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FINANCIAL TECHNOLOGY

Agencies Should Provide Clarification on Lenders' Use of Alternative Data

GAO Highlights

Highlights of GAO-19-111, a report to congressional requesters

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 nontraditional (also referred to as alternative) data to make loan decisions. BCFP has supervisory authority over some fintech lenders. Fintech lenders that have entered into third-party relationships with banks may also be subject to indirect oversight by federal banking regulators. The three fintech lending segments that GAO reviewed are personal, small business, and student loans.

GAO was asked to review several fintech lending issues. This report, among other things, (1) describes recent trends in fintech lending and (2) examines fintech lenders' use of alternative data and the extent to which federal agencies monitor lenders' use of the data. GAO reviewed literature and agency documents; analyzed relevant federal guidance; conducted interviews with agency officials and industry stakeholders; and collected data from 10 fintech lenders (selected based on size, products offered, and other factors).

What GAO Recommends

GAO recommends that BCFP and the federal banking regulators communicate in writing to fintech lenders and banks that partner with fintech lenders, respectively, on the appropriate use of alternative data in the underwriting process. The agencies each stated that they plan to take action to address GAO's recommendations.

View GAO-19-111. For more information, contact Michael E. Clements at (202) 512-8678 or clementsm@gao.gov.

What GAO Found

Two recent trends in financial technology (fintech) lending—that is, consumer and small business lending by nonbank technology-based firms—include growth in loan volume and increasing partnerships between fintech lenders and banks.

- **Growth.** Data from a sample of 10 fintech lenders and literature GAO reviewed indicated that loan volume for fintech lenders has grown in recent years and is expected to continue growing. For example, personal loans provided by lenders GAO interviewed grew sevenfold from 2013 through 2017 ($2.5 billion to $17.7 billion). The fintech lenders also reported growth in their small business and student loan portfolios.
- **Bank partnerships.** Fintech lenders are partnering with banks to originate loans. Generally, loan applicants are evaluated using the fintech lenders' technology-based credit models, which incorporate the banks' underwriting criteria. The fintech lenders then purchase the loans from the banks and sell them to investors or hold them on their balance sheets.

Some of the fintech lenders GAO interviewed said they use alternative data to supplement the traditional data used to make credit decisions or to detect potential fraud. For example, lenders may check the email address provided by a borrower against a list of email addresses that a third party has identified as fraudulent. Federal agencies and stakeholders generally define alternative data as information not traditionally used by the national consumer reporting agencies in calculating a credit score. Some alternative data (such as on-time rent payments) are financial and similar to traditional data, while others are nonfinancial (such as a borrower's educational institution and degree).

Using alternative data in credit decisions presents potential benefits (such as the expansion of credit) and risks (such as the potential for disparate impact and other fair lending issues). The Bureau of Consumer Financial Protection (BCFP) 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, BCFP'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. Further, federally regulated banks that have partnered with fintech lenders told GAO that clarification on appropriate use of alternative data would help them manage their relationships with those lenders. Federal internal control standards state that agencies should externally communicate the necessary quality information to achieve their objectives. With clear communication from BCFP and the federal banking regulators on appropriate use of alternative data in the underwriting process, fintech lenders would have greater certainty about their compliance with fair lending and other consumer protection laws, and federally regulated banks may be better able to manage the risks associated with partnering with fintech lenders that use these data.