Open finance for consumer credit

How transactional data and AI can help protect lenders against the next economic shock

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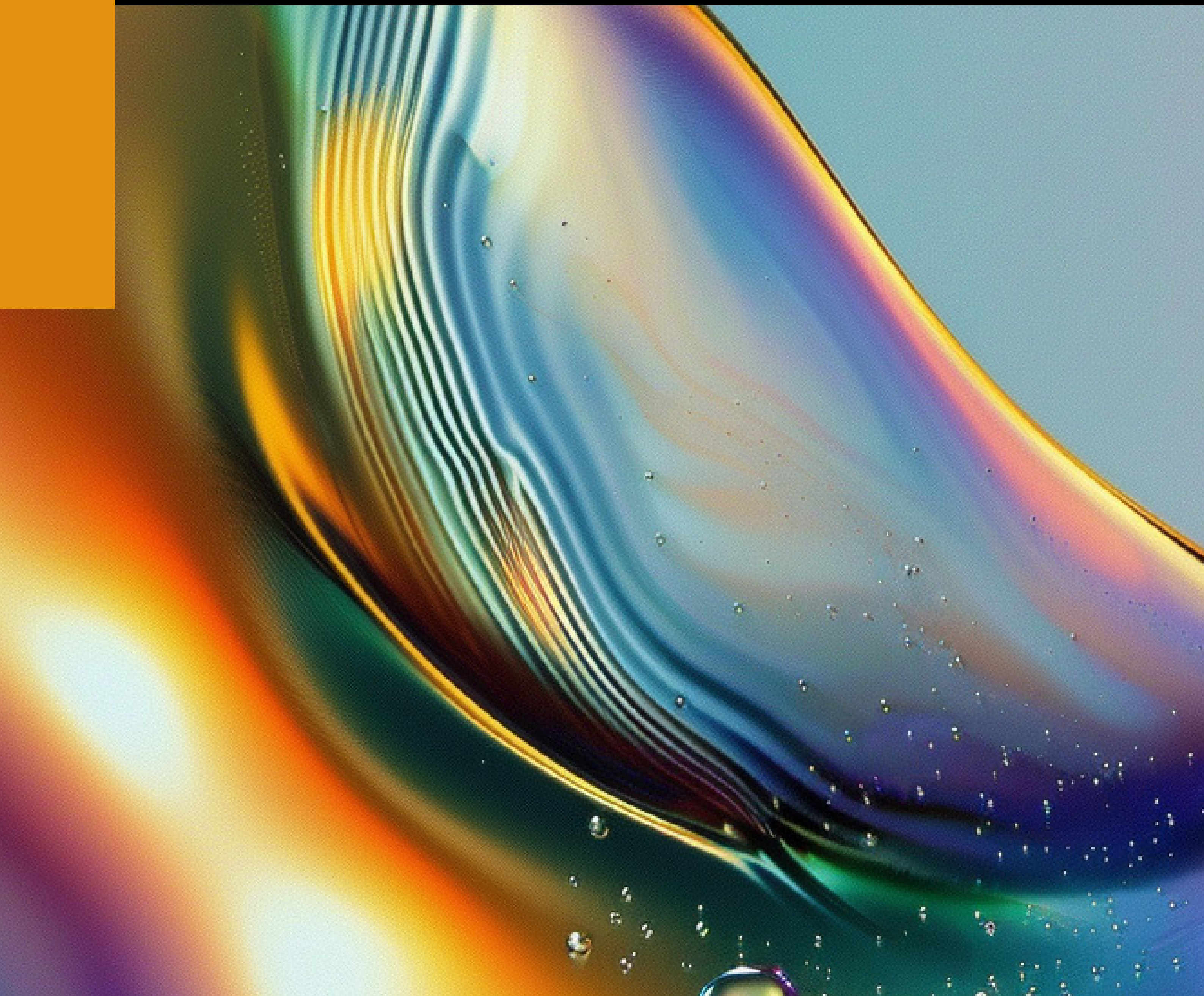

Cover image: Midjourney

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"Where I've seen lenders struggle to realize the benefit of open banking is where they've already done a hard cut-off with a bureau-based score, and then are looking for reasons to approve customers using open banking at the margin.

