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PROSPECTING

The Prime Opportunity Among the 'Thin Files'

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By Kate Berry

Though the credit crunch obviously has made it harder for consumers to get a subprime mortgage, it is also paradoxically spurring some financial institutions to give more thought to "thin-file" consumers: those who fall outside the credit-tracking norms because they do not have bank, card, or loan accounts.

This massive market, estimated at 40 million to 50 million, has long held the interest of prepaid phone and card companies but had failed to attract much notice from mainstream banks, thrifts, and mortgage lenders.

Next year the Mortgage Bankers Association expects originations to fall to their lowest levels in seven years. By some estimates, there could be as many as 12 million prime borrowers in the underbanked market, which includes low-income minorities, recent college graduates, widows, and immigrants — all with no credit history. Some observers say these consumers could qualify for loans that can be sold to or guaranteed by Fannie Mae, Freddie Mac, or the Federal Housing Administration, the three ultimate holders of credit risk for the bulk of loans written since the subprime market collapse. "We're told that it's perfect timing right now," said Michael Nathans, the chairman and chief executive officer of **Pay Rent Build Credit Inc.**, an Annapolis, Md. alternative credit bureau. "More than ever, banks and mortgage lenders are looking for new business. Everybody was worried that the credit crunch would negatively impact the business, but a lot of lenders realize there are lots of prime borrowers out there — they just don't have a traditional credit history."

To be sure, it's far from clear that such borrowers will be net beneficiaries of an environment where lending spigots are generally tightening. "There's a lot of concern that market forces will overreact and the consumer who gets squeezed will be the thin-file consumer," said Barrett Burns, the president and chief executive of **VantageScore Solutions LLC**, a joint venture of the three major credit bureaus that produces an alternative to FICO scores.

Mr. Nathans, who founded his company in 1997, acknowledges that it had taken a decade for just a handful of banks and thrifts to create test programs aimed at the underbanked. ("Banks move slowly," he chuckled. "It's unbelievable how slow they move.")

Two large mortgage lenders, **Countrywide Financial Corp.** and **Citigroup Inc.**, are expected to launch test programs in the next few months to help underbanked consumers build their own credit files based on nontraditional payment types — rent or utility payments — that are verified by a third party, Mr. Nathans said. Those files can then be combined with traditional credit reports to help consumers qualify for a mortgage salable to the government-sponsored enterprises.

Spokesmen for both Countrywide and Citi confirmed that the programs are being planned, but they would not discuss specifics.

Mike Mondelli, the president of **L2C Inc.**, an Atlanta provider of credit scores for consumers with limited traditional credit histories, said his company — which has the backing of one of the three major credit bureaus, TransUnion LLC — is getting business from mortgage lenders that "want to identify the risky accounts up front, before they originate a loan, or once a loan is on their books."

Some companies that have long targeted the underbanked see opportunities to expand further through auto and mortgage lending. For the past five years **Banuestra Financial Corp.** of Roswell, Ga., has been one of the relatively few banking companies focusing on the underbanked. It created a proprietary system that scores 25,000 of its own customers who have no credit history. The company, which offers check-cashing, remittance, and other services to Hispanics through 12 storefronts in Atlanta, recently prequalified 1,000 customers for auto loans and home mortgages.

"We call them 'new prime,' " Luz Urrutia, Banuestra's president and chief operating officer, said in an interview. "The key is these are not subprime customers. They just don't have credit, and this is the bridge to get them to prime."

Of course, projects targeting the underbanked tend to overlap with programs that some companies have created for the Hispanic market. **Bank of America Corp.** has a highly publicized program in Los Angeles that allows illegal immigrants to open checking accounts using government-issued tax identification numbers in lieu of Social Security numbers. That program has yet to extend to mortgages or auto loans.

DETERMINING CREDIT

Thomas Brown, a vice president of financial services solutions in the risk and information analytics group of Reed Elsevier Group PLC's LexisNexis, said part of the reason alternative credit models have not been used in the mortgage market is that it has long been dominated by FICO scores, which are derived from card, auto, and mortgage payment histories.

"If there's no FICO, lenders pretty much give up," he said. "FICO created an environment of uncertainty for this market, because if there was no credit file, then you essentially had emerging credit borrowers lumped into subprime. And now that … [subprime] has such a stigma attached to it, it appears there's a big chunk of the thin-file population that is creditworthy and that has a substantial amount of asset ownership."

Fair Isaac Corp., which licenses the FICO system to the three main credit bureaus, offers a FICO Expansion Score, which uses as many as 90 nontraditional data sources to rate consumers with no credit. But that score does not use underlying data that is recognized by Fannie or Freddie.

The mortgage sector has been relatively late in adopting alternative credit scores, which were introduced more than a decade ago with the advent of prepaid phone products. Card issuers followed, and then auto lenders.

But this is a critical time for the mortgage industry. State and federal agencies, as well as nonprofit housing groups, are scrutinizing the practices of subprime lenders (many of which have gone out of business) to determine if they targeted low-income and minority borrowers unfairly for subprime loans.

A study the Fed sent to Congress in August found that credit scores vary "substantially" among racial and ethnic groups. The study, which examined the accuracy and fairness of scoring by TransUnion, Equifax Inc., and Experian Group Ltd., found that their models are not biased against any particular demographic group. But it concluded that blacks, Hispanics, and young consumers on average have lower credit scores than others, because scoring models focus on payment histories and the length of credit accounts.

Such statistics have been fodder for nonprofit groups that have long tried to get reasonably priced financial products and services to the underbanked.

