LENDING IN A TIME OF DISASTER

ALTERNATIVE DATA OFFERS A TRUE, CONSISTENT AND COMPLETE PICTURE OF CREDIT RISK

BY EVAN CHRAPKO

You've worked hard to ensure you have the right tools and strategies in place when evaluating a new customer or determining the best treatment for your existing customers.

But what happens when disaster strikes, whether it's a weather-related event or a worldwide health pandemic that causes massive unemployment?

Are your data, tools and strategies able to manage through the short-term but impactful event?

How do those events get incorporated into a consumer's credit file, and do they affect a credit score?

Are there alternative methods for ensuring you are getting a complete and accurate picture of the consumer's ability to meet current and new debt obligations?

When consumers become victims of a natural disaster, there are a few ways they can handle their debt obligations. Continue to pay as agreed, work with the lender to defer payments or go into forbearance, in which they may make partial payments during a set relief period.

For consumers to take advantage of the last two options, *they* must contact their lender to initiate the process.

In turn, for it to be reflected on the consumer's credit report, the *lender* must report the new arrangement to the credit bureaus. Credit bureaus will *not* take action on their own to modify a consumer's credit report.

While there are guidelines on how a lender should do that, in practice there are wide inconsistencies in how it actually gets done.

Some lenders freeze the last reported status and only continue to report if the account is current or becomes current during the relief period.

Other lenders report all accounts that were delinquent at the time of the disaster as current and keep them there until the end of the relief period.

There are many variations of what *can* be done when reporting that information, beyond what the guidelines dictate. Some lenders even report their *entire* portfolio with these conditions even if not every consumer was impacted.

Downstream, traditional credit scores don't "penalize" consumers for having a deferment, forbearance or natural disaster classification on their account. Most "ignore" those indicators and only consider the payment status and balance information as it's reported on the credit report.

Some scores exclude an account entirely if that account negatively impacts the score – for example, a delinquent history.

All that can result in an inconsistent application of your underwriting strategies.

Let's briefly look at an example of how all this can manifest itself.

A study conducted by the Consumer Financial Protection Bureau examined the effect of Hurricane Harvey on credit reporting and credit scores. The study found reporting of disaster codes ramped up from 0 percent of all accounts prior to the hurricane's landfall to 5 percent a month later and 10 percent by the end of the second month.

After holding steady there for another month, the percent of accounts with a disaster code dropped steadily, down to 1 percent eight months after the hurricane.

At the peak, almost 40 percent of consumers in the study area had at least one account with a disaster code applied.

The application of those codes was inconsistent across account types. Mortgage lenders applied it the most, auto lenders about half as much and credit card issuers rarely. The lenders that applied the code tended to be large organizations, and about half of all lenders applied it to more than 50 percent of their portfolios.

Consumers who requested

relief carried higher balances and had twice as many delinquent accounts before the hurricane (7.5 percent of all accounts) than those who didn't request relief.

At the peak period of reporting the code, those who requested relief consumers had only 1.8 percent of their accounts reported as delinquent, though that began to climb once the codes started coming off six months later (3.6 percent).

What all that means is there were two groups: Consumers who got the disaster code and those who didn't.

Getting a true and *consistent* picture of credit risk is obviously harder when the conventional systems are not applied or invoked in a consistent way across all consumers.

Remember, the bureaus are simply repositories of a vast range of "reporting" that comes in from thousands and thousands of financial institutions.

As a result – certainly in a subset of consumers who are at the lower end of conventional scoring regimes or who are "financially stressed" in the eyes of themselves and their lenders – there can now be a false sense of reduced risk, leading to very poor lending decisions.

While the current post-pandemic situation is not exactly the same as that example, the way the credit industry will handle the outcomes of the COVID-19 event will be very similar.

Recent laws and regulations allow more relief for consumers with their lenders, but there are no additional obligations or "fine tuning" imposed on credit reporting agencies.