Naturally, once you look at transactional data, there will be additional risk factors you pick up on, which means approval rates are low. The lenders who have had the most success have brought open banking further up the funnel and adjusted their bureau cut-offs. This means you can find more of the right customers to swap in while identifying customers in your current population to swap out that might have low resilience for new credit."

Rachel Fairhurst
Credit expert

Foreword

This report explores consumer credit trends in the United States, the role of credit bureaus, and the way in which alternative data sources can help futureproof consumer credit against economic shocks.

The foundations laid by the 1033 regulation and the rise of Open Finance for new revenue opportunities and operational efficiencies are also discussed, together with the already proven role of AI and the value derived for both the lender and consumer. The report also discusses industry expert views on innovation outcomes and seeks to inform the reader of delivery best practices.

The consumer credit market

An optimistic outlook

Consumer credit lending in the US has grown year-on-year for the past three years.[1] 2024 is set to be another year where US households continue to demonstrate a thirst for credit.

However, aggregate lending growth in the consumer credit market slowed from the height of 7.6% annual growth[2] in 2022 to 2.6% in 2023. Although not at the levels of 2020 (where the consumer credit market shrunk), the 2023 slowdown in growth was largely due to high inflation caused by geopolitical instability.

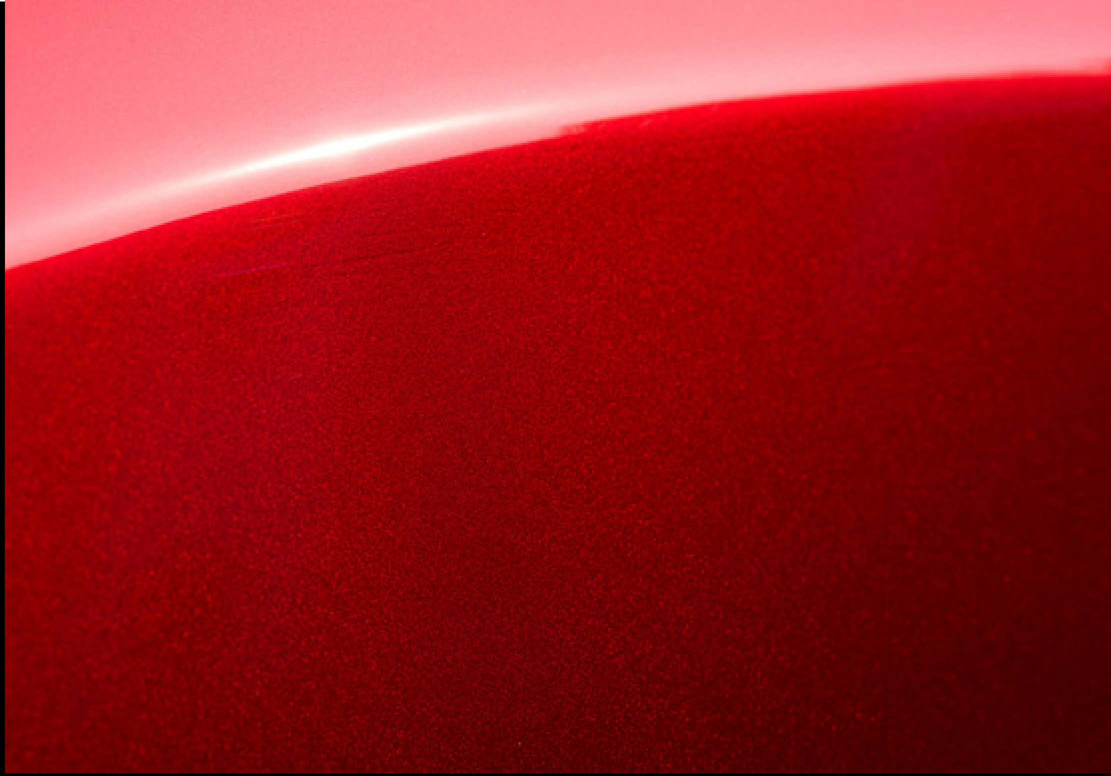
While consumers' appetite for credit didn't diminish, high interest rates provoked caution among consumer lenders.

