

Alternative Credit Scoring: What It Is, How It Works and Its Importance

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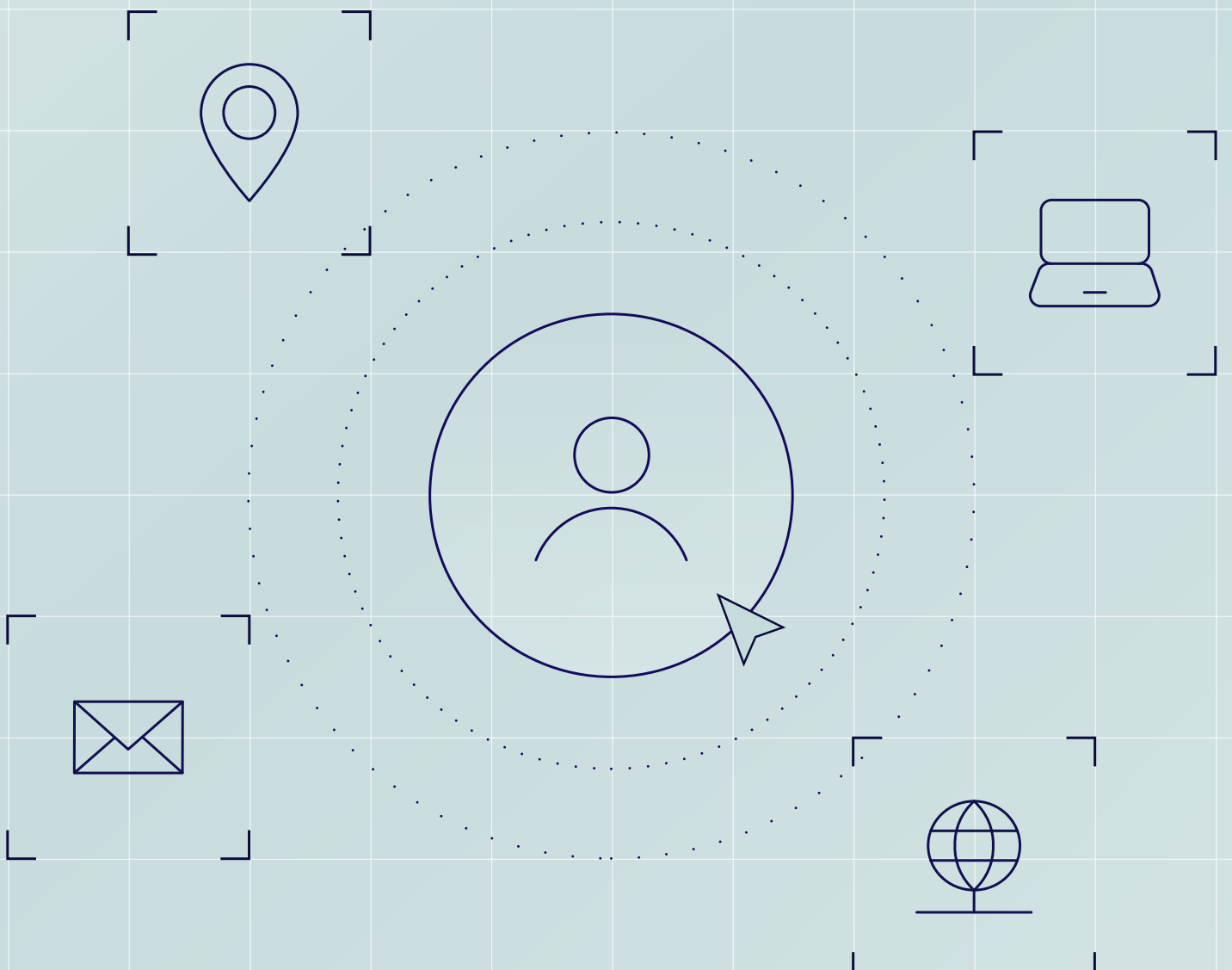


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Introduction

Microfinance is projected to reach \$496.90 billion by 2030, up from \$178.84 billion in 2020. Much of its growth is driven by a shift from traditional lending to more agile approaches that diverge from conventional lending practices, including significantly lower operational costs and those that rely on innovative technologies to support financial inclusion in emerging economies¹.

The commercial lending market is growing at a CAGR of 13.1% in business loans and is expected to be valued at \$29.4 trillion by 2030². Catalysts include flexible long-term lending options, increased digital lending collaborations and innovative technology advancements.

