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Startups assess loans without using FICO scores

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Monday, January 23, 2012

For more than 40 years, banks have counted on FICO scores to determine the creditworthiness of American consumers. Now a handful of California entrepreneurs say it's time for a smarter way to size up borrowers.

San Francisco startups BillFloat and Lending Club, along with Los Angeles' ZestCash, are hiring computer programmers to write software that can better identify candidates for loans - including people with low credit scores. The companies, backed by venture money, also plan to provide lower fees and interest rates than banks.

"There hasn't been a lot of innovation in the space for a while, and it's time for that to happen," said Rebecca Lynn, a partner at Menlo Park's Morgenthaler Ventures, which is backing Lending Club. "We're looking at companies that are doing new underwriting and using new underwriting methods."

The idea is to use technology to root out potential fraud and give more finely tuned assessments than FICO, named for Fair Isaac Corp. Rather than just looking at black marks on a person's credit score, new software can analyze how someone uses money on a daily basis, giving more insight into whether they will pay back the loan. Like other Internet companies, the new crop of lenders will keep operating costs down by delivering loan applications and services over the Web - instead of having to maintain physical branches.

FICO, founded in 1956, is used by 90 of the largest 100 U.S. financial institutions, according to its website. FICO takes into account a potential borrower's debt outstanding, payment habits and length of credit history and provides a score that ranges from 300 to 850. The median last year was 711, and lenders vary on what they consider a good credit score.

People like Holly Dickerson are benefiting from newer approaches to lending. Dickerson, a youth counselor in St. Charles, Mo., needed a loan last year to have her son's braces removed, pay her father back for a loan, and afford rent at two apartments after a divorce.

Below bank's credit rating

Dickerson's FICO score was too low to qualify for a loan from her local credit union, and she didn't want to use a payday lender. With ZestCash, the 49-year-old was able to fill out an application online and was shortly approved for a $400 loan, due in installments over six months.

"When I went to the bank, they said I needed a credit rating of 600, and I was below that," she said. "The installment program makes it so much easier to pay off the loan as opposed to having this big chunk."

The startups are each going after a different piece of the lending market. ZestCash is taking on payday lenders by providing loans of $300 to $800 that can get repaid in installments over three to eight months. BillFloat provides smaller loans - up to $225 - to pay specific services, such as electricity or mobile-phone bills. Lending Club focuses on prime borrowers and offers up to $35,000 for loans that let customers consolidate debt, remodel their homes and pay medical expenses.

Douglas Merrill, Google's former chief information officer and the founder of ZestCash, said FICO scores ignore much of the digital data that's been created by online activity and transactions. He's almost doubled his staff to 75 since July, hiring mostly mathematicians and programmers to come up with an algorithm that produces more reliable scores.

Merrill started ZestCash in 2009 with Shawn Budde, a former senior vice president at Capital One Financial Corp. By combining homegrown Web-crawling tools with underwriting expertise, ZestCash uses more than 1,000 variables to determine a score and issue loans that the company says are about half the price of payday loans. Customers typically use the money to pay rent, catch up on health bills and get their cars fixed.

Prospects for growth

It's a big potential market. U.S. payday lenders in the United States will issue $40 billion in loans in 2016, up from $33 billion last year, according to a report this month from JMP Securities LLC.

ZestCash said that it raised $73 million in equity and debt financing from investors such as Matrix Partners and Victory Park Capital. About two-thirds of the capital will be used to finance loans. The service is available in four states, and the company is working with regulators to expand into additional states this year.

BillFloat has raised $16 million from investors, including Venrock Associates and eBay's PayPal unit. It's now in talks with investors for another funding round, said CEO Ryan Gilbert.

The startup is teaming up with banks, utility companies and cable providers to provide loans specifically to pay bills. When customers apply for a loan, they agree to let the company look into their checking account to analyze money flow. The company's software looks at bill payment history, plots debits and credits, and determines the likelihood of a timely repayment.

"There's a huge demand for alternative credit," Gilbert said. Banks are "dependent on FICO and risk models that are trying to be one size fits all."

FICO of Minneapolis says its scores aren't meant to measure a person's ability to pay.

"The vast majority of lenders use FICO scores to help them assess the likelihood that a consumer will default on a credit obligation within the next 24 months," said Craig Watts, the company's public affairs director. FICO also is working with CoreLogic to develop a new type of credit-risk score that relies on a broader range of data.

Surveying checking activity

BillFloat charges a fee of $5 to $15 to process the bill, plus 3 percent monthly interest, and it requires that the borrower pay BillFloat back within 30 days. Banks may see enough value in his technology to eventually license it, Gilbert said.

Lending Club, co-founded by former Oracle executive Renaud Laplanche, also peers into applicants' checking accounts. Much of the company's technology concentrates on fraud detection, developed with the help of Chaomei Chen, the former chief risk officer at JPMorgan Chase's credit card unit.

Lending Club, which began issuing loans in 2007, focuses on lenders with better credit and offers interest rates that are less than half the average credit-card rate. In August, the company raised $25 million from investors, including Union Square Ventures.

"There are just so many things that aren't covered by the credit score," said Ian Cohen, CEO of San Francisco's Credit.com, who has worked with Lending Club. "If I can engage the user, I can learn if they are bad risks right now. I will also see positive things that the bank might not see."

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This article appeared on page **D - 1** of the San Francisco Chronicle