled Innovation

If the bureaus are allowed to control the collection, analysis and pricing of consumer credit data, analytic innovation will suffer. If they did not jointly own VantageScore, they would have appropriate incentives to sell data to any firm with good ideas on improving consumer credit scoring. These new entrants would likely use different approaches in their attempts to create more insightful models.

However, if VantageScore were to dominate the field, these new firms could be shut out of the market, either through data access restrictions or anti-competitive pricing. They could still build models with non-bureau data but would be at an enormous disadvantage compared to VantageScore, with its unfettered access to all bureau data.

Effect on Consumers and Lenders

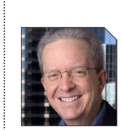
Anti-competitive control of both data and analytics is not just about one firm against another. Important systemic effects result from a lack of access and innovation, including quality control, inclusivity and pricing.

Independent modelers have incentives to uncover new insights in consumer data that expand the population of consumers accurately identified as creditworthy. FICO uses both bureau and non-bureau data to predict creditworthiness of young borrowers, consumers reentering the market, and others for whom the bureaus may have little or no information, thus adding data with potential explanatory power. By contrast, VantageScore has focused on using only bureau data but loosening the standards by which consumers are scored. VantageScore's reliance on less data, rather than more, is a direct result of their ownership structure.

Non-bureau data may be the single most promising area for credit modeling advances. Banking, transaction and real estate data can measurably increase the power of scoring models, especially for consumers who are new to credit or who have had credit problems. These consumers generally have less information in their bureau files, so new models can use additional data and advanced techniques that are well suited to relatively unstructured data.

Conforming mortgage is unique among consumer credit markets. Not only are the bureaus responsible for the pricing and sale of both credit reports and scores, the FHFA requires mortgage originators to purchase a consumer's credit report from each bureau. Without competition between the bureaus as a result of this requirement, allowing them to offer VantageScore—which they own and control—would enable them to use their market dominance to engineer the adoption of VantageScore over the FICO Score.

The FHFA's proposed rule wisely requires scoring model providers be independent of data repositories. Separation of VantageScore from the bureaus would foster healthy competition, leading to new ideas and greater insight, not only from existing players, but also from new entrants, ultimately better serving the marketplace." **M**



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