In the consumer lending arena, the total balance of personal loans in the US increased from \$143 to \$163 billion in 2023, with consumer loans in Europe reaching an all-time high of \$840 million in February 2024³. With high interest rates straining affordability, the rising popularity of buy now, pay later (BNPL) services and alternative lending models provides consumers with more flexible financing options.

But what does this current environment mean for lenders?

Lenders are now navigating a complex landscape characterized by rapid technological advancements, evolving consumer preferences and increasing regulatory scrutiny. To stay competitive, they must adopt agile, tech-driven strategies that enhance operational efficiency and customer experience – including integrating AI and machine learning for credit assessment, automating lending processes to reduce costs and expanding offerings with personalized lending products to meet growing and diverse consumer needs.

In the digital world, most lenders already possess a tremendous amount of information that can be leveraged to evaluate new customers to grow market share while lowering default ratios, even without access to traditional credit histories.

Projected growth of online lending industries



¹ [Microfinance Market Size, Share, Competitive Landscape and Trend Analysis Report by Provider and End User](#)

² [Commercial Lending market Size, Share, Competitive Landscape and Trend Analysis Report by Type, Enterprise Size and Provider](#)

³ [Euro Area Consumer Credit](#)

1. Digital Lending Risk

Digital lending risk, which refers to the potential threats and uncertainties associated with the process of providing loans through online platforms and digital channels, spans various aspects, including:

- **Credit Risk** is the risk of borrowers defaulting on their loans due to inadequate credit assessment processes. Digital lending platforms may face challenges in accurately evaluating the creditworthiness of borrowers from unbanked or underbanked populations.
- **Operational Risk** is the risk of losses from poor internal processes, systems or human errors. This can also include risks related to technology infrastructure, cybersecurity threats, system downtimes and data breaches that can disrupt lending operations or compromise sensitive borrower information.
- **Fraud Risk** is the risk of fraudulent activities in the digital lending realm, such as identity theft (opening a new account with stolen credentials without any intention of repaying the debt), synthetic identity fraud (combining the personal information of real people into new IDs, then taking out large loans and disappearing) and account takeover (phishing for current account holder information and exploiting it to borrow money). Digital lending platforms are particularly vulnerable to sophisticated fraud schemes that exploit weaknesses in online verification and authentication processes.
- **Regulatory and Compliance Risk** is non-compliance with laws, regulations and industry standards. Digital lenders must navigate evolving rules that vary by region and may include requirements for data protection, consumer privacy, anti-money laundering (AML) and fair lending practices.
- **Market Risk** is the risk of adverse changes in market conditions, such as economic downturns, fluctuations in interest rates and changes in borrower behavior. These factors can impact borrowers' repayment capacities and the overall performance of the loan portfolio.

- **Reputation Risk** is the risk of damage to the lender's reputation due to negative publicity, customer dissatisfaction or regulatory sanctions. In the digital age, negative reviews and social media backlash can quickly erode trust and credibility, affecting a lender's ability to attract and retain customers.

To manage these risks effectively, digital lenders must implement robust risk management frameworks, employ advanced analytics and fraud detection tools and continuously monitor and improve their technological infrastructure.

Hear from our customers

With SEON's help, global P2P Lending Platform, [Robocash](#), reduced the amount of manual reviews, segmented customers by risk level and blocked potential defaulting customers - without adding any customer friction.

"We are proud to provide loans to unbanked and underbanked markets, however, it usually means extra vigilance and costly manual reviews as we cannot always access valid credit information. SEON is now part of our comprehensive anti-fraud solution. And according to the results of the implementation, the number of fraud cases has significantly decreased.

The new data expands our data model and helps us distinguish between ordinary customers by risk level. We can also highlight the fraud segment, all in the most cost-effective way for the company."