Confidence, for the time being, is returning to lending markets. January 2024 saw the US consumer credit market grow by $19.49 billion[3], more than double the forecasted monthly growth.

1 Federal Reserve - Consumer Credit - G.19, March 2024

2 Federal Reserve - Consumer Credit - G.19, March 2024

3 Trading Economics - Consumer Credit Change



January 2024 saw the US consumer credit market grow by $19.49 billion, more than double the forecasted monthly growth.[1]

1 Trading Economics - Consumer Credit Change

The status quo

The ‘trusted’ role of credit bureau data

The financial services sector has come a long way since ‘The Great Recession’ and has weathered the storms and downturns of a global pandemic. However, the data and tools that are used for lending don’t look different from the credit bureau scores of the 1990s.

Bureau data has traditionally been seen as the gold standard; the tried-and-tested method to establish if a borrower is likely to repay their debt obligations.

While there is no doubt that bureau data provides value to lenders willing to follow the trends of the lending population, credit bureau data has faced new challenges in recent years:

- Some consumers freeze their credit reports in an attempt to prevent identity theft.
- Regulators have stepped in to ensure data quality is improved, data is safe and fair decisions are being made.
- Time lags in bureau reporting have presented lenders with limited information to make accurate creditworthiness assessments.

The regulators have a continued focus on fair lending and transparency, so lenders need to have confidence in new data sources and modeling tools.

Financial innovators are looking to capitalize on first mover advantage in the push for data and technology.

In parallel, bodies such as the Consumer Financial Protection Bureau (CFPB) are actively seeking to promote fair and transparent lending, encouraging regulatory changes and providing consumers with confidence to share their data with explicit consent.

Challenges

Stagnant data hinders the ability of lenders to offer credit and manage losses

The challenge for lenders has been that raw tradeline data, account and payment history data, is largely unchanged, but backwards-looking credit models do not keep pace with the emerging trends in consumer behavior. When COVID-19 hit, lenders reported delinquencies deteriorating by a factor of two.

Deterioration wasn’t uniform – high or low credit scores could not be trusted to predict risk reliably. The factors that indicate a borrower might not repay are not the same as previously.

Earlier credit models (new or adjusted) will not accurately reflect either those in hardship or those with stable cash flow amid improving economic conditions – the key to making lenders want to start opening up their books again.

Lenders only ask for supplementary information if the borrower wants a large loan. Credit bureaus drive the first part of the decision, and the customer’s self-reported income are the two primary factors driving the second part of the decision.

By looking at these elements in a two-dimensional way, lenders may not be able to judge the nuance of the consumer’s financial situation.

“Too often in the credit market, data works against people. So they’re matched with the wrong products or declined altogether.”

Alastair Douglas,
CEO of independent digital credit broker TotallyMoney

Regulatory change

Time to enhance credit assessments with supplementary data sources

In October 2023, the CFPB issued a proposed rule to ensure consumers can allow third parties to receive structured, consistent, and timely access to consumers' transaction data (personal financial data), which implements Section 1033 of the Dodd-Frank Act:

> "A covered person shall make available to a consumer, upon request, information in the control or possession of the covered person concerning the consumer financial product or service that the consumer obtained from such covered person, including information relating to any transaction, series of transactions, or to the account including costs, charges, and usage data." – Dodd-Frank Act

The CFPB's framework provides the platform for a homogeneous data standard for transaction data to be safely ported across the financial ecosystem. Data sharing is not a new concept, particularly in the US.

As the 'data aggregator' landscape evolves into reliable open finance platforms, there's an opportunity for lenders to embrace new data and modeling sources with confidence.

The impetus is now on financial providers to use open finance to improve consumer outcomes in line with CFPB targets.