The biggest macroeconomic difference the COVID-19 disaster had was a degradation of employment prospects and people's ability to repay loans due to lack of income sources, as opposed to a natural disaster that causes widespread property damage/costs and physical displacement.

Given that, how can you determine who the right consumers to do business with are?

While a credit report is still a good source of information, there is a need to complete the true picture of a consumer's ability to pay, given the potential for large inconsistencies in reporting.

You need to get access to data sources with extremely timely and detailed information that can be sourced directly from consumers' mobile phones, with their consent – information such as banking deposits, payments and withdrawals.

> **WHILE A CREDIT REPORT IS STILL A GOOD SOURCE OF INFORMATION, THERE IS A NEED TO COMPLETE THE TRUE PICTURE OF A CONSUMER'S ABILITY TO PAY,** GIVEN THE POTENTIAL FOR LARGE INCONSISTENCIES IN REPORTING.

In real time, that data lets you determine incoming money and outgoing expenses in that consumer's life.

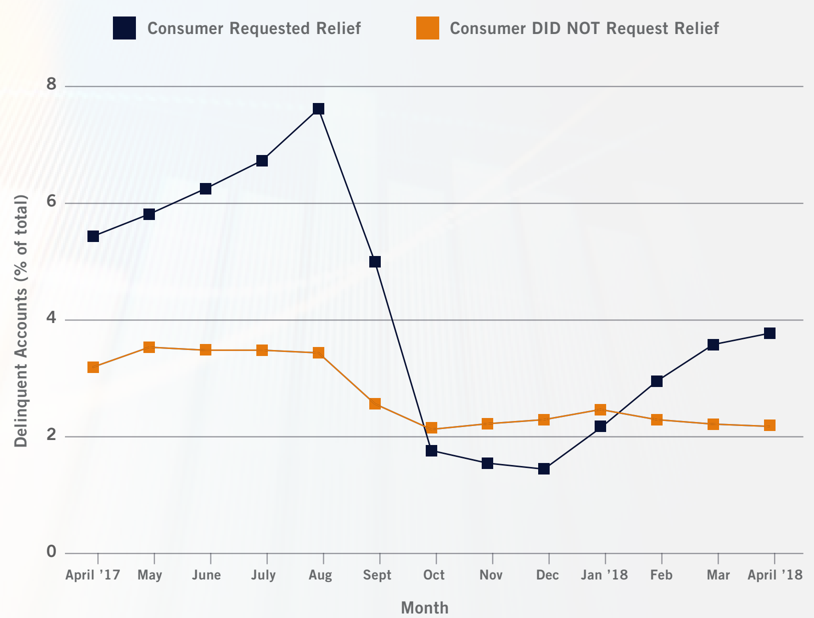
In addition, utility, TV/Internet and telecommunications payment information shows how the consumer is keeping up on services that are generally essential in modern life.

Then there is public record information, which can tip you off to a sell-off of assets like homes or vehicles, or whether a consumer's property condition shows a lack of care that could indicate financial difficulties.

Other alternative data sources, such as social media and payroll sources, drive predictions about employment changes (actual or potential) or whether the consumer is employed in an industry that has been impacted more or might rebound faster than others (such as essential workers).

The ability to leverage all those data sources *at once* in a sophisticated scoring tool, in real time, taking into account qualifiers/knockout rules and your business strategy, can ensure you are reaching the best possible lending decision – without letting the buyer walk or surf away to your competitor.

MONTHLY DELINQUENCY RATES BY GROUP, APRIL 2017 – APRIL 2018



EVAN CHRAPKO, CPA, CITP, JD IS CEO OF GLOBAL AWARD-WINNER WWW.TRUSTSCIENCE.COM INC. HE HAS SUCCESSFULLY COMMERCIALIZED MORE THAN HALF A BILLION DOLLARS OF SOFTWARE AND SAAS TECHNOLOGY. HE CAN BE REACHED AT EVAN.CHRAPKO@TRUSTSCIENCE.COM OR (403) 585-3826.