Alexey Pogrebnyak, Chief Risk Officer, Robocash



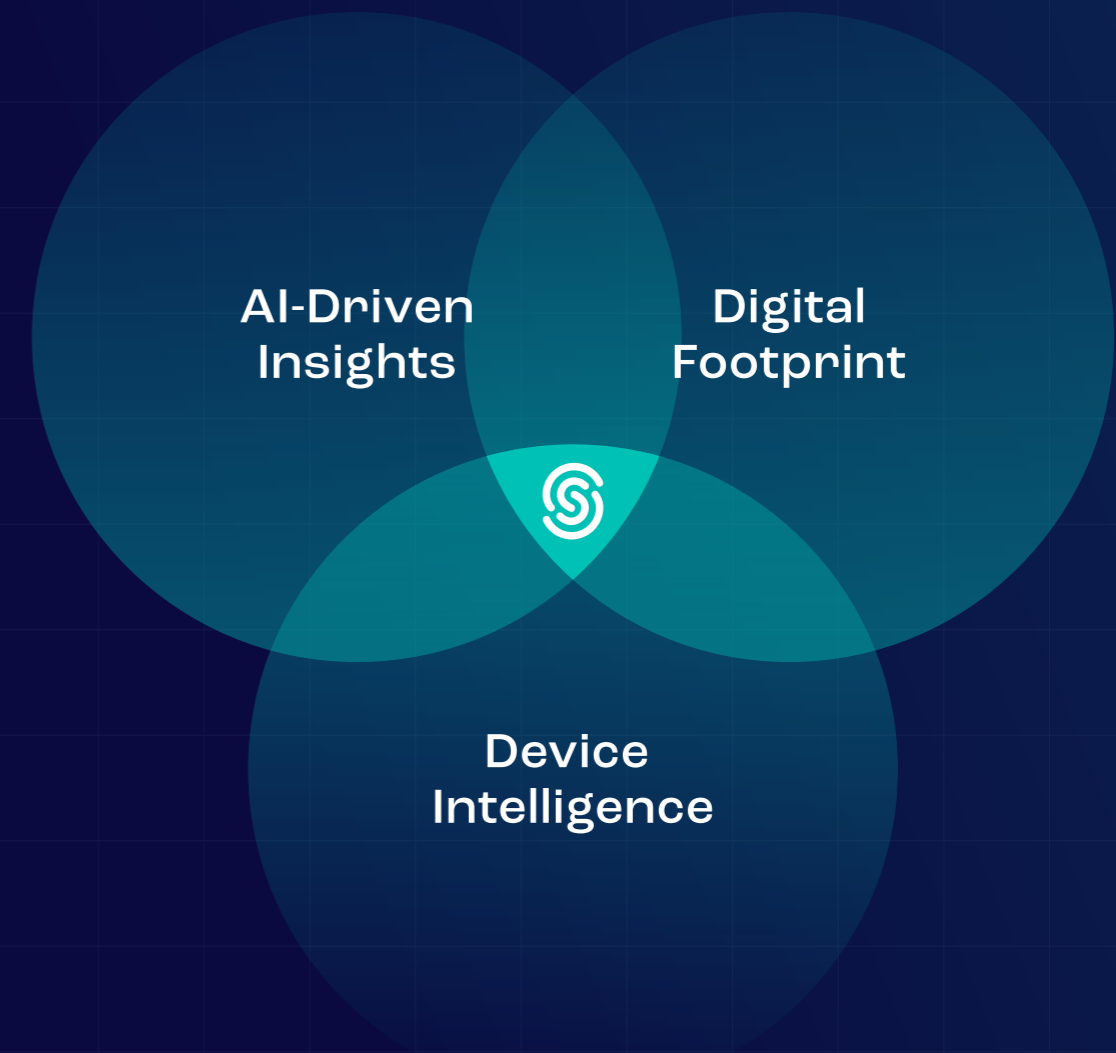
1.1. How fraudsters pass most background checks

Fraudsters are adept at manipulating the systems designed to catch them. They often test their stolen or synthetic identities through [online background check systems](#) before using them in real-world scenarios. By understanding the credit score and other background information of the person they are impersonating, they can apply for loans with a higher success rate than average borrowers. In some cases, fraudsters even obtain the assessment criteria from background check companies, allowing them to manufacture user profiles that meet them.

1.2. Modern Tools & Techniques for Enhanced Background Checks

To effectively spot fraudulent candidates, lenders can leverage modern tools and techniques, including Open Source Intelligence (OSINT), which utilizes accessible online databases to gather extensive information about candidates. Another popular tool is reverse email address lookup, which can profile individuals based on their email addresses and enable the collection of social media profiles, looking for suspicious email domains. IP address lookup identifies candidates connecting from suspicious configurations or locations and social media lookup tools can vet a candidate's trustworthiness through their social media presence.

SEON's suite of anti-fraud tools provides deeper insights into online identities, enabling lenders to profile individuals quickly and flag suspicious data to avoid lending to untrustworthy entities or individuals. Combining [digital footprint analysis](#), [device intelligence](#) and [AI-driven rules engine](#) to combat emerging fraud schemes, including those prevalent in the online lending industry.



2. What is Credit Scoring?

Credit scoring is the process by which financial institutions, primarily lenders, assess the creditworthiness of an individual or business. This evaluation typically occurs during the loan application phase for various financial products, such as mortgages, personal loans and microfinancing. Traditionally, credit scoring is based on credit reports that reflect the applicant's credit history, helping lenders mitigate the risk of bad debt.