The role of transactional data

How transactional data will impact the underwriting process

A customer's checking account transactions, or indeed credit card transactions, bring together all the elements of their financial life. The real power comes from combining all of this information to obtain a complete view of a customer's unique financial position. With this data, lenders are able to:

- Verify income
- Identify housing costs, such as rent and mortgage payments
- Identify committed ongoings, such as credit payments, utilities, and cellphone contracts
- Identify other regular payments, such as streaming services
- Note positive indicators, such as consistent regular payments, savings and investments
- Forecast creditworthiness

All of these elements can be taken as standalone features in a model or a policy-led underwriting process. Making more informed decisions using transactional data will allow US lenders to take first mover advantage as consumer confidence increases. They will be able to give customers access to credit quicker, leading to volume gains while costs remain flat, if not reduced.

Future-proofing with AI

1033 provides a reliable data source, so what's next?

Raw transactional data surfaced via APIs is an invaluable element in being able to profile the customer. The reality is that interpreting this data with manual assessments is a painstakingly long process, prone to human error, and ultimately costly.

The creditworthiness and verification process can be augmented, or automated, with the use of AI models. The key to delivering business and consumer outcomes is to invest in robust AI capabilities. Lenders need confidence in the insights surfaced by this data.

The most important foundational element of a robust assessment is accurate categorization – bucketing transactions in a way that is tailored to the lenders' underwriting parameters.

Categorization itself has been in existence for a number of years. Highly accurate categorization requires teams of data scientists to moderate and validate the accuracy of the models. Procuring from a specialist vendor requires a robust benchmarking process, an exercise where accuracy is scrutinized to a high degree. All vendors should be willing to demonstrate their capabilities by using real data sets.

The opportunity for Lenders

How can AI-led cashflow analytics provide better outcomes for the lender and the borrower?

1 Identifying new lending opportunities and customers at risk: understanding customers at portfolio level

Once the foundations of categorization are laid, lenders have the ability to understand the context of a transaction and their customers. The journey shouldn't stop here. Appraising customers at a portfolio level—the aggregate trends of customers and their financial health—should, ideally, be monitored and assessed.

This provides the opportunity to identify trends in the data set and ultimately improve underwriting parameters. The holy grail of customer profiling is being able to use the transaction data set to identify customers who may benefit from a change in their terms, be it a borrower who's likely to fall into arrears or a borrower who requires an alternative credit product.

One of Bud's loan aggregator clients reported a 20% increase in offers being served to consumers when they used open banking to connect to their transactional data.

2 Serving more customers: providing credit to 'thin file' customers

There is an opportunity to serve consumers currently struggling to obtain credit. It's often difficult for lenders to make a credit decision for thin-file applicants. For families with an income of less than $25,000 a year, only 57% have access to a credit card, compared to 98% for those with an income of $100,000 or more.[1]

Every institution has its own definition of a thin file but, generally, it refers to consumers with four or fewer credit tradelines on the bureau or less than six months of history. Most credit models aren't able to separate 'good' from 'bad' with limited information, therefore lenders can't accurately assess the borrower's risk.

The issue of being underbanked or underserved for credit, then, is a circular problem and needs a different approach. Transaction data helps lenders serve this audience with confidence.

> "In the US, the lending market is very competitive so naturally there is a lot of interest in using open banking to extend the addressable customer base as well as improve existing operations."
>
> WillowPays CEO, Ray Resnick

WillowPays CEO, Ray Resnick, goes on to estimate that the true credit-invisible audience in the US is up to 70M customers.

1 Federal reserve - Economic Well-Being of U.S Household in 2022

3 Reducing risk
Identifying income shocks

Supplementing bureau data with accurate cashflow analytics that leverage transaction data ultimately reduces the risk profile of those customers who have had, or who may be susceptible to, income shocks or financial instability.

Put simply, accurate profiling typically leads to higher rates of repayment.

Missed payment rates were reduced by 20% after the implementation of transaction data in the creditworthiness journey.

Evergreen Finance, specializing in personal loans, using Bud.

4 Reducing delinquencies
Intervening with collections journeys

For some organizations, the starting point to implement 'open banking' or transaction data into a lending journey is in the collections process.