The Center for Financial Services Innovation, a nonprofit Chicago affiliate of **ShoreBank Corp.**, has been beating the drum about the underbanked market for years. Last year the center said the volume of loans that could be made to "underscored" borrowers ranged from $6 billion to $45 billion a year. (By comparison, Fair Isaac estimated that lenders could originate $2.3 billion of mortgages and $750 million of auto loans by reaching just 3% of the "thin-file" population.)

The subprime crisis could have a dampening effect on new programs for the underbanked, "but how severe is an open question," Jennifer Tescher, the center's director. "Despite significant problems in the mortgage market, we haven't seen equally bad problems in the consumer credit markets. Just because you don't have a credit score doesn't mean you're a bad risk, or a good one, either. I think the most important thing we're seeing is more piloting and more testing."

Ms. Tescher said she recognizes the apparent contradiction of mortgage lenders tightening their credit and underwriting criteria while reaching out to this group of consumers.

"Thin file or no file doesn't necessarily mean subprime, and that's very exciting," she said.

OTHER USES

Some financial services companies are now using alternative credit scores for the first time to help adjustable-rate mortgage borrowers facing rate resets move into better products.

In October, **State Farm Insurance Cos.** agreed to invest $100 million in a Washington test program that could help 2,000 borrowers with little or no credit history move into 30-year fixed-rate mortgages.

The program, R-Home, uses the Anthem alternative scoring system from **First American Corp.** of Santa Ana, Calif., and requires borrowers to get credit counseling from Neighborhood Housing Services of America, a nonprofit. CitiMortgage will service the loans, which are expected to be pooled and purchased by Fannie.

Landon Taylor, the president of First American's strategic markets division, said the subprime mortgage crisis has created a vacuum for a large number of potential borrowers. The R-Home program uses the Anthem scoring model to verify borrowers' creditworthiness and combines it with an automated underwriting system that allows borrowers to get loan approvals quickly.

"It should be mandated that lenders evaluate borrowers using nontraditional alternative credit scores to get the best options," Mr. Taylor said. "Alternative credit scores may be the only mechanism available to close the minority homeownership gap."

Though mortgage lenders can use Anthem — and several other alternative scoring methods — one of the main barriers for underbanked customers is that Fannie and Freddie does not accept any alternative scores. To accept a mortgage made to a consumer without a FICO score, the GSEs typically require a 12-month payment history and at least four alternative data sources, one of which has to involve rental payments, Mr. Taylor said.

Mr. Landon said there are "a lot of people currently in loans who can't refinance out of them" as a result of the credit crunch. "And there are plenty of first-time homebuyers who have nontraditional credit."

In another response to the subprime meltdown, some lenders are using alternative scoring products for additional risk assessment and account management.

Shawn Moore, a product management director for Fair Isaac's FICO Expansion Score, said lenders are increasingly interested in reassessing the risk of their mortgage portfolios. Often they are using an alternative scoring product to determine if they need to take action on certain borrowers, such as proactive credit counseling or loss mitigation, she said.

"This kind of account management is done extensively in the credit card industry, and mortgage lenders are doing it more now, because it helps them understand if they might be exposed to additional risk," she said.

Dave Petrini, the chief financial officer of **AccountNow Inc.**, a San Ramon, Calif., marketer of prepaid debit cards, said one of the consequences of the subprime mortgage meltdown is that those consumers who have lost their homes are becoming potential customers for companies like his, because they cannot get traditional products like credit cards.

"What we're seeing with higher foreclosures is that those consumers who had no equity in their homes are falling squarely back into our market," he said.

EARLY ADOPTERS

Some mortgage lenders first took notice of alternative scoring models in 2003 when the Fed and the New York State Banking Department singled out Pay Rent Build Credit from among the various alternative credit models and bureaus as "a community development service." That meant that banks and thrifts that used the bureau's model would qualify for credit under the Community Redevelopment Act for making loans and bringing investments to underserved communities.

Still, Mr. Nathans said that the lack of a secondary market for loans made with alternative scores is hampering adoption. "Many of the scores really haven't been proven yet."

Mr. Mondelli at L2C said Fannie and Freddie "are key to the market, because if they don't get on board, then mortgage lenders won't underwrite these loans, because they don't want to hold them in their own portfolios."

The GSEs are expected to begin testing alternative models within the next six to nine months, he said. "They're rolling out a lot of programs to combat what's going on in the subprime space."

Still, because of the problems in the mortgage market, getting companies to give priority for alternative scoring models has been a challenge, Mr. Mondelli said.

"There's lots of interest in testing but a bit of challenge to get lenders to implement these scoring methods," he said. "The savvy, diversified lenders see there is a vacuum created with lots of people that can't get loans right now."

Brad German, a spokesman for Freddie, said the GSE still requires a "traditional" credit score for loans it guarantees, though it is analyzing alternatives.

Attempts to reach Fannie were unsuccessful.

"Right now the market is in shell shock, but when it all washes out, lenders will come back in and begin testing these products," Mr. Mondelli said.

Mr. Nathans said his bureau is close to an agreement with Fair Isaac to create a cobranded version of the FICO Expansion Score that takes into account his company's database on bill payments. (Banks and credit unions send their bill-payment data electronically to the database, and a third party then verifies it manually.)

Fair Isaac would not discuss the agreement. Mr. Nathans said that for years the mortgage industry was so satisfied with loan volume that it had no need to reach out to the underbanked. Now "they need production volume, and they also need to show that they're not putting people who pay their bills on time into subprime loans."

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