2.1. How is Credit Scoring Calculated?

Credit scoring is performed by credit bureaus, which seek to answer the question: "How likely is it that the debtor will repay the loan?" Historically, the data used to determine this likelihood includes:

- **Proof of Income Statements** – Verification of the applicant's income.
- **Proof of Payment of Phone or Utility Bills** – Evidence of timely bill payments.
- **Debt Trail** – A record of existing debts and repayment history.
- **Credit Card Usage** – Patterns and history of credit card usage.

In the US, credit scores are commonly calculated using the FICO model, which ranges from 0 to 999. In the UK, credit reports are compiled by Experian, Equifax or TransUnion, and the credit score is calculated on a scale between 0 to 999 or 0 to 850. Regardless of the specific scale, a lower score always indicates a higher risk of default.

3. What is Alternative Credit Scoring?

Alternative credit scoring evaluates creditworthiness by incorporating data beyond traditional credit reports and scores. It addresses the limitations of conventional credit scoring methods, which often exclude individuals with insufficient or nonexistent credit histories. Using alternative data sources, this form of credit scoring provides a more inclusive and accurate assessment of an individual's or business's financial reliability. This approach can particularly benefit those underserved by traditional economic systems, including young adults, immigrants, individuals in cash-based economies and others without a substantial credit history.

3.1. How Does Alternative Credit Scoring Work?

Alternative credit scoring often incorporates social profiling – which analyzes an individual's online behaviors and social media activities to gain insights into their financial reliability. For example, engagement with platforms like LinkedIn can indicate steady employment, while regular interactions on Instagram, Twitter or Facebook can reflect stability and consistency.

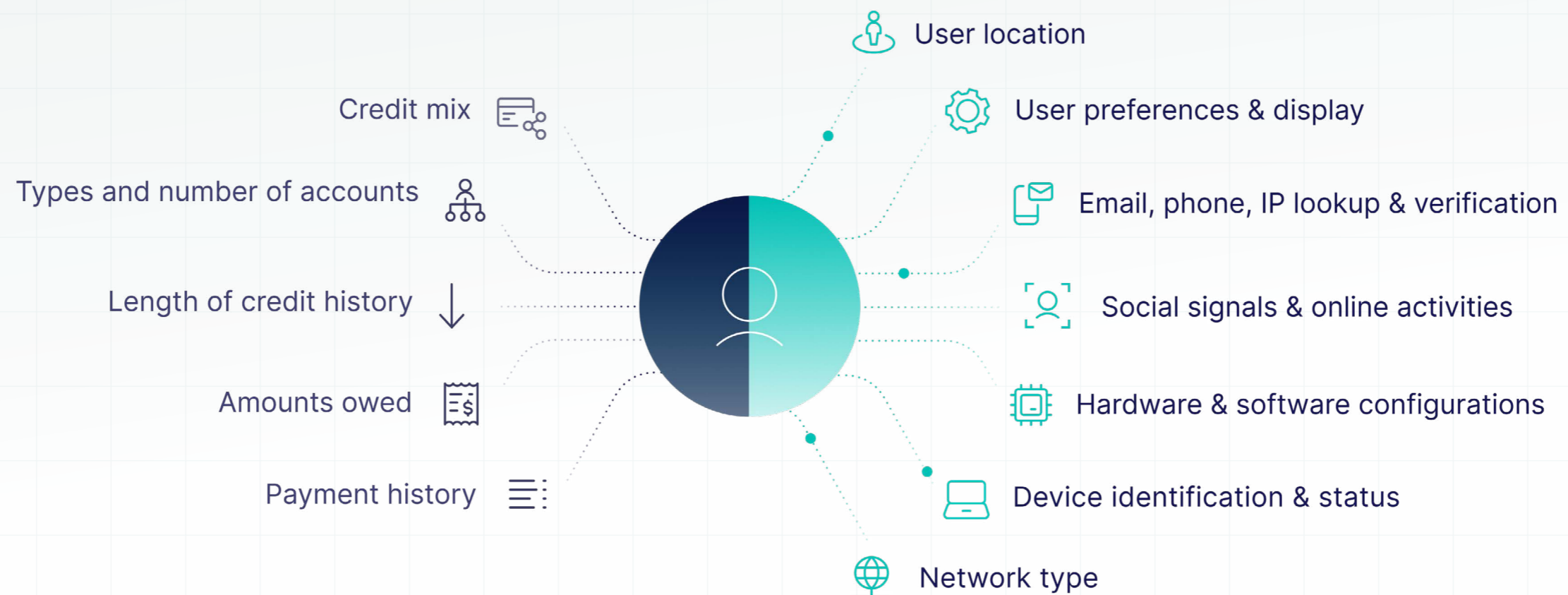
Additionally, participation in online communities and subscriptions to digital services like Netflix or Disney+ can provide further valuable data points. By examining these alternative signals, lenders can access a more comprehensive and accurate profile of an applicant's creditworthiness.