Borrowers who struggle to make payments or have proactively asked for support during economic hardship may require support from their lender.

The proof of value to the lender here is that delinquencies can be reduced. Profiling customers accurately and tailoring payment plans that match their real-time financial position with a simple account connection flow provides an opportunity to minimize delinquencies.

What's more, borrowers in these situations often have high consent rates in the account connection flow due to the value exchange for their transactional data being very apparent.

With reduced delinquencies, the borrower's treasury has a healthier liquidity position to lend more 'good' loans in the forward-looking view.

5 Reducing cost
Removing manual intervention

Turbulent markets put cost pressures on all financial institutions. AI tooling is becoming increasingly present and is helping organizations augment processes to deliver better outcomes.

If a lender requires physical statements or even digital scans of data, 1033 provides the opportunity to re-write this process, removing friction and human input along the way.

> "Application processing time has decreased by 16% for new customers and 25% for returning customers."

Moneyboat, a Bud client using transaction data for creditworthiness, a short-term loan specialist.

Deployment

How to deploy open banking and transaction AI by leveraging the learnings of other mature open finance markets

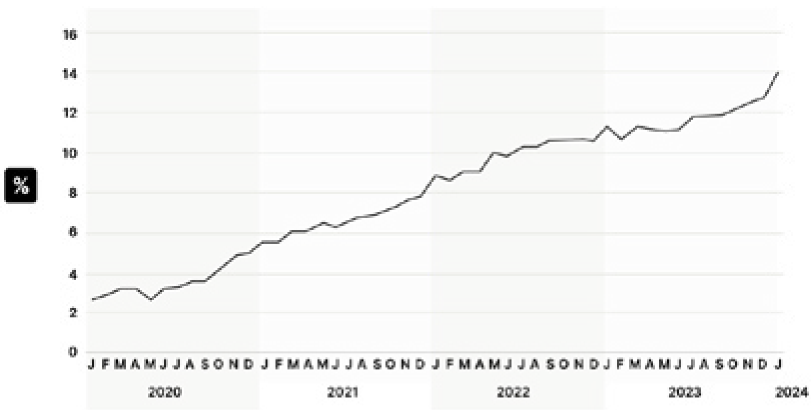
Lenders that fully embed the data consent journey into their digital experience have had the biggest successes. They create a seamless process that reduces friction and maximizes conversion. At Bud, when we made improvements to our connection flow user experience, the journey time was reduced by 20%, and conversion improved by 4.68%.

Lenders that clearly articulate the benefits and also the safety of sharing transactional data securely through the open banking process give consumers the confidence and willingness two share their data. This is known as the 'value exchange'.

User adoption of open banking in the UK is consistently growing, largely down to the value exchange for the consumer being evident in the use cases deployed and execution of those use cases. In the US, the CFPB estimates that at least 100 million consumers have authorized a third party to access their account data[1]. It is anticipated that this number will grow rapidly as 1033 brings greater confidence to consumers.

