FinRegLab

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Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

January 22, 2019

Re: Request for Information on Small-Dollar Lending (RIN 3064-ZA04)

Dear Mr. Feldman,

Thank you for the opportunity to support your study of how the FDIC can encourage small-dollar lending. As you highlight in your request for information, well-designed, responsibly-provided small-dollar credit products have enormous potential to address the credit needs of the significant number of underserved consumers and communities. We at FinRegLab support the FDIC's work to foster a system that encourages responsible innovation and access to credit.

The Market Context

The agency's inquiry focuses on an essential and timely question. Transformation of technology, markets, and consumer behavior have created the preconditions for innovations that can help to improve the estimation of credit risk. Innovations of this kind fall primarily into two categories: (1) advanced analytic techniques for underwriting (*e.g.*, machine learning) and (2) new underwriting data (*e.g.*, incorporating "cash-flow data" or data from the applicant's prepaid card or deposit or mobile payments accounts that has not traditionally been included in third-party credit scores).

By using these approaches, lenders seek to reduce the number of qualified applicants denied under conventional underwriting models and to reduce the overall likelihood of default for approved applicants. These effects, if proven and considered together, promise to expand access to credit and reduce the cost of credit over large lending portfolios and the system as a whole.

These innovations hold particular promise for underserved populations. For the 30-40 million people who are considered thin- or no-file applicants for credit,[1] data and technology can enable banks and non-banks to perform more effective and efficient evaluations of credit risk.

The impact of expanded data in underwriting of small-dollar credit products is likely to be particularly important for this underserved population. Evaluation of patterns detectable in cash-flow data – such as consistent rent payments or even an individual's application of payments decisions – can provide lenders with a much more nuanced, accurate, and complete picture of a market segment that otherwise would be hard if not impossible to credit risk assess.

FinRegLab's Research on The Use of Cash-Flow Data in Consumer and Small Business Underwriting

Established in 2018, FinRegLab is an independent, nonpartisan innovation center that conducts research into, and experiments with, new technologies and uses of data to drive the financial sector toward a responsible and inclusive marketplace. Through our research and policy discourse, we facilitate collaboration across the financial ecosystem to inform public policy and market practices and to provide financial innovators with a safe space to test how novel applications of technology and data serve policy goals and meet regulatory requirements.

FinRegLab's current research project is an experiment designed to examine the effect of using cash-flow data to determine eligibility for consumer and small business loans. In particular, we are examining data from five fintech lenders (including two short-term lenders) to evaluate whether underwriting models that consider cash-flow data expand the pool of applicants approved for loans. We are analyzing loan-level data to evaluate how cash flow data may help lenders better assess the credit risk of thin-file borrowers, as compared to the effectiveness of traditional credit data in underwriting those borrowers. We are also exploring the effects of cash flow based underwriting models on particular populations which have been historically underserved.

Our empirical research is paired with deep consideration of the policy and regulatory implications of the use of cash-flow data in underwriting. In this part of our work, we formed working groups to identify and consider critical policy and regulatory matters in the following areas: the credit information ecosystem, fair and inclusive access to credit; and consumer-facing data issues. Each working group was composed of diverse stakeholders, including large financial institutions, fintech lenders, data aggregators, consumer advocates, and legal experts. Federal regulators participated in these working groups as observers.

[1] Brevoort, Kenneth P., et al. "Data Point: Credit Invisibles." Consumer Finance, Consumer Financial Protection Bureau, May 2015, files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf.

Although our research on cash-flow-based underwriting is currently underway, we believe that many of the foundational consumer protection and prudential issues raised in our work are relevant to the agency's small-dollar lending inquiry:

- **Adapting to an Evolving Credit Information Ecosystem**: The use of cash-flow data for underwriting critically depends on the transfer of various kinds of financial data to the lender. Direct sharing of data among financial institutions – without the intermediation of a third-party credit score provider – represents a significant shift away from the market structure and practice assumed by the Fair Credit Reporting Act and other applicable laws and regulations. A network of bilateral contracts between data sources and data aggregators and data aggregators and end users of data are the emerging mechanism by which firms are allocating responsibility to ensure the accuracy, security, and permissible use of the data that is shared. The gaps in ensuring critical policy objectives – including transparency and consistent application – in this system are important to consider.

- **Consumer Data Sovereignty**: Empowering consumers to understand and exercise control over the use of their financial data is an important lever in a more open and diverse financial services sector. This principle may take many forms in policy: allowing consumers to select the accounts from which a lender can access data, enabling consumers to review the data that will be shared through an aggregator and correct errors, or defining mechanisms for resolving disputes about accuracy or misuse of shared data throughout the product lifecycle. Each option raises significant consumer protection and prudential issues which need to be evaluated against a changing landscape of privacy expectations.

- **Obtaining Informed Consent**: Credit transactions, like almost all commercial agreements, require consent of the parties. Innovations that move the market away from reliance on third-party scores point to fundamentally rethinking what information an applicant needs to have about what data will be obtained and how it will be used, as well as the risks related to the transfer of data across institutions, in order to initiate a valid transaction. Further, in the context of cash-flow-based underwriting, application-timed disclosures to the consumer take on a second layer of importance. The financial institution providing data also relies on that authorization to determine the scope of the applicant's authorization and the specific purpose for which the data can be used.

- **Fair and Inclusive Access to Credit**: Use of cash-flow data in underwriting (as well as advanced analytic techniques like machine learning outside the scope of our current research) raises questions about the distributional effects on protected classes that are important to answer. In addition, understanding whether the use of such data results in protected classes being approved for loans at greater rates than with traditional underwriting models is an essential first inquiry for validating the premise that such techniques promote financial inclusion.

Conclusion

Our work is focused on how to balance these imperatives to foster a thriving financial sector that uses data and technology to improve consumers' well-being and increase financial inclusion.

Thank you for the opportunity to provide our perspective on how small-dollar credit products can be responsibly provided. We expect to publish our report on the use of cash-flow data in consumer and small business underwriting this spring, where you will find more information on our process, findings, and recommendations, and more insight into our approach to data-driven policy research.

Best regards,

[redacted]

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