3.2. Approaches to Alternative Credit Scoring

With over 1.4 billion adults worldwide still unbanked and 7.1 million US households lacking access to traditional financial services, assessing creditworthiness is becoming more complex⁴. This issue is particularly severe in low and middle-income countries, where less than 10% of people are recorded in public credit registries. Traditional credit evaluation methods, which depend on historical data, often need to catch up in predicting future financial stability, especially as personal economic situations change rapidly. This scenario underscores the need for alternative data sources to provide a more accurate picture of creditworthiness, especially for those typically underserved by conventional banking systems.

Digital footprint analysis, which involves collecting and analyzing data from online activities and behaviors, presents a valuable alternative. With 5.35 billion internet users and 5.04 billion social media users worldwide, digital footprint data offers a broad and accessible measure of financial reliability. By examining real-time digital, social and behavioral signals, financial institutions can streamline the process of customer verification, enhance fraud prevention and gain a more comprehensive understanding of an individual's economic stability. This method enables lenders to perform more precise and agile credit assessments, improving the user experience and adapting to the rapidly changing financial behavior landscape.

Traditional Credit Scoring Factors vs. Alternative Credit Scoring Factors



⁴ How America Banks: Household Use of Banking and Financial Services - FDIC

3.3. How to Collect Alternative Data for Credit Scoring

In a digital age, online habits and activities can provide a trove of insights. The essential methods for collecting alternative data for credit scoring include:

- **Digital Footprint:** As discussed above, digital footprint analysis involves examining an individual's online presence, including social media activity, interactions with digital services and general online behavior, to assess the consistency and reliability of an individual's online engagements, which can correlate with financial responsibility.
- **Social Media Analysis:** This involves using information from social media platforms to evaluate creditworthiness by reflecting on behavior patterns and identifying potential red flags, such as erratic behavior or associations with known fraudulent activities.
- **Transactional Data:** Analyzing transaction data from digital wallets and payment apps to reveal spending habits and financial discipline. Regular subscription service payments, timely bill payments and consistent financial transactions indicate financial stability and responsibility, enhancing overall credit assessment.
- **Behavioral Biometrics:** Analyzing patterns in how individuals interact with their devices and online platforms, including typing speed, mouse movements and navigation patterns, can help lenders identify genuine customers and detect fraudulent activities, adding another layer of security to the credit assessment process.
- **Community Engagement:** Evaluating online community and forum participation to gain additional context about an individual's interests, stability and reliability. For instance, active engagement in professional or community groups can indicate a stable and trustworthy individual, contributing positively to their credit profile.
- **Device Fingerprinting:** Analyzing digital information from devices that access lending websites can help relay important user information. For example, operating in private mode or using emulators can raise suspicion levels and may indicate fraud.
- **Email Profiling:** Conducting reverse email lookups to identify suspicious or disposable domains is another way to understand untrustworthiness.
- **Phone Analysis:** Tracking phone numbers is another way to gather evidence of financial stability or fraud. Using cheaper mobile carriers in some regions can indicate lower financial stability, while fake phone numbers suggest fraud.
- **Location Analysis:** Filter applications from high-risk locations to identify potential defaults and fraud. Spotting applications from such areas helps assess the likelihood of default and identify fraudulent activities.

4. Key Takeaway: The Importance of Alternative Credit Scoring

Alternative credit scoring is changing how lenders assess creditworthiness, especially for those lacking traditional credit histories. By incorporating diverse data sources into decision-making frameworks, lenders can gain a more comprehensive and accurate understanding of an individual's financial reliability and application intentions. This broadens access to credit for underserved populations and enhances the precision and reliability of credit evaluations, leading to more inclusive (and less risky) financial services.

Benefits of alternative credit scoring



Increases financial inclusions

Greater access for underbanked, unbanked expanding global reach



Enhances accuracy in credit assessment

Real-time data and comprehensive customer profiles



Improves risk management

Supports proactive fraud detection and reduction in default rates



Operational efficiencies

Automation and AI integration enable personalized lending products



Adapts to customers' digital expectations

Flexible lending models deliver better customer experiences

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