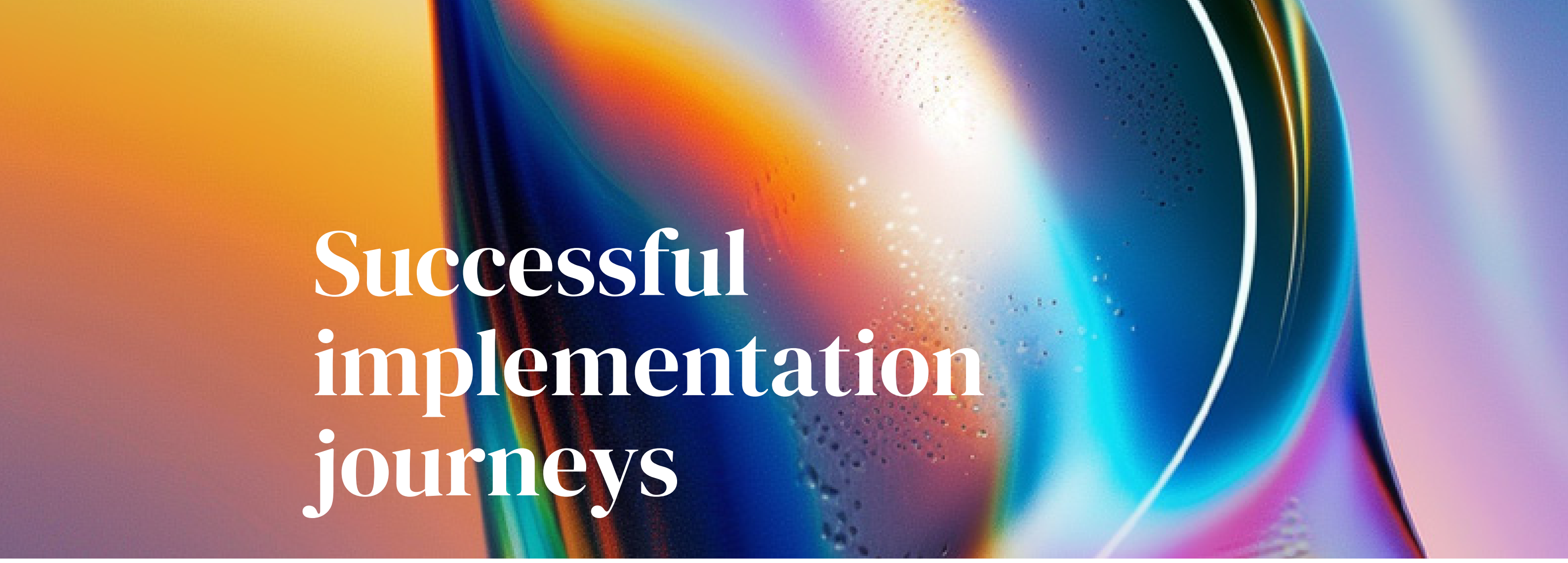
1 Congressional Research Centre - CFPB Proposes New Regulation on Consumer Data Rights

Exhibit 1: Open Banking Penetration



Graph showing open banking penetration (the proportion of digitally active banking customers using open banking) in the UK.

Source: Open Banking Ltd, Open Banking Impact Report (March 2024)



Successful implementation journeys

Any change to origination journeys and decisioning can be a costly and time-consuming process, with projects often taking many months to complete.

How do early adopters of transactional data choose a partner and de-risk this kind of project?

Ensure your chosen partner has excellent coverage across the main banks and also the long tail of smaller providers. Customers will need an alternative process if their chosen banking institution is not available and you will want to minimize the number of users going through this process.

1

Choose a connectivity vendor with a proven track record of maintaining connections and up-time.

2

Deploy a large-scale categorization engine built on US market data, specifically for lending use cases.

3

Opt for an API-based integration with a modular approach, allowing quick adjustment of the scorecard based on observed performance and changing market conditions.

4

Take a selective approach to data, never retaining more than is necessary while always being in a position to track back the decision to specific data points for transparency and explainability.

5

Summary

Economic turbulence will forever create knee-jerk reactions in the lending market but the severity of the response can be softened with innovative ways to serve and nurture borrowers.

Bureau data still has a role to play. However, transactional data will have widespread adoption in the US market and will be transformational to lenders and consumers alike. As the economy and credit lending improves, there is merit to being ahead of the curve and using this supplementary data in credit policy and in-house models.

Account connectivity has become commoditized. Partnering with an organization that specializes in the upkeep of account API connections is often the most economical and fastest way to implement the ingestion of transaction data. Forward-thinking lenders will choose data intelligence partners to implement a robust, quick-to-market solution to deliver benefits for both institutions and consumers. Interpreting data with AI models will facilitate process augmentation and innovation.

Lenders must be prepared to scale the use of transaction data. They should prove value and leverage alternative data in more borrower journeys. Lenders need to be open to driving innovation in their products and services, leveraging insight on their customers to do so. And perhaps most importantly, they should have a futureproofed vision of how transaction data and AI models will enable them to leapfrog the competition.

If you want to learn more about how transaction enrichment can help futureproof your business, speak to the team today at thisisbud.com